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The Packagers Report

A strategic perspective on the packager market

NMG Insight Series

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Key findings

- The packagers market is still growing, with 80 to 100 true independent packagers - including satellites this rises to 350
- Consolidation is likely, with mainstream providers reducing to 15 to 25 'super packagers', supported by a number of smaller, niche players
- Successful organisations in the future will develop integrated technology and address the issues of reducing fees and regulation

Introduction

Despite comments from leading industry figures before and immediately after the onset of mortgage regulation in November 2004, the packager sector has prospered and grown. During the two and half years between regulation and the fieldwork for this research, a number of lenders in this sector, and especially new entrants, have relied on packagers as a key distribution channel. At the same time, many intermediaries have found it easier to cope with the ever increasing complexity and competitiveness of lender portfolios by using packagers both for product sourcing and for handling their clients' non-conforming, specialist and sub-prime mortgage applications. Further growth in the packager sector seemed assured.

The fieldwork for this research was carried out during June and July of 2007. Expectations that lenders would have to reduce margin pressures started to come to fruition when, towards the end of the fieldwork, Mortgages PLC was the first to announce reductions in some procurement fees. There was no expectation, however, of a major impact to packagers' livelihoods through fall-out in the UK from problems at sub-prime lenders in the US. As the impact did not become apparent until August, and the extent of the impact not really understood until into September, the issue does not feature in this research.

In subsequent conversations with, and in articles and speeches by, some of the research respondents, packagers seem convinced that the sub-prime market will return in 2008, although it may not be until the second half and, initially at least, not at its previous level of activity. Consequently, we would sum up the situation within the packager sector as 'paradise postponed' rather than 'paradise lost'.

NMG's comprehensive report on the packagers market covers:

- **Strategic perspective** – based on in-depth interviews with industry influencers from key trade bodies and packager associations
- **Market analysis** – desk research to provide an overview of the market size, growth, drivers and trends
- **Packager viewpoint** – based on in-depth interviews with decision makers at medium and large packagers
- **Mortgage Intermediary requirements** – based on quantitative research via NMG's Mortgage Intermediary Census survey

This document is a summary of the findings from a strategic perspective.

Strategic Perspective on the Packagers Market

Satellites

Over recent years the overall number of players in the packagers market has increased, driven largely by the practice of employing satellites. Over 75% of packagers interviewed have satellite offices, averaging 22 per packager.

The proliferation of satellites can continue successfully and profitably only through:

- Use of a common technology platform direct to lender
- Use of a dedicated team to manage such operations
- Careful selection to prevent cannibalisation of existing business
- Balancing the reduction in margins against the financial returns of using satellites

“You need a completely separate team to manage the satellites. We have a satellite committee and salesperson and look after them, with training and back-up.”

Satellites will continue to play a role in the packagers market, but only if they are seen to add value, in order to be worth the commitment required to manage them.

“When you speak to those with satellites candidly they admit that out of say 50 satellites it only works for about 3 – 4 of them. The time spent trying to manage them far outweighs the value.”

Associations

Associations provide a useful support network for packager firms. For smaller packagers, they provide a means to maintain independence and preserve higher fee levels. They also provide an opportunity to combine distribution power, creating leverage to negotiate exclusive products and services. On the other hand, for the larger organisations, associations fulfil a valuable role by providing compliance and regulatory support.

In a changing industry, associations are likely to struggle with decision-making (e.g. selecting a common technology platform), given the large number of members with differing agendas. However, because they operate across a number of packagers, they are also able to assist with strategic relationships and joint ventures.

As the packager market continues to mature, the number of associations is likely to reduce.

Key Industry Dynamics

Technology

All those interviewed view investment in technology as critical to future success. Many larger firms are working to implement automated processing with direct links to lenders and brokers, based on the belief that lenders will only wish to maintain electronic links with larger packagers who can solve the issue of inter-operability of platforms. Several believe that they have a unique proposition that will give them a competitive edge, though not all can be correct in this belief and there are likely to be some who flounder.

The 'electronic hub' concept has supporters amongst smaller / medium sized organisations. However, the practical

implementation may be too difficult for some, and larger packagers investing in their own solutions will affect take-up of the hub concept by the market.

Views are divided on whether technology will be the sole driver of success in the future.

“Technology is important but not entirely necessary. For example, one firm might not offer anything special IT wise but the relationship is great so things are offered pretty much the same day, whilst another who has an online system depends on their technology completely to get by.”

A few of the larger packagers appear to be moving to a model akin to a pure technology platform, typically taking the view that cost will be the critical success factor and hence are planning for a significant reduction in current fee rates.

“There is still a huge demand by mortgage brokers and IFAs for assistance with cases outside the norm. Technology will improve sourcing systems and will make them more reliable ... but it's the way that you present a case to the lender in many cases that actually wins it through...and having a discussion with an on-site or Head Office based underwriter that you have a relationship with.”

Others view the technology solution as high risk, believing that:

- A more personalised service is important, especially for smaller brokers
- It will never be possible to process more complex cases through a technology platform
- Lenders can be influenced to take on business in other ways, e.g. by ownership of distribution

Fees

Due to the fact that packager costs will decrease with greater automation, the majority of packagers see reduced fees as a certainty, through increased pressure for margin from lenders.

“The lenders argue that their margins are squeezed all the time, so by their very nature they will try to squeeze those margins from others in the chain. This will not only affect the financial model but also push lenders to a direct model.”

The extent of the decrease in fees varies, with some citing up to

a 50% reduction in margin, whilst others do not believe that such dramatic reductions will be the case.

In the medium term lenders will need to pass on a realistic margin, unless they can rapidly develop D2B or D2C channels.

Packagers aim to reduce the impact of lower fees through a variety of means including increasing volumes of business, achieving higher loan values and fees for other activities apart from processing.

“Packager fees will reduce but the amount earned from lenders will be maintained - it will be paid in different ways. There will always be lenders who are willing to spend elsewhere with the packager (e.g. advertising) which brings overall revenue back up.”

Regulation

Although packager regulation is not currently on the FSA's agenda, many respondents see regulation as a driver of change in the way their business models develop.

“Packagers will become an FSA regulated single point of contact for all lending for brokers across all sectors, including prime business.”

Many believe that there should be no room for companies that do not operate in a compliant manner and that Treating Customers Fairly and robust audit trails are essential.

“It will be pretty much the same model as currently but with more regulation on the packager's side. Packagers will get regulated some time soon and adhere to more compliance measures than currently.”

A principal concern from respondents is how any regulation would work in practice, given that a packager doesn't give advice.

“I'm not sure how they could regulate packagers other than to ensure work was carried out in an honest manner and with integrity which is difficult to prove.”

Future Industry Structure

Most packagers are confident in their businesses and believe they will prosper, although they feel that the overall number will reduce dramatically. Most respondents forecast that from the current 80 to 100 main players in the market, 15 to 25 'super-packagers' will emerge, with links to a number of satellites and three or four mortgage networks.

Outside of these 'super-packagers' the successful smaller players will need to specialise to ensure they can survive in the predicted technology-driven, reduced margin world.

“To be able to survive as a packager / distributor they must embrace new technology ...it will become an essential to sit at the ‘big table’ with the lenders.”

It is perceived that a minority will position themselves along the lines of more specialist providers for less straightforward cases, with very close partnerships with lenders.

“A specialist role dealing with the problem case that won’t go through an automated system.”

Smaller players will need to consider becoming a satellite or franchise in order to share the costs of technology. As part of a larger group, these packagers could then benefit from the higher fees paid to larger packagers.

“Probably as few as 12 big independent packagers doing the bulk of the volume. Most of the small guys that are left will likely find they have to fall under someone else’s banner.”

Consolidation is a real option in order to reduce costs and share skills, but there is little evidence that leading packagers see themselves either merging or acquiring. The industry has been entrepreneurial to date and until pressures peak or prices rise, it is likely that egos may delay consolidation in the short term.

Some also take the view that there will be businesses that fail, and that it is better to wait and pick up the pieces than enter into costly M&A negotiations at this time.

Some larger packagers have seen investment from bigger financial institutions (e.g. GE Money investing in Solent) and it is likely this trend will continue. There are also early signs of venture capitalists and investment banks.

“Some larger players – such as Enterprise – who have capital investment behind them, will go on to buy a successful packager because they will never be able to acquire the distribution of other packagers to the extent that they would like, i.e. to ‘conquer the world’”

Whilst the current uncertainty around the US sub prime market may act as a temporary brake on investment, further M&A activity is to be expected as packagers grow in size and are able to exert greater influence over distribution.

The Role of Packagers in 2010

Packagers are unanimous that they will still have a role in 2010 and beyond. All are agreed their role will change with the main dynamics being:

- Clearer role as distributors
- Smaller number of large players
- Highly efficient processes for more straightforward cases
- Automated multi-lender, multi-product cascading
- Manual processing of ‘difficult’ cases
- True partnerships with a limited number of lenders
- Reduced fees
- Regulation

All packagers believe they are going to be successful, but it is those who adapt to the following drivers of change that will win through:

- Technology driven processing
- Limited number of key mortgage networks
- Larger packagers with manufacturing capabilities
- The need to diversify to increase margins
- Increase in panel size
- True partnerships with lenders
- Multi-lender cascading
- The use of satellites

About NMG

NMG is a multinational consulting firm specialising in insurance and investments. Our proprietary adviser, broker and consumer research platforms provide an information advantage in developing evidence-based solutions to strategic issues.

Research Methodology

Qualitative research was undertaken by NMG during the summer of 2007. Participants in the study included the leading firms within the packaging market and in most cases the interviewees held board-level positions, frequently Chief Executive or Managing Director. Participating firms cover around 75% of the packager market.

Copies of the complete and comprehensive report are available from our contact below.

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