



The Month In Review

July 2007

What's New?

Compass continues its growth and is pleased to welcome Mary Malloy as Managing Director. Malloy has over 17 years of Secondary Marketing management experience and joins Compass most recently from New Century Financial where she was Vice President, Enterprise Hedge Manager. While Malloy's specialty has always been in hedging, she is also an accomplished whole loan trader and has experience in many other facets of mortgage lending including managing trading departments, mortgage loan pricing and product development, contract negotiation, investor loan delivery, and bond clearance functions for major mortgage companies.

In other news, Compass continues its monthly Webinar training series with two interesting topics for August. First is "Modeling the Price Impact of Credit Rating Agency Model Changes" on Tuesday, August 14th at 12:00 PDT and second is "Originator Profitability: Modeling Different Originator Delinquency and Prepayment Performance and the Associated Impact on Servicing Values" on Tuesday, August 21st at 12:00 PDT. Please email Kellie Kramer at kkramer@compass-analytics.com if you have not received an invitation to a previous session so you can be added to the list of invitees. Additionally, if you would like to request a certain topic be covered in an upcoming training, please email Kellie Kramer at the above email address as well.

Look forward to seeing some of you at the Western Secondary Conference next week.

New in CompassPoint™!

Compass is pleased to report its recent development progress in CompassPoint™, including:

- Expanded File Import Columns
- Expanded Deal Templates
- Continued Expansion of Cash Flow Vector Views and Reporting
- Migration of Structured Cash Flow Settings to Grid Based Interface w/Copy Template Capabilities
- Expanded File Import File Types: Excel, MS SQL Server Tables, Flat Files (w/out Headers)

CompassPoint™ features and capabilities reflect the business needs as defined and requested by its users. For additional information on new features or to submit suggestions and requests, please contact Rob Kessel at 415-925-2812 or e-mail at rkessel@compass-analytics.com.



Market Update

Since the sharp sell-off in May and early June, bonds have spent most of the last month consolidating, albeit with quite a bit of volatility in place. Yields on the 10-yr treasury dropped in the latter half of June, briefly ticking below 5.00%, before a ricochet sent yields back near 5.25%. The treasury market has spent the last couple of weeks searching for a comfort zone with the 10-yr yield seemingly contained between 5.00% and 5.25% for the time being.

With the yield curve stabilizing somewhat, focus returns to credit spreads and the risk of a further slowdown in the housing market. Hedge funds with large holdings in subprime mortgage securities, including some managed by UBS and Bear Stearns, saw dramatic losses, forcing creditors to seize then auction hundreds of millions in fund assets. Fire sales like this may be just beginning and the prices received in these sales will likely affect valuations for assets that to this point have performed reasonably well.

While a few subprime funds have made the headlines due to huge losses, the rating agencies have remained somewhat on the sidelines, cautious about rerating recent security issues that have yet to feel the foreclosure pinch. But, a change may be in the works. Standard & Poor's issued notice on July 10 that over \$12 billion in RMBS backed by subprime mortgages were being moved to the CreditWatch list. The securities were originally rated by S&P between the fourth quarter of 2005 and the fourth quarter of 2006. In addition to the notice regarding those specific issues, changes to S&P's rating methodology will likely affect the valuations of many RMBS issues going forward.

As much as ever, it seems that the Fed has its work cut out for it. Benchmark rates overseas have risen recently as inflation fears take hold in Europe and elsewhere. The Fed may be close to the growth/inflation balance they're after, but a further meltdown in credit spreads, especially if it's combined with higher benchmark rates, may push the housing market over the edge. It's always something. *—Lindsay Hill*

Topic of The Month: Fundamentals of Default and Loss Severity Modeling

With delinquencies and defaults on the rise, this is a good time to investigate the factors which may lead to a loss for an investor and how these factors are modeled. Of course, in the agency universe, the agency absorbs defaults as there is an explicit guarantee protecting the investor from principal and interest losses. With respect to non-agency investors, this is not the case. In order to properly model risk, many assumptions must be made. Two fundamental assumptions in cash flow risk-based pricing are the probability of default and the severity of the loss given a default.

When a borrower misses payments, the loan is said to be delinquent. Delinquencies are classified as greater than 30, 60, 90 and 120 days past due. The greater the delinquency of a loan, the less probable it is the borrower will become current or cured and the more likely the borrower will default. When a loan is greater than 90 days delinquent and the borrower is in default, foreclosure proceedings will typically begin. Foreclosure can be a long and costly process, as administrative, maintenance and sale costs accumulate. If the property is in poor condition, or repairs are required, the cost of foreclosure only grows. There are also legal and regulatory issues which may



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vary by state. On average, it takes about a year before the property is sold and the actual loss is realized. The more quickly the property can be liquidated, the less susceptibility of a loss to the investor. Given the costs and likely losses associated with delinquencies and foreclosure it is important to employ comprehensive default and loss severity modeling.

Loan level characteristics used to determine the probability of default such as FICO score, debt-to-income ratios and delinquencies are important inputs in any default model. Models should also provide the user the ability to modify observed collateral specific default rates on a loan level basis, allowing for more granular default modeling. For instance, an investor may want to reduce an observed default rate by 20% for FICO scores greater than 750, as FICO scores are negatively correlated with defaults. As a delinquent loan becomes more serious, the observed default rate can be scaled up. The capacity to modify the default rate on a loan level affords a means to a more polished default model, and in turn, a more accurate representation of future cash flows.

Though there are many factors correlated with loss severity in the event of foreclosure, the LTV ratio is a chief component in determining whether a loss will be incurred and the severity of the loss. Loss severity is defined as the percentage of the outstanding balance and accrued interest that is not recovered in the foreclosure transaction. As LTV increases, holding all else constant, so does loss severity. There is little chance of a loss when a first lien loan represents only 30 percent of the property value, even after the cost to foreclose. The outstanding principal balance and accrued interest payments will most likely be recovered through liquidation of the property. Though this represents an involuntary prepayment, the investor is made whole. The likelihood of fully recovering the delinquent interest and outstanding principal on an 80 percent or higher LTV loan is greatly diminished versus the 30 percent LTV loan, especially after accounting for the costs associated with foreclosing on the property. In a time of flat or falling home prices, the prospect of incurring a loss on a high LTV loan is magnified, as is the severity of the loss.

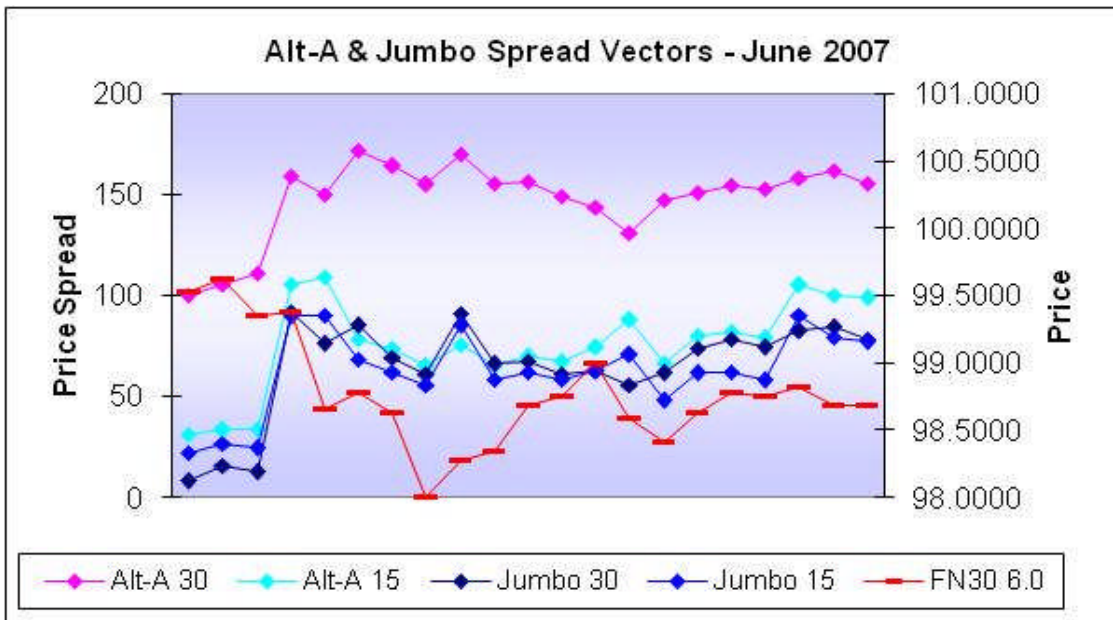
Other significant factors affecting loss severity include loan amount, interest rate and mortgage insurance. In general, again holding all else constant, a lower loan amount will increase the loss severity in that a greater percentage of its principal is eroded by the cost of foreclosure. Higher interest rate loans accrue a larger amount of unpaid interest to the outstanding principal balance, possibly leading to a negative equity situation. Mortgage Insurance is an obvious reason to scale down loss severity. All of these factors can be applied to loss severity models on a loan level basis and scaled to affect loss severity for fine-tuning cash flows in valuation models. These fundamental factors are the foundation of complex risk-based pricing models used in the valuation of loan pools and pipelines. Though many dealers and traders employ the same modeling techniques, it is typically performed on an aggregate basis rather than loan level. In a more robust pipeline, pool or MSR valuation model, any factor that is correlated to default or loss severity can be used as inputs into the model and applied at a loan level, arming the user with a powerful analytical tool and granularity on expected cash flows and losses. –*Virgil Caselli*



Alt A and Jumbo Spreads

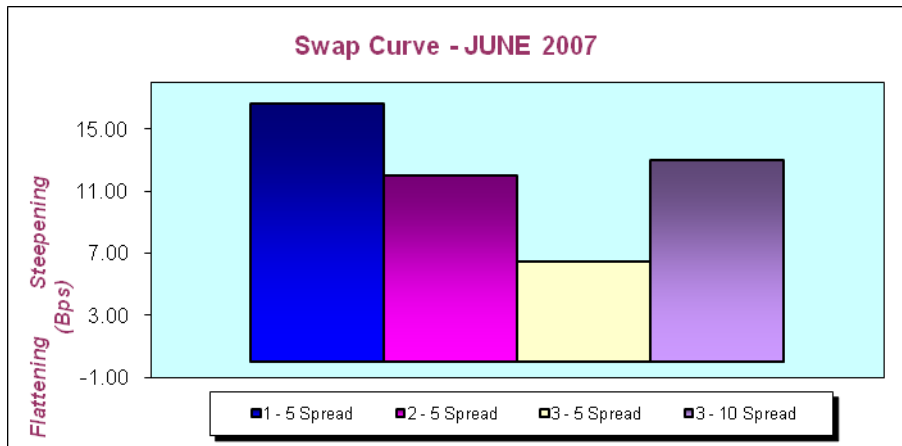
Alt-A and Jumbo spreads, for the most part, widened in June following a persistent tightening during the month of May, meanwhile there was more severe volatility in the MBS market than in the prior month. FN30 6.0's traded within a 162.5 basis point range, getting a sharp bounce mid-month with lower than expected core CPI readings, both month over month and year over year. The only sharp move in spreads occurred on the front end of the sell-off, but afterward stayed relatively range-bound for the remainder of the month. FN30 6.0's dropped from the beginning to the end of the month, but did not arrive there in a straight line. Between Bill Gross giving his first bond bearish comments in 20 years, then reverting back to being a bond bull and subprime hedge funds collapsing, the bond market had a great deal of information to process in June. Alt-A and Jumbo spreads ended the month significantly wider with a sharp move early in the month after Fed Chairman Ben Bernanke noted that the restriction of subprime credit may "restrain housing demand" and that inflation risks were "somewhat to the upside". This June widening may signal that, even though investors bid spreads throughout May, a long-term floor has not been found.

Compass's valuation of the Alt-A and Jumbo Fixed bulks in June derived prices within a 31bp average range from the winning bids. Investors have become notably more conservative and selective in their bidding on bulk products, with no consistent front-runner among investors looking to bid for bulk product. *-Dave Bennett*





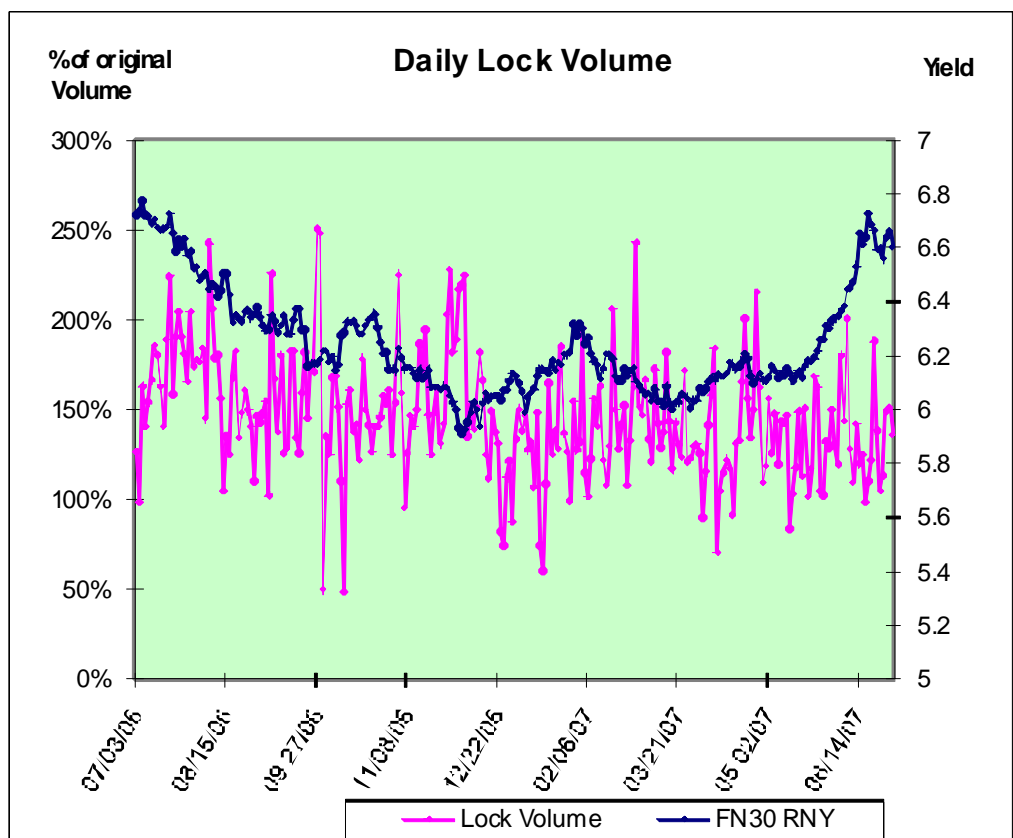
Hybrid Arm Hedge Analysis



The swap curve steepened significantly in June as short term yields were little changed and longer term yields rose on mounting concerns of accelerating inflation. Early June predictions of a Fed rate cut by the end of the year swung to apprehension of a possible rate hike following an unexpected increase by New Zealand's central bank and strong economic data prints. The 1 year LIBOR yield finished the month down 2 bps while the 10 year swap yield tacked on 21 bps, leaving the 1-10 swap spread with a positive slope of 27 bps to end June. -Virgil Caselli



Production Index



Production in June gained slightly while rates traded in a wider range (34bp range in June versus 26bp in May), with the average yield increasing 38bps from May. Average volume for the month was 136% of our base volume (vs. 129% in May) ranging from a low of 99% to a high of 201%. The average yield on the FN30 RNY in June was 6.59% (vs. 6.21% in May) ranging from a low of 6.38% to a high of 6.72%. —*Dave Bennett*