# NON-PRICE CONSIDERATIONS IN YOUR BEST EXECUTION ANALYSIS

A WHITEPAPER BY MORTGAGE CAPITAL TRADING (MCT) AND FREDDIE MAC

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# NON-PRICE CONSIDERATIONS IN YOUR BEST EXECUTION ANALYSIS


### *ABSTRACT*

Like every good mortgage lender, you strive to improve the profitability of your business. Reviewing your best execution analysis is generally the first step to ensure you're maintaining optimal performance. You measure the normal costs incurred in your loan sale pipeline, but are you also including hidden costs not typically evaluated in your profitability model?

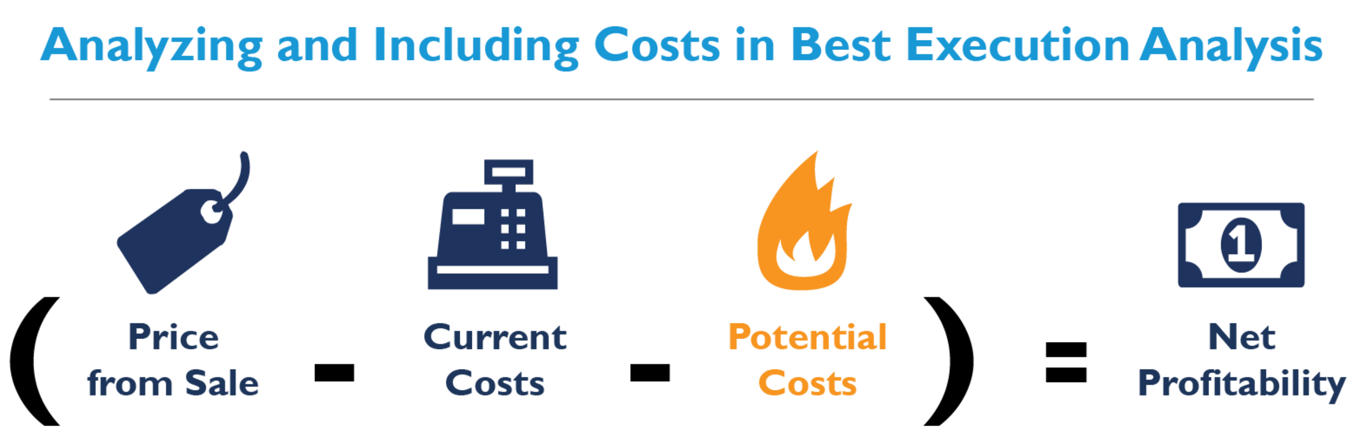
Setting up your profitability model to incorporate hidden costs is especially vital during times of market volatility. The market volatility that resulted from the pandemic in 2020 is no exception. Lenders who are able to avoid hidden costs are better prepared to withstand uncertain times.

In this whitepaper, Amy Creason, Director of Secondary Execution Strategies at Freddie Mac, teams up with Mortgage Capital Trading to expand on interest following her panel appearance during the MCT Exchange client conference in 2019. The focus of this whitepaper is to identify unexpected costs associated with your loan sales to improve profitability.


## INTRODUCTION

The costs of selling loans on the secondary market can be viewed as current or potential. Current costs, such as the cost of hedging and overhead, are more obvious and easy to calculate. Potential costs, like the cost of selling to a new investor, are not as easy to anticipate and are often omitted from the profitability equation.

In this whitepaper, we will focus on potential or unexpected costs to be considered within your best execution analysis and how to identify and mitigate them in the future. We will examine considerations for operational efficiencies and the economic impact of those operational efficiencies, as well as the importance of your relationship with your buyers contributing to your profitability. Buyer relationships also became important as capacity issues began to affect certain buyers during 2020 market volatility. The quantification of these costs can help lenders improve their computation of best execution and subsequent loan sale profitability.



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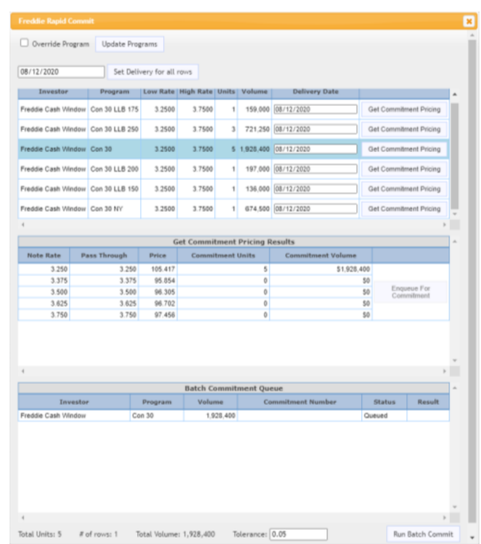
## OPERATIONAL EFFICIENCIES TO CONSIDER WHEN CHOOSING A BUYER

The first step in reviewing the potential or hidden costs of your best execution analysis is the review of your technology and supported operational processes. Outdated processes can burden your team with unnecessary data entry and cross-checking procedures while exposing you to additional data inaccuracy and security risks. For example, leveraging technology to automate the creation and submission of bid tapes allows your analysts to spend more time examining the returned investor pricing rather than manually manipulating information. In this section, we will explore how new technology can improve efficiencies and profitability of your loan sales.

### *Using Technology to Price and Commit Loans*

Sophisticated investors – such as Freddie Mac – have created efficient application programming interfaces (APIs) to provide pricing and committing communications with sellers. These investors have developed automation of their loan purchase process to improve efficiencies and reduce risk for their sellers. Likewise, secondary marketing platform providers – such as MCT – have integrated with investor APIs to improve the seller experience with investors. Sellers are able to price and commit their loans, oftentimes with the click of a button – and, in some cases, from their mobile devices. A speedy trade execution reduces communication lag time and decreases the risk of market movement during the trading process. **This API integration has empowered mutual clients of MCT and Freddie Mac to commit more than 16,000 loans in the first 6 months of 2020.**




*MCTlive! Rapid Commit for Freddie Mac*

Once the loan is committed by the seller, the investor price and commitment information is transmitted by the investor to the seller via this system-to-system integration. Information accuracy is improved through the electronic communication and confirmation processes with the investor, and access to investor trade reporting reduces the seller's record-keeping and reporting burden. For those sellers whose secondary marketing trading systems are integrated with their loan delivery systems, additional benefits of accuracy and reduced data entry risk are experienced during the delivery process.

The utilization of technology in the process of pricing, analyzing, committing, and confirming loan sales allows secondary marketing staff to focus on more important tasks. Removal of manual processing and data entry may eliminate recordation errors and costly corrections while improving audit performance. Perhaps the greatest benefit of using system-to-system connectivity with your investors is the real-time understanding of pricing and the ability to act strategically, rather than reactively, in a dynamic market such as the market seen in Q2 2020. The agility, precision, and seamlessness of technology is now available to lenders of all sizes; the cost savings impact, however, is most significant for smaller lenders with limited secondary marketing staff.

## Freddie Mac & MCT Clients Leverage Benefits of API Integration

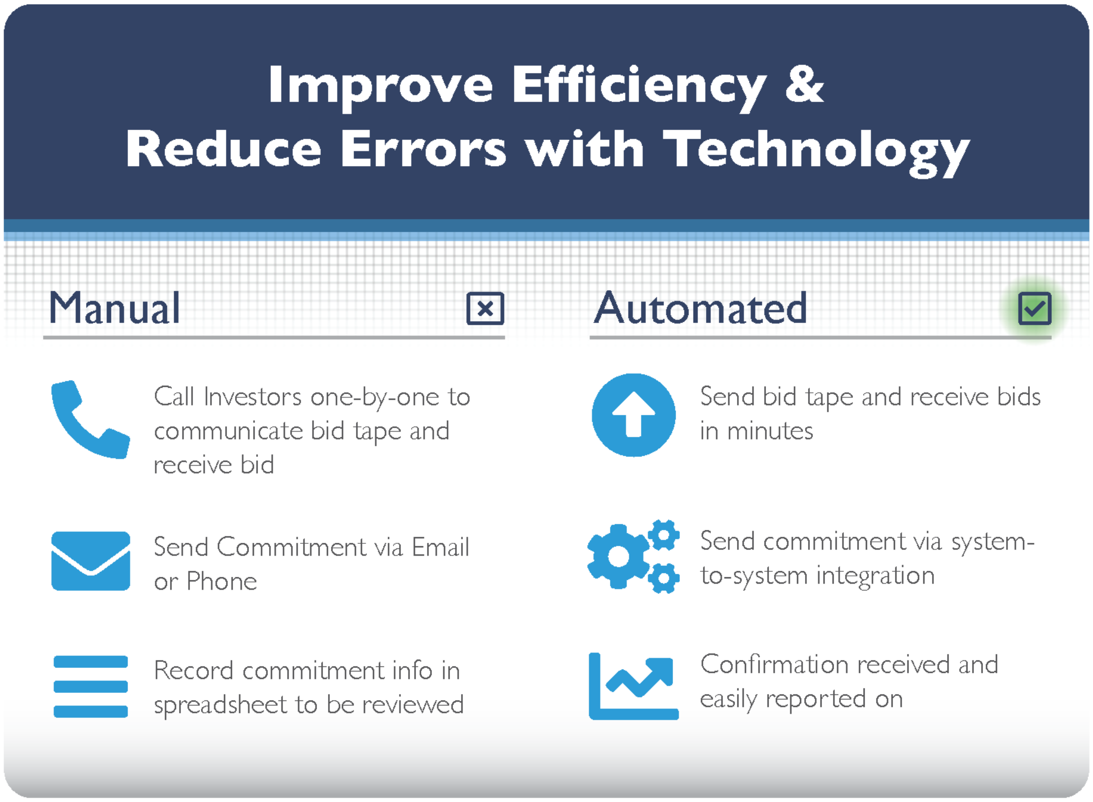
| **16,000** total committments | **2,700** monthly average | **3.5** hours saved monthly |
|---|---|---|
| This API integration empowered mutual clients to commit more than 16,000 loans in the first six months of 2020. | 2,700 monthly commitments on average, totaling more than $12.5 billion in the first six months of 2020. | 3.5 hours saved monthly per client on average, with some clients saving as much as 31 hours a month. |

***Using Technology to Deliver Loans***

Sellers are also taking advantage of both their own and their investors' technologies to deliver loans. The flexibility to auto-generate a delivery file in either standardized (e.g., ULDD) or customized investor format now replaces the onerous process of manual delivery data preparation. Some lenders must cobble together data from multiple systems – a situation which encourages data errors and consumes personnel resources – and timelines may be lengthened when system processing cycles are unsynchronized. Modernization of your loan delivery technology platform and related processes can provide significant cost savings and support shorter delivery dates. The result of such operational improvement encourages narrower investor commitment periods and faster fundings due to increased delivery speed and improved data accuracy. Loan delivery cost savings resulting from efficiencies may be passed-through to your borrowers via tighter price margins and more competitive pricing.

The preparation and shipping of loan documents - virtual or physical - to an investor can also impact your operational costs. Leveraging your loan delivery technology in combination with your investors' platforms may yield additional operational efficiencies and cost savings. For example, Freddie Mac's Cash-Released XChange® program moves the servicing data file creation workload from the lender to the Freddie Automated Servicing Transfer® (FAST®) tool. In the Cash-Released XChange program, an upload of loan file documents by the lender, coupled with the normal Freddie Mac ULDD file, are ingested by the FAST tool to produce the servicing transfer data required by the program's servicing buyers. The elimination of servicing transfer data tape creation, validation, and correction by the lender improves quality while reducing servicing transfer costs and should be included within best execution analysis. Working with investors committed to forward-thinking approaches to loan delivery optimization will encourage your operations team to adopt a continuous improvement mentality.

The final benefit of automating the delivery of loans is added security. The transmission of NPI borrower information through traditional or virtual mail increases risk of interception. Transferring sensitive borrower data and documentation through a gated system is safer and reduces the risk of exposure to headline and reputation risks.

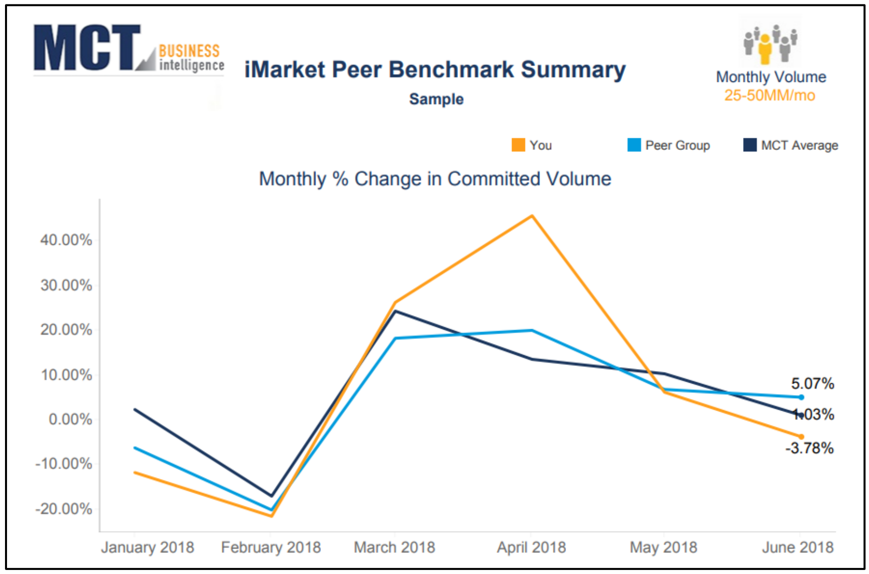



***Seller- and Investor-Produced Reporting and Analytics***

Reporting and analytics of your loan sale process provides insight into your unique business. Your secondary marketing technology platforms capture valuable information that you can use to better understand your pipeline, your hedge costs, the effectiveness of your lock polices, and your relationship with your investors. Analyzing and reconciling reporting sourced from your and your investors' platform can help you identify areas of opportunity for operational improvement, as well as a better understanding of the true costs of supporting various programs and investors.

Ensuring an understanding of variables impacting performance is critical to the improvement process. Internal reporting of warehouse turn-times, reasons for loan delivery delays, sources of data errors, and loan margin calculations are powerful windows into operational costs. When reconciled with investor pend reports, repurchase requests, and loan performance, your finance team can help provide the organization with unparalleled insight into your business and identify issues in your loan manufacturing and sale process. Reviewing these analytics can be used to unmask hidden costs and identify performance improvement opportunities.

Sophisticated investors may provide a performance comparison with peers in your industry. This benchmark reporting is vital to understanding how your business performs compared to your competitors and will help identify potential problem areas. Leveraging these reports has also proven extremely valuable for lenders during market volatility, allowing them to identify crucial fixes. Some hedge advisors may offer additional support for these analytics. For example, MCT's iMarket Peer Benchmark Summary Reports compare MCT client performance by committed volume, number of investors, pricing and more.




*Sample MCT Client iMarket Peer Benchmark Summary Report*

## IDENTIFYING HIDDEN COSTS OF NEW INVESTOR APPROVALS

Investors who offer technology and automation to request pricing, commit loans, and deliver loans improve operational efficiencies for their sellers. The adoption of the technology necessary to take advantage of these operational efficiencies may require additional setup, but the long-term benefit often outweighs the short-term costs. In this section, we will review the economic impacts of these operational efficiencies and how they may be affecting your net profitability.

### *Technology Required to Sell to Investors*

A seller must have the systems, hardware, and platform proficiency required to take advantage of investor technology integrations. Setting up and maintaining this technology may come at an additional cost depending on the sophistication of the lender. Other costs, like product training and the hiring of specialized platform administrators, must also be considered. Lenders must budget yearly for the adequate and appropriate training of platform users with as much diligence as it does for other technology hardware and software expenses.

The use of new technology will impact your data storage. For example, lenders moving from physical to computer document storage will need to review their processes to ensure documents are handled properly in the new system. Such a storage transition may change the risks associated with your business process, so your disaster recovery plan may also need updating.

Evaluating new technology to take advantage of investor integrations and operational efficiencies is highly recommended. For example, MCT's Bid Auction Manager integrates with existing lender and investor processes to encrypt bid tapes within the MCTlive! platform. [MCTlive! has integrated with Freddie Mac's Cash-Released XChange Browse Price API] which permits the user to efficiently analyze multiple loans for a Cash-Released Xchange execution.

### *Staffing Requirements for Assumed and Unanticipated Production*

The operational efficiencies gained from the adoption of investor technology will have an impact on your staffing resources and required skill sets. For example, the new automation of price retrieval through integrated platforms will reduce manual tasks and permit skilled analysts to allocate time for price validation and review. Integrated committing features allow traders to reduce loan sale processing time by minimizing data input, thus supporting increased production without the need for additional trading staff. Similarly, loan delivery staff may be able to handle more loan production volume by taking advantage of investor technology tools, such as Freddie Mac's Automated Servicing Transfer® (FAST®) feature within the Freddie Mac Servicing-Released XChange℠ programs.

New investor technology will also change how your staff manages market shifts and volume changes. Ensuring proper training of your staff on both your technology platforms and those of your investors will help you accommodate volume swings while controlling operational costs.

### *Reviewing Setup Costs and Dependability*

Ramping up with a new investor will require the adoption of new procedures for sending and receiving information. Staff will need to be trained on these new procedures to ensure compliance with the new requirements. Additional training of staff on the new investor's data, documents, and loan delivery requirements may be necessary.

As with anything new, there may be unforeseen technology problems or delays when getting started. The dependability of your technology is crucial to reducing down time. Dedicated IT resources and robust disaster preparedness plans to remedy unforeseen technology issues can prevent loss from technology problems.

### *Investor Mix Can Be Crucial During Market Volatility*

In March, the COVID news and stay at home orders caused the immediate fear that the U.S. economy would be significantly and adversely impacted (accurately predicted, of course) and unemployment would go up. Suddenly all of the loan programs not backed by the government were at risk, with companies that invested in such loans realizing overnight illiquidity. As a result, their loan purchasing either slowed dramatically, they effectively exited the market, or made their pricing extremely conservative.

This situation created pressure for lenders who were not approved by government-backed investors. Ensuring your investor set is optimized for these scenarios is vital. This will help you avoid last minute approvals during crunch time, provide much needed liquidity and preserve loan pricing. Freddie Mac, for example, stood with their clients throughout market volatility and purchased loans consistently throughout the crisis.

## SELLER RELATIONSHIP AND OPTIMIZING LOAN SALE PROCESSES

Evaluating any new investor will likely start with the question – will this investor offer me a better price? While certainly price is king, customer service and additional value added must be queen. In this section, we will review how a holistic understanding of the costs and benefits of working with a new investor should be part of your calculus when evaluating a prospective investor. This includes counterparty risk analysis, contract considerations and investor analytics.

### *Counterparty Risk Considerations*

Sellers may occasionally come across an investor who has a short-term price opportunity. In this case, sellers may go through the approval process to take advantage of the opportunity for superior pricing. A careful review of the risks of engaging with a new counterparty must be weighed against the gain on sale opportunity. In some cases, the effort of the approval process may exceed the pricing benefit, thus rendering the one-and-done relationship unprofitable.

Working with a new investor is sure to have a certain number of bumps at the start of the relationship. Distinguishing “learning curve” issues from programmatic or endemic investor issues is best revealed through inquiry, monitoring, and measurement of technical and operational issues during the first transactions. Mitigating profitability impacts may be achieved through smaller commitments of varying loan characteristics to “test drive” the new investor. Until you are comfortable that you can confidently forecast and realize expected loan margins through the sale of loans to your new investor, you may seek to avoid large exposures to an untried investor.

### *Contract Considerations*

One of the worst mistakes a seller can make when working through the approval process with a new investor is to rush the review and analysis of the governing agreements for the new relationship. When reviewing the loan sale agreement, it is important to spend time considering the early payment default and early payoff provisions. Checking these terms against your historical loan data will help you anticipate the value of such penalties.

Similarly, reviewing the representations and warranties of the new investor contract is critical in the assessment of risk of repurchase. Understanding how your origination programs, processes, data collection and data persistence could trigger a repurchase demand will help you quantify the potential repurchase risk associated with the new investor. A thorough review of on-going obligations post-sale should be quantified for inclusion within the total execution analysis, as burdensome operational requirements will reduce the profitability of the loan sale transaction.

### *Servicing Performance*

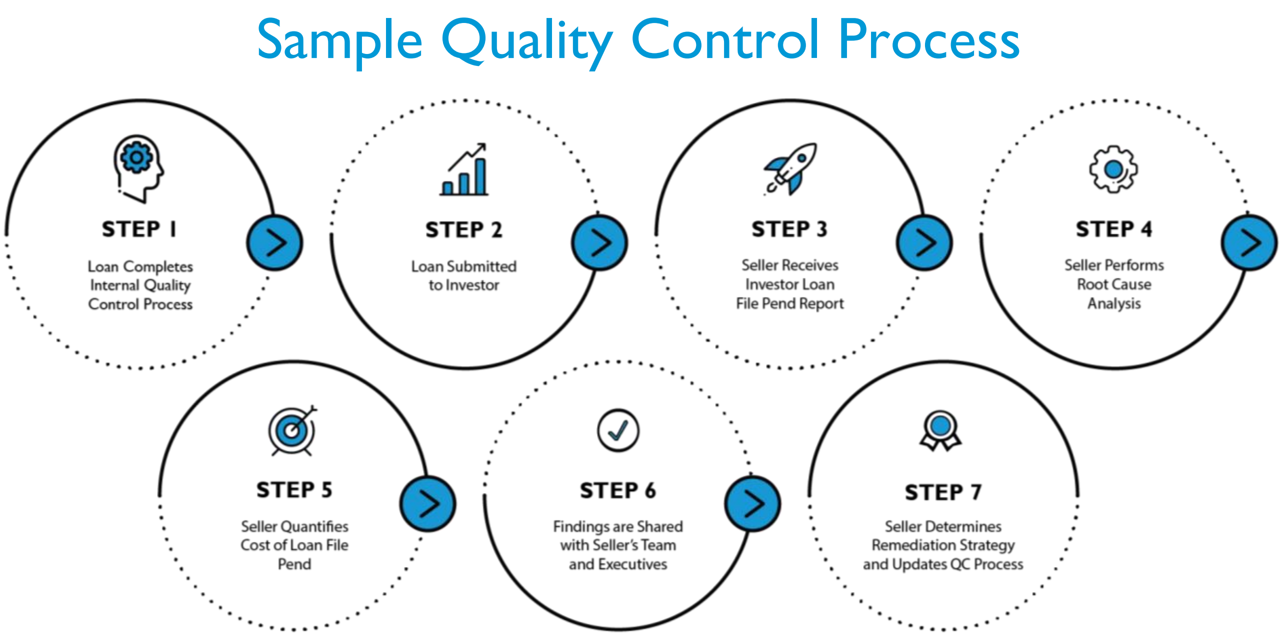
The servicing of the loan after sale can create residual impacts to your reputation and future business. Mortgage servicing rights (MSR) investors with poor customer service or operational issues can adversely affect your origination relationship with a borrower, and prevent that client from returning to or recommending the originating you for future financing. When considering a new investor, conduct due diligence on the ultimate MSR investor and, where applicable, the subservicer employed by the investor in order to develop a confidence level for your customers’ servicing experience.

Releasing cross-sell rights to a servicing buyer is a significant component of SRP price. A lender should ensure the value of releasing such cross-selling opportunities are measured against the SRP price paid, and confirm its ability to monitor compliance with the contract restrictions and duration provisions. As a lender changes its business model through the growth or contraction of other related business, its value of cross-sell rights and ability to abide by the selling agreement may, likewise, change.

***Loan File Pend Reports***

The investor loan file pend reports are extremely helpful in identifying problems in your loan process, but these reports should not be used as your quality control process. Relying on these reports to identify problems will hurt your reputation with an investor. In the tight remediation period with an investor, you may not have the time nor the focus for a 'root cause' analysis. Instead, use these reports to validate your own quality control process.

Quantifying the cost of your loan file pends will also shed light on how these problem areas affect your bottom line. Sharing this information regularly with executives can ensure a deeper understanding of the issues, support agreement on the profitability impact, and help determine remediation strategies.




***Investor Bias and Leakage***

Sellers starting a new relationship with an investor are expecting liquidity, profitability and, likely, efficiency gains. Properly reviewing a new investor's requirements can ensure you're receiving exactly what you expected and avoid unforeseen leakage due to delays in funding or incurring fees. An understanding of important loan production requirements – some of which may require operational changes within your manufacturing process – is critical in your assessment of total loan sale costs with each investor.

A poor operational process on the buyer side can also have a negative impact on your pipeline. An investor with volatile file review turn-times will lengthen your warehousing period, which may subsequently impact your expected loan margin and subject you to increased market risk and hedge costs. Conversely, an extremely efficient buying process with an investor may provide operational cost savings that, when included within your best execution analysis, result in a more profitable and preferable investor relationship.

***Bonus Tip: Speedy Loan Deliveries Affect Pricing***

Specific market conditions, such as a flat yield curve and high money market rates, can result in reduced hedging costs for mortgage pipelines. This market condition can create an opportunity for depositories to take advantage of their low funding costs to pick up additional investment income when employed within prudent risk management policy guidelines.

In a recent whitepaper, Carry Opportunity: Strategy for Banks and Depositories, Bill Berliner outlines how to improve profitability using this carry opportunity. Ira Brownstein, Senior Vice President of WSFS Mortgage shares his experiences implementing this carry strategy for a positive gross monthly carry of roughly 30 basis points.

## CONCLUSION

Squeezing every drop of profitability from your best execution analysis is critical in maintaining a healthy business. While typical lenders always consider current costs, like the costs of hedging, it is also important to measure and calculate potential costs. These considerations were magnified during market volatility in 2020. Focusing on operational efficiencies and the costs associated with each investor can reveal hidden costs not typically associated with your profitability analysis. Mortgage lenders who can successfully navigate away from manual processes, technology downtime, leakage and other non-price considerations can reduce the costs of their loan sales and, consequently, improve the profitability of their business.

### *ABOUT FREDDIE MAC*

Freddie Mac makes home possible for millions of families and individuals by providing mortgage capital to lenders. Since our creation by Congress in 1970, we've made housing more accessible and affordable for homebuyers and renters in communities nationwide. We are building a better housing finance system for homebuyers, renters, lenders and taxpayers. Learn more at FreddieMac.com, Twitter @FreddieMac and Freddie Mac's blog.

## *ABOUT MORTGAGE CAPITAL TRADING*

MCT is a capital markets advisory firm focused on technology and service with a 15+ year track record of success.

- **Growing for Your Needs** - Since 2001, MCT has grown from a pipeline hedging services specialist into a fully-integrated provider of capital markets services & software.
- **Capital Markets Expertise** – Through a combination of unparalleled industry experience and relentless focus on data, MCT is pioneering the future of capital markets technology. From MCTlive!, to MSRlive!, to our award-winning Bid Auction Manager (BAM) – MCT pushes the envelope to exceed client expectations.
- **Clients & Employees Agree** - MCT delivers unparalleled customer service. MCT prides itself on being a regular winner of San Diego's "Best Place to Work" Award.

**MCT hedge advisory**

- ✓ HALO – Traditional Full Service Hedge Advisory
- ✓ MCT*live!* – Capital Markets Software Platform
- ✓ BAM – Bid Tape Management Solution
- ✓ Best Execution Analysis & Loan Sales

**MCT MSR services**

- ✓ MSRlive! Cloud-Based Servicing Valuation Model
- ✓ Servicing Portfolio Valuations
- ✓ Customized Grids
- ✓ MSR Hedging
- ✓ MSR Brokerage
- ✓ Enhanced Retain-Release Analyses

**MCT lock central**

- ✓ Outsourced Lock Desk Services
- ✓ From Initial Locks Only to Full Service
- ✓ Works with all LOS & PPE Systems
- ✓ Best Practice Recommendations
- ✓ Policy & Procedure Development

**MCT PRODUCT & PRICING**

- ✓ Proprietary Pricing & Eligibility Engine
- ✓ Real-time Pricing for *ALL* Delivery Channels
- ✓ Loan Sale Best Executions
- ✓ White-Label Rate Sheet Generation
- ✓ Fair Value Accounting

**MCT BUSINESS intelligence**

- ✓ Proprietary Loan Sale Best Execution Database
- ✓ Investor Report Cards
- ✓ Price Competitiveness
- ✓ Client Opportunity Curves
- ✓ Capital Markets Consulting