

ABCD

**The Department for Work and  
Pensions**

**Social Fund Reform  
Feasibility Study**

KPMG LLP

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## 1 **Executive summary**

The Department for Work and Pensions ('DWP') is interested in considering ways of expanding the current Budgeting Loan Scheme to a wider range of low income borrowers. This feasibility study was to consider whether there is an appropriate model whereby private sector funding could be attracted.

Whilst the range of market participants involved with this feasibility study has been wide, the key messages on the development of an expanded Budgeting Loans Scheme have been remarkably consistent.

The key findings of each of the areas of the proposed operational model are summarised below; however, the most critical finding is that the market does not currently have the appetite to fund a model lending to this socio-economic group and there remains key data deficiencies within the market which would be likely to prevent any model being able to attract serious commercial interest at this stage.

### 1.1 **Funding a model**

The recent economic environment has shown that the appetite for the funding of unsecured retail lending in the UK market has abated significantly since the start of the credit crunch in July 2007. This effect has been felt most severely by the sub-prime lenders in the market and has resulted in a number of lenders either withdrawing from, or pricing themselves out of the market.

In our interviews of market participants, all said that in the current economic environment, they would not wish to fund a model lending to a deep sub-prime sector. Moreover, if the liquidity crisis currently being experienced were to ease, they would still expect any funding to be done on purely commercial rates with the highest risk of losses being absorbed by a subordinated funder – which they saw as a possible role for Government. Since our field work was completed in early summer 2008 the risk appetite of banks to take exposure to non prime assets has shrunk further making the prospect of bank funding on commercially acceptable terms more remote.

Given the lack of track record on lending in this way to this sector of the sub-prime market, a pilot demonstration programme would be essential to achieve the level of reassurance the commercial lenders would need on the ability to earn a commercial return comparable to those available in the market today – though this would not, of course, guarantee involvement.

To be able to obtain any detailed, reliable information on payment patterns and credit risk expected under this model, the pilot scheme would have to replicate the full scale model. To do this, funding would be needed to build the infrastructure and supply the capital to lend. Based on our discussions with the market participants, it would be difficult to attract funding from the private sector for this pilot. We understand that primary legislation changes may also be needed to run a pilot scheme.

## 1.2 **Distribution**

The distribution of loans is the method by which the borrower gains access to the lender. To achieve the national distribution that the scheme requires through conventional means would require either the building of a branch network (at significant capital cost) or the use of current network providers such as the banks, Credit Unions or other providers.

Building a network would carry a high cost and potentially be a very inefficient use of resources. The use of existing networks has a number of disadvantages. The banks and building societies we spoke to have no appetite to become part of the distribution network of an expanded scheme. The use of Credit Unions within the model does make logical sense, however, issues with national coverage, scalability and current statute severely limits their participation in practice.

The use of door-to-door style distribution and collection would be ideal given the profile of the likely borrowers but the cost of such a distribution channel would be impossible to absorb within the affordable interest rate assumed within the model (limited to 2% a month in line with the limits maintained on Credit Union lending).

To deal with these issues, the operational model we propose assumes continuing distribution for those on benefit via the Jobcentre Plus with the use of call centres and internet distribution for new classes of borrower. It is acknowledged that this will in itself lead to additional issues of increased bad debt.

## 1.3 **Administration**

The administration of the model includes all the day-to-day activities that would need to be completed to set up new loan accounts and manage the customer relationship.

To allow for minimal set up cost and an ability to obtain the correct experience in the minimal time possible, all aspects of the day-to-day operation could be outsourced. There are a number of outsourcers in the UK market who have the skills to manage an unsecured loan book of this nature, a number of which are already using similar operational models to this.

Additional loan approval procedures would need to be introduced above and beyond those currently adopted by the DWP to help reduce the bad debt risk noted above. Ideally these would include detailed credit and affordability checks; however, the majority of data currently held comes from the mainstream financial institutions. A high proportion of the population that would be lent to under this model would not necessarily be active within the mainstream consumer borrowing market and it is therefore highly unlikely that they would be captured on current credit databases. The larger of the licensed Home Finance Companies do now register information on their client base with credit bureaux; however, this data will not be able to be utilised for another two years and would always exclude borrowings taken out within the black market.

To address the limitations in current data, we propose a number of face to face approval checks that could be carried out and have suggested that one possible route through which these checks could be carried out is the Post Office Counters business.

A potential area where the current data may be of use is in fraud prevention, credit impairment and over indebtedness checks.

## 1.4 Collections

The collections process is important not just to ensure maximum cash flow but also in managing the bad debt risk. The key to a successful collection model is to make it as efficient as possible whilst maintaining the level of customer contact needed to contain bad debt risk.

As noted above, the use of door-to-door collection would be ideal; however, the cost of such a collection channel would be too much to sustain the affordable interest rate assumed within the model.

The current Budgeting Loan Scheme uses a process by which a borrower's loan repayments are taken from their weekly benefit payments prior to the payments being made (a process which is assumed to be maintained under the proposed new model). Deduction from source in this way has the advantage of reducing bad debt risk as cash is collected prior to benefits going to the borrower. The real bad debt risk in this scenario is therefore limited to those borrowers that move from receiving benefits to waged income. In this circumstance, collections can no longer be made from source and control of payment therefore passes to the borrower.

By far the most cost efficient way of collecting payments from those on low income is via direct debit from the customer's bank account. For this process to work, the borrower would need to possess a bank account with a sort code and account number. This would exclude people who are unbanked, although all of the high street banks currently offer basic bank accounts that support the use of direct debit payments and the model could act in a positive way to encourage people to engage with mainstream financial services.

It was noted by all market participants that the expected levels of bad debt that would be experienced using a remote collection method such as direct debit would be significantly higher than that seen in door-to-door collection. To date, there are no large scale retail lenders using a direct debit collection model to this socio-economic group and therefore insufficient data to show what increase in bad debt losses could be expected.

If a method of large scale collection from source could be found for those borrowers on low wage income, the bad debt profile of the loan book could be substantially reduced and the model would become far more commercially viable.

## 1.5 **Bad debt and recoveries**

The key dynamic in this model will be the level to which bad debt can be kept to a minimum. As detailed above, the model assumes the continued collection from benefits which will limit the levels of bad debt on borrowers on benefits; however, estimating the level of bad debt on borrowers in low income is more difficult as there are currently no retail lenders advancing loans to this socio-economic group in this way.

Using publicly available financial information we have compared the bad debt ratios of various sub-prime lenders in both the credit card and other unsecured lending market. This shows that bad debt ratios range from circa 5% on the near prime credit card providers to 20% to 30% for the Home Finance Companies. Further to this as part of our market participant meetings we confirmed that the levels of bad debt experienced in different segments of the sub-prime market can vary considerably. Bad debt at the higher end of this range would not be sustainable on an interest rate that would be considered affordable by the DWP.

As mentioned previously, running a pilot scheme would allow for detailed, reliable information to be collected on the levels of bad debt that could be expected under this model.

## 1.6 **Base case model**

A financial model has been built that takes into account the most practical or attainable features of each area of the operational model. This Base Case model currently shows that the operational model would not be a financially viable option, by which we mean the operation would be loss making and therefore would not be attractive to private sector participation.

Various other scenarios and sensitivities have been run on the financial model to demonstrate the underlying drivers of performance. The two most significant drivers are the monthly interest rate charged to borrowers and the bad debt rate.

Section 11.3 shows under which scenarios of interest rate payable by the borrower and bad debt rate experienced the model would be financial viable or non-viable.

If the monthly interest rate were to increase to 3.0% per month (APR of 42.7%) then the financial model would be viable. The break even point is circa 2.7% per month (or 37.7% APR).

If the bad debt rate were to remain to below 10%, once again, the financial model would become viable. The break even point is circa 9% bad debt write-off.

## 1.7 **Potential next steps**

One of the key deficiencies within the market is the level of data available to support a business model of this type. One potential way of obtaining this data would be via a pilot; however, this may require primary legislation change and would therefore be a significant undertaking. If a pilot were to be considered then we suggest a detailed business case would need to be prepared in advance of any commitment to a pilot scheme.

If a pilot were to be run, then it would be important that it was set up to collect data that was statistically valid and could be used to build robust scorecards to enable better prediction of the payment patterns within this type of lending.

A further area of data deficiency is in the data being currently supplied to the credit reference agencies. We acknowledge the progress made in requiring the larger Home Credit Companies to supply data to the agencies; however, certain market participants believed that if data on Post Office Card Accounts were also shared, this could significantly improve the use of income verification and credit and fraud checks in the underwriting processes.

Finally, further investigating ways of collecting loan payments from source could significantly improve bad debt rates and therefore make the model more commercially viable.

## **2 The objectives of the Department for Work and Pensions**

The objectives of the Department for Work and Pensions ('DWP') in commissioning this study were to identify and explore possible alternative models whereby the private and third sectors might work in partnership with the Government in delivering a reformed and expanded version of the Budgeting Loan Scheme.

Any model must aim to provide reasonable access to credit on a consistent national basis to people on income related benefits and to people on low earnings and other forms of low income. It must also make provision for access to debt/money management advice and access to information on financial services and savings products.

### **2.1 Key objectives**

- i. To determine whether it would be feasible to develop a public private partnership model whereby sufficient external capital would be invested to increase capacity for lending to financially excluded people beyond that currently provided by the Social Fund Budgeting Loan Scheme;
- ii. To assess the capacity of the third and commercial financial sectors to work in partnership with DWP to deliver a reformed Social Fund Budgeting Loan Scheme; and
- iii. To show how any feasible model could be implemented nationally to offer a consistent service across Great Britain; and the extent to which it could impinge on or compromise current policy initiatives such as the Growth Fund affordable loans, and the fit with wider Social Fund and with welfare to work objectives.

## 3 Introduction

### 3.1 The issue

The DWP currently provides significant numbers of loans to those on benefits through both the Budgeting Loan Scheme (which made just under 1.3 million loans during the 2006/07 financial year with a total value of approximately £590 million), and the Crisis Loan Scheme (which is outside the scope of this study). However, the Budgeting Loans scheme is cash limited and demand on it is high. The DWP has asked that the study should be based on an assumption that no additional resources would be made available.

The scheme is open only to those on benefits (being those in receipt of income based Jobseeker's Allowance or Pension Credit for a minimum of 6 months) when the loan is requested. The policy intention of the current scheme is to provide these people with a fair, simple, non intrusive loan scheme to meet intermittent or unexpected expenses.

The DWP seeks a more ambitious programme that can provide support to a wider range of low income borrowers, and provide an affordable and responsible alternative to doorstep and other high cost lenders.

By its nature, lending to economically disadvantaged borrowers is costly for the borrower and often only available from organisations outside the mainstream retail banking business. A successful model will have to reconcile the higher risk profile of the borrowers, not just those on benefits, and potentially high administrative cost of the scheme with a sufficiently low-cost source of flexible finance so that the scheme can generate genuine economic and social benefits.

### 3.2 Background

There are already a number of entities that provide funding in various ways to low net worth borrowers. Of these the Credit Unions most closely match the profile that the DWP is seeking for any new arrangement; but no single Credit Union offers the depth of funding capacity, or national coverage that would be required to achieve the DWP's objectives. Further, there are large geographic areas of the UK where there are currently no Credit Unions at all.

A number of private sector businesses currently service this market, but tend to have high cost, labour intensive business models or rely on higher than market prices for goods supplied or expensive warranty or service agreements to provide additional margin to offset high bad debt costs. Barriers to market entry are perceived to be high and management of scale issues are difficult for a national, or even super-regional, business.

A number of market participants have withdrawn from this sector, for example Park Group Plc, in the early years of this decade. The successful businesses that remain are typically regionally based, although Provident Financial Plc, Cattles Plc and Brighthouse have successful National businesses. Several credit card based lenders have moved

towards this market but retreated as a consequence of rising bad debt and regulatory pressures over charges that impacted the profitability of their business models.

There remains some private sector interest in entering the market if lower cost business models can be identified, and more importantly, where funding can be obtained.

### 3.3 **Aims and objectives of the research**

Against this background, our research has sought to build on other research of the recent past. Our aim was to develop a business model for delivering an expanded Budgeting Loan Scheme and to test the viability of this model via market participant interviews and detailed financial modelling.

This research was completed to provide:

- A high level operational model for running the expanded scheme with alternative models where appropriate (i.e. for funding, distribution etc);
- A commentary on all aspects of the operational model;
- A financial model based on a set of base assumptions;
- A range of financial outcomes following sensitivity analysis on the key areas of the financial model; and
- A commentary on the capacity and willingness of third and private sectors to work in partnership with the DWP to deliver a reformed social fund scheme.

This analysis is set in the context of the current national unsecured lending market (both term loan and revolving credit) and discusses the potential impact of the ‘credit crunch’ on the overall funding of the model.

### 3.4 **Research methods**

The research comprised five stages:

#### **Stage one: Initiation and mobilisation**

This stage comprised a literature review and a series of meetings with the DWP to confirm our understanding of the research completed to date, confirm the proposed approach to the following stages of the project and to help develop a list of key market participants to be interviewed for the study.

#### **Stage two: Survey the market**

Following identification of potential market participants, a full list of which can be seen in Appendix A3, we had discussions with them to understand the following:

- The size and shape of the potential market opportunity as perceived by existing participants;

- Current market processes, their benefits and areas for potential improvement;
- Obstacles to market entry in the present environment; and
- Conditions under which participants may be interested in supporting a new model.

The market participants were selected from a range of sub-sectors within the financial sector and were interviewed via the use of both face-to-face and telephone based in-depth structured interviews.

Our work in this stage sought to identify the key economic, service and access drivers of success in structuring a commercially viable solution which would be capable of meeting the DWP policy objectives. In identifying these drivers we also drew upon KPMG's retail banking benchmarking databases which helped provide indicative costs for key banking and credit processes.

### **Stage 3 - Develop Straw Men models**

Using the results of Stage 2 as their foundation, a series of innovation workshops were run to identify alternative business models that may be viable for the private and third sectors to work in partnership with the DWP ('straw men' models). In creating the straw men consideration was given to consistent national delivery and impact of existing policy initiatives. The model development work also sought to identify any specific market failures that provide a justification for DWP involvement/intermediation.

Using the drivers of success identified in Stage 2 together with data from the cost benchmarked databases we then created high level straw men models for each viable alternative. These models formed the basis of our subsequent market testing discussions.

### **Stage 4 – Test**

The straw men developed in Stage 3 were then tested with market participants to gauge their view on feasibility and their potential interest in supporting each model in practice.

This was completed by sending the straw men in advance of a meeting with the key market participants and discussing their attractiveness for funding, delivery and investment. This stage was also used to obtain a clear understanding of any key obstacles or conditions to each model to help refine the options in a way that was likely to maximise their appeal to potential partners.

The results of the market testing were then collated together with testing of the concept via a workshop. The highest ranked straw man was then subject to a further level of scrutiny before moving to Stage 5.

### **Stage 5 - Refine and Conclude**

Taking the highest ranked straw man from Stage 4 and using the output of the market testing, the model was then refined it to make it as practicable and appealing to the market as possible. The target operating model for the straw man was then developed in

more detail, including an indicative implementation timetable and identification of key partners.

A financial model for the straw man was also developed and stress tested for differing volume and economic outlooks. This provided key financial metrics for the model.

### 3.5 **About this report**

Section 4 of the report draws from market analysis and the market participant meetings to outline the key market dynamics and processes and also to identify the key obstacles to the market and development of a new model.

Sections 5 to 10 then draw on the information collected from the market participant meetings and outline a suggested operational model. This is based on the practical issues and perceived requirements of the market participants which are then discussed in more detail.

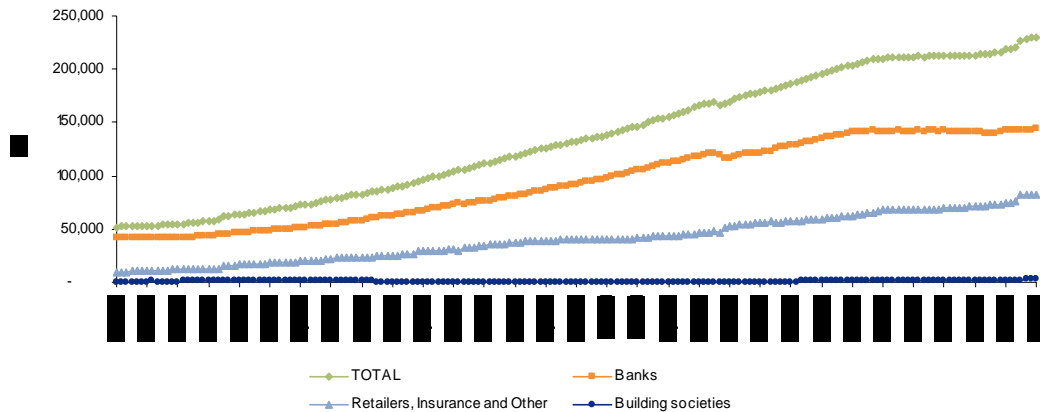
Section 11 outlines how the operational model has been reflected in a financial model to come up with a Base Case financial model output. This Base Case has then been tested for other possible operational scenarios and also sensitised for the key financial assumptions.

## 4 The market

### 4.1 Size and shape of the market

It is a well documented fact that the level of unsecured lending in the UK has been rising since the 1990's with a record £229bn of personal unsecured lending outstanding as of April 2008<sup>1</sup>. Figure 4(a) below shows the growth in lending from 1993 to date and figure 4(b) the split between credit card and other consumer lending.

Figure 4(a) Unsecured lending (April 1993 to April 2008)

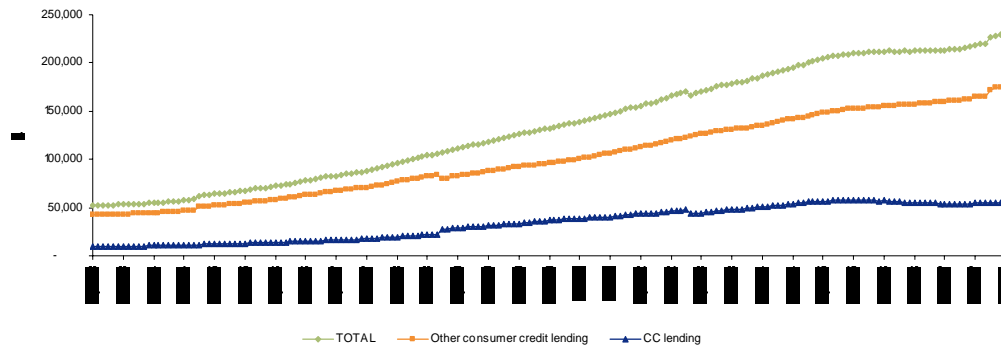


The banks have traditionally been, and continue to be, the largest of the sectors participating in unsecured personal lending with a commanding 63% of the market by value in April 2008 (building societies 1% and other lenders 36%). The growth in non-bank lenders has been a significant feature of the growth in the market over the last 15 years.

The growth in other lenders has been brought about by a number of new entrants to the market attracted to the high levels of return seen throughout the buoyant late 1990's and early 2000's. This was due to the perceived improvements in credit scoring and modelling which theoretically allowed a greater understanding of who to lend to and how. These high returns were also achievable due to the low cost of borrowing, improved technology reducing cost structures, the stable economic conditions and low unemployment leading to a consumer boom.

<sup>1</sup> Bank of England: Statistical Interactive Database

Figure 4(b) Credit card versus other consumer credit lending (April 1993 to 2008)



## 4.2 Current market participants

Naturally, the majority of the personal unsecured lending in the UK which is written by the banks and building societies is concentrated to those with good or fair credit ratings.

The sub-prime lending market is more fragmented in terms of both product offering and product provider. Whilst the mainstream lenders are also active at the top end of the sub-prime market, usually through separately branded products such as HFC Bank (part of the HSBC Group) and First Plus (part of the Barclays Group though closed down to new business in July 2008), there are a number of specialist and regional lenders working in the lower end of the sub-prime market. In addition to these ‘traditional’ style lenders are a number of lenders using different products, distribution and collection processes briefly detailed below.

### 4.2.1 Home Finance Companies

The Home Finance Companies use a network of offices and local agents to both lend and collect money door-to-door. They specialise in lending small value loans with a typical value of less than £500, which tend to be lent over a short period of three to six months. The collection amounts and periods are typically very flexible, an element of this type of lending that the borrowers find attractive as it allows them to manage their cash flow on a weekly basis without additional fines or penalties for missing payments. A key aspect of the door-to-door lenders is that they will lend small amounts to begin with and only build those up as and when a good payment history is established. The largest participant in this market is Provident Financial who has an estimated 1.65 million home credit customers<sup>2</sup>; however, other participants include Cattles plc (through Welcome Financial Services) and London Scottish Bank.

### 4.2.2 Pawnbrokers

Pawnbroking is a well established form of borrowing with the National Pawnbrokers Association having been in existence since 1892. Pawnbrokers lend to individuals who

<sup>2</sup> Provident Financial plc: Annual Report & Financial Statements 2007

have property they can ‘pledge’ or use as security for a loan. The property tends to be jewellery as it is easy to value, store and sell in a second hand market should the loan not be repaid.

The loan values tend to be small (with the main participants offering loans from £5 upwards) and the credit agreements tend to be six months in duration with options to extend beyond that time.

Once all capital and interest is repaid, the pledged item is returned to the borrower. Where the repayments are not met, the pledged item is sold and any excess cash made over and above the amount owed to the pawnbroker is passed back to the borrower.

#### 4.2.3 **Sale and buy back**

Another product similar to that of pawnbroking is sale and buy back. This product is not a credit agreement regulated by the Consumer Credit Act 2006 (‘CCA’) as it works differently to a normal credit agreement. A ‘borrower’ will sell items of property to the company, who in turn will give the borrower the right to buy it back in the future at the same price plus a fee.

These products are often offered by the larger Pawnbroking companies such as Cash Converters and Cash Generator.

#### 4.2.4 **Cheque cashing and payday loans**

Cheque cashing and payday loans are offered by a variety of national, regional and local companies, sometimes alongside other credit products, such as pawnbroking and sale and buy back.

Cheque cashing is used to allow individuals instant access to cash where they have a cheque which has not yet been banked. The company will cash the cheque instantly in return for a fee (usually a percentage of the amount being obtained).

Payday loans work in a different way. Where a borrower needs cash but will not be paid for a number of days (typically up to 28 days), the company will give the borrower cash on receipt of a personal cheque which they agree not to present until a set date. Once again, a fee is charged for the service.

#### 4.2.5 **Mail order**

Another form of credit in the sub-prime sector is mail order goods. Whilst these products are seen as being interest free, the price paid over a period of time is normally higher than that seen on the high street.

### 4.3 **Obstacles to market entry**

There are a number of obstacles to market entry, some of which are more specific to this particular sub-prime market. Each is dealt with in more detail in later sections of the report; however, a brief description of the key barriers is given below.

#### 4.3.1 **Funding**

The main obstacles to entry in this market currently reside around funding any sub-prime lending. The recent liquidity crisis in the banking sector, widely acknowledged to be as a result of losses being made on securitised US sub-prime mortgage assets, has led to the large commercial and retail banks rationing their lending and, in some cases, withdrawing from the sub-prime sector.

#### 4.3.2 **Debt collection**

The companies that are currently successful in this market all use door-to-door collection methods. Our market participant discussions made it clear that most felt that this form of collection was the only form that would work in this sector.

This causes a barrier to entry in two ways; firstly as it would require a national network of offices / collection agents to be set up and secondly as the cost of running such a network would not be sustainable on an interest rate of 2% per month. This is discussed further in the collections section of the report.

#### 4.3.3 **Bad debt**

Part of the reason that it is believed that door-to-door collection is the only collection method which works in this sector is the level of bad debt experienced. The Home Finance Companies experience bad debt rates of circa 20% and a number of the market participants believed that where a remote collection model were used, the bad debt rates could exceed 30-35%. Finding a way to maintain lower levels of bad debt whilst using low cost methods of collection is therefore critical in funding a model that can work at lower levels of interest rate. This is therefore a key barrier to this market.

#### 4.3.4 **Data availability**

There is a general lack of data available on the borrowers in this sector which has come about for a number of reasons. Many of these individuals do not have mainstream borrowing or savings products and therefore the credit reference agencies do not have data on them. This issue is made worse as historically the Home Finance Companies have not shared data on their borrowers (a practice which has recently changed) and bank accounts such as the Post Office Card Account also do not share data with the credit reference agencies. As many people in this sector do not own their own house, they can be more transient and so may not be registered on the electoral roll.

This lack of data leads to two barriers to entry; firstly it makes the borrowers difficult to credit check and secondly, more data on bad debt losses and payment patterns is needed to obtain the funding for the model. These are discussed in more detail in the Administration and Financing sections of the report.

#### 4.3.5 **Switching propensity**

Research completed by the Joseph Rowntree foundation showed that borrowers liked the ease of access and uncomplicated application forms / procedures of the current forms of credit offered. They also enjoyed the flexibility of the loans and the ability to be able to

pay in cash, weekly and from home. Familiarity was also mentioned as a reason for the appreciation of home credit in particular<sup>3</sup>.

This leads to the borrower’s propensity to switch products to be low even where advantageous interest rates are offered as cost is not the key differentiator for this sector.

Assuming that a new model could be funded, barriers still exist in the form of well established market participants who have networks in place, and more importantly, have the trust of the customers.

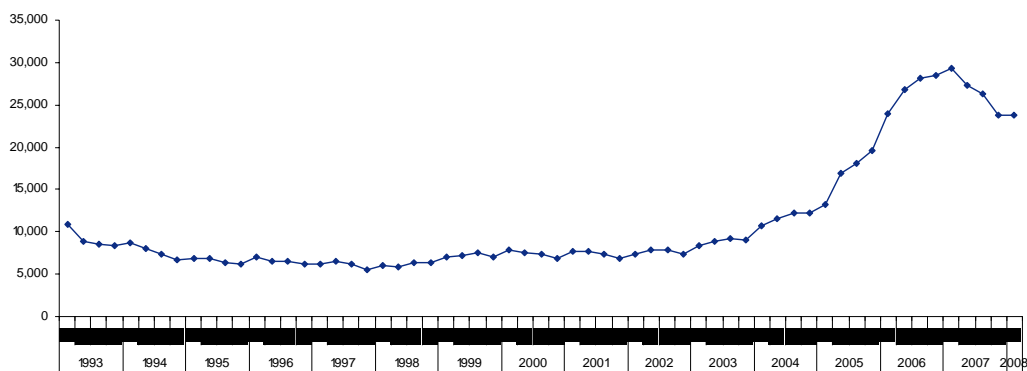
#### 4.4 Supporting a new model

The objectives of the DWP with regard to Social Fund Reform are outlined in section 2 of this report with the aim of an expanded scheme to cover people on low earnings as well as those on income-related benefits. In addition, demand on the current budgeting loan scheme is high. This, coupled with the wider financial inclusion objectives of the Government and the research done to date, suggests that the market could support a new product from a demand perspective.

This excess demand will be exacerbated by the general slow down in lending and tightening of lending criteria seen in the market since the ‘credit crunch’.

Additionally, recent trends in bankruptcy and individual voluntary arrangements (‘IVA’) show that more people are getting into financial difficulty (see figure 4(c) below). This would indicate that the number of people that could require credit outside of the mainstream credit providers could be growing.

**Figure 4(c): Individual insolvencies in England and Wales**



<sup>3</sup> Affordable Credit, Sharon Collard and Elaine Kempson, The Joseph Rowntree Foundation, 2005

## 5 The operational model

### 5.1 Overview

The key to a successful business model is to reduce operating costs through automation, whilst at the same time minimising bad debt costs. These two objectives are not mutually exclusive as our discussions with the market participants highlighted that more extensive knowledge of the end consumer and more intensive client contact and management are both key to reducing the ultimate bad debt losses incurred.

In developing the model, consideration has been given to balancing the cost of delivery with the cost of default and to balancing the key economic, service and access drivers needed for commercial viability model. At the same time, the model must also be capable of meeting the Government's policy objectives.

To achieve this, the financial model has been designed to be sufficiently flexible to allow the 'testing' of different scenarios, both operational and economic. Additionally, whilst the outline operational model takes into consideration the sometimes conflicting requirements of both the public and private sectors, it will not necessarily meet the idealistic requirements of all the stakeholders involved.

This section of the report outlines the core operational structure of the model and investigates the potential governance and contractual relationships the model would require. The following sections of the report then consider in detail the various processes throughout the lending cycle and how they fit in to the overall model.

In developing this model, a number of core assumptions have been made as follows;

- i. Interest rate a maximum of 2% per month: The rate was set at a maximum of 2% per month, in line with the current maximum rate Credit Unions can charge.
- ii. Market size of £2bn: Sizing the market opportunity is challenging to determine due to the fragmented nature of the market and lack of data. We have assumed that a market size of £2bn would be achievable based on the current Budgeting Loan Scheme (assuming that 100% of applications were accepted) and doubling this to take account of those on low income (i.e. assumes that the increased coverage of the new scheme would mean demand that over time would be more than double that for the current Budgeting Loan Scheme). This is supported by the Office of Fair Trading estimates for the size of the home finance market in 2004, also £2bn, in their response to the super-complaint on home credit made by the National Consumer Council.
- iii. Benefit recipients will continue to have their loan payments deducted at source.

Due to the restrictive interest rates that can be charged, more emphasis has been placed on developing an operational model with low overhead cost to ensure that the lending is

as affordable as possible, as opposed to building a model that concentrates purely on bad debt reduction (i.e. a standard door-to-door model). Where possible, bad debt risk mitigating points learned from the door-to-door model have been built in to the operational model where the incremental cost can be contained.

## 5.2 Summary organisational structures

### 5.2.1 Multi-supplier model

Our outline business model has been devised to ensure that, where possible, the key operational features of the Budgeting Loan Scheme are retained to the extent that they offer a real benefit to the overall structure. These have been overlaid with a structure that encompasses commercial practices commonly used within the unsecured lending sector to help promote a more attractive financing proposition, minimise administration cost and maximise debt collection.

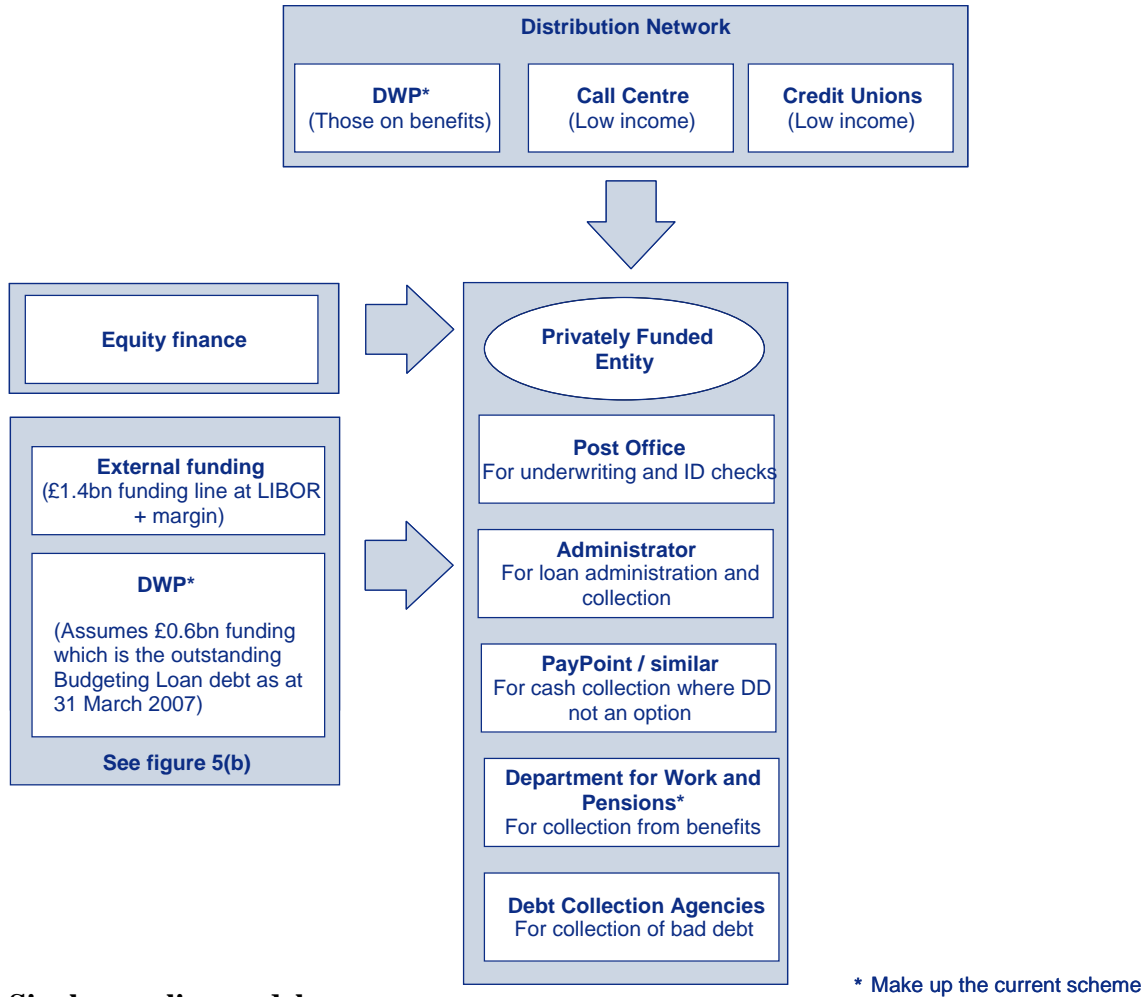
For purposes of the study (and the model) we have assumed that the distribution of loans through Jobcentre Plus and the collection of payments from the benefits system will continue for people on benefits.

The crucial commercial element of the outline model is that the loans become interest bearing and the target consumer market is expanded beyond those on benefits with the collection of payments in the control of the DWP. To enable this expanded model to work additional distribution, administration and collection capacity needs to be added to the current Budgeting Loan Scheme. This infrastructure would include:

- A call / internet contact centre to act as an additional distribution route and customer contact centre;
- Enhanced credit scoring / lending decision policies to help reduce bad debt;
- Third party outsourced loan administration;
- Third party collection mechanisms for those unable to make repayments by way of direct debit ('DD') payments;
- Third party debt collection mechanisms for the recovery of bad debt; and
- Crucially, additional funding from the private sector and structures in place to accommodate this.

Figure 5(a) shows a diagrammatic overview of the business model. For the remainder of this report, this will be referred to as the Privately Funded model ('PF model') or entity ('PF entity').

Figure 5(a) Overview of the business model



5.2.2 Single supplier model

The multi-supplier model assumes that different elements of the model are delivered by those currently best placed to do so, using current infrastructure and skill sets.

An alternative version of the model could be to use a single supplier to deliver as many parts of the model as possible to help reduce the complexity of the model. This could lead to a longer set-up period and higher set-up cost as no one organisation would currently have all areas of the model in place.

Two market participants, Post Office Counters and A4e, expressed an interest in supplying the whole model and the advantages and disadvantages of this are discussed further in the relevant sections of this report. The diagrammatic overviews of the PF model assuming single supplier models such as these can be seen in appendices A4 and A5.

Both companies would still need to raise finance for the model. Currently, Post Office Counters do run the Post Office Card Account ('POCA') which could be used to help

fund the model through the use of balances in the accounts (i.e. a simplistic banking model). This would need to be investigated further following the current tender for the running of the POCA scheme post 1 April 2009.

### 5.3 Funds flow and securitisation

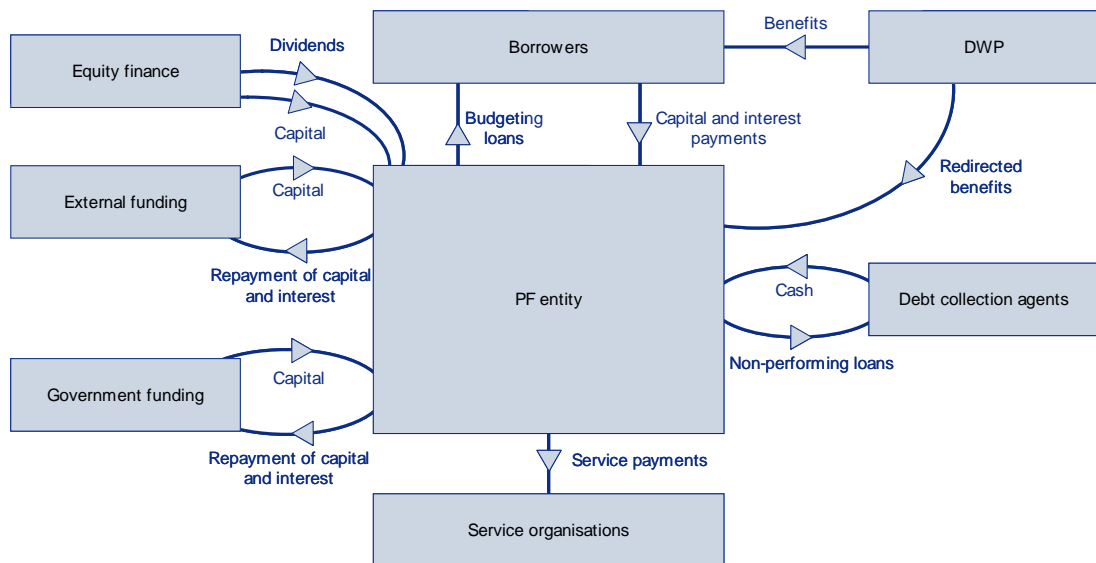
One of the most challenging areas of the PF model has been finding a way to make the proposition a viable investment opportunity for the potential retail and commercial banking partners given the current economic climate.

To ensure any PF entity was appropriately arm’s length from Government, it would need to be majority owned by a private sector entity. This could be achieved through the use of minimal amounts of equity being subscribed by those who would be acting as either infrastructure or funding providers. As equity finance is more costly than debt, the funding situation would need to be heavily weighted to lower cost debt options to ensure the overall cost of funding is kept to a minimum (i.e. have small amounts of the more costly equity finance and large amounts of the cheaper debt finance).

The market participants identified that for the debt financing of the model to be a success, the level of security, risk and return on the debt being offered would have to be comparable to those currently seen in the commercial markets. The impact of this from a commercial and operational point of view is considered in detail later in this report.

The funds flow diagram in figure 5(b) shows how the funds would flow around the PF model.

**Figure 5(b) Funds flow via direct funding**



## 5.4 **Governance and contractual relationships**

The governance mechanism put in place within the structure would be the main tool by which the policy objectives of the Government will be managed. Alongside this, the commercial aspects of the model will then be managed through a series of contractual relationships with the various financing partners, service organisations and suppliers. Additionally, the mechanisms and tools by which the end consumer experience is managed will be via a detailed service level agreements ('SLA's) with the service organisations governed ultimately by the regulation set out in the Consumer Credit Act ('CCA').

For the business model to deliver successfully the policy objectives of the Government and remain commercially viable, care will need to be taken to ensure that all governance and contractual relationships are well defined from the outset.

### 5.4.1 **Governance and control**

The governance and control structure within the PF entity would be primarily in place to take responsibility for the following;

- Monitor the third party administrator ('TPA');
- Maintaining funding of the entity;
- Maintaining the credit quality and debt portfolio; and
- Set the strategic objectives of the scheme.

As such, the structure could be kept to a minimum number of both executive and non-executive directors on the Board as set out in figure 5(c).

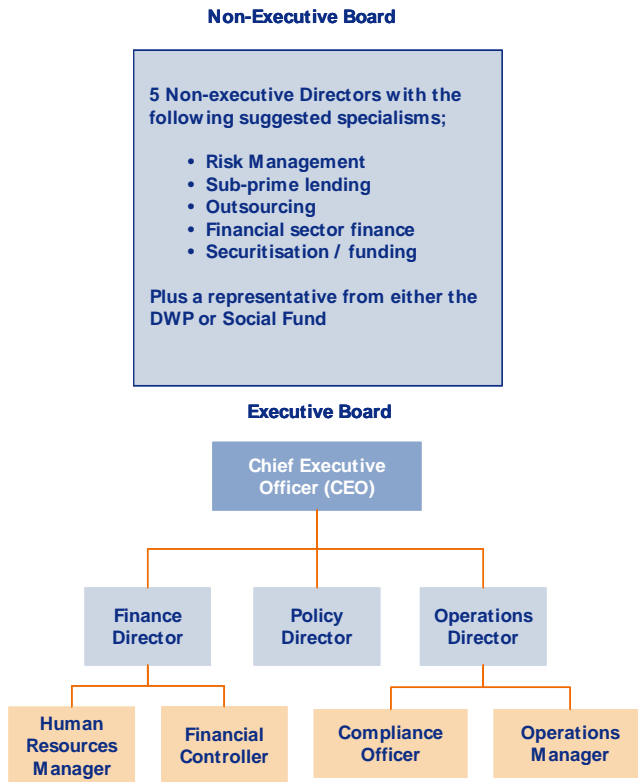
Whilst it is not envisaged that the PF entity would be a listed company, given it would be a public interest entity by virtue of the perceived or actual Government involvement, it would be considered prudent for the PF entity to apply the best practice guidelines of the Combined Code.

As such the Board would be expected to comply with the following principles:

- i. The Board should be effective in ensuring the success of the PF entity. As such it should set the strategic direction of the entity and ensure there is sufficient financial and human resource to meet these objectives. This includes the continued challenge, scrutiny and development of the entity's strategies, people and processes.
- ii. There should be clear division of responsibilities, specifically between the executive and non-executive directors and between the Chairman and Chief Executive.
- iii. The Board should have a good balance of both executive and non-executive directors in terms of both numbers, skills and experience.
- iv. Procedures will need to be in place for the transparent appointment, development and performance evaluation of the Board, its sub-committees and individual directors.

Further consideration would also need to be given to the principles surrounding remuneration of directors, accountability and audit and the relationship with shareholders.

**Figure 5 (c) Governance structure**



In addition, further control measures would be needed in terms of a Money Laundering Reporting Officer, internal and external audit and compliance. The later three of these could be outsourced, however, the Money Laundering Reporting Officer would need to be one of the management team (potentially the Compliance Officer).

**5.4.1.1 Financing**

The initial financing of the PF entity would be via equity investment, in which case the Articles of Association and Memorandum of the PF entity would become the main contractual relationship.

Where an equity partner then leveraged the initial equity of the PF entity via some form of debt financing, the contractual relationship would vary depending on the type of financing raised. This is explored in further detail in the financing section of the report.

**5.4.1.2 Out-sourcing arrangement**

The PF model is based on the premise that the PF entity itself is very ‘thin’ in terms of the staffing and level of day to day activity. Whilst the governance structure is retained

within the PF entity, all day to day management of the loan portfolio will be outsourced to a TPA. This will be done via a master service agreement which includes detailed SLA's to which the administrator must adhere (usually motivated through a series of financial rewards for achieving certain standards). The main role of the governance structure is therefore to monitor the performance against the SLA's and set the strategic direction for the entity, and in doing so, the activity of the TPA.

#### **5.4.1.3 Sub-contact and servicing arrangements**

A number of sub-contract or servicing arrangements are then entered into by either the PF entity or the TPA to supply specific services to the PF model via normal commercial contracts. These are considered in more detail in the contractual relationships section below.

#### **5.4.1.4 Debt collection agents**

These are considered in more detail in the contractual relationships section on the next page.

Where debt is sold to a debt collection agents ('DCA's') as opposed to having the debt collected on behalf of the PF entity for a fee, the legal title of the debt will pass to the DCA as opposed to remaining with the PF entity. This is explored further in the Bad debt and recoveries section of this report.

#### **5.4.1.5 Executive Board**

The Executive Board will need to consist of the following key people:

- i. Chief Executive Officer – responsible for the overall running of the PF entity.
- ii. Finance Director – responsible for the financial reporting and control of the PF entity and the Human Resources.
- iii. Operations Director – responsible for the infrastructure and management of the various out-sourced activities as well as the overall compliance with the relevant legal and regulatory aspects of the entity.
- iv. Policy Director – responsible for the distribution of the loans including any sales and marketing activity and communication with Government around public policy and financial inclusion.

#### **5.4.1.6 Non-Executive Board**

The Non-Executive Board would consist of up to five non-executive directors with both Government policy and industry expertise to help set the strategic direction of the PF entity from both a policy and a commercial perspective.

The non-executives would need to include a Chairman, who is responsible for the leadership of the Board, and an independent non-executive director.

## 5.4.2 Contractual relationships

The key contractual relationships needed within the structure can be seen in table 5(e) below. The contractual relationships can be segmented into three main areas as follows:

*Table 5(e) Key contractual relationships*

| Financing                               |  |
|---|--|
| Finance type                            | Key contractual relationships  |
| <b>Equity</b>                           | <ul style="list-style-type: none"> <li>● Equity subscription agreement</li> </ul>                                      |
| <b>Financing</b>                        | <ul style="list-style-type: none"> <li>● Loan agreement</li> <li>● Security documents</li> </ul>                       |
| Outsourcing arrangement                 |  |
| Partner                                 | Key contract   |
| <b>Loan administrator</b>               | <ul style="list-style-type: none"> <li>● Service contract</li> <li>● Service level agreement</li> </ul>                |
| <b>DWP</b>                              | <ul style="list-style-type: none"> <li>● Service contract (distribution)</li> <li>● Service level agreement</li> </ul> |
| <b>DWP</b>                              | <ul style="list-style-type: none"> <li>● Service contract (collections)</li> <li>● Service level agreement</li> </ul>  |
| Sub-contract and servicing arrangements |  |
| Area                                    | Key contract   |
| <b>Post Office Counters or similar</b>  | <ul style="list-style-type: none"> <li>● Service agreement (for ID checks)</li> </ul>                                  |
| <b>PayPoint / Post Office Counters</b>  | <ul style="list-style-type: none"> <li>● Service agreement (for cash collections)</li> </ul>                           |
| <b>IT supplier</b>                      | <ul style="list-style-type: none"> <li>● Service / maintenance contract</li> </ul>                                     |
| <b>Software supplier</b>                | <ul style="list-style-type: none"> <li>● Licence agreements</li> </ul>   |
| <b>Debt collection agents</b>           | <ul style="list-style-type: none"> <li>● Debt sale agreements</li> <li>● Debt collection agreements</li> </ul>         |
| <b>Credit checking agents</b>           | <ul style="list-style-type: none"> <li>● Service agreement</li> </ul>  |

## 5.5 State Aid

State Aid is generally prohibited under European legislation, although the Treaty leaves room for a number of policy objectives for which State Aid can be considered compatible. Within the context of Article 87(i), State Aid has four characteristics:

- i. ***It is granted by the state or through state resources.*** *State resources includes public funds administered by the Member State through central, regional, local authorities or other public or private bodies designated or controlled by the State. It includes indirect benefits such as tax exemptions that affect the public budget.*
- ii. ***It favours certain undertakings or production of certain goods.*** *It aids an undertaking, i.e. an entity engaged in economic activity. Economic activity is activity for which there is a market in comparable goods or services. It can include voluntary and non profit-making public or private bodies such as charities or universities when they engage in activities which have commercial competitors. It includes self-employed / sole traders, but generally not employees as long as the aid does not benefit the employers, private individuals or households.*
- iii. ***It distorts or threatens to distort competition.*** *It potentially or actually strengthens the position of the recipient in relation to competitors. Almost all selective aid will have potential to distort competition – regardless of the scale of potential distortion or market share of the aid recipient.*
- iv. ***It affects trade between member states.*** *This includes potential effects. Most products and services are traded between member states and therefore aid for almost any selected business or economic activity is capable of affecting trade between states even if the aided business itself does not directly trade with Member States. The only likely exceptions are single businesses, e.g. hairdressers or dry cleaners with a purely local market not close to a Member State border. The case law also shows that even very small amounts of aid can affect trade.<sup>4</sup>*

Examples of forms of state aid would include:

- Interest rate relief or preferential interest rates;
- State guarantees or holdings or guarantees of loans on especially favourable terms; and
- Indemnities against operating losses along with a number of other activities that could be seen as conferring an advantage of a financial kind or an undertaking.

Whilst this study has not considered in detail the complex and strict rules governing what would and would not constitute State Aid under Article 87(i) of the European Community (EC) Treaty, there is clearly a possibility that the rules could be breached and we would recommend a full legal review prior to implementation of any PF model. A full application to the European Commission would be needed.

## 5.6 Ethical considerations

A number of the market participants were interested in discussing the potential ‘moral hazard’ of participating in a scheme such as this. The main considerations centred around the charging of interest and fees, over-indebtedness, cross-subsidy and collection strategies.

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<sup>4</sup> The State Aid Guide, Department for Business Enterprise and Regulatory Reform, October 2007

### 5.6.1 **Charging of interest and fees**

Most market participants understood, and indeed agreed with, the concept of charging both interest on the loans and potentially late payment fees. There was, however, considerable debate around how this could be perceived by the general public.

As the loans are currently interest and fee free, a number of the market participants felt that there would be a significant reputational risk in moving to an interest bearing scheme as it could be seen as financially disadvantaging a section of society that is felt to be vulnerable. Whilst this is a significant risk predominantly to the Government, it was felt that being associated with any bad press surrounding the scheme would act as a disincentive to being involved.

### 5.6.2 **Over-indebtedness**

The issue of lending to sections of society that may not be able to afford to repay their loan was also seen as a potential reputational risk.

The PF model considers as part of the loan approval process the issue of over indebtedness and affordability; however, there remains a risk that borrowers could have debt that does not show on any credit rating agency databases that would not be taken into account. Additionally, borrowers could take further debt out subsequent to borrowing from the scheme or circumstances could change which could make the level of debt no longer appropriate. In these circumstances there would be an element of reputational risk to those involved with the scheme.

### 5.6.3 **Cross-subsidy**

Many financial services and other product offerings have an element of cross-subsidy whereby more profitable products allow for less profitable products to still be offered at competitive rates.

Within the PF model, the largest cost line is the bad debt loss. As the borrowers on benefits will continue to have their loan payments deducted from their benefits, it is likely that the bad debt losses experienced on these borrowers will be lower than those experienced on those borrowers on a low wage income. Perversely, this leads to the more financially disadvantaged subsidising those less financially disadvantaged.

Once again, from a Social Policy viewpoint, this leads to a moral hazard issue as the only way to rectify this would be through the differentiation of interest rates (i.e. charge higher interest to those on low income than to those on benefits). Whilst this could be implemented operationally, it could act as a disincentive for people to move from being on benefits into work. The calibration of differential rates (and the timing of transition from one rate to another) would have to be considered very carefully. This may be a subject that could usefully be explored during a pilot study.

#### 5.6.4 **Collection strategies**

The current PF model assumes that where bad debt reaches a certain age, it will be sold to a debt collection agent. The DWP's own collection department currently outsources some of its collection activity to debt collection agencies and so the practice of using these is not new.

However, a number of the market participants again expressed some concern over the reputational risk of using DCA's to collect from the financially disadvantaged. To overcome this issue, were DCA's to be used, the service level agreements would need to be drafted in such a way that the collection techniques used could not lead to reputational damage.

## 6 **Financing**

### 6.1 **Overview**

One of the key sensitivities in devising the PF model for this study was how to attract funding into the PF entity at a rate that was sustainable over the long term.

The appetite for the funding of unsecured retail lending in the UK market has abated significantly since the start of the credit crunch in July 2007. This effect has been felt most severely by the sub-prime lenders in the market and has resulted in a number of institutions either withdrawing from, or pricing themselves out of, the market.

At the same time, the securitisation market (the method by which large volumes of listed debt finance have been raised over recent years) has dramatically reduced as the large retail and commercial banks take stock of the assets they currently hold on their balance sheets. It is a reasonable supposition that the securitisation and debt financing markets will return but to what level, and at what price, is currently impossible to determine.

Against this background, generating enthusiasm for a purely commercial solution, with no Government input, has not been possible and the negative sentiment which pervades in the market has also undermined the attraction of funding from a purely social inclusion stand point.

The key to securing funding lines is to make the opportunity commercially attractive in line with, or better than, other opportunities in the market that compete for the same capital resource. There are two principal considerations that affect the likelihood of raising funds:

- **The Risk:** Providing verifiable, historically proven data to give confidence that the scheme assumptions work and the business model will be robust; and
- **The Return:** Pricing the debt to ensure it is attractive to the market and appropriately reflects the risk (incorporating the capital impact likely to arise from a particular structure under the Basel II regime, which is the regime by which certain banking entities must determine the level of capital they must hold based on the assets they have).

There are a number of ways to structure a potential funding solution and a number of markets to approach. There are ways to widen the spectrum of potential investors like arranging a formal listed instrument, externally credit rating the debt through a recognised ratings agency, accessing syndicated bank markets or through private placement to specialist investors. The remainder of this section explores the practical considerations in relation to the different funding models explored in our research.

## **6.2 Financial structure**

### **6.2.1 Understanding the risk profile**

The starting point of any funding structure is to understand the risk profile. In most default scenarios there is an element of recovery even if this does not enable repayment of all the original funding and hence there is a spectrum of higher to lower risk across the loan portfolio: equity; subordinated debt; mezzanine debt; senior debt. These levels of risk are matched by the level of return such that the most risky portion, the pure equity, should attract the highest return and the “safest” lending, the senior portion, the lowest.

Whilst conceptually the risk profile is understood the calibration of that profile is very difficult as there is a lack of historical data on which to build credible assumptions.

### **6.2.2 Equity & Subordinated Debt**

In discussions with prospective lenders it became clear that there was no appetite to provide equity. Even for those institutions for whom equity investment is relatively routine, the risk associated with the proposed fund would require very high internal rates of return. This would be at odds with the ethos of the social fund and not likely to be politically supportable. No bank was prepared to accept the risk to its reputation that could arise from making entrepreneurial-type equity returns from the poorest echelons of society.

The market participants were clear that they would expect there to be a level of seniority in any debt financing. In essence, there would need to be a lender who was prepared to take the ‘first losses’ (i.e. the bad debt losses arising on the worst borrowers in the loan portfolio) to a point where the risk and return on more senior levels of debt were comparable with those seen elsewhere in the capital / debt markets. This can be done via different debt mechanisms, however, the overall principal would be that there would need to be a significant level of subordinated investment (be it pure equity or subordinated debt). In the PF model the assumption has been made that this funding would come from a relatively small equity investment of £10 million (non-Government) and a subordinated debt provision of £600 million from Government in line with the current outstanding debt levels (as at 31 March 2007).

Given the risk of bad debts (discussed later in the report) this slice of funding will be at higher risk even after any pilot period has developed experience of selecting borrowers (i.e. identified the borrowers that would not be lent to as they were considered too high risk of leading to bad debts). Clearly a funding package with an element of Government risk capital could have implications for the public sector borrowing requirement, and the Government’s balance sheet, and this may not be palatable.

The remainder of the funding for the PF entity could then be priced at a rate which reflected the residual risk in the PF entity and would be more comparable with other sub-prime opportunities in the market.

## 6.3 Senior Lending

There are two principal funding sources for the senior debt portion; bank debt and bond finance.

### 6.3.1 Bank debt

The simplest form of bank debt, a bilateral loan, would involve a bank lending directly to the PF entity under a loan agreement signed by both parties. However, the size of the modelled senior lending is such that no bank in isolation would be prepared to accept the risk and would seek therefore to share the senior lending through a club deal or syndicated loan. These both involve a number of banks jointly lending to the PF entity under a single agreement signed by all parties, with the distinction being that a club is usually a smaller group of banks all of whom usually help to structure and negotiate the transaction. In a broader syndication a bank or group of banks would act as mandated lead arranger(s) (MLA(s)) to negotiate and underwrite the transaction before on-selling the loan to a wider group. The syndicate banks are presented with a fully structured deal and decide whether or not to join in the debt provision based on the information presented to them.

The information requirement would be dependent on the level of due diligence requested by the MLAs and participating banks and their respective credit processes. Typically this would be in the form of financial due diligence of the underlying loan book on which any finance was to be secured and operational due diligence around the policies and practices in place from agreeing the initial loans through to final collection of any bad debts. This would require detailed information on not just the track record of lending under similar schemes completed to date, but also some data on the type of competing lending which would typically be targeting the same low income borrowers.

A key concern is the lack of historical data to support the proposed model and this needs to be addressed in order to stand any chance of accessing the financial markets. This issue could be addressed through either or both of:

- The proposed pilot scheme to allow for detailed data to be collected. The feedback received from the institutions approached was that a minimum of two years data would be required; or
- A staged introduction of the offering to low income earners following a period of stable operation under an enlarged model of the current Budgeting Loans Scheme (i.e. a phased implementation).

The cost of setting up such a loan facility would be include a combination of upfront fees for the banks (arrangement, underwriting and commitment fees) and the cost of the various advisors that they would use as part of the due diligence process, namely financial, technical and legal.

By its very nature a new lending model is difficult to price as there is no direct market precedent. However for the purposes of the model created it has been assumed that up front fees total 1.0% and the interest margin is 2.5% above LIBOR along with initial costs of £0.5m to cover the professional advisor fees incurred in obtaining such a facility.

In the existing Budgeting Loan Scheme the Government funding of £600 million (based on the outstanding debt levels of the current Budgeting Loan Scheme as at 31 March 2007) is effectively a grant to the fund, it is never "repaid". Clearly commercial lenders will expect that any investment not only earns a regular reward for the risk (the interest margin) but also that the investment is returned over time. A key driver in modelling any new structure is the length of time the senior loan facility takes to get repaid. Clearly the longer the tenor of the debt the cheaper the repayments but this has to be countered with increased interest cost and lessening appetite from external funders the longer the tenor assumed. To achieve a definitive view on debt tenor from the commercial banks will need greater understanding of the risk profile and this would only realistically come from a rigorous pilot scheme.

Whilst any form of lending needs an extensive due diligence process there are some extra steps involved in moving to the bond market and these are covered in the next section.

### 6.3.2 **Bond finance**

Lending by way of bond can theoretically open up a wider source of capital as bond purchasers include not just banks but wider financial investors like pension funds. Historically at least there has been a significant pricing advantage to bond finance as compared to bank debt based primarily on the fact that they are priced off long term gilts rather than LIBOR and the margins have been lower. This has changed in the current credit market and the spread of pricing for traded bonds has widened significantly making the product uncompetitive. There have been very few new bond issues launched this year.

To procure a bond there are also additional procedural hurdles to undertake including a formal credit rating process (through a recognised rating agency) and a formal information memorandum setting out the details of the issuer (the PF entity) and the risks associated with the underlying investment. To attract investors at a viable coupon rate for the social fund the bond would need an external rating at investment grade (typically BBB) and this further emphasises the need for a significant junior subordinated tranche of funding to take the first loss(es) up to a level that achieves this rating.

Until recently many bond finance transactions achieved even finer pricing through the addition of a monoline insurance "wrap". The insurance vehicles offering this product effectively underwrote the lending and, by virtue of their own AAA rating, lowered the risk of default from an investors perspective and hence the cost of the bond. The monoline insurance market has been significantly undermined in recent times as many of the insurance companies themselves have been downgraded. In the current market this product is not realistically available.

Bonds themselves have several routes to market typically through a private placement to a pre-selected group of investors or more generally through a listing on a recognised bond exchange. Either route is viable but each predicated on achieving an investment grade rating.

Once again, as this is a new business model there is a lack of trading and financial record which will act as a barrier to achieving the requisite rating.

This requirement may be more easily overcome if the debt or bond issue is fully secured, asset backed or guaranteed in some way by Government. Since one of the criteria for the business model was that the debt must not be underwritten or guaranteed in any way by the Government, notes would have to be secured, or asset backed by the loan portfolio itself (albeit with the first loss taken by the subordinated lender) and this still needs a high degree of certainty not present in a new un-tested structure as here.

## 7 **Distribution**

The distribution of loans is the method by which the borrower gains access to the lender. This section also considers some of the key features of the loans and criteria borrowers would need to adhere to before receiving a loan.

### 7.1 **Current market practice**

Current distribution channels within the unsecured personal lending market are varied depending on the end consumer and level of automation.

Whilst many lenders prefer to minimise the level of interactions between the borrower and lender to help reduce cost, this is mainly seen within the prime lending sector, or where lenders have payment or income data history already in place for the borrower via other lending products or bank accounts.

The most common mechanism for targeting prime borrowers where data history is held is that of targeted mailshots. Naturally, the PF model should not set out to positively encourage borrowers to increase their indebtedness, rather to give those on benefit or low income an alternative, lower cost form of credit.

A common element in cost reduction is the use of internet application processes, or call centres, whereby credit decisions can be made instantly using credit scoring software. The use of credit scoring and the wider lending decision process is considered further in the Administration section of this report; however, the use of call centres and internet technology to lower the cost of distribution would in our view be essential in delivering a commercially viable model.

At the other end of the market are the deep sub-prime lenders whose business models rely on high levels of face to face contact with the consumer to ensure that bad debt levels are kept to a minimum.

Whilst in theory the use of door-to-door style distribution and collection would be ideal, the cost of such a distribution channel would be too much to sustain given the restrictive interest rate within the PF model. This is discussed further in the collections section of the report. National distribution must be achieved as it is one of the Government's objectives for the scheme. Therefore a supplier with a national distribution network already in place would need to be used in the PF model.

### 7.2 **Jobcentre Plus**

Jobcentre Plus delivers all aspects of the Budgeting Loans Scheme. This includes dealing with all applications, making decisions, and paying loans, and arranging for deductions from benefit.

As a large proportion of the target market for the PF model would be getting benefits it would appear to make sense for Jobcentre Plus to retain a distribution role, drawing on their current systems and processes. However, cost data on the provision of the Budgeting Loan Scheme via Jobcentre Plus is difficult to obtain and therefore it is difficult to demonstrate that this is the most efficient way of distributing the loans. Also, the core services that Jobcentre Plus offers its consumers are related to getting people back into work as opposed to distributing loans.

### **7.3 Other network suppliers**

If the assumption were made that using Jobcentre Plus was neither cost efficient nor a core service it wished to continue supplying then another network supplier with national coverage would need to be used. Given the objectives of the PF model are to distribute loans to the financially disadvantaged and promote financial inclusion, using a network that currently promotes similar objectives would enhance the model overall. Two organisations (Post Office Counters and a current private sector provider of public services) felt they met these objectives and expressed an interest in participating with a new PF model.

#### **7.3.1 Post Office Counters**

Post Office Counters currently has the contract for delivering the Post Office Card Account, a basic bank account which was introduced to allow the financially excluded access to the mainstream banking system. As such, the Post Office currently has contact with the socio-economic group that are likely to be part of the target market for the PF model.

Its national distribution network and potential involvement in the underwriting and cash collection processes (see Administration and Collections sections of the report) would create more of a 'single supplier model' which has the advantage of reducing complexity in the PF model. The Post Office is also a trusted brand within the community and a place that people are familiar with which could help gaining the trust of the borrowers.

#### **7.3.2 Private sector public service providers**

One provider currently delivers a number of public services on behalf of the Government and the DWP which typically have a welfare to work background. Because of this, they typically work with the socially and financially excluded and so also have daily contact with the target market for the PF model. Like Post Office Counters, they have a network of offices around the country which are typically within the neighbourhoods in which the target market resides. Services offered from these offices include legal aid and debt advice and therefore they believe the Budgeting Loan Scheme is well understood as many of the clients they deal with on a daily basis have Budgeting Loans.

Unlike the Post Office, most public services providers would not currently have the skill set required for making loan decisions or debt collection. However, using a business such as this would allow for a more holistic service offering (i.e. debt advice, legal advice, financial inclusion work) which would help deliver the longer term Government objective

of reducing financial exclusion and moving more people into the mainstream financial markets.

Additionally, public service providers would tend to have a history of delivering Government projects including development and delivery of pilot schemes.

### **7.3.3 Banks and Building Societies**

Another obvious choice for the national distribution of the expanded scheme would be the larger Banks and Building Societies. This was discussed as part of the market participant interviews but there was no appetite to become part of the distribution network of an expanded scheme.

## **7.4 Call centre**

To ensure operating costs are kept to a minimum, many of the mainstream lenders have turned to call centres and the internet as a way of maintaining contact with their borrowers. Using the latest telecommunication technology and staff trained specifically in the operation of call centres, companies are able to site their operations in low cost areas (including overseas) and drive efficiencies from the traditional forms of customer contact.

As the practices used by call centres have become more and more standardised through the use of scripted responses to questions and standard underwriting forms, many companies have chosen to outsource this activity to specialist third party providers. This allows for speed of set up (as core systems are already in place), access to well trained staff in the minimum amount of time and the ability to flex quickly the resource available to match demand.

There are a number of third party providers already in the market so competition is well established and the cost of delivery can be driven down. Estimated lead times for the setting up of a call centre operation which deals with both the front end distribution of loans, processing of new account applications and the day to day administration of the loans is around three months to a year (dependent on the levels of lending).

Further detail around the processes needed to underwrite and collect the loans is given in the Administration and Collections sections of this report.

## **7.5 Credit Unions**

The Credit Union movement in the UK is governed by the Credit Union Act 1979 (amended in 1998) and regulated by the FSA.

There are circa 500 Credit Unions in the UK and whilst some of the top 10 Credit Unions have a common bond which is related to a particular employment, the majority are community based and serve the same socio-economic group that this study is aimed at. Even those Credit Unions that have employment as a common bond will, in certain circumstances, be dealing with a large number of people in the low wage bracket. A

good example of this is the Voyager and Alliance Credit Union whose common bond is those employed in passenger transport in England and Wales (currently the 10<sup>th</sup> largest Credit Union affiliated with the Association of British Credit Unions Limited ('ABCUL') which is the largest of the Credit Union Associations in the UK).

The two largest Credit Unions (Scotwest and Glasgow with 19,700 and 18,302 members respectively) both have common bonds based on geographic regions.

The main objectives of a Credit Union are set out in statute and comprise:

- The promotion of thrift amongst members by the accumulation of their savings;
- The creation of sources of credit for the benefit of members at a fair and reasonable rate of interest;
- The use and control of members savings for their mutual benefit; and
- The training and education of members in the wise use of money and in the management of their financial affairs.

Two of these objectives sit alongside the Government's policy objectives for this study, i.e. the provision of sources of credit at a fair and reasonable rate of interest and the training and education in the wise use of money and management of financial affairs.

Because of this commonality in objectives, the use of Credit Unions within the PF model does make logical sense; however, there are issues with the statute which limit the amount of participation they can have.

#### 7.5.1 **Wholesale funding limits**

The Credit Union Act 1979 was amended in 1998 to allow Credit Unions to borrow money from institutions other than authorised banks and other Credit Unions; however, the level of wholesale funding allowed was set out at just 10% of the retail funds available. Given the relative size of the Credit Union movement this would prevent the Credit Unions being able to participate on the scale that this model requires.

To overcome this issue would require further legislation change and also would require the Credit Unions to prove to the FSA that they were financially stable enough to accommodate high wholesale levels.

#### 7.5.2 **National coverage**

In addition to this legal barrier, the national coverage of the Credit Unions would not currently be sufficient to prevent the scheme discriminating against those in areas where a Credit Union is not operating. Areas such as Scotland and the Borders do currently have good CU coverage as do many of the Northern towns. Coverage in the South and in rural areas would, however, be more patchy and in some areas, non-existent. This could be redressed through the setting up of regional Credit Unions, with common bonds based on counties or borough councils; however, this could once again need changes to primary legislation. Most Credit Unions are either wholly or substantially reliant on volunteers to run them. It seems unlikely that in the short to medium term a national network of Credit Unions could be created through the voluntary sector alone which would be able to attract

the correct calibre and volume of volunteers to run it as a regulated financial institution. In the longer term, and with changes to the legislation which is currently under review, it could be possible to create such a network, which had a common 'back office' (a project that ABCUL is currently actively reviewing) that could deliver such a proposition.

### 7.5.3 **Involving Credit Unions in the model**

Whilst there are barriers to the Credit Unions acting as the sole supplier they could certainly be used to an extent, as a point of sale for members and in the supply of ancillary services for members such as completing the checks needed in providing the loans (see Administration section of the report).

Under the amendments of the Credit Union Act 1979 made in 1998, Credit Unions were granted the ability to supply ancillary services to their members, a duty previously barred. This has led to a number of Credit Unions offering loan products (typically mortgages) of other financial institutions to their members for a fee from the loan provider. In this way, the members get access to a wider product range and the Credit Union has another way of generating income to sustain a dividend payment each year. The Credit Unions could be used in a similar way to offer the DWP loan product to their members should they not qualify for a loan under the Credit Union's lending policies. Naturally, any fee paid for this service would have to be sufficient for the Credit Unions to want to supply the service. Our market participant interviews have suggested that the take up from Credit Unions may not be high due to the increased cost of regulation that would be needed to act as an agent in this way.

## 7.6 **Advertising**

The current Budgeting Loan Scheme is not widely advertised by the DWP. Whilst those on benefits are made aware of the scheme via Jobcentre Plus, those on low income would also need to be made aware of the expanded scheme.

National advertising, via television or other non-targeted methods would not be cost effective due to the relatively limited target consumer group. Advertising could therefore be limited to leaflets and explanatory material being made available through current third sector organisations such as the Post Office Counters and Citizens Advice Bureaux.

## 7.7 **Loan dynamics and criteria**

The loan dynamics will impact considerably on the financial model as the two key inputs from an income perspective are the size of the loan and the interest chargeable on it.

The policy objective of the budgeting loans scheme is to help people in receipt of the main income-related benefits to meet intermittent or unexpected expenses they have not budgeted for. The scheme is deliberately designed to be easy to access and non-intrusive for customers. Loans are intended to cover expenditure in the following broad categories:

- Furniture or household items;
- Clothing and footwear;
- Rent in advance or removal expenses to secure fresh accommodation;

- Home improvements, maintenance or security;
- Travelling expenses;
- Looking for or starting work (including childcare costs); and
- Repaying hire purchase or other debts that have been taken out to pay for any of the above.<sup>5</sup>

Applicants are required to indicate which broad category of expense they are requesting help with but do not have to specify the precise purpose of the loan. Under the PF model we would expect an applicant to state the reason for the loan albeit acknowledging in reality, there would be little way of enforcing this use other than through vouchers or prepaid cards.

#### 7.7.1 **Voucher or prepaid card systems**

The one way in which the use of the loans can be restricted in an operational way is through the use of vouchers or prepaid cards as a payment method rather than cash. Vouchers could be purchased in bulk from a range of retail outlets and applications for loans to purchase goods sold by those outlets could be paid using these vouchers. This has the advantage of reducing costs as the bulk buy of vouchers can be done at a discount.

Another similar method is the use of ‘closed-loop’ prepaid card system. This is where the borrower is paid the loan through a debit card which can be used in a limited number of retail outlets (hence the term ‘closed-loop’). A system similar to this is already in place with the Post Office Counters. Whilst both of these would have the advantage of restricting the use of the loans, they do have significant drawbacks:

- i. If either system is used, this could be seen as affecting the normal competition in the market by favouring specific outlets. This could lead to State Aid issues where the Government is involved;
- ii. Restricting the outlets where goods can be purchased could lead to goods being purchased at higher cost than they are available in other outlets. This could lead to borrowers having to get into more debt than if they had complete freedom of choice where to buy goods and would be a departure from the Social Fund which places the responsibility for purchasing the items they need on the benefit customer ;
- iii. Some of the items that are covered by the current Budgeting Loan Scheme would not be able to be covered by a voucher or prepaid card scheme (such as childcare, travel, expenses etc) without unduly complex processes;
- iv. Retail outlets such as large supermarkets that could supply many of the goods listed, also supply many items that are not listed and so would not be an effective control mechanism;
- v. Stigma – having a card / voucher that labels you as poor; and

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<sup>5</sup> A Guide to the Social Fund, The Department of Work and Pensions, April 2007

- vi. Experience of other similar schemes which failed as the vouchers became tradeable instruments (exchanged for cash at a discount thereby defeating the object).

### 7.7.2 **Loan size**

Under the current Budgeting Loan Scheme there are strict rules restricting the level of borrowing any individual can have access to. These rules have been designed firstly to ensure that the borrower is able to repay the loan over a sensible time period and at a level that is not going to materially deteriorate their current standard of living.

The maximum amount is dependant on the following:

- An individual's personal circumstances;
- Existing debt under the Budgeting Loan Scheme or Crisis Loan Scheme;
- Any savings an individual or their partner has over £1,000 (£2,000 if the individual or their partner are aged 60 or over); and
- The overall state of the loan budget.

An individual's personal circumstances impact the limit on the maximum amount a borrower can receive under a Budgeting Loan. First the limit is set for a single person; then a couple will be limited to 1½ times that of a single person; and a person/couple with children will be limited to 2½ times that of a single person.

Currently (as at July 2008), the maximum debt an individual can have with the Social Fund (which includes Budgeting and Crisis Loans) is £1,500, and the maximum given the current state of the loan budget are £315, £420 and £735 for single person, couples or borrowers with children respectively.

Another limiting factor on the size of loans an individual can have is the time period and level at which they can pay the debt back. An individual's total debt to the Social Fund must normally be repaid within 104 weeks (two years). The repayment rates are typically equivalent to 12%, 10% and 5% of the individual's amount of benefit entitlement before deductions for income and capital (being Income Support, Jobseeker's Allowance or Pension Credit, including Child Benefit and Child Tax Credit where appropriate). There is, however, provision within the rules to extend this repayment rate to 20% of weekly benefit income and to extend the repayment period where the repayments can no longer be met.

The overall average initial Budgeting Loan award for 2006/07 was £451<sup>6</sup>.

Given the loan size is a key factor in determining the economics of the model (i.e. the number of borrowers in a cash constrained, supply driven environment and also determines a number of the costs / income ratios), the average loan size and loan volumes will be flexed as part of the sensitivity analysis.

Our discussions with the sub-prime lenders corroborated the fact that loan sizes to this socio-economic group are often small, of the magnitude of a few hundred pounds, and that typical borrowing behaviour is for this amount to be borrowed over short periods,

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<sup>6</sup> Annual Report by the Secretary of State for Work and Pensions on the Social Fund 2006/07.

and then reborrowed (i.e. similar to a standard revolving credit facility). The implication of this is discussed further in the Administration section of the report, however, in income terms this has the effect of extending the average indebtedness due to borrowers moving from one loan to the next (i.e. potentially extending the overall indebtedness period to greater than 104 weeks despite individual loan periods being lower than this). Once again, the impact of moving from a term loan to a revolving credit facility is flexed as part of the sensitivity analysis.

### 7.7.3 **Interest rate**

One of the key objectives of the study was to determine the feasibility of lending to those on benefits and on low income at a rate that is accessible to those with better credit ratings.

The interest rates currently charged within the sub-prime sector vary according to the type of loan (i.e. via a pawnbroker or licensed moneylender) and more significantly, between licensed and unlicensed moneylenders. Whilst this study does not set out to investigate the reasons behind the variability in interest rates, or indeed what would be considered a 'fair' rate to charge, our research did highlight that the annual percentage rate ('APR') on a loan is not a key determinant in a borrower differentiating who they borrow from. At the outset of the study we assumed that the interest rate used in our base PF model would not exceed that set out by the Credit Union Act 1979 and amended in 1998 at 2% per month (or 26.8% APR).

Once again, as this is a key variable within the financial model, it has been included in the sensitivity analysis.

### 7.7.4 **Criteria for borrowers**

The current Budgeting Loan Scheme does not stipulate any further criteria above and beyond being on a qualifying benefit and meeting the affordability criteria in the loan size section above.

Under the PF model, the loan size criteria would still be applied to applicants to ensure that affordability criteria are met; however, further criteria would also be set in determining whether or not an application was accepted. These would include:

- All applicants must be aged 18 and above;
- Applicants currently under IVA's or debt management programmes would not be accepted; and
- Applicants who have been bankrupt in the past five years would not be accepted.

This would prevent borrowers with the most severely impaired credit histories from obtaining loans.

## 8 Administration

The administration of the PF model includes all the day to day activities that would need to be completed to set up new loan accounts and manage the customer relationship. The collection of loan payments is considered separately in this report.

### 8.1 Cost structures

As described in the overview to the operational model, all aspects of the operation would be outsourced to allow for minimal set up cost and an ability to obtain the correct experience in the minimal time possible.

There are a number of suppliers in the UK market who have the skills to manage an unsecured loan book of this nature, a number of which are already using similar operational models to this. Often, these companies are able to manage different parts of the product life cycle from initial provision of the loan to final collection (or write-off in a bad debt situation).

The biggest cost is the staff needed to manage the volume of applications. For the type of processes assumed in this model it is estimated that one staff would be needed per 1,000 loans underwritten per annum. This has been based on a benchmark study completed by KPMG into the cost structures experienced in unsecured lending at a number of prime lenders. Whilst this lending would be to sub-prime borrowers, the procedures expected to be used in the administration of these loans are not dissimilar.

Other direct costs of administering the loans, such as dealing with fraudulent applications, statementing etc have also been included in the financial model.

All cost assumptions have also been sensitised as part of the sensitivity analysis section of the report.

### 8.2 The credit decision

The process by which lenders decide whether or not to lend to a potential borrower typically includes a number of checks, including identity, address, credit record and the usual concerns of lending (affordability, purpose, amount etc) as well as fraud prevention. This process of provision of loans will be important in preventing fraud and ensuring the maximum repayment going forward.

#### 8.2.1 Credit checks

Most loan approval processes would include the use of a credit check; however, for this to be successful, data is needed to be held on the recipient population. A credit check is typically carried out by a credit agency such as Experian, Equifax or Callcredit and involves them matching the potential borrower with data held in their databases on past payment record. The majority of data currently held comes from the mainstream financial institutions. Current datasets held by credit checking agencies can show a hit

rate of up to 90%; however, a high proportion of the population that would be lent to under this model would not necessarily be active within the mainstream consumer borrowing market and it is therefore highly unlikely that they would be captured on the current databases. For example, when applying these datasets to the client base of the DWP these hit rates have been shown to be significantly reduced.

The larger of the licensed Home Finance Companies do now register information on their client base with the credit checking companies; however, this data will not be able to be utilised for another two years and would always exclude black market borrowings.

Many market participants felt good data on this socio-economic group would be available through the Post Office Card Accounts ('POCA') system. However, data on this population is not currently shared with the credit bureaus and obtaining access to wider databases can prove difficult. Even if data is obtained (such as Tax Credit data) then there would need to be changes in Data Protection Act legislation to allow it to be used. This has not been considered as an option within the scope of this study and it appears unlikely that relaxing data protection laws is currently a viable option.

As the whole operational model is predicated around lending to those on benefit, the use of credit checks would be limited as we know that the borrowers are a high credit risk.

### 8.2.2 **The use of scorecards**

Scorecards are the tool used in the approval process to help determine if the credit risk posed by a potential borrower is of an acceptable level for the lender to grant the loan. Scorecards take the information received on the credit checks and other application form data and give the borrower a 'credit score'. The lender can then determine what score constitutes an acceptable credit risk to them to help determine which borrowers to approve and which to reject.

The use of automated scorecards has become widespread within the industry as it is a tool that can be easily automated, statistically accurate and also allows lenders a method by which they can change their risk appetite quickly and easily.

For scorecards to work effectively they must be used over a period of time and also contain data that is a good predictor of future performance of a loan. It is widely accepted that the scorecards used within the prime end of the unsecured credit market would not be suitable for use within a model such as the PF model as they are modelled on payment patterns of prime borrowers.

This would mean that a new scorecard would need to be developed for the PF model which takes into account the differing payment patterns of this socio-economic group (see the Collections section of this report) and the lack of data availability referred to above. The scorecard would also have to take into account the fact that very small changes in income or expenditure of the borrower could have a very large impact on their ability to repay a loan. This scorecard could be built as part of a pilot or developed outside of the PF model as a separate project.

### 8.2.3 **Lending decisions within the PF model**

As highly automated credit checking and scorecard analysis will not be available under the PF model in the short to medium term, the loan approval procedure must, as a minimum:

- i. Identify via face to face contact and suitable documentation that the applicant is who they say they are;
- ii. Validate the level of income of the applicant in line with repayment tests currently in place in the Budgeting Loan Scheme as detailed in the distribution section (i.e. up to 20% of income);
- iii. Validate the borrower's address; and
- iv. Enable basic fraud checks to take place to prevent the initial 'fraud attacks' encountered by most new entrants to the sub-prime lending market.

As outlined in the distribution section of the report, all applicants will be asked to fill in an application form either on-line or over the phone. This application will capture basic information such as name, address, income status etc. The typical information requested in loan applications can be seen in Appendix A7. If applying via the call centre, the applicant will be sent the completed form via the post or if applying on-line the form can be printed. These forms will then be taken to either the Post Office or a local Credit Union along with a number of additional items as listed below:

- i. Photograph ID in the form of either a driving licence, passport or EC Identity Card;
- ii. National Insurance number
- iii. Proof of address in the form of either a utility bill or bank statement;
- iv. Proof of income in the form of last three months of pay slips, a letter showing benefit entitlement or three months of bank statements showing regular income;
- v. A signed copy of a direct debit mandate; and
- vi. A signed copy of the original application form.

In terms of the Post Office Counters, the systems will soon exist in all outlets to allow for the checking of the data presented above to the signed application form and then for either electronic or hard copies to be sent to the PF entity. The Post Office has relevant experience in this process and could implement the system with little additional infrastructure needing to be in place. Similar processes would need to be put in place with the Credit Unions or other third party suppliers if they were to be involved in the model.

## 8.3 **Fraud prevention**

The basic checks completed as part of the underwriting process will act as a 'front-line' fraud prevention mechanism. In addition to these procedures, there is merit in running fraud, credit impairment and indebtedness checks to help eliminate as many fraudulent applications as possible.

### 8.3.1 **Fraud**

Often when new lenders enter the market, and in particular sub-prime lenders, they find themselves being targeted by fraudsters until their systems and internal data are strong enough to cope with better identifying these fraudulent applications.

The credit checking companies do have products to help identify these transactions based on historic attacks and frauds. Whilst these products cannot eliminate all fraud, they are effective and simple ways of trying to reduce fraud risk in a proactive way.

As the loans are small in nature, this could also act as a disincentive for fraudsters as they would need to complete a high volume of fraudulent loan applications to secure significant amounts of cash.

### 8.3.2 **Credit impairment**

The current Budgeting Loan Scheme will lend to all people on benefit regardless of their current or historic credit record. As discussed in the Distribution section of this report, under the new model it is suggested that, in order to reduce bad debt losses, people with previous County Court Judgements ('CCJ's'), those who have entered into Individual Voluntary Arrangements ('IVA's') or those that have previously been declared bankrupt would not qualify for loans under the PF model. Once again, the credit checking companies maintain full lists of each of these that could be utilised to filter out fraudulent applications.

### 8.3.3 **Over indebtedness**

The policy objectives behind this study, and indeed behind the current Budgeting Loan Scheme, are to encourage individuals not to become over-reliant on debt to a point whereby they end up with either a CCJ, an IVA or at worst, bankrupt. Whilst the underwriting checks will help establish the correct level of income an individual has to allow a maximum loan amount to be calculated, other debtor balances would be harder to identify.

The credit checking companies do hold data on the level of indebtedness of individuals; however, if the debt is outside of the mainstream lenders then it may not be captured. This is therefore an area of risk for the PF model; however, this risk is similar to that currently faced by the Budgeting Loan Scheme on the benefits recipients albeit these are collected from source and the amount borrowed is limited.

## 8.4 **Contractual considerations**

Loans of this nature are regulated and governed by the CCA and this Act sets out a number of areas which need to be considered in terms of the ongoing administration of the customer relationship.

### 8.4.1 **Communication with customers**

As part of the collection process, the model assumes that borrowers will be sent a text message two days prior to their payment being due. Additionally, where a payment is missed, the borrower will be phoned that evening to determine if this was an oversight or a genuine issue around repayment of the debt.

To be able to maintain contact with borrowers in this way, it will need to be written into the loan documentation that these forms of communication, and any others felt appropriate, are permitted to be used.

### 8.4.2 **Bi-annual statements**

Section 77 to 78 of the CCA require that statements are sent out to borrowers on a bi-annual basis detailing certain information dependent on whether the loan is a revolving credit facility or a term loan. Lenders are also required to inform borrowers of any changes to interest rates in writing.

The cost of statementing has been included within the financial model.

### 8.4.3 **Section 75 liabilities**

Section 75 of the CCA requires that where goods or services are purchased via CCA regulated credit, if the company selling those goods or services were to cease trading, it becomes the responsibility of the credit provider to provide the goods or services purchased. This responsibility also extends to honouring warranties in respect of those goods and services. Care will need to be taken in the drafting of the loan documentation to ensure that no section 75 liabilities arise as part of the ongoing lending undertaken.

## 9 Collection

Collection includes the regular repayment of loan balances via different methods. What happens where loan payments are missed and the debt becomes non-performing, is considered in the Bad debt and recoveries section of this report.

### 9.1 Overview

The collection process is important not just to ensure maximum cash flow (and therefore maximum amounts of cash to re-lend) but also in managing the bad debt risk. The key to a successful collection model is to make it as efficient as possible whilst maintaining the level of customer contact needed to contain bad debt risk.

Over the past five years the use of debt management companies has become more prevalent in the market. The companies have become more sophisticated in the way they obtain leads, filter the customers' requirements and then match the customers' needs with a product, whether that is debt consolidation, debt management or in the most severe cases, an individual voluntary arrangement.

In developing their business models, these companies have had to develop ways of ensuring that their clients continue to pay off their debt on a regular basis as they only continue to make money as long as the client is performing in line with any arrangements agreed. Key to this is the level of contact maintained with the client, a view that both the debt collection agencies and the sub-prime lenders agree with. Their experience has shown that, as this socio-economic group of individuals tend to manage their finances on a weekly, or even daily basis (and typically in cash) they are most likely to pay those creditors kept at the forefront of their minds.

This has also been borne out in the research carried out by the Joseph Rowntree Foundation into Affordable Credit which showed that a key aspect of credit that people liked was regular (weekly) collection of debt from the house by someone who was familiar to the borrower.<sup>7</sup>

As detailed in the previous section, the use of door-to-door collection processes, whilst reducing the overall level of bad debt, is too costly to be commercially viable given the restrictions on the level of interest chargeable in the PF model. By way of compromise, a level of contact can be maintained in line with that of the debt management companies through the use of automated text messages and early intervention calls where a payment is missed. As noted in the Distribution section of the report, care must be taken in the writing of the general terms and conditions of the loan contract to allow for all forms of contact to be made with customers.

Automated texts could be used to remind customers that a payment is due two days prior to the pay date. This system will typically cost 3p to 5p per text and has been assumed to

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<sup>7</sup> Affordable Credit, Sharon Collard and Elaine Kempson, The Joseph Rowntree Foundation, 2005

cost an average of 3.5p for the purposes of the financial model. This practice has already been adopted in one of the CDFI retail lending entities.

Where payments are missed altogether, a phone call could be made that evening to determine whether or not the issue is a clerical error or whether the customer is showing signs of financial distress, which could lead to a potential bad debt loss situation.

Whilst default notices would have to be sent to the customer in a default situation under the CCA, other forms of 'chaser' letters (other than those required by the CCA) would not be used due to their cost of production and mailing and also due to the ease of which they can be ignored.

## 9.2 **Current benefits deduction**

The current Budgeting Loan Scheme uses a process by which a borrower's loan repayments are taken from their weekly benefit payments prior to the payments being made. Deduction from source in this way has the advantage of reducing bad debt risk as cash is collected prior to benefits going to the borrower. The real bad debt risk in this scenario is therefore limited to those borrowers that move from receiving benefits to waged income. In this circumstance, collections can no longer be made from source and control of payment therefore passes to the borrower.

Under the proposed new model, the deduction from benefit process would be maintained as this will not only reduce the level of collection cost to the new model, but also retain the advantage of reduced bad debt risk.

Similar to other forms of payment, the amounts expected to be received and actual amounts received would need to be reconciled as part of a back office collections process. To reduce the level of work, consideration could be given to completing this process on a four weekly basis (i.e. DWP collect payments weekly and transfers these across to the PF entity once every four weeks), however, notification of non-payment would be necessary to allow for prompt chasing of arrears.

Consideration would need to be given to the technical capability of the DWP and PF entity's systems to be able to interface properly and allow this reconciliation process to take place. This would include consideration of the level of information currently kept by the DWP and that required by the PF entity.

Procedures would then need to be put in place for the DWP to inform the PF entity where a borrower ceases to receive benefits. These customers will need to switch to another form of payment from the time they no longer receive benefits. Where appropriate, mandates for the collection of payments via deduction from source or direct debits should be set up from the outset of the loan, even for those on benefit, to ensure a seamless transition from payment via the DWP to payment via a different method.

This has been corroborated by the current market participants as part of this research and has an impact on the collection systems needed for the PF entity.

### 9.3 **Deduction from source income**

As noted above, a key element of the current Budgeting Loan Scheme is that the loan payments are taken from the borrowers' benefits prior to release. This is considered a key way of keeping bad debt at a minimum (collections from the 2005/06 financial year stood at 92.5% at the end of 2007/08 and therefore, allowing for common write off policies in the residential lending sector, bad debts of circa 10% would be experienced) and other forms of deduction from source income would be ideal for the PF model going forward.

The Credit Union movement has had success in getting employers to deduct loan payments direct from borrowers' salaries via a pay as you earn ('PAYE') style system. In most cases the employers have not charged the Credit Unions for this service; however, they would be likely to want to recover their costs from a larger scale, commercial entity such as the PF entity.

Our market participant interviews indicated that whilst this process was relatively simple to set up (especially now many firms outsource their payroll functions), many participants felt that employers would not necessarily be willing to participate due to increased administration for them.

The likely impact on bad debt if the PF model were to collect from source could be significant and we would recommend that this be investigated in more detail if the PF model were to be taken forward.

### 9.4 **Direct debit**

By far the most cost efficient way of collecting payments is via direct debit from the customer's bank account. Typically a direct debit mandate is completed as part of the application process and then regular payments can be collected at a cost of around 1p to 2p per transaction. As the majority of the process is automated there is little further overhead cost involved albeit the reconciliation of payments expected and actually received will require a certain amount of manual intervention.

For this process to work, the borrower would need to possess a bank account with a sort code and account number. Currently the budgeting loans are paid directly into the bank account as the benefits payments. Insisting all borrowers have a bank account could be a significant barrier as many of those that this scheme would be aimed at are currently unbanked. Research by the Joseph Rowntree Foundation<sup>8</sup> has shown that borrowers from the socio-economic groups being targeted as part of this research tend to manage their money on a weekly, and in some cases, a daily basis.

Normal practice for collections within the prime market would be to collect on a monthly basis; however, within this market, if collection did not continue to be weekly, there could be an adverse impact on the level of bad debt experience. This would need to be offset against the additional cost of collecting on a weekly basis, which under a direct debit mandate would be 5p to 6p a month. It has not been possible to show the impact on

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<sup>8</sup> Affordable Credit, Sharon Collard and Elaine Kempson, The Joseph Rowntree Foundation, 2005

bad debt if payments were to switch to a monthly model; however, the market participants were unanimous in believing that this would outweigh the cost of weekly collection.

## 9.5 Cash collection processes

Another dynamic of this socio-economic group which differs from a more prime borrower is the level at which money is managed on a cash basis. Once again, the research carried out by the Joseph Rowntree Foundation showed that preference was given to dealing as much as possible in cash rather than via electronic payment methods.

The collection of cash is by its very nature a more costly way of collecting loan payments. The cost base of the current door-to-door money lenders is considerably higher than that of other lenders at between 20% and 40% (depending on mix of lending) of the outstanding loan book compared to 5-8%. This level of cost would not be possible to sustain in a model where financing and bad debt costs would also be high and the interest rate is capped at 2% a month. As such the preferred model for collection will have to remain as deduction from benefits, payroll or by direct debit.

It is, however, recognised that on certain occasions borrowers may need the facility to be able to pay by cash and as such a system is needed to manage this. Currently the two largest participants in the UK market in this area are PayPoint and Post Office Counters, both of which have a number of years experience of cash collection.

PayPoint boasts 19,500 outlets in the UK which it believes gives it circa 97.8% coverage of the population (assuming radius of 1 mile in urban areas and 5 miles in rural areas). Similarly, Post Office Counters has 14,300 outlets and 99% urban and 83% rural coverage (based on 1 mile radius) making them both viable options for the PF model.

Given both are used to collecting smaller amounts of cash the profile of the payments fits well and both can offer a number of different ways in which the customer can be identified as follows:

- Paper 'bill' with either an account number or bar code that can be entered;
- Swipe cards or fobs carrying the account information;
- Mobile phone bar codes sent via text; or
- Hand-keyed entry where the borrower has a code number.

In all cases the system would work off-line (as the payment is not as time critical as say a mobile top-up transaction which needs to be recognised instantly). This system records transactions and then batches the data and sends it to the PF entity overnight. The actual cash payment to the PF entity would then typically occur four days after the transaction.

Indicative costs were given by both PayPoint and Post Office Counters for completing such a service and whilst these have been used for the purpose of the financial model, for commercial reasons they cannot be disclosed here. In comparison to the direct debit cost, the cash collection cost via this route is again too punitive to allow this to form the basis

of the regular collection method for the PF entity; however, the system could be used where no other alternative payment method is available.

As the PF entity could involve substantial cash repayments from borrowers via either PayPoint terminals, Post Office or debt collection agents, internal fraud risk mitigation strategies would need to be considered to ensure all cash payments were properly recorded.

As the processes needed for cash collection are not dissimilar to those already in place, both the set up cost and time can be kept to a minimum.

## 9.6 **Other collection considerations**

One other consideration in collection of payments is that of ease to the borrower. Door-to-door collection or deduction from benefits both give good discipline of payment and ease of payment to the borrower; however, for a borrower to have to go to a local store or post office to pay a bill could reduce the likelihood of payment considerably.

## 10 **Bad debt and recoveries**

A debt is termed as being 'in arrears' once an expected payment has been missed. Arrears are typically measured in the number of payments missed. A debt is classed as being 'bad debt' when it is no longer expected to be collected under normal collection processes. Recoveries are where a debt that has gone 'bad' is collected through collection procedures outside the norm or is collected unexpectedly.

### 10.1 **Arrears management**

Arrears management takes many different forms dependent on the type of lending and the lending organisation concerned. A typical prime, secured lender would use standardised letters to chase repayments that were in arrears in the first instance, sometimes not even writing until the arrears were over one month old. Unsecured lenders in the prime market tend to follow-up on arrears more quickly due to the lack of security over the loan. In the sub-prime sector; however, arrears management is viewed very differently. Some forms of sub-prime credit such as pawnbroking or cheque cashing take security up front in the form of cheques or valuables. With cheques this guarantees the payment is in the control of the lender (acknowledging the risk of the cheque 'bouncing'), and with pledged valuables allows the lender to sell on the items to recover their debt.

Home Finance Companies work in a very different way to other forms of unsecured lending in that they expect a certain level of arrears to arise. When a Home Finance Company lends money, it forecasts for only eight out of every twelve payments to be made. Whereas a prime lender would charge additional fees for missed payments, Home Finance Companies use their flexibility as a unique selling point, albeit this flexibility is built into the pricing of the loan.

Another way in which the Home Finance Companies manage their arrears levels is through the management of the loan amounts. Where a customer is new to the company, they are only lent a small amount of money which, when paid back to prove a good payment history, can be increased in subsequent loans. In this way the customers know that the only way of maintaining a good relationship with the lender (and hence the opportunity of being able to borrow in the future) is through paying back in full all loans outstanding.

The PF model has had to take elements from the home finance model and find ways of replicating those in a more cost effective way. As mentioned previously, text messages will be sent to borrowers two days prior to payment being due to try and contain arrears in the first instance. Where a customer is aware that a payment may be missed, flexibility will be allowed in the model for payment holidays to be taken, but only where the PF entity is informed prior to the payment being due.

Where a payment is missed without prior agreement, a charge will be made against the account by way of contribution towards the costs involved with chasing that payment.

This will be kept to a minimum amount (currently assumed to be £5 in the financial model compared to the industry norm of £12) to ensure it remains within OFT guidelines.

The customer will be contacted that evening, via telephone, to ascertain the reason for the missed payment and arrange alternative collection.

The market participants, and in particular the debt management companies, felt that the early intervention was key to recovering missed payments. The use of letters would be ineffective due to the time lapse from the payment being missed to the receipt of the letter and also due to the ease of which a letter can be ignored.

If the rescheduled payment was to be missed then a default notice would need to be sent to the borrower prior to any further collection action being taken as required by the CCA.

## **10.2 Bad debt and recoveries**

Once a default notice has been issued the debt would be considered to be bad. At this stage, there are a number of different actions that could be followed.

### **10.2.1 In house debt collection**

An in-house debt collection team could be used to continue chasing the debt. This would be part of the TPA servicing agreement and once again, is a standard service offered by most TPA's in this market.

### **10.2.2 Debt collection agents**

Where debt collection does get outsourced, the majority of debt in the UK is outsourced via debt collection agencies ('DCA's'). Typically the DCA's will chase the debt on behalf of a client for a fee which is a percentage of the debt they collect. Where they are chasing prime debt (i.e. the chances of recovery are higher) the fee charged is lower.

Certain other costs, such as trace charges, would also be borne by the client rather than the DCA. Typically, this debt would be collected door-to-door rather than over the telephone as it is sub-prime and for small amounts, collection percentages of around 20% can be achieved. The timing of when the debt is passed to the DCA also impacts on the overall recoverability of the debt. If debt is passed early in the arrears cycle, there is more chance of the debt being recovered as the data held (i.e. address, telephone number etc) would be more up to date.

Where debt has been chased internally for a long period of time and is then passed to DCA's, the DCA's tend to have less favourable collection results (in the low single digit percentages).

Another key consideration in the recovery of debt is the level of information available on the borrower. The higher the level of information, the better recovery achieved.

### 10.2.3 **Debt sale**

The sale of debt to DCA's or similar organisations is again a well established practice and currently a very competitive market. The major high street banks alone will sell circa £300 million of debt each year and many retail companies such as telecommunications companies also regularly sell debt portfolios. Once again, the credit crunch has led to the funding lines of these companies tightening; however, this is a growing business and competitiveness still exists in the debt auctions which ensures good pricing.

The key difference between using a DCA to collect debt on your behalf and selling debt is that the legal title to the debt transfers to the DCA under a sale agreement. This can be done via debt auctions to inject an element of competition for the debt or via 'forward-flow' agreements where all debt of a certain age is sold to an individual DCA at pre-determined rates.

Many of the considerations around recoverability through the DCA route are also significant in the pricing achieved through debt sales (i.e. age of the arrears and information available on the borrower). Where a debt has been through a number of DCA's before being sold, the value would be low pennies in the pound as opposed to achieving 15 to 20p in the pound if it was at very early stages of arrears.

If the debt was segmented into different portfolios dependent on the information available and age of the debt, different prices could be achieved. Removing the worst debtors that are not likely to pay at all, or where no current data is held, could help to achieve a better price on the remainder of the debt.

In terms of overall cost to the PF model, the level of return would not differ significantly under either a DCA or debt sale route as the overall economics remain the same under both scenarios. The key considerations therefore become operational in terms of ensuring information is kept up to date, determining the best time to outsource / sell to the DCA's and deciding the level of residual control the PF entity would want over the debt collection process.

### 10.2.4 **Bad debt experience**

Obtaining reliable and consistent data on the bad debt experience for the PF model is challenging for two reasons:

- i. The data kept by the DWP on the bad debt rates experienced on the current Budgeting Loan Scheme is not comparable to that usually used within industry;
- ii. There is a lack of data on bad debt experience of lending to this group using a remote collection mechanism rather than door-to-door collection.

#### 10.2.4.1 **Current Budgeting Loan Scheme**

As collections are made direct from a borrower's benefits before the benefits are paid, the bad debt experience is kept to a minimum. Bad debt can only occur where someone leaves the benefit system. Even where this happens, the debt is not written off as

borrowers will typically come back onto benefits at some point in the future and the repayments can then be collected.

As such, the published Budgeting Loan Scheme data does not represent the type of bad debt write-off we would expect under a purely commercial operation.

Using the current collection experience of the DWP, it is estimated that bad debt levels of circa 10% could be experienced under a more commercial write-off policy.

Another impact would be that as the debt is currently interest free, you would expect the bad debt rates to increase if interest was to be charged. There is no historical data to show what the impact of moving to an interest bearing model would have on bad debt rates.

#### 10.2.4.2 *Low income borrowers*

There is currently very little data on bad debt experience of lending to low income borrowers and using a remote collection model. Where companies are lending to this target consumer group, they tend to be collecting door-to-door which helps to reduce the level of bad debt.

#### 10.2.4.3 *Other indications of bad debt experience*

Using publicly available financial information we have compared the bad debt ratios of various sub-prime lenders in both the credit card and other unsecured lending market. The results of this can be seen in Appendix A8.

This shows that bad debt ratios range from circa 5% on the near prime credit card providers to 25% to 30% for the Home Finance Companies. Further to this as part of our market participant meetings we confirmed that the levels of bad debt experienced in different segments of the sub-prime market can vary considerably.

Due to the lack of information available, the bad debt rates have been sensitised in the financial model to show a range of outputs dependent on various bad debt levels.

To be able to obtain any detailed, reliable information on what level of bad debt could be expected under the PF model, a pilot scheme would have to be run that would replicate the full scale PF model. To do this, funding would be needed to build the infrastructure and supply the capital to lend. We understand that primary legislation changes may also be needed to run a pilot scheme.

## 11 Key sensitivities

### 11.1 Overview

This section of the report focuses on the financial model that has been built as part of the feasibility study. The first section looks at the Base Case model, that being the outcome of the model based on the most practical or attainable features of each area of the operational model.

There are a number of areas of the operational model where either alternative mechanisms are available (i.e. types of financing) or where the assumptions are so key that it is felt running a sensitivity to show the financial impact of a range of outcomes is necessary. Where this is the case, each option or sensitivity has been run independently to allow us to assess the impact on the financial outcome of that change alone. The detailed outcomes of the scenario and sensitivity analysis have been included in the appendices A9 to A14 to this report for information.

We have determined from the scenario and sensitivity analysis that the key sensitivities in the model are the interest rate being charged to the customer and the bad debt rate experienced on the loan portfolio. We have therefore run a number of combined sensitivities to show at what level of interest rate and bad debt rate the model is financially viable.

It should be noted that this section of the report deals solely with the financial impact of the changes to assumptions. What may give the best case financial outcome may not be considered the best case from a practicality or social policy perspective.

### 11.2 Base case scenario

The Base Case scenario shows the financial outcome from an operational model that is considered to be the most realistic in terms of practicality to set up and run, commercially realistic in terms of funding and administrative cost and socially and politically acceptable in terms of cost to the end consumer. The Base Case scenario also contains assumptions around the level of participation in the scheme (in terms of value and volume of loans written) and the levels of bad debt that is likely to be experienced on a loan book of this nature.

The key assumptions can be seen in table 11(a) and are explained in more detail below.

#### 11.2.1 Global assumptions

The global assumptions are used throughout the model and set the key macro-economic variables including inflation, LIBOR and taxation rates.

These assumptions also set how the cash receipts are utilised (i.e. reinvested or used to repay funding). In the Base Case, it is assumed that all principal receipts are reinvested in new lending and any cash surpluses in the bank are used to repay funding. This has the

effect of minimising the level of funding needed rather than building up both funding lines and cash balances.

**Table 11(a) Base model assumptions**

| <b>Base model assumptions</b> |                    |                      |                  |
|-------------------------------|--------------------|----------------------|------------------|
| <b>Global assumptions</b>     |                    |                      |                  |
| Inflation                     | 4.40%              |                      |                  |
| LIBOR rate                    | 5.60%              |                      |                  |
| Deposit interest rate         | 4.60%              |                      |                  |
| Overdraft interest rate       | 6.60%              |                      |                  |
| Corporation tax rate          | 28%                |                      |                  |
| Principal receipts            | Reinvested         |                      |                  |
| Cash surpluses                | Repay funding      |                      |                  |
| <b>Lending assumptions</b>    |                    |                      |                  |
| <b>Lending</b>                | <b>Type</b>        | <b>Interest rate</b> | <b>Loan size</b> |
| Current scheme lending        | Term loan          | 0%                   | £451             |
| New lending                   | Term loan          | 2%                   | £600 - £880      |
| <b>Funding assumptions</b>    |                    |                      |                  |
| <b>Type</b>                   | <b>Amount</b>      | <b>Interest rate</b> |                  |
| Equity                        | £10 million        | 0%                   |                  |
| Government debt               | £600 million       | 0%                   |                  |
| External debt                 | £1,857 million     | LIBOR plus 2.5%      |                  |
| <b>Arrears assumptions</b>    |                    |                      |                  |
| Arrears rate                  | 30%                |                      |                  |
| Arrears handling fee          | £5                 |                      |                  |
| Arrears recovery period       | 6 months           |                      |                  |
| Arrears recovered             | 50%                |                      |                  |
| Arrears going bad             | 50%                |                      |                  |
| Bad debt provision            | 15%                |                      |                  |
| <b>Cost assumptions</b>       |                    |                      |                  |
| <b>Type of cost</b>           | <b>Cost driver</b> | <b>Amount</b>        |                  |
| New account opening           | Per a/c            | £14.85               |                  |
| Routine collections           | Per a/c pm         | £0.32                |                  |
| Bad debt collection           | Per a/c pm         | £3.00                |                  |
|                               | Per a/c value pm   | 12.50%               |                  |
| Running expenses              | Per a/c pm         | £0.90                |                  |
| General overheads             | Per month          | £447k                |                  |

### 11.2.2 Lending assumptions

The lending assumptions are used to manipulate the type, value and volume of loans as well as the interest rate charged on each type of loan.

The Base Case assumes that the current Budgeting Loans outstanding continue to attract a 0% interest rate and are paid off over a 12 month period. As these are paid off, all new lending is done as a term loan facility at 2.0% per month.

Current Budgeting Loan Scheme statistics show that only 74.4% of applications actually receive an award which suggests that in 2006/07 an additional £200 million of lending could have been achieved. Whilst the new model would require interest to be paid which could lead to a reduction in demand, this would clearly be off-set by the increase in demand for the scheme introduced from widening it to people on low income. The Base Case model has therefore assumed a total value of loans building to £2.0 billion with an average loan size of £600 (growing by 10.0% p.a.) due to the fact that those on low income would be eligible for larger loans.

The average loan size has been calculated using the theoretical average loan size based on the current budgeting loan scheme rules and also to average loan sizes in the personal unsecured loan market.

The resultant value of loans (£0.6 billion to £2.0 billion across the financial model projection period) equates to just 0.9% of the current unsecured loan market by value.

### 11.2.3 **Funding assumptions**

The Base Case assumes there are three different funding sources, being equity, Government and external debt funding.

The minimal equity funding has been set at £10 million to cover the cost of set-up and higher levels of cost compared to income in the first few months. The cost of this equity is basically the profit or loss made by the PF entity.

The DWP have stated that they would be willing to consider sustaining the current level of outstanding debt (as at 31 March 2007) as part of the PF model, that being £600m, and this has been assumed in the Base Case to have a cost of 0.0%. This would need further investigation to ensure that State Aid rules were not broken.

The external debt has been set at a cost of LIBOR plus 2.5% to take into account the higher cost of funding. Arrangement fees have also been set at 1.0% of new funding.

The level of funding required has been determined by having annual placements of a level high enough to cover new lending and costs and ensure that the bank account does not go into overdraft.

### 11.2.4 **Arrears assumptions**

The Base Case arrears assumptions have been set at a blended arrears rate of 30%. This takes into account the lower level of arrears seen on the loans to borrowers on benefit and a higher level of arrears to those on low income. Assuming a 50/50 split between the two types of lending would result in arrears of 15% on those on benefits and 45% to those on low income.

Arrears being recovered are assumed to be 50% given that the arrears number will include those loans where one payment is missed and then caught up at a later date.

The overall bad debt rate is then assumed to be 15%, once again based on a blended bad debt rate. As this is a highly subjective number, this has been sensitised in the next section.

Whilst the DWP has indicated that they may be willing to accept a level of continuing cost equivalent to that currently experienced by the Budgeting Loan Scheme, we have not included within the financial model a 'subsidy' from the Government equivalent to the current loss rate experienced.

### 11.2.5 **Cost assumptions**

The cost assumptions have been broken down into five separate types of cost;

- i. Account opening costs: this is based on cost information taken from the market participants and the KPMG benchmarking data.
- ii. Routine collections: this is a blended cost of collection taking into account cash and direct debit collections on a weekly basis. Again, the information on the costs is taken from the market participants.
- iii. Bad debt collection: this is split into two types of cost, firstly that for early chasing of arrears and secondly based on an average percentage of outstanding debtors cost from the market participants.
- iv. Running expenses: this is a routine cost taken from KPMG benchmarking information.
- v. General overheads: this is based on average costs by overhead type and assumes a direct staff of 40 heads. This data is again taken from the KPMG benchmark data.

### 11.2.6 **Base Case results**

Under the Base Case scenario the PF model is not financially viable, by which we mean the operation would be loss making and therefore would not be attractive to private sector participation. Over the forecast period of five years the operation would lose circa £632 million.

A detailed set of financial results from the Base Case, including profit and loss account, balance sheet and cash flow can be seen in Appendix A15.

### 11.3 Interest and bad debt sensitivity analysis

Our sensitivity analysis showed that the PF model was most sensitive to changes in the interest rate charged to customers and the bad debt rates experienced on the loan portfolio. A number of joint sensitivities were run to see the impact of different combinations of interest rate and bad debt on the viability of the model.

Critically, the viability of the model is determined by the point at which the business becomes profitable so that an equity investor may make a return on their investment.

The first table below show the results of this analysis with non-viable combinations denoted by a cross and viable combinations by a tick.

The second table shows the level of profit or loss made under each scenario over the whole of the five year projection period, with numbers in brackets denoting a loss (i.e. not viable) and non-bracketed numbers denoting a profit (i.e. viable).

*Table 11(b) Interest rate and bad debt sensitivity analysis*

| Interest and bad debt sensitivity results |    |     |     |     |     |
|---|----|-----|-----|-----|-----|
| Bad debt \ Interest rate                  | 5% | 10% | 15% | 20% | 25% |
| 1.0%                                      | x  | x   | x   | x   | x   |
| 1.5%                                      | x  | x   | x   | x   | x   |
| 2.0%                                      | ✓  | x   | x   | x   | x   |
| 2.5%                                      | ✓  | ✓   | x   | x   | x   |
| 3.0%                                      | ✓  | ✓   | ✓   | x   | x   |

| Interest and bad debt sensitivity results |         |           |           |           |           |
|---|---------|-----------|-----------|-----------|-----------|
| Bad debt \ Interest rate                  | 5%      | 10%       | 15%       | 20%       | 25%       |
| 1.0%                                      | £(715)m | £(1,310)m | £(1,756)m | £(2,096)m | £(2,359)m |
| 1.5%                                      | £(39)m  | £(694)m   | £(1,194)m | £(1,578)m | £(1,879)m |
| 2.0%                                      | £414m   | £(88)m    | £(632)m   | £(1,061)m | £(1,400)m |
| 2.5%                                      | £873m   | £316m     | £(98)m    | £(545)m   | £(921)m   |
| 3.0%                                      | £1,333m | £727m     | £268m     | £(81)m    | £(444)m   |

As the table shows, there are a number of combinations which would make the PF model viable; however, for every viable combination the controlling of bad debt in practice would be critical in ensuring that viability was achieved in reality.