Podcast Transcript:

Risk Management Excellence with Terri Merlino

Phil Treadwell, Host of The Mortgage Marketing Expert Podcast
Terri Merlino, SVP and Chief Credit Officer at Freddie Mac, Single-Family

Phil Treadwell:

All right. Welcome back to the Mortgage Marketing Expert podcast. I'm your host, Phil Treadwell. Our mortgage marketing expert today is Terri Merlino. She's a senior vice president and chief credit officer at Freddie Mac Single-Family division, her and her team leverage broad-based knowledge to cover mortgage operations, sales, processing, all kinds of different things to really substantially and positively impact Freddie Mac's mortgage credit risk management efforts, and really at the end of the day, our client experience.

Terri, I'm really excited to have you here today and have a conversation about risk management. I know a lot of times people are like, "Well, that's an interesting topic to talk about," but I think people will find it affects so many things about the mortgage industry as a whole and really affects what salespeople marketing people all do on the ground. So welcome to the podcast.

Terri Merlino:

Great. Thanks a lot, Phil. So thrilled to be here and thank you for taking the time to spend with us today.

Phil Treadwell:

Likewise. Likewise. Well, I love in your bio here that we've got in the show notes for people that are listening, you've worked at some pretty cool companies and had a really kind of broad experience, but I'd love for you to just give us the nickel tour of how you even got in the mortgage industry. I know most of us didn't raise our hand in kindergarten and say, "I want to be in the mortgage business." Everybody has an interesting story about how we got in, and then just kind of some highlights of how you ended up at Freddie Mac and what you're doing today.

Terri Merlino:

Yeah, Phil. You kind of stole my line because that's what I always say to everyone, no one grows up thinking that I want to work in the mortgage industry. So that's definitely true in my case as well just like everybody else. My background actually is in public accounting. Started at KPMG in the audit function. My clients were financial institutions. One of whom was an independent mortgage bank that I serviced for a number of years. And as pretty traditional, I think in the public accounting world, you go work for one of your clients. So that's how I ended up in mortgage banking.

And what was a little bit even more interesting I think about my journey is, unlike many people who leave public accounting, I actually did apply originally for a controller role, but I didn't get that role. And they were still interested in having me join. And so I joined the secondary marketing department. One of the things that I like to tell people, I truly treasure the time that I worked in secondary marketing. Anybody that has the opportunity to work in that side of the business, I believe that's where the rubber meets the road. That's where you know what works, what doesn't work, what's saleable, what's profitable, how all of it comes together. I spent a number of years in secondary market, nine years.

Terri Merlino:

And then my career took a very interesting path over time that I had the opportunity to have a number of parallel or lateral moves into sales, which is very unusual for somebody who starts in public accounting. And so it was direct to consumer, overseeing that side of the business. And then I was what I like to call “voluntold” to go run processing nationally for a large independent mortgage bank. And then ultimately, I was promoted into a position of risk management, overseeing underwriting for all the sources of business for that independent mortgage bank--so correspondent retail, as well as the broker business. I was particularly fortunate to ask to be do that a year or two before the crisis hit. So my background in risk management is baptism by fire in one of the most challenging times of the environment.

And then I think the other thing that I just like to emphasize is my approach to risk management, I think, is also kind of unique because a lot of people who come up in risk management or an underwriting tend to just go through the vertical and may not have an appreciation for all of the different aspects of the business. I feel very fortunate to have walked in a number of shoes. I appreciate things from a capital markets. I understand what it's like on the sales side. I understand what it's like from a processor as well as the risk management. So I try to bring that to everything that I do at Freddie Mac.

Phil Treadwell:

It's interesting. I do think some of the best professionals I've seen in a lot of different departments and positions within the industry are ones that have had that more holistic approach or had some cross training with other departments, because you have the context of not just the how, but a broader understanding of the why. And especially when we're talking about risk management, that's super important. So when you take that holistic approach and you kind of have that integrated variable, if you will, from different sides, what approach do you take when it comes to risk management? How is that woven into which you guys do at Freddie Mac?

Terri Merlino:

Yeah. It's interesting because you'd say the how and the why. I think having that broad based experience is that I can understand and what I try to bring to the conversations is, number one, I always like to explain to any stakeholders, any mortgage professionals that I'm working with the why. Not just say what it is that you have to do and how you have to do it, but why-- why is it important? Ultimately, we still might not agree that it's the right thing to do, but at least we agree on the why and that there's some level of understanding there. And I find that's really beneficial. I found that during the financial crisis, I found it during the pandemic to really be able to explain to anybody, clients that we're working with, all of the different stakeholders, why we need to think about it this way, give them some of the background.

And then I think it's also important, I really try to think about, "Okay, I remember what it was like to be in some of these other roles. What are the things that either they're thinking about?" What's really important to us at Freddie Mac is really to engage with all of our clients and to be asking them. I was in those roles. A number of years ago, life has changed. We know how dynamic this industry is. I think probably all I bring at this point is an appreciation that I need to ask what the impact is going to be.

Terri Merlino:

And what's critically important when we're thinking about risk management at Freddie Mac, I can come up with the most brilliant or my team can come up with the most brilliant ideas as far as how we manage risk. But if no one can operationalize it successfully, if it doesn't make sense, if loan officers aren't actually going to execute on that or processors or underwriters, it's not worth the paper that we're going to write on it or of how we're going to send it out.

So having that engagement with clients to understand, "Okay, this is what the risk is that we're trying to manage. This is how we're thinking about might be the best approach. Can you actually operationalize this?" Or, "Hey, do you have a different idea knowing what we're trying to address and what the concern is?" Because many times, we'll come up with that synergy of understanding things more holistically that you can come up with an even better understanding or approach or pivot in some way.

Phil Treadwell:

Yeah, it's really interesting. I think a lot of people will like hearing that Freddie is actually engaging their seller/servicers, engaging their clients and then having these conversations because too often I think people think that the GSEs are just shoving things down as far as policy goes and say, "Hey, here's a new thing we need to do" and may not necessarily have that understanding. I think a good example on a more granular level is, you have different styles of underwriting and risk management with different companies. And from a loan officer perspective, I know a lot of people will say you'll have companies that will underwrite to approve versus the underwrite to decline, right? And I think we all kind of understand what that means as far as reasons that, "Hey, here's the reasons we can make this work. This is a great loan that's likely to perform well. And then we have these ones over here that they're trying to poke holes in it."

In that context, when you talk about layering risk management, how do you do that successfully and still protect investors, protect consumers, protect lenders, and still keep a good eye and focus on what the mission of Freddie Mac is, which is obviously providing home ownership and affordability and all those types of things?

Terri Merlino:

That's a great question, Phil. It definitely is a balancing act, but we really look at our mission, which like you said is providing that stability, that liquidity and affordability. And it's our responsibility and the role that we play to make sure that we're able to provide all of that regardless of the economic environment that we're in and making sure that we're thoughtful about that approach and definitely do not believe that supporting that mission and risk management, that those are mutually exclusive. So how do you do that in a way that benefits both of those?

Some things that you can do. Number one, of the things that I'm very excited about is if you just think about technology. How can technology and data really drive us to identify those opportunities to better evaluate the borrowers risk? There's so much data that we now have access to that you don't have to pour over in a manual way. Freddie Mac recently released our direct deposit, gathering all of that information.

Terri Merlino:

If you think about... That's one of the advancements that I am most excited about that is we've just really touched the tip of the iceberg on that particular one. I know back in the years when I ran underwriting and I'd be working on FHA loans back then and you'd be pouring over a couple of months worth of bank statements and really trying to identify. I have a high DTI, high debt-to-income ratio here. Can I feel comfortable giving this loan to this particular borrower, looking at what the nature... Like how they manage their money? But I can only see a couple of months and it's a lot of detail to evaluate. But think of the information that you have now that we could have at our fingertips when I can have 24 months worth of all their bank data and I can see their cash flow, the inflows, the outflows. All of that can be evaluated literally in a matter of seconds to determine and understand how they really manage the cash flow.

Terri Merlino:

So the opportunities to provide expanded access to credit and being able to support the market environment regardless of what is there is really thinking about things from a new and a different perspective. How can I leverage technology? How can I leverage data that I can more finely evaluate that layered risk? Not all 45, let's just pick a number, 45 DTI ratios are created equal. And we know, loan officers, processors, every underwriter, you document income to the extent that you need to get the approval. You're not going to keep gathering income information so that you can get the DTI. Maybe you could get it down to 10, but what does it matter? Once you get your approval, you're not going to continue to gather documentation. Whereas there's other 45 DTIs, man, you've gathered every scrap of income that you possibly can. So it gives us the ability to start to evaluate those things a little bit differently and give us a little bit more expanded view.

Phil Treadwell:

I think that's interesting. We had an automation and AI and data conversation with Michael Bradley at Freddie Mac Single-Family. And then we recently had kind of the digital evolution with Srijana Giri talking about some of those platforms from income and assets and some of those verifications, and obviously Scott Reuter recently with collateral valuation. But with Kevin Kauffman, we talked about change and really embracing change. And so I'd love to talk about that for a second in terms of how risk management is being handled in a market environment like this. It's obviously a very hot market. It's a changing market. We have the, I say the media. I think there's the broad sources that like to sell fear. You have the headlines of housing bubble. All of us in the industry know this is nothing like 2007, 2008. This is a very, very different market, but it is growing and evolving and changing for a lot of different reasons. Have the philosophies changed in terms of risk management this calendar year? And if so, what have those kind of adjustments been?

Terri Merlino:

I wouldn't say that there's been a change towards risk management. I mean, I think that kind of stays steady and true as far as how you approach it. I think there needs to be an awareness of additional risks that are out there that you are incorporating that in part of your evaluation. Thinking about the risks that are in the marketplace, if we think about... And it's a really interesting environment right now, because I was just going to say thinking back during the pandemic, you had strong employment. We still have strong employment right now. I think one of the things that we think about now is what is to come, what is the environment that we might be moving into, concerns about a recession. We're still seeing really strong home prices, to your point.

Terri Merlino:

But I do think about one key component is the inflationary concerns, particularly when you think about those borrowers and the impact that has on affordability. Affordability is just being hit in so many different ways right now. You have increasing home prices, you have inflationary concerns. So my grocery shopping, my gas bill, those things that might not be reflected in DTI and what I need in order to survive are different and we don't know where the end is for that. And then we have the influence on DTI not only of the home prices, but then rising interest rates. Look at how much interest rates have increased over the last few months, unprecedented speed at which it's moved. So I think trying to anticipate and think about how does all of that come together and how do we make sure that we do the right thing for the borrower. I don't think any of us in our professional roles want to put someone in a home that they cannot afford to keep.

Phil Treadwell:

Right.

Terri Merlino:

One of the things that we think about at Freddie Mac is sustainable home ownership. So it's not just thinking about the loan, the home, that the borrower can afford right this minute, but what is their sustainability? How are they going to keep, be able to stay in that home? What kind of support systems should we be creating for them? It's greater than 40% of the originations that we do are first time home buyers. Think about that. How prepared is a first time home buyer? Like, if you've been renting all your life or if you are just moving out of your parents' home, you've never even rented, are you prepared for all of the pitfalls that may come with home ownership. Especially if you're buying something that's not brand new, the HVAC that may go and the borrower that could be stretched to the limit if they don't have any reserves.

Terri Merlino:

So how do we make sure that we're preparing them for that sustainable home ownership. And as an industry, what more should we be doing? Even from a servicing perspective, I think we do home buyer training, like how to buy the home, how to apply for the mortgage, how to get the mortgage. But then what should be the support that we're providing after that? How do you continue to manage your money? How do you prepare for these events making sure that they're saving funds for things that may go wrong along the way?

Phil Treadwell:

Well, I think to your point in inflation hits in a couple different areas, yes, groceries, I know gas is one that's just really skyrocketed recently. And to your point, those aren't things that typically show up in a debt ratio. So the affordability piece not only of being able to purchase a home, but to your point, sustain and keep the home that they have. So in that context, is there things from a risk management perspective that you guys look at from disposable income to potential reserve requirements and things of that nature, not to put restrictions necessarily but also just to ensure to your point that this not only is a mortgage that's going to perform, but we're doing the right by the client and customer in context of some of the other market factors that are happening?

Terri Merlino:

Within our automated underwriting system, which is LPA, there's proprietary aspects of that where we take into account either reserves or how we evaluate the layered risk. Thinking about what the borrowers FICO is, which demonstrates their willingness to repay, balance that with their debt-to-income ratio, which is their ability to repay. And looking at that kind of holistically, looking at the collateral that we have. What's the LTV? What is the layered risk that you can be creating in a particular loan? So that is part of the consideration when we're doing that risk assessment that we provide back through our tools.

Phil Treadwell:

Yeah, it's interesting. I know that those are always ever evolving in every season of the market.

I want to shift gears just a little bit and get into the culture and mindset of risk management and how you really instill that into everything that's done throughout Freddie Mac or even how companies can instill this. Because I know again on one hand it can be looked at as very restrictive, but on the other hand it's also something that's very freeing because we're talking about responsible home ownership, we're talking about sustainability and things of that nature. And as we've kind of mentioned, almost every guest we've had from Freddie, thus far, kind of plays a role in this bigger conversation and everyone really at Freddie Mac for sure seems to have an understanding and kind of commitment to what this mission is.

I'd love for you to kind of talk a second just about how do you nurture that risk management culture and mindset throughout the company and then what maybe some takeaways that other companies and leaders can do to instill that in their organization as well.

Terri Merlino:

Yeah, I think the most important thing is understanding that there is a need to have a risk culture and for that to be embedded throughout the organization. Too often, employees may think that the responsibility of risk management is the risk management, the department, it's the responsibility of the underwriters. But really risk management is the responsibility of every employee regardless of what their role is throughout the organization.

And that's the environment that we really try to support throughout Freddie Mac, that everybody plays their own role in managing risk regardless of what it is that you do. And that's true, whether you are at a GSE like Freddie Mac or if you are at a mortgage bank and you're producing the loans. I think every employee needs to think about their role, whether it's the loan officer, they have to be thinking about what are the questions that they should be asking so that they understand really the borrowers' situation and being that advisor that I think borrowers really want. When you think about the whole revolution that was going to occur, that borrowers were only going to go to online and did they really need the loan officers, at the end of the day, yes, they do. They need the loan officers. They need the processors.

Terri Merlino:

For most people, almost 50% of the borrowers are first time home buyers. This is the most significant transaction that they're going to enter into in their life and probably the first significant financial transaction. It's frightening. It's scary. It's a whole different language that no one really knows or understands until you kind of dip your toe in the water. And you think of the awesome opportunity and responsibility that loan officers and processors have, like this is what they do for a living and how they can enlighten and prepare homeowners for what is one of the greatest opportunities, to own a home, to do that not only for the family but for the community. So it's embracing that everyone has a role in that risk management, thinking about how are you helping that borrower be prepared for this financial responsibility that they're taking on. And that's what we try to do at Freddie Mac, making sure that everybody thinks about the different roles that they have, regardless of what you're doing, how it plays into that responsibility.

Phil Treadwell:

I love that. I think that's really sums up everything in a nutshell, because we're talking about the consumer, the lender. We're talking about everybody as a whole. And I think that that's an important topic because we want to do this responsibly. We want to have sustainable home ownership and an affordable home ownership. So I think that this is a great conversation for people to have, especially in the light of the current environment.

Well, Terri, you've been an incredible guest. I want to ask you one last question and we asked this of all of our guests, and that's, if you could just give one tip to mortgage professionals today to go out to use to build their business, what would it be?

Terri Merlino:

I think it ties back to what we were just talking about. I think you build your business by being that advisor, that reliable, that word of mouth. If every borrower that you work with feels that you treated them in a respectful way that you did the right thing by them, they're going to recommend you over and over again. That they feel like they got a good deal, that they were treated honestly. And word of mouth, isn't that what it's about?

Phil Treadwell:

It is. Absolutely. I mean, people have done business, are doing business will always do business based upon relationships, right? And that happens word of mouth. So I think that that's a great tip. Well, Terri, we appreciate your time again. If people want to connect with you on social or follow you somewhere, throw out a social media handler or someplace where they might be able to get in touch and just kind of learn more.

Terri Merlino:

Yeah, just on LinkedIn, it's Terri Merlino. You can do a search and send me any kind of message, and happy to respond to that. We'd love to hear from folks.

Phil Treadwell:

Awesome. Well, we'll definitely put that in the show notes as well as the Freddie Mac Single-Family website. Terri, appreciate your time and we look forward to catching up again really soon.

Terri Merlino:

All right. Thanks a lot, Phil.