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Further evidence on choices of dominated mortgage products

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Introduction

In May last year, FCA Occasional Paper 33 (Iscenko, 2018)[1] found that almost 30% of UK mortgage customers chose products that were strictly 'dominated' by other options. To count as dominated, a borrower's chosen mortgage product had to be worse on all price dimensions than another available alternative which had comparable features and for which the borrower also satisfied the eligibility criteria.

This note explores two further dimensions of these dominated choices. The first is the supply of dominated products and the alternatives that dominate them. This is whether they are concentrated within a small range of lenders, whether the superior products are only offered by niche lenders or in small supply, and whether it is common for lenders to be persistently dominated for all consumers that choose their mortgage products. The second is whether dominated choices could be explained by preferences for non-product characteristics of the chosen lender, such as branch proximity or service quality rankings.

Supply of dominated products and alternatives

The dominance measure used in Iscenko (2018) is based on individuals and alternatives they face. Hence, the same mortgage product may be dominated for some borrowers who choose it, but not others. For discussing the broader market dynamics of who supplies dominated products and where the strictly superior alternatives come from, we need to aggregate those borrower-based measures to firm level.

Suppliers of dominated products For each lender (or a category of lenders) j, I define j's proportion of dominated mortgage transactions as the ratio of the number of instances where a borrower chooses j's mortgage product which is dominated by another alternative to the total number of times j's mortgage products are chosen.

This ratio varies considerably between suppliers. For one half of the lenders, the proportion of dominated mortgage transactions lies between 18% and 62%, and the average is 43%. Extremes are very uncommon. Every lender, big or small, had at least some mortgage transactions where their product was dominated by other alternatives available to the borrower. There are also only a couple of very small suppliers whose products were dominated for every borrower who chose them.

Figure 1 shows that there are systematic differences in the proportion of dominated mortgage transactions depending on lender size.[2] Perhaps predictably, suppliers whose mortgage loans are dominated most often tend to be small, potentially reflecting both aversion to more expensive products among at least some borrowers and also suppliers' higher costs due to lack of access to lending economies of scale.

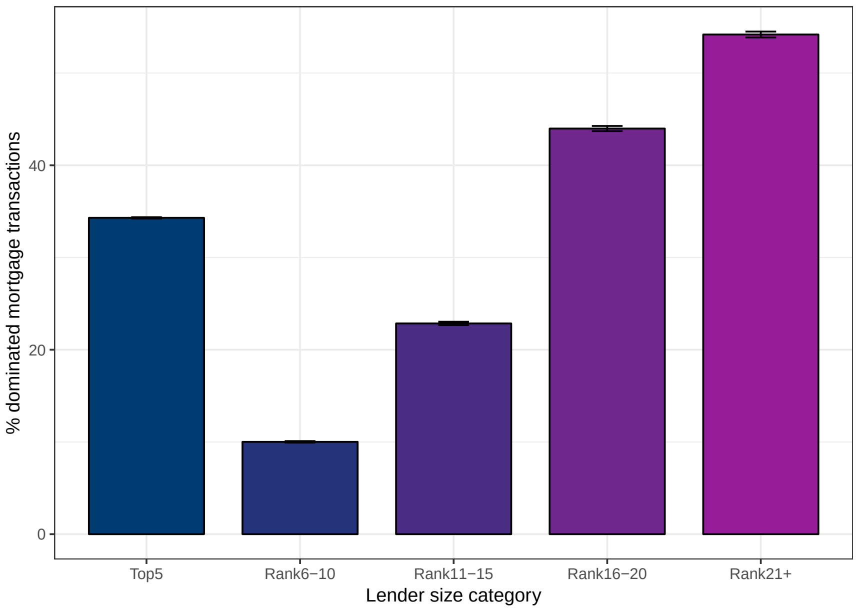
The proportion of dominated mortgage transactions does not decline monotonically as lender size increases which is what one would expect if only those two factors were at play. The lowest proportion of dominated mortgages of below 10% is seen among the second-tier lenders ranked between 6 and 10 by size, with smaller banks ranked 10-15 not too

[1] Iscenko, Z. (2018) *Choices of dominated mortgage products by UK consumers.* Financial Conduct Authority Occasional Paper 33.

[2] Here and henceforth, lender size bands are based on lender's rank by total mortgage lending volume between January 2015 and June 2016.

far behind. The top 5 largest lenders buck the trend with over 30% of their mortgage transactions dominated by other alternatives. This might suggest that a getting a mortgage from a Top 5 bank offers additional benefits that borrowers value and trade-off against the product specific characteristics captured by the dominance measure. Alternatively, it is possible that the largest lenders are a natural focal point for borrowers who are less able or willing to search (and thus to identify the best priced deals).

Figure 1: Proportion of dominated mortgage transactions, by lender size category



Suppliers of dominating products It is also useful to consider which lenders supply the *dominating* products (ie the available alternatives that were strictly superior on price and product characteristics to the chosen dominated product). This is also not a straightforward question, as there were two or more dominating alternative mortgages for more than a half of the borrowers who made dominated choices.

To compare lenders' relative importance as a source of dominating alternatives, I calculate two measures. First, lender k's 'frequency of dominating other products' is a simple ratio of the number of dominated mortgage choices in which lender k's mortgages are among the dominating alternatives to the number of all dominated choices in the sample. Second, k's frequency of dominating lender (or a category of lenders) j is the ratio of dominated choices where j's mortgage was chosen and it was strictly dominated by at least one product from k to the total number of dominated choices of j's mortgages.

If the majority of dominated choices were driven by dominating alternatives from the same one or two lenders, one would expect the frequencies of dominating other products to be very high (approaching 1) for those suppliers, and be near zero otherwise. What we see in practice is very different. On average, each supplier of a dominating alternative appears in fewer than 5% of dominating choices. Even for the 5 most frequent suppliers of dominating alternatives, the proportion of dominated choices in which they appear is below 24%. All this strongly suggests that suppliers of dominating products vary from one borrower's case to the next, and no single 'superior' lender is responsible for driving the majority of the dominated choices.

Figure 2: Frequency of dominating other lenders, by size category

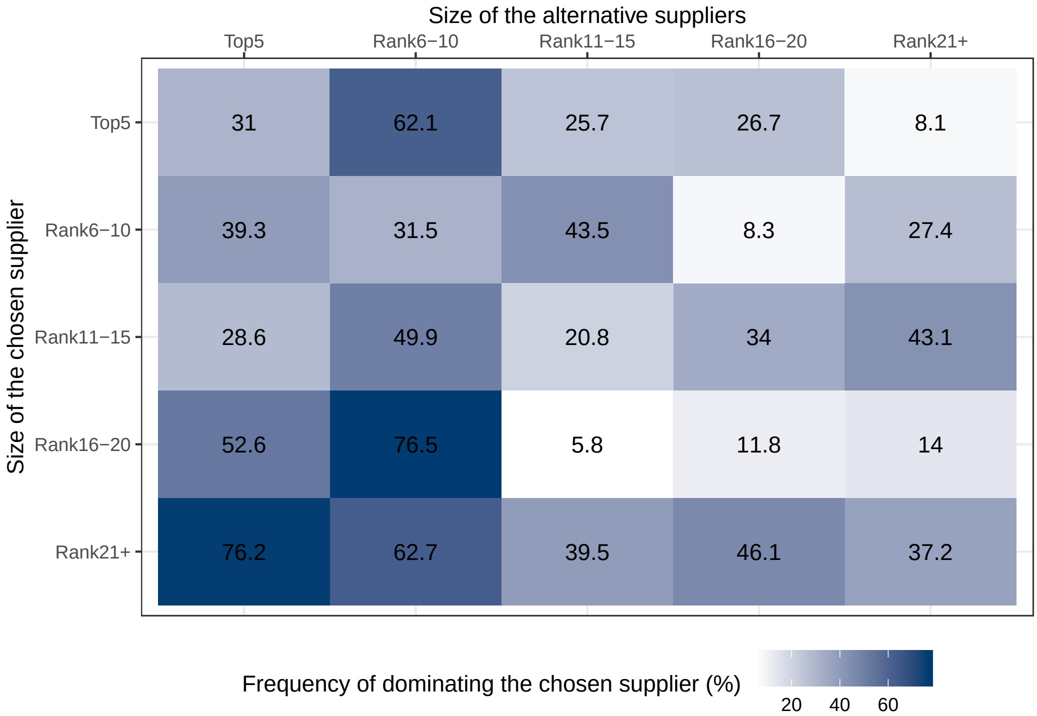


Figure 2 illustrates the complex nature of dominance relationships between lenders further. Out of all dominated mortgages originated by the largest 5 lenders, at least one dominating product came from another Top 5 firm in 31% of the cases, from lenders ranked between 6 and 10 in 63% of the cases, and from smaller lenders ranked 11 and below in around 40% of the cases.

For the choices where a mortgage from a lender in the 6-10 bank was dominated, one of the dominating alternatives also came from a Top 5 lender in more than a third of the cases even though those lenders have much higher proportion of dominated mortgage originations on average. In general, no single group of lenders is solely responsible for dominating the other lenders' mortgages. Instead, when a borrower's choice of a particular lender is dominated, it is due to a mix of better products being available from different lenders at the time of that particular choice. In fact, it is not uncommon for the same 2 lenders to dominate each other's products depending the borrower's circumstances (eg the LTV band).

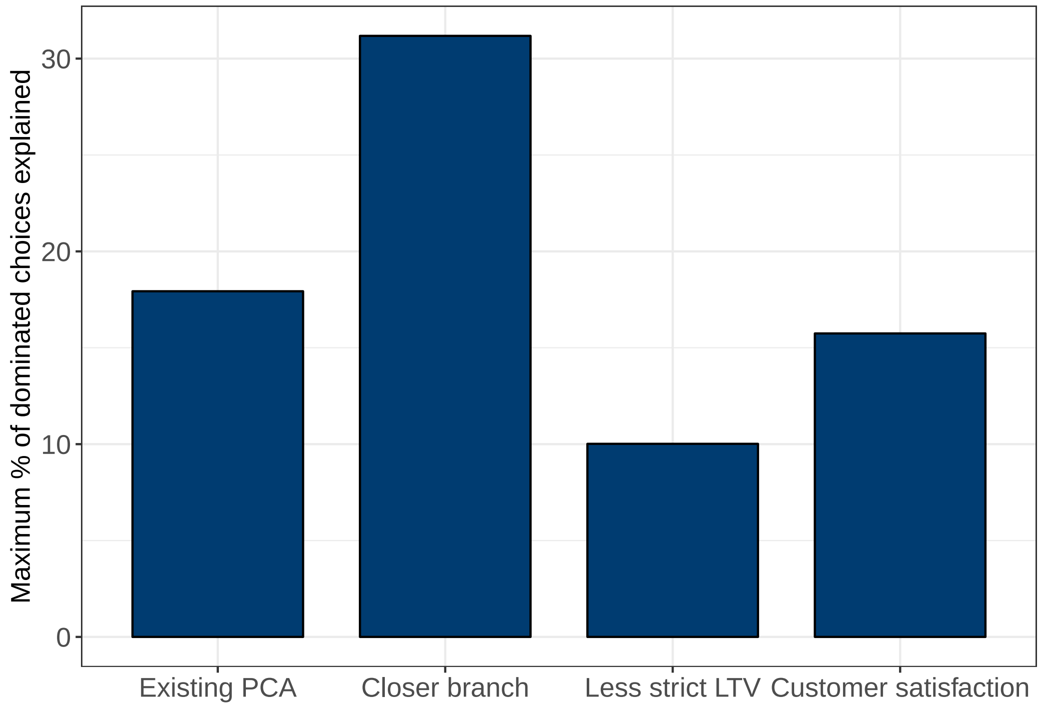
These stylised facts strongly suggest that the supply of dominated products is more complicated than some 'bad' lenders that are consistently dominated by 'better' maverick ones. Dominated choices, instead, are a product of a complex match between the alternatives on offer by different suppliers and the individual borrower's circumstances and abilities to find them.

Contributions of different factors

The dominance analysis in Iscenko (2018) identifies choices that cannot be explained by preferences for characteristics of specific mortgage products. In this section, I further explore to what extent those dominated choices could, at least in principle, be attributable to extremely strong preferences for other choice dimensions. I rank the borrower's chosen product and all of its dominating alternatives on 4 additional attributes of the choice situation and the lenders:

- whether the borrower has an existing relationship (current account) with the lender,
- distance to the lender's closest branch from the borrower's old address,
- maximum loan-to-value ratio the lender accepts for the product, and
- the lender's customer satisfaction score.[3]

Figure 3: Maximum proportion of dominated choices explainable by tastes for lender characteristics



A borrower's dominated choice is considered 'potentially explainable' by one of 4 criteria if the chosen product is even slightly better on this criterion than all of the dominating alternatives. In this case, it is possible that strong preferences for the comparative advantage offered by the chosen product (eg for dealing with the lender with which one already has an account) might have outweighed the strictly lower costs of the available dominating alternatives.[4]

For some borrowers, the 'explanations' offered by such advantages will not be very plausible. It is extremely unlikely, for instance, that someone would choose to pay hundreds of pounds for being with a lender whose branch is 0.1 mile closer. This very generous definition of 'potential explainability', however, makes it possible to obtain an upper bound on the proportion of dominated choices that could be, at least in principle, attributed to the additional measurable lender characteristics.

[3]Based on the results of a survey by Which? reported in *Advice Guides: Compare mortgage lenders* in May 2016.

[4]This can also be thought of as extending the definition of dominance in Iscenko (2018), Definition 4 to include the four criteria above.

Figure 3 shows the maximum proportion of the observed dominated choices attributable to each new measure. Potential preference for closer branches could explain at most a third of dominated choices. The other individual criteria fare even worse - only up to 18% of the dominated choices are attributable to preference for using one's current account provider for a mortgage, up to 16% to preference for higher customer satisfaction ratings and up to 10% to perceived lender strictness as proxied by the maximum LTV ratio they accept for the product. To put it differently, lenders who offer dominating alternatives are not systematically worse than providers of the chosen dominated products on other non-price dimensions borrowers might care about.

Overall, in just over 50% of the dominated mortgage choices the chosen lender is slightly better than all dominating alternatives on *any* of the four criteria. This is the maximum proportion of dominated choices that could be explained by these additional characteristics. Nearly a half of the observed dominated choices cannot be attributed to borrower preferences, however extreme, for lender familiarity, proximity, customer service and the (observable) lower lending standards.

Therefore, additional explanations, such as the difficulty some borrowers have in identifying some available alternatives or comparing them, are needed to account for many of the observed dominated mortgage choices.