

# Options And Strategies To Reach Agency Best Execution Delivery

*Hypothetical examples illustrate what's needed to obtain best execution.*

By Rob Kessel

Agency product, or loans eligible for delivery to Fannie Mae, Freddie Mac or Ginnie Mae, is often considered by secondary marketing managers (SMMs) the easiest to value, hedge and deliver. In the last few years, this assessment has become increasingly belied with the options, necessary analytics and available strategies now available to SMMs.

SMMs enjoy a host of delivery options when selling closed conventional and government production. Lenders wishing to retain servicing may sell loans through agency cash or conventional or government mortgage-backed securities (MBS) transactions.

SMMs electing to release their servicing have the option of selling loans to the agencies and servicing to co-issue (flow) servicing buyers, or selling whole loans to investors as either single, bulk or assignment of trade (AOT) transactions. Table I summarizes these sale options.

Typically, SMMs will choose the sale method or methods consistent with both strategic objectives and best execution principals. For example, some lenders, such as credit unions or



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successful cross-selling platforms, may view retention of a servicing relationship with their customer as being strategic to their core business practices. In such cases, servicing may be retained independent of best execution analysis, or a best execution threshold may be set where loans will only be released if their released value or servicing released premium (SRP) exceeds the retained value of the mortgage servicing rights (MSR) by more than some defined threshold.

## Relationships and strategies

Notwithstanding strategic objectives, SMMs endeavor to approach agency loan sales with best execution principals in mind. In this case, best execution starts with establishing possible sale outlets, defining specific valuation assumptions and ultimately establishing specific relationships with investors.

Consider Example I - a fictional SMM named Jill whose company is currently closing \$40 million of conventional product and \$20 million of government product. Jill has the responsibility to establish sales strategies for agency product. Her firm is contemplating retaining servicing but is not quite sure if it makes sense. Using Table I, Jill seeks the following information in order to evaluate sales options:

- applicable agency cash pricing,
- applicable agency guarantee fee,

- internal value of retained mortgage servicing rights (MSRs),

- co-issue bid for base and excess servicing,

- negotiated bulk terms from desired investors,

- AOT bids from desired investors, and

- opportunity costs (operational differences, bid/ask spread, interest float, specified pools, investor fees and other costs).

Using this information, Jill then evaluates her possible sale strategies in order to identify winning sales methods across different product types. Throughout the evaluation, Jill must apply specific value to applicable opportunity costs in order to evaluate all sales options.

The following are investor and delivery methods, with their descriptions and values:

**Bid/ask spread:** SMMs delivering loans into securities or participating AOT programs are able to deliver their loans into previously sold to-be-announced securities (TBAs). This practice allows SMMs to avoid any bid/ask transaction cost associated with pairing off hedges while simultaneously selling cash commitments.

**Value:** three to nine basis points (bps).

**Early shipping requirements:** Some delivery types require earlier submission of collateral/shipping packages than other deliveries. AOT collateral submissions are often required two weeks earlier than

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agency securitization for a given settlement date. AOT deliveries are often priced to subsequent months due to earlier document requirements.

Value: zero to 30 bps depending on rolls and cost of funds.

Interest float: Through various repurchase (repo) finance arrange-

and/or delivery method, potentially negating other delivery options that may represent better execution.

Value: zero to five bps across applicable production.

Document requirements: Some investors require more documentation in collateral packages than others. Such

deliveries. Cash delivery G fees are implied and may be calculated by solving for what G fee most consistently provides the same price for the applicable note.

Buyup/buydown schedules (Bu/Bd) are the product, note rate buyup or buydown schedules providing multiples to calculate price improvement when the G fee is increased (increase in G fee multiple) or when there is a decrease in price when the G fee is decreased. Some investors use straight agency grids; others make modifications.

Excess, also in Example I, is often valued at a buyup multiple to a larger cap by AOT investors.

Now that Jill has selected her preferred sales methods for the near term, she implements the tactics necessary to maximize her execution. In other words, as sufficient product becomes available for sale, she evaluates her execution opportunities between AOT and cash delivery options.

**Table I: Conventional And Government Sale Methods**

Sale Method	Servicing Retained	Servicing Released
Agency Cash (Conventional)	Yes	When coupled with co-issue or flow servicing relationship.
Agency MBS (All)	Yes	When coupled with co-issue or flow servicing relationship.
Investor – Single Loan	No	Yes
Investor – Bulk	No	Yes
Investor – AOT	No	Yes

SOURCE: Compass Analytics

ments, agency securitization provides for the opportunity to extend interest income periods at more attractive rates.

Value: zero to 20 bps.

Specified pools: Lenders securitizing agency product can craft pools with specific aggregate characteristics - such as geographical concentrations, low loan balances, etc. - fetching a small premium on TBA prices.

Value: zero to nine bps.

Accumulation: Negotiated, AOT and securitization deliveries may require some period of accumulation in order to form pools within a specified tolerance level (500,000 with 10,000 in tolerance). Such accumulation may result in longer warehouse periods or cash flow implications. AOT aggregation does provide for tolerance optimization, which can be valuable in periods of large market moves. Some investors do provide for direct trades outside of the delivery tolerance.

Value: zero to three bps.

Volume pledges: Some delivery agreements entail minimum delivery volumes over a stated period, with penalties for failure to meet minimums. Such minimums may lock in production to a particular investor

requirements may represent an additional operational expense.

Value: varies.

Investor terms and fees: Some investors have early default or refinance provisions, which may represent contingent risks to lenders. Some investors charge funding fees not charged by agencies.

Value: zero to nine bps.

After collection of investor information specific to her firm and careful analysis presented in Example I, Jill concludes that AOT execution coupled with periodic cash sales makes the most sense for her firm. Jill knows that in following best execution practices, she will refresh this analysis on an ongoing basis to assure continued best results.

In Example I, MSR/SRP is the internal value of MSR given the servicer's cost of servicing, servicing assumptions and product mix for retained servicing, as well as the investor's SRP for released production. Both MSR and SRP are values for base (minimum) servicing.

The guarantee fee (G fee) is the agency guarantee fee (rate) for MBS deliveries and the implied guarantee fee for cash pricing, as well as the stated/implied guarantee fee for AOT de-

**Evaluating AOT execution**

Jill first looks at the delivery schedule for her AOT investors in order to identify the applicable security settlement date. In Example II, on Oct. 22 Jill sees that she has an investor cut-off date of Oct. 27 for November settlement securities. She can receive November pricing if she can deliver loan packages to the investor by the cut-off date.

Jill then obtains current market MBS prices for the applicable settlement date and coupons, in the case of Example II, getting current indications for November 5.0 and 5.5 coupons.

Next, using the guarantee fee and buyup/buydown schedules, Jill determines which MBS coupon represents the best execution for each note rate and establishes the applicable note rate level price for each note rate. In the case of Example II, Jill determines that 5.5 coupons represent best execution for both 5.75 and 5.875 note rates.

After determining the best execution coupon, Jill must also consider any loan-level price adjustments, SRP and investor note rate adjustors that may apply. She must also consider any additional interest income she may

earn if delivery-delay is an option.

Finally, she must consider any aggregate, miscellaneous adjustments that may apply to her AOT delivery, including what combination of loans is required to meet delivery tolerance requirements or create an over/under allocation opportunity.

Example III illustrates Jill's derivation of loan-level prices and aggregate adjustments. Examples II and III illus-

on a note- and loan-level basis. However, Jill has one additional delivery option available to her.

Deriving an aggregate-weighted price - including all price adjustments - on her salable product for both AOT and loan-level cash execution, she compares the aggregate prices to the bulk bids she requested and received from bulk investors representing the same market levels at the time of AOT

ment - provided she is within delivery tolerance, meets the delivery cut-off date and achieves best execution to the delivery. In this case, she maximizes her execution by under-delivering the loans against the commitment number provided by the investor.

Note that in Example II, current market MBS prices were used in determining AOT security prices. In Example III, a trade was selected for under-delivery

because it was the most underwater - that is, the lowest mark-to-market (MTM). Because Jill is assigning a specific trade to the investor, the investor will use the price of that trade in determining the price paid for that loan. In Examples II and III, the base price used for the 5.75% and 5.875% note rates would be 100.457 instead of the 101.719 used in the analysis.

However, because Jill has now assigned the underwater trade to the AOT investor, she no longer has the negative MTM in her position. When we add that negative MTM percent to the

purchase price of the assigned loans (100.457 + 1.262), we get back to the 101.719 current market MBS levels.

Notwithstanding the multiple tables, examples and analysis presented in this article, we have only topically addressed the rigor and discipline necessary to maximize agency execution given a specific lender's objectives.

Other delivery practices beyond the scope of this article can also sway execution to one delivery vehicle versus another. Clearly, SMMs who approach agency execution with the appropriate discipline and analytics can institute delivery practices consistent with the maximization of delivery execution, a nontrivial pick-up for product that represents a lion's share of many lenders' originations. Indeed, many lenders searching for improved secondary performance may find the lowest hanging fruit in the least obvious place.

**SME**

## Example 1: Best Execution Analysis

Careful analysis of sale methods in our hypothetical example can help lead to best execution. Except for Bu/Bd, values are expressed in terms of basis points.

Component/ Method:	Agency Cash		Agency MBS - Retained		Investor - Single		Investor - Bulk	
	Retained	Released	Retained	Released	Released	Released	Released	
Servicing								
MSR/SRP	106.25	131.25	118.75	137.5	170	175	190	
GFE	23	23	22	22	22	21	21	
Bu/Bd			Agency	Agency			Agency	
Excess	N/A	N/A	3.0:1	3.5:1	N/A	N/A	4.0:1	
Bid/Ask	-4.5	-4.5	0.0	0.0	-3.1	-3.1	0.0	
Cut-off Schedule	0.0	0.0	0.0	0.0	-5.0	-5.0	-20.0	
Float	0.0	0.0	15.0	15.0	0.0	0.0	10.0	
Spec. Pools	0.0	0.0	3.0	3.0	0.0	0.0	0.0	
Documents	0.0	0.0	0.0	0.0	-1.0	-1.0	-1.0	
Investor Fees	0.0	0.0	0.0	0.0	-5.0	-5.0	-4.0	
Misc.	0.0	2.0	0.0	2.0	0.0	1.0	0.0	

SOURCE: Compass Analytics

trate a single-investor AOT best execution process. Were she approved with multiple AOT investors, such best execution would need to take place across the multiple AOT investors who may have different guarantee fees, buyup/buydown multiple schedules, delivery cut-offs, SRPs, etc.

### Evaluating cash execution

Confirming that the current market is at the same levels used for AOT execution (otherwise Jill would update AOT execution), Jill evaluates her cash options by obtaining note-rate-level prices directly from cash investors, considering any loan-level adjustments and adding applicable SRP when not included in the investor price.

Additionally, Jill must consider any interest float opportunity for any cash delivery dates different than AOT delivery. At this point, she is able to compare her cash execution to AOT execution

and cash execution analysis.

In Example III, the loans Jill selected for her AOT receive their highest individual prices delivered under the AOT (compared to loan-level cash prices) as well as the highest aggregate price when compared against the best bulk bid for the specific loans selected. Were she to receive any single-loan cash prices in excess of her AOT value, she would consider selling the loans for cash and determining if the remaining AOT loans would represent delivery within tolerance under her AOT agreement.

Confident that the AOT execution is her best delivery option for the loans, she registers her AOT with the applicable investor by providing trade information (trade X from Example II) and assignment amount (\$1 million). She then receives a commitment number against which she will deliver the loans.

Note that she retains the ability to deliver any loans against the assign-