Our work on motor finance – final findings

March 2019

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1 Introduction

1.1 In April 2017, we announced in our Business Plan for 2017/18 a review of the motor finance sector. We wanted to understand the use of motor finance products, and to assess the sales processes employed by firms and whether the products could cause consumer harm. For example, this could be because the finance is ancillary to the acquisition of a vehicle, and so may be a secondary consideration for the consumer.

1.2 In July 2017, we set out some key questions for the review to answer:

- Are firms taking the right steps to ensure that they lend responsibly, in particular by appropriately assessing whether potential customers can afford the product in question?
- Are there conflicts of interest arising from commission arrangements between lenders and dealers and, if so, are these appropriately managed to avoid harm to consumers?
- Is the information provided to potential customers by firms sufficiently clear and transparent, so that they can understand the risks involved and make informed decisions?
- Are firms managing the risk that asset valuations could fall and ensuring that they are adequately pricing risk?

1.3 In March 2018, we published an update report setting out what we had done and our initial findings. We also described the further work we would be undertaking.

1.4 Our initial findings included the following:

- The motor finance sector had continued to grow, particularly for personal contract purchase (PCP, a form of hire-purchase with lower monthly instalments and a final balloon payment linked to the residual value of the vehicle).
- The largest lenders were adequately managing the prudential risks from a potential severe fall in used car values, but firms should regularly consider relevant changes in the market.
- Growth in motor finance had been strongest for lower credit risk consumers (higher credit scores), who are less likely to face repayment difficulties.
- Arrears and default rates generally remained low, but had increased somewhat, particularly for higher credit risk consumers (lower credit scores), despite relatively benign credit and macro-economic conditions.
- If not properly managed, some of the commission arrangements in place could provide incentives for dealers to arrange finance at higher interest rates.
- In some cases, information to consumers on websites and in contract documentation was not sufficiently prominent or easy to understand.

1.5 We committed to focusing in the remainder of our review on the issues of greatest potential harm to consumers. These included:

- Whether lenders are adequately managing the risks around commission arrangements, and whether commission structures have led to higher finance costs for customers because of the incentives they create for brokers.

- Whether customers are being given the right kind of information, at the right times, to enable them to make informed decisions, and whether firms are complying with relevant regulatory requirements.
- Whether firms are properly assessing whether customers can afford to repay the credit, particularly when lending to higher-risk consumers.

1.6 Our follow-up work included an analysis of loan data collected from 20 motor finance providers, a mystery shop exercise and a survey of lenders that looked at how they assess affordability and exercise control over their credit brokers.

1.7 Our key findings are set out in the following chapters, and summarised below.

Executive summary

Commission arrangements

- We are concerned that the way commission arrangements are operating in motor finance may be leading to consumer harm on a potentially significant scale.
- Some customers are paying significantly more for their motor finance because of the way lenders choose to remunerate their brokers.
- In particular, we are concerned about the widespread use of commission models which link the broker commission to the customer interest rate and allow brokers wide discretion to set the interest rate. This gives rise to conflicts of interest and creates strong incentives for the broker to charge a higher interest rate.
- We found that these incentives have significant effects on the cost of motor finance for consumers, even after controlling for other factors which might affect interest costs, such as the customer's credit score, loan value or length of the agreement. For commission models where the broker has discretion over the interest rate, increases in broker commission are associated with higher increases in interest rates, particularly for difference in charges (DiC) models.[1]
- Across the firms in our analysis (around 60% of the market) we estimate that commission models which allow broker discretion over the interest rate could be costing customers £300m more annually when compared against a baseline of Flat Fee models.[2] We estimate that on a typical motor finance agreement of £10,000, higher broker commission under the Reducing DiC model can result in the customer paying around £1,100 more in interest charges over the four-year term of the agreement.
- It is not clear to us why brokers should have such wide discretion to set or adjust interest rates, to earn more commission, and we are concerned that lenders are not doing enough to monitor and reduce the risk of harm.
- Such commission arrangements can also break the link that might otherwise be expected between credit risk and the customer interest rate. This can impact on pricing and affordability for individual customers.
- We consider that change is needed across the market, to address the potential harm we have identified. We have started work with a view to assessing the options for policy intervention. Subject to analysis of the costs and benefits of potential

1 The different commission models are explained in paragraph 2.3 below and the associated footnotes.
2 See paragraphs 2.14-2.17 below.

interventions, this could involve consulting on changes to our consumer credit rules to strengthen existing provisions or other policy interventions such as banning DiC and similar commission models or limiting broker discretion.

Sufficient, timely and transparent information

- Our mystery shopping results raised a number of concerns in relation to pre-contractual disclosure and explanations, and we are not satisfied that firms are complying with regulatory requirements. We will follow up with individual firms.
- While it is possible that disclosures may have been made later in the process (not covered in our mystery shopping exercise), it is unclear whether this would be in good time before entry into an agreement, to enable the customer to make an informed decision.
- Where disclosures or explanations were given, these were not always complete, clear or easy to understand. As a result, customers may not be given sufficient information and explanation to enable informed decisions.
- We have particular concerns in relation to disclosure of commission, especially in respect of DiC and similar commission models where the broker has discretion to adjust the interest rate. There are existing requirements in our Consumer Credit sourcebook (CONC) on disclosure of brokers' status and remuneration, but we did not see clear evidence of compliance with these.
- In particular, brokers must disclose the existence of any commission or other financial arrangement with a lender which could affect the broker's impartiality in promoting a particular product or impact on the customer's decision-making. Such disclosure should be clear and readily comprehensible. In addition, the broker must disclose the amount (or likely amount) upon request.
- Lenders also have obligations in this area. In particular, CONC 1.2.2R requires lenders to take reasonable steps to ensure that persons acting on their behalf comply with CONC. This includes compliance with rules relating to disclosure of commission. However, while in principle the way lenders told us they frame their controls appeared broadly reasonable, we have doubts as to whether and to what extent these are always implemented in practice. Our work suggests that some lenders may be unduly reliant on contractual requirements and the provision of standard documentation and procedures, and may not monitor brokers sufficiently closely or act where issues are found. We were particularly concerned that some lenders appear to take the view that it is sufficient that a broker is FCA-authorised, as it can be assumed that they will be compliant with FCA rules (as the FCA will monitor compliance).
- Firms should review their policies, procedures and controls to ensure they are complying with all relevant regulatory requirements and are treating customers fairly.

Affordability assessment

- We are not satisfied that all lenders we surveyed were complying with FCA rules on assessing creditworthiness, including affordability. Some seemed to focus unduly on credit risk (to the lender) rather than affordability (for the borrower), and there were gaps or anomalies in information provided.
- We introduced new rules and guidance last July, which came into force on 1 November 2018. We expect firms to have reviewed their policies and procedures, in light of these, and made changes where necessary. We will follow up with individual firms to check this has been done.

2 Commission structures

2.1 The question we set initially was:

> **Are there conflicts of interest arising from commission arrangements between lenders and dealers and, if so, are these appropriately managed to avoid harm to consumers?**

2.2 We wanted to understand the different commission structures between lenders and dealers (and other credit brokers) and the incentives these may create. In particular, we wanted to assess whether they give rise to conflicts of interest which could lead to higher finance charges for customers.

Commission arrangements

2.3 In the first phase of our work, we analysed contracts between some of the largest lenders (accounting for around 45% of the motor finance market) and their top dealers, covering the period 2013 to 2016. There were 4 main types of commission structure used in the sample of contracts we reviewed – Increasing Difference in Charges (Increasing DiC)[3], Reducing Difference in Charges (Reducing DiC)[4], Scaled Commission (Scaled)[5] and Flat Fee Commission (Flat Fee).[6]

2.4 We found that Increasing DiC and Reducing DiC commission arrangements can provide strong incentives for brokers to arrange finance at higher interest rates. This is because the amount of commission increases with the interest rate that the consumer is charged. In these cases, the broker has discretion to set the interest rate payable by the customer, within parameters set by the lender. Other commission structures provide a weaker link to the interest rate or none at all.

2.5 In the final phase of our work (since March 2018), we collected data from lenders to assess whether commission arrangements have led to higher finance costs for customers. This involved a sample of around 1,000 motor finance agreements from 20 lenders representing about 60% of the market. These covered January 2017 to July 2018 and represented a range of customers with different credit risk profiles.[7]

2.6 The sample covered a range of brokers, including franchised dealers, independent dealers and online brokers. The commission models mentioned above featured in over 95% of the agreements in our sample.

3 Also known as 'Interest Rate Upward Adjustment'. Brokers are paid a fee which is linked to the interest rate payable by the customer. The contract between the lender and the broker sets a minimum interest rate, and the fee is a proportion of the difference in interest charges between the actual interest rate and the minimum interest rate.

4 Also known as 'Interest Rate Downward Adjustment'. This is similar to Increasing DiC, except that the contract between the lender and the broker sets a maximum interest rate.

5 Also known as a variable product fee. The broker is paid a fee which varies (within parameters) according to certain product features such as the type of credit agreement or the interest rate.

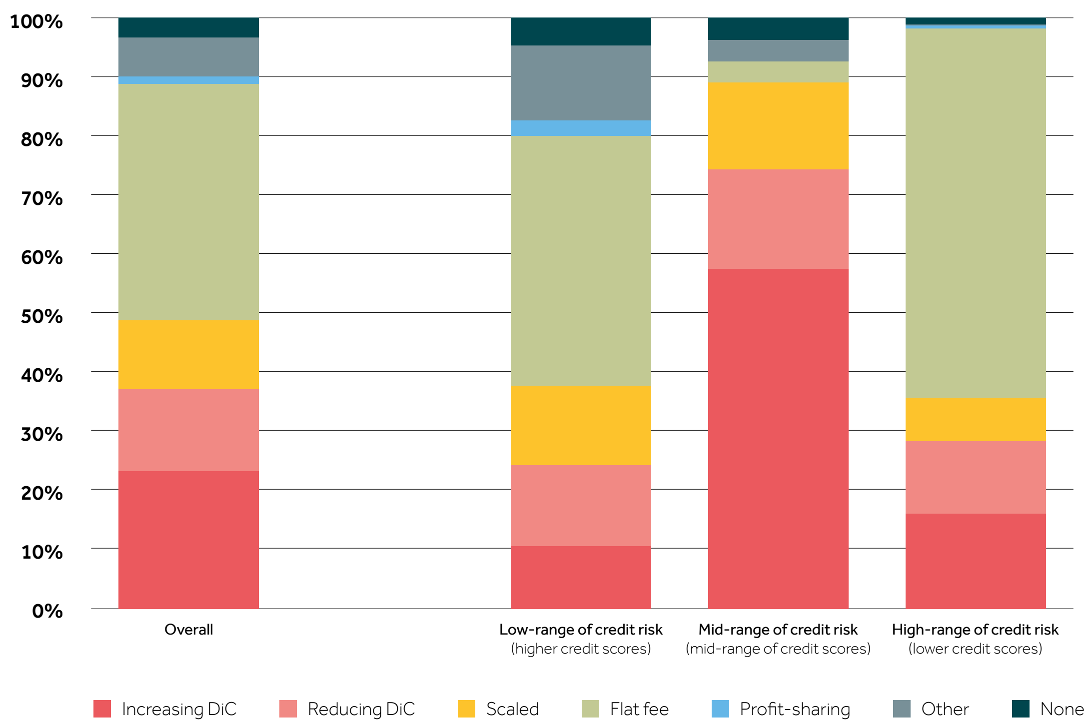
6 Brokers are paid a fixed fee for each credit agreement they process or arrange.

7 We adjusted the credit scores provided by lenders, using credit reference agency data, to ensure a meaningful level of comparability between the credit scores provided by the firms.

2.7 The adoption rate of the commission models varied significantly across the sample. In particular, Flat Fee was prevalent in the higher credit risk end of the sector, accounting for around 60% of the volume of lending within that segment. Difference in charges models (Increasing and Reducing) were more prevalent in the mid-range of credit risk, accounting for around 75% of lending within that segment.

2.8 This is illustrated in Chart 1 below:

Chart 1: Share of lending by risk segment and commission model



2.9 Broker earnings varied significantly across the commission models, particularly for Increasing DiC, Reducing DiC and Scaled models. For example, the difference between the average and highest commission[8] was around £2,000 for the DiC and Scaled models, compared to £700 for the Flat Fee commission model. The significant differences in commission levels in the DiC and Scaled models mean that they give rise to incentives for the brokers to charge the highest interest rates, given the associated sharp increase in commission levels that can be achieved.

Impact on interest rates

DiC models have a significantly stronger link to interest rates

2.10 We then considered whether the potential conflicts of interest we identified in the first phase of our work were leading to higher interest costs for consumers. Our review had indicated that broker earnings could vary significantly and commission models could create a strong link between the customer interest rate and broker earnings, particularly for difference in charges models.

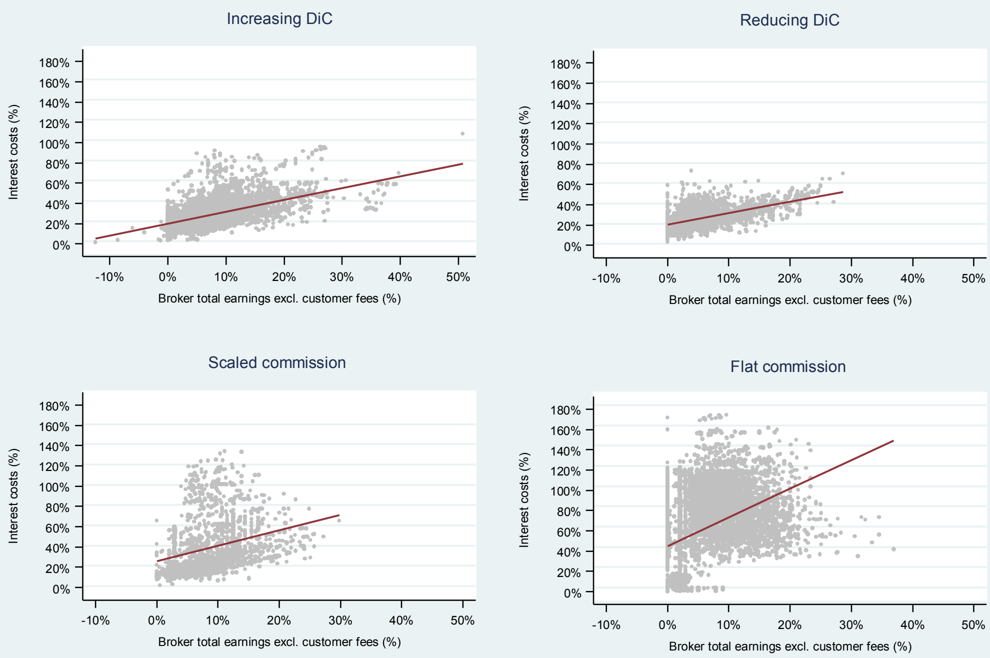
8 Excluding very large commission values by taking the 99th percentile of commission values.

2.11 We initially tested whether this relationship held in the sample of motor finance agreements we collected, or whether lenders' systems and controls were limiting the impact on customer interest costs.

2.12 As a first step, we considered whether there was a strong relationship between broker earnings and customer interest costs. If this relationship was weak, we could conclude that the amount of interest that the customer pays was not primarily driven by the amount of commission that the broker received and that other factors were more important (for example, the broker may have little or no discretion in setting the interest rate or this may be limited effectively by the lenders).

2.13 The top two boxes in Chart 2 below show that there is a significantly stronger association (indicated by the tighter clustering of loans around the fitted red line) between broker commission and interest costs for the DiC models.[9] This indicates that the inherent incentives in DiC models create a stronger link between customer interest costs and the commission earnings of brokers.

Chart 2: Interest costs (%) against broker earnings (%) by commission model



The link persists even when you remove other factors that affect interest rates

2.14 We wanted to test whether this relationship held when controlling for other factors that might affect customer interest costs (such as the customer's credit score, the size of the loan and the length of the agreement).[10] The analysis indicates that,

9 In particular, the R-squared value, as a measure of association, is twice the size for Reducing DiC than Flat Fee.

10 We used an econometric model, using different specifications, which examined the relationship between customer interest costs and broker commission, controlling for lender and broker characteristics (size of lender and broker, broker channel), customer characteristics (age, income, credit score) and credit characteristics (product type, amount and duration of credit, loan-to-value LTV ratio).

controlling for other factors, commissions are strongly associated with higher interest costs for difference in charges models.

2.15 For example, a 1% increase in broker earnings is associated with a 1.3% increase in customer interest costs under the Reducing DiC model. These effects are significant. On a typical motor finance agreement of £10,000, increasing commission under Reducing DiC is typically associated with an increase in interest costs of around £1,100 over the four-year term of the agreement or an increase of 50% in interest costs.[11] Similar results apply for Increasing DiC. For the Scaled commission model, the association is smaller and for Flat Fee models it disappears altogether.

2.16 We also compared the effects of Increasing DiC, Reducing DiC and Scaled commission on customer interest costs against a baseline of Flat Fee models. To do this, we relied on the fact that Flat Fee models do not create incentives to charge higher interest rates. We calculated the impact on interest costs of the higher commission amounts found in Increasing DiC, Reducing DiC and Scaled commission models (than in Flat Fee commission models).[12]

2.17 Across the firms in our sample (around 60% of the market), we estimate that the 560,000 customers of the firms affected by such commission models could pay in total £300m more annually in interest costs as a result of the commission models.[13]

DiC models appear to break the link between credit risk and interest rate

2.18 We wanted to test whether the commission models were affecting the link between interest rates and credit risk. This is because we would expect customers with lower credit risk (higher credit score) to typically receive lower interest rates. To this end, we analysed the relationship between customer interest rate and the customer's credit score, using credit scores as an indicator of credit risk.

2.19 Chart 3 shows that under DiC models, there is typically little relationship between the customer interest rate and their credit score, while the relationship holds more for Scaled and Flat Fee models. For example, under the Reducing DiC model, there is typically no association between the customer's credit score and their interest rate (indicated by the clustering of loans around the red line showing no association)[14], whilst for Flat Fee commissions, the association is significant.[15] This result fits with our findings above that there is a strong association between interest rates and broker commission, even after controlling for other factors (including credit scores).

11 We tested the impact on interest costs of increasing commission from the 25th percentile to the 75th percentile, ie the associated interest costs of being a customer that contributes towards a higher commission amount.

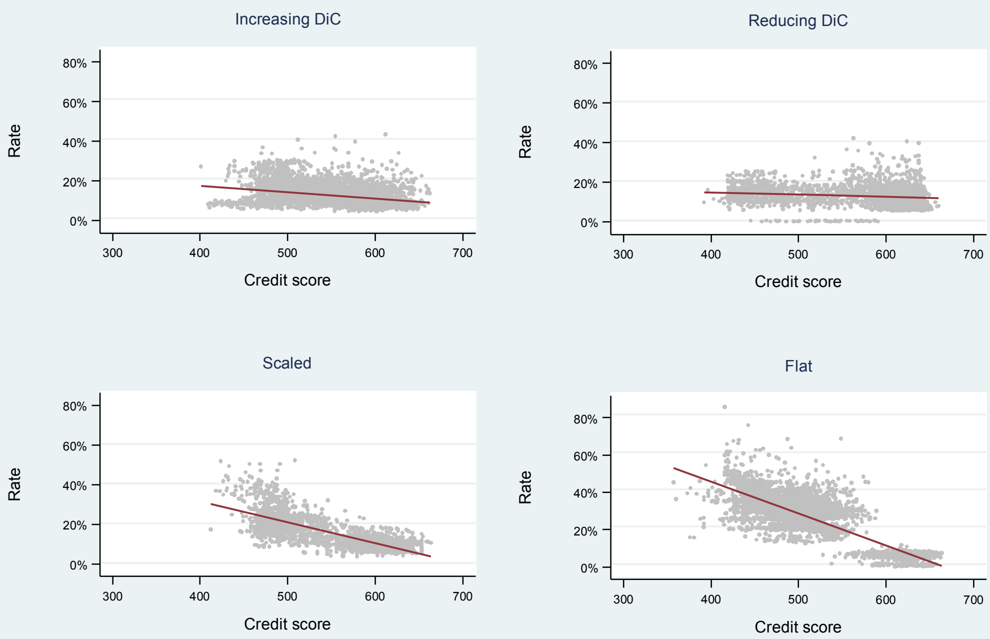
12 That is, we re-scaled Increasing DiC, Reducing DiC and Scaled commissions to Flat Fee commission levels. We then model the effect of increasing commission to the actual commission level, on the interest costs. The multiplier for each commission model is the estimated effect from the regressions (see footnote 11). The difference between actual and modelled interest costs is assumed to arise because of the incentives that the different models create. We then scale up this difference within each firm, which involves assuming that the sample of loans is representative of the rest of the portfolio for the firm (we asked firms for a representative sample of loans). The sum of these firm-level effects amounts to around £300m across Reducing DiC, Increasing DiC and Scaled commission models.

13 By commission model, the scale of effects is as follows: Increasing DiC is around £150m, Reducing DiC around £80m and Scaled commission around £70m.

14 More specifically, the R-squared for Reducing DiC agreements is close to 0.

15 The R-squared is around 0.69, indicating a strong negative correlation between the customer's credit score and the interest rate, i.e. increasing credit scores are typically associated with lower interest rates.

Chart 3: Customer interest rate against credit score



Our findings

2.20 We are concerned that commission models allowing broker discretion on interest rates have the potential for significant customer harm in terms of higher interest charges. This applies particularly to Increasing DiC and Reducing DiC, but also to a lesser extent to some Scaled commission models.

2.21 We have not found that the risk of harm from Reducing DiC, in terms of customer interest costs, is less than Increasing DiC – as has sometimes been claimed. Scaled models typically provide less discretion (or none at all) for the broker to set the interest rate, so reducing risks, but in principle could also lead to consumer harm.[16]

2.22 We are also concerned that DiC and other commission models which allow brokers discretion over the interest rate may break the link between credit risk and the customer interest rate that might otherwise be expected. This may make pricing less efficient, and may increase risks for the lender. It may also increase the interest rate payable by consumers – lower risk customers may be charged higher interest rates than would otherwise be the case, and higher risk customers may be priced out of affordable credit or given credit which is unaffordable.

2.23 It is not clear to us why brokers should have such wide discretion to set interest rates or to adjust the rate to – in effect – pay themselves more commission.

2.24 In principle, there may be a rationale for higher commissions where the broker undertakes more work on the lender's behalf to gather information and makes an initial assessment (for example, in the case of customers who are higher credit risk and so

16 That is, while brokers could earn significantly more in commission by increasing interest rates, the range of interest rates – and by implication potential interest charges to the consumer – is smaller than under DiC models.

more detailed assessment of affordability may be necessary). However, we did not find this in our sample of agreements. We found DiC was mostly prevalent in the mid-range of credit risk, and the relationship between commission levels and credit score was typically stronger in the case of Flat Fee commission models (where the broker has no discretion) than DiC and Scaled.

Next steps

2.25 Based on our findings, we do not believe that all lenders are doing enough to limit risks from their commission models. We have therefore started policy work with a view to assessing the options for policy intervention, which could include banning DiC and similar commission models or limiting broker discretion.

2.26 We may also consider changes to existing CONC rules and guidance. For example, CONC 4.5.2G states that a lender should only offer or enter into a commission agreement providing for differential commission rates, or for payments based on the volume and profitability of business, where this is justified based on the extra work for the broker. This could include where the commission rate as a percentage of the amount of credit varies according to the interest rate charged to the customer.

2.27 The onus, therefore, is on a lender to show that any differences in commission rates are justified, based on the work involved for the broker.

2.28 We also remind firms that they have obligations under our Senior Management Arrangements, Systems and Controls sourcebook (SYSC) to take reasonable steps to establish and maintain appropriate and effective systems and controls to reduce risks and ensure compliance with regulatory requirements and standards.

2.29 We expect lenders to review their systems and controls, in light of our findings. Where harm, or potential harm, is identified, this should be addressed.

3 Sufficient, timely and transparent information

3.1 The question we set initially was:

Is the information provided to potential customers by firms sufficiently clear and transparent, so that they can understand the risks involved and make informed decisions?

3.2 We undertook a mystery shopping exercise. This involved visits to 122 motor retailers and other brokers. These comprised 37 franchised retailers (acting as a franchisee for a motor manufacturer), 60 independent retailers (smaller, local dealerships), 14 car supermarkets and 11 online brokers (offering either finance-only solutions or an introduction to a franchised retailer).

3.3 Our findings need to be taken in context: the sample size was small and biased towards independent retailers offering PCP or other forms of hire-purchase (HP). It is not possible to simply extrapolate to the wider market. However, we are concerned issues raised by the mystery shopping may apply more generally.

3.4 Credit broking often forms a major profit centre for motor retailers, reflecting that significant sums can be generated from the sale of finance. For many consumers, a car is a very significant purchase. So, it is important that consumers are provided with timely information that is appropriate to their needs.

Customer needs and circumstances

3.5 Most brokers in our sample appeared to make sufficient efforts to establish customers' change cycles, ownership/usership preferences and budget.

3.6 By retailer type, this was generally the case for franchised retailers and car supermarkets. Online brokers performed well too. Independent retailers performed less well. This may in part reflect the respective investments made in staff training by the different industry sectors.

3.7 However, we would remind brokers that, where they give explanations or advice to a customer, or make recommendations, they must pay due regard to the customer's needs and circumstances. In particular, they must pay due regard to whether the credit product is affordable and whether there are any factors that the firm knows, or reasonably ought to know, that might make it unsuitable for that customer.

3.8 In addition, brokers must take reasonable steps to satisfy themselves that a product they wish to recommend to a customer is not unsuitable for the customer's needs and circumstances. Under Principle 9, a firm must also take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

Initial discussions

3.9 A consumer approaching a motor retailer may have decided what type of vehicle they want, and possibly other elements of the package. However, they may not have given much thought to finance or be aware of all the options.

3.10 We found that some brokers in our sample appeared to assume that the customer knew what they wanted when they arrived at the showroom. As such, some salespeople were quick to start negotiating an overall finance deal with a particular focus on one finance product over another, but without considering whether alternative options should be offered, with an explanation of how they work, to better enable the customer to make an informed decision.

3.11 For new car sales, PCP tended to dominate sales discussions, with other forms of HP usually being offered only as comparators. In some cases the customer expressed a clear desire to own the vehicle outright at the end of the agreement, but this was either ignored or not given sufficient weight in the process. Independent retailers predominantly offered HP, reflecting that their used vehicle stock was typically older, with lower prices, and so might be unsuitable (or unavailable) for PCP.

3.12 The lower monthly costs associated with PCP were generally promoted as the most attractive feature for customers when compared to other HP products. However, it was not always clear that there was sufficient balance between the benefits and downsides of the various finance options offered or available to customers.

3.13 Firms need to ensure that financial promotions and communications, including oral communications at point-of-sale, are clear, fair and not misleading. In particular, they must be balanced, and must not emphasise any potential benefits of a product without also giving a fair and prominent indication of any relevant risks. They must also not disguise, omit, diminish or obscure important information, statements or warnings. They must be sufficient for, and presented in a way that is likely to be understood by, the average customer.

Pre-contract disclosure and adequate explanations

3.14 The practical limitations of our mystery shopping exercise (we stopped short of finalising details or entering into a credit agreement) meant that we were unable to fully test all elements of pre-contract disclosure and explanations. Where these were not provided, or not provided in full, that may have been a reflection of the nature of the sales process, and we cannot rule out that compliant disclosures and explanations would have been provided subsequently.

3.15 However, we found evidence that disclosures or explanations given during the initial visit were often incomplete, and sometimes potentially misleading, raising doubts as to compliance with relevant obligations.

3.16 The pre-contract disclosure requirements are principally in legislation (the Consumer Credit Act 1974). The obligations are on the lender, as creditor, but the lender may choose to delegate these to a broker or other intermediary. The lender must, however, be satisfied that the intermediary has disclosed the required information to the customer in the manner required by the legislation (and if this has not been done, the lender must do so to avoid breach of the requirements).

3.17 Similarly, the obligation to provide an adequate pre-contractual explanation under FCA rules falls on the lender, unless a broker or other intermediary has taken on responsibility for providing the explanation and the lender is satisfied that an explanation has been provided and is compliant.

3.18 The pre-contract disclosure, in the form of the SECCI (the Standard European Consumer Credit Information form), must be provided 'in good time' before a credit agreement is made. The information must include key details of the credit and its cost, including the total amount payable, the interest rate, APR (annual percentage rate of charge), default charges and any other costs. In the case of PCP and other HP, this would include the cost of acquiring ownership of the vehicle at the end of the agreement. It must also state the cash price of the vehicle.

3.19 If the SECCI is not provided in good time, or is deficient, the credit agreement is improperly-executed and so is unenforceable against the customer without a court order. The FCA also has powers to take enforcement action.

3.20 The pre-contractual explanation must be provided before the agreement is made, and should enable the customer to make a reasonable assessment of whether they can afford the credit and to understand the key associated risks. In particular, the explanation must cover any features of the agreement which may make the credit unsuitable for particular types of use, or which may operate in a manner which could have a significant adverse effect on the customer in a way they are unlikely to foresee. It must also cover how much the customer will have to pay periodically and in total under the agreement (the total amount payable).

3.21 In addition, the firm must advise the customer to consider the pre-contract credit information (and that they can take it away), and how to ask for further information or explanation. The customer must have an opportunity to ask questions.

3.22 In general, we found that – where key features of ownership and end-of-contract options for PCP, including final balloon payments, were explained during the mystery shopping – this was usually clear and transparent. However, only 31% of brokers in our sample explained that, for PCP and other HP, customers do not own the goods until all sums have been paid, including any option-to-purchase fee, and any other conditions have been satisfied; and that goods can be repossessed without a court order in the event of default (unless the customer has paid a third or more of the total amount payable).

3.23 In addition, only 28% of brokers in our sample explained the total amount payable, the principal consequences arising from a failure to make payments under the agreement, and the effect of withdrawing from the agreement.

3.24 We expect lenders and brokers to review their policies and procedures, to ensure that customers are treated fairly and with appropriate transparency. In particular, firms should satisfy themselves that any required disclosures and explanations are clear and easy to understand, and are provided sufficiently early in the process to enable the customer to make an informed decision.

Commission disclosure

3.25 We found that only a small number of brokers disclosed to the customer, during the mystery shopping visit, that a commission may be received for arranging finance. This was the case for only 1 out of 37 franchised retailers, 4 of 60 independent retailers, 2 of 14 car supermarkets and 4 of 11 online brokers.

3.26 As above, it is possible that disclosures would have been made later in the process but it is not clear to us that this would be sufficiently early to effectively alert the customer to the potential conflict of interest or that there may be scope to negotiate on the finance as well as the vehicle and other price elements.

3.27 We were also concerned that, where disclosures were made, they were often not prominent and were unlikely to be noticed by the customer. For example, they may be difficult to find in a document, without being drawn to the customer's attention.

3.28 Our rules in CONC 4.5.3R require brokers to disclose, in good time before a credit agreement is entered into, the existence of any commission or fee or other remuneration payable to the broker by a lender (or a third party) if knowledge of the existence or amount of the commission could actually or potentially:

- affect the broker's impartiality in recommending a particular product; or
- have a material impact on the customer's transactional decision

3.29 This would include DiC and similar commission arrangements which allow the broker discretion to adjust the interest rate, to earn more commission. This is a conflict of interest that may affect the broker's impartiality. It may also affect the customer's decision on whether to deal with the broker or to proceed to an agreement. If the customer is aware of the existence of such arrangements, they can take this into account, and probe further if they want or request an indication of the amount or likely amount of the commission (which the broker must provide upon request).

3.30 It may also apply in other cases, where the broker does not have discretion but the amount of commission may vary by lender or product, as the customer may be unaware of this and so may not factor it into their decision making.

3.31 In accordance with CONC 3.3.1R (and Principle 7), such disclosure should be clear, fair and not misleading. As above, it should be sufficient for, and presented in a way that is likely to be understood by, the average customer, and the firm must not disguise, omit or diminish important information.

3.32 Separate provisions in CONC 3.7 require brokers to make clear, in financial promotions and other documents, their status and the extent of their powers. This includes whether they work exclusively with one or more lenders or independently. Accompanying guidance makes clear that communications with customers should indicate prominently the existence of any financial arrangements with a lender that might impact on the broker's impartiality in promoting a credit product.

3.33 Unlike CONC 4.5, this is irrespective of whether knowledge of the existence or amount of the commission might have a material impact on the customer's transactional decision. It is also irrespective of whether the broker is recommending a particular product. In addition to such disclosure being prominent, the guidance makes clear that it must also be clear and easily comprehensible.

3.34 Credit brokers in the motor finance market should review their policies and procedures to ensure they are complying with the CONC rules, and are treating customers fairly. They should take steps to address any deficiencies identified. We also remind lenders that CONC 1.2.2R requires them to take reasonable steps to ensure that persons acting on their behalf comply with CONC.

3.35 As noted above, we have started work with a view to assessing the options for policy intervention, which could include consulting on changes to the CONC rules and guidance to strengthen existing provisions.

Unfair business practices

3.36 Our review did not highlight any widespread evidence of other poor practices that caused us significant concern.

3.37 However, we remind firms that CONC includes requirements relating to the conduct of business by credit brokers and highlights examples of unfair business practices.

3.38 For example, brokers must not inappropriately offer a financial or other incentive or inducement to a customer to enter, immediately or quickly, into a credit agreement. They must also not secure more credit for a customer than was requested, or at a higher interest rate than requested, where this was for the personal gain of the broker rather than in the best interests of the customer.

3.39 There are also separate requirements on lenders. For example, they must not unfairly encourage, incentivise or induce a customer to enter into an agreement quickly, without allowing the customer time to consider the pre-contract information and explanations, or for an amount higher than the customer requests.

4 Lender controls

4.1 We also asked lenders, as part of the questionnaire to 20 firms, about the controls they had in place to monitor compliance by brokers with our CONC rules.

4.2 Arrangements ranged from checking that a retailer was FCA-authorised, to periodic monitoring (eg quarterly visits or annual audits) and the scrutiny of relevant management information (such as complaints data). We were told that compliance was also a key feature of contractual arrangements between the parties. Several lenders advised that the performance of dealers was a standing item at various risk, conduct and oversight committees within their own risk frameworks.

4.3 For pre-contractual disclosures and explanations, some lenders told us that they follow up directly with customers to verify compliance by brokers. For example, they check that key information has been provided, and key product features explained, and whether the customer appears to understand the main contractual obligations. One lender said that it made validation calls to 100% of customers.

4.4 The increase in showroom point-of-sale/finance quotation systems and their use in the sales process was seen by lenders to drive better disclosure. Many contain scripted messages for salespeople to refer to while in front of the customer. Some require e-signatures from customers to demonstrate that pre-contract disclosures have been made; other systems generate emails direct to customers that include links to on-line packages of pre-contractual information. We were not able to test this in practice, or to assess their effectiveness.

4.5 For commission arrangements, lenders told us that they applied various measures including capping interest rates, allowing only downward adjustments in rates, reducing the extent of rate discretion or removing discretion altogether. Again, many of the lenders said that they use management information (eg quarterly identification of commission outliers) and monitoring to assess fairness. A number regularly review reward structures at dealers to ensure there is no incentive for them to push for higher interest rates to generate increased commissions.

4.6 However, while in principle the way lenders told us they frame their controls appeared broadly reasonable, we have doubts as to whether and to what extent these are implemented in practice in all cases.

4.7 Our review of survey responses, and the findings from our mystery shopping exercise, suggest that some lenders may be unduly reliant on contractual requirements and the provision of standard documentation and procedures, and may not monitor brokers sufficiently closely or act where issues are found.

4.8 Furthermore, our findings from the analysis of motor finance agreements show that commission models, such as DiC, are leading to poor outcomes for a significant number of consumers and that lender controls are not mitigating the risks sufficiently. This is a key concern that we intend to address.

4.9 For example, while lenders may require brokers to comply with CONC requirements on disclosure of status and remuneration, there appears to be very little monitoring of this. We were particularly concerned that some lenders appear to take the view that it is sufficient to check that a broker is FCA-authorised, as it can be assumed that they will be compliant with FCA rules (as the FCA will monitor compliance).

4.10 We remind lenders that they are required to take reasonable steps to ensure that persons acting on their behalf comply with CONC. This could include dealers or other credit brokers involved in selling the lender's finance products. A lender may also be liable in law for representations made by a broker acting as its agent.[17]

4.11 We expect lenders to review their systems and controls, to reduce risk of consumer harm. They should monitor brokers adequately and take reasonable steps to ensure compliance with CONC, where applicable.

17 Section 56 of the Consumer Credit Act 1974.

5 Affordability assessment

5.1 The question we set initially was:

> **Are lenders taking the right steps to ensure that they lend responsibly, in particular by appropriately assessing whether potential customers can afford the product in question?**

5.2 We sent questionnaires to 20 lenders (representing 60% of the market) asking how they assessed creditworthiness, including affordability. We also asked for copies of relevant policies and procedures, including details of key policy rules and what information and data or other factors are taken into account in assessments.

5.3 The responses were by reference to the CONC requirements at the time. Since then, we have published new rules and guidance in PS18/19, with the aim of further clarifying our expectations. These came into force on 1 November 2018.

5.4 We make clear in PS18/19 that firms should review their policies and procedures in light of the new rules and guidance, and make changes where needed. They should also ensure that they keep their policies and procedures under review to monitor compliance with the requirements on an ongoing basis.

5.5 In 5 cases, the firms' processes appeared to be broadly in line with the prevailing CONC requirements at the time (but changes may have been needed in light of the new creditworthiness rules from 1 November, for example in relation to policies and procedures or being able to demonstrate compliance).

5.6 In 7 cases, the firms' processes seemed generally satisfactory. However, there were gaps or ambiguities in the information provided, and elements of the assessment were unclear. In particular, it was not always clear what information or data would be used in an assessment, or whether and how this might be verified, particularly in marginal cases. It was also unclear how indicators of affordability risk would be taken into account, according to the costs and risks to the individual customer, and how these were reflected in metrics used.

5.7 In 8 cases, we did not have enough information to assess compliance with CONC. The firms' responses did not provide sufficient details of the process used, or how this might vary depending upon the product and customer. For example, it was unclear how policy rules or scorecards would operate (particularly where processes were automated) to decide whether applications were accepted or rejected or referred to manual underwriting. In most cases firms appeared to rely on a mix of applicant information plus data from credit reference agencies (CRAs). However, it was not always clear which CRA products were being used, and in what ways, or what might trigger asking the customer for documentary evidence.

5.8 In a small number of cases the focus appeared to be on credit risk, rather than affordability, with insufficient checks on ability to repay without the repayments having a significant adverse impact on the customer's financial situation. Some policies and procedures were missing, or incomplete, and in some cases were written at a high level which did not give a clear indication of process or likely outcomes. These did not clearly demonstrate an understanding of the underlying principles.

5.9 We will be providing firm-specific feedback to those lenders included in our review where we had significant concerns, and will be assessing compliance with the new requirements through supervisory work during 2019.

5.10 We remind firms that the new CONC provisions include the following:

- Firms must make a reasonable assessment of creditworthiness, based on sufficient information. They must not lend unless they can demonstrate that they have had proper regard to affordability risk in the individual case.
- The extent and scope of an assessment should depend upon, and be proportionate to, the individual circumstances. In particular, the firm should take into account the type and amount of credit, its duration, the cost of the credit, and the total amount payable, both in absolute terms and relative to the customer's financial situation where known.
- The higher the affordability risk in the particular case, the more rigorous the assessment is likely to need to be. For example, the firm may need to obtain additional information, or subject it to additional scrutiny. Firms should consider whether information should be verified, and by what means, to ensure that it is reasonable to rely on it, and how it should be factored into the assessment.
- Where income is not taken into account in the assessment, the firm must be able to demonstrate that affordability is obvious. If not, our rules require it to take reasonable steps to establish or estimate current income and likely future changes (where these could impact adversely on affordability). It is not generally sufficient to rely solely on self-declaration by the customer.
- Where income is taken into account, the firm should also take account of non-discretionary expenditure (including other credit and non-credit commitments and essential living expenses), unless it can demonstrate that it is obvious in the particular case that the customer's non-discretionary expenditure is unlikely to significantly affect affordability risk.
- Any estimates of income or expenditure should be reasonable in the circumstances. Again, the firm should be able to demonstrate this if challenged. It may not be reasonable to rely on statistical data if the firm has reason to suspect that the customer's non-discretionary expenditure is significantly higher, for example because of their personal or household situation.
- Firms' policies and procedures should set out clearly the principal factors to be taken into account in assessing creditworthiness, including affordability, in individual cases. The firm must assess and periodically review the effectiveness of its policies and procedures, and its compliance with CONC, and take steps to address any deficiencies identified.

6 Next steps

6.1 We are publishing this report on our website, and are taking steps to draw it to the attention of relevant firms and trade bodies.

6.2 All firms acting as lenders or brokers in the motor finance sector should read this report and consider whether they need to review or amend their policies and procedures and associated systems and controls.

6.3 Where we have identified concerns through our findings, we will follow up with the individual firms. Where necessary, we may consider supervisory or enforcement action. We may also ask firms to report to us on progress in addressing issues.

6.4 As noted above, we have particular concerns in relation to commission arrangements, including the structure of commissions (and whether and to what extent they allow broker discretion over the interest rate) and relevant disclosures by brokers. We have started policy work with a view to consulting, subject to cost benefit analysis, on changes to CONC to strengthen existing provisions and to explore other policy interventions such as banning DiC and similar commission models or limiting broker discretion.

Appendix 1
Key CONC provisions

CONC 2.5	Conduct of business: credit broking
CONC 3.3	The clear fair and not misleading rule
CONC 3.7	Financial promotions and communications: credit brokers
CONC 4.2	Pre-contract disclosure and adequate explanations
CONC 4.4	Pre-contractual requirements: credit brokers
CONC 4.5	Commissions
CONC 4.8	Pre-contract: unfair business practices: consumer credit lending
CONC 5.2A	Creditworthiness assessment
CONC 5.4	Conduct of business: credit brokers

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