Which?, 2 Marylebone Road, London, NW1 4DF
Date: July 2018
Response to: FCA Mortgages Market Study Interim report

Consultation Response

Summary

- Which? welcomes the Financial Conduct Authority's (FCA) mortgages market study, and we agree with the FCA's overall vision and approach. We particularly welcome the FCA's analysis of the significant financial detriment experienced by consumers who purchase more expensive products or who do not or cannot switch mortgage product.
- The FCA rightly highlights that there has been a lack of innovation in the distribution of mortgages, and that better tools could be enabled to help consumers find better deals and to choose an intermediary.
- Before removing any requirements for consumers to take advice, the FCA should undertake further analysis of whether consumers are currently purchasing suitable products, and explore the benefits and costs of any such changes.
- We welcome the FCA's aim to encourage and enable switching. However the FCA should **r**equire active lenders to switch 'mortgage prisoners' to better deals, and work closely with government to find a solution for those consumers with inactive lenders.
- The FCA should also undertake further work to understand the characteristics of those mortgage holders who could potentially switch, but do not do so, and to design and test potential remedies tailored to these different groups of consumers.

Which? agrees with the FCA's overall vision and approach, and we particularly welcome the FCA's analysis of the significant financial detriment experienced by some consumers [Question 1]

Which? welcomes the FCA's mortgages market study, and the research and analysis that the FCA has undertaken to inform the findings of the interim report. Mortgages are by far the largest consumer credit product, with mortgage debt accounting for over 80% of total UK household liabilities. So this is a crucially important sector for consumers.

It is also an important juncture to review the mortgage market. Changes to the regulation of the sector that resulted from the 2014 mortgage market review have heralded a dramatic shift in the way that mortgages are sold. Save for some exceptions, all new sales involving spoken or other interactive dialogue are advised. 80% of mortgage sales are now advised. The mortgage credit directive has also meant that affordability rules for new mortgages have become far more stringent. The FCA is right to explore how these major regulatory changes have affected outcomes for consumers.

We agree with the FCA's overall vision for the mortgage market, which is that:

- *borrowers who can afford a mortgage can choose suitable and good value products and services*
- *firms have a culture of treating all consumers fairly, and*
- *competition and proportionate regulation empower consumers to make effective choices before taking out, and throughout the life of, a mortgage.*

The FCA has concluded that overall the mortgage market is working well. We broadly agree with this view. For most consumers, relatively high levels of competition between providers means that new deals offer good value for money for most types of mortgage product. The way that mortgages are typically priced means that, as is the case in many other markets, consumers must switch product and/or provider relatively frequently in order to access the best prices. Unlike some other sectors, switching levels are relatively high. The FCA's findings show that three quarters of mortgage customers switch provider within six months of their introductory deal. This suggests that, in terms of prices at least, the mortgage market is likely to be working well for most consumers.

Yet the FCA's findings show that some consumers who do switch, or purchase a new mortgage, are still experiencing significant financial detriment due to purchasing more expensive products. This suggests that even for more active consumers, the market could be working more effectively. The FCA's findings show that:

- 30% of consumers who purchased a mortgage could have found a cheaper mortgage with the same key features as the product they chose; and
- on average, these consumers paid around £550 per year more over the introductory period compared to a cheaper product - which, in our view, is potentially an underestimate.[1]

The FCA's analysis has also highlighted the significant financial detriment experienced by consumers who do not or cannot switch mortgage product. These findings are well in excess of the financial detriment experienced by such consumers in most other markets. We also think that the FCA's estimates are potentially an underestimate.[2] The FCA's findings show in particular that:

- one in ten (800,000) consumers could have saved around £1,000 per year in the first two years and around £100 per year for the rest of the term of their mortgage;
- consumers with an interest-only mortgage could have saved an average of over £2,000 per year in the first two years; and
- 150,000 'mortgage prisoners' were unable to switch mortgage product due to affordability requirements that were introduced since the financial crisis and/or because their lender does not offer new products.

The FCA's strategic review of banking has recently highlighted that the average difference between standard variable rates (SVRs) and the cheapest deals for new customers has grown over recent years. Nine years ago there was no difference between the two averages. Since then the difference has grown steadily to 2.71%. At the same time, the percentage of customer

[1] The FCA's analysis is based on a comparison to products that are better on all price features, rather than the overall cost, which is what ultimately matters for good consumer outcomes.
[2] The FCA's analysis is based on a comparison to the best deal available with a consumer's existing lender rather than to the wider market. The analysis is also based on the full mortgage term but assumes that all consumers only switch once, and so stay on a reversion rate after two years. Consumers who switch more frequently could save more than £100 per year in subsequent years, and it is reasonable to expect some of these consumers will switch again over the course of their remaining mortgage term.

balances on SVRs has almost halved from 35% in 2013 to less than 17% in 2018.[3] This has meant that, while consumer engagement has increased, providers' pricing strategies have worsened the financial detriment experienced by consumers who remain on SVRs.

The FCA rightly highlights that there has been a lack of innovation in the distribution of mortgages, and that better tools could be enabled [Questions 2-4; 8-10]

Choosing a mortgage is a comparatively more significant and complex decision for consumers than other products. Innovation may therefore be inhibited to some extent, as technology-driven solutions require a greater degree of complexity than those required for other financial products, such as general insurance. However, there is still significant scope to improve the quality of tools to enable consumers to better compare products, get support (including advice), and apply for a mortgage. Comparison sites, for example, have not had the same level of impact as in some other sectors. Furthermore, innovation should help to improve the provision of advice, both by improving the quality of information available to advisers and reducing the underlying cost of providing advice.

Developing better tools and comparison sites can particularly help to enable consumers to compare total costs and charges. Our previous research has shown that a lack of information on the total costs of each deal and the reliance on annual percentage rates (APRs) can distort consumer decisions in some circumstances. In our tests using fixed-term deals, when adding information on the total costs, including fees, and removing reference to the APR, significantly more consumers were able to identify the cheapest fixed-rate mortgage deal from the options we presented them.[4] However, the FCA's latest findings show that information provided by many lenders, comparison sites and other third party sites continues to be focused on headline rates.

As the FCA notes, there needs to be more consistent and reliable industry data on eligibility criteria and maximum borrowing amounts for particular products. The FCA should also consider any specific barriers to the use of Open Banking to improve the process of validating consumers' income and expenditure, which could be used to feed into eligibility tools as well as streamlining this part of the application process.

Before removing any requirements for consumers to take advice, the FCA should undertake further analysis of whether consumers are currently purchasing suitable products [Questions 5-7]

So far, the FCA's market study has focused almost exclusively on prices. While prices are extremely important, the FCA should now conduct further analysis of product suitability. Product suitability is one of the key parts of the FCA's vision for the market, as cited above. More generally, it is one of the four key sources of consumer harm that are cited in the FCA's Approach to Consumers. Ensuring consumers receive suitable products is also the primary purpose of the advice requirements that were introduced as part of the mortgage market review.

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[3] FCA (2018), *Strategic Review of Retail Banking Business Models: Progress Report*, pp.47-48
[4] Which?/Council of Mortgage Lenders (2015), *Final Report of the Transparency review of mortgage fees and charges*

The FCA should particularly analyse the impact of advice on product suitability, to understand to what extent existing rules are leading to good outcomes. The FCA concludes that its previous thematic reviews of advice in the mortgage market showed that 'consumers are largely provided with suitable products that they can afford'. However, the FCA's 2015 review found that only 59% of mystery shops and files reviewed resulted in suitable mortgage recommendations to customers, with 3% demonstrably unsuitable and 38% where the FCA was unable to determine whether the mortgage recommended was suitable. Further, while the FCA's 2015 review did not find evidence of 'systemic customer detriment', the FCA concluded that 'overall, the quality of advice in the mortgage market was mixed'.[5]

The FCA's most recent findings also show that advised consumers are more likely to purchase short-term deals. Advice increases the probability of buying a two-year fixed rate mortgage by 16 percentage points. But the FCA has not assessed whether advised and non-advised consumers are purchasing products with the most suitable deal period for their circumstances.

Given how complex and financially significant mortgages are for consumers, we strongly support the increased take-up of advice that has occurred as a result of the regulatory changes introduced since the mortgage market review. The mortgage market review had found that almost a third of customers were sold a mortgage without any assessment of whether that mortgage was appropriate for them.[6] This should no longer happen for advised consumers and, in the event of unsuitable advice, consumers can seek recourse to the Ombudsman.

The FCA is right to consider how its rules and guidance affects the form that advice takes, and whether this is working for consumers. Robo-advice and other forms of streamlined advice could provide a better route for some consumers, particularly for consumers with significant experience of purchasing mortgages and with relatively straightforward circumstances.

However, we are concerned that the FCA's proposal to remove the requirement for almost all interactive sales to be advised could lead to worse outcomes for consumers who, as a result of these changes, do not take advice. Before proceeding with any changes, the FCA should set out clear evidence that non-advised consumers are consistently choosing suitable mortgages, and that there are certain groups of advised consumers who could choose suitable products without taking advice.

The FCA should particularly explore outcomes for consumers who could potentially be vulnerable. While, on average, mortgage holders are less likely to exhibit vulnerable characteristics than non-mortgage holders,[7] consumers are much more likely to be vulnerable when purchasing a mortgage. First time buyers, in particular, are likely to be vulnerable due to the pressures of purchasing a home for the first time and due to having no prior experience of purchasing a mortgage. Other consumers may be vulnerable due to particular circumstances, such as having to remortgage to meet financial pressures or to meet later life care costs.

For certain types of purchase, there are already relatively high levels of non-advised sales. 51% of internal switches, where the consumer stayed with their existing provider, were execution-

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[5] FCA (2015), *Embedding the Mortgage Market Review: Advice and Distribution*, pp.3-4
[6] As cited in FCA (2015), *Embedding the Mortgage Market Review: Advice and Distribution*, p.7
[7] The FCA cites evidence from its Financial Lives Survey that 37% of residential mortgage holders show characteristics of potential vulnerability compared with 50% of all UK adults.

only in 2016. For other types of purchase, levels are much lower. Just 2% of first time buyers are execution only. All equity release sales are also required to be advised. Without further evidence on product suitability, it is difficult to assess whether these are the 'right' levels. However, we would be particularly concerned if the FCA's proposed changes removed the requirement for all equity release products to be advised sales, or if changes to the rules made sales to first-time buyers, or the sale of interest-only mortgages, less likely to be advised.

The FCA should require active lenders to switch 'mortgage prisoners' to better deals, and work closely with government to find a solution for those consumers with inactive lenders [Questions 11-14]

Through no fault of their own, many 'mortgage prisoners' have been left paying high reversion rates due to regulatory changes to affordability requirements introduced since they took out their mortgage. The FCA defines these consumers as those that took out their mortgage or last switched before the financial crisis and are up-to-date with their mortgage payments. These consumers have therefore experienced significant detriment over many years, and urgent action is required to address this.

For the 10,000 consumers who are with active lenders, we agree that it may be difficult to secure switches to other providers due to the requirement to conduct an affordability assessment when taking on a consumer from another lender. For most lenders, internal switches are likely to offer significant savings. While not the best on offer in the market, this is likely to be sufficient to address most of the detriment experienced by these consumers.

However, we are sceptical as to whether a voluntary industry agreement will be sufficient to address this issue. Lenders are already able to waive affordability for internal switchers. This highlights that there are weak incentives on firms to help consumers switch to their better deals. The FCA should therefore require active lenders to switch 'mortgage prisoners' to better deals, as this is more likely to be an effective way of reaching the FCA's intended outcome. Given how small this group of consumers is, the unintended consequences of such a requirement are likely to be limited.

For the 140,000 mortgage prisoners with inactive lenders, the FCA notes that where firms sit outside the FCA's regulatory remit and/or offer no new products to new or existing customers the solution is more challenging. The FCA should work closely with the government to explore whether its remit should be extended to cover these firms. In terms of a solution for those consumers who are unlikely to be able to switch to other providers, the FCA should work with the government on a potential scheme to address this specific issue.

The FCA should undertake further work to understand the characteristics of consumers who could potentially switch but do not do so, and to design and test potential remedies [Questions 15-17]

The FCA should investigate the characteristics of those mortgage holders who could potentially switch but do not do so. This should include an assessment of whether certain groups are particularly vulnerable. This will help the FCA to be as precise as possible about the problems that consumers face. The FCA should then undertake further work to design and test potential remedies that are tailored to these different groups of consumers.

The FCA's existing proposal is to ask lenders to contact affected customers a year or so after moving onto a reversion rate, and giving them a simple and straightforward means of moving to a cheaper mortgage. This sort of remedy could potentially help some of these consumers to switch product. The FCA is right to draw lessons from other similar remedies in financial services and others sectors, while recognising that effective remedies need to be tailored to the specific context.

However, in many cases simply supplying more information is not sufficient. In 2016, Which? reviewed similar 'demand-side remedies' across different sectors. We found that some remedies have wrongly been based on the assumption that reducing the search and switching costs faced by consumers will straightforwardly act to improve consumer decision-making and enhance competition.[8] Based on the findings of our review, we recommend that:

- the FCA should consider developing a package of complementary remedies, which work together to achieve their objectives and to help the different groups of consumers who are not switching; and
- the FCA should review the effectiveness of any final remedies over time.

About Which?

Which? is the largest consumer organisation in the UK with over one million members and supporters. We operate as an independent, apolitical, social enterprise working for all consumers and funded solely by our commercial ventures. We receive no Government money, public donations, or other fundraising income. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives, by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

Which? Mortgage Advisers was set up in 2010 to help consumers obtain the right mortgage for their unique scenarios by researching the whole of the market, including those products that might only be available direct to consumers as opposed to through an intermediary. In the year to June 2018, Which? Mortgage Advisers arranged 7,149 mortgages.

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[8] Which? (2016) *The Role of Demand-Side Remedies in Driving Effective Competition: A Review for Which? by Professor Amelia Fletcher*, available at https://www.which.co.uk/policy/consumers/335/the-role-of-demand-side-remedies-in-driving-effective-competition