Technical support note: Partial Bad Debt Guarantee and Tapered Profit Share

This document explains how we expect the partial bad debt guarantee and the tapered profit share to work in practice. It should be reviewed alongside the draft Heads of Terms and simplified excel file which shows the calculations for these mechanisms in a simple model that enables lenders to see the calculations in more detail and. This document, the draft Heads of Term and the excel file show:

Partial bad debt guarantee mechanism

- how the lenders' maximum bad debt budget provided by the 'fund' is apportioned across the waves of lending, where volumes in subsequent waves are influenced by the extent to which the bad debt guarantee budget is projected to be absorbed by earlier waves
- how we expect to calculate the call on the guarantee after lenders absorb the same level of bad debt losses they incur on their 'normal' lending within the same time period
- how the claims on the partial bad debt guarantee will operate while loans are still in flight, including interim claim payments aligned with lenders' financial year ends, with a final wash up in the year following the lending concluding altogether for that wave ie in year 4 of a lending wave where loans are offered over a 3 year term
- how the interim payments are capped reflecting the longer term nature of the consolidation loans and the need for lenders to continue to collect effectively. We note that some of these aspects will involve a contingent liability that will span multiple years

Profit share mechanism

- how profit generated on the incremental lending underpinned by the guarantee is shared between Fair4All Finance and the lender

- how the profit share owed to Fair4All Finance reduces where the call on the bad debt guarantee decreases between lending waves

Within this document the principles of operation are covered, in support we have designed the attached link that allows lenders the opportunity to input some figures themselves to see how the partial bad debt guarantee and the profit share work alongside each other.

We are actively seeking feedback on this construct and want to work collaboratively to get a package in place that is genuinely supportive of incremental additional consolidation lending and where we share the risk and reward with lenders.

Partial bad debt guarantee budget and waves

Bad debt budget apportionment

To manage our total £3.5m fund we are setting an absolute bad debt budget (£) per lender to be apportioned across separate waves of lending.

To ensure the lending volumes produce the data and learning we ideally require lenders to commit to a minimum volume of lending across the three waves of 1,000 loans, with an absolute minimum of 500. Whilst we appreciate the challenge of forecasting volumes in the future and in the current economic climate there should be reasonable grounds for believing each lender can achieve their forecast as a minimum.

Using the anticipated forecasts across 3 waves of lending we can then agree an overall bad debt budget total for each participating lender and agree the basis and timings for ongoing monitoring. The allocation of partial bad debt budget will be agreed and tie in with the forecasted volume.

Our view is that lending to these incremental groups carries a greater likelihood of calling on the bad debt guarantee more in the first wave than subsequent waves, as lenders learn more about these customers and refine their lending criteria and support processes, so are suggesting the partial bad debt budget is apportioned as follows

- Wave 1 – 50% of budget aligned
- Wave 2 – 30% of budget aligned
- Wave 3 – 20% of budget aligned

Worked example

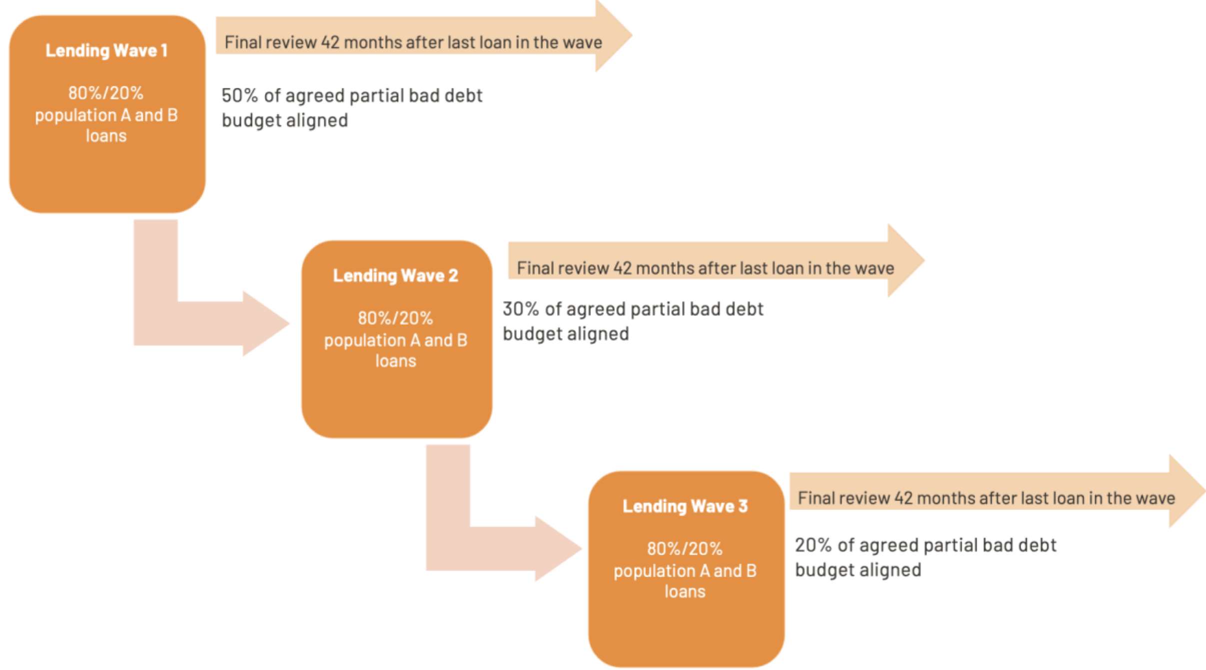
As an example, if the total partial bad debt guarantee budget for a lender was agreed at £350K then £175k would be aligned to wave 1 (50% of the budget), £105k against wave 2 (30% of the budget) and the balance of £70k against the final wave.

We also require an 80/20 lending mix of Population A and Population B customers with the wave budget being apportioned accordingly.

We are proposing that we do not pay the out the full disparity between the 'normal/baseline' lending and the consolidation lending until the conclusion of the lending wave in totality, this being 42 months after the last loan in that wave was dispersed.

Interim claims on the partial bad debt guarantee in each review period within the wave will be capped at a maximum of 2.5 times greater than bad debt of those in the normal/baseline lending portfolio from the same time period, in light of the need for lenders to continue to collect effectively.

Once all consolidation loans have been repaid and the final debt position is known on the lending wave a full retrospective review will evidence any partial bad debt guarantee still owed and will be settled to the maximum of that waves budget.



Comparing lending in specific time periods

Having the lending in waves will enable us to test performance in controlled manner and will limit the exposure of the bad debt guarantee to a known volume and value of lending in each waves period.

For each lending wave we expect to complete an analysis comparing the performance of consolidation lending underwritten by the bad debt guarantee to populations A and B with all lending done by the lender over the same period, not covered by the guarantee providing a baseline. This is a vintages analysis and we expect lenders to be able to report on these waves until they have completed their 42 month cycle.

We will be using this analysis to determine what share of the losses on the consolidation lending the lender absorbs (equivalent to the level they experience on their normal baseline lending) and what portion the partial bad debt guarantee absorbs.

The extent of the projected call on the total available guarantee will influence how much of that guarantee can be assumed to be available for subsequent waves of lending.

We will agree with each lender what the wave start dates will be as well as the review dates. We expect the wave start dates to be at least 6-9 months after the consolidation lending has ceased in the previous wave so that an adequate picture of initial bad debt performance can be built up.

For example, we'd expect to agree these parameters with a lender wanting to work with us from January.

Wave 1 start date	**1 January 2023**
Wave 1 end date	1 May 2023
Review date (CU Financial Year end)	31 December 2023
Forecasted incremental volume of Population A and B in period	500 in total to be lent as: 400 population A 100 population B

We expect review dates to be scheduled to support lenders end of year reporting requirements and any claim on the partial bad debt guarantee will be paid accordingly.

How the partial bad debt guarantee mechanism will operate

Comparing the consolidation and baseline lending at the end of each lending wave timeframe

When the wave ends there is a need to understand the volume of loans written with the partial bad debt guarantee alongside all other loans written during that same wave period. This allows the performance of the loans that are guaranteed to be directly compared to the performance of the main loan portfolio, giving a genuine like for like performance of loans during the same lending period, for example the initial wave could look something like this.

Covered by guarantee		**Total loans disbursed in this Wave period**	
		volume	value
Yes	Consolidation loans pop A	400	£2,500,000
	Consolidation loans pop B	100	£650,000
No	all other loans ("baseline")	2,500	£15,000,000

At each review date (lenders' financial year) the relative performance of each set of loans is compared side by side to establish the bad debt performance and the level of bad debt relative to each other.

For example if the first wave ran from 1 January 2023 until 30 April 2023 and the lenders financial end of year was 31 December 2023 the review dates would be as follows

1. First review 31 December 2023
2. Second review 31 December 2024
3. Third review 31 December 2025
4. Final review for this wave 31 October 2026 – this being 42 months after the last loan in the wave was written

Participating lenders must have the capability to extract the data in a manner that allows continued direct date range performance comparisons between the partial bad debt guarantee backed consolidation loans and the baseline lending that occurs in the lending waves. This will enable our credit risk partner to complete a vintages analysis.

Example review data at the first review date

Having established that 3,000 loans in total were written in the wave period, 500 consolidation loans with a partial debt guarantee and 2,500 standard loans, their performance can be compared.

In this simplified example the volume of loans written off, their value and provision levels are illustrative amounts.

Year 1 first review example

	Volume	Value	Total bad debt value	Bad debt %
Consolidation loans population A	400	£2,500,000	£125,000	5.0%
Consolidation loans population B	100	£650,000	£35,000	5.4%
All other loans (baseline)	2,500	£15,000,000	£375,000	2.5%
			relative performance of PopA	2.00 x baseline
			relative performance of PopB	2.15 x baseline
			PBDG cap relative to baseline	2.50 x baseline

In this example the total bad debt represents 5.0% of Population A, 5.4% of Population B and 2.5% for all the normal baseline loans written in the same period. Resulting in the guaranteed consolidation loans performing just over 2 (5.0% / 2.5% = 2.00) and 2.15 (5.4% / 2.5% = 2.15) times worse than the standard loan book.

To ensure that lenders continue to engage borrowers in an effect arrears collection process and to encourage borrowers to get into a payment plan we are not paying out the full disparity between the 'normal' lending and the consolidation lending until the end of the loan life cycle, but in the interim will make a payment capped at a maximum of 2.5 times greater than bad debt performance on loans covered by the guarantee than those in the baseline/normal lending portfolio from the same time period.

The same process will be repeated at each review date, with the final review and reconciliation at 42 months after the end of the wave availability period.

The tracking at each review phase will also recognise that each wave has a proportional allowance from the total budget, so for example wave 1 that would be against 50% of the total lender budget allocated.

How the partial bad debt guarantee and the profit share work together

On the basis that the following has all been agreed and put in place

- The forecasted volume and the lending wave timescales agreed
- The overall partial bad debt budget has been agreed and proportioned 50%/30%/20%
- The lending wave review dates are all agreed and known
- Operationally and contractually, everything is ready to start

There is a basis to operate and monitor progress but more importantly a basis for the monitoring of

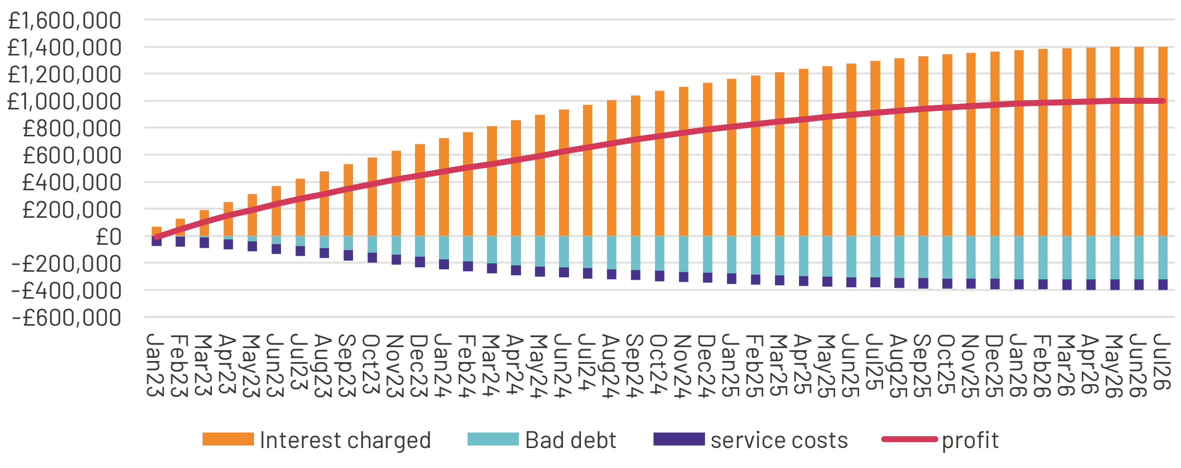
performance.

As a reminder we intend to settle any claims against the partial debt guarantee on a regular basis that correspond with your end of year financial reporting, interim payments being capped at 2.5 times the baseline performance with final settlement agreed 42 months after the last loan dispersed in that lending wave. Any profit share return we propose to do once per wave, this being assessed also at the 42 month point once the absolute outcome of that lending wave is known.

To illustrate the build-up the following diagrams explain the relationship of the constituent parts and support the principle that overall lenders should make a return on the incremental lending.

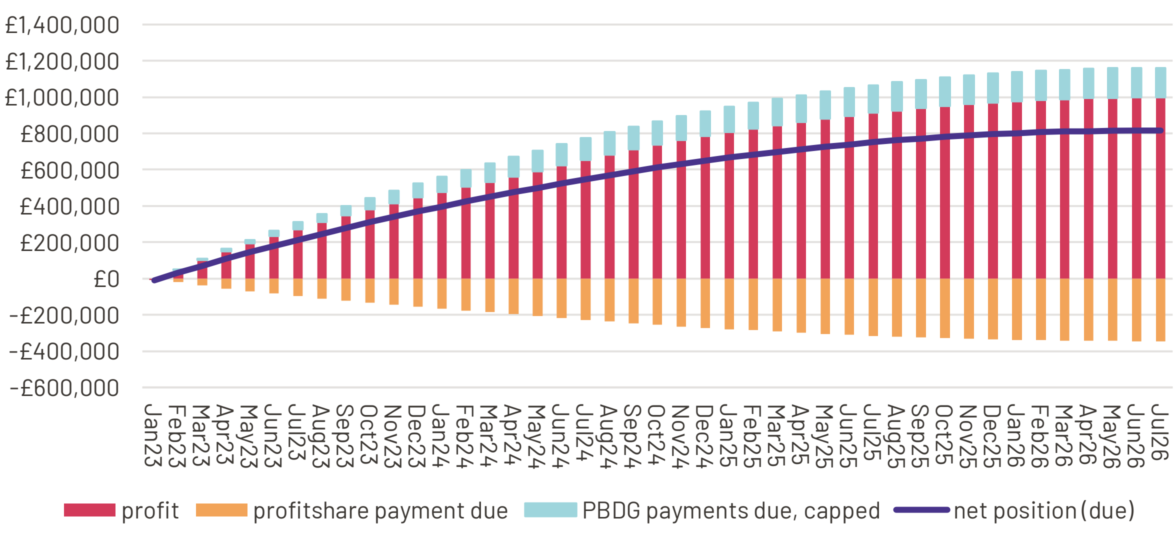
Stage 1 – The core lending model

This diagram shows a simple profit calculator with profit being shown as interest earnt on the lending less the costs of bad debt and servicing. For simplicity all lending is done in month one and data is then shown cumulatively



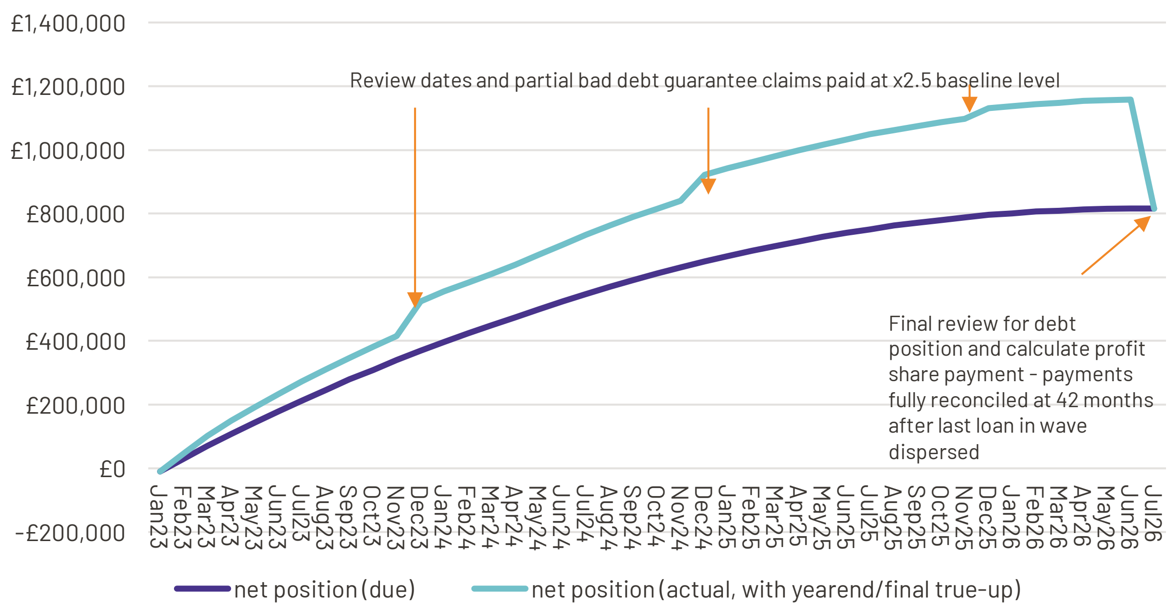
Stage 2 – Cumulative position introducing partial bad debt and profit share

This diagram introduces the relationship between the partial bad debt and the profit share due relative to the overall profit position for the lender and the net position. Note the partial bad debt guarantee and the profit share payments are shown as due on a cumulative basis, but they will be reviewed and paid accordingly in line with the timelines above.



Stage 3 – The effect of the year end reviews and final 42 months position

The aim of this next diagram is to show that the lender will maintain any profits accumulated until the 42 months point but partial bad debt guarantee claims will be paid in line with the review dates - hence the payments made in December 23, 24 and 25. Depending on the underlying performance the lender could be temporarily either better or worse off until the final reconciliation at month 42.



nb for simplicity assumes all lending dispersed in month 1

Summary of wave 1 payments to lender

Milestone	Date	Payments to lender
Wave 1 start date	1 January 2023	N/A
Wave 1 end date	1 May 2023	N/A
Review date (CU Financial Year end)	31 December 2023	Partial bad debt payment up to a maximum of 2.5 times baseline loan bad debt performance
Review date (CU Financial Year end)	31 December 2024	Partial bad debt payment up to a maximum of 2.5 times baseline loan bad debt performance
Review date (CU Financial Year end)	31 December 2025	Partial bad debt payment up to a maximum of 2.5 times baseline loan bad debt performance
Final true up	42 months after the last loan in the wave is dispersed	Partial bad debt payment up to a maximum of the remaining portion of the bad debt budget (50% of budget assuming lending wave 1) Note – Profit share taper calculated on completed lending wave performance and paid to Guarantor

Tapered Profit share mechanism

Profit share structure

On the assumption the incrementally written guaranteed consolidation loans overall make profit across the review periods we have designed a structure that provides for some money to come back into the fund to extend its lifespan. We believe the income coming back will not support the fund indefinitely but should help prolong it.

This example uses the starting values in our excel model. The expression of interest invites lenders to propose the settings they suggest for the profit share percentages.

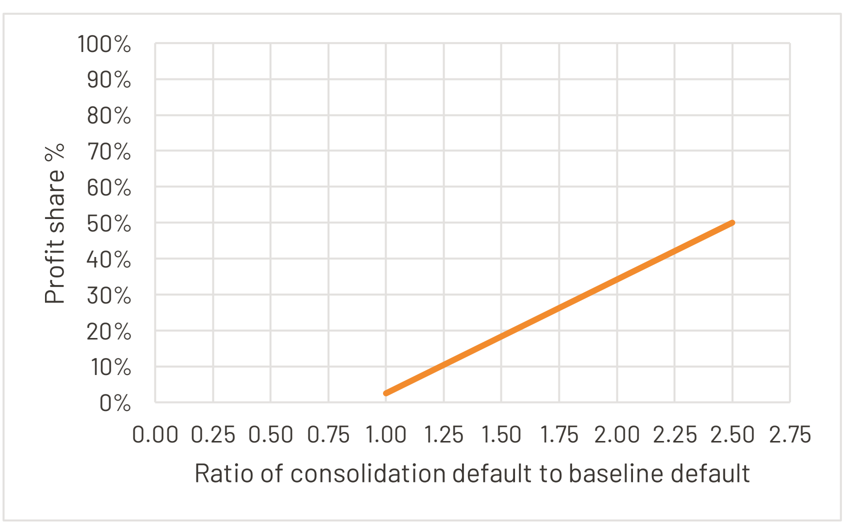
The structure is designed in such a way that the greater the call on the partial bad debt guarantee the greater the level of profit that gets returned to Fair4All Finance. At the maximum level this is 50/50 split of

the profit and at the lowest level 2.5% of profit, the ratio of return dependent on the performance of the loans covered by the partial bad debt guarantee and the baseline loans. The maximum cap ratio will be 2.5 times above the baseline portfolio performance for the respective lending wave.

Where the bad debt rate is the same or better than the lenders' normal portfolio the level of profit return to Fair4All Finance will be 2.5%.

Our proposal is that whilst we will pay the partial dab debt guarantee at regular claim intervals the profit share payment can be considered retrospectively at 42 months after the last loan was dispersed in the respective lending wave.

Shown graphically the taper works as follows



The full sliding scale is shown in the excel modeller:

The taper profit share rationale

Consolidation default rate vs baseline loans 'default ratio'	Profit Share return %
2.50	50.0%
2.43	47.6%
2.35	45.3%
↓	↓
1.08	4.9%
1.00	2.5%

The rationale here is that we want to reward lenders for both iterating their learning and carrying that into future lending waves whilst continuing to support customers getting payment arrears back on schedule. Over time as we move through the second and third lending waves moving to a point of less reliance on the guarantee, ultimately reaching a point not needing the guarantee at all when lending to populations A and B.

Feedback we are interested in

We are interested in your views, so if necessary, we can adapt the Heads of Terms and mechanisms accordingly, please use the expression of interest form feedback section for this.