Brief

Alternative Credit: The Rise of Consumer Lending

Patrizia Lando and Alfonso Ricciardelli, CFA

CFA Institute Research Foundation

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ALTERNATIVE CREDIT: THE RISE OF CONSUMER LENDING

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Introduction

Consumer lending allows investors to gain exposure to the creditworthiness of individuals. As a result of the recent technology revolution, this practice has evolved dramatically over the past two decades.

Although securitization gave rise to mortgage-backed securities (MBS) and other asset-backed securities (ABS), such as loans backed by credit card, student loans, or auto loans payments, it was the emergence of online lending platforms, along with changing consumer behaviors, that contributed to the exponential growth of the consumer loans subasset class.

Some practitioners have recently included consumer lending within the private credit space, arguing that it provides substantial growth to the entire sector. Arguably, consumer finance is currently the fastest-growing segment within the private credit space.

Defining Consumer Loans

The two core categories of consumer loans are (1) property-backed residential mortgages and (2) non-property-backed, traditional consumer loans, which include personal loans, auto loans, student loans, and credit cards. In addition, more recently, buy-now-pay-later (BNPL) equivalents and hybrid derivative products, such as salary advance loans, which would typically fall under the broader umbrella of alternative credit, have been added to the mix, offering investors different risk–return profiles, often uncorrelated with public credit allocations (Ricciardelli and Clements 2024).

Consumer loans can also be classified as collateralized (e.g., auto loans and secured personal loans) or noncollateralized (e.g., credit card, BNPL, and unsecured personal loans).

Finally, in the context of consumer credit and lending, we use the US classification for borrow risk profiles as a proxy in this brief. Consumers are categorized into prime, near-prime, and subprime based on their creditworthiness and risk profile. Lenders use this information to assess the likelihood of timely repayment.

As of August 2025, the US credit score levels are as follows.[1] Prime consumers are those with a credit score of 660 or more (varies slightly based on credit scoring models), have strong credit histories, consistently make payments on time, and maintain low levels of debt relative to their income. Their risk of default is low, and they typically qualify for the best interest rates and terms. Near-prime consumers have a credit score between 620 and 659, with average credit histories. They might have some missed payments or have higher debt levels, but they still have a moderate ability to repay. Their risk level is medium, and they may be eligible for loans with higher interest rates and stricter terms than prime consumers. Subprime consumers have a credit score of 580–619 (below 580 for deep subprime), with poor credit histories, missed payments, high debt-to-income (DTI) ratios, or even defaults. They are seen as high risk for lenders and thus face limited credit options with significantly higher interest rates and stricter terms, which often come in the form of secured loans, high-interest credit cards, or payday loans.

On the back of the explosion of consumer credit, as well as the addition of new products, the consumer lending market has grown considerably in the past decade. Today, it is estimated at €27 trillion (Ricciardelli and Clements 2024).

Credit card, auto loan, and student loan securitizations are long established and well-known structures. Much less is known about new types of lending for which securitization is still at its inception. The structure of BNPL securitizations—for instance, the fact that the loans often bear no interest and are very short term—naturally raises questions about what risk–return profile investors are gaining exposure to and whether the credit enhancement levels are sufficient to cover the losses. These questions are particularly important given the lack of asset historical performance across different economic conditions, especially stressed markets.

Overall, each of these types of consumer lending carries a distinct set of risk–return drivers. Broadly speaking, however, from a macro perspective, their performance is somewhat tied to consumer "health"—that is, to an equilibrium between strong and growing consumer spending and sustainable levels of consumer debt.

A healthy economy relies heavily on consumer spending, and consumer debt is not to be considered negatively, per se. For example, mortgages are a form of consumer leveraged buyout, which allows individuals and families to make exponential gains when properties appreciate. Student loans allow less affluent college and graduate students to access an opportunity to climb the economic ladder. Credit card and auto loans support the economy by facilitating the purchase of discretionary consumer goods, contributing to entire supply chains.

Overall, the current consumer delinquency rates in the US market, while on the rise (as shown in **Exhibit 1**), remain relatively subdued if compared with past crises (4.85% in Q2 2009).

Consumer stress levels, however, are increasing as the effect of generous fiscal policies begin to dry up, while consumer spending remains strong. How long it will take for defaults to pick up and reach levels that can create systemic problems remains to be seen.

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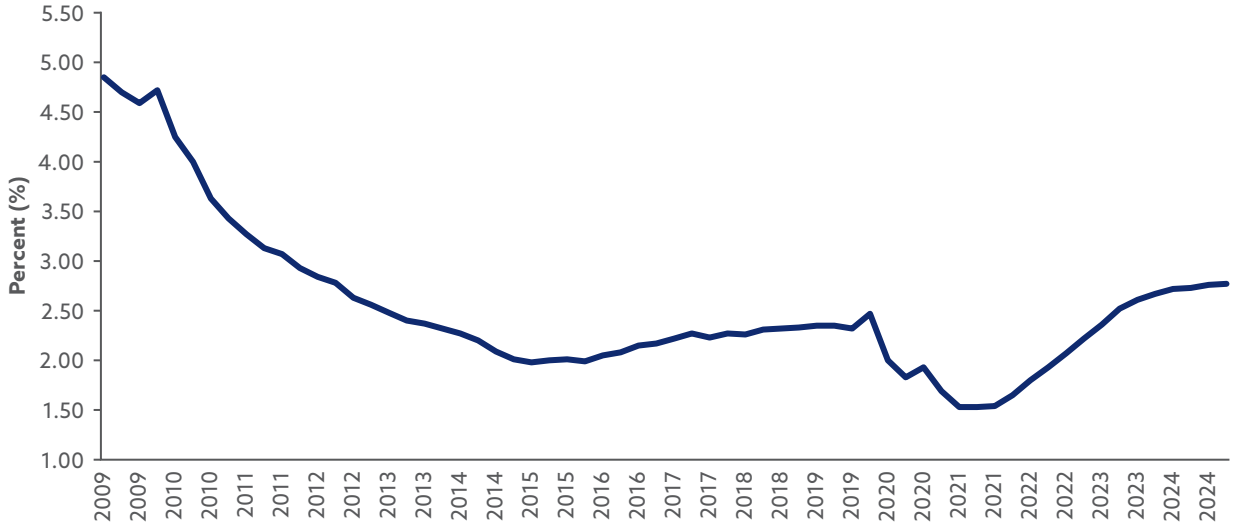
[1]See the US Consumer Financial Protection Bureau webpage at https://www.consumerfinance.gov/data-research/consumer-credit-trends/student-loans/borrower-risk-profiles/. Note that different jurisdictions adopt different credit score scales or methods (e.g., for the United Kingdom, see https://www.barclaycard.co.uk/personal/money-matters/credit-score-basics/what-is-a-good-or-average-credit-score).

Exhibit 1. Delinquency Rates (%)



Source: "Federal Reserve Economic Data (FRED)," Federal Reserve Bank of St. Louis: https://fred.stlouisfed.org/series/DRCLACBS.

The Evolution of Consumer Lending

The first reported examples of consumer lending date back to the days of the Sumers, almost 4000 BC, when consumer lending was used to finance food purchases. The first regulations that put a cap on the interest rates charged to consumers are found in the Hammurabi Code, approximately 1800 BC (Ricciardelli and Clements 2024).

In modern times, credit reporting as a tool for risk reduction and monitoring was used in England in the early 19th century, when a group of tailors decided to exchange information about delinquent customers.

Consumer credit monitoring became more sophisticated during the 19th century, first with the publication in daily newspapers in England of the names of bad payers, and then in the United States, during the Civil War, when R. G. Dun first started a system of rudimentary credit scoring that has been in use until the 20th century. The company now known as Equifax was founded in 1899, and to this day, it remains the oldest of the US credit rating agencies.

The first car loans were issued in the 1920s by an innovative corporation created by General Motors. By 1930, in the United States, two out of every three cars were sold in installments.

Credit cards were first introduced in the 1950s, coinciding with the first US consumer boom. As soldiers returning from World War II started having families and buying homes, most department stores became accustomed to keeping revolving accounts for all customers. This, however, created an opportunity for a company (e.g., Diners Club) to create a consolidated account with each consumer's position.

Early credit reports were created using index cards, with agencies collecting information from local newspapers about marriages, deaths, arrests, and promotions. The first comprehensive credit report appeared in the 1960s in the United States, on paper. A few years later, these reports started to be issued in computerized form.

In the 1980s, the three largest consumer credit score agencies in the United States—TransUnion, Experian, and Equifax—reached national coverage. FICO (originally Fair, Isaac, and Company), a standardized score that is ubiquitous to this day, was introduced in 1989.

Finally, the past 10 years have seen the rise in online lending platforms, which have allowed the disintermediation of consumer lending through peer-to-peer (P2P) lending. Unlike traditional banks, which often require lengthy in-person processes and extensive paperwork, online lenders have streamlined the borrowing process. Consumers can now apply for loans entirely online, receive approvals within minutes, and often get an instant response.

Moreover, online lending platforms have leveraged technology to expand access to credit for those underserved by traditional financial institutions. By using alternative data sources, such as utility payments, social profiles, or transaction history, these platforms can assess creditworthiness more comprehensively, often providing loans to individuals who might be overlooked by traditional credit-scoring models. This data-driven approach has democratized access to credit, although such "relaxed" lending standards also have the potential to increase the overall default risk in the system. A recent example of this type of technology-driven disintermediation is BNPL loans, which were first introduced during the pandemic as an alternative form of delayed payment (this one, interest free).

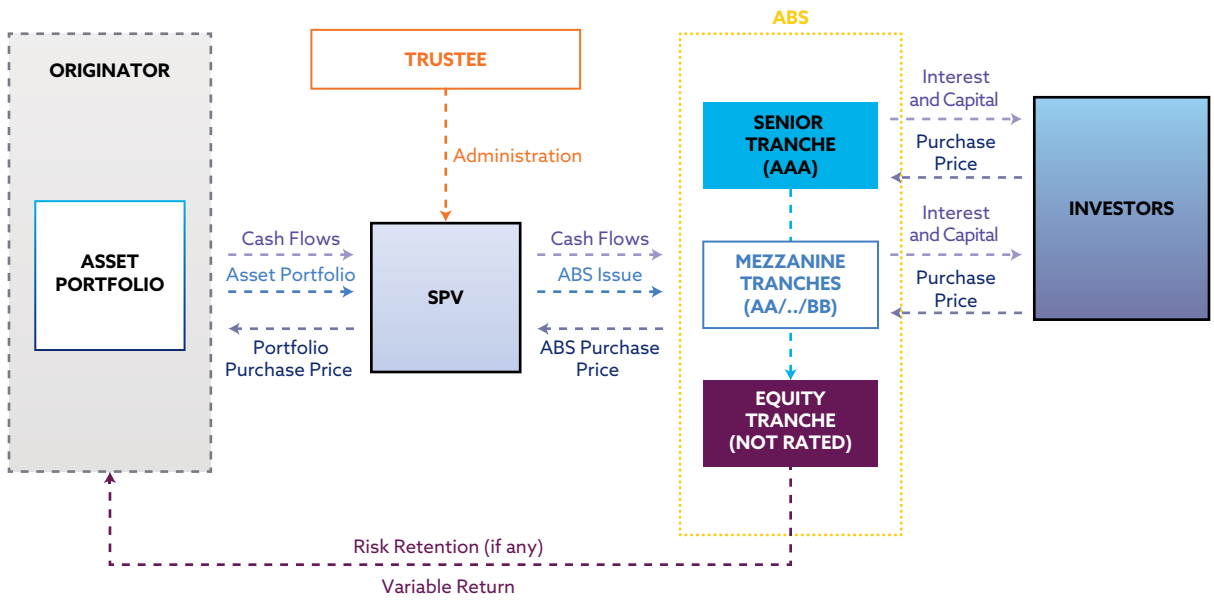
This paper explores the evolution and current landscape of consumer lending, tracing its historical roots from early credit practices to today's technology-driven platforms. After defining core categories of consumer loans, it examines how online lenders and alternative data have expanded access—as well as created new sources of risk. The analysis then turns to securitization, focusing on tranching, credit enhancements, and the key performance drivers of consumer ABS. The paper also situates consumer lending within the broader alternative credit universe, evaluating its benefits of diversification, low correlation to public markets, and potential for stable cash flows, while outlining best practices in originator due diligence, tranche selection, and risk management. Finally, it assesses the implications of regulation, technology, and investor stewardship.

Consumer Loan Securitization

Securitizations, or "securitized products," are bonds backed by pools of individual loans or receivables. These loans are aggregated into an asset portfolio by the originator and sold to a special purpose vehicle (SPV). The SPV, in turn, issues interest-bearing securities (e.g., ABS), which are sold on the market (see **Exhibit 2**). Collections from this asset portfolio allow for the payment of interest and principal of the securitized bonds.

The issues are called tranches and have varying risk–return profiles. The tranche with the highest credit rating is the most senior issue because it sits at the top of the priority of payments (i.e., the predetermined order in which the lenders get repaid). It provides more stable and more conservative returns, making it particularly appealing to risk-averse investors.

Exhibit 2. Consumer Loan Securitization



Source: Fasanara Capital.

Mezzanine tranches have lower credit ratings—both investment-grade and non-investment-grade ratings—and higher yields to compensate investors for the additional risk. These tranches are typically most suitable for investors with a higher risk tolerance. Junior or equity tranches represent the riskiest notes issued and bear a variable return. These are often retained by the originator to comply with regulatory risk retention rules.

Within the ABS market, investors can choose the type of asset portfolio in which they prefer to invest. Some of the main categories are unsecured consumer loans, credit cards, auto loans, student loans, small and midsize enterprise loans, and leases or receivables, each with its own distinct features. For consumer credit, the credit quality of the borrower can span prime, near-prime, and subprime borrowers. These features highlight the customizability of securitized products.

Notwithstanding its value proposition, the securitized market has faced several challenges, with volumes being heavily affected during the 2008 Global Financial Crisis (GFC). Issuance volumes have since returned to pre-GFC levels, however, and are expected to hit an all-time record in 2025, with KBRA forecasting $345 billion in ABS issuance in 2025 (up from $325 billion in 2024 and surpassing the previous post-GFC record of $287.4 billion in 2021) (KBRA 2024). European and Australian volumes, although more modest, are also expected to grow in the coming years; specifically, 2025 ABS volumes are projected to be €140 billion and €40 billion across Europe and Australia, respectively (Charleston 2025).

In this dynamic market, understanding key performance drivers and risks as well as their nuances is imperative to make informed decisions.

Key Performance Drivers

The performance of consumer loan securitization and the cash flows that are available for the payment of the securitization notes rely on a few key elements: (1) credit quality of the assets; (2) interest rate fluctuations, which drive borrowers' prepayment decisions and, in turn, affect the predictability and amount of collections; (3) counterparty default risk, which can cause interruption of the cash flows to investors; and (4) liquidity risk.

Credit Quality

Credit quality of the assets drives the borrower's payment performance and consequently losses of consumer loan securitizations. As many finance practitioners are aware, credit losses are a function of the likelihood of default of the underlying assets and the severity of losses, which is in turn influenced by the recovery rate.

As described in detail next in the "Key Risks and Mitigations" section, debtors with high credit scores, stable incomes, low indebtedness, and a history of timely repayments (i.e., "prime") are less likely to default, which decreases risk and increases cash flow predictability. Conversely, subprime borrowers—those with lower credit scores and a likely more unstable financial status—have higher probabilities of default and potentially more severe losses. Therefore, understanding the borrower profile composition of the securitized pool allows for a more comprehensive view of its overall risk.

For unsecured consumer loans, the inherent risk stemming from borrowers' creditworthiness is magnified. Unlike MBS, in which case recoveries are secured by collateral, unsecured consumer loan pools typically lack guarantees, resulting in significantly lower recovery rates in the event of default. This implies that credit losses are more sensitive to default rates, highlighting the importance of robust credit quality assessments and effective risk mitigation strategies. To compensate for this additional risk, unsecured loans bear monthly interest that is higher than that of secured loans.

To assess credit quality, analysts should evaluate borrower traits within the securitized pool that serve as a proxy for their ability to repay the loans. Key factors include payment history (which indicates a borrower's track record of meeting their financial obligations on time), credit usage (the amount of credit a borrower is currently using compared with the overall available amount), and credit history length (which is useful to understand how much experience a borrower has in handling debt). Other relevant attributes include the types of credit used (e.g., revolving versus amortizing), income verification (to confirm affordability), and the DTI ratio (useful to analyze a borrower's debt burden versus income). All of these factors affect a borrower's financial stability and ability to repay.

To get a full picture, these borrower attributes get pooled and fed into a credit-scoring model that, by assigning different weightings to each factor, computes a final credit score. This score essentially represents the summary of a borrower's creditworthiness and facilitates comparisons across borrowers.

Widely used models currently include FICO scores and VantageScore. These models use proprietary algorithms to optimize the credit assessment and ensure that loans meet the quality standards required for securitization pools. Although FICO and VantageScore remain industry standards, fintech companies are increasingly incorporating artificial intelligence (AI) and

machine learning in their underwriting models. These models consider a range of real-life behaviors, such as how consistently someone pays their bills, how much they spend, or even patterns in their social media activity, to build a more comprehensive picture of their creditworthiness. Machine learning is also paving the way in fraud detection by flagging unusual patterns or shady transactions.

Consumer repayment behaviors differ among loan types. On the one hand, debtors want to pay down the most expensive loans first, rather than the cheapest; on the other hand, they cannot afford to default on collateralized loans as they would lose the collateral. As a result, unsecured loans are more susceptible to defaults and have lower recovery rates. Being aware of this practical debt hierarchy and incorporating it into expectations is crucial to effectively mitigate potential losses across loan types.

Another important area of analysis is underwriting standards. Originators directly affect the quality of their products—and thus the underlying pool of loans in the securitization—through their criteria.

Sound underwriting consists of setting criteria to ensure that the loans meet the predefined risk levels, maintain the credit quality of the pool, and produce stable loss-adjusted returns. The analysis of these standards has become more complex with the growth of marketplace lending platforms. These originators use algorithmic underwriting, along with nontraditional data (e.g., online behavior) to expand access to credit. Evaluating the historical performance in terms of defaults rates, delinquencies, and recoveries can allow lenders to forecast future trends.

Finally, macroeconomic conditions can affect default rates and recovery prospects. During booms, borrowers have a stronger financial position, leading to lower defaults and thus better performance of the pool. In contrast, during economic contractions (e.g., higher unemployment and lower consumer spending), borrowers tend to experience higher financial stress, leading to greater default rates, with unsecured loans facing the most severe losses.

Interest Rates and Prepayment Speed

Interest rate levels are a key driver of borrower behavior and end up influencing the performance of consumer loan securitizations.

In a falling interest rate environment, early redemption on the loans increases as borrowers tend to refinance their loans when cheaper credit becomes available in the market. When prepayment rates rise, the principal amount outstanding of loans amortizes at a faster rate.

Most consumer loans are fixed rate, meaning that the interest rate remains constant over the life of the loan. When prepayments occur, if there are no prepayment penalties, investors receive their principal back sooner. They miss out, however, on the returns that could have been generated from the additional interest payments due on the outstanding principal balance during the remaining life of the loan.

Conversely, in a rising interest rate environment, prepayments tend to decrease because of the lack of cheaper refinancing options. Then, defaults and delinquencies tend to increase as borrowers, especially subprime ones, face increased financial burden, especially those that had planned to refinance their loans at a lower rate.

The types of loans within the pools tend to affect the sensitivity of the securitization to changes in interest rates. For example, fixed-rate loan portfolios tend to have more stable default rates in an increasing rate environment but would also be more exposed to prepayment risk (because borrowers will likely want to refinance at lower rates) in a declining rate environment.

Therefore, to mitigate risks and ensure the long-term stability of these securitizations, it is essential to monitor macroeconomic conditions and market liquidity while analyzing the dual impact of prepayments and defaults.

Counterparty Risk and Liquidity Issues

Counterparty risk occurs when one of the key players in the transaction—such as the servicer, originator, account bank, or hedge counterparty—fails to perform its duties correctly or, worse, defaults, which can lead to disruptions or losses. To mitigate this risk, it is crucial to work with financially and operationally strong counterparties.

The originator is perhaps the most important player in the transaction, being the counterparty that generates the loans underlying the securitized pool. As a result, the quality of the pool is directly affected by the originator's financial health, underwriting standards, and consistency in the origination process. Indeed, if the originator were to default, run into financial trouble, or loosen the underwriting standards, the securitization would suffer from increased defaults.

A distinct feature of securitizations is the set of legal and operational structural protections that must be put in place to isolate the performance of the assets from the performance of each counterparty involved in the transactions.

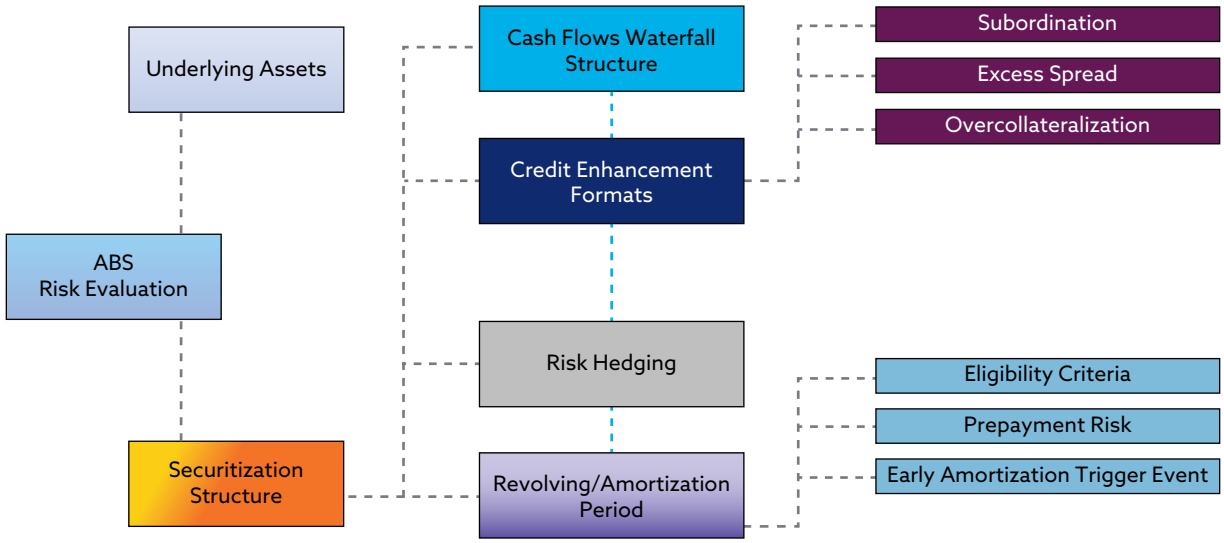
Bankruptcy remoteness is achieved by carving out the assets from the originator's balance sheet and transferring them into a newly created SPV—that is, effectively, an independent entity. This SPV ensures that the cash flows generated by the assets are shielded from any claims from other creditors (e.g., in case the originator were to default), ensuring that they continue to flow without interruption into the vehicle and, in turn, to the securitization investors.

Third-party service providers can be engaged to isolate the originator's risk from that of the underlying assets. Such services include administration, borrower communication, payment collection, and management of delinquencies and defaults throughout the entire life of the securitization. This expertise is essential for the basic operational functions of collections and record keeping as well as to maximize loan performance and minimize losses. Indeed, skilled servicers that actively manage the pool can greatly improve recovery rates and decrease delinquencies. To ensure that their interest is aligned with investors' interests, many servicers are partially paid through performance-based compensation structures, providing further protection to investor returns.

Key Risks and Mitigations

Understanding the fundamental risks in a transaction is essential to maximize investors' outcomes and put in place the correct mitigations. As described earlier, credit risk is the main factor that determines the quality of the underlying borrowers in the pool, and therefore, the cash flows that are available for the payment of the securitization notes. Other types of risk include prepayment and interest rate risk, counterparty risk, and liquidity risk.

Exhibit 3. Structural Protections



Source: Fasanara Capital.

Exhibit 3 illustrates the various structural protections that are put in place to protect investors from underperformance. Overall, these structural protections form a strong framework that ultimately drives consumer loan performance under various conditions.

Credit Risk

As discussed in the section "Key Performance Drivers," credit risk is the primary risk for consumer loan securitizations. It is a measure of the extent to which borrowers in the securitized pool may fail to make their payment obligations, causing investors to incur losses. Hence, in assessing this risk, an extensive assessment of the quality of the underlying loan pool, combined with broader economic factors, is key.

Attributes to analyze include borrower-specific data, such as credit scores, income stability, DTI ratio, and repayment performance, as well as loan characteristics, such as term, interest rates, and collateral value. Market and geographic diversification also need to be taken into account, because they help alleviate specific risks by reducing the exposure to localized economic downturns. Last, macroeconomic trends, such as unemployment rates, inflation, and GDP growth, can be overlaid to provide a view into broader economic risks.

Borrower credit scores, usually reported by credit bureaus, such as Experian, Equifax, and TransUnion, are indicative of a borrower's past credit behavior, such as payment history, credit use, and total debt burden. Lower scores typically indicate a higher likelihood of default (subprime), whereas higher scores indicate higher debt-servicing capabilities (prime).

By analyzing the distribution of these scores, investors can gain insight into expected default rates. A pool dominated by subprime borrowers is more likely to be affected by higher default rates than one that includes mostly prime borrowers.

Income stability is also an important factor. Borrowers with stable, predictable, and consistent sources of income, such as salaried employees or individuals with long-term contracts, tend to be less likely to default than freelancers and temporary workers. To examine the vulnerabilities of the loan pool, it is also essential to assess the composition of income levels and types of employment within it. For example, pools that are concentrated around seasonal employees or borrowers in volatile industries are inherently riskier.

DTI ratios demonstrate a borrower's debt burden and are an indicator of their ability to pay. A high DTI ratio indicates that the borrower bears a lot of debt compared with their income, making it more likely they will miss a payment under stressed financial conditions. A low DTI ratio, in contrast, indicates more financial flexibility. Again, analyzing the distribution of this ratio within the pool can give some insight into the expected defaults of the underlying borrowers.

Repayment behavior can give more insight into borrowers' creditworthiness. Consistency with making on-time payments indicates reliability, whereas past delinquencies or defaults raise red flags. Understanding the percentage of loans within the pool that went delinquent or defaulted provides a strong empirical basis to predict future performance.

Credit risk is also affected by the specific contractual attributes of the loans within the pool, such as the loan term, interest rate, repayment frequency, and loan amount. Longer-term loans, for example, can, *ceteris paribus*, represent greater risk, because borrowers must maintain their ability to pay within a longer time frame. The upside is that monthly installments tend to be smaller, spreading principal repayments over a longer period of time, thus increasing a borrower's ability to pay. High-interest loans can also burden borrowers, leading to higher default risk.

For collateral-backed loans, like auto loans, one of the most important metrics is the loan-to-value (LTV) ratio. Lower LTV ratios indicate that the borrowers have more equity in the assets and thus a lower risk of default. Needless to say, it is essential to have robust mechanisms in place to correctly assess the value of the assets as well as perform third-party valuations to ensure reliability.

Another consideration is the geographic diversification of the pool. Regions with strong or stable economic performance generally have lower default rates than those undergoing economic stress. Intuitively, pools in which the borrowers are concentrated in a single geographic area are more susceptible to local economic downturns. Therefore, this risk can be mitigated by including loans that are geographically diversified.

Finally, external macroeconomic factors, such as unemployment rates, GDP growth, inflation, and fiscal policies, also play a role in affecting credit risk. Defaults are less likely to occur during economic booms versus recessions or inflationary periods, when finances tend to become tight. The sensitivity to these shocks is higher among lower-income households. To account for these factors, stress testing analysis is essential to understand the pool's resilience to economic shocks.

Analysis of the borrower data—segmenting it based on credit scores, income stability, and employment status—can help identify the risk distribution within the pool. This analysis highlights the segments of a portfolio that bear higher risk, allowing the securitization to set maximum concentration limits for the riskier buckets.

Structural Protections

Eligibility criteria and concentration limits are essential to ensure that the pool credit quality standards and composition are maintained at the outset and during the revolving period, if any (i.e., a revolving period is a period whereby collections from the asset portfolio are used to repurchase loans or receivables instead of redeeming the securitized notes). Eligibility criteria are typically designed to ensure that the underlying loans are at least of an acceptable minimum quality—for example, by excluding delinquent loans or prohibiting specific types of borrowers (e.g., FICO below a minimum score) or geographic areas deemed at higher risk of default. Concentration limits instead cap the percentage of a pool that's linked to a single factor, such as subprime borrowers or loans with very low interest rates.

Note that it is essential to continuously monitor these factors throughout the entire life of the securitization to ensure that the credit quality of the pool remains consistent. Monitoring involves conducting regular audits of the origination, the underwriting models, borrower evaluation criteria, and platform processes.

In addition to the protections mentioned above, a securitization transaction can implement several different structural protections to protect investors from downside scenarios and increased credit risks—namely, credit enhancement and hedging, which are embedded into the structure of all ABS.

Credit enhancements can take various forms. The standard enhancements are excess spread, reserves, overcollateralization, and subordination.

- Excess spread is the cash flow that is left from all interest and fees collected from the borrowers after the payment of the interest on the notes. It represents the first line of defense against losses derived from a borrower's default. As such, it represents an additional cushion ahead of any impact to principal loan repayments. The net present value of excess spread minus losses equals the value of the assets above par.
- Reserve account is an account that is set up at the outset of a transaction. It is usually sized to cover a few months of interest and senior costs of the transaction, should there be a servicer interruption, but it can also be used to covers losses. It's usually funded partly at inception by the originator, with the proceeds from the sale of the assets, and partly during the securitization phase, through the allocation of excess spread. Should losses not be covered by the excess spread, the funds standing in the reserve account can be used as an additional buffer.
- Overcollateralization occurs when the amount of the notes issued is lower than the amount of the nominal principal outstanding of the portfolio of assets. Overcollateralization is more common when a portfolio is sold at a discount by the originator.
- Subordination creates a repayment hierarchy across tranches (priority of payment). This priority of payments is known as the "waterfall," which ensures that losses are first absorbed by the junior tranche (for this reason, they are also called the "first loss piece"). It protects the more senior tranche from initial defaults (after consideration of excess spread and reserves).

Securitized notes also benefit from a dynamic priority of payments. As a result, when the securitization is under stress, and depending on the performance of the cash flows from the assets, the collections on the assets can be redirected and can stop repurchases of new assets and the payment of interest to the mezzanine notes, and accelerate the repayment of the most senior tranches of notes.

Asset performance triggers serve as an early warning system to set off these preventative actions before the situation worsens. These triggers can include maximum delinquency rates, maximum defaults rates, and minimum yield on the assets. They are thresholds that, when breached, prescribe an automatic course of action. Depending on the type and severity of the breach, they come into play in different ways.

The critical aspect becomes the definition of the appropriate levels of triggers when structuring a securitization. A typical approach includes setting these thresholds at a level that, if breached, ensures that the notes will be repaid in full. As an example, if historical data show expected default rates of [X], the threshold of [2X] could kick off an early amortization event; then, there would be repayment of all the notes pro rata while no excess cash flows would be paid to the junior noteholders. Should losses reach an even higher level [3X], all collections could be used to pay interest and principal on the senior notes; meanwhile, mezzanine interest and principal will continue to accrue but will be fully subordinated.

The wider the triggers with respect to historical performance, the higher the credit enhancement required for the same size of tranches as the transaction allows for a deterioration of the performance of the assets before the trigger is hit. The combination of triggers and credit enhancement will determine the appropriate risk and rating of the various notes.

Prepayment and Interest Rate Risk

Prepayment risk is key for consumer loan securitizations, and it occurs, as mentioned earlier, when borrowers pay off their loans sooner than anticipated. Frequent prepayments can prematurely dilute cash flows in the securitization and reduce excess spread, thus limiting the securitization's ability to absorb higher credit losses.

The degree of prepayment risk is influenced by several factors, including the interplay between interest rate movements, borrower behavior, and broader economic conditions.

Borrowers are much more likely to refinance existing loans when interest rates are falling so that they can reduce their total cost of borrowing. This increase in prepayment rates reduces the total amount of cash flows directed to the SPV. The opposite is true when interest rates increase. Although the cash flow profile is more stable and predictable with lower prepayment rates, an increase in interest rates also increases default risk.

Interest rate movements, although the prime driver, are not the only variable affecting prepayments. Macroeconomic conditions are another crucial factor. When the economy is strong, prepayment rates tend to go up because borrowers have more income or are in better overall financial shape and pay down their debt sooner. In periods of economic stress, the reverse applies—as layoffs rise, borrowers are more likely to choose preserving liquidity over repaying their debt.

Last, the type of loan also shapes prepayment rates. For instance, personal loans exhibit different prepayment behaviors compared with auto loans. Personal loan borrowers might repay as soon as they receive unexpected cash, such as bonuses, tax refunds, or inheritances. Auto loans, however, can be prepaid when a borrower sells their car or trades one in to purchase another vehicle.

Structural Protections for Prepayment and Interest Rate Risk

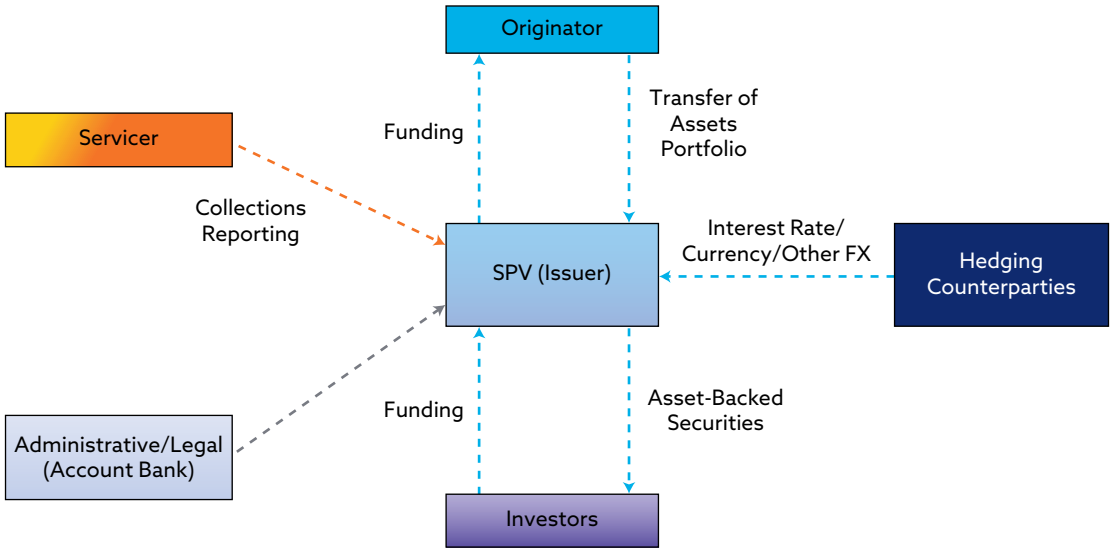
Prepayments can be managed by carefully structuring the securitization. Techniques include sequential pay structures, whereby prepayments are first directed to the most senior tranches, paying down their principal balance quickly. Excess spread minimum triggers and excess spread trapping mechanisms (in which excess cash flow is temporarily withheld to generate reserves) are standard structural features of most securitizations. These mechanisms can be used not only to offset the impact of greater-than-expected prepayments but also to replenish additional—potential—future shortfalls.

To understand the level of measures that need to be implemented, it is essential to design cash flow models that take into account different prepayment rates and stress these scenarios in order for the cash flows to remain robust.

Counterparty Risk

As previously mentioned, counterparty risk is another important factor that needs to be taken into account. **Exhibit 4** summarizes the main players involved in a securitization, including the originator, the servicer, the account banks, the hedging counterparties, and, of course, the investors.

Exhibit 4. Primary Players in a Securitization



Source: Fasanara Capital.

Each of these parties can contribute to counterparty risk in different ways. They are described in detail as follows:

Originator

The originator plays the most important role in the transaction, and in practice, it typically represents the highest counterparty risk. In the event of default, the performance of the securitization could suffer because of higher default rates. To address this risk, extensive due diligence must be conducted on the originator before structuring the transaction. This due diligence should be specifically focused on the company's track record, financial health, and consistency in underwriting. Periodic annual follow-up due diligence at the originator site during the life of the transaction should also be conducted in the form of audits on the portfolio and review of the processes. This due diligence can ensure that the credit quality of the securitized pool is preserved and that loans continue to be originated according to the standards negotiated in the transaction.

Servicer

The servicer is at the heart of the securitization process because it is responsible for collecting borrower payments, managing delinquencies and defaults, and transferring the collections to the accounts of the SPV. If the servicer were to fail to correctly perform any of its duties (e.g., by mishandling late payments) or worse, default, cash flows to investors may be delayed or disrupted, negatively affecting their returns. If the originator is also the servicer, this represents an additional concentration of both performance and counterparty risk.

To address this risk, extensive servicer reviews are conducted during the whole securitization process, assessing policies, procedures, infrastructure, and business continuity plans. This process ensures that the servicer has the appropriate systems in place to effectively manage their operations. Important areas of assessment include the servicer's track record, experience in managing similar loan portfolios, information technology infrastructure, and contingency plans in case of potential operational disruption that may occur in the life of the securitization.

To provide an additional layer of protection in case the original servicer defaults or fails to perform operationally, a backup servicer is often preselected and embedded into the structure. This setup ensures minimal disruption of collections and distributions, and thus it maintains the funds flowing toward investors. Backup servicers are thus evaluated not only based on their operational capacity but also on their ability to take on responsibilities in a timely manner as well as by their knowledge of the loan pool.

Account banks

Account banks hold the SPV accounts where the funds transferred by the servicer are held before they are distributed to investors. If an account bank were to default, it could cause a delay or disruption in payments, potentially affecting the stability of the transaction. To reduce this risk, securitizations typically engage highly rated financial institutions for the role of account banks.

Additionally, triggers may be put in place in the legal documents that require the account bank to be replaced in case of a breach. For example, this could involve establishing a minimum credit rating

level that the account bank counterparty must satisfy to remain in the transaction. This trigger guarantees that funds are deposited in a strong institution, preventing the disruption of cash flows.

Hedging counterparties

Hedging counterparties help manage cash flow mismatches between the securitization's assets (the underlying loans) and its liabilities (the securities issued to investors). These counterparties achieve this through financial instruments, such as interest rate and currency swaps, which help protect the transaction from market fluctuations and keep cash flows stable.

If, for example, the underlying loans have fixed interest rates but the notes issued to investors pay floating rates, an interest rate swap is used to match the cash flow characteristics of the assets and liabilities. If such hedges were not in place, investors would be exposed to the unpredictability of cash flows and to losses as a result of sudden movement in interest rates. The same principles apply to currency hedging.

To prevent securitizations from suffering from the default of the hedging counterparty, replacement triggers are often included in the documentation. These triggers work in the same way as those put in place for account banks. Additionally, agreements may include collateral posting requirements, in which case the hedging counterparty must pledge collateral as a safeguard in case its credit quality deteriorates. If the counterparty were to default, this collateral acts as a financial buffer, thus protecting investors from potential losses.

Liquidity Risk

Given the relatively smaller market size of consumer securitization compared with the more traditional public markets, such as equities and corporate bonds, liquidity risk is a primary area of concern.

Securitized products are typically purchased by institutional investors. Banks and insurance companies are the most active buyers of the most senior classes and higher-rated securitized bonds, driven by their strict regulatory capital requirements. Hedge funds and other alternative asset managers tend to invest in the lower tranches of securitized products, because the higher yields and higher risk are better suited for their risk–return targets.

Because of the relatively smaller size of unsecured consumer ABS compared with public markets, it is often assumed that investors may face challenges selling their securitized notes as efficiently as other investments in their portfolios—especially amidst wider bid/offer spreads and increased transaction costs, particularly during volatile markets. Recent evidence, however, suggests that these liquidity concerns may be less significant than what is believed. According to a 2022 study by Risk Control Limited, the liquidity of investment-grade ABS has markedly improved since 2016, in many cases outperforming covered bonds and even the most liquid corporate bonds (Perraudin 2022). This improvement indicates that the yield pickup that these securities command in the market for similar credit risk not only compensates for potential illiquidity but also may in fact offer an additional premium.

Diversifying across different asset classes and securitization tranches can help reduce liquidity constraints and strengthen overall portfolio stability. By spreading investments across various sectors, investors can improve their ability to manage market fluctuations and unexpected cash flow needs.

Consumer Loan Securitization: Subasset Classes

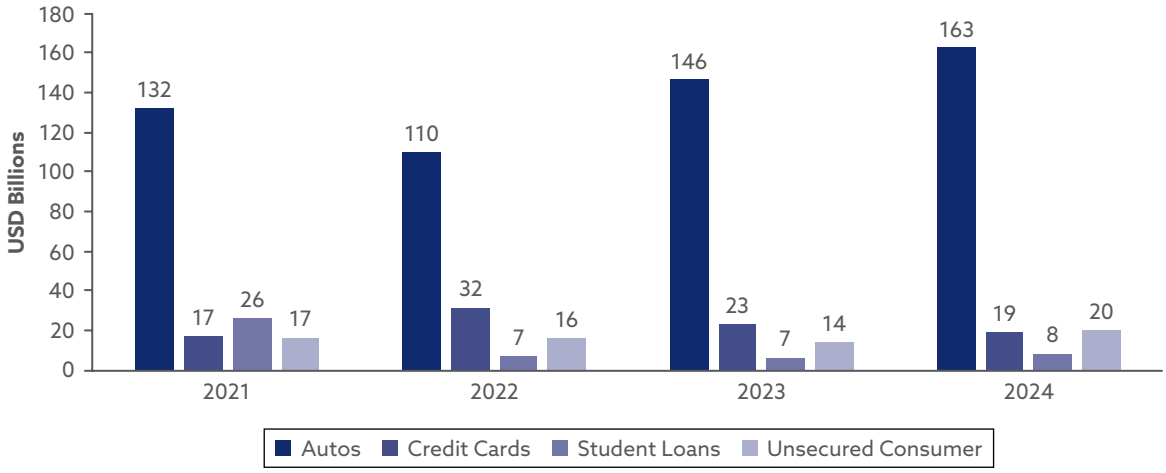
In the consumer ABS market, key segments include unsecured personal loans, auto loans, credit card receivables, student loans, and such specialized (i.e., niche) products as BNPL and payday loans.

Looking at trends in the US ABS market, auto loan–backed securities continue to dominate, with issuance rising from $132 billion in 2021 to $163 billion in 2024, as shown in **Exhibit 5**. Credit card ABS saw a sharp increase in 2022 but has since declined and has now settled in the $20 billion range. Student loan ABS have also significantly dropped since 2021, from a record issuance of $26 billion to only $8 billion in 2024. Meanwhile, unsecured consumer loan ABS have remained relatively stable, around the mid-teens with the exception of the $20 billion issued in 2024 (JPMorgan 2025a).

Exhibit 6 shows securitizations in Europe. In Europe, auto securitizations have traditionally accounted for the largest segment, with stable issuance at around €25 billion annually. In 2024, however, they were surpassed by issuance of unsecured consumer loan securitizations with a record issuance of €27 billion. Credit card ABS, instead, were minimal in Europe, peaking only at €1 billion in 2021 and 2023, while student loan ABS were nonexistent.

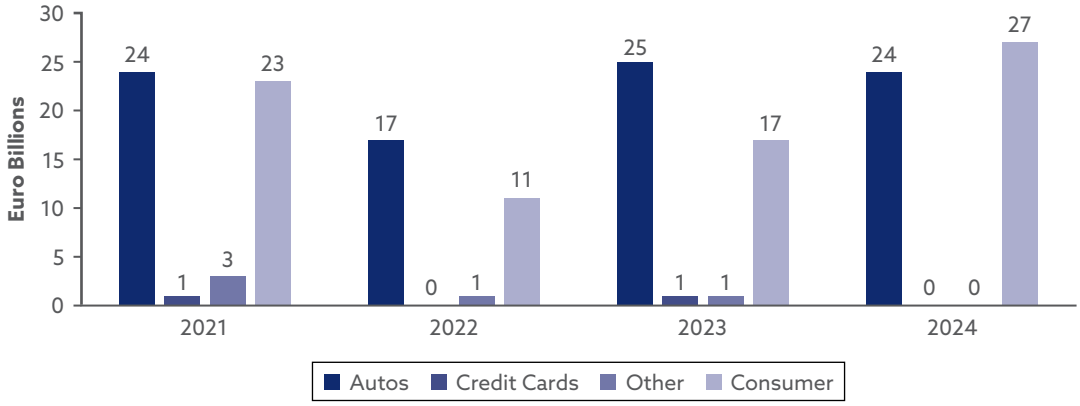
Within the European market, ABS issuance is quite fragmented, as shown in **Exhibit 7**. The United Kingdom and France lead the way, with 2024 ABS supply at €54 billion and €37 billion, respectively. These two countries, however, have followed separate trends. French issuance had been steadily increasing since 2021, reaching €70 billion in 2023, but then experienced a sharp drop in 2024. In contrast, UK issuance dropped in 2022 but has recently picked up. Following behind are Germany and Italy, with issuance levels around €25 billion, except in 2024. Spain and Ireland also show some activity, albeit on a smaller scale. Issuance in the Netherlands seems to have died down since 2021, when it peaked at €34 billion.

Exhibit 5. US Consumer ABS Supply by Sector ($ billions)



Source: JPMorgan (2025a).

Exhibit 6. Eurozone Consumer ABS Supply by Sector (€ billions)



Source: JPMorgan (2025b).

Exhibit 7. Eurozone ABS Supply by Country (€ billions)

Source: JPMorgan (2025b).

Auto ABS: Stability Backed by Tangible Collateral

Auto asset–backed securities offer a potential combination of stability, predictable cash flows, and tangible collateral. These securities are backed by loans or leases issued to consumers for vehicle purchases and are secured by the vehicles themselves. This built-in security helps reduce losses in case the borrower defaults, because most repossessed vehicles still hold enough value to recover a portion of the outstanding loan amount. Backed by tangible collateral, auto loan ABS are considered less risky than unsecured consumer loans, which instead rely solely on borrower repayments to cover losses.

The residual value of the vehicle collateral, however, is not static and can be influenced by a number of factors, such as depreciation rates, current market conditions, and the vehicle types. Although new vehicles usually depreciate more predictably, used cars are more heterogeneous in terms of car age, condition, and miles driven and are also exposed to a wider range of uncertainties. Therefore, the performance of the securitized assets is based on the age of the vehicles and changes through time. Indeed, auto loan ABS with a higher percentage of new vehicles in the pool tend to have a more stable performance than those with older vehicles.

LTV ratios are key to assess the quality of the underlying pools, as they measure the loan amount against the vehicle's current value. Higher LTV ratios indicate greater risk, because there is less collateral value to compensate for potential losses if a borrower defaults. The risk can be amplified by the term of the loan, with longer-term loans, particularly those more than 60 months, deemed riskier as the car may depreciate faster than the borrower is repaying their balance. This situation can lead to negative equity, in which case the total outstanding loan balance is greater than the market value of the vehicle, further decreasing debtor willingness to pay and making it harder for lenders to fully recover the loan amount through repossession.

This dynamic highlights the importance of efficient collateral management, including a sound repossession framework as well as realistic valuation models. Indeed, timely repossession and resale of vehicles are crucial to minimize losses, because delays, which result in further depreciation or inaccurate valuations, can reduce recovery value.

Auto ABS are structured with traditional securitization features alongside specific elements that mitigate risks tied to vehicle collateral, such as accelerated depreciations during market downturns or disruptions. Similarly, overcollateralization plays a pivotal role in this type of securitization, given the depreciating nature of the underlying collateral. Indeed, the aggregate value of the pool should always exceed the face value of the issued securities.

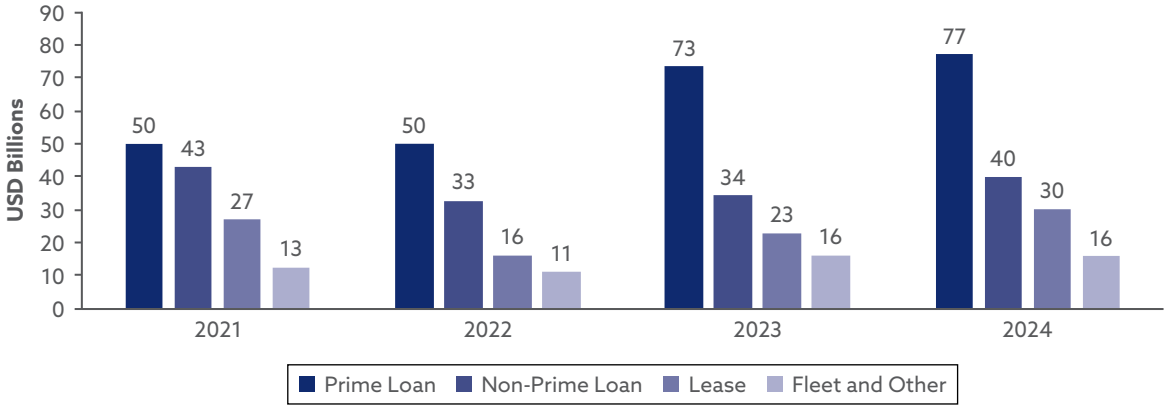
Similar to other consumer ABS, auto ABS are divided into prime, near-prime, and subprime based on the borrower's credit score, with the first ABS offering a lower default rate but also lower yields. Subprime borrowers have typically higher annual percentage rates (APRs), offering higher returns with higher risk.

Macroeconomic variables also affect auto ABS. Aside from the previously discussed macro trends that have an impact on all consumer ABS, auto ABS are particularly sensitive to trends in the wholesale vehicle market as it directly affects both borrowers' ability to repay as well as recovery rates. Changes in consumer tastes, such as greater demand for electric vehicles (EVs), also affect the value of vehicles. Although EVs are well aligned to sustainability goals, they also introduce new challenges for securitization, including uncertain depreciation rates and higher upfront costs.

Cash flow modeling and stress testing, with scenarios such as rapid depreciation curves and volatility in used car markets, are essential to test the auto ABS resilience and understand the structure's capacity to absorb losses.

The auto ABS supply continues to increase steadily across all categories, with prime loans experiencing the most significant growth followed by nonprime, as shown in **Exhibit 8**. The lease market also seems to present good opportunities, jumping from $16 billion in 2022 to $30 billion in 2024. This trend is expected to continue in 2025.

Exhibit 8. US Auto Loan ABS Supply by Type ($ billions)



Source: JPMorgan (2025a).

Credit Card ABS: High Liquidity and Rapid Cash Flow

Credit card ABS are supported by collections of revolving credit card balances, which provide investors with a high cash flow turnover through recurring payments made by borrowers.

Unlike other closed-end consumer loans, whereby no further borrowings are allowed during the term of the loan, credit cards allow consumers to borrow at any time without prior approval as long as they have not exceeded their credit limit and their account is in good standing. Another major difference is that credit cards do not have a predetermined repayment schedule, given that they are revolving products that constantly create new receivables, as borrowers draw down and repay their credit lines. This high turnover—along with the short tenor of the receivables and the floating-rate coupons—makes credit card ABS attractive to investors keen on liquid assets and potentially predictable returns.

In credit card ABS, transactions pool receivables from thousands of credit card accounts into a centralized trust that operates under a master trust agreement. During the revolving period, principal collections from all credit cards flowing into the trust are reinvested to finance new receivables, rather than being immediately distributed to investors. This allows the collateral pool within the trust to remain stable until the end of the revolving period. Then, when the transaction enters the amortization phase, all collections are used to pay down investors. This framework facilitates cash flow–timing predictions for investors. Additionally, the framework can respond to changing markets and investor preferences because it enables multiple series of notes to be issued over time, generating significant diversity.

Given the inherent high turnover of credit card receivables, the monthly payment rate (MPR) and the purchase rates are critical to this type of securitization's analysis, in addition to the key performance drivers of consumer ABS discussed earlier. The MPR represents the fraction of outstanding balances that cardholders pay off each month. Prime borrowers often prefer to pay the total balance in full (or at least more than the minimum payment before the end of the month), whereas near-prime and subprime borrowers frequently make only

minimum payments. Therefore, a pool composed mainly of subprime borrowers will have a lower MPR but will generate higher yields because the debtors will have to pay interest as the outstanding balance rolls over to the next month. The MPR is also influenced by the purchase rate, which indicates how consistently new receivables are being generated. Low purchase rates lead to a lower MPR and therefore increase the need for additional credit enhancement to cover defaults in the case of an early amortization event. Therefore, it's essential to constantly check these two metrics through cash flow modeling and scenario analysis to ensure that the quality of the underlying pool remains consistent in time, even during economic downturns.

In addition to stress testing, credit card securitizations often contemplate various mechanisms to protect performance, including specific performance triggers alongside traditional ones, that are tied to the MPR. A typical safeguard is the provision of dynamic loss reserves. Unlike static reserves, for which the level is fixed at inception, these reserves get replenished with excess cash flows from receivables, allowing them to promptly adjust based on portfolio performance and economic conditions. This mechanism serves as a liquidity buffer given that for any changes in defaults or delinquencies, these reserves adjust accordingly, ensuring that enough liquidity is available to cover any shortfalls or unexpected losses and leaving the cash flow to investors intact.

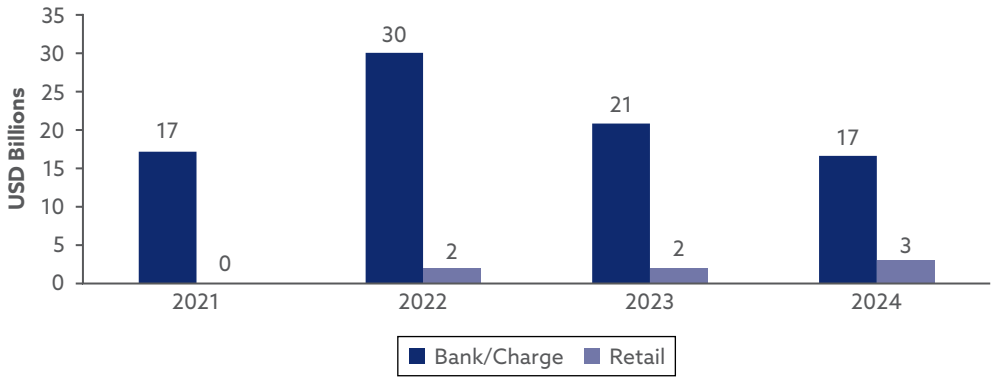
Traditional credit enhancements are usually included as well. Their required amount depends on various factors, including the likelihood of the originator's default. Indeed, if the originator is in distress, its ability to transfer credit card receivables into the trust may be impaired, which increases the need for more credit enhancements to mitigate the impact on investors.

As is the case for all consumer ABS, the performance of credit card ABS is also tied to such factors as employment rates, disposable income, and consumer confidence. During periods of economic stability or growth, debtors are generally more likely to pay on time, enhancing cash flow stability. Economic recession, instead, causes higher delinquencies and charge-offs, negatively affecting performance. The same dynamic applies to regulatory changes—for instance, changes in interest rate maximum caps can affect portfolio yields. Thus, continuous monitoring of these external factors is necessary to ensure the ongoing viability of credit card ABS in the long term.

Recent trends have had a positive impact on credit card issuances, especially retail issuance (i.e., credit cards issued by nonbank financial institutions), which have been on a steady upward trend since 2022 (as shown in **Exhibit 9**).

This performance has been driven by various factors, including the rise in credit card reward-based programs that attract higher-quality borrowers, and the advancements in data analytics and credit-scoring models that are improving underwriting precision and risk management tools. Lenders are increasingly using AI and machine learning to analyze large volumes of data and spot patterns that help them better assess a borrower's creditworthiness. By drawing on alternative data—like transaction history or even social media signals—these models build a fuller picture of someone's financial health, especially when traditional credit data are limited. This approach can lead to fewer defaults and stronger financial performance.

Exhibit 9. US Credit Card ABS Supply by Type ($ billions)



Source: JPMorgan (2025a).

Student Loan ABS: Navigating Longer Horizons

Student loan securitizations are backed by loans taken out by individuals in the pursuit of higher education, either through private lenders or government-backed programs. These types of securitizations are concentrated in the United States because of its expensive education model, whereas higher education is typically affordable in Europe. Student loan ABS are characterized by long durations, typically 15 to 25 years, and deferred repayment schedules, often beginning only once the borrower graduates. In addition, because students do not usually have a credit history nor a consistent income stream, these loans are often underwritten by a cosigner (typically a family member). Some postgraduate master's and international student programs also marginally contribute to private student loan origination.

Because few investors are keen on the 15- to 25-year term, liquidity is concentrated primarily in US federal programs as well as some private lenders and established legacy programs.

Student loans issued by private lenders face greater default risk and loss rates because they lack government guarantees. Although these loans can offer higher yields, the risk–return profile and relative value are not always compelling. In addition, prepayment rates play a significant role in risk management and valuation, and they must be properly analyzed.

Government-backed student loans, in contrast, come with explicit or implicit guarantees, which help to offset losses and keep returns stable. Investors, however, need to be aware of extension risk—that is, the risk the investment lasts longer than expected. In some cases, the clean-up call options (i.e., repaying early) have not been exercised in a higher-rate environment, which can lead to longer maturities than expected.

Student loan ABS resilience to economic volatility is highly dependent on the credit quality of the underlying portfolio. Evidence can be found in the recent performance of the 2023 and 2024 graduate cohorts, which faced increasing affordability issues in a high-interest-rate environment as well as rising living costs. Undergraduate student loans face additional challenges. Dropout rates and failure to graduate or find employment can pose significant issues because of the nondischargeable element of these loans. Bankruptcy realistically helps only in prioritizing

payments, but it does not really mitigate risks when the debtor is distressed. Although cosigners can provide some level of additional safety to lenders, they also may be financially distressed or overleveraged, especially during periods of economic stress.

Another issue faced by this type of ABS is the exposure to regulatory and political risk, both at the federal and state level. Indeed, during an economic downturn, student loan borrowers typically provide a strong case for political support, leading to potential government interventions that can directly affect cash flows. A clear example of this was the US federal debt moratorium during COVID-19 (and long after, for federal loans), which allowed borrowers to pause all loan payments. This raised concerns that similar relief programs could be extended to private student loans in similar situations in the future.

State-level usury rate caps also create constraints, particularly as benchmark rates rise, potentially compressing yields and affecting the pricing of higher-margin loans. A guiding principle should be that with very large unsecured loans, the all-in rate should not be above the low teens; otherwise, it becomes unaffordable in the long term, and it enters usury territory. Moreover, in some cases, private student loans have been subject to predatory legal action in the United States, underscoring the importance on the investor side of carefully scrutinizing origination practices.

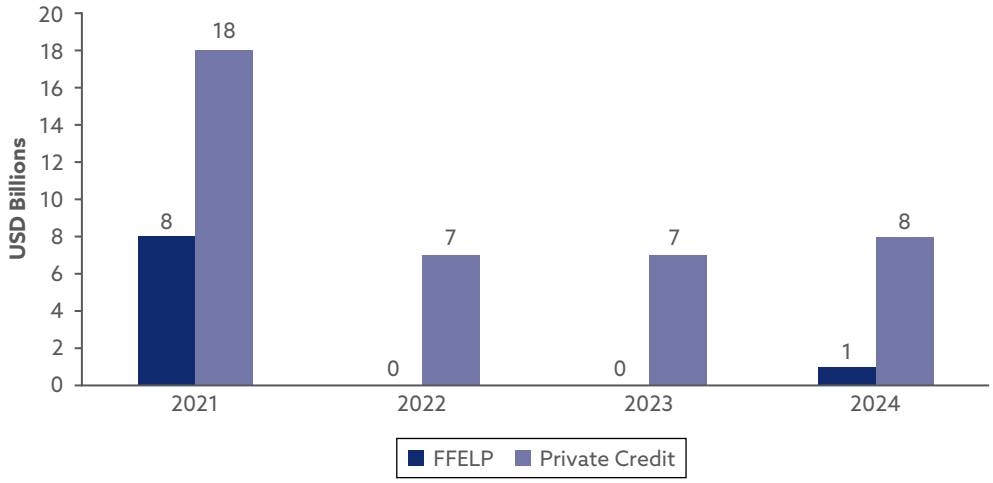
Given these dynamics, the deferred payment structure needs to be carefully modeled. The same is true to forbearance and arrears: Depending on regulation, unpaid accrued interest typically is capitalized only at the end of the study period. Unpaid interest during subsequent forbearance and arrears periods may not be compounded or capitalized, resulting in yield compression. Additionally, lenders may offer margin discounts and benefits, such as interest rate reductions for auto-debit use or good performance, which can further erode margins.

The presence of a cosigner with prime credit risk, as well as the inclusion of government guarantees, provides additional comfort for investors. Absent these safeguards, performance is closely tied to the student's field of study, professional area, university ranking, country of study, and postgraduation employment opportunities. Outside of the United States, the quality of the universities and the depth of job markets may not be sufficient to ensure good credit performance. Overall affordability is another issue, particularly for expensive or longer undergraduate courses (three to four years), which require significant debt burden.

Recent trends indicate that the private student loan refinancing market, heavily influenced by interest rate cycles, presents both opportunities and risks. During periods with low rates, refinancing increases as borrowers seek lower costs. Since 2022, however, the current variable rates offered have lost competitiveness compared with the prior low fixed rates. This trend, combined with the impact of the debt moratorium in the United States, has significantly reduced refinancing volumes. Despite this slowdown, refinancing lenders can cherry-pick the best borrowers from existing portfolios—those who are high-earning professionals and who have improved FICO scores—to offer them refinancing at lower rates. The flip side of this option is that traditional private student loan portfolios lose their best borrowers, leaving the original loan pool with a higher concentration of worse borrowers.

Since 2022, US government–backed student loans have mostly disappeared from the US market, as shown in **Exhibit 10**. This drop reflects the natural runoff of the Federal Family Education Loan Program (FFELP), which ended in 2010, leading to a shrinking pool of eligible loans for securitization. Student loan ABS issuance backed by private credit has seen a decline since 2021, with signs of a slight recovery in 2024.

Exhibit 10. US Student Loan ABS Supply by Type ($ billions)



Source: JPMorgan (2025a).

Niche Products: Buy-Now-Pay-Later and Payday Loans

Buy-Now-Pay-Later

Fueled by the expansion of e-commerce, technological innovation, and changing consumer behaviors, BNPL has gained a lot of traction because it allows consumers to easily access low-cost financing. Borrowers can fund purchases in installments, often at a 0% APR—provided they pay on time—with yields being driven by fees charged to merchants at inception. BNPL typically has smaller balances, shorter repayment times, and looser underwriting criteria than traditional point-of-sale loans.

Other key aspects that contribute to this product's success are simplicity and accessibility. Many borrowers are approved on the spot with a streamlined and frictionless process. This process makes BNPL especially appealing to younger consumers as well as frequent online buyers, leading to better sale conversion rates and larger average order volumes. In response to its success, many traditional banks and credit card issuers have started to offer similar products to maintain their competitive edge.

BNPL introduces novelties, and challenges, in securitization. This distinct operational model requires an increased need for advanced data analytics and risk modeling to assess affordability and borrower repayment patterns. One important obstacle is what is referred to as "phantom debt," which is the result of differing credit reporting practices. BNPL loans rarely go through the traditional credit bureaus and rely on "soft," rather than "hard," credit checks, producing an incomplete picture of a borrowers' financial health and total indebtedness. This lack of transparency becomes even more detrimental when consumers balance multiple BNPL accounts from different providers, increasing the chance of overextension when lenders unknowingly approve loans for borrowers already burdened with hidden debt. Coupled with very short maturities, these products' cash flows can be heavily disrupted, making it harder to reliably predict them.

This asset class is also exposed to macroeconomic volatility because it relies heavily on high transaction volumes and low margins. When unemployment is high, the risk of default increases, as BNPL repayments often rely on discretionary spending. Similarly, rising interest rates are problematic for this asset class as the higher funding costs are hard to pass on to consumers because the products are typically interest free. On the contrary, in a booming economy, BNPL performs well, as stable incomes and higher retail sales support repayments.

From an analytical standpoint, BNPL is not fundamentally different from traditional unsecured consumer lending. Metrics analyzed and risk drivers remain mostly the same. The key distinction is the limited relevance of prepayment analysis, given the very short duration of this product and limits on merchant concentration. Also, the modeling remains standard. Note, however, that the nature of the portfolios requires strong technical capabilities. BNPL portfolios are typically more granular, with large volumes of individual loans because of the high turnover, and have short maturities and relatively smaller ticket sizes. In addition, given the short repayment cycles, a robust monitoring system is essential to enable near-real-time visibility into transaction flows and borrower activity. These systems help ensure that reserve levels and other credit protections are adjusted appropriately as risk conditions change.

More recently, the rapid growth of BNPL has caught the eye of regulators. Previously, in some markets (including the UK market), BNPL products were exempt from standard consumer credit regulations as long as they met certain conditions, such as being interest-free and offering short repayment periods. However, the regulatory gap is now closing. Regulators are tightening oversight, imposing new rules on affordability checks, clearer disclosures, and fair treatment of consumers. On the one hand, these measures increase the operational costs for BNPL lenders—and reduce their competitive advantage. On the other hand, these measures are beneficial for investors because they improve the quality of underlying receivables by enforcing more stringent underwriting standards.

Payday Loans

Payday loans offer small amounts of cash instantly to borrowers in urgent need of liquidity. These loans tend to be unsecured, typically with higher rates and short maturities (usually two to four weeks), and their creditworthiness is based on borrowers' income. These features create a high-risk/high-yield product that attracts a selected set of investors. Substantial controversies surround these practices, however, mostly related to predatory lending.

Payday loans often come with relatively higher default rates, reflecting limited borrower creditworthiness and a lack of in-depth affordability checks that normally should be carried out by lenders. Although the high APRs on these loans absorb part of the default risk, the volatility of payday loan portfolios presents major challenges for securitized transactions. In certain markets, such as the United Kingdom, regulatory scrutiny has become more stringent, with the Financial Conduct Authority introducing such rules as caps on interest rates and fees, mandatory affordability checks, and restrictions on loan rollover. These measures were introduced to protect vulnerable borrowers, but they have had the unintended effect of limiting payday lenders' profitability and scaling potential; in turn, they have affected the performance of the securitization. Another negative incentive for investors, especially those with environmental, social, and governance (ESG) requirements and preferences, is the reputational risk faced when investing in these products because of questionable lending practices.

Similar to that of BNPL loans, the performance of payday loans is also extremely sensitive to the macroeconomic environment, including changes in employment rates and disposable income. The short-term nature makes them particularly vulnerable to liquidity shocks.

As the competitive landscape widens with the entry of online and mobile lending platforms, the risk of originators loosening their underwriting standards to attract more borrowers while potentially negatively affecting the quality of securitized portfolios, is increasing. For this reason, thorough analysis and modeling are essential for lenders who want to be active in this space.

Consumer Lending within the Alt Credit Space

In recent years, institutions' appetite for private credit has grown. As of early 2025, the global private credit market has surpassed $3 trillion in assets under management (Alternative Investment Management Association 2024). It is expected to continue growing, with a potential addressable market size of $30 trillion in the United States alone (McKinsey & Company 2024). A significant portion is expected to be allocated to consumer lending strategies through the $6 trillion ABS market (Bass 2025). In 2023 in the United States alone, $1.9 trillion consumer finance assets were held in nonbanking institutions' balance sheets (McKinsey & Company 2024). This trend is also evident in the United Kingdom, where pension funds, insurance companies, and other institutional players in search of diversification, higher yields, and insulation from public market volatility have increasingly included private credit into their strategic allocations.

Key Benefits

Few assets provide as much diversification, low correlation to public markets, and predictable cash flows as consumer loans. By pooling diverse loans, this asset class is able to mitigate individual borrower defaults and offer stability during economic downturns.

Size

The consumer lending market is large and has strong potential for growth. In the United States alone, outside of residential mortgages, household debt—including personal loans, student loans, and credit card receivables—accounts for more than $17 trillion (Kraus, de Silva, and Steiner 2024). This expansion is driven by several factors. Technology, for example, has made it much easier for people to apply for and manage credit as digital platforms offer a faster and more transparent experience than traditional banking channels. Younger consumers are also more comfortable using credit to pay for goods and services, which is another driver of the growth of online lending options. At the same time, the regulatory improvements introduced after the 2008 GFC have helped rebuild confidence in the credit system. Collectively, these trends have strengthened the consumer credit market.

Diversification

Consumer lending is widely considered to be an effective diversification strategy. Unlike single-name investments (like corporate bonds or equities invested in a single company's stocks or fixed-income issues) that are inherently dependent on the underlying entity's financial health,

consumer lending diversifies that idiosyncratic risk away by spreading it across a broader borrower base. This way, losses from several defaults can be absorbed and offset by stable repayments from the broader pool, creating a relatively more resilient asset class in the process.

Geographical and sectoral diversity add an additional layer of stability to consumer lending. Borrowers in the pool are usually based in different regions and industries, making this strategy less vulnerable to localized economic shocks. If a region or sector is distressed, the negative impact on the portfolio is offset by the performance of other loans across unaffected regions or sectors.

Therefore, consumer lending represents a potentially valuable addition to investment portfolios. It allows investors to diversify investment strategies and offers them an opportunity to be exposed to consumer credit, which cannot be done in most of the corporate credit-dominated fixed-income markets.

Lower Correlation with Public Markets

One very appealing aspect of consumer lending is its low correlation with traditional public markets, including equities, fixed income, currencies, and commodities. As a result, this asset class is potentially more resilient across economic cycles and market swings, a particularly important feature in an increasingly interconnected financial system. Indeed, traditional assets like equities and corporate bonds often move in unison because of similar sensitivity to macroeconomic factors, such as central bank policies, geopolitical news, and corporate earnings announcements. Moving in unison causes higher volatility across these traditional asset classes, and it dilutes the effectiveness of diversification within public markets.

Consumer lending is relatively insulated from these dynamics because cash flows are driven by repayment patterns rather than by market sentiment. The appeal of consumer lending is enhanced by the structural nature of consumer loans, which are typically amortizing; regular repayments of both principal and interest must be made over the life of the loan. Unlike bullet instruments, such as corporate bonds, in which the principal is repaid in full at maturity, these amortizing loans self-liquidate over time, thus eliminating refinancing risk.

Overall, consumer lending has a much lower correlation to public markets, functioning as a potential natural hedge against systematic volatility. During periods of equity market turbulence or stress in corporate credit markets, consumer lending performance tends to remain stable because cash flow streams come from the borrower's capacity and willingness to pay their obligations.

Stability and Predictability of Cash Flows

Consumer lending also provides stable and predictable cash flows because it is tied directly to the repayment commitments of a pool of borrowers, which potentially decreases concentration and idiosyncratic risk. The legal, operational, and financial protections described earlier are other factors that add stability to cash flows, even during downturns.

Another feature that contributes to the stability and flexibility of consumer loan securitizations is tranching. By dividing the capital structure into different tranches, consumer lending offers different risk–return profiles, allowing investors to meet their investment goals and risk appetite. Senior tranches are lower yielding but less risky because they are at the top of

the waterfall, making them an attractive option for conservative investors focused on capital preservation. Mezzanine and equity tranches typically provide higher yields in exchange for higher credit risk exposure, appealing to yield-seeking investors.

Investment Implementation

Depending on their risk appetite, financial objectives, and capital constraints, investors can opt for various investment vehicles to gain exposure to the consumer credit market. These options include private credit funds, ABS, investment trusts, mutual funds, and P2P lending. Each vehicle is suitable for different types of investors (e.g., institutional and retail investors have different priorities) and offers its own advantages and disadvantages.

Institutional investors, such as pension funds, insurance companies, and endowments, typically allocate capital to private credit funds and ABS because they favor scalability, control, and strong risk management practices. Retail investors can access consumer credit primarily through P2P platforms, mutual funds, and a few investment vehicles—for example, European long-term investment funds (ELTIFs) in the EU, long-term asset funds (LTAFs) in the United Kingdom, and newly emerging exchange-traded funds (ETFs).

Institutional Investors

Private credit funds pool, invest, and actively manage capital in nonbanking loans across a range of sectors, including consumer credit. Instead of originating loans directly to companies, they gain credit exposure through securitized assets, forward flow agreements, and private placements. As a result, they are able to diversify risk and offer stable returns with higher yields than traditional fixed-income vehicles. However, they come with limited liquidity and complex credit risk management.

ABS are also key investment vehicles for institutional participants. Among the many advantages, transparency and flexibility are the most cherished. Investors can choose the tranches in which they prefer to invest, depending on their yield preference and risk tolerance. Nevertheless, the complexity of ABS structures requires thorough due diligence and a deep understanding of credit quality and structural protections. Higher-yielding but lower-rated tranches may be more susceptible to losses during times of economic stress and therefore need stronger credit enhancement mechanisms and frequent stress testing to mitigate risks.

Retail Investors

Retail investors are generally unable to participate in private credit funds, but they can gain exposure to consumer credit in several ways. Options include listed investment trusts, mutual funds, P2P platforms, and the investment vehicles mentioned above (ELTIFs, LTAFs, and certain ETFs).

Listed investment trusts that are focused on consumer credit allow retail investors to access professionally managed portfolios of consumer loans or ABS. These trusts, which are publicly traded on exchanges, are liquid and transparent, and they allow investors to benefit from cash flows generated by the underlying assets. The share prices, however, are also subject to market volatility. As a result, they partly disconnect the vehicle's performance from its underlying

portfolio and therefore lose the inherent benefit of low correlation to markets that this asset class typically provides.

Mutual funds are another alternative for retail investors. Although they are generally less liquid, they provide additional benefits in terms of active management, which is especially useful in a more volatile economic environment. Major disadvantages of these vehicles, however, are that they lack customization and transparency, with investors having less visibility into the actual performance of the underlying assets. As a result, just like with listed trusts, mutual fund performance can be affected by market sentiment, occasionally leading to price fluctuations that are completely unrelated to the fundamental performance of the assets in question.

P2P lending platforms provide retail investors with direct access to consumer loan funding and allow investors to choose individual loans with target risk profiles. P2P platforms claim to offer attractive yields and transparency at the loan level. Despite initial growth, however, P2P lending has lost investor confidence because of the increased competition faced from institutional players and the concerns regarding sustainability. With the increase in default risks, this alternative has become less appealing.

The regulated structures of ELTIF and LTAF emerged amid a push to include retail investors in private markets. These vehicles have been specifically designed to allow retail investors to participate in long-term illiquid assets. After the ELTIF regulation failed in 2015 because of its numerous constraints, in January 2024, the *Commission de Surveillance du Secteur Financier* launched the ELTIF 2.0 to facilitate the participation of retail investors. This regulation allows for broader marketing and investment rules. A similar structure was set up in the United Kingdom, with the first LTAF being launched by Schroders in March 2023.

ETFs have been experiencing a similar trend. Apollo Global Management introduced one of the first ETFs offering exposure to both public and private credit markets. This structure provides greater liquidity because investors can trade shares on a daily basis, compared with the longer lockup periods associated with ELTIFs and LTAFs. ETFs, however, may face challenges in valuing illiquid assets and potential liquidity mismatches, whereas ELTIFs are structured to be better aligned with the long-term nature of private investments, potentially reducing short-term volatility but at the expense of immediate fund accessibility.

Best Practices for Investment Selection

Although investing in consumer credit provides a range of benefits, it is also a niche asset class that requires specific expertise and a disciplined approach. This approach can include an evaluation of loan originators, an analysis of collateral to the selection of appropriate tranches in ABS, and the consideration of macroeconomic variables. Each step is critical in risk mitigation and return optimization. Moreover, stringent compliance with regulatory frameworks protects both the sustainability and integrity of investments in the long run.

Loan originators are responsible for sourcing, underwriting, and managing the loans underlying credit portfolios; thus, ensuring they are qualified, professional, and proficient is essential to achieve success in consumer credit investments. Effective underwriting practices include thorough credit screenings, income verification checks, and DTI ratio calculations to maintain the credit quality of the underlying pool.

The performance of these products, however, relies not only on underwriting but also on how the book is serviced to manage defaults as well as delinquencies. Best practice methods—such as early intervention techniques for late payments, proactive borrower outreach, and effective recovery processes—are vital. Thus, by examining originators' and servicers' practices as well as their performance history based on default rates, prepayment trends, and portfolio diversification, investors can better understand their track record. Strong performance and low default rates indicate that the company can manage credit risk well.

Another key factor in determining risk profiles and recovery prospects is the underlying collateral of consumer loans. With different loan types come different risks and benefits. Auto loans, for example, are backed by vehicles, which provide tangible collateral but are also depreciating assets. Vehicle values are determined based on depreciation, which considers a vehicle's age, conditions, mileage, and market demand, requiring accurate valuation models to assess these loans. Timely repossession and resale are critical to mitigate losses, given the vehicle's rapid depreciation rates. In contrast, credit card receivables are unsecured and depend more on the payment behavior of consumers. Credit quality, in these cases, is derived solely from a borrower's ability and intent to repay, requiring a thorough knowledge of borrower demographics, historical repayment patterns, and the original creditor's collection practices. Therefore, in portfolios with diverse types of collateral, it is important to understand the overall allocation and diversification to balance risk versus return.

Tranche selection is another critical decision in consumer lending that directly affects an investor's exposure to credit risk and potential returns. Investors need to choose their allocation within the capital stack based on their investment goals and risk tolerance. A thorough evaluation of credit enhancements, such as overcollateralization and excess spread, is essential when making these decisions because it provides insight into tranches' resilience under adverse conditions.

Ongoing monitoring of macroeconomic factors is also essential. Interest and employment rates, as well as inflation, directly affect the ability of borrowers to pay, which then influences portfolio performance. To account for these influences, scenario analysis and stress testing must be conducted. These scenarios model the effects of downside economic outcomes, such as a recession, on loan performance, enabling investors to understand how to best equip their portfolios to withstand economic volatility.

Finally, it is essential to ensure that consumer credit investments comply with legal and ethical principles as well as with regulatory requirements. In the United Kingdom, for example, regulators have increased their scrutiny of high-interest consumer credit products, such as payday loans. These and similar regulations are designed to protect consumers against predatory lending practices, high fees, and unclear terms. For investors, compliance hinges on partnering with originators who operate within their local compliance frameworks and adhere to strong lending principles and accepted practices. The loan terms must be transparent, the interest rates must be reasonable, and the marketing must not be predatory. This way, investors can ensure the health of the investment both financially and reputationally. The potential cost of noncompliance is high, from hefty fines to reputational damage and lower portfolio performance—thus, the importance of conducting thorough due diligence.

Overall, investing in consumer credit requires a multidimensional approach, as the analysis hinges on various factors, including the originator, the collateral, the tranche selection, the correlation to macroeconomic factors, and the adherence to regulatory regimes. A holistic consideration of all of these elements can help investors build resilient portfolios that strike a balance between risk and reward while remaining aligned with ethical and legal principles.

Conclusion

Consumer lending has evolved into one of the most dynamic and complex areas within the private credit landscape. This transformation—driven by technological innovation, evolving consumer behavior, and the growing influence of fintech—has broadened access to credit and diversified product offerings. It has also introduced new risk considerations for investors, especially linked to new products.

Indeed, more established offerings, such as auto loans and credit card receivables, are being complemented by newer structures, such as BNPL and payday loans—creating a wide array of potential investment opportunities across structures, maturities, and risk–return profiles. This growing heterogeneity makes consumer lending uniquely customizable but also uniquely demanding from the point of view of professionalism and client stewardship. It requires a robust understanding of underlying borrower quality, asset-level cash flow dynamics, and even macroeconomic sensitivity despite the asset class's weak linkage with broader market moves.

Securitization, the primary gateway for institutional access, adds a further layer of sophistication through tranching, credit enhancements, and structural protections—all of which must be actively managed and stress tested by experienced professionals. At the same time, the quality of the originator and servicer and (mostly in Europe) ESG considerations can significantly affect long-term performance. Regulatory alignment can also take the front seat as the era of fintech brings new challenges for global legislators, and with them, the potential for swift changes in key rules that are at times not even directly related to the space (e.g., bankruptcy rules).

What makes consumer lending particularly compelling in today's market is its potentially low correlation to public markets, its amortizing and often floating-rate cash flows, and its potential to offer both yield and diversification in investor portfolios. This is especially relevant in an environment in which traditional fixed income has shown surprisingly high correlations with equities and public markets are increasingly concentrated, with their performance, especially in the United States, closely tied to a few mega-cap stocks. In addition, consumer lending's capacity to disperse idiosyncratic risk across large, granular borrower pools makes it more resilient to localized shocks—for instance, economic downturns in a specific geography—than many corporate credit instruments.

The same attributes that make consumer credit attractive—digitization, nontraditional data usage, and algorithmic underwriting—also introduce tail risks that are not yet fully understood. BNPL is a prime example: This innovation boosts conversion rates for merchants but poses fundamental questions around borrower affordability, data transparency, and regulatory oversight. The rise of such models underscores the need for investor vigilance, especially as the regulatory perimeter catches up to market developments. That said, with the introduction of AI and a higher level of regulatory scrutiny, BNPL loans seem to be on the right track to increased transparency, which brings potential risk mitigation for investors.

From a portfolio construction standpoint, consumer credit offers a flexible tool kit in the form of different risk levels depending on the investment tranche. Senior tranches provide capital preservation and steady income for more risk-averse allocators, whereas junior and mezzanine tranches offer enhanced yield amid higher risk. A key development is that investors now have multiple access points—ranging from traditional ABS and private credit funds to new vehicles like ELTIFs, LTAFs, and ETFs. These new access points are reshaping how both institutions and retail players engage with the asset class.

Ultimately, successful investing in consumer lending is contingent on a disciplined, data-driven, and forward-looking approach. In some ways, it is potentially conducive to alpha opportunities given that a manager's skills and experience matter both in the underwriting phase and in the monitoring phase.

A successful strategy may depend on partnering with capable originators, adopting rigorous underwriting and servicing standards, selecting the right tranche for the right investor, and, last but not least, understanding macro trends and structural safeguards.

When done well, consumer credit can serve as a core allocation within alternative credit portfolios, delivering stable and scalable returns while supporting broader financial inclusion.

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