MMS Interim Report – UK Finance Response

EXECUTIVE SUMMARY

UK Finance welcomes the Interim Report – we agree with its finding that the market is, on the whole, working well. Lenders have responded to the challenge of so-called "mortgage prisoners" with a voluntary industry agreement announced alongside this response and we have agreed to explore with members and the FCA what might be possible for customers of inactive and unregulated lenders over the coming months. We have made lenders' product transfer data available, and we will continue to work with the FCA on the implementation and possible extension of these projects. There are, however, a number of recommendations that we wish to see explored:

- further research into the non-monetary factors that influence consumers' selection of a mortgage product.
- the fintech industry, along with lenders and intermediaries, should be allowed to develop products to allow the comparison of mortgage products before there is any regulatory intervention. A range of commercial solutions have already been launched and more are being developed by the fintech sector that will make it easier for intermediaries to select the most appropriate products for applicants. It is only a matter of time before consumer facing solutions are launched.
- a thorough review of the rules and guidance issued in relation to advised and execution only sales.
- further consideration of the provision of holistic financial advice to customers.
- financial education on mortgage types should be a priority for the Single Financial Guidance Body.
- to allow the continued development of new products and distribution channels, regulatory intervention should not be triggered unless the market is not meeting the needs of the consumer.
- a review of the position of the customers of unregulated owners of mortgage books.
- a review of the implementation of the MCD in relation to triggering a new affordability assessment for existing customers.

Introduction

UK Finance is a trade association formed in July 2017 to represent the finance and banking industry operating in the UK. It represents around 300 firms in the UK providing credit, banking, markets and payment-related services, including 154 authorised mortgage lenders. The organisation brings together most of the activities previously carried out by the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

Our members are large and small, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. Our members' customers are individuals, corporates, charities, clubs, associations and government bodies, served domestically and cross-border. These customers access a wide range of financial and advisory products and services,

essential to their day-to-day activities. The interests of our members' customers are at the heart of our work.

In relation to this consultation paper, the key group of members we represent are authorised first charge mortgage lenders. This is a wide-ranging group of firms with differing company structures, business models and risk appetites.

We welcome the opportunity to respond to the Mortgage Market Study Interim report.

Our first observation is that the UK first charge residential mortgage market is a complex eco-system reliant on many firms working together. The firms have a symbiotic relationship and when considering where consumer participation in the market may be improved, potential remedies overlap and cannot be easily addressed in separate boxes. Therefore, there is inevitably some repetition in this response to the interim report.

Q1: Do you have any views on our vision for the market?

UK Finance supports the FCA's vision for the mortgage market and we are pleased to see that, in addition to borrowers being able to choose suitable good value products and services, and firms having a culture of treating customers fairly, it is acknowledged that both competition and proportionate regulation are also required to empower consumers to make effective mortgage choices. Particularly in areas where societal changes mean lenders may need to take a different approach in order to meet upcoming consumer needs (e.g. for self-employed, complex affordability, new construction methods, vulnerability etc).

The study found that the market is working well:

- There is a high level of engagement in the remortgage market with more than 75% of borrowers moving their mortgage within 6 months of their deal period ending.
- There is a wide range of products on offer and competition on headline rates.
- There is no evidence that the commercial arrangements between firms result in material harm for consumers.
- Approximately 70% of customers **do** find the cheapest deal when selecting a mortgage – but we do not think that this is the only indicator of a suitable mortgage.

We note that the report found a continued 2-year fixed rate bias on products. We question if this is a sign of a healthy advice market or is in fact a sign that price is the dominant factor in all decision-making.

There clearly are inefficiencies in the market. Some groups of consumers have significantly less choice. In certain segments this is at least in part due to the operation of the regulatory framework and in the disconnect between consumer demands, government policy objectives, MCOB regulation and prudential regulation. The cost and constraints on higher LTV lending and the constraints on higher LTI lending, combined with the FPC recommendation on the level at which mortgages have to be stressed, are a particular case in point which impact disproportionately on those seeking to become homeowners for the first time.

When potential borrowers think about a mortgage they are thinking about the purchase of a home. They may not know the detail of the financial product that they want but they know they will probably need to borrow a substantial amount of money over a long period. UK Finance members recognise that different customers have different needs, aspirations and goals and that it is important that the mortgage is not only affordable but suitable for their needs. The fair treatment of customers is essential in having a good financial relationship.

The FCA has undertaken extensive thematic reviews on responsible lending and the fair treatment of customers. They indicate that firms do have fair treatment of customers at the heart of their culture. For example:

- In May 2016 the FCA published a market-wide thematic review of how firms are applying the responsible lending rules introduced in April 2014 following the Mortgage Market Review (MMR) which found firms have recognised and positively engaged with the aim of the responsible lending rules and there was no evidence of previous poor practice.
- The FCA looked at the treatment of financially vulnerable customers in September 2016 and found most firms had considered what characteristics may make a customer more vulnerable to a rise in interest rates and have carried out analysis to assess the number of customers and level of impact on those most vulnerable to an interest rate rise.
- In January 2018 the FCA published their report looking at the treatment of interest-only customers. The report said all the lenders in the sample have made progress in the fair treatment of interest-only mortgage customers. Strategies exist to contact customers with interest-only mortgages, understand their repayment plans and provide appropriate solutions where no suitable plan is in place. The FCA considered that the repayment options recommended were likely to be fair in almost all cases and that the potential harm caused by non-repayment at maturity was reduced.

Making it easier for consumers to find the right mortgage

Mortgages are fundamentally different from other financial products. The loan is secured on a specific property, the financial commitment is far greater, the contracts are longer lasting, and the wrong mortgage deal could cost a borrower thousands of pounds. Therefore, entering into a mortgage contract should be a considered activity.

We think it is important to make the distinction between the “cheapest” mortgage and the “right” mortgage. This section of the Interim Report assumes that 30% of consumers do not have the “best” mortgage because a cheaper mortgage is available to them. Occasional Paper 33 sets out the FCA’s analysis that is the basis of that assumption. We think that some of the assumptions are flawed and argue these in Annex 1 of this response.

Some mortgages might not be suitable for an individual borrower. For example, the borrower might have disclosed that they may move in the near future and therefore need to port their mortgage, or they want to use a bonus to make regular overpayments. Under these circumstances the borrower may be prepared to pay a little extra to benefit from more flexibility.

Because regulated mortgage contracts are based on the value of the property the mortgage is secured on, a lender will need to consider whether they are prepared to lend against a specific property and if so how much it will be prepared to lend. And if the borrower is looking for assistance with their purchase through help-to-buy, guarantor backed or shared ownership options there are further considerations that a lender has to take.

The wide range of property types in the UK also add to the complexity of selecting a product. Almost all lenders will limit the range of properties they will lend on or will specialise in lending on specific property types – non-standard construction types, green mortgages, self-build, flats above a certain level, properties above shops, mixed use developments, listed properties or those with restrictive covenants. Again, this will limit the products a customer is eligible for and this may mean the mortgage is more expensive.

The risks associated with non-conventional building types, for example the cost of repairs on ex-council homes or restrictions on listed homes mean that number of firms prepared to lend on non-standard properties is far fewer than for conventionally built homes. In many cases the lender will require additional information before they can make a decision. This will make the search for a lender more complex.

This can be seen in the table below:

Number of lenders prepared to lend on non-conventional property types	No	Yes	Refer to Lender
Agricultural Restrictions	54	6	27
Flat Above Shop	23	17	47
Flat Converted	3	52	32
Flat Ex Council / Ex Local Authority	22	32*	33
Flat Freehold	64	7	16
Flat Purpose Built	-	75	12
Flat Storeys	-	54	33
Flying Freehold	19	20	48
Holiday Home	35	15	37
House Ex Council / Ex Local Authority	3	63	21
Leasehold	-	81	6**
Maisonette	14	59	14
New Flat	5	36	46
New House	1	47	39
Prefabricated Concrete	58	5	24
Right to Buy	32	45	10
Second Home	25	38	24
Steel Frame	29	-	58
Tenanted	29	12	46
Thatched	7	46	34
Timber Frame	13	28	46

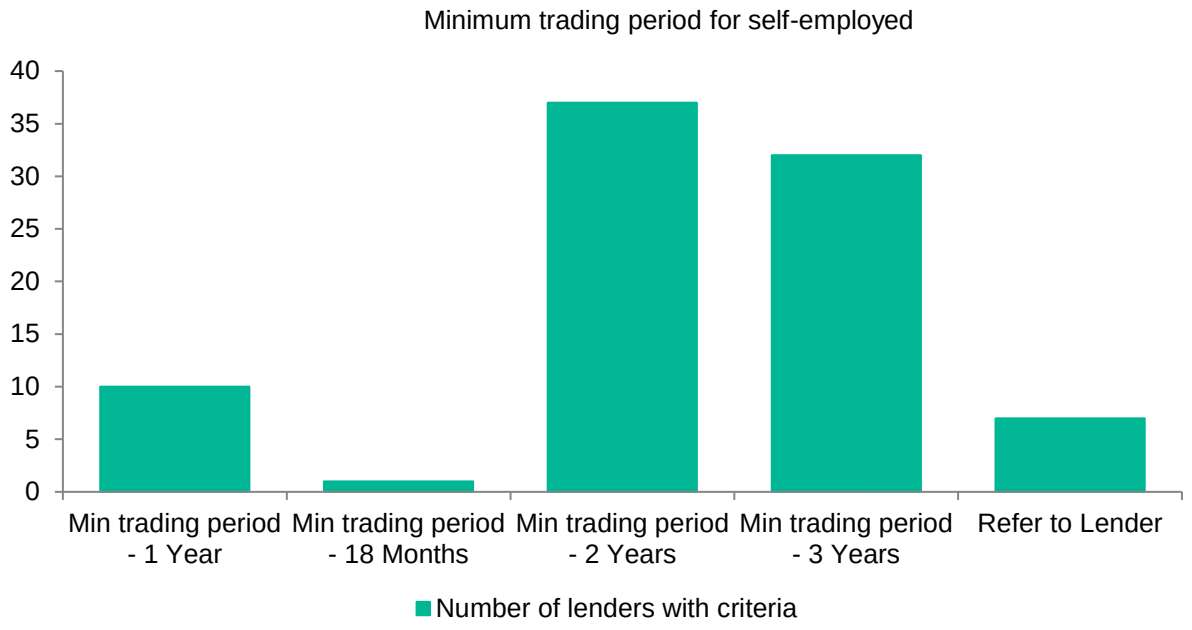
Source: Moneyfacts
*** - Of which, one lender will only lend if the property has 4 storeys or less**
**** - of which, 4 lenders have conditions on the numbers of years remaining on the beginning and/or end of the lease**
This table includes residential loans only

Lenders have developed a wide range of products (including fixed, tracker, offset, lifetime, repayment, part payment, interest only, sharia compliant, home reversion etc) that will be suitable for borrowers under certain circumstances. However, not every product will suit every consumer.

Consumers tend to have more complex circumstances as the way we work changes. Fewer customers will have ‘standard’ circumstances – single or joint PAYE income.

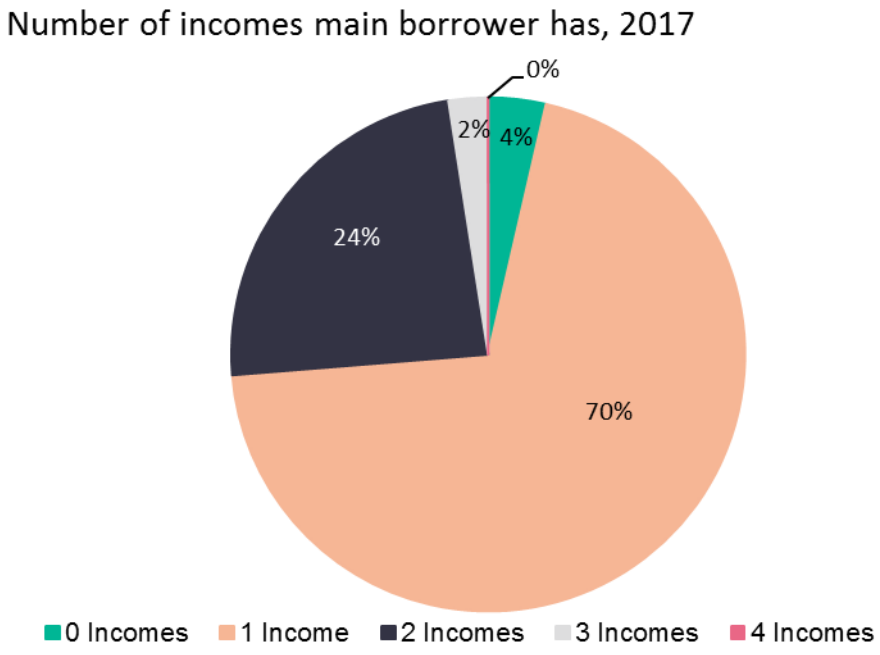
The number of self-employed increased from 3.3 million people (12.0% of the labour force) in 2001 to 4.8 million (15.1% of the labour force) in 2017. To meet the needs of the growing self-employed sector, lenders are developing different criteria for acceptance.

This can be seen in the chart created from Moneyfacts data below:



Where people are employed, the applicant may be relying on income from than one job, or from other sources (e.g. BTL), self-employment, contractors, flexible working patterns etc. The number of people employed on “zero-hours contracts” in their main job, during October to December 2016 was 905,000,representing 2.8% of all people in employment.

We can see this in the statistics collected by UK Finance on the number of income streams the main borrower has listed and set out in the chart below.



The mortgage market has had to adapt for this and develop methods of verifying income. Manual underwriting is an important element of underwriting processes across various classes of lending for different types of lenders and is not restricted to just specialist lending.

The increasing complexity around consumer profiles and the diversification of product and competition means that a basic search of criteria is not adequate. Understanding the nuances of different lender approaches is important as is the capacity that lenders have to underwrite in the round.

Given the complex nature of consumer circumstances (and properties) it is understandable that consumers find it potentially difficult to select a suitable mortgage without the benefit of advice.

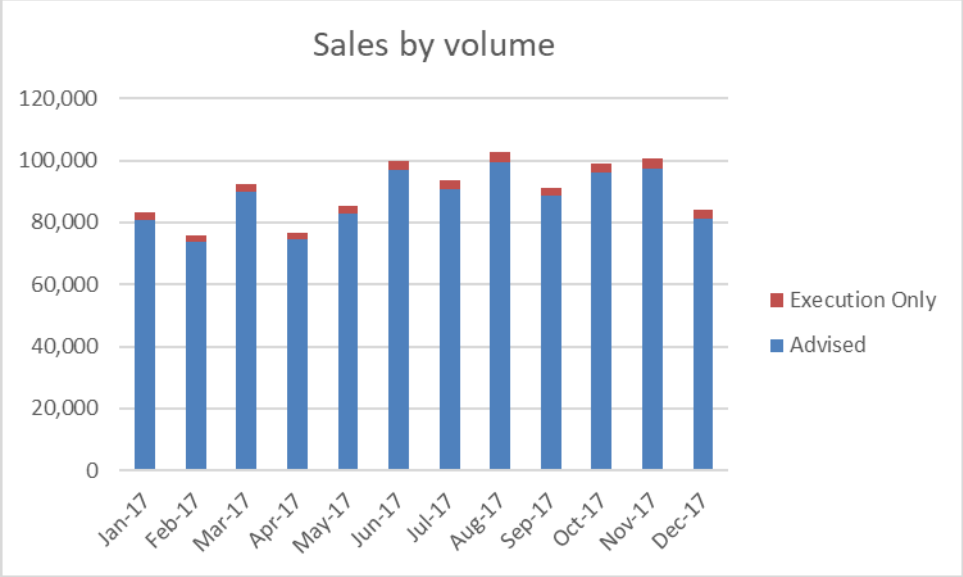
Q2: Do you think tools of the kind outlined could help consumers find more easily the best mortgage for them?

Research undertaken for UK Finance by ComRes looked at how borrowers source advice. It found:

> "As a rule, we found that most consumers first talk to friends, family and professionals to gather the initial information they need to start their search; once they feel more empowered to look on their own consumers then tend to bring the search online, starting with the financial institution they have a current account with, price comparison websites (PCWs) and MoneySavingExpert; finally, they usually go back to talk to financial professionals before signing off on their choice. The diagram below presents an overview of the mortgage search process, before delving deeper into each step in the following sections:"

The tools currently available balance accuracy against time commitment from the customer. For tools to provide more accurate information on customer eligibility etc, they will require more data to be inputted and a greater time requirement from the customer. This could even result in customers deciding not to use the tools if they become over cumbersome. A balance between accuracy and time commitment should be maintained.

People can and do select their mortgage without advice. This can be seen on the chart below which sets out the number of all mortgage sales on an execution only basis and advised basis.



However, execution only sales tend to be concentrated in the product switching area. These customers may find it easier to accept an offer from their existing lender rather than spend time researching the market or making a new application which would entail gathering quite a lot of information together.

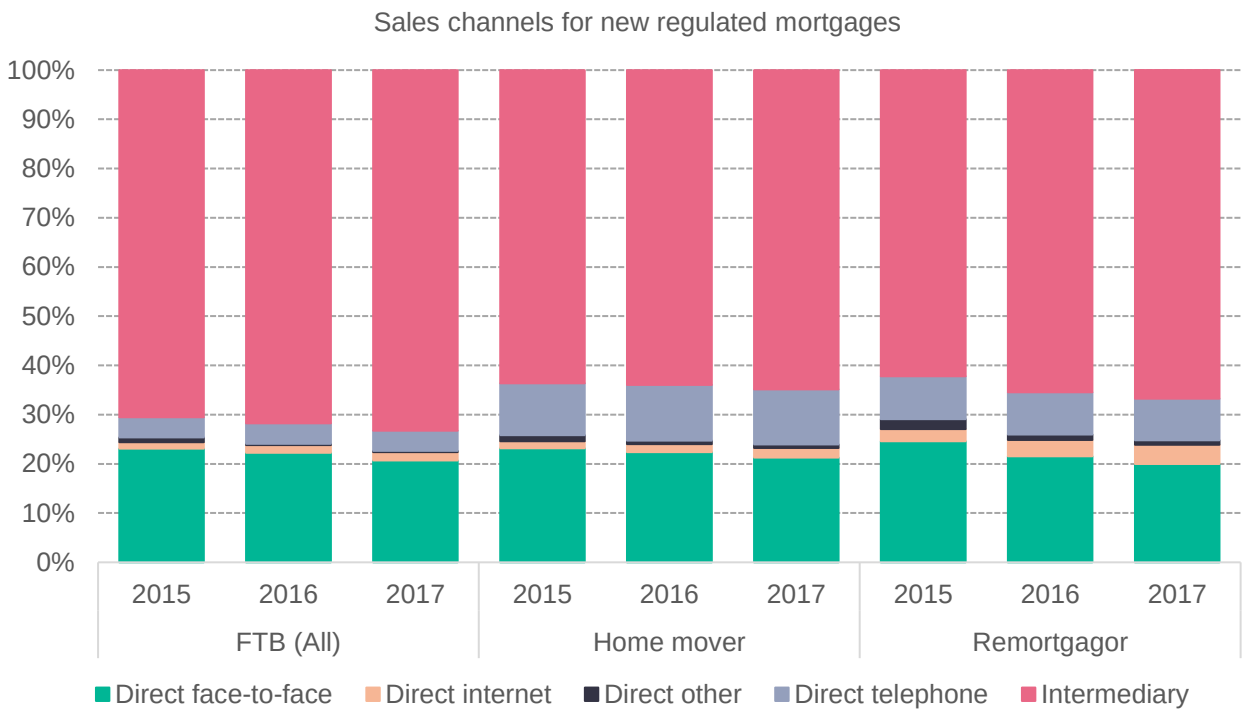
Anecdotal evidence suggests that borrowers may use price comparison websites and best buy tables in the weekend newspapers to ensure that their new offer is comparable with what is available in the market. For the past five years we have been in a stable interest rate environment which has probably reduced the appetite for people to shop around.

As with other financial products, borrowers are increasingly looking to receive advice, make applications and transact online. To meet this demand lenders and intermediaries are developing digital solutions to allow customers to connect directly or to improve the interface between intermediaries and lenders.

In June 2017, CML published a research document "Digital Change and Mortgage Borrowers". (https://www.cml.org.uk/news/cml-research/digital-change-and-mortgage-borrowers/) This set out a snapshot of digital innovation in the mortgage space. It found "Across the industry, there is a recognition that customer experience and operational efficiency can be enhanced through a digitally enabled end-to-end home buying experience."

A key driver will be Open Banking which will let a lender access a customer's bank account information in real time (once the customer has provided their consent) and verify their mortgage affordability instantly, rather than requesting they submit multiple physical documents. Fintech firms are beginning to set out their visions of how they will use Open Banking to assist in mortgage applications and lenders welcome this development.

Automatic Income Verification has made the application process easier for customers and lenders and further development of this tool does not have to be achieved solely through Open Banking. The provision of central data sets such as that held by HMRC would support AIV and further develop it.



Because many lenders are dependent on mortgage intermediaries to drive business to them, they work with sourcing systems to ensure that up to date criteria is available to the broker. Failure to maintain accurate information will mean brokers will not recommend products and the reputation of the lender will be diminished.

A good working relationship between lender and broker can result in more flexibility than a strict interpretation of the lending criteria would allow. Lenders are naturally more cautious when lending on an execution only basis. The lender will not have had the benefit of exploring in detail the borrower's financial and personal situation that happens in an advised sale. They may be prepared to flex the lending criteria if an intermediary has additional information that is not captured on the application form.

Lenders have noted that price may not be the only consideration for some of the customers who are not on the cheapest deal. Anecdotal evidence suggests that convenience, speed and quality of service and brand loyalty are just as important for some customers as headline prices. Consumers will go with lenders for different reasons including brand loyalty or not wanting to take a mortgage from a lender they have not heard of. We would like to see more published research in this area.

For some customers getting certainty quickly will be a priority even if it's not necessarily the cheapest mortgage. Brokers will often know which lenders offer the quickest turn around and also know that this may change at different times depending on funding cycles.

Recommendation: further research into the non-monetary factors that influence the consumer's selection of a mortgage product.

Q3: What do you think would be necessary for this approach to work and what do you see as the main challenges? (e.g. what would be required to ensure that lenders can provide intermediaries with the means of identifying (earlier) products for which consumers qualify? Are there any technical barriers to further development? What is needed to give consumers meaningful outputs, even if they don't qualify for products?)

Lenders agree that quicker identification of consumer eligibility presents time saving opportunities for both the consumer and the lender.

Open Banking and the development of APIs are going to be transformative for the industry. One of the key difficulties with a wide range of lenders and products is that the definitions of the criteria will be difficult to harmonise – one lender may need the date of birth of dependents, another the age at the date of application and another the age at next birthday. To a large extent this is being solved as legacy systems are discontinued and as new fintech API products are coming onstream. A range of products have been launched recently, are in development or are lodged with the regulatory sandbox. We therefore think it is premature to direct remedies in this area.

UK Finance is concerned that a requirement for lenders to make their lending criteria widely available may have adverse effects on competition and has a number of flaws:

- Mortgages are dependent on both the customer and the property being purchased. Both parts have to satisfy the lender. So, you could have someone with a decent deposit, a good salary and affordability but they cannot get a mortgage because the property is a listed building. Similarly, a standard property may not attract a mortgage because the borrower is credit impaired. And just because you get a mortgage in principle this does not mean you will get it in practice.
- Opening lending criteria to public examination may lead to mortgage fraud – if a fraudster knows exactly how a firm assesses risk they can adjust their application to meet the criteria rather than the lender have a true picture to assess risk on.
- Just because a mortgage is the cheapest monthly repayment does not mean it is the most appropriate. Application fees, early redemption penalties, lack of portability etc. may make it an unsuitable product.
- Complex financial circumstances may make it difficult to compare products; will a lender accept bonuses as part of income; how does it calculate for contractors, zero hours contracts, self-employment, multiple part-time jobs etc.; intergenerational lending; deposits as gifts or loans from parents; non-resident mortgages.
- Firms will use more than a simple credit check to assess risk. These algorithms are commercially sensitive and are the business' key tool in developing competitive advantage, so they will not want to share these. In any case some firms may not even have access to the algorithm, as the black box is provided by a third party.

- Each lender has their own risk appetite and lending criteria which will focus on specific parts of the market. As a rule, this works well for consumers as a majority can find a lender who will serve their needs. Standardising lending criteria and risk appetites risks losing this and could lead to worse consumer outcomes.

Once the borrower has identified which product to apply for the application may not be approved for a range of reasons:

- Funding tranches may be used up quickly. A loan at 3.29% may be the “best buy” and used up quickly.
- In the case of new housing developments, a lender may be wary of lending on too many properties on one site. The concentration of risk may be too great and so once they have lent against, for example, 40% of the properties in one area the lender may no longer approve loans.

After the assessment of the borrower the process is not complete. Even if the property is standard there are a number of hurdles:

- valuations may be lower than expected (so the mortgage is not enough to buy the property).
- searches may throw up complexities; restrictive covenants, mines, charges outstanding on the property, ground rent is excessive etc.

There are many reasons why a customer may not get the mortgage they applied for – something emerges later down the line that causes issues e.g. something to do with the property that only emerges through searches; a lender’s credit risk model rejects them; the lender has enough of that type of mortgage for the time being (particularly e.g. high LTV, self-employed); sufficient concentration risk on a new build site; or the tranche of money for a particular product has been used up. All of which reflect the complexity of the home buying process. Lenders will try to make sure that customers do not get rejected late in the process but sometimes it is unavoidable.

Recommendation: the fintech industry, along with lenders and intermediaries, should be allowed to develop products to allow the comparison of mortgage products before there is any regulatory intervention. A range of commercial solutions have already been launched and more are being developed by the fintech sector that will make it easier for intermediaries to select the most appropriate products for applicants. It is only a matter of time before consumer facing solutions are launched.

Q4: Could there be any unintended consequences? (e.g. do our ideas in this area present any risks to consumers or industry? Does this dampen incentives to innovate?)

UK Finance is concerned that even the prospect of regulation or reform of regulation will delay the development of products. Firms are not going to want to invest in new products if there is a risk that regulators will prescribe a “solution” or a format that is inconsistent with their vision.

As stated above, the fact that each lender has their own risk appetite and lending criteria which will focus on specific parts of the market. As a rule, this works well for consumers as a majority can find a lender who will serve their needs. Standardising lending criteria and risk appetites risks losing this and could lead to worse consumer outcomes, or even excluding customers with more complex or different requirements.

Consumers may also think that they are entitled to a mortgage if they meet all the published criteria when there may be other, valid reasons why they (or their property) do not qualify.

A wider range of tools giving consumers more choice about the support (including advice) that they need and offering greater convenience

As stated above, the variety of mortgage types, consumer circumstances and properties on sale contribute to a complex matrix of eligibility criteria, affordability and suitability of products which need to be navigated.

Lenders who use intermediaries as a distribution channel already make their lending policies and criteria available, through specific websites, mortgage sourcing systems or mortgage clubs. Many technological developments in the market are currently mainly aimed at intermediaries but we suspect these will be consumer-facing too before too long.

While technological solutions are coming on stream, lenders have noted that currently, these are aimed at standard or non-complex customers. This is understandable as it will be simpler to develop and test products for these groups. In time it is hoped that technological solutions will expand in scope.

Q5: Do you think consumers would benefit from more choice on the tools they use (including advice) and the support they receive in the way outlined above? (if so, which categories of consumer? Or if only some consumers should have more choice about whether or not to receive advice, which categories of consumer are these? What else could we do to encourage the development of online advice?)

The FCA have stated that they are neutral when it comes to how advice or information is delivered. However, lenders have said that they need to be very careful not to provide advice by stealth, and that any “interaction” could be interpreted as delivering advice. This has stifled innovation in the field of digital advice. The current case studies in PERG 4.6 do not reflect the current multi-channel approach that consumers expect from lenders. For example, a consumer completing an application form on line and making a phone call clarifying a point about fees and later using webchat to confirm a fixed rate end date.

The current execution only rules set out in MCOB 4.8A.10 1(b) are preventing innovation in the market. Currently firms are only able to present new rates to customers in a non-interactive way. This makes things difficult for firms by preventing them interacting with customers and presenting them with new rates. As a result, customers may not be aware of the full range of new rates and products that may be available to them.

Lenders have said that they would like to be able to discuss options with customers, e.g. whether a five-year fixed rate would be cheaper than three 2-year fixed products but at the moment they are not sure if this would be considered advice.

By using the Article 3 1(b) exemption from MCD, lenders to high net worth customers are able to offer advice and then allow the customer to proceed on an execution only basis. If there could be a relaxation to MCOB 4.8A.7(3) more high net worth customers could benefit from some advice before selecting their final product.

All lenders would welcome more guidance from the FCA on what constitutes guidance, as well as clarification of the rule designed to prevent firms steering customers away from advice. This has led to firms not marketing their execution-only channels.

A further consideration for borrowers and the people offering advice is the whether the mortgage is the best deal for today or the best deal in the long term. Unless the borrower is an active switcher they could end up on a worse deal when the reversion rate is applied. For example, a base rate tracker could be set at base + 2% over the whole term of the mortgage but a two-year fixed rate mortgage would be cheaper, but it reverts to a higher SVR. There is a danger that consumers will focus on cheaper monthly payments today and lose sight of the value a tracker product may offer.

There are likely to be several contributing factors to the recent decline in balances on SVRs including the increasing spread between fixed rates and SVRs; consumer expectations on the direction of interest

rates; firms' strategies to retain existing customers through attractive re-mortgage offers and brokers increasingly following up on customers who are near the end of their initial fixed rate period.

Recommendation: The FCA should undertake a thorough review of the rules and guidance issued in relation to advised and execution only sales.

Q6: What do you think would be necessary for this approach to work and what do you see as the main challenges? (e.g. should we trial an approach to give consumers more information about whether to receive advice? Are there other regulatory barriers to the development of tools to help consumers choose a mortgage more effectively?)

As stated above many customers are confident to select a mortgage on an execution only basis.

There are groups of people for whom a standard approach to regulated mortgage advice is not appropriate, for example high net worth individuals who will use mortgage products alongside general wealth advice. It is important that any new regulation/information requirements do not needlessly capture parties who do not need this enhanced protection.

The report gives an example of treating experienced re-mortgagers as lower risk (see paragraph 9.20). This could present problems in the long term. Some consumers may have re-mortgaged several times during the recent period of history post financial crisis when rates have remained low. They may not have the requisite experience to make informed choices in a volatile market.

With an aging population all lenders are having to consider the needs of older borrowers. Lenders have asked if there need to be different considerations for lifetime mortgages. And now, with Retirement Interest Only (RIO) mortgages being made available, it is even more important that customers take advice about what might be right for them and their circumstances. It is unclear if there are the right advisers available in the market to advise older customers, especially if there are other considerations such as pensions, tax and benefit advice.

Recommendation: further consideration needs to be given to the provision of holistic advice.

Q7: Could there be any unintended consequences? (e.g. do you have any views on the impact of reduced regulatory consumer benefits for those consumers who would no longer seek advice? Could there be any unintended consequences to increasing provision of online advice? If so, how might these risks be mitigated)

There is a suggestion in the report that relaxing rules around advice would only be considered if brokers could also carry out execution-only sales.

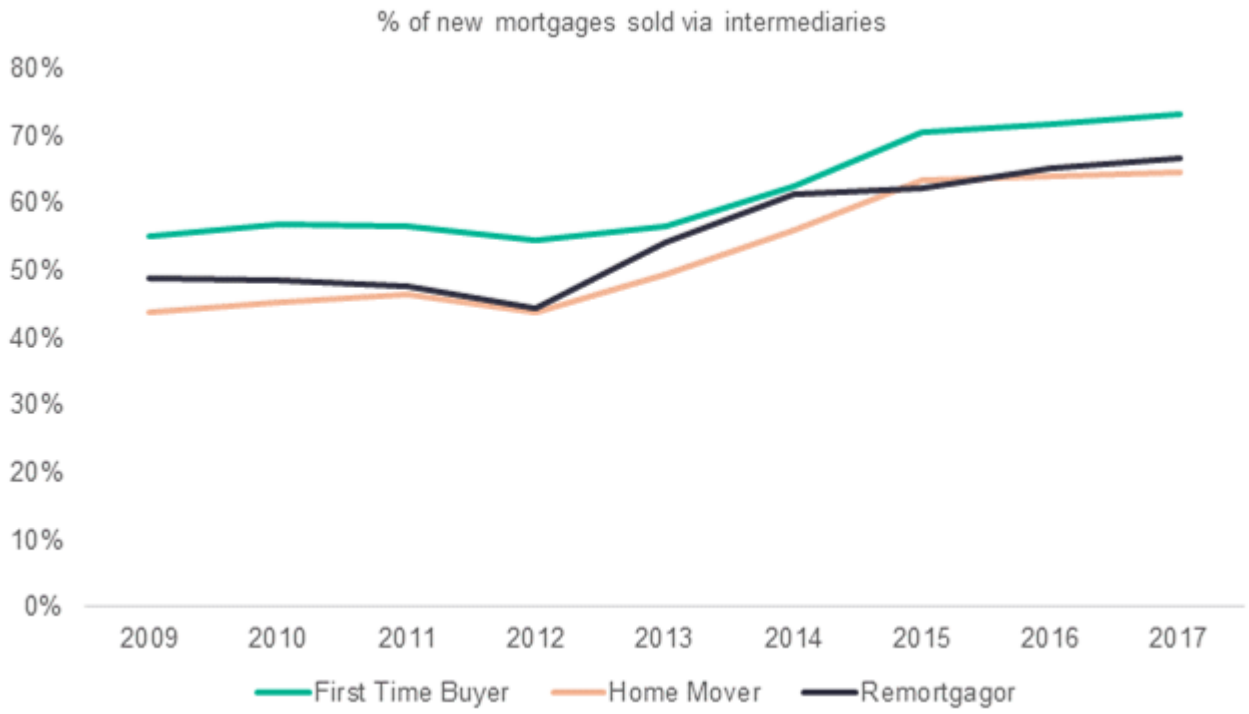
The current structure of mortgage sales is binary – advised or execution only. This raises the question of what role would a broker play in an EO sale and how would they be paid? As set out above, we think that there is a role for assistance with or guidance on a particular sale. This may lead to a broker assisting someone to select a type of mortgage and then the consumer make the final selection from a range of appropriate products.

As there is no or less time spent with a consumer an execution only mortgage should cost less to the consumer. If lenders decide to reduce the cost of non-advised loans by offering a discount on interest rates this may skew the market away from advised loans. Customers may also use a fee free advisor before opting to transact with the lender on an execution-only basis.

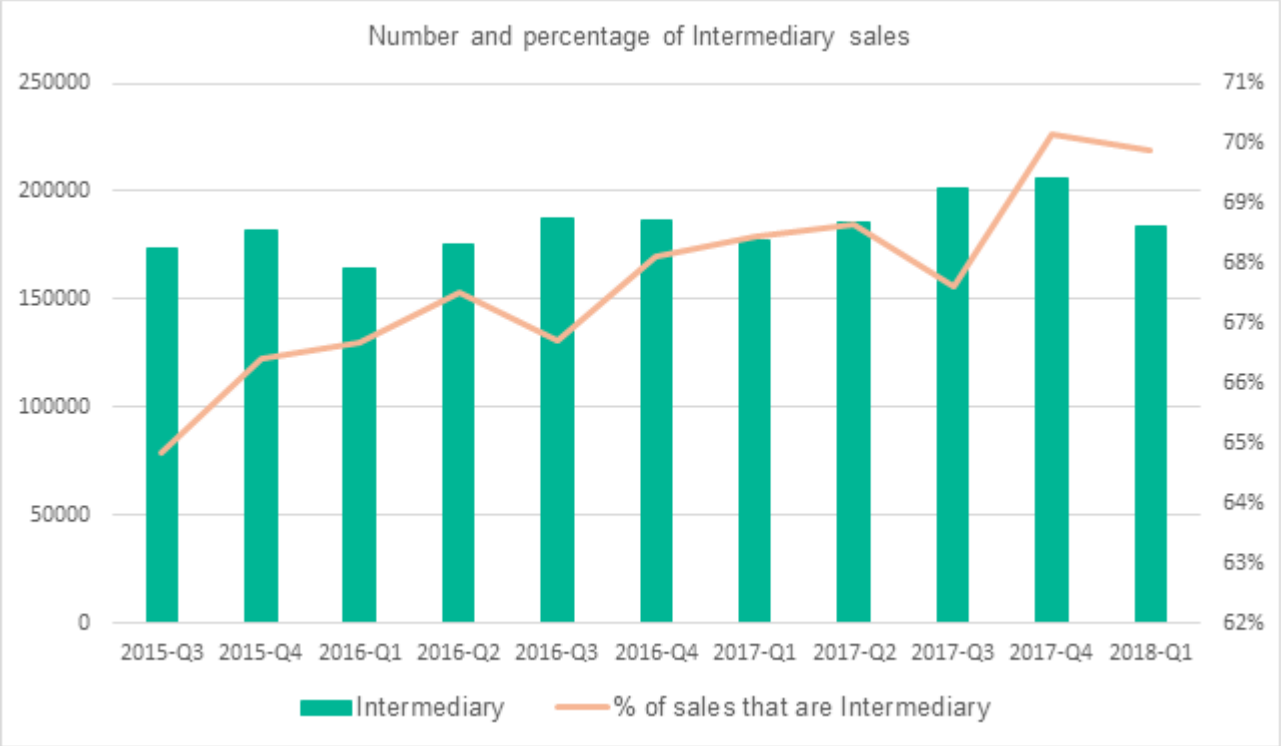
<u>Helping consumers choose an intermediary on an informed basis</u>

Mortgage intermediaries are very significant for lenders and form their most important distribution channel. For small lenders it is difficult to justify the investment in the infrastructure necessary to recruit, train and retain their advisers. Lenders make their lending policies available to intermediaries via sourcing systems. The increasing percentage of lending business going through intermediaries is as a direct result of MMR which has caused a structural shift in the market.

The trend to intermediated mortgage sales can be seen in the charts below:



Source UK Finance



Source UK Finance

Q8: Do you think consumers should be given more help to assess intermediaries' strengths and weaknesses in the way outlined above?

If consumers are to pick the appropriate broker, they probably need to know what sort of product (fixed term, retirement interest only etc.) they are looking for. Research by lenders and consumer groups has

consistently shown that borrowers are not aware of the range of products available, or which product they currently have. We think financial education and the provision of easy to understand information on product types should be a priority for the Single Finance Guidance Body and that the availability of this information is widely advertised.

Lenders know who the intermediaries are, they work with panels or are on panels and get to know the types of borrowers they work with and the products they are looking for.

Firms currently undertake checks on the firm when they agree to accept referrals, including confirming that the firm is authorised. However, once the relationship has been established firms do not routinely "mark the homework" of intermediaries, as it is up to the FCA to supervise the firms it authorises. There is a concern that firm level authorisation may not be enough to prevent fraudulent brokers to operate.

We note that under the reform of the SMCR regime, the FCA is proposing to maintain a register of authorised persons. We welcome this proposal as it will allow lenders to ensure that consumers are receiving advice from qualified people.

If a database of intermediaries is recommended, lenders have raised the following concerns and questions:

- What will the governance of the database look like, how will it be paid for, who will set the standards for inclusion, who will agree who is allowed on and who should be removed, who will act as the appeal body?
- If brokers are taken off the database will the FCA investigate the conduct of the firm? There is a concern that fraudulent brokers will continue to operate.
- How would Agents and Authorised Representatives be recorded on the database and would the purpose of the database be to give information about the firm or the advisers within it?
- Some fear that the database could impact negatively on competition. It is likely to play to the strengths of larger firms while smaller specialists are left behind. A firm description as "whole of market" may attract consumers with complex needs but which cannot deliver as they do not know a market segment e.g. credit impaired as well as a specialist firm.
- Information on the concentration of business allocated to a lender may not be useful for a customer. It may be that the bulk of business is referred to one lender because they offer cheap products and/or good service and it would not necessarily indicate that the broker does not shop around for the customer.
- Number of complaints as a measure of quality is a very blunt tool and not very informative. Complaints data may generally create an imbalance as lenders are only required to publish this when it has received more than 500 in a reporting period. If complaints are included in the published information, the number of complaints should be reported as a ratio (to cases completed). Otherwise it may not be representative for side-by-side comparisons of different brokers/organisations. If the database contains the number all complaints including those not upheld, the consumer may get a false picture, for example brokers may receive complaints that should be directed at a lender.

The role of introducers is unclear in this scenario. Lenders are concerned that the inclusion of a broker or introducer on the database could give a false sense of security to consumers.

Recommendation: Financial education on mortgage types should be a priority for the Single Financial Guidance Body

Q9: What do you think is necessary for this approach to work and what do you see as the main challenges? (eg what information is needed for this to be of practical value to consumers, such as the price, service and quality factors? How can we ensure the information gains traction with consumers?)

The biggest challenge is how will consumer satisfaction be judged. It would be helpful to know how brokers source their customers at the moment and see if there is any change over time.

The outcomes of any customer satisfaction survey should be published through the Single Financial Guidance Body.

Q10: Could there be any unintended consequences?

As stated above, depending on how the database is funded it may give larger brokers with bigger budgets etc. an unfair advantage especially if the database accepts paid content or allows firms to purchase enhanced listings.

If customers feel that they need to invest time in researching broker quality (as oppose to receiving a recommendation from family and friends) they may be deterred from seeking advice. It would be interesting to compare how may people drop out of searches for other financial advice.

Reducing barriers for those consumers who do not or cannot switch

Q11: Do you think it should be made easier for consumers with active regulated lenders to switch?

Most borrowers are able to switch and as the report found over three quarters of consumer originally on a fixed term product switch to another loan within six months of moving to a reversion rate.

Recently released figures from UK Finance show that 390,200 homeowners switched product with their existing provider (product transfers) in the first quarter of 2018. By value, this represents £53.7bn of mortgage debt refinanced internally. These figures do not feature in any market data on remortgage, or other published gross mortgage lending data. This shows that the market is working well.

Within the total 203,200 product transfers, worth £29.5 billion, were conducted on an advised basis and 187,000, worth £24.2 billion were execution-only.

These figures echo the FCA's findings in its Mortgages Market Study. Customer engagement is high, and the majority of mortgage customers switch to a new deal shortly after their previous deal expires. Our data also supports the FCA's observation that most borrowers choose to remain with their current lender when they switch product.

For many consumers their first step would be to go see the bank or building society they hold a current account or a mortgage with. There are many reasons why:

- There is an existing relationship – and therefore familiarity.
- There is trust if the relationship has been positive.
- It is deemed easier to have all financial products with the same institution.
- For re-mortgagers, staying with their lender means they do not have to go through the process of getting bank statements and other information required to re-mortgage.

For many, the hassle, complexity and time consumption of the process, means that they would prefer to stay with their existing lender or current account provider if the offer is perceived as good. Other reasons not to switch include the flexibility of a product, the lack of an early repayment charge and the possibility of making regular over-repayments.

We think that it is good news that lenders are more proactive in retaining customers and providing a way for them to transact and move onto a new rate easily. Internal switching is a positive outcome for consumers. They can make these transactions in a wide variety of ways to suit their needs. Borrowers who know exactly the product they want can elect to switch quickly and efficiently through the execution-only route. But, for those who require help in choosing the right product, mortgage advice is widely available both through direct channels and from intermediaries, with more than half of borrowers taking advice for their new deal.

For some customers with small value loans or with short repayment terms there may be little value in switching. Even at the end of loan and/or a small balance some customers may still benefit from a switch. This is particularly true of interest-only customers if it means they could pay off some of the capital based on the same monthly payment but with a lower interest rate (although depending on the size of the capital sum it may have little impact).

The FCA recognises that there are a range of reasons that some customers do not switch when they could benefit (6.29). Lender research that suggests some people think they are on a fixed rate when they are in fact on the lender's SVR. This is probably a result of long term interest rate stability.

Barriers to switching have, to a large extent, been created by the adoption of the Mortgage Credit Directive which means that an affordability assessment is triggered every time a new regulated mortgage contract is written. It means that lenders cannot use the transitional provisions for customers even if they show that they are up to date with payments. It would be worthwhile revisiting the transposition of the MCD into UK regulation to see if these barriers can be reduced.

UK Finance members have responded positively to the FCA challenge to commit to helping longstanding borrowers who are currently unable to switch to a better deal; supporting those customers who are often referred to as 'mortgage prisoners'.

Large and small lenders are signing up to a principles based voluntary agreement to assist these customers. Lenders will contact customers once they have identified eligible borrowers. To qualify, the following standard principle-based criteria* will apply:

- be first charge owner-occupiers
- be existing borrowers of an active lender
- be on a reversion rate
- be looking for a like-for-like mortgage
- have no material breaches of contract
- have a minimum remaining term of 2 years
- have a minimum outstanding loan amount of £10,000

And be able to benefit from switching.

Lenders are identifying those customers who would meet these criteria and are developing contact strategies for customers inviting them to consider a new offer.

For the avoidance of doubt the agreement is not intended to apply to all customers on a reversion who are able to switch and have already been contacted which is our understanding of the 800,000 in the FCA's report (page 51 of the report). This is about customers who previously did not meet all the criteria (and therefore were unable to switch) and have not previously been contacted.

While it may appear obvious to say that unregulated owners of mortgage books should be regulated, any proposals to regulate the currently unregulated owners of mortgage books may have an impact on the future securitisation market. This is because there may be a view that regulation would make books less valuable because of the overheads that regulation would bring. This is an area that requires further consideration as to how to ensure these customers are treated fairly.

Recommendation: The FCA should review the interpretation of the MCD for existing customers and the position of the customers of unregulated owners of mortgage books.

Q12: Which consumers should be covered in our approach? (eg do you have views on whether any intervention in this area should be limited to consumers who took out a mortgage or last switched prior to a tightening in lending criteria post-crisis? If so, what would be an appropriate date? Also, should we include other groups of customers such as those who have fallen into financial difficulty as a result of being unable to afford payments on a reversion rate, but would otherwise satisfy the remedy constraints/criteria? Or should we leave customers in arrears to be considered under our payment shortfall rules and guidance in MCOB 13 which set out how we expect firms to treat consumers in payment shortfall fairly given the customer's individual circumstances?)

There will be some exceptions to the voluntary agreement. The following exclusions apply:

- Any change to the terms of the mortgage which is likely to be material to affordability would be excluded e.g. additional borrowing, change of term, adding or removing a party to the mortgage.
- Overseas properties - only mortgages on properties in the UK are included in this agreement.
- Arrears – customers who have aggregate arrears of more than one monthly payment in the past 12 months are not eligible and will be dealt with under firms' existing MCOB13 processes.
- Discontinued products – firms do not need to replicate like for like e.g. if they no longer offer particular products (such as Sharia compliant products, etc).
- Permissions for commercial lets – the agreement will not apply where consent to let has been given.

Some firms have noted that there are restrictions placed on some mortgage books, both closed and with active lenders, as a result of securitisation. Sometimes the method of securitisation means customers will lose all the benefit of an internal switch, for example where products can only be offered if the mortgage is fully redeemed. While not a total bar on moving borrowers to a new rate, some firms may not be able to offer new products immediately due to regulatory and/or legal constraints. As stated previously, the MCD requirement for an affordability assessment every time a new regulated mortgage contract is written is a real barrier to switching for many closed book customers. It means that lenders cannot use the transitional provisions for customers even if they show that they are up to date with payments.

Q13: What do you think is necessary for this approach to work, and what do you see as the main challenges? (e.g. How could any changes be effectively communicated to the relevant consumers?)

UK Finance has set up a working party to take forward this project and will work with the FCA to agree project scope, timeframe and outcomes.

Lenders have signed up to implement the voluntary agreement to assist the 10,000 'mortgage prisoners' who hold mortgages with 'active' lenders that continue to lend.

Q14: Could there be any unintended consequences?

If a large number of customers switch to lower interest rates, there could also be implications for firms' prudential requirements and for the cost of future funding.

We note that in its Strategic Review of Retail Banking Business Models the FCA is considering the extent to which firms are reliant on SVR customers for profitability. It is important that the FCA co-ordinates these two pieces of work to prevent unintended detriment to the industry.

Long-term inactive customers

Q15: Do you think we should do more to encourage long-term inactive customers to switch in the way outlined above?

Inactive consumers exist in all markets. Economic conditions have made the interest rate landscape very benign. Lenders have noticed switching rates increase as rumours of Band of England rate rises circulate.

Firms have developed sophisticated contact strategies to encourage interest only consumers to have conversations with their lenders about switching to a repayment product. Whilst the number of people on IO Mortgages has reduced, there is still a substantial hard to reach cohort, a situation the FCA has recognised.

Under existing regulation all borrowers are in receipt of an annual statement which sets out the balance of their mortgage and details of their mortgage terms, including interest rate. For many consumers this is a trigger to contact their lender.

We will work with the FCA over the coming months to review the status of people who have been on reversion rates for a long period.

Q16: What do you think is necessary for this approach to work in the mortgages sector and what do you see as the main challenges? (eg is this something that could be delivered by the industry or would it require new or amended rules or guidance to prove effective? What would be an effective alternative where no suitable product is offered by the customer's existing lender? Do you have any views on how affected consumers could be offered a better deal?)

Where there are large closed books there could be restrictions caused by securitisation on moving borrowers to a new rate, so some lenders may not be able to offer new products immediately due to regulatory and/or legal constraints.

As noted above, the MCD potentially provides the biggest barrier to helping long-term inactive borrowers. We will be exploring with members and the FCA to see what might be possible for customers of inactive and unregulated lenders over the coming months.

Q17: Could there be any unintended consequences? (eg any impact this could have on prices for new customers)

There is a risk of reputational damage to the industry as customers of unregulated firms or securitised books may not understand why they are unable to switch to a lower rate.

There could also be implications for firms' prudential requirements and for the cost of future funding.

Remedies – timeline and general questions

Q18: Do you have any comments on our timelines?

The mortgage industry has been through a massive amount of regulatory change over recent years with the reforms after the Mortgage Market Review and the implementation of the Mortgage Credit Directive. Firms are at last able to review their products and services to consumers and are bringing in new ways of working and innovative products to meet consumer demand.

This is particularly noticeable with new entrants to the industry offering specialist mortgages that are manually underwritten, the development of Retirement Interest Only mortgages by specialist and mainstream lenders and new products for self-employed borrowers.

Any proposed regulatory change must be mindful of the impact reform will have on products and service innovation as resources are diverted to meet that change.

Recommendation: to allow the development of new products and distribution channels, regulatory intervention should not be triggered unless the market is not meeting the needs of the consumer.

Q19: Do you have any views on the relevance of our findings on first-charge residential mortgages to other mortgage markets that we regulate, and which were not within the scope of the market study – for example, second charge?

We have no comments on the application of the remedies to other regulated markets. See above our comments on the need to consider bringing unregulated products within the scope of FCA regulation.

Q20: Do you have any views on the extent to which these potential remedies (with further enhancement or refinement) are relevant to lifetime mortgages (in light of our assessment of lifetime mortgages in Annex 5)?

We have no comment on the application of the remedies to the lifetime mortgage market except to say there is a need to move to more holistic advice. This could be a real opportunity to ensure a wider financial wellbeing to the mass market. Wealth and Mortgages should not be separate conversations. It would be useful to have a discussion on the collapsing of mortgage advice/product silos that currently exist between mainstream and Equity Release markets.

Other potential approaches

Q21: Do you have any views on these options or any other alternatives

We have no comments on other potential approaches.

Contact

This response has been prepared with the assistance of UK Finance members. Should you have any questions or queries on its content please contact Sue Rossiter (sue.rossiter@ukfinance.org.uk).

31 July 2018

Annex 1

Dominated mortgages

One of the findings reported in the FCA's Mortgage Market Study (MMS) was that an estimated 30% of recent borrowers took out a mortgage that was price-dominated. This means that these consumers could have found an alternative mortgage offering the same rate with a lower fee, or offering a lower rate with the same fee, given the borrower's required LTV. This finding is used to back up the FCA's view that a significant minority of borrowers are being underserved by a confusing mortgage marketplace.

We believe it is important to note that this assertion is underpinned by several challengeable assumptions. We recognise that the assumptions may be helpful to simplify the empirical analysis presented the accompanying Occasional Paper 33. However, we also believe the assumptions promote an overly-simplified view of the market and may lead to an overestimation of the number of consumers with sub-optimal mortgages.

The first major assumption is that **mortgage borrowers' preferences are only based on a group of measurable and standardisable prices and loan characteristics**. Specifically, the research presumes borrowers just want to minimize the interest rate and fees that they pay the mortgage lender.

The reality is that when customers shop around, they are looking for more than just the lowest interest rate and fees—they are also looking for a product with the features they need. There are several non-price factors which customers take into consideration when looking for a mortgage (speed and certainty of receiving an offer, ease of application, level of customer service, brand recognition and trust, the available product range, and type of product features available etc) and these might result in the customer not selecting the cheapest product. The analysis conducted by the FCA doesn't take these non-price factors into account.

During the length of time examined by the research, January 2015-July 2016, around 40% of loans for home purchase and 50% of remortgage loans had a mortgage feature of some type. The most common features include cashback offerings (which nearly one-third of first-time buyers opt for) and "flexible" elements, which can include having interest calculated daily, loan portability, and the options to make overpayments, underpayments, and payment holidays.

It would be very difficult to quantify and compare the value of these various features, as the value of each feature may differ among consumers. For example, borrowers who have substantial amount of income from bonuses or seasonal work may find that a generous overpayment option is a more valuable proposition than a borrower whose income is consistent. Similarly, a first-time-buyer might find a cashback offer an extremely useful feature and may prioritise that over other aspects of the loan, even if it does make the mortgage more expensive in the long-run. These are just a few examples of customers who might rationally choose a mortgage which might not necessarily offer the lowest fee and interest rate but is nonetheless the most appropriate product for their needs.

A second assumption which underpins the research **is all borrowers could feasibly qualify for all products available in the market**, so long as their credit score meets the minimum requirement.

The report concedes that additional eligibility criteria which is not readily observable in the data might make it seem that dominated mortgages are more common than they truly are. However, this point is not sufficiently examined, and we believe it is key to understanding consumers' rationale for choosing various products.

Eligibility for a product is usually down to more than just a borrower's credit score and required LTV. A wide range of factors relating to the borrower, the property, and the timing of the loan may impact whether a product is available to a given consumer. While mortgage lenders might commonly apply standardised underwriting processes, they are aware that each mortgage has a unique counterparty risk and is secured against a unique asset. Therefore, not every borrower will be eligible for every product.

We present some examples below of cases where a borrower might meet the headline criteria, but still not be eligible for a mortgage, and may therefore rationally choose a mortgage that is dominated.

- When a property is ex-local authority or nearby a commercial residence, some mortgage lenders may consider the value of these properties to be less stable and refuse to mortgage them, even if the customer meets all other eligibility requirements.
- Borrowers may have certain characteristics which some lenders consider higher risk. For example, if a borrower has been self-employed or resident in the UK for a short period of time, not all lenders may be willing to offer them all products.
- Remortgage applicants often seek to raise capital with their loan. Some lenders may have stricter requirements around the purpose of additional lending then others. For example, a borrower who wishes to take out capital to fund a wedding may have a more limited choice of products than a borrower who wants to refinance to remodel their kitchen.
- House purchase transactions notoriously face delays which can be due to many factors. This can lead to a long gap between a borrower getting their mortgage approved and the completion of the purchase. During this time, it's possible that new and better deals might come to market—however few consumers would risk jeopardising the transaction by chasing a new mortgage deal.

A third assumption baked into the report is **that brand familiarity has no value to the customer**. As has been shown in the FCA's own Strategic Review of Retail Banking Business Models notes that firms benefit from cross-selling with the analysis indicating customers frequently turn to their PCA provider for a personal loan, mortgage, or credit card. This suggests customer satisfaction and trust are as important as price for some consumers.

To sum up, we believe that the reasons for why a consumer might take out a price-dominated mortgage are many and varied. We do not think market failure is the real driver here, and we believe there is a need for further education on the potential range of complex needs and requirements that borrowers might have of their mortgage lenders.