Freddie Mac Single-Family Home Starts Here Podcast Episode Transcript:

CRTcast: Breaking Down Structured Finance with Credit Suisse

Announcer [00:00:01] Welcome to the 'Freddie Mac Single-Family CRTcast' a series under the "Home Starts Here Podcast." Now investors have a front row seat to conversations discussing economic and housing markets, portfolio management and analytics, servicing policy and credit risk management from Freddie Mac leaders and other industry experts.

Mike Reynolds [00:00:28] Welcome to Freddie Mac's Single-Family 'CRTcast', our new series under the "Home Starts Here Podcast" focusing on Credit Risk Transfer and its three spokes - securities, reinsurance and mortgage insurance. My name is Mike Reynolds, I'm a vice president at Freddie Mac responsible for Single-Family's Credit Risk Transfer program. Today I'm really happy to have Dan King, who's a managing director at Credit Suisse and we're going to talk about investment banks and structuring. With that, Dan, welcome to the program.

Dan King [00:01:00] Hey, Mike, how are you doing? Happy to be here.

Mike Reynolds [00:01:02] I hope your summer is going well, maybe you took a little bit off time off and thank you very much for being willing to take time with us and our listeners to dig into CRT. Today's podcast is focused on like your expertise, which is how do we actually execute a transaction and how do we structure, what are some of the components that go into that? What is the role of an investment banker? So hopefully our listeners will find this enlightening and we won't get too technical, although I was really glad that you accepted the invitation to come on, because I think of a lot of the folks that we work with, you're one of the best in taking very complex concepts and making it understandable. So, I'm glad you're here. But why don't we start off, why don't you tell folks a little bit, what is your role at Credit Suisse?

Dan King [00:01:53] Sure. Thanks, Mike. Yah, first of all, I really appreciate the kind words and the invitation to be on the show with you today. Definitely hope I can provide a little bit of information and context for your audience about investment banks and how we kind of fit into the overall picture. My role at Credit Suisse is that I head up the structuring and analytics department within Securitized Products Finance, and we'll definitely dig a little deeper later on into what some of those, those terms mean if they're unfamiliar. I've been in the industry about 15 years, primarily focused on residential mortgage credit, but I've spent time with many other asset classes within the securitized product universe as well. So, in terms of credit risk transfer, as you know, I originally got involved with the first STACR deal actually. You know, Credit Suisse was hired by Freddie Mac to structure and place the original STACR notes, and that deal was done in July of 2013. But you know, again as you know, we started that process well in advance of that and I think we were involved as early as 2011, maybe even before the genesis of the STACR name. And since that time, you know, we've had the good fortune to be very involved in the space and to be involved in many of the kind of groundbreaking and more innovative transactions in CRT. So, thanks for having me.

Mike Reynolds [00:03:05] Absolutely. And I do remember well the launch of the STACR program and the CRT product line for Freddie Mac. And Credit Suisse and your team have certainly been at the heart of a lot of innovation, not only for us, but for other issuers. And we did engage with Credit Suisse as an advisor prior to issuing the first transaction. And that was all around trying to figure out how do we create CRT - credit risk transfer – at, in my words, agency scale. Like we were looking for a vehicle that could over time really get broad traction and be able to handle the level of risk that attract the dollars or capital that we do for such a large company. And so, Credit Suisse had an extended period in that advisory role, if you will, prior to the first transaction. And then certainly were an underwriter on our initial transactions and several transactions. Dan, in your words what are what are the general roles that investment bank performs on behalf of the issuer and investors?

Dan King [00:04:13] Sure. Yeah, that's a short question with potentially a very long answer. But yeah, I'd say investment banks play a few different roles throughout the life cycle of a CRT transaction. For one, investment banks generally have trading desks that are active in making markets for existing transactions. That's not something I'm as focused on, so maybe talk about a couple of things we do when we're hired, like you said, to structure and place a new securitization. My primary focus is working on those types of transactions, even within that, there's a number of different hats that we wear. An important one is certainly helping with the coordination of the transaction, the timing and coordinating the third parties. But I guess I'd really think about the two key roles there are structuring and placement. You know we can get into more detail in those, but just at a very high level, structuring is kind of the, I'd say the art of designing the deal and putting the deal together and then placement is, is the process of actually finding investors and putting the bonds into their hands.

Mike Reynolds [00:05:13] In that structuring role function, we would have a lot of conversations, Dan, with you and your team around "well, you know, what are the various considerations in structuring?" Right? And it's a combination of understanding the market and understanding which investors are out there, understanding rating agencies, to the extent that that we get our securities rated, which we currently do on several of them. And then certainly, all kinds of investment rules and regulations, both domestically and then in our case, we market globally. And so, we do depend on an underwriter to kind of blend all of those things together to try to create what will ultimately be a pretty efficient and repeatable structure for us as an issuer. Let's start with investors, you know, when you think about the various investors out there, they have different investment guidelines. Right. And when we're talking about placing credit risk, we have to consider who can take the risk and under what circumstances. Can you talk a little bit about how you're factoring in your knowledge from other issuances, other asset classes, and how you're kind of feeding that back into the way we structure the transaction?

Dan King [00:06:30] Absolutely. You know, the institutional investors who make up the STACR investor base, or the credit risk transfer investor base, is, in a word, 'complex.' And maybe in another word, it's 'everchanging.' You probably have a better estimate of the exact numbers than I do. But there's certainly been dozens of different investors who have bought a STACR bond at some point in time. And it's a constantly evolving population. So we've seen individual players come and go and sometimes come back again, right? So the best way to think about it is that all of these investors are constantly looking at and evaluating opportunities to invest across a variety of issuers and markets. And they're going to have a diversity of views at any one time as to what's the best relative value for them. So our goal is, for particular transactions, is to kind of find the optimal set of investors for that point in time. So, many of these investors have a special focus in securitized products, but, you know, many of them are looking at opportunities across other debt and equity markets as well. As we, we relate that back to the structuring process, one of the things that, as you talked about, we're trying to do is basically come to market with a deal where most of the terms are finalized before we begin the marketing process. Clearly, there's some points like pricing, etc., that we're working through in the marketing process. But the goal is to have a deal that we've put together that we can put in front of the market. And so all of the different things, and we can talk about, I think some of the things you mentioned, all the decision points we make, all the different 'what if' scenarios we run ahead of that time to put different ideas in front of you of how that structure might look need to be done beforehand, before we start engaging with investors. So, totally agree with you. It's important to have an understanding of how investors are going to react to those things while you're actively in the structuring process.

Mike Reynolds [00:08:21] We're in triple digits, unique investors program to date now, and actually, probably even just this year, we're nearing that mark. So, the program really has evolved, programs, I'm talking about capital markets in that case. We've definitely had a very, very large number of investors come in. And just like you said, investors come in and they kind of go out depending upon the relative value. But largely speaking, we've got a pretty solid core. I think, from an investment bank perspective, clearly, you're hired and paid for by the issuer, Freddie Mac in this case, but you do have that independent duty and responsibility, right? I think that's critical for us in being able to bring the program to agency scale, is to be able to have that independent third party, you know, separate from the issuer, look at the transaction. There's a coordination of some other third parties that happens in a transaction. I already mentioned rating agencies, but we also hire an independent due diligence firm that reviews individual case files. We have an independent accounting team, there could be some other functions, a calc. agent and whatnot. I think overall, I think the function of that investment bank is to, you know, to give a, a comfort level to the buyer that an independent party has reviewed the transaction and feels comfortable with bringing the offering to market.

Dan King [00:9:42] Completely. One of the ways I kind of think about securitization in general and CRT transactions and how they're distinguished from other products that these investors are looking at outside of securitized products is really just the, the complexity of the transaction and the fact that each individual transaction is kind of its own animal. If you look at a marketing process for other products, like 'a corporate debt' type product, that might take only a matter of hours or days, whereas we're in the market for, days or a week or even more if you include the entire period of time where we start talking to investors about a deal to when we price it. You know that's an important amount of time for investors to really dig in and understand, right? You know you have a reference pool that might have a few hundred thousand individual mortgage loans on one side. And on the other side, you have maybe three or four different classes of bonds that are sold to investors, right? And ultimately, the cash flows of those bonds and the performance of those is determined by the mortgage loans. But the process by which that happens is obviously tremendously complex. It's a maze of different defined terms and payment allocation rules. So one of the things that's important to us when we're marketing a transaction is to try to distill those rules into ways that investors are actually able to analyze a transaction and take a view on it. So, that's certainly something my team in particular, and when you think about structuring in particular, focuses on is, is on the analytical side of these transactions. So, creating cash flow models, allowing them to run different projections and really understand the risk and understand the return profile for a bond that they're looking at.

Mike Reynolds [00:11:15] Mm hmm. And, generally speaking, when we look at our Freddie Mac's UMBS offering, which is a guaranteed offering, an investor in that is primarily focused on rate risk, prepayment risk. There is an aspect of credit in that, to the extent that if a borrower gets distressed that may result in an acceleration of a loan out of that UMBS. But very intentionally those are credit guaranteed, and so the investor is able to kind of focus on rate, which is complicated enough on its own. But then on the credit side, yes, credit has its own set of dimensions. And it requires a lot of sophisticated analysis and analytics. We restrict who we offer the bonds to. You have to be a qualified institutional investor to be able to participate, because these transactions do carry risk and investors have to have a very solid understanding of the risks that they're exposed to. And, as you said, you're modeling up the cash flows, understanding how the triggers inside the cash flows flow inside of the transaction. How does that operate under different scenarios? I think one of the pieces is when we look at, say, structuring the bonds, we have an idea of who we're going to try to sell these bonds to. And I would say you can make a broad distinction between investors who have investment mandates to only purchase rated bonds, and those bonds have to be investment grade. There's other investors that would be able to purchase below investment grade or non-rated securities. And, generally speaking, the spreads that we as an issuer have to pay on investment-grade securities is less than the spreads that we have to pay on below investment-grade, because there is more credit risk in the below investment grade. And I feel like that is a significant part of the process of where we're trying to determine how we build this capital stack, is just understanding or estimating which investment desks, which companies might invest in here and then try to make sure that what we're offering kind of fits their investment guidelines. And I think, certainly, you and your team at Credit Suisse give a lot of consideration to that on every transaction that we bring to market.

Dan King [00:13:34] Yah, certainly. Certainly. You know, there's s kind of familiar ways, I think that you disclose how we classify the investor base in terms of kind of what type of institution they are. Whether that's money managers or insurance companies or banks or hedge funds or those are probably the biggest ones. You know, those are not always perfect definitions. Every firm's a little bit different. There's shades of gray in between. I think you've keyed on how when we're structuring a deal and putting it together, really the more important distinction is, is how you kind of can draw lines and demarcate the investor base by a few important considerations in terms of their investment guidelines and how they think about relative value. And one of those is definitely credit rating, right? So as you mentioned, certain investors need a credit rating, are often an investment-grade rating, which would be triple B minus or higher. And there's a number of rating agencies that are active in this space, and they are also constantly tweaking their rating methodology. So they have an established way of looking at credit risk and establishing rating criteria for transactions. But that's a living, breathing animal. You can look as recently as some of the response to COVID, where you know all of them were making adjustments to their assumptions just because of the difference in environment. So that's something we're always keeping in mind. And I think another way to think about kind of a split in the investor base is duration. Mortgages are, are definitely one of the longer duration assets in securitized products. The loans themselves tend to have 30-year terms, and the duration of a portfolio is quite a bit shorter once you account for things like amortization and prepayments, but it's still a relatively long duration. So one of the things we're able to do with the structuring and tranching process is to create some shorter cash flows, some longer cash flows. You certainly have investors who have a need or only have an ability to invest in a shorter time period and vice versa. So those are just two of the maybe larger considerations as we're looking at the investor universe and how to think about it from a practical standpoint in terms of putting together a transaction.

Mike Reynolds [00:15:31] I think that's a great point on the duration. What we do for our CRT offerings is we have shorter M1 bonds. What we offer is basically four bonds and what we call M1, M2, B1 and B2. Dan you probably had a pretty strong hand in the naming convention of that structure. And those bonds that are at the top, the M1 at the top of this, like kind of, theoretical capital stack, they are the most credit risk remote, meaning the bonds subordinate to it, which are M2, B1, B2, have to take losses prior to it taking losses. They also get paid off first. The structure is set up so that it's a sequential pay, meaning M1 gets paid off completely before M2 starts to get paid, which must be paid off completely before B1 and so on to B2. So, from a duration perspective, an expected weighted average life of the bond outstanding, that M1's going to be the shortest, M2 will be longer and B2 would be the longest. When you have that duration split, if you will, right? There's like relative investments, right? So, say somebody who's looking at this M1 bond likes short cash flows, they're also looking at other asset classes that might have like a similar profile to it, right? And that may be residential, but that might be autos or credit cards or other asset classes. Can you just touch on that a little bit? Like what are some of the other opportunities that a typical investor may be comparing their investment choice with?

Dan King [00:17:03] Sure, yah, I mean, certainly at the shorter end of the spectrum. As I mentioned, mortgages are some of the longer duration assets within securitized products. Student loans and CMBS are the other two kind of longer duration ones. Most of the other deals done in the securitization world are shorter duration assets. So whether that's various types of consumer loans, including auto loans or a whole variety of other types of ABS deals. Those tend to be more in the one, two, three-year type range of a weighted average life. So there's quite a bit of competing supply there in terms of competing with you as an issuer, in terms of sort of alternative investment strategies or investment opportunities for these investors. And again, that's just within the SP space. As we talked about, many of these investors have the ability to be sector agnostic and focus on opportunities in other debt markets as well. And they effectively have to look at it from a from a relative value perspective. So, what makes your deal more interesting to them is obviously a combination of a whole number of factors, including duration and pricing and their view on risk.

Mike Reynolds [00:18:11] And I think tied to that and one of the functions that the investment banks do for us as an issuer is program consistency. Investors are continuously getting all these opportunities. The offering materials are hundreds of pages long. The data tapes that accompany the offering can have fifty thousand, one hundred thousand, even more loans in them. So it's a real heavy lift. So I think what we've tried to do, and I think the advice that we often receive, is to try to get that consistency in the program. It has to evolve, and we've made a number of enhancements to the program over the years. But at the same time, we do put a heavy emphasis on trying to make it easier for an investor to, once they understand the program, to keep a lot of the basics the same, or if we are making a change, really make that an emphasis on when the deal is being marketed to make sure folks understand what the changes are and how that might impact their situation. And I think that's part of the investment banks' role, is to kind of help us as an issuer to be making those changes in the most programmatic way that we can. And then as those changes develop, to help investors understand what that means for them so they can make an informed investment choice.

Dan King [00:19:27] Totally agree. I know that's something that, as an issuer, you constantly need to be keeping in mind and maybe sometimes struggle with, which is, you know, obviously you want to have an efficient structure, but you also need to think about the longer term as well. And, it's worth pointing out, that even if you keep the same structure for every deal, as we mentioned, the market environment, the supply demand dynamics of this type of product or similar product changes, that's out of your control. There's home price trends, which can change right out of your control. There's trends in rates. Just last year we saw a huge refinance wave with lower rates, which obviously had a huge impact on prepayments and the lack of new product coming to market. And then you have things like COVID, right? So regardless of how consistent you want to keep it, there is a constantly changing environment that you have to keep in mind on a deal-to-deal basis, but I think you guys have done a really good job of trying to be clear about when you're making changes that your hand is forced on, you explain to the market why you're doing them and consistently do them going forward.

Mike Reynolds [00:20:26] Yah, I think that's a great point. I like how you kind of walk through those factors that really do change from deal to deal. And the ReFi is a great case in point. You know, just the underlying collateral has shifted quite a bit. And on our last podcast, we had Jim Benson on from Arch, and he talked through how they used as a base a lot of the STACR Freddie Mac CRT transaction to help facilitate their shelf. And I think that broadening capital base, investor base, is net-net beneficial for all of us. And a lot of that has to do with the consistency, but of course, as you walked through, every single transaction is unique and requires a deep dive by the investor prior to buying. Well, Dan, thank you very much for joining us today. Hopefully, our listeners got to learn a little bit more about the structuring aspects of the CRT program. And, hope you enjoy the rest of your summer. And thanks again for taking the time to be with us.

Dan King [00:28:23] Thank you.

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