Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Switch and Save in the Irish Mortgage Market?

Kenneth Devine, Sarah Frost & Rory McElligott[1]

Economic Letter Series

Vol 2015, No. 8

Abstract

This letter examines the opportunities that exist for mortgage holders to switch between lenders. The sample of loans examined incorporates all mortgages for Principal Dwelling Homes (PDH) at the three Irish headquartered banks. We show that 21 per cent of loans studied have the potential to make savings. Despite this, switching activity is currently exceptionally low - this may be explained by a number of factors, primarily the non-financial costs of switching. Greater transparency surrounding mortgage products and the switching process would be welcome in the Irish mortgage market.

1 Introduction

Switching in the mortgage market can help improve pricing through the promotion of healthy competition between existing players in the marketplace and by attracting new entrants, who could quickly gain market share. It can also act to protect consumers, as banks that increase rates relative to the competition would lose mobile customers in a market with active switching. We examine who can save by switching mortgage, why certain borrowers cannot switch and the financial gains to be made by those who can. Our analysis uses a loan–by–loan dataset collected by the Central Bank of Ireland from the three Irish headquartered financial institutions and focuses on Principal Dwelling Homes (PDH) mortgages only. This includes 522,407 mortgages, or 69 per cent of total PDH mortgage accounts outstanding at end-Q1 2015. These loan level data include a wide variety of static variables about the borrower (e.g. income, marriage status) at origination and dynamic variables about the loan such as current outstanding amount, loan performance and current loan–to–value (LTV)[2]. For the purposes

[1]Corresponding authors: kenneth.devine@centralbank.ie, sarah.frost@centralbank.ie and rory.mcelligott@centralbank.ie. We thank Joe McNeill, Gabriel Fagan, Gerard O'Reilly, Reamonn Lydon, Jean Cassidy and attendees at an internal seminar for helpful comments. The views presented in this paper are those of the authors alone and do not represent the official views of the Central Bank of Ireland or the European System of Central Banks. Any remaining errors are our own.

[2]For more information, see McElligott & O'Brien (2013).

of this analysis we restrict the switching search to just floating rate products as the decision to fix mortgage rates is complex and determined by factors including borrowers' willingness to lock into long term arrangements. In addition, we do not include discounts on interest rates for bundling accounts with a given mortgage provider (e.g. also transferring a current account).

2 Who might Save from Switching?

Based on our analysis of over half a million mortgages, we estimate that 21 per cent of borrowers could save by switching. The basis for this figure is summarised in Figure 1 and the main steps of the analysis are as follows:

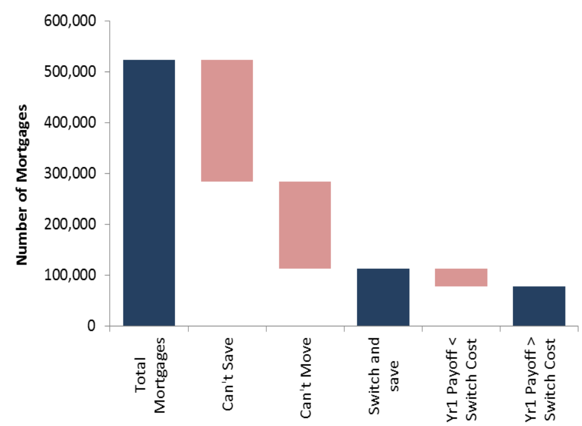
Step 1: For each mortgage in our sample, a search is conducted to find the product with the lowest interest rate available for a loan with similar characteristics (i.e. a product available to a switcher customer and for a corresponding LTV ratio).

Step 2: Where a cheaper product is available, the borrower undergoes an assessment of whether he can, in fact, switch. For the purpose of this analysis, mortgages are only eligible for switching if they satisfy all of the following conditions[3] :

- The current loan-to-value is less than 90 per cent
- The outstanding balance on mortgage is greater than €30,000
- The mortgage is currently performing
- The mortgage has been performing for the past 12-months
- The mortgage has not had any arrears balance in the last 12-months
- The mortgage is not locked into a fixed rate contract with the current lender beyond end-2015

Roughly half of borrowers cannot currently find a cheaper floating rate mortgage on the market (Figure 1). The overarching reason for this is the high prevalence of tracker mortgages in Ireland; these products were sold at margins which have proven to be unsustainably low[4].

Figure 1: Switching Process Results



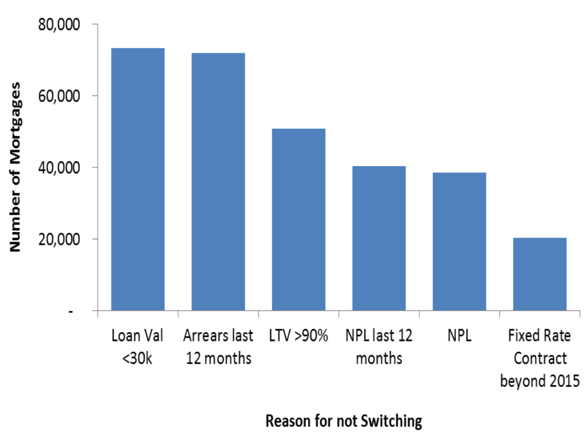
[3]In practice, the borrower would undergo a credit assessment with the new mortgage provider. However, the loan level dataset primarily contains information on borrower characteristics at the time of original loan drawdown so it is not possible to simulate a credit assessment based on the current borrower characteristics.

[4]We estimate that 92 per cent of borrowers who cannot find a cheaper mortgage are currently on tracker mortgages. The average interest rate on outstanding tracker mortgages in March 2015 was 1.05 per cent compared to the average new business LTV SVR rate of 4.13 per cent during Q1 2015 (CBI 2015).

The remaining borrowers include a cohort on zero interest rates but these are the warehoused component of split mortgages and borrowers where no alternative switching products exist for their current LTV ratio.

A large cohort of mortgages (33 per cent of sample total) could make savings from switching but are not in a position to switch for a variety of reasons highlighted in Figure 2. The main factors eliminating people from the switching process are small loan values[5] and the existence of an arrears balance on the account in the past 12 months. In any event, it is likely that the borrowers with small outstanding balances would not benefit substantially from a mortgage switch as the remaining life and interest costs are low.

Figure 2: Reason for not Switching



Note: The reasons for not switching are not mutually exclusive and some borrowers failed multiple tests.

3 Potential Savings for Switchers

We present the gross savings achievable across three dimensions[6]: (1) the 12-months after switching; (2) over the remaining lifetime of the loan[7]; and (3) discounted lifetime savings to take into account the impact of inflation and the risk factor of actually achieving the savings. In the first 12 months after switching, approximately 16,000 mortgages will save in excess of €1,000 (before switching costs) assuming the interest differential between the new and old lender remains the same (Figure 3). These borrowers typically pay high interest rates on their current contracts, have large outstanding balances and tend to have a longer time to maturity than other mortgages. The upfront financial costs faced by consumers when switching mortgages are primarily made up of legal fees which can amount to approximately €1,200 although the majority of lenders cover at least €1,000 of this and valuation fees of around €130. Therefore the net financial cost of switching can be as much as €300[8]. We estimate that 70 per cent of potential switchers would cover the net financial cost within one year of switching. The cumulative available savings across all mortgages in the 12 months after switching are €65 million[9].

[5] The average minimum new mortgage accepted by Irish banks for a switcher customer is approximately €30,000.

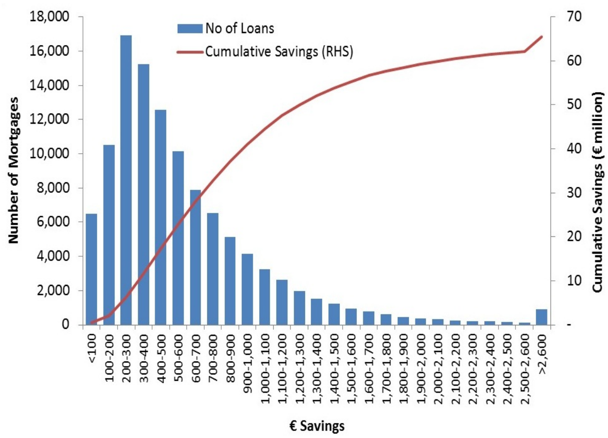
[6] Throughout Section 3 we deal only with those 111,627 loans who can switch and save, that means they can find a cheaper rate on the market and they meet the minimum switching criteria acceptable to the banks.

[7] To achieve these savings, it is assumed that the interest rate differential between the new and old lenders is maintained throughout the remaining life of the loan. This assumption is tested by including a risk factor discount on lifetime savings.

[8] See `http://www.mortgages.ie/go/remortgaging/about_remortgaging` for an overview of the financial costs involved in switching mortgages. However, there may be further hidden costs involved when considering a mortgage switch as the incentives may be clawed back by the bank if the mortgage is redeemed within a certain number of years.

[9] The total interest income loss to the three banks studied if all possible mortgages switched to another lender is €326 million in the first year (this is a gross figure,only accounting for switchers moving out of each bank). This represents 5 per cent of the 2014 interest income from loans and advances to customers of these three banks.

Figure 3: Gross Savings in the 12 months after Switching



In terms of total savings over the lifetime of the loan, 26,955 of switchers have the potential to save in excess of €10,000 (Figure 4). However, in reality people attach greater importance to savings made today compared to savings in the future. To account for people's time preferences and risks of actually achieving the savings, a range of discount factors are applied to future cash flows.

Figure 4: Gross Lifetime Savings(Undiscounted)

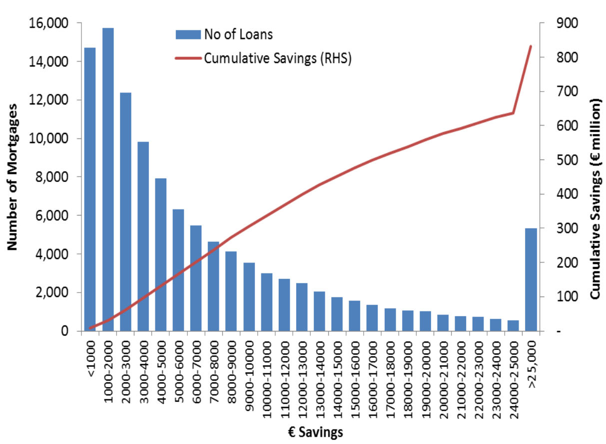


Figure 5 presents the impact of the discounted lifetime savings for a sample of 10,000 loans, using discount rates of 2 and 10 per cent per annum[10]. The number of borrowers that could save in excess of €10,000 falls to 19,446 when a 2 per cent discount factor is applied and 3,582 when a 10 per cent discount factor is applied.

Figure 5: Discounted Lifetime Savings

An undoubted risk associated with switching mortgage to another provider is the possibility that the decision turns out to be incorrect. For example, the new lender may increase rates and the expected lifetime savings do not materialise. It is extremely difficult for a borrower to predict the future pricing behaviour of a new lender. However, lessons may be learned by observing the past pricing behaviour of lenders.

[10]The 2 per cent discount factor is included to account for the effects of inflation. It is possible that these potential future savings may never actually be achieved due to a range of risk factors, some of which are investigated in further detail below. To account for unforeseen risks, a higher discount factor of 10 per cent is also presented.

We construct a transition matrix showing the probability of a low (or high) rate lender remaining a low (or high) rate lender at some date in the future (Figure 6)[11]. From this information, it is possible to construct the probability that low or high rate lenders will remain so in future periods. For example, historical observation would indicate that if the current status of a lender is low rate, there is a 50 per cent chance that the lender will still be classified as low rate in 3 years time. Conversely, a borrower may currently be with a high rate lender, and waiting to see how interest rates develop (i.e. to see if the lender will become low rate). Based on historical experience, the balance of probability is that the high rate lender will be either average or high rate (75 per cent probability) in 3 years' time.

4 Why do we not observe lots of switching?

There is little evidence that those who could benefit financially from switching are actively seeking to switch. Switching activity is extremely low. Among the 5 main banks who account for a 90 per cent share of the Irish mortgage market, the number of incoming switchers per month since January 2014 averaged just 38 out of an approximate 684,000 mortgages. So why don't more mortgage holders switch? One possible explanation is that the existing bank may match the best offer available to the customer and thus eliminate the need to switch. The data set does not provide details on this type of activity, however market intelligence indicates that this behaviour is at play in the market. Another potential explanation for the lack of switching activity in the Irish mortgage market may be the associated costs, both financial and non-financial, faced by those initiating a switch. The financial costs have already been shown to be relatively low and should not act as a deterrent to switching activity.

The non-financial costs related to the complexity of the process or a lack of understanding of the potential savings may be a larger constraint. Poor decisions are often made when it comes to mortgage choices - behavioural economic research offers some insights into the low switching activity in the Irish mortgage market. Possible reasons include:

Figure 6: Historical Lender Type Transition Matrix (Three year time horizon)

		Low Rate	Average Rate	High Rate	Exit market
Current Status	Low Rate	50%	25%	16%	9%
	Average Rate	22%	33%	40%	5%
	High Rate	19%	43%	32%	7%

[11] This is conceptually very similar to the widely used bond rating transition matrix constructed by rating agencies. This transition matrix is informed by a dataset of the interest rate charged by all mortgage providers active in the market at all times since 1998. At each time period, lenders are split into three categories: high rate (interest rate greater than the 66th percentile in the rates distribution); average rate (rate less than the 66th percentile but greater than the 33rd); or low rate (rate less than the 33rd percentile).

- As potential switchers often struggle to absorb the complexity of information relating to mortgage options they replace in-depth analysis with biased techniques and rules of thumb such as sticking with the status quo (Samuelson & Zeckhauser, 1988).

- Borrowers may defer switching because they believe it is important and warrants additional time and effort, which is not immediately available. This behaviour, known as naïve procrastination, leads to a continuous deferral of action with the result that mortgage switching may never occur (O'Donoghue & Rabin, 1998).

- Lack of consistency in time preferences for savings now and in the future. Borrowers place a disproportionate weight on immediate savings (Gathergood & Weber, 2015).

- If borrowers believe there is little differentiation between mortgages then they will make little effort to search and compare products.

There is significant evidence that consumers have difficulty in evaluating the difference between alternative financial products (Woodward 2003), and these difficulties are likely to be prevalent for mortgages. In this context, greater transparency in the rules applying to mortgage terms and conditions might be justified to reduce search costs (Schwartz & Wilde, 1979). Specifically, being clear and upfront about pricing, savings and potential fluctuations in rates would ensure that consumers are better equipped to make a choice that is suitable for their needs. Bucks & Pence (2008) have also shown that variable rate mortgage holders are more likely to underestimate, or even be unaware of, the potential for variation in mortgage rates. Finally, Anderson et al. (2015), show that failure to refinance in Denmark is related to demographic factors, with younger, better educated and higher income households being more active in refinancing decisions.

5 Conclusions

This letter has examined the potential for switching in the Irish mortgage market. The analysis shows that roughly half of mortgage holders will not benefit from switching, primarily because they hold tracker products. The rates payable by this cohort of mortgage holders are also below any rates likely to be offered by a new entrant to the mortgage market at any time in the future. While the remaining mortgage holders can identify a better rate on the market for their given LTV, only 39 per cent of this group are likely to be successful in the switching process once the new lender criteria are applied. Nevertheless, there are substantial savings available to a significant cohort of borrowers, and yet switching activity to date has been extremely low. Research from behavioural economics indicates that this may be due to the complexity of information and the inability of mortgage holders to differentiate between products. In this regard, increased information and greater transparency on mortgage products and switching options would be beneficial. The potential savings available to switchers may present opportunities for new entrants to the Irish mortgage market, particularly as variable rates charged in Ireland remain above euro area averages. The current low levels of switching would suggest that an intensive information and marketing strategy may be required to convince mortgage holders of the potential savings to be made.

References

[1] Anderson, S., J.Y. Campbell, M.K. Nielson & T. Ramadorai (2015) "Inattention and Inertia in Household Finance: Evidence from the Danish Mortgage Market".

[2] Bucks, B. & K. Pence. (2008) "Do borrowers know their mortgage terms?" Journal of Urban Economics 64.2 218-233.

[3] CBI (2015), Retail Interest Rates, Central Bank of Ireland.

[4] Gathergood, J. & J. Weber, (2015) "Financial Literacy, Present Bias and Alternative Mortgage Products".Cedex Discussion Paper .

[5] McElligott, R. & M. O'Brien, (2013) "The evolution of loan level data in Ireland." Session A: Central Credit Registers I 20: 18.

[6] O'Donoghue, T. & M. Rabin, (1998) "Procrastination in preparing for retirement." University of California-Berkeley Working Paper.

[7] Samuelson, W. & R. Zeckhauser, (1988) "Status quo bias in decision making". Journal of Risk and Uncertainty, 1(1), 7-59.

[8] Schwartz, A. & L.L. Wilde, (1979) "Intervening in markets on the basis of imperfect information: A legal and economic analysis". University of Pennsylvania Law Review, 630-682.

[9] Woodward, S. E. (2003) "Consumer Confusion in the Mortgage Market".