FCA's Review of Historical Motor Finance Commission Arrangements

On 11 January 2024, the FCA announced it would use its powers under section 166 of the Financial Services and Markets Act 2000 to review historical motor finance commission arrangements and sales at several firms, following high numbers of complaints from customers. The review followed the Financial Ombudsman Service ("FOS") publication of its first two decisions upholding customer complaints relating to discretionary commission arrangements ("DCAs") against two other lenders in the market.

The FCA issued an update to the market on 30 July 2024. In the announcement, it stated that due to delays in collecting and reviewing historical data, as well as relevant ongoing litigation, it would not be able to set out the next steps of its review by 24 September 2024 as it originally planned. The FCA now aims to set out next steps by the end of May 2025.

Overview of Commission Models Operated[1]

CBMF has operated in the motor finance market for over three decades, during which we have sought to comply with the relevant regulatory requirements.

Prior to 2016, CBMF operated an Upward Difference in Charges ("DIC") model. This allowed the dealer or broker full discretion over the customer rate and the commission earned on point-of-sale finance, subject to a hard cap on the amount of commission. Under the DIC model, commission, if any, was paid as a percentage of the total interest paid by the customer.

From 2016, CBMF introduced a Downward Scaled Commission ("DSM") model, which capped both the interest charged to the customer and commission paid to the dealer or broker. This meant that CBMF set the headline rate for the customer and the dealers could only reduce this by decreasing their level of commission. Under the DSM model, commission, if any, was paid as a percentage of the loan size.

From 2021 onwards, CBMF introduced a Risk Adjusted Pricing Model which set the rate for the customer and adjusted the rate according to the customer risk profile. Dealer discretion was removed entirely. Under the Risk Adjusted Pricing Model, commission, if any, is paid as a fixed percentage of the loan size.

All historical models included a "hard cap" on the commission amount paid to the broker or dealer. Commission disclosures were also reviewed and enhanced, as required, over time.

Impact on Close Brothers

The FCA review is progressing to determine whether there has been industry-wide failure to comply with regulatory requirements which has caused customers harm and, if so, whether it needs to take any actions. Based on the status at the end of the financial year and in accordance with the relevant accounting standards, the board has concluded that no legal or constructive obligation exists and it is currently not required or appropriate to recognise a provision at 31 July 2024 in relation to this matter. The FCA has indicated there could be a range of outcomes, with one potential outcome being an industry-wide consumer redress scheme. On 30 July 2024, the FCA indicated that, while no final decisions have been made, it is more likely than when it started its review that some kind of redress mechanism may be necessary. The estimated impact of any redress scheme, if required, is highly dependent on a number of factors including, for example, the time period covered; the DCA models impacted (the group operated a number of different models during the period under review); appropriate reference commission rates set for any redress; and response rates to any redress scheme. As such, the timing, scope and quantum of the potential financial impact on the group, if any, remain uncertain and cannot be reliably estimated at present. In addition, it is not currently practicable to estimate or disclose any potential financial impact arising from this issue.

The group is subject to a number of claims through the courts regarding historical motor finance commission arrangements. One of these, initially determined in the group's favour, was appealed by the claimant and the case was heard in early July 2024 by the Court of Appeal together with two separate claims made against another lender. The Court's decision is now awaited.

As of 31 August 2024, where individual cases were adjudicated in County Court, the courts found that there was no demonstrable customer harm and hence no compensation to pay in the majority of decided cases for Close Brothers. Nevertheless, there have been only a limited number of adjudicated cases at this time.

There are also a number of complaints that have been referred to the FOS for a determination. To date, no final FOS decisions have been made upholding complaints against Close Brothers. On 9 May 2024, the FOS announced that it would be unlikely to be able to issue final decisions on motor commission cases for some time due to the potential impact of a judicial review proceeding started by another lender in relation to one of its January 2024 decisions and also the outstanding Court of Appeal decisions.

1. For simplicity, dates shown above assume transition when substantially complete.

Since the announcement by the FCA of its review of historical motor finance commission arrangements in January 2024, we have seen a further increase in enquiries and complaints. We have also taken steps to enhance our operational capabilities to respond to increased complaints volumes and potential changes such as the implementation of a consumer redress scheme, if required. This financial year, we have incurred £6.9 million of costs associated with complaints handling and other operational costs associated with the FCA's review. This included increased resourcing in our complaints and legal teams, along with associated investments in data, systems and business processes. These costs are lower than our previous estimate of c.£10 million as we remain focused on mitigating the impact on resource expenses through outsourcing and deployment of automated solutions to assist in triaging new complaints, improving our processing speed. In the 2025 financial year, we currently estimate these costs will be between £10-15 million. We continue to monitor the impact on our current handling of these complaints and are following the playbooks in place to ensure we have the appropriate resources to respond effectively.

Further Strengthening our Capital Base to Continue to Support Customers and Protect our Valuable Franchise

While there is no certainty regarding any potential financial impact as a result of the FCA's review, the board recognises the need to plan for a range of possible outcomes. It is a long-standing priority of the group to maintain a strong balance sheet and prudent approach to managing its financial resources. To that end, the board considers it prudent for the group to further strengthen its capital position, balancing this with the need to continue supporting our customers and protecting our business franchise.

In March 2024, we announced a range of management actions which have the potential to strengthen the group's available CET1 capital by approximately £400 million by the end of the 2025 financial year (when compared to the group's projected CET1 capital ratio for 31 July 2025 at the time of our Half Year results announcement, prior to any management actions). We are now providing an update on the progress made since then.

We have retained c.£100 million of CET1 capital in the 2024 financial year as a result of the group's previously announced decision not to pay a dividend for the 2024 financial year.

We announced steps to further strengthen the group's capital position by optimising risk weighted assets ("RWAs"). We plan to reduce RWA growth by approximately £1 billion through a combination of selective loan book growth, partnerships and significant risk transfer of assets related to our Motor Finance business through securitisations. The combination of these actions could release c.£100 million of CET1 capital by the end of the 2025 financial year. In the second half, we grew the loan book selectively while maintaining support for our existing customers, with the impact reflected in the lower loan book growth of 2% in the six months since 31 January 2024. We currently plan for low single-digit percentage growth in the loan book in the 2025 financial year, with the associated impact to be reflected in the group's CET1 capital ratio over the course of the 2025 financial year. We have concluded the work in preparation for a significant risk transfer of assets in Motor Finance. Subject to market conditions, we are ready to launch a transaction at the optimal time to maximise the peak capital benefit, aligned to the revised timetable for the FCA's work in the motor finance market.

We have progressed on the delivery of the additional cost management initiatives previously announced to generate annualised savings of c.£20 million, reaching the full run rate by the end of the 2025 financial year. These initiatives include the continued rationalisation of third-party suppliers and simplification of our property footprint, as well as adjustments to our workforce to drive increased efficiency. We have partnered with a leading technology services and consulting company to help us drive our technology transformation programme, which has led to a headcount reduction of c.100 as we made increased use of outsourcing and the removal of over 115 IT applications to date. We have served notice to vacate our Wimbledon Bridge House office and establish a more suitable London footprint to meet the needs of the business, resulting in the removal of approximately 800 desks. As a result of the review of our workforce, we have incurred £3.1 million of restructuring costs, primarily relating to redundancy and associated costs.

We continue to progress a range of other potential management actions which include potential risk transfer of other portfolios through securitisation and a continued review of our business portfolios and other tactical actions. On 19 September 2024, the group announced that it entered into an agreement to sell CBAM to Oaktree. The transaction is expected to increase the group's common equity tier 1 capital by approximately £100 million, further strengthening our capital position.

Additionally, as our business continues to organically generate capital through 2025, the retention of earnings could potentially strengthen the group's capital position by a further £100 million, if required.

Subject to the execution of these management actions and capital generation, we have the potential to increase the group's CET1 capital ratio to between 14% and 15% at the end of the 2025 financial year (excluding any potential redress or provision related to the FCA's review of historical motor finance commission arrangements).

While there remains considerable uncertainty regarding the specifics of any potential redress scheme, if required, as well as its timing, the board is confident that these actions leave the group well positioned to navigate the current uncertain environment.