Introduction to Motor Finance

What is motor finance?

Motor finance helps individuals and businesses to spread the cost of owning or using a vehicle over an agreed period of time ('term').

Over 91% of all private new car registrations in 2018 in the UK were financed by **FLA members.**

There are a range of different types of finance products available, depending on the customer's preferences and needs.

Motor retailers that sell finance act as 'brokers' for motor finance providers. Most work with a number of finance providers to obtain finance for the range of customers they serve.

How does motor finance work?

- Most motor **finance agreements** are provided under a **tripartite structure**. This means there are three parties involved in order to set up the finance:

The customer	The retailer	The finance provider
• May pay a deposit or make advance payments. • Signs the credit agreement. • Takes away and uses the vehicle. • Makes monthly payments to the finance provider over the term of the agreement.	• Sells the vehicle and the finance at the point of sale. • Invoices the finance provider.	• Pays the retailer for the vehicle and takes ownership ('takes title'). • Takes monthly payments from the customer over the term of the agreement.

- The amount the customer repays to the finance provider will include **interest** and, sometimes, **fees**. These elements are often referred to as the cost of borrowing – what the customer pays the finance provider in order to obtain the finance.
- The rate of interest paid by the customer will vary and may depend on how '**creditworthy**' the customer is i.e. how likely they are to repay the credit.
- Business customers also purchase or lease vehicles on finance and are also assessed to see how creditworthy they are. Businesses will often obtain finance for one or more vehicles at a time.

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Protecting customers and treating them fairly

Treating customers fairly

- Motor finance providers, retailers and brokers are regulated by the Financial Conduct Authority (FCA) and therefore must adhere to FCA rules and relevant provisions of the Consumer Credit Act (CCA) - outlining how and when credit and hire agreements can be sold to consumers.
- Specific information must also be provided to consumers before, during and after an agreement is signed. This includes providing '**adequate explanations**' of the finance agreement to the customer before they sign it.
- The FCA is a principles-based regulator and it expects regulated firms not only to follow its prescribed Rules, but also to follow the 'spirit' of what the FCA is seeking to achieve. One of the most important Principles the FCA expects from firms is to **pay due regard to the interests of its customers and treat them fairly.**

Responsible lending

- The FCA has rules about how motor finance providers make lending decisions based on information provided by the customer and other sources such as **Credit Reference Agencies** – data companies that keep a record of how creditworthy customers are.
- Before entering into a credit agreement, a finance provider must assess the customer's **creditworthiness** and their ability to afford the monthly payments ('**affordability**'). This means making a lending decision based on the risk of providing the credit to that customer and their ability to repay the credit sustainably:
  - **Prime customers** – have good credit ratings and are therefore more likely to fully repay the credit agreement. Most if not all finance providers will provide finance to prime customers and the rate of interest charged is usually lower.
  - **Non-prime customers** – have poor credit ratings and are therefore riskier to lend to as they are less likely to make all of their payments ('default'). Therefore many finance providers will decline to offer finance to non-prime customers and the rate of interest charged by those that do is usually higher.
- Motor retailers must work with finance companies to make a reasonable assessment of whether customers can afford to make regular payments under a finance agreement.
- Special consideration must be given to a customer if they appear to be vulnerable or have mental capacity limitations which may prevent them from making a particular borrowing decision.

Commission and other fees received by a motor retailer

The FCA has rules about financial incentives, including the amount of commission paid by finance providers to retailers and other brokers for each finance sale. The rules include scenarios in which information about commission earned must be disclosed to the customer.

Commission or '**incentive schemes**' must be properly managed so they do not pose risk or cause harm to customers, for example, by encouraging the sale of a particular motor finance product that might not necessarily be suitable for the customer.

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Hire Purchase

What is Hire Purchase?

Hire Purchase is a **fixed cost, fixed period loan** linked to (or secured on) the purchase of a vehicle.

Who is the product suitable for?

It is suitable for **customers who want to own the vehicle** once they have made all the necessary payments.

What is the process for the customer?

The customer will:

1. Usually pay a cash deposit or part exchange their old vehicle as a deposit (or both).
2. Make all of their monthly payments. Typically payments will be structured between 3 years (36 months) and 5 years (60 months) depending on the customer's circumstances and preferences.
3. Pay an Option to Purchase fee – a small payment which enables the customer to take title to (own) the vehicle at the end of the agreement. The customer can also refuse to pay this fee and hand back the vehicle if they wish to, but this would not usually be sensible since they have effectively paid all of the monthly payments to keep and own the vehicle.

What else does the customer need to know?

- The finance provider owns the vehicle until the point the customer has made all necessary payments. The customer is therefore not entitled to sell the vehicle before this time.
- There are no mileage restrictions, servicing requirements or other charges because it is expected that the customer will own the vehicle at the end of the agreement.
- The customer can 'voluntarily terminate' their credit agreement before the final payment is due but (as set out in the credit agreement) will be required to:
    - Hand back the vehicle to the finance company.
    - Pay, or have paid, at least half of the total amount owed.

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Conditional Sale

What is Conditional Sale?

Conditional Sale is a very similar product to Hire Purchase but the **customer commits to buying and owning the vehicle** when they sign the credit agreement. There is no Option to Purchase fee and therefore no option to hand back the vehicle at the end of the agreement.

Who is the product suitable for?

Like Hire Purchase the product is suitable for **customers that are certain they would like to own the vehicle** after they have made all necessary payments.

What is the process for the customer?

The customer will:

1. Usually pay a cash deposit or part exchange their old vehicle as a deposit (or both).
2. Make all of their monthly payments. Typically payments will be structured over 3 years (36 months) to 5 years (60 months) depending on the customer's circumstances.

What else does the customer need to know?

- The finance provider owns the vehicle until the point the customer has made all necessary payments. The customer is therefore not entitled to sell the vehicle before this time.
- There are no mileage restrictions, servicing requirements or other charges because the customer will own the vehicle at the end of the agreement.
- The customer can voluntarily terminate their credit agreement before the final payment is due but (as set out in the credit agreement) will be required to:

Hand back the vehicle to the finance company	Pay, or have paid, at least half of the total amount owed.

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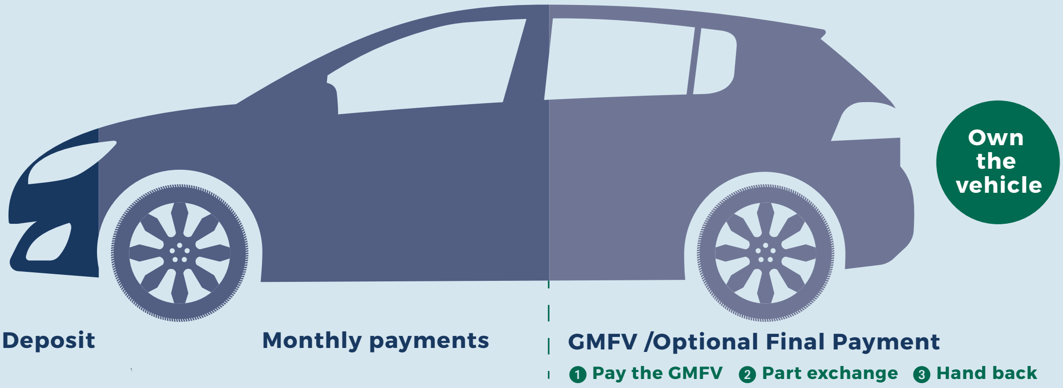
Personal Contract Purchase (PCP)



What is PCP

PCP is the most popular form of motor finance because it gives the customer flexibility at the end of the agreement and a lower monthly payment compared to alternative products like Hire Purchase, or Conditional Sale.

Who is the product suitable for?

- ✓ Customers who would like to have **options at the end** of the term, and a lower monthly payment.
- ✓ The product can be made available to both **consumers and business customers**.

What is the process for the customer?

The customer will:

1. Usually pay a cash deposit or part exchange their old vehicle as a deposit (or both).
2. Agree a mileage allowance and term over which the repayments are made. This will determine the monthly repayment. The more the customer uses the vehicle the higher the monthly payment will be.
3. Be informed by the retailer how much the Guaranteed Minimum Future Value (GMFV) of the vehicle will be. This is often called the optional ‘balloon’ payment or optional final payment.
4. Sign the credit agreement and take delivery of the vehicle. The agreement will outline any fees or charges that are payable.
5. Make all of their monthly payments – typically payments will be structured between 2 years (24 months) and 4 years (48 months) depending on the customer’s preferences and circumstances.

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Personal Contract Purchase (PCP)

6 Before the end of the agreement the customer will be asked by the finance provider whether or not they would like to own the vehicle by paying the GMFV. The customer might also have to pay an Option to Purchase fee, depending on what is set out in the credit agreement.

7 The customer has three options at this point:

Pay the GMFV (and any Option to Purchase fee due) and take ownership of the vehicle.	**Hand the vehicle back** and make no further payments, subject to mileage and vehicle condition, ('wear and tear').	**Part exchange for a replacement vehicle** by using any proceeds ('equity') gained if the amount the retailer is prepared to pay for the part exchange is more than the GMFV payment due.

What else does the customer need to know?

- The finance provider owns the vehicle until the point the customer has made all necessary payments, including the GMFV and Option to Purchase fee. The customer is therefore not entitled to sell the vehicle before this time.
- As the GMFV is deferred to the end of the agreement, the monthly repayment is lower for a PCP because the customer is only paying back a proportion of the total amount of credit as part of their monthly repayments. Effectively the customer is therefore initially only paying to use but not own the vehicle.
- If the customer opts to hand the vehicle back at the end of the term, or earlier in the agreement, they might be required to pay charges set out under the credit agreement:

If the mileage allowance is exceeded - the customer will be required to pay a pence per mile charge.	If the vehicle is damaged beyond 'reasonable wear and tear' - the customer will be required to pay a damage charge.

- The customer can 'voluntarily terminate' their credit agreement before the final payment is due but (as set out in the credit agreement) will be required to:

Hand back the vehicle to the finance company.	Pay, or have paid, at least half of the total amount owed.

- The customer is not guaranteed to have any 'equity' in the vehicle at the end of the agreement.

Contract Hire

What is Contract Hire?

Contract Hire is a form of **flexible leasing** to fund the use of a vehicle. The customer ('**lessee**') may never take title to ('own') the vehicle.

Who is the product suitable for?

- **Customers who do not want to own the vehicle** and are happy to hand it back after a specified period.
- **VAT registered businesses** - because the monthly rental includes VAT which the business can claim back.
- Personal Contract Hire (PCH) has also become a popular method of financing the use of a vehicle for consumers.
- **Servicing plans**, **maintenance plans** and **road tax** payments can often be incorporated into Contract Hire agreements to provide the customer with a fixed cost of motoring. This helps consumers and businesses with planning and budgeting.

What is the process for the customer?

The customer will:

1. Agree a mileage allowance based on the maximum number of miles they are likely to travel each year – the more the customer uses the vehicle the higher the monthly payment will be.
2. Make an advance rental payment - usually 3 or more rentals (monthly payments) are paid in advance.
3. Sign the hire agreement and take delivery of the vehicle.
4. Pay all of their remaining monthly rental payments.
5. Hand back the vehicle at the end of the agreement.

The amount the customer pays overall will be the total amount the vehicle **depreciates** over the term plus interest and any additional charges.

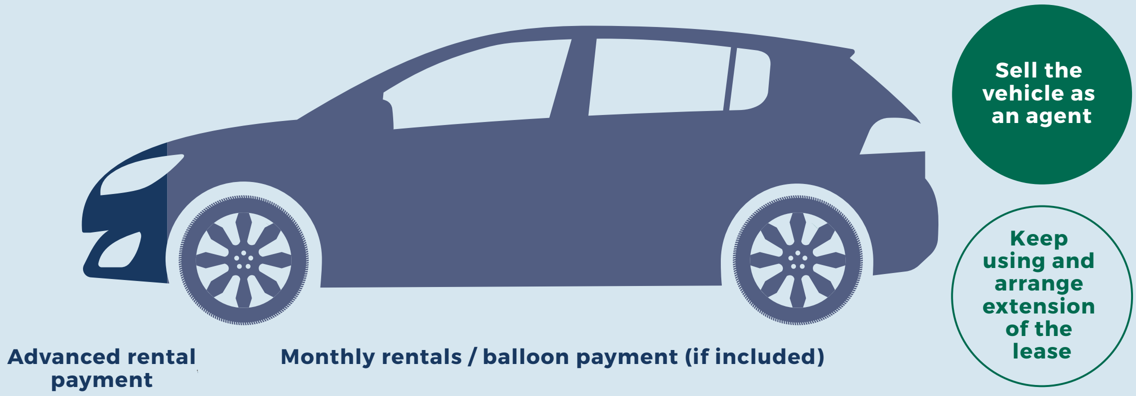
Continued overleaf

Contract Hire

What else does the customer need to know?

- The finance provider ('lessor') owns the vehicle - the customer is therefore not entitled to sell and must make sure it is kept in good condition.
- If the mileage allowance is exceeded the customer will be required to pay a pence per mile charge to the lessor – set out in the hire agreement.
- If the car is damaged beyond 'reasonable wear and tear' the customer will also be required to pay charges – set out in the hire agreement.
- The customer can terminate the hire agreement early but early termination charges are often applied and can be high. The charges will be set out in the hire agreement.

Finance Lease



What is Finance Lease?

A Finance Lease is a form of **flexible leasing** to fund the use, but not the ownership, of a vehicle. The customer ('**lessee**') can never 'take title to' (own) the vehicle. Finance leases differ from Contract Hire because:

- The customer can include a balloon payment at the end of the agreement. This is where a proportion of the credit is repaid as a lump sum payment at the end.
- Rather than handing back the vehicle the customer
  - a) sells it on behalf of the finance provider and receives a percentage of the sale proceeds; or
  - b) can extend the term of the lease to continue using the vehicle.

Who is the product suitable for?

Business customers that have smaller fleets. This is because it is difficult to manage the resale of a large number of finance leased vehicles at the end of the agreement. Finance leases are not usually offered to consumers.

What is the process for the customer?

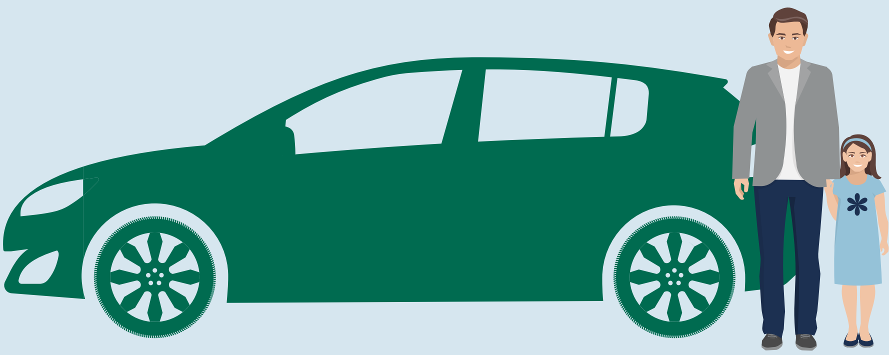
The customer will:

1. Make an advance rental payment - usually 3 or more rentals (monthly payments) are paid in advance.
2. Pay all of their remaining monthly rentals and balloon amount (if applicable) – in line with the term of the agreement or how long they will use the vehicle for.
3. Sell the vehicle, as an agent, and keep a large percentage of the proceeds, or arrange an extension of the lease and keep using the vehicle.

What else does the customer need to know?

- The finance provider or 'lessor' owns the vehicle - the customer can only sell once all repayments and charges have been made, and the finance provider has given their consent.
- The customer can terminate the hire agreement early but early termination charges are often applied and can be high. The charges will be set out in the hire agreement.

Personal Loans


Customer makes monthly payments but owns vehicle from the outset

What are Personal Loans?

Personal Loans are **unsecured finance agreements** that the customer will arrange directly with a finance provider. They are not tri-partite finance structures like motor finance products.

Who is the product suitable for?

Consumers that are **certain they want to own the vehicle**.

What is the process for the customer?

The customer will:

1. Select the vehicle they wish to purchase.
2. Apply for a personal loan with a finance provider, sign and return the credit agreement and receive the funds directly into their bank account. There may be an arrangement or administration fee which can be included as part of the loan.
3. Complete the purchase of the vehicle and make a cash payment to the retailer.
4. Make all of their monthly payments to the finance provider.

What else does the customer need to know?

- The customer owns the vehicle once they have signed the **sale of goods agreement** and paid the retailer.
- The customer can terminate the credit agreement early, by paying off the remaining amount owed, but this may result in a fee or charges being applied.
- The customer has no right to 'voluntarily terminate' and hand the car back to the retailer as they would with Hire Purchase, Conditional Sale or PCP.
- The customer can sell the vehicle at any time but they must continue to make the loan payments until the finance is settled.

Glossary

Adequate explanations

Information the customer needs to be aware of when entering a credit agreement. FCA rules require consumers to receive adequate explanations before the credit agreement is signed.

Affordability

The ability for the customer to afford the finance repayments over the term of the agreement. The FCA expects the customer not to have to borrow money to be able to meet the repayments.

Annual Percentage Rate of charge (APR)

An APR is the total percentage rate of interest that is charged against the amount of finance borrowed by a customer. The APR includes the flat/fixed interest rate charged by the lender, plus any other administration fees or charges incorporated into the agreement. APRs were introduced as a means to give the customer the chance to compare the cost of one credit agreement with another on a fair basis.

Commission/incentive schemes

A payment or gift provided to incentivise and reward sales activity. Finance providers pay commission to retailers and brokers for arranging finance sales.

Credit Reference Agencies

Agencies that collect, store and provide credit history data that help finance providers understand whether their customers are creditworthy enough to lend to and can afford to meet all of their contractual repayments. The largest agencies are Equifax, Experian and TransUnion in the UK.

Creditworthiness

A measure of the likelihood the customer will make all of their contractual repayments based on their credit history and other factors.

Default

The failure or inability for the customer to repay the finance provided to them.

Depreciation

The value the vehicle loses over the term of the finance agreement.

Equity

Equity (positive equity) occurs when a vehicle is worth more than the outstanding finance the customer must pay to settle the agreement. Equity can be used as a deposit towards a replacement vehicle.

Fees

Fees can include charges for arranging the finance and administrating the relevant documents. The cost will be included in the total amount payable and taken into account when the Annual Percentage Rate (APR) is calculated.

Finance

Motor finance helps to spread the cost of a new or used car. Instead of paying the full amount upfront, customers pay monthly.

Finance agreement

A document that details all the terms and conditions of a financial arrangement as well as vehicle and customer details.

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Glossary

Guaranteed Minimum Future Value

The optional final balloon payment a customer makes at the end of the agreement to take ownership. The GMFV is set by the finance provider at the beginning of the agreement and is a fixed amount.

Interest

An amount of money payable to the finance provider in addition to the amount of capital borrowed.

Lessee

The user of leased goods (customer).

Lessor

The owner of goods that are leased such as vehicles (finance provider / bank / leasing company).

Sale of goods agreement

The contract for the sale of the vehicle, governed by the Sale of Goods Act 1979.

Secured finance agreements

Finance agreements that are secured against an asset such as a vehicle. They provide security to the finance provider because if the customer does not make the repayments the vehicle can be repossessed. Ownership remains with the finance provider throughout the agreement until all payments are made.

Tripartite structure

This is a term used to describe a finance agreement where there are three parties involved in the process of its provision - the creditor (finance provider); the supplier (retailer); and the debtor (customer).

Unsecured finance agreements

Unsecured finance agreements such as personal loans are not secured against the vehicle. This means customers who purchase a car using a personal loan will own the vehicle as soon as they take possession.

Vulnerable customers

All individuals can be or become “vulnerable” at some point in their lives, for a variety of reasons. This includes but is not limited to mental capacity limitations. Finance providers and retailers need to be aware of vulnerability and add additional protections into their processes to help mitigate the risks to vulnerable customers.