# Alfred Chang

## Episode 248: Why are Residential Whole Loans the Talk of the Town?

GUEST Q & A

**Stewart:** Welcome to another edition of the InsuranceAUM.com Podcast. My name's Stewart Foley, I'll be your host. Welcome back. It's nice to have you back. And we're here to talk about residential credit today. And we're joined by Alfred Chang, who's the Head of Residential Loan Trading at MetLife Investment Management. Alfred, you're a repeat guest. We're thrilled to have you back on. Welcome back.

**Alfred:** Thrilled to be back. Thanks for having me again, Stewart, very excited to be able to talk about residential whole loans again.

**Stewart:** You are the head of residential loan trading and portfolio strategy for the residential mortgage portfolio at MetLife Investment Management. And I want to get into that because this asset class is getting a lot of attention, which is why you're on today. But before we get going too far, tell us about, for those who didn't listen to your first podcast, tell me about where you grew up, and what was your first job? Not the fancy one, just so that everybody can get to know you a little bit.

**Alfred:** So I was born in Virginia, and then moved to Texas at a very young age. And I think there's even some bumper stickers in Texas, I followed this, "I wasn't born in Texas, but I got here as soon as I could." So I follow that path. I grew up in Fort Worth, Texas, a town about an hour west of Dallas. My first job was in the mortgage industry, started my love of mortgages as a whole. My job was to collect on delinquent loans. So that was my first job right out of school.

**Stewart:** Wow. And that's a tough job, that's a tough start. You could have easily spent six months at that and been like, "I'm done." But here you are, which is fantastic. So we're thrilled to have you. And everybody remembers what happened in 2008, and it was a meteoric rise. No one had ever... I was running money at that time, and nobody had really ever contemplated that house prices could fall precipitously at that time. So I remember, way back when subprime was trading 40 wide to agencies. And it's just a different time today. So when people ask, "Is this housing market like '08?" It seems to me like a resounding no, but what's your opinion? When clients ask you to compare these two time periods, how do you come about that?

**Alfred:** You're absolutely right, the question does come up. But you're also right that today's housing market is very different, largely because there is a significant lack of supply today versus what supply was going into 2008. And so it's that lack of supply that keeps home prices up. If you, or anyone listening to the podcast, is to try to go out and buy a home nowadays, it's not easy. There's not a lot of supply out there of available homes to buy. The loan products created today are also better credit quality from what we see. You just don't see the higher loan to values, or combined loan to values, that you had in 2008.

And, also, you just don't see the adjustable rate mortgages like you did in 2008. It's a much smaller percentage today. So one of the things that was talked about a lot in 2008 is the risk of rate resets, meaning you're in an adjustable rate mortgage today, but if rates go up, you could be facing a higher payment because of that. So you just don't see that today as well. So what that's basically created is home prices to be stable because of the lack of supply. And because home prices are stable, people want to keep things that they have equity in.

**Stewart:** One of the things that's interesting about residential whole loans for life insurance companies is that they enjoy a very favorable capital charge. But I'm not clear on what happens if you increase credit risk, or with the liquidity to say like rated RMBS in the public market. So can you compare and contrast those two, the residential whole loan market that we're talking about versus the publicly available RMBS securities?

**Alfred:** You're exactly correct. Capital is very efficient for life companies that invest in residential whole loans. Residential whole loans do have an increased risk, just because there's a lack of credit enhancement, and could be less liquid. But the investment strategy starts with the fact that we see a pretty significant spread pickup, versus public opportunities that could have credit enhancement, such as RMBS, as you mentioned. And so our job is to see how we can mitigate credit risk through a whole loan strategy. And that's where, through whole loan trading, we can utilize control and transparency into the types of loans we're buying, who we want to buy from, and how we want to buy those loans, to try to mitigate as much of that risk as we can. So at the end of the day, you're able to pick up spread, but because of how we're actually investing in this asset class, you're able to get a lot of that spread pickup without having to take on outsized credit risk.

The other aspect that is very interesting, as far as what we can do, is through the transparency of what we can get from a loan level during our due diligence process, we can remove loans during this process that we see as further mitigating the credit risk.

**Stewart:** And so what's interesting to me about that, and it just occurred to me while you were answering, and I did a case on this when I was teaching, there's a cost to being over liquid. Too much liquidity in a portfolio, there's a cost to that, and the cost is yield. And so, certainly, liquidity is necessary in a portfolio. But I think, sometimes, insurance companies are more liquid than they need to be, particularly if they've got federal home loan bank relationships, wherever they can provide some backstop liquidity, just in case there's an unforeseen set of circumstances. But you guys have been, when I say 'you', I'm talking about MetLife Investment Management, has been in this space for over a decade. It seems to have picked up a lot of momentum, in terms of folks talking about it lately. But what has that 10 years taught you, and how does that translate into expertise in this market from others in the market?

**Alfred:** Sure. And maybe I'll just hit on the other aspect of what you just mentioned too, as far as the liquidity aspect. In order to get that extra liquidity, like you mentioned, and whether maybe there's a focus on too much on liquidity, but also on the credit enhancement side as well, there's a cost to that. And so there's cost of structuring, and cost of getting the rating agencies to rate it and provide that liquidity. That all comes at a cost. So what we're looking to do is to take away that cost, and get down to the hard assets. And really bring that to our clients in a way where we think we've mitigated a lot of the risks, and give them a suitable asset to invest in.

To hit on what you just mentioned, we've been in this asset class for over 10 years, 12 years to be exact. And I think a way to answer it is, how do we think about MIM and our place in the market? And why choose us? At the end of the day, residential whole loan trading is a relationship business. We have forged strong relationships over the last 12 years. We've invested over 45 billion in residential whole loans for both internal and external clients. Many of those relationships were born out of MetLife, which MetLife has historically been a big institutional investor in the marketplace. And what we've done is, once we've established those relationships, the whole loan team has forged strong relationships with those counterparties, by just being a reliable investor in residential whole loans, even during times when others weren't active, like 2020.

So our significant experience in this place has really helped us keep those relationships. And the residential whole loan trading side isn't just bidding on something, and you just go close it. It also involves due diligence and negotiating legal contracts. I think that sets us apart too, because of how active we've been. People know what they're going to get when they deal with MetLife.

**Stewart:** It's an interesting point, and I'm wondering, when you mentioned control and transparency earlier, can you talk about some scenarios where the control and transparency has led to, for lack of a better term, better outcomes?

Alfred: Sure. So to answer the question, I'd flip around control and transparency a bit, and take a look at transparency first. Which is, if you use the transparency we have of investing in whole loans, you can utilize the control you're afforded to limit any number of risks. So through our clients' buy and hold strategies, we have a vast amount of transparency into who we've bought from, what loan types we've bought, performance on those loans at a servicer level, and how we've bought those loans across the $45 billion that I mentioned. That $45 billion's over 140,000 loans. And as we continue to stay active, that invaluable transparency across all those aspects only grows. So this means, based on all that data, we can stop buying from counterparties, or price them differently. We can stop buying specific loan types, or price them differently, or structure trades that are most beneficial for our clients.

And through the feedback of our portfolio performance, we have refined the counterparties we work with, the loan types we'll buy, where we have loans serviced, the credit attributes of individual loans we want to buy, and our trade structure. So this continuous feedback is extremely valuable. And I don't see it ever ending because it's such a strong aspect of bringing a risk mitigation strategy into investing in residential credit.

And so one of the examples, and how I think will result in a better outcome for our clients, is really a hallmark of our whole loan strategy. And that's the credit discipline and consistency. That means we target loans that we believe are more conservative in credit, and are more suitable for our clients, which are insurance companies. We do this by controlling with our sellers the loans we want to buy. That can mean a material number of loans in a trade we wouldn't buy. So we would remove these loans from our bid, or seek out other investors where the credit may be more suitable. This control prevents our clients from ever owning these loans, which could be loans that have only recently re-performed from a serious delinquency, higher loan to values, or even lower credit scores, or all of the above. So the transparency into what a loan pool consists of allows us to remove the loans we don't want, and our clients don't ever have to buy.

Another example of control and transparency is, we had one of our servicer's service loans where they were delinquent, and we saw that they had poor performance versus our other servicers. And, today, we have six servicers that we could look across. And what we found was, they had poor performance around collections on delinquent loans. And what we did was, we transferred those delinquent loans to another servicer that had historically shown better performance around collections on their delinquent loans. So, ultimately, this resulted in better performance on the loans, meaning loans that were delinquent were able to be brought current. We even were able to lower servicing fees for our clients. And, also, identified us now that we should be very reluctant to put loans at the servicer that had the poor performance.

**Stewart:** So, really, it's a form of underwriting. You're, in a way, not quantitatively re-underwriting the loan pool. Is that a fair assessment?

**Alfred:** Yeah, so the way we look at it, underwriting is an origination term. And we're not an originator. We're buying things on the secondary market. And because of that, that also prevents all our clients from having to have any lending licenses. But we're getting as close to what I would call re-underwriting the loan as much as possible. And that goes into what I mentioned earlier, which is the due diligence aspect of it. When we go through due diligence, we're checking if the loans are compliant with laws, if the credit is what we were disclosed when we bid on the loans. Does it follow the guidelines in which the loans should have been originated to? So in a way, we are re-underwriting the loan. And then, what we find on what loans were originated, we give that  feedback throughin the performance. So when we're owning the loan from when we buy it, all the way through to the end, we get that monthly extremely valuable data. So that helps us refine our buying strategy and the loans we want to target.

**Stewart:** That's interesting. So one of the things that, in addition to the capital treatment of the asset class, is that it's my understanding that this asset is pledgeable to FHLB. So that's interesting because that's a very hopeful attribute. In fact, I was just with the gentleman who's at the Cincinnati Federal Home Loan Bank at an industry event, and we were just talking about this exact thing. Talk a little bit about that, and how MIM, which is how you refer to MetLife Investment Management, how MIM helps their clients pledge those loans?

**Alfred:** In short, we're involved from the beginning, all the way through owning, after our clients pledge, for months and months, years and years down the line. So MIM has, and certainly can, help clients with pledging strategies. We start from the initial setup. We're talking with our clients to the FHLBs on what are their data requirements. We help them through any of the collateral setup that's needed. What's specific to FHLBs is that they need to have a clear insight into the collateral of the loan, meaning the notes, the mortgages, all these documents in which the borrower executed at time of closing. They want to be able to have access to those, and be able to check the completeness of those, before they allow a loan to be pledged, and for them to give an advance on it. So we've worked with three different FHLBs so far, and so we're very versed with the different needs of FHLBs. And the reality is, we've found each one has its own criteria.

**Stewart:** That's exactly right. It's so funny you say that because I ran into some folks who said those exact things to me a couple of days ago, that it's not a uniformity across those banks. And the fact that you've worked with three different ones, obviously, you could work with the other nine, but at the end of the day, they are not perfectly uniform.

**Alfred:** That's correct. And how we address the lack of uniformity across the FHLBs is, we believe we have all the data, and can put that data into any of the FHLBs' required formats needed to pledge. So we've done that. We've seen that. And the reality is, we recognize that pledging is a very important aspect, when investing in residential whole loans for our current, and any potential client. So much so, we even have an employee that previously worked at an FHLB that helps pledging for our clients. And we've also run into some FHLBs may not currently accept residential whole loans as acceptable collateral today. We came across that with one of our clients. But through our support, through the process, that client now is pledging residential whole loans to that FHLB. We, of course, can't guarantee that all FHLBs that don't allow would follow this path, but we are there to support every step of the way.

**Stewart:** Yeah, I've been told repeatedly that then it works to pledge, so that's good to know. The one thing about this asset class that can create challenges is that you're owning individual loans that have relatively low loan balances. Even if it's a $0.5 million dollars, it's still, if you're going to deploy a $100 million, that's a lot of loans. So that creates some reporting and accounting challenges, or can, if you're not steeped in the tea, if you will. So can you talk a little bit about how you work with clients to help them with the reporting on this asset class, which is, as you know well, very important to any insurance company hiring a third party asset manager?

**Alfred:** Really, in one word, experience. As I mentioned, we've purchased over $45 billion in whole loans across 140,000 very diverse loans, from adjustable rate, to fixed rate, and even loans with several aspects of the original loan terms modified. The common theme was that all of these loans were for life insurance companies. We supported our clients from the first loan. And even today, after thousands of loans that we've bought for them, on how to account, and how to report on those individual loans. We recognize that, many times, this may be the largest barrier of entry into the asset class, but we have a dedicated team of three, solely focused on this support. So, generally, when a client has an accounting or reporting need, because of the uniformity of our client base, we likely are already working on it for all our clients. Said another way, talking the same language makes it a lot easier for us but, more importantly, for our clients to be able to get into this asset class.

**Stewart:** Absolutely. I've learned a lot. Just, if you would, can you wrap with a couple of key takeaways? And then I've got a couple of fun ones for you at the door.

**Alfred:** Sure. So I think the key takeaways are, I would say to potential clients, think about the spread that you're able to pick up to public opportunities. But I would think of it as a spread pickup, but also a way to mitigate risk investing in residential credit. Housing fundamentals today are much different than 2008, so you have that. But then, we believe that investing in residential mortgages through a whole loan strategy is just a very good risk mitigation strategy. You add on pledging and capital efficiency, like we talked about, that really creates the picture of how this investment strategy can be beneficial for clients. And, ultimately, at MIM, we believe is a great choice for lining up a whole loan strategy, because of our experience. We've done this, we have the reputation, we have the counterparties that continue to want to work with us. And we have countless people that want to trade with us going forward. So that's what I would leave the listeners with.

**Stewart:** That's great. Thank you so much. I really appreciate it. We've gotten a great education on that. Couple of fun ones for you at the door. My notes tell me that you went to TCU, and I want to take you back there. And when I came out of the University of Missouri, I don't think anybody was any dumber or greener than I was. But I'm sure that you would benefit from the years of experience you've had since your graduation day. So I'd like to give you the opportunity to go back and talk to a 21-year-old Alfred Chang and say, what would you tell yourself, or someone else who's graduating from college with a degree in finance or business or something else, that wants to get into this industry? What would you tell them today?

**Alfred:** I would say network. You never know where opportunities come from. And I think the other thing, too, is take chances. As I said earlier, I started in the mortgage business as a collector on delinquent loans. I never thought that I would be running a residential credit strategy. But those experiences I learned, because I gave it a chance, has really helped me, even on my job today. The processes that I know mortgage companies go through to collect on loans, that gives me insight on whether the servicers that I have hired to service loans for our clients are doing a good job or not.

**Stewart:** Yeah, that is really invaluable. That's impossible to price that. When you're making those collections calls, you can't get any closer to it than that, for sure. What about, we've asked this lunch question a bunch of different ways, but if you could assemble a group of four people for lunch, including yourself, who would it be? Alive or dead, fictional characters count, whatever you wanted. Who would you most like to have lunch with, alive or dead?

**Alfred:** Sure. So that's a good question. I'd probably split the lunch up into two lunches.

**Stewart:** Wait a minute, these are not... There's not optionality. There's covenants in this deal. Are you looking for a covenant modification right off the bat on this one?

**Alfred:** Yeah, I'm to get two lunches out. I'm trying to get two lunches out of you.

**Stewart:** You can, you can. Go ahead.

**Alfred:** I would say the first one is, I never got to meet my grandfathers.

**Stewart:** Oh, wow. There you go.

**Alfred:** So I would love to have the opportunity to be able to sit down with them.

**Stewart:** Do you know much about them?

**Alfred:** I don't, only through what my parents have told me about them. And it's always interesting to hear the old saying, the apple doesn't fall too far from the tree. How there's similar personalities of me that they saw in them. So I'd love the opportunity to be able to sit down with them. And the other one would be, I'm a huge U2 fan. I would love to have lunch with Bono. The things that he's done in his career, having such a long career, and being so relevant for so long. It'd be great to just hear stories of how music, in his mind, has changed over the vast number of years he's been in the business.

**Stewart:** That's cool. That would be two cool lunches, for sure. Thanks for being on. We really learned a lot, and it's great to get to know you a little bit. You were on once before, and you're back, and you're welcome back anytime. So thanks so much for being on, Alfred. I appreciate it.

**Alfred:** Great. Thank you, Stewart. Glad to be on again. Thanks.

**Stewart:** We've been joined today by Alfred Chang, Head of Residential Credit at MetLife Investment Management. Thanks for listening. If you have ideas for podcast, please shoot me a note at stewart@insuranceaum.com. Please rate us, like us, and review us on Apple Podcasts, Spotify, Google Play, or wherever you listen to your favorite shows. We'll see you again next time on the InsuranceAUM.com Podcast.