White Paper

BCG Perspectives: U.S. Mortgage Industry Predictions and Priorities for 2021

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2020 was a year of rapid change for the U.S. mortgage industry. In January and February, many participants voiced concerns regarding how to make money in a low profit-per-loan market. Then in March, the pandemic hit and brought new waves of uncertainty. However, by early summer, a boom had begun that no one could have imagined. Low interest rates coupled with rising home prices led to a record year for origination volume and profitability. These increases played out against a backdrop of meaningful government action to keep individuals in their homes in the face of COVID-19 and societal changes regarding racial equity, remote work, and digital and virtual engagement.

2021 is anticipated to be another historic year of change for the mortgage industry. With continued expected strength in the housing and mortgage markets, many originators and servicers are looking to capitalize on the conditions to make investments to set themselves up for the remainder of the 2020s. Boston Consulting Group's (BCG's) discussions with 20 top leaders in the mortgage industry, along with project work, have informed seven predictions for 2021 and recommended priorities all market participants should consider to ensure they are in the camp of mortgage "winners" for the decade.

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Part I. Reflections on 2020

Before focusing on 2021, it is valuable to reflect on what was a rollercoaster ride in the mortgage industry in 2020, inclusive of 4 trends that are accelerating key shifts in the market.

1. 2020 was a banner year for housing, origination and profitability. 2020 brought a stable housing market with median home prices +15% for existing home sales and +2% for new home sales from November 2019 to November 2020.[i] There were over $3.5T in mortgage originations, the second largest market ever after $3.7T+ in 2003.[ii] As volume exceeded capacity, value increased in the mortgage industry and profitability increased from ~$1,500 per loan in 2019 to ~$4,500K in 2020.[iii] The strength in origination also filtered into ancillary services (e.g. title and appraisals) and service providers (e.g., data, technology) to the mortgage market.

2. Shifts in the competitive structure of the market accelerated Across originators, servicers, and service providers, there is a wave of market share moves and changes in ownership. Independent mortgage banks (IMBs) represented 65% of originations in 2020 versus 50% in 2016, and 50% of servicing versus 40% in 2016.[iv] The largest of these IMBs grew originations 30-110% in Q3 2020 compared to Q3 2019, while top banks were more stagnant, with many seeing year-over-year declines.[v] Subservicing has increased to 25% of the servicing market.[vi] In addition, a wave of IPO activity emerged in the second half of 2020, with 10 IMBs accessing or indicating intentions to access public markets.[vii]

Finally, consolidations and investments in the service provider space have strengthened leading players (e.g., Black Knight and Optimal Blue, ICE and Ellie Mae).

3. In an uncertain environment, the government stepped in meaningfully. The Fed took swift action after the onset of COVID-19 and purchased over $1T in mortgage-backed secruties (MBS) from March to September to provide liquidity and stability to the mortgage market.[viii] Additionally, as part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act passed in March 2020, borrowers with federally backed loans could request forbearance of payments, and servicers are prevented from foreclosing through early 2021. As of October 2020, more than 2.7M borrowers were in active forbearance plans, though this dropped from a peak level of ~5M in May and June.[ix] Capital markets felt a shift in the securitization mix, as conforming loan MBS issuances grew to 74% of total issuance for the first 9 months of 2020, up from 65% for the first 9 months of 2019.[x]

4. Societal changes accelerated by the pandemic moved to the top of mortgage agendas. 3 macro-trends in the U.S. impacted how mortgage companies engaged with employees, borrowers, and society. First, remote work became the norm when as much as ~90% of employees shifted to working outside the office by early summer.[xi] Companies restructured technology and workflows to support employee productivity and collaboration. Second, borrower comfort levels with digital and virtual interactions increased. For example, Notarize, a provider of online notarizations, saw 700% growth in the months following the pandemic.[xii] And, in a BCG survey of borrowers over the summer, borrowers who got a loan post the onset of COVID-19 placed significantly less importance on meeting in person with their lender for their next loan than those who received a loan pre-COVID-19. Third, racial equity took center stage on the agendas of mortgage companies and many top originators and servicers have announced efforts to advance racial equity through affordable housing programs.[xiii]

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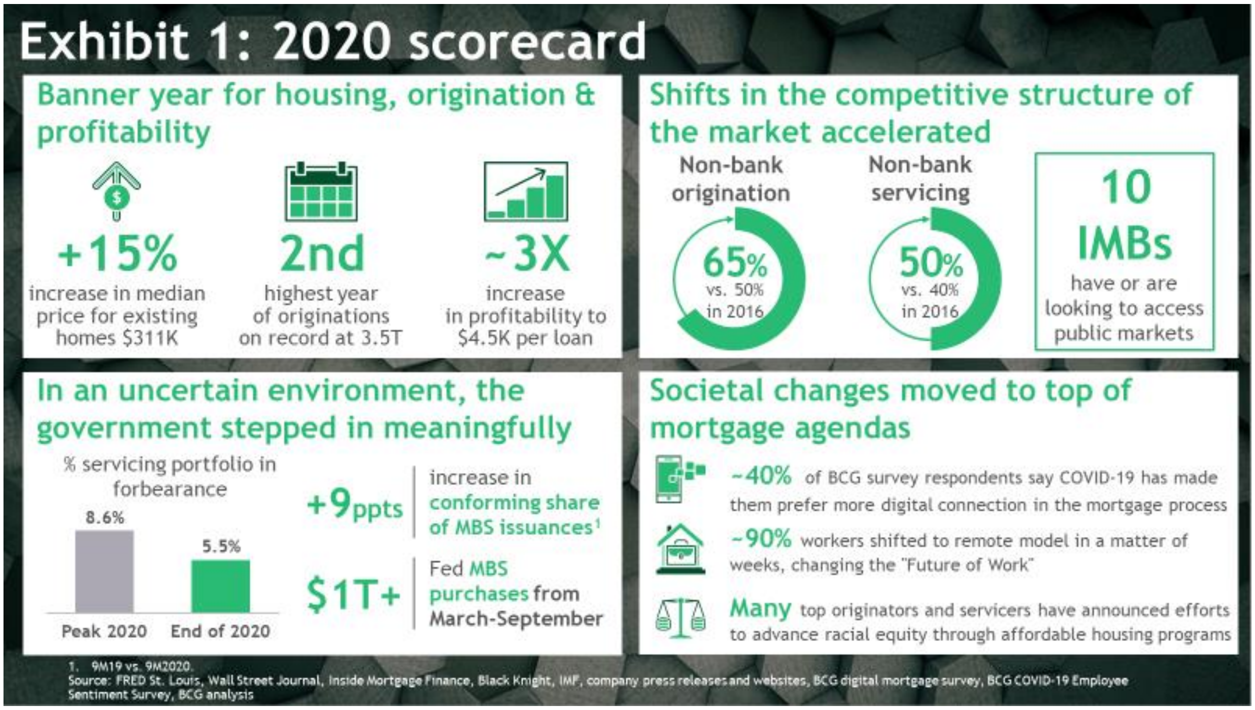

Part II. Seven predictions for 2021

Many of the conditions that made 2020 extraordinary are far from over and 2021 is expected to be another landmark year. However the market will be stepping down from a unique high point that was 2020, with increased competitive intensity, heightened borrower expectations and new regulatory guidance.

Prediction 1: While volumes may drop compared to 2020, they will remain historically high with strong refinancing and purchases. Consensus forecasts indicate a 20%+ reduction in mortgage originations from 2020 to $2.7T, with only ~40-45% being driven by refinancing, as compared to 60% in 2020.[xiv] However, there is more juice in the refinance boom. Black Knight reported 6.4M homeowners had taken advantage of a refinance by the end of Q3 2020 and predicted a total of 9M would refinance by the end of the year. This leaves 16M+ high quality candidates - e.g., current on their mortgage, have 720+ credit scores, at or above 20% home equity and could reduce their interest rate by 0.75% or more.[xv]

The purchase market will remain healthy with relatively elevated new home builds and existing home sales. Demand will be driven by millennials aging into prime homebuying years, the majority of whom are not impacted by unemployment. Census data indicates ~4M millenials will reach age 29-30 each year for the next several years, the average age this generation enters the home buying market.[xvi]

Prediction 2: With that said, something's gotta give: with volumes down and large players committing to gaining share, profit margins will compress. 90% of large originators BCG spoke with recently had plans to significantly increase market share in 2021. Priorities included major investments in hiring sales teams and increasing digital capabilities, automation, and other cutting-edge technologies to support a differentiated customer experience. With IPO activity and other unique ownership structures, IMBs are building war chests to fuel these investments. As competition heats up, it will be an increasingly crowded space to gain borrowers' attention.

Prediction 3: Borrower expectations will continue to shift to a "multichannel" world. It seems articles are published almost daily to discuss how customers are moving to a digital world. While the digital trend rings true, it underemphasizes a nuance of shifting customer behavior in mortgage: it's not just to digital but to omnichannel. According to a BCG borrower survey, with the onset of COVID-19, 76% of borrowers are using mobile/web platforms in conjunction with traditional in-person, call center and email channels, proving the need for a multi-faceted engagement experience.[xvii] Furthermore, borrowers are asking to engage not just on the application process, but linking that step seamlessly to the broader home buying journey, from saving and searching for a home to post-closing support.

Prediction 4: Reliance on new channels, partnerships and talent sources will increase. Market participants are changing who they work with in dramatic ways. From a channel perspective, further growth in both direct and wholesale/broker is anticipated. For example, broker has already grown from ~10% of distribution to ~15% over the last few years.[xviii] Companies like United Wholesale Mortgage and Rocket have made significant investments in the broker channel, growting through tactics such as offering new purchase leads to entice brokers to sign up. From a partnership perspective, originators and servicers are increasingly relying on third parties to deliver a wider range of "best of breed" offerings to borrowers. 75% of the top players BCG spoke with indicated that building the right ecosystem is a key area of investment. And there is a wide selection to choose from: BCG's landscape analysis indicates 300+ service providers are participating in point solutions for automation, pricing, compliance, and default, among other areas. Finally, digital and COVID-19 trends are leading to a rethink of the type of talent needed, with a shift to hiring more product designers, software engineers and data scientists. In a remote working environment, companies are broadening their search for top talent across geographies while at the same time implementing new operating models to maintain company culture in disparate locations.

Prediction 5: Mortgage and real estate will continue to blend (with RESPA compliance intact). Real estate companies see mortgage as a growth opportunity; at the same time, many in mortgage want to expand into real estate to fuel their own growth. On the real estate side, Zillow, Opendoor and Redfin all have built mortgage offerings. Mortgage participants are also expanding into real estate, as seen with Guaranteed Rate's joint venture with Realogy. This dynamic extends to solution providers as well. For example, a mortgage insurer, Radian, has built a software-as-a-service platform for realtors. And HouseCanary, a valuation player, is offering search capabilities through its ComeHome platform.[xix]

<u>Prediction 6: The forbearance period will elongate, and hardship mitigation will be under the microscope.</u> Despite the strength of 2020 originations, the mortgage industry has also been impacted by elevated levels of delinquencies and loans in forbearance. In the last decade, the industry has made positive strides to develop hardship mitigation capabilities, such as with the application process for forbearance or loan modification. However, low levels of delinquencies before COVID have shifted focus away from scaling capabilities and driving new methods to solve non-performing loan servicing pain points (e.g., customer experience in trying times). Cure rates seen to-date (~50% of COVID related forbearances are reperforming or paid off) are promising in terms of levels of hardship mitigation required. [xx] However, servicers will need to maintain a greater focus on hardship mitigation once forbearance is lifted and as there is increased scrutiny on the treatment of borrowers by the CFPB and other institutions.

<u>Sidebar</u>: Select regulatory changes and potential industry updates with incoming Administration

1. Potential slowdown or **change in direction for existing GSE housing reform** activities (e.g., conservatorship exit)
2. **Extension of GSE qualified mortgage (QM) patch** and changes to general QM loan definition
3. **Expansion of Community Reinvestment Act (CRA) requirements** to broader set of industry participants (e.g., independent mortgage banks)
4. **Greater regulatory** focus placed on **ending discriminatory and unfair practices** (e.g., proposed establishment of homeowner & renter bill of rights)
5. **Increased regulatory scrutiny** via Consumer Financial Protection Bureau (CFPB) enforcement
6. **Increased financial assistance** for housing (e.g., Greater Section 8 voucher funding, proposed tax credit for first time homebuyers, Low-Income Housing Tax Credit (LIHTC) expansion)

<u>Prediction 7: There will be a minor resurgence in non-QM and jumbo and products & services aimed at affordability.</u> With the onset of COVID-19, non-QM issuance dropped as uncertainty in the market increased.[xxi] However, as 2021 kicks off and the market gathers more data on forbearance policy and delinquency trends, it is possible non-QM could begin to pick up, particularly if yields on agency paper are low. Appetite for low-risk investments with higher than treasury yields may also drive a resurgence in jumbo loans.

In addition, expect to see new products geared toward supporting affordability in an environment placing value on racial equity. A key example that has seen resurgence is down payment assistance loans. Improving the reach and breadth of existing product offers and developing services that guide customer journeys to attract new borrowers will also be imperative.

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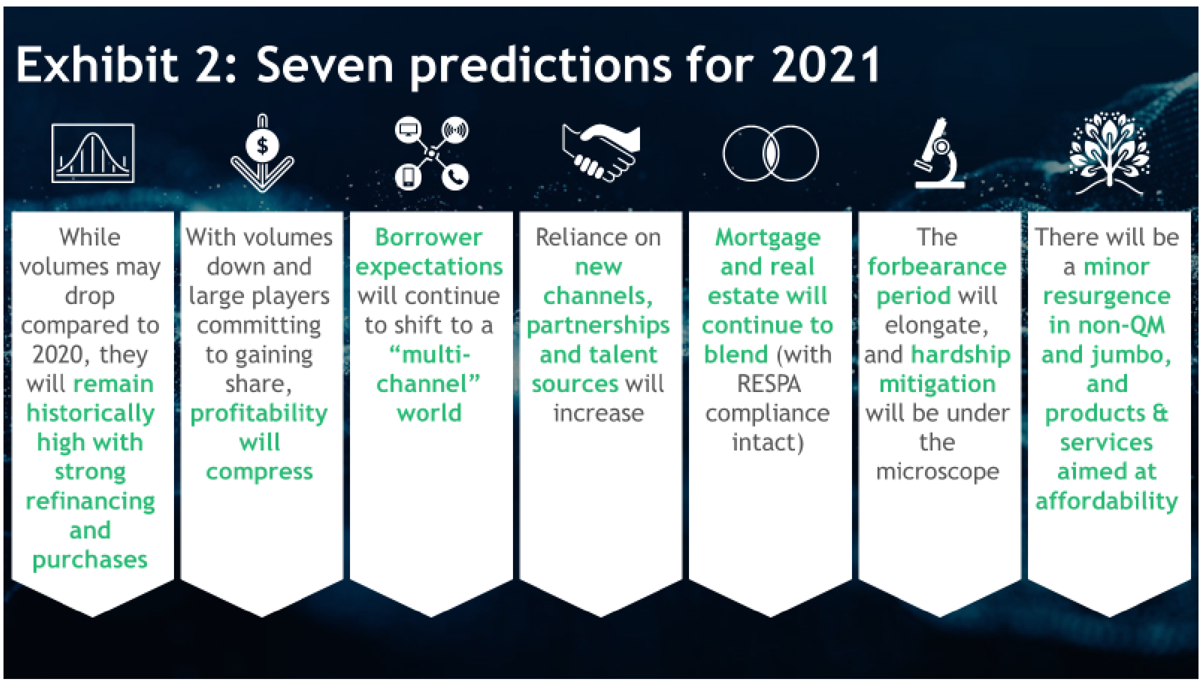
Taken together, these 7 trends (Exhibit 2) provide both opportunities and challenges for mortgage market participants. So, what should leaders do? Mortgage players who prepare to address and take advantage of these predictions through a range of priorities, discussed in the next section, will be best positioned to win in 2021 and beyond.



Part III. Seven key priorities to tackle in 2021

The mortgage market winners in 2021 will be companies who invest during the current good times to create a differentiated position for the remainder of the 2020s. Based on BCG's conversations with 20 top industry leaders and market observations from working with clients, there are **seven key priorities** for 2021 that mortgage participants should focus on to create a differentiated playbook, capitalize on the opportunities ahead, and be prepared for cyclical risks (Exhibit 3).

1. Pivot to purchase. While refinancing will continue in 2021, the party will eventually be over, and lenders will need to increase their purchase share to maintain volumes. However, it takes time to get the purchase engine going at full speed. Lenders need to prepare by changing where and how they play. From a "where" perspective, lenders should reconsider their participation in traditional channels of purchase growth. For example, while the market narrative has recently been focused on direct and digital channels, few lenders have been successful at scaling this strategy in a meaningful way to address the purchase market. Now is the time to provide customers an omnichannel experience and consider how to combine digital, loan officers in the field and call centers to optimize for purchase. Clients in the industry who have invested in an end-to-end omnichannel strategy have seen a 30+ improvement in NPS and near doubling of purchase recapture rates. In addition, there is brewing competition for unique partnerships that provide purchase leads. Players are teaming up with digital giants, non-mortgage lenders, and home insurers. Originators can look for these types of innovative partnerships and consider any opportunities to cross-sell across client bases to increase lead generation and win purchase in 2021.

From a "how" perspective, three capabilities are critical in a purchase market: digital marketing, data and analytics and personalization. In practice, these three capabilities can be combined to enable targeted, individualized programs aimed at specific market segments, such as customers likely to upsize their home in the near future. Companies that have improved lead generation through advanced analytics have seen a 3x uplift in appointments for home loans.

2. Focus on analytics driven retention. While refinancing drove volume in 2020, industry average retention rates for the 2.7 million borrowers who refinanced in Q3 were well below 50%, highlighting the need for servicers and originators to implement new retention tactics.[xxii] Expanding engagement with customers from the outset of the relationship is critical and can be achieved by offering home ownership ancillary services such as unique information on homes, neighborhoods, and service providers in their areas. As with purchase, data and analytics, digital marketing, and personalization are key levers for retention. Servicers must develop triggers, such as the number of times and when a customer calls, to predict future behavior. Mortgage players are hiring 10s to 100+ data scientists depending on company size to build this muscle, and the most successful companies are embedding this talent into core operational functions across the business. For example, one mortgage company BCG works with that invested in building personalization capabilities and improving engagement saw a 20% reduction in balances that churned and recouped 20% of margin lost due to churn.

3. Transform the end-to-end workflow to re-imagine the customer experience and create cost advantage. Transforming the end-to-end customer experience means thinking not just about the loan itself, but the entire home buying and home ownership journey. For example, Rocket Companies has built an extensive ecosystem that includes Rocket Homes for integrated home buying and selling via a real estate agent network.[xxiii] End-to-end transformation also means taking a holistic approach across front and back office processes to avoid designing in silos. For example, one of our clients observed a meaningful improvement in cycle times and cost per loan simply by investing time upfront to ensure the quality and completeness of initial applications, and rejecting loans quickly that would not get approved, prior to flowing into the back office. Leaders are also using dynamic checklists tailored to the individual borrower to reduce back and forth in gathering documents. Multiple clients have started this journey, with some reducing cost per loan by 25% to-date.

4. Optimize costs through organization redesign, outsourcing and real estate optimization. While end-to-end workflow transformation is one lever to reduce costs, others are critical as well. With a large increase in headcount in the industry in 2020, there now is an opportunity to take a step back and re-think organization structures and cross-functional collaboration mechanisms to right size non-customer facing roles. In addition, BCG discussions with banks, independent mortgage banks, and third-party providers of key services such as Business Process Outsourcing (BPO), indicate high expectations that mortgage players will increase outsourcing, facilitated by increased digital capabilities. Finally, increased remote work driven by COVID-19 will create opportunities for mortgage participants to re-examine and optimize their real estate footprint across branches, offices and facilities.

5. Underwrite for affordability. In all 20 end-of-year interviews BCG conducted with top industry leaders, there was a consistent desire to increase access to mortgages and deliver the dream of home ownership to a broader set of individuals. While affordability is a high priority, lenders face regulatory challenges and uncertainty surrounding borrower performance. To meet this priority, lenders will need to move beyond a "one size fits all" credit overlay approach to create opportunities for a wider set of borrowers. To do this, originators can enhance credit decisioning with alternative data sources at the individual level that provide information beyond simply credit, while rethinking products and partnerships for underserved populations.

6. Re-imagine hardship mitigation. COVID-19 has created the need for forbearance provisions as borrowers navigate the impacts of the pandemic, but as these provisions are extended or expire and delinquencies follow, servicers must prepare for new operating model needs. In BCG conversations, servicers say that they are leveraging online education content tools to inform customers, adding call center capacity to handle anticipated volume, creating borrower and employee tools to enhance digital processes and training employees. While these approaches are effective, more can be done to improve the borrower experience and outcomes at scale. Servicers can take a borrower-centric approach that considers different personas likely to be experiencing hardships to ensure needs are met. There is also opportunity to refocus design on incorporating the full customer journey, including proactive identification of intervention points on the front end and proper follow-up mechanisms on the back end to ensure continued performing loan performance. Market leaders have cited that taking these measures will not only lead to a better experience but also improve adherence to regulatory and compliance standards.

7. Leverage the capital markets for differentiation. Two trends could create opportunities for originators and servicers: 1) participation in the private label securitization (PLS) space and 2) mortgage servicing rights (MSR) strategies.

While PLS will likely remain a small percent of securitization, PLS will grow with greater stability in the market. Lenders and servicers will need to decide how to play in the space. Some private issuers are vertically integrating across the origination/securitization/investment value chain. For example, PIMCO, with First Guaranty, plays in the origination, securitization and investment space, as does JPMorgan Chase. Building out securitization capabilities enables mortgage players to flex their securitization muscles, preparing them to take advantage of opportunities that could arise.

Opportunistic Mortgage Servicing Right (MSR) strategies could bring value, particularly to servicers with scale and a strong cash position. While low interest rates have translated into notably low MSR values, prepay burnout could begin to set in some time in 2021, potentially providing an increase to the value of MSRs. In addition, what some servicers view as complex-to-service loans (e.g., Ginnie), others see as an opportunity to serve given specialized capabilities. This opportunistic strategy led to success for some players following the 2008 financial crisis, and similarly, there may be opportunities available now for players willing to invest in MSRs while values remain low.

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An important note before concluding the discussion on priorities for 2021. In addition to undertaking these seven priorities, companies must consider two critical and foundational changes to the mortgage operating model 1) the future of work is changing and 2) customers and employees expect commitment to racial equity. Across each priority, mortgage leaders must take these lenses into consideration. They must strike the right balance to maximize employee satisfaction and effectiveness in a post-COVID-19 world, maintain what is core to the company culture, and leverage opportunities to hire talent and assemble teams in remote locations. Leaders must also continue to invest in closing the racial equity gap, which has become a consideration for customer and employees alike and can be both an opportunity to do good and stand out in the market.

Conclusion: How to prepare for 2021

2020 saw unprecedented shifts that are likely to change the mortgage industry for good. Now, originators and servicers must prepare for the trends expected to shape 2021: lower (but still historically high) volumes, compressed (but still historically high) profitability, blurred lines between real estate and mortgage, borrower expectations of multichannel, reliance on new channels, partnerships and talent sources, increased forbearance and hardship requirements, shifting capital markets and focus on affordability. To say the least, there is a lot for leaders in the market to contemplate.

Those who begin acting on priorities now will be the winners for 2021. Players must use the good times to invest in the future. The high profitability environment enables investment in a range of specific priorities to support growth, best-in-class customer experience, differentiated offerings, and reduced costs. Additionally, originators and servicers must rethink core beliefs around the future of work and their role in supporting racial equity in housing. Those that prepare now will not only be noticed by borrowers, employees, investors and other stakeholders in 2021, but will set themselves up for success through the remainder of the 2020s.

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