HALCYON

FINANCIAL FUNDAMENTALS FOR MORTGAGE LENDER GROWTH

INTRODUCTION

What a difference a year makes. While things are still all about capacity, it is now more about managing the excess rather than expanding to address a shortage. According to recent MBA estimates, originations are expected to fall from 4.4T in 2021 to 3T in 2022, driven in large part by a steep rise in interest rates, going from 3.1% in q4 2021 to 6.33% as of the end of q3 2022.

This comes as no surprise. The mortgage business is famously cyclical. Even with over a decade of artificially low interest rates thanks to the Fed's efforts to keep our economy humming along, it was just a matter of time before rates rose, refinance business fell off and housing inventory shortages at the low end of the market shut down the first-time homebuyer business.[1]

Competition has intensified and margins have compressed. In response, some mortgage lenders have closed divisions or laid off large numbers of people. Mortgage lending has always adopted a hire/fire approach to address its cyclicality. That's one way to reduce expenses, though it often comes with a large price tag as a system built for rapid growth is dismantled, often in piecemeal fashion, and relationships and knowledge are lost.

To thrive going forward, lenders have to develop streamlined, more flexible business structures that facilitate both cost reduction and revenue scaling. They are also going to have to re-learn how to prospect and acquire mortgage leads. That won't mean opening their wallets to purchase leads from the big real estate search engines. Competition for internet leads, which were never considered the highest quality new business opportunities, has become more intense as loan volumes fall off.

This paper will describe a new technology that is making it possible for lenders to increase revenues, reduce costs, better serve low-income and minority borrowers and secure a viable source of mortgage leads so they can grow as they move through the industry's cycles.

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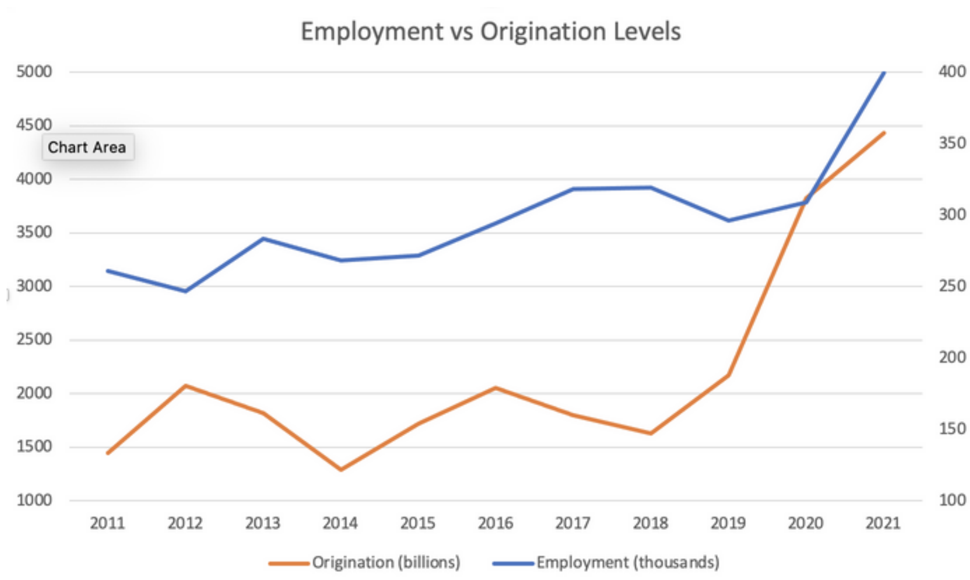
[1] How 2020 broke the housing market: So many homes are selling that we could run out of new houses in months. (2021).

THE PROBLEM THE INDUSTRY HAS CREATED FOR ITSELF

From an Expense Perspective

Adjusting head count as the primary way of managing expenses is costly and inefficient. As you can see in the chart below, hiring often continues after originations have started to fall and is slow to increase when originations start to rise. The result is a mismatch between actual and needed capacity levels. Consequently, lenders often have excess capacity that bloats expense lines or lack capacity which can impede revenue.



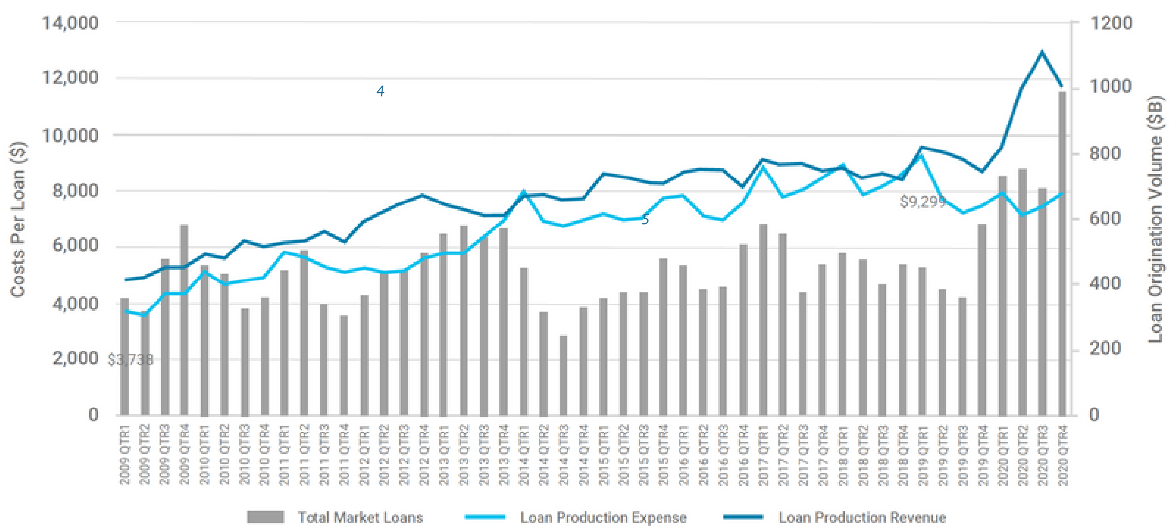
Source: MBA, Inside Mortgage Finance, BLS

The humane approach is to use terminations as a last resort. Additionally, it takes time, money and resources to train new hires on internal systems, guidelines and the different loan programs. It also takes time and resources for loan officers to cultivate relationships for both referral and direct business. When an employee is let go, these investments and relationships go with them. This helps explain why employment levels seem to be more reactive than proactive.

In the age of instant gratification, the mortgage process is anything but instant. According to data from Freddie Mac, the average time to close a loan hovers around 40 days, but varies based on market conditions and can vary significantly from lender to lender and borrower to borrower.[2] The long time to close reflects the manual or antiquated processes that are used to acquire, collect, analyze and present data into actionable insights which the lender and borrower can quickly and easily act on.

This process inefficiency and excess capacity in times of low volume, along with increased compliance costs and technology spend, has led to a 100% increase in average loan production expense over the last ten years.

Table 1: Average Loan Production Revenue/Expense ($ per Loan) & Loan Volume



Source: MBA and Freddie Mac

From an Originations Perspective

Sales leads are a means to an end and in the mortgage business the end goal is company growth. Like every other business in every other industry, the mandate is to grow or die. Companies that don't achieve the former always succumb to the latter.

Mortgage company growth is generally delivered by marketing, sales, strategic business referral partnerships, and M&A. All of these, with the possible exception of the last one, require basic sales skills and a thorough understanding of lead prospecting. Unfortunately, that's not a well-developed skill in our industry right now, which may be why we have so many sales trainers working here.[3]

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[2] Freddie Mac, Mortgage Closing Cycle Time, Dec. 2020

[3] Selling mortgages is not rocket science - The secret of role-playing. (2014).

Because mortgage interest rates have been so low for so long, most of the loan officers working in the field today have had years of easy refinance business.[4] Thus, the people working in the industry today have never been subject to the stress that creates well-trained salespeople. We have become an industry of order takers.

Furthermore, because mortgage customers don't come back for a new mortgage loan very often, building loyalty programs has been a non-starter. Without a system to allow prospective borrowers to alert their lender of their need for a new loan, lenders are forced to guess when consumers are in the buy zone.

Today, that means hoping a real estate agent will call on them to finance a deal or buying leads from someone on the internet who is watching to see when a consumer is searching online for mortgage rates or real estate.

Catching a consumer in the buy zone is very difficult and so most lenders use "spray and pray" marketing methods or just buy as many leads as they can afford.

While business referral partnerships have generally been the least expensive method of getting new business, this has been problematic for lenders because finding, building and maintaining those relationships is difficult and time consuming.

Whereas real estate salesperson relationships were the bedrock of a lender's business 40 years ago, today they are far less effective.

That's because the Realtor isn't just connected to the loan officers who live in their neighborhood, but also all of their social media contacts as well. Sharing business among all of those connections means fewer leads for any individual lender.

"Business referral partnerships have generally been the least expensive method of getting new business"

The problem the mortgage industry has created for itself today is that it has existed for so long on easy refinance business that it has all but lost the critical skills required to source, cultivate and convert mortgage leads.

This has happened because company growth has not depended on increasing sales, but rather on increasing capacity.

We saw this very recently in the volume runup coinciding with the global pandemic when explosive loan growth effectively doubled the cost to hire experienced loan underwriters and processors and sent many lenders offshore in search of business process outsourcing.

The only existing strategy that provides both growth and additional capacity is M&A.

M&A, YESTERDAY'S GROWTH ENGINE

In 2021 U.S. M&A activity in the financial services sector rose, total $284B in 2021 an increase of 38% from 2020. Deals were up 57% to 4972.[5]

[4] 30-Year Fixed-Rate Mortgages Since 1971 - Freddie Mac. (2021).

[5] Financial Services M&A, 2022. Cravath, Swaine & Moore LLP

Unfortunately, growth through acquisition is not organic and while it ensures that the size of the company increases, the critical metric, closed loan per full time employee, doesn't increase. This renders growth by merger or acquisition unsustainable because after the boom part of the cycle ends, the company could collapse under its own weight.

When one lender acquires another, the staff count in every department increases. A lender now has more operations staff than before but because the two companies are almost never working on the same tech stack or operating by the same playbook, the new company does not achieve 100% efficiency. The new company rarely performs as well as part of the new organization as it did when it was on its own.

This is particularly troublesome in the sales department, where the lender now has twice as many order takers as it did before. Both teams are subject to the pareto principle, so 20% of the resulting sales force will generate the lion's share of the company's revenue.

Additionally, from a mortgage lead perspective, growth by acquisition is the most expensive way to generate new business. It costs a great deal of money to find the prospective company, perform due diligence, negotiate a deal and then complete the acquisition. Even then, many of these transactions don't work out and don't ultimately serve to grow the business.

Some would argue that you're not actually even acquiring new business when you buy another lender, but instead just acquiring another operation that also needs to source leads. The acquirer gets bigger, it's capacity to process business increases, but the transaction does little if anything for the operation's ability to source new business.

IT'S TIME FOR A BETTER SOLUTION

To Control Costs

Lending institutions have to figure out how to remain cost effective no matter what environment they find themselves in. Increasing automation is a key component to this, especially when it comes to finding long term solutions to the reduction of increasing origination costs.

Those lenders that are adopting origination side technology are already seeing results. A recent study by Freddie Mac found that “Fintech lenders who accelerate the mortgage lending process using technology from loan application to approval and closing showcased 13% lower production cost per loan than non-fintech independent mortgage banks (~$7,900 vs $9,100 as of Q4 2020).”[6]

To Drive Revenue

On the revenue side we’re caught in a loop, working in an industry that hasn’t unlocked customer loyalty, is no longer expert at sourcing new business and is therefore dependent upon low interest rates to bring in new business.

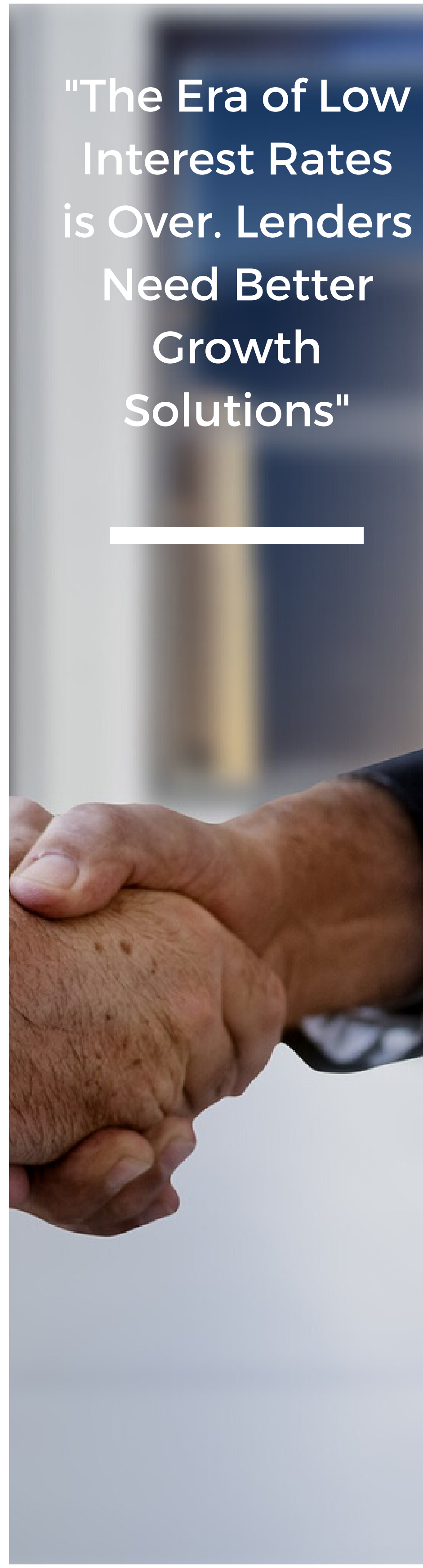
Unfortunately, the era of low interest rates seems to be over. Lenders now have to find a better solution to growth.

But there is a solution and diversified financial services companies are already adept at using it. Traditional banks (depositories) have long known that the key to a successful banking relationship hinges on share of wallet. The more bank products and services the consumer buys, the more tightly bound that consumer is to the institution.

That’s why cross-selling is an important competitive strategy for these institutions. Mortgage lenders also need to find a way to diversify their offerings and gain more share of wallet.[7]

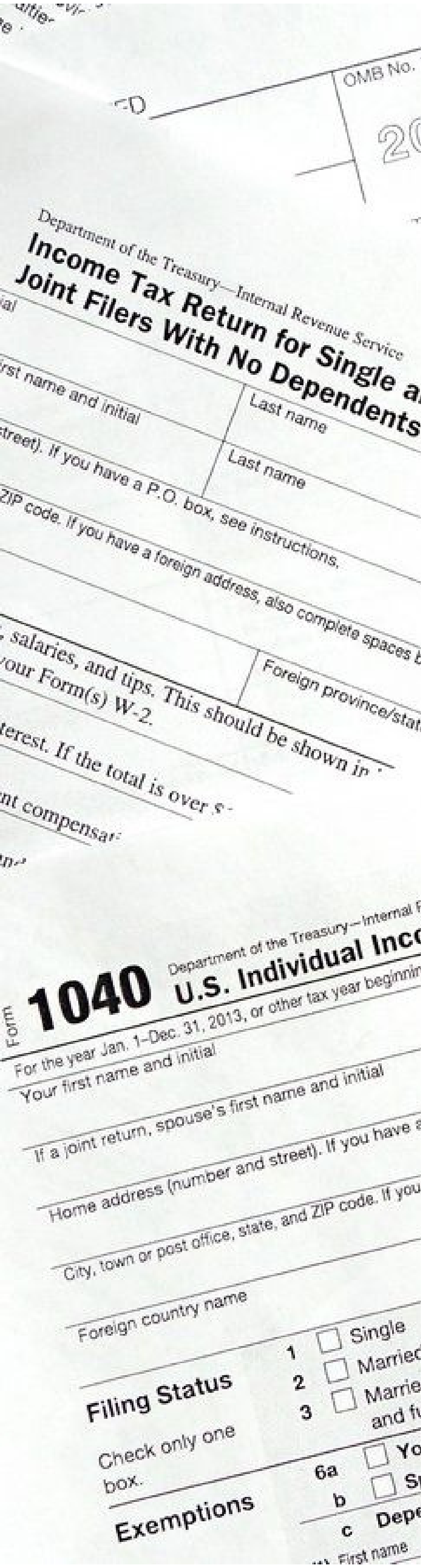
To achieve this, some lenders are forming alliances with professionals who serve prospective borrowers every year, like tax preparation professionals. In fact, this could be the very best move a lender could make in order to source a continuous supply of affordable mortgage leads.

Each year consumers complete their annual tax returns, providing a plethora of information about their financial position. While this information is an essential work input for the CPA completing the consumer’s tax return, it is much more to a lender. This data unlocks the prospective borrower’s financial situation and opens the door to the lender adding value by suggesting new home financing options that would be of benefit.



[6] Freddie Mac, Cost to Originate Study. How Digital Offerings Impact Loan Production Costs. (Nov, 2021)

[7] What Share of Wallet (SOW) Tells Us. (2021).



Benefits to consumer….

By accessing a consumer's tax data, the lender will know if the borrower could benefit from a new loan even before the consumer knows. They will be able to better assess the consumers ability to repay and can therefore build better recommendations. This puts the lender in a position to be a true advisor, helping to educate and offer options that would improve the borrowers financial position. Such advice builds loyalty, as borrowers realize that the lender is there to offer assistance, not just try to sell something. This type of borrower loyalty is an allusive goal that the mortgage industry has been trying to crack for years.

Determining the borrower's ability to repay is crucial for lenders but can be a source of frustration for many borrowers, particularly low-income borrowers. According to the Poverty Fact Sheet published by the Institute for Research on Poverty and the Morgridge Center for Public Service at the University of Wisconsin-Madison, 42% of low-wage workers work irregular job schedules and 12% have seasonal employment.[8] Inconsistent hours and secondary employment make the income verification process significantly more difficult and time-consuming, placing even greater barriers to homeownership ahead of low-income borrowers. Low-income borrowers are disproportionally Hispanic, Black, or another minority accounting for 30%, 22% and 6% of all low-income individuals according to the Urban Institute.[9]

Borrowers often become frustrated with repeated requests for income and asset verification. Sellers typically require pre-approvals from borrowers to have their offers considered. In an ever-competitive market, buyers compliantly respond and pony up document after document to their lender to be pre-approved. Buyers often spend months searching for a home and making multiple offers before being able to complete a transaction. During that time, their income and asset documents often expire requiring buyers to complete the documentation process again. Once the loan heads to underwriting, there are often questions from the underwriter requiring the borrower to gather additional documents. This causes an emotional strain that is again more acutely felt by low-income borrowers who often have multiple jobs forcing time constraints and significant additional documentation requests to prove continuity of income.

Easy access to tax data can help reduce some of the verification needs, thus simplifying and streamlining the process and creating a better customer experience.

[8] Institute for Research on Poverty. University of Wisconsin-Madison. Poverty Fact Sheet. Unstable Jobs, Unstable Lives. Low Wage Work in the United States.

[9] Urban Institute. Racial and Ethnic Disparities Among Low Income Families. Aug. 2009.

Of course, the reason more lenders don't utilize tax data to try to overcome these hurdles now is that forming relationships with tax preparers and CPA's is often difficult, to say nothing of maintaining them. The seasonal work means CPAs are often out of the office and unreachable except for tax season, when they are too busy to be bothered. Additionally, CPA's aren't able to receive referral fees unless they disclose them to the client. Most CPA's find more value in being seen as a trusted advisor then any referral fee they would receive, so they haven't been very receptive to referral partnerships.

Still, having these relationships will pay huge dividends to both lenders and consumers. The question is, how can this best be accomplished?

A NEW PARTNERSHIP EVOLVES

Lenders need an effortless way to build new business referral contacts and better serve their customers, but instead of tossing their client relationships over the fence to a partner or begging for a piece of the action, the lender needs to actually own the relationship by offering the service.

Tax accounting is a perfect solution for this as every borrower needs it every year, the tax return data provides accurate mortgage lead information and there is now powerful software available to make tax reporting easier.

The right solution would use technology to handle most of the work and then a national network of CPAs to sign off on the paperwork once completed, so the lender would never have to give up the client relationship while adding no new risk or effort to the lending operation.

While this may sound like a dream, Halcyon has launched a crowdsourced platform built on software used by tax professionals on millions of individual consumer returns that now allows mortgage lenders to easily offer tax preparation services to their borrowers and profit from it by easily partnering with professional tax preparers

The service is easy and convenient for consumers, instantly connects lenders to thousands of credentialed tax preparers and provides the perfect reason for lenders to stay in touch with borrowers, year after year.

Here's how it works.

Mortgage lenders make the Halcyon platform available to their mortgage customers on their existing websites. This borrower-facing site makes it easy for consumers to come to the lender's website and find the expert tax preparation support they need. The lender needs to do nothing during this process.

The platform itself offers industry-leading Optical Character Recognition (OCR) technology that is already in use by some of the mortgage industry's largest investors and by thousands of tax preparers across the country. This allows the consumer to start the process easily, uploading their documentation into the platform.

On the back end, thousands of licensed CPAs from around the country connect to the Halcyon platform to find new clients. Consumers enjoy the convenience of an instant connection to a qualified tax-preparation professional via chat or video call to answer questions and get advice that allows them to minimize tax liabilities without having to book appointments and then wait months to get time with a CPA still working in the brick-and-mortar world.

Because the Halcyon platform does much of the heavy lifting, CPA's are able to review all the documents and sign off on them in a fraction of the time it took previously. This allows CPAs to focus on providing valuable advice to consumers. In a world where the tax code seems to get more complex each year, this is a fantastic benefit to offer the lender's past customers.

Halcyon also has an API integration with the IRS that offers lenders and borrowers quicker access to the income and asset information. Tax transcripts can be pulled in minutes to hours rather than days.

QUANTIFYING THE BENEFITS

Customer pain points go away. Halcyon allows borrowers to make a one-time request for their tax data that allows for updates to the lender without any additional burden to the borrower. Getting more accurate data faster and eliminating the need to constantly re-verify helps shorten the life cycle of the mortgage lending process

The income verification system creates a faster, lower cost process for both the borrower and the lender. In addition, it offers a more reliable and less frustrating customer experience that reduces abandonment rates and helps level the playing field for lower income borrowers.

With the recent increase in technological advancement, there is also increased risk associated with the transfer and accessibility of an individual's personal information. Halcyon's API integration is secure and meets all government regulations, ensuring that borrower's PII is protected.

If lenders suddenly had a system that facilitated the building of lasting relationships with their borrowers, it would:

- Give them a reason to stay in touch with the borrower every year;
- Give them insight into when the borrower may need a new loan;
- Give them fee income for every tax transaction that occurs;
- Give them immediate access to most of the information required to underwrite a loan;

That's what Halcyon does. It changes the game and makes customer loyalty finally an achievable goal for the home finance industry. Suddenly, the mortgage lender/borrower relationship won't just be transactional. It will become an ongoing partnership.

While perhaps 10% of a borrower's past customers will traditionally be ready for a new mortgage in any given year, 100% will be ready to file an annual tax return. Self-employed borrowers will require quarterly assistance.

In truth, many more borrowers could benefit from a new loan, but they don't know it and the CPAs who traditionally file their paperwork don't know it. But with Halcyon, the lender will know it and be in the perfect position to grow their business by adding this valuable service for the existing customers. This not only helps expand the prospect base, but it increases access to mortgages for all borrowers.

Perhaps one of the most consequential outcomes from using the Halcyon system is the reduction in marketing costs for a portion of your originations. Rather than paying for leads, a cost that is currently increasing as leads become harder to come by, you are cross-selling and upselling existing clients.

Generally, leads for low margin, agency loan products tend to be less expensive, but often those same leads are sold to many lenders. It's a race to get to the borrower first and the return isn't very high.

Higher margin loan products allow lenders to spend more to acquire leads. Once acquired, it's all about conversion. And that's another problem. Because borrowers are completing loan applications with more than one lender, the conversion rate on these leads is lower.[10]

This is a risk lenders face even after the application is in the pipeline, with about 50% of the loans being processed failing to close because the borrower ultimately didn't qualify, the borrower chose to go with another lender who was either further along in the process or offered the borrower a lower rate or better terms.

Ultimately, the industry expects to convert between 18%-20% of the leads lenders buy, depending upon the source of the lead and the expertise of the lender's sales team.

[10] Berry, C. (2019). Can you apply for a mortgage with two lenders at once? | Mortgage Rates, Mortgage News and Strategy : The Mortgage Reports.

In MBA surveys, the sales and marketing expense generally accounts for 58% of the total cost to close a mortgage loan.[11] With the average cost of a loan at $8,000 in Q4 2020 (see earlier chart), sales and marketing expense would be roughly $4640 per loan. While it varies by lender, a good rule of thumb is that a lender should expect to spend upwards of $2500 on marketing for every loan they close.

With Halcyon, the cost to acquire is reduced to the cost of an email or phone call to an existing customer to cross sell them on an additional product. This effectively saves the lender the $2500. If you are a mid-sized lender originating 1,000 loans a year, and you could get 20% of your business from existing clients, that would mean $500,000 in savings. Considering that the average independent mortgage banker lost $82 for each loan originated in Q2 2022, saving $2500 per loan can be the difference between profitable and unprofitable lending.[12]

WANT MORE INFORMATION?

This white paper is provided by Halcyon as a tool to help shape the reimagining of the mortgage process. More information can be found at https://www.halcyonsw.com/about-halcyon.

[11] MBA Chart of the Week: Components of Cost to Originate in Retail Production Channel | Mortgage Bankers Association . (2021).

[12] HousingWire Magazine Aug 18, 2022.