MS24/2.2 Profitability of Premium Finance

July 2025

Contents

Introduction

Firms usually charge consumers for premium finance when they pay monthly for their insurance. Although there are instances of interest- and fee-free premium finance, as set out in our Terms of Reference, we are aware of a proportion of Annual Percentage Rates (APRs) above 30% being charged across motor and home insurance.

To understand why firms set the prices we see in the market and the financial performance of premium finance, we performed an analysis of the revenues the firms earn, their underlying cost base, and the margins they make.

We used a variety of data sources, with most coming from our financial data collected as part of a dedicated Request for Information (RFI). For a complete view of our data sources, please refer to the Technical Annex.

Summary of Key Findings

Firms earn interest, fees and commissions from premium finance, with SPFPs earning the least revenue per policy across all our business model cohorts.

We observe a variety of business models amongst the premium finance providers in our sample which we refer to as cohorts in this paper. Insurers, intermediary lenders and Specialist Premium Finance Providers (SPFPs) all act as lenders of premium finance and primarily earn interest and fees, while intermediary brokers are distributors and earn commissions and fees only. This brings us to a total of 4 cohorts.

The significance of premium finance activities relative to other segments of firms' business activities also varies. For example, insurers sell premium finance as an add-on for their core insurance products, whereas SPFPs only provide premium finance and not the associated insurance. As a result, premium finance may be a more significant proportion of SPFPs' overall business.

Although revenues grew across the premium finance market over our sample period from 2018 to 2023, on premium finance policies with interest, revenue per policy was broadly stable across all firm cohorts between 2018 and 2022. In 2023, revenue per policy rose. Firms attributed this to a combination of rising base rates, hardening market conditions, and premium inflation in motor insurance which causes the premium finance loan to increase, subsequently increasing the interest on a policy.

On premium finance policies with interest, intermediary lenders and intermediary brokers tend to earn more revenue per policy than insurers or SPFPs.

Insurers earn relatively lower revenue per policy because they tend to offer lower APRs than other cohorts. For SPFPs, this arises because, while SPFPs charge similarly high APRs for premium finance, typically over half of this APR is attributable to the intermediary broker as commission (also referred to as an 'overrider'). Since SPFPs do not record the amounts attributable to intermediary brokers within their revenue or costs, this causes revenue per policy for SPFPs to be lower.

On average, revenue per policy is higher for motor insurance than home insurance. This is due to:

- Higher average premiums in motor insurance.
- Higher availability of interest-free policies in home insurance.
- Higher APRs for motor insurance, which firms attribute to higher bad debt and operational costs.

Key costs faced in providing and distributing premium finance are costs of funding for insurers, intermediary lenders and SPFPs, and bad debt costs for brokers.

The cost of providing premium finance varies by firm cohort. Lenders incur funding costs, typically as interest expenses for external funding or the opportunity cost of lost investment income. As of 2023, funding costs were a high proportion of total costs due to the rising external interest rate environment.

While late or missed payments are prevalent in the market, these do not necessarily translate into high bad debt rates, which tend to be lower on average than other types of consumer lending. This is largely due to insurers' ability to cancel the underlying insurance, as well as measures firms implement to collect premiums from customers in arrears, such as regular check-ups with customers and arrangements for alternative payment plans.

Bad debt primarily arises when there is a timing difference between customer default and insurers' cancellation of the underlying policy. This timing difference can span between a few weeks and a few months, particularly where there are affordability concerns for the defaulting policyholder such that firms exercise forbearance. Firms also incur operational costs from collecting monthly premium finance payments and an allocation of overheads (such as central functions, staff and regulatory costs).

Premium finance margins declined by 6 to 30 percentage points between 2018 and 2023 across our cohorts. However, we remain concerned that revenues appear high compared to costs for most cohorts.

We calculated margins based on economic profit before tax earned on premium finance as a percentage of premium finance revenue. Insurers and intermediary brokers tend to earn the highest margins from premium finance, earning a weighted average margin of 53% and 38% respectively across the period 2018 to 2023. This was followed by intermediary lenders, earning 36%. SPFPs earned on average the lowest margin from premium finance than the other cohorts, with a weighted average margin of 24%.

Premium finance margins fell over the sample period for insurers, intermediary lenders and SPFPs. This is because cost growth outpaced revenue growth. This was primarily the result of high growth in funding costs, which rose at a compound annual growth rate of 29% between 2018 and 2023, with particularly high growth from 2021 onwards. Insurers' margins were particularly impacted by the increased opportunity cost of lost investment income, which caused their margins to decline in 2023.

Intermediary brokers are less exposed to the external interest rate environment, and therefore their margins were broadly consistent over time. Motor premium finance generated higher margins than home premium finance (categorised as buildings, contents, and buildings & contents insurance) in 2023, even though motor premium finance typically incurs higher costs per policy. However, prior to 2023, motor and home premium finance earned comparable margins.

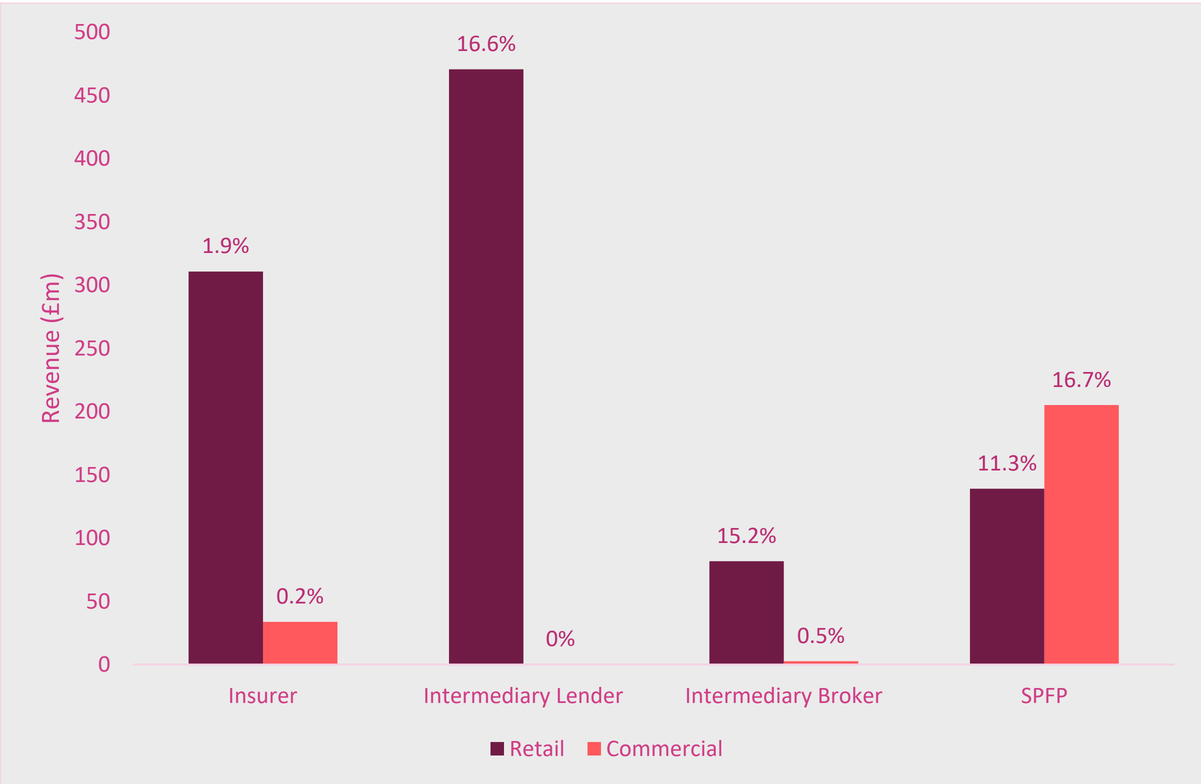
Despite the decline in premium finance margins over time, they continued to appear high compared to costs for most cohorts except SPFPs.

Premium Finance Providers

We identified four different types of firms that offer premium finance: insurers, intermediary lenders, intermediary brokers, and SPFPs. Each firm type operates a distinct business model in relation to premium finance. The importance of premium finance to overall businesses depends on the business model. In the graph below, we present revenue from premium finance per cohort in 2023. We used businesses' proportions of revenue from premium finance to approximate the proportion of their business activity relating to premium finance.

FIGURE 1: Revenue from Retail and Commercial Premium Finance in 2023 (£m)

Figure 1 includes 11 insurer firms, 8 intermediary lender firms, 4 intermediary broker firms, and 4 SPFPs. We include three vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories. Retail premium finance includes home, motor, pet, and other consumer insurance.



Source: Financial data collected from firms

Revenue is earned by firms from charging customers for premium finance. In our publications, it is often appropriate to use alternative ways of illustrating the cost of credit depending on the context. This includes showing costs as APR, total interest paid, and total interest as a proportion of loan. For an explanation of APR see our Technical Annex. Each of our papers indicates which cost of credit metric(s) are being used.

We analysed revenue from retail and commercial premium finance in 2023. We also analysed revenue from retail and commercial premium finance as a proportion of businesses' overall revenue. In the above chart, the data labels correspond to the percentage of the cohorts' overall revenue attributable to retail and commercial premium finance respectively. While there was variation within each cohort regarding the proportion of revenue attributable to premium finance, the weighted averages presented are broadly representative of what we observe within each cohort. Where variation is particularly significant, we note this below.

Insurers’ main revenue sources are from underwriting and investing. As a result, retail premium finance accounted for 1.9% of the revenue earned in 2023. This proportion fell over the sample period due to flat premium finance volumes for insurers and several insurers’ decisions to reduce interest and fees charged for premium finance. Some insurers ceased charging interest altogether for home insurance. Commercial premium finance accounted for 0.2% of insurer revenue in 2023 because very few insurers in our sample offer this product.

Intermediary lenders earn interest income from premium finance lending, in addition to commission from arranging and distributing insurance. For this cohort, retail premium finance accounted for 16.6% of the revenue earned in 2023. This proportion grew from 10.6% in 2018 due to rising interest income from premium finance over the sample period and falling profit share and other income from insurance arrangement and distribution since 2021. None of the intermediary lenders in our sample offered commercial premium finance.

Intermediary brokers earn commissions from arranging and distributing insurance. For premium finance, SPFPs provide the financing, with part of the APR paid by customers being earned by the SPFP as interest, and part earned by the broker as commission.

For intermediary brokers, retail premium finance accounted for 15.2% of the revenue earned in 2023. This proportion peaked at 20.5% in 2020, due to declining income from insurance arrangement and distribution, coupled with rising premium finance commission. Since our sample represents a smaller proportion of the intermediary broker market than other cohorts, there is likely to be more variation in this figure across the full population of brokers.

SPFPs earn revenue by lending money to customers and other businesses, earning interest on their lending. In 2023, retail premium finance revenue accounted for 11.3% of total revenue in this cohort. Commercial premium finance accounted for a further 16.7% of total revenue. These proportions were broadly flat over the sample period.

The SPFPs in our sample represent a variety of business models, some of which primarily lend premium finance, while others also provide other forms of lending. Therefore, the weighted average business proportions of premium finance reported above obscures variation within the cohort.

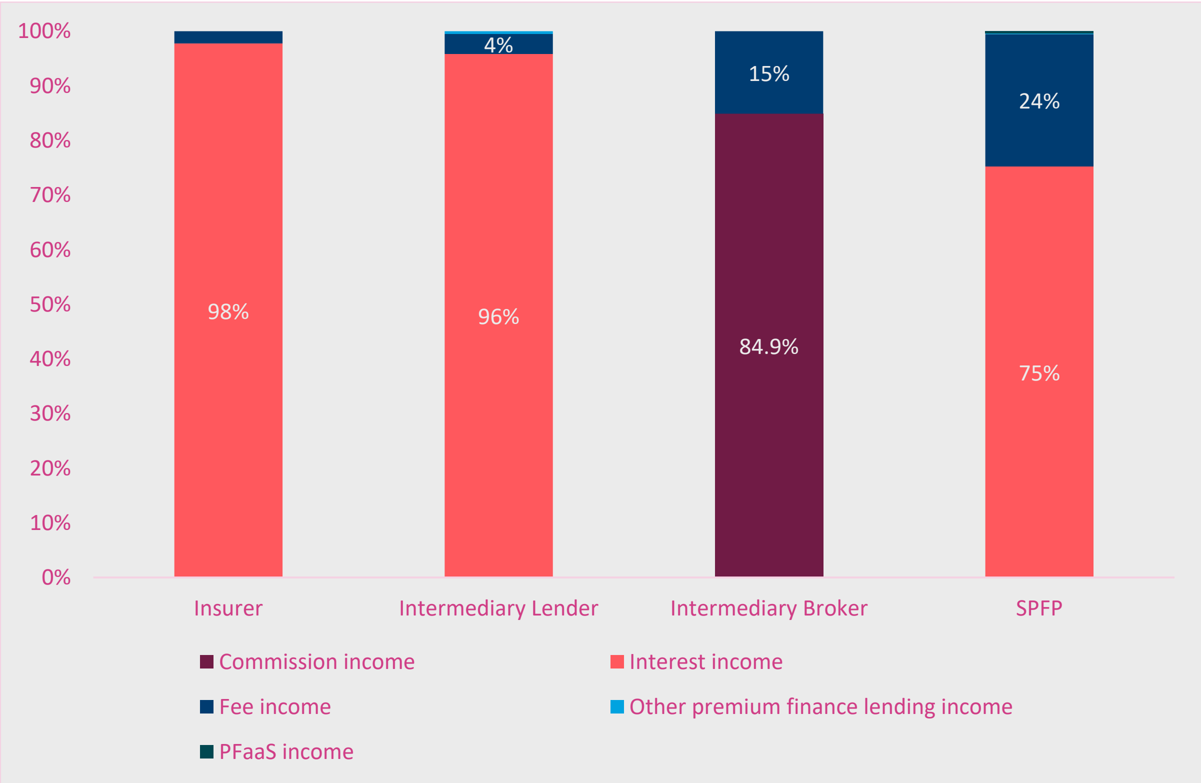
Premium Finance Revenue

Across our sample of premium finance providers, we identified four types of income associated with offering premium finance:

- Interest income is earned by firms that lend premium finance to customers.
- Commission income is earned exclusively by brokers distributing premium finance on behalf of lenders (usually SPFPs).
- Fee income, which includes missed or late payment fees, cancellation fees, policy set-up fees, or default fees.
- A limited number of firms also earned "premium finance as a service" (PFaaS) income. This relates to services such as the sale of white-label software that allows business customers to engage in premium finance lending directly and associated consultancy or training services. This is not a material income source.

FIGURE 2: Retail Premium Finance Revenue by Type in 2023 (%)

Figure 2 includes 11 insurer firms, 8 intermediary lender firms, 4 intermediary broker firms, and 4 SPFPs. We include three vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories. Retail premium finance includes home, motor, pet, and other consumer insurance.



Source: Financial data collected from firms

For the lender firms in our sample, premium finance revenue predominantly consists of interest income. The proportion of premium finance revenue from interest income was stable over the period 2018-2023. Intermediary brokers do not earn any interest income from premium finance. As a result, most of their premium finance revenue is commission, which they receive from SPFPs for distribution of premium finance.

Some firms in each of our cohorts also charge fees for premium finance. This is particularly common in the SPFP and intermediary lender cohorts, where over half of firms in our sample charge fees. The most common fee types are missed payment or default fees, which are charged when a direct debit collection fails.

Some firms do not earn interest on premium finance and may only earn fees from cancellations or missed payments. These are 0% APR policies, which we also refer to as interest-free premium finance policies. A small number of firms removed interest or fees on their premium finance offering during the sample period.

Premium finance revenue growth

Between 2018 and 2023, total revenue from premium finance across our sample grew. The annual growth rate increased year-on-year from 2021 primarily due to rising interest income. Some firms attributed this to increasing interest rates, while others attributed this to volume growth, primarily within the intermediary lender, intermediary broker and SPFP cohorts.

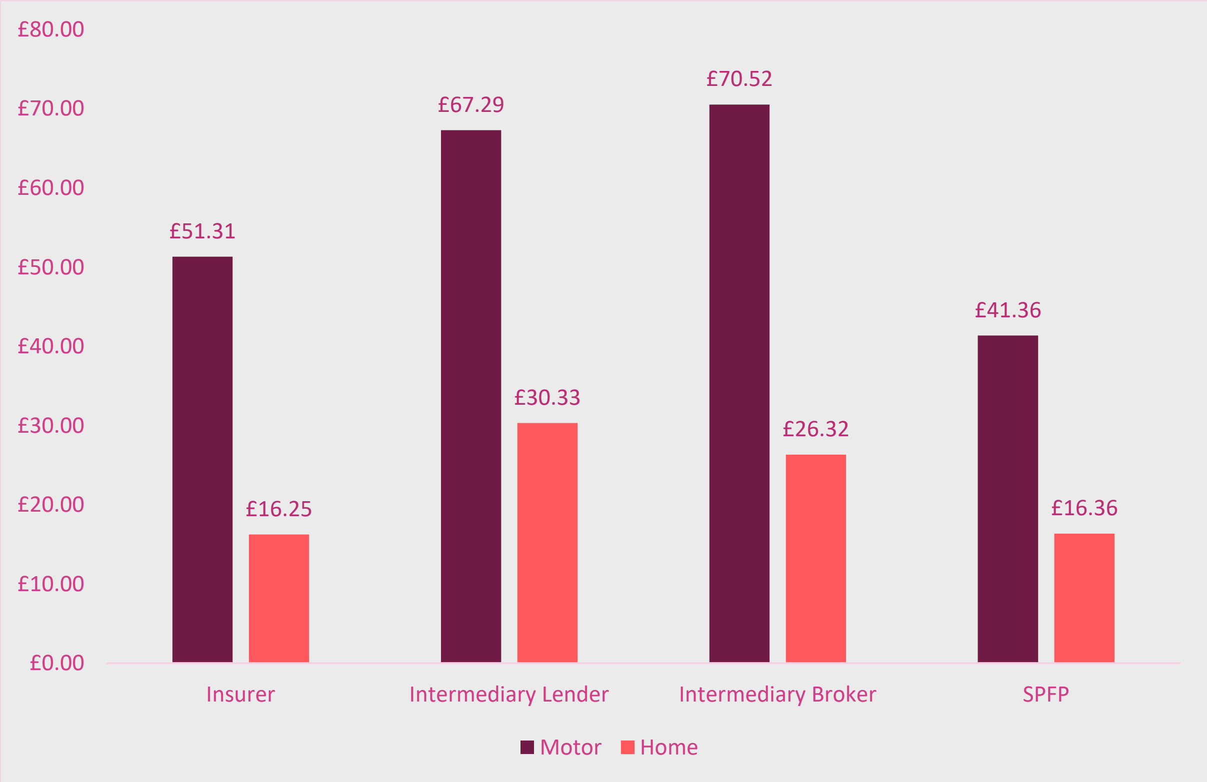
We use the term "interest-bearing premium finance policy" interchangeably with "premium finance policy with interest". To assess the relative impact of pricing and volume on premium finance revenue, we analysed revenue per interest-bearing premium finance policy. We observed that weighted average revenue per interest-bearing premium finance policy was relatively stable for all cohorts between 2018 and 2022. This suggests that revenue growth during this period was broadly proportionate to volume growth. However, between 2022 and 2023, weighted average revenue per interest-bearing premium finance policy increased for all cohorts.

Some of the SPFPs in our sample attributed this growth to their rising lender rates in response to the Bank of England base rate rise and higher loan balances resulting from premium inflation. Insurers, intermediary lenders and intermediary brokers attributed this growth to hardening market conditions and premium inflation within motor insurance.

Premium finance revenue per interest-bearing policy

FIGURE 3: Revenue per Interest-bearing Premium Finance Policy in 2023 (£) (including fees)

Figure 3 includes 9 insurer firms, 7 intermediary lender firms, 4 intermediary broker firms, and 3 SPFPs. We include three vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories. As some firms in each cohort offer only motor or home insurance, the precise sample size varies by product.



Source: Financial data collected from firms

We analysed whether revenue per interest-bearing premium finance policy varied across cohorts. We also analysed whether firms earn more premium finance revenue depending on the products they offer. It is important to note that policies distributed by brokers and financed by SPFPs lead to both earning revenue on the same policy.

By cohort, we observe that the intermediary lenders and intermediary brokers earned the highest revenue per interest-bearing premium finance policy. This was consistent over the sample period and occurred even though, on a per-firm basis, intermediaries tended to have lower premium finance volumes than insurers or SPFPs. This suggests that neither insurers nor SPFPs were able to leverage their higher premium finance volumes relative to intermediaries to earn higher revenue per policy.

For intermediary lenders, 98% of retail premium finance policies sold in 2023 had an APR greater than 20%. However, for insurers, only 51% of retail premium finance policies sold in 2023 had an APR greater than 20%. These proportions were stable over time.

For SPFPs, which distribute premium finance via intermediary brokers, over 93% of the premium finance policies sold in 2023 had an APR greater than 20%. Typically, less than half of this APR is attributable to the SPFP as revenue, with the rest comprising the intermediary broker's commission. For this reason, SPFPs have lower revenue per policy with interest, despite comparable pricing to the intermediary lenders.

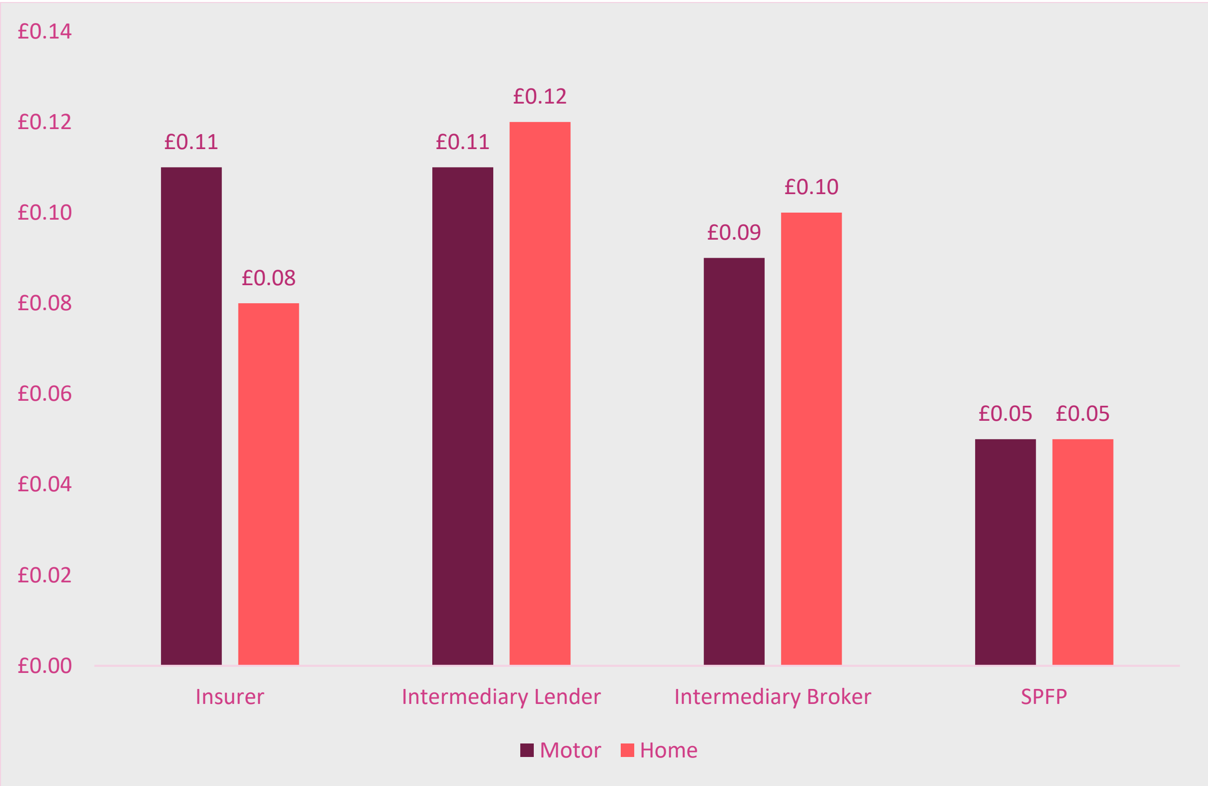
Figure 3 also demonstrates that motor insurance tends to earn significantly more revenue per interest-bearing premium finance policy than home insurance. This arises due to the greater volume of lower-APR premium finance options for home insurance. In 2023, 24% of home premium finance policies with interest in our sample were sold with an APR below 20%. For motor insurance, 17% of premium finance policies with interest sold over the same period had APR below 20%. For both home and motor insurance, over 90% of these products with APRs below 20% were sold by insurers.

Revenue per premium finance policy with interest is also impacted by the average loan size. Since motor insurance premiums are typically higher than home insurance premiums, motor insurance premium balances per policy are larger. As a result, the absolute value of interest and commission payments associated with motor insurance is larger than home insurance.

Premium finance revenue per pound of interest-bearing balance

FIGURE 4: Revenue per Pound of Interest-bearing Balance in 2023 (£)

Figure 4 includes 9 insurer firms, 7 intermediary lender firms, 3 intermediary broker firms, and 3 SPFPs. We include three vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories. As some firms in each cohort offer only motor or home insurance, the precise sample size varies by insurance product. Values were rounded to the nearest penny.



Source: Financial data collected from firms

To account for the impact of different average premiums on revenue per interest-bearing premium finance policy, we calculated revenue per pound of interest-bearing premium finance balance. This reflects the fact that the size of premium finance loans extended for home insurance is typically smaller than for motor insurance. We calculated this by dividing the premium finance revenue of a product (e.g., motor insurance) by the outstanding interest-bearing loan balance for that product. For example, the value of £0.11 for motor insurance for insurers indicates that, on average, this cohort earns £11 of premium finance revenue per £100 of interest-bearing motor premium finance loan.

When we factor in the impact of differing premium amounts for home and motor, we observe that both products generated a similar amount of revenue per unit of interest-bearing outstanding balance for intermediaries and SPFPs. For insurers, home premium finance generated lower revenue per unit of interest-bearing outstanding balance than motor due to lower APRs. This is because they offered lower-APR products for home insurance than motor insurance.

Premium Finance Costs

Cost categories and limitations

This section seeks to understand the accounting and economic costs to firms from providing premium finance.

Accounting costs are recorded in a company's profit and loss statement. In this paper, we separate these costs into direct, indirect and joint costs:

- **Direct costs** can be directly and exclusively attributed to a particular business activity.
- **Indirect costs** are allocated to a particular business activity using an allocation methodology. They include overheads incurred as part of firms' overall operational activities, such as central staff and IT costs.
- **Joint costs** are incurred simultaneously for multiple business lines. For example, providers pay price comparison websites (PCWs) to display insurance products with premium finance. The commission payments to PCWs are incurred regardless of whether the policy is sold with premium finance. Therefore, they cannot be split from the core policy and are therefore considered a joint cost. A key characteristic of joint costs is that these are incurred in absence of another business line. Further explanation and examples of joint costs are provided below.

Economic costs do not affect accounting profitability in firms' financial statements. However, they are important in creating a comprehensive picture of the true cost of providing a product or service. In this paper, we considered opportunity costs in the form of lost investment income, which is typically a cost to insurers. We recognise that opportunity costs can arise in many different forms and will affect our cohorts outside of insurer lenders. These will be considered in more detail as part of our next steps.

Before setting out our cost analysis, it is important to consider the reliability of the cost data submitted. In some cases, firms held cost data that could be directly attributed to their premium finance business or could make limited assumptions to allocate costs based on drivers (such as volume and revenue). However, for a large proportion of firms, premium finance is not assessed as a product line in routine financial reporting or internal management accounting. In these cases, firms had to apply significant judgement and assumptions to fill out our Financial RFI.

Recently, many firms began to develop improved cost allocation methodologies to support their Consumer Duty Fair Value Assessments (FVAs). We reviewed these and factored their results into our analysis where reasonable. For many firms, the allocations applied in their FVAs only relate to 2023 and should not be retrospectively applied to prior years. Firms also emphasised that cost allocations developed for FVAs are not designed to assess profitability or financial performance. Rather, their purpose is to help firms judge whether their premium finance offering provides fair value.

Due to the data limitations in the Financial RFI and discrepancies between Financial RFI data and FVAs, we applied further assumptions to estimate the cost base of premium finance on a best-endeavours basis. We have noted in our analysis below where we applied assumptions.

For firms that were able to fill out indirect costs, we are comfortable with the methodologies they used to allocate them to premium finance.

The table below outlines the types of joint costs reported by cohorts:

Business type	Joint cost
Insurer	• Commissions paid to PCWs or other intermediaries with contractual commission terms • Staff costs driven by shared service teams
Insurance intermediary lenders	• Commissions paid to PCWs • Marketing costs
Insurance intermediary brokers	• Commissions paid to PCWs • Lead generation costs
SPFPs	• *Does not recognise joint costs*

For joint costs, firms either:

- Included a pre-allocated joint cost to premium finance, which we used as part of all our models, or
- Provided joint costs in their entirety, which mostly related to both insurance and premium finance. For these, we used a revenue-based approach to allocate some of those costs to premium finance.

We apportioned an amount to the premium finance business segment to exercise prudence when considering the operational burden on firms' activities.

Key premium finance costs

Qualitative responses from firms suggest the most significant costs of providing premium finance are:

- **Costs of funding**, which manifest differently across business models. For SPFPs and intermediary lenders, these are often traditional interest expenses paid to both/either intra-group funding companies or external funders. For insurers, these are typically the opportunity cost of lost investment income, calculated by firms as a risk-free rate applied to the premium balance loan. This represents the amount the firm could have earned from investing the premium had it been received upfront.
- **Bad debt write-offs** and other costs surrounding arrears and defaults. Most firms have measures in place to mitigate the number and value of defaults, such as credit and affordability checks, following up with customers and making alternative payment plans. These measures incur operational costs for firms, even if there is no eventual write-off of debt.
- **Dedicated premium finance staff costs**, such as advising, customer service and payment handling.
- **IT and technology costs** of maintaining and improving internal and customer-facing platforms.
- **Allocated overheads** and indirect costs such as central staff costs, regulatory and compliance costs.

Where a broker sells premium finance where the lender is a SPFP, the price paid by the customer is split into two elements:

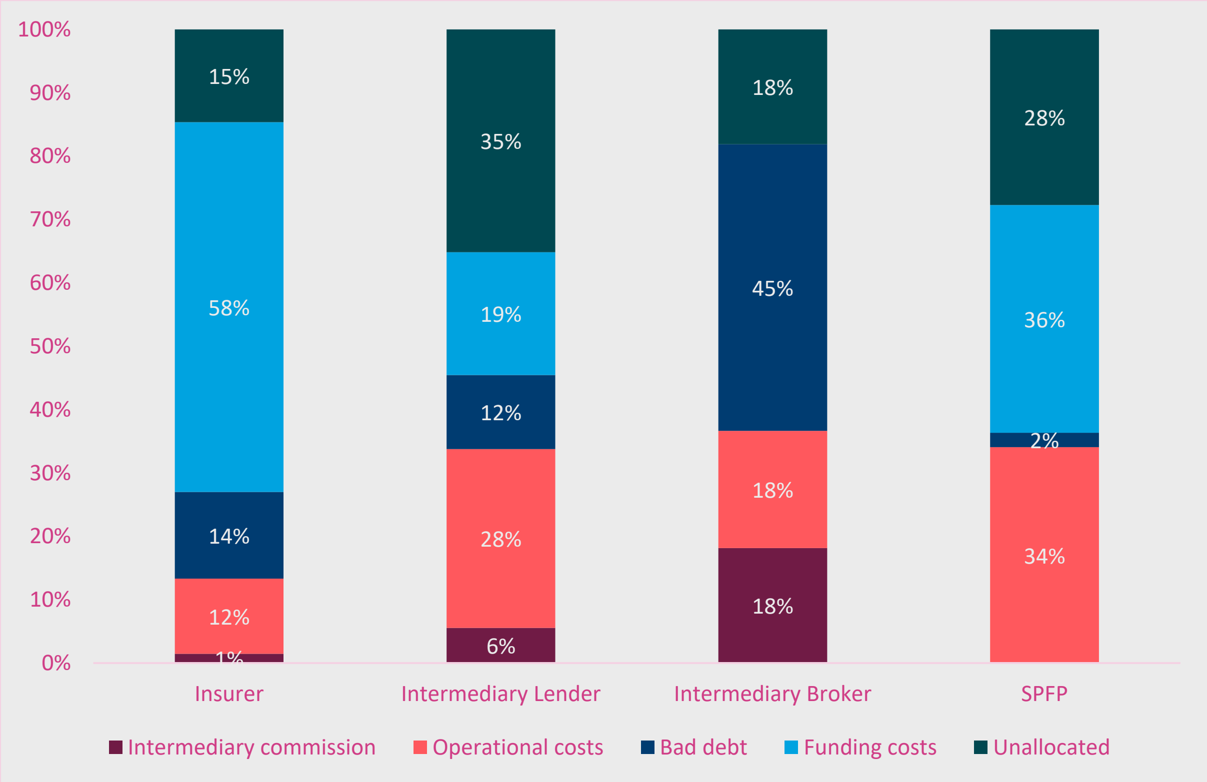
- The intermediary broker's commission ('overriders'), and
- The SPFP's own lender rate.

As stated above, overriders do not constitute a cost for SPFPs in their profit or loss statements and is not represented in the cost analysis below. Any mentions of intermediary commission in our cost section below refer to arrangements outside of overriders.

Premium finance cost composition

FIGURE 5: Split of Premium Finance Costs in 2023 (%)

Figure 5 includes 7 insurer firms, 7 intermediary lender firms, 4 intermediary broker firms, and 4 SPFPs. We include three vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories.



Source: Financial data collected from firms

The chart above splits premium finance costs into 5 key components: intermediary commission, operational costs, bad debt, funding costs and unallocated costs. The operational costs in this graph are a sum of dedicated premium finance staff costs, IT and technology costs, allocated overheads, and other immaterial cost lines which we did not include in our 'Key premium finance costs' section (e.g. marketing, travel costs). Unallocated costs are those which firms were unable to allocate to specific cost lines.

The major drivers of premium finance costs varied by cohort. For insurers and SPFPs, the most significant cost in 2023 was funding cost. For insurers, funding costs were consistently the largest component of costs throughout the sample period. However, for SPFPs, funding costs became more significant since 2022. For both cohorts, absolute funding cost grew significantly since 2022 due to rising base rates.

Within our sample of firms, SPFPs had the largest premium finance cost base. This is because these firms dedicate a higher share of their operational activities to premium finance. This is in contrast to the other three cohorts, where:

- Facilitating premium finance activity is typically a minor part of their wider business activity and therefore does not lead to significant additional costs; and/or,
- A large proportion of the costs incurred to run or distribute premium finance were already incurred as part of the core insurance activity (joint costs).

Bad debt made up a particularly high and low proportion of costs for intermediary brokers and SPFPs respectively. This is because most of these firms in our sample operate contracts under recourse arrangements, allowing the SPFPs to recoup most of their bad debt costs from the intermediary brokers. This results in a redistribution of bad debt costs from SPFPs to intermediary brokers.

Bad debt costs were a moderate proportion of premium finance costs for intermediary lenders and insurers. Since they do not engage with any premium finance brokers, they do not benefit from the ability to arrange recourse agreements. This means they bear the cost of exposure to bad debt from policy cancellations directly.

The below analysis looks to further explore the cost trends and various key drivers for premium finance.

Change over time in premium finance costs

Total costs of premium finance across our sample of firms increased between 2018 and 2023. Increases in volume contributed to a growing operational cost base. However, we also saw that cost per premium finance policy increased over the period, suggesting that increasing costs were not purely driven by increases in volume.

Costs per policy rose primarily due to a sharp increase in interest expense and lost investment income. As these funding costs are heavily influenced by the external interest rate environment, this upward trend may not have continued as interest rates declined in 2024 and 2025.

FIGURE 6: Economic cost per premium finance policy in 2023 (£)

Figure 6 includes 7 insurer firms, 7 intermediary lender firms, 4 intermediary broker firms, and 4 SPFPs. We include three vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories.

Source: Financial data collected from firms

When we observed economic cost per policy across our cohort breakdown, we noted that SPFPs have the largest across the four cohorts. As mentioned above, this is because SPFPs dedicate a higher proportion of their cost base to facilitating premium finance activities. This materialises through both higher direct costs and greater central overhead allocations to premium finance. Firms in the other three cohorts also directly incur costs related to premium finance activities and allocate central overheads. However, since premium finance is a relatively small proportion of their overall business, the proportion of costs allocated to premium finance is significantly lower.

Drivers of Premium Finance Costs

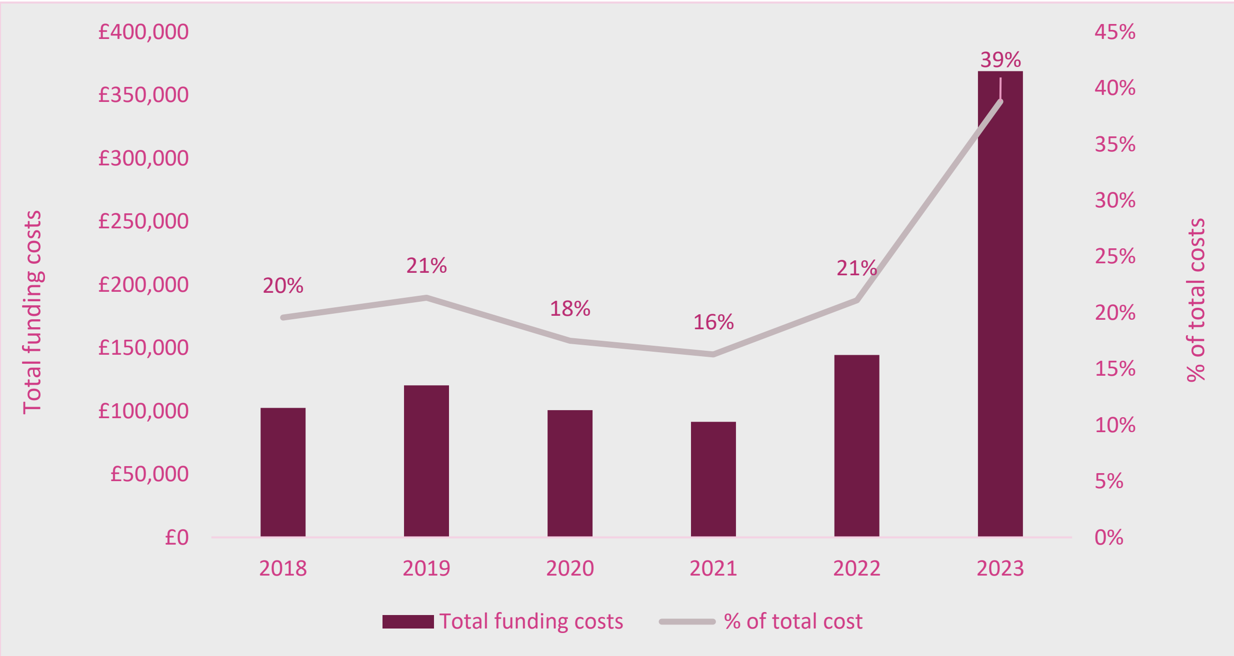
Cost of funding

All premium finance lenders face a cost of funding. For insurers, we represented this as the opportunity cost of lost investment income. Between 2021 and 2023, lost investment income grew to above 35% of insurers' total premium finance costs. This was due to the rising interest rate environment, where higher risk-free rates increase the opportunity cost of premium finance activities.

SPFPs' cost of funding is the interest rate paid on funding facilities. Since these interest rates are typically linked to external market rates (such as SONIA (previously LIBOR) and the BoE base rate), these increased between 2022 and mid-2023.

FIGURE 7: Funding Costs as a % of Total Economic Costs for Lenders (£000s, %)

Figure 7 includes 7 insurer firms, 7 intermediary lender firms, 4 intermediary broker firms, and 4 SPFPs. We include three vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories.



Source: Financial data collected from firms

Insurers and intermediary lenders generally do not pay interest to third parties to facilitate premium finance activities. Instead, we observe:

- Intermediary lenders that pay intercompany interest expenses to group insurers who provided 'funding' by allowing payments to be deferred.
- Insurers or intermediary lenders that pay an interest expense to a central treasury function, with prices decided on a Transfer Funding Price (TFP) basis.

These rates are set at an arm's length basis, meaning the interest rate that is set for these transactions are in-line with external market rates. Therefore, we expect these to align with funding costs that self-funded insurers or SPFPs face.

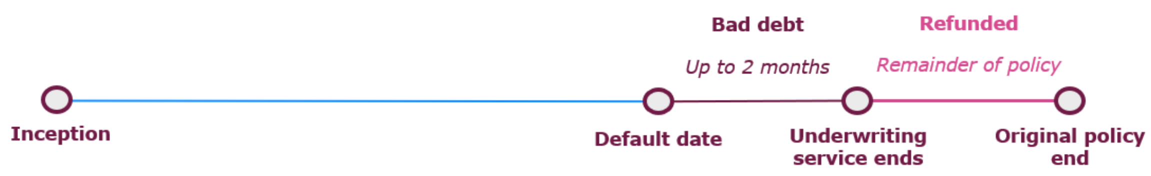
Bad debt costs

When customers default on their payments, insurers can cancel the underlying insurance policy. Where an insurer is not the lender for premium finance, the insurer is obligated to refund the remaining unearned premium to the lender (for example, the intermediary lender or the SPFP).

Bad debts arise in premium finance primarily under the below scenarios, with the cost recorded in firms' profit and loss statements:

- During the time between the customer entering arrears and the policy being cancelled, insurance coverage continues. Where an insurer uses an SPFP through an intermediary broker, they will refund the remaining premium amount to the intermediary broker or SPFP following cancellation.
- The intermediary broker or SPFP, depending on the recourse arrangements between them, will be responsible for the cost of insurance coverage from when the policy enters arrears until the cancellation date.
- Insurers may apply a short-rate cancellation on the policy. This means the refund issued to the intermediary broker or SPFP by the insurer is less than the unused premium, because the insurer deducts a penalty. This is to manage risk, cover upfront costs and discourage policy churn.
- Insurers typically charge a cancellation fee for policies terminated early. This amount is typically subtracted from the refund provided to the intermediary broker or SPFP.

FIGURE 8: Example timeline of bad debt occurrence



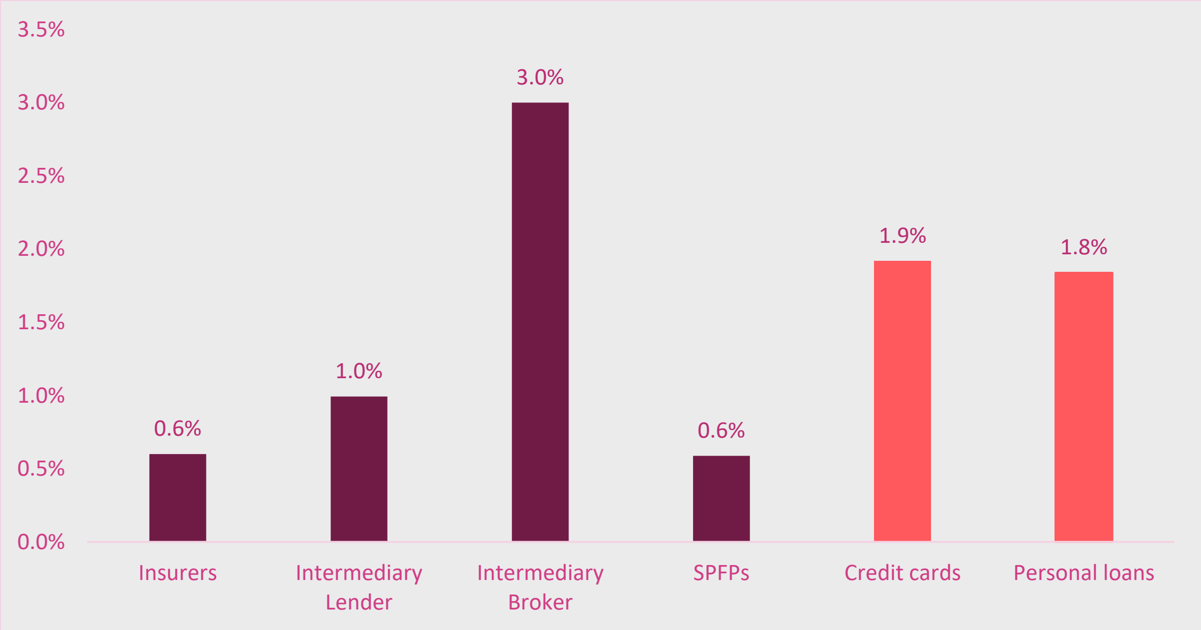
The firm that bears the bad debt costs depends on the type of commercial agreement between the intermediary broker and the SPFP. Under a recourse agreement, the intermediary assumes responsibility when a customer defaults on payments, and the SPFP can recover outstanding debt from the intermediary. Under a non-recourse agreement, the SPFP cannot recover all of the outstanding debt.

We looked to understand the impact of bad debt to assess the level of credit risk firms face for premium finance. Due to data limitations, some firms were unable to segregate costs by type and submitted significant values as 'other direct costs'. To increase the robustness of our analysis, we applied a 30% allocation of 'other direct costs' to bad debt costs. We chose this allocation because we assumed that firms with a large share of bad debt costs (>50% of total costs) would be able to split their costs within our template. For prudence, we conducted a sensitivity to see how our total bad debt costs changed when we allocated between 0% to 50% of other direct costs to bad debt. This exercise did not result in material changes to our bad debt rate analysis.

The below analysis only considers premium amounts written off as bad debt. The operational costs surrounding bad debt and missed payments, such as staff costs or debt collection agency costs, are considered in the next section.

FIGURE 9: Bad Debt as a Percentage of Premium Finance Loan Balance vs. Credit Card and Personal Loan Impairment Rates in 2023

Figure 9 includes 10 insurer firms, 6 intermediary lender firms, 4 intermediary broker firms, and 4 SPFPs. We include four vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories. Credit card and personal loan impairment rates are calculated using samples of 13 and 19 retail banks respectively.



Source: Financial data collected from firms

We calculated bad debt rates (bad debt costs, including an allocation of other direct costs, divided by premium finance loan balances) for each of our four cohorts and compared it with impairment rates for credit cards and personal loans (calculated using financial data submitted by retail banks as part of our retail banking business models data collection). Other than for our sample of intermediary brokers (within which there was variation between firms), we observed lower bad debt rates on premium finance than credit cards and personal loans. This occurred even though these products typically have more stringent affordability checks than premium finance, especially when provided by retail banks.

A significant part of this is because, unlike loans, premium finance users do not receive funds from the lender upfront. Instead, the loaned funds pass directly to the insurer. This means the lender does not need to write off the full balance, because insurers can refund unearned premiums to lenders. This makes premium finance a less risky product compared to mainstream consumer lending products.

Operational costs of arrears and missed payment fees

When a policy enters arrears, firms employ mitigation strategies to prevent a missed payment escalating to a full default and eventual bad debt write-off. These strategies include customer contact to chase payment or use of a debt collection agency. They may result in the cancellation of the underlying insurance policy.

These default mitigation strategies incur additional operational costs. Therefore, even where they are effective in preventing default and the associated write-off, firms will still incur a cost. As a result, many of the premium finance lenders in our sample charge missed payment fees (also called default fees) to customers to allow them to recoup some of these costs. These fees are charged when a direct debit payment fails and are typically added to the customer's next payment.

Missed payment fees are most common in the SPFP and intermediary lender cohorts. Therefore, SPFPs and intermediary lenders recoup a larger proportion of the operational costs associated with arrears than insurers. Within our sample, fees varied between £12-£25 per missed payment. During our sample period, some firms introduced a cap on the number of missed payment fees charged per agreement term.

As mentioned above, while intermediary brokers do not lend to the customer directly, they are liable for bad debts if they are operating under a recourse agreement with their SPFP. Despite this, none of the intermediary brokers in our sample charge missed payment fees. This suggests that these brokers have fewer opportunities to recoup additional operational costs associated with missed payments.

Premium Finance Costs and Pricing

Distribution of customer payments across cohorts' cost bases

We conducted analysis to understand how customer premium finance payments are distributed across cohorts' cost bases. We analysed how the amount paid by the customer for premium finance is absorbed into various cost lines and how this differed depending on whether the lender is an SPFP, intermediary lender or insurer. The purpose of this exercise is to understand the proportion of the price paid by the customer that is retained by the lender firm after these costs are accounted for.

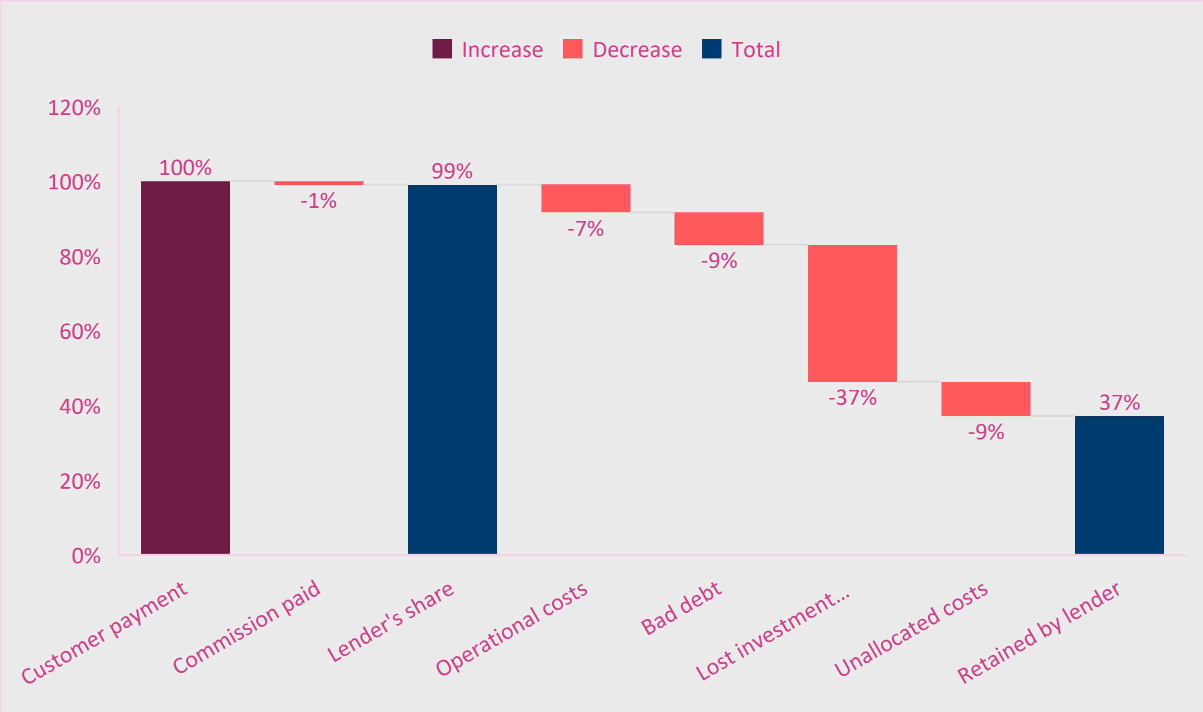
In this section, profit is reported as a percentage of customer payments. For insurers and intermediary lenders, the total amount paid by customers is analogous to revenue from premium finance. For SPFPs, total customer payments were calculated by summing SPFP revenue and the total amount of commission paid by SPFPs to intermediary brokers. This is because SPFPs do not record the commission paid to intermediary brokers as revenue. As a result, we report a lower retained share for SPFPs (in percentage terms) in this section than in the later section on premium finance economic margins.

We excluded insurers which only offer 0% APR premium finance because these firms do not report any revenue (i.e., customer payments) from premium finance. We also excluded revenue and costs relating to "Premium Finance as a Service", as this is not relevant to customer payments. These exclusions result in some small discrepancies between the retained share figures reported in this analysis and the later section dedicated to premium finance economic margins.

For all cohorts, the cost data is as reported by firms but includes supplementary allocations to staff costs and impairments from reported other direct costs.

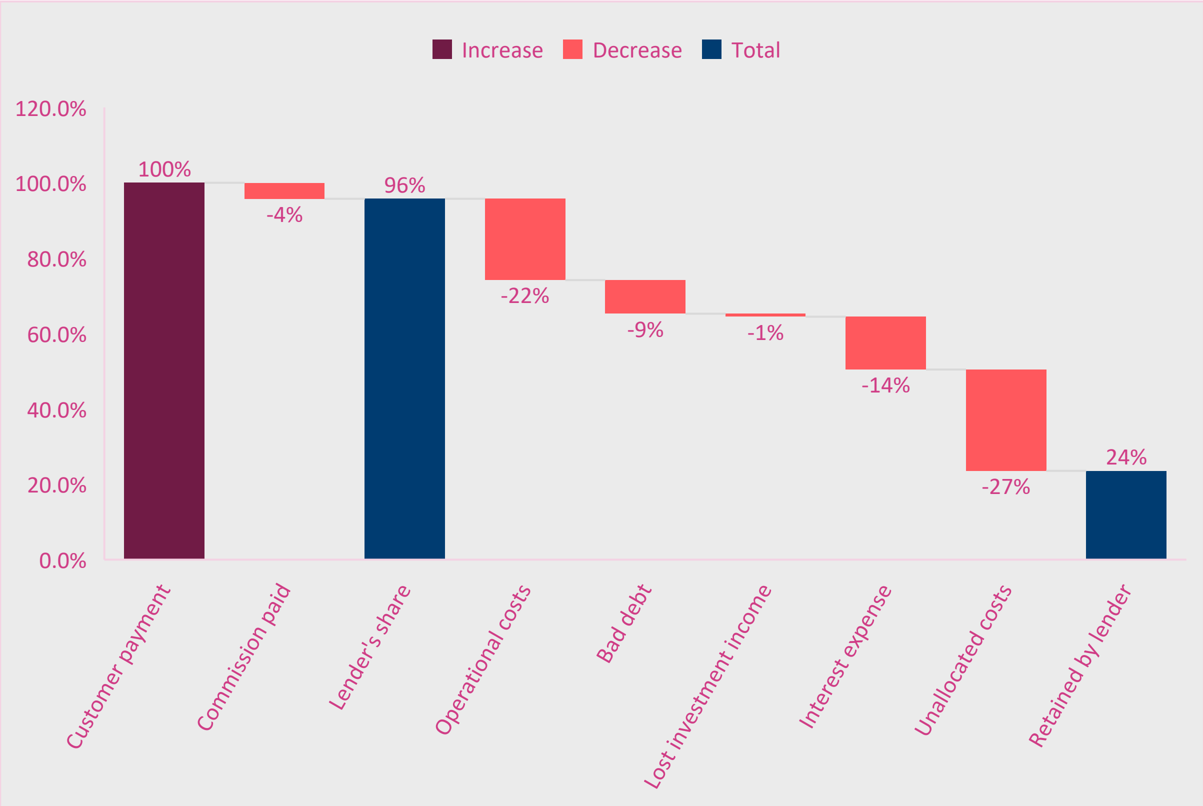
Figures 10a, 10b, and 10c include 7 insurer firms, 7 intermediary lender firms, and 4 SPFPs respectively. We include three vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories. These include data from 2023 only.

Figure 10a: Insurer Customer Payment Waterfall (%)



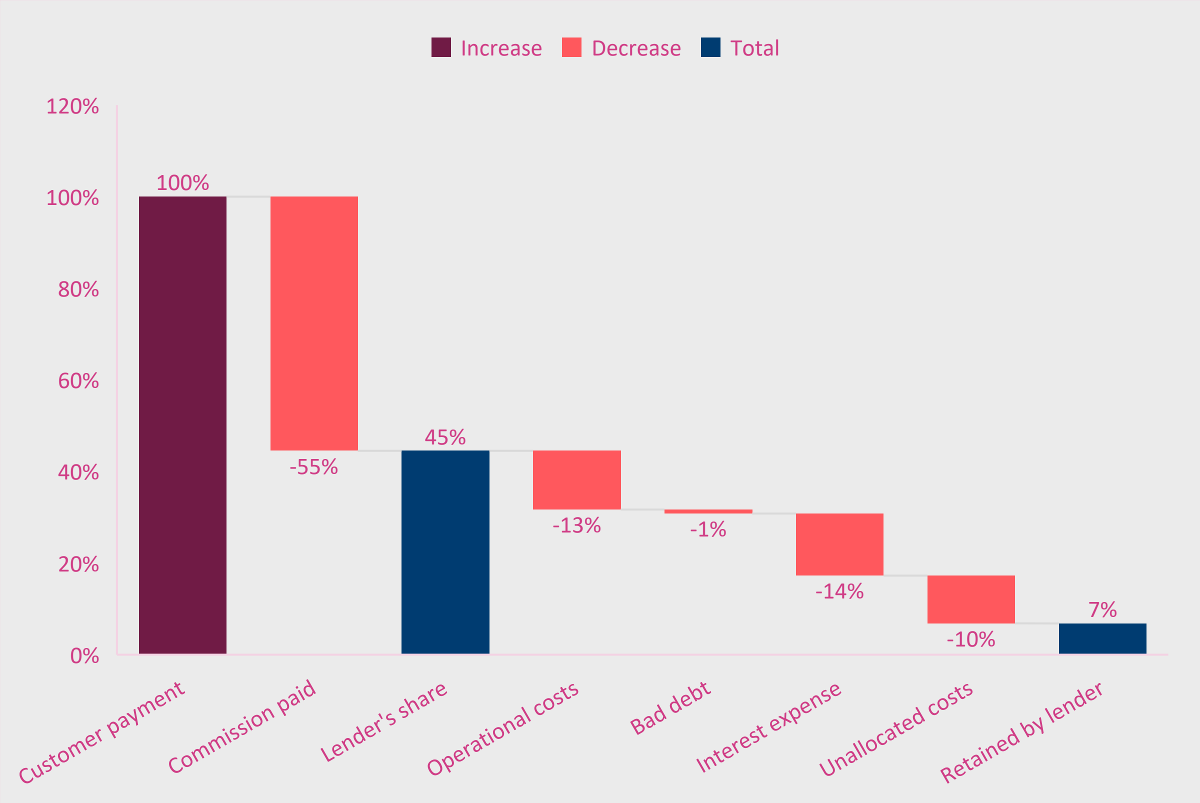
Source: Financial data collected from firms

Figure 10b: Intermediary Lender Customer Payment Waterfall (%)



Source: Financial data collected from firms

Figure 10c: SPFP Customer Payment Waterfall (%)



Source: Financial data collected from firms

We observed that where an insurer or an intermediary lender was the premium finance lender, only a small proportion of customer payments was passed on as commission. The remaining shares were spread out over their respective cost bases, with operational costs and funding costs, either in the form of lost investment income or interest expense, constituting the majority of premium finance costs in each case.

Premium finance profits for insurers and intermediary lenders should be considered as part of their core activities. Particularly for insurers, it is common for firms to earn limited margins on their key underwriting activities but recoup their earnings from add-ons such as premium finance. We explore more on the cost and profitability dynamics between premium finance and core activities below.

Policies in which an SPFP is the lender are always distributed by intermediary brokers. In this case, approximately 55% of the total price paid by the customer was passed to the intermediary broker as commission. The remainder was spread out over the SPFPs' cost base and its profit.

The amount received by the intermediary broker from the SPFP was then split over the intermediary brokers' cost base and profit. Due to data limitations, we are unable to map the intermediary brokers' cost base as a proportion of customer payments. Figure 5 contains an indicative assessment of the most significant components of intermediary brokers' costs.

The consideration of costs into price-setting

We found that most premium finance providers consider their cost base when setting premium finance prices. For many, bad debt, funding and operational costs are key factors.

Firms typically set different premium finance prices (primarily their interest rate) at a product line (e.g., motor and home insurance) and brand level. Within these categories, prices are consistent for all customers. This is regardless of the distribution channel or method, as well as customer characteristics such as their credit profile.

Firms state that higher APRs for motor insurance than home insurance reflect the higher costs associated with that type of premium finance, such as:

- Higher operational costs due to more frequent cancellations or in-term policy adjustments.
- Higher insurance premiums which lead to higher funding costs per policy.
- Overall riskier credit profiles for motor premium finance customers than home premium finance customers, resulting in greater bad debt.

We saw that the average cost per motor policy was significantly higher for our sample of firms than home (£38.11 and £10.82 for lenders and £46.31 and £11.46 for brokers respectively).

Premium Finance Profitability

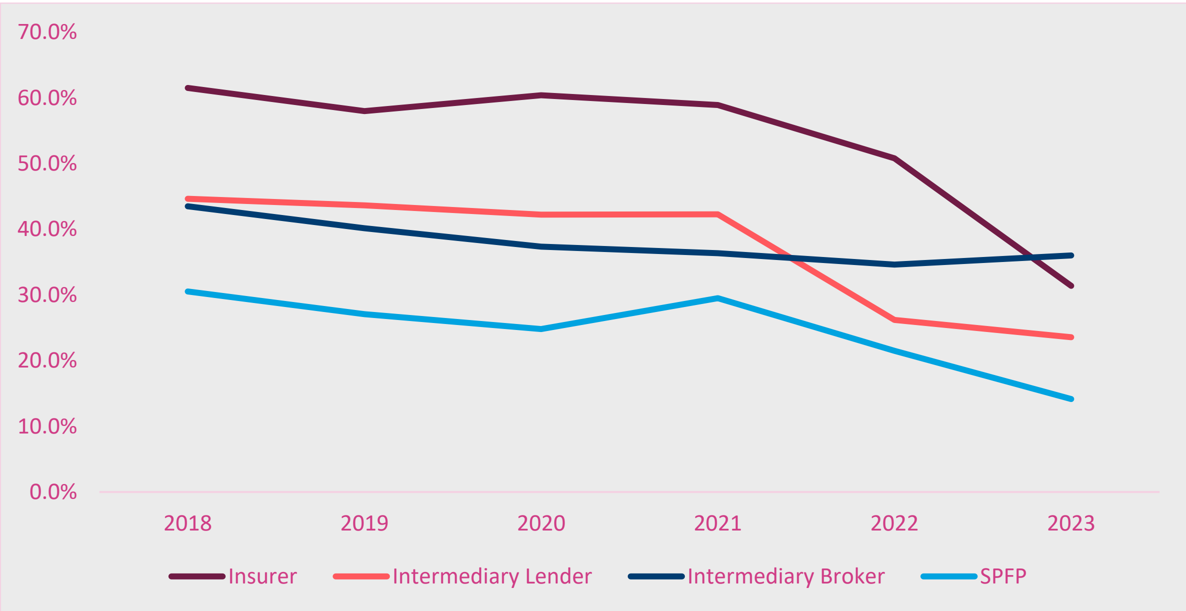
Premium finance economic margins

The below analysis demonstrates pre-tax economic profit margins on premium finance. This includes commercial premium finance, which primarily impacts SPFPs' margins. To calculate margins, we included all revenues attributable to premium finance, deducted costs and divided the result by revenue.

As noted above, some firms were unable to provide cost data at the level of detail requested in the Financial RFI. Where cost data submissions were not sufficient, we referred to firms' Fair Value Assessments (FVAs) to observe the premium finance margins they calculated themselves. This means there are limitations with cost data prior to 2023. We made assumptions regarding the cost base based on discussions with firms and the below analysis reflects our best-endeavours results.

FIGURE 11: Weighted Average Premium Finance Margin (%)

Figure 11 includes 14 insurer firms, 8 intermediary lender firms, 4 intermediary broker firms, and 4 SPFPs. We include four vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories. Figure 11 includes an allocation of joint costs to premium finance.



Source: Financial data collected from firms

For most cohorts, we observed consistent margins between 2018 and 2021, followed by a decline between 2022 and 2023. For premium finance lenders, this was due to the significant increase in funding costs associated with the higher base rate environment. This decline in margin shows that cost growth has outpaced revenue growth for these cohorts and suggests that these cohorts are not able to pass through the entirety of these cost increases to consumers via higher prices. Intermediary brokers did not experience the same decline in margins in 2022-2023 as they do not face the same exposure as lenders to external interest rates.

Estimated margins were lowest for SPFPs relative to the rest of the cohorts. This was driven by the larger premium finance cost base for SPFPs, where firms incur more facilities, staff and funding costs from premium finance activities.

It is important to note that this paper analyses the margins of premium finance in isolation. However, we note that it cannot be sold in isolation because it is an add-on for the core insurance product, leading to firms making decisions on the provision of premium finance in conjunction with the core insurance policy.

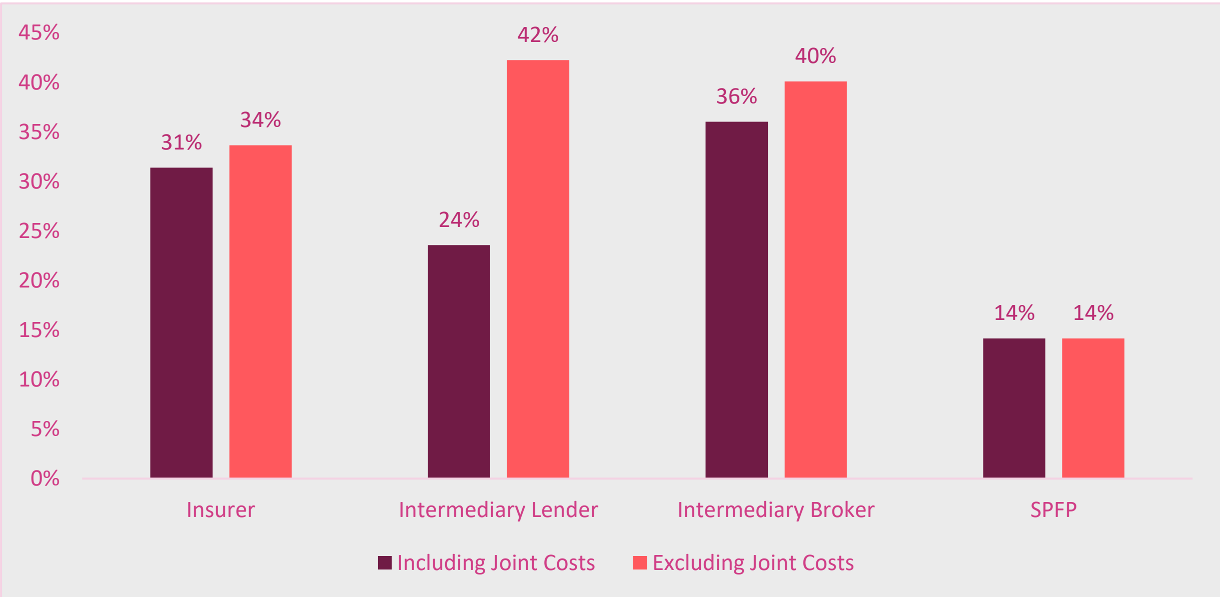
Our analysis shows that insurers and intermediary lenders can recoup returns on their low margin insurance products by tagging on higher margin premium finance products without incurring significant additional costs. In these situations, a significant proportion of costs has already been incurred as part of their underwriting or insurance intermediary activities.

Whilst brokers had higher bad debt rates compared to insurers and intermediary lenders, they were able to compensate for this by charging high commission rates. Paired with a lack of funding costs, this allowed them to maintain their high margins throughout the sample period.

While the analysis above represents our current understanding of the financial performance of premium finance, it is based on data which is highly sensitive to assumptions. In particular, joint costs are difficult to assess economically, and their inclusion and allocation can lead to a different picture compared to when they are excluded.

FIGURE 12: Weighted Average Premium Finance Margin, including and excluding Joint Costs in 2023

Figure 12 includes 10 insurer firms, 7 intermediary lender firms, 4 intermediary broker firms, and 4 SPFPs. We include four vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories.



Source: Financial data collected from firms

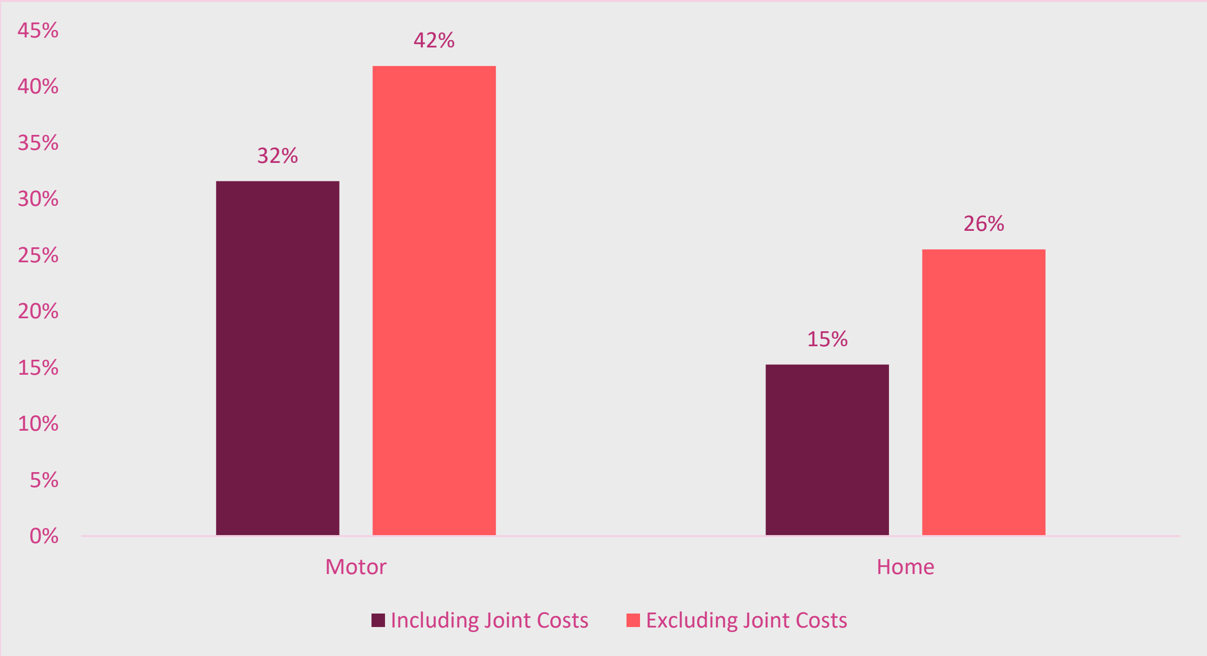
In Figure 12 above, we contrasted the results for 2023 when including and excluding an allocation of joint costs. Including joint costs generates a lower bound estimate of premium finance margin. When excluding joint costs, margins appeared higher for all cohorts except SPFPs, which do not recognise joint costs. This exclusion shifted intermediary lenders' margins the most, showing intermediary lenders' costs are sensitive to allocations of joint costs.

However, even when exercising prudence by including joint costs, we observe that operating margins remained above 20% for all cohorts that recognise them.

Home and motor premium finance economic margins

FIGURE 13: Motor and Home Premium Finance Margins in 2023 (%), including and excluding joint costs

Figure 13 includes 9 insurer firms, 7 intermediary lender firms, 4 intermediary broker firms, and 3 SPFPs. We include four vertically integrated firms, which are accounted for once in either the insurer or intermediary lender categories. As some firms in each cohort offer only motor or home insurance, the precise sample size varies by product.



Source: Financial data collected from firms

Having observed that revenue and costs were higher per policy for motor compared to home premium finance, we explored whether there was also a difference between their margins. The above analysis illustrates estimated pre-tax profit margins on retail motor and home premium finance. The calculation includes product-specific interest, fees, commission and direct costs, and allocations of funding costs, indirect costs, and joint costs. This analysis is not split by cohort, rather it reflects weighted averages across all firms in our sample. This is due to sample size limitations within some cohorts.

Cost allocations were made via either the product's share of premium finance revenue or the product's share of premium finance balances. In some cases, these allocations will differ from firms' own allocations of costs (for example, in their FVAs). However, to ensure comparability, we followed the same allocation approach for all firms in the sample.

We show the results for 2023 both including and excluding joint costs. We present results excluding joint costs because allocating joint costs to motor and home premium finance required a significant number of highly sensitive assumptions, which may not be representative. We observe that the overall weighted margins were higher for motor than for home premium finance, irrespective of whether joint costs are included.

While both motor and home premium finance margins were positive in all years, there is no clear pattern showing one as more profitable than the other. The margin differential widened in 2023. Before this, motor and home premium finance margins were close, with motor being more profitable in 2018 and 2019, and home in 2020-2022.