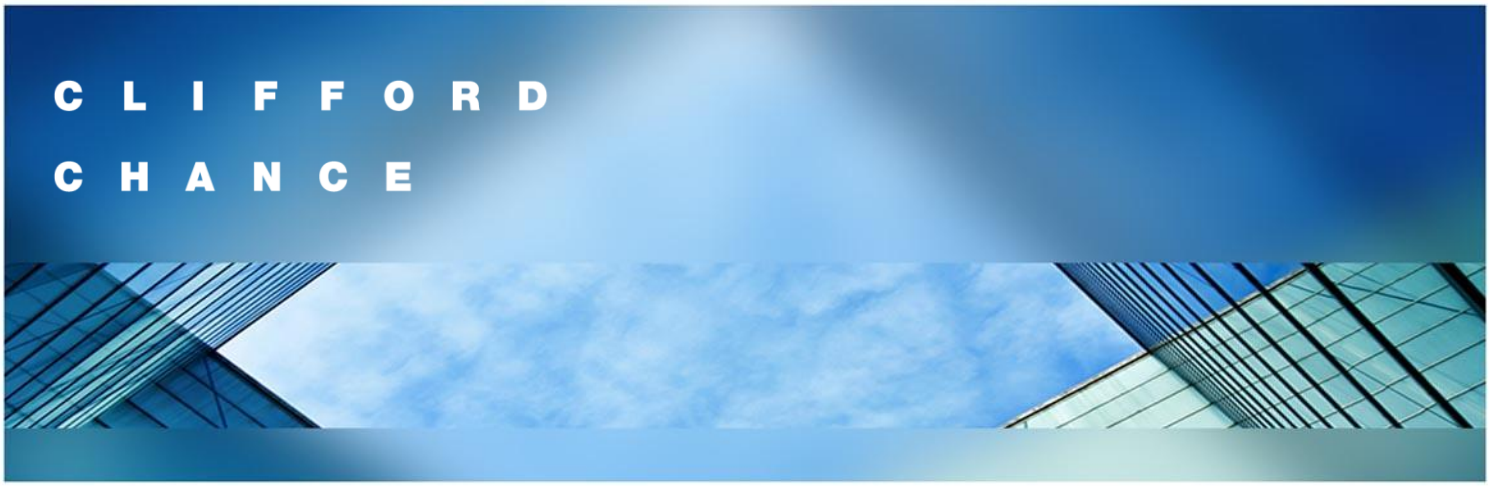

MOTOR FINANCE COMMISSIONS – TAKING STOCK

The investigation by the Financial Conduct Authority (FCA) into potential mis-selling of motor finance on the basis of discretionary commission arrangements will potentially have a wide-reaching impact. In this briefing, we set out a stocktake of the ongoing FCA investigation, the position of the financial ombudsman and the outcome of recent court challenges in relation to broker commission which may impact a wider range of commission models. Finally we highlight implications and action points for firms.

Key issues

- In 2021, the FCA banned Discretionary Commission Arrangements (DCAs), which link broker commission to the customer's interest rate and allow brokers wide discretion to set or adjust that rate.
- After the DCA ban, a surge in complaints involving DCAs and recent FOS decisions upholding rejected claims have caused FCA to launch a review to investigate whether there has been widespread consumer harm requiring remediation, potentially in the form of a statutory redress scheme.
- Judicial review of a FOS decision may have a bearing on the FCA's proposed course of action following its investigation.
- The recent Court of Appeal judgment in Hopcraft, Johnson and Wrench has implications beyond motor finance and the FCA may extend its complaints-handling pause to other financing arrangements not involving DCAs.
- The time-frame for the FCA investigation was extended to 4 December 2025 in September and firms will not know the FCA's conclusions and any redress proposals until May

INTRODUCTION

Many people buying a new car or other private vehicle will prefer to look at ways to spread the cost rather than purchase outright in cash. Motor finance brokers (including motor dealers) arrange finance for vehicle purchases by consumers, acting as brokers for the lenders with whom a customer enters into a financing arrangement (a credit agreement or Personal Contract Purchase, a form of hire purchase agreement[1]). This 'credit broking' activity is FCA-regulated, and those licensed to carry out credit broking must (among other things) comply with the provisions of the FCA's rules in its Consumer Credit sourcebook (CONC). Additionally, all FCA-authorised firms must comply with the FCA's high level Principles for Businesses[2].

How brokers are paid for introducing business to lenders is a commercial matter between the lender and broker. In many cases this payment is by means of commission arrangements, or a combination of a flat fee plus commission.

The FCA's CONC rules require brokers to make a range of pre-contractual disclosures to consumers. In relation to commission arrangements, the FCA changed its rules with effect from 28 January 2021 following a review that found certain commission structures had led to higher financing costs for consumers due to the incentives they created for brokers and the associated conflicts of interest (see **BOX 1** for background on the FCA's previous work in the area). On that date, alongside clarificatory changes to existing commission

[1] Consumers may decide to lease a car instead of purchasing it – under so-called Personal Contract Hire arrangements, a customer leases, but does not own, the vehicle.
[2] Firms must comply with all of the FCA Principles, but particularly relevant in this context are Principle 6 (treating customers fairly), Principle 7 (communications with clients) and Principle 8 (conflicts of interest). Since 31 July 2023, Principles 6 and 7 have been replaced by Principle 12 – the Consumer Duty - for firms serving retail customers.

disclosure rules[3] to address inconsistent application by firms, the FCA introduced a new rule (*CONC 4.5.6R*) prohibiting lenders and brokers from entering into so-called discretionary commission arrangements (DCAs), which allow a broker discretion to adjust the interest rate a borrower pays to earn more commission (see **BOX 2**).

Under that rule, "*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, fee or other financial consideration*."

BOX 1 Timeline of FCA scrutiny of broker commission

- **April 2017** – In its Business Plan 2017/2018 the FCA announced its intention to conduct an exploratory review to look at sales processes in the motor finance sector, due to concerns that there might be a lack of transparency, potential conflicts and irresponsible lending in the motor finance industry.
- **July 2017** – The FCA published details of the work it was undertaking and its key areas of focus .
- **March 2018** – The FCA published an update on its work setting out its initial findings and further work it would be undertaking. Alongside issues including affordability and adequacy of disclosures, this included exploring whether lenders were adequately managing the risks around commission arrangements, and whether commission structures had led to higher finance costs for consumers because of the incentives they created for brokers.
- **March 2019** – The FCA published 'Our work on motor finance – final findings', in which it expressed concern that the way commission arrangements were operating in motor finance may be leading to consumer harm 'on a potentially significant scale' because of the way lenders choose to remunerate their brokers. In particular, the FCA flagged up the conflict of interest in discretionary commission. FCA estimated that commission models which allowed broker discretion over the interest rate could be costing customers £300m more annually when compared against a baseline of flat fee models. On a typical agreement, these models might cost a consumer £1,100 more over a four year term. The FCA also noted that these commission arrangements had the potential to de-link credit risk and customer interest, such that, where these commission models were utilised, a customer with a high credit score might not be able to access a lower interest rate to reflect their lower risk to the lender, as would be expected in other finance arrangements. The FCA confirmed that it was assessing the options for a policy intervention.
- **July 2020** – Following a consultation in October 2019, the FCA released its policy statement in July 2020 confirming its proposal to introduce a ban on DCAs and making minor changes to its Handbook rules and guidance on the disclosure of commission arrangements with lenders, with the aim of ensuring consumers in all consumer credit markets receive more relevant information.
- **28 January 2021** – the FCA's ban on DCAs and clarificatory Handbook changes took effect.

[3] The rule clarifications (including the new DCA ban) are set out in FCA rule instrument 2020/36.

COMMISSION ARRANGEMENTS – WHAT *SHOULD* BROKERS DISCLOSE?

Pre-contractual disclosures by brokers must be made "in good time before a credit agreement is entered into". Typically a firm would put such disclosures in customer information forms and/or initial disclosure documents. In line with the requirements of CONC and Principle 7, pre-contractual disclosures must be clear, fair and not misleading.

Pre-28 January 2021

Prior to the FCA rule changes in January 2021, brokers were required to disclose to customers the existence of any commission (or fee, or other remuneration) in circumstances where knowledge of the existence/amount of commission might: (i) affect the broker's impartiality in recommending a particular product; or (ii) have a material impact on the customer's transactional decision. If asked, brokers were also required to disclose the amount (or likely amount) of commission.

However, the FCA's CONC rules contained no explicit requirement for brokers to disclose further details of the nature of the commission and/or whether the commission arrangements gave rise to any conflict of interest.

The effect of these rules was that it was possible that wording such as "*Lenders may pay us a fee for [introducing consumer finance customers]*" could comply with the relevant rules – and indeed many brokers in the market used disclosures worded along these lines. The use of this wording was recently considered (and found inadequate) by the Financial Ombudsman, as noted below.

28 January 2021 onwards

Following the January 2021 rule changes, brokers were additionally required to disclose the nature of the commission. Brokers still did not have to disclose the amount of commission unless specifically asked. These rules apply to all consumer credit markets, not only to the motor finance sector.

FCA INVESTIGATION

Before the introduction of the DCA ban in 2021, DCAs were the most common commission arrangement in the motor finance sector. Since the DCA ban has been in effect, the FCA has noted a surge in complaints about DCAs, mirrored by a similar increase in data subject access requests (DSARs, often a precursor to complaints).

Almost all[4] of these complaints have not been upheld (i.e. have been rejected) by the firms to which they were addressed.

Rejected complaints can be referred to the Financial Ombudsman Service (FOS). At the beginning of 2024, the FOS issued its first two final decisions on motor finance complaints involving DCAs, in each case finding against the firm involved.

BOX 2 What *is* a Discretionary Commission Arrangement?

In its Glossary, the FCA defines a discretionary commission arrangement as:

"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 (directly or indirectly) in connection with that regulated credit agreement is affected (in whole or part) by the amount referred to in (a)."

New Guidance introduced by the FCA into its Handbook in January 2021 (CONC 4.5.7G) provides the following examples:

(1) "Increasing Difference in Charges (DIC)" arrangements (also referred to as “interest rate upward adjustment” arrangements)

(2) "Decreasing DiC” arrangements (also referred to as “interest rate downward adjustment” arrangements)

(3) “Scaled models”

[4] In its January 2024 policy statement, the FCA noted that 99% of complaints received between January 2019 and the end of June 2023 were rejected.

The FCA announced[5] in January 2024 – without prior consultation – that it was making temporary changes to the complaints-handling rules while it deployed its powers under s166 of the Financial Services and Markets Act 2000 (FSMA 2000)[6] to conduct an in-depth investigation of firms' historical practices. The FCA's concern is that the FOS decisions may prompt a significant increase in complaints to firms (and, if rejected, referrals to FOS). The aim of the FCA's investigation is to establish whether there is likely to have been widespread failure by firms that means large numbers of consumers are owed redress. The investigation entails a 'skilled person' examining a large sample of customer files to review the arrangements between lenders and brokers, and the information provided to consumers at the point of sale, including how commission was disclosed.

The effect of the changes to the complaint-handling rules was to apply a 37-week (approx. 9 month) pause to the eight-week deadline for motor finance firms to provide a final response to customer complaints about motor finance involving a DCA between the lender and the broker.

Originally, this pause was to apply to complaints received by firms on or after 17 November 2023 and on or before 25 September 2024. However, at the end of September 2024 the FCA confirmed[7] it would extend the duration of the pause until 4 December 2025. The FCA may consult on an earlier end-date if considers it does not need this length of time.

FCA investigation: Key relevant dates

- **6 April 2007** – the date on which the FOS took over jurisdiction of motor finance complaints.
- **April 2014** – the date on which the FCA took on the regulation of motor finance and other consumer credit firms.
- **28 January 2021** – DCA ban took effect. Lenders were expected to review their systems and controls in light of the FCA's motor finance review findings and address any harm or potential harm they identified.
- **17 November 2023** – For complaints received after this date, the FCA has paused the eight-week deadline for motor finance firms to provide a final response to customer complaints related to DCAs.
- **11 January 2024** – Temporary adjustments to motor finance complaints- handling rules took effect from this date.
- **25 September 2024** – original expiry date for the adjustments to motor finance complaints-handling rules; and date by which the FCA originally expected to issue the findings of its investigation.
- **May 2025** – revised date by which FCA intends to set out its next steps. This will include whether it has concluded that compensation

[5] See PS24/1: Temporary changes to handling rules for motor finance complaints, published 11 January 2024: https://www.fca.org.uk/publication/policy/ps24-1.pdf

[6] The FCA can use its 's166 power' to the power to appoint a 'skilled person' to produce a report on any issue, if it is relevant to the carrying out of our statutory functions. Firms must provide all reasonable assistance to a skilled person, including any information that the skilled person considers necessary or desirable to carry out their task.

[7] See PS24/11: Extending the temporary changes to handling rules for motor finance complaints
, published 24 September 2024: https://www.fca.org.uk/publication/policy/ps24-11.pdf

should be payable to affected consumers and, if so, a consultation on proposed remedies.

- **4 December 2025** – date by which FCA intends to confirm final rules for how consumers will be compensated. End of pause to the complaints-handling rules - firms will be expected to provide a final response to existing complaints from this date, and resume complaints-handling within the usual 8-week time-frame going forward..
- **11 April 2026** – FCA proposes to extend until this date the rule requiring lenders and credit brokers to maintain and preserve records relevant to future claims relating to agreements with DCAs entered into before the DCA ban was imposed.
- **29 July 2026, or 15 months from receipt of a final response letter from a firm** – The FCA proposes these timescales for consumers to be able to refer a complaint to FOS (an extension on the usual six-month window).

FCA investigation: The potential scale of the problem

The FCA is examining thousands of loan records over a 14-year period (2007 to 2021) to identify patterns, determine the extent of any overcharging, and assess the overall impact on consumers. In its January policy statement, the FCA estimated that "*On average, between 2007 and 2020, approximately three quarters of all agreements had a DCA of some description*."

In terms of affected financing arrangements, the potential scope is any financing involving a DCA, taken out between 6 April 2007 and 28 January 2021, for the purchase of a private vehicle (business financing is excluded). 'Vehicle' for this purpose would include other vehicles besides cars, such as motorcycles or vans. Car leasing (personal contract hire) arrangements are excluded.

The potential level of compensation for affected customers will be subject to the FCA's decision on remedies.

FCA investigation: Possible redress scheme?

Following the conclusion of its review, the FCA will take into account its findings, as well as issues arising from judicial review proceedings brought in respect of one of the FOS decisions and the recent Court of Appeal decision which found against lenders FirstRand Bank and Close Brothers. These are discussed further in the sections below.

The FCA has said that, should its investigation reveal a widespread issue, it will "*identify how best to make sure people who are owed compensation receive an appropriate settlement in an orderly, consistent and efficient way".*

The FCA may decide to implement a consumer redress scheme using its powers under section 404 of FSMA 2000. Previous schemes introduced under these powers include in relation to PPI (mis-selling), IRHP products (mis-selling), Arch Cru (mis-selling), and most recently British Steel Pension Scheme redress (poor advice).

FINANCIAL OMBUDSMAN SERVICE

The FOS said in January[8] that, as at the beginning of December 2023, over 10,000 rejected motor finance complaints had been referred to it, with over 90% of those complaints referred since the start of 2022. In a further update in May[9], the FOS noted that it had been contacted by 20,000 individuals related to car finance commission. Given the prevalence of DCAs prior to the ban, it is reasonable to assume a large proportion of those other FOS referrals will relate to DCAs.

The FCA noted in its January 2024 Policy Statement that the basis on which firms had been rejecting almost all DCA complaints was that they did not consider that they had acted in an unfair or non-compliant way and that their actions had not caused loss to consumers. While firms are likely to continue to reject complaints on this basis, many consumers disagree with firms' decisions to reject their complaints.

JUDICIAL REVIEW OF THE OMBUDSMAN'S DECISION

In April 2024, Clydesdale Financial Services Limited – trading as Barclays Partner Finance (Barclays Partner Finance) – applied for judicial review of the FOS decision[10] to uphold a complaint relating to its use of a DCA. This is one of the two FOS decisions that has prompted the FCA's investigation.

At a rolled-up hearing in October 2024, the Court considered the question of whether to grant permission and, if permission is granted, consider the substantive claim. That claim involves important questions of law about the proper interpretation of the FCA's rules, its Principles for Businesses and Consumer Credit Act 1974 and will also be expected to impact the FOS's approach to complaints involving similar issues. The FCA is an interested party in this case. Given the importance of the Court's decision in the judicial review, FOS does not propose to issue any further final decisions on cases involving DCAs pending the outcome.

The outcome of the hearing has not yet been published. At this stage, it is difficult to predict what that outcome will be. Applications for judicial review of FOS decisions are relatively rare and often unsuccessful. In the event that the judicial review application is dismissed, it would also be open to the applicant to seek permission to appeal.

COURT OF APPEAL DECISION IN HOPCRAFT, JOHNSON AND WRENCH

A significant number of cases relating to DCAs are also brought in the county courts, on grounds that the DCAs were either not disclosed or hidden in the fine print ('secret commissions') or although commission was disclosed, important details were not ('half-secret commissions').

Three civil cases were heard together by the Court of Appeal in early July and judgment in *Johnson v FirstRand Bank Limited [2024] EWCA Civ 1282* was

[8] https://www.financial-ombudsman.org.uk/news/fca-announces-temporary-complaint-handling-rules-relating-certain-motor-finance-complaints
[9] https://www.financial-ombudsman.org.uk/news/update-car-finance-commission-complaints
[10] FOS Decision DRN-4326581: https://www.financial-ombudsman.org.uk/decision/DRN-4326581.pdf

handed down on 25 October 2024[11]. The three civil appeals involved proceedings brought by Mr Johnson and Mr Wrench against FirstRand Bank (T/A MotoNovo Finance) and by Ms Hopcraft against Close Brothers. Each of the claimants sought, among other things, the return of the commissions paid to the credit brokers by the defendant lenders (some of the commissions where paid under DCAs and others on the basis of a fixed percentage of the loan). The Court was asked to consider issues such as the common law authorities on secret and half-secret commission, the nature of a broker's duty towards a borrower for whom it has arranged finance, the liability of a lender as an accessory to a broker's actions (under s56 of the Consumer Credit Act 1974), and the nature of an unfair relationship under s140A-B of the CCA.

In a judgment viewed as potentially far-reaching, and which may be overturned on appeal to the Supreme Court, the Court has held unanimously that:

- brokers could not lawfully receive a commission from a car finance lender without obtaining fully informed consent from the customer; and
- for the customer to be able to give fully informed consent, the customer would have needed to be told all the material facts that might affect their decision, including the amount of commission to be paid to the broker and how this would be calculated.

The Court was of the view that a broker's role in providing information to lenders on the customer's behalf, and to the customer about the available finance, means that brokers owe a 'disinterested duty' to customers. Furthermore, brokers also have a fiduciary duty to customers arising from the nature of the relationship, the tasks with which the brokers are entrusted, and the obligation of loyalty which is inherent in the disinterested duty.

In terms of what is adequate disclosure of commission, the Court held that the question whether the borrower has been told or informed about the commission will depend on the facts of each case, including the steps, if any, that are taken to bring the matter to his attention. This means that a statement in the terms and conditions of the credit agreement that commission may or will be paid may not be sufficient.

In terms of a lender's potential accessory liability, the Court stated that "*The lender cannot assume that there has been full disclosure of the commission simply because the lender (or even the regulator) requires the broker to make such disclosure. If the lender does not take it upon itself to give full disclosure to the consumer, it deliberately takes the risk that the broker will not do so…*"

The Court was only asked to consider the unfair relationship provisions of the CCA (sections 140A-B) in respect of one of the appeals. It confirmed that claims for unfair relationship must be determined on the merits of each individual case. In this case, it concluded that payment of commission of which the consumer is unaware will not necessarily make a relationship automatically unfair but confirmed that "*If the commission is very high in relation to the sum borrowed that may, in itself, be enough to make the relationship unfair where nothing, or nothing of substance, has been done to disclose the relationship between the lender and the broker*."

Stephen Haddrill, director general of the Finance and Leasing Association, has commented that the judgment is "significant and unexpected" and would

[11] Johnson v Firstrand Bank Limited [2024] EWCA Civ 1282

have consequences "which stretch far beyond the motor finance sector". Both respondents in the Court of Appeal have indicated that they will seek to appeal the decision in the Supreme Court.

PROVISIONING

As with most types of consumer credit, motor finance is not protected by the Financial Services Compensation Scheme. If firms fail, consumers may not get back money they are owed. The FCA wrote[12] to motor finance firms in April 2024 to remind them that they must maintain adequate financial resources.

Additionally, amid concern that the FCA's investigation may lead to an industry-wide obligation to pay compensation, key lenders in the sector have been setting aside funds to meet potential compensation demands arising from 'deemed liability' for broker failures under s56 of the CCA. For some firms, this provisioning is reported to be in the hundreds of millions.

CONCLUSIONS

If the FOS is not found to have exceeded its remit in the judicial review, the ramifications of the position FOS has taken on DCAs could be significant. A key element of those decisions was to view the presence of a DCA as causing an inherent conflict of interest between broker and customer. Appropriate management of that conflict of interest required, in the ombudsmen's view, more than compliance with the rules in CONC in order for the firms concerned to appropriately discharge their duty to comply with FCA Principles.

Should it not be overturned in the Supreme Court, the Court of Appeal decision could result in a dramatic increase in claims and have a very significant impact on some lenders and on how motor and other consumer financing is conducted going forward. The case has implications for both consumer and business to business credit. The Court of Appeal stated in the conclusion to its judgment that "*..it may be that on some future occasion it will be felt desirable for the Hurstanger and Wood lines of authority to be considered in greater depth, and for a definitive pronouncement to be made by the Supreme Court about the circumstances in which the payment of a commission by a third party to another person's agent or fiduciary will give rise to a liability (whether as principal wrongdoer or an accessory) on the part of the payer."*

Some lenders have paused lending in light of the judgment. The FCA has stated[13] that it is considering the Court of Appeal judgment carefully and "*working at pace through the potential benefits and risks*" of potentially extending the complaints-handling pause to cover complaints relating to other types of commission in motor finance. The FCA is keen to understand if the Court of Appeal decision is the final decision on this issue, with FCA CEO Nikhil Rathi stating "*The 2 lenders in the case intend to appeal and it is in everyone's interest that when they do, the Supreme Court decides quickly*

[12] FCA 'Dear CEO' letter, Action needed: maintaining adequate financial resources, published 12 April 2024: https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-action-needed-maintaining-adequate-financial-resources.pdf
[13] FCA statement on Court of Appeal judgment in Hopcraft, Johnson and Wrench https://www.fca.org.uk/news/statements/court-appeal-judgment-hopcraft-johnson-wrench

whether it will take the appeal and, if it does, whether it agrees with the Court of Appeal."

Claims Management Companies (CMCs) will be paying close attention to developments in this area. The FOS annual complaints data and insights released in July[14] showed professional representatives (including CMCs) were involved in 25% of FOS referrals in 2023/2024, an increase from 18% the previous year.

However, according to CMC annual complaints data for 2023/2024[15] CMC-assisted complaints referred to the FOS have a 46% uphold rate overall, with consumer credit complaints having an average uphold rate of less than 30%. Nonetheless, CMCs are likely to market their services aggressively in DCA cases – and, following the Court of Appeal judgment, cases involving other commission types - and may not be deterred by the FOS's proposals (under new statutory powers) to charge case fees to professional representatives.

Firms should engage with processing any existing claims (albeit that their obligation to issue final responses is paused) and co-operate with the FCA's information and data requests as part of its investigation.

[14] https://www.financial-ombudsman.org.uk/data-insight/annual-complaints-data/annual-complaints-data-insight-2023-24#block-7253
[15] https://cmc.financial-ombudsman.org.uk/data-insight/cmc-annual-complaint-data

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