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Harriett Baldwin MP
Chair
Treasury Select Committee
House of Commons
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12 April 2023

Our ref: 230322A

Dear Harriett,

Re: Competition in the retail banking market

Thank you for your letter of 21 March 2023. I welcome the opportunity to expand upon the discussion we had at the Committee hearing on 8 March.

While the FCA does not set prices in retail financial services markets, we do have a statutory objective to make sure markets operate with effective competition in the interests of consumers. We are closely monitoring how firms pass through rate changes and as I mentioned to the Committee we have recently expressed our concerns to firms regarding some practices we have observed[1].

The new Consumer Duty, which comes into effect for new and open products on 31 July, represents a step change in how we can ensure firms are focused on delivering good outcomes for consumers. The fair value requirement within that Duty means firms must understand the costs and benefits of their product to their target market and be able to assure themselves and us of the value that they offer to their customers. Through the discussions we have been having with firms ahead of the Consumer Duty, we have stressed our interest in how they have been moving mortgage rates and savings rates, the considerations they balance and the governance around decisions made. The Consumer Duty also challenges firms to tackle practices which make switching provider unnecessarily burdensome (such as sludge practices) and, in the context of savings rates, we would encourage consumers to actively consider switching should they be dissatisfied with the value they are getting from their current provider.

Please find below our response to the Committee's specific questions.

Q1: What recent work has the FCA done to ensure the UK savings market, with regard to easy access savings accounts in particular, is competitive and that banks are not relying on customer inertia to keep their savings rates low?

[1] Implementing the Consumer Duty in the Retail Banks and Building Societies sector – FCA. February 2023

We have been monitoring the speed and extent of firms' pass-through to their savings products following increases in the base rate. We have challenged and sought further information from some outlier firms that had made relatively small increases to their variable rate savings products in 2022 and where we saw a material time lag in pass through to savings products relative to mortgages.

Alongside this we are improving our data collection to further deepen our understanding of the savings market. We will use this data to explore issues with individual firms, for example their efforts to identify and engage customers who might benefit from moving their deposits into higher-rate accounts, and how the impact and effectiveness of this has been monitored and tracked.

The rates firms offer are essentially commercial decisions. Pricing helps firms manage demand and some may want to limit their growth in a particular market to help manage operational capacity and / or meet the needs of their own corporate strategy, for example in situations where they wish to reduce reliance on deposit funding. Pricing decisions are likely to balance factors including liquidity and prudential considerations as well as our existing principle that firms treat their customers fairly. From 31 July, when setting rates, firms must comply with the Consumer Duty including acting in good faith towards, and providing fair value to, all groups of savers.

We have made clear that firms should be able to justify and explain the rationale for the speed and degree to which they make changes to their various savings rates. This includes the extent to which such decisions have been subject to internal scrutiny that is consumer-focussed, and how promptly and transparently consumers are told about any changes.

In our assessment of firms' compliance with the Consumer Duty, we will review the fair value assessments firms have made of their savings products and follow up with any firm whose approach to pricing seems at risk of not providing fair value.

Q2 Are the reforms the FCA was proposing *[whereby all firms would set a Single Easy Access Rate across all easy access accounts]* no longer relevant; and if so, why?

We began consulting on a Single Easy Access Rate (SEAR) policy in January 2020 with the aim of addressing concerns about a potential 'loyalty penalty' in the cash savings market. The pandemic, and the historically low interest rate environment, caused us to stop this work in November the same year. We would note that the consultation never progressed past the preliminary phase.

Given rising interest rates and firms' performance on base rate pass-through we have considered whether we should restart this work. However, we believe the Consumer Duty gives us greater flexibility to react to market developments, rather than needing to introduce detailed and prescriptive rules. Unlike the SEAR proposal, the Consumer Duty is all encompassing and requires firms to review every product and assess how it performs against the outcomes, including fair value. It therefore goes further than the SEAR policy would have done and allows us more flexibility to intervene in response to identified harm. The Consumer Duty will also enable us to act faster (and target specific outlier firms) as compared to the time it would take to refresh evidence in relation to the SEAR and then re-consult on a remedy which would inevitably need a significant time period to implement, given the operational changes that would be required of firms.

We are open to revisiting SEAR-type measures or considering other more onerous interventions if we later conclude that potential 'loyalty penalty' harms that we identify have not been adequately mitigated.

Q3 How widespread does the FCA believe this practice *[of offering competitive interest rates to new savers while leaving existing savings account holders with historic lower rates]* is? What is the FCA doing to ensure that existing customers of banks are earning competitive rates on their savings?

It is, and has been, standard practice for firms to offer more attractive rates to new savers, while leaving existing savers earning less competitive rates. We saw evidence of this during our preliminary work on the SEAR proposals in 2020. We expect that the harm from this practice (and the loyalty penalty faced by longstanding customers) will have increased as the base rate has risen. The Consumer Duty's focus on the fairness of pricing for all groups of savers challenges this practice and will require a significant cultural shift from firms. We would acknowledge that some firms have already made adjustments.

Our recent letter (see Footnote 1) to retail banks and building societies on implementing and embedding the Consumer Duty made clear that firms should be able to explain and justify their pricing decisions. This includes being able to demonstrate that savers receive fair value throughout the product lifecycle, both during the introductory period and beyond. Firms will need to take appropriate action to prevent further harm where they identify groups of savers receiving poor value.

Under the Consumer Duty we also expect firms to consider:

- whether, if there is weak consumer engagement and low rates of switching, this is allowing or encouraging the firm to sustain poor value savings products over time;
- whether the communications and support provided by the firm to its savers are commensurate with the number and variety of its account offerings and helping customers make effective savings decisions (including potential switching among the firm's accounts), rather than confusing them or discouraging them from acting in their own interests;
- whether the firm's fees or penalties for early exit from term savings accounts are cost-reflective and not unreasonably discouraging or preventing savers from switching accounts or providers; and
- whether sufficient support is being provided by the firm to enable savers to move or exit their account easily if they choose.

Embedding the higher standards set through the Consumer Duty is a cornerstone of our strategy and this will drive our supervision strategies and prioritisation, with further resources planned to be allocated to this work in our 2023/24 Business Plan. Firms should not be seeking to exploit customer inertia. As I said at the hearing, the Consumer Duty leaves firms with no place to hide in this respect.

Q4 What market analysis has the FCA done to check whether banks are earning disproportionate profits through increasing the net interest rate margin and increasing rates on mortgages far quicker than rates on savings products?

We have previously considered the net interest margins of firms as part of our Strategic Review of Retail Banking Business Models, which reported in 2018 and 2022[2]. We know from this work that assessing whether increases in net interest rate margin and associated profits have been disproportionate is very complicated. But as the base rate rises, we would anticipate seeing firms

[2] Strategic review of retail banking business models. FCA. 2018 & 2022

increasing their net interest rate margin. The sustained low interest rate environment previously seen has compressed, by historical norms, the margin firms have been able to earn between mortgage and savings rates.[3]

The Consumer Duty will require firms to be able to justify and explain the rationale for the speed with, and degree to which, they make changes to their various savings rates.

Q5 Would the FCA expect a greater proportion of *[mortgage]* consumers to switch to a different provider in a competitive market? What work has the FCA done recently on competition in the mortgage market?

We investigated competition in the mortgage market through a market study[4] in 2018/19. This found that over three quarters of borrowers switched within 6 months of the end of an introductory deal. Since then, we have continued to monitor key features of competition in the market, including the level of switching. The level of switching has increased since the market study. Using 2016 data the market study estimated there were 800,000 consumers who did not switch when they would benefit from doing so. Analysing similar data from the second half of 2021[5] we more recently estimated this number had fallen significantly, to borrowers of around 370,000 mortgages. We continue to track the number of borrowers who are not switching when it would save them money.

The market study found that consumers are more likely to switch to a new product with their existing lender than to a new lender. Our analysis indicated the gains are comparable once switching costs are included. When we compared the overall savings for consumers switching internally to the overall savings for similar consumers switching externally, the average Annual Percentage Rate obtained by those who switched internally was only a few basis points higher after accounting for switching costs. The process of switching internally tends to be less complicated and less time-consuming for the borrower, when compared to switching provider. In addition, some lenders are currently offering lower rates to existing customers than they do to new borrowers.

At the most recent accountability session, I mentioned our work on the impact on consumers of increased costs where cheaper legacy deals are replaced with more expensive ones in a rising interest rate environment. We have now published this analysis[6]. We continue to engage industry on what more they can do to encourage mortgage borrowers to think about switching to a less

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[3] The Bank of England's Financial Stability Report, December 2022, noted the following. Major UK banks' capital positions have been supported by a rise in pre-provision profits relative to 2021, largely driven by expanding lending margins.

Banks' pre-provision profitability influences their ability to absorb losses as they arise, by supporting their capital positions over time. The major UK banks have earned year-to-date pre-provision profits of £41 billion, a 29% increase compared to the same period in 2021. Should pre-provision profitability continue to support banks' capital positions, then it should bolster their ability to supply credit, as well as offsetting impairments as they arise.

Banks' recent profitability reflects increases in their NII (net interest income). Banks earn NII by receiving higher interest on assets, such as loans, than they pay out on liabilities, such as deposits. Total NII earned by the banks is the product of the net interest margin (NIM) they earn on interest bearing assets, and the total volume of these assets the bank has available. The increase in NII has been driven primarily by higher policy and market interest rates, which have allowed banks to increase NIMs, as well as by strong lending growth. NIMs typically increase as interest rates rise since the interest banks pay on their liabilities (such as current account balances) is typically less sensitive to policy and market interest rates than the interest they receive on their assets.

[4] Mortgages Market Study. FCA 2018 & 2019
[5] Switching in the mortgage market- update. FCA. August 2022
[6] Mortgage borrowers and macroeconomic developments- research note. FCA. March 2023

costly option where that is available. Given cost of living pressures, it is important that borrowers consider their options early and switch if they can, where it meets their needs and circumstances and saves them money. Lenders and mortgage intermediaries should support customers to do this.

Q6 What additional mortgage forbearance measures does the FCA regard as necessary in response to the cost of living crisis? What are the risks to banks and customers from implementing those measures, and are the measures likely to be long-lasting?

Throughout the pandemic and during the cost of living challenges, the FCA has been proactive in working with firms to make sure they are actively considering approaches to consumers that may face payment difficulty. We welcome the steps that a large number of firms have undertaken. Firms already deploy a range of different tools and options to support customers. We regularly remind firms of our expectations and there is flexibility to offer borrowers support within our existing mortgage rules. Collectively this action confirms existing expectations rather than imposing new requirements, or introducing new risks, for firms. As is normal, in taking these steps we have worked closely with the Prudential Regulation Authority (PRA) to ensure we consider any new or increased risks for lenders.

In June 2022, we wrote[7] to 3,500 mortgage and consumer credit firms to remind them of our expectations. This includes treating all customers with an appropriate level of care and giving support that takes account of any characteristics of vulnerability. Borrowers in payment difficulty should receive appropriate forbearance that is in their interests and that takes account of their circumstances. Those in payment difficulty or struggling with debt should be made aware of, and helped to access, money guidance or free debt advice.

Our letter made clear our Tailored Support Guidance (TSG)[8], issued to address exceptional circumstances arising out of coronavirus, is also relevant for borrowers in financial difficulty due to other circumstances such as the rising cost of living. This provides further guidance on our expectations of firms when supporting borrowers, and providing tailored forbearance and debt help to those in financial difficulty. We plan to consult shortly on transposing relevant parts of this guidance into our Handbook to build out and give permanent effect to it. This will provide greater clarity on our expectations of firms when supporting borrowers at risk of, as well as those already in, payment difficulty.

We have also published Finalised Guidance[9] explaining the flexibility firms have when providing forbearance to those who need it, as well as the scope firms have to vary contract terms for other borrowers who want to reduce their monthly payments. This could include term extensions, switching the mortgage to an interest-only basis, or agreeing a reduced payment plan for a temporary period to allow a customer time to adjust to increased payments.

Collectively our actions confirm long-established principles regarding the fair treatment of borrowers, with possession proceedings a last resort. Our measures do not involve a fundamental change to the balance of risks and protections. Forbearance provides customers with time and support to adjust, get back on track and pay their mortgage in the long term. There are downsides to taking such support and deferring payments, including the risk that borrowers will need to pay more later and more overall. That is why our guidance is that firms offer forbearance tailored to individual needs.

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[7] The rising cost of living – acting now to support consumers. FCA. June 2022
[8] Finalised guidance: Mortgages and coronavirus: Tailored support guidance. FCA. March 2021
[9] FG23/2: Guidance for firms supporting existing mortgage borrowers impacted by rising living costs. FCA. March 2023

Borrowers should speak to their lender early if they are worried about making their payments. They should not wait until they have missed a payment. Simply speaking to a lender to discuss support options will never impact a borrower's credit file, and the sooner contact is made, the sooner borrowers can get the help they need. Firms must be clear about the implications of any support options they offer, including in terms of cost and impact on credit files.

It is important that credit files accurately reflect the degree of financial difficulty that a borrower faces. Such information is essential to ensuring lenders have an accurate picture of a borrower's financial circumstances and the credit risk they present. This supports responsible lending. Not recording evidence of credit impairment risks borrowers being able to take out further credit that they cannot afford and falling into, or deeper into, financial difficulty.

Regarding any new risks for firms, we are clear that there is no set amount of forbearance that a lender should provide. If a mortgage becomes unsustainable such that the customer cannot possibly get back on track there is a risk of poor outcomes for both consumers and firms from over-forbearance. For example, delays in exiting the market can lead to an increasing mortgage balance eroding equity in the property, particularly when property values may be falling. Therefore, what is appropriate will depend on a customer's specific individual circumstances, but a firm should only start repossession action if all reasonable attempts to resolve the position have failed. There were 1,248 mortgage accounts newly reported as possession cases in Q4 2023, and we would note that this repossession level remains significantly lower than in the years preceding the pandemic[10].

Our latest estimates of the number of mortgages that could, under certain conditions, be associated with 'financial stretch'[11] are set out in our recently published research note (see Footnote 6). The headline assessment is that by the end of June 2024, the number of mortgages with 'financial stretch' may increase to 356,000, with monthly payments rising by 50% or more for 67,000 of these mortgages, and a median rise of £340 for fixed term mortgages with 'financial stretch'. However, many mortgages (around 90%) that are exposed to interest rate rises before the end of June 2024 are not expected to become financially stretched.

Q7 What is the FCA's assessment of the risk that people with properties in areas of flood risk will no longer be able to re-mortgage their properties in the future?

Businesses, governments, regulators, financial service firms and individuals all have a part to play in tackling the climate crisis. Our environmental, social and governance (ESG) strategy[12] sets out our target outcomes and the actions we expect to take to deliver these. This includes working with both insurers and mortgage lenders to ensure that they have effective monitoring of climate and other risks[13].

Our supervision of mortgage lenders has not indicated concerns about the future eligibility of properties in areas of flood risk. But should the cost of buildings insurance significantly increase this will impact on mortgage affordability because it will reduce the income available to make mortgage payments.

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[10] Mortgage Lenders and Administrators Statistics: 2022 Q4 – Summary table 3. Bank of England/FCA. March 2023

[11] For this analysis 'financial stretch' is defined as a situation where the borrowing household faces monthly mortgage payments exceeding 30% of gross income

[12] A strategy for positive change: our ESG priorities. FCA. November 2021

[13] Bank of England report on climate-related risks and the regulatory capital frameworks. Bank of England. March 2023

Any extension of the operation of Flood Re beyond 2039 is a matter for government and the industry. Flood Re agreed several changes following its first Quinquennial Review[14] aimed at improving both its own resilience and that of properties affected by flood claims.

More generally, we have previously highlighted the mortgage sector's need to consider the impact of coastal erosion and flood risk on housing valuations[15]. The Basel Committee on Banking Supervision has raised concerns for households exposed to severe flood risk, since this can affect house prices. There is evidence of a decline in property values because of extreme weather events or chronic flooding. For example, prices for flooded areas in New York City dropped almost 20% after Hurricane Sandy, and 3 years later, homes in those areas were still valued at 10% lower than those in unflooded ones. Furthermore, the Bank of England has previously highlighted that around 10% of the value of mortgage exposures in England is on properties in flood-risk zones. Banks could face greater losses than anticipated if values of collateral are reduced. Our ongoing engagement with lenders and insurers will allow us to keep under review any risk to mortgage availability for properties in areas potentially more likely to be flood-affected.

Q8 What effect do you expect the Consumer Duty to have on how financial institutions sell and price their mortgage and savings products?

A key part of the Consumer Duty is that firms must be able to define, monitor, evidence and stand behind the outcomes their customers are experiencing. This monitoring must enable firms to identify where customers, or groups of customers, are experiencing poor outcomes. Where this is the case, firms must take appropriate action to rectify the situation. A firm's board should review and approve, at least annually, an assessment of whether the firm is delivering outcomes for its customers which are consistent with the Consumer Duty.

Once the Consumer Duty is in force in July, we will be able to identify and act against practices that do not deliver good outcomes for consumers more readily. As in all areas of the market, the Consumer Duty, and our supervision of it, will drive further improvements within the cash savings and mortgages markets through firms carrying out and delivering better product design, assessing fair value, sales practices, customer communications and support. We note that the executives from the four large UK banks that appeared before the Committee all confirmed that they would be in a position to meet the requirements of the Consumer Duty by the July deadline, and this is consistent with the information we are receiving from our supervisory interactions with the largest firms across sectors. We are appreciative of the substantial work undertaken by a large number of firms to ensure they are on track to implement the Consumer Duty.

Our answers to the first three of the Committee's questions address the importance of the Consumer Duty in the cash savings context. Our February 2023 letter on the Consumer Duty to retail banks and building societies (see Footnote 1) highlighted that lenders must be able to demonstrate that their mortgage products and pricing, including any associated fees and charges, provide fair value to customers in the identified target market. We also flagged that lenders should ensure that products do not have features which exploit customers by, for example, charging unjustifiably or unreasonably high fees or interest rates to groups such as those with a poor credit history, or older customers.

Our Guidance supporting the Duty[16] also explains that: "When considering whether a mortgage offers fair value, firms should consider the overall price of a mortgage including any initial discounted rate, fees and charges and the reversion rate applicable at the end of a fixed rate

[14] Regulation 27: Quinquennial Review report. Flood Re. July 2019
[15] Climate Change Adaptation Report. FCA. October 2021
[16] FG22/5: Final non-Handbook Guidance for firms on the Consumer Duty. FCA. July 2022

period. This does not require firms to move away from designing products that revert to a variable rate (such as an SVR), and fair value can still be delivered by an approach in which introductory rates are lower than the rates that borrowers later pay."

More broadly, the February 2023 letter also highlights other issues where we expect banks and building societies to act to deliver good outcomes. These include:

- providing appropriate support to customers in financial difficulty – in the present economic conditions, more customers will be seeking support, including reassurance, practical information, and advice about their financial position, and many of these customers will be in vulnerable circumstances;
- considering the needs of small and medium enterprise (SME) customers, where we consider there is scope to improve the fairness and consistency with which firms support those customers;
- ensuring the channels of support that firms offer meet the needs of their customers, for example when considering branch closures or other changes to service provision;
- simplifying and easing the complex and sometimes burdensome customer journeys around dealing with the accounts of deceased or incapacitated family or friends (or other similarly sensitive kinds of scenarios); and
- considering processes to freeze accounts or deal with alleged cases of fraud, to ensure appropriate levels of communication and support to customers and to avoid treating them unduly harshly.

I hope that the Committee find these responses helpful.

Yours sincerely,

Nikhil Rathi

Chief Executive