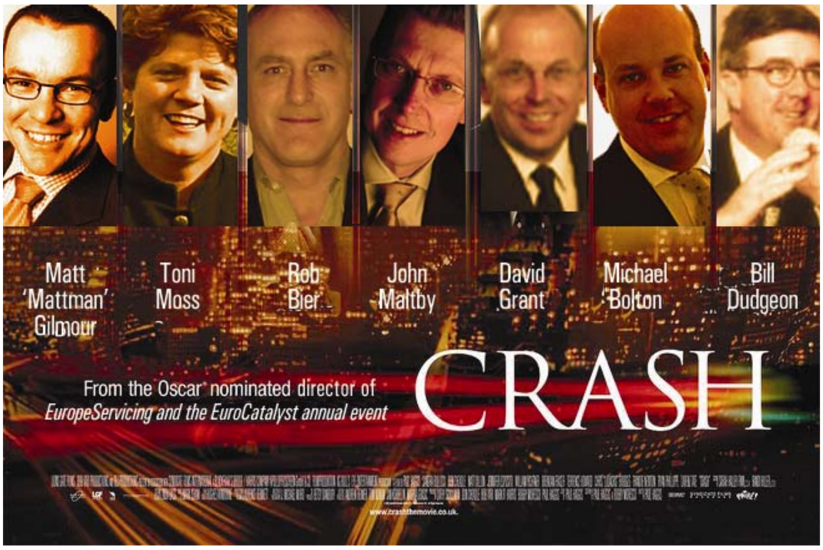
EUROPESERVICING 2006

SESSION 6: 'CRASH'

When High Street meets Wall Street in The City, which way do you turn?



This session moves beyond last year's lively discussion, "Fighting in the food chain and survival of the fittest", and zooms in on the Darwinist transformation playing out along the front-end of the mortgage value chain across major European markets as a battle over mortgage distribution. With more than 10 formidable new lenders entering the non-conforming sector over a short period of time, the UK market is the best place to watch the drama unfold. The discussion will provide ideas and inspiration for some and a warning for others, but no one in the European mortgage industry remains untouched by its implications. With the churn-driven 10-year prime market coming to an end, mainstream lenders face a struggle between generating profit from their books vs. regulatory pressure to price for risk. Enter the investment bank conduits and principal finance. The same regulatory hurdles that many anticipated to act as barriers to entry have instead provided the market stability that attracts investors. The result is a clash between the relationship-driven, operationally expensive "High Street" approach to mortgages vs. the operationally lean, commoditization-driven conduit lending model. The ultimate showdown is the battle over distribution for those closest to the largest volumes of customers. The nature of non-conforming lending demands increased labour and documentation in the mortgage fulfilment process, a need that has risen to the growth of packagers who specialize in collecting and organising information faster, cheaper and more efficiently. Morgan Stanley's recent acquisition of packager Advantage Home Loans and the tieup between Investec and Infinity Mortgages to create Unity Homeloans (lending arm of the Professional Mortgage Packager's Alliance) shows exactly where battle lines are being drawn. With all of the new competition entering the lending market, which parties will be making the credit decisions, process and administer the volume, collect the payments, provide loss mitigation and arrears management? Stay tuned for a provocative session to see who stands to benefit most from the fallout, how they intend to pursue it and how the third-party sector will change as a result.

host

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co-host

ROB BIER, Chairman, Sparck Hypotheken

panel

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BILL DUDGEON , Managing Director, db Mortgages

MATT GILMOUR, CEO, Infinity Mortgages

DAVID GRANT, Managing Director, Homeloan Management Limited

JOHN MALTBY, Chief Executive, Kensington Group

'Crash'

TONI MOSS: Welcome to the most anticipated session of the day, and one which everyone at EuropeServicing has come to look forward to – we always end with a bang! Many of you will know all of the gentlemen on stage here today. Starting on my left is Rob Bier. Rob is the Chairman of Sparck Hypotheken, which is a new non conforming and sub prime lender in the Dutch market. Next to him is David Grant, who is the Managing Director for HML. Next to me is the "Godfather" of the group, John Maltby, from Kensington Mortgages. Next to John is Bill Dudgeon of db Mortgages, one of the promising new investment bank-funded lenders created by Deutsche Bank.

Next to Bill is Michael Bolton, who I genuinely love to "wind up" and who never disappoints in putting on a great show with some terrific take-away sound bites. I'm always happy to have Michael show up because he speaks his mind - as does everybody else on this panel - which is why I called it Crash in the first place! Michael is representing the Oakwood Group's new venture which is soon-to-be-named. Michael, I heard a recent rumour about Oakwood and will ask you about that as we get into the session.

I'm going to change the lineup here – which will be a surprise to him but I would like to ask Rob Bier to replace Matt Gilmour of Infinity Mortgages since it is impossible for Matt to be neutral in this of all sessions. Rob is originally from the UK market and now that he is operating in the Dutch market he is as neutral as he can be in this particular session. This gentleman *(MOSS POINTS TO MATT GILMOUR, THE DAY'S CO-HOST)* is being sent to the panel because he is not invested in one but two of the new lenders that we're going to be discussing today. If you gentlemen would not mind shifting here, Matt you and Rob can switch chairs here.

ROB BIER: Toni, you want me near you, do you? *(LAUGHTER)*

TONI MOSS: Absolutely! The reason I called John Maltby the Godfather is because of Kensington's role in really creating and driving the UK sub-prime market over the past 11 years. Recently Kensington was bestowed the Queen's Award for Innovation - which not only validates the sector with unprecedented exposure but takes it to a new level of exposure that will have interesting consequences over the next year. John, congratulations again for receiving that award.

JOHN MALTBY: Thank you. I wondered if calling me the "Godfather" had anything to do with our collection processes! *(LAUGHTER)*

MATT GILMOUR: A horse's head!

TONI MOSS: Ahem. Rob, please feel free to jump in when you like and let's get this discussion started. In the meantime Matt, you had wanted to start with a particular question. *(TONI MOTIONS TO THE PRODUCTION BOOTH)*. Can we actually show the slide up on the screen here that we're all looking at right now? There we go, we've got all the guys in there. *(THE AUDIENCE IS LOOKING AT A POSTER OF THE MOVIE "CRASH" WITH ALL PANELLISTS SUPERIMPOSED ONTO THE POSTER).*

Okay, Matt, fire away...

MATT GILMOUR: Did we talk about this? What was the first question? Was it a question for Mr Bolton? I think it might have been.

TONI MOSS: Well heck, the most obvious question for this session is, is there room for everybody in the market?

MATT GILMOUR: Is there room for everybody?

TONI MOSS: Yes. Who will be the winners, who will be the losers, how much will this distort the market and is there enough servicing capacity to manage the needs of everyone?

MATT GILMOUR: This was unprepared.

ROB BIER: I understand there are ten new entrants into the sub-prime, give or take.

TONI MOSS: Actually, there are 14. While we are sitting here Matt is secretly creating another. And where is Mike Culhane anyway?

ROB BIER: I heard 14 also. So let's call it a dozen. Indeed the question is, is there room for everyone in the market?

JOHN MALTBY: The short answer has got to be, "No". I mean if you talk to the FSA and they have to -- in many ways, the FSA is the best source of information about who's coming in, because everyone has to apply and put a business plan together. So if you talk to the FSA and they add all the numbers up, they end up with a number that they say, "Could it possibly be this big?" The answer is clearly, "No" because that number is probably three times the size of the existing market.

Having said that, Toni's second question, which is, "Who will be the winners and who will not?" is a very much more difficult question to answer, because each of the existing players and the new entrants have some particular strengths and some challenges that they bring to the party. Is it better to be an existing player with 11 years' experience with the credibility among intermediaries, with funders and with an established team? There are many obvious advantages to that.

Kensington has been the organisation that new players look to for recruiting staff, so there are the challenges that that brings. We're the organisation that people look to in terms of seeing what Kensington does and can we actually improve on it and develop that. And that certainly keeps us on our toes.

I think it's a very interesting and very challenging time, and certainly not one that Kensington is complacent about. I do, though, think the backing and the funding of the organisation is very important. I think we're entering a period of intense competition, but also a period where the credit environment, on the one hand, works in our favour, because the credit environment is more challenged, so there will be more customers that need our product, because all the drivers of growth are increasing. Currently the numbers of county court judgments, the amount of credit card default, the numbers of personal bankruptcies and numbers of self employed people are all increasing. At the same time, you need to get your credit processes absolutely right and, therefore, your ability to grown and meet your expectations - particularly if you are a new entrant - I think will be challenging. Your ability to keep those risks within the boundaries of what you, the bond investors and your stakeholders and shareholders require is also going to be more challenging than it's ever, ever been.

So, my personal view is there isn't room for everybody. If I was a new entrant, I'd have liked to have entered three or four years ago rather than today. But it is not clear, necessarily, that that will be the only determinant of who will be successful and who won't.

ROB BIER: Well, Bill (Dudgeon), as db Mortgages you're one of the brand new entrants. What convinces you that there is room and that you can become one of the winners?

BILL DUDGEON: I think, dependent on the existing players, their appetite for market share, the new lenders' appetite for market share will determine where there's room or not. I think I agree with every-thing John said; there's competition, people are going to existing lenders to recruit the best people, there's a lot of movement. He's just been berating me outdoors for pinching a couple of his staff! (Bill is referring to John Maltby of Kensington) But it does look to me a bit overcrowded, I must admit.

Having said that, Deutsche Bank are coming in with quite a strong plan, not just in the UK, but in some other markets as well. We're fairly confident that we can achieve the amount of business that we're planning to write.

ROB BIER: I'm curious, Michael (Bolton), you're both starting pretty much in the same timeframe, one backed by an international investment bank, another by a private equity firm. Is that important? Is one better than the other? Or is it just down to execution?

MICHAEL BOLTON: In actual fact, we haven't confirmed all the shareholders and alleged new lending business that might be coming in the second half of the year. I don't know if there are any lawyers from HBOS in the room! But currently I'm still working for my self-employed consultancy. I'm hopeful that perhaps (inaudible).

But if I go back to the original question, (is there room for everyone) I think it really shows your understanding of the UK market. The sub prime market is clearly over supplied. Any new lender coming in this year, based on the old model of high fees, high rates, dealing only through the package market is going to get screwed, absolutely. The combination of GMAC-RFC and BM Solutions has been and continues to destroy that market.

If you look at the total size of what we call the non-conforming market last year, 80 billion sterling out of the market size of circa 283, HBOS were 30% of it. Now, if you then start segmenting that, sub prime is the smallest and within that it's totally dominated by the moment generally what you call package distribution, but it's on the wane. And year by year, it's being eroded away, as what I call transparency and (inaudible) to the consumer come out at the expense of big fees to the new distribution base.

So, for me, the best risk adjusted returns are found in what I call the specialist market, which - loosely speaking - is all the non prime and isn't in the sub prime sector. I'm not going to tell you where I think it is. You can find out later. There's no reason why you shouldn't be in the sub prime sector. But it's not actually about product. It's entirely about distribution. If you've got this old model, and when you go back to that 80 billion figure, only circa 15 of that is routed or distributed via what you call third party packagers. The rest of it is a direct broker model. All the historic new entrants to the non prime market have had to rely on that package distribution. Today, they're hamstrung by that legacy.

GMAC have been trying over the last couple of months by splitting their brands to try and say to the direct broker market, "This is a very different proposition to the package market" and with some degree of success. So, if you drill it back, what we achieved at HBOS through the BM brand is we took 20% market share within three years. We stuck two fingers up basically to the package market, because that is not where the volume is. Frankly, it's not also where the credit quality is. The far better credit quality is in the direct broker market. Let's face it, what do packagers do? Their job is to manipulate the client and the application to make it fix.

TONI MOSS: Wham! Michael tell us how you really feel about this! Matt, you're working with packagers I presume...

MATT GILMOUR: I have to speak up and say I disagree to a large extent with what Michael said about the packaging market. I think the packager remains a very, very strong distribution channel in the UK mortgage market. We're seeing packaging, as an industry, crop up in other European jurisdictions. But I think the existing players - and this is where I would agree with Michael - the GMACs and the Kensingtons who have been around for some time are looking to maintain their margins by cutting down on the cost of origination, the cost of distribution, by going around the packager and trying to get directly into Michael's model of going directly to the broker. They are largely hamstrung by those legacy models, because you are biting off the hand that has fed you for the last five, ten years, as the case may be.

But I think what we're seeing now, and I'm an advocate and proponent of this, is the packager fighting back and saying, "What is the mortgage industry really about?" It's about distribution and funding. Now, packagers have distribution. That's unquestioned. They have the power, the ability to process and distribute mortgage products into the marketplace. The investment banks and the private equity houses have the funding. What you need to do is marry the two together. That's what we've done with Unity Home Loans. We've said, "Okay, packagers, there's a group of you guys here that are very good at distribution and what you do. You're feeling a little bit disenfranchised and disillusioned with some of your lending partners with whom you've been working with for a number of years, trying to cut you out of the equation. Let's help you become a lender yourself". This is exactly where it comes back to what Toni (Moss) has been promoting over the last few years; the mortgage broker is becoming the mortgage banker. We've seen two or three models now in the UK mortgage market where packagers have actually become lenders and fought back. Now, those packagers - instead of being suppliers - are actually becoming viable competitors.

TONI MOSS: I tend to be all for reducing the middleman if possible, particularly if you go by the theory that the most important parties in a mortgage transaction are the borrower and the investor and the rest are all friction. It's inevitable that competition and capital Darwinism will lead many European brokers to transition from being a mortgage broker to a mortgage banker - and easier access to capital through securitisation enables that. I don't know how sustainable it is in the long run, but we can look to the US market history to see that dynamic. Hey, speaking of precedents, come January of 2007 the US market will start showing some unprecedented negative implications of sub-prime lending that will make everyone's hair stand on end and will dominate next year's agenda – you just watch. Special servicers, put on your shades - your time is coming! But back to the point, John what do you make of Matt's comments about distribution?

JOHN MALTBY: I'd have to disagree in two respects. One is I think that there is an opportunity for the co-existence of old and new and organisations like Kensington. We grew 53% last year in a market that fell by 4%, so there's some opportunities there.

Secondly, in terms of competence, I agree that distribution and funding are critical. But the competence that no-one has spoken about is risk management. Actually, I also listened to the back end of the last session, where the view was that servicing is a commodity and that servicing is not a core competence of the organisation of the lenders. In the credit environment that we are about to enter into, that is a mistake.

We happen to be a very active and very happy user of outsourced services. Actually, in the way in which we've done that over the last 11 years has made that a core competence of our own in partnership with our servicer. I do think this whole philosophy that packagers can suddenly turn themselves into lenders has been imported from the US, but there's a couple of very important differences. In the US, you have a credit environment, a credit score, a credit facility, FICO scores that actually gives you good stratification of the risk association with a particular lender. You don't have that in the UK.

The second thing is where I would agree with Michael (Bolton) is that packagers' jobs are to find a solution to meet a client's, and, therefore, a broker's requirements. That solution means having a variety of options at their disposal. If a packager is a lender, then sometimes the answer has to be "No". That actually defeats much of the fundamental objective and reason of being a packager.

So, I think we will have a very interesting development in the UK, where we have some of these non lending institutions trying to turn themselves into packagers, funded by investment banks that don't really fully understand the issues associated with mortgage lending, mortgage risk management, mortgage servicing. I think that will be some of the areas

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where we will see some of the most challenging situations.

We've already had - and Michael's alluded to it - some recent new entrants that have tried to follow an old model. The way in which those organisations have had to compete are by relaxing the criteria, so taking loans and products that other people wouldn't, by paying more maybe for the business as they're going through it. And that, as a result, you know, leads to a poorer quality product and a less profitable product in a very competitive environment where risk is going to increase. That is not a sustainable proposition.

So, I do think that this idea that suddenly distributor can suddenly become lenders, I don't think will succeed in the UK market.

MICHAEL BOLTON: I agree with a lot of what John is saying there. Let's just stick to the facts. Last year, the UK's largest association of packagers, the PMPA, their volume is 40% down on the previous year. Are you telling me that's a measure of success on this side of the market? The launch of their in-house lender, Unity, caused the splitting of that organisation. Its nickname is Disunity, not Unity! So, if you're backing some of these businesses, to me there's some clear conflicts of interest here, where you've got the distributor that's actually got some control over the credit decisioning.

I like to call myself a mortgage banker. Agreeing with John, servicing and arrears management is absolutely core and principal. If I don't know how to do that, I wouldn't be in this market, it's as simple as that. There are absolute competitive advantages to be gained from having that in house. You ally that to the fact that there aren't great third party partners out there that can do a decent job of it, and it just reinforces why you should be doing this in house.

ROB BIER: We've seen some pretty important differences in terms of your thoughts on distribution. Michael accepted a number of the players, including several in this forum, are all dependent on one third party for servicing. That third party, HML, has - let's say, near a monopoly position in the UK. I have two questions about that. Given that it is a core competency, as you both say, does that create a risk that your intellectual property in servicing is disseminated to your competitor? Second question, does it create an overall industry risk, because so much of the industry is dependent on a single supplier?

JOHN MALTBY: I'll give a view and I'll be interested in David's point (David Grant of HML). I think that there are some advantages here of being a scale player, a scale outsourcer. We have had a model from day 1, where we effectively work very much in partnership with HML. We have our own teams on site, dedicated to supporting the servicing of our loans. Many of the team from HML have worked with Kensington on Kensington customers longer than members of the Kensington team. We've got a dedicated team up there of over 100 people that work on Kensington loans.

That model, I say, was unique until GMAC chose to bring its business that was in house, and actually worked in partnership with a very similar structure with HML. I think if you don't have that opportunity, and if you don't build that competence in house and through very strong, long term partnerships, then I agree with Michael. I think my fear for the new entrants is that it isn't economic and they don't have the scale to do what we have done, and what GMAC have done, to actually, in my view, get the best out of HML.

DAVID GRANT: To answer the first question, I think we want everybody to be successful with the number of opportunities that we have. But it's being able to support each of those lenders, because you never quite know. When we started off with Kensington 11 years ago, we weren't quite sure how successful they would be and here we are, very grateful that we've had that opportunity to develop that partnership over that time.

I think, from an HML point of view, the model is changing quite drastically. I think the requirement to dedicate in bespoke, and as John puts it, I know it's key on their agenda, to help the lender or partner of ours maintain a competitive advantage in dealing with us. That's difficult when you're dealing with and we're servicing for probably upwards of 25 to 30 mortgage players.

The driver for us always is to help maintain that servicing arm, utilising the partnership approach with the lenders and to try and deliver the servicing that they want.

ROB BIER: What does that really mean? Does it mean that you have 25 internal Chinese walls, and cannot provide good advice to a new fellow who comes along and says, "I want a bit of what John has"? Or does it mean that actually you do provide that advice and, in so doing, disseminate Kensington's intellectual property?

DAVID GRANT: That is always a danger with HML in terms of dealing with the number of clients we've got. You have to ask yourself, "Could that advice or could that information be gained outside HML?" Product differentiation, for instance, if you're working with HML and somebody copies a product, you could look at it on Mortgage Brain, you could look at it on Mortgage Finance Gazette, it doesn't necessarily mean that you've got a disadvantage with HML. But we work with the lenders to try and protect that, but it is difficult to protect.

TONI MOSS: Bill, you've recently differentiated yourself from the pack in trying to put a chink in the HML monopoly through your choice of Vertex Financial Services, the former Marlborough Stirling. Have you started working together working with them yet and are you actually live?

BILL DUDGEON: Yes, we started the back end of last year. We had conversations with HML, but we chose Vertex in the end. But we'd taken the partnership approach that John's mentioned and has been mentioned over there. So, although we work with Vertex, we have a bespoke building in Chester, where Vertex staff work alongside our underwriters, product team, marketing team and the executives. So, it's kind of a halfway house. We kicked off at the end of April and we did the first completion on Friday. I think, for anybody, at the back end of the previous session, to talk about servicing, whereby you just get the loan on the books and throw it over the counter to a third party servicer just doesn't work. I've been there in a previous life with HBOS. We outsourced some servicing within the group, and I was MD of the specialist lender within the group, as Michael (Bolton) was. We outsourced the servicing and the arrears servicing to a mainstream partner - the HBOS operation - and it was a disaster, a total, unmitigated disaster!

So, you need to know who you're working with, get close to them, get a good, ongoing working relationship. And also, just to finish, have a really robust contract as well, that you can both rely on. You hope, when you sign the contract, that you just leave it on the shelf to gather dust, but it needs to be robust as you go through the process.

JOHN MALTBY: I just think there is an external measure of this as well, in that increasingly in the UK, you are getting rating agencies and Fitch going out there that are actually giving their view, their assessment of the quality and the capability, and the track record of mortgage servicing. And it happens to be that HML, I understand, have actually been rated as the highest rating that Fitch have provided in Europe to date. And they also rate special servicing, the sort of things that Bill has talked about, that we provide; some of that management, the supervision, those strategies. Kensington happens to have been rated the highest at that in Europe to date.

I think that Fitch, as an external provider, is a good benchmark. People that invest in our bonds and other people's bonds do look at the quality of servicing, and do try to understand what is behind that. The sort of solution that seemed to be suggested, as people expand into the rest of Europe, at the previous session, whereas Bill said the differentiation between prime servicing and specialist servicing, I think that's wrong. I think there is a huge difference with dealing with customers dependent on their particular circumstances. We're talking about major outgoings for the individual; average loans of £100,000. You can afford and should afford to spend the money to make sure that you've serviced that well.

It might not have been so important in the last ten years, when the UK market was extremely benign, we had a house price inflation of 10-15% a year. But it will be extremely important going forward.

ROB BIER: I'd like to take you up on that house price inflation point. Let's say there are two views of the world. One is that over the last five years, in particular, the non-conforming sub-prime market in the UK came out of the woods and is now seen as a respectable industry in its own right. Kensington's share price was at an all-time high until the markets got a cold last week. All of a sudden, it looks like a very respectable industry. And, indeed, that's one of the reasons why all the new fellows are piling in, because they're the sheep that follow the success.

The counter view is perhaps there are structural instabilities that are not so apparent. I'll just name a few and let people react. The market has been very robust in terms of property prices. That's clearly helped enormously. Secondly, it has been dependent on a few key suppliers, HML for servicing, BarCap for a lot of warehousing. Is that really a stable structure? And probably all sorts of other risks that I'm not clever enough to see. Are we really moving into a period where this is a stable, respectable industry, or have we just seen the best part of the cycle and now it's going to look a bit more difficult?

MATT GILMOUR: I hope so. I hope it's stable, because otherwise I'm in the wrong place at the wrong time. I don't think another 10 or 12 individuals or organisations can be wrong about it. I mean the question that was raised from the outset, "Is there room for everybody?" I think as long as everybody carves their own niche and sticks to what they know that they're good at.

I largely think, just going back to what Michael was saying earlier, it's actually about your distribution and who your customers are. There are certain organisations that would be perceived to be competitors to each of the lenders on the panel on paper, but actually in practice, have got a very, very different distribution base. I think as long as you carve out your distribution opportunity and you stick to it, I think there is long term stability to be had for all.

I think product differentiation is also going to help as well. Going back to the original Datamonitor expectations from about six, seven years ago, the non conforming or sub prime market was estimated at 14, 15 billion. Now, the statistic is 75 - 80 billion, because the actual definition has gone that much wider. I think the risk pricing that we're seeing in the market now, as we've sub-divided the different aspects, we've sub-divided out the self-cert risk, the arrears risk, the default risk, the self-employed risk, and we've created a product range that is much more comprehensive that covers off that market. More consumers have fallen into this bucket that we're now calling non conforming.

So, there are a lot more players, but I think the actual breadth of the market has expanded so much that there can be long term stability for everybody if they stick to what they're good at.

ROB BIER: Michael, any view on the fundamentals? Are they as robust has they have been?

MICHAEL BOLTON: I think the best thing that ever happened to this market was HBOS getting involved four or five years ago. That was the single most credible thing that ever happened to this sector. Surprising, some of the other – like all large institutions haven't followed suit, I suspect, because they fundamentally haven't go the credit risk expertise, which is what you need.

When HBOS came to the market four or five years ago, we were laughed at by our competitors for basing our credit decision entirely on score cards. You need physical guys looking at each individual deal. You can't apply score card based credit decisioning. Lo and behold, here we are - four or five years on - and virtually every lender has followed us. I think that pricing for risk, that discipline, is something that HBOS revolutionised over the last four or five years.

Looking forward, I'm semi relaxed about the state of the market. I think for me the real issue for the moment is the falling away of what I call the retail sector at the expense of the B2B or the intermediated sector. A couple of years ago, the ratio was widely believed to be 60/40 in favour of the broker market, and if you use HBOS as parameter for last year, then the B2B sector is circa 80% of the UK's total gross mortgage lending now, which is a pretty astonishing figure.

So, in terms of competition, I heard somebody else have a similar debate a few months back, saying, "You know, it's not so much the new entrants". In his view, and he ran one of the largest distribution clubs in the UK, 50% of the UK's lenders are mediocre run by mediocre management.

So, I suspect it's probably more a case of existing players struggling, because clearly the guys backing some of the new entrants, one would assume they think they're getting the crème de la crème of the sector.

MATT GILMOUR: I constantly remain bemused actually at some of the high street brands -- we're talking High Street meets Wall Street -- I'm still constantly bemused by the HBOSs and the Nationwides and the Britannias of this world, major high street brands that are still getting into this sector, but hiding behind a subsidiary brand. If it's really that respectable and that long-term stable and the view is such, why are they continuing to hide behind sub-brands, and not using their high street brand?

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MICHAEL BOLTON: I'm quite happy to respond back on that. HBOS has got five mortgage brands. It has a pretty well-known multi brand strategy. And, frankly, in terms of segmentation of the consumer base, why on earth would you want to sell sub-prime mortgages under the Halifax label? You're only going to confuse your target market. One of the features of the UK mortgage market is what I call confusion marketing. We're all at it. Our actual objective isn't the TCF. It is actually to confuse the hell out of everybody. That is the objective of the market at the moment.

The HBOS multi brand mortgage strategy is pretty well-acknowledged as being the best thing this country has had, in terms of the sector, over the last four or five years. What amazes me is, in an outfit like RBS/NatWest, who claimed to have a multi brand strategy, where, in actual fact, they've got the same brands flogging the same product; they haven't actually expanded out their product range. That's more the surprise in my view. Again, you've only got to look at where the profit drivers are within the HBOS mortgage business now.

JOHN MALTBY: I just want to go back to your question, you said, Rob, "Are we in for a continued period of stability?" I don't think it is going to be as stable as it's been. I do think we are all going to be tested. I think some of us are up to that test and some of us may find ourselves lacking.

I do think that house price inflation, at the level that it's been, has hidden some challenges. We are not anywhere near the situation in the States, where people have been withdrawing equity to fund their lifestyles and only if house prices go up, are they able to do that. Even so, there are people that have avoided repossession because they've been able to re-mortgage themselves out of difficulty. That is a situation that will be more difficult going forward.

I also think this issue of if you are a new entrant coming into this marketplace, what is it that you can offer to do something different? Some of them will succeed. Michael has set his stall out very clearly allegedly! There will be others who won't necessarily have such a clear focus. The only way they'll be able to get into the market is through being that bit cheaper or that bit more risky or that bit more expensive in terms of their cost origination, or their costs of actually recruiting people. I do think that those are the people that will have the difficulties, because they won't have the scale to build the infrastructure that is needed to service those loans.

So, I do think -- the title is called "Crash". I think there will be some, who at the very least will be disappointed with what their business plans are setting out, and some that might actually find it much more difficult than they sensed.

You only have to look at what's happened in the unsecured market in the UK at the moment. Unsecured market, defaults are increasing. The secured market is very different, but it will be subject to the same issues. Levels of customer indebtedness are at high levels and there are certain people out there that will struggle to meet their payments. You've got to know what you're doing in that sort of market. It is more difficult to know what you're doing if you haven't done it before.

TONI MOSS: Well John, perhaps among those who become "disappointed" – you are always so kind in your words – looking at it positively you could always hire them back! *(LAUGHTER)*

BILL DUDGEON: Just coming back to Matt's point about the high street, Michael obviously knows that BM had an access system, which was if somebody went into a Halifax branch or a Bank of Scotland branch and they couldn't satisfy their needs, they went directly over to BM. I think basically that's flawed.

To me, I take the more simplistic approach. If you go into Halifax, you want to come out with a Halifax mortgage. If you go into McDonald's, you like to come out with a McDonald's and not a Burger King. To me, none of the high street lenders have got their head round capturing everybody that walks through the door. Lots have tried, but nobody's actually succeeded there yet.

MICHAEL BOLTON: Don't get me wrong. God help the day that the retail sector actually understands how to sell a mortgage. They've got order takers sitting in 1,000 branches of HBOS and they're clueless about how to sell a mortgage. Since the sector became regulated, HBOS have pulled right back from any risky products. You used to be able to get a self cert deal through HBOS Retail. You can't today.

So, if anything, ironically, where you would have thought regulation would have benefited the high street brands with this mass of management structure, supervisory structure, I actually work the opposite way round. Absolutely kill that channel, because they over supervise and over regulated their own direct sellers, which allowed the intermediated sector to take off. Sitting where I currently sit now, long may that continue.

BILL DUDGEON: The other aspect of that is they still want to offer a cheaper deal through vanity, stupidity, whatever it is, as Michael said, through the high street branches, than they offer on the internet. Now, it can't be sustainable.

MICHAEL BOLTON: If I was a City scribbler, I'd be saying to Hornby, "Why the hell are you opening up a shed load more branches and trying to flog products that don't make any money, as opposed to investing in your B2B sector?" We all know why - and it's nothing to do with business sense!

BILL DUDGEON: The other thing is they don't actually know what it costs, as Michael said. I think your words were, "Sitting there and not knowing what you're doing and paying them". They don't actually know what the cost of that is, because they're multi skilled. So, during the days, they might speak to somebody about a credit card, an investment product and then a mortgage, and they just can't track what it's costing them at all. It's a weird set up.

If you go into Halifax, you want to come out with a Halifax mortgage. If you go into McDonald's, you like to come out with a McDonald's and not a Burger King. To me, none of the High Street lenders have got their head round capturing everybody that walks through the door. Lots have tried, but nobody's actually succeeded there yet.

TONI MOSS: Bill, you used the word, "McDonald's" earlier and I'm not quite sure why you looked at me when you said it.

BILL DUDGEON: Sorry!

TONI MOSS: ...but since you brought it up, some of these new players being launched are franchises – to a certain extent – as part of a greater pan-European plan. Michael, certainly the venture that you may or may not be creating would fall into that category. You may – or may not - be just one among a much larger string of pearls. And Bill, under the Deutsche banner you might fall under that category as well. At the same time – for the sake of riling you guys up - John, Kensington has been firmly rooted in the UK and yet are now looking at the Irish market under an entirely different brand. Why isn't the branding of these ventures streamlined?

JOHN MALTBY: Yes, yes.

TONI MOSS: What's prompting your foreign entry? In particular, what signifies that it is the right time to finally take your model elsewhere?

JOHN MALTBY: I think there are opportunities out there. We have proven a model in the UK. That model is recognised in other markets. That has generated some opportunities that are presenting themselves to us; the first of which is in the Irish market, where we looked at the fundamentals of that market and thought that the Kensington business model would work well. But we were determined that that would only be delivered by a very strong local team. Very much, like I think that the guys from the US think that actually the UK market is just like the US, it's not. The Irish market is not just like the UK market, and neither is the French, the German, the Italian market. They all have their differences.

So, I think we saw this is as an opportunity to use our experience, use our business model, use our reputation and to support and enhance the capability of a very strong local team, and work in partnership with that team to establish and help grow the non-conforming mortgage market in Ireland. We will do that in other countries where the opportunity presents. But we will only do it where the characteristics of that country, the demographics of the borrower, the regulatory regime, the competitive environment, the distribution channels are appropriate for our type of product. We don't have to do it; it's an opportunity that presents itself. When it does, we'll actually look at it very, very favourably.

TONI MOSS: Michael, do you feel like a small part of a larger franchise?

MICHAEL BOLTON: You're joking! I'm a mortgage man. Whichever way you cut me, it says Mortgages UK. Whatever the rest of my shareholders choose to do, that's entirely up to them. There may be opportunities, but the markets, the European markets are so different and so far behind the UK, I'm not entirely sure I'd want to be one of the guys spearheading, revolutionising some of those markets.

I was over in Germany, helping a guy out in the HBOS International Division last year, and...well, good luck!

ROB BIER: We've talked a lot about servicing and its role in risk management, but in my opinion, perhaps not enough about the mid off as the actual underwriting, the decision-making, which is obviously crucial in the non conforming market, and I guess getting more crucial as perhaps conditions deteriorate.

We came from a period where it was all a bit of art and guesswork because there wasn't much history to judge by. Now, we've got a lot more data and a lot more history, which has allowed lenders to adopt credit scoring and make it work. What's the future? Are we moving towards a US FICO style machine score, drop it in a bucket, price it and shoot it out to the appropriate capital provider? Is that going to be lead to greater commoditisation because anybody can do it? Or are we still in a world of black art underwriters with a secret knowledge of where to put risks and which risk to take?

DAVID GRANT: I think John said it earlier, because it's about risk management, this business. Certainly, when you get into near prime, non-conforming and sub-prime, and we're certainly seeing that the credit decisioning is becoming more paramount with the lenders moving away from us. We're not exactly displeased with it moving away from us and making those decisions.

ROB BIER: Is the way that they make those decisions converging towards a single approach, or is it diverging and they're all developing their own systems and techniques and methods?

DAVID GRANT: I think it's diverging. John may have a different view. I think it's diverging in the fact that how they undertake their risk management, in terms of behavioural scoring, or credit risk ratings at the beginning of the process.

MATT GILMOUR: I think this whole notion of credit scoring, you've really got to look very closely at what is the asset that you're credit scoring. If it's prime, yes fine, because you know you've got a reasonably good counterparty risk there, and you can take a little bit more of a punt on the property. But if you're talking traditional, sub-prime and non-conforming, you are taking more of a punt on the counterparty, where you have to make sure that the collateral stacks up.

The biggest problem that we find in this particular sector is not actually the credit risk of the borrower, which you can assess, and I do agree, you can assess that with some degree of credit scoring; it's actually fraud. That's a risk that I don't think a credit scoring system can mitigate for. There are various fraud prevention systems out there, but I don't think they capture it quickly enough.

What we find, and this is quite a shocking statistic, is that one in five of our applications have got some element of deception or outright fraud. That's 20% of our applications are automatically rejected, or they're rejected by our underwriters, because they've found something untoward. Great examples: fraudulent passport, fraudulent driving licences, fraudulent utility bills. A great one we had recently, we had a bank statement from a major clearer to prove residency for a particular borrower, and it looked pretty good. It would pass many underwriters' tests and obviously it would get through on the automated credit decision system. On closer inspection, we found that Mr Smith had withdrawn £10 from his bank account, yet the balance had gone up. Whoever had put that bank statement together, the mental arithmetic clearly wasn't very good. We took it into our local branch of that bank and they said, "Yes, this one is notorious. We know about this one. Thanks very much for pointing it out to us".

No automated decision making system will counteract that, and I think that degree of fraud and risk is much, much more prevalent and prominent in our industry than it is in the high street. I think automated decision making would be very risky in our sector in the black art of underwriting.

MICHAEL BOLTON: I obviously entirely disagree with that.

MATT GILMOUR: You're welcome to my rejects, Michael!

MICHAEL BOLTON: Yes. I don't trust humans. At the end of the day, I don't trust humans anywhere near credit decisioning, particularly in a B2B environment. They come under so much pressure, so much coercion, so much influence, you never get what I call impartial neutral credit decisions.

I think clearly the biggest problem using score cards is lack of data. If you haven't got access to data to be able to build a score card, that's your biggest drawback. I've lived in that environment for five years. I know the quality of the sub-prime bucket at BMS within HBOS. None of it has been securitised and the benefit I've got is knowing the credit quality of that versus obviously all the portfolios that are, you know, quite easy to track. There is a significant difference. So, however you're filtering out fraud, that's down to each individual business. I'm content that there is only one way forward. It's no surprise that the GMACs of this world, as soon as we launched our system four or five years ago, they were full steam to replicate.

ROB BIER: You remind me of a story. Years ago, my sister was dating a guy who was building an expert system for medical diagnosis, and my father was giving the boyfriend the conventional grilling that fathers do. My father happens to be a doctor. So, he said to this fellow, "Isn't this system going to make a lot of mistakes in diagnosis?" And the fellow said, "Yes, it is. Just not as many as doctors make". So, John, question - doctors or computers?

JOHN MALTBY: I think both. I think both. I think that organisations that have access to the data and have the history, have the opportunity to actually build the automated tools. We happen to have the automated tools. We use it to supplement the decisions that we take, because we do also agree that there are some aspects of the risk decision that we would prefer to be taken by humans with, in our case, an average of 14 years' mortgage lending experience. So, I think that we, again, have a hybrid model.

I think that there a number of issues and a number of challenges. One of the problems that you have with data, and you do have with humans to a degree as well, is that it is whether or not the past is a good enough predictor of the future. I think one of the fundamental differences about lending in the specialist market, in the non conforming market, is you are not just looking at the borrower covenant, you are looking at the whole package. You are looking at the assets, you are looking at the borrower covenant, you are looking at the equity that the borrower has got in the property and in terms of their attitude.

And back to a point we said before, you're also doing then the whole customer management process on the basis of all that information. You cannot disconnect the risk appraisal at the front end with the corrections at the back end, because if you disconnect that too much, you will actually be missing a complete trick. So, I do think the answer is both. But to have both, you need to have the data. HBOS has the data, Kensington has the data. It is much more difficult for the new entrants to get the data.

Your other question was, "Are we going to get FICO scores?" Well, when you've got organisations as strong and powerful and dominant as people like HBOS, in some respects why would they give up that competitive advantage that they've got today, to share that information with everybody else, to generate what, effectively, you've got in the States as a FICO score? I don't actually see that happening.

Also, I would argue, if you look at the performance of some of the US guys, and in terms of the volatility in some of their portfolios, where they rely on FICO scores and so on, I'd argue and see whether or not the FICO scores have given them what they really want. It makes it simple, it makes it tradable, but does it actually make it more of a risk management process?

TONI MOSS: I've been sitting here thinking about the session name here. Let's say there is going to be a market crash, or at the very least a collision in which there are casualties. What's the worst that could happen?" You have 14 players entering the market and 7 of them fail. Does that mean you have 7 larger lenders? Will they go bankrupt, or will they just get acquired by a larger player? For example, Matt - seems to me that as a new player you have little to lose. Even if you fell flat on your face someone would acquire you in this optimistically bullish environment.

MATT GILMOUR: Why would we?

TONI MOSS: That's another discussion.

MATT GILMOUR: No, but no. I think the point is --

JOHN MALTBY: Fantastic management team you've got!

MATT GILMOUR: But I do think, though, that if it's over-supplied, then what does an existing player need from another vendor if you've got the distribution and you're comfortable with the distribution and there'd be the portfolio as the value. The question is how much is that value? If that business has got itself into a position where it's had to do things that we wouldn't have done, then that value to us would be less than it might have been to somebody else. So, I do think that it isn't a no lose situation for anybody, for Kensington, for Michael or anybody. I think that the stakes are high.

ROB BIER: I'm going to agree with that. One of the things I always think of, partly because I get calls from head hunters now all the time, "I briefly worked for this man and that gave me a thin veneer of respectability". And because there are so many lenders that are coming into the market, let's say the numbers of CEOs of sub-prime based in the UK was, whatever, 6 or 8, until recently, and suddenly it's 25, which means by definition, the experience of the next 18 is zero. They may have been very good guys doing very interesting things, but we've had a tremendous number of relatively inexperienced people promoted up two or three levels, just to fill all the boxes in all the org charts of all these new lenders. Somehow that feels like it creates risk for everybody, risk for the industry. That makes me a little nervous.

MATT GILMOUR: Within those organisations and where that management team has been lifted or exited, as the case may be, obviously they're left a bit thin on the ground. But we talk about these new lenders, it's not necessarily new management teams, it's not necessarily people that are new to the industry. They've got the experience built up over 10, 15 years prior. I mean why do you think the new lenders go to Kensington to poach underwriters and staff? Because they're the best. We're talking start-up in terms of organisational start-up risk, but we're not necessarily talking operational start-up risk with the people and the management.

TONI MOSS: When you're talking about the importance of the management team - it's starting to sound like it's just a new type of packager. Are these new players just repackaging executives and experience to a certain extent?

MATT GILMOUR: Sure feels like that.

JOHN MALTBY: I think businesses are far more than just executive teams. I think that the background, the experience of the two gentlemen on my right from HBOS, I think, is something that they and the people that they bring into their organisation will take and they will disseminate through that whole organisation. I think that the way in which the reputation, the brand, the relationships that you built over time, those are the things that actually make an organisation successful. It also means the things that attract good quality people to them We at Kensington have had no problem recruiting good quality people, because good quality people want to work for an organisation that has 11 years' experience, and is recognised in the marketplace for what it's done.

I do think it is a challenge that, as a new entrant, there is a sense of you've got to do something different. You've got to pay more, you've got to do something different. You've got to promise more to actually get people. That inevitably increases your cost base. You're never sure about whether you are getting the right people, because guess what? All of the people that have been poached from us, there's probably twice as many, if not three times as many, who have chosen not to be poached, because they like to stay. We happen to believe that the vast majority have the best people stay and we work very hard to keep them. But it's also, we do get a good source of new people that actually come to us.

So, I don't think the issues are necessarily about the individual's risk. I just think it's about the investor's risk. The thing I would be worried about is people who invest in these organisations think that this is suddenly going to be a ticket to get a very significant growth, because this is a growth market. Some of those people will be disappointed and some of those people, private equity firms, have quite short term timeframes. This is not a market to have a short term timeframe. Other organisations have a long term timeframe and I'm sure they will be among the survivors. But people come in here that actually want to make a quick buck in two or three years and think that somebody's going to buy them out. Guess what? Some of those will be disappointed.

ROB BIER: And also what about your shareholders? One of the possibilities is the irrational competitor syndrome. All these fellows come in, find it pretty hard to originate, decide it's their last ditch effort, they'll drop price significantly, and, let's say, screw up pricing and erode profitability in the market as a whole. What's the risk to the established firms like Kensington where you remain structurally healthy, risk healthy, but all the profits are drained out by price competition?

JOHN MALTBY: I think that's one of the reasons why we're very glad that we have a very strong back book that generates 80% of each of our profits each year. We've got business units that actually have broadened our business. This means if there is a position where we find that it's uneconomic to originate businesses for a period of time, we won't have to. I think that's because we've got the scale, we've got the maturity, we've got the back book to be able to sustain us through that period.

I don't actually think people have come into the market to be irrational. I think one of the things that's changed in the market is that we used to compete against organisations that had retail funding and they had an investor base, which was part of maybe a more retail network. When you've actually got investment banks, when you've got private equity, their actual focus on return on equity is as much, if not more, than our investors' requirement for return on equity from us. So, they won't be happy about them driving the value out of the marketplace. I do think there is a self regulation in that part.

MATT GILMOUR: I think the biggest threat to the industry with the new entrants, and I am actually going to exclude myself from this, is the volume motivation of the financial backers. There's one or two examples of global financial, or institutions, major investment banks, coming into this market with massive volume expectations. Fortunately, my model, I'm not necessarily under pressure to deliver volume.

Following on from what John was saying, you've got to come in with something different and we're seeing a relaxation of underwriting standards in order to win business from packagers and brokers alike, and very, very competitive pricing, which is undercutting the GMACs, the Kensingtons, the Southern Pacifics of this world by quite some margin to win that business. What we're ending up with there is major service problems and major back book credit issues, one of which we've recently seen bite the market. That's going to have a knock-on effect to all of us from a credit perspective.

I think the biggest threat to those new entrants is can they sustain and bail themselves out when a credit crunch comes, and they end up drawing on reserves and they're not being replenished, and downgraded transactions, etc? Can they survive or can they maintain their distribution base when their service is shot? That's actually the biggest threat and that will bring out the headlines, and then that will have an impact on everybody in the industry, old and new.

TONI MOSS: I can't let this session end without ending on a servicing note. So, I'm going to come back to David Grant. Certainly the fall-out would have a major impact on you considering how much time and effort goes into the service level agreement and the intricate links within those SLAs. Are you actually preparing for that, and have you thought about those contingencies if that happens? At the same time you've finally got some semblance of competition rising in the distance. Vertex, of course, is gearing up. SMS is buying, boarding and selling portfolios servicing retained to beef up their "third-party" business. Western Mortgage Services is hinting that they could potentially go third party. Until such time, you guys remain "it". What would the impact of a major collision among the new market entrants be on HML, who is enabling so many of them.

DAVID GRANT: I think it would be huge. I mean one of the things that we know we've got to gear up for and we've got to improve upon is the arrears management. I think from an investor point of view, given the amount of servicing we do on the securitisation pools that we have, I think some 192 at the last count, is vitally important, because it's about cashflow from their point of view and from us.

I think from a capacity point of view, we've certainly moved a long way in the last five to six years with the infrastructure that we've put in place. We've certainly got to develop that infrastructure to have the capacity and be able to be proactive and manage any increase in activity that comes along. We are quite well placed actually, because we can do new business, but we can also do arrears management. So, we don't quite mind which way the market goes. We can get some business out of that. We hope for everybody's sake, it's not on arrears side and it's on the new business piece.

TONI MOSS: Unfortunately, I'm going to have to end on that note although I do think that at EuropeServicing 2007 we will be talking a lot about this arrears side. Do we have any compelling questions out there?

MALE SPEAKER: I want to follow up on something mentioned earlier, because I think since we're here at a servicing conference I was quite interested in the comments that we made in the servicing panel, and I'll put my hand up and say that I was one of the ones that said that I think it is true that an outsourcing model is the model that people have followed in their core competency of serving. There was a reason why there was third party servicers that have developed. And then the following comments by the panellists, because I think that the implication was that you just are devoid of responsibility for your servicing, which I don't think is what anybody was advocating.

I do think it's interesting from your following comments, and, John, yours specifically, which is you split the two and I think it's right. I would 100% agree. The core competency on the intellectual side of the strategy for servicing and the core competency on processing an doing the actual physical servicing. At least it seems to me, there could be two possibly different issues.

There is a reason why people presumably don't add 200 staff on their own balance sheet to build a servicing platform. There is also a reason why people keep responsibility of the intellectual process, what kind of servicing do we want to follow. So, it would be quite interesting for myself and for the crowd for one of you guys to take on the question of how has the interaction between the servicer and the lender change, whereby you get value out of the scale they offer, and the processing they offer, but at the same time, you want to keep in house the rules and the guidelines under which they serve? And how competitively different are they really if you had to boil it down? How different are the servicing platforms from one to the other lender? It would be interesting.

MATT GILMOUR: One of the things that I would say is that as well as the intellectual side, you have got to keep very much, as an outsourced servicer, or as a user of an outsourced servicer, you have to keep right on top of your relationship with your partner. David, I suspect, would agree that whilst Kensington is probably one of its largest clients, they're probably one of their most demanding clients, and deliberately so. We are pushing HML all the time to innovate and develop.

The point was made that sometimes that innovation benefits other people. Well, so be it. We do get the benefits of the fact that we've got the scalability and the skills, and innovation that's come from other people that actually does help our proposition. But if we feel, and if anybody feels that that balance isn't right, then they should go for an in house model.

I think you've clarified the points that were made before, and I think that it is the intellectual side, but it is actually the fact that you are totally accountable and totally responsible for the performance of your book. As a result of that, you are hugely demanding of your outsourced servicer, and that that actually makes them be a better servicer to you, and ultimately a better servicer to other people. You've got to keep absolutely focused on top of that.

We happen to believe today that the balance is in the favour of the outsourced model. Actually, it's something you always have to keep under review. I think it is more difficult if you're smaller, it is more difficult if you're newer and it is more difficult if you don't have that track record.

TONI MOSS: Before we get kicked out of this venue, I'd better close this down formally. You will be hearing an announcement from EuroCatalyst on some new roles that we'll be playing in the market, and some of that news will surprise you. No - we're not being sold and, yes, we are currently relocating from The Netherlands. So watch this space...

ROB BIER: Toni, EuroCatalyst is opening a sub prime lender in the UK?!

TONI MOSS: Well, we may - or may not be - and meanwhile remain advisors (LAUGHTER). Besides, we hear the weather is much better here in London than in The Netherlands. But until that announcement is made...I want you all to know we will be back again next year in London for Europeservicing 2007. At that time, I expect to see more of you rated and those that are, I expect your ratings to be higher! I expect all of your businesses to be stronger and in fact, I just expect you back period. No disappointments or excuses. I want to invite you to share that success on this stage, of course contingent upon your willingness to share the secrets of that success when you're up here. No reason to be shy like Michael Bolton. As you can see, we don't have a lot of patience for small talk and I believe now, more than ever, the event should drive your business forward and not distract you from it. Thank you all very much for your interest and loyalty in coming this year, I very much look forward to seeing you all again next year. Matt Gilmour and Michael Bolton will be buying drinks for all of you, please follow them to the party (LAUGHTER). Thank you to the EuroCatalyst team, Shirley (Jackson) we could never do it with you! Thanks to Louise Hunter and everyone at Thompson / IFR. Thank you everyone, goodnight! Matt, wait for me...