SECONDARY MARKETING EXECUTIVE®
secondarymarketingexec.com
The Journal for Mortgage Banking Professionals
Vol. 31, No. 5 July - August 2017

The Bulk Bid

Investors took advantage of new market structures to pioneer the bulk-bid transaction style as we know it today.

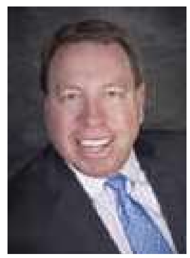
page 24


BID

The Bulk–Bidding Boom

What are the most important aspects of this popular delivery channel?

By Don Brown



A major industry trend of the last four years has been the explosion in the volume of loans being sold through a bulk-bid-style transaction. This article explores the emergence of this trend, how it differs from past strategies, how it can benefit originators, how to take advantage of those benefits, what to avoid, and whether this trend will persist.

How did we get here?

Let's start with the basics. Bulk-bid transactions are different from the bulk transactions that took place in the days preceding the great crisis. Prior to the crisis, a bulk transaction was one in which an originator sent a tape to one or more investors that would then respond with an "all-in" price for the package of loans. If the investor bid on the package, it was an "all or nothing" proposition for the loans that were bid, with no loan-level pricing. Determining eligibility was the responsibility of the investor.

Today's bulk-bid strategy is a different beast entirely.

The bulk-bid strategy started several years after the crash, when the industry broke away from the duopoly that dominated the market after the storm. In that market, the credit box became extremely tight. Carnage was still strewn all over the battlefield as we migrated from checking the Implode-O-Meter daily to weekly. Rates were low, but investor apprehension was high, as capital was leery of mortgages in general.

This led to an environment where the only mandatory investors were major banks. The result was that the bid became weak. It was in this era that we established a report we call the "implied SRP report." The idea was to compare the aggregator bid against the cash window price, which did not include a servicing component.

At times, the government-sponsored enterprise (GSE) market bid beat the aggregator bid. That meant that if you were approved to sell to the GSEs and able to retain the servicing asset, your acquisition cost for that asset was negative. With the market in this posture, why not retain as much as your cashflow and balance sheet could tolerate? Those that were not yet GSE-approved joined the mass that focused on putting together their applications so they could distance themselves from the perceived tyranny of the big bank mandatory investors.

The rise of new liquidity

As with any economic imbalance, the market rushes to the vacuum. Thus, as the fog rose from the murky post-crisis mortgage scene, investor activity grew aggressively on many fronts. While the rooted investors and GSEs were laying low at big mortgage industry events by getting "anonymous" meeting spaces off-site, new liquidity rapidly invaded the market.

Within the span of three years, the industry began to witness a cavalcade of new investors coming into the mandatory buying space. First came the larger players, which were generally key industry-veteran executives backed by new capital that was eager to capture the volumes being originated at such low rates. Next was a flock of aspiring correspondent investors. What evolved was the bulk-bid environment.

The first wave of these new investors descended from the pre-crisis, "big mortgage bank" mentality. Most set up mandatory desks in the fashion they were accustomed to and bought loans through the direct trade and assignment of trade-style transactions - business as usual.

However, as the new investors leapt into the scene, they did not immediately have the infrastructure to set up a direct trade and/or assign a trade style of buying loans. Instead, they improvised. They took advantage of new market structures to pioneer the bulk-bid transaction style as we know it today.

How does a bulk bid work?

The bulk-bid (sometimes referred to as mini-bulk) transaction is relatively simple. The originator sends a data set for a group of loans to the investor and sets a deadline for the investor response. The investor then prices the loans on an individual loan basis and sends the bid back to the originator. The originator then assesses the bids as they come in from several investors and sells the loans based on a best execution strategy that may or may not be combined with alternative criteria that drives some business objective.

Unlike the historical bulk transaction, in which loans were sold in groups, this style empowers originators to dig down to the loan level to find the best execution. In the alternative, the bulk bid gives investors the ability to build their investment or strategic preferences into the loan pricing. For example, if an investor had a trade to fill, it may buy up for a certain coupon. More likely, if an investor were looking for low balance, high FICO, low loan to value, or loans with any other specific characteristic, it could adjust its price accordingly to wave in loans that best fit the investment perspective.

Originators gain an upper hand

At first blush, this environment seems to give a tremendous advantage to originators. Now, they can develop relationships with multiple investors, each of which is attempting to optimize its loan-level pricing.

The originator's initial step is to choose the investors with which it wants to work. This should be a bit more deliberate than simply waving in any investor whose representative comes calling. Originators need to investigate the potential pricing being offered by the investor. This can be done through a process called shadow bidding. Most investors will allow the originator (or a secondary marketing consultant) to send them data on a group of loans (referred to hereafter as a "file") prior to being approved, allowing the originator to gauge each investor's competitiveness.

If the pricing is in the desired ballpark, then the originator must investigate each investor's operational performance. Even if an originator receives top dollar for its loans when it commits to a specific investor, profits can be chewed up if the investor can't buy the loan on a timely basis or dominates staff time with burdensome and superfluous documentation requests. (As an aside, searching for new investors is not a cure for inadequate loan delivery processes. If an originator is unable to deliver a complete loan package, it will experience delays and extra staff costs regardless of the investor. While the level of scrutiny investors give to loan packages varies, what is being referenced here are requests from investors that go beyond the boundaries of the normal complete loan package.)

Finally, it is important to assess the investor's ability and willingness to work with you as you encounter the inevitable and unforeseen operational challenges associated with the loan delivery process. The bulk-bid delivery process is likely to transform the relationship into one that is more transactional. Nevertheless, it is important that all parties understand and agree to the rules of the relationship and that all are willing to adhere to those rules when challenges or disputes arise. As with any business relationship, integrity is critical to success.

… Or do they?

Although at first blush it may appear that the originator gains an upper hand, a closer inspection reveals advantages for the investor, as well. The foremost advantage is that investors now have another tool that enables them to rifle their pricing so that they are buying the product that they want without overpaying for less valuable production.

Bulk-bid pricing is a spot-pricing style of doing business. Aggregators may be seeking to buy a product that meets a long-standing investment thesis, such as high-FICO or low-balance loans. Perhaps they have a specified pool pay-up that they would like to take advantage of in the securitization process, and you can't take advantage of that same pay-up yourself. This gives the aggregators the ability to hit that specific pool bid and gain access to some of that spec-pool pay-up benefit.

Alternatively, an investor may be interested in filling an immediate trading need. It may have open pools that are not yet complete, and a delivery deadline is approaching. The bulk-bid process gives the investor the ability to be nimble in filling its pools quickly. The result is that the aggregators can focus their pricing more quickly than they could with the traditional mandatory delivery channels, such as assignment of trade, direct trade, co-issue or rate sheet mandatory.

We also have witnessed aggregators neutralizing an originator's ability to arbitrage between bulk-bid and more traditional pricing structures by forcing the originator to pick a lane. Whether the originator makes this choice evident through its selling behavior or the investor proactively steers the originator, the result is identical. Once an originator focuses on the bulk-bid channel, the pricing on its other delivery channels from that same investor is likely to deteriorate.

Most importantly, transitioning to a bulk-bid style of loan delivery may deteriorate your relationship with that aggregator so that it becomes a relationship that is completely transactional in nature. This may not be a bad thing for the originator. However, don't expect the aggregator to go above and beyond to help resolve a situation with a loan that may have missed the target for one reason or another. The investor's perspective is if an originator is willing to slice and dice its pricing at a loan level to maximize the best execution, why should the investor come to the rescue in a situation that would require it to go beyond the bounds of the agreed-upon contractual rules?

We are currently in an environment where there is a crowded field of aggregators willing to go the extra mile to earn and keep business. This will not always be the case.

Many of us clearly remember when the field narrowed to two primary mandatory investors in the early 2010s - both of which were big banks. At that time, had you soured your relationship with an aggregator and market circumstances changed to the point where you needed that relationship, it was not so easy to revive. Some of those scars persist today.

While it may be gratifying in the near term to take advantage of the shiny pricing that is available through the bulk-bid delivery channel, keep an eye on the larger long-term picture by continuing to feed and nurture the relationships with the investors that you know will be there for you when the skies are not so sunny and bright.

How do you take advantage of it?

In developing an approach to the bulk-bid delivery channel, the first question certainly should be whether to take advantage of this delivery channel at all. As previously discussed, the bulk-bid style of delivery risks changing the nature of your relationship with investors (which is not necessarily a bad thing). However, the advantages to be gained in terms of near-term pricing may be eroded by the distance of a more transactional relationship. To be clear, there are several investors whose only mandatory delivery channel is bulk bid. This makes the decision simpler.

Aside from potential relationship issues, originators must address the operational challenges. The bulk-bid delivery channel requires an originator to be able to generate loan files, establish deadlines, and receive the bids as they are returned by the investor, as well as assess the best execution among the received bids and any traditional delivery channels that are available. This begs for an automated system. Without the use of advanced automation, this delivery method will drag you down into a spreadsheet Hades that is prone to error and inefficiency.

There are several options when looking for a system. There are stand-alone software packages available that require the user to manually manage pricing and eligibility input. Such systems are useful but still leave the user vulnerable to costly mistakes and lost opportunities of selling to the best appropriate execution.

On the other hand, there are services available that will do the work for you; often, they are part of a hedge management process. If this route is selected, it is imperative to look under the hood at all efficiencies and processes. Are these services able to digest all of the pricing sources quickly? Are they favoring one investor over another by giving an investor a "last look," and if so, how does that affect your relationship with other investors? Are these services able to bring your traditional delivery channels into the best execution analysis? This is crucial, as experience shows that 67% of loans that go out for a bulk-bid price eventually are committed through a bulk-bid channel. If your provider focuses solely on bulk-bid channels, you clearly are not optimizing your loan commitment strategy.

Finally, there are several emerging loan-sale platforms that offer to help maximize a best execution strategy. In evaluating these services, be sure to investigate the same questions outlined for the outsourced providers. Additionally, you want to understand whether they can bring new liquidity your way, and if so, what will that cost you? If you are selling to the same investors but now have incurred a fee, are you better off?

Consider adopting an inclusive secondary marketing platform capable of bridging the gaps among lenders, investors and providers. Such a system will, at its core, provide accurate investor eligibility and pricing data. In addition, it will include integration with your other vendors - a system that shepherds the originator from content through committing. An ideal platform should also be supported by investor content that is updated in real time. This type of system provides originators with accurate pricing to match every borrower's specific circumstances with the best possible loan option. The same comprehensive system can then be used for hedge position management while the loan is in process, best execution and trade allocation.

Investors now have another tool that enables them to rifle their pricing.

The future of the bulk bid

Bulk-bid transactions, in one form or another, are here to stay. They represent the innovation that arrives with improved technology. Information is shared more easily and quickly. The gap in access to pricing and eligibility information has narrowed, changing the relationships between investors and originators.

Be thoughtful in your approach to this delivery channel. Like that viral video of the guy who launches himself into the pool only to find that it is frozen solid, a hasty or thoughtless approach can lead to a painful landing. However, if you take the time to think through this delivery method in comparison to overall business strategy, partner appropriately with investors, and utilize a comprehensive technology platform capable of bolstering your success, the bulk-bid delivery channel can be a valuable arrow in your operational quiver. SME

Don Brown is founder and managing director of Optimal Blue Secondary Services, which provides content-managed mortgage eligibility, pricing real-time compliance, pipeline risk management, best execution, and loan allocation software and services. He can be reached at dbrown@optimalblue.com.