Improving the Mortgage Market

Citizens Advice formal FCA Mortgage Market Study response

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Dear colleague,

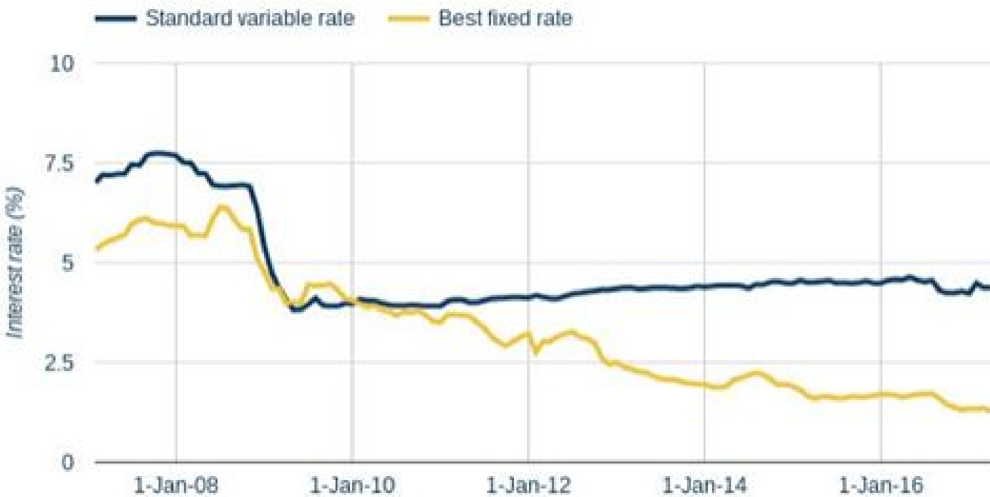
Citizens Advice provides free, independent and impartial advice to anyone who needs it. In the last year, Citizens Advice advised 28,310 clients on professional and financial services including 4,002 mortgage and secured loan issues. Our data allows us to spot new pockets of consumer detriment and respond accordingly.

We are pleased to respond to the FCA's *Mortgage Market Study Interim Report.* We agree that competition works well for many customers in the mortgage market, but that the negative effects when the market does not work well can be highly impactful. It's therefore welcome to see the FCA reviewing this market in detail.

We hope our recommendations and proposals for further study will be useful in guiding the FCA's actions to improve the functioning of the mortgage market, particularly in relation to the significant loyalty penalty that long term inactive consumers pay. This is a structural issue across many markets and regulators are increasingly turning their attention to protect long-standing consumers from this unfair pricing strategy. We welcome, for example, the FCA's recent proposals for a basic savings rate (BSR) in the cash savings market and measures taken in the energy market to protect SVR consumers. While the mortgage market is more active than that for cash savings, we would encourage the FCA to think whether a similar logic might apply here as well. We set out our proposal for further work in response to Question 21.

A significant minority of consumers are unfairly penalised for remaining with lenders after their fixed rate expires. As shown in Figure 1 below, standard variable rates (SVR) have remained relatively stable since the 2010 crisis while fixed rates have fallen dramatically.

Figure 1. The gap between SVRs and the best available rate has grown



Source: Bank of England, Bankstats database

Competition does not appear to be driving the price of SVRs and many providers are gaining an unearned benefit from customers' tendency to not shop around. A well functioning market should reward companies for serving their customers well and at a low price, not by penalising their most loyal customers. Our prior research suggests that the customers disproportionately affected by this are from vulnerable demographics, though we are conscious that the FCA has arrived at a different view in this study.

In order to improve competition around SVRs, ensure the market better reflects consumer behaviour and protects vulnerable consumers from unfair additional costs we believe there are a number of steps the FCA could adopt. These are simple and low cost solutions that we believe have the potential to significantly benefit consumers and the market. There are also some more extensive solutions that should be strongly considered. The FCA make a number of positive recommendations already:

- Improving tools so that consumers can more easily find the right mortgage
- Requiring lenders to notify consumers more clearly about their fixed rate

We believe these positive steps can be extended simply and at a low cost to make it significantly easier for consumers to switch and more comprehensively tackle the loyalty penalty. Our principal recommendations are:

- Require lenders to prompt customers when their fixed rate is due to expire in a standardised format according to consumer preferences, by
  - Prompting consumers at 12 months, 6 month and 3 months before their fixed rate expires with benefits of switching clearly explained
  - Allowing consumers to select preferred method of for this communication from lenders
  - Set out the costs and benefits of switching in standardised and tested format
- Label mortgage costs and rates more accurately, by
  - Renaming the standard variable rate to become the 'expired rate' for example
  - Including the total cost of credit included in all communications

In addition to these extensions to the FCA's recommendations we propose the FCA give consideration to more substantive action to protect lower income consumers. We suggest the FCA conduct further research on and strongly consider:

- Requiring lenders to give consumers whose income is recorded as below median income when making their initial application the opportunity to switch to a better deal
- Implementing a relative price cap on SVRs to limit interest rate rise from fixed rates

We offer brief commentary on the loyalty penalty before addressing your questions in more detail.

Our concerns about the loyalty penalty

Customer loyalty is a common characteristic across financial services. When taking out a mortgage, borrowers can choose to pay a fixed interest rate, which the provider guarantees for a given period. At the end of the fixed interest period, customers automatically roll onto the bank's SVR and can experience an increase in their monthly payments.

We welcome the FCA's research that reveals the extent of the loyalty penalty - 800,000 mortgage holders forgoing a potential saving of £996 a year with a total cost to consumers of £796.8 million. Our own research suggests 1.2 million households are paying an average loyalty penalty of £439 a year - a total cost to consumers of £526.8 million. Given that 1 in 5 mortgagors (21%) are currently on their lender's SVR and our analysis suggesting only 17% of SVR payers are not being penalised, this constitutes a significant minority of consumers in the mortgage market suffering substantial unnecessary cost.[1]

96% of consumers believe the loyalty penalty to be unfair. It has led to dysfunction in the market with SVRs remaining stable while fixed rates have fallen drastically since 2010. While we note the FCA's assessment of the financial profile of those consumers who would benefit from switching being more affluent than those on fixed rates, our research suggests that vulnerable demographics are disproportionately affected by the loyalty penalty. Nearly a third (29%) of SVR payers are on a low income - defined as the bottom 40% of incomes - compared to only 19% of mortgage holders on other deals.[2] It would be helpful to resolve the differences in our findings here as we think helping these consumers is most important. However, whichever way it turns out, vulnerable consumers deserve protection. Given we agree that the average cost to the average consumer is between £439 and £996 a year, the harm being caused to these already stretched consumers will be substantial.

In summary, it would be productive to tackle the loyalty penalty to address the unfairness of penalising loyal customers. Tackling the penalty also presents the opportunity to improve price transparency, making the market more responsive to consumer behaviour. For vulnerable customers, action to reduce or eradicate the penalty would considerably alleviate unnecessary financial pressure.

Our thoughts are expanded in more detail in subsequent answers to your questions.. This response is not confidential and may be published in full on your website.

Kind regards,

Ed McDonagh

Policy Researcher, Citizens Advice

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[1] Bank of England/NMG survey, 2016.
[2] Bank of England/NMG survey, 2016.

Vision for the market

Response to Question 1

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

The proposed vision for the market should include an additional remedy: 'Greater action from lenders to enable switching.' Improving broker choice and widening the range of tools available are useful for aiding consumers entering the market but do not address the reasons consumers fail to switch. Most consumers fail to switch not because of a lack of tools but because of misplaced trust in their lender. To facilitate proper competition on SVRs, the responsibility of lenders to notify consumers on the implications of their fixed rate expiring should be integrated into the vision.

Our analysis of polling carried out by ComRes has found that the most popular reason for people remaining on their current contract among those paying a lender's SVR is, 'I trust my provider' (45%) followed by 'I think I am on the best deal available' (37%).[3] Since 2 in 5 people aren't aware of the loyalty penalty, it's perhaps unsurprising that trust and being on the best deal are two of the most common reasons listed by respondents for remaining with their lender.[4] Improving tools or broker choice does not go far enough to improve the functioning of the market for loyal customers who remain with their lender due to misplaced trust. 'Greater action from lenders to enable switching' should be integrated into the vision of the market to ensure its proper functioning.

[3] Citizens Advice analysis of forthcoming ComRes data
[4] Citizens Advice, The cost of loyalty, 2018

Long term inactive customers

Response to Question 14

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

The FCA's proposed remedy

The FCA's proposed remedy of requiring lenders to contact affected customers a year after moving onto a reversion rate is a concrete step forward that will reduce detriment in this market. It shifts the onus for increasing switching onto lenders by requiring them to make customers aware that their fixed rate has expired and the implications of this. This is central to making the market more responsive to consumer behaviour. Currently, consumers are expected to be more engaged than is reasonable and lenders are gaining an arbitrary benefit from this. We recommend that the FCA goes further than the proposed remedy. This is possible without adding either complexity or excessive cost to the intervention and has the potential to instigate significantly more switching, reinvigorate competition on SVRs and reduce the loyalty penalty.

Our subsequent suggestions are rooted in our experience of what works well with encouraging consumers to switch. However, this expertise is not a substitute for proper testing. As it has done with prior interventions, we suggest that the FCA undertake randomised controlled trials to provide an evidence base for what is most likely to change consumer behaviour.

Improved consumer prompts

Companies should be making all reasonable efforts to contact customers to warn them of upcoming price increases and, also, when there are better deals available to them. Lenders should be required to contact consumers 12 months, 6 months and 3 months prior to them being moved onto an SVR, prompting them to switch and indicating the annual cost increase if they remain on the SVR.

While providers have to inform their customers of any interest rate rises, low awareness of the advantages of switching shows that the way in which they do so is not always effective.[5] Providers often notify their customers that they are going to roll onto their SVR by post, and only once before the end of their fixed rate period.[6] 82% of mortgagers surveyed believe that providers of essential services should inform their customers when they are eligible for a better deal, 69% of respondents who rolled onto an SVR say they had never been informed that they could save money by remortgaging.[7] Nearly half (44%) of respondents who haven't remortgaged since the end of their fixed rate deal think long

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[5] Citizens Advice, Exploring the loyalty penalty in the mortgage market, July 2017
[6] This information was obtained by calling providers' customer helplines.
[7] Citizens Advice, Exploring the loyalty penalty in the mortgage market, July 2017

standing customers pay the same or less than new customers.[8] An additional notification after a consumer has already been paying an SVR for 12 months would not go far enough to respond appropriately to these trends in consumer perceptions and tackle the loyalty penalty. Three prompts should be sent to customers 12 months, 6 months and 3 months before the expiry of their fixed rate.

We welcome the findings of the FCA's thematic review that showed customers may become more engaged with their lenders if communications are personal, relevant and highlight the benefit of making contact. Previous research by Citizens Advice highlighted the importance of the format of communications in improving consumer behaviour.[9] The FCA should require lenders to ask their customers how they prefer to be contacted and use this method to deliver prompts. The FCA should test and develop a standardised format for prompts across the industry that is proven to most effectively drive switching. This should include a re-labelling of products to more accurately reflect their nature and a clearer indication of the total cost of credit for each product.

Prompts should not be regarded as marketing and should contain tested and standardised information clearly explaining the benefits of switching to a different deal. People have busy lives and don't always have the time or inclination to shop around.[10] Our polling suggests that, among those who stand to benefit from remortgaging,[11] 67% have done very little or no shopping around.[12] Of those who have switched, large numbers found the process challenging. Only 24% of those who remortgaged found the process straightforward with over 1 in 10 (11%) finding it difficult.[13] Better labelling of rates and clearer indication of the benefits of switching would not only assist time restricted consumers but also address some of the difficulty they face understanding deals. For example, the 'standard variable rate' label could become the 'expired rate' to more accurately describe the nature of the contract. In addition, price information should include the total cost of credit to counter consumers present bias that draws then them to cheaper initial rates as well as removing some of the complexity from mortgage pricing structures.

Prompts could easily be designed to detail the benefits of switching without contravening pre-contractual disclosure requirements mandated by the MCD or other FCA rules. The MCD allows consumers to switch internally without new affordability checks provided they are not borrowing more. The FCA has shown that the average APR obtained by those who switched internally is only a few basis points higher than borrowers who switched externally.[14] Lenders could present the benefits of switching internally without either

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[8] Citizens Advice analysis of forthcoming ComRes data
[9] The Behavioural Insights Team for Citizens Advice, Applying behavioural insights to regulated markets, 26 May 2016.
[10] Citizens Advice, Against the clock, November 2016.
[11] Those who said they were on a 2, 3 or 5 year fixed rate mortgage and who also said they they began their contract more than 2, 3 or 5 years ago (base: 285).
[12] Citizens Advice, Exploring the loyalty penalty in the mortgage market, July 2017
[13] Citizens Advice analysis of ComRes data
[14] FCA, Mortgage Market Study: Interim Report, May 2018

contravening FCA regulations or falsely advising consumers about the best rate. Prompts could encourage consumers to use intermediaries to check for a better suited deal explaining that switching lenders may require a new affordability test.

Vulnerable consumers

The preceding recommendations deal with what is appropriate for the whole of the market. We believe there is a specific case for helping customers in vulnerable circumstances in the mortgage market, as part of the FCA's wider strategic commitment to improving outcomes for vulnerable consumers.

In the mortgage market, vulnerability is particularly likely to manifest itself in terms of income. Lower income households are more likely to fall into arrears or experience difficulty paying monthly payments. Companies are also able to identify lower income households through their household income at the time of making a mortgage application, making it a feasible group to provide further support to.

For these consumers we believe more than just increased communication from lenders is required to protect them from the potential harm of incurring the additional cost of an SVR.

Lenders have a responsibility to pay due regard to the interest of their customers and treat them fairly. Acting on this key market principle the FCA should consider extending the regulations for consumers in payment shortfall - requiring lenders to switch them onto suitable cheaper rates - to consumers below median income who are also up to date with payments.

Lenders should be required to make all reasonable efforts to ensure that customers on lower than median income are on the best value products. Lenders are *de facto* already required to consider this if they fall into payment shortfall under MCOB13, given the requirement to consider whether they are on the right type of mortgage. This principle - that lenders should give financially vulnerable consumers the opportunity to switch onto better deals - should be extended to include low income consumers up to date with payments.

Low income consumers are least able to pay a loyalty penalty. It they were to fall into arrears lenders are already required to consider them for switching. We have found that this group are among the least likely to switch of their own fruition with prompts having limited effect. The FCA should require lenders to make all reasonable efforts to ensure these consumers have the opportunity to switch onto a better deal. When a consumer from this income bracket is found to have been on an SVR for more than six months lenders should be able to provide evidence that the consumer either rejected the opportunity to switch or, despite all reasonable efforts, were uncontactable.

Nearly a third (29%) of SVR payers are on a low income compared to only 19% of mortgage holders on other deals.[15] This contrasts with the FCA's assessment that most inactive customers have a slightly higher income so it would be interesting to compare data on this.

For vulnerable consumers, more regular and better designed prompts are not enough to encourage switching or avert potential harm. Financially vulnerable consumers already spend less time making decisions and our research has shown that these groups are less responsive to prompts than other demographics.[16] Lenders should be required to give consumers below median incomes who are up to date with payments and not looking to borrow more the opportunity to switch onto a better deal. They should also be able report on the steps they took to switch any low income consumers who remain on an SVR for longer than six months.

Response to Question 15

What do you think is necessary for this approach to work in the mortgages sector and what do you see as the main challenges?

This approach requires lenders to take more responsibility for prompting consumers to switch and explaining the nature of their contracts. The FCA should also have a role in testing and standardising methods and content of communications.

This shift would have significant positive implications for consumers and also for the proper functioning of the market. It does not appear too onerous for lenders although we would welcome their comments on the challenges posed.

We recognise the FCA's broad remit and limited capacity to undertake wholesale market studies to improve efficacy and clarity of lender communications. Given the number of consumers currently on a lender's SVR and the potential harm to vulnerable consumers, however, this work seems worthwhile.

Response to Question 17

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

Give the healthy profitability of the retail banking sector (£12.7bn profit last year) we would be confident that any increases would be marginal and and adverse impact on consumers currently on fixed rates would be limited. The cost of marginal rate increases would be outweighed by the potential to rectify the current dysfunctionality in the market that penalises loyal customers on SVRs.

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[15] Bank of England/NMG survey, 2016.
[16] Citizens Advice, Against the clock, November 2016.

Other Potential Approaches

Response to Question 21

Do you have any views on these options or any other alternatives?

The FCA should consider the mortgage market in the round, reflecting on interventions that have been implemented or proposed in other markets.

We welcome the FCA's proposed basic savings rate in the savings account market that would require providers to apply single interest rates to all easy cash saving and ISA accounts that have been open for a certain period. As the FCA notes this would address the harm caused by price discrimination against loyal customers as well as promoting competition through increased price transparency.[17] This is another positive step towards fixing the loyalty penalty, following the Government's intervention in the energy market to place an absolute cap on standard variable tariffs (SVTs).

We believe the same dysfunctionality exists in how SVRs are functioning. While different markets require different solutions, the FCA should not be afraid to follow a more interventionist line here as well.

The mortgage market is, in practice, two markets. On the one hand, the active, switching part of the market works well for the high proportion of consumers who do switch. Including those who have been on an SVR for less than 6 months, this accounts for 75% of the market (6 million of 8.04 million borrowers according to the FCA). On the contrary, for that smaller group of consumers who do not switch (the remaining 2 million borrowers), the loyalty penalties can be the highest for any consumer market.

However, because competition is relatively strong in this market, lenders' margins are much more reliant on acquiring new customers than on the price they charge long-standing ones. This makes a relative restriction between introductory and standard interest rates more attractive and less prone to unintended consequences: given lenders are so much more reliant on competition for active consumers, the likely consequence of such a restriction would be a decrease in standard variable rate rather than an increase in introductory rates. The interests of long-standing consumers would, in effect, bootstrap on the competition-promoting efforts of active consumers.

It is instructive to draw a comparison with the energy market, where we thought such an approach would prove counterproductive. There, 58.8% of customers with the six largest energy companies were on standard variable tariffs in August 2017.[18] In the energy market, the incentives would be quite reversed: companies rely on SVT customers for the

[17] FCA, Price discrimination in the cash savings market, July 2018
[18] Ofgem, 'Number of non-prepayment domestic customer accounts by supplier: standard variable, fixed and other tariffs'

majority of their revenues, so would remove introductory deals from the market rather than lower their SVT price.

Given competition appears much stronger in the mortgage market than the energy market, a relative price cap in the mortgage market could therefore be more of an appropriate mechanism to reduce the cost of the loyalty penalty and promote improved price transparency. Unlike in the energy market there is a strong incentive for incumbents to remain in the acquisition market due to the high levels of engagement. Given the healthy competition that already exists on acquisition pricing and the greater value of lenders' front book consumers we predict that this intervention could cause an overall reduction in SVR interest rates. Limiting the spread between a lenders fixed rate and their standard variable rate would place a ceiling on the penalty faced by loyal consumers. In addition, by pinning SVRs to fixed rates consumers would also be better able to consider the merits of different packages as rates would better reflect the total cost of credit.

More research is needed into the consequences of such an intervention particularly to clarify the margins lenders operate on their introductory fixed rates so as to avoid unintended price increases in this part of the market. However, given the scale of the loyalty penalty for those who do pay it, we would strongly recommend the FCA test the potential impact of a relative price cap.