UK motor finance sector faces potential crisis after court ruling on hidden commissions

A brewing storm in the motor finance industry is bracing itself for a potential crisis, with lenders facing a flood of compensation claims following a recent court ruling. Lars Mucklejohn examines whether the sector is on the cusp of a disaster akin to the PPI scandal.

A London court's decision on "secret" car loan commissions has sent shockwaves through the industry, prompting major lenders to halt new business, overhaul their systems, and seek urgent talks with the government, as reported by City AM.

The Court of Appeal's ruling, handed down last Friday, determined that brokers cannot lawfully receive commissions from lenders without obtaining customers' fully informed consent.

This development has increased the likelihood of the Financial Conduct Authority (FCA) introducing a redress scheme for lenders as part of its review into discretionary commission arrangements (DCAs), potentially exposing banks to billions in additional compensation costs.

In response, Lloyds Banking Group has eliminated commission payments for new loans at its motor finance arm, Black Horse, the UK's largest auto lender.

On Tuesday, William Chalmers, the group's chief financial officer, held an emergency call with analysts and investors to discuss the court ruling's implications, according to City AM.

However, he did not provide details on whether Lloyds would set aside additional provisions beyond the £450m allocated in

February to cover potential costs. However, Chalmers did mention that the factors influencing the bank’s provisioning model have broadened beyond just estimating the impact of the FCA’s review.

Since the ruling, Lloyds’ share price has plummeted by 14 per cent. RBC Capital Markets predicts that in a worst-case scenario, Lloyds could suffer a £3.9bn blow to its profits.

Earlier this year, Close Brothers, deemed the bank most vulnerable to the FCA’s investigation in relative terms, made arrangements to strengthen its finances by £400m and has since offloaded its wealth division for £200m.

However, the circumstances have deteriorated significantly for the 146 year old merchant bank.

Close Brothers, which participated in last week’s test case, has suspended new car loans following the ruling. Its share price, already severely impacted earlier this year, has plunged 37 per cent since last Friday and is now at a thirty-year low.

RBC has projected a worst-case scenario where Close Brothers suffers a £387m loss from compensation, interest, and administrative costs. This figure surpasses the company’s current market capitalisation of £343m.

In other news, Santander UK has postponed the release of its complete third-quarter results to assess the ruling. RBC anticipates a downside impact of £1.8bn.

The precedent set by the decision could apply to a range of consumer finance commissions, lawyers have argued
(Image: PA Archive/PA Images)

Exits are on the horizon

Several smaller auto lenders have also halted loans, including Zopa, Secure Trust Bank, MotoNovo, Mann Island, V12, and Northridge.

Analysts are flagging concerns that the recent legal developments could see several companies exiting the market as a result of judges essentially overturning prior guidance from the Financial Conduct Authority (FCA). Benjamin Toms from RBC remarked to City AM, “Banks will quickly adapt their contracts and processes to comply with the new rules,” but warned, “However, in the medium term, some lenders will decide that lending in this sector is no longer for them.”

Noticeably, firms like Secure Trust, which have ceased lending operations, had previously indicated they were not majorly affected by the FCA’s investigations. An industry executive confided in City AM about previous scepticism towards analyst warnings that financial institutions might face billions in potential liabilities for compensation, especially considering that the FCA had pointed out that only £165 million in additional fees had been levied upon consumers annually by Default Charges Agreements (DCAs) between 2007 and 2021a period now under FCA scrutiny.

The ban on DCAs, which were at one time a standard feature in around three-quarters of car loan agreements, has prompted a surge in historical complaints against the banking sector. Navigating these legacy issues, claim management companies are capitalising on the situation, vying for consumer compensation.

The aftermath of the FCA commencing its investigation was stark: within just four months, the Financial Ombudsman Service, which adjudicates disputes between consumers and finance entities, was inundated with 20,000 complaints concerning car finance.

An executive from a motor finance company disclosed to City AM that following Martin Lewis citing their bank on television as one not using Debt Collection Agencies (DCAs), the firm was inundated with over 2,000 complaints despite the endorsement.

Ministers scramble

Urgent consultations were initiated on Tuesday by Treasury ministers with Financial Conduct Authority (FCA) executives and members of the Finance and Leasing Association (FLA), the body representing car loan providers, centring around the recent court decision.

The FLA is now pressing the regulator for an extension of the temporary respite on the standard two-month period within which firms must address DCA grievances, a cessation that’s currently operative until December 2025. In a statement on

Tuesday, FCA chief Nikhil Rathi revealed the watchdog would think over this recommendation.

A spokesperson from the Treasury informed City AM: “The Treasury is working closely with the regulators and industry to understand the impact of this judgement.”

Subsequent to the judges’ ruling that lenders are obliged to disclose to consumers any dealer remunerations including not only bonuses but also flat fees there’s speculation by legal experts that the ramifications of this verdict might ripple out to encompass consumer finance commissions more broadly.

Toms remarked: “Three examples of the many questions which have been left outstanding include: Does this decision extend beyond motor finance? Which years are now in scope? And do all commissions paid need to be returned to customers? “.

In the wake of last week’s court ruling, it is anticipated that the Financial Conduct Authority (FCA) may further delay its progress on the review initially scheduled for September, then deferred to May 2025 this past July. This follows announcements by Close Brothers and First Rand, a South African bank, that they intend to challenge the recent judgement in the Supreme Court.

With the case’s commercial sensitivity in mind, the court is expected to fast-track the appeal, yet a swift resolution appears doubtful, putting the FCA’s ability to factor in the outcome into its May update in jeopardy. Furthermore, as banks ready their annual financial disclosures slated for February, calculating the full ramifications remains a challenge.

RBC analysts project that as a result, the regulatory body will likely postpone its announcement until summer. The FCA has yet to comment on these predictions.

Big business

The stalling of the motor finance sector could have severe repercussions on the UK economy by disrupting the automotive market and impacting sales. Last year saw lenders issue car loans amounting to £16.9bn, with 80% to 90% of new cars being bought on credit.

“Ultimately this will lead to lower supply of motor finance products, which will inevitably result in a higher cost of motor finance for the customer,” Toms explained.

A potential redress scheme might bear the weighty distinction of being the most significant for UK banks since the notorious payment protection insurance (PPI) scandal. In that instance, customers were compensated over £38bn between 2011 and 2019 due to the mis-selling of insurance policies.

Analysts have estimated that banks’ combined exposure has reached approximately £16bn to date. This figure does not account for the finance divisions of motor companies, which are responsible for the majority of auto lending in the UK.

Following the ruling, Honda and BMW temporarily halted sales to customers but have since resumed deliveries.