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European mortgage distribution

Changing channel choices

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Foreword

The European residential mortgage market is an essential driver of the economy, supporting the home-ownership aspirations of European citizens. Today the European mortgage market is comprised of over €5 trillion of outstanding loans with over €1.3 trillion of new loans advanced in 2005[1].

European mortgage distribution is an area where broad changes have occurred over the past ten years and where many markets are undergoing significant change as we write. As well as the growth of remote and intermediary channels in many European countries, improvements in technology and consumer sophistication have allowed providers to adopt very different approaches to sales, retention and pricing than they have done in the past.

Given this climate of change, we wanted a greater level of information about the market and how participants and customers perceive mortgage distribution. We therefore commissioned Mercer Oliver Wyman to undertake a substantive piece of research into the issues relating to mortgage distribution across Europe. Our goal was to present a comprehensive picture of the market today, how it is changing and how financial institutions involved in the mortgage industry can best adapt to the new landscape.

We are delighted to present this report describing the findings of this new research.

Patrick Desmarès
Secretary General – EFMA

Jos Clijsters
CEO Retail Banking
Member of the Fortis Executive Committee

1 Source: EMF Hypostat 2005

Contents

1 Summary

Explaining European mortgage distribution

European mortgage volumes have grown massively in the past ten years, fuelled by growing house prices, low interest rates, increased availability of mortgage credit and a broadening range of mortgage products and solutions. This growth has attracted new entrants in most European markets who compete directly with incumbent lenders, often the major banks within each country. Via primary research and analysis of 13 European markets, we reach two significant conclusions:

- **The traditional bank branch is losing ground:** Alternative distribution channels to the traditional bank branch have gained significant share in some of the European markets. Third-party distribution, either via mortgage introducers or brokers, is a large part of mortgage distribution accounting for over 40% of lending (over €500 billion pa) in the countries surveyed. Secondly, remote distribution (phone and Internet) has also established a small share of initial applications, particularly among more sophisticated customers
- **Mortgage distribution mix is heavily skewed across Europe:** Large differences in distribution channel mix can be observed across Europe. In the most developed intermediary mortgage markets – such as the UK and the Netherlands – more than 60% of mortgages are now distributed through indirect channels

The main drivers of differences in product mix at a national level can be explained by four main factors:

- Competition and market structure
- Product complexity
- Branch density
- Financial sophistication

Looking forward, we see indirect and remote distribution continuing to grow as European markets develop in terms of product choice, customer awareness of indirect channel and remote channel propositions, and technological sophistication allowing online search and intermediary wholesaler models to further develop.

In terms of policy and regulation, the growth of the intermediary channel provides new challenges for regulators, since only the more developed intermediary markets (e.g. the UK, the Netherlands) are currently directly regulated. The 'one service contract' represented by the old world of direct lender-consumer relations only requires a simple consumer protection framework, as reflected in most current European legislation. However, as the number of service contracts and different pricing models increases with intermediary involvement, and disintermediation in general, a case for more sophisticated consumer protection regulation can be made.

However, we see some specific limitations. Most importantly, after reviewing business models and existing regulations, we see little choice for regulators but to accept some degree of dependency of intermediaries, i.e. define a 'still acceptable' market structure rather than aim for maximum independence and transparency. This is, in short, the rationale of the wholesaler model of intermediation, which dominates in Europe and produces offers from between 10 to 30 lenders, i.e. far below total market transparency in most markets, but large enough to provide consumers with a significantly greater choice than the bank distribution model.

Implications for lenders

Mortgage lenders are therefore faced with serious challenges in addressing the different distribution channels:

- **Optimising branch distribution**

  It is no longer the case that banks can rely on the majority of their customers to come to them only for their mortgage. In all countries surveyed by us, over 50% of customers took offers from providers other than their 'house bank', with over half of these customers switching to a new provider as a result of this broader search. While banks still have an inherent advantage from their customer relationships as the first port-of-call, we see this benefit eroding over time for the remaining 25-50% of customers. Furthermore, banks are increasingly demanding more from their branches in terms of sourcing mortgage leads and converting these to sales. To achieve this goal, banks must take a more disciplined approach to the management of their branch sales force, including resource allocation, incentives and sales processes and systems

- **Increasing cross-sell**

  The attractive economics of cross-sell arise from the fact that the customer is already buying a mortgage, providing improved convenience for the customer and typically lower price elasticity and costs for the distributor. Optimising the cross-sell model requires fast credit decision, process integration and effective sales training

- **Addressing the intermediary channel**

  Fewer than half of all lenders in our sample discriminate between intermediaries regarding their product offers or commissions. As intermediary markets become more competitive, this differentiator is likely to become more important in terms of getting a larger share of intermediary wallet (regulation permitting). A very high share of lenders provide intermediaries with education and IT support, suggesting that this is one of the main propositions provided to intermediaries across Europe and so a source of leverage for lenders. In addition, cross-sales incentivisation via third parties is notoriously difficult since intermediaries typically will provide choice of ancillary products to their customers. Lenders are faced with three main options to increase cross-sell realisation through the intermediary channel: intermediary incentives, customer incentives and standalone post-sales initiatives

- **Using remote channels in mortgage distribution**

  Remote channels are typically used by consumers for market research or initial information provision and capture purposes with less than 5% of mortgage purchasing currently on-line across Europe (albeit over 10% in some countries). While consumers commonly use the Internet and telephone to search for products, rates and deals as shown, the majority then make the actual mortgage application through a branch or intermediary. However, there is a small but increasing subset of financially sophisticated consumers who are willing to deal through remote channels for application as well as search. Although the use of remote channels further decreases the volume of mortgage business generated through the branch, many banks do not want to miss out on this customer segment as part of their multi-channel strategy. We see two successful models in remote channel mortgage distribution today:

  - Lead generation with face-to-face closure: combining the strengths of e-distribution and the need for face-to-face mortgage advice
  - Integrated fulfilment (low-cost solution) with pricing to drive volume

- **Managing relationships with existing customers**

  Retaining existing customers is important. Given the high costs of customer acquisition and the regular flow of profits from existing customers for mortgages held on balance sheet, keeping customers longer has always been an important driver of profitability. Our analysis shows that in all markets studied, over 30% of all existing customers will shop around for refinancing offers. Many lenders have therefore invested significantly to develop their understanding of how to retain the right customers. Leading mortgage players understand that three steps are critical in successful retention management strategies:

    - Understanding prepayment propensity
    - Information-based ‘test and learn’ retention initiatives
    - Incorporation of retention into business activities to incentivise retention while avoiding ‘customer churn’

- **Pricing**

  Better pricing between lenders and consumers provides greater leverage than lowering costs or increasing sales, is relatively easy to implement and will quickly take effect. Yet mortgage pricing remains relatively unsophisticated across Europe. Prices are set centrally based on aggregate costs and competitor comparisons, with little or no price differentiation by customer. To improve pricing, lenders need to have an integrated view of the role of pricing and a clear responsibility for pricing processes, supporting analytics around pricing choices and sales incentives, and performance metrics that take account of pricing

- **Cross-border distribution**

  Interestingly, despite only limited cross-border lending in Europe to date, the majority of our survey respondents are considering cross-border expansion and have a general preference for cross-border lending over acquisition with a green field entry strategy the least likely entry mechanism. We note that two organic cross-border expansion models have proven to be successful in Europe to date:

    - Transfer of a simple, typically low-cost business model
    - Niche market entry via distinct customer segments, markets or products

Third-party distribution can also play an important role in facilitating entry and, in particular, quick growth in a foreign market.

Conclusions

Changes in distribution mix and the emergence of new business models in mortgage distribution are causing lenders to re-think their distribution strategy across all channels and business practices. Mercer Oliver Wyman has developed a checklist for lenders to prioritise those issues and has identified six business models that can be successful in the future:

1. Branch-focussed lender
2. Scale originator
3. Direct lender
4. Giant all-channel lender
5. Branded distributor
6. B2B platform

The winners are those firms that have identified those areas where they can (and do) outperform their competitors, have aggressively driven performance improvements in that focussed part of the value chain and, in many cases, abandoned alternative distribution models to others. Those lenders that stick to the old branch model and merely dabble in other emerging channels will be out-competed by focussed distributors and will risk further erosion of their share of distribution and profits unless corrective action is taken.

2 Introduction

Context

European mortgage volumes have grown massively in the past ten years, fuelled by growing house prices, low interest rates, increased availability of mortgage credit and a broadening range of mortgage products and solutions. This growth has attracted new market entrants in most European markets who compete directly with incumbent lenders, often the major banks within each country. As growth begins to slow in the more mature mortgage markets, this heightened level of competition results in margin compression and increasing marketing investment by mortgage lenders.

At the same time, the branch is coming under serious threat from intermediaries and, to a lesser extent, direct channels as the major channel for mortgage distribution across Europe. Many of the developed mortgage markets have seen a large increase in the number of mortgages sold or introduced from intermediaries, in many cases directly competing with banks for customers and share of mind, putting further pressure on costs, margins and product lifetimes (e.g. customer loyalty). Secondly, a (currently small) subset of customers are increasingly willing to deal directly with the mortgage provider – either by phone or the Internet – further decreasing the volume of mortgage business generated through the branch. Coupled with this, the mortgage is increasingly used as a lead product from which to generate immediate cross-sales opportunities and a longer-term client relationship, all of which has been, until now, most successfully executed via the branch channel.

These factors have significantly increased the emphasis on distribution issues such as pricing, sales productivity, channel management and retention within Europe's mortgage lenders. Focussing on this key theme, the European Financial Management and Marketing Association (EFMA) and Fortis have commissioned Mercer Oliver Wyman, supported by financial services and policy specialist Hans-Joachim Dübel (Finpolconsult), to undertake a study looking into these issues. In particular, the study examines the current European mortgage distribution landscape, how this is changing across Europe's major mortgage markets and how lenders can respond to these changes in terms of targeting the growing channels and optimising branch operations to maximise their share of new business value.

Purpose of the study

The European mortgage distribution study has four main objectives:

1. To provide a comprehensive overview of the current European mortgage distribution landscape
2. To examine and describe the main drivers of mortgage distribution channel mix in order to explain differences between different European mortgage markets
3. To examine customer behaviour and experience and its impact on distribution channel mix
4. To discuss best practice mortgage distribution across Europe, focussing on key trends and emerging best practice amongst Europe's mortgage lenders

Approach

The study, which focusses on residential mortgage lending only, examines the following 13 European mortgage markets as representative of EU mortgage markets:

Belgium	Poland	Denmark
Spain	France	Sweden
Germany	Switzerland	Ireland
Turkey	Italy	United Kingdom
Netherlands		

We believe that a broad coverage has been achieved with this country selection – in 2005, the above-mentioned countries covered more than 95% of European outstanding balances.

In writing this study, we have tried to draw on the widest possible range of information sources, including published reports, academic research and our own primary research. This primary research consisted of a detailed questionnaire that has been completed by over 25 lenders in the 13 mortgage markets and interviews with over 20 participants in the mortgage market, including lenders, servicers and brokers. In addition, we have undertaken an online customer survey getting views from 2,500 customers across five markets (France, Germany, Spain, Sweden, and the UK) on attitudes to mortgage distribution – the findings from this survey are included throughout this study to provide additional context and support to the findings. The detailed results of this consumer survey are provided as a separate appendix to this report.

Data issues still provide a key constraint on the depth of analysis that can be undertaken and so shape the analysis that is presented[2]. Therefore, qualitative information obtained from interviews and market experience has been used to support the findings of the surveys.

Format of the study

The remainder of the study is divided into two sections and nine additional chapters as follows:

Chapter	Title	Content
Section I Explaining European mortgage distribution		
3	Mortgage distribution in Europe	Overview of the European mortgage distribution landscape
4	Explaining the mortgage distribution market	Analysis and discussion of the main drivers of distribution channel mix: market supply and consumer behaviour
5	Regulation and policy issues	Discussion of the main regulatory issues associated with mortgage distribution, the current regulatory landscape and an evaluation of the costs and benefits of the regulation of mortgage intermediation
Section II Implications for lenders		
6	Optimising branch distribution	Best practice in branch distribution, focussing on building customer relationships and improving sales productivity
7	Managing the intermediary channel	Overview of models which are most effective in managing the relationship with intermediaries, including service offerings and the management of intermediary compensation
8	Using remote channels in mortgage distribution	Optimising the use of remote channels either to generate leads (for face-to-face closure) or for direct sales purposes
9	Managing relationships with existing customers	Having the right tools and processes in place to realise the – widely recognised – economic value of customer retention and having the capability to broaden existing relationships
10	Pricing	Discussion of drivers of mortgage pricing and the optimisation of pricing at a product level
11	Cross-border distribution	Successful distribution models for entering new markets and obstacles/issues related to cross-border distribution
12	Conclusions – Winning models in mortgage distribution	Discussion of current (and future) winning models in mortgage distribution

2 For example, information on distribution cost structures is difficult to obtain in a detailed, consistent format and is therefore difficult to compare across countries

Section I.
Explaining European mortgage distribution

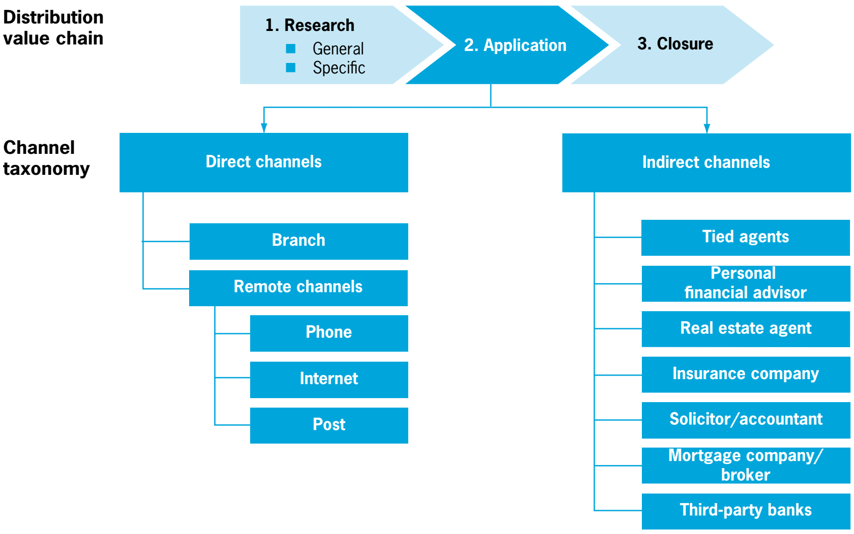
3 Mortgage distribution in Europe

Distribution channel taxonomy

Before providing a comprehensive overview of the European mortgage distribution landscape, we should discuss the different distribution channels that are available to consumers.

In a simplified distribution value chain, three typical steps can be distinguished: research, application and closure (see Figure 1). In this study, we focus on distribution by channel of application i.e. initial channel of contact for the purpose of applying for a mortgage, recognising that the research stage plays an essential role in the ultimate choice for a distribution channel.

Figure 1: Overview of different distribution channels



When applying for a mortgage, consumers have a choice between using direct and indirect distribution channels. They can apply directly to the lender – either through a branch or using remote channels such as phone or the Internet – or they can apply via a third party intermediary or formal introducer. Figure 1 provides an overview of these channel choices.

Although it is often presumed that indirect distribution channels (or intermediaries) provide choice between providers, a clear distinction should be made between tied and independent indirect distribution:

- **Tied:** Tied agents are advisors who are contractually or through other incentives permanently linked to one specific financial institution. As they only sell one company's mortgages – rather than advising independently on all products available in the market – they can also be viewed as a direct channel for the lender. The Spanish mortgage market provides an 'extreme' example of this classification issue: in Spain, many tied agents are operating under a branch franchise model of the large Spanish banks but are classified as 'indirect' under our classification
- **Independent:** Independent agents offer advice on mortgages of a number of different institutions
- A large range of agents can operate as indirect distributors (either tied or independent):
  - *Loan brokers* focus on mortgages/retail lending, often combined with insurance
  - *Personal financial advisors* provide financial advice to – typically – affluent customers; mortgages are typically side-product
  - *Real estate agents* often work together with real estate developers to provide mortgage advice to buyers of new property; oldest indirect channel, but fraught with conflicts of interest
  - *Insurance companies* sell mortgages due to the close link with life insurance products
  - *Banks* may decide to cease to produce loans or both distribute and produce depending on the product and/or customer segment
  - *Other agents* such as solicitors/accountants or mortgage companies

We shall see below that finding a metric for the independence of service is a hotly debated issue in many European markets.

One may also reasonably differentiate intermediaries by the type of service they provide to lenders on the one hand, and consumers on the other hand.

With regard to services for lenders, a traditional taxonomy distinguishes:

- **Introducers** who merely establish contact between the consumer and lender
- **Packagers** who provide lenders with additional support, e.g. ranging from customer application and documentation collection to full application processing

With regard to consumer services, it would be appropriate to distinguish between:

- **Advisors**, who focus on providing the consumer with an (individually) optimum choice for his product and lender selection problem
- **Wholesalers,** a class of intermediaries whose model consists of *pre-selecting* a range of different lenders in order to minimise rates while establishing a reasonably wide product choice for the typical, rather than an individual, consumer

Terminology necessarily varies in a relatively new market, and with swift changes we might see more categories of service appearing – for example most UK mortgage brokers provide some service to the lenders in the form of application completion and so are not pure 'introducers'. However, 'packagers' are typically defined as those intermediaries that provide significant extra services to the lender. Often intermediaries combine overlapping functions in their business models (e.g. wholesaler and packager).

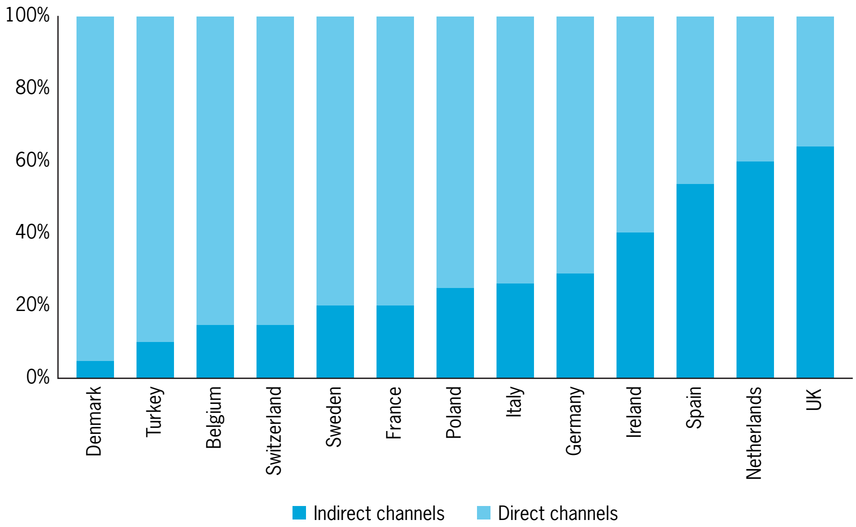
Comparing mortgage distribution across Europe

Figure 2 shows the distribution channel mix by country, split into direct and indirect channels. It can be observed that the channel mix across European countries shows very different patterns. In general, intermediaries have increased in importance and market share as mortgage markets have developed. However, this has happened with varying speed and intensity in different markets. Still, in only four countries (Ireland, Spain, the Netherlands and the UK), a share of more than one-third falls under indirect channels. The results for Spain should be interpreted carefully: in Spain, many tied agents operate under a franchise model of the large banks and while classified as indirect in our sample, operate in a very similar manner to bank branches and so could be argued to be more 'direct' in their model.

We notice two distinct trends in mortgage distribution across Europe. Firstly, indirect channels (in particular mortgage brokers) are increasing in share in most markets. In part as product complexity increases their value added, and in part as technology makes product search and selection and fulfilment easier for mortgage brokers. Indirect channels, as defined above, now account for over €500 billion of mortgage advances per year in the markets surveyed – over 40% of all mortgages. We expect that the trend towards mortgage intermediation will continue across Europe, and that by 2010 over 50% of mortgages in Europe will be distributed indirectly.

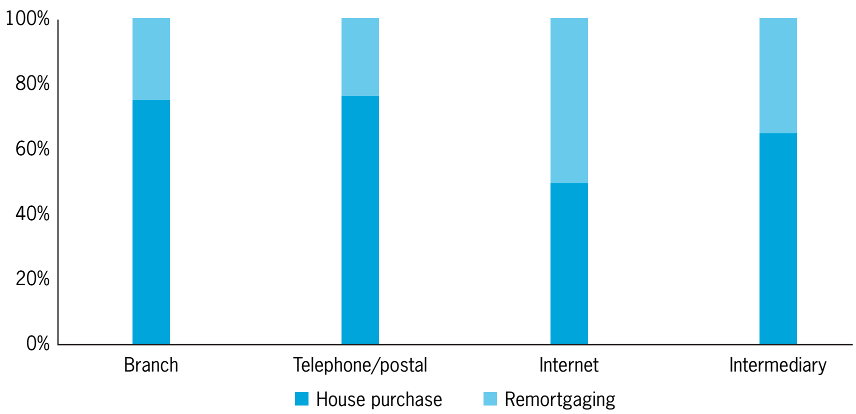
The second trend, which is less progressed at present, is towards greater use of remote channels, in particular the Internet, for mortgage activities such as product and information searches and increasingly initial application. This trend is a longer-term trend, and we expect little change from current levels (around 5% of all advances), but that this will rise to 10% by 2010 and over 20% of all advances by 2020.

Figure 2: Residential mortgage distribution mix between direct and indirect channels by country (2005)



Source: Mercer Oliver Wyman analysis based on lender survey responses, CML, Datamonitor, Consart and Mortgage Strategy

Figure 3: House purchase vs. remortgaging channel mix



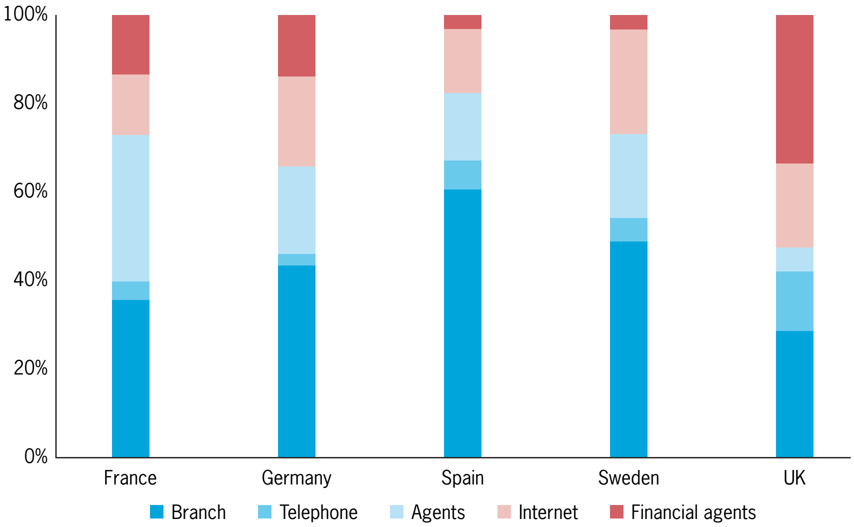
Source: Mercer Oliver Wyman analysis based on lender survey responses

If the channel distribution mix is further analysed regarding the motivation for the product purchase, a clear observation can be made (Figure 3). First-time buyers have a stronger need for advice and search for a personal contact point in the branch or on the telephone.

In contrast to that stands a significantly higher remortgage percentage through the Internet (and also slightly higher through intermediary channels), where customers very often already gathered knowledge about the technical details of the mortgage product – because they already went through the whole process – and are subsequently more focussed on searching for the best offer.

This position is broadly supported by our findings from an online survey of 2,500 customers in five European markets as shown in Figure 4 below.

Figure 4: Customer survey – Distribution channel mix by country



Source: Customer survey

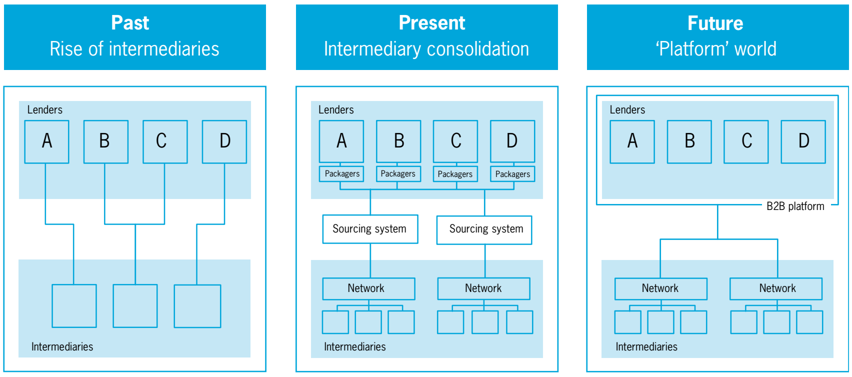
Here we see a bias towards Internet channels versus the lender survey where overall share of Internet business was under 5%. This possibly reflects a bias in the customer sample towards more Internet-aware customers. In our customer survey, the Internet accounted for 10% of applications in all markets and over 20% in Sweden.

Development of the intermediary market

We have noted above that the development of mortgage markets typically goes hand in hand with the expansion of the intermediary (indirect) channel. Looking at the differences in distribution channel mix across Europe, we can see two important phases in the development of the intermediary market – with a possible third, future state (also refer to Figure 5):

- **Past – Rise of the intermediaries:** In the early stages of the development of a mortgage market (e.g. Turkey and Poland), first intermediary parties (often family businesses, real estate agents or property developers) enter the scene – rapidly followed by additional intermediary players. The intermediary service offering is still unsophisticated, and many third parties are tied to an individual lender. The market may stay in this form for a while (e.g. Spain). In addition, intermediaries may be used to complement thin branch networks as a way of quickly expanding reach (e.g. Turkey)
- **Present – Intermediary consolidation:** As the mortgage market becomes more complex (increased number of lenders and product diversity), more and more dedicated and independent intermediaries are established, offering choice and transparency to consumers. This, in turn, drives the need for increased consumer protection regulation (to guarantee transparency and independence of advice) and technological advancement. Increased compliance and technology costs often lead intermediaries to join together, e.g. as partners in mortgage networks and clubs (or so-called 'inkoopcombinaties' in the Netherlands) or via takeovers. At the same time, the mortgage value chain is being unbundled with the emergence of service providers: intermediaries outsource certain parts of the mortgage process to packagers, and sourcing systems provide the technological interface between large groups of lenders and intermediaries. The UK and the Netherlands provide the best examples of such markets, with Germany developing these institutions very quickly

Figure 5: Development of the mortgage intermediary market



Characteristics

Past:

- Limited number of intermediaries rapid entry of new parties
- Many intermediaries tied to individual banks
- No or limited technological interface between parties

Present:

- Intermediaries organise themselves in network/clubs
- Increased number of independent agents
- Lenders outsource parts of the mortgage process
- Advanced sourcing systems provide matching role

Future:

- All value-added services along the mortgage value chain are integrated in one platform
- Providing a technology platform for all particpants

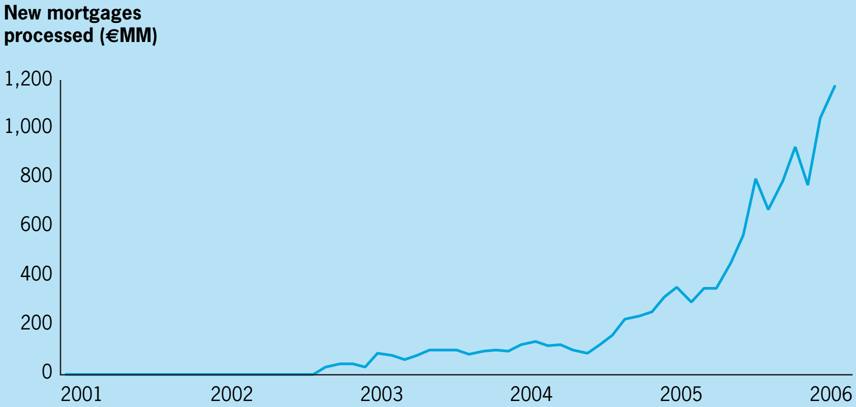
- **Future – 'Platform' world:** Although it remains to be seen what the future state of the intermediary market will be, some trends suggest that the market is moving towards a 'platform' world: the previously unbundled services along the value chain can be integrated into one large technology platform, facilitating all participants across the value chain. Furthermore, extra value-added services are offered which go beyond the traditional sourcing systems, such as securitisation and risk management (see also the 'Europace – A brave new 'platform' world' case study in Figure 5)

Europace – A brave new 'platform' world?

In the developed UK mortgage market, sourcing systems (or matching platforms) have boosted the rise of intermediaries. Sourcing systems, such as Mortgage Brain and Trigold, solve the implied coordination problem of large numbers by bringing lenders and intermediaries together under a unified matching technology. They search products offered by a group of lenders and allow intermediaries to send off completed application forms directly to lenders.

The recent growth of the German Europace platform (run by Hypoport AG) illustrates the emergence of 'next generation' sourcing systems. Since its creation in 2001, Europace has shown exponential growth in mortgage matching (see Figure 6) to currently c. 10% of the German mortgage market.

Figure 6: Europace mortgage processing



Source: Hypoport AG

Although Europace is still focussed on providing sourcing services, it takes the traditional sourcing systems several steps further by providing an extensive range of services to lenders, intermediaries, issuers and investors, e.g. securitisation, data management, pre-closing and customer relationship management.

The emergence of this 'platform' world could have some serious implications for the European mortgage distribution landscape, enabling:

- The (rapid) development of intermediaries in 'branch-heavy' countries through increased process standardisation
- Cross-border distribution by removing some of the barriers to foreign entry (e.g. the lack of access to information and the inability to realise scale benefits)

The final impact of the platform on the market remains to be seen: it will depend on how aggressively the platform model is transformed into a participant in the value-added chain and thus eventually into a competitor of its own users.

4 Explaining the distribution market

The previous chapter has provided a comprehensive overview of the European mortgage distribution landscape and can be summarised by two main observations:

- **The traditional bank branch is losing ground:** On the other hand, alternative distribution channels to the traditional bank branch have gained significant share in some of the European markets. Third-party distribution, either via mortgage introducers or brokers is a significant part of mortgage distribution (over 40% of new mortgages in the markets surveyed accounting for over €500 billion of loans per year) and remote distribution (phone and Internet) have also established a small but significant share of initial applications. The impact on lenders is felt particularly in those markets starting a catch-up process from moderate levels of intermediation, but showing high growth, e.g. France or Germany. However, even in markets with very low intermediary penetration, such as Belgium and Denmark, a trend towards indirect channel usage can be observed
- **Mortgage distribution mix is heavily skewed across Europe:** On the one hand, large differences in distribution channel mix can be observed across Europe. In mature mortgage markets – such as the UK and the Netherlands – more than 60% of mortgages are distributed through indirect channels. In other large mortgage markets, for example France and Germany, the share of intermediary business is only 20-30%. Some markets like Denmark, Turkey or Belgium still show high shares of direct channel usage. In Denmark and Belgium, this is mainly driven by a strong competitive position of the largest players in the market

What is driving these developments, and how can we explain the significant differences across Europe? Does this enable us to project future developments in mortgage distribution?

Transparency and choice

For financial products in general, but for mortgage products especially, advice is an essential element of the product 'package'. It plays an important role in the interaction between the two main forces on each end of the mortgage distribution process: consumers (demand) and their preferred mortgage distributor (supply).

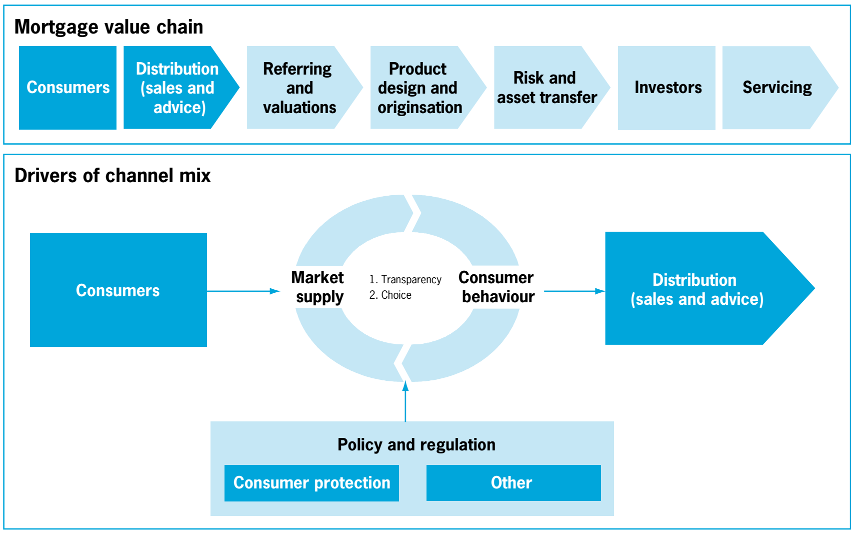
However, as seen in the previous chapter, advice is of particular value for first-time buyers due to high uncertainty and often very limited knowledge about product features, pricing, application procedures etc.

For remortgages, the customer is much better informed since he or she already ran through the process and was able to build knowledge (see Figure 3).

At the point where demand and supply meet, the customer decision to use a certain distribution channel is driven by two important factors: transparency and choice (closely linked with the independence of advice). The extent to which transparency and choice are available (and fully benefited from) depends on the development of specific supply and demand factors – often influenced by other external factors such as consumer protection regulation. Figure 7 provides a schematic overview.

For example, financially sophisticated consumers in a completely transparent market will know exactly which mortgage products are available, what the price is and where they can get it. They will not require any additional advice. However, in a complex market with many different players offering even more different products, consumers are more likely to struggle to choose and may look for independent advice, ideally providing them a comprehensive overview of the market. Alternatively, consumers in this environment may look to trusted brands (either lenders or intermediaries) to provide confidence in their product choice.

Figure 7: Drivers of mortgage distribution channel mix



To understand the drivers of distribution channel mix, we need to understand the main drivers of transparency and choice in the mortgage market – both from a supply and demand perspective:

- **Market supply factors** are pivotal in explaining distribution channel mix. Factors such as competition and product availability/complexity can impact distribution channel mix directly and indirectly by driving a large part of consumer behavioural factors
- **Consumer behaviour** is largely driven by market supply factors (What can the market offer me?), and financial sophistication (How much do I understand of the market offering?). In a complex market such as the mortgage market, increased financial sophistication drives increased consumer awareness and the desire to 'shop around' more extensively
- **Policy and regulation,** such as consumer protection regulation, can have additional impact on distribution mix, e.g. by forcing market transparency and increasing choice

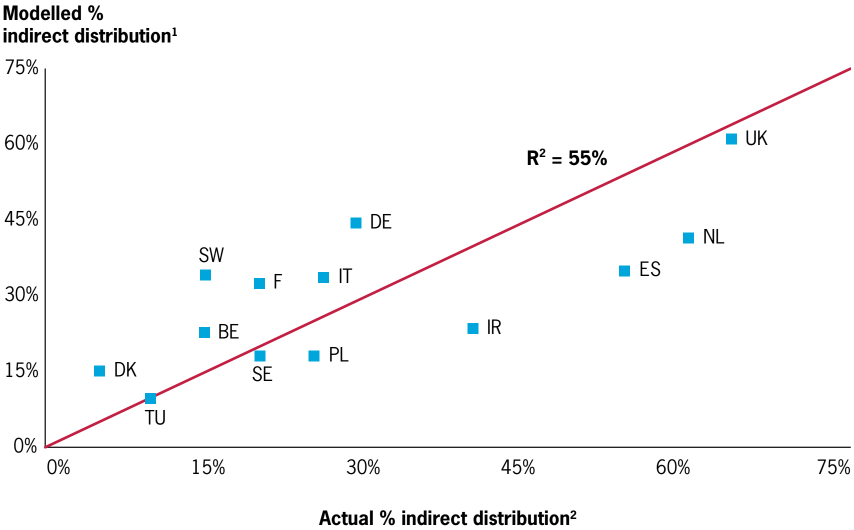
Using the framework described above, Mercer Oliver Wyman has developed a simple analytical model to explain the distribution mix in 13 European countries. The model aims to describe a relationship between mortgage distribution mix and a set of explanatory supply and demand factors. The model finds that four factors are significant in determining distribution mix, namely:

1. Competition and market structure
2. Product complexity
3. Branch density
4. Financial sophistication

The model has been tested on non-European countries (the US, Australia, and Canada) and is accurate within 10% share of total distribution for 70% of the countries in the model. Figure 8 below shows our estimates of the distribution mix in each country against the actual channel mix – illustrating the predictive power of the model.

In addition to these factors, we expect that other (non-modelled) factors will influence the level of indirect distribution, including policy and regulation, proportion of new builds and relative process efficiency of direct versus indirect distribution.

Figure 8: Actual and estimated distribution mix by country



1 Source: Mercer Oliver Wyman mortgage distribution model
2 Source: Mercer Oliver Wyman analysis based on lender survey responses, CML, Datamonitor, Consart, Mortgage Strategy

Two main conclusions can be drawn from the model estimates:

- The mortgage distribution model is generally a good predictor of channel mix. For 70% of the countries, the model is accurate within ~10% share of total distribution, indicating that the four identified factors are good predictors of distribution channel mix
- For some countries (e.g. Spain), the model appears to over– /under-estimate the share of indirect distribution, potentially indicating that other structural factors are impacting channel mix. In the case of Spain, the large share of tied (but indirect) distribution may explain the result

It is worth examining in more detail why the identified factors are significant drivers of mortgage distribution channel mix and – maybe even more interesting – why the distribution mix of several European countries appears hard to predict.

Market supply factors

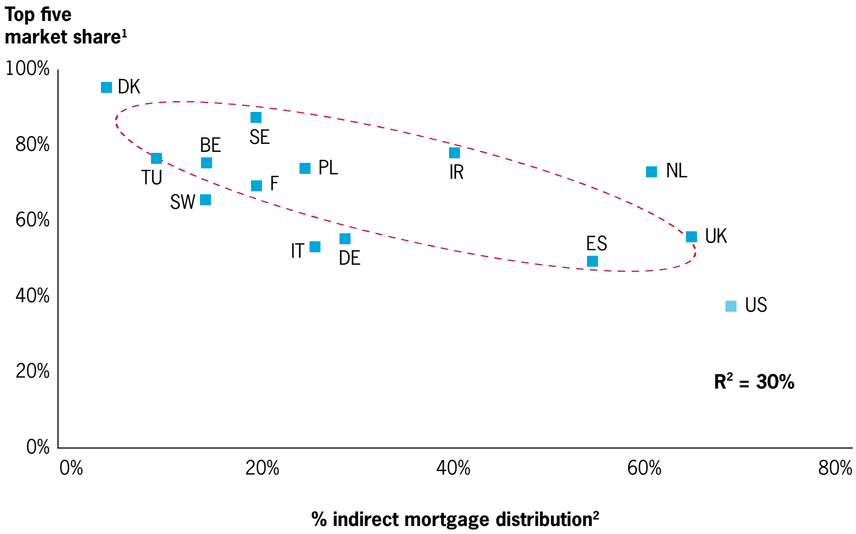
Competition

High levels of product competition – characterised by the product offering of many different players – will decrease market transparency but increase choice. These effects will increase the need for independent advice, moving consumers towards indirect distribution channels. We also note that competition via price alone in standardised markets can be intensified by the presence of intermediaries who improve price transparency to the consumer, thus enhancing the volume effect of price changes. This can be observed in many of the analysed markets: e.g. in Germany the growth of intermediaries like Interhyp and Dr. Klein, has intensified price competition, forcing lenders to attempt to differentiate by product, thus increasing product competition. We also note that product proliferation can sometimes impact customers to tend towards strong brands in order to bypass a long and time-consuming selection process.

A second driver of intermediary presence related to levels of competition is the existence of small or new lenders without a national footprint (either new entrants or local providers) who will use intermediaries to increase their reach. This form of competition is enabled by the presence of intermediaries and is also enhanced in more mature markets by the ability of the smaller entrants to pursue niche product strategies (e.g. UK lenders exporting products to Germany or the Netherlands).

Market concentration provides an indication of the level of competition as it indicates the extent to which leading lenders are able to dominate the market and thus avoid intense competition on product or price. The market share (based on mortgage outstandings) of the top five mortgage lenders in each country provides a good measure (see Figure 9).

Figure 9: Residential mortgage market concentration versus distribution mix



1 Source: EMF Hypostat, CML, Merrill Lynch, Datamonitor, Swiss National Bank, Bundesbank, Realkreditrådet, annual reports

2 Source: Mercer Oliver Wyman analysis based on lender survey responses, CML, Datamonitor, Consart, Mortgage Strategy

Interestingly, Figure 9 shows the large difference between two of the most sophisticated mortgage markets in Europe: the UK and Denmark. Denmark is highly concentrated (with the top four players holding virtually 100% of the market[3]), whereas the UK is not. A clear distinction between the share of indirect mortgage distribution in these two countries can be observed, with the share in the UK being significantly higher than in Denmark.

Figure 9 also shows that market concentration is negatively correlated with the share of indirect mortgage distribution, confirming the proposition stated before: heavy product competition in a mortgage market will increase opportunities for intermediaries, in part because the 'tail' of smaller lenders often use third-party distribution to grow volumes (with mixed success). In a highly competitive market, intermediaries are able to grow share by providing choice and transparency.

A final element of competition that we do not explicitly consider within our framework is around competition and appetite for mortgage assets. Over the last five years, demand for mortgage assets has greatly increased among investors and banks across all European markets. This, in turn, has increased demand (and competition) for mortgage origination, which encourages a broader channel search for mortgages. This has increasingly included accessing flow via third parties (even at higher cost) in part contributing to the growth in intermediary distribution in the UK, Germany, and the Netherlands, and to a lesser extent Ireland and France. The broker channel is typically the most price elastic channel from an originator perspective (i.e. volume can be increased fastest via changes in product price since broker reach is typically wider and price-based decisions more common), and so the increased demand for assets is reflected in a disproportionate flow to brokers.

Product complexity

Product complexity is another important driver of distribution channel mix. Partly driven by market competition, product complexity has a serious impact on market transparency and choice.

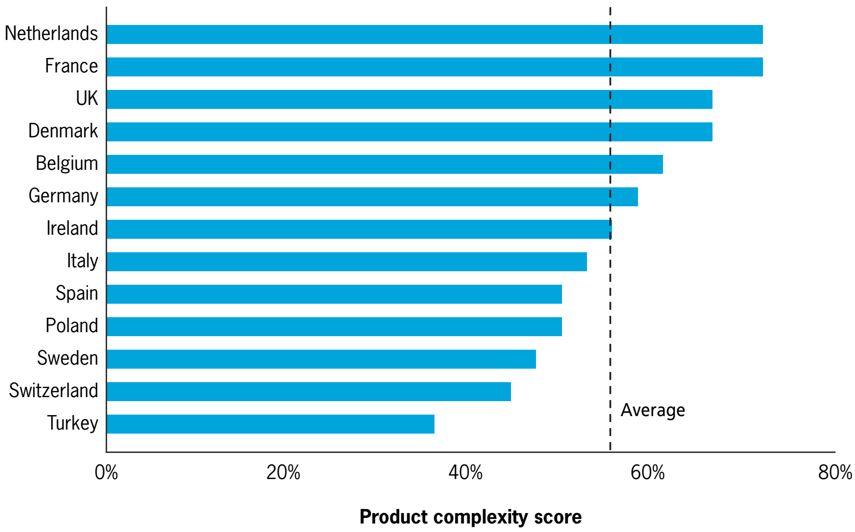
Based on three main factors, we have taken a scorecard approach to analyse product complexity in each country, similar to the approach taken in our 2003 Study on Financial Integration of European Mortgage Markets:

3 In Denmark, most mortgages up to 80% LTV are provided by licensed mortgage banks with lending above 80% offered by retail banks. We refer to the share of the top four mortgage banks of below 80% LTV loans in the statistic

- **Rate structure:** Availability of different types of variable and fixed rate structures
- **Repayment structure:** Existence of repayment structures such as amortising, interest only and flexible structures. The prevalence of fee free redemption and yield maintenance fee has also been accounted for
- **Price components:** Pervasiveness of complex fee structures (e.g. ongoing, servicing), pre-payment penalties and existence of product bundling

Figure 10 shows product complexity is especially high in the UK, Denmark, the Netherlands and France. In those countries, product variation is high shown by the (widespread) existence of long-term fixed rate mortgages (except for the UK), capped adjustable rate products, flexible repayment products and tax-advantaged structures.

Figure 10: Product complexity by country



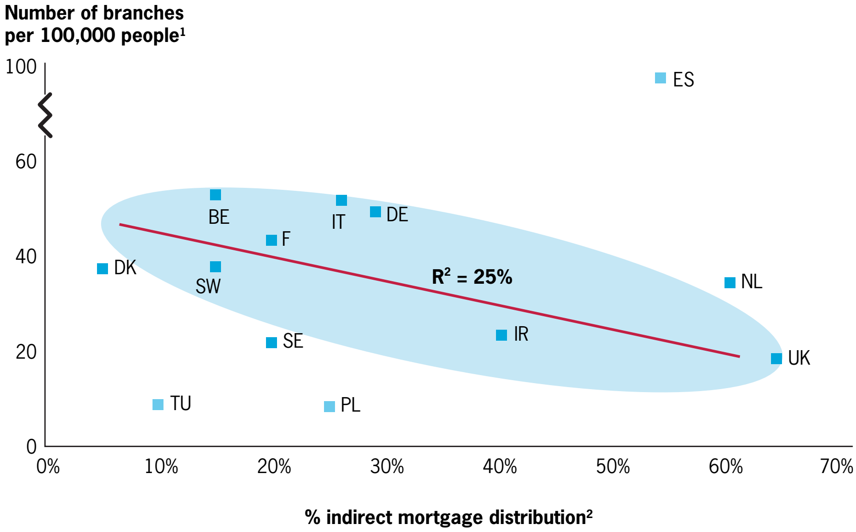
Source: Mercer Oliver Wyman analysis

As expected, product complexity is highly (positively) correlated – more than 40% – with the share of intermediary distribution. Increased product complexity evidently reduces transparency and increases choice – reinforcing the key strengths of intermediaries.

Branch density

Although an apparently simple measure, physical presence of branches – for example measured by the number of branches per 100,000 people – has a strong correlation with distribution mix. As Figure 11 shows, there is a negative relationship between branch density and the share of indirect distribution. The UK and the Netherlands have low branch density and high intermediary share, with Italy, Belgium and France at the other end of the spectrum[4]. We see two reasons for this correlation. Firstly, absence of branches provides an opportunity for intermediaries to fill the gaps in the distribution reach of lenders. Secondly, a strong intermediary presence in the mortgage market (and other products) will reduce the importance of branches to banks, thus leading to closures and the reduction of branch density (e.g. the Netherlands).

Figure 11: Physical presence of mortgage banks



1 Source: World Bank 2005
2 Source: Mercer Oliver Wyman analysis based on lender survey responses, CML, Datamonitor, Consart, Mortgage Strategy

Two distinct types of 'outliers' should be looked at more closely:

- **Spain:** The number of branches per 100,000 people in Spain is the highest in Europe. However, this reflects the fact that Spanish branches are typically very small (~3 employees per branch) compared to, for example, the UK (~10 employees per branch). In addition, the common use of tied bank-branded agents in Spain (included in the total branch numbers) increases the branch density metric. Adjusting for these effects brings Spanish branch density in line with the rest of Europe
- **Turkey and Poland:** The Turkish and Polish mortgage markets are the newest and, hence by most measures, the most under-developed markets included in this study. Given the lack of branch coverage per capita, we would expect both bank branch density and intermediary distribution to grow going forward as the banking and mortgage markets develop in parallel

4 Note that this is also true relative to GDP or geography

We also note that in some countries, such as the Netherlands, intermediaries are positioned as high street brands with a wide branch network across the country. As bank branches have declined, intermediary branches have accounted for an increasing share of physical mortgage distribution in the Netherlands.

Consumer behaviour

In the context of mortgage distribution, consumer behaviour is driven by two main factors:

- **Market supply:** What can the market offer me (in terms of product, price and search speed)?
- **Financial sophistication:** How much do I understand of the market offering?

Key market supply factors – which drive distribution channel mix – have been discussed extensively in the previous sections. In this section, we will therefore focus on financial sophistication: to explain the impact of consumer behaviour on distribution channel mix, we need to understand how consumers themselves can improve transparency and choice given a certain market environment.

Context

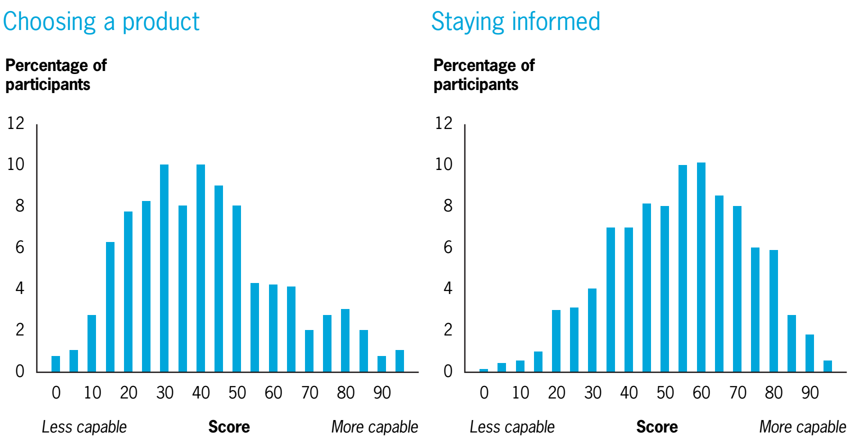
Financial sophistication (or literacy) is increasingly regarded as a key aspect of government/regulatory policy. Although several initiatives are being undertaken on a national level, we are not aware of any European-wide studies that provide an overview of the level of financial sophistication across Europe – most likely because financial sophistication is very hard to measure. The Financial Capability Survey 2006[5] conducted by the UK Financial Services Authority (FSA) provides a good framework to more closely investigate financial sophistication. In this large study, four financial capability domains were distinguished:

- **Managing money:** 'Making ends meet'
- **Planning ahead:** Being able to deal with sizeable future financial commitments
- **Choosing products:** Being able to make product choices appropriately
- **Staying informed:** Keeping abreast of financial developments and knowing where to get help and advice

5 Note that this is also true relative to GDP or geography

In the context of mortgage distribution, 'choosing products' and 'staying informed' are our main areas of interest. Figure 12 shows the findings of the study for these categories.

Figure 12: Financial capability in the UK



Source: Financial Capability Survey 2006, FSA

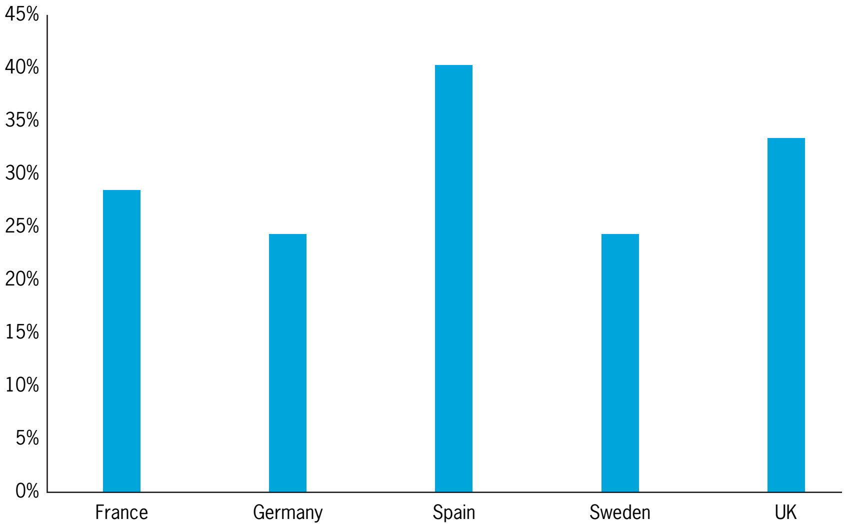
The FSA found that survey participants scored worst in the 'choosing products' domain, exhibiting low levels of financial capability. The most significant factor in explaining financial capability in this domain is a person's level of engagement with buying financial services: people learn through experience.

Furthermore, people feel it is important to keep up to date with financial matters and changes in the economy, however they do not necessarily do so themselves. Those who do, rely heavily on information from the TV, radio or newspaper.

The FSA study provides good insight into the financial sophistication of UK residents, but what about the rest of Europe? Are we able to apply a similar framework?

We see from Figure 13 below that the proportion of customers seeking advice in other countries is similar to the UK, with only Spain showing a lower propensity to undertake provider and product searches without any advice. This suggests that similar behaviours are likely to be exhibited by consumers across Europe when it comes to researching and purchasing financial products such as mortgages.

Figure 13: Proportion of customers choosing provider without external support



Source: Customer survey

Secondly, we note that information sources used are extremely similar across the European markets surveyed in our customer survey (see Figure 29), again suggesting similar actions of customers with respect to information search and advice in relation to mortgages.

Financial sophistication across Europe

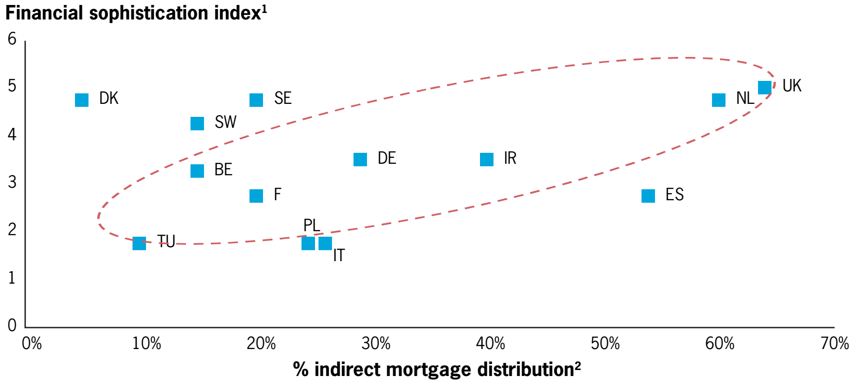
Using the insights from the FSA study – focussing on 'choosing products' and 'staying informed' – we have constructed a financial sophistication index to assess relative differences in financial sophistication across Europe. Figure 14 provides an overview of the different factors included in the financial sophistication index.

Figure 14: Financial sophistication framework

Factor	Measure
Frequency of mortgage purchase	■ Average holding period (years)
Recency of mortgage market development	■ Number of years for which outstandings have been more than 20% of GDP
Education and urbanisation	■ General education statistics (World Bank) ■ Urbanisation statistics (United Nations)
Information availability	■ Pre-contract information ■ Public information sources

There is some correlation between this metric and the share of indirect distribution. Sweden and Denmark do not conform to this correlation, as they are markets that have high levels of financial sophistication but low levels of indirect distribution (see Figure 15). The overall correlation is not strong but helps to explain some of the residual after including other factors, and so is useful in the overall framework.

Figure 15: Correlation between financial sophistication and % indirect distribution



1 Source: Mercer Oliver Wyman analysis
2 Source: Mercer Oliver Wyman analysis based on lender survey responses, CML, Datamonitor, Consart, Mortgage Strategy

In addition to the factors listed above, a number of additional factors influence distribution mix. However, these have not been included in our core quantitative model as they did not add significantly to its accuracy or, in the case of regulation, were not easily converted to quantitative values.

Proportion of new home builds

In a market where the housing stock is being quickly replenished or grown, developers have a strong position in the mortgage market, since they often are the first to interact with the customer in their home-purchasing process. This makes them well positioned to intermediate the mortgage either via an introduction to a lender or by tying the purchase of the mortgage to the purchase of the property. In markets where new builds are more common, we would expect, in general, to see a greater share of indirect distribution (via developers) than in markets where most purchases are of existing housing stock.

Policy and regulation

In the context of mortgage distribution, it is important to assess the impact of policy and regulation on market transparency and choice. This topic and the impact that regulation has on the mortgage market are discussed in more detail in Chapter 5.

5 Regulation and policy issues

Introduction

We have seen in the previous sections that the development of mortgage markets drives increased market complexity: an increased number of lenders offering more and more (complex) products. The related rise of independent intermediaries creates a 'transparency paradox': although intermediaries reduce market complexity by offering transparency to consumers and thereby reduce their selection costs, they also add complexity through an increased number of different service contracts and market participants.

To see this, consider that in an indirect (intermediary) distribution model, a consumer receives information, and possibly also advice, from an intermediary according to a search mandate, but applies to and is underwritten by a lender. As a result, there are several, additional service contracts (consumer-intermediary and lender-intermediary in addition to consumer-lender) as opposed to the 'one service contract' branch distribution.

With the number of contract parties involved, the number of pricing models increases as well. For the indirect distribution model, three main pricing models can be distinguished:

- Lender pays a fee to the intermediary, no consumer commission is paid
- Lender pays a fee *and* consumer pays commission
- Lender pays a fee *and* consumer pays commission with 'rebasing', i.e. a part of the lender fee payment is passed through to consumer once the loan closes

The 'one service contract' world only requires a simple consumer protection framework, as reflected in most current European legislation. However, as the number of service contracts and different pricing models increases, the need for more sophisticated consumer protection regulation becomes apparent as consumers start to face several risks:

- **Enhanced conflict of interest:** 'Fee gravitation' to lenders and/or products generating the highest fees may reduce the independence of intermediaries. This gives rise to issues such as unfair competition between dependent and independent intermediaries. A particular problem arising for the consumer is that truly independent intermediaries will often no longer be able to charge (sufficient) fees for their services, as they are undercut by dependent intermediaries
- **Regulatory arbitrage:** Lenders may use intermediaries to reduce the overall consumer protection level or shift the regulatory burden to intermediaries, which are often smaller and potentially less capable to address consumer protection issues or are inadequately capitalised to pay ensuing consumer claims

- **Distorting and unfair pricing techniques:** Intermediary fees may be hidden and/or hard to compare and aggregated with lender fees, especially if the relevant effective interest rate legislation (e.g. APR requirement and definition) is incomplete or confusing. Intermediaries may charge fees to both consumers and lenders without sufficient disclosure
- **Insufficient professional standards:** Intermediaries, frequently new and/or small companies, may not deliver the proposed services accurately or comply with regulations due to lack of expertise. This is particularly problematic where regulation assigns important consumer protection tasks to intermediaries, such as the duty to advise
- **Absence of contracts, unfair contract terms:** No contract is given to the consumer by the intermediary that allows enforcement of the proposed services. Unfair terms may exist where contracts are given: e.g. payment of fees despite non-performance (i.e. consumer able to close a loan) and the waiver of the intermediary's liability for providing proper information and advice

Does current European consumer protection regulation currently address these risks? A review of European consumer protection regulation provides some interesting insights.

European regulation for mortgage intermediaries – a selection

Overview

An introductory study into mortgage distribution like ours is not the place to provide a comprehensive overview of consumer protection regulation across Europe. Yet, in order to highlight the main possible implications of a fast moving regulatory debate for the market, we have selected five (proposals for) regulatory frameworks for review that either have started to deal directly with mortgage credit intermediation or have developed lines of thoughts that could become relevant for the industry:

- EU Consumer Credit Directive, unconsolidated proposal of 2005
- EU Forum Group on Mortgage Credit, report of December 2004
- EU Insurance Mediation Directive of 2002, of which parts have been directly included in the new Dutch *Wet Financiële Dienstverlening* (WFD 2006)
- UK FSA regulation introduced in 2004 that comprehensively regulates mortgage credit offerings (so-called 'M-Day')
- German Civil Code of 2002, into which the Consumer Credit Act of 1991 has been integrated

Of this sample, only the Dutch WFD, the UK 'M-Day' regulation and the German Civil Code of 2002 are currently legally binding documents for mortgage intermediaries in their respective jurisdictions. Although it is expected that many other European jurisdictions will adopt legislation in the medium-term, binding EU regulation for credit intermediaries as yet does not exist. The issue has been occasionally addressed in a Commission initiative on the Integration of EU Mortgage Markets that has gone through various iterations since its inception in 2003. An early report produced by the Mortgage Credit Forum Group in 2004 – ominously without intermediaries represented as members – had called in general terms for the introduction of European mortgage intermediary regulation[6].

In force is the EU Insurance Mediation Directive. The proposed new formulation of the EU Consumer Credit Directive – while no longer aiming at covering mortgage lending – has introduced references and a section on credit intermediation that could serve as a yardstick for EU regulation in the mortgage sector.

Figure 16 compares the five (proposals for) regulatory frameworks across eight key areas of consumer risk exposure.

6 For a compilation of the various papers produced under the initiative, refer to: http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm

Figure 16: Comparison of consumer protection issues and regulations for EU mortgage credit intermediaries

Consumer risk	EU IMD	EU CCD	EU FGMC	UK FSA	DE CC
Intermediaries unregulated & unsupervised	■ Requires regulation and supervision ■ Mutual recognition	■ Requires supervision or regulation of entities	■ Demands regulation	■ Regulation of activities ■ Licensing system for entities	■ Regulation only of activities ■ Entities unregulated
Intermediaries' dependency on lenders undisclosed	■ Insurer ownership>10% ■ Existence of contractual obligations with one or more insurers to be disclosed	■ Exclusive work relations with one or more lenders must be disclosed	■ Not addressed	■ Independence assumption linked to mandatory offer of consumer fee payment option ■ Exclusion of rivalling activities	■ Not addressed
Lender-intermediary fees undisclosed	■ Not addressed	■ Not addressed	■ Consumer groups call for intermediary-lender fee disclosure ■ Industry opposed	■ Detailed disclosure guidelines for lender-intermediary fees ■ APR inclusion	■ Civil code requires lender-intermediary fee disclosure ■ No APR inclusion – separate reporting
Overcharging, consumer-intermediary fee triggers	■ Not addressed	■ No dual fee charges from lenders AND consumers allowed ■ Loan must close to demand fee	■ Not addressed	■ Refund policies to be spelled out in KFI ■ Fee can be charged without loan closing ■ Scale-related fees are prohibited ■ Margin-share fees are prohibited	■ Fee to be charged only when loan closes ■ Lender-intermediary fee refunds to consumers are prohibited
Scope of information, advice, responsible lending requirements	■ General information duties ■ Entity must declare whether it provides advice ■ In latter case it must offer 'sufficiently large' number of insurers	■ Information duty with exceptions ■ Advice duties generally modified ■ Responsible lending duty	■ Consumer groups call for pre-contractual information duty (ESIS) ■ Intermediary to 'search for best credit adapted to consumer's needs' ■ Industry groups opposed	■ Information standardised under IDD and KFI (goes beyond ESIS) ■ Entity must declare whether it provides advice ■ Must show lenders with best price	■ Not addressed
Absence of separate intermediary-consumer contract	■ Not addressed	■ Fee collection from consumer only based on written document	■ Not addressed	■ KFI establishes indirectly a contract between consumer-intermediary.	■ Civil code indirectly requires contracts ■ Addresses unfair terms
Lack of professional standards and indemnity insurance	■ Both explicitly addressed	■ Not addressed	■ Intermediary to be 'fit and proper' ■ Indemnity insurance called for	■ FSMA sets out threshold conditions for licensing ■ Fines firms and individuals, risks not covered usually by PII	■ Not addressed
Complaints/redress scheme	■ Addressed	■ Not addressed	■ Addressed	■ Addressed	■ Not addressed

Source: Dübel/Finpolconsult

Abbreviations: CCD – Consumer Credit Directive, ESIS – European Standardised Information Sheet, FGMC – Forum Group on Mortgage Credit, FSA – Financial Services Authority, FSMA – Financial Services & Markets Act, IDD – Initial Disclosure Document, IMD – Insurance Mediation Directive, KFI – Key Facts Illustration, MCOB – Mortgage Conduct of Business

Unsurprisingly, given the 20-year history of the UK intermediary market, the UK FSA rulings are the most comprehensive while the German regulation, where the broker market has only emerged in the current decade, shows the largest gaps. We focus our comparison on three areas of intervention: safeguarding independence, defining the scope of business and intervening into the pricing process.

Independence

A key motivation of UK regulation has been to try to ensure the independence of intermediaries from lender interests through a combination of several measures, including licensing, pricing and scope of business rules (see below). The other compared regulations show gaps of varying sizes in that regard:

- In the IMD, emphasis is laid on making any direct dependence of intermediaries through ownership and contractual relations with insurers transparent. However, items generating indirect dependence, such as undisclosed intermediary fee structures, are not addressed
- In the CCD proposal, intermediation is generally more a side issue. By not requiring intermediary-lender fee structure transparency, the Directive remains silent on the most important indirect dependency issue
- In the Forum Group on Mortgage Credit (FGMC), indirect dependency was discussed heatedly and remained contested between lenders and consumers. The group also did not deal with direct dependency issues, such as ownership
- The German Civil Code legislation, as probably most other European legislation, remains silent on the issue, except for a pricing intervention (see below)

We will demonstrate below that it is not easy to reconcile the intermediary economics with the regulatory goal of independence.

Scope of business

In terms of the scope of transparency duties, intermediaries tend to fall under comparable rules as lenders, with some exceptions; e.g. in the case of the CCD there is no duty – if the intermediary is tied to a lender. The UK applies with the Initial Disclosure Document (IDD) and Key Facts Illustration (KFI) sheets a very comprehensive and detailed information approach that goes far beyond anything discussed on the EU level, including the European Standardised Information Sheet created under the voluntary European Home Loan Code of 2001.

More importantly perhaps, both EU IMD and UK rules take the position that intermediaries have to declare to the consumer whether they provide advice, and if so, fulfil additional independence conditions related to the number of lenders (and therefore products) on offer. In the UK, independent intermediaries are forced to give full advice, regardless of circumstance with non-independent intermediaries permitted to offer products from a restricted panel of lenders. Due to significant industry pressure, the CCD proposal has limited earlier provisions on advice to rules governing the closing situation, which is usually not relevant for intermediaries.

Of great relevance could also be optimisation rules for searches run by intermediaries, which are applied in the UK where intermediaries must point to the best offers, and which are called for by consumer groups in the FGMC.

Pricing interventions

Noticeable are also the differences in approach when addressing lender-intermediary fees relations, which in an unregulated market are typically hidden to consumers, as well as consumer-intermediary fees.

A first point is whether a consumer-intermediary fee can be charged at all. The CCD proposal as well as the German Civil Code try to regulate under which conditions this may happen, while under UK regulations charging a fee to the customer must be offered by all intermediaries (although in practice few customers take this option). In both types of regulation, though, dual charging of fees – from both consumers and lenders – is restricted: the CCD wholly forbids a dual fee policy while the UK rules only require fee refunds and full transparency (beyond a threshold of £250).

Widely differing are also the approaches to intermediary fee regulations. The UK forbids business scale-related fees for example as well as margin share agreements between lenders and intermediaries in order to maximise competition. EU legislation and the German Civil Code take no position here.

Costs and benefits of intermediary regulation – a preliminary assessment

Given the early and still somewhat conceptual stage of many credit intermediary regulations and the simultaneous growth of mortgage intermediary markets, any assessment of costs and benefits of regulations must be preliminary. We report findings from several intermediary and lender interviews across Europe and the very limited data sources, mainly from the UK and the Netherlands, which started to implement specific national regulations in 2004 and 2005, respectively.

Costs of intermediary regulation

We can distinguish four main types of costs:

- **Direct compliance costs (bureaucracy costs)** have been at the centre of the discussions between industry and government after 'M-Day' in the UK. IMLA reports survey results of September 2005 that "reflect an almost unanimous view amongst intermediaries that regulation had increased firms'" costs. Of 296 firms surveyed, over 98% said their costs had risen, by an estimated average of around 14%. Furthermore, the intensity of supervision and thus permanent compliance costs should be highlighted. In various interviews, UK intermediaries made it clear that they see the requirement to report every single loan closing to the FSA – in order to allow the agency to check for inadequate service – as excessive. Such an approach indeed requires significant IT investment, and it is questionable whether the FSA has the capacity, or even the suitable indicators, to reach her goal. Several intermediary interviews in the Netherlands suggest that the cost of compliance here are significant too, although the regulatory approach is less comprehensive than in the UK. Some of the largest mortgage intermediaries in the Netherlands recently observed a 5-10% increase in total costs due to compliance
- **Litigation risk costs** arise in particular when an intermediary is providing advice to consumers. The additional costs may take the form of additional capital to be held by intermediaries, or equivalently professional indemnity insurance costs, and are deemed by some of our interviewed intermediaries to be at least as important as bureaucracy costs
- **Customer retention risk costs:** Consumer retention strategies are generally observed with suspicion by consumer protection strategists because of their potential to discriminate on price for long-serving 'back book' customers. In the UK case, this has led to a regulatory prohibition of 'trailing' fee arrangements that share margins between intermediaries and lenders in order to keep intermediaries from inducing clients to prepay ('churn') shortly after a loan has been arranged. Such direct interference into the pricing mechanism will likely not lead to the desired result, or impose significant retention-related costs on lenders. Most likely is that lenders will develop institutional – rather than contractual – ties with intermediaries or use less intermediary distribution in total, in order to retain consumers nevertheless. The consequence in all these cases is less choice, or higher ultimate costs, for consumers
- **Other costs:** If the intermediary-lender fee structure is limited to lump-sum arrangements only, as it is essentially the case in the UK, additional risk factors – such as adverse selection risk for the lender – may not be addressed directly through the price mechanism

Benefits of intermediary regulation

Opposed to the abovementioned costs, two main types of benefits of intermediary regulation should be emphasised:

- **Market consolidation and improved professional standards:** Market consolidation resulting in greater professional quality and capacity to provide consumer protection functions is an explicit benefit sought by intermediary regulations. We note first that such a strategy comes necessarily at the expense of competition. This is not a particular problem in a market like the UK, with more than 7,000 intermediary firms, 25,000 related professionals and a large mortgage sector, but it could be in emerging European mortgage intermediary markets with fewer suppliers, e.g. Germany, or smaller mortgage markets such as Poland or Czech Republic.

  In the UK, so far only few intermediary networks and firms disappeared as a result of the increased 'M-Day' regulations and there is as yet no clear sign of a market shakeout. Some previously independent firms have chosen to become appointed representatives of authorised principal firms. Yet, the number of free-lancing practitioners seems to have been falling substantially, according to an interviewed intermediary from c. 35,000 to 25,000. Interlocutors believe that a combination of the above cost factors and a more aggressive stance by FSA may speed up restructuring in the future – yet, given the relatively slow speed of this consolidation, the UK is likely to remain a relatively fragmented intermediary market.

  In the Netherlands, in contrast, there is evidence that approximately 10% of intermediaries have already left the market since the new AFM regulation (WFD) came into place. Several large players in the Dutch mortgage market expect that once the AFM will become more active in enforcing the WFD, many more competitors will exit the market. In addition, it should be noted that that the new WFD has not caused a large exit of parties yet, as many smaller parties are joining so-called 'inkoopcombinaties' (similar to the mortgage networks and clubs in the UK).

- **Providing maximum transparency to consumers**
  - **Intercepting direct ownership of intermediaries by lenders:** Direct ownership of intermediaries by lenders appears to be the most obvious conflict of interest. In the Netherlands, several mortgage lenders – e.g. Aegon, Delta Lloyd, and SNS Bank – have been selling their participations in intermediaries as result of the new WFD. However, in Germany – lacking such regulation – lender ownership is a widespread phenomenon: two of the four largest intermediaries are partially or wholly owned by banks, GMAC-RFC and HVB

- **Intervention into fee structures:** The UK's regulatory approach is directly reigning into contractual relations by imposing lump-sum intermediary-lender fees and enforcing the offering of a full fee payment model to consumers. We discussed before the implications of a lump-sum-fee-only approach for lender risks/costs; while it is too early for an empirical assessment, we believe that such a radical approach eliminating a price incentive for greater retention or scale achieved by intermediaries may not be in the interest of the consumer. Paying an intermediary some sort of retention premium, for example, does not mean that the consumer cannot prepay at fair cost levels and change the lender easily. Yet, banning it means that the consumer will have to pay higher closing costs, due to a lower expected duration of the loan through 'churn'

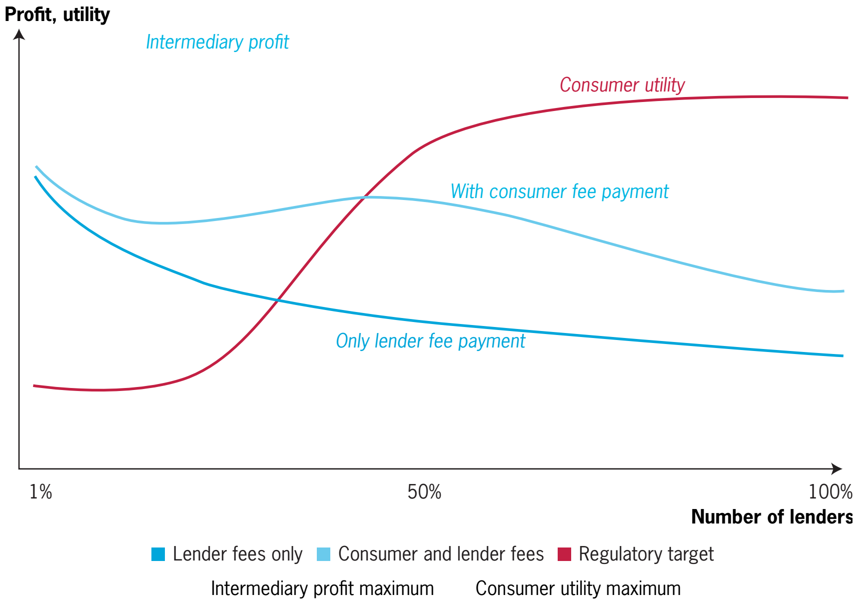
Balancing costs and benefits

As far as creating market transparency and minimising search costs is concerned, is there an optimal regulatory strategy? Where should reasonable limits to a differentiated intermediary-lender fee policy lie? And will a consumer fee payment option change anything if the empirical test shows that consumers are perfectly happy with paying small or no fees against accepting a degree of dependence of the intermediary? In fact, dual pricing of intermediaries to both consumers and lenders is, in practice, very rare.

Case Study – Balancing interests

As is shown in Figure 17, we interpret the regulators' target as inducing intermediaries to provide the consumer with the unbiased offers of the entire universe of lender offers in a given market, i.e. full independence and transparency. We assume that reaching this target maximises also the typical consumer's utility (red curve). However, the incentive structure governing lender-intermediary relations creates a profit curve for the intermediary that will limit the number of competitors a given lender faces in his or her league tables (dark blue curve). Yet, at the maximum of that profit curve – effectively turning all consumers over to a single lender – consumer utility of the intermediary model will likely be lowest. In this situation, the idea of an independent consumer fee payment is to shift the intermediary profit curve towards greater choice (light blue curve). Yet, standard microeconomic theory suggests that consumer willingness to pay will be highest at the point where his or her marginal increase in utility through an increase in choice is largest. This is unlikely to be the case when being presented with full transparency; rather, a certain number of offers will ensure maximum *marginal* utility. The intermediary profit curve will likely thus change its maximum towards greater market transparency, but not to full market transparency.

Figure 17: Intermediary profit with/without consumer fee payments and typical regulatory transparency target



In the end, we see – for both theoretical and empirical reasons – little choice for regulators than to accept some degree of dependency of intermediaries, i.e. define a 'still acceptable' market structure rather than aiming for maximum independence and transparency. Figure 17 in the case study above demonstrates our analytical point. This is – in short – the rationale of the wholesaler model of intermediation, which usually in Europe produces offers from between 10 to 30 lenders from a single intermediary, i.e. far below total market transparency, but large enough to provide consumers with a significantly greater choice than the bank distribution model.

It is noteworthy that this result is reached usually without a regulatory demand for a consumer fee payment option, i.e. in a market with fully lender-funded intermediaries. We would offer the explanation that reputation risk keeps the intermediary from offering only very limited choices to consumers. Furthermore, it should be noted that this result even holds for the UK – the largest mortgage intermediary market in Europe – where despite the large number of intermediaries, the majority operate with a 'short panel' of 8-10 lenders. In the Netherlands, with the second largest intermediary market share in Europe, the typical policy is also to flag just 15% of available offers to consumers.

Does this market result imply that no regulation of intermediary-lender fee structures is needed? Possibly, indeed the more promising avenue than the adopted legal interventions for the regulator would be to monitor directly how representative intermediaries' offers are. This is an avenue also pursued by the FSA amongst many other measures, in order to establish a directly observable reputation risk metric for consumers.

Whatever the likelihood of success of demanding a consumer fee payment option to be provided in the UK, adopting the opposite approach of severely restricting consumer fee payments, such as linking a payment duty only to the event of loan closing in German legislation and the proposed EU CCD, seems counterproductive to consumer interests. In Germany, the corresponding Civil Code provision has led to the virtual disappearance of consumer fees paid to intermediaries, as well as to an absence of explicit consumer-intermediary contracts. This can only support any existing 'gravitation' trend of intermediaries to lenders.

Advising the consumer properly

It should be clear from the discussion by now that not only the regulatory desire to maximise transparency, but also the attempt to impose a duty to advise on intermediaries will meet significant tension with market dynamics and business models.

We find in this study that many intermediary businesses in Europe have limited focus on advice, except for the UK where this is a regulatory requirement with the associated costs imposed on them. In Germany, for instance, 'advisors' are a niche business separated from 'brokers' who form the bulk of the intermediary market. In the Netherlands, some intermediaries promote advisory services in order to position themselves in a highly competitive market. In Poland, almost all intermediaries call themselves 'advisors' (a completely unregulated term). Yet, such strategies seem often more related to boast reputation rather than to provide a credible individualised service.

There are indeed numerous arguments for clearly separating transparency and advice functions institutionally, from cost levels to the quality of service provision, including the intermediary incentive problems discussed before. The economics of the intermediary business contradict the very nature of advice, which should imply helping the consumer under his or her *specific* economic circumstances to find an *individually optimal* financing solution. Ideally such individualised service should be related to some form of legal enforcement mechanism, in order to protect the consumer against the potentially severe financial consequences of detrimental advice given.

This individual optimisation problem is remote from the problem of optimally serving the typical consumer that represents an intermediary's broad customer base with a menu of lenders and products. It requires both a different approach and organisation of the intermediary compared to the currently dominating wholesaler function: an almost impossible, and in any case costly, addition.

We would regard it as wholly sufficient to require that intermediaries should inform consumers comprehensively about their product and lender menu on offer, including obvious typical risks associated to them, with the least possible bias. Intermediaries that wish to move beyond and provide individualised advice in order to distinguish their services from others should be subjected to a different, stricter form of regulation in exchange.

It remains to be seen how in the specific example of the UK, intermediaries will cope with their current dual mandate as providers of transparency and advice; but we observe that to date the process has not been entirely smooth. A recent M-Day evaluation included the following assessment: "Firms will strive to be compliant in the detail as well as adhering to principles. Education is important but will be very slow to take effect. Consumers would become more empowered if brokers were not forced to give Full Advice regardless of circumstance. There is an increasing litigiousness, the blame culture in which lawyers will stoke up another mis-selling scandal before long – today's regulation will always find fault with yesterday's products. We need to take small but positive steps on education, increased simplification and transparency." [7]

7 Source: KPMG, The future of advice – A report for the FSA, May 2006

Section II.
Implications for lenders

We have seen in the previous sections that the growth of indirect mortgage distribution channels is highly driven by the general development of mortgage markets, and that the growth of indirect distribution can support price competition and product development.

This interaction leads to an increased need for advice and transparency, driven by greater product complexity, an increased number of players on the market and growing consumer awareness.

In many cases, this development is unavoidable by lender actions alone, putting banks in a very difficult position. On the one hand, the growing share of intermediary business helps them to gain significant market share more quickly, resulting in increased economies of scale. On the other hand, the mortgage is increasingly used as a lead product from which to generate immediate cross-sales opportunities and a longer-term client relationship, all of which is typically most successfully executed via their own branches.

Mortgage lenders are therefore faced with serious challenges in addressing the different distribution channels:

- **Optimising branch distribution:** Ensuring the owned sales force is sufficiently effective, is incentivised to perform and has the appropriate support
- **Addressing the intermediary channel:** What can the rest of Europe learn from developed intermediary markets such as the UK and the Netherlands? Which models are most effective in managing the relationship with intermediaries?
- **Managing remote channels:** Optimising the use of remote channels either to generate leads (for face-to-face closure) or for direct sales purposes
- **Managing relationships with existing customers:** Having the right tools and processes in place to realise the widely recognised economic value of customer retention and having the capability to broaden the existing relationship
- **Pricing:** How can lenders maintain control of pricing in a more transparent, more intermediated market? What strategies are available to defend pricing against downward pressure from competition and transparency?
- **Distribution across national borders:** How can mortgage operations be leveraged into new markets, and what restrictions does distribution place on expansion?

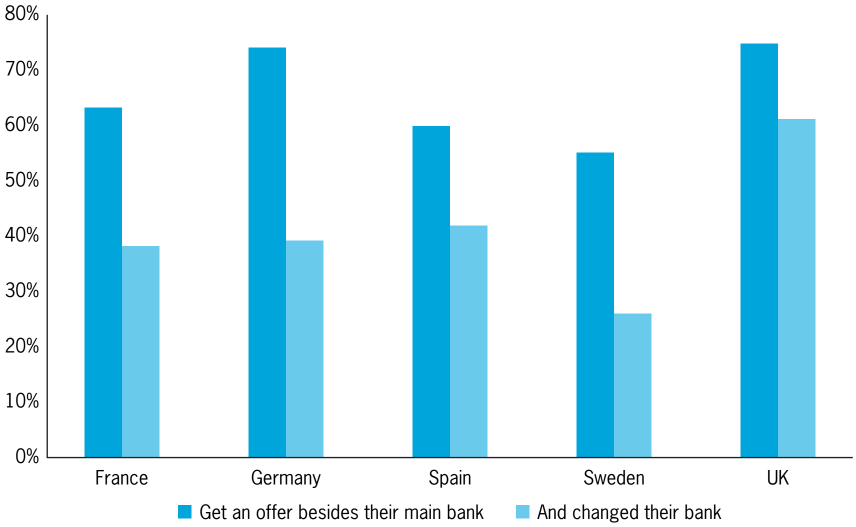
In this section, we look at each of these items in turn, describing challenges facing product providers and successful practices for addressing them. We conclude by identifying a checklist of issues and winning business models in mortgage distribution for the future.

6 Optimising branch distribution

The competition for customers

It is no longer the case that banks can rely on the majority of their customers to come only to them for their mortgage product needs. Figure 18 below shows that in all countries surveyed, over 50% of customers took offers from providers other than their 'house bank', with over half of these customers switching to a new provider as a result of this broader search. While banks still have an inherent advantage from their customer relationships as being the first port-of-call, we see this benefit eroding over time for the remaining 25-50% of customers. Furthermore, banks are increasingly demanding more from their branches in terms of sourcing mortgage leads and converting these to sales.

Figure 18: Proportion of customers getting offers from lenders other than their main bank and proportion moving lender as a result



Source: Customer survey

Strategic positioning

Banks' positioning in terms of their customer proposition and segment focus is important for assessing how large the threat from other channel propositions is for their business. For example, a bank that has heavily invested in its brand, developing strong customer relationships and premium products (e.g. lower rates for valued customers, fast approval times) may face less direct competition for its customers from the intermediary proposition (transparency, choice, advice).

On the other hand, a bank that provides a standard mortgage product and service without a strongly branded offering is much more susceptible to its customers being attracted by the intermediary proposition.

Regardless of strategic positioning, it is still important to have efficiently owned distribution, particularly branch-based sales staff.

Improving sales productivity

Figure 19 sets out the three main pillars of a successful performance management framework, built upon a clear vision and governance model. We examine how each aspect applies to mortgage distribution through the branch[8].

Figure 19: Performance management framework

Capability
Are staff able to perform role?

- Are resources matched to realisable **opportunity**?
- Is **staff-time** spent on customers?
- Is **talent** managed?

Motivation
Do staff want to excel?

- Is **performance measurement** simple?
- Are **targets** fair?
- Is **reward** transparent and differentiating?

Support
Do you help them do it?

- Is **management** drawing on best practice from the network?
- Are **tools** designed to help sell/service customers?
- Is **training** tailored to individuals and value-adding?

Operating Model
What is distribution supposed to do?

- What is your **proposition** for different customer segments?
- What **coverage** and **roles** are required by segment, channel and geography?
- What **rules** and **authority** are needed to ensure that the different elements work together?

Each of the building blocks is a fundamental driver of branch performance: the area where the bank is worst positioned will determine the overall level of performance. Clearly, if the branch network does not know what it is expected to do or if it lacks appropriate capabilities or support, it will be hard to optimise performance, regardless of how good the incentive scheme is.

Operating model: What is distribution supposed to do?

Many banks only have a superficial vision on what distribution is supposed to do and specifically lack a clear idea of:

8 Many of these practises are also relevant for intermediary businesses themselves, and many practises have already been adopted by large intermediary chains

- What **coverage** is required by segment, channel and geography to fulfil this proposition, and what **roles** are needed within each network to provide this coverage?
- What is the (distribution) **proposition** for different segments of customers?
- What **rules** are needed to ensure that the different elements work together, and how does authority cascade down the hierarchy?

Focus is one aspect of this. Typically for mortgage distribution this means deciding whether to have dedicated mortgage sellers or generalist sellers. In our experience, the advantages of dedicated sellers in terms of focus, familiarity with processes and product knowledge make this a much more profitable choice for banks, providing that the geographical area that needs to be covered by the seller (to justify the costs of dedicating them to mortgages) can be practically navigated by the mortgage specialist.

Secondly, this means measuring and rewarding other branch staff for sourcing and passing on mortgage leads to those who can sell the product. Finally, each member of staff (both lead providers and most importantly sales staff) needs to clearly understand how the mortgage is positioned within the overall customer proposition of the bank for different customer types, e.g. as a profit generator in its own right, as a central product encouraging customer retention and cross-sell, or as an entry product for building a future relationship with customers.

We note that external contractual sales staff (tied agents) can be managed in a similar way to the bank's own staff, e.g. insurance agents selling mortgages as part of a broader product range.

Capability: Are staff able to perform their role?

Regardless of how good the motivation, if staff lacks the capability to perform the role, the incentive scheme will not deliver the expected results. There are three main reasons why staff may be unable to deliver:

- **Location**: Matching resources to the *realisable* local opportunity. In client assignments, we typically find that 25% of staff are in the wrong branches – with a significant opportunity cost
- **Time**: In a well-run branch, there should be nowhere to hide, and no excuse for sales-staff not to be with customers – often more than 50% of staff-time is wasted on non-core activities (administrative tasks, internal meetings, etc.)
- **Talent:** There is a huge range in staff talent, which can be modelled in almost the same way as a customer's risk or potential value profile. However, in marked contrast to risk policy, we find staff recruitment/

retention and broader HR policy in most banks is more art than science, with little analytics around what makes staff successful in terms of experience, training and professional background

For mortgages, this means identifying those staff who are well suited to mortgage sales (in many cases this will be the most value-creating role in the branch), matching mortgage specialists with mortgage demand, ensuring that mortgage specialists' diaries are full with appointments (both by branch-sourced leads and if necessary by leads sourced directly by the seller) and that distractions such as administrative tasks are taken away from sales staff (regulation allowing).

Motivation: Do staff want to excel?

Motivation is driven by short-term factors, primarily the performance measurement and incentive scheme, good management and longer-term factors such as career path.

It is important that the incentive scheme is simple and linked to value-added, targets are seen to be fair and rewards are both transparent and truly differentiate between individuals and teams. Secondly, mortgage specialists must have a well-defined career path, which ensures that the bank attracts, maintains and develops talented individuals. Finally, management must ensure that each of these elements is clearly communicated, issues are addressed and disputes are resolved to ensure that individual and team motivation is maintained.

Support: Do you help them do it?

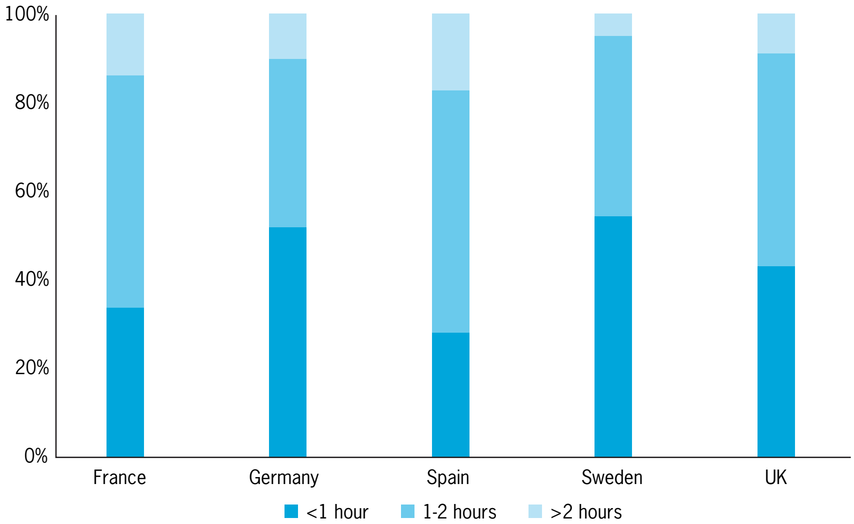
In banking, we see three main ways in which the bank helps frontline staff succeed:

- **Management:** Consistent processes and support, drawing on best practice from across the network
- **Tools and processes**: Good branch tools help sell/service customers. They are designed for end-users, not by IT. Bad ones either remain unused or create a reason for staff not to sell. For example, a fast application process will allow sales staff to be more productive (more meetings per day), improve conversion rates (customers more likely to buy from a slick sales process) and increase likelihood of cross-sell (more time for broader financial needs' discussions). Figure 20 shows that, in a majority of cases, mortgage applications[9] are longer than one hour in all countries surveyed. It is therefore incumbent upon the organisation to provide sales staff with effective processes and tools to allow them to maximise their and the organisation's performance

9 Time taken to complete the initial mortgage application with the customer. Does not include follow-up activities undertaken by the bank or the customer, e.g. document collection, underwriting etc.

- **Training**: Training, often seen as 'a necessary evil', should be tailored to individuals who understand the value-added. Poorly designed training has both a direct cost and a substantial opportunity cost as staff who are being trained are not selling

Figure 20: Time taken to complete the mortgage application by country



Source: Customer survey

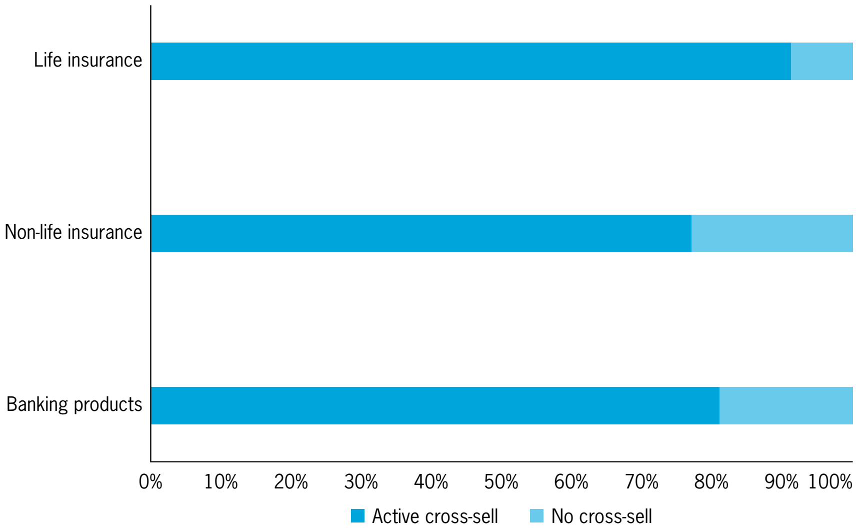
Increasing cross-sell

The attractive economics of cross-sell – also known as annex sales – arise from the fact that the customer is already buying a mortgage. For example, a mortgage customer needs and probably lacks home insurance, making the probability of a sale high. The convenience of getting it at the same time as the mortgage, and the relative cost of the mortgage itself, make the customer price-insensitive. And, provided the insurance sale is properly integrated with the mortgage sale, the marginal cost is close to zero. At the same time, this packaging creates convenience for consumers who might otherwise have gone elsewhere for their cover.

Optimising the cross-sell model is largely a matter of integration and effective sales training:

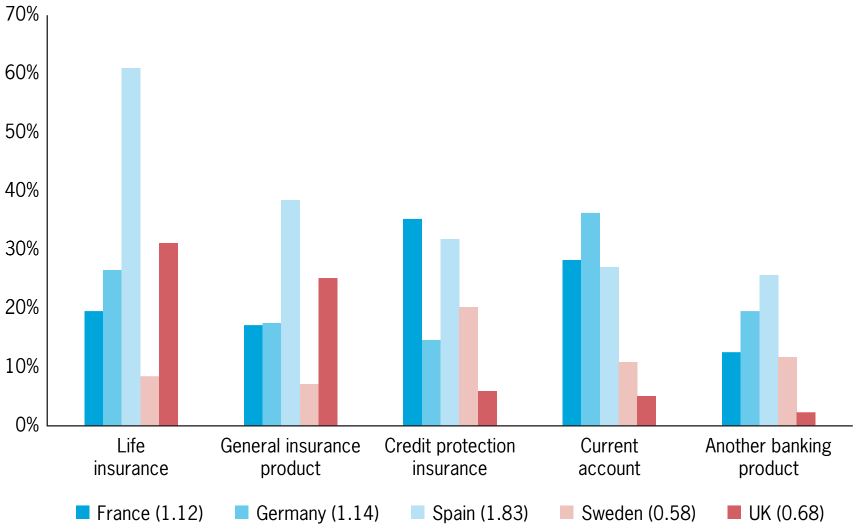
- **Fast credit decision:** Fast credit decisions will provide the salesperson with more time to discuss and sell any ancillary products as well as significantly reduce the probability that the customer will ultimately buy elsewhere
- **Integration**: The annex product should be integrated as closely as possible into the mortgage. This will maximise take-up and minimise additional sales time. Single application forms and integrated monthly billing, for example, help here. Where the law permits, making the product an opt-out rather than an opt-in is also beneficial. Product design can help: for example, annually costed mortgage life insurance, with premiums taken with the mortgage payment. This type of integrated product and process is used by several leading players in Europe, especially in the UK. Yet, many banks lag this best practice. They use separate application forms or screens that need to be repopulated with the same data
- **Effective sales training**: Many European banks try to cross-sell insurance products with a mortgage. Insurance products (especially life) are complex, particularly for a banking advisor whose core skill is typically selling banking products. Training must therefore address product understanding (features, exclusions, benefits etc.) as well as belief in the product

Figure 21: Cross-sell practice European banks



According to Figure 21, cross-selling focus is across all products including banking and insurance products. Figure 22 below shows the products purchased by mortgage customers who participated in our mortgage survey.

Figure 22: Customer Survey – Cross-sold products per mortgage



Source: Customer survey

This chart shows the wide variations by country. For example, in France, Spain and Germany, cross-sell ratios are high with on average over one additional product sold at the same time as a mortgage. One reason for that is that the mortgage product in these countries is strongly positioned as an entry point for the client relationship. This can also be seen in relatively lower prices for the mortgage than in other European countries (e.g. in France). In the UK and Sweden, cross-sales are less common, in part due to differences in regulation (e.g. in the UK insurance sales cannot be made compulsory) and customer practices (e.g. shopping around for insurance products).

Those who get the annex sales model right see significantly higher penetration rates – for example, mortgage-related penetration rates for creditor insurance and related life cover in the range of 50–60% compared to 20-30% for lagging players.

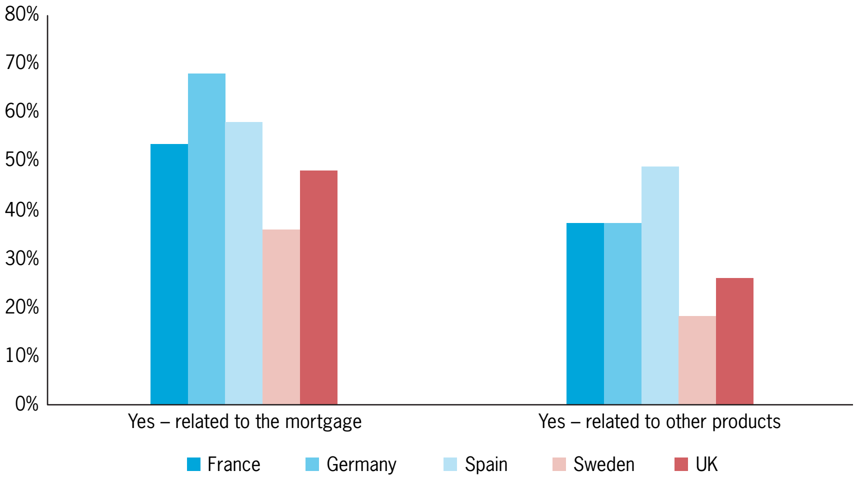
The strategic imperative is clear: do not miss a trick. Banks should review both the market and their own offering to ensure that they are not missing any opportunities for annex sales.

In less mature markets, this may be through identifying opportunities to promote new products, or at least products that have not yet reached penetration levels shown in more mature markets. In more mature markets, opportunities for increasing annex sales by promoting new or under-penetrated products will be rarer. Gains are more likely to come from improved packaging of existing products.

Effective processes will also help cross-sell rates. For example, lenders are inconsistent in following up with customers after a mortgage sale, despite evidence that such activity will increase cross-sell conversion rates (see Figure 23 below).

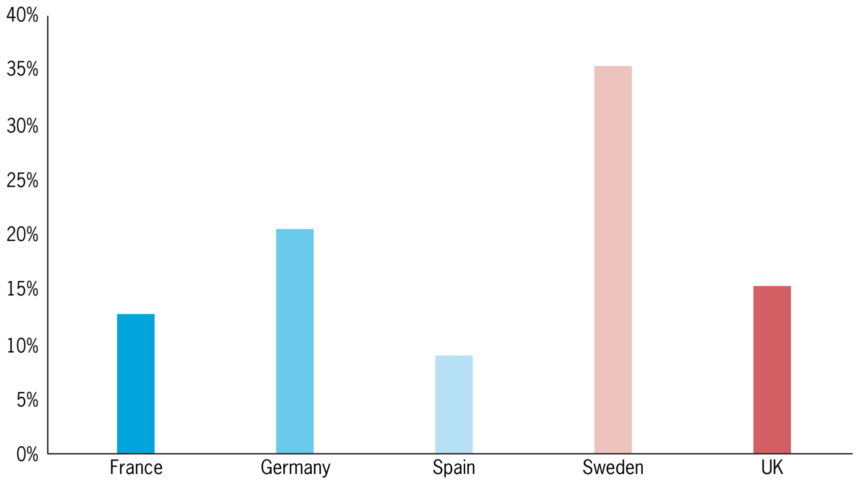
Figure 23: Frequency of post-sale follow-up by country

After you applied for the mortgage, did the company/advisor get in touch with you over the following weeks or months?



Source: Customer survey

Proportion of clients buying an additional product after a follow-up



Source: Customer survey

Interestingly, this approach had the most success in Sweden, where it was used least frequently and where cross-sell in general is the lowest of the five countries surveyed in the customer survey, suggesting that this approach could prove successful in boosting sales of additional products to Swedish mortgage customers.

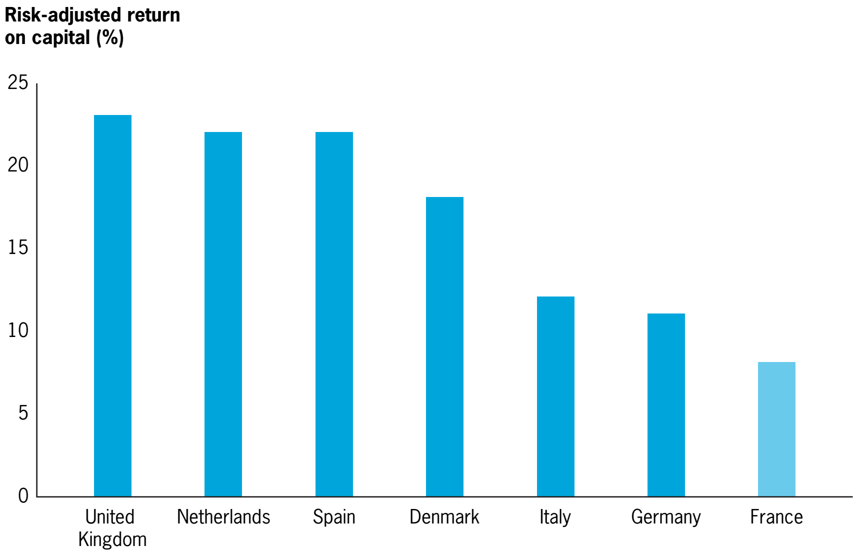
Vive la cross-subsidisation!

French mortgages as a loss-leader

In a highly competitive mortgage market, French banks have taken cross-subsidisation to an extreme. Mortgages are not regarded as a source of profitability but as the entry point for long-term customer relationships. A similar situation exists in the Belgian market.

In 2003, an industry-wide survey[10] showed that a standalone mortgage in France is typically sold at an economic loss by mainstream lenders (see Figure 24). Fighting for market share, a substantial proportion of lenders in France are unable to make sufficient returns to cover their cost of capital. To remain price-competitive in this environment, many French banks have focussed on improving their credit processing (both for front and back office activities), while reducing their costs (especially through an increased centralisation of IT and back office activities).

Figure 24: Estimated risk-adjusted return on capital



10 European Mortgage Federation/Mercer Oliver Wyman 2003, A study on the financial integration of European mortgage markets

Once smoothly completed and performing as expected, the mortgage provides a strong foundation for building a trust-based relationship and generating increased, profitable cross-sell. This is further reinforced by the obligation for consumers to buy certain (insurance) products with a mortgage; although we note later in the report that some countries (e.g. Spain) appear to be out cross-selling French lenders even without the necessity for cross-sell revenues to maintain profits[11].

The French 'loss leader' mortgage market has restricted the development of the intermediary channel and entry of foreign players, although recent developments show that intermediaries are beginning to play an increasingly important role to help the bank to get the client contact as early as possible in the mortgage process.

Banks that use the 'loss leader' model to get market share need to ensure that they get the pricing right and optimise the cross-sell model through product integration and sales training.

11 Note that our analysis only looks at cross-sell at the time of the mortgage, and so 'relationship sales' during the time that the customer holds the mortgage are not included in this assessment

7 Managing the intermediary channel

As we have seen previously, banks and intermediaries are entangled in a complex hybrid relationship. They need to develop commercial relationships to gain market share but are at the same time direct competitors for customer relationships. This relationship causes some significant challenges for mortgage lenders trying to manage intermediaries in a multi-channel distribution approach.

Intermediary service offerings

Typical trend in service offerings

The growth of the intermediary market has significant consequences in terms of how incumbent (often bank) lenders deal with intermediary players. The option of directly competing or ignoring intermediary distribution becomes an important strategic decision; and as the market develops further, intermediary service offerings also must change significantly to meet the increasing competitive demands of intermediaries.

In a developing intermediary market, the service offering by lenders is initially very limited. Banks have a dominant position and set the standard; intermediaries accept their role and follow. However, rapidly, lenders are faced with the large decision of whether or not to deal with intermediaries. On the one hand, they can provide a significant source of business volume, thus providing revenues and leveraging large fixed cost-investments in lending operations. On the other hand, intermediaries are direct competitors with banks' direct channels in terms of distribution and reduce the margin on the project via the commissions that they charge to the lender. In the two most developed mortgage markets – the UK and the Netherlands – some lenders (e.g. Rabobank, ABN AMRO, HSBC) were reluctant about participating aggressively in the intermediary mortgage market and may have lost business as a result.

With the rapid growth of indirect channels, the roles change. As the intermediary market consolidates, the larger, surviving networks realise their strong bargaining position and are able to negotiate higher fees and access to exclusive products (e.g. Interhyp in Germany). At this stage, mortgage lenders have responded by setting up business channels dedicated to serving the needs of intermediaries. For example in the UK and the Netherlands, many banks have set up sub-brands to deal with the intermediary channel, providing an extensive range of services with a strong focus on integrated technology to reduce cost to serve, e.g:

- Dedicated websites for electronic application, immediate decision-making and extensive product and mortgage rate information

- Account managers/sales consultants providing intermediaries with specialist service support
- Dedicated processing centres with underwriters and mortgage processors

However, in a number of cases only a sub-brand is provided to avoid brand conflict and cannibalisation with the main bank brand.

Two aspects of the intermediary management service offering should be highlighted:

- Tiered coverage models
- Cross-sales incentivisation

Tiered coverage models

Less than half of all analysed lenders differentiate between intermediaries regarding their product offers or fees that are paid from lenders to intermediaries (Figure 25). As intermediary markets become more competitive, product and/or price differentiation is likely to become more important in terms of getting a larger share of intermediary business (regulation permitting). For example ‘specials’ are commonly used by UK lenders to drive share through a particular broker or network.

Figure 25: Differentiation between intermediaries

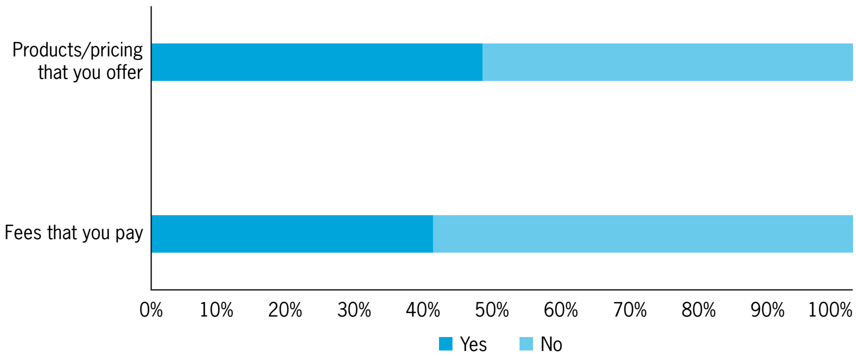
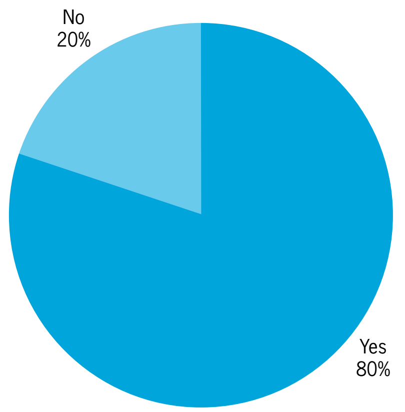
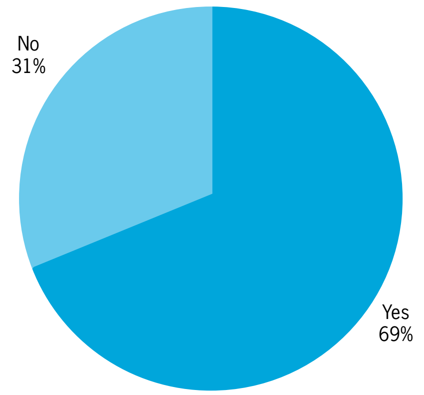


Figure 26: Segmentation of intermediaries based on volume and quality



A much higher level of differentiation can be found regarding the volume and quality of the business that lenders pursue through intermediaries (Figure 26).

Figure 27: Provision of intermediaries with education and IT support



As Figure 27 illustrates, a very high share of lenders support intermediaries with education and IT support, suggesting that this is one of the main propositions provided and one of the most important support issues for intermediaries across Europe. For those lenders that provide no product training or systems support, it is likely that they will gradually lose out to providers that provide these services until broader independent platform solutions are available.

Cross-sales incentivisation via third parties

Creating cross-sales via the intermediary is notoriously difficult since the lender often has limited control of the customer interface. While intermediaries are incentivised via commissions to offer additional products to the lender, they are typically free to recommend other providers' products either because they are more suitable for the customer or because they pay greater commissions or a combination of the two (subject to regulatory constraints). Lenders are faced with three main options to increase cross-sell realisation through the intermediary channel:

- **Intermediary incentives**: Providing increased commissions to intermediaries for cross-sold products with the mortgage, providing separate targets for cross-sell (regulation allowing)
- **Customer incentives**: Discounting cross-sold products, bundling products together to encourage customers to buy multiple products with the mortgage
- **Standalone post-sales cross-sell initiatives**: Targeting the customer following the handover of the mortgage application from the intermediary to the lender (contracts allowing), e.g. via telephone follow-up prior and/or post completion. This is becoming increasingly common in the UK and Germany as cross-sell economics become more crucial to overall customer profitability from the mortgage purchase

Lender risks from intermediary distribution

There are some potential risks for lenders arising from intermediary distribution, in particular those arising from the challenges of designing an incentive-compatible contract and fee structure with the intermediary:

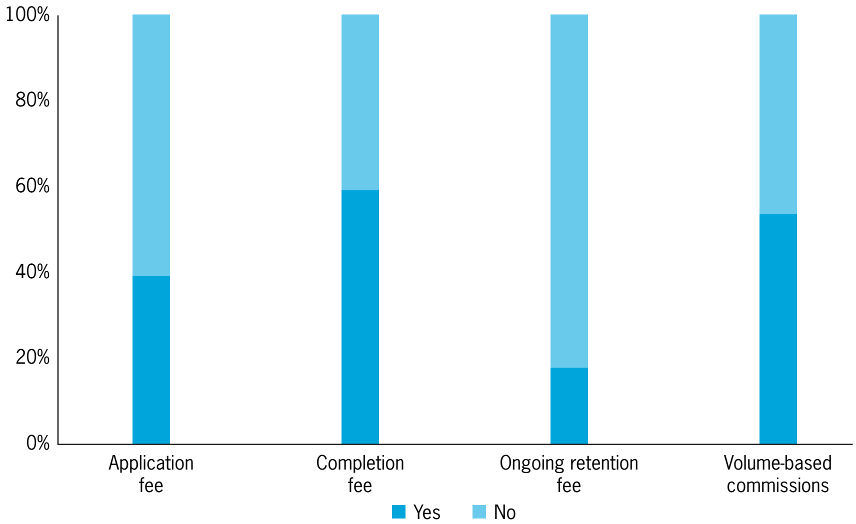
- **Higher credit risks** through adverse selection of the lender by the intermediary: in the typical risk-insensitive but volume-sensitive fee structure environment, the intermediary has an interest (at least in the short term) in delivering higher risks to the lender, in order to maximise volume and market power
- **Fraud risks:** Intermediaries with small opportunity costs of bankruptcy have incentives to defraud lenders by delivering bad risk or even non-existent client relations
- **Other operational risks:** Independent (multiple-lender) intermediary systems may not lend themselves easily to standardisation of underwriting practices and documentation, which produces operational risk for lenders in the underwriting process. B2B platforms between intermediaries and lenders may create public goods by fostering standardisation

- **'Churn' market risk:** Lump-sum fee structures do not provide intermediaries incentives against motivating a borrower just delivered to a lender to prepay and choose another lender

Lenders must take these risks into account when evaluating the costs and benefits of the intermediary channel and in designing their operating model (fees, coverage model, service offering, intermediary tiering) for their intermediary channel.

Managing intermediary compensation

Figure 28: Fee structure to reward intermediaries



Looking at the fees in Figure 28, it can be observed that these are mainly influenced by the completion of the business or based on volumes where regulation permits this. In just a few cases, fees depend on ongoing retention activities. In other markets, such as Australia, trail fees have been used but have had limited impact on overall customer retention rates across the whole market. Trail fees are being introduced into the Dutch mortgage market via recent regulatory intervention (as part of the consultation process on the 'Gedragstoezicht Financiële Ondernemingen').

Successful lender models in intermediary distribution management

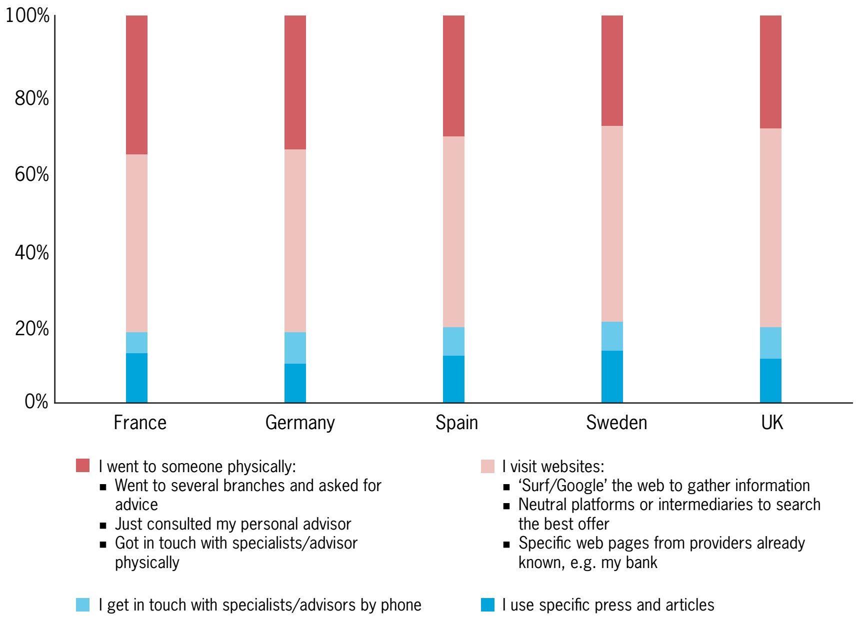
We see three ways in which lenders have been successful in gaining share of intermediary business:

- **Price led:** Lenders ‘force’ intermediary to recommend their product. This typically requires a regulatory framework, brand coverage including separate advertising and a low-cost model to ensure that the product economics work
- **Service led:** Lenders differentiate on speed and efficiency of service, which drives return business as intermediaries want to work with the lender again since this maximises return on their time (less time required, few/no complaints from customers)
- **Relationship led:** Lenders build good relationships with intermediaries at the individual and company levels, ensuring sufficient volumes of business. A pure relationship model will be a weaker proposition in regulated markets but typically is combined with the service-led model, i.e. closer relationships with local intermediaries ensures that service is better tailored to individual broker requirements ensuring repeat business

8 Using remote channels in mortgage distribution

Remote channels are typically used for research purposes with only a small proportion of mortgages sold online or over the phone across Europe (less than 5% across Europe according to our lender-based survey). However, a recent EFMA study[12] found that 30% of mortgages were sold online in Sweden with expectations for up to 50% by 2010. Consumers use the Internet and, to a lesser extent, the telephone to search for products, rates and deals as shown in Figure 29 below. Currently, the majority of those consumers then make the actual mortgage application through a branch or intermediary.

Figure 29: Customer survey – Information search channels



12 EFMA, November 2006, L'impact d'internet sur le comportement d'achat de services financiers

Case Study – www.turning_search_into_sales.com

Online search tools are big business. There are many websites in Europe that compare a large range of financial products, from the Italian *mutuionline.it* to the Swedish *pricerunner.se*. These websites are covering the full range of financial products, from simple motor insurance to complex mortgage products. They are attracting millions of visitors a year and typically generate a revenue stream through lead generation. What if this enormous amount of Internet traffic can be transformed into a direct sales channel? Then the sky must certainly be the limit! The Dutch *independer.nl* provides a successful example of turning search into sales, but also illustrates that the need for advice limits the potential for online mortgage distribution.

As many other search sites, *independer.nl* initially started as an online lead generator for product suppliers. The marketing value of six million browsing consumers was quickly recognised by (general) insurance companies: leading the product rankings did not only result in more leads but also translated into increased brand value and direct distribution volumes. This double effect enabled insurance companies to offer more competitive rates than through other third parties. *independer.nl* also realised this potential and decided to start with direct product supply.

Although still focussed on general insurance products (*independer.nl* sells more than 2,000 motor insurance policies a month), mortgages are starting to play a more important role. However, one factor is limiting the current conversion rate of online mortgage sales: the need for advice. The group of customers willing to deal directly through the Internet is (still) too small to generate sufficient sales volumes.

To increase this conversion rate, *independer.nl* is extending its sales force. Not only are they recruiting mortgage advisors, but they also are working together in a joint venture with some of the largest mortgage intermediaries in the Netherlands (e.g. De Hypotheekshop and Huis&Hypotheek). Once again, this example illustrates the critical need for (specialist) advice in mortgage distribution.

However, there is a limited subset of financially sophisticated consumers who are increasingly willing to deal through remote channels for application as well as search. The fact that this customer segment is limited and more prevalent in some markets than others is driven by four main factors:

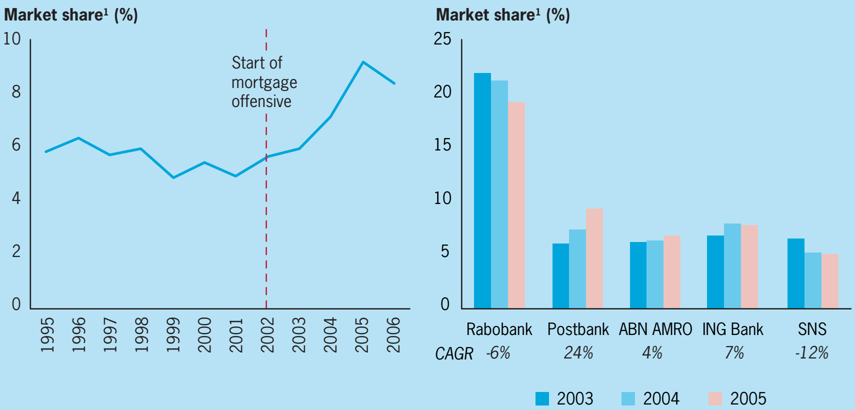
- **Financial sophistication** is key in being able to buy complex mortgage products through remote channels
- **IT access and security** are important in building customer confidence in using the Internet for important financial transactions
- **Technological advancement** can pose restrictions on remote capabilities. For instance, Internet availability is not yet widespread in all European nations. In countries where remote channels are prevalent – such as the UK and Sweden – Internet penetration is high
- **Lender appetite** restricts take-up as many providers are reluctant to spend on advanced Internet or call centre operations without assurances that they will be successful. Some degree of risk taking is therefore required to drive demand in this channel. Successful examples include SBAB in Sweden and online mortgage brokers in Germany, both of which have driven direct volumes in their markets

Although the use of remote channels for fulfilment further decreases the volume of mortgage business generated through the branch (putting pressure on cross-sales opportunities), many banks do not want to miss out on this customer segment as part of their multi-channel strategy. Either they use remote channels to generate leads or take it a step further by using remote channels as a direct sales channel.

Case study
Postbank – Towards a lion's share of the Dutch mortgage market?

With more than 7 million current accountholders, Postbank – operating independently as part of ING Group – has always been one of the largest financial services providers in the Netherlands. In 2002, with increasing pressure on profits, traditionally strong, from payments and savings products and significant under-penetration in mortgages, Postbank decided to launch the Mortgage Offensive – a direct attack on players such as ABN AMRO and Rabobank. Four years later, Postbank has become the second largest mortgage provider in the Netherlands (see also Figure 30).

Figure 30: Postbank's market share development (all channels)



1 Source: Postbank Mortgage Offensive, EFMA conference, market share based on gross advances

In addition to a strong intermediary mortgage business, one of the main pillars of the Postbank strategy has been to improve lead generation through remote channels (Internet, phone, post) with face-to-face closure using specialist mortgage advisors. This approach built upon:

- **An agile back office:** Moving de-centralised processes and architecture ('spaghetti infrastructure') onto a common platform
- **Advanced customer information/contact management:** Leveraging the 7 million-customer database to target customers
- **Lead generation:** Lead generation and database pre-selection for face-to-face closure – strongly focussing on conversion rates
- **Specialist mortgage advisors:** Closing deals using a sales force of ~250 mortgage advisors visiting customers at home

To close the gap with market leader Rabobank, Postbank will have to continue to build upon its strong internal processes but, more importantly, must ensure the retention and incentivisation of its mortgage advisors. In an advice-driven mortgage market, they can make the difference.

Using remote channels as a sales channel

Financially sophisticated consumers will only use remote channels if there is incentive to do so. Three such incentives exist:

- **Convenience:** Remotely sold mortgages are more convenient for some segments of consumers than products sold through branches and intermediaries. Firstly, the process tends to be markedly quicker, especially on the Internet. Secondly, applications can be made outside of working hours, an important feature for some consumers
- **Cheaper products:** Lower rates may be offered to consumers as a result of the cost savings afforded by the adoption of a multi-channel distribution strategy
- **Service:** Features such as online tracking and e-mail updates provide an improved service for the customer, which may attract them to the Internet channel

However, lower distribution costs are not always passed on to consumers. Lenders are faced with a difficult strategic choice. They want to capture as large a volume of the bounded segment of remote channel users as possible to maximise mortgage volumes. However, they also want to maximise the number of sales through branches so as to optimise cross-selling potential.

Managing costs via use of remote channels

Remote channels provide lenders and intermediaries with an opportunity for lower costs since the unit costs of remote distribution are commonly lower than for face-to-face distribution. Travel time is eliminated, capacity can be spread more effectively for phone distribution and fixed costs of technology can be leveraged over a large number of applications.

However, lower costs are not a given from adopting remote channels for mortgage distribution, particularly given the complex nature of mortgage products and related processes. Firstly, fixed costs spread over a low volume of transactions will result in costs higher than expectations, and so it is important to drive volume to these channels either via compulsion (i.e. making products only available via remote channels) or via customer incentives, e.g. lower rates/convenience. Secondly, it is important to ensure that channels are all able to effectively interface with core mortgage systems so that additional interfacing costs are avoided. Finally, effective and efficient sales processes are equally important in remote channels to ensure that the maximum benefit is being gained from the use of remote channels.

Examples of successful models

As highlighted in this chapter, there are two main examples of successful models in remote channel mortgage distribution:

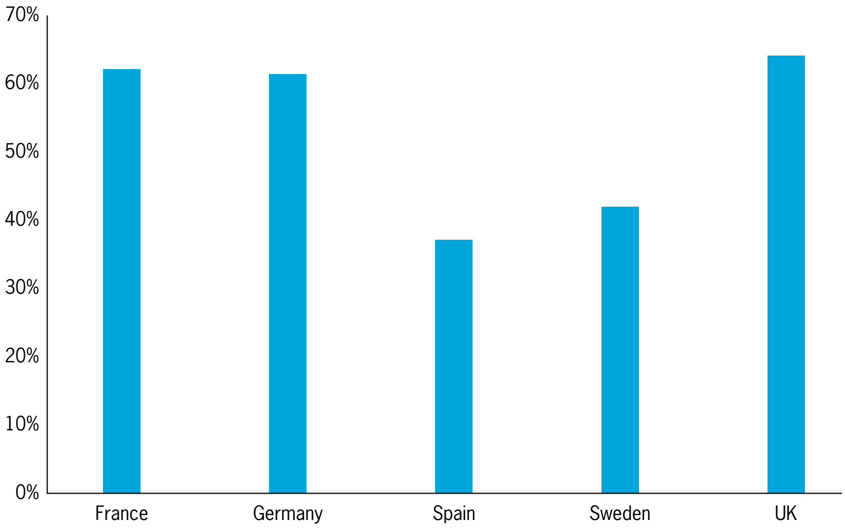
- **Lead generation with face-to-face closure:** Combining the strengths of technological advancement and the need for face-to-face mortgage advice. Although a strong combination, it poses several challenges for banks: not only do they need state-of-the-art technology, but they also need to ensure the retention and incentivisation of its mortgage advisors
- **Integrated fulfilment** (low-cost solution) with pricing to drive volume. This model has been less successful to date due to customer and lender preferences and some regulatory constraints (e.g. need for in-person signing of documents or non-acceptance of electronic signatures). SBAB in Sweden is a striking counterexample to this general message, having built a market share of just under 10% via a direct model. Going forward, however, we expect that improvements in technology, mortgage processes and regulation (e.g. permission of remote closure and electronic signatures) will make this an attractive standalone option in a broader number of developed mortgage markets

We see remote distribution of mortgages as a model that is likely to gain share as customer sophistication and technological improvements make this a more accepted channel for customer transactions, and we expect European markets to follow Sweden's lead in the next 10 years, significantly growing remote distribution to 15% of new lending and beyond.

9 Managing relationships with existing customers

Retaining existing customers is important. Given the high costs of customer acquisition and the regular flow of profits from existing customers for mortgages held on balance sheet, keeping customers for longer has always been an important driver of profitability. However, as customers become more aware of their ability to shop around for mortgages and not just at the point of buying a new home, the battle to retain customers (and for other lenders to acquire customers from other lenders) is increasing in intensity in most European markets. For example, Figure 31 shows that in all markets over 30% of all customers will shop around for remortgage offers (e.g. when the fixed rate or offer period ends), and this proportion is as high as 60% in France, Germany and the UK. Many lenders have therefore invested significantly to develop their understanding of *how to* retain the right customers. Broadening the existing relationship is then the logical next step.

Figure 31: Proportion of customers shopping around for remortgaging



Source: Customer survey

Retention management and remortgaging

The economic value of customer retention is widely recognised. Customer attrition is a major destroyer of value, and is increasing across many markets as customer inertia decreases. The strong relationship between customer retention and profitability can be described by four main factors:

- **Focus:** Allows banks to focus on the needs of their existing customers by building strong relationships
- **Cross-sell:** Long-term customers buy more

- **Cost:** Attracting new customers is generally considered to be five to six times more expensive than retaining existing customers
- **Competition:** Long-term customers are less sensitive to competitive marketing activities

Figure 32 shows that around 60% of all lenders surveyed proactively manage customer retention.

Figure 32: Proactive management of customer retention

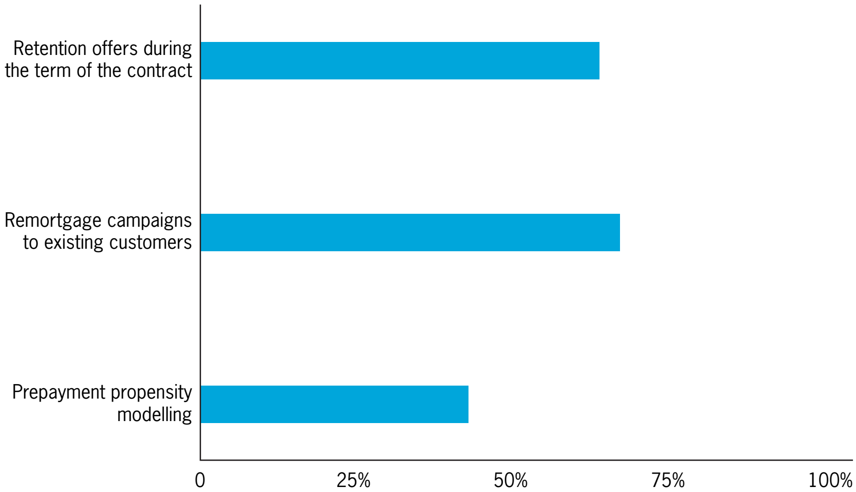
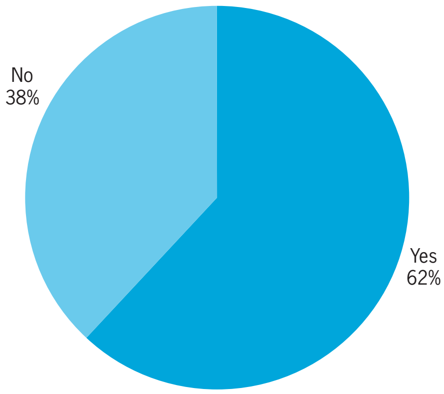


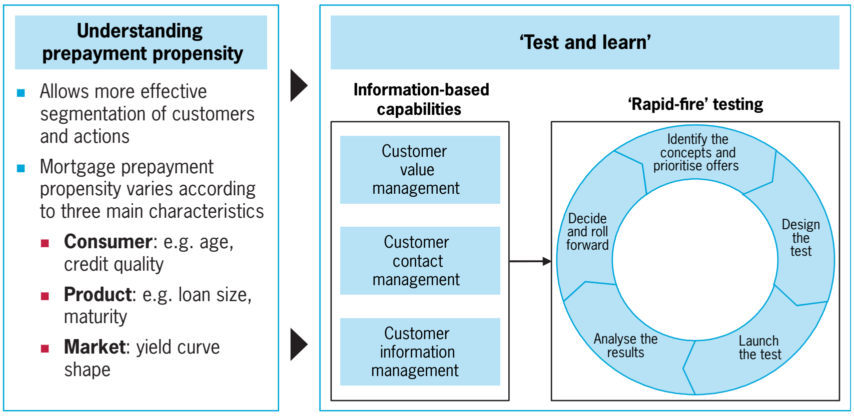
Figure 33: Reactive management of retention



Although this relationship is widely understood, it is a complex challenge to truly understand the fundamental drivers of attrition behaviour and to manage customers accordingly. Retention efforts are often of a 'try stuff and see what works' or 'see what we can get away with' nature. Such poorly targeted retention initiatives often cause more harm than good. Leading mortgage players understand that three steps are critical in successful retention management strategies (also refer to Figure 34):

- Understanding prepayment propensity and blockers (e.g. fees, transaction costs)
- Information-based 'test and learn' initiatives
- Incorporation of retention into business activities

Figure 34: Using 'test and learn' to improve mortgage retention



Understanding prepayment propensity

Although a prerequisite for effective retention management, the complex nature of prepayment propensity makes it difficult to grasp: it varies according to consumer (e.g. age, credit quality, financial astuteness), product (e.g. maturity, interest rate binding period, prepayment fees, loan size) and market characteristics (e.g. yield curve shape, interest rate volatility).

A better understanding of prepayment propensity allows more effective segmentation of customers and actions. The key challenge is to understand the drivers of prepayment propensity and offer acceptance for the large group of 'swayers', i.e. those customers that can be persuaded to stay with the lender via some form of action but might otherwise choose to leave to a competitor. It is this group that should be targeted with proactive retention offers, reactive retention tactics or loyalty programmes. But how and when? And what should be the value of the offer? Although apparently straightforward questions, a 'test and learn' approach is often the only way to find out the answer.

Test and learn

A retention management strategy will never converge to one static answer. It needs to be dynamic to constantly evolve with the changing market conditions. In-market experimentation therefore provides the best approach to match the customer's prepayment propensity to the right retention strategy, and to match retention offers to current macro-economic conditions and a competitive market.

Three factors are critical to a successful 'test and learn' programme:

- **Disciplined analytical process:** Using a deep understanding of prepayment propensity to balance 'end-to-end' economics (future customer behaviour, process costs, margin) requires a disciplined analytical process as pitfalls of the testing process are widespread (e.g. testing without valid control groups, confusion of customer cause and effect)
- **Information-based capabilities:** A set of linked information-based capabilities forms the basis for any in-market experimentation. Building upon existing customer contact management (e.g. response tracking across multiple distribution channels) and customer information management (deep and rich accumulation and synthesis of data) capabilities is key
- **Agility:** In order to learn from in-market testing, a rapid testing cycle with accelerated learning is essential. Retention offers should go out straight away, providing immediate learning and successes

A combination of these three factors provides the basis for an iterative investment which can start small scale, but will immediately start (and continue) to provide invaluable insight into those customer segments which matter most.

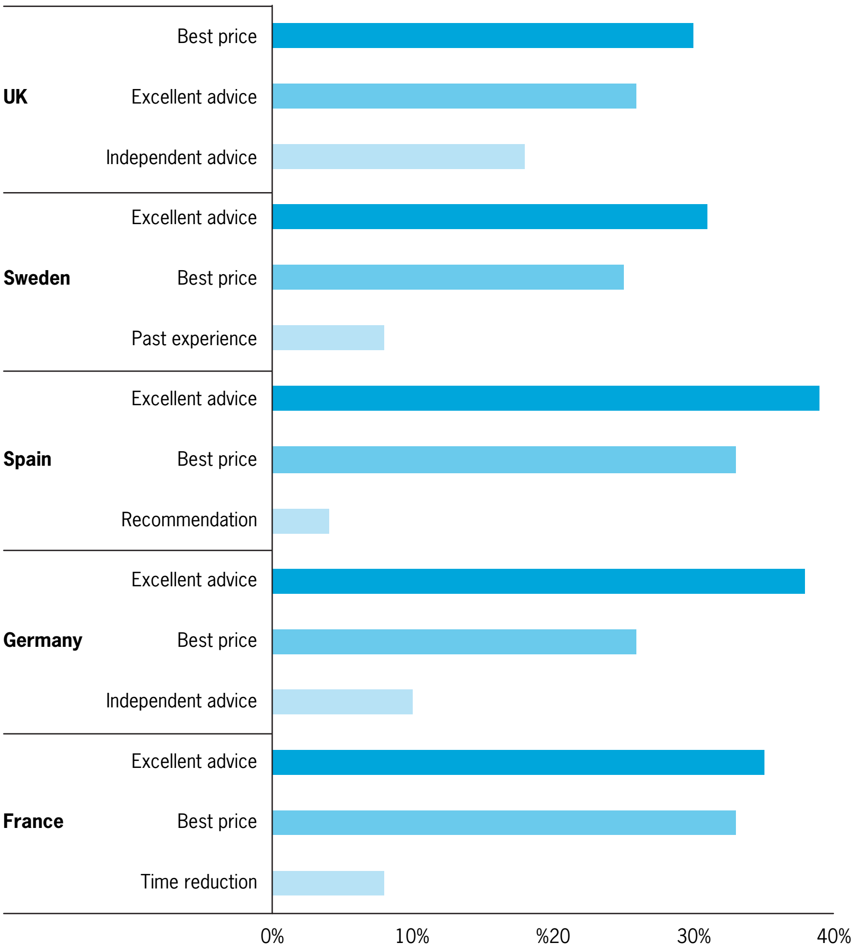
Incorporation of retention into business activities

Such approaches must be placed within a consistent framework for them to be effective. We see P&C and life insurers as leading the way with thinking about retention, and it is now commonplace for an insurer to take a multi-disciplinary approach to retention management, employing a retention unit that oversees activities from customer selection through product design and including bespoke customer communication and dedicated save teams in an effort to maximise retention levels. As the mortgage market looks increasingly like the transactional general insurance market, we believe that such a multi-disciplinary approach is necessary for lenders to get the most out of their retention activities.

10 Pricing

The growth of mortgage intermediaries and price comparison tools, combined with mortgage customers placing price as one of their primary selection criteria (see Figure 35 below), have increased pressure on mortgage pricing and margins. Although it is widely recognised that better pricing enables sustainable income growth, pricing remains unsophisticated across Europe. Differentiated pricing, either by customer segment or at an individual customer level, provides significant opportunities for mortgage lenders – some of which can only be realised through strong distribution channels.

Figure 35: What are the value drivers for customers?



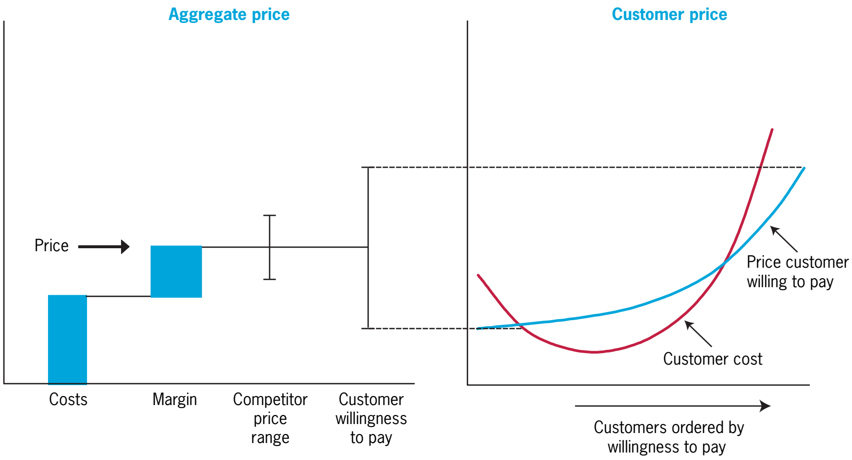
We note that price is not always the top criterion quoted by customers (excellent advice is often placed higher), presenting some scope for a price premium for good advice. However, in many cases the advice is likely to be around finding the best-priced product and so may come down to the same decision factor for the customer.

Optimising pricing at a product level

Improving profits through better pricing is not a new idea. Better pricing provides greater leverage than lowering costs or increasing sales, is relatively easy to implement and will quickly take effect. Yet, mortgage pricing remains relatively unsophisticated across Europe. Prices are set centrally based on aggregate costs and competitor comparisons, with little or no price differentiation by customer. This is not only due to its complexity, but also because it is a politically sensitive topic with scattered responsibility throughout the organisation (typically marketing and sales). While there are some advantages to pool pricing (e.g. simplicity of customer message), more sophisticated pricing allows for greater value creation by capturing consumer surplus and managing customer selection.

It is the difficulty of measuring customer price sensitivity (or, 'willingness to pay') that results in uniform prices set based on aggregate costs and competitor comparisons. However, as Figure 36 shows, in practice there is a wide variation in customers' 'willingness to pay' – the uniform pricing therefore results in consumer surplus. Differentiated pricing will capture some of this surplus by individualising prices to customers. However, a strong underlying pricing process is a prerequisite.

Figure 36: Comparison of aggregate price and customer price sensitivity



Differentiated pricing

Several mechanisms for increasing price differentiation exist in financial products. For mortgages, a number of options can be used:

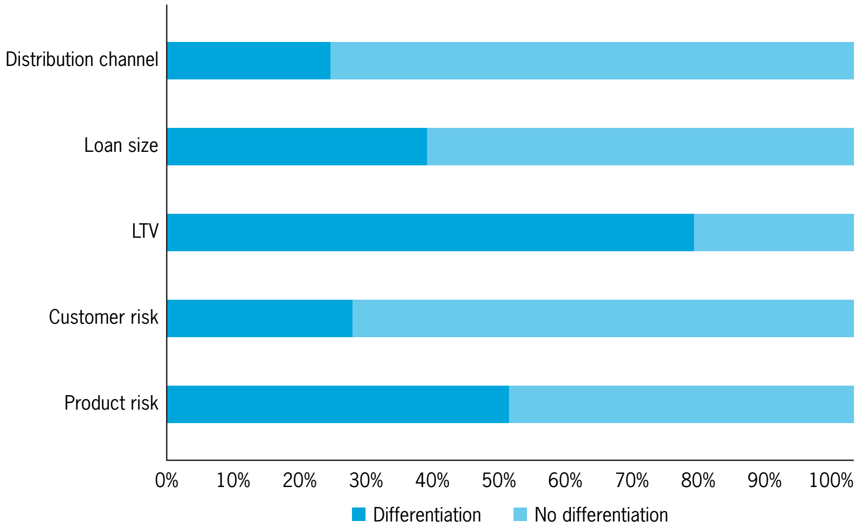
- Risk premiums
- Offer versioning

- Price negotiation at point of sale
- Customer screening
- Customer self-selection

Risk premiums

Figure 37 below shows the existence of price differentiation by different characteristics of the mortgage product for lenders across Europe.

Figure 37: Existence of differentiated pricing across mortgage lenders



Source: Mercer Oliver Wyman Mortgage lender survey

Pricing for product risk (e.g. via LTV-based pricing) or for certain product characteristics (e.g. self-certification of customer income) are the most common types of price differentiation. Differentiation of product price by channel, typically reflecting either cost differences or price elasticity by channel, is much less common at present. Pricing for risk can be easily communicated to customers and as such can be included within a transparent framework, e.g. price lists. As mortgage markets develop and lenders become more sophisticated in terms of understanding value and price sensitivity, we expect that price differentiation will become much more commonplace.

Offer versioning

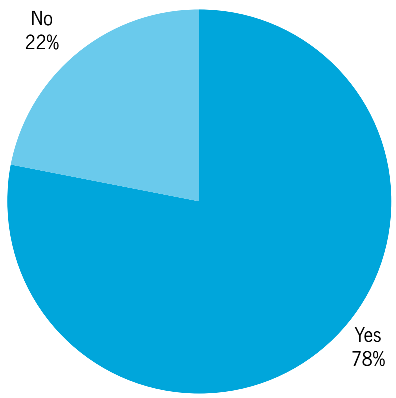
A second way to improve price realisation is through offer versioning, i.e. attracting customers via special offers which then revert to a higher price after a certain time, or which attract customers who then take out another higher-priced product. In both cases, realising higher prices demands a good understanding of customer behaviour and preferences – to ensure that actual customer attrition and product choice behaviour allow higher price realisation rather than adverse selection of price-sensitive (and often value-destroying) clients.

Price negotiation

The most complex method for price differentiation, and the method that has the potential to maximise the capture of any consumer surplus, is price negotiation at an individual customer level.

According to Figure 38, most lenders within our survey allow price negotiations on a customer level, and this is the norm in many of the countries studied (e.g. Spain, France, Belgium, Sweden). Price negotiation is often linked to the value of the customer to the organisation offering the loan, e.g. the value of deposit, investment and current account business with a retail bank.

Figure 38: Allowance of negotiation on customer level



While this approach has the potential to maximise value (by ensuring that customers pay the highest rate that they are prepared to pay), it also has the potential for value erosion by over-discounting to customers where it is not needed and not justified from a customer value perspective. Such over-discounting is often driven by sales incentives that value volume of mortgages over value, often not taking into account the realised price. Discounting will also be driven in markets where customers are more prone to shop around for their mortgage and where intermediaries provide greater price transparency. To overcome this issue, lenders that allow point of sale price negotiation need to have three items in place:

- Sales incentives and performance metrics that take account of realised price
- Point of sale information that allows sellers to make informed choices about customer value (e.g. value of current product holdings and projected into the future)
- Training and provision of information on negotiation success, e.g. distribution of realised price by seller or sales team

Rabobank – Room for negotiation

Since 1 May 2006, a comparison table of mortgage rates across Dutch mortgage lenders will not include the cooperative Rabobank, the largest mortgage player in the Netherlands. Rabobank has decided to stop publicising its mortgage rates. With this move, Rabobank aims to give more room for price negotiation to its 250 local branches, which will be able to 'tailor mortgage rates to the individual customer situation'.

Pricing process

The basis for any mortgage price optimisation is a robust pricing process. Although this is not 'rocket science', many European players forget to apply a structured approach to the pricing process:

- **Strategy:** What do we want to achieve with pricing?
- **Analytics:** What is the best price for a given customer type?
- **Realisation:** How do we achieve the best price with individual customers?

Figure 39: Pricing process

	Strategy (ad-hoc)	Analytics (weekly/monthly)	Realisation (continuous)
Typical process	■ Prices set at launch ■ Periodically reviewed ■ Some competitor and market research ■ Broader proposition rather than just rate/fee	■ Funding rate movement + ■ Published competitor rates = ■ Target margin/rate	■ Prices adjusted locally to reflect competition ■ Some monitoring of average margins
Department Responsible	(Marketing)	(Finance)	(Distribution)

Best practice	■ Set target returns by product/segment
	■ Agree pricing strategy (leadership, x-subsidy, etc.)
	■ Agree policy (discretion, discrimination, etc.)
	■ Understand customer sensitivity in more detail (e.g. using research)
	■ Set prices and framework for change
		■ Close monitoring of shares/volumes/ prices in market
		  ■ Own
		  ■ Competitors
		■ Prices set to achieve objectives
		  ■ Using supply/ demand model
		  ■ Incorporating discounting and competitor position
			■ Pricing performance monitored and reported by advisor/bank/ region
			■ Local elasticity measurement (share vs. relative price)

	(Multi-disciplinary team)	(Pricing unit)	(Distribution)

Figure 39 illustrates the differences between the typical and best practice pricing process. Best practice mortgage originators will have both robust pricing strategies and processes to ensure that these strategies are followed. Within mortgages, differentiated approaches for different customer segments proves a particular challenge, specifically in relation to new versus existing customers (front book versus back book). Strategies for price realisation and retention must be carefully managed to take account of the trend towards increased transparency of front book pricing and its effect on the price elasticity and behaviour of back book customers.

11 Cross-border distribution

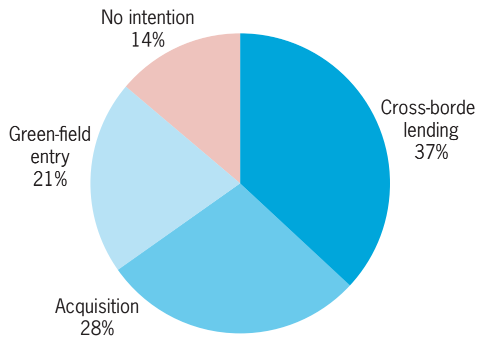
Cross-border expansion is driven by the ability to realise scale benefits or leverage capabilities in the core market into other markets and/or to take advantage of superior economics in other markets. In mortgage lending, most lenders find this difficult to achieve, as mortgage processes are sufficiently different to require dedicated staff and systems for each country. More importantly, distribution reach is critical for successful expansion into foreign markets.

Distribution models for entering new markets

As with any other cross-border expansion strategy, there are two main ways to enter a new market, either through mergers/acquisitions or by organic entry. The nature of mortgage distribution limits the options for successful distribution models under these two strategies.

Interestingly, despite only limited cross-border lending in Europe to date, the majority of our survey respondents are considering cross-border expansion and have a general preference for cross-border lending over acquisition, with a green-field entry strategy the least likely entry mechanism (also see Figure 40).

Figure 40: Preferences for cross-border expansion



Source: Mercer Oliver Wyman Lender Survey 2006

Mergers and acquisitions

Over the last few years, several European retail banks have tried to expand their distribution reach in emerging European markets through acquisitions and joint ventures. Examples include the purchase of banks in Poland and Turkey (see below) by Western European banks and some large-scale mergers across European borders (e.g. Santander/ Abbey, Unicredit/HVB). Penetration of the mass market in mortgages is extremely difficult without acquisition since distribution reach and processing scale are required to achieve attractive economics, and the lack of an indirect channel in many markets eliminates this option. Cross-border synergies are often impossible to realise as processes and systems need tailoring to local conditions, resulting in sharing of only limited competences such as product know-how and risk management. This observation is supported by the continuation of distinct mortgage (and banking) businesses within cross-border institutions in Europe (e.g. Santander, Nordea), in particular for distribution where local management is critical.

Case study – Turkish delight

In response to economic stabilisation and profitability in the financial sector, Turkey has experienced a wave of M&A activity over the past two years (see Figure 41).

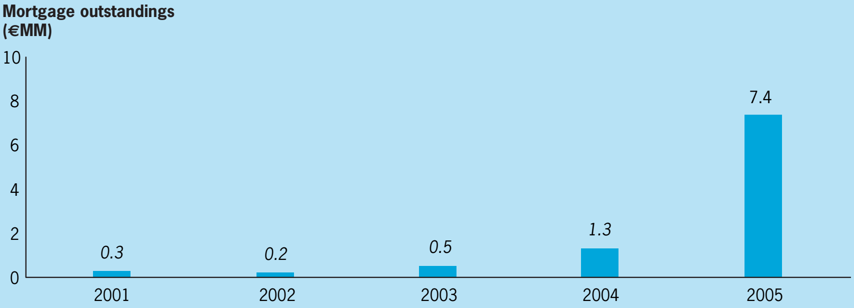
Figure 41: Recent M&A transactions in financial services in Turkey

Recent M&A activity in Turkey . . .

Acquirer	Target	Deal size (US$MM)	Deal date	Market share of assets	Number of branches
Dexia	Deniz	3,253	May 06	2.3%	244
NBG	Finans	6,031	April 06	3.3%	221
GE CF[1]	Garanti Bank	1,556	August 05	9.4%	436
UniCredit[1]	Yapi Kredi	1,489	May 05	5.7%	405
Fortis	Disbank	1,144	April 05	1.8%	191
BNP Paribas	TEB	217	February 05	1.4%	115

1 Acquired stake in Turkish target

. . . Fueled by a growing market



Source: European Mortgage Federation

Though still insignificant compared to the rest of Europe, the Turkish market is expected to grow rapidly, also fuelled by a new regulatory regime. All entrants realise that distribution reach through the acquisition of a branch network is essential for reaching out to the mass market. With the privatisation of several major Turkish banks, for example Ziraat Bank and Vakiflar, we will not have to wait long before another European player pays Turkey a visit. There is also reason to expect growth in the share of intermediaries since the branch network is small relative to the population (but expanding fast) and appetite among (foreign) lenders for mortgage assets is likely to be high.

Organic entry (cross-border lending or green-field entry)

As we have seen in the previous section, distribution reach is essential for a successful cross-border strategy. Although this limits the options for a successful organic entry strategy (as setting up a large branch network from scratch is typically out of scope other than via acquisition), some of the largest European mortgage providers have been creative in entering new markets. They have realised that the cross-border business model needs to be simple or different.

Two main options have proven to be successful:

- **Transfer of a simple business model:** Simplicity is key when entering a new market: low cost to drive volume through competitive pricing is a prerequisite. Distribution reach can be realised through the Internet or through indirect channels such as mortgage brokers (examples such as ING DiBa in Germany, Bank of Scotland in the Netherlands have tended to use both of these channels to build market presence, given the small volumes of Internet sales to date). Bank Millennium in Poland has also established a strong market share (currently number two by originations) via an intermediary-driven model
- **Niche market entry:** Cross-border expansion via niche markets has proven to be a successful model. Examples of such strategies include not only focussing on expatriates (e.g. HBOS, Barclays) and High Net Worth Individuals (e.g. UBS) where tailoring skills are needed, but also targeting owners of holiday houses in the south of Spain and France (e.g. Nykredit). Driving down the Côte d'Azur and Costa Brava, a large number of branches of large European banks will come into sight. Other models include product niche entry (e.g. GMAC-RFC entry by offering high LTV loans in Germany) often using established intermediary channels or the third-party bank channel, especially where incumbent lenders are reluctant to take on the risk associated with new products

Obstacles and issues related to cross-border distribution

Although there are several benefits to cross-border distribution, the study on the financial integration of European mortgage markets in 2003[13] also identified a large number of barriers to successful cross-border expansion, all of which are still valid in today's still largely un-integrated mortgage market:

13 EMF/Mercer Oliver Wyman

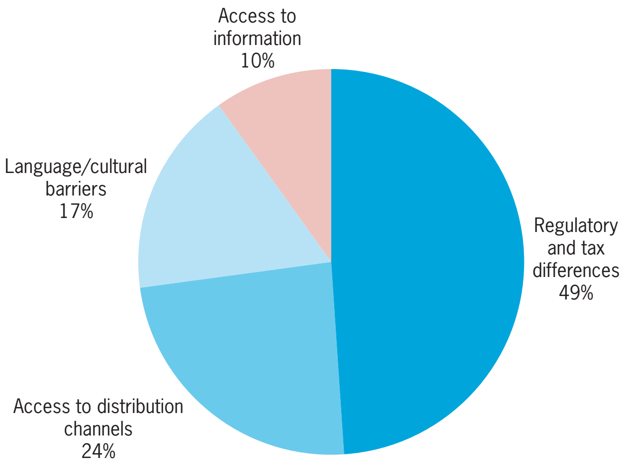
- **Lack of access to distribution:** Access to distribution is a very important component of any market entry strategy. In those markets that are dominated by branch and tied distribution, it is often difficult for a foreign entrant to access distribution and correspondingly difficult to achieve any significant market share. This leads lenders to seek to enter niche markets within these markets, where distribution is more specialised (e.g. sub-prime lending). Markets where distribution is more accessible (e.g. the Netherlands, the UK) have seen a greater level of foreign entry as new lenders can access a larger proportion of the market without owning a branch network. Similarly, the ability to access third-party servicing capabilities makes it much easier to enter a foreign market. There have been significant improvements in distribution accessibility in many European markets driven by the growth of indirect channels (e.g. Germany, Poland) in recent years, although this is still a large barrier to foreign entrants
- **Policy and regulatory barriers:** A large set of policy and regulatory barriers makes successful cross-border expansion more difficult, e.g. laws regarding collateral and tax barriers. Mortgage lenders must fully understand the regulation that applies in any market they plan to enter. As an example, differences in consumer protection across countries are a factor that deters foreign lenders from lending in new markets. While some of the regulatory differences seem reasonable, others such as barriers to marketing and advertising for non-domiciled institutions seem protectionist
- **Lack of access to information:** Lack of access to information on foreign mortgage markets is a key barrier to entry. When considering entering a new market or acquiring a company, mortgage lenders will require information on the market, such as credit quality and collateral values, all in a format that is compatible with the information available in their own market so that conclusions can be easily reached. There are a number of barriers to achieving this ideal situation. Firstly, the information is not always collected. For example, land registries are not always complete, and electronic databases have not been completed in all markets. Secondly, foreign lenders cannot always get access to information such as credit bureau data due to access restrictions. Finally, data is almost always in a format that is specific to the individual market and so requires a great deal of interpretation by a foreign lender to reach sensible conclusions
- **Inability to realise scale benefits cross-border:** The ability to realise scale benefits or leverage capabilities in the core market into other markets are key drivers of cross-border expansion. However, in mortgage lending most lenders find this difficult to achieve, as

mortgage processes are sufficiently different to require dedicated staff and systems for each country. Currently, cross-border synergies are confined to funding and risk management, as distribution, origination and servicing activities must be tailored to the national market. This observation is supported by the separation of the mortgage (and banking) activities of cross-border institutions in Europe (e.g. Fortis and Nordea), which retain separate businesses in each of their countries of operation

- **Low returns on standalone mortgage strategy:** In some markets a deterrent to foreign entry of mortgage markets are the current low returns in those markets. In addition to average returns, the costs of establishing a business are often high in the early years. This is because distribution and origination, along with any initial discount offered to the borrower, must be paid out in the first years of the loan. This factor, coupled with low returns, makes the breakeven period on any investment quite long and makes cross-border expansion even less attractive than other options available to European lenders. In some cases, the situation of low financial returns is driven by product cross-subsidisation (e.g. as we have seen in the case of France)

Our lender survey backs up these findings. According to lenders surveyed, nearly half of all lenders see regulatory and tax differences as the main obstacle followed by access to a distribution network (see Figure 42).

Figure 42: Main obstacles for cross-border expansion



Source: Lender survey

12 Conclusions – Winning models in mortgage distribution

Our analysis indicates that mortgage distribution is changing and that lenders and mortgage intermediaries must develop their business models in order to be successful looking forward. In particular, lenders must ensure that they are getting the most from their existing distribution channels and are well positioned to meet customer needs in the future. To assist this, we have developed a distribution checklist to identify where lenders need to focus:

Mortgage lender's distribution checklist

Branch management

- Have you evaluated the cost/benefit of specialist mortgage sales staff versus generalists?
- Are your incentives aligned with value or volume?
- Do you have processes and metrics in place to encourage lead provision to mortgage sellers?
- Have you matched sales resources with local opportunity?
- Are sellers doing low value-added tasks that could be done by other staff?
- Do mortgage sellers have a clear management structure and career path?
- Have you invested in clear, effective processes and technology support to make the mortgage sales process easier and faster for sales staff and customers?
- Are sales of additional products built into your sales process and performance measurement and management framework?

Intermediary management

- Do you actively cover the intermediary sector and if not, how much volume and value is this currently costing you?
- Do you differentiate service and coverage into different tiers of intermediary (e.g. product specials, technology support, training) and coverage levels?
- Do you have a clear approach for incentivising cross-sales via intermediaries?
- Are you using the available range of fee levers to improve volumes with intermediaries?

Remote channel management

- Do you have a clear customer proposition for your remote channels (e.g. convenience, price, service)?

- Are your remote channels integrated with your core mortgage systems and customer information systems to provide an integrated view for the customer and the bank and to minimise costs?
- Do you have a mechanism for tracking and following up on remote channel leads (e.g. outbound calls, home visits etc.)?
- Do you have the capability for online application completion and application tracking?

Optimising existing customer relationships

- Do you understand the drivers of customer retention and attrition?
- Do you use reactive or proactive retention initiatives to try to keep customers?
- Do you understand the value impact of each retention initiative?
- Is retention included in other business processes (e.g. pricing, customer acquisition, relationship management)?

Pricing

- Do you have a clear view of the impact of pricing levers on profitability?
- Do you differentiate product pricing by the underlying profitability drivers (e.g. size, LTV, customer and product risk, channel)?
- Do you allow price negotiation at point of sale and if so, do you measure and manage over-discounting?
- Do you have clear processes and accountability for pricing within the organisation, including a strategy and supporting analytics (e.g. around price elasticity)?

Cross-border distribution

- Are you clear about your cross-border ambitions and the reasons for them (e.g. growth, product leverage, cost savings)?
- Have you a clear plan regarding acquiring distribution capability in the target country (e.g. acquire, partner, build)?
- What skills will you bring to the new market from your existing market, and how will these differentiate you?

Winning models in mortgage distribution

Based on our assessment of the trends in mortgage distribution and our analysis of best practices and successful models in each component of the mortgage distribution model, we have identified six winning models within mortgage distribution:

1. *Branch-focussed lender (e.g. HSBC UK, Société Générale)* – Leverage local distribution and customer relationships to get increased cross-sell and improve economics to the extent that aggressive price competition is not fatal
2. *Scale originator (e.g. Northern Rock, ING DiBa)* – Focus on mortgage origination, developing close relationships with mortgage intermediaries and leveraging scale benefits in production to deliver superior economics
3. *Direct lender (e.g. SBAB, ING Direct Italy, Bankinter)* – Exclusive use of remote channel distribution to deliver a customer segment specific proposition and achieve aggressive management of the cost base
4. *Giant all-channel lender (e.g. HBOS, Santander, Bank of Ireland)* – Deliver scale across all channels (technically a combination of the above)
5. *Branded distributor (e.g. De Hypotheker, Interhyp, Meilleurtaux)* – Focusses on winning customers via a focus on advice, best product and price
6. *B2B Platform (e.g. Europace*, *Mortgage Brain, Empruntis*) – Service providers adding value to the mortgage value chain via provision of software and process support for lenders and intermediaries. Includes information aggregators, product selection engines and loan-processing platforms

Within each of these strategies, execution is critical since most players currently are pursuing one or more of these strategies. The winners are those firms that have identified those areas where they can (and do) outperform their competitors, have aggressively driven performance improvements in that focussed part of the value chain and, in many cases, have abandoned alternative distribution models to others. Those lenders that stick to the old branch model and merely dabble in other emerging channels will be out-competed by focussed distributors and will risk further erosion of their share of distribution and profits unless corrective action is taken.

Authors

Henk Douna, Mercer Oliver Wyman

Simon Low, Mercer Oliver Wyman

Achim Dübel, Finpolconsult

MERCER OLIVER WYMAN

A leader in financial services strategy and risk management consulting

For more information, please visit the website at *www.merceroliverwyman.com*, or contact:

Tracy Seidensticker
marketingeu@mow.com
+44 20 7333 8333

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For more information, please visit the website at *www.efma.com*, or contact:

Jean-Guillaume Despres
jean-guillaume@efma.com
+33 1 47 42 67 71

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For more information, please visit the website at *www.fortis.com*, or contact:

Vincent Vanwijnsberghe
vincent.vanwijnsberghe@fortis.com
+32 2 565 33 96