Financial Conduct Authority

Feedback Statement FS16/3

Call for Inputs on competition in the mortgage sector

May 2016

Contents

In this Feedback Statement we report on the main issues arising from the Call for Inputs on competition in the mortgage sector and our next steps.

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You can download this Feedback Statement from our website: www.fca.org.uk. Or contact our order line for paper copies: 0845 608 2372.

Abbreviations used in this paper

AMI	Association of Mortgage Intermediaries
APR	annual percentage rate
APRC	annual percentage rate of charge
BBT	best buy table
CfI	Call for Inputs
CMA	Competition and Markets Authority
CML	Council of Mortgage Lenders
CRD IV	Capital Requirements Directive (2013/36/EU)
EO	execution-only
ERC	Equity Release Council
EU	European Union
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Service
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act
IMLA	Intermediary Mortgage Lenders' Association
IRB	internal ratings based (model)
MCD	Mortgage Credit Directive

MCOB	Mortgages and Home Finance: Conduct of Business Sourcebook
MMR	Mortgage Market Review
MSS	mortgage sourcing system
PRA	Prudential Regulation Authority
PCW	Price Comparison Website

1. Introduction

1.1 We published a Call for Inputs (CfI) on competition in the mortgage sector in October 2015 seeking views on any areas of the mortgage sector which might raise competition concerns meriting further investigation.[1]

1.2 In this Feedback Statement, we:

- explain the key themes which have emerged from the responses to the CfI and explain why we consider these to be important
- outline the further work we intend to undertake and the timeframe for doing so, and
- in an annex, provide a summary of the responses to our CfI

Background

1.3 The mortgage sector has been subject to a significant amount of regulatory change in recent years, including our own Mortgage Market Review (MMR). The principal focus of those reforms has been to ensure appropriate protection for consumers. Now those reforms are in place, it is timely to consider how the market has developed and whether competition can be improved further to bring greater consumer benefits.

1.4 Promoting competition in the interests of consumers is an integral part of the FCA's strategic objective to make financial markets function well, and is, together with consumer protection and market integrity, one of our three operational objectives.

1.5 In ensuring that markets are working well, we consider our three operational objectives in the round. Market integrity and an appropriate degree of consumer protection are essential pre-conditions for effective competition. Equally, promoting competition can support market integrity and drive important benefits for consumers.

1.6 We also have a duty to promote effective competition when addressing our consumer protection or market integrity objectives. As a matter of policy, we normally aim to choose the most pro-competitive measure open to us provided that it is compatible with our duties as a whole.

1.7 A mortgage is a significant product for a large number of consumers; for many it represents the biggest financial commitment of their life. The mortgage sector also plays a vital role in the UK economy. So it is important that competition in this sector works effectively. Effective competition creates incentives for firms to operate as effectively and efficiently as possible,

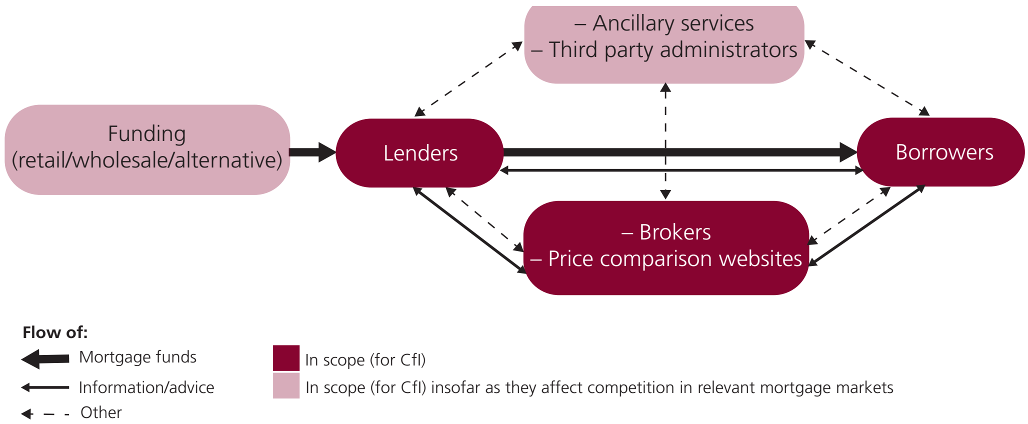
1 The FCA's 2015/16 Business Plan announced a review of barriers to competition in the mortgage sector to be launched in Autumn 2015. The review would then inform the scope and timing of any subsequent competition-focused work on mortgages.

providing benefits to consumers in the form of lower prices, improvements in quality or choice, and/or more innovation. We are keen to ensure that competition in the mortgage sector is healthy and working to the benefit of consumers.

Scope of the Call for Inputs

1.8 Figure 1 below summarises the areas that were within the scope of our review.

Figure 1: Scope of our CfI



1.9 To aid discussion, the CfI provided examples of issues that could raise competition concerns. These included:

- demand-side issues, focusing on whether consumers can effectively access, assess and/or act on information about mortgage products or services
- supply-side issues arising from the way firms interact with consumers and with each other, including whether:
  - firms design products in a way that may inhibit competition
  - firms may have market power (and abuse it)
  - firms may be able to coordinate their actions, and
  - relationships between firms may hinder effective competition
- other market features (beyond consumer behaviour or firm conduct) that might restrict, prevent or distort competition, including the regulatory regime, and any barriers to entry and expansion, and to innovation

1.10 We asked interested parties to give us their views on whether these potential concerns were borne out in practice. We also asked whether there were other areas that we had not specifically highlighted where competition might not be working effectively. In recognition of recent changes in the sector, we also requested views on the appropriate timing and scope of any subsequent competition work.

1.11 During the CfI process, we met over 80 organisations and individuals, through a combination of roundtables, workshops and one-to-one conversations. We also received over 40 written responses from a variety of stakeholders, including lenders, intermediaries, trade associations, consumer groups, charities, advisory/consultancy firms and academics.

Summary of main themes and work we intend to pursue

1.12 The responses to the CfI can be categorised into four main themes:

- consumers face challenges in making effective choices, particularly when it comes to assessing and acting on information about mortgage products, with intermediaries being key to the process
- there are opportunities to make more effective use of technology in the provision of information and advice
- commercial relationships between different players in the sector's supply chain – in particular the use of panels – might give rise to competition concerns, and
- certain aspects of the regulatory framework might have a negative impact on competition

1.13 Chapter 2 outlines these themes in more detail, and the Annex provides a summary of the responses to the CfI.

1.14 We have considered these emerging themes in the context of the FCA's strategy and priorities for 2016-17,[2] our other ongoing and planned work in the mortgage sector and market intelligence more generally. As a result, we have identified a number of areas where we believe there is scope for improving competition in the interest of consumers. These are summarised below.

1.15 We have decided to undertake **a targeted market study focused on consumers' ability to make effective choices**, with a view to improving how competition works in consumers' best interests.

1.16 We intend to consider the following questions:

- do the available tools for helping consumers make choices (such as price comparison websites, best-buy tables, advice) effectively meet their needs?
  - are there any distortions because of undue focus on particular headline charges or features?
  - is there suitable provision for specific consumer segments with less common needs/circumstances (for instance, those without online access, those with greater levels of experience and understanding who have lesser advice needs, older borrowers needing advice across a wider product range)?
  - are there opportunities for better technological solutions?

2 See the FCA Business Plan 2016/17: www.fca.org.uk/news/our-business-plan-2016-17

- what is the impact of increased intermediation in the mortgage sector on consumer outcomes?
  - how has the MMR changed the market in terms of intermediation?
  - are there differences in the outcomes for those consumers who obtain their mortgages through mortgage brokers when compared with those who go direct to lenders?
  - if so, what drives those differences and is there room for improvement?
- what is the impact of panel and other commercial arrangements between lenders, brokers and other players in the mortgage supply chain?
  - is there potential for conflicts of interest or misaligned incentives?
  - do any such arrangements create barriers to entry or expansion resulting in less consumer choice?

1.17 We will conduct more detailed scoping work before issuing the terms of reference for the market study in Q4 of 2016.

1.18 Alongside the market study, we will also be undertaking three **smaller pieces of follow-up work** relating to the themes emerging from the CfI:

- contributing to the next phase of the Council of Mortgage Lenders (CML) and Which? work on the transparency of mortgage fees and charges[3], with the aim of ensuring that relevant concerns raised by stakeholders during the CfI are appropriately taken into account
- acting on specific aspects of the FCA's current regulatory regime where there is a case for change to improve competition – and considering the effect of our regulatory regime in the course of our planned competition work, and
- working with industry to increase competition law awareness in the sector

1.19 As explained in further detail in Chapters 2 and 3, respondents to the CfI raised a number of concerns in relation to non-FCA regulations. We will ensure that these views are shared with the relevant organisations. We are liaising with the Prudential Regulation Authority (PRA) with a view to building greater understanding of the potential impact on competition of capital requirements.

3 For further information see www.cml.org.uk/policy/policy-updates/all/transparency-of-mortgage-fees-and-charges/.

2.
Main themes emerging from CfI

2.1 This chapter sets out the main themes emerging from the responses to the CfI. In summary, these are:

- consumers face challenges in making effective choices, particularly when it comes to assessing and acting on information about mortgage products, with intermediaries being key to the process
- there are opportunities to make more effective use of technology in the provision of information and advice,
- commercial relationships between different players in the sector's supply chain and, in particular, the use of panels, may give rise to competition concerns, and
- certain aspects of the regulatory framework might have a negative impact on competition

2.2 We discuss these themes in more detail below.

Consumers' challenges in making effective choices, and the role of intermediaries

2.3 The potential for improving consumers' ability to access, assess and act on information was a strong theme in the responses we received to the CfI. Many respondents – including lenders (both mainstream and specialist), brokers, and consumer organisations – commented on the extent to which consumers, either acting on their own or through their interactions with advisers or other intermediaries, can drive competition in the sector, and therefore on how important it is that consumers are able to make their choices on an informed basis.[4] If consumers struggle to choose products that best meet their needs, competition between firms will not work effectively in consumers' interest.

2.4 Many respondents noted that the challenges faced by consumers when choosing a mortgage are different from, or more pronounced than, those faced in some other financial services. Notable features of the sector include a large number of available products[5] (not all of which a consumer may be eligible for), the use of information sources like price comparison websites (PCWs) largely for informational (rather than transactional) purposes, and a variety of

4 In June 2015 we published a Discussion Paper on smarter consumer communications (DP15/5) to seek stakeholder views on how firms' communications can engage and empower consumers to make informed decisions about their finance: http://www.fca.org.uk/static/channel-page/dp-smarter-comms/dp-smarter-comms-index.html

5 Approximately 3,600 mortgage products are available to consumers in April 2016 (Moneyfacts, April 2016). This has been steadily increasing since 2009, when the total number of residential mortgage products dipped to approximately 1,500. Pre-crisis, the number of products available was in excess of 10,000.

behavioural biases[6]. There are also difficulties associated with the house buying process itself. All of these factors interact with each other to make the consumer journey more complex.

2.5 In addition, intermediation is playing an increasing role in the sector, and therefore in the decisions consumers are making. Intermediated mortgage sales, which had decreased to around 50 per cent in 2009/10 following the financial crisis, increased to 71 per cent by value and 67 per cent of the number of sales in Q2 2015.

Consumers' ability to assess complex product information

2.6 The evidence gathered so far suggests that consumers' difficulties in assessing and acting on information are mainly linked to two underlying reasons:

- challenges due to product complexity and a lack of transparency in relation to fees and charges[7], and
- consumers' behavioural biases

2.7 In the annex, we provide a summary of respondents' views on the types of information that consumers have difficulty understanding, and the circumstances in which their understanding may be affected by behavioural biases. Respondents generally agreed that consumers face constraints when assessing the information available to them, whether they are doing so on their own or with the help of a lender or intermediary. These difficulties may result in consumers over-paying for a mortgage or choosing a product that is not best suited to their circumstances.

Complexity and transparency of mortgage products

2.8 There are a large number of mortgage products available in the market (see footnote 5).

2.9 Some basic product features, such as the product term and the interest rate, are common to all mortgage products. Others – such as portability, overpayment facilities and early repayment charges – vary between different lenders and types of mortgage product.

2.10 Respondents had mixed views about the complexity of mortgage products and whether it necessarily leads to better outcomes for consumers. Many respondents argued that because consumers have very different preferences and circumstances, a complex and large range of products should be available to ensure that all consumer needs are satisfied.

2.11 Others argued, however, that consumers find mortgages to be complex products whose features are difficult to understand and to compare, and that some product complexity might be unnecessary.

Consumers' behavioural biases

2.12 Behavioural biases are specific ways in which normal human thought can cause people to misjudge important facts or to be inconsistent.

2.13 For a number of reasons, choosing a mortgage product is particularly prone to behavioural biases:

6 For example, some consumers may be excessively optimistic about their future financial circumstances. See 'Understanding consumer expectations of the mortgage sales process' (ESRO 2015): www.fca.org.uk/your-fca/documents/research/understanding-consumer-expectations-of-the-mortgage-sales-process-esro

7 Which? and CML have also identified this as an issue, and are pursuing an initiative to improve transparency and comparability of fees and charges. This includes a tariff of the 22 most common fees and charges, published in November 2015. See www.cml.org.uk/policy/policy-updates/all/transparency-of-mortgage-fees-and-charges/

- Mortgage products are complex for most people: like other financial products, mortgages are abstract and intangible and often have many features and complex charging structures. Faced with complexity, consumers can simplify decisions in ways that lead to errors, such as focusing only on headline rates

- Mortgages involve trade-offs between the present and the future: people can make decisions against their long-term interests because of self-control problems or optimism biases

- Decisions on mortgages require assessing risk and uncertainty (including in relation to the macroeconomic and housing environment): people are generally bad intuitive statisticians and are prone to making systematic errors in decisions involving uncertainty

- Decisions on mortgages can be emotional: stress, anxiety, fear of losses and regret, rather than the costs and benefits of the choices, can drive decisions. The mortgage purchasing decision is secondary to the main aim, the purchase of a property – which can be particularly emotional

- Some products permit little learning from past mistakes: choosing a mortgage is not a frequently made decision, allowing for little learning from previous decisions, and with consequences revealed only after a long delay

2.14 To identify and correct the consequences of these mistakes, we need to be able to detect biases and understand their significance. Some behavioural biases can make it more difficult for consumers to assess the different offers in the market. For example, consumers' tendency to focus on the most prominent product characteristics, such as initial monthly repayments, and to consider more complex features only later on in the selection process, can lead them to choose a product that is not best suited to their needs.[8]

2.15 As part of our recent Advice and Distribution thematic review[9] we commissioned research which confirmed that consumers' own biases may affect their ability to assess product risks or mortgage features objectively.

Consumers' ability to act on relevant product information

2.16 While switching is not an end goal in itself, it is a means of ensuring that firms are driven to offer the best possible products and services to win and retain business. So for competition to work well, consumers need to be able to ''vote with their feet'', including by switching to a different product, whether with their existing lender or not, if this is right for them.[10]

2.17 Whether they actually do so will depend on a number of factors, including whether there is a trigger to consider doing so (such as the expiry of their existing deal, or being prompted by a lender or intermediary), but also on their assessment of the relative benefits and costs of taking up a different deal.

2.18 Many respondents commented on the fact that consumers have differing, and not necessarily accurate, perceptions of the costs and benefits of switching their mortgage products.[11] This

8 See 'Understanding consumer expectations of the mortgage sales process' (ESRO 2015): www.fca.org.uk/your-fca/documents/research/understanding-consumer-expectations-of-the-mortgage-sales-process-esro

9 Embedding the Mortgage Market Review: Advice and Distribution: www.fca.org.uk/news/tr15-09-embedding-the-mortgage-market-review-advice-and-distribution

10 This is also acknowledged in the Switching Principles Call for Evidence (BIS, 2015): www.gov.uk/government/uploads/system/uploads/attachment_data/file/469998/BIS-15-533-call-for-evidence-switching.pdf

11 Including a switch to another provider, and a product transfer with their current lender.

may prevent them from switching when it would be beneficial for them to do so, and this can have an effect on how well competition works in the sector.

2.19 In the mortgage sector, switching costs consist mainly of redemption charges (such as early repayment charges) and transaction costs (such as fees associated with re-mortgaging to a new lender and the inconvenience of applying for a new loan; some consumers may for example perceive the time cost associated with receiving advice as a deterrent to switching).

2.20 We are keen to explore further what can affect consumers' ability to act on deals which they identify as appropriate for them.

Advice requirements under MMR

2.21 The MMR identified risks to consumers entering into significant, infrequent financial transactions without having their product preferences challenged by a qualified adviser. We now require advice in the vast majority of sales to mitigate those risks. The MMR has been advanced as one of the reasons why intermediation has grown significantly in recent years, and might be expected to continue to be on the increase.[12]

2.22 Some responses to the CfI have reiterated that advice can be very valuable to consumers in the mortgage sector, whether delivered by intermediaries or by lenders themselves.

2.23 However, some respondents also pointed out potential problems with the advice process, including that some approaches to advice have resulted in lengthy, stilted conversations that impeded firms' ability to assess customers' needs and circumstances. These concerns echo a number of findings of our recent thematic review on advice and distribution.[13]

2.24 We recognise that where advice takes too long and fails to engage the customer it can act as a barrier to shopping around.[14] We also recognise the challenges in interacting with a customer and providing them with information without straying into advice.[15,16]

2.25 As part of our general interest in the impact of regulation on financial services, we are keen to ensure that our rules work towards maximising the potential benefits that consumers can get from the advice process. In assessing whether that is the case, we are interested in the impact of our rules on specific types of consumers. We are also interested in assessing the impact of our rules on market dynamics more generally. We want to know whether, for example, the regulatory framework favours some distribution or business models to the detriment of others, and whether that is ultimately to the benefit of consumers. As part of this, we are also interested in whether our advice rules, which do not aim to differentiate between interactive channels, may have inadvertent impacts on innovation.

12 Brokers' share of mortgage sales, which decreased following the financial crisis, has increased in recent years and is now some two thirds of the market (see paragraph 2.5 for further detail). It has been argued that the cost and risk associated with providing advice to mortgage applicants under MMR has led many lenders to de-emphasise their branch networks as a distribution channel or, in some cases, end direct distribution altogether. See IMLA (2015): www.imla.org.uk/perch/resources/1512-imla-changing-face-of-mortgage-distribution-december-2015.pdf.

13 Advice and Distribution Thematic Review: www.fca.org.uk/news/tr15-09-embedding-the-mortgage-market-review-advice-and-distribution. However, the review also found examples where suitable advice was delivered more swiftly and simply. Our report explained where firms could work within our rules to deliver advice in a more engaging, outcomes-focused way.

14 Our rules do not prescribe how an advised sale must be conducted or the length of time it must take, but provide firms with a framework for discussing a customer's needs and circumstances before recommending a suitable product or products. In addition, not all contract variations require advice, even if a firm is engaging interactively with a customer. Examples of this include a rate switch where the borrower has been presented with information on retention deals, or a term extension.

15 Our perimeter guidance (PERG 4.6) includes a non-exhaustive series of examples of what does and does not constitute advice, with firms required to use their judgement.

16 We have also recently conducted the Financial Advice Market Review (FAMR). We have taken the FAMR work into account in our CfI, although the FAMR findings and recommendations are not focused on the mortgage sector.

2.26 We believe that the various challenges consumers face in assessing and acting on information could lead to competition in the sector not working as well as it could. More in-depth analysis is required to establish what consumer harm arises from this, and what potential changes can be made to improve competition.

Opportunities to make more effective use of technology in the provision of information and advice

2.27 The second theme that emerged from the responses to our CfI is the role of technology in the provision of information and advice. Respondents argued that digital information tools (such as PCWs, online calculators and mortgage sourcing systems) and digital advice processes may have a significant impact on the incentives and behaviour of consumers, brokers and lenders.

2.28 Several respondents commented on the impact of **online calculators** on consumers' information gathering.[17] Some expressed concern that they potentially mislead consumers by presenting them with loan sizes that do not equate to what they would be offered in reality.

2.29 Many respondents were critical of the impact of **PCWs** on consumers' search efforts. Their concerns mainly related to the limitations of the information shown by PCWs, and whether PCWs' commercial arrangements might affect search results without consumers' knowledge.

2.30 Several respondents commented that **mortgage sourcing systems (MSSs)**[18] are also limited in terms of the information they provide to users (i.e. brokers) and that certain innovative products may be less prominent in the results because of the systems' filtering criteria. Where brokers' and lenders' behaviour is influenced by the design of these systems, MSSs have the potential to distort innovation and competition in the sector.

2.31 Respondents had mixed views about **digital advice processes** and their suitability for the mortgage sector. Some lenders are already trialling virtual appointments and are keen to innovate. The broker community challenged whether digital tools can incorporate 'soft' facts about the consumer's circumstances, which can be relevant to the consumer's product choice but more difficult to establish.[19]

2.32 We consider that further work needs to be done to understand the effect the different tools have on how well competition works in the sector, and what needs to be done to ensure that their potential benefits are realised.

Commercial relationships in the mortgage sector

2.33 A third theme emerging is that the mortgage sector is characterised by varied and complex relationships, and that while there are many reasons why these arrangements exist and why they can be useful, they also have the potential to distort competition.

17 In some instances, online calculators can lead to consumers developing unrealistic expectations of how much they can borrow. See 'Understanding consumer expectations of the mortgage sales process' (ESRO 2015): www.fca.org.uk/your-fca/documents/research/understanding-consumer-expectations-of-the-mortgage-sales-process-esro

18 Mortgage Sourcing Systems are software used by intermediaries to help them identify potentially appropriate products for their customers. They filter and rank mortgages listed on the system according to criteria chosen by the broker.

19 For example, any needs for debt consolidation, protection, or retirement savings, which may warrant consideration of a wider range of products than a first charge residential mortgage.

2.34 Respondents commented in particular on the effects of commercial arrangements on firms' ability to compete effectively. These concerns fall into two main areas:

- commercial arrangements giving rise to conflicts of interest and misaligned incentives, and
- commercial arrangements as a potential barrier to entry and expansion

2.35 These are discussed further below.

Commercial arrangements giving rise to conflicts of interest and misaligned incentives

2.36 Several respondents commented on the effect of procuration fees[20], with differing views. Some respondents felt that they do not give rise to conflicts of interest while others said they could result in broker interests being misaligned with consumer interests.[21]

2.37 Many respondents were critical of relationships between brokers and estate agents. Criticism was directed in particular at situations where a consumer may be under the impression that consulting a certain mortgage broker is necessary in order to view, or submit an offer on, a property.[22]

2.38 Respondents also commented on the relationships between brokers and providers of other ancillary services, for example conveyancers and surveyors, particularly when these services are provided by the same group of companies to which the broker also belongs. Respondents said there should be safeguards in place to ensure that consumer choice is not limited either as a result of ownership ties or commercial arrangements.

2.39 Both lenders and intermediaries expressed concern about relationships between firms in the new-build sector.[23] Respondents claimed that developers have close relationships with certain brokers and that these brokers tend to place business with a limited number of lenders who they are confident can meet tight timeframes imposed by the developers. Respondents said this may make it more difficult for new lenders to enter the market, limiting the choice available to consumers.

Panels as a potential barrier to entry and expansion

2.40 Respondents commented on the challenges that smaller firms in particular face in entering the market or certain segments of the market due to panel arrangements.

2.41 Lenders and lender representatives commented that some smaller lenders have had problems accessing bigger broker networks and feel pressurised to accept their terms. The comments also noted that large broker networks have significant influence over the market, because they control visibility and access to lenders' products.

2.42 Brokers commented that smaller brokers may experience difficulties in accessing products to distribute from certain lenders. Lenders need to undertake due diligence on their distributors

20 Procuration fees are fees that lenders pay brokers upon completion of a mortgage contract.

21 The FSA previously concluded that there is scope for product and provider bias resulting from procuration fees, but that this did not justify at that stage the banning procuration fees, given the small differentials in procuration fees in the prime mortgage market at the time (typically 0.31 – 0.35% of the loan). See paragraphs 5.41-5.49 in DP 09/3 'Mortgage Market Review': www.fca.org.uk/static/documents/discussion-papers/fsa-dp09-03.pdf

22 As the UK's enforcement authority for the Estate Agents Act 1979, the National Trading Standards Estate Agency Team of Powys County Council has published guidance for estate agents which contains provisions directing estate agents not to pressure potential buyers to use associated services such as an in-house mortgage broker.

23 According to ONS statistics, 143,560 homes were started and 142,890 completed in 2015. www.gov.uk/government/uploads/system/uploads/attachment_data/file/502930/House_Building_Release_Dec_Qtr_2015.pdf

and the cost of this is balanced against the volume to be expected from them. While one respondent commented that being part of a network may mitigate this by allowing smaller brokers to access a larger range of products, another noted that the way networks and clubs operate can by definition restrict some intermediaries' access to certain lender products.[24]

2.43 Respondents also commented that the criteria to be included on a panel are not always communicated transparently. As a result prospective panel members do not necessarily know why they have not been included on a panel, which can make it more difficult for them to expand.

2.44 While in many respects there are similar issues in specialist as in mainstream lending, these may be more acute in some types of specialist lending, for example when there are strong existing relationships between broker networks and lenders.

2.45 We have summarised some of the questions that have arisen about the impact of relationships between firms in the mortgage sector and the effect they may have on competition. More in-depth analysis needs to be undertaken to establish the cause of any distortion of, and possible improvements to, the dynamics of competition in the sector.

Impact of the regulatory framework on competition

2.46 The CfI asked for views on market features beyond consumer behaviour or firm conduct that might restrict, prevent or distort competition, including the regulatory regime, and any barriers to entry and expansion, and to innovation. Respondents commented primarily on regulation, but there were also many submissions relating to barriers to entry and expansion in the market.

2.47 A key theme emerging is that there is no appetite for further large-scale regulatory change. One of the main reasons put forward is that the sector has been subject to recent regulatory change, and needs time to focus on bedding these changes in and developing systems and products that comply with the relevant regulations.

2.48 However, respondents commented on a number of aspects of the regulatory regime that may affect competition. Responses can be categorised as commenting on:

- FCA regulation, in particular our rules on responsible lending and advice
- non-FCA regulation

2.49 These are discussed further below.

FCA regulation, in particular our rules on responsible lending and advice

2.50 Many responses commented on the effects of our responsible lending rules and their impact on lending volumes – both overall and to certain customer groups (e.g. interest-only customers and those unable to verify their income).

2.51 The responsible lending rules aim to prevent borrowers from taking out mortgages they cannot afford. To understand in greater depth their impact on firms and consumer outcomes, we

24 According to IMLA, appointed representatives who are authorised through mortgage networks provide 45% of intermediated mortgages. (IMLA, 2015): www.imla.org.uk/perch/resources/1512-imla-changing-face-of-mortgage-distribution-december-2015.pdf

launched a responsible lending review in April 2015, the results of which we are publishing alongside this Feedback Statement.[25]

2.52 Respondents also commented on potential issues with the advice process that we should consider, as described earlier in this chapter.

2.53 While there was no appetite for wide-ranging reform, respondents mentioned a small number of specific issues with our rules which they argued would improve the sector dynamics. Chapter 3 sets out our views on these issues and the potential changes we are making or considering.

Non-FCA regulation

2.54 Respondents also commented on those elements of the regulatory framework and government policies that are not overseen by the FCA, and which can have an impact on competition in the sector. In particular, many respondents noted on the effects of the capital requirements regime, Solvency II requirements and the Building Societies' sourcebook. Their views are explained in more detail in the Annex.

2.55 We will ensure that these views are shared with the relevant organisations, and we will work with them to inform their approach to these issues in light of their potential impact on competition. We are liaising with the PRA with a view to building greater understanding of the potential impact on competition of capital requirements.

25 www.fca.org.uk/news/tr16-04-responsible-lending-review

3.
Next steps

3.1 In this section, we set out the work we are planning to do following the CfI, and the associated timescales.

3.2 Our decisions on further competition work in the mortgage sector have been informed both by the responses to our CfI (as summarised in Chapter 2 and, in more detail, in the Annex), and other relevant intelligence, including industry publications and academic research. We have also considered the overall FCA priorities for 2016/17 as well as our on-going and planned work and priorities in the mortgage sector.[26]

3.3 We have decided to undertake **a targeted market study focused on consumers' ability to make effective choices**, together with **three smaller pieces of follow-up work** relating to the themes emerging from the CfI:

- contributing to the next phase of the Council of Mortgage Lenders (CML) and Which? work on the transparency of mortgage fees and charges, with the aim of ensuring that relevant concerns raised by stakeholders during the CfI are appropriately taken into account
- acting on specific aspects of the FCA's current regulatory regime where there is a case for change to improve competition – and considering the effect of our regulatory regime in the course of our planned competition work, and
- working with industry to increase competition law awareness in the sector.

3.4 These parts of our forward work programme are discussed in turn below. We also set out our views on issues that have been raised with regard to impacts on the sector arising from non-FCA regulation.

Market study

3.5 We have considered the emerging themes in the context of the FCA's strategy and priorities for 2016-17,[27] our other ongoing and planned work in the mortgage sector and market intelligence more generally. As a result, we have identified a number of areas where we believe there is scope for improving competition in the interest of consumers. While others have emerged as being of potential interest, we have adopted a proportionate approach, focusing our future work on those areas where we believe there to be the greatest scope for improving competition in the interest of consumers.

3.6 We have decided to undertake **a targeted market study focused on consumers' ability to make effective choices**, with a view to improving how competition works in consumers' best interests. We intend to consider the following questions:

26 FCA Business Plan 2016/17: www.fca.org.uk/news/our-business-plan-2016-17
27 FCA Business Plan 2016/17: www.fca.org.uk/news/our-business-plan-2016-17

- Do the available tools for helping consumers make choices (such as price comparison websites, best-buy tables, advice) effectively meet their needs?
  - Are there any distortions because of undue focus on particular headline charges or features?
  - Is there suitable provision for specific consumer segments with less common needs/circumstances (for instance, those without online access, those with greater levels of experience and understanding who have lesser advice needs, older borrowers needing advice across a wider product range)?
  - Are there opportunities for better technological solutions?
- What is the impact of increased intermediation in the mortgage sector on consumer outcomes?
  - How has the Mortgage Market Review changed the market in terms of intermediation?
  - Are there differences in the outcomes for those consumers who obtain their mortgages through mortgage brokers when compared with those who go direct to lenders?
  - If so, what drives those differences and is there room for improvement?
- What is the impact of panel and other commercial arrangements between lenders, brokers and other players in the mortgage supply chain?
  - Is there potential for conflicts of interest or misaligned incentives?
  - Do any such arrangements create barriers to entry or expansion resulting in less consumer choice?

What is a market study?

3.7 Market studies are a key way in which we investigate markets to see how well they are working for consumers. They focus on the market from a competition perspective, while also taking into account consumer protection and market integrity.

3.8 We undertake market studies when we have identified that there are potential competition issues in a market. We do not need to have found definitive evidence of such issues. Instead, we would look to undertake further work into understanding and identifying competition issues and the impact that they have on a market.

3.9 Before launching a market study we consider the issues that concern us and develop our views on the reasons that competition may not be working in the interests of consumers.

3.10 Generally, we launch market studies with the publication of terms of reference setting out the scope of the study and the possible causes of concern.

3.11 We use the data we collect to assess evidence of competition issues or other market failures and assess the extent of any consumer detriment. We do this by considering the evidence and views we receive with reference to the issues identified and the theories we are testing. We use data we already hold, and data from public sources, and gather more information on the specific issues under consideration.[28]

3.12 If we conclude that competition is not working well we have a number of tools at our disposal to propose and/or implement remedies (for instance, publishing guidance; making proposals for enhanced industry self-governance; taking supervisory or enforcement action; reviewing the relevant elements of the regulatory framework which could include making new or amending exisitng rules as well as removing regulatory barriers). If required, the proposed remedy would be subject to consultation.

3.13 More information on market studies can be found on our website.[29]

Other competition work in mortgages

3.14 In addition to the market study, we will be undertaking **three smaller pieces of follow-up work** to the CfI:

- contributing to CML/Which? work on transparency of fees and charges
- acting on specific aspects of the FCA's regulatory regime where these is a case for change to improve competition, and
- working with industry to increase competition law awareness in the sector

Contributing to CML/Which? work on transparency of fees and charges

3.15 Closely related to our interest in the challenges faced by consumers in making effective choices is the work already underway by CML and Which? on the transparency of mortgage fees and charges[30], which has already led to the implementation of the 'tariff of charges' by most lenders. This work is now in its second phase, and we will contribute to the project to ensure that it is informed by the specific concerns raised by stakeholders during the CfI. We will take the progress made on this issue into consideration in our scoping of the market study.

Specific aspects of the current FCA regulatory regime where there is a case for change to improve competition

3.16 In addition to the advice rules, discussed in chapter 2, respondents mentioned other aspects of the regulatory framework that they considered had an impact on competition, primarily as a result of the rules on responsible lending.

3.17 We discuss our next steps with respect to these different aspects below.

Responsible lending

3.18 A number of respondents offered views on the impact of the responsible lending rules introduced through the MMR. Our responsible lending rules are designed to prevent a return to the poor lending practices seen pre-crisis, ensuring that consumers only take out mortgages that are demonstrably affordable.

28 Whenever possible, we use data we already receive (e.g. Product Sales Data) to minimise the burden on firms arising from any information requests.

29 www.fca.org.uk/news/fg15-09-market-studies-and-market-investigation-references

30 For further information see www.cml.org.uk/policy/policy-updates/all/transparency-of-mortgage-fees-and-charges/.

3.19 To understand in much greater depth how the responsible lending rules have affected firms and consumer outcomes we launched the responsible lending review in April 2015. The review, published alongside this document, has collected evidence from a range of lenders representing approximately 75% of post-MMR lending as well as conducting research into the market more widely. We are publishing our thematic report[31] outlining the findings of this review alongside this Feedback Statement.

Opportunities for changes to existing FCA rules

3.20 Where issues raised are within our remit, we have reflected on the comments we have received, and will act on specific aspects of the current regulatory framework where we agree that there is a case for change.

3.21 We want to ensure that markets work well for consumers and we are especially mindful that **older consumers** represent an increasing proportion of the UK population.[32] Older consumers are not a homogenous group (for example, they will differ in their asset wealth and income) and are best served by having a range of mortgage products and services available so they can find the option that best suits them. Lifetime mortgages can play an important part in serving some of these borrowers, and we are keen that our regulatory requirements do not place unintended barriers to growth and innovation.

3.22 We recognised both through feedback from CfI respondents and through the responsible lending review that our responsible lending rules could have contributed to restricted development and take-up of lifetime products that allow a customer to make regular payments but switch to interest roll-up at any point without risk of repossession.[33] To allow firms to more readily offer this type of product, which can be of benefit to consumers concerned about equity erosion, we have published a modification by consent on our website to tailor our rules to particular types of hybrid lifetime product.[34] We intend to consult on updating our Handbook to reflect this change in approach.

3.23 Respondents commented specifically on the fact that **MCD** treats **foreign currency lending** as high risk, given the impact of exchange rate variations, and that this will strongly restrict foreign currency loans. We recognise respondents' concerns. As part of our response to the European Commission's call for evidence on the EU regulatory framework for financial services[35], we have explained that the MCD definition of 'foreign currency loan' could be improved to better align with the exchange rate risk the MCD seeks to address.

3.24 We will be considering **other aspects of the regulatory regime** either as part of the market study (e.g. the effect of our advice rules on consumers' ability to make effective choices) or our wider policy work (e.g. we will consider the potential for opening up further routes to obtaining an equity release qualification). Any rule changes deemed necessary as a result would be subject to our usual consultation process.

31 www.fca.org.uk/news/tr16-04-responsible-lending-review

32 We recently launched a significant piece of strategic work exploring whether and how financial services meet the needs of older consumers, both now and in the future (we published our Ageing Population Discussion Paper on 22 February 2016: www.fca.org.uk/news/dp16-01-ageing-population) This will include further analysis of the key issues and challenges arising across multiple sectors and aspects of financial services, including mortgages. We are considering the information submitted in response to our CfI alongside the other evidence we are collecting and will run an extensive programme of stakeholder engagement, analysis and research. Our work will culminate in a series of recommendations and a regulatory strategy for the ageing population in Spring 2017.

33 From speaking to industry representatives, we understand that this type of product constituted approximately 15% of the lifetime mortgage market before we introduced our MMR rules, and 5% post.

34 www.the-fca.org.uk/modification-consent-hybrid-lifetime-mortgage?field_fcasf_sector=unset&field_fcasf_page_category=unset

35 www.fca.org.uk/static/fca/documents/eu-regulatory-framework-call-for-evidence-response.pdf

Increasing the sector's awareness of competition law

3.25 As explained earlier, our engagement process has highlighted that it would be helpful to promote greater awareness of competition law across the sector, with a particular focus on how competition law would apply to the relevant players' commercial relationships and interactions with one another.

3.26 As an example, information exchange between competitors may be prohibited under competition law, in particular if it makes firms aware of their competitors' market strategies. Firms should therefore take care in meetings and discussions when they may disclose information such as future pricing strategy if their competitors are present, including in meetings of trade associations. Competition law also prohibits certain terms in vertical relationships (e.g. between suppliers and distributors) and places conditions on the operation of some types of vertical agreements (for example, exclusive distribution agreements).

3.27 We intend to work together with the industry, starting in the second half of 2016, to promote awareness of and compliance with competition law.

Impacts on the sector arising from non-FCA regulation

3.28 The FCA, Prudential Regulation Authority (PRA) and Financial Policy Committee (FPC) each has different objectives set out in legislation. The FPC has powers to make recommendations to, or to direct, us and/or the PRA about the exercise of each authority's functions.[36] When acting on an FPC recommendation or direction, both we and the PRA must comply with the Financial Services and Markets Act (FSMA). For us, this means that we must be satisfied that a proposed action is consistent with our strategic objective, advances one or more of our operational objectives, and is consistent with our regulatory principles. We must also comply with relevant procedural requirements, such as requirements to consult and carry out a cost benefit analysis. We and the PRA also have a duty, and process in place, to consult with each other.[37]

3.29 As we have our own objectives, there will be occasions when we intervene in the mortgage market in different ways to the PRA and the FPC.

3.30 In terms of prudential regulation, a number of respondents have argued that firms operating with a standardised model to meet their capital requirements may be at a competitive disadvantage compared to their more established rivals. We welcome the PRA's response to the European Commission's recent consultation on the impact of the Capital Requirements Directive (CRD IV) (2013/36/EU) on bank financing of the economy, where the PRA called for a more proportionate approach that could help foster greater competition without any material negative impact on financial stability. Importantly, this included a call to narrow the gap between the capital requirements delivered by the use of internal models and standardised approaches, particularly for credit risk.

3.31 We also note the difficulties that have been communicated by respondents regarding the implementation of Solvency II, particularly with regard to the lifetime mortgages market. We will continue to work with the PRA and government departments to inform their approach

36 Sections 9Q and 9H of the Bank of England Act 1998.

37 The PRA and FCA have a series of Memoranda of Understanding outlining joint working arrangements www.fca.org.uk/your-fca/list?ttypes=MoU+Domestic&yyear=&ssearch=

to capital requirements and the consideration of their potential impact on competition in the mortgage sector.[38]

3.32 Some respondents also find the Building Societies sourcebook problematic. One respondent took the view that, while it is supposed to be guidance, in many cases it has the effect of rules. It was also pointed out that building societies are more restricted by guidance on types and volumes of lending depending on their size, but banks do not have similar guidance. Some respondents also believe that building societies are potentially restricted in meeting demand for fixed-rate lending. We note the publication of the PRA's consultation on a new Supervisory Statement[39] and will share all relevant feedback we have received.

3.33 We also have a Memorandum of Understanding with the Financial Ombudsman Service to ensure our coordination for the benefit of firms and consumers. The service is operationally independent from the FCA, and we have no power to intervene in the decisions it makes on individual complaints.[40] We will ensure that we will share the relevant views we have heard in the CfI with the Financial Ombudsman Service.

38 The PRA recently published a discussion paper on equity release mortgages. See DP/16: www.bankofengland.co.uk/pra/Documents/publications/cp/2016/dp116.pdf

39 See CP12/16 "Supervising building societies' treasury and lending activities' –' at www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp1216.aspx

40 It must determine disputes on the basis of what it believes to be fair and reasonable in all the circumstances of the case, taking into account the relevant law, regulatory requirements, guidance and standards, relevant codes of practice and good industry practice.

Annex 1
Summary of feedback

1. Our CfI requested views on a range of factors which may be distorting competition in the mortgage sector. This Annex provides a summary of the main competition concerns on which respondents provided comments. It does not attempt to provide an exhaustive record of the wide range of issues raised, nor should it be viewed as an endorsement of these views.

2. This summary follows the same structure as the CfI document, and covers demand side behaviour, supply side behaviour and market features, with sub-sections on relevant topics under each heading. It reflects feedback from both written submissions and views shared during the wider engagement process.

3. Each section starts with a brief introduction which summarises the main topics raised by respondents. Where relevant, we highlight the types of respondents that commented on particular issues. Where views relate to specific market segments or types of consumers this is clearly flagged; otherwise, comments generally refer to mainstream lending.

Demand side behaviour

4. Our CfI requested feedback on how demand side factors, in particular issues relating to consumers' ability to access, assess and act on relevant information, might distort competition in the mortgage sector. The vast majority of respondents commented on these demand side factors.

5. Respondents' comments focused mainly on consumers' ability to assess information, use of information gathering/comparison tools, and the role of mortgage advice.

Consumers' ability to access complete, relevant and accurate information

Use of information gathering tools

6. Many respondents (lenders, brokers and consumer organisations) shared their views on this topic. Responses focused on PCWs in the mortgage sector, both in terms of how they work, and their impact on consumer behaviour. Reference was also made to best buy tables (BBTs)[41] and online calculators[42], which respondents generally considered blunter tools than PCWs.

7. Respondents pointed out that consumers seek and value help in navigating the large and complex mortgage product landscape and that PCWs are a potentially useful source of information for them, as a "familiar and trusted" resource to enable comparisons between products and to reduce search costs.

41 BBTs contain information on mortgage deals highlighted as competitively priced and are often published in newspapers or other print sources.

42 Online calculators are a digital tool offering information to consumers on how much they might able to borrow for a house purchase, depending on the size of their deposit and current earnings. These are generally provided online by lenders and aggregator sites, such as PCWs.

8. There was particular focus on how some consumers prefer to conduct their own online research before contacting a lender or broker. Some respondents considered that PCWs are some consumers' first port of call to assess the range of mortgage products currently available, and therefore have a significant influence on the decisions they make. Numerous respondents however emphasised the limitations of PCWs as an informational tool.[43] Concerns were expressed both about how comprehensive and accurate the information presented to consumers by PCWs is, and about the scope for bias in their results:

- Firstly, many respondents felt that PCWs show only a subset of relevant product information, with much more limited information available on more complex aspects of mortgages. Some respondents argued that the lack of such information makes PCWs' comparison of mortgage products less meaningful than consumers might believe it to be. Also, some respondents (primarily lenders) commented negatively on the fact that product information is not reliably or frequently updated, potentially rendering the information provided less valuable or relevant.

- Secondly, many respondents expressed concerns about the scope for bias or distortions in the ranking of results by PCWs. They noted that this may arise as a result of the prominence of the headline rate over other product features (such as total cost of credit), and/or for other reasons such as sponsored deals or links being made more prominent to consumers.

9. Overall, both lender and broker representatives expressed significant concern that consumers might change or limit their product choices based on the information shown by PCWs. There was agreement that poor outcomes might result from consumers making incorrect assumptions based on information from PCWs, e.g. where they interpret a particular lender as offering the best value for money even though they might not offer a product that meets their individual requirements.

10. Respondents considered that the limitations of PCWs could pose particular problems in the mortgage sector if the prominence of the headline rate compounds consumers' own behavioural biases, reinforcing them in prioritising the initial monthly cost over other factors linked to product suitability. Respondents were also concerned that consumers may not be aware of PCWs' commercial links with lenders and/or brokers, with several lenders arguing that a ''whole of market'' labelling[44] system for PCWs would lead to a fairer and more transparent service.

Limited information on product or service offerings

11. Respondents highlighted that consumers with common requirements tend to have access to a lot of relevant information about mortgages, whereas there is less available to those consumers with less common requirements and, those unable to conduct online research.

12. Some respondents expressed concerns that brokers' relationships with other firms in the mortgage supply chain (through panels, for example) might bias and therefore limit the range of products offered to consumers. These concerns are set out in more detail in the section on supply side factors.

Consumers' ability to assess information

13. Many lender, broker and consumer representatives shared their views on consumers' ability to make informed purchasing decisions and the effect of any behavioural biases. Transparency and comparability were identified as key factors affecting consumers' ability to assess information.

43 PCWs are rarely used as a transactional tool (that is, as a means for consumers to pursue a transaction) in the mortgage sector.

44 This labelling would mirror the term commonly used for the coverage of mortgage brokers.

14. Many respondents commented on the difficulties consumers face when assessing product information. They referred to consumers' limited understanding of certain product features, their inability to compare deals, and/or their behavioural biases. Respondents broadly agreed that, when looking at mortgage products, consumers initially focus on the required loan sum and initial monthly repayment. There was a common view that consumers tend to consider other important product features (such as eligibility) at a later stage.

15. A range of respondents identified specific product features that consumers typically find difficult to understand. These included, in particular, cost elements (such as the total cost of credit, or charges prompted by uncertain future triggers) and the trade-off between rates and charges more generally. Both lender and broker representatives commented that consumers' understanding can be further hindered by complex and inconsistent charging structures between products.

16. Several respondents referred to the ongoing joint initiative between CML and Which? on the transparency of fees and charges.[45] Many acknowledged and welcomed its attempt to standardise jargon, but views were mixed on how effective it will be in mitigating the challenges consumers face when assessing information.

17. A number of representatives from both lender and consumer organisations also felt that APR/APRC[46] is flawed as a metric to enable consumers to compare mortgage products. Many felt that it lacks meaningful information reflecting the real cost of a mortgage, and is therefore unhelpful to consumers.[47]

18. Both lender and broker representatives agreed that, in addition to the difficulties associated with comparing mortgage deals, consumers' assessment of product information tends to be hindered by behavioural biases.[48] Typical biases include a focus on short-term price elements[49], excessive optimism about their future prospects, and stigma associated with certain products.[50] Some respondents argued that these biases are exacerbated by the use of PCWs.

19. Several lender and broker representatives noted that different types of consumers differ in their ability to assess information. For example, consumers with low financial literacy or non-standard requirements may face particular challenges. It was suggested that consumers lacking confidence or experience are most likely to get information from a single source, which could exacerbate the effect of other behavioural biases or commercial biases affecting the source of the information.

The role of mortgage advice

20. The MMR led to changes in our mortgage advice rules, which now require advice to be given in the vast majority of interactive mortgage sales. Firms can only conduct sales without advice ('execution-only') with certain specific customer groups (e.g. high net worth mortgage customers or professional customers), where the purpose of the loan is solely for business purposes, or with customers who know precisely what product they require.[51]

45 See www.cml.org.uk/policy/policy-updates/all/transparency-of-mortgage-fees-and-charges/

46 Annual Percentage Rate/Annual Percentage Rate of Charge

47 It should be noted that the ESIS (European Standardised Information Sheet) required by the MCD has to include at least one APRC (unless the loan is fixed for life), and this is not within the FCA's ability to change.

48 The consumer research done as part of our Advice & Distribution Thematic Review found the same.

49 Such as the cost of their monthly outgoing payment during the initial discounted period.

50 A trade body commented that consumers may feel this way about lifetime mortgages products.

51 Certain 'vulnerable' consumer groups (e.g. consumers seeking an equity release transaction) cannot opt out of receiving advice and can only proceed on an execution-only basis if they reject the advice provided.

21. This approach, and how it plays into customers' ability to access and assess information, was a strong theme in the responses to the CfI. Responses focused on the interaction between consumers and advisers, the value added by advice, and concerns about some features of the advice process.

22. Respondents recognised that mortgage advice plays a significant role in many consumers' decision-making process. Both lender and broker representatives argued that most consumers prefer some form of advice, mainly because consumers feel that significant financial transactions such as mortgages are complicated and risky. Many respondents said that consumers seek reassurance for fear of making a bad choice.

23. Respondents expressed mixed views about the significance of consumers' own research prior to speaking to brokers and lenders. For instance, while a PCW provider felt that consumers are not unduly influenced by their prior online search efforts, broker representatives stated that consumers approach them with pre-formed preferences and a belief that ''they know what product they want''. Others, including some lenders, felt that consumers are open to having their initial views challenged.[52]

24. Broker representatives were keen to emphasise that advice helps consumers to make good decisions, therefore adding value. Brokers highlighted the limitations of online tools such as PCWs, and said that dialogue is a crucial element to test assumptions. Brokers also argued that advice is essential given that underlying eligibility criteria can be complex, making the product landscape more difficult for consumers to navigate on their own.

25. Broker and lender respondents were in broad agreement that advice is particularly useful for consumers with non-standard requirements and/or lower levels of financial literacy, where consumer circumstances mean that detailed knowledge of product features is required.

26. Although many comments highlighted the significance and usefulness of advice, both lenders and brokers also raised concerns about some features of the advice process. In particular, lenders commented on the transparency of brokers' commercial arrangements and their impact on consumers' ability to access information, the challenges associated with digitalisation of advice processes, whether advice in its current form is proportionate for all types of consumer, and the availability of holistic advice:

- Many lenders argued that the current advice process is not proportionate for some consumers, most notably experienced mortgagors with standard requirements. Several felt that a "restricted" or "partial" advice category should be established to address their needs, and that this would reduce the frustration or perceived switching costs associated with the current advice process.

- A related strand of feedback focused on the length of time advice takes and how this could prevent customers from engaging with the sales process. In particular, some lenders felt that onerous, overly long interviews reduce the likelihood of customers shopping around. One respondent argued that, if products were less complex, customers' ability to assess their own needs should improve thereby reducing the need for advice.

- A number of lenders felt that brokers should operate with greater transparency. Respondents felt that an "intermediary register", through which brokers would be required to reveal their

52 These issues have also been highlighted in our Advice and Distribution Thematic Review.

business mix[53] and procuration fees, would provide reassurance to consumers that brokers are acting in their interests, and not basing their recommendations on other incentives.

- Many lenders and brokers shared their views on the growing trend towards digitalisation of mortgage advice processes. Several lenders highlighted the potential benefits of virtual appointments and other digitalised advice processes, which have the potential to "make the mortgage process simpler, more flexible and convenient for our customers". In light of this, lender representatives urged the FCA to consider whether the advice rules could be clarified and/or improved so that they are attuned to an online environment. Although little detail was supplied as to precisely where our rules act as a barrier, one respondent argued that more lenders could offer advice and new intermediaries could enter the market if online advice proved compatible with the regulatory regime.

- However, intermediaries argued that any move towards what they perceive as a lighter advice process or "robo"/automated advice would prevent nuanced discussions between adviser and customer. They felt this would reduce the likelihood of a customer's needs and circumstances being properly explored and challenged, which could lead to poor consumer outcomes. For example, if a digital process were unable to capture more subtle information about an individual's circumstances[54], the consumer may end up selecting one product when there is a preferable one available. They felt that this could be a particular issue for consumers with non-standard requirements.

- Some respondents wanted a clearer understanding of how to provide information without giving advice. They believe that greater certainty on this point would allow firms to deal more efficiently with customers' information needs without needlessly steering customers into the advice process.

- In terms of lifetime mortgages, several respondents felt that more should be done to facilitate holistic advice, encompassing investment, residential mortgages, lifetime mortgages and tax considerations. Lifetime mortgage providers also wanted a more formal hand-off process between advisers where a customer applies for a residential mortgage but may be more suited to a lifetime mortgage or vice versa. A lender trade body argued that the distinction between advice standards in the lifetime and mainstream mortgage markets should be determined by customers' circumstances rather than product type. However, two trade bodies saw risks in the provision of holistic advice and questioned whether it would be practical to expect an adviser to specialise more broadly without jeopardising the quality of advice they are able to deliver.

- At the same time, respondents acknowledged that the provision of quality advice across a large number of products is not straightforward. Some therefore suggested that a "strengthened triage system" allowing brokers to seek expertise from their peers with different specialisms where appropriate could work as a solution.

Ability to act on information to make effective mortgage choices

27. As explained in the CfI, for competition to work well it is important that consumers are able to act on their assessment of the products available to them. Making an effective mortgage choice does not necessarily mean selecting the cheapest product, but one which is appropriate given the consumer's needs, circumstances and preferences.

53 Including relationships with ancillary service providers, such as valuers and conveyancers.

54 Such as any longer-term needs for debt consolidation, protection, or retirement savings, which may warrant consideration of a wider range of products beyond a typical first charge residential mortgage.

Switching costs

28. A range of respondents commented on switching.[55] While comments focused on the benefits and costs consumers associate with switching, they also commented on how switching prompts that consumers receive from lenders and/or brokers might affect consumer behaviour.

29. Lenders described several factors as likely to make consumers re-mortgage. These include the maturity of the consumer's existing deal, fluctuation in interest rates (either actual or expected), and changes to an individual's lifestyle or circumstances.

30. Several broker representatives described the factors that may put consumers off re-mortgaging. These perceived switching costs include the 'lengthy' advice process, confusion about eligibility criteria, and general consumer inertia or disengagement with the process or product. Some commented that consumers may also make a conscious and informed choice not to switch (for example, if their current product suits their needs and the savings from re-mortgaging are outweighed by the associated costs, such as valuation, arrangement fees and legal costs).

31. A number of brokers and lenders commented on the direct switching prompts that consumers receive from different sources. Lender representatives highlighted brokers' 'sophisticated strategies' to engage with previous clients, arguing that this is a 'staple' portion of their business.

32. By contrast, brokers commented on lenders' strategies to retain borrowers who they perceive to be a 'good risk', in particular by offering them deals that are not yet available through other channels. They went on to suggest that, in addition to diverting business from brokers, this may lead to poor outcomes if it discourages consumers from considering switching options.

33. One lender argued that consumers would benefit from increased visibility of deals being offered both to new and existing customers. This lender said that lenders should be required to inform their existing customers about the full range of deals, which would prompt them to consider whether they are being treated fairly. It also commented that requiring lenders to increase the visibility of deals would enhance competition, rather than allowing them to "rely on natural inertia… to retain business".

Consumers' inability to access certain products

34. Responses on consumers' inability to access products focused primarily on so-called 'trapped borrowers'[56] and execution-only processes.

35. A number of broker representatives flagged concerns about borrowers being unable to switch products. They said that lenders had been choosing not to implement the flexibility offered through MCOB 11,[57] and suggested that the scope for consumer detriment may increase in the event of rising interest rates.

36. We received limited feedback on issues faced particularly by first-time buyers or different types of consumers, although one lender commented on the fact that consumers without online access are excluded from the execution-only sales process. They suggested that this could be mitigated if the 'no interaction' constraint was modified to permit execution-only transactions through non-digital channels, therefore no longer excluding consumers without internet access.

55 By which we mean either a product transfer with the existing lender, or a product switch to a different provider (remortgage).

56 The term 'trapped borrowers' has come to refer to those borrowers with an existing mortgage who have difficulty accessing any other products, therefore being constrained in their ability to switch mortgage product or provider.

57 This issue has been considered as part of the Responsible Lending Review.

Supply side behaviour

37. The CfI requested feedback on how supply side issues, in particular the way in which firms interact with consumers and with each other, may distort competition in the mortgage sector.

38. While most responses concerned the range and nature of relationships in the sector, respondents made comments about a variety of issues relating to supply side behaviour, including lenders' business and product design strategies and lenders monitoring and reacting to changes in offerings by their competitors. These issues are discussed in more detail below.

Reactions from firms to consumer characteristics and behaviours

39. The CfI suggested that firms' business strategies may take into account consumers' characteristics or behaviours, and may fail to help consumers with, or may even amplify, any potential limitations in their ability to make effective product choices.

40. For example, if consumers over-focus on the level of monthly repayments, firms may choose to increase the complexity of fees and charges, while still ranking highly when compared on the basis of monthly repayments.

Product design to respond to consumer demand

41. Several lenders said that they design products to meet consumer needs, and gave examples of products designed in response to consumer demands, making reference to internal review processes intended to ensure that products continue to meet consumer demands. A broker representative argued that the prevalence of two and five year fixed term interest rate mortgages is a response to consumer demand (with the early repayment charges on these products being the lenders' way of managing risks associated with lending on a fixed rate basis).

42. In relation to lifetime mortgages, one respondent commented that lenders are innovating to cater for consumer needs, for example, through hybrid products that are intended to cater for consumers in higher loan to value bands.

Product design to obfuscate the cost of products

43. In the CfI we asked whether firms design products in response to consumer behaviours and biases, and whether this has increased product complexity over time. Some responses argued that mortgage products have not become more complex over time. One respondent argued that it is in fact the underlying affordability, eligibility and other criteria which create complexity. A number of responses also noted that complexity is mitigated by information and advice.

44. Several respondents observed that customers focus on headline rates when making purchasing decisions. Consequently, firms have an incentive to structure products in way that reduces the headline cost, but increases fees and charges in other areas which are less scrutinised by consumers.[58]

Product design to influence the ranking on comparison sites and mortgage sourcing systems

45. Respondents also commented on the importance of products ranking highly on MSS[59] or PCWs, and that this can have an impact on how lenders design their products, which is not necessarily in consumers' interests.

58 A trade body raised this concern in particular about valuation fees.

59 Mortgage sourcing systems are software used by intermediaries to help them identify potentially appropriate products for their customers. They filter and rank mortgages listed on the system according to criteria chosen by the broker.

46. However, brokers said that this was mitigated by the fact that MSS are only one of the tools they use, as a complement to their wider knowledge of lenders and products on the market.

Market power

47. As explained in the CfI, market power exists when one or more firms, acting independently, are able to set higher prices, or offer poorer quality, than would be the case in a competitive environment. Respondents did not comment on any individual firm having significant market power in the mortgage sector.

48. Respondents commented on the fact that firms in the mortgage sector commonly choose a selection of partners with whom to do business. In particular, brokers commented that this may make it more difficult for small brokers to access lenders' products, whereas some lenders and lender representatives argued that large broker networks have 'significant influence' over the market because they control visibility and access to lenders' products. These issues are discussed in more detail in the section below on relationships between firms leading to constraints on firm behaviour.

Coordination between firms

49. None of the responses made reference to explicit agreements that restrict competition.

50. In the CfI we asked about lenders monitoring and reacting to changes in offers by competitors, and whether there are patterns of behaviour that suggest firms are following each other. One respondent noted that small lenders may want to monitor the products offered by larger lenders to avoid being flooded with applications if these larger lenders withdraw from specific segments. Some respondents said that most lenders, regardless of their size, would be reluctant to be the first to move into new markets, while others stated that they would not hesitate to be the first to offer a new type of product.

51. Several responses indicated that market-wide patterns in product offering and price mirror changes in the underlying cost of funding. One submission stated that changes in pricing differ by customer segment, each segment having its own patterns and variations.

Vertical and horizontal relationships

52. Respondents confirmed that there are varied and complex relationships in the mortgage sector. They referred for example to relationships between lenders and brokers, between lenders and ancillary service providers, and between brokers and PCWs.

53. As the CfI points out, such relationships may provide benefits to consumers. However, we received a number of comments raising concerns that relationships between firms which could lead to either constraints on firm behaviour or to conflicts of interest or misaligned incentives.

Relationships between firms leading to constraints on firm behaviour

54. The CfI suggested that commercial relationships between firms could, under certain circumstances, make it difficult to gain access to products or consumers.

55. Mostly, respondents said that such constraints arise from the fact that both lenders and brokers operate by using panels (which means they choose a selection of firms they do business with) and that this may affect the ability of smaller brokers and smaller lenders to compete. Feedback on the different types of relationship included:

- *Effects of lenders' use of panels of brokers*: Brokers commented that smaller brokers may experience difficulties in accessing products to distribute from certain lenders because it is not cost efficient for lenders to distribute their products through very large numbers of brokers (lenders need to undertake due diligence on their distributors and the cost of this is weighed up against the volumes expected from them)

- *Effects of brokers' use of panels of lenders*: Some lenders and lender representatives felt that large broker networks have significant influence over the market because they control visibility and access to lenders' products. This was expressed as a particular challenge for smaller and new lenders. It can be difficult for smaller lenders to retain distribution via a larger intermediary unless they agree to the terms of the contractual agreement. However, some respondents have pointed out that new and smaller lenders may, as part of their distribution strategy, choose to limit the channels through which they distribute products in the short term to ensure quality and efficiency. A few lenders noted that the effort associated with maintaining broker relationships, and on educating brokers about their products is proportionately higher for smaller lenders

- In the area of *specialist lending*, respondents offered varied views as to lenders' abilities to access consumers through brokers. A trade association commented that in second charge lending, the range of relationships is more limited than in the mainstream market and that new entrants have not experienced difficulties in joining brokers' lender panels. In relation to bridging loans, on the other hand, a respondent stated that new lenders have found it difficult to enter the broker channel because of the existing relationships between broker networks and lenders

Ownership structure and/or relationships between firms leading to conflicts of interest or misaligned incentives

56. The CfI suggests that relationships between firms can give rise to conflicts of interest and misaligned incentives. We received a large number of responses on this issue. Comments were made about relationships within the mortgage supply chain as well as relationships with providers of ancillary services. The following paragraphs present respondents' views on:

- the relationship between lenders and brokers, in particular the potential effects of procuration fees
- the use and ownership structure of MSS
- the relationships between estate agents and brokers
- valuation services
- lenders' panels of conveyancers
- firms that are active in several ancillary services markets, and
- relationships in the new-build sector.[60]

57. Several respondents commented on aspects of the relationships between lenders and brokers. As a lender representative pointed out, the industry is aware of the challenges associated with this relationship and CML, IMLA and AMI have issued joint guidance designed to ensure that these relationships work in consumers' best interests.[61]

60 Respondents also commented on the commercial arrangements that firms have with PCWs, and the need to communicate the various relationships in the sector openly and transparently to consumers.

61 The guidance will be updated during the course of 2016.

58. Many respondents commented on the procuration fees paid by lenders to brokers at the completion of a mortgage transaction, which are typically a small percentage of the value of the loan. Respondents had diverging views on the effect of these fees.

59. Some brokers argued that procuration fees do not give rise to any conflicts of interest and referred to previous FSA work in this area.[62] A few brokers noted that, while there is a hypothetical risk of conflict, in practice the relatively low level of procuration fees does not give rise to conflicts.

60. However, some respondents disagreed and were of the view that procuration fees may incentivise brokers to recommend certain products over others, and that new lenders may see higher procuration fees as a way to enter the market, focusing on this rather than the quality of their products.

61. Some respondents commented on the fact that one of the two large mortgage sourcing systems is owned by a consortium of lenders. Such an ownership structure could lead to a conflict of interest, and potentially make it more difficult for other lenders to have their products represented and compete. One lender commented specifically that in their opinion this ownership structure does not affect competition, as the system is run on an arm's length basis and does not limit which lenders can list their products on the system.

62. Respondents also commented on the relationships between estate agents and brokers. One lender noted that estate agents are influential in guiding the customer journey because many have structural links with brokers or because they encourage the use of brokers. A few brokers were critical of recommendations made by estate agents that customers seek advice from certain brokers, particularly if they imply that doing so is necessary to view or secure a property.

63. Some respondents identified issues with valuation services.[63] One lender noted that the cost of valuation services differs between providers and that, while this does not give rise to conflicts of interest, it may affect the cost of taking out a mortgage. Another respondent noted that consumers do not understand that a valuation is a risk management tool for lenders and suggested that brokers who work on a commission basis do not have an incentive to recommend a survey to their consumers as this potentially adds time to the purchase process. In bridging finance, a respondent commented that relationships between lenders and others are important, and that this is particularly relevant in valuations as they thought that there is limited availability of valuers.

64. A few respondents expressed concerns at lenders operating panels of conveyancing services. They noted that consumers are often not allowed to choose a conveyancer that is not on the panel or will be charged a fee for doing so.

65. Some respondents noted the possibility of conflicts of interest arising from arrangements where brokers are part of a group of companies which also provide ancillary services. However, one respondent did question whether this necessarily leads to poor outcomes for consumers.

66. Several submissions, both from lenders and intermediaries, have made specific comments about relationships in the new-build sector. Both lenders and brokers expressed the view that developers have close relationships with certain brokers and that these brokers tend to place business with a limited number of lenders (who they are confident can meet the tight timeframes imposed by developers).

62 The FSA's previous findings on the impact of procuration fees are presented briefly in footnote 21.

63 Valuation services include valuations for lenders and surveys for consumers. Valuations for lenders would typically be included in the fees and charges that consumers pay when taking out a mortgage and a survey is instructed separately by a consumer.

Market features

67. In the CfI we used the term 'market features' to describe those aspects of the market not explicitly linked to demand side behaviour or supply side conduct, but where there might be nevertheless potential for poor competition outcomes. In this context, we referred to, for example, the regulatory framework, barriers to entry and expansion, and barriers to innovation.

Regulatory framework

68. We received comments from firms and trade bodies about the challenges and consequences of regulation, especially the key tenets of the MMR: advice and responsible lending. There was a widely held view that the volume and pace of regulatory change had been challenging for firms. This view was expressed not only in relation to FCA regulation, but also about PRA, FPC, European and international interventions. Many respondents also expressed concerns about the cost of complying with regulation, including high overheads and significant spending on new IT systems, which some argued has distracted from product development and innovation.

69. Some lenders and trade bodies were concerned about the effects of capital requirements on smaller lenders. They strongly felt that these could lead to a competitive disadvantage as smaller lenders are required to hold proportionately more capital than their larger counterparts.

70. In addition, specific concerns were expressed about the lifetime mortgages sector, in particular due to the introduction of Solvency II, an EU directive to harmonise insurance regulation.

71. There were also concerns about the appropriateness of our affordability rules for particular lifetime mortgages products. More widely, respondents provided feedback on the challenges of meeting demand in certain areas, especially lending into and during retirement, lending to the self-employed, and the provision of interest-only mortgages. Sectors including affordable housing and self and custom build were also thought to be under-served.

72. These issues are discussed further below.

Capital requirements

73. The PRA and the FCA ensure that banks, building societies and investment firms hold a minimum amount of capital. We are jointly responsible for implementing the EU-wide CRD IV, which is shaped by Basel III. Basel III is the most recent iteration of the Basel Accords, and sets out international standards for the minimum amount of capital that banks must hold. Minimum capital requirements are designed to provide a more resilient framework to ensure that banks, building societies and investment firms are able to withstand unexpected losses.

74. Several lenders and other respondents expressed concerns about the effects of regulation on the capital requirements which apply to deposit-taking mortgage lenders. These requirements set out the amount of capital that a lender must hold for each mortgage. For example, a higher risk weighting is assigned to higher loan to value residential mortgages, which means that a lender must hold more capital for such mortgages.[64] A trade body felt that small firms are disadvantaged by the uniform approach of EU directives and regulations, arguing that treatment should be proportionate to firms' relative size in the market.

75. Smaller and newer lenders emphasised that larger incumbent banks have a competitive advantage as they are allowed to design their own internal ratings based (IRB) models[65] to

64 The standardised model shows less variation between loan-to-value ranges than the IRB model.

65 These allow lenders to calculate risk weights using existing internal data including historical lending. Approval from the regulator is required to operate IRB models. There is a 'foundation' and an 'advanced' approach to the IRB method. See CMA report: *Retail banking market investigation: Barriers to entry and expansion, capital requirements, IT and payment systems*.

assess risk. Established lenders with the requisite historical data and compliance capacity are permitted to hold significantly less capital against mortgages than smaller lenders, who must use a standardised model. The advantage was said to be particularly significant at lower loan to value ratios, making it difficult for smaller lenders to compete and potentially driving them into specialist and/or riskier markets. One respondent called for the Bank of England to share aggregate market data to widen access to IRB modelling. A building society also called specifically for revisions to buy-to-let risk weightings.

Responsible lending[66]

76. The responsible lending rules we introduced under the MMR set out the basic standards for assessing affordability as well as clarifying who is ultimately responsible. In summary, the key changes to the responsible lending rules require lenders to:

- assess affordability on the basis of a borrower's verified income, credit commitments, essential expenditure and basic quality of living costs
- take into account known or likely future changes to income and expenditure
- consider the effect of expected future interest rate rises
- not assess affordability on the basis of self-certified income or house price inflation, and
- only grant an interest-only mortgage where the customer has a credible repayment strategy

77. Several respondents expressed concern that these requirements are restricting access to mortgage credit for some new and existing customers. However, respondents also recognised that there are other relevant factors that affect access to credit, such as lenders' risk appetites and changing demographics. Another lender asked that any work resulting from the CfI focuses on whether our rules have unintentionally restricted some customer groups' ability to access mortgage finance and also the relative impact of other factors.

78. Some lenders felt that our existing rules did not cater for particular borrower types. Two lenders said that there can be difficulties for self-employed customers in providing evidence of income.

79. If the firm is or should reasonably be aware that there are likely to be future changes to the income and expenditure of the customer during the terms of the mortgage, the firm must take this into account when assessing affordability. Some respondents felt that this was an obstacle to lending to customers whose mortgage term extends beyond their likely retirement age. Lenders pointed to difficulties in accounting for known or likely changes to income and expenditure over the life of the loan, particularly where only a small portion of the term extends beyond retirement age. Indeed, two lenders questioned whether it is necessary to account for changes many years in the future, given that many customers remortgage well in advance of the term end. Respondents felt that these issues were compounded by the combination of first-time buyers entering the market in their 30s and increasing average terms.

80. More generally, respondents also expressed a perception that they could not take into account certain factors when conducting an affordability assessment, including bonuses, pay rises and income from sources other than employment, such as savings and investments.

66 Reference to RLR; www.fca.org.uk/news/tr16-04-responsible-lending-review

81. Some respondents, including lenders and their representatives, recognised that firms' own risk appetites have resulted in a shift away from dealing with complex cases. A trade body felt that the risk of regulatory action in the future was a driving factor in firms' attitude to risk. For example, our rules allow a firm to disapply aspects of our affordability requirements where an existing customer wishes to vary their contract, is not borrowing more and there is no material impact on affordability. The trade body believes that some firms are consciously taking a conservative view of what constitutes a material impact and so not fully exploiting this flexibility.

82. Several respondents commented that this approach posed risks to existing borrowers unable to move to a new deal. A consumer body felt that this could lead to firms overcharging existing customers.

83. Two intermediary representatives felt that lenders should have made more use of transitional arrangements that, in certain circumstances, allowed them to take on other firms' customers without carrying out an affordability assessment and the FCA should have exerted more pressure on them to do so. These transitional arrangements have been removed as part of our implementation of MCD and both respondents asked whether a different (and less onerous) affordability assessment could be introduced, for instance by looking at a borrower's historic mortgage payments and servicing of other credit commitments.

Regulation of lending to older borrowers

84. Several respondents raised issues relating to lending to older borrowers and, in particular, lifetime mortgages.

85. Lifetime mortgage providers, insurers and trade bodies were particularly concerned about the impact of Solvency II on the lifetime mortgages market. This is a newly implemented EU Directive which codifies and harmonises existing insurance regulation. A specialist lender noted that the new regime does not recognise lifetime mortgages as appropriate assets for backing annuity liabilities and that lifetime mortgages do not fit the eligibility rules for a Matching Adjustment. Another specialist lender felt that the PRA's implementation of Solvency II was problematic, with structuring solutions likely to be costly.

86. Market participants and their representatives felt that our responsible lending rules were restricting product development in the lifetime mortgage market, in particular where firms wish to develop products that allow customers to make payments to preserve equity rather than start out on interest roll-up. Our rules require a lender to assess affordability where payments are expected or anticipated, to mitigate the risk that failing to make these payments could ultimately lead to possession. Firms saw this as unnecessary where the customer can convert to interest roll-up at any point, thereby removing any risk of repossession. This was viewed as particularly problematic for firms not geared up to assess affordability.

87. We received a range of comments on the role of advice in the lifetime mortgage market, some of which are set out in paragraph 26 above. Two respondents that called for holistic advice for older borrowers also did not wish to see any reduction in lifetime mortgage advice standards.

88. Several lifetime mortgage providers and their representatives raised concerns with our requirement that advisers hold a QCF Level 3 equity release qualification. They felt that the qualification was too mortgage-focused and, given the relatively modest size of the market, acted as a barrier to pensions and investment advisers advising on lifetime mortgage products.

89. Respondents felt that a lifetime mortgage component could instead be rolled into existing qualifications for other types of adviser that typically offer services to older borrowers to improve access.

Other regulatory issues

90. A number of other issues were also raised. These included:

- A trade body expressed concern over the application of the Building Societies sourcebook[67], which they described as leading to more onerous requirements on building societies, particularly where it is applied in a prescriptive rather than advisory way by the PRA. The restriction on fixed rate lending is one aspect of the sourcebook that was said to remain challenging for some building societies

- One lender suggested that the FPC rules which limit the proportion of a lender's mortgages sold with a loan to income ratio greater than 4.5 should be revised, as they may have unintended consequences on choice. In particular, the rules were said to lead to abrupt entry and exit from the market as thresholds are approached. It is currently necessary to report on these rules quarterly, but the lender suggested that annual reporting could improve the situation

Barriers to entry and expansion

91. In the CfI, we asked for views on any barriers for firms to enter the market and grow their customer base. These barriers can come in a variety of forms, and vary between different players in the supply chain, or different subsectors. Below we summarise the main views fed back to us, by type of firm and by subsector where relevant.

Barriers to entry and expansion for intermediaries

92. Respondents had different views on whether there are significant barriers to entry and expansion for brokers. One respondent stated that there are significant economies of scale in the market which might represent a barrier to entry, another suggested that mortgage clubs provide a way to overcome these barriers.

93. An intermediary body stated that some lenders are pursuing options to increase capacity for execution-only services, posing a potential barrier to expansion for brokers. In particular, some lenders may offer a retention product to existing borrowers but do not simultaneously release this information to intermediaries.

Barriers to entry and expansion for lenders

94. Responses put forward several different kinds of barriers to entry and expansion for lenders, which in some cases vary by type of lender and by subsector.

Access to funding as a barrier to entry or expansion

95. A trade body stated that smaller building societies have limited access to secured funding, constraining their ability to expand their business. A building society commented that Help to Buy[68] effectively excludes smaller lenders, causing a further barrier to expansion. However, they also stated that Funding for Lending[69] has been a helpful source of funding. A trade body stated that lenders use a variety of markets to secure funding for UK mortgage books, using differing currencies, terms/maturities, and calculations of interest. These funding sources need

67 www.fca.org.uk/static/documents/handbook-releases/specialist-sourcebooks136.pdf

68 Help to Buy is a government scheme which aims to support first time buyers. See www.helptobuy.gov.uk/

69 Funding for Lending was launched by the Bank of England and HM Treasury and is designed to incentivise banks and building societies to boost their lending to the UK real economy. See www.bankofengland.co.uk/markets/pages/fls/default.aspx

to be matched to the mortgage products the lender is offering, and the necessary hedging strategies can be costly and may therefore constitute a barrier to entry.

96. While some lenders commented that a range of funding sources is available to them, another disagreed, noting that sources are not diversified and that this is evidenced by changes in risk appetite.

Distribution channels as a barrier to expansion

97. A view was put forward that broker distribution channels tend to favour larger lenders over smaller and/or specialist lenders. A lender also stated that the cost of maintaining a multi-channel distribution strategy is hard to manage for most specialist and new lenders. However, a trade body fed back that lending entrants can succeed from a very small scale due to the intermediary network, although accessing the largest intermediaries can be difficult.

Barriers to entry in the new-build sector

98. Some lenders pointed out that they have struggled to enter the new-build sector, which appears to be dominated by two lenders. Some respondents suggested that the new-build sector is less competitive than others parts of the mortgage market, since they observed that increased prices amongst some firms did not appear to affect their sales or market share.

Lack of a strong brand as a barrier

99. A lender put forward the view that larger lenders have an advantage due to their brand strength. It was stated that brokers are more likely to acknowledge recognised brands when they consider products beyond the top ranking results on mortgage sourcing systems.

The importance of a branch network, or presence in other financial services markets

100. A respondent commented that, since consumers now visit physical branches less frequently, lenders no longer need to operate a branch network if they wish to enter into the mortgage sector.

101. Overall, respondents differed in their views as to whether a lender's ability to compete in the mortgage sector depends on having a presence in other financial services markets. Some expressed the view that larger lenders enjoy an advantage over smaller lenders through their personal current account books, for example, because of their ability to access data on their existing customer base. Others respondents did not feel this was a decisive factor in being competitive. Some respondents also referred to the CMA's findings in the Retail Banking Market Investigation in this respect.[70]

102. The most popular entry method into the UK market for a non-UK lender was said to be a merger or acquisition with a UK banking subsidiary (such as an insurer). Alternatively, EEA lenders can passport into the UK, but this can prove a more challenging option when aiming for compliance with UK regulations. During a roundtable event we held with members of the European Mortgage Federation we heard the view that new entrants need to find funding from within the host market, and that this requires them to establish both a viable lending and a savings proposition.

70 For further information see www.gov.uk/cma-cases/review-of-banking-for-small-and-medium-sized-businesses-smes-in-the-uk

Barriers in the lifetime mortgages sector

103. For lifetime mortgages, the main barriers to entry and expansion that were mentioned were:

- issues related to capital requirements (see also paragraphs 4.68 onwwards)
- the market's current lack of scale, which in itself may discourage new entrants
- a lack of qualified advisers potentially making it difficult for lifetime mortgages providers to expand their business, and
- challenges in the authorisation process

104. The importance of brand was also highlighted. One stakeholder explained its decision to make an acquisition rather than enter the market itself for this reason, demonstrating a barrier to entry. This suggests that other prospective entrants might be discouraged from entering the lifetime market without an established brand.

Barriers to innovation

105. We asked for feedback on any barriers to product innovation (such as mortgages with simpler pricing structures) or process innovation (which as technological advances making parts of the mortgage application process more consumer friendly).

106. Opinions differed not only on how innovative the mortgage sector is, but also how much potential there might be for product and process innovation, and to what extent past product innovation has delivered good outcomes for consumers.

107. With regard to the sector's general appetite for innovation, we heard that a culture exists whereby lenders are reluctant to innovate and to enter new markets first, so as to not be uniquely exposed to new risk.

108. One barrier to innovation identified by many respondents was the pace and scope of regulatory change. They asserted that this led to investment being diverted from innovation and product development towards compliance costs, and to a tightening of risk appetite.

Process innovation

109. An industry body stated that digitalisation is a driving force of change in mortgage markets worldwide, especially in the use of big data. Lenders generally felt that consumers were receptive to technological change in financial services.

110. However, one lender said that the UK regulatory regime discourages the effective use of new technology, in particular the MCOB rules discourage some online interactions with lenders or brokers because they could be deemed as giving advice. Another lender stated that it is hard to justify investment in execution-only and digital innovation because of regulatory risk. There was a view that if this could be resolved, digital innovations could be helpful in presenting mortgages in a simpler way.

111. Another respondent said that the current rules do not consider technological advances, and incumbent lenders' IT systems do not necessarily allow for easy transportation of customers.

Product innovation

The impact of regulation on product innovation

112. A trade body suggested that regulation itself is causing product choice to narrow, which was supported by a building society statement that the MMR and MCD have shown an "appetite for vanilla [products]". Indeed, one intermediary stated that fear of regulation stifles innovation, while another felt that a cultural shift in lenders in terms of conduct risk is also responsible for limited innovation.

113. One respondent felt that the regulator had historically displayed a lack of urgency in accepting innovation and that more consideration of the impact of regulation on the industry would help. Some felt that products had been introduced and then been subject to more harsh treatment after a period of time, weakening the incentive to invest in innovation.

114. A lender welcomed the regulatory sandbox[71] which the FCA has set up to foster innovation, but wanted clarification that the Financial Ombudsman Service would not penalise any related initiatives.[72]

Barriers to innovation in lifetime mortgages

115. Some respondents felt that innovation in lending into later life would be opened up if regulation were amended to support it.

116. Some lenders specifically expressed a view that ERC standards[73] are too limiting in scope, restricting product innovation.

Funding as a barrier to product innovation

117. A consultancy firm noted that a lack of funding options for lenders, especially in the longer term, has led to limited choice and a scarcity of long term mortgage products. A building society identified a lack of scale as prohibitive to investment in technology that would facilitate innovation.

118. While some comments referred to funding in this context, there was little sign of appetite or perceived need for innovation in funding models amongst respondents.

119. One lender suggested that the FCA lacks the appetite for alternative sources of funding for mortgages, including peer to peer. They believed that the rules are not aligned with innovative business models to allow firms to enter markets and expand.

71 The FCA has introduced a 'regulatory sandbox' as a 'safe space' in which businesses can test innovative products, services, business models and delivery mechanisms without immediately incurring all the normal regulatory consequences of pilot activities. This builds on Project Innovate. See www.fca.org.uk/news/regulatory-sandbox

72 The FCA's position on this issue is that the regulatory sandbox will not transfer risks of testing new activities from firms to consumers. Thus, we expect retail consumers engaged in sandbox tests to have the same rights as consumers who engage with ordinary authorised firms – their rights to complain to the firm, the Financial Ombudsman Service and the FSCS should not be affected.

73 The ERC has a Standards Board which aims to ensure that equity release products are safe and reliable for consumers. It sets the Statement of Principles, standards and principles for members of the Equity Release Council. See www.equityreleasecouncil.com/ship-standards/

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