General Insurance Pricing Practices Market Study Interim Report

Annex 2: Business Models and Financial Analysis Technical Annex

October 2019

1 Introduction

Objectives and description of financial analysis

1.1 This annex presents the financial analysis of firms in the motor and home insurance markets conducted as part of the market study. There are two main reasons we have undertaken a financial analysis. First, understanding the business models of the firms in motor and home general insurance markets helps us to understand how firms make their money and how firms compete.

1.2 Second, we want to understand what financial performance suggests about how competition is working in the general insurance market as well as the impact pricing practices have on the profitability of firms and how this varies between different business models and parts of the supply chain.

1.3 The structure of this annex is as follows:

- Our approach: we provide an overview of the scope of our sample, which firms were selected and why. We also discuss some of the issues with the data we received and the conditions and limitations this places on our analysis.
- We explain the business models in GI motor and home market and how they make money. We give, for each of the 3 main categories – insurers, intermediaries and price comparison websites (PCWs):
  - The firms' main revenue sources. We explore how revenue might vary between firms in relation to size of book of new vs renewing customers for insurers and type of revenue – underwriting vs non-core [1] revenue for insurers and commission vs non-core revenue for intermediaries.
  - A breakdown of firms' cost base and key cost drivers with a focus on acquisition costs.
  - An assessment of overall operating profit margin and how profit changes over time. We also analyse and compare the relative profitability of different business models along the GI supply chain.
- How the overall operating profit margin of firms is affected by:
  - Size of gross written premiums (GWP) of firms and any relationship to type of business model adopted.
  - The proportion of renewal business to total business (insurers), with the hypothesis that firms with a larger renewal book will be more profitable.
  - Share of non-core revenue to total revenue (insurers and intermediaries) – to test if firms with higher proportion of non-core revenue have higher profit.
  - Customer margins[2] dispersion. We compared the profitability of insurers with a higher proportion of customers paying high customer margins with the market average.

[1] We have defined core revenue as revenue from underwriting the main product risk and non-core as revenue from investment, sale of add-on products, fees and charges and premium financing.

[2] The customer margin for each policy is the difference between premium and expected claims costs as a proportion of the premium. This customer margin measures the contribution of an individual policy to non-claims costs, expenses and profit.

2 Our approach

Data: an overview

2.1 We collected annual financial data over a 6-year time horizon, from 2013 to 2018 for 17 underwriting[3] firms (insurers), 12 intermediary firms and 4 PCWs.

- The market share of the insurers based on Gross Written Premium (GWP) in our sample represent 76% and 91% of the motor and home market respectively.
- The intermediaries were selected to be representative of the different types of business models which exist in the markets (which includes both price setting and non-price setting intermediaries). In terms of market share, the intermediaries in our sample represent 38% of motor and 20% of home.
- We have selected the main four price comparison websites for the last piece of our analysis; they represent 96% of the price comparison market[4].

2.2 We asked firms for financial data regarding revenue, costs and balance sheet data at product level (motor and home) and data for revenue and costs at distribution and brand level. We have also asked for information such as the number of new and renewal policies sold per year, GWP for new business and operating ratios (loss ratios, expense ratios, combined operating ratios – both gross and net of reinsurance) calculated by firms on written and accident year basis.

2.3 In 2018, the insurers in our sample wrote GWP of £9.9 billion in motor business and £4.3 billion in the home business while generating total revenue of £13.1 billion and profit before tax of £1.5 billion in total.

2.4 The intermediary firms selected include intermediaries which set the street prices paid by consumers as well as intermediaries which do not.

Important considerations relating to the data

2.5 Firms were able to provide a breakdown of revenue, for instance GWP for new and renewal business and non-core income relating to motor and home business. However, most of them could not provide the costs associated with the sale of add-ons, fees and charges and premium financing. Hence, we have focused on the analysis of revenue rather than the overall profitability of these different revenue streams.

2.6 The PCWs found it particularly demanding to provide us with cost data as they do not consider motor and home general insurance as separate standalone businesses. They were only able to provide us with direct advertising & marketing costs and internet search fees for motor and home. We have allocated the indirect PCW firm level costs (e.g. staff costs) to motor and home products based on the proportion of clicks, to assess the operating profit margin contribution of motor and home business. PCW firm level operating profit margin is also presented for context.

2.7 Many firms informed us that they do not monitor financial performance[5] by distribution channels or brands which limit our ability to undertake analysis beyond

[3] Underwriting in insurance involves the evaluation of risk of a future event occurring and charging premiums in return for a promise to reimburse the consumer an agreed amount if the event occurs.

[4] PCW portfolio Strategy

[5] Firms were able to provide revenue breakdown but costs are not allocated to the brand or distribution channel levels.

the motor and home product level. As a result, we are unable to analyse and compare the performance of the different channels and brands at this stage.

2.8 There were challenges around the firms' ability to split their balance sheet items meaningfully by product. This is because motor and home general insurance is only one of the product lines to some of the firms and the capital firms hold is effectively shared across all lines of business. This restricted what we can do to determine the economic resource base (capital employed) from which the firm earns its profit. Calculating return on capital employed (ROCE) was thus difficult for motor and home as a measure of profitability[6]. In addition, ROCE analysis would have been less meaningful for intermediaries because they are typically not capital intensive – they do not generally carry long term debt or have a high level of long term assets due to the nature of the business model and the amount of regulatory capital required.

2.9 In the absence of consistent balance sheet data by product, we have used conventional industry performance ratios (loss ratios and combined operating ratios) to determine underwriting profit for the insurers. We then analysed pre-interest, tax and extraordinary items profit margins over sales (operating profit margin) as an indicator for overall profitability for all the firms in our sample.

2.10 The operating profits that we present reflect accounting profit and do not include opportunity cost of capital. This however does not change our conclusions as such as our conclusion on insurers' core underwriting profitability is drawn from our analysis of the performance ratios and we also observed that intermediaries in our sample do not carry long term debt in their balance sheets and are not capital intensive. This suggests that any opportunity cost of capital calculated for the intermediaries would be minimal. We have also analysed revenue/cost per policy for the insurers, intermediaries and PCWs to provide insights into the relative profitability along the chain.

2.11 To protect the confidentiality of firm information we typically show market averages to reflect financial performance across the industry. Where results are notably different between different firms we also note ranges and levels of variance in the sample data.

[6] The conventional way to look at economic profitability is to determine ROCE of the firm and compare it with its weighted average cost of capital.

3 Business models in GI motor and home

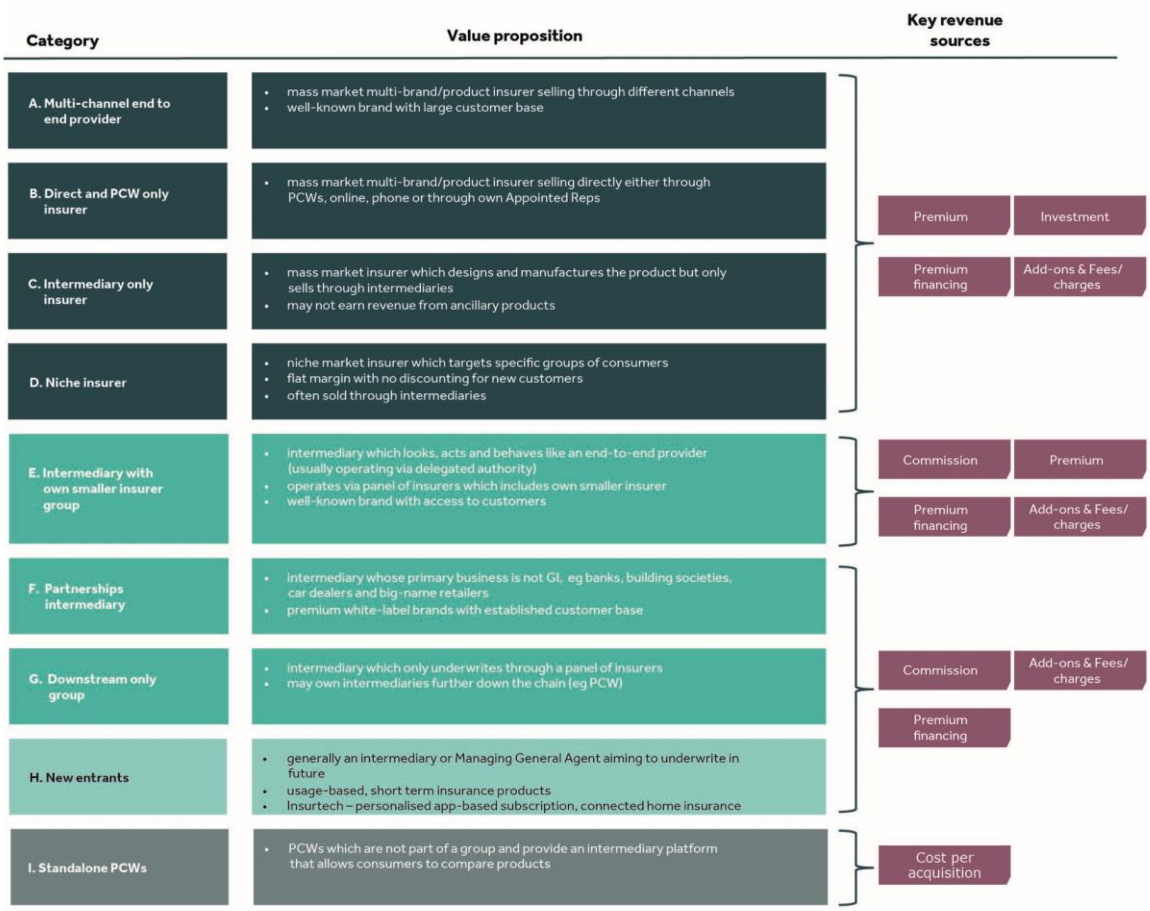
3.1 GI providers can be broadly classified into one of following categories depending on the type of activities and revenue they earn along the supply chain. This structure is how we have analysed and presented our findings.

Figure 1: Breakdown of business models showing revenue, costs[7] and profit

	Income	Costs	Profit
1 Insurers	• Core income: Net earned premium • Non-core income: Investment income, premium finance, add-ons, fees and charges.	• Claims cost • Expenses: acquisition cost (commission paid, CPA and advertising & marketing), staff costs, other operating costs (including add-ons claims cost and default cost).	• COR: Underwriting profitability (>100% is loss making on underwriting) • Operating profit: overall profitability of the business
2 Intermediaries (excl. PCWs)	• Core income: Commission • Non-core income: Add-ons, premium finance, fees and charges.	• Expenses: commission & CPA paid, advertising & marketing, staff cost, other operating costs.	• Operating profit: overall profitability of the business
3 PCW	• Core income: Cost per acquisition (CPA)	• Expenses: advertising & marketing, staff costs and other operating costs.	• Operating profit: overall profitability of the business

3.2 Within the category of insurers and intermediaries, we have identified the following models which exist in the market, differentiated by key revenue sources they earn and the firms' value proposition.

[7] To note that costs do not include opportunity costs of capital as mentioned in para 13.



3.3 We find that firms may adopt one or more of the business models identified – the main differentiation being the way the policies are distributed. Insurers have much more stringent capital requirements than intermediaries. The pricing practices of the different models are relatively similar – most firms told us they may set the level of new business prices low and then increase prices over time.

Insurers: Revenue

3.4 Insurers' primary source of revenue is premiums received from policies sold to insured consumers, in exchange for an agreement to indemnify for claims made against the policy.

3.5 GWP is the total revenue from a contract expected to be received by an insurer. While gross earned premium (GEP) is the part of GWP that is attributable to risk borne by the insurer during the financial year[8]. A portion of the GEP is ceded out as reinsurance to reduce the insurer's risk exposure. In our sample on average 16% of GEP is reinsured in motor and 7% of GEP is reinsured in home.[9]

3.6 Net earned premium (NEP) is GEP net of payments for reinsurance. We regard this to be the core underwriting business revenue earned by insurers.

3.7 In addition to the core NEP revenue, insurers also generate other forms of revenue. We have defined this as non-core revenue. This includes:

- investment revenue: earned by insurers from their investment portfolios[10].

[8] FCA Handbook: https://www.handbook.fca.org.uk/handbook/glossary/G1531.html

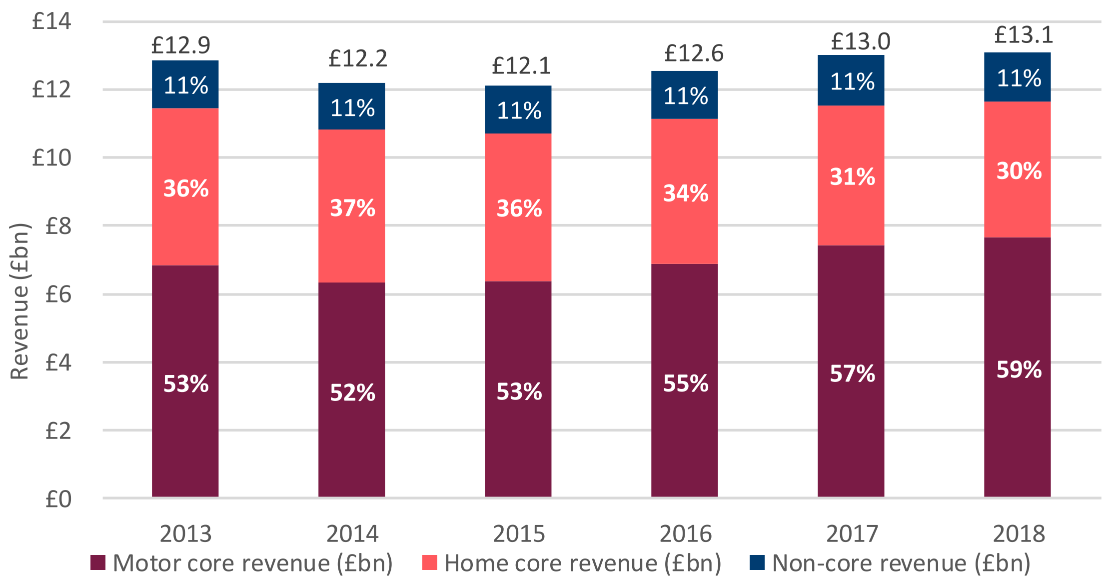
[9] The average is weighted by GEP. Note that, in motor, reinsurance as a percent of GEP ranges from 1% to 62% and for home from 0% to 82%.

[10] Investment revenue includes interest payments, dividends, capital gains from investment in stocks, bonds and other investment.

- instalment/premium finance revenue: earned by insurers for lending funds to insured customers to pay the policy premiums.
- add-on revenue: earned from the sale of products in addition to the core insurance policies, e.g. legal expenses, breakdown cover, home emergency cover.
- revenue associated with claims: received as part of the claims process including referral fees, rebates and profit shares for example from 3rd party repair businesses.
- commission/ profit share: earned from any profit share arrangements with intermediaries.
- other revenue – including profit share on reinsurance

3.8 Figure 2 shows motor and home insurance total revenue (NEP plus non-core revenue) between 2013 to 2018 for the firms in our sample – total revenue is £13 billion per year on average. The figure shows that while revenue has been relatively constant over the last six years, the composition of motor and home core revenue has changed. This reflects the increase in motor premiums over time (peaking in 2017).

Figure 2: Insurer's revenue (2013–2018)



3.9 Motor NEP revenue accounts for an average of 55% of the total revenue earned by insurers in our sample, while home accounts for an average of 34% of total revenue and the remaining 11% is from non-core revenue. We notice that:

- the average NEP per policy in motor is £299[11] and in home £231.
- further, the average number of policies sold per year in our sample in motor is 23 million and in home it is 19 million.

Renewal GWP is higher than new business

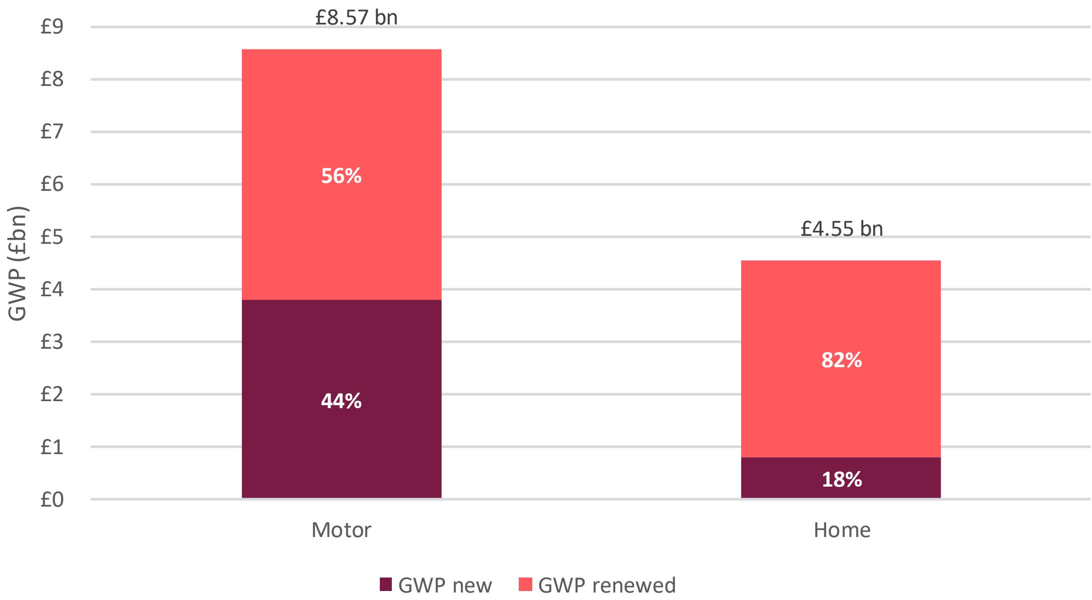
3.10 In both the motor and home insurance firms in our sample, the share of GWP from renewal business is higher than new business for the insurers in our sample. The average share from renewal business is 82% in home and 56% in motor.

[11] To enable consistent comparison, we have used average market total number of policies sold for motor and home to calculate all the per policy numbers quoted in the annex.

3.11 We find that the contribution of new business has increased between 2013 and 2018. In motor, new business share of GWP has increased from 39% to 46% and in home, it has increased from 16% to 21%.

3.12 In terms of number of policies, we found the number of renewed policies to be quite similar for motor and home at about 14 million but the number of new policies for home is significantly lower at 6 million as compared to motor new policies of 11 million.

Figure 3: New business vs renewal GWP for insurers (average)

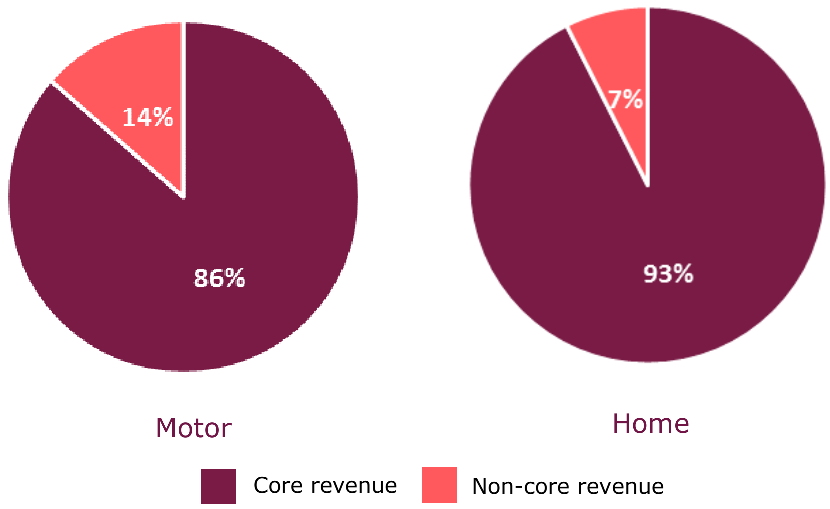


3.13 Looking at the number of policies for motor and home at the start of the time period, 2013 and the end, 2018, for the firms in the sample, we see roughly a 6% increase in number of new policies for both motor and home but a 28% in number of renewed policies for motor and a 6% increase for home.

Non-core contributes between 7% to 14% to total revenue

3.14 As shown in Figure 4, non-core revenue constitutes a larger proportion of total revenue in motor than home for the insurers in our sample. That is, in motor, non-core share of revenue is 14% of the total, while in home it is 7%.

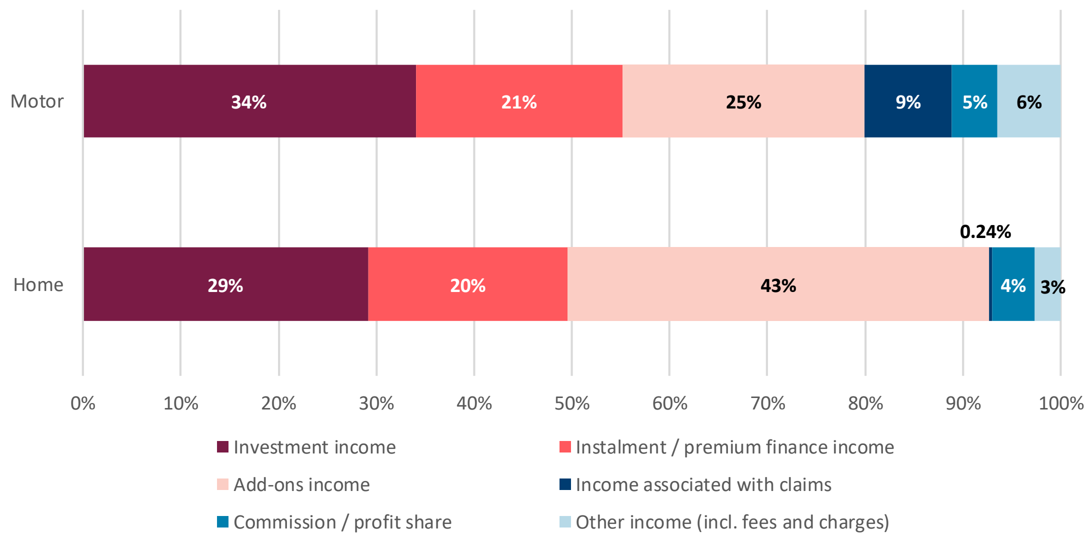
Figure 4: Core and non-core share of revenue (average)



3.15 Looking at the make-up of non-core revenue for motor and home. We see that:

- Investment revenue is higher in motor than home in proportion to non-core revenue (34% vs 29%) and in absolute value (£366 vs £101). This is possibly due to premiums for motor generally being higher than home which results in a greater pool of money which can be invested.
- Add-ons revenue as a proportion to non-core revenue is lower for motor (25% vs 43%) but in absolute terms is higher than in home (£266m vs £149m). In motor, add-ons share ranges from 20% to 81% of non-core revenue[12] and in home it ranges from 17% to 96% of non-core revenue.

Figure 5: Non-core revenue in motor and home (average)



Premium financing can be a significant source of revenue for some insurers

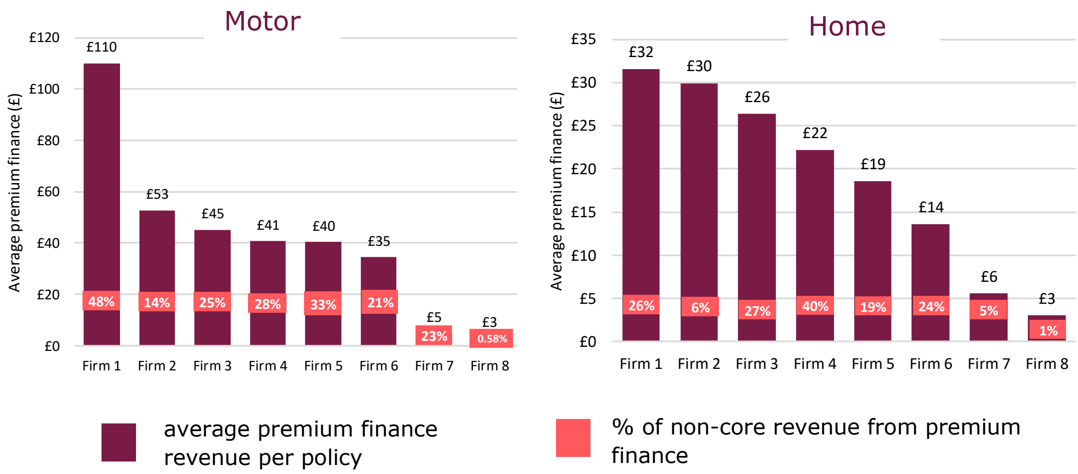
3.16 Premium finance is the revenue firms earn from providing credit to consumers to fund their purchase of GI policies. This can take the form of interest earned if the funding of premium finance is provided through the firm's working capital.

[12] Variance in the percentages could be due to some firms in our sample not reporting investment revenue allocated to the motor and home products as the investment is done centrally at group level.

3.17 We found that revenue from premium financing can be quite significant for some firms[13]. It accounts for 21% of non-core revenue in motor. However, if we look closely at the firms that provide premium finance, we see that there is a large range in the average premium finance revenue earned. As shown in Figure 6, the average premium financing revenue[14] per policy ranges from £3 to £110 in motor. These firms derive between less than 0.6% to 48% of their non-core revenue from premium finance.

3.18 In comparison, premium finance income accounts for 20% of non-core revenue in home. For firms that offer premium finance, the average premium finance revenue ranges from £3 to £32. These firms derive between 1% and 40% of their non-core revenue from premium finance.

Figure 6: Average premium finance revenue per policy by firm[15]



3.19 Almost all motor insurers (except those which belong to a group with an intermediary) earn premium-financing revenue, which forms a large proportion of their non-core revenue. There can be quite a wide variation in the premium finance revenue earned per premium finance policy between firms. We see this variation in revenue earned because firms use various annual percentage rates charged as well as the fact that there could be wide variation in premiums (e.g. young drivers will have much higher premiums). Some firms adapt the premium charged based on both the customers decision to accept premium finance and on the likelihood of a customer taking out premium finance. We observed that insurers which sell direct to consumers (whether as part of a multi-channel model or selling direct either through online/phone or PCW) have a higher level of policies sold with premium financing. Insurers which are part of a group with an intermediary do not earn premium financing revenue, instead the premium financing revenue is being taken by the intermediary.

[13] This is based on premium financing data from 7 insurers in our sample.

[14] Average premium has been calculated using premium financing revenue earned by firm, divided by the number of motor and home policies which were sold with premium financing.

[15] Only 7 firms have provided us with data on the number of premium finance policies sold.

Legal expenses cover is the main add-on revenue earner for both motor and home insurers

3.20 Add-ons account for £266 million and £149 million of revenue on average per year for motor and home respectively. This translates to an average per policy amount[16] of £12 for motor and £8 for home, but there is a large variation between firms. The detailed analysis of add-ons is based on a small sample of firms so might not be representative of the market.

3.21 In motor, the largest share of add-ons is composed of legal expenses insurance 48%, breakdown cover 22% and courtesy car 11%.

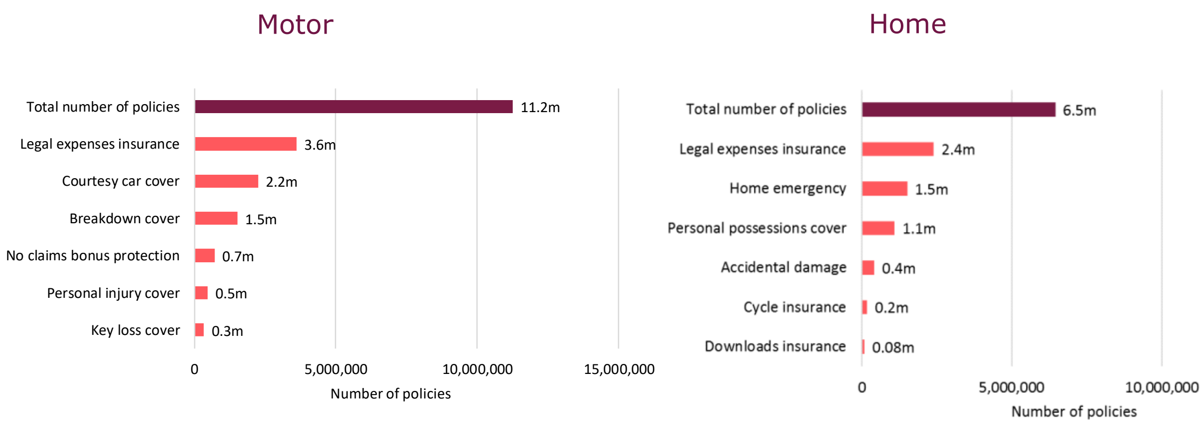
3.22 Comparatively, in home, the largest proportion of add-ons consists of legal expenses insurance 37%, personal possessions cover 28% and home emergency 14%.

3.23 Figure 7 below show the number of add-ons sold in motor and home for a sub-sample of firms[17].

3.24 For the sub-sample, we find that, at least 32% of motor customers and 37% of home customers are sold add-ons.

3.25 However, there is a range between firms in the number of add-ons sold. Specifically, for legal expenses add-on, we see that between 4% to 64% of customers are sold add-ons in motor. Further, in home, between 5% to 90% of customers are sold legal expenses add-ons. Add-on revenue is earned by the intermediary in the group for the firms which fall in the business model of 'intermediary with own small insurer group'.

Figure 7: Average number of add-ons sold in motor and home per year (2013-2018)



Insurers: Cost

Claims and acquisition costs make up the bulk of insurers' costs

3.26 The insurer carries the risk associated with a policy hence its key cost factor is net insurance claims – this represents the net costs of claims (after reinsurance recoveries) made to indemnify the insured against financial loss on a core policy sold.

[16] To enable consistent comparison, we have used average market total number of policies sold for motor and home to calculate all the per policy numbers quoted in the annex.

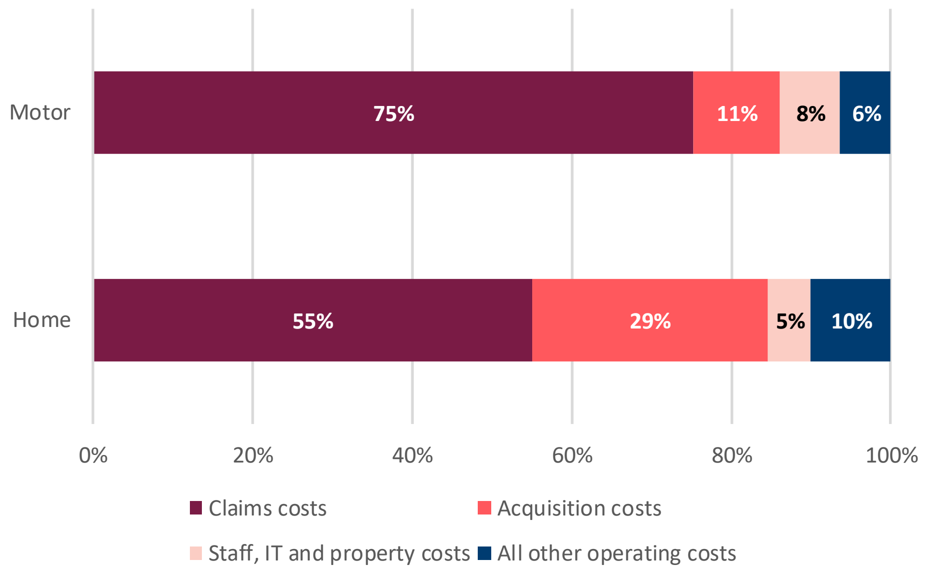
[17] Sub-sample includes 6 out of the 14 motor companies and 5 out of the 15 home companies. The rest of the firms did not provide us with number of add-on policies sold.

3.27 Other costs include:

- Acquisition costs – these represent the internal and external costs towards acquiring new policies/customers including direct marketing, PCW fees, commissions paid to intermediaries and internal marketing[18].
- Staff costs, IT and property costs – these include wages paid to employees and costs associated with infrastructure.
- Other operating costs – the costs and expenses directly related to running of the GI business.

3.28 Figure 7 splits insurers costs by the above components. We find that claims cost accounts for 75% of total costs in motor and about 55% in home. Acquisition cost makes up the next highest proportion of costs – at 11% for motor and 29% for home.

Figure 8: Breakdown of insurers' cost (average)



3.29 This translates to an average of £739m and £1.2 billion spent on acquisition costs in motor and home respectively[19]. We however notice a downward trend in firms' home insurance acquisition costs, from £1.4 billion in 2013 to £1 billion in 2018.

3.30 Commission paid to intermediaries and partners averages about 75% of acquisition costs for motor and 84% for home insurance. We show this in Figure 9.

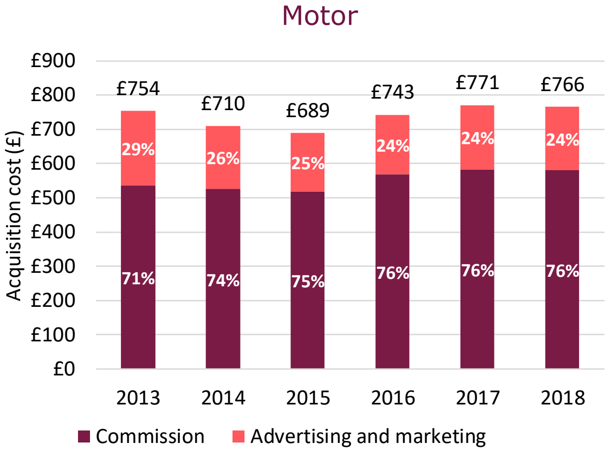
3.31 Overall, we notice that expenditure on acquisition cost has remained relatively stable in motor but has decreased in home, driven primarily by a decrease in commission.

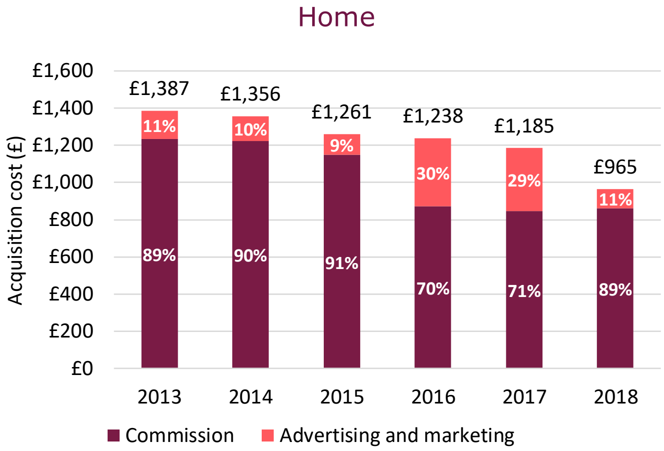
3.32 However, one component of commission is the price paid to PCWs to sell products on their website. We find that spend on PCWs has increased for both products, from £95m to £134m in motor and from £32m to £55m in home.

Figure 9: Total acquisition costs for motor and home insurers

[18] May also include base and contingent commissions of sale, share of profits on policies sold, and other related insurance commissions

[19] This accounts for 7% of premiums for motor insurers and 29% of premiums for home insurers. While all firms provided figures for commission, only 9 out of 14 motor insurers and 12 out of 16 home insurers provided us with data on advertising and marketing.





Insurers: Profit

Insurers depend on non-core revenue to make profit, especially for motor

3.33 In order to see the contribution of the core underwriting activity to overall profitability, we have segregated the underwriting profit from the other revenue earning activities (investment, add-ons, fees & charges and premium financing). In our analysis, we have assumed all costs incurred are associated with the core underwriting activity as firstly, firms do not allocate costs to the granular level to match different revenue streams and secondly, this is the conventional GI industry method of assessing underwriting profitability.

3.34 We used the ratios used in the GI sector to assist us in comparing the operating profit of the insurers. These ratios[20] are defined as:

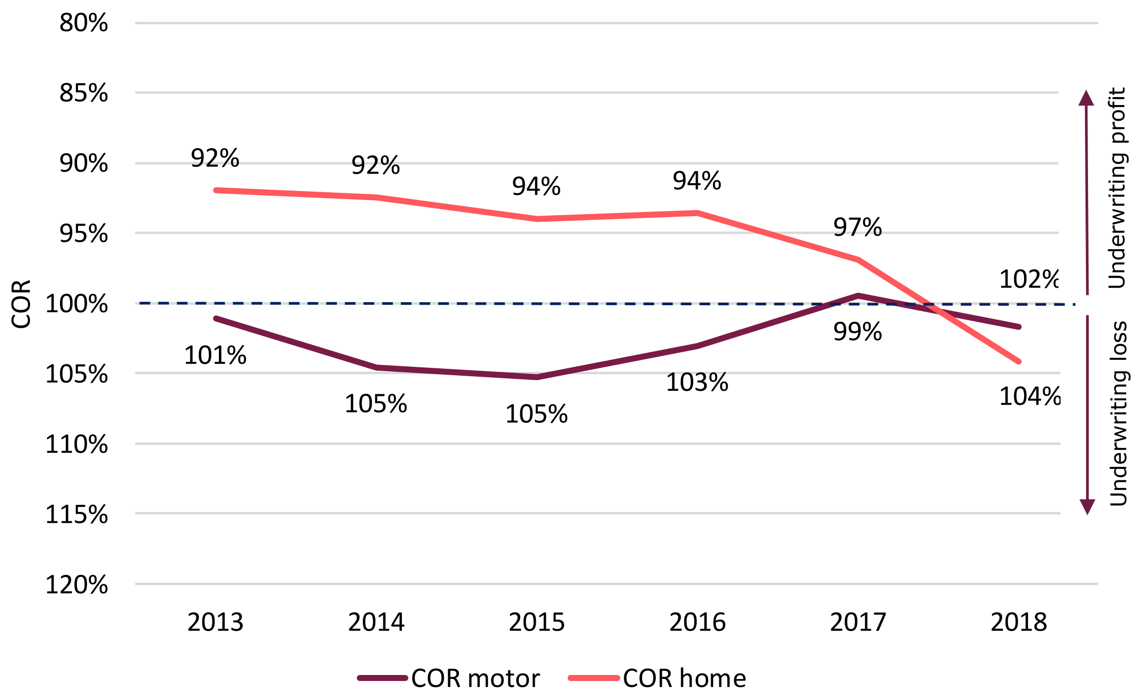
- **Loss Ratios (LR)** – This represents the core underwriting profitability of a firm and is computed as a percentage of premium that an insurer pays out in claims.
- **Combined Operating Ratios (COR)** – This is a measure of overall underwriting profitability computed as the sum of the Loss Ratio and Expense Ratio. Hence a COR of >100% suggest that a firm is making a loss from its underwriting activity[21].

3.35 The market average LR for motor of 76% is higher than home 56% for the years analysed. Within the sample of firms, there are a handful of firms which showed consistently more favourable LR compared to market average in both the motor and home market.

[20] Ratios reported here are based on firms' submissions – calculated and reported by firms on written year basis where available. They may differ from financial ratios which are calculated using accounting or management accounts.

[21] Conventional industry metrics ignore important sources of revenue like investment, add-ons, premium financing and can give a false picture on overall profitability.

Figure 10: Insurers’ Loss Ratios and Combined Operating Ratios (2013-2018)



3.36 Overall the COR for motor exceeds 100% for the period 2013 to 2018 except 2017 which indicates that the motor underwriting business is paying out more in costs than the underwriting revenue they are bringing in. This suggests that without other sources of revenue, insurers in motor will be loss-making. Also, there is a relationship between underwriting revenue and non-core revenue: when firms’ underwriting revenue deteriorate, there may be a knock-on impact leading to lower investment income (from lower premiums collected and available for investment) and lower premium finance revenue.

3.37 Within the category of insurers, we observe the following business models:

Category	**Value proposition**	**Key revenue sources**
A. Multi-channel end to end provider	• mass market multi-brand/product insurer selling through different channels • well-known brand with large customer base	Premium; Investment; Premium financing; Add-ons & Fees/ charges
B. Direct and PCW only insurer	• mass market multi-brand/product insurer selling directly either through PCWs, online, phone or through own Appointed Reps	
C. Intermediary only insurer	• mass market insurer which designs and manufactures the product but only sells through intermediaries • may not earn revenue from ancillary products	
D. Niche insurer	• niche market insurer which targets specific groups of consumers • flat margin with no discounting for new customers • often sold through intermediaries	

3.38 We notice that a minority of firms in our sample which show a favourable LR in comparison to market average, also present with favourable COR. These firms appear to either fall in the business model of being a small insurer which distributes primarily through a related intermediary and sits on insurer panels or a niche insurer.

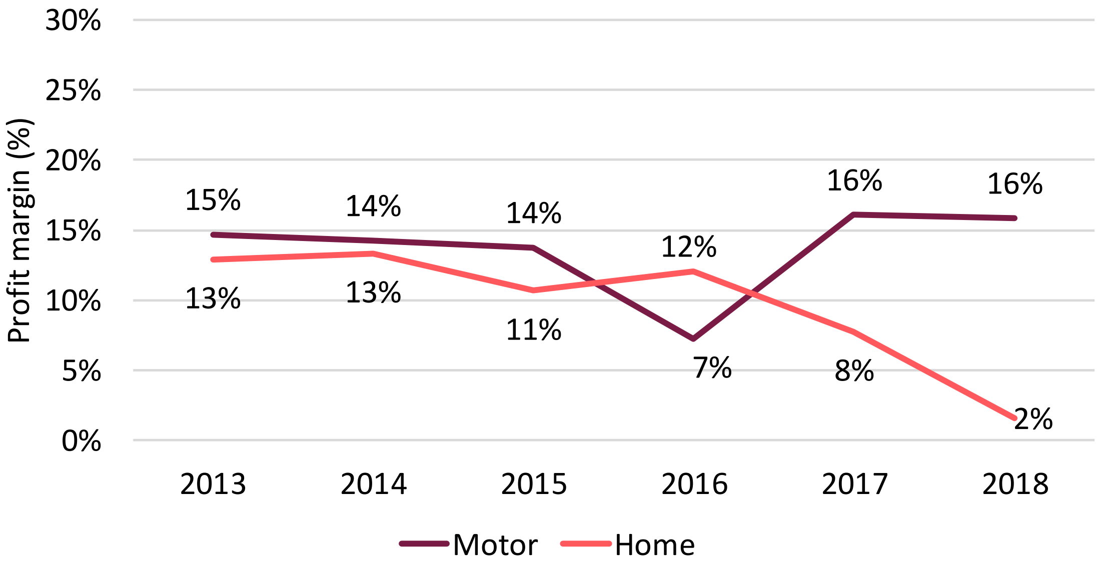
3.39 Profitability in the motor market is affected by Ogden rate[22] and Civil Liability Act reforms while weather condition is the main factor driving variation for home market profitability.

3.40 This is reflected in what we observed in COR for home: ranging from 92% to 97% in 2013-2017 with 2018 being the only year in our analysis where core underwriting business was loss-making. Even so, a few firms in our sample have COR in the range of 72%-90%. Profitability for home is expected to continue to be squeezed in 2019 with downward pressure on GWP caused by a soft market and an increase in weather-related escape of water claims and subsidence notifications.

3.41 Overall, the core underwriting activity is working within very tight operating profits and motor in general is loss-making in 5 out of the 6 years we've analysed. Home, on average, has a 4% core underwriting profit margin from 2013 to 2017 and is loss-making in 2018.

3.42 As discussed in paragraph 21, insurers also earn revenue from investment, sale of add-ons (e.g. legal expenses cover, car breakdown cover, home emergencies cover), fees & charges and premium financing. We analyse how the operating profit margins of the insurers are affected after these revenue sources are included. This is reflected in the chart below.

Figure 11: Overall operating profit margin of insurers (2013 to 2018)



3.43 Insurers in motor, after including all revenue sources, now show on the average, an operating profit margin of 14% over the 6 years. This is compared to the loss-making (5 years out of 6) from the motor core underwriting activity. Profitability in motor has been relatively stable, except for in 2016 where we notice a reduction in profits to 7%. This is likely to be driven by the change in the Ogden rate which increased claims costs.

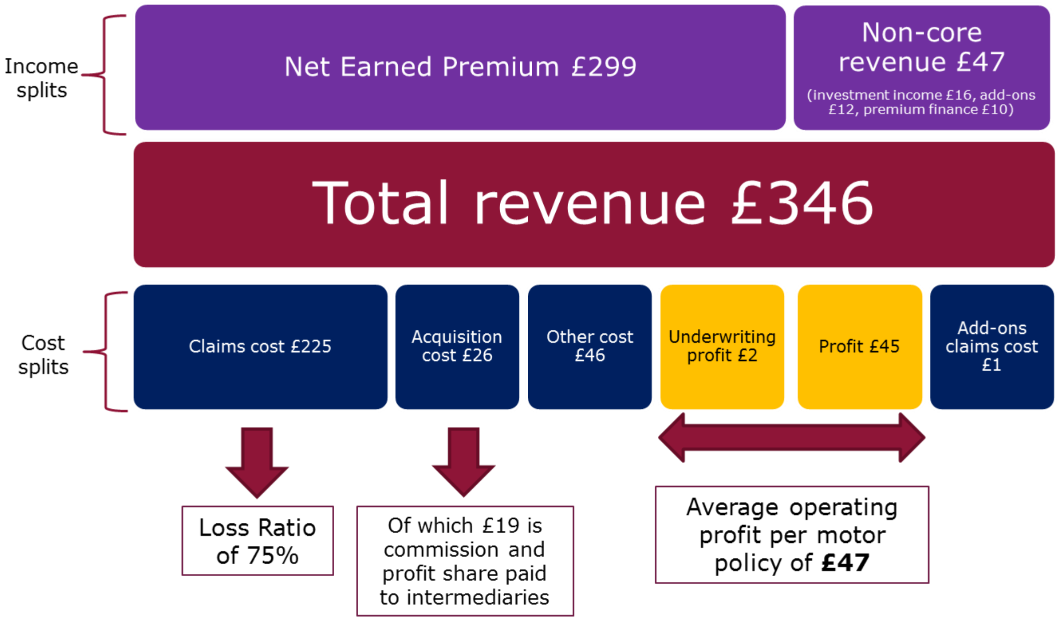
3.44 The profitability for insurers in home was stable between 2013 and 2016 at an average of 12%. However, this decreased substantially to 2% in 2018. This is likely to be due to adverse weather conditions that hit the UK in the first half of 2018 which increased claims cost.

[22] The Ogden rate is used to calculate the appropriate lump sum settlement required to cover future (annual) losses a claimant will incur as a result or personal injury or fatality so is used by insurers for settling motor and liability claims.

3.45 These operating profits are reflective of accounting profit and do not include opportunity cost of capital. This however does not change our conclusions as such as our conclusion on insurers' core underwriting profitability is drawn from our analysis of the performance ratios and we also observed that intermediaries in our sample do not carry long term debt in their balance sheets and are not capital intensive. This suggests that any opportunity cost of capital calculated for the intermediaries would be minimal.

3.46 We analyse revenue and costs on a per policy basis as a further illustration of drivers of profitability. Motor insurers, on average, earn £299 per policy in premiums, of which they make an underwriting profit of only £2[23] per policy. In addition to premiums, firms also earn non-core revenue of £47 per policy, since the incremental cost of providing non-core products is low, the profit earned on non-underwriting activity is £45, giving us overall profitability of £47. This indicates that the motor insurers depend on non-core revenue sources to maintain their profitability.

Figure 12: Indicative motor insurer per policy breakdown[24]

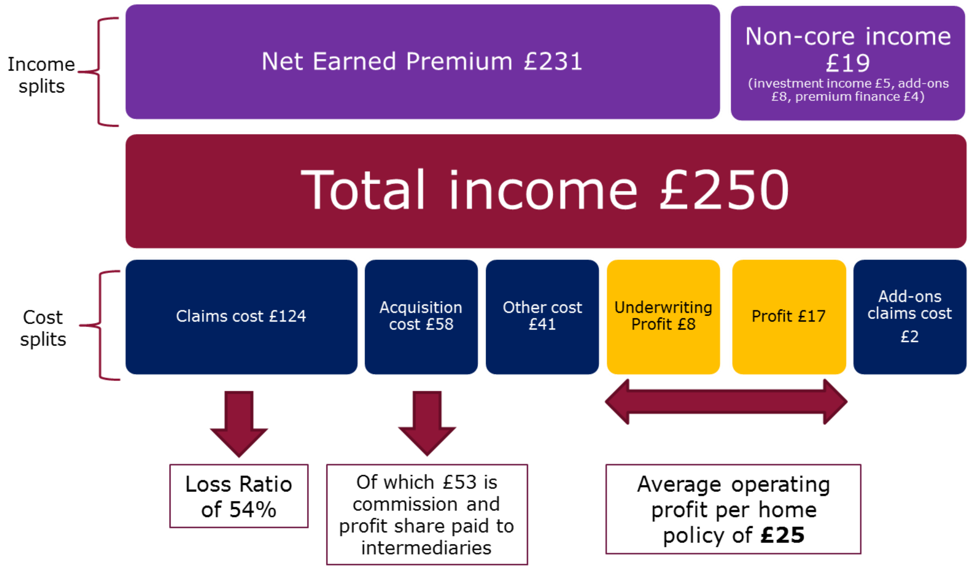


3.47 We calculated that firms in our sample earn an average of £231 per policy in premiums and made an underwriting profit of £8 profit per policy. Non-core revenue is lower per policy than for motor insurers, at £19, with non-core profits of £17, giving us overall profitability of £25.

[23] All per policy numbers are calculated based on financial accounting data submitted by firms in our sample, averaged over period 2013 to 2018, divided by the average total number of policies sold per year.

[24] All numbers showed are weighted average for 14 motor insurers, averaged over period 2013 to 2018.

Figure 13: Indicative home insurer per policy breakdown[25]



[25] All numbers showed are weighted average for 16 home insurers, averaged over period 2013 to 2018.

Intermediaries: Revenue

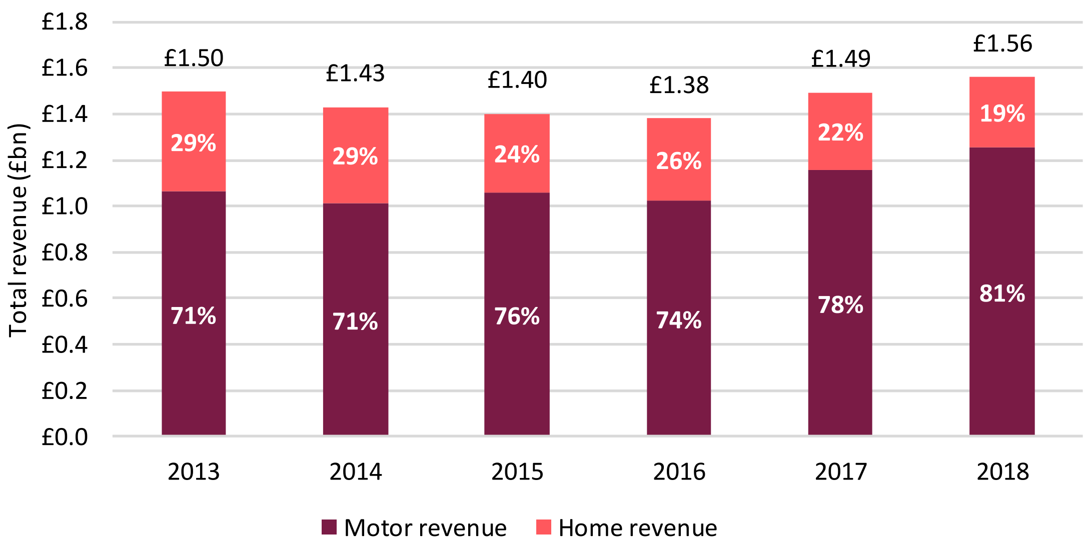
Motor commission is the dominant source of revenue for intermediaries

3.48 Intermediaries arrange policies for the insurer, and are compensated by a commission for placement of the policy. This can be a percentage of the premium. We have defined this as core revenue.

3.49 Intermediaries also earn non-core revenue from add-ons (legal expenses, breakdown cover etc), fees and charges and premium financing. Profit sharing and claims related revenue (earned as part of the claims process e.g. referral fees) also makes up revenue made by intermediaries.

3.50 We find that like in the insurers, motor revenue makes up a higher proportion of the total revenue for the intermediaries in our sample.

Figure 14: Intermediaries' revenue (2013-2018)

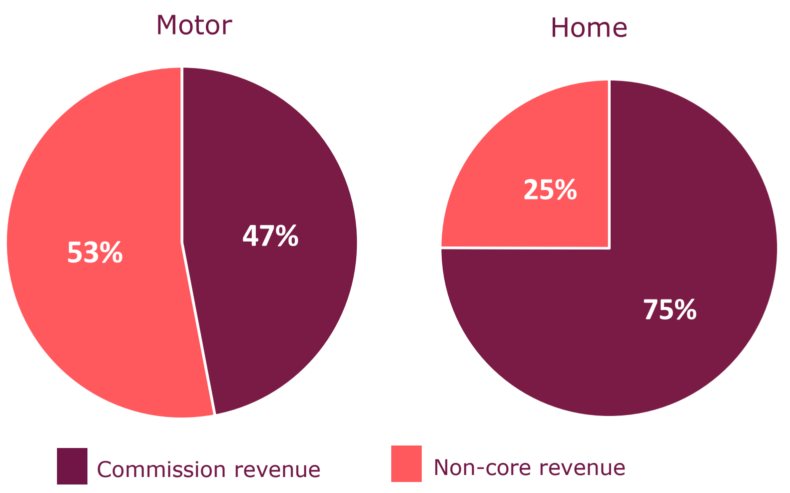


3.51 Additionally, for our sample of firms between 2013 and 2018, the number of motor policies intermediated has increased by 61% from 8.0 million to 12.9 million, while we see that in home, policies have decreased by 2% from 5.4 million to 5.3 million.

Intermediaries in motor earn more from non-core sources than home

3.52 We found that non-core revenue makes up 53% of motor revenue and 25% of intermediaries' home revenue. This is consistent with the findings from our analysis of insurers' revenue, that add-ons and premium financing were important revenue earners for the intermediaries on top of the commission earned.

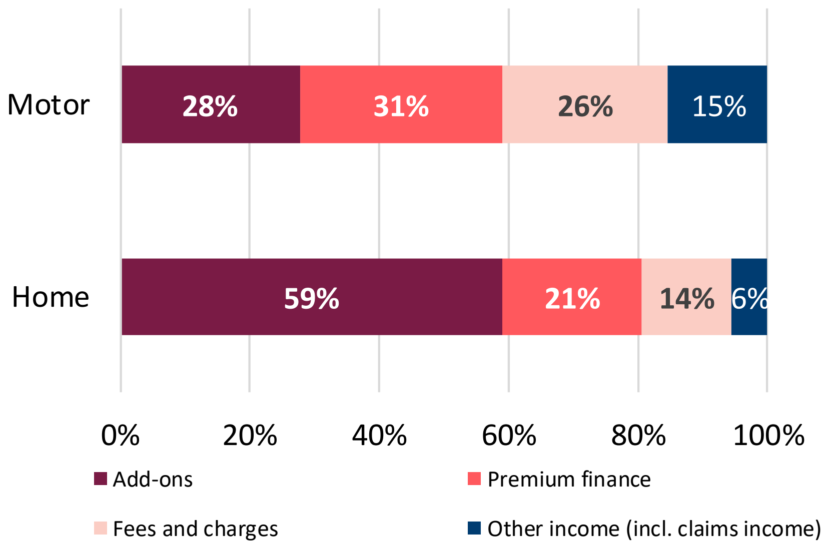
Figure 15: Commission and non-core share of revenue (average)



3.53 Premium finance accounts for the largest proportion of non-core income in motor at 31%. Further, add-ons and fees and charges constitute 28% and 26% respectively.

3.54 In comparison, in home, add-ons account for the largest proportion of non-core income at 59%. Premium finance and fees and charges account for 21% and 14%, respectively.

Figure 16: Composition of non-core income (average)



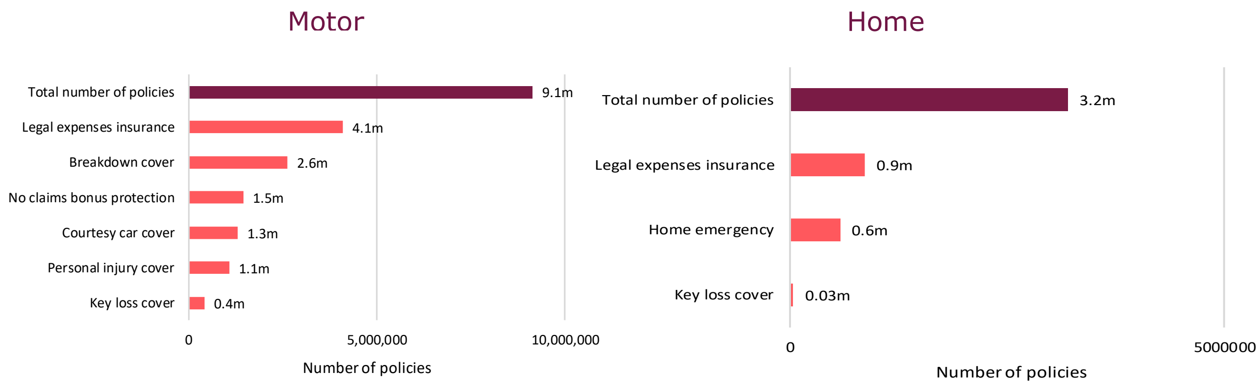
3.55 The add-on share of non-core income can vary significantly between companies. We see that in motor, it ranges from 21% to 71% of non-core income and for home, it ranges from 12% to 100% of non-core income.

3.56 For motor, add-on revenue is composed of legal expenses (40%), breakdown cover (28%) and personal injury cover (9%). While in home, legal expenses (49%) and home emergency (44%) account for the largest proportion of add-ons.

3.57 Figure 17 below shows the number of add-ons sold in motor and home for a sub-sample of firms that provided these data[26].

3.58 For the sub-sample, we find that, at least, 45% of motor customers and 35% of home customers are sold at least one type of add-on. We see lower sales of add-ons in home.

Figure 17: Average[27] number of add-ons sold in motor and home



Intermediaries: Cost

Staff, advertising and commission costs are most material to intermediaries

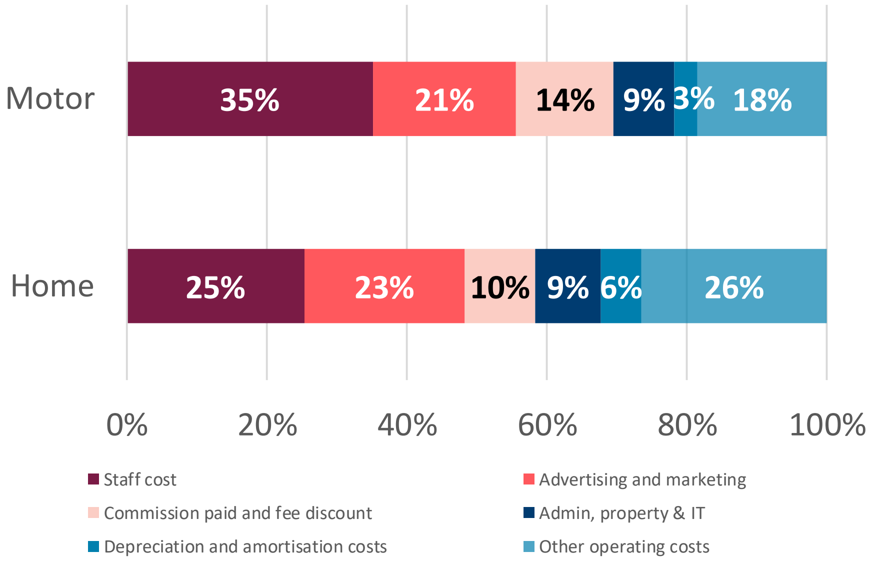
3.59 Intermediaries primarily design, manufacture and distribute insurance products. While they can undertake pricing activities, they do not underwrite the risk. As such, they do not incur any claims related cost like insurers. Figure 18 shows the breakdown of intermediaries' costs.

- Staff costs account for a higher proportion of total costs in motor (35%) than home (25%).
- Advertising is a major cost for both markets as the intermediaries build on their brands in order to attract customers. This explains why we find that for most firms, advertising is not a directly attributable cost but allocated to the product line. Intermediaries in our sample spend on average £158m a year on advertising.
- Commission paid to other intermediaries and partners accounts for 14% of costs for motor and 10% for home. This translates to an average of £99m a year.

[26] The sub-sample includes 6 motor intermediaries and 4 home intermediaries.

[27] Average of policies sold by firm per year for 2013 to 2018.

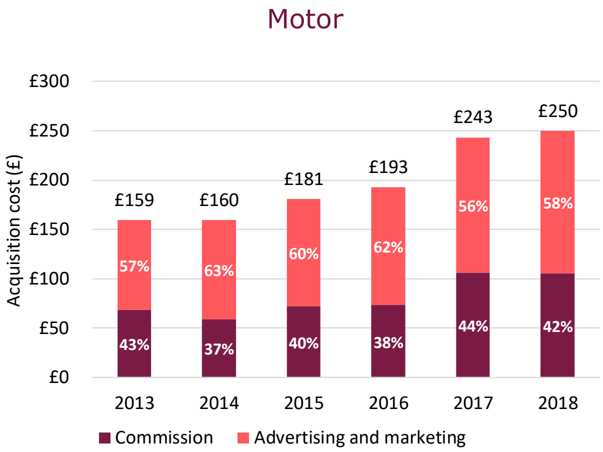
Figure 18: Breakdown of Intermediaries' cost (average)

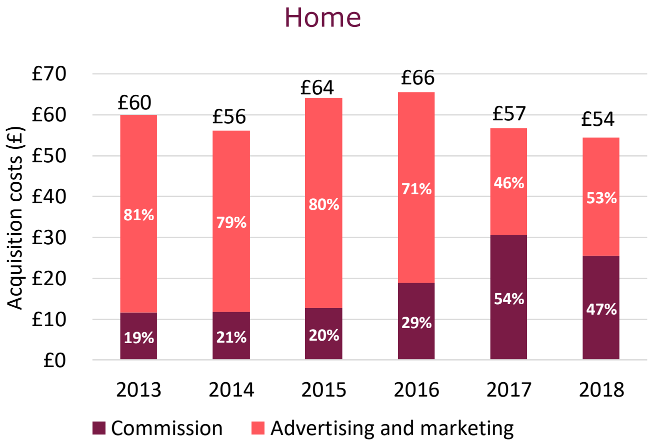


3.60 Combining commission paid and advertising together gives us an indication of the acquisition cost of the intermediaries in our sample. We notice that acquisition cost as a percentage of total cost is quite close for motor and home, with it ranging between 30% to 38% over the years.

3.61 That is, intermediaries spend on average £198m in motor and £59m in home on acquisition costs. Unlike insurers, this is largely composed of advertising and marketing costs rather than commission paid as shown in Figure 19.

Figure 19: Total acquisition costs for motor and home intermediaries

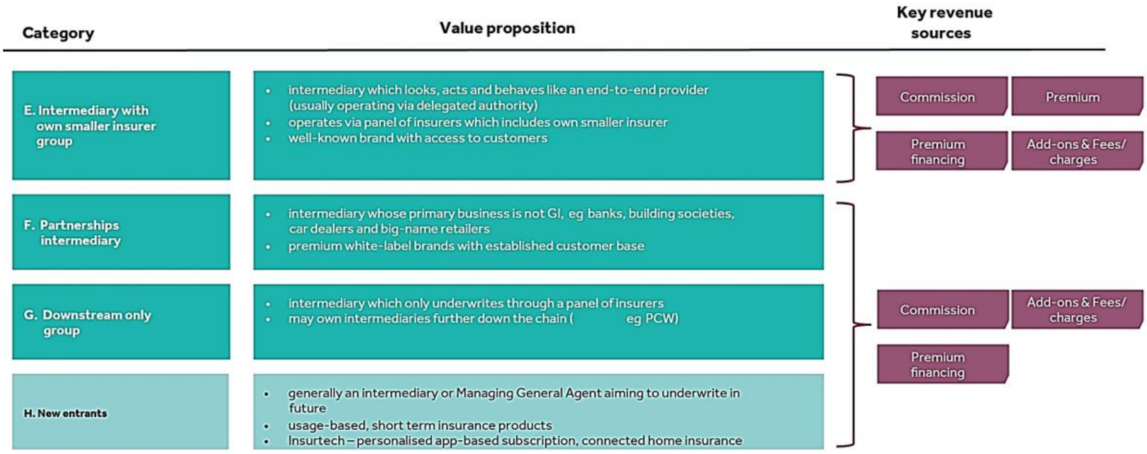




Intermediaries: Profit

Intermediaries are profitable

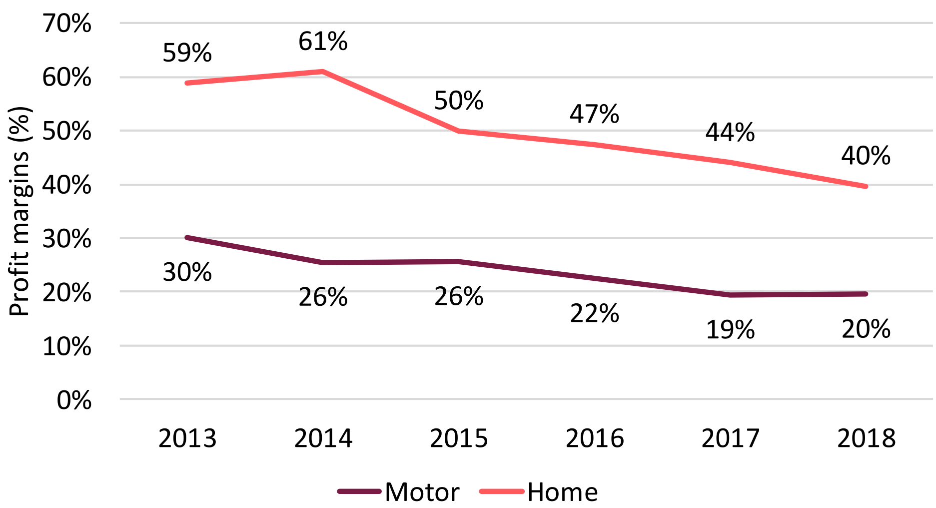
3.62 We notice that the following business models exist in the intermediary segment of the market:



3.63 Intermediaries, in our sample, earn a higher level of profit margin than insurers – 19% to 61% operating profit margin with home being more profitable than motor for the period 2013 to 2018. However, we only have 4 firms in our sample which have both motor and home lines of business which makes comparison of profitability between products challenging. For these 4 firms, home is typically more profitable.

3.64 It is also important to note that our sample of intermediaries was chosen to be representative of the business models present in the market but might not be statistically representative of the whole intermediary motor and home markets.

Figure 20: Intermediaries' operating profit margin (2013-2018)



3.65 Comparing the per policy revenue breakdown of motor and home shows the difference in level of commissions earned. Motor intermediaries in our sample earn on average £31 per policy compared to £58 per policy by home intermediaries, resulting in an average per policy profit of £24 for motor and £39 for home.

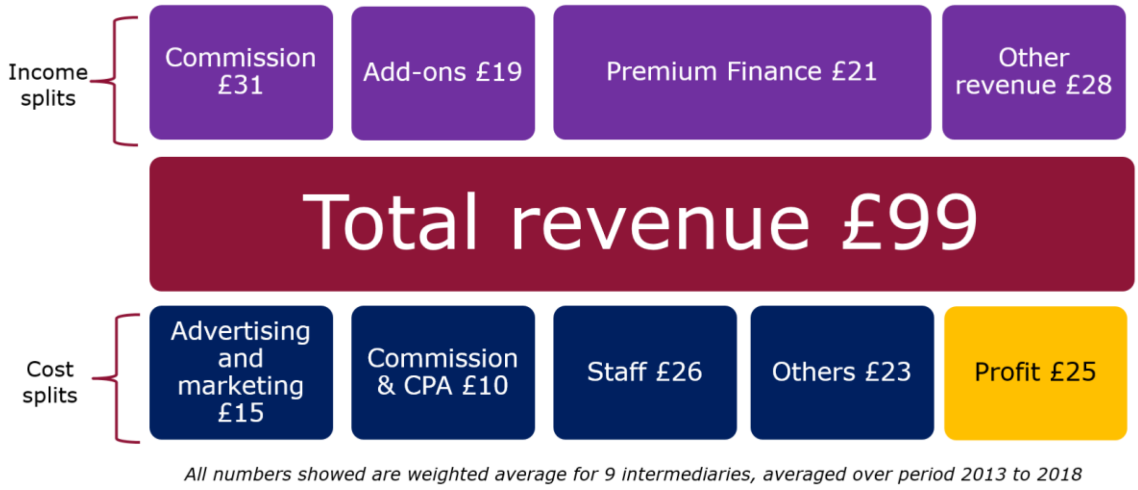
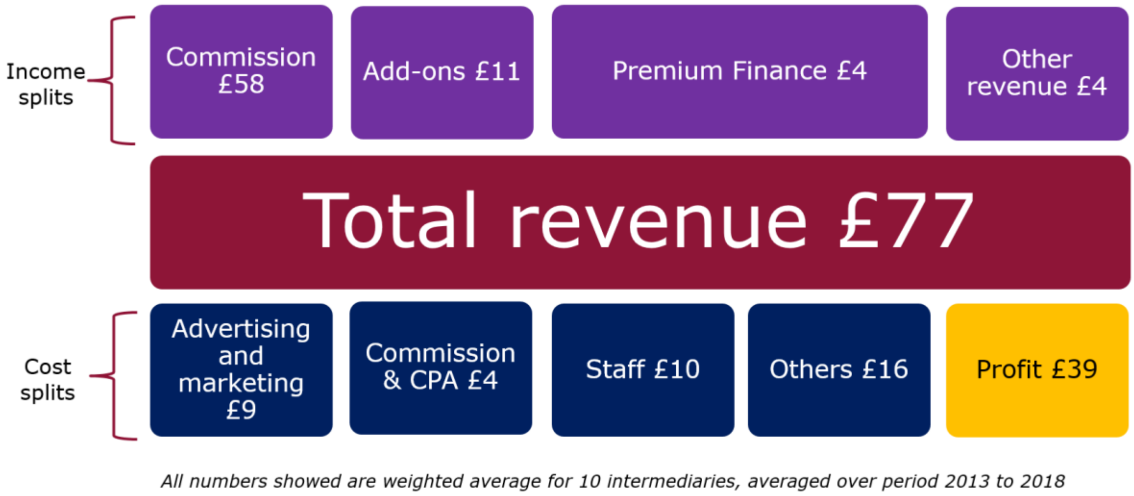


Figure 22: Indicative home intermediary per policy breakdown



PCWs: Revenue

PCWs' fee per click through sale has been growing over time

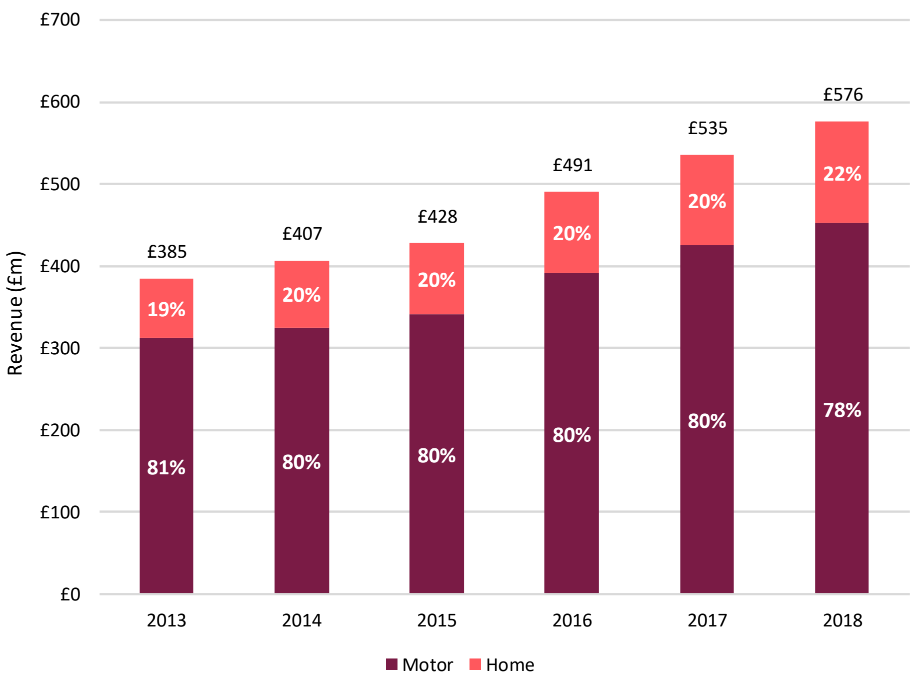
3.66 PCWs offer an important service in connecting insurers and intermediaries to new customers. Around 71% of new customers buy their motor insurance via a PCW compared to 50% for home[28]. This represents 31% and 13% of the total market for motor and home respectively.

3.67 PCWs typically receive a fee when a consumer successfully buys a new product on the provider's own site after being directed from the PCW platform. This is known as cost per acquisition (CPA).

3.68 Each insurance provider negotiates the amount of the CPA commercially with the PCW. The fee negotiated can be either:

- A flat cost per sale, or
- Tiered, depending on different factors such as:
  - Volume of sales;
  - Cover type (building only, contents only or combined cover);
  - Cover level (based on conversion rates);
  - Minimum conversion floor – where they ask a brand to guarantee they will achieve a minimum conversion of customer clicks from the PCW quotations page to the product providers website.

Figure 23: PCWs' revenue for motor and home (2013-2018)



[28] Source: ABI data and data provided by PCWs

3.69 From our analysis, we find that motor insurance is the largest revenue-generator for all the PCWs in our sample. In 2018, the motor market generated 31% to 76% of PCWs' total revenues. The home insurance market accounted for between 9% and 18% of their revenues. Of the motor and home revenue, 80% of their yearly revenue is attributed to motor insurance on average between 2013-2018.

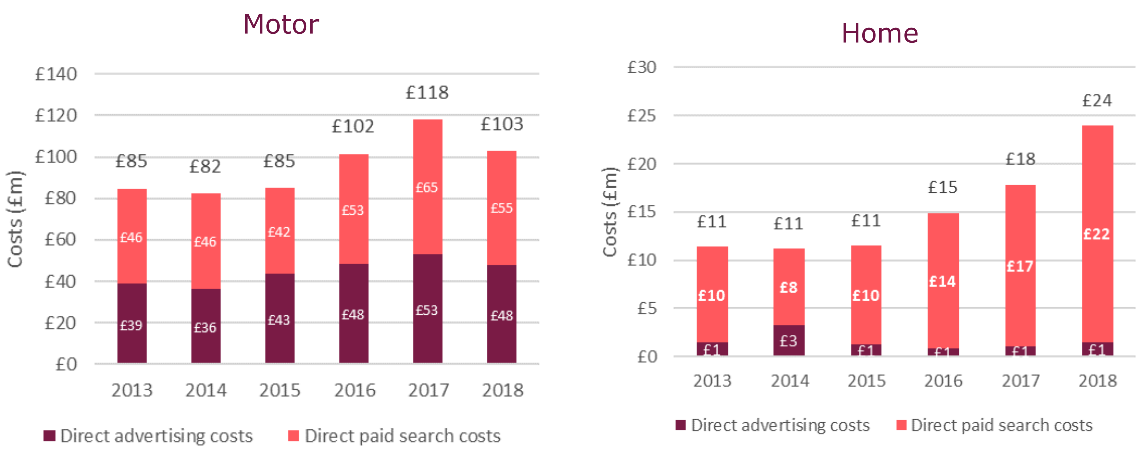
- 8.4m motor policies were sold in 2018 through PCWs which is more than 3 times higher than the 2.6 million policies sold for home.
- To a lesser extent, motor policies have also brought in higher revenue per policy (CPA) than home, with the average CPA for motor being £51 per policy, compared to £45 per policy for home.

3.70 The revenue acquired by PCWs for both motor and home has increased over time. However, we notice that the rate of growth in revenue for home is higher than that of motor, averaging at 11% per year, compared to 8% for motor. Volume of business being sold through PCWs is growing year-on-year (motor has gone up by 28% and home 51%) while CPA has increased by about 13% for motor and home over the 2013-2018 period.

PCWs: Cost

Advertising and search fees make up the bulk of PCWs' cost

Figure 24: PCWs' direct advertising and paid search fees for motor and home



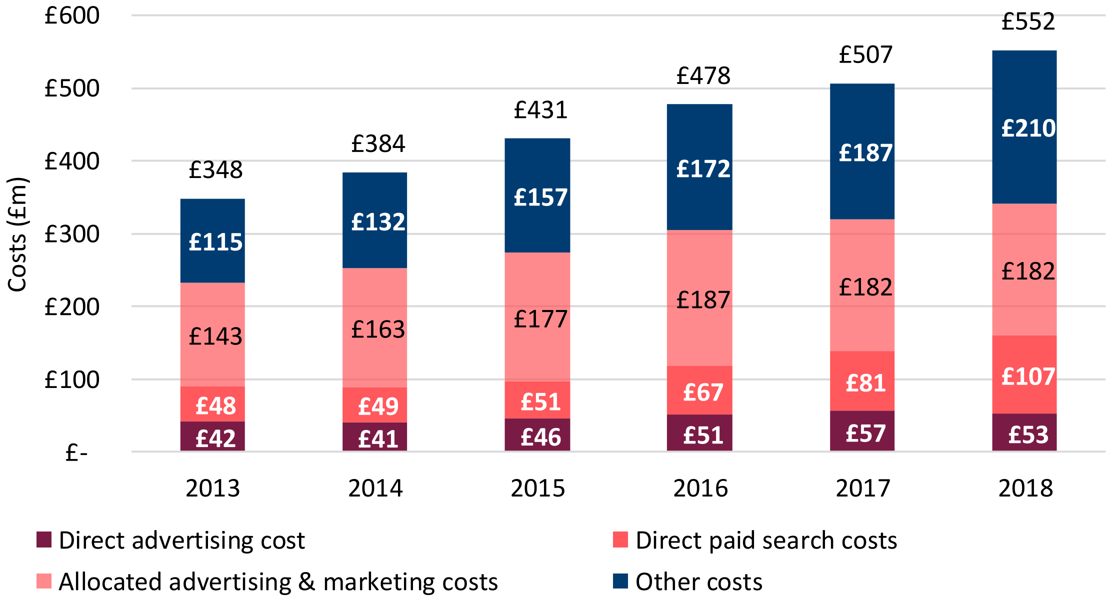
3.71 While PCWs monitor and could provide us with details on revenue for motor and home, they found it challenging to provide us with a breakdown of costs as financially they do not prepare separate management accounts for the different products.

3.72 The only direct costs the firms could provide are advertising costs and paid search costs[29]. In Figure 24, we see that PCWs spent between £82m to £118m per year on advertising and paid search fees for motor. For home, the spend is £11 million to £24 million annually. Although the total spend by home is much lower, we notice that the costs paid to search engines to direct online traffic to the PCW websites more than doubled over the period.

[29] Paid search fees are costs paid to search engines like Google, Yahoo etc to direct online traffic to the PCW website.

3.73 We also analysed PCWs' total costs at the firm level to understand the proportion of advertising, marketing and paid search fees to total costs. We can see that they formed the majority of the costs (62% in 2018). This included between £143 million to £182 million per year spent on general advertising for the PCW brand and for promotional items.

Figure 25: Breakdown of PCWs' total cost (2013-2018)



PCWs: Profit

PCWs earn a positive operating profit margin for motor and home

3.74 To calculate the profit margin at the product level, we have allocated indirect common cost like staff, IT and general brand advertising/marketing costs to motor and home. Splitting allocated costs based on the size of the revenue share of that product line can lead to circularity issues since larger revenue would imply that higher costs will be allocated, which may understate profitability. A better measure would be the volume of sales. However, since we did not have data on the volume of sales, we have instead used number of clicks as a proxy. We understand that the actual profit margin could differ from what we have found in our analysis due to the caveats used in our calculations, nonetheless it provides a useful indication of profit margins.

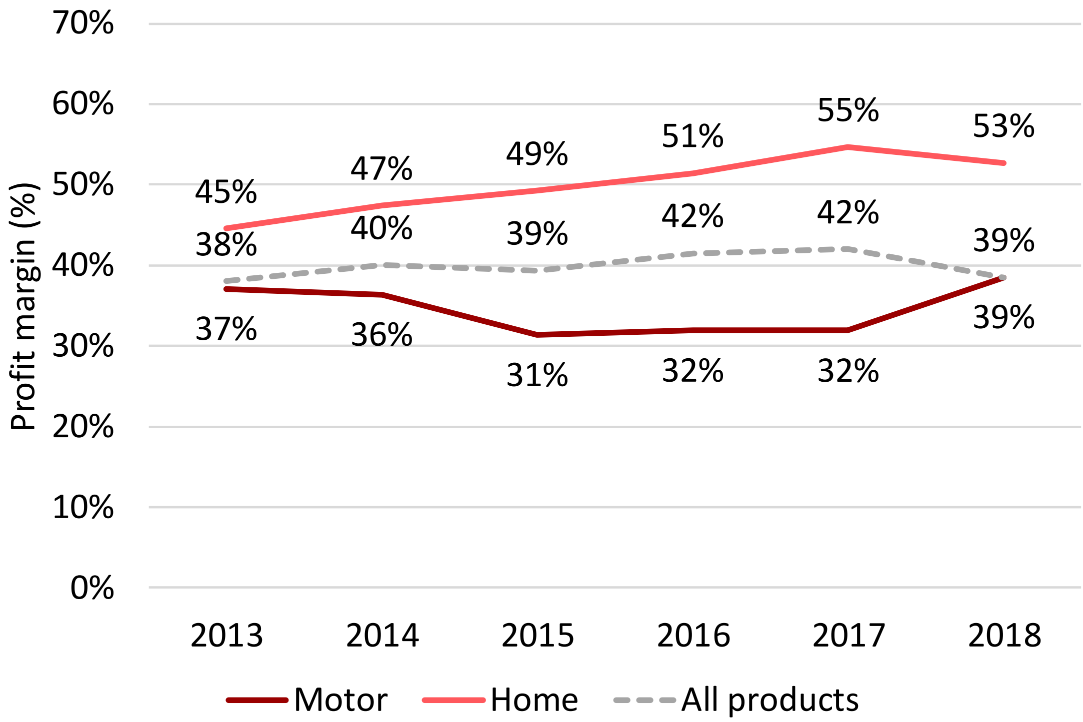
3.75 As a cross-check to our estimation, we have also calculated the profit margin for the PCW firm level including all product lines sold by PCWs.

3.76 Between 2013 and 2018, PCWs earned profit margins between 31% and 39% and between 45% and 55%, for motor and home respectively. For motor, our analysis shows that 2 firms are consistently earning higher than the average profit margin of 35% throughout 2013-2018. For home, we see 2 firms earning substantially higher profit margins than the average of 50%.

3.77 There has been growth in revenue for both the motor and home businesses, with the revenue growth for home being higher at 71%, compared to motor's 45%. However, for the home business, total costs have increased by 46%. This would explain why the profits margins for home has been steadily increasing.

3.78 The actual profit margins for all products is within our estimates of the profit margin for motor and home which gives us some confidence that our estimates are within a reasonable range.

Figure 26: PCWs' profit margins for motor and home (2013-2018)



4 How profit is affected

4.1 We see that firms have used various strategies to differentiate themselves from competitors, using for example, brand, distribution channels/access to customer base, pricing strategies. We have looked at how profitability varies in relation to size and type of revenue which will provide further insights on the drivers of profitability.

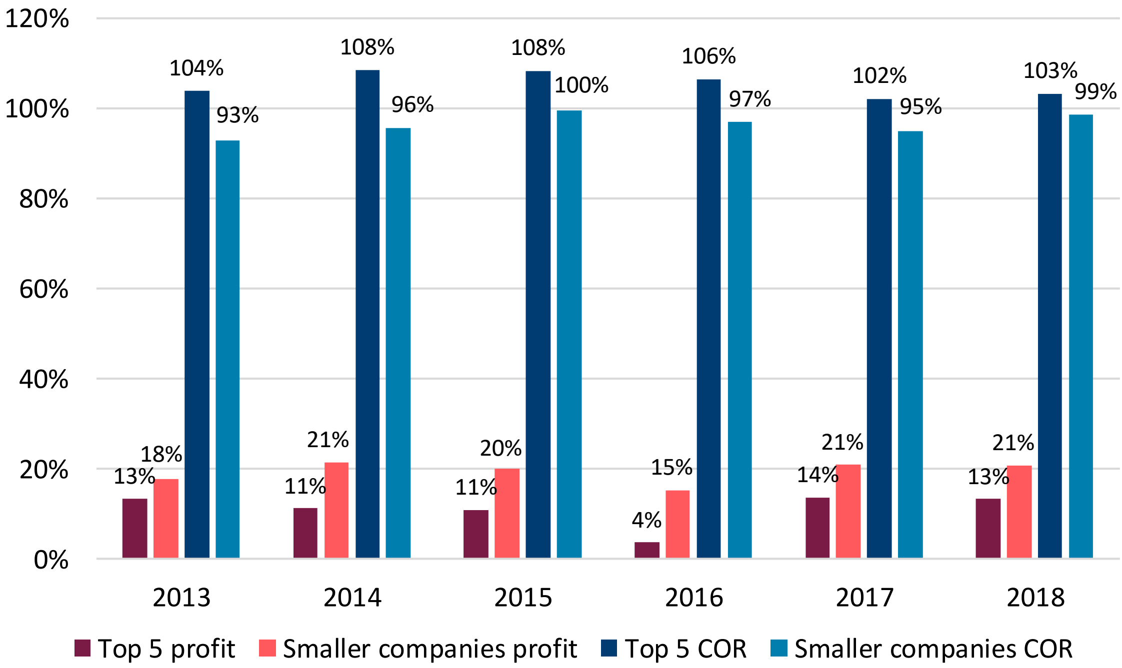
By size

The larger motor insurers have higher COR and lower operating profit margin than smaller ones.

4.2 For motor insurers in our sample, we observe a negative relationship between the size of the firms and their operating profits. Between 2013 and 2018, the top 5 motor insurers (ranked by size of total income) on average showed COR of 105% and operating profit margin of 11% as compared to the smaller firms which have COR of 97% and operating profit margin of 19%. This trend holds for all the years we've analysed.

4.3 However, for home, the size of the firm has no impact on the COR or the operating profit margin over this period.

Figure 27: Operating profit margin and COR of Top 5 motor insurers vs others (2013 – 2018)



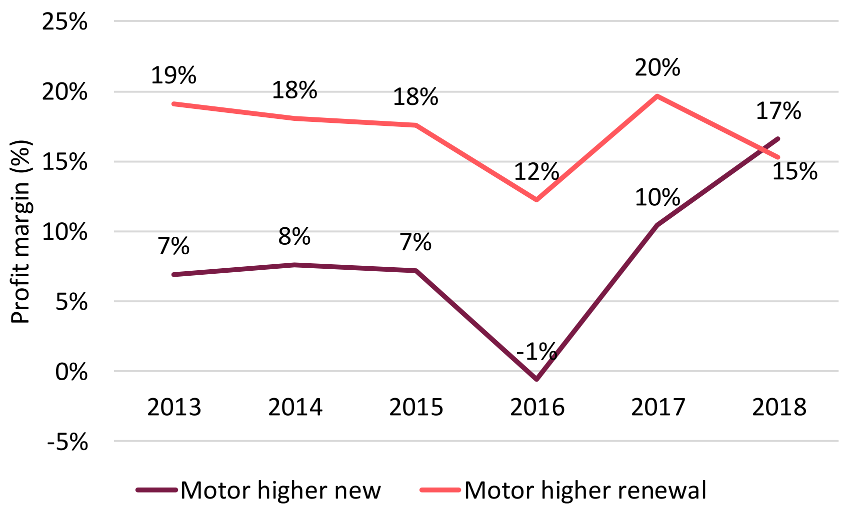
By type of revenue

Renewal business is more profitable than new business for both motor and home insurers

4.4 We find that insurers with a larger renewal business proportion[30] make almost twice as much operating profit margin as insurers which rely more on new business. This is the same for both motor and home markets.

4.5 We also observe that insurers with more new business tend to sit on panels[31] with some of them falling in the category of being in a group with an intermediary which operates like an end-to-end provider. A reason for this could be that the intermediary will reach out to its panel to requote at renewal and the insurer which underwrites the risk may change year-on-year for the same customer.

Figure 28: Operating profit margin of motor insurers with higher new business vs insurers with higher renewal business (2013 – 2018)



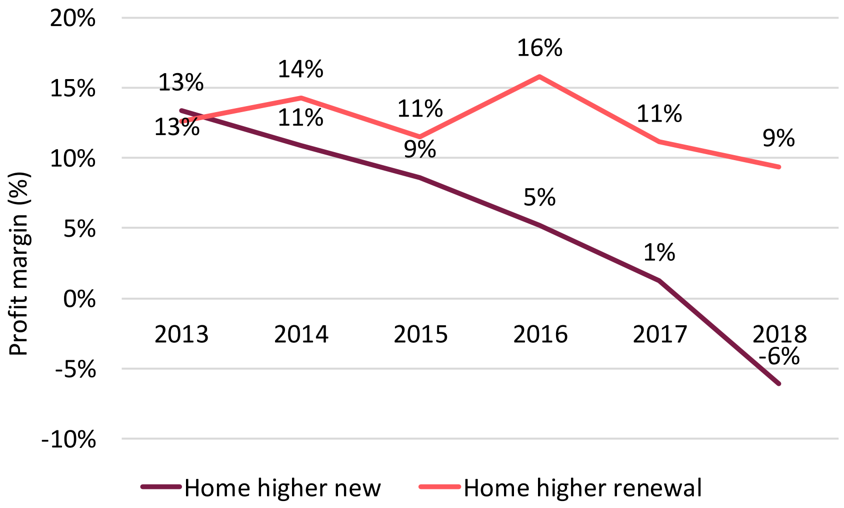
4.6 For home[32], there is a similar trend especially in the years from 2015 to 2018 where we see a fall in the profit earned from new business, leading to a loss of 6% in 2018. 10 firms in our sample recorded losses in 2018, compared to 3 in 2017. Firms which have a higher proportion of renewal business were better at withstanding the impact of adverse weather conditions and increase in claims costs in 2018.

[30] We have defined insurers with higher renewal business proportion as firms where their proportion of renewal to new is higher than the market average which is 50% for motor and 20% for home.

[31] An insurer panel is a pre-arranged group of insurers that an intermediary can go to for a quote to underwrite the policy. The insurers will quote competitively (if non-advised) and the product is usually not differentiated.

[32] Some home insurers have not provided us with the split between new and renewal business for one or more years so we have excluded them from the analysis.

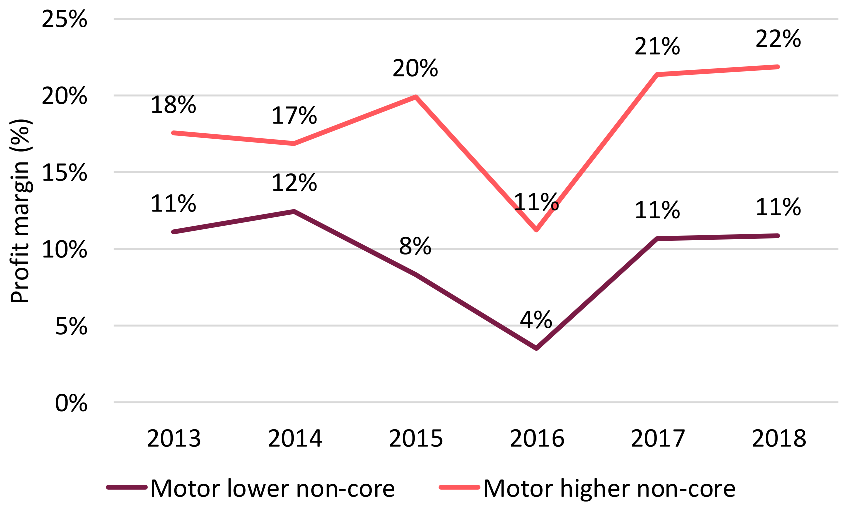
Figure 29: Operating profit margin of home insurers with higher new business vs insurers with higher renewal business (2013 – 2018)



Motor insurers with higher proportion of non-core revenue have higher operating profit margins.

4.7 We also analysed how operating profits for insurers and intermediaries vary in relation to the proportion of core to non-core revenue earned. Motor insurers, on average, earn 14% of their total revenue from non-core sources (e.g. investment income, sale of ancillary products). Firms which have higher level of revenue from non-core earn 18% average operating profit margin compared to 10% earned by motor insurers which focused more on core revenue.

Figure 30: Operating profit margin of motor insurers with higher proportion of non-core revenue vs insurers with lower proportion



4.8 However, we do not see a similar trend for home insurers. This could be because their non-core revenue is a smaller proportion of total revenue, at only 7%, and that the core underwriting profitability of home insurers has historically been higher than motor. It is also possible that firms do not invest as much in non-core revenue acquisition for motor insurance as for home because motor underwriting activity is unprofitable, unlike home insurance.

4.9 We notice that firms with a higher share of non-core revenue typically are insurers with a large direct or PCW distribution channel.

Home insurers with larger proportion of customers paying high customer margins have better operating profit margin.

4.10 We observed that the top 5 home insurers with the largest proportion of customers paying high/very high customer margins[33] also have the lower COR on average (94% compared to 98% for the rest) and higher operating profit margin (12% vs 7%) when compared to the other firms in the sample.

4.11 We did not observe a similar trend for motor insurers.

[33] The customer margin for each policy is the difference between premium and expected claims costs as a proportion of the premium. This customer margin measures the contribution of an individual policy to non-claims costs, expenses and profit. We then set thresholds that were 50% above this (this is the high margin) and double the market average (this is the very high margin).