

LLOYDS & THE MIS-SELLING OF MOTOR FINANCE

Another potential major headache for the bank

Last Friday, the Court of Appeal issued its ruling in the Hopcraft vs Close Brothers case regarding the mis-selling of motor finance, which went firmly in favour of the appellant. The Finance & Leasing Association (FLA), which represents the car loans industry, described the verdict as “significant and unexpected.” Close Brothers plans to appeal to the Supreme Court but if the later upholds the ruling of the Court of Appeal, it would represent a major potential headache not only for Close Brothers but also for Lloyds, which is the UK’s largest lender of motor loans.

Consumers owed a duty of care

The Court of Appeal ruled that motor dealers, acting as credit brokers, owe a fiduciary duty, which includes a duty of care, to their customers. This imposes “an obligation on the part of the broker to act in the best interests of the customer and not to put themselves in a position of conflict.” It means that motor dealers cannot lawfully receive a commission from the banks and other lenders “without obtaining the customer’s fully informed consent to the payment”, which they failed to do. Hence, the court’s ruling, which it should be noted relates to consumer lending.

The PPI scandal involved incentivising bank staff to sell a financial product, payment protection insurance, to their customers, which they often neither wanted nor needed. It was the UK’s largest mis-selling scandal and ultimately cost Lloyds £22bn. The motor finance scandal involves another type of mis-selling, this time whereby, over a long period, the lenders paid hidden commissions to car dealers, which were not disclosed to customers. On this occasion, the mistreatment of customers was at arms’ length from the banks and other lenders but once again, it involved their exploitation.

Potential scale of the problem

If the Supreme Court upholds the ruling of the Court of Appeal, it will represent a major problem for the motor finance industry. The stockbrokers, Jefferies have suggested that total compensation could reach £16bn, while RBC Capital Markets has given a wider and potentially lower range of estimates: £6bn to £16bn. Either way, it is likely to represent the second largest amount of compensation awarded for mis-selling since the PPI scandal.

In 2019, the UK market for motor finance was estimated by KPMG to be worth £50-60bn.¹ Lloyds is the largest provider, followed by Santander and is understood to have a motor loan book of £15bn. Despite contacting the FLA, we have been unable so far to confirm Lloyds’ market share but it could be in the order of 25-30%. The FCA review covers motor loans over a fourteen-year period from 2007 to 2021 and some experts consider that lenders could also be held liable for loans made before 2007. RBC Capital Markets estimate Lloyds’ losses at £2.5bn but since the latest third quarter figures, the

¹ <https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2019/12/a-revolution-for-motor-financing.pdf>

bank's market capitalisation has fallen almost £5bn. Certainly, its current provision for motor finance compensation of £450mn looks to be significantly inadequate.

Was Lloyds blindsided by the Hopcraft judgment ?

Certain indications from Lloyds' third quarter results and their subsequent presentation suggest that the bank was caught out by the verdict of the Court of Appeal, which came only two days after its latest figures. Early in the Q&A session, which followed the webcast with analysts, Lloyds' Chief Financial Officer, William Chalmers stated that "there have been no further charges relating to the FCA investigation into historical motor finance commission arrangements." Later, he indicated that the bank has been waiting for the publication of the FCA's motor finance review, which is expected next May but added that court cases have "mostly gone in our favour."

This suggests that Lloyds was indeed wrong-footed by the Hopcraft judgment but more seriously, this latest adverse development regarding motor finance supports investor scepticism about the bank's published figures and specifically, its treatment of impairment and provisioning for potential losses. With its previous legacy issue, the HBOs Reading fraud, Lloyds has provided a textbook example of how not to handle a major banking scandal, by lying, denying and covering up and a decade after the events in question, appointing a series of entirely unnecessary inquiries² to avoid compensating the victims of the fraud, either adequately or at all. The second of these, the Dobbs review is still ongoing more than seven years later, at the insistence of its paymaster, Lloyds.

Ultimately, it comes down to a matter of trust

Following the bank's third quarter figures, which exceeded analysts' expectations, the share price might have been expected to hold steady or firm slightly. Instead, in the response to the Hopcraft ruling, it has fallen 13% to 54p. Between 2013 and 2017, the taxpayer's 43% holding in Lloyds was unloaded by UK Finance & Investments (UKFI) acting on Chancellor Osborne's instructions, in a series of tranches onto hapless institutional investors, including some major US funds, at prices between 65p and 81p. Since that time, there have been no bonus or rights issues, so the current price is directly comparable with those historic prices. The performance of the share price over the last decade has been abysmal.

Most investors cannot reasonably be expected to understand the highly complex nature of bank accounts, so ultimately, it comes down to a matter of trust and Lloyds' shareholders want, in particular, to see that all legacy issues have been resolved. The bank's robust results presentations downplay such issues and repeatedly suggest that it is well positioned for the future. Yet, legacy issues keep surfacing.

We prefer, therefore, to leave the last word to Warren Buffett, who in May 2023 declared:

"I don't like it when people get too focused on the earnings number and forget banking principles. Some of the dumb things that banks do periodically become uncovered during this period."

² The combined cost of which is estimated at £90-100mn.