Technical Annex 4: Market Impacts Methodology

7 October 2025

1 Introduction

1. This technical annex outlines our methodological approach to assessing the potential market impacts of a Consumer Redress Scheme (CRS) set out in our Consultation Paper (CP), Annex 2 Cost benefit analysis (CBA) and CP25/27 Technical Annex 3: Market Impacts.

2. Chapter 3 of the CP sets out why we are proposing a redress scheme. To consider the potential impact of the proposed CRS on the market integrity of the motor finance market we have developed an analytical framework which aims to identify and quantitatively model, where feasible and proportionate, the potential market impacts of a redress scheme. It considers how market participants could respond to the scheme, and the potential impact on market structure and consumer outcomes such as access to and the price of motor finance.

3. The proposed CRS, and market participants' response to it, may also have wider knock-on impacts beyond the motor finance market. Our framework also considers potential quantitative and qualitative impacts on:

    - Substitute credit and/or vehicle access products including leasing and hire agreements;
    - Upstream funding markets including wholesale lending and securitisation;
    - Downstream markets including finance brokers, vehicle dealerships (franchised and independent), vehicle sales and prices;
    - Investment risk perception and impact on wider UK financial services markets.

4. While our quantitative framework aims to illustrate the potential direction and scale of market impacts in different scenarios, these scenarios should not be interpreted as producing forecasts, but instead an indicative range of potential outcomes. We complement and inform (for example where we make modelling assumptions) our quantitative analysis with qualitative evidence to build an overall understanding of the potential market impacts from the proposed CRS, including insights from work we commissioned on the impact on market integrity, investment and potential wider impacts on lending markets.

5. This annex outlines our methodological approach to assessing the potential market impacts of an industry-wide CRS. It is structured as follows: Chapter 2 provides an overview of our modelling approach and the data sources used, Chapter 3 details the historic market, Chapters 4, 5 and 6 set out the approach to assessing the impact of the proposed CRS on financial resilience, supply of motor finance and price of motor finance respectively.

2 Overview of modelling approach

6. To fully consider the potential market integrity impacts of the proposed CRS, we consider the impacts of the proposed interventions on the motor finance market in absolute terms, assessing how the market could change relative to how it operated in the recent past, and against the do-nothing counterfactual set out in Annex 2 Cost benefit analysis (CBA), where consumers continue to complain directly to firms or to the courts to receive redress – a complaints-led approach.

7. When considering market impacts in absolute terms, we consider the potential implications of the proposed CRS realising cost liabilities for firms, taking into account any current provisions already made by firms, relative to the recent past where cost liabilities as a result of historic harm had not yet been realised. We note, however, that the liabilities associated with historic harm would still exist absent the CRS, and are not derived from it.

8. We also consider the market impact of the proposed CRS at a segment level, assessing the new, used, and sub-prime segments of the wider motor finance market separately.[1] As set out in CP25/27 Technical Annex 2: State of Competition in the Motor Finance Market, the competitive dynamics differ in each of these segments, and therefore the impact of the proposed CRS is also likely to vary.

9. In undertaking this market impact assessment we are aware of a number of limitations with our approach:

   - Our quantitative analysis is partial by design, generally considering potential impacts on the supply, demand and price of motor finance separately. We have not undertaken an equilibrium analysis which would reflect the interaction between supply and demand in determining market outcomes.
   - We assess market impacts at an aggregate level, considering changes in average outcomes for each segment. This abstracts from the heterogeneity across firms and consumers participating in the motor finance market and may fail to fully reflect potential impacts on certain consumer or firm types.
   - Our modelling approach includes a number of simplifying assumptions which facilitate quantitative analysis, but may not be reflective of how firms, with their strategic reactions, and consumers respond in practice. In particular, our modelling does not directly consider changes in the size of the market as a result of consumers responding to price changes by switching to alternative forms of finance. Demand is assumed to remain constant at historic levels.
   - Our modelling also includes a number of explicit input assumptions which are informed by our understanding of the market, but for which there is uncertainty over appropriate values.
   - Our quantitative analysis utilises firm level data from a number of different data sources, reflecting historic market outcomes. Across these data sources the coverage and quality of data can vary, with implications for the robustness of the insights we can derive from them.

[1] The sub-prime segment is considered as a separate segment, but is also an element of the vehicle condition segments (new and used).

10. To mitigate some of these limitations we have undertaken scenario and sensitivity testing to understand the sensitivity of our quantitative results to alternative specifications. We also complement our quantitative analysis with qualitative evidence where necessary. The key input assumptions impacting the scenario outcomes presented in CP25/27 Technical Annex 3: Market Impacts are presented in Table 1.

Table 1: Key input assumptions

Firms who stop new lending	Lenders who are assumed to be unable or unwilling to continue lending in the market
Replacement rate	Percentage of agreements lost as a result of exit replaced by remaining lenders
Volume lending contraction	Percentage reduction in volume of lending in non-prime segments
Cost of capital increase	Absolute change in lenders' costs of capital
Cost of capital increase pass through rate	Percentage of cost of capital increase passed through to customer APRs
Redress and non-redress pass through rate	Percentage of theoretical APR increases to finance costs which are passed through to customer APRs
Commission reduction	Percentage reduction in lenders' average commissions

11. Despite these limitations, our quantitative modelling is an attempt to give an indicative scale, and test the sensitivity of, potential market impacts under a number of different scenarios. We do not regard these scenarios as forecasts or predictions, but instead an indicative range of potential outcomes. They are intended to consider the potential channels through which markets may change, and to what extent, and in conjunction with our qualitative evidence reach a balanced assessment of overall potential market impacts.

Data sources

12. Our quantitative and qualitative evidence is informed by a number of data sources, see CP25/27 Technical Annex 1: Data, analysis of loss, and liability and cost methodologies for a description of data sources used.

13. The data sources we use vary in their level of granularity, and not all data sources can be broken down at the segmented market level. For example, some firms did not respond to our Lender and Broker surveys with agreement data by creditworthiness.

14. In defining the motor finance market, and its segmentations, our analysis and data aims to consider motor finance agreements as defined in Chapter 4 of the CP. Where possible we do not include business lending or consumer hire agreements. However, in some cases data limitations can mean firm data cannot be disaggregated in this way.

15. To provide as comprehensive and representative view of motor finance segments as possible, in our modelling we have adopted the principle of using all available data for a given segment. As not all data can be broken down across all segments this approach can introduce some inconsistency in terms of the data sources used, and the ability to consistently aggregate across segments.

Historic market

16. When considering potential market impacts in absolute terms, we compare market outcomes under the CRS relative to a stylised description of the motor finance segments in the recent past (reflecting data from 2022 and 2023, the most recent full year data available at time of collection). This modelled representation of the market and segments includes information on market outcomes such as market size, average prices, commissions and lenders' market shares.

17. Comparing outcomes to the recent past allows us to consider the future viability and shape of the motor finance market, relative to how it operates today. However, this requires careful interpretation of events, or changes, in the market which have taken place since 2023. For example exit, cost or price changes, contractual arrangements or consumer behaviour. Such changes should not be attributed to the proposed CRS, unless those changes were in anticipation of prospective redress.

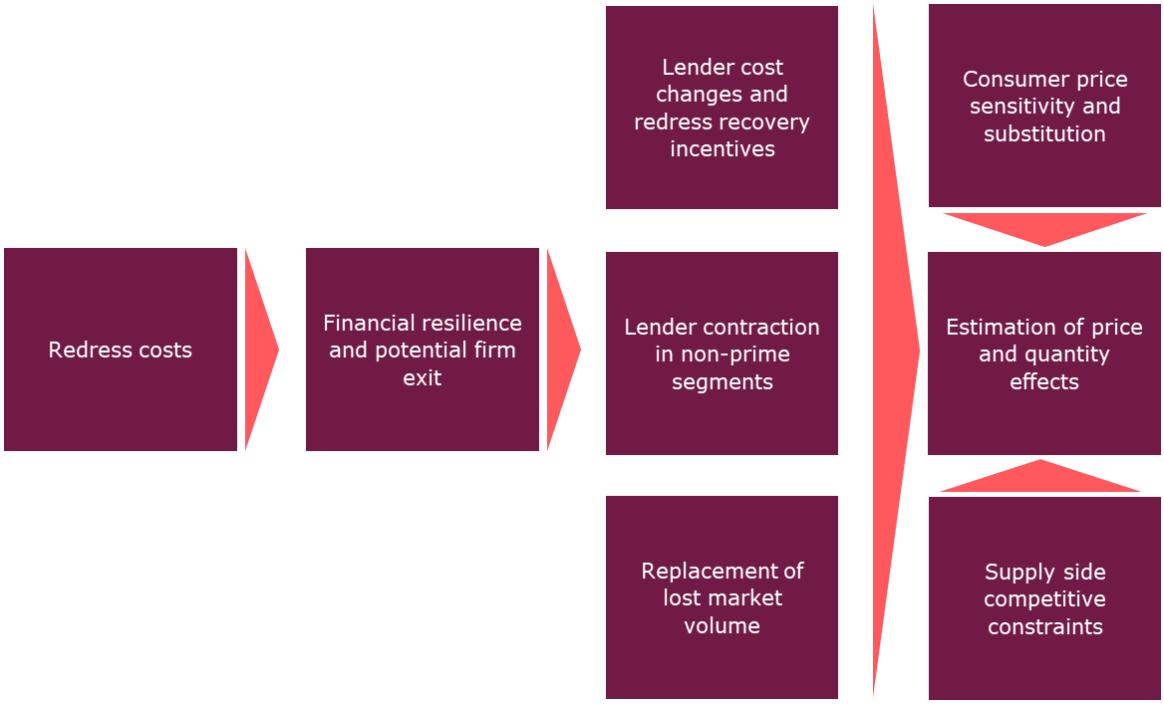
18. Assessing market impacts in absolute terms also does not assess the impact of the scheme relative to the CBA counterfactual where, as we set out in Annex 2 Cost benefit analysis (CBA), in the absence of our regulatory intervention we would expect to see considerable market disruption, inconsistent and significantly delayed compensation for consumers, and unnecessary costs and burdens to firms, the Financial Ombudsman Service ('Financial Ombudsman') and the judicial system. Quantifying the potential market impact of the CRS relative to this counterfactual is challenging, given this state of the world is unobservable and the associated market outcomes within it are highly uncertain.

Market under regulatory intervention

19. To model how the market could change in future under the proposed CRS, we consider how lenders, brokers and consumers may respond to the redress scheme, and how key market outcomes might change as a result.

20. Figure 1 illustrates the main routes through which market outcomes would change as a result of the CRS in our modelling.

Figure 1: Overview of approach to modelling redress impact



21. The first stage of the modelling adjusts the market for any lenders who are assumed to exit in response to the CRS i.e. lenders who will be unable or unwilling to provide finance to new customers in future.

22. Redress and non-redress costs are used to conduct a financial resilience assessment which assesses the potential impact of redress liability estimates on the risk of exit of individual lenders. This assessment compares a firm's potential redress liabilities with reported financial resources after adjusting for provisions. This analysis, in combination with supporting qualitative evidence received from market participants, informs assumptions on which lenders could exit the market under alternative scenarios and sensitivity testing.

23. After adjusting the stylised description of the market for lenders who are assumed to remain in different segments, we then consider how the supply, demand and price of motor finance could change as a result of remaining lenders' responses to firm exit and their redress and non-redress costs.

24. To assess potential changes in the supply of motor finance we test the impact of assumptions varying the extent to which 'lost' market volume from exiting lenders is picked up or diverted to remaining lenders, using assumed replacement and diversion rates. We also test the impact of assumptions varying the extent to which remaining lenders respond to scheme costs by contracting lending in non-prime

segments, by assuming non-prime lenders reduce the volume of agreements they supply to the market.

25. When considering market demand for motor finance (and demand for individual lenders) we take a qualitative approach. We do not quantitatively consider consumers' price sensitivity directly when estimating market size. We assume demand for motor finance is equivalent to the supply provided by lenders remaining in the market – independently of price. However, informed by our Yonder Consulting: Motor Vehicle Finance Consumer Research, we qualitatively consider how consumer price sensitivity across segments may influence firms' incentive and ability to increase prices.

26. This approach does mean that we are not quantitatively considering the impact on marginal consumers who, if prices of motor finance rose, are likely to change behaviour. For example, changing the terms of an agreement to lower monthly costs (including a longer repayment term, or lower cost vehicle selection) or potentially no longer being able to purchase a vehicle at all. To the extent consumers switch away from motor finance products in response to price increases, the market would be smaller than we assume in our quantitative analysis. The extent to which customer switching constrains lenders' ability to increase prices we model through our assumed pass through rates (discussed further below).

27. The prices – interest rates for consumers, and commission for brokers – of motor finance could be impacted by the scheme through a number of channels, both directly as a result of changes to firms' cost base and indirectly as a result of changes to market structure or the nature and intensity of competition.

28. In modelling potential changes in prices as a result of the proposed CRS, our methodological approach assesses:

    - The incentive and ability of lenders to change commission arrangements;
    - Potential impact on interest rates from changes to lenders' marginal, or variable, costs including funding costs/costs of capital or operational costs as a result of the scheme;
    - Potential impact exit might have on interest rates through changes in the mix of providers and changes to the intensity of competition;
    - What change in interest rates would finance lenders' redress and non-redress costs from future consumers (given current agreement levels). What ability do lenders have to change interest rates in response to scheme costs, considering:
        - Within market competitive constraints which limit lenders' ability to increase interest rates independently, such as consumers ability to switch to alternative motor finance products or providers.
        - External competitive constraints from consumer demand sensitivity (incl. alternative consumer credit substitutes), potential entry from new credit providers and potential new vehicle manufacturing entrants.

29. There is a significant degree of uncertainty when assessing how lenders, brokers and consumers could respond to a redress scheme, and therefore what the potential impact on market integrity could be. To reflect that uncertainty we use a combination of quantitative and qualitative evidence.

3 Historic market

30. Assessing the market impacts of our proposed intervention in absolute terms compares the impact of the proposed CRS relative to historic outcomes, using a stylised description of the motor finance market as it was using data from 2022 and 2023. This modelled representation of the market, and its key segmentations, includes information such as market size, average prices, commissions and lenders' market shares.

31. We utilise data from 2022 and 2023 as this was the most recent full year data available at time of collection and provided broad market coverage. We utilise data from multiple data sources to provide a representative view of firms across the different market segments and operating different business models.

32. Using the market as it was in the recent past as a starting point to consider potential market and consumer outcomes in future has potential limitations. The market in 2022 and 2023 may not be reflective of the market today if there had been significant changes in market outcomes since 2023, especially given recent market uncertainty. However, we have monitored market trends since 2023 using industry trade body quarterly data, and the volume and value of motor finance market agreements has remained relatively stable since 2023. Other changes since 2023 have included the number of active lenders in the market.

Market coverage

33. Using lender level data collected through our Motor Finance lender Survey we aggregate the volume and value of motor finance agreements in 2023 by segment, producing estimates of market size, average prices and commission levels and lenders' market shares. Table 2 provides an illustrative snapshot of some of the market outcomes used to define our stylised description of the market.

34. Where appropriate we complement data collected through our lender Survey with additional data sources to develop as complete a picture of lenders operating in each market segment as possible. We validated our market outcome estimates against third party external sources, as well as alternative data sources available to the FCA (as described in CP25/27 Technical Annex 1: Data, analysis of loss, and liability and cost methodologies) and have further engaged with firms to clarify where differences existed.

35. While we also consider broker outcomes, such as commission levels, the data collected through our Motor Finance Broker Survey is not disaggregated at a segmental level and is combined with other data sources and qualitative evidence to inform our analysis of broker outcomes at a segment level.

Table 2: Illustrative snapshot of model output[1]

	New	Used	Sub-prime
Volume	700k	1.5m	72k
Value	£18.7bn	£23.7bn	£632.8m
Average value	£26,500	£15,300	£8,800
Weighted Average APR[2]	6.0%	13.2%	33.1%

1. Note: differences to values reported in CP25/27 Technical Annex 2: State of Competition in the Motor Finance Market reflects the use of multiple data sources in our modelling.
2. Average firm APR by segment in 2022/23. Weighted by lenders' proportion of total 2023 Motor Finance agreements (volume). Our analysis also considers consumer outcomes, such as total cost of credit, under an indicative finance agreement. Specifically, we assume an illustrative hire purchase type agreement with a 4 year term, loan value and APR equivalent to the market average.

Limitations of using historic market outcomes

36. When assessing the market impacts of our proposed intervention in absolute terms, historic market outcomes are compared to equivalent outcomes estimated under the CRS. We focus on key aggregate outputs to understand price and quantity outcomes. This includes weighted average APRs, total volume and value of agreements, and market concentration metrics (based on the value of agreements), which are calculated separately for the new, used, and creditworthiness segments.

37. In defining a stylised motor finance market using key market indicators, such as volume and average prices, we have attempted to assess potential market impacts using a framework which allows us to consider potential effects in a structured, consistent way.

38. However, by simplifying the market down and describing it with a series of aggregated summary metrics, we are not able to reflect the variance and complexity of the market. This is most evident when considering the prices consumers face. While our modelling assumes that volumes can be diverted or substituted across lenders easily, and reports a single weighted average APR to provide a representative description of outcomes in the market, in practice within segments there is considerable price variation, and not all lenders will be close substitutes to each other.

39. We attempt to mitigate the risk of reaching potentially erroneous conclusions from relying exclusively on the stylised market model, by complementing model outputs with qualitative evidence and understanding of how these markets operate in practice.

4 Impact on financial resilience

40. To assess the impact of the CRS we assess how lenders, brokers and consumers may respond to the scheme, and how key market descriptors (such as size, prices and concentration) could change as a result. We start by assessing the potential impact on financial resilience.

41. Lender-specific redress and non-redress cost estimates, reflecting both redress payments to customers and the administrative costs of administering the scheme, are used as an input into a financial resilience assessment, which is used to assess the risk of lenders exiting the market.[2]

Financial resilience and potential firm exit

42. Redress cost estimates are used to inform financial resilience analysis of lenders. This assessment compares a firm's potential redress liabilities with reported financial resources after adjusting for provisions.

43. The assessment is based on data provided by lenders in the Motor Finance Commission Monitoring survey (as described in CP25/27 Technical Annex 1: Data, analysis of loss, and liability and cost methodologies) and engagement with lenders included in the firm monitoring survey programme.

44. Firms may exit the market if they are unable to cover their liabilities and/or if they assess the strategic value of remaining in the motor finance market to be insufficiently low. The financial resilience assessment is used to focus on the former.

45. While the financial resilience assessment serves as the primary input to determine exit assumptions, our analysis also considers qualitative evidence to allow adjustments where appropriate, and assess lenders outside the scope of the monitoring information requests. When assessing the likelihood of group support, we considered a range of qualitative and quantitative factors. For qualitative factors we assessed the presence of various forms of credit support informed through motor finance commission monitoring information requests (e.g. letters of comfort) and investor type (e.g. part of banking group or car manufacturer). For quantitative factors we considered the strength of the group balance sheet and credit ratings, at a point in time. However, it should be noted that group or investor behaviour cannot be fully predicted, under a potential redress scheme.

46. While the financial resilience assessment considers firms' ability to remain in the market by covering their liabilities and capacity of group support, we also consider firms' incentives to remain in the market. In particular, reflecting evidence received from lenders in response to our Motor Finance lender Survey, whether firms have broader incentives to remain in the market, such as the strategic value of the motor finance business to the firms' wider operations and perceived future profitability of the motor finance market.

[2] The market impact assessment utilises lender-specific redress and non-redress costs covering over 95% of estimated total market redress and non-redress costs. It assumes lenders are subject to redress and non-redress costs at a single point in time, it does not consider a time profile of redress and non-redress costs. As discussed in our Consultation Paper it assumes lenders will deliver the scheme, rather than brokers.

5 Impact on the supply of motor finance agreements

47. Given potential firm exit and estimated redress and non-redress costs to firms remaining in the market, our methodology assumes that the supply of new agreements will be potentially impacted in two ways. Firstly, through a reduction in supply due to firms exiting the market, and secondly, through a potential contraction in supply by firms who remain in the market to reduce risk profiles and maintain profitability.

Replacement of lost volume following firm exit

48. Where lenders exit the market, the agreements they previously provided would be lost from the market and their customers would need to access alternative providers.

49. This demand may be absorbed by remaining lenders in the market, either partially or fully depending on the incentive, capability and technology of remaining lenders. The proportion of the lost sales that are absorbed by remaining firms in the market is likely to differ across segments and reflect the substitutability of lenders, determined by firm and market elasticities of supply which we do not know. For example, while in the used market, finance may be a relatively homogenous product and consumers can switch easily between alternative finance providers, this may be less true in the new segment where captive lenders (associated with car manufacturers) provide the majority of finance and there is stronger product differentiation.

50. As such, the replacement rate by segment (the proportion of lost volume from exit which is replaced by remaining lenders) is an assumption we vary under sensitivity testing, reflecting uncertainty over incumbent firms' ability to expand and new firms to enter the market. A 100% replacement rate, as assumed in some of our scenarios, results in all lost volume being replaced in full by remaining lenders, such that the market size and access to finance remains unchanged under the redress scheme.

51. The replacement rate does not however determine how replaced volume is reallocated across remaining firms. Our methodology uses a simplifying assumption that lost volume is reallocated across remaining firms in the market according to diversion ratios, which are informed by historic market shares. Specifically, the diversion ratio represents the proportion of sales recaptured by a remaining firm as a proportion of the total sales lost when exiting firms exit the market. Therefore, the diversion ratio for a remaining firm is calculated as the below:

$$Diversion\ ratio_i = \frac{Market\ share\ of\ remaining\ firm_i}{1 - Market\ share\ of\ exiting\ firms}$$

52. The firm-specific diversion ratio is multiplied by the replacement rate to estimate the proportion of lost sales which are expected to be absorbed by a given firm. This is added to remaining firms' historic agreements.

53. To simplify our methodology, we assume there is no new entry from alternative finance providers. Lost volumes from exit are replaced only by existing lenders. In practice this assumption will have limited impact on the supply of motor finance agreements in our modelling, as assuming the expansion of existing lenders to replace lost volume or volume being replaced by new entrants would have the same effect on the total number of agreements. However, we recognise that whether volume is replaced by existing or new entrants is likely to influence competition and price outcomes.

54. These simplifying assumptions can produce unrealistic outcomes for some lenders under certain stress tests. In addition to the potential for volume to be naively reallocated between non-substitute brands, 100% reallocation of volume from exiting lenders can result in large increases in lending amongst smaller providers assumed to remain in the market. This effectively assumes lenders face no capacity or funding constraints, something which is unlikely to be the case. Where necessary assumptions are adjusted to ensure credible outcomes in scenarios and sensitivities.

55. Note this approach to reallocating volume lost to exit does not consider the price the replaced volume would be supplied at, nor changes to consumer demand (discussed further below).

Lending contraction by remaining firms

56. Our methodology also allows for sensitivity testing on the impact of lenders remaining in the market choosing to reduce their lending, by tightening lending criteria and/or agreement terms, to reduce the risk profile of new customers.

57. This is informed by qualitative evidence we received in response to our Motor Finance Lender Survey that in response to rising interest rates, lenders, especially in the non-prime segment, had contracted lending by tightening lending criteria as a means of maintaining profitability and an alternative to passing through funding cost changes onto consumer prices.

58. For example, lenders may increase the minimum deposit size or decrease maximum loan-to-value ratios, driven by a need to maintain margin levels, higher cost of funds or lower capital availability, or a lower risk appetite.

59. This is represented in our methodology by a percentage reduction in the volume of new agreements for near-prime and sub-prime segments only, which is applied equally to all firms operating in those segments. This reduction is applied post reallocation of exiting firms' volume as described above. Therefore, when lending contraction is non-zero the total size of the used and non-prime credit segments can decrease even if a 100% replacement rate is assumed.

6 Impact on the price of motor finance agreements

60. In the following section we consider the potential impact of the CRS on prices, in particular average APRs on new motor finance agreements.

61. Our methodological approach assumes a number of potential impacts on prices are applied sequentially. We do not consider demand and price effects simultaneously, and we assume demand remains at historic levels. However, consumer price sensitivity is considered in terms of the constraints on lenders' ability to increase prices. As discussed above, this approach does mean that we are not quantitatively considering the impact on marginal consumers who, if prices of motor finance rose, no longer take out a motor finance agreement.

62. In practice, when setting prices, firms would consider all potential influences on their optimal pricing decision together, including consumer demand.

63. Informed by economic theory and evidence provided by market participants, to help describe the different channels through which prices could change, we assume consumer pricing levels are broadly determined by three factors:[3]

$$P^* = f(Marginal\ Costs\ of\ lending^4, Commission\ rates, Lender\ margins)$$

64. We use this structure to consider three broad channels through which lenders' average prices could potentially change in response to the CRS.
    - Marginal cost effects: Potential changes in funding costs or marginal operational costs passed through to some extent to consumers
    - Commission rate effects: Potential changes to commission rates
    - Lender margin effects: Potential changes in lenders' margins, including:
        - Potential impact from exit, consolidation and changes to the nature and intensity of competition amongst remaining lenders
        - Potential impact from lenders' ability and incentive to increase APRs to finance redress liabilities

65. Further, in considering average market (or segment) wide APRs, we consider a further *exit or lender composition effect* of the CRS. That is, changes in market-wide average lending rates as a result of exit and the mix of lenders remaining in the market.

66. We discuss each in turn.

[3] For a summary of the relevant literature see: Harimohan.R et al (2016) Bank of England Staff Working Paper No. 590 Pass-through of bank funding costs to lending and deposit rates: lessons from the financial crises and RBB Economics (2014) Cost pass-through: theory, measurement, and potential policy implications

[4] Including not only cost of capital, but also adjustments such as cost of equity capital charges and expected losses.

Impact of lender exit on market average prices

Lender composition effects

67. As a result of firm exit, there is likely to be a direct impact on prices. In a market with heterogenous funding costs the market may have both high and low cost lenders. Exit may impact the mix of lenders operating in the market, and average prices as a result. We make a simplifying assumption that firms will set the price of reallocated volume at the higher of their own APR mean or the weighted average APR mean of exiting firms. If the latter is applied, this may reflect increased lending to a different, more risky customer profile which was previously served by exiting firms.

68. This is a simplifying assumption to avoid average prices falling as a result of exit and volumes being reallocated to lenders with lower average APRs. While exit could potentially result in customers switching to more efficient and lower cost lenders, given the heterogeneity in customers' risk profiles (and associated cost of finance) this assumption ensures that the weighted average market price does not fall in scenarios where customers are diverted from higher cost to lower cost lenders.

69. However, this simplifying assumption does not account for the fact the change in the composition of lenders could also change the nature and intensity of competition and market prices as a result.

Structural changes and the nature and intensity of competition

70. Significant lender exit could result in remaining lenders having the incentive and ability to increase prices, as a result of having fewer competitors to whom customers would switch to in response to a price rise. Significant changes to market structure and increased concentration amongst some lenders could therefore result in higher prices if those exiting the market previously imposed a competitive constraint on lenders' ability to increase prices.

71. We consider the potential for changes in market structure and the intensity of competition to impact lenders' pricing decisions qualitatively when considering potential changes to lender margins (discussed further below).

Potential impact of redress scheme on lender marginal costs

72. Redress and non-redress costs may increase the perceived financial risk of motor finance or lenders operating in the market to its shareholders and debtholders, leading to a greater required return to compensate for the increased risk. The cost of equity and cost of debt, and therefore, the overall cost of capital for additional funding, would increase. To assess the potential impact on firms' average APRs we assume each lender's average APR will change by:

$$\Delta APR_i = \Delta Cost\ of\ capital_i\ x\ Pass\ through\ rate_i$$

73. A firm's average APR is assumed to change by the product of an assumed change in the cost of capital, for example, a 1.0 percentage point increase, and an assumed

pass through rate (the proportion of the change in the cost of capital that the lender increases APR by).

74. Our modelling allows changes in costs of capital to impact all lenders symmetrically (by assuming one change in cost of capital and one pass through rate across all lenders equally) as well as testing scenarios where cost of capital changes and pass through rates vary across lenders - by categorising lenders into one of three groups with varying cost of capital changes or assumed pass through rates.

75. This categorisation is based on information on firms' funding sources from our Motor Finance lender Survey, and work we commissioned on the impact on market integrity, investment and potential wider impacts on lending markets.

76. An increase in the cost of capital will increase the marginal cost of new agreements for lenders. Lenders may attempt to pass on the increase in marginal costs to consumers by increasing the APRs offered on new agreements.

77. The extent to which lenders have an incentive and ability to pass on marginal cost increases, will differ by segment, reflecting who is impacted by cost changes, market structure, competitive conditions, and supply and demand side constraints. To reflect this uncertainty, pass through rates of marginal cost changes are sensitivity tested to assess alternative scenarios and impacts.

Potential impact from lenders' ability and incentive to increase margins to finance redress liabilities

78. For those firms subject to redress and non-redress costs, redress will increase lenders' fixed cost base.

79. It is often assumed that changes in fixed costs are not passed through to consumers, given profit maximising pricing decisions are typically a function of marginal costs. Under this simple assumption, redress and non-redress costs would not impact a lender's optimal pricing decision for new customers.

80. However, in practice, the separation between fixed and marginal costs is often less clear, and firms' competitive pricing decisions may also include a margin, with profitability levels determined by the competitive constraints they face from competing lenders and customers' price sensitivity (see, for example, references described in footnote.3).

81. In theory, if redress and non-redress costs on historic agreements shift the market in a way which changes lenders' incentives and/or competitive intensity, lenders may attempt to finance costs via higher margins, and prices, on new customer agreements.

82. However, this ignores the competitive constraints that are likely to restrict lenders' ability to raise prices on new customers especially from competitors not subject to redress and non-redress costs, potential new entrants and/or customer price sensitivity including their ability to which to alternative providers or finance products should motor finance (or certain motor finance providers) increase prices above competitive levels.

83. We consider two main channels through which lenders may attempt to increase their margins, reductions in commission rates and increases in APRs, which could have direct and indirect impacts on the prices that consumers face.

84. To undertake this analysis at a segment level, firm-specific redress and non-redress costs must be allocated across segments, for firms who operate in more than one segment - calculated by apportioning redress to segments based on the percentage share of value of agreements of each segment. This is a necessary simplification but does ignore the likelihood that firms would consider total firm-wide redress cost financing through prices based on the relative competitive constraints they face in the different segments within which they operate.

Financing through commission decreases

85. We assume that firms may seek to increase their margins to finance redress by reducing their marginal costs first. This may be achieved by lowering commission payments to brokers.

86. This is reflected in our methodology by adjusting firm-level average commission per agreement by an assumed percentage reduction which can be varied for the new and used segment. As set out in Annex 2 Cost benefit analysis (CBA) the weighted average commission for the sample of agreements in 2024 in the used segment was £980 compared to £352 in the new segment.

87. Given uncertainties in segment level commission data by firm, and the variation in commission arrangements across the market, there is significant uncertainty over the extent to which lenders may attempt to reduce commission rates. As such our methodology allows for sensitivity testing on this assumption.

88. While reductions in commission rates may benefit lenders, this may still result in changes to consumer interest rates. Brokers may seek to offset lower commission rates and maintain overall commission revenue by increasing their overall showroom interest rates.

89. Alternatively, brokers may seek to offset lower commission through other revenue sources which are at their discretion, for example, by increasing vehicle prices, lowering part-exchange values, or increasing the costs of additional services offered at sale. This is not reflected quantitatively in our methodology but is qualitatively considered.

Financing through APR increases

90. Where redress in each segment is not able to be fully financed from commission reductions, we consider whether the remaining redress and non-redress costs could be financed by increasing APRs for new agreements (equivalent to increasing the lender's margin on each new agreement).

91. First, our methodology estimates the theoretical increase in average APRs that would be necessary for each firm to finance their redress and non-redress costs over a period of 4 years, by increasing interest income on each agreement, given current agreement levels are maintained. For ease of computation, this is modelled assuming

a Hire Purchase (HP) type agreement which is not reflective of market outcomes where a high proportion of deals are PCP agreements. It also does not discount future interest income streams and therefore, would underestimate the increase in APRs necessary to finance redress if assessed on a Present Value basis. We also do not reflect early repayment/settlement of motor finance agreements, which would reduce expected future interest income.

92. However, this theoretical calculation is interpreted as a likely overestimate of potential price increases, as it assumes firms face little or no supply or demand side competitive constraints and therefore, can increase prices unilaterally without concern for lost sales or profitability.

93. Secondly, we adjust the theoretical maximal increase to reflect the competitive constraints firms are likely to face, and therefore, a more plausible potential increase in APRs.

94. We consider two types of competitive constraint.
    - Within market competitive constraints limiting lenders' ability to increase APRs independently. This is modelled by assuming firms increase prices by a weighted market average of each firm's theoretical increases. This is to reflect firms' inability to increase prices unilaterally to the extreme of their theoretical increase. However, should all firms in the market face similar incentives to increase prices, there will be a general upward price pressure. This weighted price pressure index is applied to all firms' prices equally.
    - External competitive constraints. Firms currently operating in the motor finance market (or its segments) are also subject to out of market/external competitive constraints on their ability to increase prices. This includes from consumer demand sensitivity (incl. consumers ability to switch to alternative consumer credit substitutes such as credit cards, loans or alternative vehicle access products incl. hire or subscription services), potential entry from new credit providers and potential new vehicle entrants. These competitive constraints on pricing are modelled as defined pass through rate (assumed to be between 0 and 1), which adjusts the price pressure index further. The value of the pass through rate (at a segment level) is informed by our understanding of the competitive dynamics of the segments based on quantitative and qualitative data, and is sensitivity tested.

95. The change in lenders' average APRs by segment is therefore given by:

$$\Delta APR_i = \overline{APR\Delta}\, x\, pass\ through\ rate_{segment}$$

Where $\overline{APR\Delta}$ is the segment's weighted average (by volume) of lenders' theoretical APR increases to finance redress and non-redress costs through higher APRs, and the pass through rate is a segment-specific pass through rate.