

**Report Commissioned by  
Standard Life Bank**

**Why Mortgage Consumers Miss Out on the Long  
Term Value of Mortgages**

Dr Robert Phelps, Independent Economic Consultant  
and  
Richard Taffler, Martin Currie Professor of Finance and Investment  
University of Edinburgh

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## Executive summary

The emerging theory of behavioural finance suggests that consumers in a complex market such as mortgages will suffer from a number of cognitive biases such as an overemphasis on the short term, a strong aversion to possible loss and overestimation of the effort and persistence they will put into making their mortgage decisions. These behavioural characteristics have an important influence on financial decisions in addition to purely financial calculations. Conventional economic analysis (e.g. The Miles Review, 2004) does not fully address the importance of such factors in explaining consumer mortgage decisions.

This study examines the effect of behavioural biases on mortgage selection decisions. We carry out both consumer focus groups, including conjoint-style mortgage choice simulations, and analysis of a set of typical mortgage products on the market.

We find that representative customers appear to select mortgages mainly on the basis of initial discounted repayments offered. Customers know that to keep down costs they should continually remortgage at the end of each discount period, however, in practice, inertia sets in and they soon stay with an existing lender.

Our analyses show that typically a customer needs around 12 years (i.e. at least 6 successive two year discount periods) to have a lower total cost from a discounted mortgage compared with sticking to a non-discounted low standard variable rate (SVR) mortgage for the full term. In fact 95% of customers are estimated to be unlikely to remortgage sufficiently often (at least five times) and, as a result, are going to pay much more in total interest by selecting a typical discounted mortgage.

In the absence of significant remortgaging behaviour (i.e. typical consumer behaviour patterns) total mortgage costs over 25 years are related almost exclusively to the long term SVR and not to the discounted rate, a fact that appears to be largely ignored by customers in practice. In particular, Bank base rate (BBR) trackers and the SLB reducer mortgage offer lower long term interest rates than discounted mortgages and hence provide significantly lower total costs over the full term. Reducer mortgages appear unattractive to short term thinkers but may tend to lock in customers once the rate has reduced.

Important added value features of mortgages include flexibility and offsetting. Flexibility in a mortgage is perceived as valuable by customers and our initial estimate puts this value at around 0.1 – 0.2% off the interest rate or about £1,000-£3,500 in total over a 25 year period. Offsetting in a mortgage can make a far greater difference to total costs: customers could save over half of their total interest costs on a mortgage loan of £100,000 if they maintain the SLB average of £23,000 in their other accounts.