

White Paper

An industry set to transform

The UK is the world's largest consumer debt market after the US, but the debt recovery industry remains highly fragmented and relatively un-sophisticated. This is set to change dramatically, says *Kevin Fuller*

With over £170bn of unsecured consumer credit debt, the UK is the second largest consumer debt market behind the US. Outstanding debt continues to grow at 15 per cent per annum. However, while the size of the debt recovery industry has grown in line with the increase in consumer debt, it has yet to mature into the professional market we see in the US.

In the UK, the recovery industry remains highly fragmented, with over 300 purchasers and collection agencies – even as credit originators have consolidated. We are now facing a fundamental inflection point where the industry is poised to change dramatically over the next two to three years as it evolves to serve the credit originators requirements for scale and increased capabilities.

Credit originators are increasingly looking for one-stop solutions to remove the complexity of recoveries from their hands and provide stable and growing returns. The market has yet to develop a compelling offering to address this requirement.

Debt sale is the simplest model for reducing complexity and is now viewed as an accepted tool for recoveries – in 2003 nearly £2bn was sold in the UK. However, for many credit originators it is not clear that debt sale is the best solution for managing increasing debts. Many worry about the lure of using debt sale to opportunistically manipulate performance indicators or fear they are giving away too much value by selling large un-segmented portfolios.

With the documented success of several debt purchasers, investor money has poured into the sector and there is currently a demand bubble driving up prices. Until credit originators are able to clarify their debt sale strategies they should remain wary of using debt sale as a broad-based tool. If the pricing bubble bursts, credit originators tied into debt sale will see their recoveries returns fall.

As the recovery industry evolves to meet the needs of the credit originators, it will begin to look more like the US recovery industry where debt sale is increasingly just one of many tools used to drive recoveries. US suppliers have consolidated into large integrated solution providers providing a range of services from sale to panel management that are increasingly professional, publicly quoted and have invested heavily in technology and analysis. It is therefore to the US that we must look as the UK market transforms to understand what will separate the winners from the losers.

Over the last ten years, the US market has developed a professional and mature recovery industry. However, this did not happen overnight and reflects a prolonged period throughout the 1990s where traditional collection and purchasing agencies transformed themselves into multi-faceted debt management organizations.

In the early 1990s, the US market was similar to the UK today. Suppliers were highly fragmented and tended to focus on specific offerings or geographies. By exploiting market inefficiencies, suppliers were able to achieve high margins. Despite the fragmentation, large players such as collection agency Asset Acceptance and debt purchaser Sherman Financial were starting to appear.

During the mid 1990s, attracted by the low barriers to entry and high potential profits, new players such as PRA and Encore Capital entered the market.

These new firms brought talent into the industry from both Wall Street and from successful credit originators such as Capital One and Household International. This influx of capital supported growth in the purchase market.

With the growth in scale and funding of debt purchasers, credit originators began selling more debt and fresher debt – moving from warehouse and third placement to first placement and even pre-charge-off.

In a highly competitive market, suppliers turned to segmentation and analysis driven strategies to achieve better results. Strategies like debt resale and account level purchasing helped drive continued performance improvement. Start-up suppliers who are best positioned to deploy these new models grew at the expense of traditional collection agencies.

Over the past few years, several major players have floated (e.g. PRA and Asset Acceptance), giving additional transparency of the profitability of debt purchase. Credit originators have retrenched by moving away from selling earlier debt and began pushing for higher pricing.

As they have looked for solutions to extract greater value with minimum complexity from their debt portfolios, outsourced debt management that focuses more on developing a win-win partnership has emerged as a viable alternative to debt sale. The trend toward outsourced debt management will continue to grow as credit originators look for partners with a full range of capabilities – not just debt purchasers.

The US suppliers most successful in moving toward the partnership model have the following in common – a focus on strong client relationships, investment in analysis and technology, ability to manage large contracts and a broad capability set – from debt purchase to strategy definition to collections know-how.

The UK recovery market is at a point where it will rapidly develop into a more mature, professional industry. This change is being driven both by the credit originators and by new entrants who have observed the evolution of the US market.

In summary, there are several important learning points for the UK.

- Credit originators will want to work with fewer, larger, more client focused suppliers as they move away from transactional relationships to partnerships
- Successful suppliers will offer a range of capabilities (e.g. contingent collection, purchasing, strategic and analytic support) under terms that increasingly resemble outsourcing
- Market consolidation will happen as a result of these needs, but likely through organic growth of the best players rather than mergers and acquisition activity

While the UK development will not fully mirror the US market (because of differences in market size, legal frameworks and the competitive landscape), these valuable lessons from the US should not be ignored.

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