Shifting gears: understanding the Financial Conduct Authority's stance on car finance

In October 2019, the FCA published a Consultation Paper (19/28) aimed at the motor finance industry proposing some significant changes to commissions and some less significant changes to customer disclosures. Yasin Sridhar, Regulatory Director at Konexo, a Division of Eversheds Sutherland, provides a rundown of the implications.

What are the changes?

The FCA proposes to fully ban discretionary commission models (difference in charge and scaled commission) which are linked to the interest rates paid by customers. This presents a sizeable reduction in available commission models which would, post-ban, effectively revolve around flat fee or those which are not perceived to incentivise increased commission at the customer's expense. In addition to the ban, they also want to improve the disclosure given to customers on the risks of financing. The disclosures will now have to be in financial promotions, not just when the recommendation for the product is made, be disclosed prominently, and explain how the arrangement would impact the price payable by the customer.

Why are they being made?

In its review of the motor finance industry, with an update report published in 2018 and final findings in 2019, the FCA sought to understand (among other things) whether the commission arrangements between lenders and brokers were causing conflicts of interests and whether information to customers on the risks of the loans was appropriate. The FCA found that the commission models used by lenders/brokers indeed featured misalignment of interests by allowing brokers to set the interest rate paid by the customer to improve their commission. The FCA did not find a strong enough link to the commission being paid and the level of service delivered to the client, nor was there consistency in the interest rate applied and the customer's credit risk. From a commercial perspective, the customer is paying more than it has to. Moreover, whenever brokers were explaining the finance arrangements, they were concentrating on the benefits rather than detailing the relevant risks or the consequences of non-payment. Lenders were also found to not be overseeing their brokers as readily as they should. The FCA feels that these practices are negatively impacting customers, leading to unfair outcomes.

What is the outcome the FCA wants?

By banning discretionary commissions and improving disclosure, the FCA is signalling that it wants a fairer and more transparent market. Fairer in that broker remuneration for selecting finance deals for car buyers is not determined at the discretion of the broker (by setting interest rates) and more transparent by improving the quality and type of risk warning presented to buyers. This change will, in the FCA's eyes, ensure that customers are treated fairly and put the industry on notice that current business practices will need to reviewed through this fairness and transparency lens.

What is TCF?

Treating customers fairly (TCF) is at the heart of these changes. Most regulatory interventions arising from business practices which disadvantage customers or keep them in the dark about the full risks of a product or transaction are done the name of TCF. TCF is one of the Principles for Businesses firms must abide by which is judged by certain outcomes, such as consumer confidence that there is fair treatment and that customer needs are met.

How does the FCA's review and regulation process work

The FCA has the power to implement regulatory rules and principles to bind financial services firms, subject to authority granted by statute. It undertakes reviews of firms through different approaches, some of them due to specific failings in compliance or as fact discovery with thematic reviews. Once it has published findings following its review, it can propose steps to amend any issues or introduce new rules through Discussion Papers or Consultation Papers. Discussion Papers are typically an attempt to propose new regulation by testing the waters, subject to feedback, whereas Consultation Papers (like the one in question) are an attempt by the FCA to show that it is minded to make rule changes subject to any valuable or clarifying comments from the industry. Once the consultation period closes, a Policy Statement is released making the proposed changes formally part of the regulatory regime; changes can also be made to the FCA's Handbook which governs regulated firms.

Because this is a consultation paper, the FCA is seeking responses to its proposed changes before making them into formal policy. If you are a lender or finance broker (or other concerned party) who feels that the commission arrangements currently in place are representative of value-add and are not gouging customers, now is your opportunity to challenge the FCA's assertions. Within the Consultation Paper, there are predictions made by the FCA on the economic impact of the discretionary commission ban. If firms do not believe the impact assessment of the ban or the representation of customer detriment caused by discretionary commissions is accurate, they can posit their interpretation at this stage in the regulation-setting process. Once the consultation period closes on 15 January 2020, it will be more difficult to get your point across.

Conflicts of interest

History tends to repeat itself and regulation is no different. Unlike the oft quoted cycle of "crisis, regulation, de-regulation, repeat", the conflicts of interest theme present in the FCA's action in the motor finance industry is not cyclical. It is the natural, linear extension of its regulatory agenda in removing or mitigating conflicts of interest arising between customers, firms, and third parties. In the context of car finance, this is the car buyer, the lender, and the broker (acting as agent).

Cultural considerations?

Inappropriate sales culture has been a bug-bear of the FCA for quite some time, initially in the banking and brokerage sector where unsuitable financial services products were being sold to customers or inaccurate advice was being tendered. This was driven by a culture of incentivisation, inducement, and short-term profit. A win for the firm and disregard for customer impact. The FCA has taken significant steps to reduce these practices in the investment space and now it will be looking closely at sales practices in car finance to see if the same issues are present and need curtailing. This focus will attend to buyer user experience and assess the conduct of brokerage staff and how lenders are overseeing brokers.

Board-level oversight

Executives of brokers and lenders will need to have more (and better) information to oversee the activities of sales and marketing personnel. For lenders, this requires a risk-weighted monitoring plan of their brokers to test compliance with their obligations, initial due diligence questionnaires, onsite monitoring visits, and standardised management information for discussion at committee-level. For brokers themselves, this requires a bit of introspection: are the remuneration practices and incentivisation structures you're committing to compatible with TCF as well as getting the most out of your staff and building sustainable profit? Have your staff been given adequate training on regulatory expectations specific to your firm, driven by your policies and overarching principles for business?

The emphasis on executive-level oversight of regulatory risks ties in well with the upcoming Senior Managers and Certification Regime (SMCR), which will replace the Approved Persons Regime the FCA uses to vet people who are working in financial services for certain functions (eg partners and directors, client advisors, significant management roles). SMCR places greater responsibility on firms to certify that certain staff are fit and proper to undertake their roles, and creates enhanced individual accountability for the conduct of all staff – not just senior management. This will include representations made about commissions and related disclosures.

How Konexo can help

We have been helping firms manage their regulatory risk across various industries within financial services and are uniquely placed to help firms impacted by the FCA's activity in motor finance. We have a mix of legal, compliance, and operational professionals who can support your firm in:

- Understanding incoming regulatory change
- Managing regulatory response
- Conducting risk assessments
- Reviewing your compliance function
- Third party oversight
- Improving governance

Yasin joins Ian Stott, Head of Financial Services, for a clinic at the Automotive Management Live 2019 conference in Birmingham on 7 Nov in conjunction with Arena Group. "If you're in the neighbourhood and want to ask us anything, please swing by. If not, we are available on ianstott@konexoglobal.com and yasinsridhar@konexoglobal.com and look forward to your questions."

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