Paradigm Market Update & Outlook for 2016

PARADIGM
MORTGAGE
SERVICES

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1. Executive Summary

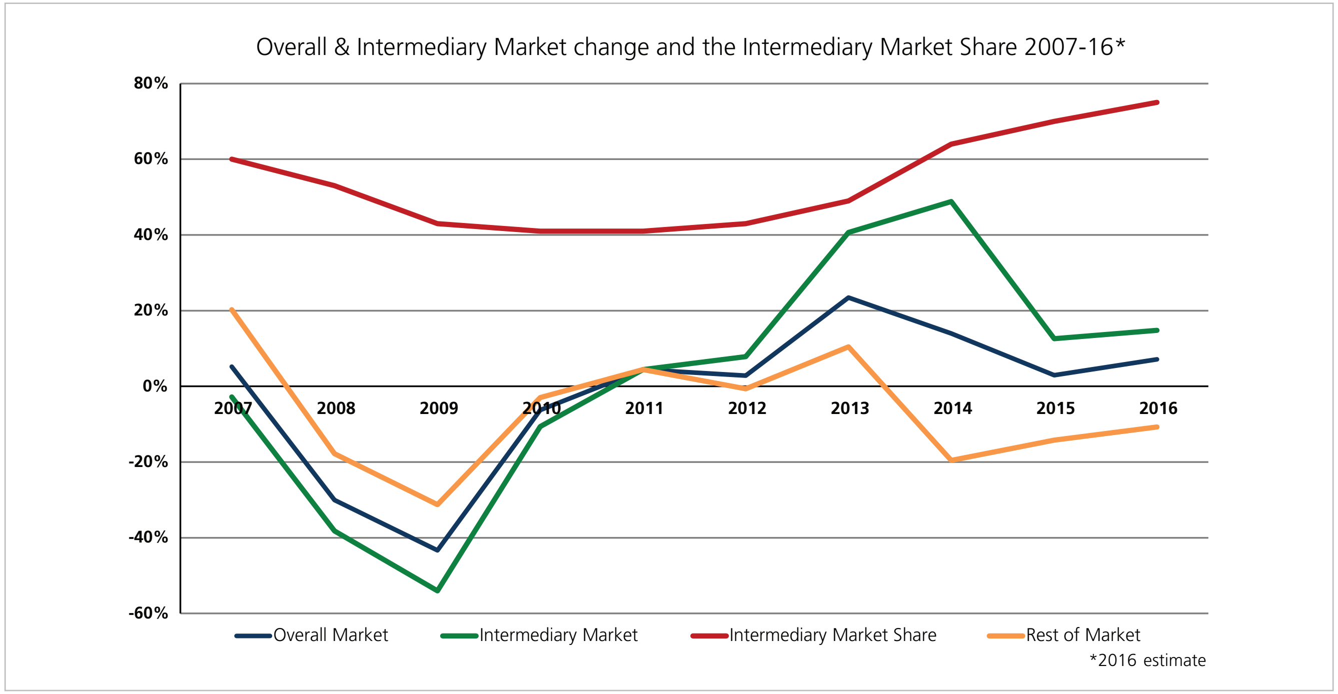
Paradigm Mortgage Services LLP, a sister business to Paradigm Partners LLP, was launched 8 years ago and is today one of the UK's fastest growing financial services Distributors.

A core aim of Paradigm Mortgage Services is to help deliver growth to you, our intermediary Partners, by developing close, trustworthy and interdependent relationships that are unpinned with great service standards, positively differentiating ourselves from other distributors.

At the time of writing, it is apparent that 2015 has been Paradigm's best year yet with Mortgage, Asset & Discretionary Fund Management, Protection and General Insurance Sales at record levels. Organic (net) recruitment of new Partner members and sales growth continues at pace, with our cost/income ratios improving month by month. Paradigm has been able to prosper throughout the worst of the credit crunch, and despite the hurdles created by what can often appear to be a consistently challenging regulatory and economic environment, it is clear that Intermediaries are benefiting significantly from the Retail Distribution Review (RDR) and more recently the Mortgage Market Review (MMR), with retail banks' sales propositions in particular suffering from the changing regulatory responsibilities.

Despite the challenges posed by RDR, retail adviser numbers have risen in the past year by 5% and are now 10% higher than on the eve of RDR[1]. In our view, this really is a great time to be a Directly Authorised financial adviser.

Looking specifically at the mortgage market, its recovery began in the summer of 2013, reversing the trend in declining intermediary channel sales, where at the low market point in 2010, intermediary share fell to 41% of the gross market which was then £135bn. Today, the intermediary channel accounts for around 70% of gross sales, with 2015 market completions on track to exceed £210bn. 2016 forecasts vary, however, the current consensus suggests a £225bn market with an intermediary channel share trending towards a staggering 75%.



Paradigm growth outstripped the market during 2014 (up 49% vs. 2013). During 2015, completions are set to exceed £3.3bn (up 23% vs. 2014); once again outperforming the market which it is estimated will grow by circa 7.5%. We are confident that we will continue to gain further ground on competitor distributors (encompassing scale, value and improved margin) through our innovative 'Profit through Partnership' approach.

1 Source: Professional Adviser, 'Adviser numbers up 5%, official figures show', 18th November 2015, http://www.professionaladviser.com/professional-adviser/ news/2434334/adviser-numbers-up-5-official-figures-show

2. The Market for Financial Services 2016

2.1 Background & Economics

In broad terms, there is rising consumer demand for independent financial advice across all product areas. The intermediary channel currently generates over 70% of all mortgage transactions in the UK and, driven by the rapid adoption and expansion of WRAP architecture over the recent years, IFAs now control c.40% of the mass Wealth Segment of Assets-under-Management, worth c.£600bn. Retail adviser numbers have risen in the past year by 5% and are now 10% higher than on the eve of RDR[2].

UK banks, the top 6 of whom encompass c.80% of all branch outlets, are rapidly moving towards digitally focused models, retreating from the high street as they take more banking services online and on to mobile platforms. These are actions that will irrevocably change retail banking and intermediaries will, in our opinion, benefit from those developments, which should lead to both significant reductions in process costs and better customer outcomes.

The opportunities within the Protection market are often shown in relation to the 'protection gap' currently standing around £2.4 trillion. The sheer volumes of these figures are often beyond the scope of comprehension. In reality, we continue to see declining protection sales in the individual sector – despite a seemingly obvious client need for this product. Since the launch of Paradigm Protect in January 2014 we have focused on helping our firms write more business by the provision of marketing support and tools. The entry in to the market in 2016 of new Providers is in itself a testimony to the scope of the opportunity. However it seems obvious that without radical simplification in the protection application process, or perhaps the development of complex but not complicated solutions, the vast majority of intermediaries are unlikely to change their habits, i.e. sticking to what seems easiest, and not creating real growth in the market. We are keen to embrace innovation, particularly in terms of technological advancements – one can understand some advisers' apathy when the average online application is still 47 pages long.

2 Source: Professional Adviser, 'Adviser numbers up 5%, official figures show', 18th November 2015, http://www.professionaladviser.com/professional-adviser/news/2434334/adviser-numbers-up-5-official-figures-show

Confidence is a huge driver for individuals and corporations, not least of all in the mortgage market. As we expected, the second half of 2015 has seen a pick-up in activity in the housing market after a slow start to the year. Low inflation, strong wage growth, falling unemployment and competitive mortgage deals are all helping to underpin housing demand. Indeed, the UK labour market figures look strong, with the employment rate and level reaching their highest levels since records began in 1971. The unemployment rate fell to 5.3% in the three months to September, the lowest it has been since May 2008. Wage growth also continues to grow at pace, with total pay increasing by 3.0% compared to a year earlier. Overall, economic fundamentals in the UK look set to remain strong despite downside global risks emanating from China and emerging market economies. GDP growth in the third quarter of 2015 was 0.5%, slightly weaker than the second quarter, but still firmly positive.

First-time buyers, the backbone of the UK housing market, and mover numbers are now stronger than a year ago for the third month in a row, although these gains are more limited than for Buy to Let (BTL). Mortgage lending is currently enjoying its best spell since 2008, and reached £21.8bn in October (up nearly 19% on a year ago); this is the fifth month in a row that there has been an increase on year on year lending. We feel that the CMLs revised annual gross lending forecast remains pessimistic at £209bn.

The rate of inflation, as measured by the Consumer Price Index, fell by 0.1% in the year to October and has been at or around 0% for most of 2015. Developments in the global economy, coupled with the low inflation meant the Bank of England kept interest rates at their record low of 0.5% for the 80th consecutive month.

Over the last few weeks, the general expectation of the first rate rise in the UK has edged towards Q416/Q117. This is likely to be dependent on the timing of Federal Reserve action to raise interest rates in the US, and the result of global risks. The Bank of England's Monetary Policy Committee continues to reiterate that when the Bank Rate does begin to rise, it will be gradual and to a lower level than in recent cycles. For many borrowers this will be the first rate increase they have ever experienced.

Compare this stability to the summer of 1982 where in July and August the bank base rate altered on sixteen occasions.

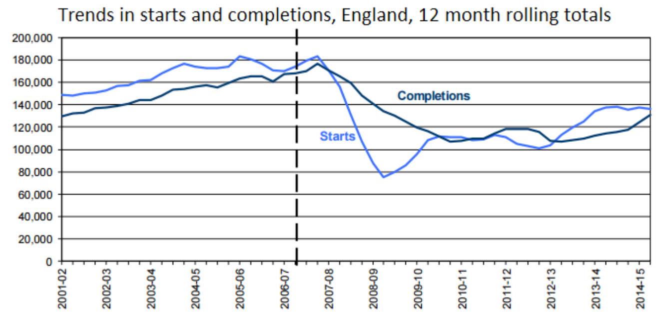
The recent increase of LTVs without using Government schemes is a welcome return and demonstrates the healthiness of the balance sheets of some of the Lenders. Alongside the Help to Buy schemes, these measures are helping more people into home ownership which has the benefit of nudging forward the rest of the housing market. Notwithstanding this, successive governments talk about how important housing is to the UK economy but housing never seems to reach the top of the agenda.

Growth in House Price Index has settled with annual growth of 5% and 6% looking far more sensible than the double digit growth seen this time last year. The perennial housing issue remains, i.e. that there is an inadequate supply of new stock and a lack of a long term plan to take into account the changing demographics of the UK population.

According to a study published by the Town and Country Planning Association (TCPA), England needs to build 312,000 homes a year for the next five years to keep up with expected growth in the number of households[3]. The need would be even more severe if not for the trend of younger adults delaying setting up home because of the expense. This rate of house building would address the shortfall in construction since 2011, but is almost half as much again as the Government's target of one million homes by 2020. In the longer term, the country needs to build 220,000 homes a year until 2031, almost double the current number, to keep up with the increase in households. 136,300 homes were started and 131,060 homes completed in the 12 months to June 2015, respectively a 1% and 15% rise from the previous year[4].

The number of households in England is still predicted to rise by a quarter to 27.5m by 2037.

Whilst we have witnessed a dramatic increase in the number of mortgage applications in the market generally, it is somewhat disappointing that the protection market in general has not followed this trend. ABI stats indicate that protection volumes have not kept pace, and were lower in Q2 than in Q1 2015. However, Paradigm sales volumes continue to buck the trend, predominantly down to the fact that our firm numbers are well balanced between mortgage advisers and Wealth Management firms. Client relationships are central to Wealth Management firms and these firms will continue to distribute protection products regardless of market conditions. Notwithstanding that, we continue to focus on supporting our firms in writing protection alongside mortgage related business. We are also concentrating our efforts on aligning Protection with BTL activity which is growing rapidly within the group.



Graph source: Department for Communities and Local Government, 'House Building: June Quarter 2015, England', 20th August 2015, p.2

3 Town and Country Planning Association, Press Release: 'We are only building half the homes we need – and younger couples are suffering most", 4 November 2015, http://www.tcpa.org.uk/resources.php?action=resource&id=1273

4 Department for Communities and Local Government, 'House Building: June Quarter 2015, England', 20th August 2015, p.2

3. Market Regulation

3.1 Mortgage Market Review

The Mortgage Market Review (MMR) rules have now been in place for 19 months, and there is no question that they have had a significant impact upon the mortgage market and the industry as a whole. Lenders have implemented affordability assessments into their processes successfully, although many continually tweak their parameters within these rules. This results in significant differences in borrowing capacity for clients from one Lender to the next – as we have documented in our quarterly newsletters which are distributed to our members.

The FCA's thematic review published in July, 'Embedding the Mortgage Market Review: Advice and Distribution', found that "59% of mystery shops and files reviewed resulted in suitable mortgage recommendations to customers – with only a very small number of cases assessed as demonstrably unsuitable (3%)"[5]. However, many firms did not go through the processes sufficiently regarding the clients' needs, and they subsequently made recommendations without having all of the facts[6].

5 FCA Thematic Review, 'Embedding the Mortgage Market Review: Advice and Distribution', July 2015, p. 3
6 FCA Thematic Review, 'Embedding the Mortgage Market Review: Advice and Distribution', July 2015, p. 3

Whilst 59% of firms did carry out these processes adequately, the "overall the quality of advice in the market was mixed"[7].

Indeed, the Network model came under scrutiny, "appointed representatives of many large retail intermediary networks are delivering advice with little or no structure…Needs and circumstances were often assumed or missed"[8], thus showing that they placed too much emphasis on process and did not have the client at the heart of their business transaction. In other instances, the advice process was centred on "point-of-sale application systems allowing the advisor little to no flexibility for judgement"[9] which can clearly lead to detrimental client outcomes.

7 FCA Thematic Review, 'Embedding the Mortgage Market Review: Advice and Distribution', July 2015, p. 3
8 FCA Thematic Review, 'Embedding the Mortgage Market Review: Advice and Distribution', July 2015, p. 3
9 FCA Thematic Review, 'Embedding the Mortgage Market Review: Advice and Distribution', July 2015, p. 3

The lessons and experiences learned from MMR have shaped our approach to other regulatory changes – where we are committed to continuing to support all DA firms through the impacts and requirements of the MCD, in particular where that links to Consumer Credit and the BTL market. As we move forward to embrace the new MCD changes, there is clearly work to do in helping firms reach a good standard, ensuring they are giving quality advice around a model that puts the client at the centre of its business.

3.2 Consumer Credit License

This change was brought about by moving the responsibility for regulating consumer credit activity from the Office of Fair Trading (OFT) to the FCA. For many, it was by far the biggest and most confusing area yet to hit the Financial Services Industry. The repercussions are still being felt by firms who have not varied their permissions to include credit broking and are therefore unable to trade with certain BTL Lenders, having lost their interim permissions. The MCD has put further clarity around this piece of legislation.

Where a mortgage broking firm who advises on BTL transactions will not require a consumer credit licence from 21st March 2016 in order to carry out this type of business. However, some firms will need to maintain a 'debt counselling permission' if a client wants to consolidate debt using a BTL as the asset to do this.

Paradigm have been giving guidance to firms who have yet to vary their permissions and have provided information and best practice notes around the new permission consumer BTL.

3.3 Mortgage Credit Directive

The MCD will come into effect in March 2016. Unlike the MMR where the impact of the new rules were mainly felt by Lenders, the MCD will have more impact upon the adviser community, and firms will need to make changes to their business models and processes to cope with the demands set by Europe. Much of the MCD has been implemented by the changes made during the MMR, however, where there was no existing regulatory framework in place there has been a complete read across from the European Directive. The MCD has meant that the UK will begin to regulate second charge loans, and therefore, first and second charge mortgages will become one relevant market place. This change means that advisers will need to make a decision on whether they will give such advice on the second charge market. If a firm decides that they do not want to give advice to their clients on second charge loans or they want to continue to refer these clients to a third party Master Broker who specialises in second charge loans, then they will no longer be able to call themselves 'independent' or describe their services as 'whole of market'.

At its peak in 2007 the second charge market was worth £7bn, but by December 2014 this had fallen to £600m. The pricing, structure, commission and non-regulated nature of this market have all had an adverse effect on the writing of this business since the downturn in the markets, which has become a very specialist area. Most intermediary firms have either chosen to ignore second charge loans unless it has either been an obvious solution for a client, or a direct request for a comparison. This has led to most firms referring this business to a Master Broker.

With MCD, firms will need to consider carefully how they will deal with the onset of second charges – particularly where a client approaches a firm to borrow further money by way of re-mortgaging and that firm still holds themselves out to be ‘independent’. As part of a firm’s disclosure they will need to inform a client wanting to borrow further money that as well as a capital raising first charge re-mortgage, there may be alternative financial options that could be more suitable, such as a second charge loan or a further advance from their existing Lender, or even an unsecured loan. This will be an additional disclosure but is not a new regulatory requirement, as within the MMR rules a firm needed to disclose to a client that the option of a further advance from their existing Lender could be a more suitable option. Following this disclosure, the firm can then choose to either:

1. offer the appropriate advice on all of the alternative financial options,
2. refer to a third party Master Broker, or
3. declare that the firm does not offer advice in these areas.

Sourcing systems such as Mortgage Brain and Trigold are in the process of developing their systems to be able to offer second charge sourcing post 21st March, where advisers will be able to directly compare these loans with first charge re-mortgages. This will further support a firm’s advice process, particularly if they choose to give advice on all areas of the market. We are working closely with both of these technology firms ensuring that these solutions will be available to our members.

As the second charge market evolves and becomes more regulated the product pricing, structure, affordability and commission will become more aligned to first charge loans and less of a specialist function – the idea being that the market will be known as the “secured lending market” and not differentiated by labelling as it is now.

At the September Financial Service Expo Keith Hale, Technical Mortgage Specialist at the FCA, said “There seems to be a business opportunity available for those who can provide a more holistic answer. Consumers who are introduced away…makes for a disjointed transaction. Smart people will be able to spot a chance here”. Paradigm is working with our Strategic Partners to offer support, training and guidance in this new market place, offering various workshops to showcase what is available to members, giving them the confidence required to advise on these products and offer their clients a holistic proposition.

3.4 Consumer BTL Transactions

BTL transactions have always been non-regulated, however most firms have tended to treat them in the same way as regulated mortgage contracts. Nevertheless, the actual provision of advice on a BTL is captured under regulation via the Consumer Credit Act and the regulatory activities order. A misunderstanding occurred when consumer credit regulation was moved from the OFT to the FCA, as most firms were under the impression that they would not need a consumer credit permission to carry out a BTL transaction. As part of the MCD, BTL has moved completely out of the consumer credit remit, meaning that a firm will no longer need a consumer credit license to give advice on a BTL.

The FCA feel that there are some BTL clients who would benefit from the protection that regulation brings and they have introduced a new category of BTL called “Consumer Buy to Let”. The definition of which is a client who is not purchasing an investment property wholly for business purposes. The types of clients that may fall into this new category are First Time Landlords, Let to Buy transactions and potentially inherited properties. There will be a new permission introduced for Consumer BTL and firms will need to apply for this permission if they want to carry out such transactions. It will then be the Lender that decides via their application process whether the client should be treated as a consumer BTL or not. A declaration will be produced for a client to sign if they are deemed not to be a consumer BTL client. Paradigm are working closely with our members to help them understand the new rules and how to apply for the new permission. We will also work with our Strategic Partners so that they continue to be comfortable with the quality of business they receive from our member firms.

4. Paradigm's Business Activities

4.1 Background and Business Model

Key Group Facts:

- Paradigm has, at the time of writing, **c.3,000 Directly Authorised RI members**, via 902 firms
- Applications to the Mortgage/Protection Club are growing at a pace **19 new firms per month** (net)
- Mortgage business volumes are currently running at circa **£415m per month** in mortgage applications
- Mortgage completions are projected to finish **23% up v 2014**, a total of £3.3bn – we project that this will exceed **£4bn in 2016**
- Average loan size is **£192,000** and average loan to value (LTV) is **c. 62%**
- Paradigm has **284** member firms signed up to Paradigm Protect, aggregating **in excess of £10m** APE in life sales
- Protection business volumes (est.) via Paradigm firms is set to exceed **over £25m commission** in 2016
- The launch of Paradigm Protect to non-Paradigm firms has substantially added to volumes with a focus on GI in 2016 we believe a targeted strike rate of **25% of residential mortgage apps** is achievable as we develop and expand the proposition
- Tatton Investment Management, our sister DFM business, now manages assets in excess of **£2.38bn** making it the largest on platform DFM in the UK, adding **c£100m per month** in new assets
- Jargonfree Benefits now has over **100 non-Paradigm firms** using the auto-enrolment software adding to the potential reach of users of Paradigm services
- Paradigm Wrap Assets currently exceed **£2.5bn** – representing **c.28%** of all Nucleus Assets

4.2 The Intermediary Mortgage Market: Our Perspective

It is perhaps an understatement to say that the intermediary market is in a far healthier position than it has been for years. 2015 has witnessed the intermediary mortgage market share grow, with the half year channel split (according to the CML) at 69% intermediary and 31% direct. By year end the intermediary figure is expected to have grown to between 70-75%. This reduced retail channel share is itself changing with Online and Telesales, assisted by Digital enhancements – rising at the expense of conventional Branch sales. MMR is now fully embedded, the consequences of which continue to play a significant part in driving clients towards intermediaries. Largely as a result of the competitive environment, margins have been driven to lows that are generally considered unsustainable and whilst innovation is stifled by regulation, it is encouraging to witness such high levels of Lender engagement with intermediaries. Therefore, it is not inconceivable that the intermediary share will rise beyond 80% as early as 2017.

Looking ahead to 2016, Paradigm concurs with the market view that overall lending will be around £225bn, an increase of 7.6% on 2015. However, as we remarked earlier, we see the intermediary sector continuing to take a greater share of the market and expect this segment to account for c.75% of total lending, which will be £169bn. With new Lenders coming to market and choosing intermediaries as their preferred route to customers we are confident this will be achieved.

Despite the Chancellor’s efforts, there doesn’t appear to be any let up in the growth of the BTL market, which has traditionally been dominated by intermediaries. As more regulation – albeit currently indirect – is applied to the sector, landlords are turning even more towards the expertise of intermediary firms. Paradigm’s BTL business has continued to grow (currently representing over 30% of our wallet) with many new Lender entrants choosing this richer margin territory as a place to develop their proposition.

As 2015 has progressed, we have finally seen remortgaging business begin to pick up. In the BTL sector the remortgaging has been far more active, with landlords securing long term rates to control their costs, but the residential sector has been slower on the uptake. Whilst there has been steady growth, it is unlikely to expand significantly until a rate rise actually occurs. When it does, intermediaries will play a heavy part in that growth. Of course, there are many so-called Mortgage Prisoners, but there are far more who could benefit from remortgaging to a more attractive rate, which will in turn continue to drive up overall mortgage sales.

The introduction of MCD in March will not, we believe, have a negative impact upon lending volumes or appetite in 2016. There are some decisions that advisers need to take leading up to the implementation date and some processes that require altering, however we see this as more of a ‘bump in the road’ as opposed to a fundamental problem.

Paradigm’s focus has been two fold, 1) on improving the support we give to our existing members, whilst 2) continuing to take on new members. To date during 2015 we have attracted 170 new member firms, bringing our total number to 905 firms. Mortgage completions in 2015 are c.23% up, which takes the projected year end figure to £3.3bn. The applications required to reach this number are c.£4.4bn, or a run rate of £367m per month, which we are now consistently achieving or exceeding. For example, applications in October were £459m, 49% higher than October 2014.

Throughout 2015 Paradigm exhibited at major nationwide mortgage industry events – the Financial Services Expo and Mortgage Business Expo. This has helped raise our profile and has also aided in bringing new firms to Paradigm. On top of our normal monthly increase of 5-10 firms per month these events have provided an average inflow of an additional 19 firms.

4.3 Paradigm Protect

When Paradigm undertook a thorough review of the scale of protection sales generated by our member firms during 2013, the results indicated that they were collectively generating in excess of £20m AP. Given the numbers of firms we had, this was not surprising, however the business was not being attributed to Paradigm prior to launching Paradigm Protect. In reviewing the MI this year it is evident that Paradigm firms are now placing in excess of £10m AP via Paradigm Protect; with an average case size of c.£700

AP. The continued growth of Paradigm Protect leads us to believe we will enhance these numbers in 2016.

At the launch of Paradigm Protect to the DA market in 2014, our objectives were to:

- Deliver the most comprehensive range of products
- Give access to quality material via the website
- Provide ongoing training and development via seminars
- Build a sustainable business model whilst offering market-leading terms

In a short space of time these key milestones have been achieved but there are significant opportunities to improve our proposition further in 2016.

The long term objectives of Paradigm Protect remain to:

- Improve the profile of this important part of our business to Paradigm firms
- Offer firms a 'one stop shop' for all protection-related activities via www.paradigmprotect.co.uk
- Drive all protection sales via our member firms through the Paradigm business
- Continue to recruit firms into the Paradigm Group

All of these objectives remain extremely relevant to Paradigm Protect today.

4.4 Equity Release

The Equity Release (ER) market has struggled over recent years to gain any real traction. However in 2014, total lending was £1.38bn, which was the highest annual total since records began in 1992, exceeding the previous record of £1.21bn in 2007[10]. Lending in H1 2015 reached £710m - the highest amount seen in H1 of any year since half-yearly returns started being tracked in 2002[11].

The latest ER data also reveals an upwards shift in the average age of customers, as the 65-74 age group has seen the biggest growth over the last year, while the number of customers aged 55-64 has dropped8.

Different product types attract different customers, e.g. drawdown customers are typically older and tend to withdraw smaller amounts initially, whilst those taking a lump sum opt for a larger amount and are closer to the traditional retirement age of 65[12]. Innovations across the market are helping to make ER a valuable option more people to support financial planning – e.g. with some products offering repayment flexibilities. The matter of lending into retirement is certainly a topic of hot debate, particularly so since the freedom and choice in pensions withdrawal was introduced.

As before, Paradigm will continue, via its panel of Providers, to promote propositions to those amongst its membership who are appropriately qualified to give advice. Partner members who are not qualified will be given assistance in developing ER business services, and help in obtaining relevant qualifications, or support in working with our chosen referral partner, The Right Equity Release Ltd.

10 Equity Release Council, Press Release: 'Largest amount of equity release lending ever recorded – £1.4bn in 2014', 20 January 2015, http://www.equityreleasecouncil.com/news/largest-amount-of-equity-release-lending- ever-recorded--14bn-in/

11 Equity Release Council, 'Equity Release Market Report – Autumn 2015', September 2015, p.4

12 Equity Release Council, 'Equity Release Market Report – Autumn 2015', September 2015, p.5

4.5 Other Markets

It has never been as important as it is today that advisers maximise cross sales opportunities, and Paradigm will continue to support this by either assisting its advisers in the development of new competencies or via professional and fully vetted referral services. Although they are peripheral to core offerings, the collective value derived from services such as valuation and conveyancing, wills and legal services, specialist lending etc. should not be underestimated.