National Audit Office

Report
by the Comptroller
and Auditor General

The Motability scheme

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The Motability scheme

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This report considers: the Motability scheme's customer offer and performance; the scheme's financial model, its impact and profitability; and the governance of the scheme and remuneration of Motability Operations' senior management.

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Contents

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Key facts

614,000	1.72m	£888m
Motability car scheme customers in September 2017	people eligible to be customers of the Motability scheme	our estimate of the maximum annual value of tax concessions from which the scheme benefited in 2017

99%	customer satisfaction in 2017-18, compared with a target of 92%.
£2.62 billion	Motability Operations' level of reserves as at March 2018.
£2.19 billion	total profits made by Motability Operations between 2007-08 and 2016-17, compared with total forecast profits of £1.14 billion in that period.
£400 million	charitable donation from Motability Operations to Motability, from Motability Operations' profits in 2017-18.
18 years	average tenure of Motability's governors prior to appointments in September 2018, compared with the Charity Governance Code's recommended limit of nine years.
£1.70 million	total value of remuneration package for Motability Operations' chief executive, including salary, bonuses and other benefits, in 2016-17.
£1.86 million	total value in September 2018 of additional long-term bonus scheme owed to Motability Operations' chief executive, but not yet paid, of which only the initial allocations of £258,000 have previously been disclosed.

Summary

1 The Motability scheme (the scheme) enables eligible disabled people to choose to exchange certain mobility allowances paid by the Department for Work & Pensions and Ministry of Defence for the lease of a new car, powered wheelchair or scooter. In early 2018, just over 1.7 million people were eligible for the scheme.

2 Two organisations provide the scheme:

- Motability, a charity, is responsible for the strategic direction and oversight of the scheme. Its charitable purpose is to "facilitate the relief and assistance of disabled persons… in connection with the provision to the beneficiaries of personal or other transportation".
- Motability Operations Limited, a public limited company, operates the scheme through an exclusive rolling seven-year contract with Motability, known as the scheme agreement. Motability Operations Limited is ultimately owned by four shareholder banks.

3 Another charity, the Motability Tenth Anniversary Trust, was established in 1989 to invest funds to provide Motability with income to support its charitable objectives.

4 The core Motability scheme product provides a 'worry-free' car lease package, including: maintenance; servicing and repairs; breakdown assistance; comprehensive insurance; and a range of adaptations available to the customer at no additional cost. In addition, Motability Operations is responsible for selling vehicles returned by customers at the end of the lease agreement. In the year ending 30 September 2017, it had 614,000 lease agreements in place and sold nearly 240,000 cars into the used car market. In 2017, Motability Operations' sales represented 21% of total UK sales of 3-year-old vehicles.

5 In May 2018, a report by the House of Commons Work and Pensions and Treasury select committees raised questions about: the structures and governance of the scheme; government support for the scheme; the levels of reserves in Motability Operations; the remuneration of its senior staff; and the relationship between Motability and the Department for Work & Pensions. Along with the Secretary of State for Work and Pensions, the Committees recommended that the National Audit Office (NAO) should carry out a review of the scheme.

6 The NAO is not ordinarily the statutory auditor of Motability, nor of any of its related entities. Motability does not currently receive public funding, but the scheme does benefit from government support, including through tax concessions.

7 On 23 May 2018, the Chief Secretary to the Treasury reached an agreement with the Motability entities providing, for a three-year period, the Comptroller and Auditor General with a statutory power to conduct examinations into the "economy, efficiency and effectiveness with which the Motability parties have used their resources in discharging their functions".

Focus of our review

8 This report considers:

- the Motability scheme's customer offer and performance;
- the scheme's financial model, its impact and profitability; and
- the governance of the scheme and remuneration of Motability Operations' senior management.

9 Given the significance of the car scheme in terms of its scale relative to the powered wheelchair and scooter scheme, this report focuses only on the car scheme. Fieldwork was carried out from July to October 2018. Our approach and methods are set out in Appendix Four.

Key findings

The Motability scheme's customer offer and performance

10 In 2017-18, overall customer satisfaction with the Motability scheme was 99%. Customer service standards are very high, with customer satisfaction having exceeded a target of 92% continuously for the last decade. This performance is impressive in the context of a customer base of people with disabilities, many of whom have complex needs. This followed a turnaround in overall scheme performance when a new management team at Motability Operations implemented a major change programme between 2002 and 2008. In March 2018, all 23 of the scheme's contractual key performance indicators exceeded targeted levels (Paragraphs 1.16 and 1.18).

11 The Motability scheme exclusively benefits from certain tax concessions associated with the direct transfer of the mobility components of qualifying allowances from the government, worth a maximum of £888 million in 2017. Based on May 2018 figures, the lease prices offered by Motability Operations are 44% cheaper on average than comparable leasing products in the wider market — nearly two-fifths of this discount arises directly from the tax concessions provided by government. Government also directly transfers customer allowances to Motability Operations, reducing the company's exposure to customer credit risk. This reduced exposure to risk supports a higher credit rating, enabling Motability Operations to access cheaper financing. Government support has also contributed to the scheme's scale, which enables Motability Operations to negotiate substantial discounts from manufacturers (Paragraphs 1.11–1.13 and 1.19).

12 **The scheme's customers represent 36% of all eligible individuals.** The 614,000 car scheme customers in September 2017 compare with around 1.7 million individuals who are eligible for the scheme. The percentage of customers as a proportion of eligible individuals compares with 29% in 2008. The scheme agreement makes Motability responsible for managing awareness of the scheme among eligible individuals who are not customers. Motability Operations has carried out limited research on eligible people who are not customers, to understand the reasons why they have not used the scheme, including any barriers to entry, but has not been able to draw any firm conclusions from this. Citing data protection concerns, the Department for Work & Pensions has not enabled Motability to access its database of eligible individuals for research purposes (Paragraphs 1.2, 1.8, 1.22 and 1.23).

Motability Operations' financial model

13 **Motability Operations has generated £1.05 billion of unplanned profit since 2008**. From 2008 to 2017, Motability Operations planned to make £1.14 billion of profit, but generated £2.19 billion of profit. The unplanned profit was driven by inaccuracy in Motability Operations' forecast value of vehicles, which is typically lower than the wider market average. This generated £826 million, or 79%, of the total unplanned profit. Underestimating the forecast value of cars means customers were charged £390 million more than was required in their lease agreements to cover the costs of depreciation. In reality, however, Motability Operations has benefited from the continued strong performance of the used car market over the past decade (Paragraphs 2.7, 2.9 and 2.10).

14 **Motability Operations has chosen a more prudent risk management approach than other car leasing companies, despite its overall business risk being lower owing to the competitive advantages afforded through government support**. Motability Operations has made various changes to its business model since 2002, for example taking responsibility for selling ex-lease vehicles and taking on the majority of its vehicle fleet insurance risk. Alongside a growing customer base, this has made scheme administration more complex and increased its risk exposure. Motability Operations is less able to manage its risk exposure through diversification compared with other car leasing companies and has chosen a considerably more risk-averse approach by adopting an intentionally conservative reserves target. However, government has provided the Motability scheme with a number of significant advantages that reduces the overall business risk being managed as part of the scheme when compared to other companies. We consider that the advantages of government support outweigh the disadvantages and while Motability Operations' prudent approach may have been appropriate while the business was changing, it is less justified given its ongoing success (Paragraphs 2.13, 2.15, 2.17–2.19).

15 **Motability Operations' prudent approach means it is holding more reserves than other car leasing companies. At 31 March 2018, Motability Operations held £2.62 billion in reserves**. 79% of the value of total assets that make up the reserves is vehicles. Holding reserves ensures Motability Operations can withstand economic downturns without raising lease prices, providing a sustainable and stable scheme for customers. If Motability Operations adopted an approach to risk management more in line with other car leasing companies, who are more exposed to worsening macro-economic conditions, it could hold a lower level of reserves. Reducing its target reserves level would increase the level of funds available to distribute, given that it is likely that Motability Operations will continue to generate significant surpluses unless an economic shock occurs. However, a less conservative finance policy could lead to a downgrade of Motability Operations' credit rating. This would increase its cost of financing, which would have to be funded through increased lease prices or operational efficiencies (Paragraphs 2.16, 2.17, 2.19, 2.21–2.24).

16 **Investment in the scheme has supressed the level of reserves that would be considered surplus to Motability Operations' requirements**. In addition to retaining profit as reserves, Motability Operations has invested £1.37 billion since 2008 in a range of initiatives that have increased costs into its business and are designed to improve its customer offer, such as free vehicle adaptations, payments to customers when they return their vehicles in a good condition and payments to dealers to incentivise excellent customer service. Motability Operations consults with customer groups and Motability to generate ideas to improve the customer offering. However, it is unable to demonstrate how effective this investment is in driving continued achievement of the scheme's strategic objectives given its already excellent performance relating to customer satisfaction and lease affordability. Given the size of investment, we think there should be a wider consideration of the value for money of customer investment that takes into account alternative uses of money beyond the scheme (Paragraphs 2.25–2.27).

Governance arrangements

17 **In addition to investments in the customer offer, Motability Operations donated £345 million to support Motability's grant activity between 2010 and 2017.** Motability has allocated half of this amount (£175 million) to fund transition support grants for scheme customers who have lost their eligibility for the scheme following their assessment for Personal Independence Payment (PIP), where previously they had been eligible through receipt of Disability Living Allowance (DLA). These grants enable these individuals to either continue their scheme leases for up to six months or receive up to £2,000. This was introduced following government's policy change to replace DLA with PIP, but will not require funding in the longer term. In the five-year period from 2013-14 to 2017-18, Motability spent £101 million on PIP transitional support grants. Motability expects that the Department for Work & Pensions will complete its programme of reassessments in 2019-20 (Paragraphs 1.9, 2.28 and 3.4).

18 **In September 2018, Motability Operations announced a further £400 million donation to Motability**. The £400 million it received in 2018 represents 14 times its total annual spending in 2017-18. In recent years, Motability Operations has advised Motability to expect ongoing sizeable donations of at least £100 million a year, in the absence of economic shocks. Motability does not have a long-term strategy and has only recently developed a structured framework for determining specific new purposes to which it will put high-value donations. In September 2018, Motability's board of governors approved funding for a range of new initiatives, which are expected to cost around £100 million a year by 2024-25. To ensure the sustainability of these initiatives, Motability expects to use the 2018 donation to contribute to holding surplus funds of between £500 million and £600 million in future years. The surplus funds are to be held within the charity, separate and additional to the reserves held by Motability Operations. Motability plans to draw on its surplus funds if there is any shortfall in expected future donations. It is not yet clear that Motability can absorb the scale of the donations it has received as a result of Motability Operations' unplanned profit in a way that can maximise its effectiveness (Paragraphs 3.5–3.7).

19 **Motability's governors have often exceeded recommended tenure limits, and there has been insufficient consideration of diversity in appointing them**. A review of Motability's governance in 2003 recommended planned and progressive refreshing of its board and the Charity Governance Code recommends a tenure limit for governors of nine years. However, before new appointments were made in September 2018, the average tenure of Motability's governors was 18 years. In September 2018, Motability announced the retirement of three governors and the appointment of five new governors. Following these changes, there are now four governors who continue to significantly exceed the recommended tenure limit of nine years, having each served for at least 16 years. While there is collective expertise in financial and automotive services, as well as personal and professional experience of disability, there are no black and minority ethnic governors, and only one female governor (Paragraphs 3.8 and 3.9).

20 **Motability has limited formal influence over Motability Operations' executive remuneration arrangements**. Motability Operations' Remuneration Committee is responsible for its remuneration policies, with the scheme agreement providing limited influence for Motability in this area. In recent years, the charity has become concerned about the reputational consequences of high levels of pay, even though the remuneration arrangements have functioned as Motability Operations' Remuneration Committee intended, following consultation with Motability. Correspondence in 2016 between Motability and Motability Operations shows that, following confirmation of new executive remuneration arrangements in 2015, Motability's chairman expressed concerns. The Motability Operations chairman conveyed that he had been under the impression that Motability's chairman supported the new arrangements. Motability's chairman, in his further reply, maintained his concerns about the level of variable pay. Motability has now recognised that it does not have sufficient formal mechanisms or influence to address this risk to the scheme's reputation but has not yet rectified the situation. A 2018 governance review recommended that Motability should seek to amend the scheme agreement to enable it to better control Motability Operations' executive remuneration (Paragraphs 3.10–3.12 and 3.26).

21 **Remuneration for Motability Operations' executive directors has been generous and linked to performance targets set at levels that have been easily exceeded since 2008**. Motability Operations made significant performance improvements between 2002 and 2008. After that, it set the thresholds for 'excellent' performance for all of its targets for its long-term incentive plan (LTIP) below levels it was already achieving when the plan was introduced. The targets were not made more stretching over time and all targets were exceeded for the period of this scheme, from 2008 to 2015. As a result, in the first seven years of the scheme, five executive directors received £15.3 million in total, a nearly four-fold increase in the value of units initially allocated to them. A review of remuneration commissioned by Motability Operations in 2015 found that these arrangements resulted in relatively high payments for delivering consistent performance (Paragraphs 3.14 and 3.15).

22 **Total remuneration for Motability Operations' executive directors is forecast to fall from 2019, but annual bonuses have continued at near maximum levels**. In 2015, the Remuneration Committee undertook a review of remuneration arrangements. It recognised that it could use a broader range of comparators as benchmarks, although this range still does not fully reflect the structural advantages from which Motability Operations benefits and does not include comparisons with public sector entities or large charitable trusts. As a result of the new arrangements, we forecast that total executive remuneration will fall after the final LTIP payments are made in December 2018. For example, the chief executive's total remuneration is likely to reduce from £1.7 million to around £1.4 million in 2019-20. However, in the first two years of the arrangements introduced in 2015, annual bonuses have been paid on average at 93% of their maximum levels. Independent benchmarking reports provided to Motability Operations report that, on average, FTSE 250 firms have paid 70% to 75% of the maximum bonus available, with higher levels leading to investors exerting pressure to set tougher performance targets (Paragraphs 3.17–3.19).

23 **The full value of a separate incentive scheme for Motability Operations' chief executive has not been disclosed previously**. Between 2010 and 2015, the chief executive benefited from an additional five-year long-term incentive scheme (LTIS), designed to ensure his retention in post. Motability Operations has only disclosed the initial £258,000 to the public through its annual report and accounts. This complies with minimum financial reporting disclosure requirements. The full value of the scheme may be of interest to the Work and Pensions and Treasury select committees, given their previous interest in this matter. Payment of the scheme's value can be released at any time. The scheme was worth £1.86 million in September 2018 and is likely to be worth around £2.2 million by 2022 (Paragraphs 3.20–3.22).

24 **A recent governance review of Motability provides an opportunity to update aspects of governance to support the scheme's long-term effectiveness**. Motability commissioned a review of its governance from its solicitors, in response to a Charity Commission recommendation. The Charity Commission had previously carried out a review of Motability during 2017 in response to an unspecified complaint about Motability and the Motability Tenth Anniversary Trust. The July 2018 governance report made 44 recommendations, many of which touch upon issues that we have also identified in our review, for example the roles and terms of office for governors, and suggested updates to the scheme agreement, including clarification of the charity's role relating to Motability Operations' remuneration. Motability plans to provide a response to all recommendations by December 2019 (Paragraphs 3.25–3.27).

Concluding remarks

25 The Motability scheme provides an excellent service to eligible people who choose to lease a car. Motability Operations has successfully changed its business model over time, bringing aspects of the service, such as insurance, directly into the business. The management of Motability Operations turned the scheme around and built it into an increasingly profitable business and a force to be reckoned with in the UK used car market.

26 Motability Operations' management has performed well since 2002. However, we do think there is a difference between turning an underperforming business around and carrying out a series of important but not necessarily exceptional tasks to keep it on a road to successful operation. Motability acknowledges that the scheme benefits from structural advantages afforded to it through government support – for example, tax concessions, direct payment of mobility allowances and an effective monopoly. However, we do not see that Motability Operations reflects these advantages adequately in its consideration of risk when compared to other companies, how it assesses its performance, and how executives are rewarded. Its prudent view of risks and reserves tends to reinforce their 'exceptional' performance viewpoint, which we think leads to very high executive reward. While, following a review, total executive remuneration at Motability Operations will now fall, Motability has had difficulty over a long period of time influencing Motability Operations to set executive pay at the levels the charity considers appropriate. In the first two years following the introduction of new remuneration arrangements, annual performance bonuses have been paid at close to maximum levels.

27 Motability Operations has continued to benefit from upside risk such as strong performance in the used car market, and it has not brought its forecast value of vehicles into line with the wider market. While generating higher profits than expected means more money is available to support disabled people, we have not seen any evidence that Motability or Motability Operations have an effective framework to ensure their investments provide value for money. In the absence of an economic shock and unless it changes its business model, we think it likely that the company will continue to generate substantial cash surpluses. In light of all this, further consideration is needed of the executive reward structure and the issues relating to scheme governance and whether they are suitable to underpin the Motability scheme so that it can continue its excellent work for its customers. There is also a clear public interest in the government providing more clarity around its objectives for mobility allowances, given the favourable enabling conditions it provides for the scheme.

Recommendations

28 Motability should:

a Develop and publish a long-term strategy, based on broad and open consultation, that sets out how it can put the significant income it expects to continue to receive from Motability Operations to best use.

b Address all of the findings of its recent governance review and report transparently on the changes it makes as a result. It should publish an update on this in early 2020, once all changes have been implemented.

c Commission external benchmarking on the level of reserves held at Motability Operations based on comparable companies in similar industries on a global basis, both regulated and unregulated. Such benchmarking should go beyond establishing adequacy and should also assess how conservative the level is relative to that held by the company's peers.

d Carry out a review of the performance framework for the scheme, recognising that it is in a uniquely advantaged position, and that targets, including those linked to Motability Operations' executive directors' remuneration, have continuously been exceeded for many years.

29 Motability Operations should:

e Provide greater ongoing transparency through its annual report and accounts about the total value of the performance bonuses it pays to its executive directors, including the cumulative value of its long-term incentive plans, and the performance criteria used to determine these bonuses.

f Review its approach to forecasting to understand why it has consistently under-estimated profit over the last decade, so that it can better plan for future distributions of profit.

30 The government should:

g Review the value and impact of the support it provides for the scheme at an appropriate frequency, in light of its overarching objectives for mobility allowances.

h Work with Motability and Motability Operations to enhance promotion of the scheme, and support more extensive research into eligible people who do not use the scheme.

Part One

The Motability scheme and its performance

1.1 This part of the report introduces the Motability scheme (the scheme) and the organisations that support its delivery; sets out the nature and extent of government support for the scheme; and the scheme's customer offer and performance.

Introduction to the Motability scheme

1.2 The scheme enables eligible disabled people to choose to exchange certain mobility allowances paid by the Department for Work & Pensions and Ministry of Defence for the lease of a new car, scooter or powered wheelchair. Qualifying allowances are not means-tested. They are summarised in **Figure 1**. In total, 1.72 million people are eligible to participate in the scheme.

1.3 Two organisations provide the scheme (**Figure 2** on page 16):

- Motability, a charity, is responsible for the strategic direction and oversight of the scheme. Its charitable purpose is to "facilitate the relief and assistance of disabled persons… in connection with the provision to the beneficiaries of personal or other transportation".

- Motability Operations Limited, a public limited company, operates the scheme through an exclusive rolling seven-year contract with Motability, known as the scheme agreement. The company is ultimately owned by its four shareholder banks: Barclays; HSBC; Lloyds; and RBS.[1] The banks' return for ownership is £1.45 million in aggregate across the four banks made up of a fixed interest amount of £696,500 on the preference shares held by the banks per year and £750,000 in management fees. These banks also charge Motability Operations interest on loans and fees for capital market transactions, such as issuing bonds. These transaction fees are, on average, £17 million per year. The banks have waived their rights to dividends from ordinary shares.

1.4 Another charity, the Motability Tenth Anniversary Trust, was established in 1989 to invest funds to provide Motability with income to support its charitable objectives.

1 Barclays, HSBC and RBS each own 19.99% of Motability shares. Lloyds' shareholding is 39.98%, owing to the consolidation of Lloyds and HBOS, both of which had previously owned 19.99% each. The Law Debenture Trust is a minority shareholder, with 0.05% in shares.

Figure 1
Qualifying allowances for the Motability scheme

Qualifying allowance	Amount of allowance	Number of recipients
Disability Living Allowance (DLA) higher rate mobility component, administered by the Department for Work & Pensions	£59.75 per week	996,848 (February 2018)
Personal Independence Payment (PIP) enhanced rate mobility component, administered by the Department for Work & Pensions	£59.75 per week	712,081 (February 2018)
War Pensioners' Mobility Supplement (WPMS), administered by the Ministry of Defence	£66.75 per week	11,220 (March 2018)
Armed Forces Independence Payment (AFIP), administered by the Ministry of Defence	£59.75 per week	954 (March 2018)

Note

1 The total amount of the Armed Forces Independence Payment is equal to the highest rates payable in any year through Disability Living Allowance or Personal Independence Payment. The amount quoted here is therefore equivalent to a mobility component of these two benefits.

Source: National Audit Office analysis of Department for Work & Pensions and Ministry of Defence data

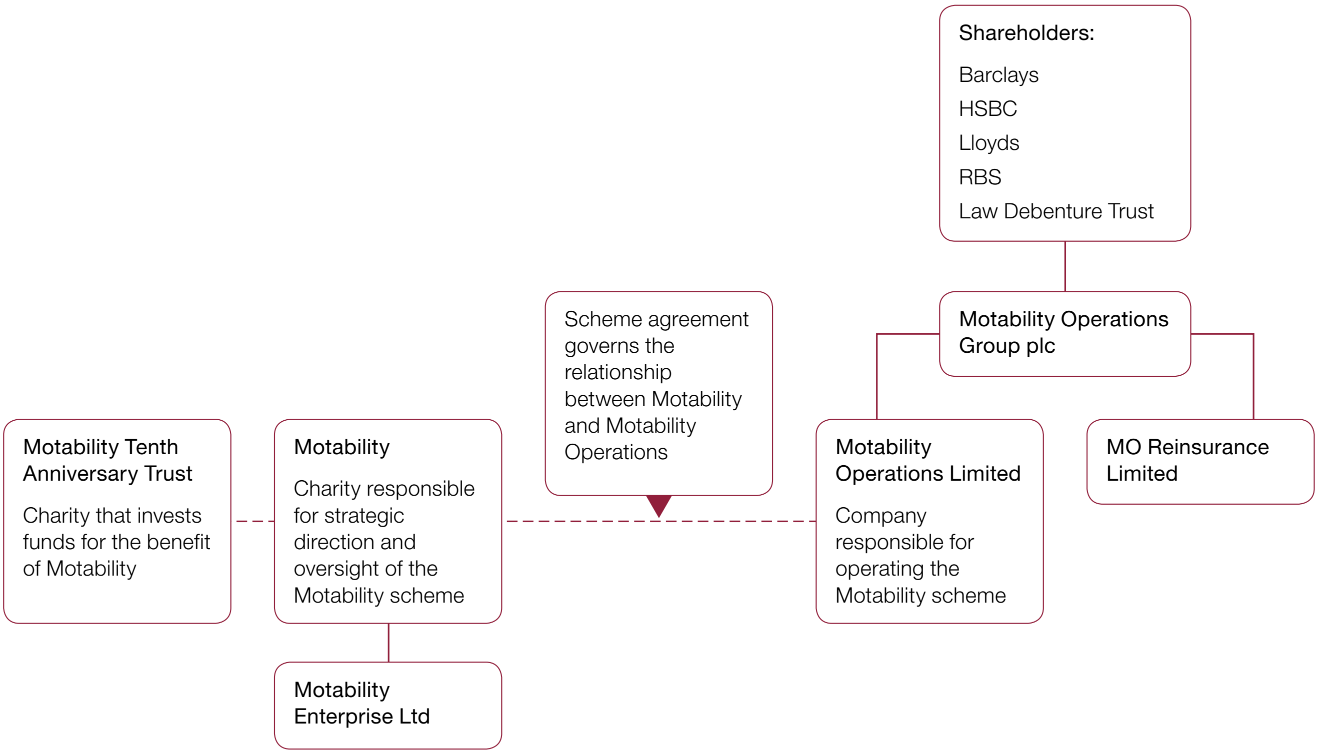
The Motability offer to customers

1.5 The main scheme product is a three-year car lease with a 60,000 mile limit, above which excess mileage charges apply. The lease includes what Motability describes as a 'worry-free' package. This includes maintenance; servicing and repairs; breakdown assistance; and comprehensive insurance. Around 200 minor adaptations, such as enhanced hand controls and pedal modifications, are available at no additional cost.

1.6 As the scheme is available to anybody in receipt of a qualifying mobility allowance, some customers who would otherwise find it difficult to pay high insurance premiums, or access credit, are able to lease a car. To support the core scheme, Motability (the charity) also provides grants for people to lease more expensive wheelchair-accessible vehicles where these are required, as well as grants for individuals facing hardship, and grants towards driving lessons. In 2017-18, the charity provided just over 8,500 grants for these purposes, with a total value of £23.1 million.

1.7 For the car scheme, customers have three options in terms of pricing. These are set out in **Figure 3** on page 17.

Figure 2
The organisations providing the Motability scheme



Source: National Audit Office analysis of Motability and Motability Operations data

Figure 3
Pricing options for the Motability car scheme

Most scheme customers make additional payments in addition to transferring qualifying mobility allowances

Pricing option	Proportion of customers (July 2018) (%)	Description	Example cars[1]
Car leases that cost less than the qualifying mobility allowance.	2	Customers receive a fixed weekly cash payment that represents the difference between the lease price and the amount of their qualifying allowance.	Hyundai i10 1.0 66bhp S 5-door (customer keeps £10.75 per week) SEAT Leon 1.2 TSI 110bhp SE Dynamic Technology 5-door (customer keeps 75p per week)
Car leases available for the cost of the qualifying mobility allowance, with no additional advance payment.	13	The lease price is equivalent to the qualifying mobility allowance, and therefore customers neither receive a cash payment, nor make any additional advance payments.	Nissan Qashqai 1.2 DIG-T 115bhp Acenta 5-door 5-seat Vauxhall Astra 1.4i 16v Turbo 150bhp Sri 5-door
Car leases for which customers make an additional advance payment	85	In addition to all of their qualifying mobility allowance, customers make a one-off, additional advance payment in order to lease more expensive vehicles. Between January and March 2018, the average value of an advance payment was £839. Following the advance payment, the on-going lease price is equivalent to the qualifying mobility allowance.	Hyundai Tucson 1.6 GDI SE Nav 132 Blue Drive (advance payment of £299) BMW X1 2.0TD 190bhp xDrive20d Sport 5-door (advance payment of £1,999)

Note

1 Example vehicles were available to customers between April and June 2018.

Source: National Audit Office analysis of Motability Operations data

The scale of the Motability scheme

1.8 More than 4.5 million vehicles have been supplied by the scheme since it was launched around 40 years ago. As at September 2017, the car scheme served around 614,000 customers.

1.9 While the volume of scheme customers has grown overall in the past 10 years, the trend in the past five years reflects the government's policy change to replace Disability Living Allowance (DLA) with Personal Independence Payment (PIP) for people aged between 16 and 64 (**Figure 4**). This has meant that individuals are being assessed against new criteria, and many have lost eligibility for the scheme as they do not qualify for the enhanced rate mobility component of PIP, although other individuals are eligible for the scheme for the first time. Motability has funded transition support grants for scheme customers who have lost their eligibility for the scheme following their assessment for PIP where previously they had been eligible through receipt of DLA, enabling these individuals to continue their lease for up to six months or receive up to £2,000.

Government support for Motability

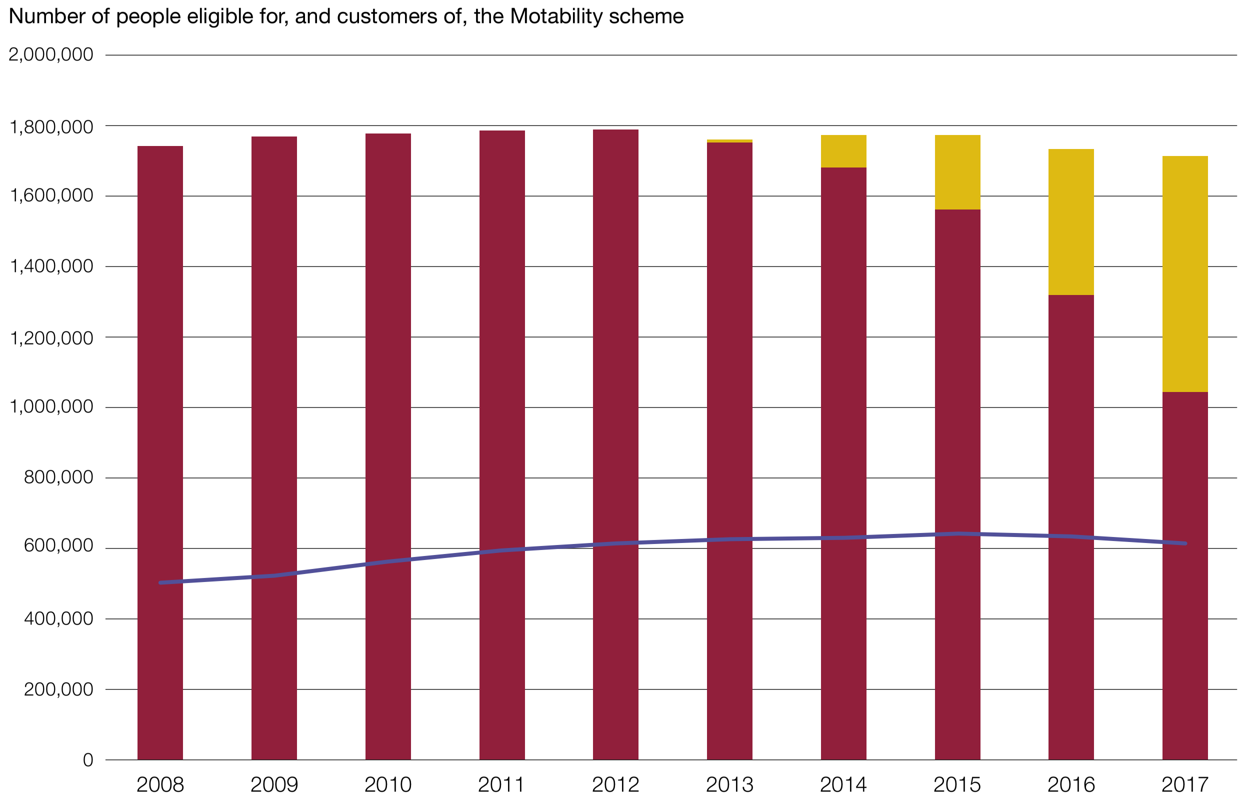
1.10 As a charity, Motability is independent of government. However, the government supports Motability through tax concessions and direct payment of customers' mobility allowances. In the past, the government has also provided public funding for certain aspects of the scheme. For example, it provided grant support for customers needing wheelchair-accessible vehicles, which was worth around £18 million a year. This funding stopped in 2016, with Motability now meeting these costs.

Tax concessions

1.11 The scheme benefits from the tax concessions set out in **Figure 5** on page 20. Neither of the legislative provisions that underpin the tax concessions make any specific reference to Motability, but lease suppliers must meet a range of specified conditions in order to be eligible. One of the conditions is that the qualifying mobility allowance must be transferred directly to the lease supplier by the Department for Work & Pensions or the Ministry of Defence. Current regulations only allow the transfer of the mobility components of qualifying allowances to be made to a lease supplier specified by Motability. In practice, therefore, only the Motability scheme benefits from the tax concessions associated with these transfers. The government has not estimated the value of these tax concessions. Had Motability Operations had to pay Value Added Tax and Insurance Premium Tax on the revenue it generated in the period to 30 September 2017 in the absence of these concessions, we estimate the value of the tax payable would be a maximum of £888 million.

Figure 4
Motability car scheme customer volumes, 2008 to 2017

Volumes of customers and eligible people from 2013 onwards reflect the implementation of the government's welfare reforms



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
DLA higher rate mobility allowance recipients	1,745,740	1,772,902	1,783,077	1,789,897	1,792,182	1,758,060	1,686,726	1,565,655	1,323,068	1,046,184
PIP enhanced rate mobility allowance recipients						8,458	89,098	211,047	416,105	669,668
Motability car scheme customers	501,300	523,800	562,400	592,600	613,400	624,400	631,800	643,000	632,800	614,200
Customers as percentage of eligible individuals (%)	29	30	32	33	34	35	36	36	36	36

Note

1 Car scheme data are as at 30 September for each year. DLA and PIP data are as at November for each year.

Source: National Audit Office analysis of Department for Work & Pensions and Motability Operations data

Figure 5
Tax concessions available to Motability Operations

Legislation	Description of tax concession	Current rate	Maximum value per annum (2017)
Value Added Tax Act 1994, Schedule 8, Clause 14	The provision of the hire of a motor vehicle to individuals in receipt of specified disability benefits is zero-rated for VAT purposes.	20%	£401m
Value Added Tax Act 1994, Schedule 8, Clause 15	The sale of vehicles used in the provision of a lease which is eligible for the zero rating of VAT is itself eligible for the zero-rating of VAT where the sale constitutes the first supply after the end of the lease.	20%	£424m
Insurance Premium Tax Regulations 1994 (Statutory Instrument 1994/1774 – as amended)	Insurance contracts supplied to people leasing vehicles under the same arrangements as above are exempt from insurance premium tax.	12%	£63m

Notes

1 The estimates are based on tax concessions not being in place and Motability Operations charging VAT and Insurance Premium Tax (IPT) through lease costs.

2 The estimates are based on figures taken from Motability Operations' Annual Report and Accounts to 30 September 2017.

3 The maximum estimate assumes that there would be no impact on the volume of scheme customers as a result of lease prices increasing in the absence of tax concessions.

Source: National Audit Office analysis of Motability Operations data

Transfer of mobility allowances

1.12 The Department for Work & Pensions and the Ministry of Defence pay customers' mobility allowances directly to Motability Operations. This reduces Motability Operations' exposure to credit risk arising from customers defaulting on payments, and allows customers who may not pass the credit checks of other car leasing providers to access the scheme.

Long-term effects of government support

1.13 Over time, government support has provided Motability Operations with a competitive advantage that further contributes to the scheme's scale and affordability. The scheme now accounts for around one-tenth of all new cars purchased annually in the UK. Motability Operations is therefore able to use economies of scale, for example by negotiating substantial discounts on cars purchased from manufacturers.

1.14 The government support for the Motability scheme is a major factor supporting credit rating agencies' assessments that Motability Operations is a lower-risk business than other car leasing companies. Credit rating agencies cite Motability Operations' position as the sole leasing company entitled to provide vehicles under the scheme, and the limited credit risk to which it is exposed, as a rationale for their ratings. One of the agencies states that it views Motability Operations' ability to generate revenue to be largely insulated from deteriorating macro-economic conditions when compared to other car leasing firms.

1.15 Motability Operations is of the view that the positive impact the scheme has on the wider economy significantly offsets the value provided through government support. We believe that this overstates the impact of Motability Operations as however people in receipt of mobility allowances use this money it will have an equally positive effect on the economy.

The Motability scheme's service performance

1.16 Between 2002 and 2008, Motability Operations' management team delivered a major change programme intended to make the company more customer-focused and financially stable. During this period, the number of vehicles available on the scheme, customer numbers and customer satisfaction all increased. Motability Operations also reduced its cost base, increased profit and built up its reserves from £62 million in 2002 to £568 million in 2008. In 2007, for the first time, Motability Operations considered that it had sufficient reserves to protect the scheme from the impact of the risks it faced at the time.

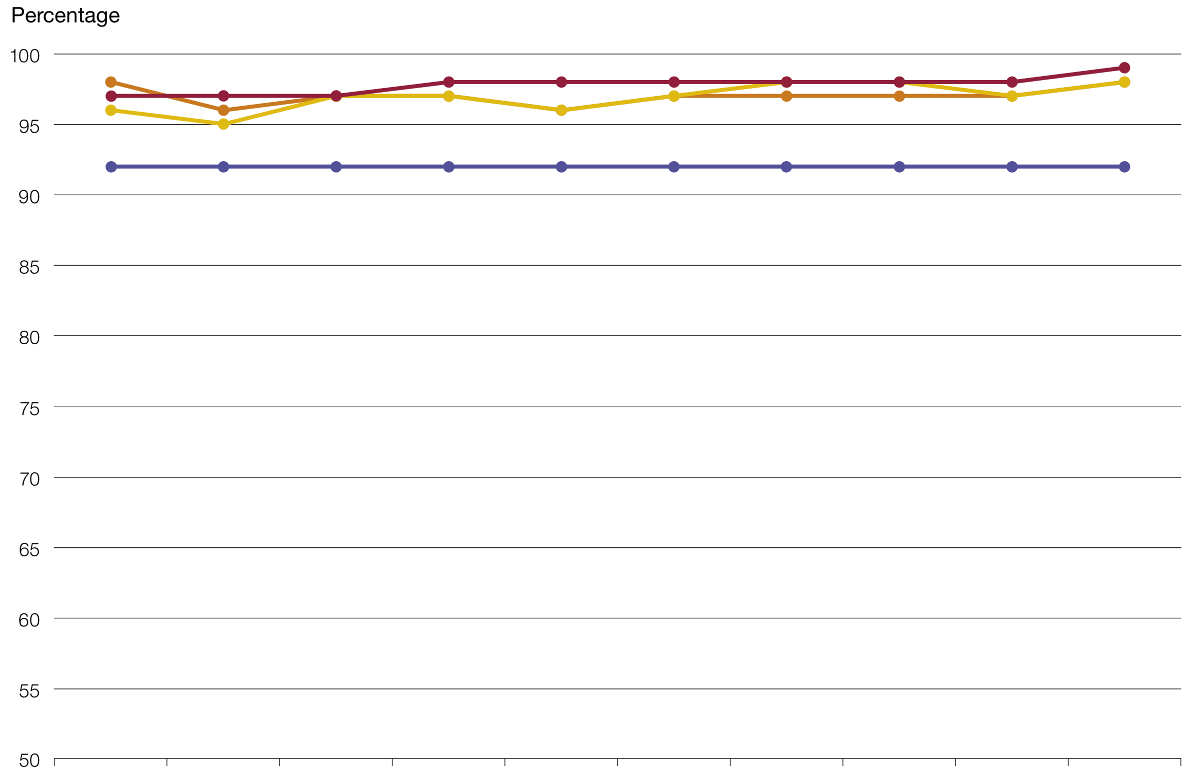
1.17 As part of their contractual scheme agreement, Motability and Motability Operations have agreed key performance indicators to measure the scheme's performance. The current 23 key performance indicators for the car scheme are based on four strategic objectives, shared between Motability and Motability Operations. These are:

- build our customer and disability expertise;
- provide value and choice;
- improve reach and awareness; and
- ensure long-term sustainability.

1.18 Performance reports are provided quarterly to Motability's Scheme Oversight Committee. In March 2018, the scheme exceeded its target levels against all 23 of the key performance indicators. The scheme has performed well against these measures for a long time. For example, **Figure 6** overleaf illustrates the trend in customer service performance in the past 10 years.

Figure 6
Customer service performance measures for the Motability car scheme, 2008-09 to 2017-18

Customer services measures have continuously been above target from 2008-09 onwards



	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Overall satisfaction with the scheme (%)	97	97	97	98	98	98	98	98	98	99
Customers who would recommend the scheme (%)	96	95	97	97	96	97	98	98	97	98
Customer intention to renew their leases (%)	98	96	97	97	96	97	97	97	97	98
Scheme agreement target	92	92	92	92	92	92	92	92	92	92

Source: National Audit Office analysis of Motability data

Value for money for the customer

1.19 One of the key performance indicators for the car scheme is the average discount of a Motability lease, compared with the wider leasing market. Lease costs were, on average, 44% cheaper in May 2018 for Motability customers than in the wider leasing market with nearly two-fifths of this discount arising from the direct impact of the tax concessions from which the scheme benefits (Figure 5).

Sales of ex-lease vehicles

1.20 Prior to 2002, Motability Operations was responsible for the resale of vehicles only when they were returned by customers before the end of the expected lease term. Vehicles returned at the end of the lease term were subject to a manufacturer buy-back arrangement. From 2002, Motability Operations took on responsibility for the resale of the majority of vehicles, with one buy-back arrangement in place until 2007. Motability Operations taking on responsibility for all vehicle sales increased both its exposure to potential financial loss and the complexity of its overall business.

1.21 Motability Operations now sells nearly 240,000 cars per year. It has developed an online sales platform, which now generates around 80% of its sales. This allows it to arrange sales before the vehicle is handed back by the customer for 20% of its fleet. Between January and July 2018, the value of its used car sales has outperformed the wider used car market by 2.2%. In 2017, Motability Operations' sales represented 21% of total UK sales of three-year-old vehicles.

The scheme's customers

Customers as a proportion of eligible people

1.22 As shown in Figure 4, 36% of eligible people currently use the scheme. This compares with 29% in 2008. One of the scheme's four strategic objectives, shared by Motability and Motability Operations, is to improve reach and awareness. The scheme agreement makes Motability responsible for managing awareness of the scheme among eligible individuals who are not customers.

1.23 Motability Operations has carried out limited survey research on eligible people who are not customers, but there is scope to do more to understand the reasons why many eligible people do not use the scheme. Citing data protection concerns, the Department for Work & Pensions has not enabled Motability to access its database of eligible individuals for this type of research. The Department for Work & Pensions sends promotional material by post to eligible people. It has sent leaflets to DLA recipients for many years, but only started sending leaflets to PIP recipients early in 2018. No mailings were sent to DLA recipients for a period of three months in 2018 to ensure compliance with the new General Data Protection Regulations (GDPR) and the PIP mailshot has been suspended since May 2018 for the same reason. In the context of a changing customer base as a result of the replacement of DLA with PIP, there is scope to enhance the research already undertaken, in particular to consider any barriers to entry that may be preventing people from using the scheme.

Part Two

The Motability scheme's financial model and its impact

2.1 This part of the report considers the financial model chosen by Motability Operations, which underpins target profit levels and target reserves levels, and the impact of these choices on customers.

Motability Operations' financial model and target level of profit

2.2 In order to offer the services under the Motability scheme (the scheme), Motability Operations purchases the vehicles it leases to its customers and has arrangements in place to provide the 'worry free' proposition either itself or through third parties. Motability Operations generates income from those vehicles both from its receipt of mobility allowances and through selling the vehicles at the end of the lease (**Figure 7**).

2.3 Income in excess of costs results in a profit. Motability Operations depends on generating profit to increase reserves. Prior to 2010, Motability Operations chose to increase its reserves level in response to a significant business transformation that increased its risk exposure and so set a profit target for a return on assets of 4% to 5%. In 2007 it reached its minimum reserves requirement and reduced its profit target in 2010 to a return on assets of at least 1.5%.

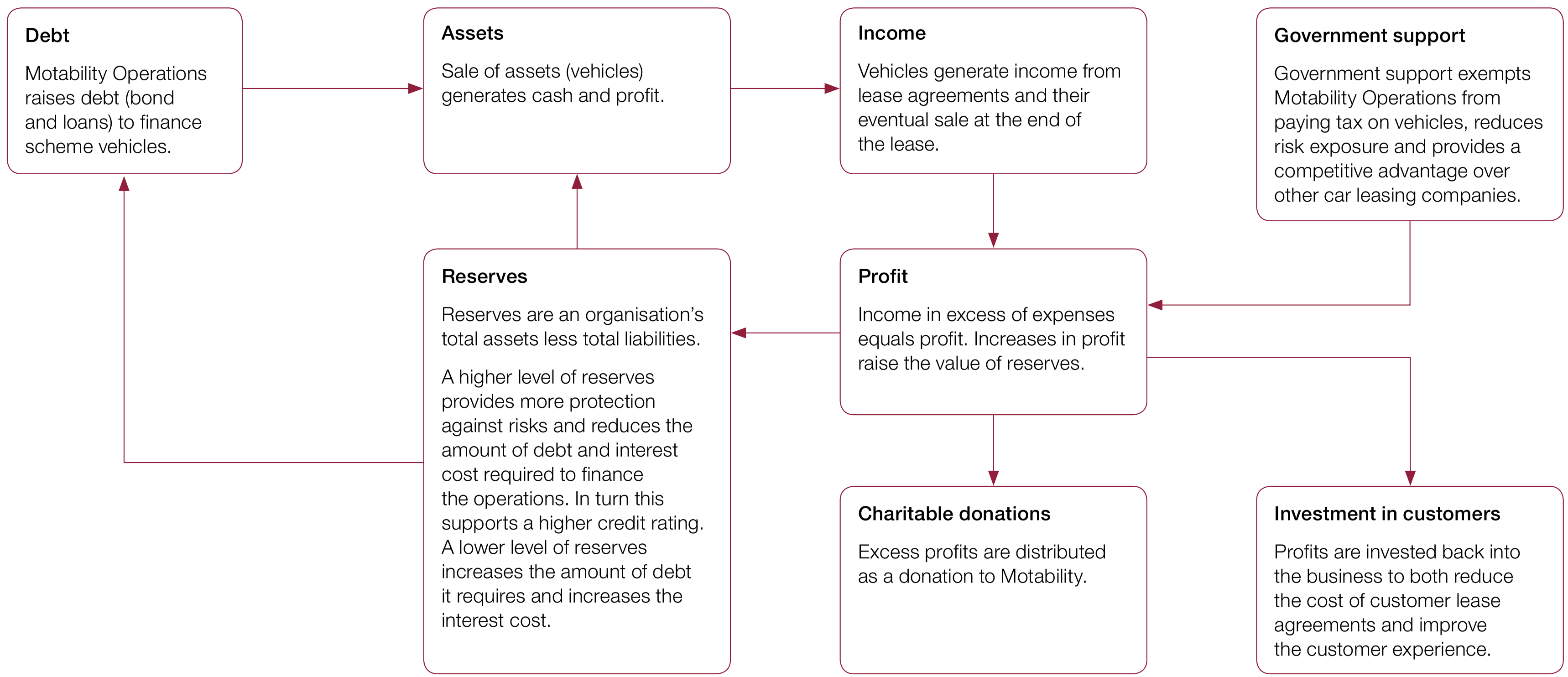
2.4 Motability Operations plans to make profit to reach this target from the following activities:

- lease agreements; and
- sale of ex-lease vehicles.

2.5 Motability Operations plans to make over 90% of its total profit from customer lease agreements. **Figure 8** on page 26 shows the costs and profit in an average lease. Motability Operations charges customers an additional 6% on average to achieve a return on assets target of at least 1.5%. However, the amount of profit priced into each lease can vary depending on make and model of the vehicle. There are some vehicles where Motability Operations may choose to make a lower level of overall profit or even a loss. This is influenced by the level of manufacturer discount Motability Operations can achieve and its performance measures relating to value and choice such as increasing the number of models available to customers with a nil advance payment. Motability Operations' management of pricing means it significantly exceeds its performance measures relating to value and choice.

Figure 7

Motability Operations' financial model



Source: National Audit Office

Figure 8
Breakdown of an average scheme lease

Depreciation makes up 43% of lease costs

Lease component	Cost (£)	Proportion of total lease costs (%)
Depreciation	4,464	43
Insurance	2,366	23
Roadside recovery and maintenance	890	9
Funding costs	748	7
Customer support	652	6
Post tax profit	623	6
Overheads	456	4
Tax	146	1
Total lease costs	**10,345**	

Notes

1 Based on Motability Operations July 2018 price lease data for an average lease over three years.

2 Tax relates to Corporation Tax payable on Motability Operations' profits.

3 Totals may not sum due to rounding.

Source: National Audit Office analysis of Motability Operations data

2.6 At the end of each lease, Motability Operations sells vehicles on the used car market. Motability Operations estimates the value of all its vehicles throughout the lease term, adjusting for depreciation. This estimate is known as the residual value. When sold, any proceeds that are above the residual value are accounted for as profit. Motability Operations do not plan to make any profit from the sale of vehicles that were used for the full length of the lease agreement.

2.7 Motability Operations' residual value forecasting directly informs the level of expected depreciation on a vehicle. Residual values are forecast and adjusted by Motability Operations throughout the lease with the intention that no profit or loss is realised on the sale of a vehicle at the end of the lease. Inaccuracies in its residual value forecasting can lead to Motability Operations making a profit or loss on sales of ex-lease vehicles. Underestimating the residual values of cars means more depreciation would be charged to customers through lease agreements than was required. Figure 8 shows that depreciation makes up 43% of the lease costs charged to a customer.

2.8 Customers can cancel their lease agreement and hand their vehicle back. On average, lease cancellations occur 18 months into a lease. As the planned residual value of a vehicle is based on a three-year-old car, sales of cars that are less than three years old generally make more profit. In the past 10 years, Motability Operations planned to make £233 million in profit from the sale of early termination vehicles. Sales of early termination vehicles make up around 30% of total sales by volume.

Profit performance against plan

2.9 From 2008 to 2017, Motability Operations made £2.19 billion profit against a plan of £1.14 billion – an unplanned profit of £1.05 billion. **Figure 9** overleaf shows actual profit compared with planned profit over time. Motability Operations has made more profit than it planned to in every year over the past 10 years. This was the case even in 2008, where the value of used vehicles dropped sharply following the UK recession.

2.10 **Figure 10** on page 29 shows the underlying drivers of this unplanned profit. The biggest drivers of unplanned profit were higher than expected profit on the sale of vehicles and increases in the residual value of vehicles. These drivers were caused by Motability Operations' inaccurate forecasts of the residual value of its vehicles and the strong performance of the used car market. This contributed £826 million, 79% of total unplanned profit. Motability Operations' forecasts of the residual value of vehicles at the end of lease agreements have been more pessimistic than wider market averages since 2009. Overall, underestimating the forecast value of cars means customers were charged £390 million more than was required in their lease agreements.

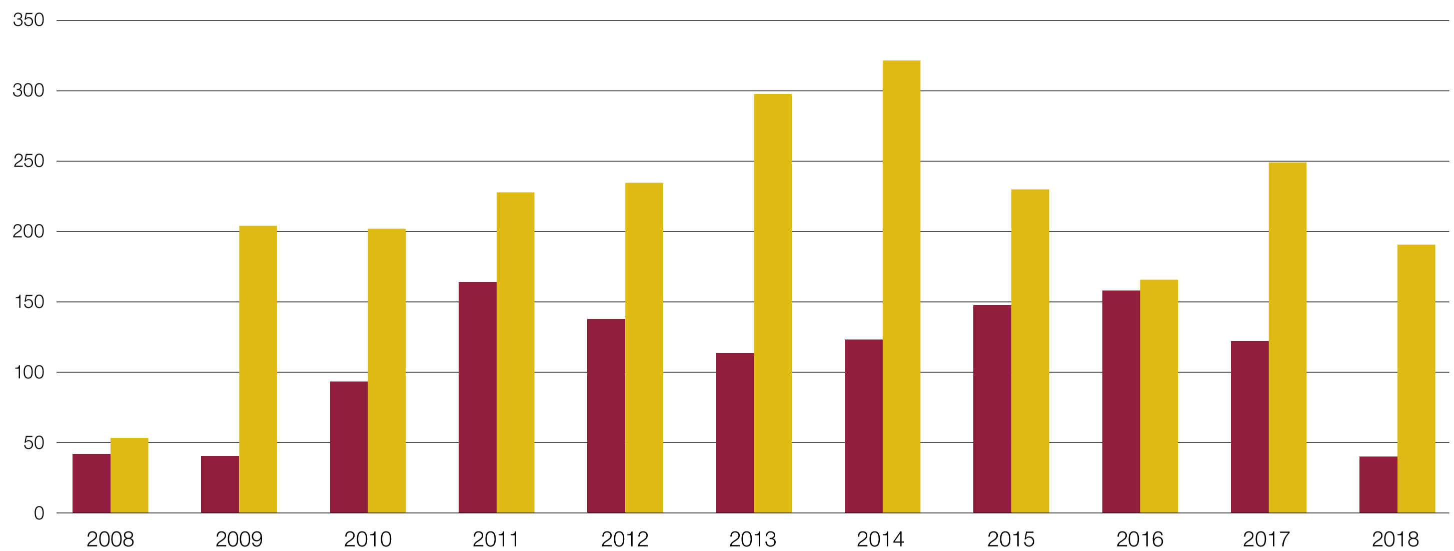
2.11 Generating unplanned profit compromises the ability for either Motability or Motability Operations to plan effectively for how best to use this profit in the longer term. Motability Operations has sole determination in how that profit should be used. Motability Operations can choose to:

- retain unplanned profit as reserves which protects the scheme from risk and reduces its cost of financing; or
- invest in activities that support business transformation; or
- invest in enhancing the customer proposition for scheme customers through reductions in lease pricing; or
- carry out strategic projects that improve the efficiency of the business or providing other forms of support to customers; or
- make donations to Motability or Motability Tenth Anniversary Trust.

Figure 9

Actual and planned post-tax profit before charitable donations

Actual profits have consistently exceeded forecasts



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Planned profit (£m)	42	41	93	164	138	113	123	147	158	122	39
Actual profit (£m)	53	204	202	228	234	298	322	230	165	249	190
Performance ahead of plan (%)	27	402	118	39	70	163	162	56	5	104	386

Notes

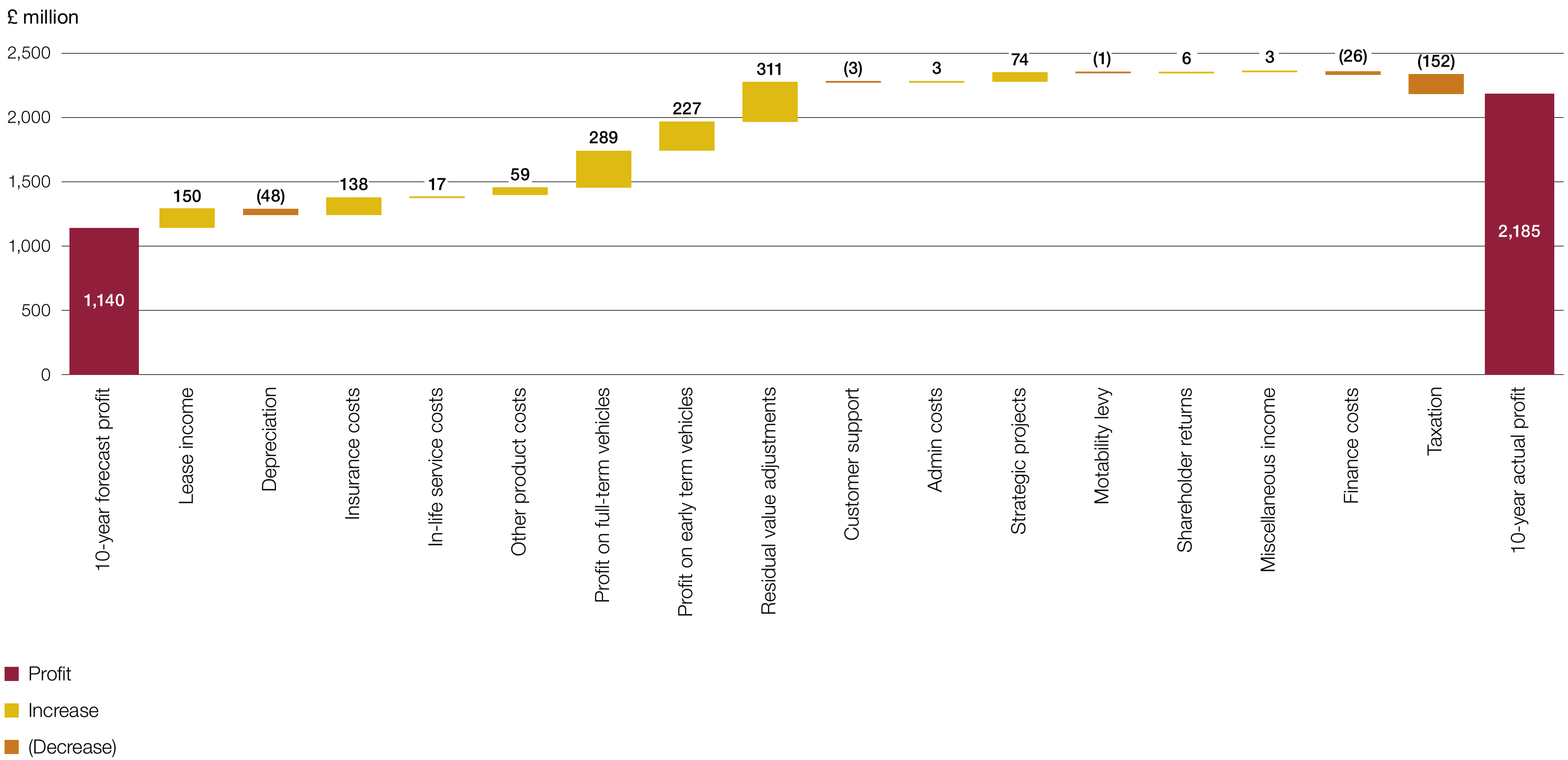
1 Profit is shown post tax but before charitable donations.

2 The 2018 planned profit is for the first six months of the year. The 2018 actual profit is that reported in Motability Operations 2018 half-year report.

Source: National Audit Office analysis of Motability Operations data

Figure 10
Profit performance against plan, 2008–2017

Increased profits have mainly been driven by the sale of vehicles and residual value adjustments



Note

1 Profit is shown post-tax but before charitable donations.

Source: National Audit Office analysis of Motability Operations data

Motability Operations' approach to reserves

2.12 In running the Motability scheme, Motability Operations is exposed to business and financial risks, against which management must protect the company appropriately. These risks are similar to those faced by other companies in the car leasing and insurance sector, and include:

- the risk that the residual values of vehicles may fall below forecast market value;
- the risk that insurance costs are higher than forecast; and
- the risk that operational events occur that have a downside impact on the business, such as a cyber-attack, regulatory fines or business disruption.

2.13 The level of risk that Motability Operations is exposed to, however, is subject to judgement. Owing to the unique structure of the business, Motability Operations is less able to make certain choices that other peers could make to protect the scheme from risk. These include diversifying into other products, services or countries, or choosing who is eligible for lease agreements. We consider, however, that the advantages of government support for the scheme outweigh any disadvantages or limitations that Motability Operations must manage. Government support reduces the overall business risk being managed as part of the scheme when compared to other companies given Motability Operations benefits from:

- tax concessions that allow Motability Operations to offer customers a cheaper lease package than other leasing companies;
- a de facto monopoly position as the supplier of lease vehicles to recipients of qualifying mobility allowances, providing Motability Operations with beneficial economies of scale that underpin strong negotiations with manufacturers or other suppliers; and
- a structurally low credit risk profile given that customers' lease payments are made directly by the government to Motability Operations on behalf of customers.

2.14 Motability governors (specifically the vice-chairman in 2012 and the chairman in 2016) have recognised that the advantages of government support reduce the level of risk being managed by Motability Operations' senior executives when comparing the business to comparators, also citing its de facto monopoly position with almost zero credit risk (see Appendices One and Two).

2.15 The business transformation undertaken by Motability Operations since 2002 alongside a growing customer base has made scheme administration more complex (**Figure 11**) and increased its risk exposure. An increased risk exposure can lead to benefits for a business, should those anticipated risks not arise. Over the past 10 years, the generation of high levels of unplanned profit shows that Motability Operations has significantly benefited from the upside risk associated with its risk exposure.

Figure 11

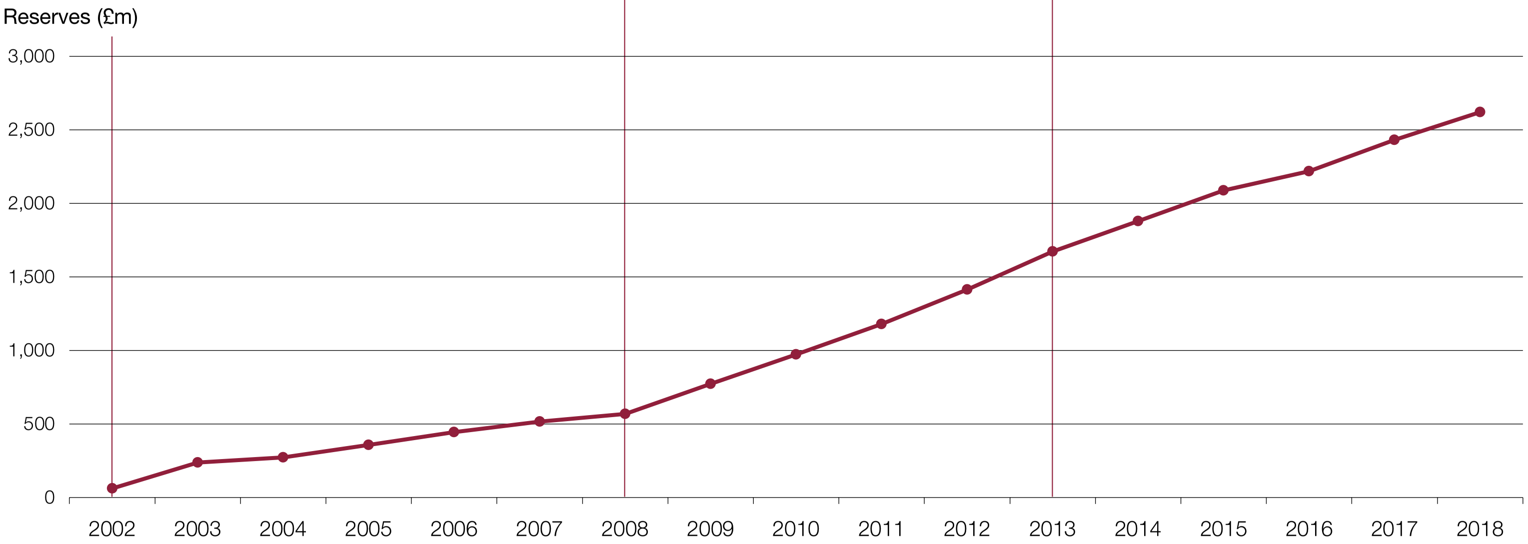
Motability Operations' reserves and business transformation

Reserves have increased as result of growth in the customer base and changes to its operating model and risk profile

2002
Vehicle ownership
Motability Operations became responsible for owning the vehicles on its fleet. It then sells the vehicles at the end of the lease term

2008
Refinancing
Motability Operations underwent a corporate restructuring to enable access to debt capital markets

2013
Insurance
Motability Operations took on 80% of its vehicle fleet insurance risk



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
● Reserves (£m)	62	237	274	357	444	515	568	772	974	1,180	1,414	1,674	1,879	2,089	2,218	2,431	2,621
Customer Volume	390,200	386,100	391,300	417,300	442,600	466,300	501,300	523,800	562,400	592,600	613,400	624,400	631,800	643,000	632,800	614,200	610,400

Note

1 The value of reserves is as at 30 September, as reported in Motability Operations' Annual Reports and Accounts; 2018 figures are taken from Motability Operations' 2018 Half-Year Report.

Source: National Audit Office analysis of Motability Operations' Annual Reports and Accounts, available at https://www.motabilityoperations.co.uk/investors/financial-performance/ and Motability Operations information

2.16 Motability Operations' reserves have grown from £0.57 billion in 2008 to £2.62 billion as at 31 March 2018. 79% of the value of total assets that make up the reserves is vehicles. It is expected practice that businesses hold an appropriate level of reserves in light of their risk exposure, otherwise there is a risk of business failure. Because of the changes Motability Operations has made to its business since 2002, which have increased its risk exposure, we would expect the overall level of reserves to increase. However, the exact level of reserves to hold against risk is subject to judgement.

2.17 Motability Operations has chosen to adopt an intentionally conservative risk management policy when assessing the level of reserves required to mitigate against the business risks. This level of prudence makes it less likely that Motability Operations would need to increase its lease prices in response to losses arising from risk, which minimises price volatility for customers. It sets the target reserves at a level to be able to absorb the losses from risk events in the next 12-month period in all but a one in 10,000 event – a 99.99% confidence level. Motability Operations' risk management committee is responsible for determining this judgement, which is also endorsed by Motability in the scheme agreement. Based on a 99.99% confidence level, Motability Operations' minimum reserves requirement in 2017-18 was £2.05 billion or £3,333 per vehicle. This has increased from £1.43 billion or £2,319 per vehicle in 2013, partly driven through taking on 80% of vehicle insurance risk in 2013. The nature of the risks against which Motability Operations hold reserves is shown in **Figure 12**.

2.18 Owing to its use of a 99.99% confidence level in calculating its minimum reserves level, Motability Operations holds reserves to enable it to recover from all but the most extreme events. For example, the tax risk scenario calculates the reserves required to recover from an overnight increase of 5% in the Corporation Tax rate, whereas the Corporation Tax rate has consistently fallen since 2008 and has not experienced a 5% change since the 1980s. Motability Operations holds enough reserves against operational and cyber risk to cover the scheme from a cyber-attack disabling its online vehicle sales platform, a security breach involving customer data resulting in compliance fines and the destruction of one of Motability Operations' main offices without valid insurance all occurring in the same reporting period.

2.19 Motability Operations' approach is more risk-averse than its industry peers. It is not clear this approach is necessary given the overall business risk associated with the scheme is lower than its peers. A confidence level of 99.99% is more prudent than that used by other organisations that carry out similar activities. LeasePlan, a global car leasing and fleet management company, uses a 99.9% confidence level. Insurance companies in the European Economic Area that follow Solvency II requirements need to comply with a minimum confidence level of 99.5%.[2] Using a confidence level between 99.9% and 99.5% would allow Motability Operations to lower its minimum reserves requirement by £230 million to £448 million. Reducing its minimum reserves requirement would free up funds that could be used in other ways.

2 The Solvency II Directive (2009/138/EC) is a Directive in European Union law that codifies and harmonises the EU insurance regulation. Primarily this concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency. Chapter VI, Section 4 relates to the Solvency Capital requirements.

Figure 12
Motability Operations risk breakdown over time

The reserves per vehicle increased from £2,319 to £3,333 per car with the majority of the risk due to insurance and the uncertain value of cars at the end of the leases

Area of risk	Nature of risk	2013 amount per vehicle (£)	2017 amount per vehicle (£)	Total 2017 capital requirement (£m)
Residual value	Risk that the forecast residual values do not reflect the market value of the vehicle upon sale and sales performance is below the market value.	1,648	1,974	1,213
Insurance	Risk that insurance costs are higher than forecast.	534	928	570
Operational risk (including cyber risk)	Risk resulting from inadequate or failed internal processes, people and systems or from external events and suppliers.	237	558	343
Treasury	Risk that adverse market factors impact the costs associated with borrowing and funding requirements and activities.	266	320	196
Early termination	Risk that adverse market conditions and increasing early terminations result in losses on vehicles returned before the end of the lease.	148	221	136
Tax	Risk that the Corporation Tax rate will change.	263	167	102
Maintenance	Risk that maintenance costs rise by more than expected.	86	108	66
Credit risk	Risk of non-payment by manufacturers, auction houses, customers or dealers.	102	123	75
Diversification	Adjustment to reflect the fact that not all risks would occur simultaneously.	-965	-1,066	-655
Total		**2,319**	**3,333**	**2,047**

Note

1 Totals may not sum due to rounding.

Source: National Audit Office analysis of Motability Operations data

2.20 In addition to choosing a more prudent confidence level of 99.99%, Motability Operations chooses to hold an additional 15% margin above this minimum reserves requirement. Motability Operations' policy to target its reserves level at 15% above an already conservative minimum reserves requirement reduces the amount and cost of debt it requires to run the scheme. As the company cannot distribute profits to shareholders it cannot raise equity and relies solely on debt and its reserves to fund its operations.

2.21 Its conservative risk management policy combined with the unique structure of the scheme results in a better credit rating than its peers (Appendix Three). At the time of publication Motability Operations has a credit rating of A+ from Standard & Poor's and A1 from Moody's. A higher credit rating allows Motability Operations to access finance in the unsecured debt markets at a lower cost than lower-rated companies. A lower credit rating would increase the cost of debt, which would have to be funded either through operational efficiencies or increasing the lease payments of future customers.

2.22 As of 31 March 2018, Motability Operations' key financial ratios, which are impacted by the level of reserves it holds, were comfortably within the levels expected for an A+ rated company. Motability Operations could significantly reduce the reserves it holds and still achieve a credit rating that would allow it to access finance effectively, albeit at a potentially higher cost than its current cost of financing. This is demonstrated through industry peers accessing finance with a lower credit rating.

2.23 As a result of the choices Motability Operations makes in relation to its risk exposure and its credit rating, its reserves as a proportion of total funds available to Motability Operations is higher than most car leasing peer companies despite its overall lower business risk profile. Of its total funds, 37% are reserves, or equity, in comparison to a peer average of 24% (**Figure 13**). When comparing the level of reserves against the value of its vehicles, the value of its reserves are 40% of its total fleet.[3] LeasePlan's reserves form 19% of its total fleet.[4] This raises questions about Motability Operations' chosen approach, given other companies are more exposed to worsening macro-economic conditions and access finance with a lower credit rating.

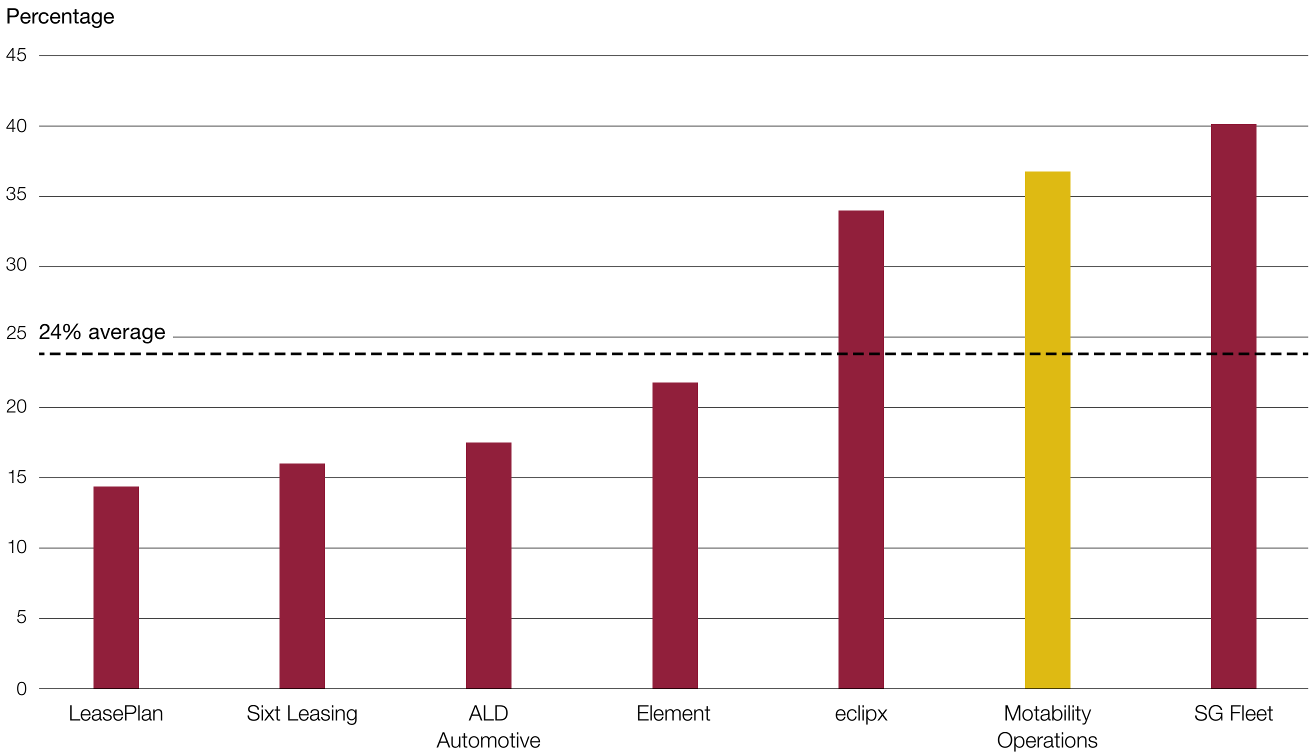
2.24 Motability Operations' actual reserves have been above its minimum reserves requirements since 2007, including during the global credit crisis and economic downturn. It has exceeded the additional 15% margin since 2014 (**Figure 14** on page 36). As at March 2018, the actual reserves stood at £2.62 billion – £250 million above its target level and £560 million above its minimum reserves requirement. In the absence of an extreme risk event occurring, it is likely that Motability Operations will continue to generate significant surpluses which are above its minimum reserves requirement.

3 Assets for use in operating leases of £6,613.6 million and total equity of £2,623.1 million as of March 2018.
4 Property and equipment under operating lease and rental fleet of €17.3 billion and total equity of €3.4 billion as of June 2018.

Figure 13

Comparison of Motability Operations reserves levels with other car leasing companies

Motability Operations' equity as a proportion of its total sources of funds (Debt and Equity) is higher than most car leasing companies

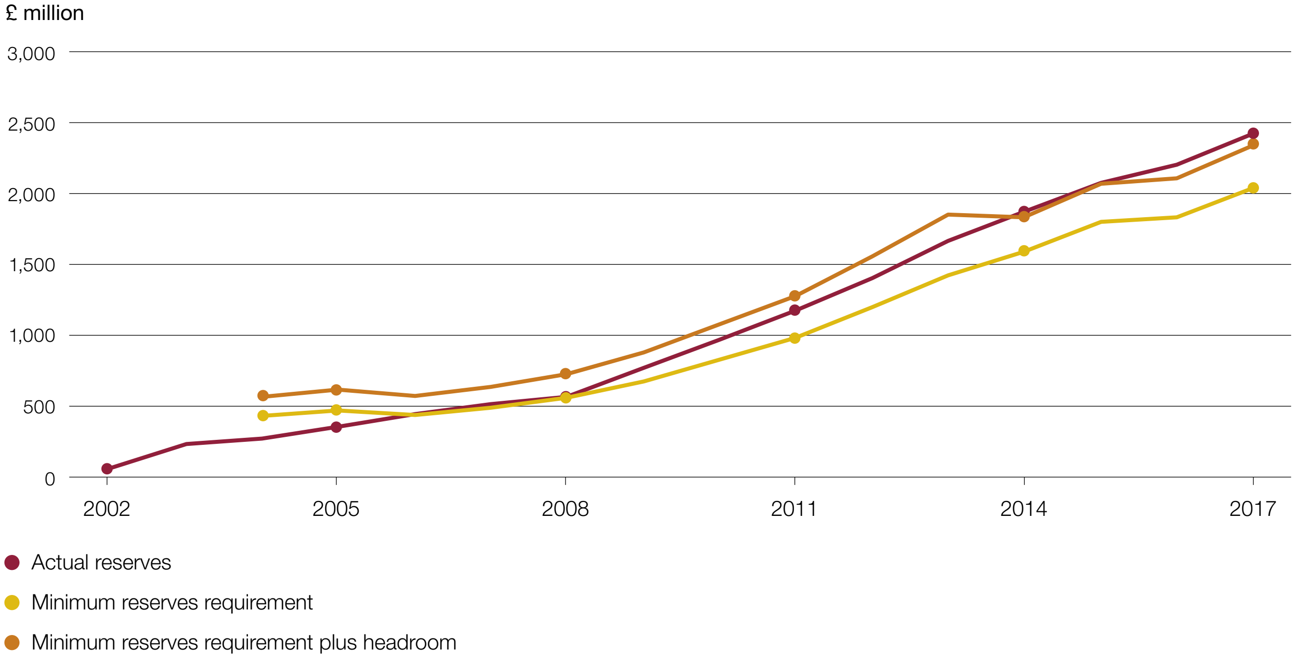


Source: National Audit Office

Figure 14

Motability Operations' reserves compared with target levels over time

The actual reserves have been above the minimum requirement since 2007, and exceeded the additional 15% margin since 2014



Source: National Audit Office analysis of Motability Operations data

Enhancing the customer proposition for scheme customers

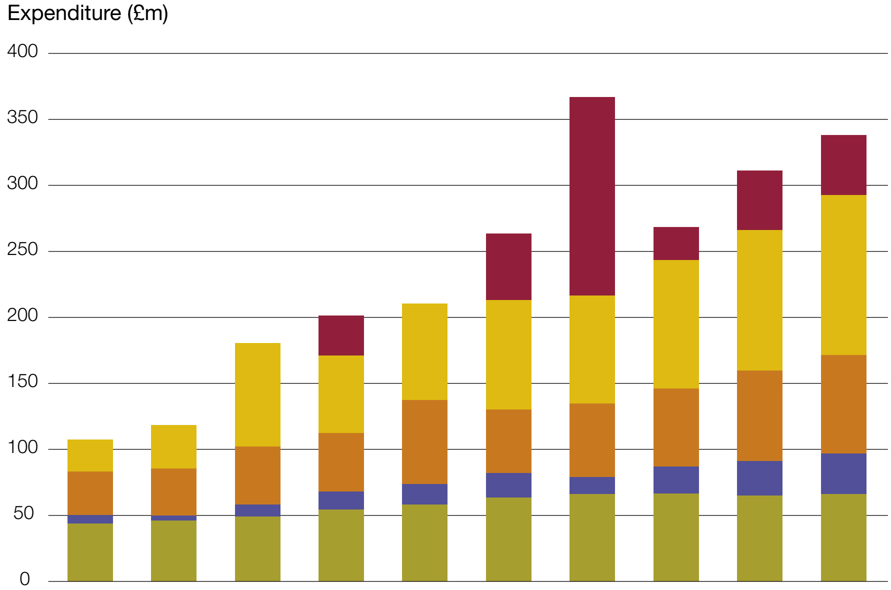
2.25 Motability Operations has a number of areas of expenditure in addition to purchasing the vehicles it leases to customers and providing associated services such as insurance and roadside cover. **Figure 15** shows the major areas of expenditure that do not directly relate to vehicle leases. Motability Operations consults with customer groups and Motability to generate ideas to improve the customer offering.

2.26 Motability Operations has invested significantly in supporting its customers and continues to significantly exceed its performance targets in relation to customer satisfaction. Since 2008, Motability Operations has invested £1.37 billion into both direct and indirect customer support. Direct customer support includes benefits such as a £250 good condition bonus for customers who return their vehicle in good condition at the end of their lease and free vehicle adaptations. Motability Operations has recently increased the good condition bonus to £500. Indirect customer support includes payments to other businesses, such as vehicle dealerships that provide support to Motability customers. While this investment will have improved the service offered to scheme customers, between 2008 and 2018 overall customer satisfaction increased by 2% to 99%.

Figure 15

Major areas of customer support and overhead expenditure over time

Expenditure on discrete non-vehicle lease-related expenditure has fluctuated over time



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total
Charitable donations (£m)	0	0	0	30	0	50	150	25	45	45	**345**
Direct customer support (£m)	24	33	78	59	73	83	82	97	107	121	**757**
Indirect customer support (£m)	33	36	44	44	64	48	56	59	68	74	**526**
Strategic projects (£m)	6	4	9	14	15	18	13	20	26	31	**156**
Administrative costs (£m)	44	46	49	54	59	64	66	67	65	66	**580**
Indirect and direct support per customer (£)	113	129	215	172	221	209	216	243	279	319	

Note

1 Totals may not sum due to rounding.

Source: National Audit Office analysis of Motability Operations data

2.27 The sustained level of investment into customer support has reduced the level of surplus reserves, which are considered as eligible for donating to Motability. Given its continued excellent performance relating to customer satisfaction, there is a risk that Motability Operations is unable to demonstrate how effective its various investments are in driving continued achievement of the scheme's strategic objectives. Motability Operations does not have a clear framework for assessing the effectiveness of its investments in customer service that considers alternative uses of money beyond the scheme.

Donations to Motability and Motability Tenth Anniversary Trust

2.28 Between 2010 and 2017, Motability Operations donated £345 million to support Motability's grant activity. It announced a further £400 million donation in September 2018.

Part Three

Governance of the Motability scheme

3.1 This part of the report sets out the governance arrangements for the Motability scheme (the scheme), and also examines: the use of charitable donations by Motability; the tenure and diversity of Motability's governors; remuneration arrangements for Motability Operations' senior managers; the scheme's performance framework; and a recent review of Motability's governance.

Relationship between Motability and Motability Operations

3.2 The relationship between Motability and Motability Operations is set out in a contractual scheme agreement, originally from September 2003, with amendments in June 2008 and March 2015. **Figure 16** illustrates the core governance structures of Motability and Motability Operations, and shows where each organisation is formally represented in each other's governance arrangements.

Motability's use of donations received from Motability Operations

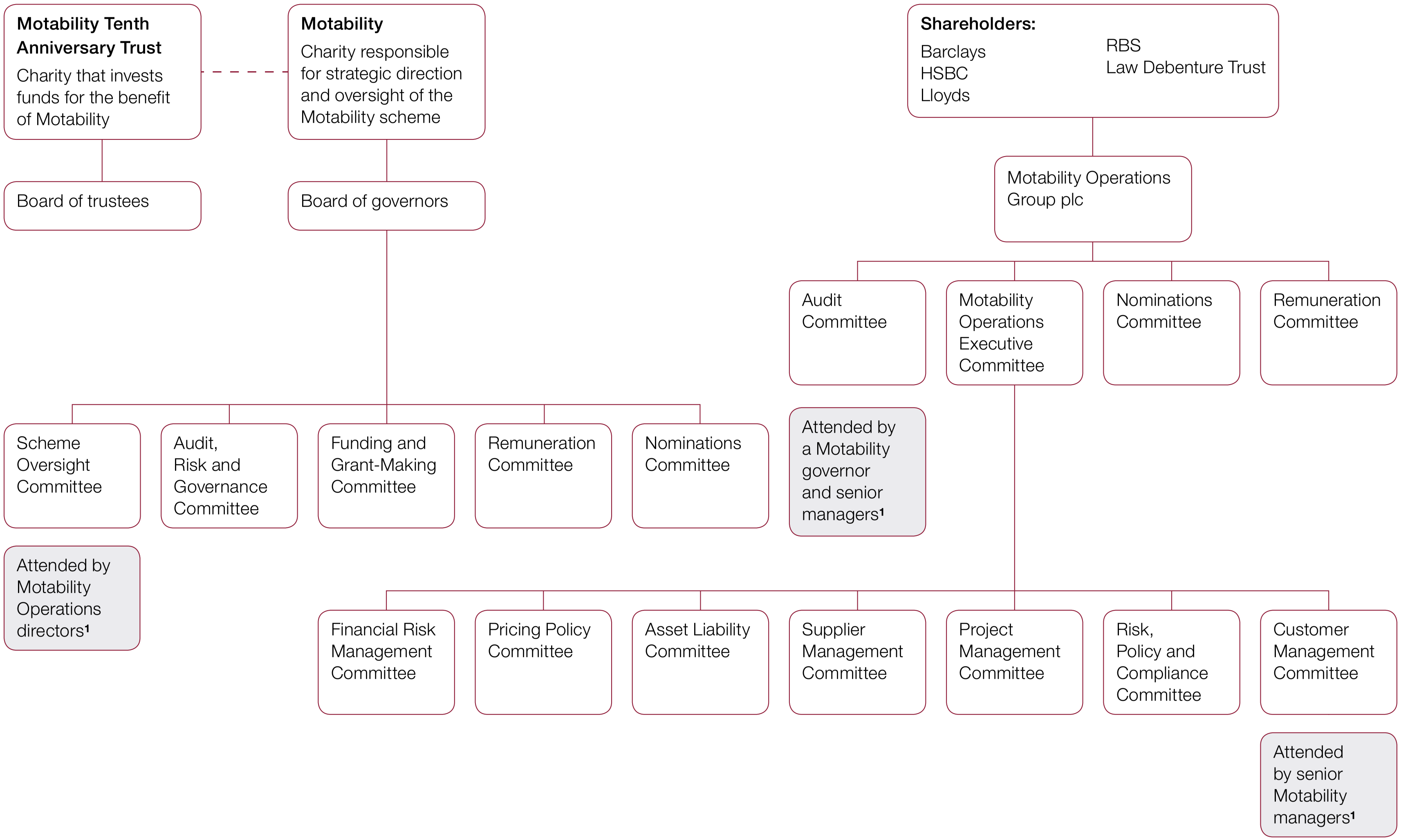
3.3 As referenced in paragraph 2.11, one way in which Motability Operations has used profits is to make donations to Motability and the Motability Tenth Anniversary Trust. **Figure 17** on page 40 shows the amounts of these donations since 2010-11.

3.4 Until 2016-17, the majority of these donations contributed to grants for two purposes, to provide additional support for its customers:

- Motability spent nearly £20 million a year in each of the past two years on the specialised vehicle fund, to provide grant support for customers needing wheelchair-accessible vehicles.
- Motability has allocated £175 million in total from donations to support customers who lose their eligibility for the scheme following their assessment for Personal Independence Payment (PIP), where previously they had been eligible through receipt of Disability Living Allowance (see paragraph 1.9). As at 31 March 2018, it had spent £101 million on this transitional support, over the five-year period from 2013-14 to 2017-18. Motability expects that the Department for Work & Pensions will complete its programme of PIP reassessments in 2019-20.

Figure 16

Formal interactions in the governance structures of Motability and Motability Operations



Note

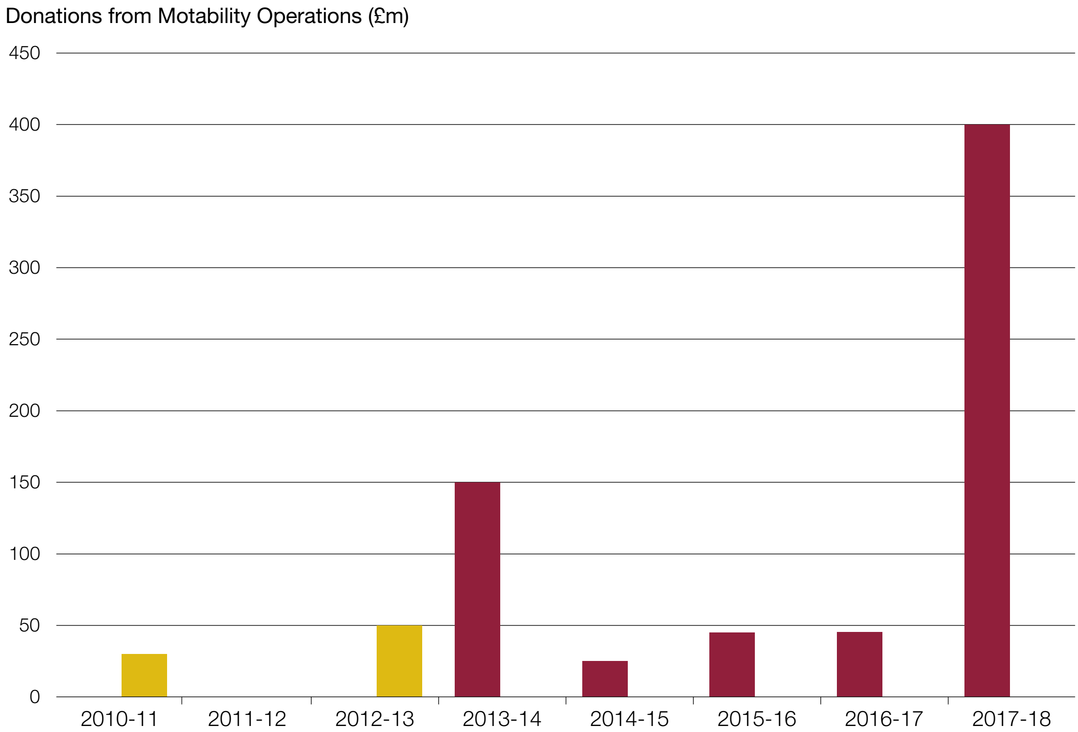
1 Shading indicates how Motability and Motability Operations are formally represented within each other's governance structures.

Source: National Audit Office analysis of Motability and Motability Operations information

Figure 17

Motability Operations' charitable donations to Motability and Motability Tenth Anniversary Trust, 2010-11 to 2017-18

The £400 million donation announced in September 2018 is larger than all previous charitable donations combined



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Motability				150	25	45	45.3	400
Motability Tenth Anniversary Trust	30		50					

Source: National Audit Office analysis of Motability Operations data

3.5 In recent years, Motability Operations has advised Motability to expect ongoing sizeable donations of at least £100 million a year, in the absence of economic shocks, as a result of Motability Operations' financial model. In September 2018, Motability Operations announced a donation of £400 million to Motability. The scale of this donation is very large in Motability's context, representing 14 times its total spending in 2017-18.

3.6 Motability does not have a long-term strategy and has only recently developed a structured framework for determining specific new purposes to which it will put high-value donations. In September 2018, Motability's board of governors approved funding for a range of new initiatives, which are expected to cost around £100 million a year by 2024-25. The consideration of initiatives used the new evaluative framework, but had not been subject to any external consultation, other than with Motability Operations, at the time of our review.

3.7 In order to ensure the sustainability of these initiatives, Motability expects to use the £400 million donation recently received to contribute to holding surplus funds of between £500 million and £600 million in the years between 2019-20 and 2024-25. The surplus funds are to be held within the charity, separate and additional to the reserves that are held by Motability Operations. Motability plans to draw on its surplus funds if there is any shortfall in expected future donations. It is therefore not yet clear that Motability can absorb the level of donations it expects to receive in a way that best supports scheme customers or the wider group of disabled people with mobility needs.

Motability's governors

3.8 Motability's trustees are its governors. The governors have a range of experience in areas such as disability, the motor industry and financial services, which are of benefit to the charity. Many of the governors have been in post for a long time. Before new appointments were made in September 2018, the average tenure of Motability governors was 18 years. The Charity Governance Code recommends that if trustees have served for more than nine years, their reappointment should be subject to a particularly rigorous review, and take account of the need for progressive refreshing of the board. We have not seen evidence that long-serving trustees have been subject to these considerations on their re-appointment.

3.9 Motability has been aware of these issues for some time. Fifteen years ago, a review of its governance also recommended planned and progressive refreshing of its board, for the same reasons now set out in the Charity Governance Code. In September 2018, Motability announced the retirement of three of its governors and the appointment of five new governors. Following these changes, there are now 11 governors, four of whom have each served for more than the recommended nine-year limit, for at least 16 years. The Charity Governance Code makes various recommendations on diversity to ensure that charities' governance is inclusive of a variety of perspectives, experiences and skills. While Motability's board of governors includes individuals with personal and professional experience of disability, there are no black and minority ethnic governors, and only one female governor.

Motability Operations' remuneration of senior staff

Governance arrangements

3.10 Motability Operations' Remuneration Committee is responsible for its remuneration policies and decisions on individual awards for executive directors, with the scheme agreement giving Motability only limited powers. Motability has the right to send a governor to attend the Motability Operations Remuneration Committee, but it has not exercised this right since 2013. The chairman of Motability was consulted about aspects of remuneration policy in detail, including long-term bonus arrangements for Motability Operations' chief executive and new remuneration arrangements introduced in 2015, before their implementation.

3.11 In recent years, the charity has become concerned about the reputational consequences of high levels of pay. The Motability chairman – and the vice-chairman, who previously attended the Motability Operations Remuneration Committee – have written to non-executive directors of Motability Operations on several occasions, including in 2012 and 2016 (Appendices One and Two). Among the concerns Motability expressed was that the comparator base used to benchmark remuneration did not include public sector bodies or large charitable trusts, and that bonus payments would be too easily achieved, given that:

- Motability Operations executives managed a monopoly and so were not responsible for growing the business in a highly difficult and competitive environment to provide increased shareholder return; and
- the executives are only one step removed from public service given the scheme's turnover is dependent on public funding and is in receipt of tax concessions.

3.12 The exchanges of correspondence in 2016 followed the introduction of new remuneration arrangements in 2015. In 2016, the Motability Operations chairman conveyed that he had been under the impression that Motability's chairman supported the new arrangements, but Motability's chairman, in his further reply, maintained his concerns about the level of variable pay. Motability has now recognised that it does not have sufficient formal mechanisms or influence to address this risk to the scheme's reputation but has not yet rectified the situation.

Motability Operations' executive directors

3.13 Between 2002 and 2008, Motability Operations' executive directors successfully implemented a series of measures which led to significantly higher performance levels (see paragraph 1.16). In 2008, the company moved to a new corporate structure and introduced a new long-term bonus scheme for executive directors. The other elements making up remuneration are: a base salary; annual performance-related bonuses; a defined contribution pension scheme (or cash payments in lieu of contributions); and other benefits such as private medical insurance and car allowances.

3.14 The long-term incentive plan (LTIP) introduced in 2008 was a three-year rolling plan, under which:

- units were allocated to executive directors in each year of the scheme, with pay-outs deferred for three years; and
- the final value of the units changes depending on performance against five targets over the three years, and movement in Motability Operations Group's credit ratings. Following significant performance improvements between 2002 and 2008, Motability Operations set the thresholds for 'excellent' performance for all five targets below the performance levels it was already achieving, and the targets were not made more stretching over time (Figure 18 on page 45).

3.15 All of the LTIP performance targets were achieved in all years of the scheme's operation. As a result, the scheme's value increased significantly. For the period from 2008 to 2014, five executive directors who received this benefit were allocated units with an initial total value of £3.9 million. The total value of benefits paid between 2011 and

2017 under the scheme to the directors was £15.3 million, a nearly four-fold increase. A review of remuneration commissioned by Motability Operations in 2015 found that these arrangements resulted in relatively high payments for delivering consistent performance. Allocations to the LTIP ended in October 2015, and the final year's pay-out relating to this scheme will be made in December 2018.

3.16 Until 2015, the maximum value of executive directors' annual performance-related bonuses was 50% of their base salary. All executive directors received the maximum possible amount in every year between 2009 and 2015. When combined with the LTIP pay-outs, Motability Operations' executive directors received bonuses of between 159% and 194% of salary during the period from 2011 to 2017.

3.17 Under a new chair in 2015, the Motability Operations Remuneration Committee carried out a review of remuneration arrangements with a scope which included the design of incentives, opportunity levels, performance conditions, target setting and the balance of the overall total remuneration package. It decided to use three separate groups – FTSE 250 companies, mutual companies and large unlisted companies – as benchmarks to inform its decisions. The review recognised, for example, that Motability Operations was in a more stable phase following the earlier performance turnaround, and that it operated in a market without equity investors to take account of. It is still the case, however, that the benchmark companies operate in more dynamic commercial environments than Motability Operations and do not benefit from the competitive advantages we discuss in paragraphs 1.10 to 1.14. The benchmarks used do not include comparisons to public sector entities or large charitable trusts, as has been previously suggested by Motability. Since 2015 there has been no equivalent of the LTIP since it ended in 2015 and maximum annual performance-related bonuses have increased on a tiered basis, according to role, to:

- 100% of salary (with an 'exceptional maximum' of 150%) for 'tier 1', which is the chief executive;
- 100% of salary (with an 'exceptional maximum' of 125%) for 'tier 2' executive directors, of which there are currently three; and
- 60% of salary (with an 'exceptional maximum' of 75%) for 'tier 3' executive directors, of which there is currently one.

Half of the annual performance-related bonus awarded is deferred for three years.

3.18 Under the new arrangements, after the final LTIP payments have been made in December 2018, we forecast that total executive remuneration will fall, with for example, the chief executive's total remuneration likely to reduce from £1.7 million to around £1.4 million in 2019-20. At this point, based on market data provided by Motability Operations' advisers in 2017, the chief executive's total remuneration is likely to be below the FTSE 250 median, and broadly comparable to the median target remuneration in mutual and large unlisted companies. The chief executive's total forecast remuneration for 2019-20 remains, however, substantially higher than for chief executives working within public sector entities which compete with the private sector to recruit senior staff. For example, in 2017-18 the chief executive officers of BBC Studios, Network Rail and HS2 Ltd received total remuneration packages of £691,000, £769,000 and £602,000 respectively.

3.19 In looking at performance-related bonuses as part of total remuneration, Motability Operations' advisers recommended that "challenging but achievable" performance levels should lead to a bonus of 50% of salary, and that this should be based on a scorecard of measures set out at the start of the year. In practice, bonuses are largely based on the judgement of the Remuneration Committee, and have continued to pay out at close to maximum levels. In the two years that these new arrangements have operated (2015-16 and 2016-17), on average executive directors have been awarded bonuses of 93% of their maximum (100% of salary for 'tier 1' and 'tier 2' directors). In the past three years, independent benchmarking reports provided to Motability Operations have reported that, on average, FTSE 250 firms pay 70% to 75% of the maximum bonus available, with higher levels leading to investors exerting pressure to set tougher performance targets.

Motability Operations' chief executive

3.20 In addition to the arrangements described above that apply to all executive directors, the chief executive has had – and continues to benefit from – separate and additional remuneration arrangements, the full value of which has not previously been disclosed. These are:

- a long-term incentive scheme (LTIS), which operated from 2010 to 2015;
- the long-term performance plan (LTPP), a subsequent arrangement for up to seven years that began in 2015; and
- retention payments agreed in 2017 that apply to the financial years 2018-19 to 2020-21.

3.21 The LTIS was designed to ensure the chief executive's retention in post. It operated similarly to the LTIP, with identical performance measures, and related multipliers (**Figure 18**). As with the LTIP and the annual performance-related bonuses described in paragraphs 3.14 and 3.15, all related performance targets were achieved throughout the period of the LTIS. By running for five years rather than a rolling three-year period, the chief executive has benefited more substantially from the multipliers relating to performance targets. Allocations to the LTIS with a combined initial value over the three allocation years (2010 to 2012) of £258,000 were worth £1.64 million in 2015 at the end of the scheme, an increase of 636%. Motability Operations has only disclosed the initial £258,000 to the public through its annual report and accounts. This complies with minimum financial reporting disclosure requirements. The full value of the scheme may be of interest to the Work and Pensions and Treasury select committees, given their previous interest in this matter.

Figure 18

Performance measures used for the long-term incentive plan (2008 to 2015) and the long-term incentive scheme (2010 to 2015)

Throughout the period of these long-term incentive schemes, all targets relating to 'excellent' performance were exceeded

Performance measure considered 'excellent'	Multiplier applied if 'excellent' target met	Performance achieved
Financial: Reserves are above 100% of Motability Operations' minimum capital requirement.	Adds 10% to scheme value in each year if met. Adds 25% to scheme value in each year if customer service and satisfaction and culture targets are also achieved.	Reserves have been above 100% of the minimum capital requirement since 2007.
Customer service and satisfaction: Achieving the following three targets: • customer renewal rates of 88% or higher; • at least 200 cars available on the scheme without an advance payment required; and • at least 92% of customers reporting that they are satisfied with the scheme.	Adds 10% to the scheme value in each year if all three of these are met.	Since 2007: • customer renewal rates have been 91% or higher; • there have only been four quarters, during and immediately after the 2008 to 2009 downturn, when fewer than 300 cars were available without an advance payment; and • customer satisfaction has been between 96% and 99%.
Culture: Motability Operations' staff survey results exceed the 'high performing organisation norm' in at least six of 11 areas.	Adds 10% to the scheme value in each year if met.	Since 2007, Motability Operations has been above the norm in all areas surveyed.
Credit rating adjustment.	Adds 10% to the scheme value if Motability Operations' credit ratings do not change over the three-year period (LTIP) or five-year period (LTIS). Adds 20% to the scheme value if one ratings agency increases the credit rating by one grade.	Standard & Poor's has not changed its rating. Moody's increased its rating by one grade in September 2015.

Notes

1 The long-term incentive plan (LTIP) applied to all executive directors.

2 The long-term incentive scheme (LTIS) was only available to the chief executive.

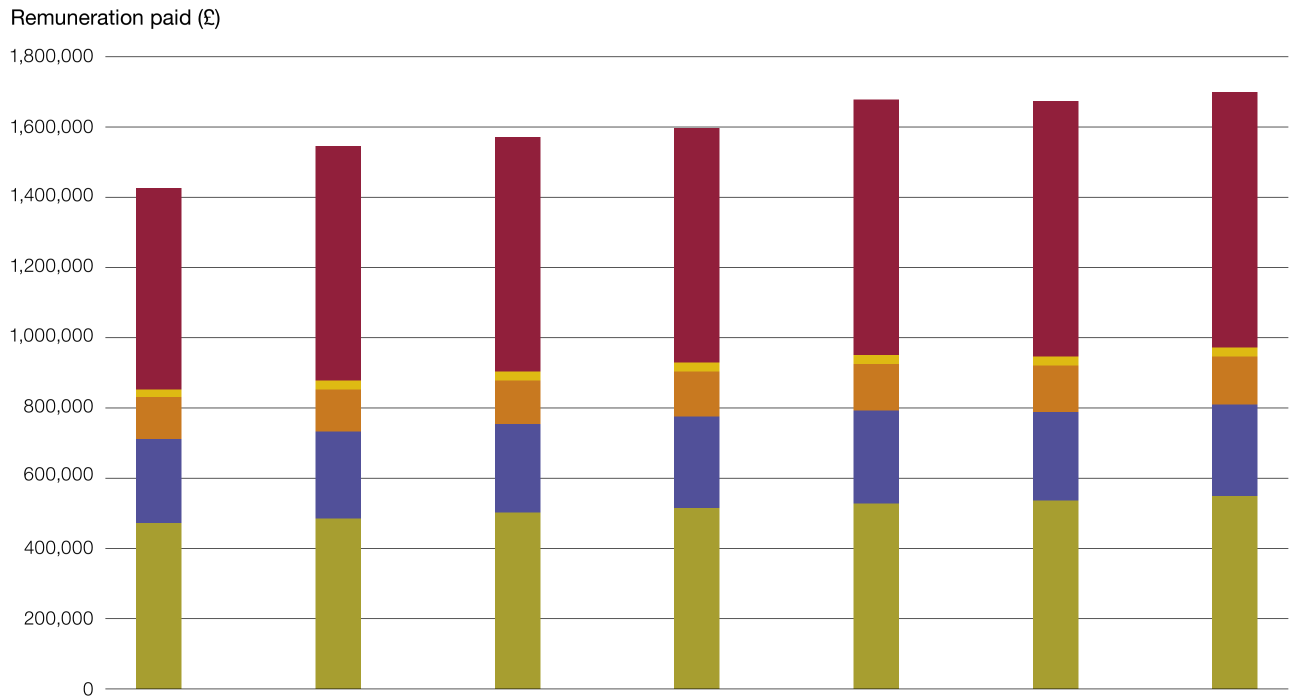
Source: National Audit Office analysis of Motability Operations data

3.22 The value of the LTIS has been transferred to the LTPP. Under this arrangement, no additional allocations are made but the value effectively earns interest at the same rate as Motability Operations borrows money (currently 4.02%), so long as Motability Operations' reserves remain above its minimum capital requirement. Either the chief executive or the Motability Operations board can choose to end the LTPP at any point in time, releasing payment of the amount then owed. The scheme was worth £1.86 million in September 2018, and is likely to be worth around £2.2 million if it continues until 2022. **Figure 19** on pages 46 and 47 shows the value of remuneration that has been received by the chief executive from 2010-11 to 2016-17, and the cash value that has accrued under the LTIS and LTPP arrangements, and is owed to the chief executive but has not yet been paid.

Figure 19
Remuneration of the Motability Operations' chief executive

Remuneration paid to the chief executive between 2010 and 2017

The Long-Term Incentive Plan has been the largest component of the chief executive's remuneration since it started vesting in 2010-11

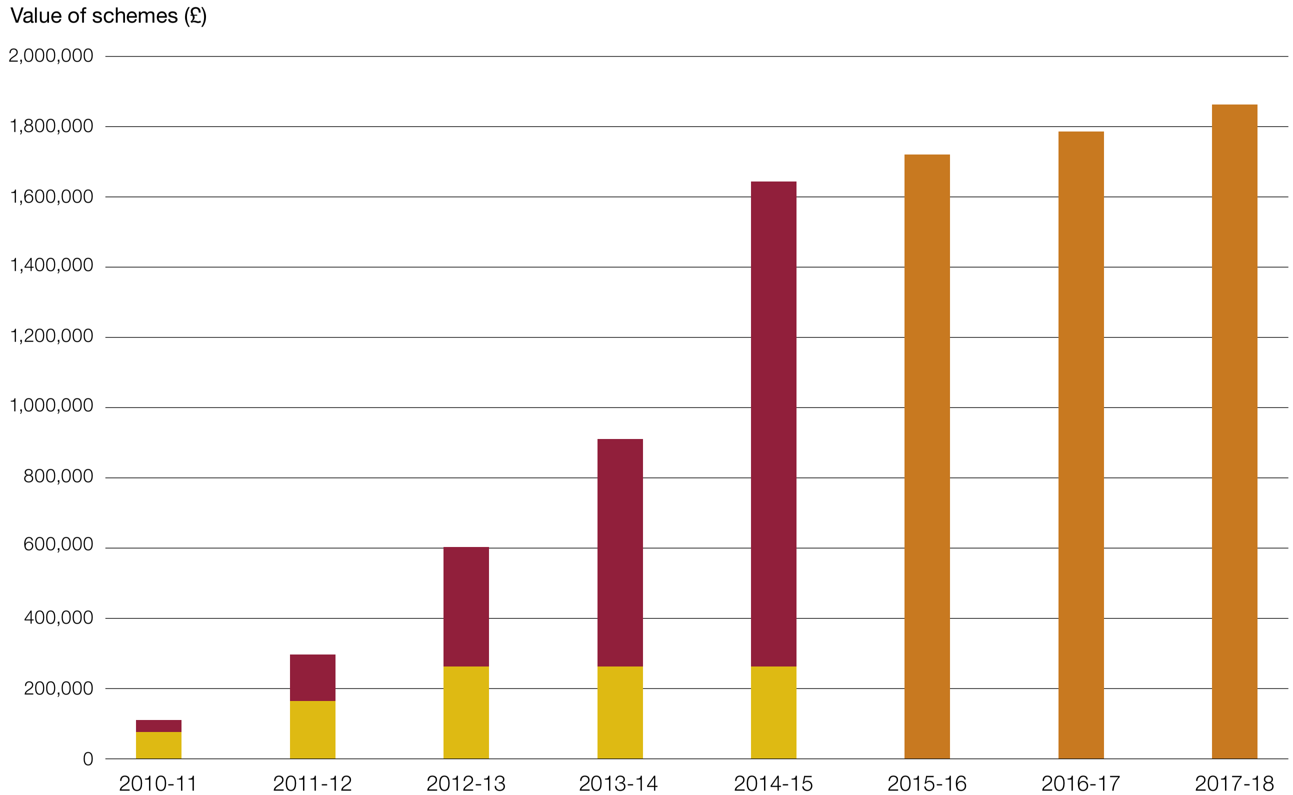


	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Long-Term Incentive Plan payment	570,913	666,065	666,065	666,065	726,617	726,617	726,617
Benefits	23,394	24,295	24,444	24,996	24,969	25,077	25,057
Payment in lieu of pension contributions	118,750	121,881	125,475	129,081	131,950	134,092	137,315
Annual performance bonus	237,500	245,850	252,650	260,000	265,200	252,758	262,624
Salary	475,000	487,525	501,900	516,325	527,800	536,367	549,258
Totals	**1,425,557**	**1,545,616**	**1,570,534**	**1,596,468**	**1,676,536**	**1,674,911**	**1,700,870**

continued

The value of long-term schemes, owed to the chief executive, but which have not been paid

The chief executive is owed a further £1.86 million, which is payable on demand, as a result of additional long-term bonus schemes



	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cumulative increase in value of Long-Term Incentive Scheme units awarded	36,900	137,299	339,889	646,308	1,383,318	–	–	–
Cumulative value of Long-Term Incentive Scheme units awarded	72,000	159,000	258,000	258,000	258,000	–	–	–
Long-Term Performance Plan value	–	–	–	–	–	1,717,311	1,786,760	1,858,640

Notes

1 This figure does not include remuneration paid to the chief executive in respect of 2017-18, since this depends on decisions taken subsequent to the period when we carried out fieldwork. We expect this to be reported in Motability Operations' annual report later in 2018. We are, however, able to determine the value of the Long-Term Performance Plan as at 30 September 2018 from information received during fieldwork.

2 Annual performance bonuses are shown in the year where the performance was delivered. Similarly. Long-Term Incentive Plan payments are shown in the year where performance conditions were satisfied.

3 The Long-Term Incentive Scheme was not payable until it vested in September 2015. The money owed at this point was transferred into the Long-Term Performance Plan.

Source: National Audit Office analysis of Motability Operations data

3.23 In addition to the LTIS and LTPP, Motability Operations' Remuneration Committee agreed in October 2017 to award three retention payments to the chief executive of £120,000 each in the financial years 2018-19 to 2020-21, subject to him continuing in the role. These amounts would either not be paid, or can be reclaimed, should the chief executive resign before 30 September 2021.

The scheme's performance framework

3.24 The consistently high levels of performance achieved against the key performance indicators agreed between Motability and Motability Operations to assess scheme performance are described in Part One. The use of such a performance framework represents in broad terms a good way of monitoring progress and ensuring any risks or under-performance are identified and can be corrected. The Scheme Oversight Committee reviews the performance framework annually but there have been few changes to the measures used. There are opportunities to reconsider the performance framework in light of the following issues:

- **The level of stretch of performance targets, particularly where these are connected to remuneration arrangements for Motability Operations' executive directors** (see Figure 18 for details of performance against these measures): There are several indicators where the level of performance achieved is continuously and substantially in excess of that required under the scheme agreement. For example, the average number of days from an incident to the provision of a replacement car, in the event of thefts or write-offs, was 0.1 days in 2017-18, against a target of five days or fewer.

- **Attributing the causes of changes in performance levels measured through customer surveys:** While it is positive that customer surveys show high levels of satisfaction, given the structural advantages the scheme benefits from, it is not possible to differentiate the relative contribution of management effectiveness. On a related point, it is difficult to measure the impact of the various additional investments in the customer proposition when performance levels are at continuously very high levels (see paragraph 1.18).

- **Assessment against all strategic objectives:** There is only one scheme agreement key performance indicator under the strategic theme to improve reach and awareness. It relates to existing customer renewals and therefore does not address this objective effectively.

Motability governance review

3.25 In response to an unspecified complaint about Motability and the Motability Tenth Anniversary Trust, the Charity Commission carried out a review in 2017. Among its recommendations was that Motability's governors should consider commissioning an independent governance review, noting also that it is recognised good practice to carry out such reviews periodically.

3.26 In response, Motability appointed its solicitors, Farrer and Co, to undertake a review of governance. This used the Charity Governance Code as its benchmark against which to assess practice. The review reported to the board of governors in July 2018. It made 44 recommendations in a range of areas. Some of the more significant issues include:

- **the roles and terms of office for governors**, noting the scope to review and expand the definition of roles, and to limit terms of office;
- **the need to review the adequacy of staffing and resources**, in areas such as strategy, policy and scheme oversight, particularly if significant donations were received; and
- **suggested updates to the scheme agreement**, for example that Motability should seek to make amendments that enable it to better control Motability Operations' executive remuneration, although it also noted that Motability would need to ensure that it, and its governors, did not inadvertently become shadow directors.[5]

3.27 While the review also identified a lack of diversity in Motability's board of governors, it did not make a recommendation specifically on this issue. Motability plans to respond to all of the review's recommendations in the period up to December 2019. If Motability responds appropriately, this represents a clear opportunity to update aspects of governance that will provide foundations to maximise the scheme's long-term effectiveness.

5 A shadow director is someone who is not appointed as a director but gives instructions or directions that directors are accustomed to act upon.

Appendix One

Email sent by Sir Gerald Acher CBE LVO, vice-chairman of Motability to John Callender, chair of Motability Operations Remuneration Committee February 2012

Dear John
Many thanks for the detailed papers in advance of next Tuesday. I have just returned from abroad and away again at lunch time so accessed the papers briefly last night so my comments are from a very quick read.

As with a year or two ago when we last considered this sort of analysis, I have major problems with the comparator used. I warned Sue that she could not ignore comparator companies that straggled the private/public sector or were in a monopoly position and I exampled the BBC where on the one hand it receives public monies for a public service but on the other hand it has to compete for both audience and its own executive pool in the commercial arena. But her comparator base is still FOOTSIE 200-250 companies and similar data.

Indeed since the last analysis the world has moved on and of course it is for REMCO to form its own judgements based on information supplied but the specific problems I have with her comparator analysis are:

- As a monopoly – like MOT ops - one huge segment is missing when using comparators such as hers – that of growing the business in a highly competitive and difficult environment to provide increased shareholder return.
- As a company where its executives are only one removed from public service one can't wholly ignore some of those constraints in considering both remuneration and annual and indeed long term bonuses. By this I mean although MOT ops is owned by the Banks, its turnover comes from the public purse (albeit circuitously) and it is in receipt of certain tax concessions from the Treasury.
- The bonus comparator for annual bonus is made against maximum payout. But no annual bonus scheme is computed to provide maximum payouts each year otherwise it would be just part of normal remuneration. Those I have been involved in are often designed to pay out 2/3rds of maximum in say 3 out of 5 years. Whether that happens in practise is another matter! With MOT ops annual bonus it is difficult to provide stretching targets because there is no competitive aspect and no shareholder return concept so once achievements have been realised in customer service, high performing organisation etc it is as much maintaining the situation; thus achieving maximum pay out is easier than in the comparator sector. This is just a statement of fact and in no way questions or fails to recognise the high impact of your excellent executive team.
- Regarding the long term bonus, if my maths is correct Sue has assumed a 60% payout of the maximum 100% of the MOT ops LTIP. But is it not already paying out at 100%?

As I am just an observer on the REMCO I have not copied this to other members but just to Neil and of course to Jeffrey.

With best wishes

Gerry

Appendix Two

Correspondence between Lord Sterling GCVO CBE, chairman of Motability and Neil Johnson, chairman of Motability Operations March 2016 and July 2016

Motability
The leading car scheme for disabled people

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Roydon Road
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motability.co.uk

07 March 2016

Mr Neil A Johnson
Motability Operations
Citygate House
22 Southwark Bridge Road
London SE1 9HB

Dear Neil

I appreciate the time that Neill has spent with me, Gerry, Richard and Alan taking us through your latest remuneration proposals. As I have said many times we all value the excellent team you have built at Motability Operations and their continued focus on delivering outstanding performance and in particular the high levels of customer service for our disabled customers.

Whilst it is your Board's decision as to the appropriate remuneration policy and levels, I wanted to share with you where we consider the areas where the scheme is vulnerable to attack and therefore is of concern to us all. You and I have of course discussed these matters over the last year or so.

It goes without saying that Neill's exercise has been very thorough and total pay to the existing senior team in relation to the long term incentive aspects has been reduced to the level that to go much further could risk the break-up of the successful team. But wherever this level lies can only remain conjecture. Our worries centre around both base pay levels and bonus percentages

Base Pay Levels
Motability Operations is as we know a unique organisation and in many respects is free of competition and enjoys a captive customer base in a relatively stable environment, with almost zero credit risk in relation to lease rental income. Clearly it operates at the most commercial end at the time of disposal of vehicles on lease expiry. But it means the business is not subject to the same external market forces that face the organisations included by New Bridge Street in their benchmarking work. We believe that too much attention has been given to more complex financial institutions and footsie 250 companies at the expense of complex trusts such as the Welcome Foundation and similar public undertakings . Thus the comparators used in the benchmark data did not include any public sector bodies or large Charitable Trusts and had such organisations been included the target levels of remuneration are likely to have been lower.

Bonus percentages
The bonus proposals which link 75% of the amount paid to achievement of the Operational plan with a strong link to Customer and employee satisfaction seem sensible. The challenge as recognised with Neill is that this is likely to result in close to the full bonus entitlement being awarded in most years for the commercial reasons mentioned above. Other financial institutions are required to "risk adjust" their bonus payments by means of a "collective adjustment" as well as "individual adjustments" in respect of material losses/risk events or inadequate risk behaviours. So whilst they start from a similar position as Motability Operations they are very likely to end up with lower proportions of their full bonus payments becoming payable. Therefore for Executives at Motability Operations who operate in a much lower risk environment the overall starting point potential bonus percentage should be lower.

The proposals have three tiers of bonus percentage, the first two at 100% and the third at 60% from memory. We consider good arguments can be made for the need to have a 100% bonus available for the Chief Executive but not for other executives. For others around 50- 60% would seem more appropriate given the nature of the operations although I accept a higher level of around 75/80% might be justified for the Commercial Director who oversees the selling of the cars at lease expiry. Whilst setting lower bonus percentages may not be possible to achieve with the existing incumbents, we cannot see why any new Executive Directors could not be appointed with the lower bonus expectations.

So in summary the vulnerability is that the total remuneration that is likely to be paid remains too high even with the new proposals and our specific concern is that as new members of the team, post January 2016, who gradually replace existing members will end up after a few years with total packages, in our view still out of line.

I hope you understand the concerns we have and that you will be able to reflect on them as your remuneration practices evolve.

May I finish by saying we are delighted at the success of the Bond issue last week. In these turbulent times it certainly gives us the opportunity of viewing the future with a degree of equanimity.

With warm regards

Copy :

Neill Thomas Chairman of the Remuneration Committee

Motability Operations | Group plc

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London SE1 9HB
motabilityoperations.co.uk

Lord Sterling of Plaistow GCVO CBE

Monday 14th March 2016

Dear Jeffrey

Thank you for your letter dated 7th March 2016. I have now discussed its content in detail with both Neill Thomas and Chris Lendrum who, together with myself, formed the Beaufort remuneration working group. What follows therefore is the considered response from that group, on behalf of the Motability Operations Group Plc Board.

I am pleased that you continue to value the excellent team that we have here at Motability Operations and to recognise their outstanding performance and in particular the high levels of customer service.

As you state, it is the Board's decision to determine remuneration policy and levels but it is also important for me to know that we have your support which is why you and I have discussed these matters at length and reached what I understood to be agreement. This is why it is necessary to respond formally to your letter and to address some of the points made therein.

Neill, as you say, has conducted a very thorough review and developed a carefully thought through methodology which is robust, grounded in market data and on current best practice. This was shared with you and Gerry, Richard and Alan in the autumn. At the time you wrote to me on 19th November referring to "an excellent piece of work, the best I have seen for a long time" and your support was greatly appreciated.

It was on this basis that the new methodology was set out in Motability Operations' Report and Accounts and the remuneration levels for each executive director role were established. The only outstanding matter regarding remuneration was to determine the criteria against which annual bonuses would be evaluated; hence the time Neill has taken in recent weeks to discuss this aspect with you and others.

Base Pay Levels

We covered this issue in our autumn conversations. Motability Operations is unique and benchmark data can only be a guide. The benchmark data needs to be relevant and drawn from organisations where executive roles are most comparable and are representative of the remuneration we would be required to pay in the market if we had to replace any of our existing executive directors. We confirmed this approach through the separate exercise that we undertook in relation to the "shadow" CEO search conducted separately and independently by Kornferry and Odgers Berndtson. That work confirmed that the pool of talent on which we would need to draw to derive a top quality executive team with the appropriate knowledge and expertise is more likely to reside in large scale mutual organisations and FTSE 250 companies than in public sector bodies and large charities.

Bonus Percentages

I am glad following recent discussions which were intended to focus solely on this issue, that you support the split of bonus criteria such that 75% is linked to achievement of the operational plan. Customer service remains paramount and we agree that we should be rewarding the correct behaviour and outcomes in this respect.

The detailed criteria do contain "risk adjustments" both collective and individual, for example in the event of an unexpected loss - perhaps this was missed as part of the discussions. Whilst we are always cognisant of evolving best practice, I believe we should also acknowledge that the policies now adopted by a number of financial institutions have been developed as a necessary response to prevent the excessive risk taking and short termism that was prevalent amongst some banking management teams. This is a culture we have never had nor will have at Motability Operations and our performance as a result speaks for itself.

As far as the percentage bonus levels applicable to the various executive director roles, these were set out clearly in the Project Beaufort papers and agreed as part of our discussions in the autumn.

As to the pay of any new executive directors this will be determined at the time with reference to the agreed methodology. The methodology acknowledges that there is a remuneration range for each executive director role which reflects the relevant experience and track record of the individual appointed to that role, referenced back to prevailing benchmark data. Hence the practical example of the CFO role where Matthew Hamilton-James, when he is appointed to the role, will be towards the bottom end of the range whereas David Gilman, as a very experienced successful CFO, is currently towards the top of the range. What we have is one, not multiple methodologies with the ability to exercise judgement without constantly changing the underlying principles.

Summary

I hope the above is helpful in providing you with the necessary clarification that you sought. Above all, however, I am disturbed that notwithstanding the discussions that have taken place between us, we are revisiting previously agreed principles. Other than establishing the detailed criteria for evaluating bonuses, we had agreed the fundamental methodology and included it in our 2015 Report & Accounts, reflecting I recall some helpful amendments which you suggested at the time. All that remained was to agree the detailed bonus criteria.

You have expressed a sentiment to me previously that you would like to put the issue of remuneration "to bed once and for all". That will never be achieved if principles previously agreed between us continue to be re-visited. I need to know if I have your support on this issue not just now but in the future and you will understand with that in mind your letter to me of 7th March cannot stand.

I understand that you have circulated your 7th March letter to all Charity Governors and I must therefore ask that you also circulate this response, in the interests of transparency and good Corporate Governance.

We have a Chairman's review meeting scheduled for 1500 on Thursday 17th, and I suggest we leave further discussion until that time, which should provide sufficient time for reflection.

With best personal wishes.

Neil Johnson
Chairman
Motability Operations Group Plc.

cc Motability Operations Group Board Directors

Motability
The leading car scheme for disabled people

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Fax: 01279 632000
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Mr Neil A Johnson
Motability Operations
Citygate House
22 Southwark Bridge Road
London
SE1 9HB

4th July 2016

Dear Neil,

We are conscious that we have discussed at length in recent months the very considerable and professional work undertaken by Motability Operations on its Remuneration policy and practice. Our recent meetings have been invaluable in helping us all appreciate what is, in any company, a highly complex and invariably difficult subject.

We recognise that the approach you have taken to the review of remuneration has been thorough and professional and has resulted in a methodology which is both rigorous and in the main market-based. We all agree that the review has been undertaken from a starting position which was less than ideal and against a background where Motability Operations has had to be recognised as a unique entity with only limited comparability with, for example, the Financial Services industry generally.

It is for the Board of Motability Operations to determine its Remuneration Policy but I am sure that you appreciate that it is necessary for the Governors of Motability to be sensitive to the broader picture and to give support and guidance to your Board on important and highly sensitive issues such as this as they have the ultimate responsibility for the conduct of the Scheme, particularly in these times.

In particular, the Governors would suggest that :

1. Motability Operations continues to keep its Remuneration Policy under review to ensure that it remains in line with best practice. Whilst the key principles may remain unchanged for some while, it is likely that the market generally will evolve best practice on matters such as deferral

and we would anticipate that you would aim to ensure that the company promptly aligns itself with changes such as these.

2. Variable pay has a part to play and should closely reflect performance and customer service, recognising that higher levels of variable pay in leveraged Financial Services organisations elsewhere is intended to align with the risks implicit in such businesses. As such, variable pay in Motability Operations should be at a materially lower level than at such businesses where it is normal to significantly reduce such incentives in the event of poor outcomes. The operation of criteria under the bonus scheme needs, of course, to be carefully calibrated to ensure that it incentivises ever better performance and service standards. I understand that Neil Thomas has spoken with Alan Dickinson in this regard and I would encourage that they continue to share knowledge in this area to achieve the right outcomes.

3. We recognise that to cut more deeply into the remuneration packages of the existing high performing team would not be wise. We both know that you have had to start this review from a less than ideal position but as I am sure you would agree, it is essential that the progress you have made is firmly consolidated and that, in other words, "New Recruits are on New Terms" and that the new packages have a suitably restricted range so that, after a period of years service of a senior executive, they do not risk remuneration levels moving toward the excessive end of the scale. I am sure that Neil's Remuneration Committee has a clear view of the way forward.

As I have said on many occasions, the Governors are highly appreciative of the splendid work undertaken by the Board of Motability Operations and Mike Betts and his management team on behalf of the Scheme.

With Kind Regards

cc: Alan Dickinson
Sir Gerald Acher
Richard Bennison

Appendix Three

Credit ratings of car leasing and manufacturing companies

Figure 20

Credit ratings of car leasing and manufacturing companies

Motability Operations' credit rating is at the upper end of its wider peer universe

Company names	Company type	Moody's credit rating	Standard & Poor's credit rating
Motability	Car leasing	A1	A+
ALD Automotive	Car leasing/fleet management		BBB+
Element	Car leasing/fleet management		BBB+[1]
LeasePlan	Car leasing/fleet management	Baa1	BBB-
BMW	Car manufacturer	A1	A+
Daimler	Car manufacturer	A2	A
Honda	Car manufacturer	A2	A+
Hyundai	Car manufacturer	Baa1	BBB+
Nissan	Car manufacturer	A2	A
Toyota	Car manufacturer	Aa3	AA-
Ford Motor Company Credit	Financial service arm of Ford	Baa3	BBB
PSA Banque	Financial service arm of Peugeot	A3	BBB
RCI Banque	Financial service arm of Renault	Baa1	BBB
VW Financial Services	Financial service arm of Volkswagen	A3	BBB+

Note

1 Credit rating for Element is not Standard & Poor's but Fitch.

Source: Standard & Poor's, Moody's and Fitch credit rating agencies websites, as of 27 November 2018

Appendix Four

Our audit approach

Figure 21
Our audit approach

The Motability scheme

The Motability scheme enables disabled people to choose to exchange certain mobility allowances paid by the Department for Work & Pensions and Ministry of Defence on the basis of qualifying criteria to lease a new car, powered wheelchair or scooter. More than four and a half million vehicles have been supplied by the scheme since it was launched 40 years ago. In late 2017, just over 1.7 million people were eligible for the scheme, which served around 614,000 customers in England, Wales, Scotland and Northern Ireland. Two organisations directly support the provision of the scheme:

- Motability, a charity, is responsible for the strategic direction and oversight of the scheme.
- Motability Operations Group, a publicly limited company, operates the scheme through an exclusive rolling seven-year contract with Motability, known as the scheme agreement.

Background

In May 2018, a report by the House of Commons Work and Pensions and Treasury select committees raised questions about: the structures and governance of the scheme; government support for the scheme; the levels of reserves in Motability Operations, the remuneration of its senior staff; and the relationship between Motability and the Department for Work & Pensions. Among its recommendations was that the National Audit Office should carry out a review of the scheme.

Our scope

The scheme's customer offer and performance.	The scheme's financial model, its impact and profitability.	The governance of the scheme and remuneration of Motability Operations' senior management.

Our evidence

The scheme's customer offer and performance:

- We reviewed legal, organisational and performance documents and data from Motability and Motability Operations in order to review the nature of the scheme and the performance framework used to assess its impact and affordability.
- We reviewed legislation to understand the government's tax concessions available to the scheme and estimated their direct value.
- We reviewed the extent to which Motability, Motability Operations and the Department for Work & Pensions have undertaken research to understand why two-thirds of eligible people do not use the scheme, and carried out our own analysis to review the distributional impact of the scheme based on people living in higher and lower income areas.

The scheme's financial model, its impact and profitability:

- We reviewed legal, organisational and performance documents and data from Motability and Motability Operations and their advisers in order to review how Motability Operations sets its reserve policy and how it performed over time.
- We reviewed external public data such as annual reports, rating agency reports, or reports companies publish as part of their regulatory obligations in order to benchmark Motability Operations' reserves against peers and to assess the amount of debt Motability Operations could raise while maintaining its credit rating.
- We reviewed Motability Operations' annual reports and accounts and company performance reports to review planned and actual profit over time and the distribution of profits. We reviewed evidence provided by Motability Operations regarding lease pricing to review costs and profit per lease.

The governance of the scheme and remuneration of Motability Operations' senior management:

- We reviewed the governance frameworks for both Motability and Motability Operations to understand their formal and informal governance interactions.
- We reviewed data on the tenure of existing Motability governors.
- We examined the scheme's performance framework to consider the extent to which it was aligned with strategic objectives, and to review performance outturn against the targets set.
- We reviewed the purposes to which past charitable donations from Motability Operations to Motability have been used, and considered the extent to which the Charity is guided by a strategy or structured framework in considering uses of future donations.
- We examined the recent governance review of Motability.
- We reviewed various documents from Motability and Motability Operations to determine the nature, and oversight of, senior remuneration at Motability Operations.

Figure 21 *continued*
Our audit approach

Our concluding remarks	
	The Motability scheme provides an excellent service to eligible people who choose to lease a car. Motability Operations has successfully changed its business model over time, bringing aspects of the service, such as insurance, directly into the business. The management of Motability Operations turned the scheme around and built it into an increasingly profitable business and a force to be reckoned with in the UK used car market. Motability Operations' management has performed well since 2002. However, we do think there is a difference between turning an underperforming business around and carrying out a series of important but not necessarily exceptional tasks to keep it on a road to successful operation. Motability acknowledges that the scheme benefits from structural advantages afforded to it through government support — for example, tax concessions, direct payment of mobility allowances and an effective monopoly. However, we do not see that Motability Operations reflects these advantages adequately in its consideration of risk when compared to other companies, how it assesses its performance, and how executives are rewarded. Its prudent view of risks and reserves tends to reinforce their 'exceptional' performance viewpoint, which we think leads to very high executive reward. While, following a review, total executive remuneration at Motability Operations will now fall, Motability has had difficulty over a long period of time influencing Motability Operations to set executive pay at the levels the charity considers appropriate. In the first two years following the introduction of new remuneration arrangements, annual performance bonuses have been paid at close to maximum levels. Motability Operations has continued to benefit from upside risk such as strong performance in the used car market, and it has not brought its forecast value of vehicles into line with the wider market. While generating higher profits than expected means more money is available to support disabled people, we have not seen any evidence that Motability or Motability Operations have an effective framework to ensure their investments provide value for money. In the absence of an economic shock and unless it changes its business model, we think it likely that the company will continue to generate substantial cash surpluses. In light of all this, further consideration is needed of the executive reward structure and the issues relating to scheme governance and whether they are suitable to underpin the Motability scheme so that it can continue its excellent work for its customers. There is also a clear public interest in the government providing more clarity around its objectives for mobility allowances, given the favourable enabling conditions it provides for the scheme.

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