FINANCIAL CONDUCT AUTHORITY

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20 January 2020

Dear CEO

Portfolio Strategy: Motor Finance Providers

As part of our new approach to supervision, implemented in 2018, we have put all the firms we supervise into different portfolios, each one being made up of firms with broadly similar business models. We have allocated your firm to the Motor Finance Providers portfolio[1].

The purpose of this letter is to:

1. Set out our view of the key risks motor finance providers pose to their consumers or the markets in which they operate;

2. Outline our expectation of motor finance providers, including in respect of how firms should be mitigating these key risks. You should consider the degree to which your business presents such risks and ensure that you have effective strategies for mitigating them; and

3. Describe our supervisory strategy and programme of work to ensure that firms are meeting our expectations, and that harms and risks of harm are being remedied and/or mitigated.

Our 'Motor Finance Providers' supervision strategy covers the period to August 2021.

Our view of the key drivers of harm

The FCA's Business Plan 2017-18[2] set out how we wanted to examine the motor finance market to develop our understanding of motor finance products, how they are sold, assessing whether the products cause harm to consumers and if the market is functioning effectively. Our concerns in this market were noted in our Motor Finance Report[3] published in March 2019.

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[1] The portfolio comprises firms entering into regulated credit agreements (including hire-purchase agreements) relating to the purchase of motor vehicles and regulated consumer hire agreements for motor vehicles.
[2] https://www.fca.org.uk/publication/business-plans/business-plan-2017-18.pdf
[3] https://www.fca.org.uk/publication/multi-firm-reviews/our-work-on-motor-finance-final-findings.pdf

In addition to this work we have also examined a range of information and data to further assess how firms in the portfolio could cause harm. Our analysis has considered the strategies, business models and drivers of culture for a number of firms. It also included a review of firms' regulatory histories and the number and nature of complaints.

Overall, it is clear that financing and insurance are important factors in shopping for cars and the value for money that consumers derive from their car ownership. A challenge exists that financing options can often be difficult for consumers to evaluate and understand, and that financing can be an important source of profitability for car dealers. The FCA is particularly concerned that the risks to consumers created by the profit incentives in motor financing and distribution business models are compounded by this lack of consumer understanding.

Through our analysis we see several key ways in which firms' interactions with consumers and markets can lead to harm, including:

- Firms innovating without considering the risks that the innovations might lead to, such as consumers being sold unsuitable or unaffordable products, and the attendant risks to firms' financial viability through exposure to residual car values;
- Conflicts of interest related to the way that some commission arrangements operate by providing strong incentives for dealers/brokers to charge customers higher interest rates;
- Lenders not complying with regulatory requirements, specifically around affordability assessments, leading to consumers obtaining unaffordable credit; and
- Firms not treating customers in default or in arrears difficulties with forbearance and due consideration.

Our areas of focus and expectations

The Motor Finance Providers portfolio includes both lending and hire models, with firms varying significantly in size. We expect you to maintain proportionate and relevant risk management, governance and oversight frameworks. These, as the systems and controls that support them, should be reflective of the risks of harm your firm presents. It is important that all firms in the portfolio ensure customers are being treated fairly.

We will prioritise our supervisory work in the following areas:

Evolving business models: we have observed some firms offering innovative/alternative services to reflect a market trend from car ownership to usership. We are supportive of innovation in the interests of consumers and we will monitor changes in the market place to determine if we need to respond more broadly. In the meantime, we remind you that you are obliged to notify us of material changes in your business model.

We are concerned that the changes in the market place could potentially put pressure on firms to move into areas of business where they have neither the expertise, nor the controls in place, to mitigate risks. We will engage with a sample of firms offering these innovative/alternative services to understand their business models. We will act quickly where we establish that firms have failed to adequately consider risks or to resource their business appropriately.

Prudential impacts: in 2018, our Prudential Specialists completed a review of the largest captive lenders[4] (accounting for over 50% of the total motor finance market). This assessment considered prudential risk management frameworks and tested whether sufficient capital existed to absorb a significant fall in used car values. We concluded that these lenders were adequately mitigating the risk of a severe fall in used car prices through realistic asset valuations and robust risk management processes. Stress testing showed that the financial impact of a significant fall in residual values would not materially impact overall financial soundness.

We are nevertheless concerned that structural changes in the marketplace and changes to business models could result in increased risk to firms' financial viability through falls in car residual values. In our Motor Finance Report published in March, we reminded firms to regularly consider structural changes in the market which could affect residual car value assumptions and undermine financial soundness. We propose to repeat this prudential work through proactive engagement with key market firms every 2-3 years.

Commission models and disclosure: in October 2019, we published CP19/28 *Motor Finance discretionary commission models and consumer credit commission disclosure*[5]. This proposes:

- Banning commission models in the motor finance market where the amount received by the broker is linked to the interest rate that the customer pays and which the broker has the power to set or adjust. We refer to these as 'discretionary commission models'.

- Minor changes to clarify aspects of our commission disclosure rules and guidance to give consumers more relevant information in all consumer credit markets.

The deadline for responding to our consultation was 15 January 2020. Subject to the responses we receive, we aim to finalise these rules at the beginning of Q2 2020. Firms would then have three months to implement our proposed ban on discretionary commission models. Our proposed changes to some of our commission disclosure rules and guidance would come into force on the day our rules are finalised.

If our proposed rules are introduced as planned in Q2 2020, we plan to monitor firms' compliance with the ban on discretionary commission models by carrying out supervisory work across a sample of firms. This would start three months from when the rules need to be implemented. We also plan to review how our intervention is working for consumers.

Affordability, arrears and forbearance: all finance providers should by now have implemented the affordability rules that came into effect in November 2018[6]. We will act swiftly where we discover that a firm's implementation of these rules has been inadequate.

Although loan arrears rates are generally low across this market, we have identified some firms whose reported arrears levels are higher in comparison to others. We recognise that high levels of arrears are not necessarily a result of inadequate affordability assessments. However, if your firm experiences high or growing levels of arrears and/or complaints, we expect you to

[4] Subsidiary businesses aligned/owned by a vehicle manufacturer/distributor
[5] https://www.fca.org.uk/publication/consultation/cp19-28.pdf
[6] https://www.fca.org.uk/publications/policy-statements/ps18-19-assessing-creditworthiness-consumer-credit

investigate the root cause and remedy any issues with affordability and arrears management. We continue to monitor such trends ourselves and engage with firms on these matters. We won't hesitate to take action on firms and senior managers if we find that a firm's practices are causing harm and/or have not been addressed.

Inactive/misreporting firms: we have identified some firms within the portfolio that do not appear to be using their hire permissions. It is possible these firms are no longer carrying out the services for which they required the permissions. If this applies to your firm we expect action to be taken to either vary or cancel any permissions that are no longer required.

A number of firms within the portfolio also hold permissions to provide debt management services. Firms holding these permissions are required to submit debt management returns and have prudential resources of not less than £5,000*. We have found that most of these firms are submitting regulatory returns that record 'nil' prudential resources. This would be a breach of our rules. If this applies to your firm you should review your regulatory returns and re-submit these to reflect the firm's true prudential resources.

*See CONC 10.2.2R. The total prudential resources requirement for firms carrying out debt management services are determined as the higher of:

- £5,000; and
- Proportion of the total value of relevant debts under management outstanding. This is calculated in the following way:
- 0.25% of the first £5 million,
- 0.15% of the next £95 million; and
- 0.05% of the remaining total value of relevant debts under management outstanding.

Next steps

We will be proactively engaging with a number of firms to assist us to complete our key priorities. Our reactive supervisory work will be supported by wider engagement and communication strategies to allow us to clarify our expectations of firms, identify harms and ensure appropriate mitigation is put in place.

We will act where we identify that motor finance providers have not put their customers at the heart of how they do business, for example, where lenders/hirers have put their own profits and income above paying due regard to customers' interests and treating them fairly. Our action will address both the firm's actions and the conduct of the senior managers responsible.

We expect you to take notice of the areas of concern we have set out, together with the new and proposed rules we have highlighted in this letter. You should examine your business and consider if you need to make changes to reduce harm, or potential harm, to consumers.

We will continue to seek to identify firms which appear to cause such harm. Whatever the size of your firm you should have appropriate governance, systems and controls in place. If we contact you we will expect you to be able to evidence these. If not, we will make full use of our regulatory powers.

In relation to Brexit, where EU withdrawal may impact customer relationships (for example, for customers based in the EEA), we expect firms to act in their customers' best interests and maintain clear communications throughout. We expect all firms to continue to plan for all scenarios, including a no-deal Brexit at the end of January 2020. You should consider the impact of Brexit on your business. You should have plans in place to address any risks for your firm and any impact it could have for your customers. Please see our factsheet for further details: https://www.fca.org.uk/publication/documents/is-your-firm-prepared-for-brexit.pdf

If you have any questions please contact your normal supervisory contact on 0300 500 0597. This is the primary point of contact for your firm's day-to-day interactions with the FCA, and further details of how we can be reached are available on our website at: https://www.fca.org.uk/contact.

However, we recognise that there may be occasions in which your firm faces urgent issues of strategic importance. In such significant circumstance, please contact me on 0131 301 2052 or at andrew.kay@fca.org.uk. If I am not available, then please contact one of my Managers, Gareth Morris, on 0131 301 2119 or at gareth.morris@fca.org.uk.

Yours sincerely

Andrew Kay

Head of Department / Retail Lending 1 / Supervision – Retail & Authorisations

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