The changing face of mortgage distribution

December 2015

Executive summary

- Intermediaries' (brokers') share of mortgage distribution by value passed the 70% mark for the first time this year, reaching 71% in Q2 2015 when brokers arranged mortgages valued at £28.8 billion. In that quarter, 164,000 borrowers used a broker, 67% of those taking out a mortgage, also the highest share on record.

- However, brokers suffered a severe contraction in business and market share during the financial crisis. The 1.3 million mortgages brokers had arranged in 2006 slumped to just 430,000 by 2010, a fall of 67%. Despite the subsequent recovery in the size of the overall market and intermediaries' share of distribution, the number of mortgages arranged through brokers this year is still only half the level prior to the financial crisis.

- Lenders' direct distribution has declined as the broker share has grown. But the change is far from uniform. Lender distributed remortgages fell 77% from 518,000 in 2006 to 117,000 in 2014 and loans for home movers fell 50% from 322,000 to 161,000, lowering the share of these loans distributed directly. But lenders' share of distribution for first time buyer loans rose from 32% to 37% over the same period, with loans arranged falling only modestly from 130,000 in 2006 to 117,000 in 2014.

- The general upward trend in intermediaries' share of mortgage distribution over the past three decades is a consequence of several key changes in the market: the widening in the range of lenders, including the emergence of lenders exclusively using broker distribution; growing complexity in the range of mortgage features and pricing on offer; and most recently regulatory changes including those brought in by the Mortgage Market Review (MMR).

- By requiring mortgage sales staff to provide advice rather than just information, with the additional qualifications that requires, the MMR has led many lenders to de-emphasise their branch networks as a distribution channel and some smaller lenders to end direct distribution altogether.

- There is some evidence from the intermediary industry that the previous trend towards mortgage networks, which undertake compliance and some administration functions for their member firms (or appointed representatives), is reversing. The Financial Adviser Confidence Tracking Index shows the proportion of brokers who are appointed representatives of networks falling from 50.5% in March to 45.4% in September with a corresponding rise in the proportion who are directly authorised.

- Distribution via the internet has become commonplace for many consumer financial services, such as car and home insurance, but has made limited inroads for mortgages, reflecting the greater complexity of the product. However, developments in artificial intelligence make it possible to imagine a time when advice might be dispensed by software programs.

- The Financial Conduct Authority (FCA) has signalled that it is keen to ensure that the industry does not hold back from innovation and is undertaking a program examining firms' approach to so-called 'robo-advice'. It is difficult to predict the impact if robo-advice becomes a reality in the mortgage market but it is bound to have a profound effect on distribution.

Section 1 – The rise and rise of the mortgage intermediary

1.1 Three decades that changed the face of mortgage distribution

The rise of the mortgage intermediary or broker is a modern affair. Prior to mortgage deregulation in the mid 1980s, the market was dominated by building societies with interest rates set in accordance with the Building Societies Association (BSA) recommended rate. The lack of price competition made brokers superfluous in the mainstream market and almost all customers visited a building society branch to obtain a mortgage.

The 1980s ushered in dramatic change. Banks entered the market in force, the range of products increased with fixed rate loans and endowment mortgages being introduced while a new class of lender, the so-called 'centralised lender', was established without branch networks. Centralised lenders depended exclusively on intermediary distribution and generally focused on niche customer segments such as the self-employed. As a result of these changes, mortgage brokers established themselves as a force and, in particular, as the main distribution channel for non-standard mortgage customers, a position they have never lost.

The next major milestone in the growth of intermediaries came in the early 1990s when lenders started to move away from uniform standard variable rate (SVR) pricing with the introduction of front-end discounting. This took the form both of explicit discounts to SVR and low short term fixed rates. Some lenders even introduced cash backs – a discount rolled into a single payment. Discounted loans usually came with early repayment charges, sometimes extending beyond the discount period.

The new pricing model served the interests of lenders that wanted to expand their mortgage books quickly. But it was also a boon for intermediaries as it introduced much greater complexity in mortgage pricing and, because the price of new discounts was constantly changing, it became increasingly difficult for the layman to keep track of the best deals.

The 1990s also saw the introduction of telephone distribution, which was followed later by the use of the internet as a stand-alone channel. However, internet distribution, by which a lender can connect with its mortgage customer without face-to-face contact, has not made substantial inroads, in part because the complexity of the mortgage product means that most customers want to be guided through the range of choices regarding rate, term, repayment type etc.

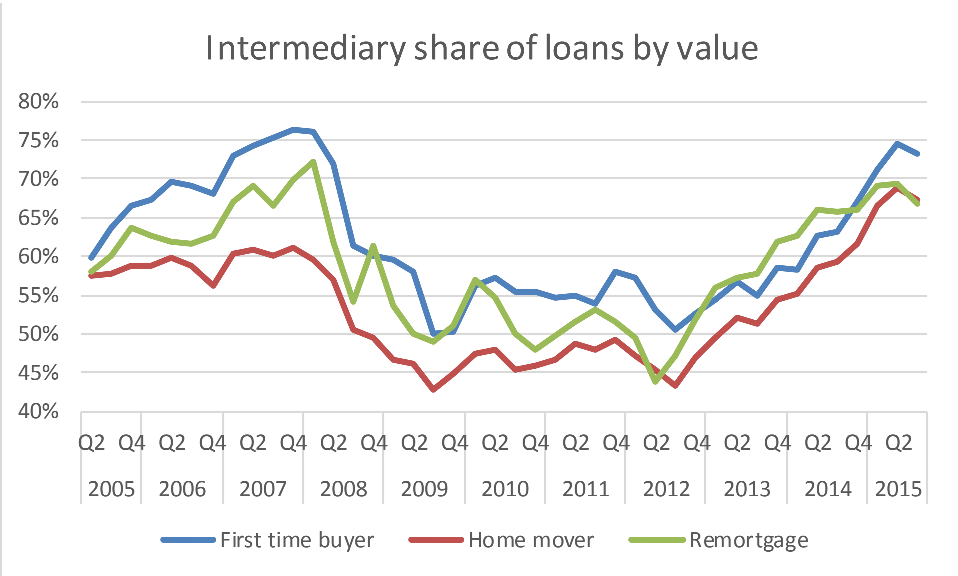
The last major shift that has bolstered the position of the mortgage intermediary is the introduction and subsequent evolution of regulation. Although the introduction of the voluntary Mortgage Code by the Council of Mortgage Lenders (CML) in 1997, and subsequent introduction of statutory regulation in 2004, may not have been seen at the time as an obvious boon for intermediaries, by making the distinction between advised and non-advised sales explicit, these changes started to make some consumers more aware of the distinction between whole of market and lender advice.

The MMR, introduced in April 2014, may prove to have a greater impact. By removing 'non-advised' sales, it requires lenders to ensure that all their mortgage professionals are qualified to advise on their mortgage range rather than just providing information. Many lenders have responded by reducing the number of mortgage advisers and some such as the Dudley Building Society have even ceased to offer mortgages to customers through their branch networks and switched to intermediary distribution only (see Section 3).

1.2 Intermediary share on the rise

This year's data show just how substantial a presence in the market intermediaries have now achieved. Intermediaries' share of mortgage distribution by value passed the 70% mark for the first time this year, reaching 71% in Q2 2015 when brokers arranged mortgages valued at £28.8 billion. In that quarter, 164,000 borrowers used a broker, 67% of those taking out a mortgage, the highest percentage on record. In Q3 brokers arranged 182,000 loans valued at £33.3 billion, the highest quarterly value since Q2 2008. Although the share fell back slightly from its Q2 peak to 69% (see Chart 1), the share remained well above its 2014 level.

Chart 1



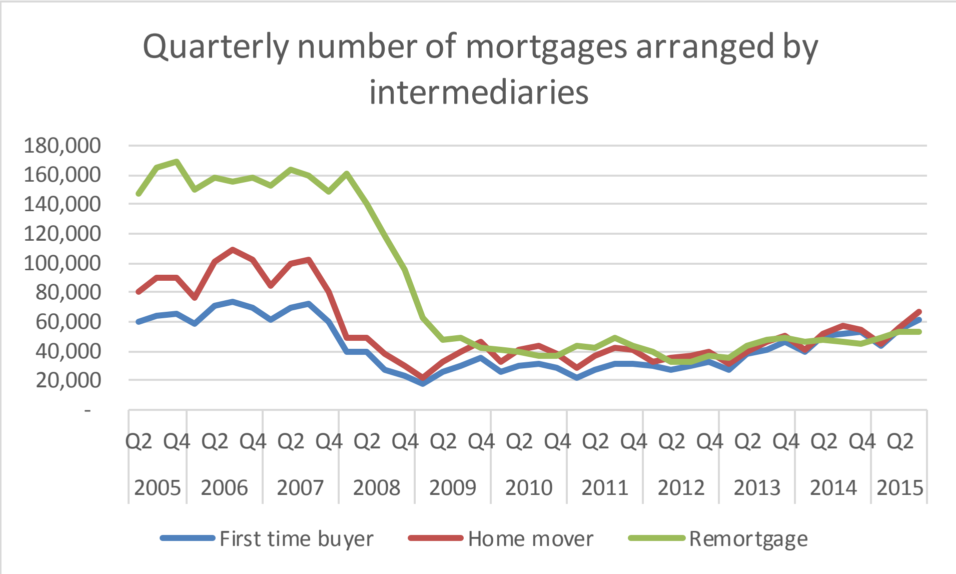
Source: CML

As well as reflecting the MMR, the impact of which was anticipated by some lenders well in advance of its implementation in April 2014, intermediaries' improved share reflects lenders' increased appetite to grow their mortgage books and the growth of niche segments where intermediary distribution is higher. For example, in Q3 2015 survey results show that 86% of buy-to-let loans were arranged through brokers and buy-to-let is a rising share of total lending.

The growth in broker volumes since 2012 has been substantial, driven both by higher overall mortgage lending and increased broker share. Q3 2015's £33.3 billion of mortgage business represents a 125% increase over the £14.8 billion quarterly average recorded in 2012. And the number of borrowers using a broker rose 78% over the same period.

However, this success follows a painful contraction that came in the wake of the financial crisis, with brokers discovering that when lenders reduced their appetite to lend many found it appropriate to focus that reduction on the intermediary channel. As a result, brokers were hit with a double whammy of lower total mortgage lending volumes and reduced market share.

Chart 2



Source: CML

The 1.3 million mortgages brokers had arranged in 2006 slumped to just 430,000 by 2010, a fall of 67% (see Chart 2). And even as intermediaries enjoy record market share this year, business levels remain well below pre-crisis volumes. The 182,000 loans arranged by intermediaries in Q3 2015 was the highest quarterly total since Q3 2008, but it is still 43% down on the quarterly average of 320,000 recorded in 2006.

1.3 Advantages for lenders from intermediary distribution

On the surface, the rise of intermediary distribution might be seen as disadvantageous to lenders. After all, they are ceding the customer relationship to a third party. But lenders do benefit from the role brokers play in several respects. Firstly, lenders can turn the tap of mortgage applications on and off more quickly via brokers. So for example, a lender can achieve a certain target level of new lending by going into the broker market with an attractive offer until a sufficient pipeline of new business has built up and then step back.

In contrast, lenders have found that their own branch networks are less responsive to price changes. Indeed, bank or building society branch networks have proven relatively expensive distribution channels with comparatively low sales per branch on average.

Second, brokers undertake pre-screening of applications – they will usually have a good knowledge of which customers are likely to be successful with which lenders. This potentially saves both the customer and the lender time by relieving lenders of applications that they would not approve.

Thirdly, brokers can specialise in advising clients with unusual circumstances or in niche product categories. It is no surprise that niche mortgage products tend to have higher rates of broker distribution given the ability of brokers to provide specialised advice.

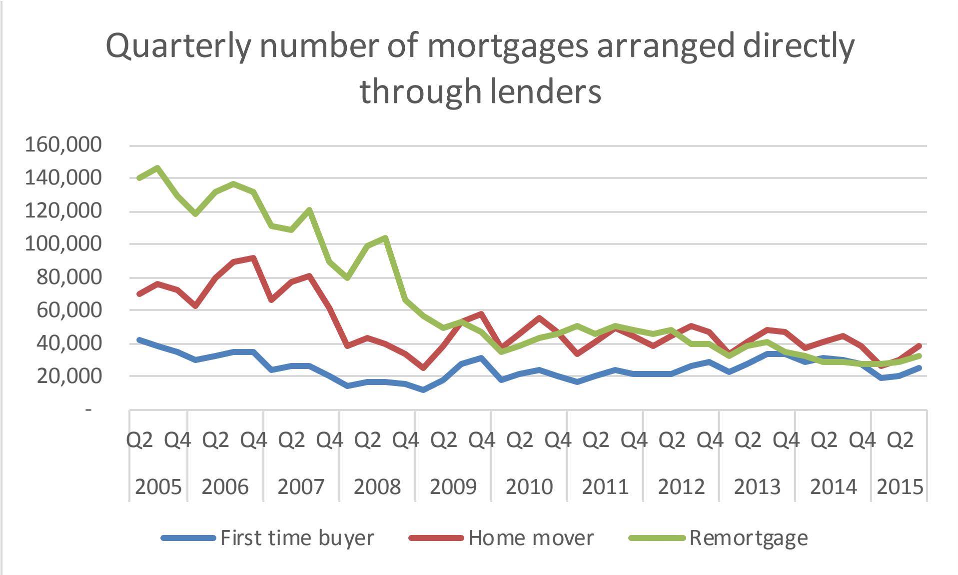
Finally, the MMR has bolstered the case for lenders to look favourably on broker distribution. For a procuration fee averaging around 40bp (0.4%) the broker takes on the compliance risk associated with making an advised mortgage sale. And the cost of retraining staff to provide advice has encouraged many lenders to de-emphasise direct sales. In consequence, some lenders find the combination of cost and risk associated with providing advice to mortgage applicants under the MMR unattractive.

Recent lender decisions seem to confirm that the role of broker distribution is becoming more entrenched. Firstly, HSBC has started selling mortgages through intermediaries for the first time. And secondly, an increasing number of lenders have followed brands such as Halifax and Woolwich in paying brokers procuration fees for product transfers i.e. when a customer asks a broker to advise on a remortgage and the broker concludes that the best deal would be a switch to another product with the customer's existing lender, that switch would trigger a procuration fee payment to the broker. So the outlook may well be for brokers to take a still higher share of distribution.

1.4 Developments in lender direct distribution

Lenders' share of distribution by value is the residual of the intermediary share shown in Chart 1. Chart 3 shows the corresponding number of mortgages arranged directly through lenders, again broken down by first time buyer, home mover and remortgage. While in aggregate between 2006 and 2014 the fall in direct distribution was greater – a 59% fall versus a 54% one for intermediary arranged loans, at a disaggregated level an interesting pattern emerges.

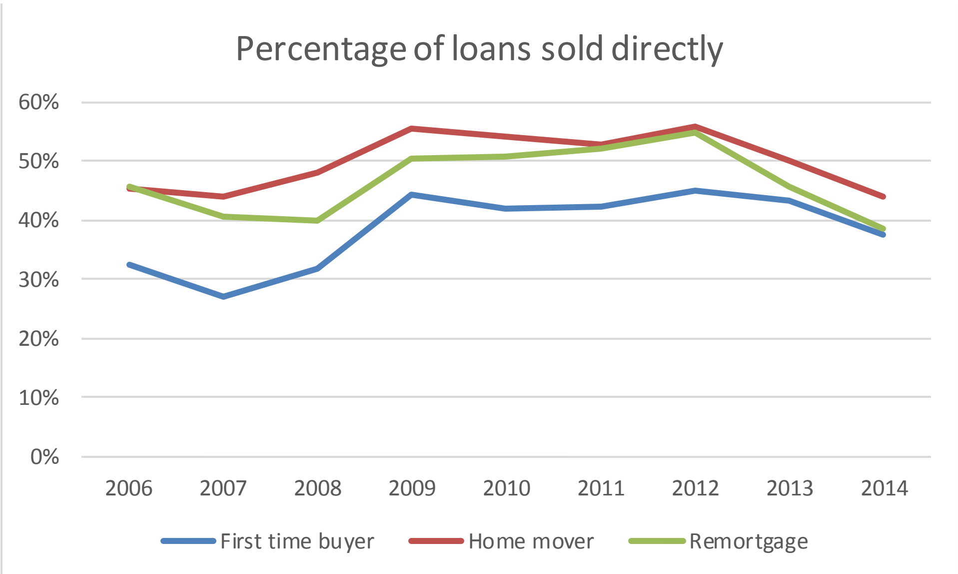
Chart 3



Source: CML

As Chart 4 shows, while lenders ceded share of distribution to intermediaries between 2006 and 2014 in the remortgage market and for home movers, they increased it from 32% to 37% for first-time buyers. So while direct mortgage sales to home movers halved from 322,000 in 2006 to 161,000 in 2014 and remortgages slumped from 518,000 in 2006 to 117,000, direct sales to first time buyers fell much more modestly from 130,000 to 117,000 over the same period. To what extent this reflects increased lender marketing aimed at this segment is hard to judge. Certainly, some lenders have done more to encourage current account customers to come to them for a mortgage.

Chart 4



Source: CML

Section 2 - The structure of the intermediary sector

2.1 Regulation driven structure

Although there are a few larger intermediaries, such as John Charcol or London & Country, the UK mortgage broking business is dominated by small firms serving a local client base. According to data from the Financial Adviser Confidence Tracking Index in September 2015[1] 69% of broking firms employed only 1 or 2 mortgage advisers with another 20% employing 3 to 5.

Regulation has come to define three key categories of mortgage intermediary that all firms fall into:

- **Directly authorised** firms, which currently account for around 50% of intermediated mortgage business;
- **Appointed representatives**, who are authorised through mortgage 'networks' and provide 45% of intermediated mortgages and;
- **Non authorised firms**, who account for only 4% of intermediated mortgage business, and deal exclusively in non-regulated (commercial buy-to-let) mortgage loans.

Directly authorised (DA) firms are independent operations that are authorised to conduct broking business by the FCA. They must meet all regulatory requirements themselves, which can be quite a heavy burden for smaller firms, but they have the freedom to operate the business without reference to the requirements and the cost of a network.

Appointed representatives (ARs) are members of mortgage networks, with the network acting as a regulatory umbrella as well as providing a range of central administrative services. The networks deal with lenders, submitting mortgage applications aggregated from their ARs. As networks typically provide much larger volumes of business to lenders than most DAs, they have the power to negotiate exclusive mortgage offers, which most DAs do not, although mortgage clubs have similar market clout (see below). This adds to the attraction of becoming an AR. Some lenders also have a preference for dealing with networks as it limits the number of intermediaries they have to transact with to deliver a given volume of business.

The issues that a mortgage broker typically needs to consider when becoming the AR of a network include:

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[1] Prepared for Paragon Mortgages by O M Carey Jones

- How financially secure is the network;
- How efficient is its administration and how strong is its compliance regime;
- How strong is its relationship with the lenders;
- Is the network independent, having access to the widest possible range of lenders, or does it deal only with a panel of selected lenders;
- Does it cover all segments of the market that the broker wishes to work in including niches like second charge and lifetime mortgages;
- How much and in what way does the network charge ARs.

Mortgage clubs

A mortgage club is a looser arrangement which is free for brokers to join and open to any authorised intermediary. The largest is Legal & General Mortgage Club with around 31% of the intermediary mortgage market but larger clubs include TMA and Pink. Mortgage clubs do not provide compliance but fulfil the role of an aggregator, negotiating attractive exclusive product offerings with lenders.

Mortgage packagers

Another term that is often used in mortgage distribution is ‘packager’. A packager is a business that packages mortgage applications for mortgage lenders where the application originated from a mortgage broker. They are middlemen sitting between the mortgage broker and the lender. Their value in the chain is that they can be an efficient route to market for lenders, particularly smaller specialist lenders, and can assist smaller brokers access a wider range of products from a larger group of lenders. They were particularly powerful in the sub-prime market prior to the financial crisis. A packager need not be a network or club but includes these categories of ‘middlemen’.

2.2 The changing shape of the intermediary market

Mortgage networks grew their share of the market prior to the financial crisis and saw a sharp increase in its immediate aftermath. However, more recently network’s share of the intermediary market has slipped and some networks have gone under or faced serious setbacks. For example, there have been some high profile fines handed down by the FCA to networks for breaches of its rules. This may have dented some brokers’ confidence in the concept of the network.

Table 1 – Regulatory status of mortgage intermediaries

Status	Dec-14	Mar-15	Jun-15	Sep-15
Directly authorised	52.4%	46.5%	51.3%	50.5%
Appointed representative	44.7%	50.5%	46.2%	45.4%
Not authorised	2.9%	3.0%	2.6%	4.1%

Source: Financial Adviser Confidence Tracking Index September 2015 – Prepared for Paragon Mortgages by O M Carey Jones

The Financial Adviser Confidence Tracking Index shows that the proportion of respondents stating that they are directly authorised increased from 46.5% in March to 50.5% in September this year, with a corresponding reduction in ARs (see Table 1). Numbers from Which Network support this finding, showing that the number of ARs fell a fifth to 5,600 this year compared to 6,981 last year. Moreover, the trend of brokers converting from being ARs to DAs could be set to continue. A poll of mortgage brokers by Mortgage Solutions in 2014 found that 19% were actively planning to switch from being an AR to a DA.

The view that networks are having to change to meet the requirements of the new regulatory and market environment is supported by Legal & General's decision to adjust the relationship with its ARs. It has been working with them to help them transition either to DA or, if that proves unattractive to the broker, to join established networks such as MAB and Stonebridge, who continue to trade via the L&G Mortgage Club.

Section 3 - Impact of regulation on mortgage distribution

3.1 Statutory regulation

When statutory mortgage regulation was introduced in 2004, it set out the distinction between an advised and non-advised (or information only) sale. In a non-advised sale, the mortgage professional could provide the customer with information on different mortgage products but could not advise on which might be most suitable.

The then regulator, the Financial Services Authority (FSA) specified that a non-advised or information only sale was only suitable for someone who was certain of the mortgage they wanted, and only borrowers who had advised sales could seek redress at the Financial Ombudsman Service (FOS) regarding suitability.

The majority of lender sales were information only, in keeping with the situation under the CML's voluntary Mortgage Code which was in place from 1997 until 2004 and with previous practice, where the granting of a mortgage was not seen as a transaction requiring the provision of advice. But as mortgage products became more varied and the market more complex, the FSA came to feel that the provision of information and advice were blurring with many customers thinking they were getting advice when they were not.

3.2 The MMR

The MMR has tried to clarify the status of the mortgage sales process through the following changes:

- All interactive sales (e.g. face to face and telephone) must be advised, except where the customer is a mortgage professional or high net worth individual or a business borrower, where the execution-only optional is available.
- Execution-only is allowed for non-interactive sales (e.g. internet and postal).
- Every mortgage salesperson is required to hold a relevant mortgage qualification.
- Firms must act in the customer's best interests.

Regulation had already become a factor shaping mortgage distribution with the introduction of the Mortgage Code in 1997 and statutory regulation in 2004, because they established an explicit distinction between advised and non-advised sales. But the MMR may prove to have a greater impact on distribution because all mortgage professionals engaged in face-to-face meetings or telephone sales must now have the appropriate qualifications (known as level 3). Staff who were previously providing only information on mortgage products did not require this qualification so lenders have been faced with the need to invest in additional staff training. The FCA has also made it clear that the execution-only route is expected to be a niche, making the possibility of lenders focusing on execution-only as their main distribution channel problematic.

As a result of the additional cost of staff training and the fact that brokers take on the compliance risk when they make an advised mortgage sale, many lenders have scaled back their mortgage distribution capacity and some smaller lenders, including the Dudley Building Society, have decided not to provide advice at all. In short, some lenders find the combination of cost and risk associated with providing advice to mortgage applicants under the MMR unattractive.

With mortgage interviews increasing in length to as much as two hours because of the additional requirements of the MMR, a backlog of interviews arose at many lenders after implementation. This left customers having to wait up to around 5-6 weeks for an appointment with a branch based mortgage adviser. Faced with such hold-ups some customers have sought out a broker instead, and brokers have for the most part been able to provide an interview at much shorter notice.

Moreover, while there is little evidence that customers were unhappy taking a mortgage via the information only route, now that the overwhelming majority of customers using face-to-face meetings must receive advice, customers may become more alive to the fact that brokers can advise on the whole market while lenders will advise only on their own product range. With each interview taking up to two hours or so, a single interview with a broker looks attractive compared to the risk of two or more interviews with lenders if the customer's first application is rejected. All this could further entrench brokers' market position.

Section 4 - Impact of technology on mortgage distribution

4.1 Mortgage distribution at the back of the queue for the tech revolution

New technology has already had a profound impact on distribution in consumer financial services. Consumers have grown accustomed to buying a range of staple financial products such as car and home insurance, personal loans and credit cards through the internet and increasingly through price comparison websites.

However, to date a purely online offering has had a limited impact on the mortgage market. A large part of the explanation lies in the complexity of the mortgage as a product. Consumers must decide whether they prefer the certainty of a fixed rate or a discounted variable rate deal. They have to consider up-front fees, the level and length of any early repayment charges and whether the rate reverts to a SVR and if so whether this rate is competitive.

But choosing a mortgage does not end there. There is also the question of the most appropriate term and whether a borrower should opt for capital repayment, interest only or a mix of the two. Where the loan is linked to a purchase of a house (rather than being a refinancing), additional complexities come into play. For instance, a mortgage offer will be subject to a satisfactory valuation, with a down-valuation potentially affecting the interest rate band into which the loan will fall, as loan pricing usually varies according to loan-to-value (LTV) band.

However, with simpler mortgage transactions such as customers looking for a product transfer with their existing lender, a web based process has proven popular. For example, a reminder letter from a lender that a loan is coming to the end of its fixed rate period can prompt some customers to go through an online product switch.

But for house purchase loans and remortgages, although there are online offerings available on an ‘execution only’ basis (for customers who know exactly what product they want), the overwhelming majority of consumers still prefer to speak to a professional either face-to-face with a broker, through a lender’s branch or over the telephone.

4.2 Radical changes that may lie ahead

Some lenders seem convinced that technology will soon change the way mortgages are distributed and are now investing heavily to capitalise on these expected changes. Nationwide Building Society has taken a step to support the sales process by creating and using video links in branches (branded as ‘Nationwide Now’) to allow customers to undertake a mortgage interview without having to pre-arrange an appointment.

By contrast many brokers are too small to make substantial investments in technology. Some have not yet invested in simpler automated processes to provide alerts to customers approaching the end of their fixed rate or initial discounted period. So technological advancements might swing the balance back in favour of direct distribution, particularly where the customer is simply remortgaging.

Nationwide's initiative is designed to improve the efficiency of their existing mortgage professionals and improve the customer experience but not to remove the human element in the sales process. So it could be described more as evolution than revolution. However, with increasingly sophisticated artificial intelligence (AI) becoming available, it seems possible that the advice offered by a broker or lender could one day be replicated by machine, but delivered with greater consistency. Rather than sitting in a broker's office or bank branch answering questions, the customer could 'chat' online with an AI software package designed to ask all the necessary questions and then select the best available mortgage.

However, some commentators doubt that AI could replicate some of the 'softer' knowledge aspects that come into play in mortgage advice. For example, a good adviser will know which questions to ask to get a sense of the borrower's requirements and how they might change over time. This will give the adviser a sense of the risk the borrower should take and therefore for example whether a fixed or variable rate loan is more appropriate. A machine may also be more susceptible to being gamed or mislead, increasing the risk of fraudulent applications getting through.

The FCA has taken a positive approach to innovation and is undertaking a program examining firms' approach to so-called 'robo-advice'. Clearly, AI based technologies will have to conform to the regulatory framework and satisfy the FCA that they do not create a risk of greater consumer detriment. Just as driverless cars are unlikely to be unleashed on the roads until governments are sure of their safety so 'robo-advice' for mortgages is only likely to become reality once the FCA is entirely comfortable that it can deliver better outcomes for consumers.

One crucial question is, if AI does create the possibility of an automated advised sales process, will it underpin the shift to a whole of market model (via robo-brokers) or could it swing the advantage back towards direct lender distribution. While it may be too early to guess at the answer, the future shape of the industry could be profoundly affected by the outcome.

Section 5 - Conclusion

Changes in the structure of the mortgage lending industry over the past three decades have played to the strengths of intermediaries. The enormous choice of rates and products available in today's market coupled with the constant change in product offerings makes it difficult for most consumers to select the best product without the assistance of a professional with a view of the broader market. The shift towards advised sales brought in by the MMR has reinforced this trend.

This powerful position in mortgage distribution has given intermediaries considerable clout vis-à-vis lenders. This has been manifest in intermediaries' ability to offer exclusive mortgage deals and more recently in the decision of some lenders to pay procuration fees to brokers on product transfers and other lenders to cease direct mortgage sales.

Few commentators see the trend towards intermediaries reversing in the near term, as the array of mortgage offers and the speed with which they change shows no sign of decreasing. But in the longer term, technology could disrupt mortgage distribution as it has so many other areas of commerce.

It is possible that AI systems could be developed that replace the mortgage adviser, automatically selecting the optimal mortgage. Just how quickly we move to such automated advice, if indeed we ever do, is difficult to estimate. But, as well as depending on the speed of development of the technology, how soon automated advice is adopted will be influenced by the regulator, which has played an increasing role in setting the structure of mortgage distribution over recent years and looks set to continue to set the tone going forward.

With special thanks to John Heron of Paragon Mortgages and Ray Boulger of John Charcol for their input

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About IMLA

IMLA is the specialist trade body representing the interests of mortgage lenders who market their products through brokers, rather than solely direct or through a branch network. Its directors and members are drawn from the senior ranks of mainstream banks, building societies, 'challenger' banks and specialist lenders.

IMLA provides a unique opportunity for senior industry professionals to meet on a regular basis to discuss key current initiatives and contribute actively through IMLA and other industry forums.

IMLA was formed in 1988 as the Association of Mortgage Lenders and was instrumental in the creation of the Council of Mortgage Lenders (CML). It changed its name to IMLA in 1995. Subsequently IMLA helped bring the Association of Mortgage Intermediaries (AMI) into being and was instrumental in bringing the mortgage advisers qualification CeMAP to fruition. For more information, please visit www.imla.org.uk

About the author

Rob Thomas is a director of research at Instinctif Partners. He previously served as an economist at the Bank of England (1989-1994), a high profile analyst at the investment bank UBS (1994-2001) and as senior policy adviser to the Council of Mortgage Lenders (2005-12). He was also the project originator and manager at the European Mortgage Finance Agency project (2001-05) and created the blueprint for the government's NewBuy mortgage scheme.