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

Freddie Mac Single-Family

Power of Partnership -- Innovient

VO [00:00:01] The Power of Partnership is our podcast under the Freddie Mac Home Starts Here podcast series that focuses on the strong relationships between Freddie Mac and our third party partners. Learn how we're teaming up with these partners to provide you with an efficient end to end experience for conducting business with us.

Amy Creason [00:00:20] Hello, I'm Amy Creason, Freddie Mac's director of Sales for our Secondary Market Advisors or SMA team. And I'm your host for this episode of The Power of Partnership: Innovient and Freddie Mac -- Best Practices for Managing Loan Pricing Economics. I'm looking forward to an informative conversation with my guest, Ted Kramer, founder and president of Innovient, one of our valued secondary market advisor partners. Today, we'll discuss important pricing components lenders should consider in their loan pricing margin management. Welcome, Ted. I'm thrilled to have today's conversation because I know listeners will be interested to learn about Innovient's technology solutions for capital markets, and how the platform interfaces with Freddie Mac and Innovient's recommendations to lenders for margin preservation in an extremely competitive market. So let's get this conversation started, Ted, with an overview of Innovient, the services you provide, and start a discussion of the key economic components of pricing to be examined and managed by lenders.

Ted Kramer [00:01:24] Thanks, Amy. It's great to be here. You know, this is a very timely discussion with this hyper competitive pricing environment we're in, margin management and preservation are more critical than ever. So I'm looking forward to discussing many of the best practices Innovient's partners depend on. Innovient opened our doors in 2002. So we're very proud to be celebrating our 20th anniversary this year.

Amy Creason [00:01:46] That's great, Ted. congratulations.

Ted Kramer [00:01:48] Thanks, Amy. One of the reasons for our success and longevity is that we are passionate about creating a superior experience for our capital markets partners through our best in class products and providing a white glove hands on consultative service. We have a great reputation for exceptional service, and it's top of mind for all of us here. We enjoy a diverse set of both independent mortgage banks, as well as depository institutions, including several of the top 20 national lenders and many medium sized regional players as well. My formal training and education is in computer and information services. I joined Prudential Home Mortgage back in 1985, dating myself a bit, and quickly migrated to the business side and capital markets. At that time, Prudential was number one or number two lender at the top of the execution food chain. And so we were creating mortgage backed securities with the GSEs, as well as had our own private label securitizations. And I've been in organizations of all sizes, up and down the spectrum, all the way down to start ups. And as a result, I've seen it all in terms of the various secondary marketing execution strategies. So providing technology solutions for the secondary market and capital markets space was just a natural progression. From day one, our objective was to provide unparalleled precision, discovery, and attribution of all the economics of a loan from pricing through final disposition, whether that's the sale or the retention of the mortgage and or servicing rights. The vast majority of shops that we see focus on effective management of pipeline risk, usually with the help of a hedge advisory service, and rightly so. But in many cases there's a lack of attention to pricing and execution that can sacrifice margin before the loan is even hitched. And that's Innovient's specialty. The vast majority of our partners prefer Innovient's capabilities for pricing and execution in concert with their use of a hedge advisor.

Amy Creason [00:03:51] Oh, interesting.

Ted Kramer [00:03:52] Most of these partners are approved with Freddie Mac, Fannie Mae, Ginnie Mae, as well as their aggregators for bulk bids for non-conforming, non-QM, ARMs and jumbo products. We have a mixed selling in Freddie Mac's cash window or in exchange for securities as well. So there's great diversity in their servicing strategies as well, whether retained or released. So we see it all and our vast libraries support every execution, structure, and strategy that's in the marketplace. There could be hundreds of economic data points to be applied or considered for even a single execution scenario. Then factor that by the number of different execution options that one lender may have, whether it be the mortgage asset or the servicing rights. It's a lot. What we do is help our partners put all those economic data points to work in their day to day pricing and execution.

Amy Creason [00:04:45] That's a great overview, Ted, thanks so much. And I know your partners appreciate your diverse personal expertise as well as the variety of problems you solve for your varied client base. I did want to follow up on your reference to economic data points. Could you discuss that concept a little bit further?

Ted Kramer [00:05:03] Sure thing. I'm referring to all of the economic components of any transaction on the pricing and or selling of a mortgage and servicing rights. First off, there are those, quote unquote, discrete economic components. These are the obvious black and white factors that most people are familiar with, right. Like the cash window or the rate sheet price from an aggregator, for a given note rate in the lock period. Although those can get even a little bit more granular on the Freddie Mac cash window, you can have more granular lock periods than you can with aggregators, so we can talk about that more. And then there's servicing rights or SRP, Servicing Release Premiums, used by the aggregators. Typically these are straightforward grids by loan size and or state, in most cases. Credit fees in price or commonly known as loan level price adjusters, the risk-based pricing factors for FICO, LTV, property occupancy and the like. And finally, fees, whether that's underwriting, funding, warehouse unit fees, servicing unit fees, certain GSE delivery fees, and even the two basis point Ginnie Mae committing fee, that many shops don't factor into their expenses.

Amy Creason [00:06:18] So, Ted, those were the discrete components. What else?

Ted Kramer [00:06:22] Well, then there's those, what we call derived economic components that are a little less black and white, but equally important, and in many cases more important. They're just not as cut and dried. For instance, if you're pulling into mortgage backed securities for Freddie Mac, Fannie or Ginnie Mae, there's the security price. And in this case, Innovient's markets product, which our partners love, automates the consumption of live pricing feeds from sources such as Refinitive Icon, Bloomberg and Trade Web, the most common sources. It also gives our partners great situational awareness by monitoring the markets and market conditions in real time and giving them updates on price tolerances and changes in the marketplace based on their own environmental tolerances that they have for a reprice. And finally, we keep historicals of all of that as well, which is very valuable for price defense, for audits, for research and analytics.

Amy Creason [00:07:20] That's really interesting, Ted.

Ted Kramer [00:07:22] Thanks. It's been a very popular product and very well received by all of our capital markets players. And then there's the servicing component. We discussed SRPs earlier as a discrete, but there's also situations whether it's released or retained, where that's going to be much more complex for both base and access servicing. And these more complex or granular servicing components typically come from co-issue buyers or valuations of market value, fair value and economic value of servicing rights that are provided by servicing brokers or even internally derived by lenders themselves. In the case of MBS, this includes determining the pull structure that creates optimum economics between this guarantor fee buy-down and excess servicing. Many times there may be partial buyouts or partial buy-downs relative to differing multiples for each tranche of excess servicing. So a lot of working components there. And if retaining servicing we have numerous pricing levers and guardrails to help lenders tailor their excess servicing creation to their own risk tolerances. Tolerances for the creation of excess, which includes prepayment risks, of course, versus just taking the present value cash form in the form of a buyer.

Amy Creason [00:08:38] Well that's really customizable, Ted.

Ted Kramer [00:08:41] It is. We pride ourselves on being able to tailor our products in a very granular fashion to any customer's needs. Then we have net interest carry, which we can expand on further. Specified pools in pricing, finding the optimum specified payup for a given loan.

Amy Creason [00:08:58] So Ted, you're speaking of the additional pricing benefit that Freddie Mac and other investors place on loan characteristics that are likely to result in slower prepayments, correct?

Ted Kramer [00:09:09] That's right. Payups for loan balance loans or geographic specific loans have been around for many years. We call those durable spec story payups. Some spec story payups are temporary because investors have a limited appetite for investment as well. And we're always looking to include new spec stories like Freddie Mac's new payup for home possible loans.

Amy Creason [00:09:30] Great.

Ted Kramer [00:09:32] Our products also fully optimize those specified opportunities. For instance, in the case of mortgage backed securities, adhering to a minimum $1 million pool size requirement . Or for high balance loans, ensuring that we enforce deminimis high balance optimization, otherwards spreading high balance product across TBA or generic pools within the 10% deminimis threshold and doing that in the most optimum way with very complex and sophisticated algorithms.

Amy Creason [00:10:03] Wow. Sounds like a lot of work. And as a former secondary marketing manager and consultant myself, Ted, I appreciate your long and deep experience over a number of market cycles. So if you will tell us as you've worked with partners through, call it, boom and bust markets, I'm sure you have a few absolute must haves that you encourage your partners to adopt in their margin management practices. May I ask you to walk us through some of the guidance and the tools you find most successful for lenders?

Ted Kramer [00:10:35] Sure, Amy. I'll share the practices and disciplines we employ for effective price and execution management. First, understanding transaction economics itself is critical. So as a lender for each execution alternative I have, the transaction economics referred to all the economics, income or expenses, of a loan from pricing through final disposition, whether it's the sale or the retention of the mortgage and or the servicing rights.

Amy Creason [00:11:03] Okay.

Ted Kramer [00:11:04] Let's start with timeframes or the secondary marketing timeline. A lender must be able to measure the days in each part of its loan manufacturing, warehousing, delivery and sale. With Innovient solutions, lenders simply need to measure and maintain these key metrics to drive precision economics. Innovient's products will take care of it from there. And we always advocate for these metrics to be measured in business days versus calendar days for maximum precision. For example, a lender's price for a particular borrower lock would be comprised of the following key metrics: days from lock to close to determine our estimated close date or lock expiration date, how many days from the time a loan closes until it's available for allocation, how many days from the time it's allocated to delivered, and what are the investor term times once that loan is received by the investor, whether that's holding funding from Freddie Mac or an aggregator or the settlement of a security. And in the case of a security, how many days prior to settlement does collateral need to be at the custodian. So a lot of key metrics in here sound logical, right? Well, precision requires continual tracking and updating of these metrics as they change, whether it's changes in delivery timeframes due to staffing increases or decreases or changing investor funding term times. And we all saw the funding backlog that occurred during the pandemic when investors were overwhelmed with volume.

Amy Creason [00:12:31] Yes, we did. Yes, we did. Well, so, Ted, then calculation of the execution time components, very important in determining the earliest delivery opportunity for a loan. What other components should lenders focus upon in the pricing calculus?

Ted Kramer [00:12:45] Well, these timeframes impact multiple pieces of the transaction economics, including role costs and net interest carrying. So let's take a look at each of those, starting with the role. Understanding and pricing the true role is critical. The term role referring to the price difference between two months of a uniform MBS security settlement. This role is in every investor's price, and it's a volatile economic component. And in simple terms, the value of a dollar today is greater than it is, say, 60 days from now. And typically these roles historically and now again have been in the ten plus tick range or 30 to 40 basis points per month, roughly equivalent to one basis point to one and a half basis points per day or per diem. And these values are used for pricing different lock periods as how they typically manifest on a rate sheet, for example. But during the pandemic, these roles were very different.

Amy Creason [00:13:45] Oh, yes.

Ted Kramer [00:13:46] When the Fed introduced quantitative easing and buying of mortgage backed securities, they created an artificial role environment and virtually there was no role. In some cases, a positive role, which meant the further out we went, the prices were either flat or improving. So in other words, it was common to see virtually no difference in price for a 15 day and a 45 day cash commitment. Well, this was a very unique situation for a limited period of time. And we are now back to the, quote unquote, normal role environment, albeit with more of our market volatility right now. So why does all that matter? Well, for agency direct pricing, whether the cash window or mortgage backed securities, based on historical levels, each additional day until the loan is sold can be a basis point to one and a half basis points of value decline. That's meaningful, and any incorrect assumptions will impact margins positively or negatively.

Amy Creason [00:14:44] Right.

Ted Kramer [00:14:45] So for instance in practice, when I'm selling, if a lender pads their back shop days based on a rough estimate that results in commitments further out than necessary, then they're leaving money on the table. Conversely, when pricing alone, if they don't factor in realistic back shop days, they are likely pricing too aggressively and they'll give up some value when those loans are ultimately sold. So we always stress with our partners to accurately and discretely price each lock period so that the lender is agnostic to changing roles and other transaction economics. We've seen where many shops will simply price the shortest, let's say the 15 day lock, explicitly, and then simply use a spread for each longer locked 30-30, 45, 60, etc. Well, this worked during the pandemic, and it even padded lenders pricing a bit because there was no role. When those artificial roles went away, though, many realize those spreads were inadequate and were eroding margin. That the spread they were using, let's call it an eighth between 12 and a half basis points between locks. Was it enough? The real drop was 15 basis points or something greater. So our products can then also ensure that a minimum spread between lock periods is also achieved so they can tune it for the actual market value. But if there's a minimum spread that they want to maintain between lock periods over and above real economics, that can also be factored in as well.

Amy Creason [00:16:16] Precision matters, right Ted?

Ted Kramer [00:16:19] It does.

Amy Creason [00:16:20] Well, you mentioned that we would discuss net interest as a derived component of economic price. So can you walk us through this particular pricing assessment?

Ted Kramer [00:16:29] You bet. Along with assessing the role, lenders should include net interest in their pricing. And again, this is a cultural thing within each organization.

Amy Creason [00:16:38] Hmm.

Ted Kramer [00:16:39] Some mortgage banks are not necessarily being credited with net interest carries in the case of being a subsidiary of a bank. So those kind of factors will come into play. But there's still an important economic component here, all in, regardless of which business unit is being credited with that value. Net interest simply being the difference between the note rate on a loan and the interest rate charged by your warehouse bank or your bank. And this net interest accrues on a loan is on a lender's warehouse line from the time of origination until the time the loan is sold. If the difference is positive, it's termed positive carry and interest is being earned while it's on the warehouse loan. That's a good thing. If the difference is negative, it's termed negative carry or also being termed as a loan as quote unquote, underwater. In this case, the lender is being charged interest every day that the loan is on the warehouse line. And this is particularly important right now as we're in an inverted yield curve. So in many cases, a lender's cost of funds is actually greater than the note rate on the loan. So they are underwater on these loans. So every day that it sits in their warehouse, they're actually paying interest to the warehouse bank. These are economics that definitely should be factored into their pricing on a regular basis. So we advocate, even if your lender does not pass on the positive net interest carry in their pricing. We advocate pricing in the negative carry since it's an expense. So by doing so, we essentially make a lender agnostic to the yield curve at any given time.

Amy Creason [00:18:10] Mhmm, very good. Well, so we've talked about the time value of pricing and ensuring the inclusion of all accurate role costs and net interest associated with the appropriate pricing period between lock and investor funding. How should a lender operationalize all these pricing components in its daily secondary marketing activities? Because it's a lot to manage, right?

Ted Kramer [00:18:33] It is if you don't have the right tools. So as we've discussed, lenders need to evaluate all of these economic pricing components to determine the net value for each individual execution option. And for any given seller, there are typically many options. Cash, MBS, bulk bids, retained versus released servicing and multiple co-issue servicing buyers, and more. This is where we feel Innovient is best in class and our partners agree. Our optimizer presents every possible execution option, time frames, economic components and the derivation of each of those economics. So what we call price discovery. So our partners never have to ask how any result is derived. It's all documented in great detail.

Amy Creason [00:19:19] Nice!

Ted Kramer [00:19:21] And this is powerful for our most sophisticated shops, but it's also great educational information as well. So this net value that we factor, after all variables are considered, is used in pricing as well as for best execution. One more important item I would like to address is margin methodology used in pricing. For pricing purposes, we strongly advise our partners to employ what we call a gross margin methodology. Simply put, it's the price passed to the point of sale equals the net value of the execution, less the desired margin.

Amy Creason [00:19:54] Right.

Ted Kramer [00:19:55] Far too often we see lenders who are hedging and selling mandatory price to a best efforts execution. And this introduces so much additional noise into their pricing. If you are hedging and selling mandatory, then price to that mandatory execution. The benefits are numerous. It's clean, there's no noise, it's easy to understand, it's transparent, to both sales and to the C-suite and your margin is your only delta. It also helps with predicting margins, which your C-suite is very interested in knowing when those loans close. What is my projected margin in 30, 60 days on my pipeline? So we find it to be a far superior practice and it takes out a lot of the basis risk of the best efforts and mandatory spread as well.

Amy Creason [00:20:41] You're right, Ted, it is so important for a lender to identify and isolate to the best of its ability the components of pricing for an honest analysis of loan margin performance, especially under unusual market conditions or in extremely competitive market cycles. And it sounds like Innovient can be a valuable collaborator in the realization and transparent monitoring of the multitude of variables impacting pricing.

Ted Kramer [00:21:07] We have happy partners who realize benefits each and every day by working with the Innovient team.

Amy Creason [00:21:12] That's great. Well, thank you so much, Ted, for being on the podcast today and for being a valued partner to Freddie Mac. Innovient provides insightful pricing solutions for its clients and I encourage our listeners to reach out to them. You can learn more about Innovient on its website at an innovient.com and that spelling is I-N-N-O-V-I-E-N-T. You can also reach Innovient's website by going to Freddie Mac's Single-Family website at sf.freddiemac.com, search for integrated SMA's and once on that page scroll down to Innovient's tile. Feel free to contact my SMA team directly via email at smasupport@freddiemac.com for additional assistance.

Thanks to our listeners for tuning in. You are Freddie Mac's important partner in our efforts to make home possible for low- and moderate-income families, minority communities and other underserved populations. As always, we look forward to our continued collaboration.

Make sure to look for the next installment of our Power of Partnership series soon. Thanks, partners. Have a great day.

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