Motor finance discretionary commission models and consumer credit commission disclosure

Consultation Paper
CP19/28***

October 2019

How to respond

We are asking for comments on this Consultation Paper (CP) by **15 January 2020**.

You can send them to us using the form on our website at: www.fca.org.uk/cp19-28-response-form

Or in writing to:
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Financial Conduct Authority
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London E20 1JN

Telephone:
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Email:
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1 Summary

Why we are consulting

1.1 This consultation paper (CP) seeks views on our plans to:

- address consumer harm in the motor finance market by banning commission models that can incentivise a broker (including motor dealers) to increase a customer's interest rate
- make minor changes to clarify aspects of our commission disclosure rules and guidance to give consumers more relevant information in all consumer credit markets

Who this applies to

1.2 Chapter 3 of this CP is directly relevant to:

- motor finance providers
- motor finance credit brokers, including motor dealers

1.3 Chapter 4 is directly relevant to brokers of regulated credit and consumer hire agreements across all credit sectors.

1.4 This consultation will also be of interest to consumer organisations.

The wider context of this consultation

1.5 We have undertaken extensive work in the motor finance sector that has led us to consult on these policy proposals to address harm.

1.6 In our 2017/18 Business Plan, we announced a review of the sector. We wanted to better understand the use of motor finance products, assess the sales processes employed by firms and consider whether the products could cause consumer harm.

1.7 In March 2018, we published an update report setting out what we had done and our initial findings. We also committed to focusing the remainder of our review on the issues of greatest potential harm to consumers. These included whether:

- lenders were adequately managing the risks around commission arrangements, and whether commission structures have led to higher finance costs for consumers because of the incentives they create for brokers
- consumers were being given the right kind of information, at the right times, to enable them to make informed decisions, and whether firms were complying with relevant regulatory requirements

- firms were properly assessing whether consumers can afford to repay the credit, particularly when lending to higher-risk consumers

1.8 In March 2019, we published our final findings. This included concerns over the widespread use of commission models that link the broker's commission to the customer's interest rate under the finance agreement and allow brokers wide discretion to set or adjust that interest rate. This gives rise to conflicts of interest and creates strong incentives for the broker to increase the interest rate paid by the customer to earn more commission. We estimated that this could be costing customers of the firms in our sample up to £300m a year when compared to flat fee models (where brokers are paid a fixed fee for each credit agreement they process or arrange).

1.9 We also found high levels of non-compliance with some of our existing commission disclosure requirements in our Consumer Credit sourcebook (CONC).

What we want to change and why

Banning 'discretionary commission models' in the motor finance market.

1.10 We are proposing a ban on commission models 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' throughout this paper. The most common examples in the motor finance market are:

- **Increasing Difference in Charges (DiC)** – also known as 'Interest Rate Upward Adjustment'. In this model, 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.
- **Reducing DiC** – 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.
- **Scaled commission models** – also known as a variable product fee. The broker is paid a fee which varies (within parameters) according to the interest rate.

1.11 Preventing lenders and brokers from using such discretionary commission models removes the financial incentive for brokers to increase the customer's interest rate. In turn, lenders should have more control over the prices (interest rates) individual customers pay for motor finance. With more control over the final interest rate, lenders will be able to profit from distributing a greater volume of loans. This should incentivise them to offer competitively priced loans, increasing competition in the market. Ultimately, we believe our proposals will result in a reduction in consumers' motor finance costs.

1.12 Further details are in Chapter 3 and our cost benefit analysis (CBA) is at Annex 2. This includes our analysis of why we do not propose to pursue alternative policy options.

Minor changes to our commission disclosure rules and guidance

1.13 We found that only a small number of brokers in our sample disclosed to the customer that a commission may be received for arranging finance. Where disclosures were made, they were often not prominent. We believe this is partly because our rules could be clearer on what we require.

1.14 So, we are also proposing minor adjustments to some of our CONC commission disclosure rules and guidance to give greater clarity on their intention. As our proposed changes would be relevant to firms outside the motor finance sector, they would apply across all consumer credit markets.

1.15 These proposals should give firms greater certainty on how to comply. This would increase the likelihood of consumers receiving more relevant information about commission arrangements. We believe this can help consumers to make better informed decisions, consider alternative options, find a cheaper deal or negotiate on the finance or other price or ancillary elements of the deal or transaction.

1.16 Further details are in Chapter 4 and our CBA at Annex 2.

1.17 The draft rules and guidance on which we are consulting are in Appendix 1.

Implementation

1.18 Subject to the responses to consultation we receive, we aim to finalise these rules at the beginning of Q2 2020. Firms would then have 3 months to implement our proposed ban on discretionary commission models. Our proposed changes to some of our CONC commission disclosure rules and guidance would come into force on the day our rules are finalised.

Measuring success

1.19 If our proposed rules are introduced as planned in Q2 2020, we would:

- **monitor** firms' compliance with the ban on discretionary commission models by carrying out supervisory work across a sample of firms, starting 3 months from when the rules need to be implemented by
- **review** how our intervention is working for consumers, starting in 2022

Next steps

1.20 We want to know what you think about the proposals in this paper. Please send your comments to us by 15 January 2020 using one of the methods in the 'How to respond' section on page 2.

1.21 We will consider your feedback and plan to publish a Policy Statement (PS), including any final rules, at the beginning of Q2 2020.

2 The wider context

Work carried out since the motor finance review

2.1 We explained in our motor finance final findings that we would carry out policy work with a view to consulting, subject to cost benefit analysis, on changes to CONC to strengthen existing provisions. We would also explore other policy interventions such as banning discretionary commission models or limiting broker discretion.

2.2 We have now undertaken that work. This has included collecting data from motor finance lenders and brokers on the implementation and operating costs of a range of possible policy interventions. We have also discussed our final findings report with both lenders and brokers.

2.3 In addition, since publication of our final report, our supervision team has followed up with firms on specific issues identified. For example, the motor finance review found that some lenders were not meeting our requirements on assessing creditworthiness by placing undue focus on credit risk (to the lender) rather than on whether the loan was affordable for the borrower.

2.4 As part of this follow-up work, individual feedback was provided to each of the lenders on our assessment of their creditworthiness (including affordability) checks. We found that lenders had considered our new rules and guidance published in PS18/19 last year and had made changes to their affordability assessments where necessary.

2.5 We are not proposing further changes to the rules on firms' creditworthiness assessments.

Scope

2.6 The scope of the proposals on discretionary commission models in this paper is limited to the motor finance market.

2.7 We are aware that DiC and similar commission models exist in other markets (for example, asset finance and premium finance). We do not currently have evidence to justify consulting on banning particular commission models in those consumer credit markets. However, if we identify evidence of harm in other markets, we will consider further interventions.

2.8 Our proposed clarifications to our commission disclosure rules would apply to most types of brokers across all consumer credit markets.

How our proposals link to our objectives

Consumer protection

2.9 We aim to make financial markets work well so that consumers get a fair deal and to secure an appropriate degree of protection for consumers.

2.10 We believe it is necessary to ban motor finance commission models that incentivise brokers to set customers a higher interest rate to earn more commission. Breaking the strong link between customer interest rate and broker earnings should decrease financing costs for consumers.

2.11 We also expect our proposed interventions to lead to improved transparency on interest charges and commission which would lead to some consumers being better able to engage with car finance solutions. In particular, this should facilitate shopping around as well as improved consumer trust and understanding of car finance.

Competition

2.12 We have an objective to promote effective competition in consumers' interests in regulated financial services. We also have a competition duty. Together, these empower us to identify and address competition problems and requires us to adopt a pro-competition approach to regulation.

2.13 We believe that our proposal to ban discretionary commission models will give lenders better control over the interest rate that consumers pay and foster greater price competition between lenders. Our proposed clarifications on commission disclosure should mean consumers are better informed and more likely to engage with what is on offer. This in turn should also promote competition.

Equality and diversity considerations

2.14 We have considered the equality and diversity issues that may arise from the proposals in this paper.

2.15 Overall, we do not consider that the proposals materially impact any of the groups with protected characteristics under the Equality Act 2010.

2.16 Other regulators – for example, the Consumer Finance Protection Bureau (CFPB) in the US and the Australian Securities and Investments Commission (ASIC) – have commented that, because of the incentives created by discretionary commission models, there is a risk of pricing decisions being made based on race or nationality. We have not observed a similar effect.

2.17 It is possible that some consumers will pay more as a result of firms moving towards flat fee commission models. However, we do not believe that potential redistribution across consumers will weigh disproportionately on consumers with protected characteristic under the Equality Act 2010, or financially vulnerable consumers who are more likely to have such characteristics. Our work on the distributional effects of our proposals is in our cost benefit analysis at Annex 2.

2.18 We will continue to consider the equality and diversity implications of the proposals during the consultation period, and will revisit them when making the final rules. In the meantime, we welcome input on any diversity implications from our proposals in response to this CP.

3 Motor finance – discretionary commission models

3.1 In this chapter, we set out:

- a summary of the relevant final findings from our motor finance review
- the harm we are looking to address
- our proposal to ban discretionary models in the motor finance market
- alternative options we have considered, but have discounted, to address harm

Summary of findings

3.2 Our motor finance review explored whether commission models could give rise to conflicts of interest. We collected data from lenders to assess whether these have led to higher finance costs for consumers. This involved a sample of around 1,000 motor finance transactions from 20 lenders representing about 60% of the market. These transactions covered January 2017 to July 2018 and represented a range of customers with different credit risk profiles, as well as a range of brokers.

3.3 Flat fee commission models – where the broker receives the same commission regardless of the amount of work carried out, the credit risk of the customer or the interest rate – were the most prevalent among transactions involving higher credit risk customers. Flat fee models accounted for around 60% of the volume of lending within that segment. Increasing and Reducing DiC models were more prevalent in the mid-range of credit risk, accounting for around 75% of lending within that segment.

3.4 Broker earnings varied significantly across the commission models, particularly for Increasing DiC, Reducing DiC and Scaled models. Excluding extreme outliers, the difference between the average and highest commission was around £2,000 for the DiC and Scaled models, compared to £700 for the flat fee commission model.

3.5 We analysed the relationship between commission rates and interest rates using an econometric model. This model controlled for other factors that might affect customer interest costs, such as the customer's credit score, income, the size of the loan and the length of the agreement. Our analysis showed that commissions are strongly associated with higher interest costs for DiC models and we did not see a strong association between a customer's credit risk and their interest rate.[1]

3.6 For example, our model showed that a £1 increase in broker earnings is associated with a £1.30 increase in customer interest costs under the Reducing DiC model. Our model also shows that these effects are statistically significant.

3.7 On a typical motor finance agreement of £10,000, increasing commission under a Reducing DiC model typically leads to an increase in interest costs of around £1,100 over a 4-year long agreement. This represents an increase of around 50% in interest

1 This model is presented in greater detail in Annex 3.

costs. Similar results apply for Increasing DiC. For the Scaled commission model, the association is smaller. In flat fee models it disappears altogether.

3.8 Next, we used the results of our econometric model to compare the effects of discretionary commission models on customer interest costs against a baseline of flat fee models. We estimated that 560,000 customers of the firms in our sample could pay in total £300m more annually in interest costs.

3.9 Our subsequent analysis, detailed in Annex 2, involved scaling this figure up to the whole market. This gives an estimated figure of approximately 924,000 customers paying in total around £500m in additional interest costs.

Harm we want to address

3.10 We want to eliminate the harm caused by discretionary commission models.

3.11 We have found a significant difference in the amount of interest customers pay when taking a motor finance deal arranged through a broker who benefits from a discretionary commission model compared to a flat fee model.

3.12 Breaking the link between interest rate and commissions should remove the incentive for brokers to set a higher interest rate and so should decrease financing costs for consumers.

3.13 This harm occurs most markedly among Increasing DiC and Reducing DiC models. However, if we were to only address harm caused by DiC models, those Scaled models that incentivise brokers to set a higher interest rate to earn more commission would pose a risk in that they already lead to higher prices. They could become more prevalent and/or brokers given more discretion on setting the interest rate.

Proposal

3.14 We are proposing a ban on discretionary commission models. We believe that this is the most effective way of mitigating harm, while also being consistent with our objectives. Our CBA is set out in Annex 2. Annex 3 presents the data analysis developed in the Motor Finance Review.

3.15 A ban would remove the incentive for brokers to set a customer a higher interest rate. Preventing lenders and brokers from using discretionary commission models should give lenders better control over the prices their customers pay for motor finance. This should incentivise firms to offer competitively priced loans, increasing competition on motor financing terms in the market (see paragraph 1.11 above).

3.16 While a ban would eliminate harm caused by discretionary commission models, not all of that harm will result in equivalent benefits to consumers – something that is true whatever intervention we could make. However, banning discretionary commission models delivers the most benefits to consumers of all the options we have considered. We estimate this at around £165m each year – see the CBA at Annex 2.

3.17 We do not expect our intervention to result in significant unintended consequences for brokers or lenders. We know that, since we published our final findings, some firms have moved, or intend to move, away from using discretionary commission models in recognition of the harm they cause. We have been told that some lenders want to move away from these models, but are wary of losing contracts with motor dealers to those lenders that do not. Banning discretionary models would remove this potential disadvantage.

3.18 In our draft rules at Appendix 1, we propose defining 'discretionary commission arrangement' with reference to the total charge for credit, rather than just the interest rate. This is designed to prevent firms from circumventing our proposed ban.

3.19 Under our proposed ban, brokers would still be able to earn commissions from fixed fees or variable commission models that are not dependant on the interest rate.

3.20 Our proposed rules would also continue to allow firms to operate models where the amount of commission is determined by the amount of work carried out by the broker. 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 make an initial assessment. For example, in the case of customers who are a higher credit risk, a more detailed assessment of affordability may be necessary. However, we did not find evidence of brokers undertaking more detailed work where they earned a higher commission in the sample of agreements we looked at in our motor finance review.

3.21 If we implement our proposals as intended, we will monitor whether firms operating variable commission models, such as those described in the above paragraph, are complying with the ban on discretionary models.

Q1: Do you agree with our proposed ban on discretionary commission models in the motor finance market?

Implementation

3.22 In collecting implementation cost estimates from firms, we asked them to assume a 3-month implementation period for each of our proposals. Our CBA is based on that.

3.23 We believe that this is an appropriate amount of time for firms to renegotiate their contracts and implement any systems or process changes necessary to comply with a ban on discretionary commission models.

Q2: Do you agree with a 3-month implementation period?

Other options considered

3.24 We have considered other options to address the harm we have seen in this market. While they might be marginally less intrusive and less costly for firms to implement, we do not believe that any would meet our objective and deliver the benefits that we expect to see from banning discretionary commission models.

3.25 Those options are set out below. Annex 2 summarises the costs and benefits of each, relative to our preferred option (see paragraph 123, Table 4).

3.26 We have also considered whether it is appropriate for firms in this market to accept commission in any form. However, we consider banning lenders from operating any commission based models in motor finance to be too invasive an intervention and a disproportionate approach to address the harm we have identified with particular commission models in this sector.

Limiting broker discretion

3.27 We looked at limiting the amount of discretion brokers have in setting interest rates, relative to a lender's recommended (or base) rate. This intervention would be similar to that implemented last year by the ASIC. While that model bans Increasing DiC, a Reducing DiC is allowed. A broker is allowed to offer an interest rate more than 200 basis points (bps) lower than the lender's specified base rate, but the reduction in commission must be commensurate with a maximum 200bps reduction in the interest rate so that lower commissions are paid to the broker where the interest rate reduces.

3.28 Overall, in our survey both lenders and brokers considered fewer customers and/or transactions would be affected by this policy compared to banning discretionary commission models and so the benefits would not be greater.

3.29 We are also concerned that this option, while limiting the harm identified to an extent, would still give brokers an incentive to set the highest rate possible. Similarly, lenders could still set an artificially high or low base rate. Brokers could also respond by allocating different interest rate ranges to different lenders in their portfolio, allowing them as much discretion as possible by arbitraging between lenders.

New disclosure requirements

3.30 We also considered whether significant changes to our disclosure rules would mitigate the harm, either as a standalone proposal or in combination with others. This included requiring firms to tell a customer, possibly orally, about the nature of the arrangement (rather than just its existence) and/or the amount of commission.

3.31 We have decided not to pursue this option. Although consumers could be affected by the amount of commission involved, we doubt whether such changes would result in a significant change in behaviour. Consumers are unlikely to engage with detailed explanations of complex commission models. So, the harm cause by discretionary commission models would likely not be significantly mitigated.

3.32 In response to our costs survey, firms also felt that there were practical difficulties in implementing this option. The survey highlighted the relatively high costs to firms in explaining information (possibly orally) about the nature of commission arrangements and the subsequent training and monitoring implications.

3.33 Some were unable to quantify such costs. As a result, the costs of this option would likely be higher than those submitted to us in our compliance cost survey.

3.34 We are however proposing clarifications to our disclosure requirements – see Chapter 4.

Allowing discretionary commission models to operate but only with sufficient justification

3.35 We considered whether discretionary models should be allowed, albeit with firms having to justify in their record keeping any difference in commission – eg based on the extra work involved, and the resulting higher interest rate, because the customer is a higher credit risk.

3.36 We and firms saw practical difficulties with this approach. Firms thought it would be difficult to determine the level of additional work needed to justify a higher commission. Additionally, justifications would likely be subjective and so could lead to wide variances in approach by different firms. We were also concerned about the risk of firms gaming this option to justify the ongoing use of discretionary commission models.

4 Commission disclosure in consumer credit markets

4.1 In this chapter, we set out:

- a summary of the relevant findings from our motor finance review
- the harm we are looking to address
- our proposal to clarify CONC provisions regarding commission disclosure

Disclosure requirements and summary of findings

4.2 The information we expect firms to disclose about commission is set out in CONC.

- CONC 3.7.4G states that, in the course of a financial promotion, 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.
- CONC 4.5.3R requires 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
- Brokers are also required to disclose the likely or known amount of commission they receive, if the customer requests it (CONC 4.5.4R).

4.3 In 2018, we carried out a mystery shopping exercise to understand how motor finance sales were being made in practice. This included looking at whether firms were providing customers with the right kind of information, at the right times, to enable them to make informed decisions.

4.4 Our mystery shopping found that only a small number of brokers disclosed to the customer 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.

4.5 In our final motor finance findings, we made clear that brokers should review their policies and procedures to ensure they are complying with the CONC rules, treating customers fairly and taking steps to address any shortcomings.

Harm we want to address

4.6 We are concerned that consumers are not being provided with the right information about commissions at the right time. This can limit consumers' ability to make informed decisions and, ultimately, choose the deal that is right for them.

4.7 Our work shows that firms are interpreting our commission disclosure provisions inconsistently. We have seen firms:

- uncertain about whether disclosure of commission is triggered when they are promoting a product and during the sales process
- interpreting CONC 4.5.3R narrowly, on the basis that they are promoting but not 'recommending' a product or that disclosure would be unlikely to affect the customer's decision
- state that a commission 'will or may be payable' without elaborating in any way – for example, by stating the amount may vary by lender or product

4.8 As a result, these disclosures, where made, are often not prominent nor early enough in the process to influence a customer's decision making.

4.9 Although our mystery shopping exercise was limited to motor finance sales, we are concerned that our disclosure rules could also be being misinterpreted and applied too narrowly by firms in other markets.

Proposal

4.10 To avoid this narrow interpretation being taken, we believe it would be helpful to clarify CONC 3.7.4G and 4.5.3R to better reflect our intention that customers receive more relevant information about the existence of commission. These clarifications would apply to all credit broking, not just in the motor finance market. Our proposed change to CONC 4.5.3R also applies to consumer hire brokers by virtue of the application of CONC 4.5.

4.11 In our draft rules at Appendix 1, we are proposing that:

- CONC 3.7.4G is amended so it is clear that firms should disclose the nature of commission in their financial promotions (as well as when making a recommendation). Guidance clarifies that firms should consider the impact commission could have on a customer's willingness to transact and that firms should consider whether and how much commission can vary depending on the lender, product or other permissible factors and tailor their disclosures accordingly.
- CONC 4.5.3R clarifies that the existence and nature of commission arrangements where the commission varies depending on the lender, product or other permissible factors should always be disclosed prominently. The disclosure must also cover how the arrangements could affect the price payable by the customer.

4.12 While our proposed ban on discretionary commission models should mitigate much of the harm in the motor finance market, we believe that clarifying the above CONC provisions will provide further benefits in this market. Firms will need to consider the proposed clarifications in the context of other variable commission models they use.

For example, where lenders pay different amounts, or where a lender pays a different amount depending on the product taken.

4.13 Clarifying these provisions to better reflect their intention should help consumers make better informed decisions, consider alternative options, find a cheaper deal or negotiate on the finance or other costs associated with the deal (eg part exchange values).

4.14 If we proceed with these changes, we propose they take effect on the day we publish any PS and make rules as they are intended to provide clarity on existing CONC provisions.

Q3: Do you agree with our proposed commission disclosure clarifications?

Q4: Do you agree our proposed commission disclosure clarifications should apply across all consumer credit markets?

Q5: Do you agree our proposed commission disclosure clarifications should take effect on the day the rules are made?

Annex 1
Questions in this paper

Q1: **Do you agree with our proposed ban on discretionary commission models in the motor finance market?**

Q2: **Do you agree with a 3-month implementation period?**

Q3: **Do you agree with our proposed commission disclosure clarifications?**

Q4: **Do you agree our proposed commission disclosure clarifications should apply across all consumer credit markets?**

Q5: **Do you agree our proposed commission disclosure clarifications should take effect on the day the rules are made?**

Q6: **Do you agree with our analysis of the costs and benefits of the proposals?**

Annex 2
Cost benefit analysis

Introduction

1. The Financial Services and Markets Act 2000 (FSMA) requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made and an estimate of those costs and of those benefits'. Section 138I also provides that if, in our opinion, the costs or benefits cannot reasonably be estimated or it is not reasonably practicable to produce an estimate, the cost benefit analysis need not estimate them; in that case, the CBA must include a statement of our opinion and an explanation of it.

2. This CBA is split into 2 sections:

A. Ban on discretionary models

B. Minor changes to certain CONC commission disclosures

A. Ban on discretionary models

3. This CBA presents our analysis of the impacts of our proposal. We also provide monetary values for the impacts where we believe we can reasonably estimate them and it is reasonably practicable to do so.

4. Our proposals are based on reaching a judgement about the appropriate level of consumer protection, taking into account all the impacts we foresee.

5. This CBA Annex has the following structure:

- problem and rationale for the intervention
- our proposed intervention
- baseline and key assumptions
- the costs of our proposed intervention
- the benefits of our intervention

Problem and rationale for the intervention

6. In March 2019, we published our Motor Finance Review final report. Our analysis of the commission arrangements in this sector concluded that issues we identified made it necessary for us to consider options for a policy intervention.

7. Lending to motorists to finance their car purchase has grown significantly in the recent past. According to data from consumer research agency Mintel,[2] approximately 2.4m vehicles were financed in 2018, compared to 1.7m in 2013. The average amount advanced was £15,280. Overall penetration of car finance is 26% of the total number of cars sold in 2018.[3]

8. Most specialist motor lending is either secured against the value of the vehicle, which means that the vehicle may be repossessed if the consumer defaults, or the lender is the legal owner of the vehicle for the duration of the contract. Most loans are introduced to consumers at the vehicle point of sale, by motor dealers.[4] Because of this, we refer to brokers of car finance as 'broker-dealers'.

9. In the remainder of this section, we present our assessment of the issue identified in the Motor Finance Review. Annex 3 presents the data analysis developed in the review.

Description of the harm

10. The Motor Finance Review final report identified a conflict of interest in the structure of certain commission arrangements between motor finance lenders and their broker-dealers. These commission arrangements allowed broker-dealers to optimise their commission earnings at the expense of consumers, because their commission level was directly linked to the final interest rate paid by consumers that brokers were able to set to a large extent.

11. In the report, we explained that the conflict of interest was identified for commission arrangements which matched our definition of "increasing difference in charge", "decreasing difference in charge", and those "scaled" commission models that incentivise brokers to set a higher interest rate to earn more commission.[5] In what follows, we refer to these arrangements as the "discretionary models", and to the share of market where these arrangements take place as the "affected segment".

12. The report demonstrated a relationship between this incentive and inflated interest charges. Using econometric analysis, it showed that transactions achieved under these models displayed a strong association between increases in commission and increases in interest costs, even after controlling for factors that may influence total interest costs.

13. To summarise, we found that conflicted incentives from discretionary models lead to significant consumer harm, in the form of higher interest costs. In the final report, we explained that '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.'[6]

2 Mintel UK Car Finance report, June 2019
3 The penetration rate is very high for new cars, at 91%, and much lower for used cars, at 18%.
4 82% of consumers say so, according to Mintel's UK Car Finance report, June 2018 (Figure 3).
5 See paragraph 1.10 in Chapter 1 of this CP for definitions.
6 "Our work on motor finance final findings", paragraph 2.17. The precise estimate of £307.5m is used in this CBA rather than the headline £300m figure.

14. Extrapolating proportionally to the rest of the market, this estimate of harm would amount to £500m.[7]

15. We note that we did not find evidence that the harm primarily affects vulnerable consumers. In fact, the majority of affected consumers were in the near-prime category of credit scores.[8]

Description of the drivers of harm

16. As explained above, discretionary commission models present conflicts of interest for the broker, at the expense of the consumer. This leads to higher interest costs for consumers, compared to a counterfactual of lower interest costs in a non-conflicted market. This harm arises from brokers' ability to optimise their commission earnings by setting consumers' interest rates.[9]

17. The potential for harm in this market is caused by the position of the broker in the supply chain. Because the broker is an intermediary between two parties, the consumer and the lender, there is a dual **principal-agent problem**.[10] On the consumer's behalf (downstream), the broker identifies a finance solution for the consumer. On the lenders' behalf (upstream), the broker promotes their lending proposals and distributes them as efficiently as possible.

18. In this context, harm arises if brokers are incentivised in a way that results in them acting against the interests of one or more of the parties. Brokers need to optimise across multiple constraints – the lenders' incentive structure (contract), consumers' satisfaction and willingness to pay, and their own profit function, which depends on the main vehicle sale as well as the finance.

19. Within this principal-agent structure, harm arises for three main reasons: the discretionary models' conflicting incentives affects the pricing of consumers' final interest rates; and this is compounded by the informational advantage of the broker vs the consumer, as well as by consumers' behavioural biases.

20. First, the principal-agent relationship between brokers and lenders means that under certain contractual arrangements brokers face **conflicting incentives** to lenders, who rely on them for distribution, leading to interest rates being higher than they otherwise would be.

21. Indeed, in the case of discretionary models, lenders generally indicate their preferred minimum interest rate, and allow broker-dealers to set an additional margin on this minimum. This means that lenders have an incentive to offer finance at interest rates that maximise their profit. However, broker-dealers' incentive is to maximise their own profit by optimising the combination of profit made with the volume of vehicles sold and commission earnings. Thus broker-dealers do not necessarily offer end-

7 While significant, this estimate of harm represents a fraction of the interest due by consumers. Given that we estimate motor finance loans to represent £13.5bn in interest due over the course of the loans, the harm would account for approximately 3% to 4% of all consumers' interest due yearly.

8 See Motor Finance Review final finding, paragraph 2.8.

9 We note that brokers' profit maximisation is nonetheless constrained by a variety of economic factors, most notably, overall profitability of their operations; consumers' price-sensitivity and satisfaction; and lenders' willingness to pay.

10 The "principal-agent problem" terminology used here refers to its economics definition and not to the corresponding competition law notions or the nature of the legal relationships. In economics terms, a principal-agent problem arises when one party (the agent) acts on behalf of the interests of another (the principal).

consumers interest rates that maximise the profits from loans sold.[11] In other words, their incentives are not fully aligned with the objectives of lenders. This may mean, for instance, that they would quote higher interest rates to receive higher commission, even if this leads to fewer loans sold.

22. The result is that the final interest rate offered will be higher compared to what a vertically integrated lender would offer. This is because both the lender and the broker-dealer set prices to optimise their margin levels independently, without taking into account the impact of their decision on each other's profits. A single operation would instead set an interest rate for the consumer that would maximise profit for the whole supply-chain, by taking into account the impact of the final price, and volume sold, on the overall profit.

23. Second, the broker enjoys **informational advantages** compared to both other parties, ie the supply chain is characterised by information asymmetries.[12] Brokers benefit from an extensive knowledge of car finance options, which the consumer does not have. Consumers may not be aware that in some transactions there is a link between the broker's commission level and the interest rate that brokers are quoting them.

24. Third, the risk that the information asymmetry between brokers and consumers leads to harm is notably driven by the complexity of the transaction which could trigger **behavioural biases** for consumers, such as **limited attention and limited financial awareness**.[13]

25. Market research shows that consumers generally are engaged in their vehicle purchase. In particular, a large proportion of consumers consider several options and are price sensitive.[14]

26. However, we expect that consumers' attention varies across the different elements of the transaction, depending on the order in which consumers consider each element for instance.[15] Research shows that during a car purchase, a minority of consumers considers their financing options early.[16] Also, consumers may be applying simplifying rules of thumb to consider the financing costs. Finally, consumers also vary in their knowledge of products and options.

27. Broker-dealers may exploit consumers' limited attention to the cost of finance. Indeed, even if consumers are attentive to the price of the main vehicle and the monthly cost of paying for the car, they may not be as aware of the cost of motor finance in isolation to the cost of purchasing the vehicle, or other forms of finance. This may make it more difficult for consumers to compare prices of different finance solutions for the same vehicle, and generally of different car purchase options. These behavioural issues are

11 In the economic literature, this is called 'the double marginalisation' problem.

12 See Occasional Paper 13, "Economics for Effective Regulation", page 12.

13 For a discussion of behavioural biases in retail finance see Occasional Paper 1, Applying behavioural economics at the Financial Conduct Authority.

14 Several publicly available market reports illustrate these points. Notably, the following recent sources show that a large proportion of consumers are price sensitive and consider options:
- Deloitte, "Navigating the consumer journey" 2018: 43% to 47% of consumers visit other dealerships apart from the one where they acquired their current vehicle. 66% of consumers cite price in the most important aspects of their vehicle purchase. (link: https://www2.deloitte.com/uk/en/pages/manufacturing/articles/automotive-consumer-study.html)
- Auto trader, "The Car Buyers Report", 2017: 47% of consumers decide on the price they are prepared to pay in the initial stages of the decision process. Consumers consider 3 car options on average. (link: https://trade.autotrader.co.uk/assets/downloads/Auto%20Trader%20Car-Buyers-Report-%20September%202017.pdf)

15 See Occasional Paper No.1, Applying behavioural economics at the Financial Conduct Authority.

16 AutoTrader's Car buyer report (September 2017) indicate for instance that 47% of consumers thought about the price of the car when considering car purchase options, vs 35% about total cost of ownership, and vs 27% about finance.

reinforced by the fact that broker-dealers do not always provide sufficient and timely information, as evidenced by the mystery shopping data analysed in the Motor Finance Review final findings.[17]

28. Given these issues, discretionary models cause harm to consumers because they create a powerful incentive to maximise their commission earnings by selling finance at higher interest costs to less price sensitive consumers.

Our proposed intervention

29. We are consulting on banning the discretionary models of commission that allow brokers to optimise their commission level by setting the interest rates paid by consumers.

30. Our proposed intervention aims at preventing the conflict of interest that arises from these models. We expect this intervention to lower the interest charges of consumers who would have financed their car purchase through a loan introduced under one of the discretionary commission models. Such loans will be intermediated through alternative arrangements post-intervention, which would not incentivise brokers to maximise consumers' interest charges in order to maximise their own commission.

31. We also expect increased lender control over the final interest rate to foster price competition between lenders. Indeed, as lenders will control their prices more closely, they will have an increased incentive to expand the adoption of car finance by pricing competitively.

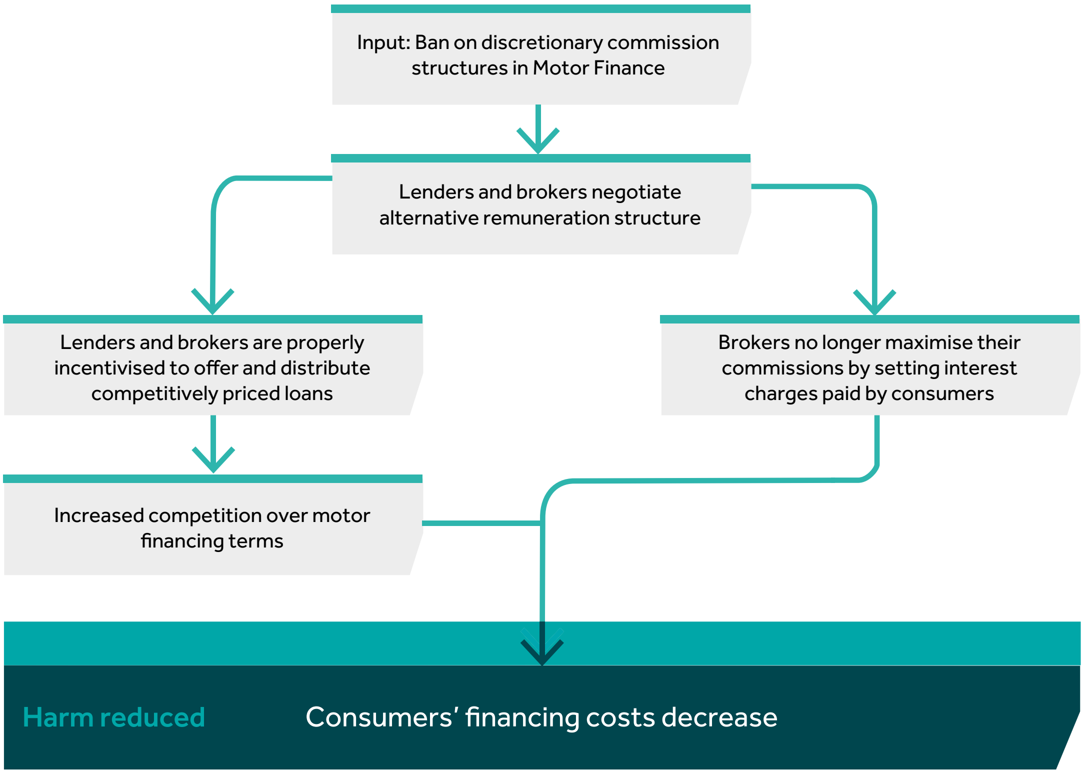
32. Finally, we note that the proposed intervention does not prevent flexibility in interest rate, and it does not prevent brokers to earn performance-related flexible commission, as long as the commission does not depend on interest rates set by the broker, a metric controlled by the broker and which directly affects consumer outcomes. This means that the industry should keep the ability to price for risk and/or offer promotional discounts to consumers when appropriate, and that solutions remain to adequately incentivise brokers to effectively distribute motor finance loans.

33. Our Motor Finance Review found that the loans originated within the discretionary segment showed a weaker link between the interest rate and consumers' credit scores, compared to other commission models. A customer's interest rate should be based, for example, on credit risk, rather than driven by misaligned incentives for the broker. We would expect this to be the case following our proposed intervention.

17 See paragraphs 3.25-3.26, here: https://www.fca.org.uk/publication/multi-firm-reviews/our-work-on-motor-finance-final-findings.pdf

34. The following figure summarises what we expect from our proposed intervention.

Figure 1: Causal chain for our proposed intervention



Baseline and key assumptions

35. Our working baseline scenario has been that, absent the intervention, we would expect the status quo described in the Motor Finance Review final findings largely to remain.

36. We note that the industry has shown some willingness to move away from increasing difference-in-charge models.[18] We also note that car finance may expand in the used vehicle segment, which could potentially increase the number of consumers harmed.[19] However, car purchases are sensitive to macroeconomic conditions, and a contraction in the automotive market will also limit the extent of harm temporarily. These three hypothetical developments have the potential to balance one another.

37. Therefore, in the absence of evidence that industry trends are likely to reduce or increase the harm, we assume that the harm is likely to remain constant.

38. In this paper, we make the following assumptions:

- The size of the motor finance market will remain stable in the short term
- Commissions in the affected segment will be renegotiated as a result of our intervention and will remain higher than commissions in the unaffected market segment, because the consumer profile in the affected segment differs from the unaffected segment.

18 However, our MFR final findings indicated that the risk of harm from Reducing DiC was not lesser than increasing DiC, so we would not expect a transition from the latter to the former of these models to significantly impact the harm.

19 Mintel's UK Car Finance report (2018) indicates that penetration rate of finance is of 88% for new car sales, but only 17% for used cars.

- Implementation costs are extrapolated under the assumption that our sample is representative of the whole industry, because our sample covers a large proportion of the lender and broker market. Furthermore:
  - With regard to firms which would be affected by the proposals, we saw no significant relationship between firm size and the scale of impact. Therefore, we do not expect that potential differences in scale, between our sample and the broader population, will have a material impact on our estimates.
  - With regard to the remaining firms, we do not have evidence that the proportion of firms unaffected by our proposal is unrepresentative of unaffected firms overall.
- Benefits derived from the loans data collected during the Motor Finance Review are extrapolated under the assumption that they are representative of the whole market. This is because the sample of loans we collected is representative of the portfolios of lenders and their agreements with brokers. Furthermore, the sample of lenders represents a large share of the overall market for motor finance. As such we would not expect that collecting full motor finance loan portfolios from all lenders would produce materially different results.

39. The rationale for these assumptions are discussed where relevant in the following sections.

Summary

40. The following table sets out the costs and benefits of the proposed ban, under our negotiated scenario (as defined in paragraph 84 and what follows). It does not include unquantified benefits, such as non-price impacts of increased competition, which could benefit consumers, but also lenders, as it is not reasonably practicable to quantify those benefits. Furthermore, these unquantified benefits would likely scale in proportion to the quantified benefits, since they are also related to the degree to which our proposals address the poor incentives of discretionary models.

Table 1: Summary of quantified costs and benefits (negotiated scenario)

		Costs	Benefits
Lenders	One-off	Implementation – £13m	
	Ongoing	Implementation – £2m	
		Indirect (revenue loss) – £40m	
Brokers	One-off	Implementation -£17m	
	Ongoing	Implementation – £3m	
		Indirect (revenue loss) – £125m	
Consumers	Ongoing		Lower interest – £165m
FCA	Ongoing	Supervision costs – covered as part of our business as usual activities	
Total (excl. indirect costs) in first year		£35m	£165m
Total (excl. indirect costs) per year in subsequent years		£5m	£165m

Note: Costs in italic are a transfer from firms to consumers.

41. We note that the major impact of the proposed intervention is a transfer from firms to consumers. Accordingly, simply comparing the total costs and benefits of the proposal, the costs (including the lost profits for firms) would outweigh the benefits. However, the intervention is designed to address the harm found in the market, which manifested in terms of higher interest charged to consumers. When taking into consideration the implementation costs only (ie excluding the firms' indirect cost that translates into a transfer to consumers), and the consumer benefits, the intervention is net beneficial.

Costs

42. We expect the proposed ban would impose costs on brokers, lenders, consumers and the FCA.

43. Brokers and lenders would face direct costs of implementing the rule change and indirect costs arising from reduced revenue and profits. Our analysis of the costs to firms is based on estimates provided by a sample of firms that we surveyed. In the following section, we present the results of our analysis of these implementation costs.

Implementation costs to firms

Survey methodology

44. In May 2019, we surveyed 69 firms in the motor finance industry, to collect data to enable us to assess the costs and other impacts of four potential policy changes we were considering. 20 lenders and 19 brokers responded. We have used their responses to estimate the costs of implementing a ban on discretionary commission models.

45. We asked firms to estimate their one-off and ongoing costs. We asked for these in several cost categories: IT development, training, communication, governance, operational, staff and other costs. Firms also provided sales and commission data by commission models and for different lines of business, so that we could compare the impact on firms with different business models.

46. The firms had varying interpretations of where their costs would fall. Some firms saw the expense of implementation largely falling within their IT budget, while others considered implementation to be a governance, operational or training challenge. This is partly because of the firms' varying structures and business models, and partly because of inconsistent use of the cost categories. Some firms, for example, included executive time within training costs rather than governance. In the light of these differences, we have focused our analysis on the aggregate costs reported by firms, which are relatively consistent, rather than the cost breakdowns.

Lender implementation costs

47. We surveyed large, small, and mid-sized lenders. The smaller lenders we surveyed make fewer than 10,000 loans a year, while the larger lenders make over 200,000.

48. We expect lenders to incur costs familiarising themselves with the rule change and conducting a gap analysis of the required adjustments. Where their previous commission arrangements are banned, lenders will need to design new pricing models, and communicate and renegotiate contracts with brokers. Further, lenders are likely to spend time conducting change management programs to oversee the shift in business practice, train staff, or potentially adjust pay or staff levels. Lenders may also need to adapt, and then maintain, IT systems and processes, to keep up to date with the wider business changes.

49. Half of our sample of 20 lenders expected to incur costs if we ban discretionary commission models. In aggregate, they foresaw the proposed ban imposing a one-off cost of £7.8m and ongoing costs of £1.4m a year. On average, each affected lender foresaw a one-off cost of £780,000 and ongoing costs of £140,000 a year.

50. The total advanced from the lender sample was £24.8bn a year. Ipsos MORI puts the whole motor finance market at £41.0bn of lending a year.[20] So, our sample of lenders represents 61% of the motor finance market by lending volume.

51. Extrapolating our survey results to the whole lending market implies that, in aggregate, lenders will incur a one-off cost of £13m and ongoing costs of £2m a year to implement our proposals. This is a total cost of £15m in the first year.

Broker implementation costs

52. We also surveyed large, small, and mid-sized brokers. The smaller brokers we surveyed facilitate fewer than 5000 car finance loans a year, while the larger brokers facilitate more than 100,000 loans a year. 19 brokers responded to our survey.

53. We expect brokers to incur implementation costs to implement the proposed rule change. Like lenders, they would initially incur costs familiarising themselves with the rule change and conducting a gap analysis of what to change, and might need to update and maintain IT systems. Where their commission models are banned, brokers would need to renegotiate contracts with lenders. Brokers would need to train staff in how changes in the commission structure affect their remuneration and interaction with consumers, and in some cases reconsider pay and staff levels.

54. One broker projected costs an order of magnitude larger than its peers, when viewed as a percentage of commission earned. The broker's other characteristics were not unusual so, for our main cost estimate, we assume its true costs would be consistent with the market average. We will return to consideration of this broker in the robustness section below.

55. Three of our remaining sample of 18 brokers did not expect to incur costs from a ban on discretionary commission models because they do not operate these models, or they only operate "scaled" models to a marginal extent.

56. Surveyed brokers expected in aggregate that the proposed ban would incur a one-off cost of £6.3m and ongoing costs of £1.0m a year, and on average, each one of the 15 affected brokers would incur a one-off cost of £420,000 and ongoing costs of £65,000 a year.[21]

57. Comparing the total commission paid by our sample of lenders, 61% of the lending market, to the commission earned by our sample of 18 brokers indicates that the 18 brokers represent 39% of the motor finance broking market.

20 Ipsos MORI, Financial Research Survey Loans Market Report, March 2019
21 The costs represent respectively 1% and 0.2% of the average commission earnings of our broker sample.

58. Extrapolating our survey results to the whole broking market implies that, in aggregate, brokers will incur a one-off cost of £17m and ongoing costs of £3m a year. This is a total cost of £20m in the first year.

Robustness of implementation cost estimates

59. To reinforce confidence in our estimates, we validated the robustness of our analysis in two ways.

60. First, we compared the implementation costs reported by firms in the survey against our standardised costs model.[22] We found that the total cost estimates were within 15% of each other.

61. Second, we tested whether our cost estimate was sensitive to our approach to the exclusion of the outlying survey submission (see paragraph 53 above). In our cost estimate, we assumed the outlying broker's true costs were in line with the market average. Aggregate projected costs can change if we reintroduce the broker to the sample under different assumptions. However, both alternative scenarios tested are within a small percentage of our initial result:

- if we assume the outlying broker's implementation costs will be as projected by the standard costs model for a firm of its size, projected aggregate broker costs for year 1 (one-off and ongoing costs together) rise 5.7% to £21m and aggregate industry (lender plus broker) costs rise 3.3% to £36m.
- if we assume instead that the outlying broker's costs are consistent with the cost-to-commissions ratio[23] of the 4 most comparable brokers, in terms of size, that operate discretionary commission models, projected aggregate broker costs *fall* 1.7% to £19.6m and aggregate industry costs fall 1.0% to £34.7m.

62. Even under the most conservative of these three scenarios, taking implementation costs as £36m does not bring total costs close to the projected benefits of the proposed policy change, so it is not prone to affect our conclusion that the proposed intervention is beneficial to consumers.[24]

Summary of costs to firms

63. In summary, we expect both lenders and brokers that currently operate discretionary commission models to incur costs implementing our proposed ban.

64. Lenders in aggregate would incur one-off costs of £13m and ongoing costs of £2m a year, while brokers in aggregate would incur one-off costs of £17m and ongoing costs of £3m a year.

65. In total, we expect the whole industry would incur implementation costs of £35m in the first year, and £5m in subsequent years.

66. The following table summarises these costs.

22 https://www.fca.org.uk/publication/corporate/how-analyse-costs-benefits-policies.pdf, page 25 and Annex 1
23 The ratio of their implementation costs over their commission earnings.
24 We've also tested further extreme assumptions and this did not change our assessment.

Table 2: Summary of implementation costs for firms (£m)

	Average incremental compliance costs per firm	Industry total incremental compliance costs
Lenders		
One-off costs	0.78	13
Ongoing annual costs	0.14	2
Brokers		
One-off costs	0.42	17
Ongoing annual costs	0.07	3
Industry total:		
In first year of implementation		**35**
In subsequent years		**5**

Consumer costs

67. We do not expect our intervention to result in direct costs for consumers, on average. However, we recognise that some consumers may be charged more for their finance after the intervention than under discretionary models. It is therefore possible that some redistribution would take place between consumers. This is discussed in the *Distributional impacts* section below.

FCA costs

68. We expect to use existing resources to supervise the implementation of the ban. These should be covered by our current supervisory activities.

Indirect costs

69. The proposed ban is expected to lower both lender and broker revenues. This is because these firms' revenues are inflated due to the use of the discretionary models, as described in the Problem and Rationale section. Therefore, we expect firms to incur indirect costs in the form of revenue loss.

70. For brokers, the revenue loss will be driven by lower commissions paid by lenders, in the absence of discretion. For lenders, any revenue loss will be driven by the impact of stopping brokers' discretion on interest rates which currently leads to inflated interest charges for consumers.

71. In this section, we present our assessment of the impact of the intervention on firms' revenues in those terms.

Indirect costs for brokers: loss of commission revenue

72. Since the intervention will remove a conflict of interest that gives brokers an opportunity to inflate interest rates in order to earn greater commissions, we expect commission revenues to decrease post-intervention.

73. Our approach to estimating brokers' loss of commission revenue is to compare commission levels currently paid out in the affected segment (we call this state of the market 'the baseline scenario'), to the commission levels we would expect in the event of a policy intervention by the FCA (ie the equilibrium situation when the harmful incentives of discretionary models are not present).

74. We considered two different scenarios which represent possible outcomes following our intervention:

- The first one, derived from the analysis undertaken during the Motor Finance Review, is set to represent the situation where consumers benefit from a transfer equal to the full amount of harm. As such, it represents the upper bound of the estimated transfer from firms to consumers;
- The second represents a situation where brokers and lenders renegotiate commission arrangements following the intervention, because brokers seek to mitigate its impact on their commission earnings.

75. We discuss these two possible scenarios to capture the uncertainty around the extent to which lenders and brokers can successfully recoup lost commission revenues.

76. Consistent with the analysis in the Motor Finance Review, we first estimate the brokers' loss of commission revenue and then estimate the changes in interest costs paid by consumers (ie the benefits of the proposed intervention). Lenders' indirect costs are then simply the difference between the gains to consumers and the brokers' loss of commission.

Upper bound scenario

77. First, we considered the indirect costs implied by the harm quantification in the Motor Finance Review. This means that this scenario relies on the assumption that all consumer harm (ie all the increment in interest costs which arises as a result of the discretionary models) is removed.

78. In the Motor Finance Review final report, we estimated that discretionary models could be leading to consumers paying higher interest costs of up to **£307.5m** (for the sample of firms). Scaling up across the motor finance market, this would equate to around £500m in higher interest costs annually (specifically, the extrapolated figure is **£507m**, because our loans sample represents 61% of motor finance lending, as explained in paragraph 50 above).

79. This estimate of harm is based on a two-step methodology:

1. For each loan in the data, an alternative commission level is simulated to reflect what commission amount would have been paid under a flat commission model (see Annex 2). The difference between this simulated commission and the observed commission level is the brokers' commission change in revenue; the sum of commission losses across the loans is the aggregate broker-dealers' loss of commission, ie. our estimate of brokers' indirect costs in the CBA. This sums to **£237.3m** for our sample of loans, or **£390m** across the market, for this upper bound scenario.
2. Then, we work out the effect this loss of commission has on the loans' interest costs, because we know how interest costs change when commission changes from the analysis for the Motor Finance Review (see Annex 2 for a discussion of the

econometric analysis). The result is the aggregate consumer benefits (the £308m in our sample, as described above) from lower interest costs.

80. The difference between the two sums (£307.5m and £237.3m – ie. £70.2m) corresponds to lower interest costs that are not matched with a decrease in commission, and hence corresponds to the revenue lost by lenders due to the lower interest paid (which are discussed in paragraph 88 and following). To sum up, the relevant costs relative to the price effects of the change in commission models are: (i) lost interest revenue for lenders – 70.2m; and (ii) lost commission revenues for brokers – £237.3m; together they account for a £307.5m transfer in lower interest costs for consumers.

81. If consumers were to benefit from the full removal of harm (the increment in interest costs observed in discretionary models, or £307.5m), it means assuming that commission levels post-intervention within the affected segment would be aligned with observed flat commissions levels.

82. In practice, this would mean that brokers would not respond to the lower commission amounts by renegotiating their agreements with lenders to mitigate their losses. But this outcome is not certain to arise, as brokers in the affected segment might negotiate commissions higher on average than the flat fee commissions currently observed in the baseline scenario. In this case, brokers would lose less in commission earnings than implied in the upper bound scenario.

83. To consider the impact of commission negotiation between brokers and lenders, we have developed a second scenario for commission levels post intervention. We refer to this scenario as the 'negotiated scenario'.

Negotiated scenario

84. In the negotiated scenario, we assume that brokers renegotiate their agreements with lenders in order to minimise the lost commission from the ban of discretionary models. This negotiation has a dual effect, on broker commissions and our modelled commission amounts post-intervention:

- Typical, average, broker commissions would remain similar to those currently achieved. This assumption reflects that brokers enjoy a significant degree of bargaining power, as explained in paragraph 86 below. We model this by retaining the median commission (by lender and commission model) as the starting point for calculating post-intervention commission amounts;
- Abnormally high commission values would be phased out as a result of the ban of discretionary models, because the brokers would lose the ability to sell loans at very high interest rates to achieve high commission amounts. We model this by assuming that commission levels post intervention will vary according to the same standard deviation as the one currently observed within flat commissions. This does not amount to assuming that flat commission models will be adopted by all within the affected segment, only that the variation around the median is assumed to be the same as that observed in the flat segment.

85. This approach means that simulated commission levels in the affected segment post-intervention remain higher than commission levels in the unaffected segment, as is currently the case.

86. We believe this is a reasonable alternative scenario for two reasons:

- First, it reflects the possibility that brokers may have significant bargaining power, and therefore that they will be able to maintain higher commissions than those earned in the current flat segment, but not as high as is currently the case in the affected segment because of the removal of the incentives to sell loans at very high rates.[25]
- Second, it is also consistent with the differences the Motor Finance Review noted between the profile of consumers within the affected segment and those within the flat segment. As the affected segment is primarily focused on near-prime consumers, they are likely more profitable than sub-prime transactions, because near-prime consumers have a lower risk of default. So, it is plausible that lenders will compete to get access to these near-prime consumers by paying intermediaries higher commissions, or that brokers may be able to negotiate these higher commissions consistently for this category of business, even after the intervention.

87. This simulation leads to estimating an aggregate level of lost commission revenue for brokers of **£75.8m** in our sample of loans, which extrapolates to around **£125m** across the market.

Indirect costs for lenders: loss of interest earnings

88. The high interest costs driven by the use of discretionary commission models also partially benefits lenders who receive the interest. This is because the increased interest charged to consumers is not fully captured by increased commissions, and some of this interest is effectively gained by lenders.

89. Therefore, lenders would also incur indirect costs in the form of a loss of revenue driven by lower interest rates. We note that these lower interest rates could also lead to expansion of the volume of loans awarded. We have not quantified the likely amount of new business driven by lower interest, which would benefit new consumers, broker-dealers and lenders, because the exercise would involve significant uncertainty about the likely response of consumers to lower interest rates. As such it could offset some of the indirect costs to firms. Because we are not taking these potential benefits into account, in that respect our analysis is conservative.

90. Lenders' loss of earnings is estimated to be the difference between the decrease in consumers' interest costs and the decrease in commission earned by brokers, on the basis of the Motor Finance Review's econometric analysis. Where the harm reduced is

25 Also, we do not believe that brokers' bargaining position is sufficiently strong so that they could force lenders to keep their aggregate level of commission earnings unchanged. To substantiate this hypothesis, we would need to have found evidence that brokers command a much larger market power compared to lenders. Instead, key facts point to the opposite situation:
- Broker-dealers market power: Brokers have limited market power on the distribution of motor finance, notably compared to lenders. Our analysis suggests that the largest brokers command shares of motor finance below 10%, and that the broker-dealers' concentration index (the Herfindahl–Hirschman Index (HHI) which is often used as an indication of market power) may be as low as three times the lenders' index. Additionally, broker-dealers have faced new forms of competition in recent years, for instance from car supermarkets and from online broker-dealers. Finally, broker-dealers face competitive constraints from other providers of finance.
- Broker-dealers bargaining position vs lenders: Brokers have a strong incentive to keep marketing their financing products to clients to secure the sale of their main vehicle, and therefore need to maintain relationships with lenders. Also, many brokers rely on lenders to finance their stocks, or rely on them through licensing agreements in the case of captive lenders, or both. Lenders are somewhat less reliant on broker-dealers since they have more options of distribution channels, and could even directly market to clients.

Finally, even if some of the largest broker-dealers could negotiate levels of commission close to their previous earnings, it would not be possible for broker-dealers in aggregate. It would not necessarily be desirable for large lenders to maintain commission levels far beyond market average, if this means they are unable to offer competitive rates to their clients.

£307.5m, of which £237.3m is the loss in commission, then the difference of **£70.2m** – which amounts to around **£116m** for the whole market – is the cost to lenders, in the upper bound scenario.

91. We apply the same logic to derive lenders' loss of earnings in the negotiated scenario. we find that lenders' indirect costs would amount to £24m within the sample, ie the difference between brokers' loss of commission of £75.8m, and consumers' decrease in interest costs of £99.8m (described in Section Estimated benefits below). This **£24m** estimate means that their indirect costs would be around **£40m** across the market.

92. The table below summarises the indirect costs for both scenarios considered:

Table 3: Summary of indirect costs for firms (£m)

	Upper bound scenario	Negotiated scenario
Lenders	£116m	£40m
Brokers	£390m	£125m

Estimated benefits

93. We expect our intervention to trigger the car finance industry to move away from models of remuneration which give rise to conflicts of interest. This would lead to benefits to consumers, directly from lower interest costs, and indirectly from greater competition and better aligned incentives among lenders and brokers.

Benefits to consumers

Lower interest costs

94. The intervention would lead to lower interest rates being charged to consumers on average.

95. The Motor Finance Review's analysis of the loans data identified the relationship between the level of commission paid and the interest charged to consumers. This statistical relationship informs us on the increase/decrease in interest charged, according to an increase/decrease in commission paid.[26]

96. From this relationship, we derive the expected impact of the change in brokers' commission earnings on consumers' interest rates.

97. In the upper bound scenario, the harm identified by the Motor Finance Review will be entirely removed from the ban. So, the benefits to consumers in our sample amount to **£307.5m** in lower interest costs, which scales up to around **£507m** for the whole motor finance market.

98. In the negotiated scenario, consumers in our sample would benefit in aggregate from a **£99.8m** transfer from brokers and lenders (the sum of £24m and £75.8m estimated in the indirect costs above) through lower interest costs within our sample, and thus from around **£165m** transfer for the whole motor finance market.

26 See Motor Finance Review Final Findings, paragraph 2.14 and footnote.

Non-monetary benefits

99. We also consider that the proposed intervention may be beneficial to consumers on non-price characteristics as well, because we expect the intervention to encourage competition between lenders, as they will control their prices more closely and have an increased incentive to expand the adoption of car finance. The intervention will also remove the incentives to broker-dealers to act in their own interest to the detriment of consumers.[27] Non-price benefits to consumers following from these effects could notably include better transparency or better explanation on the interest charges.

100. This may enable some consumers to better engage with car finance solutions. In particular, it would facilitate comparing different car finance options. It is also possible that increased transparency improves consumer trust and understanding of car finance, which could increase adoption of car finance products further where they are suitable to consumer needs.

101. Lower interest rates could potentially lead to greater access to affordable credit. This has the potential to benefit consumers who would not have used finance previously, including some who potentially would not have bought a car.

102. This 'volume effect' may offset some of the indirect costs to firms estimated above. Given the current low penetration rate of car finance in the used car segment, this volume effect could be substantial. However, it is not reasonably practicable to estimate it given the data at our disposal.

Brokers' recovery of lost profit (waterbed effects)

103. This section considers whether reactions from brokers following the ban are likely to offset the net benefits of the proposed intervention. To do so, brokers could increase prices of other components of the transaction, such as the price of the main vehicle, of add-ons, or of other components of the overall transaction with the consumer. Such strategic reactions to falling margins are often called a 'waterbed effect'.

104. We show in this section that the possibility that waterbed effects arise is unlikely to challenge the overall net beneficial effect of our intervention, with reference to our 'negotiated' scenario, which yields the lowest net benefits.

105. For waterbed effects to be a concern, they would need to outweigh, or come close to outweighing, the estimated total £130m net benefits across the market (ie £165m benefits minus £35m implementation costs). We do not think the waterbed effect will offset the net benefits to such a large extent, for three main reasons.

106. First, the intervention would impact only those firms that offer or receive commission that flexes depending on the interest rate offered by the broker. According to our data, this is 48% of the market. The majority of the market will be unaffected by our intervention, ie it will not incur a loss of commission revenue, and so the competitive pressure it exerts on market prices will remain. This will constrain the ability of affected broker-dealers to recoup losses in commission revenue by raising consumer prices beyond the current equilibrium level (overall or for a particular element of

27 Although it has not been reasonably practicable to quantify this effect specifically.

the transaction), since this may cause consumers to turn to firms in the unaffected segment. This means that a full waterbed effect is very unlikely.

107. Second, broker-dealers have limited options to raise prices of different components of the car sale transaction:

- The secondary products, such as add-ons and insurance products, are only sold to a subset of consumers and broker-dealers' associated revenue is a fraction of the commission amount they may forego. It would be difficult, therefore, to offset the revenue loss fully on these products alone.
- Dealers' pricing of main vehicles faces several constraints, in particular for new cars. The advertised price of the car is still an important factor of consideration for consumers, but also for manufacturers.[28] It is therefore unlikely that dealers will increase new car prices.
- It is also possible for brokers to reduce implied subsidies they are able to offer consumers, in the form of less generous part-exchange values or deposit contribution.[29] While these components of the transaction can appear discretionary, brokers would not be able to fully recoup their loss of commission earnings by reducing these discounts:
  - First, broker-dealers do not apply these implied subsidies systematically, and only a subset of consumers are eligible for them.[30] As for the add-ons, it is unlikely that the loss could be recouped on a subset of the transactions.
  - Second, systematically reducing these subsidies would be costly for the broker-dealer because it would mean likely losing some sales. In particular, consumers with a vehicle eligible for part-exchange are likely to be able to defer their car purchase if they receive a poor offer for their part-exchange vehicle.

108. Finally, even if a full waterbed were to arise, the intervention would still represent net benefits under our scenario. These benefits are greater than the commission lost by brokers. In fact, in our negotiated scenario, brokers' commission loss was estimated to be £125m, while the benefits net of implementation costs were estimated at £130m (ie. £165m benefits minus £35m implementation costs). So, in principle, even if brokers fully recover their commission loss by charging higher prices to consumers, there would still be net benefits of £5m. However, a full recovery is unlikely, due to the points above.

109. Overall, while we cannot measure the extent of potential waterbed effects, this analysis demonstrates that they would not offset the estimated net benefits of the intervention.

28 AutoTrader's Car buyer report (September 2017) indicate for instance that 47% of consumers thought about the price of the car when considering car purchase options, vs 35% about total cost of ownership, and vs 27% about finance.

29 A part-exchange offer would be an implicit subsidy of the consumer if the broker-dealer purchases the car for more than its market value, which means that the broker-dealer is at loss on the exchange vehicle. Without evidence of the contrary, we assumed that it is unlikely to be systematically the case.

30 According to Mintel research, 15% of consumers said they used part-exchange for their latest car purchase (Mintel Car Finance report, June 2018 – Figure 6)

Distributional impacts

Redistribution among consumers

110. We have looked at whether our intervention disproportionately affects specific groups of consumers, and particularly how it affects vulnerable groups. Vulnerability can be the outcome of multiple factors affecting individuals. The FCA has previously identified key risk factors that are typically associated with vulnerability in financial services. Financial wellbeing, levels of income and the amount of debt that individuals hold are part of these key risk factors.[31] In the context of this assessment, we have relied on credit scores and on income as indicators of financial wellbeing.

111. Given that most loans within the discretionary segment are awarded to prime to near-prime consumers (higher to mid-range credit scores),[32] our presumption was that it is unlikely that the intervention will affect consumers who tend to have lower credit scores, who are more likely to be vulnerable.

112. This was confirmed by firms' feedback. The majority opinion among firms was that high-credit/mid-credit score consumers will be more likely to be affected.

113. Earlier we have flagged that under the negotiated scenario there could be some redistribution among consumers.

114. We find that median and average consumers' income in the affected segment is larger than those of the unaffected segment, which indicates that the affected group is less likely to be financially vulnerable.

115. Also, we have found that potential redistribution across consumers is not detrimental to consumers, and does not disproportionately affect consumers with lower credit scores. Specifically, we analysed the distribution of gains among affected consumers:

- We have found that the majority of affected consumers (56%) will gain from changes in their interest costs.[33]
- We find that, for every credit score category, the number of consumers who benefit outweighs the number of consumers who will not. And it is also the case that there are net gains for each credit score category.

116. These results confirm that the proposed intervention does not weigh disproportionately on financially vulnerable consumer groups (as identified by lower credit scores). This also means that the intervention is unlikely to restrict access to finance for these groups of consumers. On the contrary, the majority of consumers will benefit from lower interest, including consumers with lower credit scores.

31 See page 23 here: https://www.fca.org.uk/publication/occasional-papers/occasional-paper-8.pdf

32 Motor Finance Review final findings, paragraph 2.8

33 Within the Motor Finance loans data, we found that 56% of consumers whose loan was in the discretionary segment will benefit from lower interest costs, while the rest will see their interest costs increase (in a smaller proportion). The interest costs decrease far outweighs the interest costs increase, which leads to the overall net benefit figure of nearly £100m lower interest costs as in paragraph 97 above.

Proportionality analysis

117. We have considered whether our intervention is proportionate to the harm identified and whether similar benefits could be obtained with less intrusive remedies.

118. We have analysed several policy responses to the harm. These are explained in Chapter 3. Apart from the proposed ban on discretionary models, we also considered intervening in the following ways:

- mitigating the most extreme cases of harm, by limiting brokers' discretion to set the interest rate (Alternative 1 below);
- significant new disclosure requirements for motor finance loans (Alternative 2 below); and
- allowing discretionary commission models to operate but only with sufficient justification (Alternative 3 below).

119. Our analysis shows that none of these options is likely to be nearly as beneficial (in net terms) as the proposed intervention.

120. First, the proposed ban on discretionary models was the only option to directly address the harm by preventing the current conflict of interest to arise. Other options would only indirectly address the harm or limit the amount of harm. These options also relied on changes to either lenders' or consumers' behaviour that are more uncertain to come about.

121. Second, the proposed intervention also avoids the implementation risks that could arise with other options which rely on increased ongoing monitoring of broker-dealers by lenders, and possibly of sales staff individuals by broker-dealers. Accordingly, firms' feedback suggested that alternatives options may be difficult to implement in practice.

122. Third, we consider Alternative 2 unlikely to address the harm. Survey feedback on this alternative was sceptical about whether consumers would engage with further detailed explanations about the nature of different arrangements, and also highlighted practical difficulties in disclosing the amount of commission at the point of recommendation as this is not always known at the outset.

123. As a result of these three factors, all other options considered resulted in much lower net benefits than the proposed intervention. We found that, although the costs of these options were somewhat lower, the expected benefits were much lower than the proposed intervention's costs and benefits. Therefore, the balance of costs and benefits clearly favoured the proposed intervention. The following table presents the comparison between the proposed option and the alternatives, for each scenario considered.

Table 4: Comparison of CBA results of each options considered

Policy option:	Net benefits of baseline	Net benefits, difference compared to baseline proposal, of: Alternative 1: discretion allowed within a limited range	Alternative 2: increased disclosure	Alternative 3: change CONC rule to only allow discretionary models in specific circumstances
Upper bound scenario	£460m	[-70%;-90%]	[-90%; 100%]	Discarded because implementation difficult in practice
Negotiated scenario	£130m	[-20%; -60%]	[-70%; 100%]	

Note: Two scenarios for benefits of alternatives 1 and 2 were considered. We expressed the net benefits of each of these scenarios as the difference relative to the net benefit of our proposed intervention (the ban). Hence the second column of the first row reads as follows: alternative 1 achieves net benefits that are between 70% and 90% lower than those estimated in the upper bound scenario of the proposed ban.

124. This observation holds irrespective of the degree of waterbed effects. The waterbed effects depend on the affected broker-dealers' ability to adapt their business model, irrespective of the exact change, to the extent that the change affects brokers' earnings.

125. Finally, the proposed intervention is not detrimental to competition in the supply of car finance. Rather it has the potential to foster competition among lenders, and align broker-dealers' incentives with consumers' interest. We did not find that alternative options were clearly more pro-competitive than the proposal.

Risks and unintended consequences

126. We acknowledge that the above analysis relies on several simplifying assumptions, as summarised in the Baseline and Key Assumptions section, and that effective changes in the market may differ from our prospective analysis.

127. Some firms have expressed concern that banning discretionary commission may trigger some participants, both broker-dealers and lenders, to withdraw from the market or to limit their offer. Whilst we cannot assess in detail the case of each firm, most firms operate multiple commission models already in this market; and multiple commission models are used for similar client types. Since non-discretionary models are deemed profitable, there is no reason to believe that firms will be unable to profitably adopt non-discretionary models more widely.

128. The market is not particularly concentrated, and there has been entry and innovation from several actors, both at lender level and at the broker level, in the recent past. This suggests that, even if that concern were to materialise, it would be unlikely to significantly affect competition.

129. Likewise, we have shown that discretionary models are not prevalent in the sub-prime market. So, we do not expect the intervention to adversely affect the ability of consumers to finance appropriately their vehicle purchases.

130. Having analysed the potential unintended consequences of our proposal, we do not foresee that they would offset the benefits of the intervention.

B. Minor changes to certain CONC commission disclosures

131. This CBA presents our analysis of the impacts of our proposed adjustments to the CONC rulebook and guidance. This analysis is appropriately separated from the CBA on the main proposal we are consulting on, namely the ban on discretionary commission models, because the two interventions address different issues.[34]

132. We provide monetary values for the impacts where we believe we can reasonably estimate them and it is reasonably practicable to do so.

133. This CBA Annex has the following structure:

- problem and rationale for the intervention
- our proposed intervention
- the costs of our proposed intervention
- the benefits of our intervention

Problem and rationale for the intervention

134. Supervision activity undertaken during the Motor Finance Review identified a significant degree of non-compliance with the CONC rulebook among motor finance broker-dealers, in particular, around contractual disclosure and explanations.

135. These rules are in place to protect consumers because motor finance loans are characterised by behavioural challenges for consumers (such as limited attention, and limited financial awareness), and information asymmetry between brokers and consumers. It is essential that consumers are given appropriate and timely information, as intended in the existing regulatory framework, to mitigate harm such as inappropriate purchases or higher prices for consumers who are not informed.

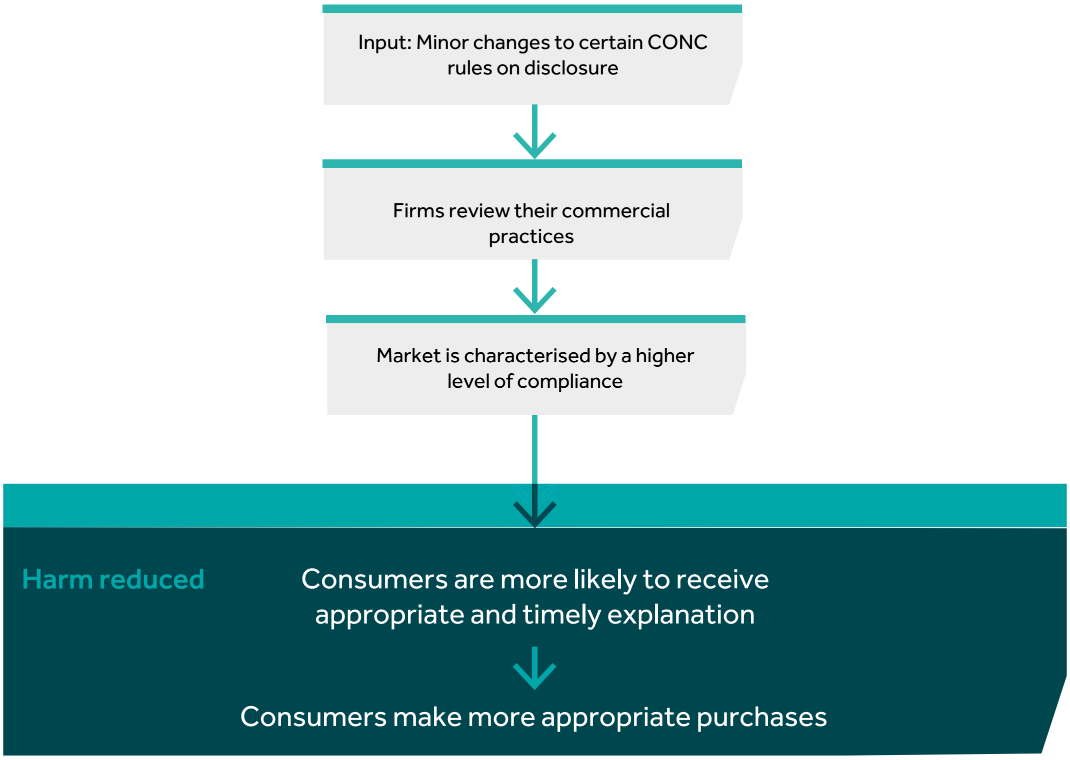
136. Non-compliance is detrimental to consumers because they may not be given appropriate disclosure and explanations when interacting with a non-compliant firm. It is also detrimental to firms operating in the market because non-compliance affects consumer trust.

Our intervention

137. We are proposing minor changes to our CONC financial promotions and disclosure rules. We believe these will improve the timeliness and relevance of the information consumers receive about motor finance commissions. Consumers will be better placed to assess and act on this information – for example, by finding or negotiating a cheaper deal. This will reduce the extent of inappropriate purchases and provide better value for these consumers.

34 Section A of this Annex, above, presents the CBA of the proposal to ban discretionary models.

138. The figure below illustrates the expected causal chain for this intervention.



Costs

139. CONC applies to about 33,300 firms that have credit broking permissions, and a few hire firms. A further 1,900 hold a lending permission. We expect these 35,200 firms to incur costs familiarising themselves with the relevant parts of the CP and new wording of the rules. They may also incur costs as their compliance and legal staff undertake a "gap analysis": a legal review of the requirements against current practices.

140. Some firms who were not compliant with the rules will incur implementation costs to bring their businesses into line with the requirements. Firms should already have been complying with the rules, and continuing to ensure their business activities are compliant. These costs were considered when the rules were originally proposed.

141. For those firms that have been complying with the rules, our proposed changes to the disclosure requirements are minimal and it is not reasonably practicable for us to estimate any implementation costs that such compliant firms would incur, but we would expect these to be non-material.

142. The new costs that apply to all firms are for familiarisation and gap analysis. To reduce the burden of compliance cost surveys on firms, we have estimated these costs using our Standardised Costs Model.

143. The firms to which CONC 3.7 and 4.5 applies (or is relevant) must read 3 relevant pages of the CP and 3 pages of legal text. We assume that the CP pages will be read by about 20 compliance staff members at around 100 large affected firms, 5 at around 400 medium affected firms, and 2 at the 34,700 small affected firms; and the legal text by a team of 4 legal staff at a large firm, 2 at a medium firm, and 1 at a small firm. At standard salaries and reading speeds, we expect this to cost large firms £620, medium firms £210, and small firms £40.[35]

144. This suggests that familiarisation and gap analysis for the consumer credit sector will be a one-off cost of about £1.4m.

Benefits

145. We expect the proposals to have several benefits, primarily to consumers but also to firms.

146. Customers of previously non-compliant firms would benefit from being more likely to be provided with relevant information. Information asymmetry between firms and consumers would be reduced, and consumers would be better able to make informed judgments in their own interest. With better information available, consumers are more likely to engage with what is on offer and as such increased compliance may promote effective competition in the interests of consumers. Increased compliance by firms will also increase trust in the market, which in turn may increase participation, to the benefit of both consumers and firms.

147. Any changes in consumer behaviour from improved disclosure will be uncertain however: as we do not know how many consumers/transactions are affected in sectors outside of motor finance, it is not reasonably practicable to estimate the total benefits to consumers.

148. Firms that were previously non-compliant but comply with the new rules would benefit from reduced risk of legal claims against their practice.

149. Firms that were already compliant would also benefit from the added legal certainty provided by the clearer rules. Further, as more of their competitors comply, they will face less unfair competition from non-compliant competitors.

150. It is not reasonably practicable to estimate these benefits in monetary terms, given these would be realised across a wide range of brokered agreements across a variety of credit markets. Our qualitative assessment is that, considering the degree of non-compliance found in the motor finance sector alone, benefits from the proposals would be likely to outweigh the small one-off costs identified because they would be ongoing benefits and they would apply to a large population of consumer credit users, so the policy cost per benefiting consumer is likely very low.[36]

35 On our approach to familiarisation and gap analysis, FCA's "How we analyse the costs and benefits of our policies". On assumptions on standard salaries and reading, see for instance CP-18-35, page 75.

36 For instance, IPSOS Financial Research survey indicates that 6.4% of the population aged 18+ has an unsecured loan, 1.4% a secured loan and 5.5% a motor finance loan. Unsecured loan users account for 1.22m individuals alone.

Annex 3
How we calculate the impact of an increase in commission on interest costs and estimate the harm from discretionary models

1. This annex presents the data analysis developed in the Motor Finance Review to calculate the impact of an increase in commission on consumers' interest costs. It discusses in turn:

- the data collected (Data section)
- the steps taken to prepare the data for the statistical analysis (Data processing section)
- the main econometric modelling which resulted in our measurement of the effect of an increase in brokers' commission on consumers' interest paid (Econometric analysis section)
- how the harm from discretionary models is quantified (Harm estimation section).

Data

2. During our review of the motor finance market, we collected loan data from selected lenders. We asked 20 lenders, to provide a sample of motor finance agreements entered into between January and December 2017.[37] [38] The sample was the minimum of:

a. 10% of the total agreements entered into during the relevant period; or
b. 1,000 agreements.

3. The sample of loans is representative of the agreements entered into during 2017 as we asked lenders to provide loans which covered all motor finance products, all commission models and all types of credit brokers through which they concluded loan agreements.[39]

4. We had a total of 16,402 loans in our sample. Table 1 below, summarises the data along with several key variables.

37 Three lenders provided some loans which ran into 2018. 730 loans were concluded in 2018, representing just over 4% of our total sample. There were 3 agreements concluded on 3 June 2018, which were the latest in our sample of loans.

38 We refer to the period covered by the loans (1 January 2017 to 3 June 2018) as 'the relevant period'.

39 To confirm this, we compared the mean and variance of the sample against the mean and variance of the total portfolio of each lender, with respect to the interest rates and broker commission. We also checked the sample and lender portfolio for the proportion of agreements that were personal contract purchase (PCP) and the proportion of agreements that were arranged through independent dealers.

Table 1: Loans data summary statistics

Variable	N	1st percentile	Average	99th percentile
Credit score	15,031	422	548	653
Loan Term (months)	16,402	24	49	61
Loan Amount (£)	16,402	£2,050.0	£9,942.7	£37,978.2
APR (%)	16,402	0.0	17.5	47.9
Broker Commission (£)	16,402	£0.0	£614.6	£2,772.3
Total Interest (£)	15,660	£5.2	£3,520.6	£12,074.4

5. Around 42% of the loans in our sample were concluded under a flat fee commission model, around 24% under Increasing Difference in Charge, around 14% under Reducing Difference in Charge and around 12% were concluded with a broker operating a Scaled Commission model. The remaining 8% of loans were concluded through brokers which operated different commission models to the four main commission models mentioned above.

6. The total advanced from the lender sample was £24.8bn a year. Ipsos MORI puts the whole motor finance market at £41.0bn of lending a year.[40] So, our sample of lenders represents 61% of the motor finance market by lending volume.

Data processing

7. Received data were compiled into a single dataset and were completed with an adjusted measure of credit scores, ie a consistent measure across lenders, and an estimate of interest costs. These two compilations are described in what follows.

Adjustments to credit scores

8. Our request for a sample of loans from the lenders also asked for the customer credit score. This was an important variable for our analysis, since it is a useful indicator of the customer's creditworthiness, that is the customer's ability to repay loans. We would expect that generally, consumers with lower credit scores pay higher interest rates than consumers with higher credit scores. This is because consumers with higher credit scores are considered more creditworthy and more likely to repay loans, such that defaults and late payments, which are costly to lenders, are fewer than for less creditworthy consumers.

9. The lenders in our sample used differing variants of credit scores, meaning we could not compare credit scores across lenders without making adjustments to these scores (i.e. a score of 500 might mean different degrees of creditworthiness for different lenders). We therefore decided to standardise the credit score ranges in our sample. To do this, we adopted the following simple methodology:

a. We accessed a 1% sample of TransUnion credit files and scores;

40 Ipsos MORI, Financial Research Survey Loans Market Report, March 2019

b. Using the TransUnion data, we calculated the 5th and 95th percentile[41] credit score range. This told us the range of typical scores for each lender, using a common credit score metric;

c. Using our loan sample, we re-scaled the credit scores using the TransUnion score ranges, separately for each lender. Given that both our sample and the TransUnion sample are representative of the total population of loans, we normalised the credit scores in our data using the TransUnion range, but preserving the shape of the distribution;

d. This gave us re-scaled credit scores using a common range, which allowed us to compare and control for credit scores across lenders.

Calculating interest costs

10. For the purposes of our analysis, we calculated interest costs over the term of the motor finance loans. We made a simplifying assumption that the loans in our sample were carried to term, even though consumers may decide to redeem the loans before full term (for example as a way of reducing the overall interest costs of the loan). We could see that 1,135 or just under 7% of the loans in our sample had already been redeemed. We decided to keep these loans in our sample, since we wanted to understand broker incentives and impact of interest costs at the point of negotiation. Given brokers and lenders cannot discern those consumers likely to redeem loans early, we assume their pricing incentives are the same.[42]

11. We calculated total compound interest costs over the loan term, using the following formula:

$$\textit{Total compound interest costs} = P * (1 + \left[\frac{i}{q}\right])^{n*q} * n - P$$

Table 2: variables used to compute total compound interest costs

Variable	Description
P	Loan amount (£)
i	Annual interest rate (%)
q	Compounding periods every year (12)
n	Total compounding periods (months)

12. For the purposes of the econometric analysis, we expressed total interest costs as a share of the loan amount. This was to allow us to set interest charges on a comparable basis (against the loan amount), rather than comparing nominal interest costs.

Econometric analysis

13. This section describes the econometric analysis of the relationship between interest costs and commission payments.

41 We dropped values outside the 5th and 95th percentiles to exclude extreme credit score values.

42 Lenders typically include broker commission recoupment terms in contracts. Given these are contract specific and we cannot discern loans where commission was recouped by the lender, we assume that the broker was remunerated for these loans.

14. The objective of this analysis was to test the impact of broker commission on final interest rates paid by consumers. To do this, we controlled for other factors which might also affect consumer's interest rate. We used Ordinary Least Squares (OLS) to estimate the following model:

$$I_i = \alpha + \beta_1 C_{in} + \beta_2 F_{in} + \beta_3 D_n + \beta_4 S_i + \beta_5 B_{ns} + \beta_m L_m + \varepsilon$$

Table 3: Econometric model's variables definitions

Variable	Description
I_i	Consumer *(i)* total interest costs as share of loan (%)
C_{in}	Broker *(n)* commission for consumer *(i)* as share of loan (%)
F_{in}	Consumer *(i)* fees as share of loan (%)
D_n	Dummy variable identifier for each lender
S_i	Consumer *(i)* credit score at the time of the loan
L_m	Vector of *(m)* loan characteristics: Retail channel (eg franchised), vehicle condition (eg new), motor finance product (eg PCP), loan term (months), loan amount, balloon payment amount, loan-to-value decile
B_{ns}	Share of number of loans at lender *(n)* derived from broker (*s*)
ε	Error term

15. We ran the model above, separately for each commission model, in order to derive an estimate of β_1, the coefficient on our measure of commission (commission as a share of loan amount), controlling for the variables above.[43] As above, we used an OLS model, but also tested different approaches (for example a Pooled Ordinary Least Squares[44] models), which yielded similar results to simple OLS.

16. Table 4 below, summarises key indicators for the four econometric models for the main commission models (Increasing DiC, Reducing DiC, Scaled and Flat Fee).

Table 4: Estimated marginal effect of commission level on interest costs

Model	Impact of commission on interest costs (β_1) and t-statistic	N	R-squared
Increasing DiC	1.5 *** (40.5)	2,362	0.9
Reducing DiC	1.3 *** (49.9)	1,106	0.9
Scaled	0.9 *** (15.9)	1,761	0.9
Flat Fee	-0.3 *** (-4.7)	5,022	0.9

*** Significant at the 1% level

43 We also included an interaction term of D_n and S_i (to capture differences between lenders in impact of credit scores) and a squared term for S_i to account for non-linear effects of credit scores on interest rates.

44 This was performed by pooling all the loan data, adding a dummy for each commission model and correcting errors to account for heterogeneity at the lender level.

17. The measured impacts above show the average impact of increasing commission by 1 percentage point on the consumer interest costs (measured as a percentage of the loan taken). This means that according to our estimates and after controlling for the other factors described above, increasing the commission rate (as a proportion of the loan's principal) by 1 percentage point, is associated with an increase of around 1.5 percentage point (on average) in interest rate, for loans arranged with an Increasing DiC model in operation.

Harm estimation

18. The results of the econometric analysis were then used to quantify the harm from misaligned incentives of the discretionary models.

19. The logic of this estimation is as follows. For each loan intermediated under a discretionary model, brokers were able to set the commission at their preferred (maximized) level. If the loan had been intermediated without such discretion, the commission would have been lower.

20. Accordingly, the quantification of harm followed the steps below:

- First, for each transaction with a discretionary commission model, an alternative level of commission is generated. This simulation is based on rescaling the amount of commission observed for discretionary models within the bounds of observed commission for the flat model;
- Second, the difference between the transaction's actual commission and the alternative is computed. This corresponds to the increment in discretionary commission against a baseline of flat fee (where the aggregate change in commission was £237m);
- Third, if the commission had been lower, this would have impacted the interest costs according to the relationship estimated in the econometric model described above. Accordingly, the result from step two is multiplied by the coefficient in that relationship (β_1 – as per Table 4 above) to obtain the impact of the increment in commission (over the flat alternative) on the interest costs;
- Fourth, and finally, the impacts on the interest costs are aggregated across the data, with appropriate weights given to each observation according to lenders' book size. The sum of these impacts is £308m, which corresponds to the harm estimated for consumers in our sample.

21. In the context of the CBA, this estimation represents the indirect costs to brokers and benefits to consumers described in the 'upper bound scenario'.

Annex 4
Compatibility statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).

2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules is (a) compatible with its general duty, under s.1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, and (b) its general duty under s.1B(5)(a) FSMA to have regard to the regulatory principles in s. 3B FSMA. The FCA is also required by s. 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.

3. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s.1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.

4. In addition, this Annex explains how we have considered the recommendations made by the Treasury under s.1JA FSMA about aspects of the economic policy of Her Majesty's Government to which we should have regard in connection with our general duties.

5. This Annex includes our assessment of the equality and diversity implications of these proposals.

6. Under the Legislative and Regulatory Reform Act 2006 (LRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRA.

The FCA's objectives and regulatory principles: Compatibility statement

7. Our proposals are primarily intended to advance the FCA's operational objective of achieving an appropriate degree of protection for consumers.

8. The intention of our proposal to ban discretionary commission models in the motor finance market is to address the significant harm identified during our motor finance review.

9. This found widespread use in this market of commission models that link the broker's commission to the customer's interest rate and allow brokers wide discretion to set or adjust the customer's interest rate. This gives rise to conflicts of interest, creates strong incentives for the broker to charge the customer a higher interest rate to earn more commission and leads to consumer harm in the form of higher interest costs for consumers.

10. Preventing lenders and brokers from using discretionary commission models should decrease financing costs for consumers and should give lenders better control over the prices their customers pay for motor finance. This should also incentivise firms to offer competitively priced loans, increasing competition on motor financing terms in the market.

11. The intention of our proposal on commission disclosure in consumer credit markets is to ensure consumers are provided with the right information about commissions at the right time to better enable them to make informed decisions and choose the right deal for them.

12. Consequently, we also consider these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well. For the purposes of the FCA's strategic objective, "relevant markets" are defined by s.1F FSMA.

13. In considering what degree of protection may be appropriate we are required to have regard to the 8 matters listed in FSMA s.1C(2)(a)-(h).

The differing degrees of risk involved in different kinds of investment or other transaction

14. We have taken this into account whilst developing our proposals by recognising that particular commission structures can lead to higher finance costs for consumers because of the conflicts of interest and strong incentives they create for brokers to increase the interest rate paid by the customer to earn more commission.

The differing degrees of experience and expertise that different consumers may have/ the differing expectations that consumers may have in relation to different kinds of investment or other transaction

15. Our motor finance review did not find any evidence that the harm we had identified primarily affects vulnerable consumers but rather high credit/ mid-credit score consumers. We expect our proposals to lead to lower interest costs for the majority of motor finance consumers, including those with lower credit scores.

The needs that consumers may have for the timely provision of information and advice that is accurate and fit for purpose/ the general principle that consumers should take responsibility for their decisions

16. Our proposal on commission disclosure is designed to ensure consumers receive relevant and timely information about the existence of commission so that they can make better informed decisions and potentially consider alternative options.

The general principle that those providing regulated financial services should be expected to provide consumers with a level of care that is appropriate, having regard to the degree of risk involved in relation to the investment or other transaction and the capabilities of the consumers in question

17. Our proposals are designed to ensure consumers are treated with an appropriate level of care by lenders and brokers when seeking car finance.

18. This is because they seek to remove conflicts of interest associated with discretionary commission models, improve the quality of information provided about commission and clarify our existing commission disclosure requirements to improve firms' compliance with them.

Any information which the consumer financial education body has provided to the FCA in the exercise of the consumer financial education function.

19. This matter is not relevant to these proposals, as we have not been provided with any relevant information by the consumer financial education body on this subject.

Any information which the scheme operator of the ombudsman scheme has provided to the FCA pursuant to section 232A

20. This matter is not relevant to these proposals, as we have not been provided with any relevant information by the scheme operator pursuant to section 232A on this subject.

21. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s.3B FSMA. We explain below how we have done this.

The need to use our resources in the most efficient and economic way

22. We do not expect our proposals to have a significant impact on our resources or the way in which we use them. They should improve our ability to supervise firms effectively and to enforce compliance with our rules.

The principle that a burden or restriction should be proportionate to the benefits

23. We have considered this carefully, seeking views and analysing the costs, benefits and impacts of a range of possible policy interventions. We have concluded that our proposals are proportionate to the harm identified and the expected benefits.

The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term

24. We do not consider our proposals undermine this principle.

25. Non-discretionary commission models currently operate in the motor finance sector and are profitable. We therefore do not consider that firms will be unable to profitably adopt non-discretionary models more widely.

The responsibilities of senior management

26. Senior management will need to ensure they comply with any new rules and guidance we introduce.

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

27. We consider our proposals recognise, take account of and reflect the diversity of relevant firms' business models as we have sought feedback and input from a variety of relevant firms in developing our proposals.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

28. Our proposals do not require firms to publish information.

The principle that we should exercise of our functions as transparently as possible

29. Our proposals have been informed by the evidence collected and published as part of our Motor Finance Review as well as engagement with stakeholders and seeking feedback from lenders and brokers on the costs and implications of a range of policy options. We are now publishing and seeking comments on our proposals and will take the feedback we receive into account before finalising any rules and guidance.

30. In formulating these proposals, the FCA has had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s. 1B(5)(b) FSMA).

Expected effect on mutual societies

31. We do not expect our proposals to have a significantly different impact on mutual societies as they do not provide the type of credit caught by our proposals.

Compatibility with the duty to promote effective competition in the interests of consumers

32. In preparing the proposals as set out in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers.

33. We believe that our proposal to ban discretionary commission models will give lenders better control over the interest rate that consumers pay and foster price competition between lenders, as they will continue to be incentivised to expand the adoption of car finance by pricing competitively.

34. Our proposed clarifications on commission disclosure should result in consumers having better quality information and being more likely to engage with what is on offer, which in turn should also promote competition.

Equality and diversity

35. We are required under the Equality Act 2010 in exercising our functions to 'have due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct prohibited by or under the Act, advance equality of opportunity between persons who share a relevant protected characteristic and those who do not, to and foster good relations between people who share a protected characteristic and those who do not.

36. As part of this, we ensure the equality and diversity implications of any new policy proposals are considered. The outcome of our consideration in relation to these matters in this case is stated in paragraphs 2.12 – 2.17 of this CP.

Legislative and Regulatory Reform Act 2006 (LRRA)

37. We have had regard to the principles in the LRRA for the parts of the proposals that consist of general policies, principles or guidance. We consider that our proposals are:

- Transparent: We are consulting on our proposed rules and guidance
- Accountable: By consulting we are seeking feedback on our proposed approach
- Proportionate: We consider that our proposals are proportionate and have undertaken cost benefit analysis of different options to inform our approach
- Consistent: Our proposed approach is intended to apply consistently to firms that offer motor finance
- Targeted only at cases in which action is needed: Our proposals are targeted at only those discretionary commission models where we have identified harm.

38. We have had regard to the Regulators' Code for the parts of the proposals that consist of general policies, principles or guidance. We consider that the proposals will be lead to improved outcomes for consumers and that they address the harms identified during our Motor Finance Review.

Annex 5
Abbreviations used in this paper

ASIC	Australian Securities and Investments Commission
CBA	Cost benefit analysis
CONC	Consumer Credit sourcebook
CP	Consultation paper
CPFB	Consumer Finance Protection Bureau
DiC	Difference in Charges
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act 2000
LRRA	Legislative and Regulatory Reform Act 2006
PS	Policy statement

We have developed the policy in this Consultation Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

All our publications are available to download from www.fca.org.uk. If you would like to receive this paper in an alternative format, please call 020 7066 7948 or email: publications_graphics@fca.org.uk or write to: Editorial and Digital team, Financial Conduct Authority, 12 Endeavour Square, London E20 1JN

Appendix 1
Draft Handbook text

MOTOR FINANCE INSTRUMENT 2020

Powers exercised

A. The Financial Conduct Authority ("the FCA") makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137A (The FCA's general rules);
(2) section 137T (General supplementary powers); and
(3) section 139A (Power of the FCA to give guidance).

B. The rule-making provisions listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Consumer Credit sourcebook (CONC) is amended in accordance with the Annex B to this instrument.

Citation

F. This instrument may be cited as the Motor Finance Instrument 2020.

By order of the Board
[*date*] 2020

Annex A

Amendments to the Glossary of definitions

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

discretionary commission arrangement	any arrangement under which: (a) a *lender* permits a *credit broker* to decide or negotiate (whether or not within specified limits or subject to conditions or restrictions) the amount of any item included in the *total charge for credit* provided for in a *regulated credit agreement* in respect of which the *credit broker* carries on activity of the kind specified in article 36A of the *Regulated Activities Order*; and (b) the amount of any commission, fee or other financial consideration payable to the *credit broker* in connection with that *regulated credit agreement* is affected by the amount referred to in (a).

Annex B

Amendments to the Consumer Credit sourcebook (CONC)

In this Annex, underlining indicates new text and striking through indicates deleted text.

3 Financial promotions and communications with customers

…

3.7 Financial promotions and communications: credit brokers

…

3.7.4 G A *firm* should in a *financial promotion* or in a communication with a *customer*:

…

(2) indicate to the *customer* in a prominent way the existence and nature of any financial arrangements with a *lender* that might impact upon the *firm's* impartiality in promoting or recommending a *credit* product to ~~a~~ the *customer* or which might, if disclosed by the *firm* to the *customer*, affect the *customer's* transactional decision in relation to the *credit* product;

…

3.7.4A G (1) Where the amount of any commission, fee or other remuneration payable under a financial arrangement in relation to the *credit* product in *CONC* 3.7.4G(2) that the *firm* is promoting or recommending varies due to a factor specified in the arrangement, for example a specific feature of the *credit* product or the level of work undertaken by the *firm*, the *firm* should make disclosure under *CONC* 3.7.4G in relation to the arrangement.

(2) Where:

(a) the *firm* has entered into arrangements (irrespective of how many other *persons* those arrangements are with) under which it may earn commission, fees or other remuneration in relation to two or more different *credit* products;

(b) the *customer* could be eligible for two or more of those *credit* products;

(c) the *credit* product that the *firm* is promoting or recommending is one of those *credit* products; and

(d) the commission, fees or other remuneration payable to the *firm* varies depending on which of the *credit* products the *customer* takes out,

the *firm* should make disclosure to the *customer* under *CONC* 3.7.4G in relation to the arrangements.

(3) The disclosure in (2) may be in general terms, but it should enable the *customer* reasonably to appreciate the effect of the arrangements.

…

4 Pre-contractual requirements

…

4.5 Commissions

Application

4.5.1 R …

(3) *CONC* 4.5.3R ~~and~~ to *CONC* 4.5.4R also apply to a *firm* carrying on the activities specified in article 36A(1)(a) or ~~(c)~~ (b) of the *Regulated Activities Order* in relation to:

…

(4) *CONC* 4.5.5G to *CONC* 4.5.8G apply to a *firm* with respect to *consumer credit lending* and *credit broking* in relation to a *regulated credit agreement* the purpose of which (in whole or in part) is to finance the purchase of a motor vehicle or under which a motor vehicle is bailed or hired.

…

Commissions: credit brokers

4.5.3 R A *credit broker* must prominently disclose to a *customer* in good time before a *credit agreement* or a *consumer hire agreement* is entered into, the existence and nature of any commission or fee or other remuneration payable to the *credit broker* by the *lender* or *owner* or a third party ~~in relation to a *credit agreement* or a *consumer hire agreement*~~, where ~~knowledge of~~ the existence or amount of the commission, fee or other remuneration could actually or potentially:

(1) affect the impartiality of the *credit broker* in recommending ~~a particular product~~ the *credit agreement* or the *consumer hire agreement*; or

(2) if made known to the *customer*, have a material impact on the *customer's* transactional decision to enter into the *credit agreement* or the *consumer hire agreement*.

[**Note:** paragraph 3.7i (box) and 3.7j of *CBG* and 5.5 (box) of *ILG*]

4.5.3A R In circumstances where the *credit broker* is required to disclose the existence and nature of any commission, fee or other remuneration under *CONC* 4.5.3R, it must also disclose to the *customer*, at the same time and with equal prominence, how the existence and nature of this commission, fee or other remuneration may affect the amounts payable by the *customer* under the relevant *credit agreement* or *consumer hire agreement*.

4.5.3B G (1) Where the amount of any commission, fee or other remuneration in *CONC* 4.5.3R varies due to a factor specified in the arrangement or agreement under which the commission, fee or other remuneration is payable, for example a specific feature of the *credit agreement* or *consumer hire agreement* or the level of work undertaken by the *credit broker*, the *credit broker* should make disclosure under *CONC* 4.5.3R in relation to the commission, fee or other remuneration.

(2) Where:

(a) the *firm* has entered into arrangements (irrespective of how many other *persons* those arrangements are with) under which it may earn commission, fees or other remuneration in relation to two or more two or more different *credit agreements* or *consumer hire agreements*;

(b) the *customer* could be eligible for two or more of those agreements;

(c) the *credit agreement* or the *consumer hire agreement* the *firm* is recommending is one of those agreements;

(d) the commission, fees or other remuneration payable to the *firm* varies depending on which of the *credit agreements* or *consumer hire agreements* the *customer* enters into,

the *firm* should make disclosure to the *customer* under *CONC* 4.5.3R in relation to the arrangements.

(3) The disclosure in (2) may be in general terms, but it should enable the *customer* reasonably to appreciate the effect of the arrangements.

(4) The *credit broker* is not under *CONC* 4.5.3AR required to provide to the *customer* an individually tailored illustration of how the commission, fees or other remuneration in *CONC* 4.5.3R may affect the amounts payable by the *customer* under the *credit agreement* or *consumer hire agreement*.

…

Prohibition on discretionary commission arrangements in the motor finance market

Purpose

4.5.5 G The purpose of *CONC* 4.5.6R to *CONC* 4.5.8G is to prohibit *credit brokers* and *lenders* to whom they introduce *customers* wishing to enter into *regulated credit agreements* to finance the acquisition of motor vehicles from making or relying on contractual arrangements under which *credit brokers* are given authority to decide or negotiate the prices of those *regulated credit agreements* on behalf of *lenders* and the amount of commission the *credit brokers* earn is affected by those prices.

Prohibition

4.5.6 R A *lender* or *credit broker* must not:

(1) enter into or have rights or obligations under a *discretionary commission arrangement*; or

(2) seek to exercise, enforce or rely on rights or obligations under a *discretionary commission arrangement*, including any rights or obligations to receive or tender payment of commission or other financial consideration.

Examples of discretionary commission arrangements

4.5.7 G The following are examples of *discretionary commission arrangements*:

(1) An agreement under which the *lender* sets a minimum rate of interest and the commission payable by the *lender* to the *credit broker* in respect of a *regulated credit agreement* entered into by the *lender* is calculated by reference to the difference between the rate of interest negotiated by the *credit broker* and payable by the *customer* under the *regulated credit agreement* and the minimum rate of interest. These types of arrangements are often referred to as “increasing difference in charges” or “interest rate upward adjustment” arrangements.

(2) An agreement under which the *lender* sets a maximum rate of interest and the commission payable by the *lender* to the *credit broker* in respect of a *regulated credit agreement* entered into by the *lender* is calculated by reference to the difference between the rate of interest negotiated by the *credit broker* and payable by the *customer* under the *regulated credit agreement* and the maximum rate of interest. These types of arrangements are often referred to as “decreasing difference in charges” or “interest rate downward adjustment” arrangements.

(3) An arrangement or agreement under which the commission payable by the *lender* to the *credit broker* in respect of a *regulated credit agreement* entered into by the *lender* varies (within set parameters) according to the rate of interest negotiated by the *credit broker* and payable by the *customer* under the *regulated credit agreement*. These types of arrangement are often referred to as "scaled models".

Accrued commissions

4.5.8 G (1) *CONC* 4.5.6R does not affect commissions under *discretionary commission arrangements* liability for which accrued before the date on which *CONC* 4.5.6R came into force. *CONC* 4.5.6R does affect, however, commissions under *discretionary commission arrangements* that became due on or after the date on which *CONC* 4.5.6R came into force, irrespective of whether the relevant *discretionary commission arrangement* was entered into before or after the date on which *CONC* 4.5.6R came into force.

(2) Accordingly, commissions under a *discretionary commission arrangement* relating to *regulated credit agreements* entered into before the date on which *CONC* 4.5.6R came into force are not affected by *CONC* 4.5.6R.

(3) However, commissions under a *discretionary commission arrangement* relating to *regulated credit agreements* entered into after the date on which *CONC* 4.5.6R came into force (whether or not the *discretionary commission arrangement* was entered into before that date) are affected by *CONC* 4.5.6R.

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