Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: PS20/8**:** Motor finance discretionary commission models and consumer credit commission disclosure

Lead regulator: FCA

Date of assessment: 5 November 2020

Commencement date: 28 January 2021

Origin: Domestic

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? All

Brief outline of proposed new or amended regulatory activity

PS20/8 introduced two sets of changes in response to harm we identified during the motor finance review.

A. Discretionary commission model ban

We found harm caused by commission arrangements 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. That is to say that the amount of commission is effectively tied to the interest rate payable. We refer to these forms of commission as 'discretionary commission models'.

For some arrangements, the interest-linked element of the dealer's commission is significant and a large share of potential earnings. Differences between commission levels paid to the broker at the lowest and highest interest rates could be significant. Without appropriate systems and controls, discretionary commission models could provide incentives for dealers to arrange finance at higher interest rates, which would significantly increase consumers' financing costs. In determining the extent of consumer harm posed by these commission models, we estimated that on a typical motor finance agreement of £10,000, higher broker commission under one form of discretionary commission model can result in the customer paying around £1,100 more in interest charges over the four-year term of the agreement. While the increased interest rate would cause an increase in the revenue earned by lenders per loan, the higher cost to consumers could cause a reduction in the total quantity of loans made. This in turn would lead to a net reduction in lenders' profits, and a reduction in participation from consumers who would benefit from motor finance at a lower cost.

We are banning discretionary commission models in the motor finance market. We believe this will be the most effective way of addressing the harm we observed during our motor finance review. We estimate this will save consumers around £165m a year in lower interest costs.

B. Changes to commission disclosures

We also found that firms were often failing to give customers timely, relevant information. So we have made minor changes to aspects of our commission disclosure rules and guidance in all consumer credit markets. Examples of these changes include requiring credit brokers to make their commission disclosure 'prominent' and requiring disclosure of the 'nature' of the commission, and not just the 'existence' of the commission. The changes to commission disclosure are designed to be low cost and result in refinements to firms' existing practices.

Which type of business will be affected? How many are estimated to be affected?

A. Discretionary commission model ban

This will impact firms that enter into or broker regulated credit agreements in respect of motor finance hire purchase or conditional sale agreements. In theory, approximately 150 lenders will be impacted – however, (i) nearly 90% of lending is concentrated among 15 firms and (ii) only those firms operating discretionary commission models will be impacted. We do not have robust estimates of how many credit brokers are engaged in motor finance – however, our most recent data points to at least 6,500 firms, some of which will be carrying out motor finance broking as a secondary business line. Our data analysis ahead of consulting on the discretionary commission model ban comprised a representative sample of agreements entered into by lenders, across all broker types.

B. Changes to commission disclosures

These changes will apply more broadly across consumer credit sectors, not just motor finance. Approximately 35,200 firms will be affected – 33,300 holding broking permissions and 1,900 holding lending permissions.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2020	2021	10	-1442.8	167.6	838.0

Please set out the impact to business clearly with a breakdown of costs and benefits

A. Discretionary commission model ban

Direct costs (one-off and ongoing)

We expect lenders and brokers that currently operate discretionary commission models to incur costs implementing our ban. In total, we expect the whole industry would incur implementation costs of £200m in the first year, and £170m in subsequent years.

Lenders in aggregate would incur one-off costs of £13m and ongoing costs of £42m a year.

The high interest costs driven by the use of discretionary commission models 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.

Therefore, lenders would also incur direct costs in the form of lost earnings driven by lower interest rates. We estimate that lenders would lose around £40m from the intervention, which would transfer to consumers in the form of decreased financing costs.

We did not consider it necessary to carry out a full profitability analysis, as we believe the figure we have calculated as the loss of earnings is a good proxy for profit. Our figure for the loss of earnings for lenders is calculated as the difference between the decrease in commission income paid by lenders to brokers and the revenue losses to lenders due to consumers being charged lower interest rates. We believe these factors cover the major changes to lenders' earnings so provide a good proxy for change in profit.

We believe the only other notable cost changes will stem from changes to consumer behaviour. As a result of lower financing costs, we would expect consumers to increase the number of motor finance agreements they enter in to and for more consumers to be able to access motor finance. This 'volume effect' would offset some of the lost revenue for lenders and brokers (and benefit consumers) through increased sales, however there is a large degree of uncertainty in how consumers would respond so we have chosen not to estimate this. The 'volume effect' is likely to make our estimated cost to lenders an overestimate of the true cost.

We did not believe that our proposals would precipitate firms exiting the market, due to lending becoming unprofitable, and pose a risk to our market stability statutory objective. As a result, we did not believe this consideration provided sufficient justification to undertake full profitability analysis. Given these factors, we believe that loss of earnings, as we have calculated it, is an acceptable basis on which to estimate the costs borne by firms.

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. We surveyed large, small, and mid-sized lenders (representing 61% of the lending market) and used their input when scaling up estimates of these implementation costs. We do not expect the familiarisation costs to fall disproportionately on small firms.

Brokers in aggregate would incur one-off costs of £17m and ongoing costs of £128m a year.

Credit broking often forms a major profit centre for motor retailers, reflecting that significant sums can be generated from the sale of finance. Since the intervention will remove a conflict of interest that incentivises brokers to inflate interest rates in order to earn greater commissions, we expect commission revenues to decrease post-intervention. We estimate that brokers, the main beneficiary of increased commissions, would lose £125m, which would transfer to consumers in the form of decreased financing costs. As mentioned above, we did not carry out a profitability analysis. However, our estimate of brokers' lost revenue could be considered to be pure profit, given that our estimate bakes in an element of renegotiation between lenders and brokers to offset lost revenue.

We expect brokers to incur other 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. We surveyed large, small, and mid-sized brokers (representing 39% of the broker market) and used their input when scaling up estimates of these implementation costs. We do not expect the familiarisation costs to fall disproportionately on small firms.

<u>Summary of costs of A. discretionary commission model ban</u>

Type of firm	Direct costs
Lender	**£13m one-off and £42m/yr ongoing**
Broker	**£17m one-off and £128/yr ongoing**

B. Changes to commission disclosures

We expect firm will incur costs familiarising themselves with the relevant parts of our policy document and new wording in the rules (such as the new requirement to disclose the 'nature' of commissions). They may also incur costs as their compliance and legal staff undertake a "gap analysis": a legal review of the requirements against current practices.

Some firms were not previously compliant with the rules on commissions even as they were before our changes (note the motor finance review found that many firms were not), such as the disclosure of the 'existence' of commission as required by CONC 3.7.4G and 4.5.1R. They will incur implementation costs to bring their businesses into line with these existing requirements. Firms should already have been complying with the rules and ensuring their business activities are compliant. These costs were considered when the rules were originally proposed.

The new costs that apply to all firms are for familiarisation and gap analysis. The firms to which the new rules are relevant must read 3 relevant pages of the policy documentation 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.

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

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

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. The sample was the minimum of:

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

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. We had a total of 16,402 loans in our sample.

The overall cost benefit analysis which informed this proposal may assist the RPC to validate the score and can be found in Annex 2 of our consultation paper CP19/28.

The final policy statement (PS20/8), which includes feedback on our cost benefit analysis, confirmed our intention to go ahead with our proposals largely unchanged. This also explained that we plan to review our intervention in 2023/24. We will use market research reports to track the volume and composition of motor finance agreements contracted over time (by type of agreement and for new/used cars) and the volume of vehicle purchases. This will enable us to monitor finance agreements in new and used car sales.