The Intuition Finance Digest

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UK Supreme Court ruling highlights conduct risk

"Uninsurable world" poses systemic risk

Uk Supreme Court ruling highlights conduct risk

A recent UK Supreme Court decision in relation to car finance may mean that the banking industry has escaped its worst fears in that specific case, but the issue has served to bring the issue of bank conduct risk out into the open once more.

UK banks have avoided a potential GBP 44 billion bill for customer compensation related to hidden commission payments on car finance contracts. This comes courtesy of a Supreme Court ruling that overturned the decision of a lower court last year that commission payments paid to car dealers by lenders without disclosure were unlawful.

The complaint was that the commissions amounted to bribes, or to secret profits received by the dealers who were considered to be fiduciaries. As fiduciaries, the dealers were obliged to act for their customers to the exclusion of their own interests.

No fiduciary duty owed by dealers

In the UK, the provision of motor finance products is a regulated credit activity under the Consumer Credit Act 1974 (CCA), and lenders and dealers acting as credit brokers in the sourcing of finance come under that regulatory framework.

The Supreme Court noted that although the rules require a dealer to disclose commissions if they could affect the dealer's impartiality or have a material impact on the customer's transactional decision, nothing in the regulations requires lenders or dealers to disclose the existence or amount of any commission paid by lender to dealer, or to obtain the customer's consent to the payment.

Ultimately, the Supreme Court found there was no fiduciary duty owed by dealers and no secret commissions or bribes.

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Unfair relationship under CCA

In the only win on the consumer side, the relationship between one of the borrowers and one of the lenders was found to be unfair within the meaning of the CCA, with the Supreme Court citing three grounds for its decision:

- The undisclosed commission was very high, amounting to 25% of the advance of credit and 55% of the total charge for credit (comprising interest and fees).
- The documents provided to the customer did not disclose the existence of a commercial tie between the lender and the dealer that gave the lender a right of first refusal. Rather, it created the false impression that the dealer was offering products from a range of lenders and recommending a product that best met the customer's individual requirements.
- The customer did not read any of the documents provided by the dealer, however the court queried to what extent a lender could reasonably expect a customer (especially a commercially unsophisticated customer) to have read and understood the detail of such documents. In any case, no prominence was given to the relevant statements in the documents.

Echoes of PPI scandal

The UK has been the source of numerous instances of financial mis-selling controversies over the years, most notably the payment protection insurance (PPI) scandal that resulted in the UK banking industry being forced to issue billions of pounds in refunds and compensation on multiple grounds.

PPI was created ostensibly to safeguard consumers. The product was designed to insure a consumer's loan or credit repayments in events of failure to work due to illness, accident, unemployment, and other related events. It was widely sold by banks and other lenders as an add-on to loans or other credit products.

However, many policies from the 1990s to around 2010 were sold to people who did not need them, could not claim on them, or didn't even know they had been signed up. In the area of motor finance, for example, consumers opposed the PPI, yet dealers sold it to them. More widely, consumers were effectively compelled to acquire PPI because they were given to believe that it was necessary to secure loans, credit cards, mortgages, and other financial products.

Furthermore, PPI was inadequately discussed with consumers, and it was later ruled that it was not suitable or applicable for many consumers such as those with pre-existing medical conditions, self-employed, or those working in areas such as the military, professional sports, or prisons.

The PPI scandal stands as one of the most high-profile examples of systemic mis-selling in banking history, exposing how poor sales practices, misaligned incentives, and weak oversight can lead to widespread consumer harm.

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US CFPB struggles with cutbacks

Following the UK Supreme Court car finance ruling, the country's Financial Conduct Authority (FCA) will start a consultation process to set up a compensation scheme for those affected customers. Should such a scheme be established, the FCA estimates that compensation would be between GBP 9 and GBP 18 billion, much lower than the figures mooted prior to the ruling.

While the UK's FCA can be expected to pursue industry transgressions with customary zeal, the ability of its US counterpart, the Consumer Financial Protection Board (CFPB), to do likewise would seem to be severely compromised in the wake of major staff and funding cuts.

In what is perhaps a sign of things to come, New York State is suing payments company Zelle on the grounds that the company failed to adopt critical safety measures that resulted in the loss of more than USD 1 billion of customer funds. New York Attorney General Letitia James filed the lawsuit after the CFPB abandoned a similar lawsuit, filed in December 2024, following the change in the federal administration.

This is just one of numerous cases dropped by the CFPB recently. Attorney General James is seeking restitution and damages for affected consumers, as well as a court order forcing Zelle to maintain more robust anti-fraud measures.

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"Uninsurable world" poses systemic risk

As the United States rolls back the climate risk mitigation measures of the previous administration, elsewhere the implications of rising temperatures are being keenly studied. This is particularly the case in the insurance industry which is effectively pronouncing more and more assets uninsurable with far-reaching consequences.

Disruption to the global labor market as a consequence of climate change is the focus for a recent report by the Centre for Economic Transition Expertise (CETEx) at the London School of Economics. It warns that climate-driven shocks would lower labor productivity, particularly in agriculture, construction, and other sectors exposed to heat – even under an optimistic scenario where global warming is limited to 1.5–2 degrees.

With some 1.2 billion workers vulnerable to climate disruption, the report urges central banks to integrate environmental employment risks into their policies and operations, warning that labor market disruptions could "weaken the effectiveness of the transmission of monetary policy to the economy." But the CETEx report is just one of many expressing concern over mounting climate risk and its implications for the financial system.

Climate change directly affecting growth

In early 2024, Reuters reported that the Bank of England was approached by a group of institutional investors intimating that UK banks might not be holding sufficient capital to cover climate risks and calling for more extensive climate risk disclosures by leading banks. The Bank of England did not comment on this. It publishes an annual climate-related financial disclosure that sets out its approach to managing the risks from climate change and reflects its "commitment to transparency, accountability, and collaboration."

In July this year, the European Central Bank (ECB) reported that extreme weather events have the potential to cause an almost 5% drop in euro area growth in the near term and it projects a 15% drop in global GDP under current policy settings.

This was based on a scenario designed by the Network for Greening the Financial System (NGFS), a group of central bankers and supervisors tasked with assessing the impact of climate risk on the financial sector and the economy. The NGFS has developed a set of tools to help banks and companies evaluate the impact of climate change on business. The US Federal Reserve withdrew from the NGFS at the beginning of the year, stating that the increased scope of the NGFS fell outside its mandate.

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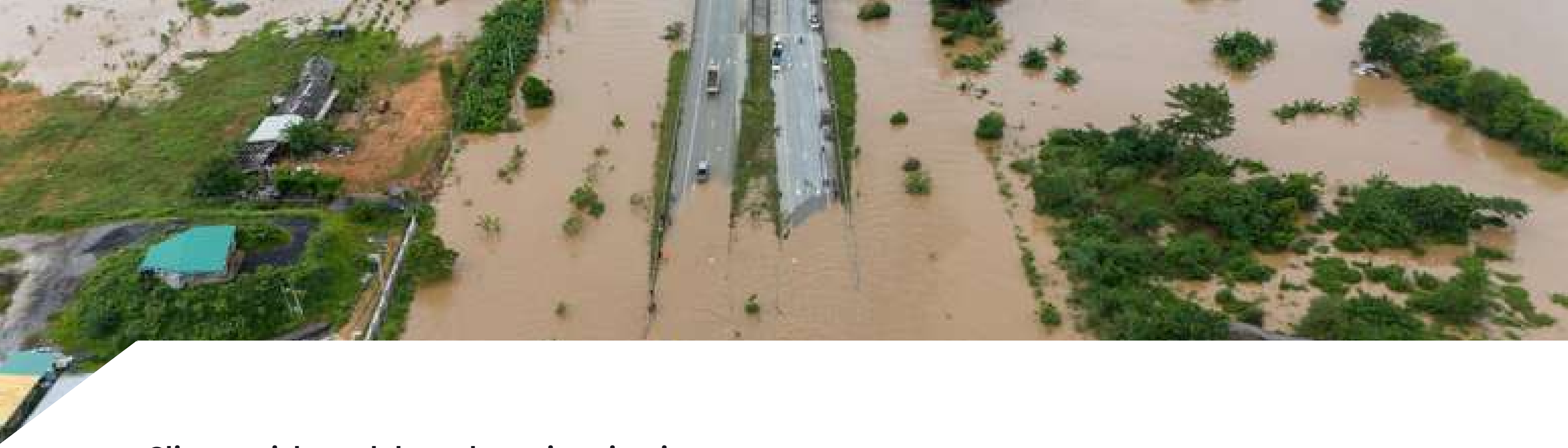

Climate risk models underestimating impact

Alarmingly, there is growing unease among central bank analysts that their models are more likely to underestimate risk as they fail to take into account the negative potential of climate tipping points.

A similar conclusion was reached by the Institute and Faculty of Actuaries (IFoA) earlier this year. This body believes that economic models vastly underestimate climate-driven risks and predicts a 50% loss to GDP in the event of temperatures rising 3 degrees between 2070 and 2090.

Uninsurable risks on the rise

Nowhere are the effects of climate change as keenly monitored as in the insurance industry, where distress calls around climate are becoming increasingly vocal.

One notable recent intervention came from a member of the Board of Management of insurance giant Allianz, who drew attention to the potential for systemic risk to the financial system arising from the increasing uninsurability of many risks. Allianz followed up with a white paper, "Climate change: Our responsibility to act" that developed on this theme. Climate change is transforming the risk landscape, the paper stated unequivocally.

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Systemic risk threat

Since the early 2000s, about one-third of natural disaster losses have been insured. Although insurers expand their scope of coverage to take account of a wider range of risks, insurance is priced to reflect the particular risk. This sometimes means that premiums become unattractive or unaffordable for customers. Hence, although insurers are covering more risks in aggregate, uninsured risks may grow even faster.

The growing insurance gap, according to Allianz, "threatens the foundations of economic stability and thus societies. When insurance becomes inaccessible, credit slows, investment stalls, and development is disrupted."

This new scenario is not a one-off market adjustment but a systemic risk that threatens the very foundation of the finance sector. In the face of climate change, all kinds of risks are rapidly becoming uninsurable and other financial services become unavailable too. A bank cannot lend to any business or against any asset where risk cannot be insured. This applies not only to housing, but to infrastructure, transportation, agriculture, and industry in general. Allianz warns that "The economic value of entire regions – coastal, arid, wildfire-prone – will begin to vanish from financial ledgers. Markets will reprice, rapidly and brutally."

Ultimately, the health of the planet is intricately linked to the stability of the financial system, and non-sustainable economies and societies are inherently risky.

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