FINANCIAL CONDUCT AUTHORITY

Our work on motor finance – update

March 2018

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1 Introduction

The motor finance sector has grown rapidly, largely due to the popularity of personal contract purchase (PCP). We undertook work to identify the potential for consumer harm and whether firms are adequately managing risks. Our initial findings are:

- Most of the growth in motor finance has been to lower credit risk consumers (higher credit scores). They are less likely to face repayment difficulties. Arrears and default rates generally remain low. However, we are mindful that these appear to have increased somewhat, particularly for higher credit risk consumers (lower credit scores). This is despite favourable credit and economic conditions. So, we are focusing on how lenders assess affordability and whether current procedures are working in the interests of consumers.
- The largest FCA solo-regulated lenders are adequately managing the prudential risks from a potential severe fall in used car values. The financial impact of such a fall wouldn't materially affect their overall financial soundness. We remind all FCA solo-regulated firms to regularly consider changes in the market, which could affect their assumptions of residual car values and their financial soundness.
- Some types of commission arrangements can provide incentives for brokers to arrange finance at higher interest rates for their customers. We are assessing whether the risks are adequately controlled by lenders, to minimise the potential for harm to consumers. This includes whether lenders and brokers acting on their behalf comply with current regulatory requirements. We are also testing whether commission structures have led to higher finance costs for consumers, because of the incentives they create for brokers.
- We are looking at the customer journey, including through a mystery shopping exercise. We are assessing whether firms are complying with current regulatory requirements and whether consumers are being given the right kind of information, at the right times, to make informed decisions.
- We expect to complete our work by the end of September 2018. At that stage, we will publish our findings, setting out any areas of concern we have identified and how we intend to tackle these issues.

1.1 In April 2017, we announced in our Business Plan for 2017/18 a review of the motor finance sector.[1] We wanted to understand the use of motor finance products, and assess the sales processes employed by firms and whether the products could cause consumer harm.

1.2 In July 2017, we set out the key questions for the review to answer.[2] These were:

- Are firms managing the risk that asset valuations could fall and making sure that they are adequately pricing risk?
- Are firms taking the right steps to make sure that they lend responsibly, in particular by appropriately assessing whether customers can afford the product in question?

1 See page 72 of the FCA Business Plan 2017/18 – www.fca.org.uk/publication/business-plans/business-plan-2017-18.pdf
2 www.fca.org.uk/news/news-stories/our-work-motor-finance

- 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?

1.3 To address these questions we have undertaken several strands of work. This includes:

- engaged with FCA-authorised lenders to assess their approaches to managing the risk of falling asset valuations

- detailed analysis of customers' credit reference agency (CRA) files, to assess relevant trends and indicators

- reviewing agreements between lenders and motor dealers 'acting as motor finance brokers', to assess whether they raise the potential for conflicts of interest

- reviewing firms' sales practices and processes

1.4 We have completed some strands of this work while others are still in progress. In this document, we provide an update on what we have done and our initial findings, describe the further work we are carrying out, and set out our expected timelines for the rest of this review.

2 Growth in the motor finance sector

2.1 The Bank of England's Financial Stability Report in November 2017[3] noted that consumer credit has grown rapidly and that household debt is high relative to incomes. Motor finance has contributed to the growth in consumer credit – for example, the number of point-of-sale consumer motor finance agreements for new and used cars has grown from around 1.2m in 2008 to around 2.3m in 2017.[4] New finance contracts accounted for 88% of private new car registrations in 2017, up from 59% in 2008.[5] However, the annual growth rate for the value of point-of-sale consumer motor finance contracts has fallen from around 20% in 2014 to around 6% in 2017.[6]

2.2 Personal contract purchase (PCP)[7] agreements have become particularly widespread, accounting for around 66% of the value of new and used car finance lending in 2017 (up from around 34% in 2008).[8]

2.3 From a consumer perspective PCPs provide flexibility by offering the option to buy the vehicle at the end of the agreement by paying a balloon payment, using any equity as part exchange in the purchase of a new vehicle, or simply returning the vehicle. Also, because part of the payment for the vehicle is deferred to the end of the agreement, PCPs result in lower monthly repayments.[9] From the perspective of the lender, they raise the risk of losses if the value of the vehicle falls below the guaranteed future value (GFV) estimated at the beginning of the agreement.[10]

2.4 We wanted to understand the drivers of the growth in motor finance and reviewed a sample of CRA files.[11]

2.5 The CRA data showed that, while motor finance accounted for 16% of total unsecured debt for the consumers in our sample in 2013, this increased to 24% in 2016. We found that more consumers were using motor finance to fund the purchase of vehicles, rather than financing the transaction in other ways. The average value of motor finance contracts in our sample also increased, from just under £13.5k in 2013 to just under £15k in 2016 (an increase of just under 9.4%). This growth was faster than the general increase in car prices (which increased by around 3.5% over the same period[12]), suggesting that the typical motor finance customer bought a slightly more expensive car or put a smaller deposit in 2016 than in 2013.

3 www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2017/november-2017.pdf
4 FCA calculations using data provided by the Finance & Leasing Association (FLA).
5 See footnote 4.
6 See footnote 4.
7 PCP is a form of hire-purchase which combines lower monthly repayments with a final balloon payment which is linked to the residual value of the vehicle. The expected value, known as the guaranteed minimum future value (GMFV) or guaranteed future value (GFV), is estimated at the time of the agreement.
8 See footnote 4.
9 Compared to traditional hire-purchase agreements where repayments for the value of the car are equal and there is no (or no significant) balloon payment.
10 The loss would materialise if the customer hands the car back at the end of the agreement and the lender disposes of the asset in the used car market below the expected value. See also footnote 7.
11 A 10% representative sample of motor finance contracts on the files of one CRA over six years from 2011 to 2016. The sample is representative of typical motor finance contracts for the period.
12 Office for National Statistics (ONS). 2018. ONS CPI index for new cars. Available at: www.ons.gov.uk/economy/inflationandpriceindices/timeseries/d7e8/mm23

3 Are firms managing the risk that asset valuations could fall and making sure that they are adequately pricing risk?

3.1 The provision of motor finance in the UK is split between firms which are prudentially regulated by the Prudential Regulation Authority (PRA) or by the FCA. Firms solely regulated by the FCA account for 59% of the market.[13]

3.2 The PRA undertook a review of PRA-regulated firms' consumer credit lending in the first half of 2017, covering credit cards, personal loans and motor finance. This examined firms' asset quality and underwriting practices. The findings of the review were published in a PRA Statement in July 2017[14], and the PRA followed up with individual firms. The PRA wrote to the Chairs of the relevant firms in January 2018 to communicate key findings and recommended action points.[15]

3.3 In particular, the PRA found that PRA-regulated firms providing motor finance have adopted a reasonably prudent approach to setting GFVs, ranging from 85-95% of expected future value. However, it also found that firms may be under-estimating the potential for structural changes in the market to amplify price movements.

3.4 We undertook a parallel review of the approach of the largest FCA solo-regulated[16] lenders of motor finance. These firms account for 52% of the total market and are therefore most likely to represent a material risk to market functioning.[17] Our review assessed firms' prudential risk management, and in particular whether firms have sufficient capital for a significant fall in used car values.

3.5 We found that the asset valuations and risk management processes at these firms appear to be robust. Stress tests showed that the financial impact of a fall in residual values wound not materially affect their overall financial soundness. The firms were able to show that they had appropriate strategic plans in place in the event of a fall in vehicle prices and their approach to managing credit risk appears to be appropriate.

3.6 We have concluded that the largest FCA solo-regulated lenders are adequately managing the risk of a severe fall in used car prices, such that this would not materially affect their overall financial soundness. We remind all FCA solo-regulated firms to regularly consider structural changes in the market which could affect their assumptions of residual car values and could impact on their firm's financial soundness.

13 Based on the stock of consumer credit as at the end of March 2017. See Chart A in the Bank of England June 2017 Financial Stability Report: www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2017/june-2017.pdf?la=en&hash=EB9E61B5ABA0E05889E903AF041B855D79652644

14 www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/pra-statement-consumer-credit-july-2017.pdf?la=en&hash=93C4354B6172DC3B666404820F05E6018EC7D5E4

15 www.bankofengland.co.uk/prudential-regulation/letter/2017/follow-up-to-pra-statement-on-consumer-credit

16 Firms regulated by the FCA but not by the PRA.

17 The lenders selected for review are all ultimately owned by motor manufacturing groups. We have assessed the regulated entities on a stand-alone basis without reference to the wider group.

4 Are firms taking the right steps to make sure that they lend responsibly, in particular by appropriately assessing whether potential customers can afford the product in question?

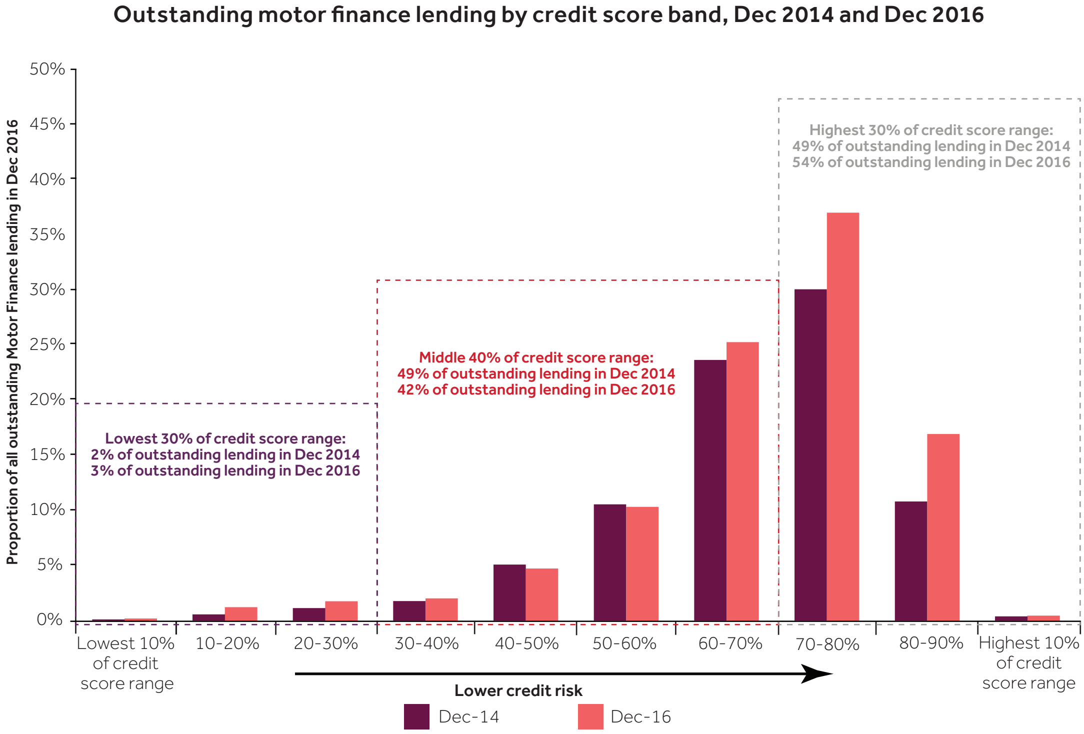
4.1 We used the CRA data to help us understand whether the growth in motor finance could pose risks to consumers. We firstly wanted to test whether motor finance and the recent growth in lending was concentrated around higher credit risk consumers, using credit scores as indicators of credit risk. We then wanted to assess whether the growth in motor finance was leading to more consumers being unable to afford repayments, by analysing arrears and default rates for motor finance.

4.2 We are aware that CRA data can't provide a full picture and that financial distress may arise without necessarily leading to arrears or defaults. This may particularly be the case for motor finance, where consumers could prioritise payments over other credit and non-credit commitments. Equally, arrears and default rates may not in themselves reveal anything about lending practices and affordability. They may be caused by unforeseen events such as a change in personal or macro-economic circumstances. There are also gaps in CRA coverage, reflecting differences in the way that lenders report data to CRAs across the wider market.[18] However, the CRA data can help us identify emerging trends.

4.3 We considered whether higher credit risk consumers accounted for a large share of motor finance lending and whether there had been significant changes in the credit risk profiles of customers. If this were the case then we would be concerned about the sustainability of this trend. However, our analysis suggests that consumers in the lowest credit score range (higher credit risk) account for a relatively small share of motor finance lending. For example, consumers in the lowest 30 percent of credit score range accounted for only 2% of outstanding motor finance lending in December 2014 and 3% in December 2016 (see Chart 1). Furthermore, motor finance lending to consumers in the highest credit score range (lower credit risk) has grown more than lending to consumers in the lowest credit score range (higher credit risk). For example, consumers in the highest 30 percent of credit score range accounted for 54% of outstanding motor finance lending in December 2016, up from 49% in December 2014.

18 For example, we have previously found that there was a 24% difference in the total value of outstanding debts reported to two different CRAs for the same 1.2m individuals who had taken out a high-cost short-term credit loan. See paragraphs 5.79-5.84 of CP17/27 'Assessing creditworthiness in consumer credit: Proposed changes to our rules and guidance' (July 2017) – www.fca.org.uk/publication/consultation/cp17-27.pdf

Chart 1: The distribution of motor finance by consumer credit risk



Note: Lowest and highest 10% groups contain <1% of lending and therefore might not be visible on chart. Totals may not add up to 100% due to rounding.

4.4 We next considered whether the growth in motor finance was leading to more consumers being unable to afford repayments.[19] For the purposes of this analysis, we used several measures of performance and delinquency – missed payments, arrears, severe arrears and defaults.[20] We found that in aggregate, these measures are generally low – for example, 2.4% of accounts in our data had one or two missed payments and 0.4% of accounts had between 3 and 5 missed payments in the 12 months to December 2016. By comparison, 1.6% of mortgage accounts were in arrears in the fourth Quarter of 2016.[21] For personal loans and credit cards, around 0.3% and 2.2% of customers respectively are two or more payments behind.[22]

4.5 We assessed whether missed payments, arrears, severe arrears or defaults had increased significantly for specific consumer segments. Chart 2 shows that across all these measures, there have been only moderate increases between 2014 and 2016. However, missed payments and arrears rates for consumers in the lowest credit score range (higher credit risk) – who account for around 3% of outstanding motor finance lending in our data – are relatively high when compared to consumers in the middle and highest credit score range (lower credit risk) and have increased more in percentage points.

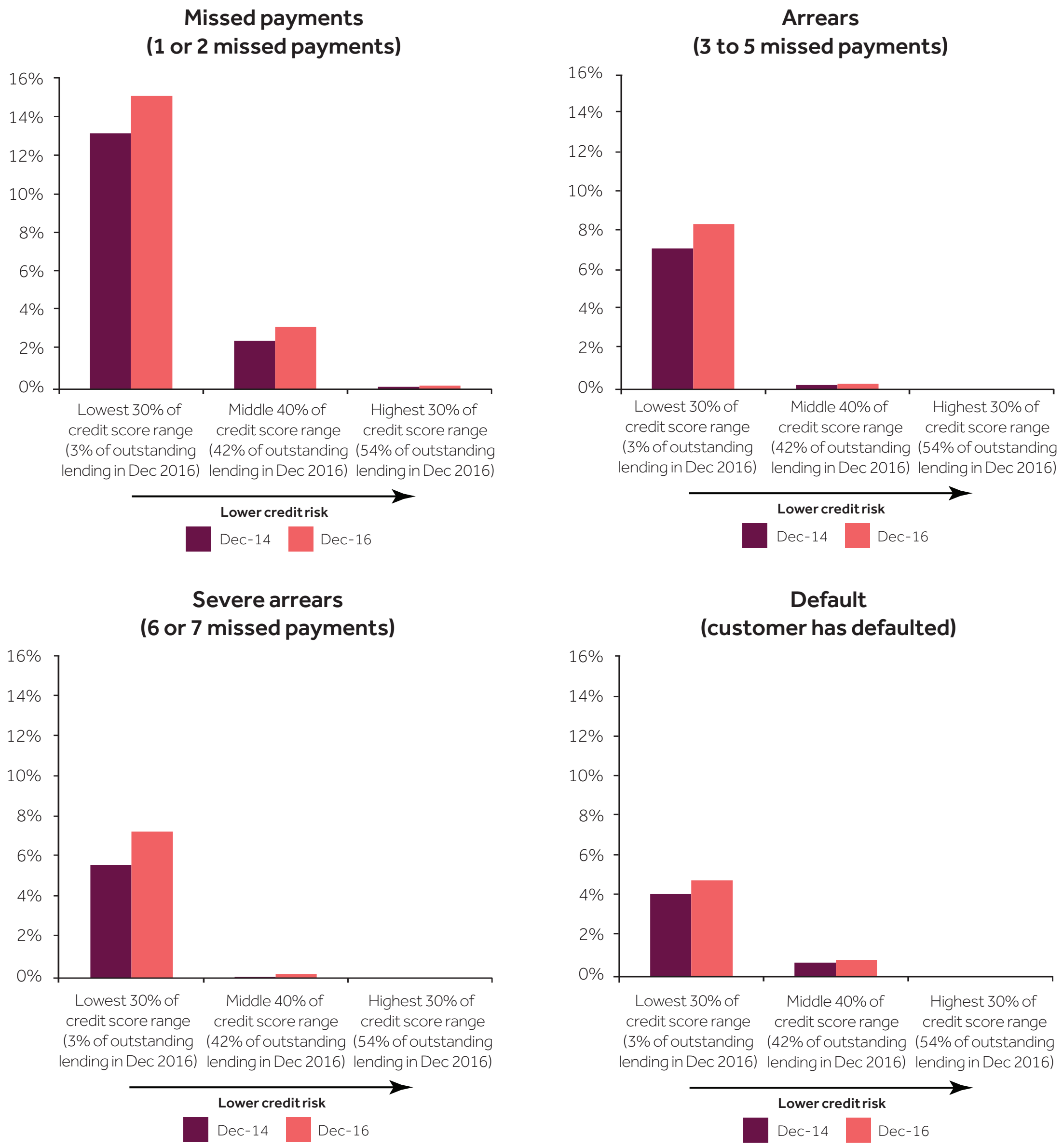
19 Unaffordable repayments may lead to consumer harm, whether financial or non-financial.

20 See Chart 2 for definitions.

21 Defined as the proportion of accounts in arrears of 1.5% and above of the mortgage value for the fourth quarter of 2016. See Table 1.4 in FCA and Bank of England Mortgage Lenders and Administrators Statistics: www.bankofengland.co.uk/-/media/boe/files/statistics/mortgage-lenders-and-administrators/mlar-longrun-detailed.xlsx?la=en&hash=C19A1AC6C462416B0DA71926A744233793B8049B

22 See table 7 here: https://www.fca.org.uk/publication/occasional-papers/occasional-paper-20.pdf

Chart 2: Measures of delinquency in motor finance (December 2014 & December 2016)



Note: Some groups have rates equal to or very close to zero percent, and are therefore not visible in the chart.

4.6 We also considered whether consumers are prioritising repayment of motor finance contracts over other types of debt, leading to greater incidences of defaults in other products. For example, we tested whether defaults in other consumer credit products preceded or followed defaults in motor finance by individual consumers. We found that there were no meaningful patterns in the timing of defaults. This suggests that there is no significant relationship between financial distress in motor finance and other consumer credit products.

4.7 We are mindful that arrears and default rates have increased, in particular for higher credit risk (lower credit score) consumers. These rises have been in the context of benign credit and macro-economic conditions. This means that consumer circumstances and their ability to meet repayments could change as a result of changing conditions.

4.8 In the next phase of the work we will be exploring whether lenders are adequately assessing consumers' ability to repay motor finance. For example, we are seeking information from a sample of lenders on how they assess affordability in motor finance and what information or data they take into account. Given the findings of the CRA data analysis, we are focusing on assessments for higher credit risk consumers, and whether these comply with our current requirements in CONC.[23]

23 Our Consumer Credit sourcebook – see also CP17/27, footnote 19 above.

5 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?

5.1 We wanted to understand the different commission structures between lenders and dealers. This included the incentives these may create for the dealers (acting as credit brokers). Specifically, we wanted to assess whether they give rise to conflicts of interest on the dealer's part, which could lead to higher finance charges for motor finance consumers.

5.2 We analysed agreements between some of the largest lenders (accounting for around 45% of the motor finance market) and their top dealers, between 2013 and 2016. There are 4 main types of commission structures used in the sample of contracts we reviewed – Interest Rate Upward Adjustment (Increasing DiC)[24], Interest Rate Downward Adjustment (Reducing DiC)[25], Scaled Commission[26] and Flat Fee Commission[27]. We also found other types of financial mechanisms, such as volume bonuses (or volume overriders) and consumer fees.

5.3 Increasing DiC and Reducing DiC commission arrangements may create similar incentives for the dealer, since the dealer commission increases with the interest rate that the consumer is charged (see Figure 1). Other commission structures provide a weaker link to the interest rate or none at all. There is some variation within commission models. For example, agreements in the independent dealer segment typically provide a stronger link between dealer commission and the consumer interest rate, than in the franchised dealer segment.

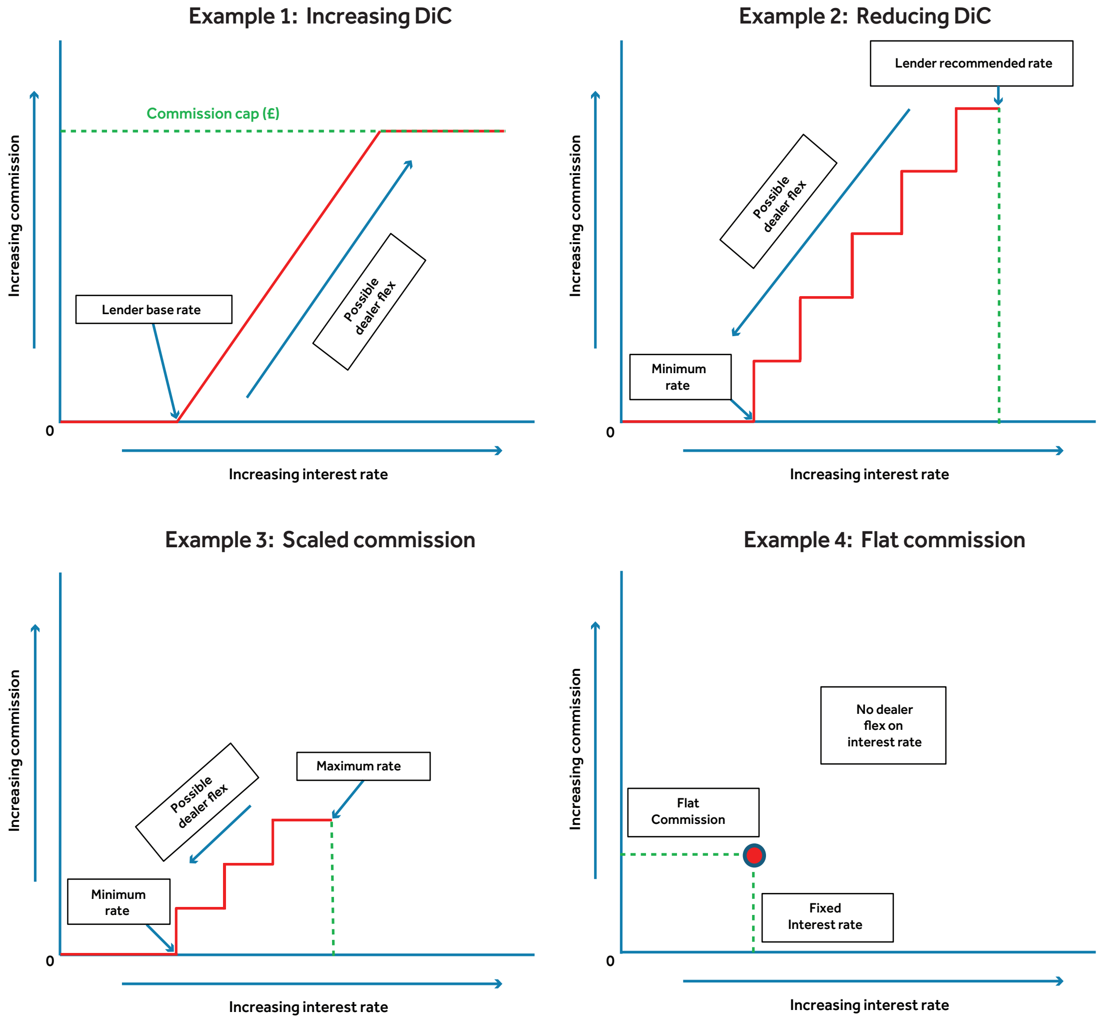
24 Also known as 'Increasing Difference in Charges'. Brokers are paid a fee which is linked to the interest rate on the agreement. The agreement between the lender and the broker sets a minimum interest rate, below which the dealer subsidises the loan. The dealer fee is a proportion of the difference in interest charges between the actual interest rate on the agreement and the minimum interest rate. See also Figure 1.

25 Also known as 'Reducing Difference in Charges'. Brokers are paid a fee which is linked to the interest rate on the agreement. The agreement between the lender and the broker sets a maximum interest rate and the dealer can lower the interest rate. The dealer receives the highest commission at the maximum interest rate and this reduces with lower interest rates. See also Figure 1.

26 Also known as a variable product fee, brokers are paid a variable which changes with certain product features such as type of agreement or the interest rate of the agreement. See also Figure 1.

27 Brokers are paid a fixed fee for each additional loan agreement they process. See also Figure 1.

Figure 1: Examples of motor finance commission structures



5.4 For some arrangements, the interest-linked element of the dealer's commission is significant and a large share of potential earnings. Also, differences between commission levels at the lowest and highest interest rates can be significant. Without appropriate systems and controls, Increasing DiC and Reducing DiC structures could provide incentives for dealers to arrange finance at higher interest rates.

5.5 In the next phase of our analysis, we are planning to test the effectiveness of lenders' systems and controls. We will undertake a lender survey to assess systems and risk controls with respect to commission structures and dealer incentives. This will include the extent to which lenders comply with relevant requirements and take steps to make sure that brokers acting on their behalf comply with CONC provisions such as disclosure of status, remuneration and commissions. We are collecting data on motor finance contracts to assess whether commission arrangements have led to higher finance costs as a result of the incentives they create for the brokers.

5.6 The new rules and guidance proposed in July 2017 in our consultation paper '*Staff incentives, remuneration and performance management in consumer credit*'[28] would apply to motor finance firms. Motor finance firms would be required to manage the risk of consumer harm that may arise from staff incentives, remuneration and performance management.

28 See FCA CP17/20, 'Staff incentives, remuneration and performance management in consumer credit: Findings from our thematic review and proposed new rule and guidance' (July 2017) – www.fca.org.uk/publication/consultation/cp17-20.pdf

6 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?

6.1 We are assessing the quality and transparency of information provided to consumers. Our review[29] found that the contracts are generally transparent. However, in some cases relevant information is spread across multiple documents which may make it difficult for consumers to absorb key information.

6.2 We have reviewed the websites of a sample of lenders and dealers. Our initial analysis suggests that terminology and language in general appear to be clear and consistent. However, we have seen cases where information is not sufficiently prominent and may not meet our requirements. We will continue to review further websites and address issues as part of our normal supervisory processes.

6.3 We are separately assessing, through a mystery shopping exercise, whether consumers have access to clear, timely and transparent information at the point of taking out motor finance. This will develop our understanding of current practices and whether consumers are aware of the risks and benefits of different motor finance options, including the cost implications. The mystery shopping exercise will allow us to test compliance with relevant regulatory requirements.

29 We have not at this stage looked at the transparency of pre-contract information and explanations provided to the consumer, including compliance with the Consumer Credit Act 1974 (CCA) and our CONC rules.

7 Next steps

7.1 Our work so far has allowed us to narrow our focus to issues where we see continuing potential for harm. We have found that the largest lenders' approach to credit risk and asset values appears robust. The growth in motor finance has been strongest for lower credit risk consumers, who are less likely to face repayment difficulties.

7.2 We want to make sure that consumers have sufficient, timely and transparent information when taking out motor finance, so that they can fully understand the different motor finance options, including the risks they may pose. We are testing this in a number of ways, including through a mystery shopping exercise.

7.3 We are undertaking further work on responsible lending, particularly the approach taken by motor finance lenders to assessment of creditworthiness (including affordability). Our work will be primarily (but not solely) focused on assessments for higher credit risk consumers (lower credit score).

7.4 We are doing further work in relation to commission arrangements. In particular, some commission structures create a strong link between the dealer commission and the interest rate charged to consumers. This can create incentives for dealers to arrange motor finance at higher interest rates. Without adequate systems and controls, this could lead to consumer harm.

7.5 We expect to complete our review of the motor finance market by the end of September 2018. At that stage, we will publish our findings, setting out any areas of concern we have identified and how we intend to tackle them.

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