fair4all finance

Overview
Partial bad debt guarantee for consolidation lending

Key principles and processes

October 2023

Bad debt guarantee key principles

We are open to discussion on duration and targeting and have set out below our starting position

Duration

- Lending in waves so that tweaks to underwriting and customer journey can be made iterative as learning is identified, therefore we assume that the second wave of lending should probably only commence 6–9 months after the first has started
- We have assumed consolidation loans are 36 months but open to shorter or longer terms, and assume two waves of lending, a period of evaluation will be needed to run for at least one year after the last loans have paid back
- Lenders propose split of lending across the waves as long as there is enough initial volume to provide useful learning and evidence eg 30%/50%/20% or 33%/33%/33%

Who this helps

- Lending enabled by this guarantee is monitored separately to regular consolidation lending to enable portfolio performance comparisons. A special purpose vehicle or other ring fencing may be needed
- Lending enabled by the guarantee is split 80% to those just outside a lenders' existing risk tolerance (Population A) and 20% to those significantly outside of tolerance and in vulnerable circumstances (Population B)
- Lenders propose their own definitions for borrowers in these populations which are broadly expected to align with the Fair4All Finance segmentation model
- Lenders can consolidate debt(s) they are already owed – lenders can propose on what limit is appropriate here eg debts owed to the lender could comprise £1,000 or 20% of the consolidation loan whichever is lesser

Bad debt guarantee key principles

How the guarantee and profit share functions – what we do and don't expect to vary

We are not expecting to negotiate on these aspects:

- Lender absorbs first losses on consolidation lending equivalent to losses experience on their normal portfolio- the 'baseline' portfolio – monitoring of incremental vs existing 'normal' lending is essential
- The guarantee is capped at a fixed amount and careful monitoring of the projected bad debt covered by the guarantee and the wave process enables lenders to reduce volumes to mitigate a scenario where bad debt is higher than projected
- A profit sharing mechanism applies so that we share in the upside of profitable incremental lending at the portfolio level and can reinvest these funds to further extend lending
- Profit sharing will operate on a taper and will taper up if more of the guarantee is used and taper down if less of it is used and so incentivise ongoing improvements in lending
- Profit sharing is paid out at the end of the lending wave and is calculated **after** servicing costs are included, open book accounting applies
- Robust affordability processes apply to all lending along with clear communication to borrowers re loan purpose, borrower must be in an overall better position with the consolidation loan and careful triaging to alternatives is essential

We are expecting lenders to submit their proposals for parameters on:

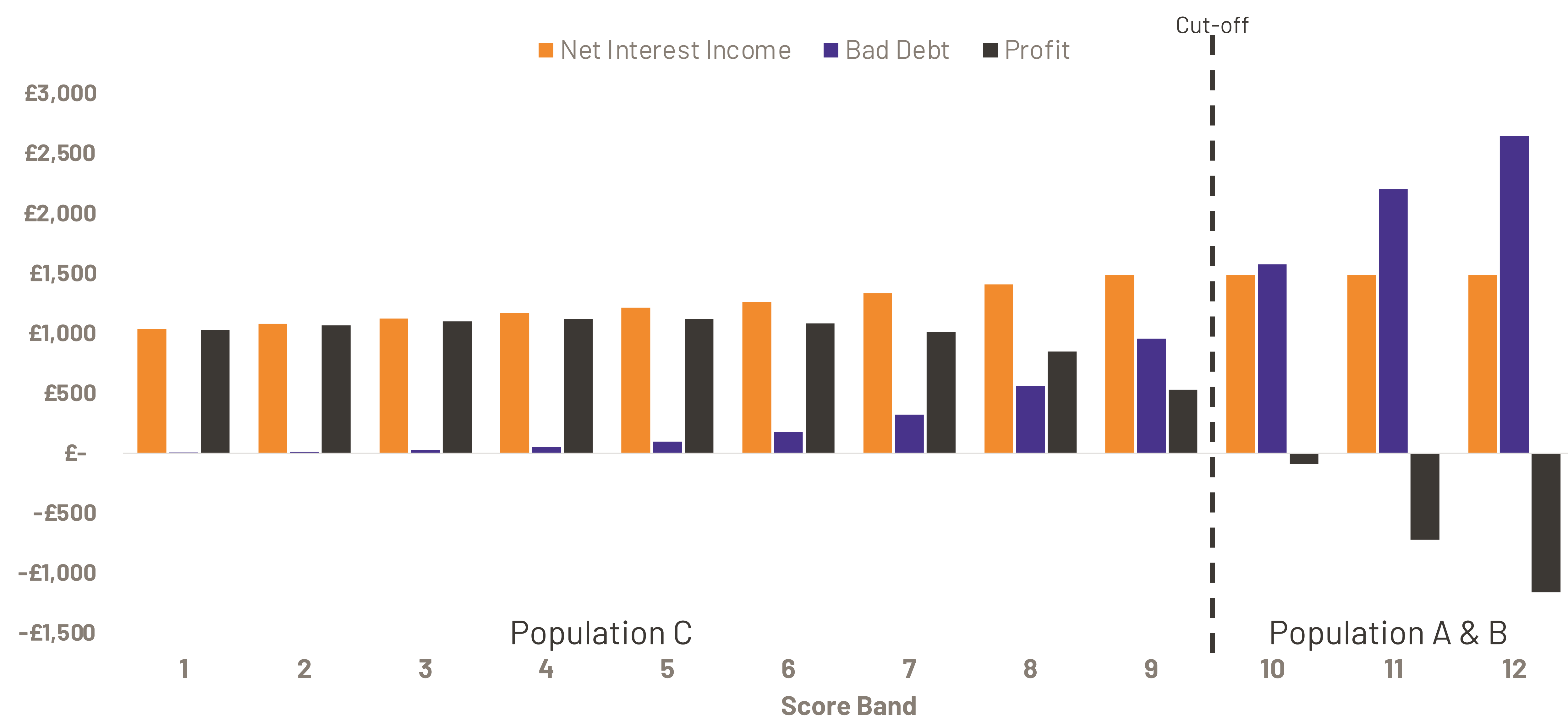
- The level of guarantee sought eg £m, projected bad debt per population and #000 loans delivered
- The exact settings in the profit share taper and maximum profit share cap are up to the lender to propose
- We have drafted the guarantee so that bad debt costs are paid out in part during the lending period as loans are provisioned to 100%, capped at 2.5 x the level of bad debt occurring in the baseline portfolio during the term of the lending wave
- A final 'true up' calculation at the end of the wave to pay out up to the maximum bad debt guarantee. We can discuss alternatives to this pay out mechanism or lenders can agree to be paid out in full at the end of the wave period at the same time that profit sharing is calculated

Bid and contracting phase

1. Lender participates in competition to enter Fair4All Finance consolidation lending pilot scheme which is targeted at supporting borrowers outside the lenders usual credit risk tolerance
2. Lender sets target volume for population A and population B consolidation lending and confirms baseline of existing customers consolidation loans (population C) can be used as comparator
3. Lender proposes maximum profit share percentage from portfolio A and B which will be due to Fair4All Finance under the gainshare arrangement if profitable
4. Lender sets out planned loan product assumptions inc interest rates with risk based pricing for population A and population B vs population C (existing customers), projected bad debt on each population, and share of consolidation loan that can cover lenders' existing loans to the borrower
5. Fair4All Finance and Lender confirm available bad debt budget and settings for it including how budget will be phased across waves of lending to allow for learning and iteration
6. Contract signature
7. Establish appropriate monitoring mechanism for observing baseline vs Population A or Population B lending, may include special purpose vehicle if Fair4All Finance capital is also provided
8. Lending processes assurance by Jaywing
9. Commencement of lending

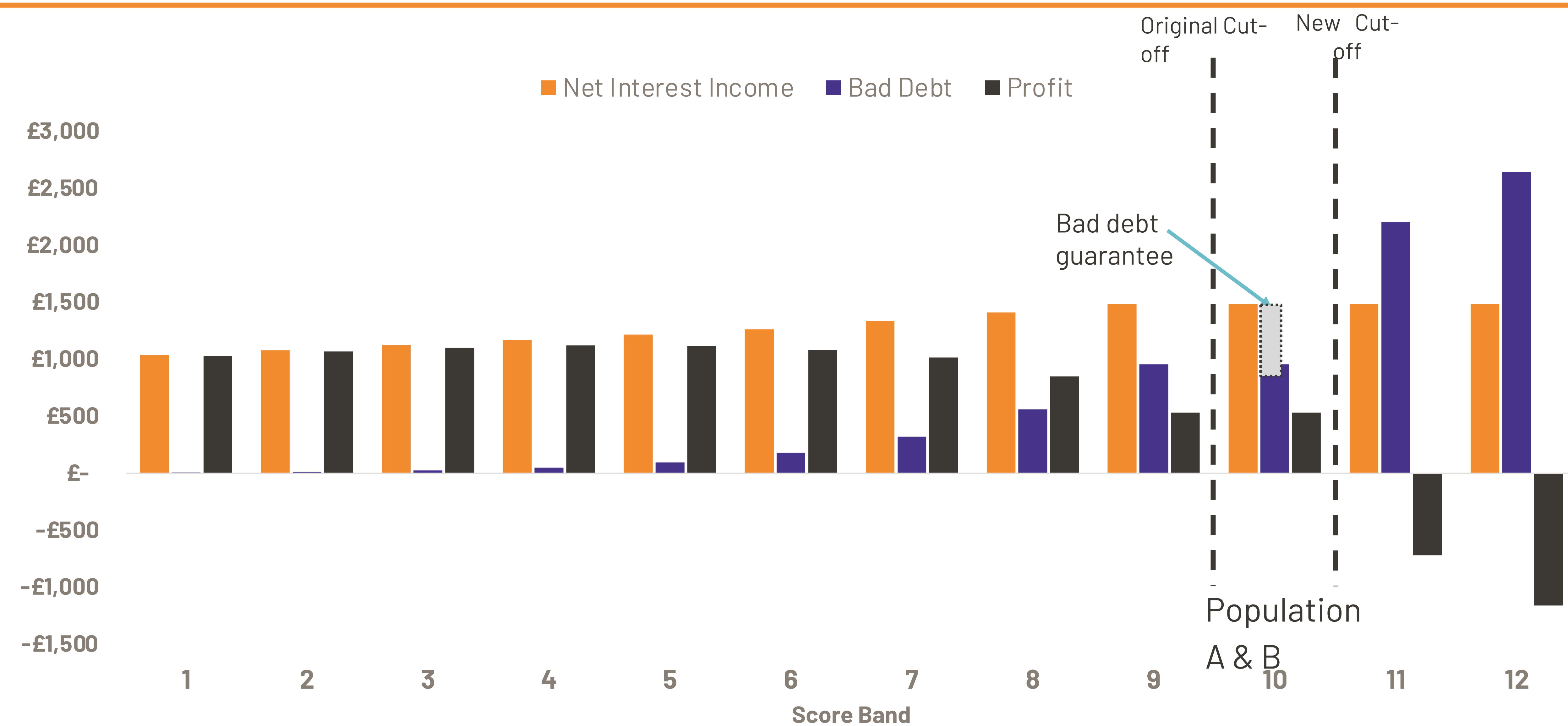
The Bad Debt Guarantee

In a theoretical consolidation loan book, net interest income increases due to higher APRs as credit risk increases but bad debt costs increase more sharply. The combination creates a segment of customers that are value negative at the high end of the risk distribution if loan products do not exist with high enough APRs to offset the increased risk of default. A similar scenario could exist for policy declines (eg decline due to adverse data, such as a CCJ) where bad debt propensity cannot be accurately estimated given this population may have never been lent to.



The Bad Debt Guarantee

In this scenario the Fair4All Finance Consolidation Loan Bad Debt Guarantee scheme could offer a route to lending profitably to score or policy declines whom Fair4All Finance are looking to offer financial inclusion to. In this case, the bad debt seen above the banks' risk appetite would be covered under the bad debt guarantee and the loan becomes profitable, without increasing APR beyond banks' existing lending product suite. A profit share on the incremental business written using the bad debt guarantee ensures the fund is topped up for future lending.



What does this enable?

The bad debt guarantee enables consolidation lenders to:

- Self-determine what flexibility to introduce to enable appropriate and profitable lending outside of "normal" criteria to reach 'Population A' (80%) and 'Population B' (20%) – we are open to proposals on this
- Factor loan performance data into credit model redevelopment
- Stabilise existing own brand lending – where consolidation with existing external finance will improve customer financial position
- Improve customer product penetration
- Attract new customers and reduce attrition of existing customers
- Build customer loyalty to improve whole life customer profitability

What might this look like for mortgage holders?

- In Population A we'd expect customer with providers' own brand mortgage. Many of these customers will also have credit card, buy now pay later finance, cheque account and unsecured higher interest loan all with other providers

- Own brand mortgage is being repaid with monthly payments on time but customer is finding that the cost of living crisis/high energy costs is impacting their ability to maintain contractual payments across their other credit commitments

- Open banking data evidences the issues with one unsecured loan payment missed recently and late credit card payments, payments have not yet commenced on the buy now pay later facility

- The early signs of financial stress the mortgage lender has the opportunity to seek to assist the customer and prevent mortgage product payments being negatively impacted in future by:
  - Consolidating other providers lending facilities to own brand standard interest rate product extending term to reduce monthly commitments
  - Enabling own brand saving product with 'surplus' income to improve future financial resilience and deepen the customer relationship
  - Providing an opportunity for the customer to transfer their cheque account from other provider deepening relationship
  - Enabling future value eg on repayment of consolidation loan, the customer takes out own brand credit card further deepening the relationship

Helping mortgage holders - alternatives:

Option	Immediate impact	Medium term impact	Overall financial to customer
Switch to interest only for finite period (6–9 months)	Potentially significant reduction in payments per month (depending on interest/capital share and stage of mortgage) Provider still exposed to mortgage payment risks because of customers debts elsewhere	Pay more in the medium term as capital not reduced for finite period	Negative
Extend mortgage term	Reduce payments Provider still exposed to mortgage payment risks because of customers debts elsewhere	Increased cost and increased duration of obligations eg postponing retirement choices	Negative
Consolidation of customers higher cost debts into provider fixed term loan	Potentially significant savings per month eg >£200 on £6.6k debt moving from 55% APR to lower APR Providers receipt of mortgage payments may stabliise/lower risk of default	Sustained savings per month	Positive