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The Month In Review

March 2007

What's New?

S & P LEVELS version 6.0 Summary: S&P and has released the latest version of its Residential Loan Pool rating and credit enhancement tool, LEVELS. LEVELS analyzes 70 different characteristics on each loan, determining foreclosure probability and loss severity rates, in turn leading to the level of credit enhancement required to rate the bond in a specific tranche.

Two enhancements included in LEVELS 6.0 are the abilities to rate Closed-End Second Lien loans and 100% LTV loans. LEVELS 5.7 only had the ability to rate loans less than 95% LTV and had no rating capabilities for Closed-End Second Lien loans.

There are also three major changes to the credit enhancement calculations. First, CLTV is now the primary driver of probability of default. In LEVELs 5.7, LTV was the primary driver and loans were penalized for carrying a simultaneous second. This simultaneous second penalty has been removed.

Second, the weight of the Risk Grade has been increased in the foreclosure frequency calculation. The four characteristics leading to the Risk Grade (CLTV, FICO, Property Type and Purpose) as a very predictive variable and therefore S&P saw reason to increase their weighting.

Lastly, there were changes made to the Risk Grade buckets and Credit Enhancement based on loan characteristics. Low FICO, LOW LTV loans were moved from the Prime credit category (RG4-RG5), to Sub-Prime risk grade categories (RG6-RG10). Low FICO, LOW LTV loans will require more CE, Sub-Prime and Alt-A deals with large simultaneous seconds transactions typically will require more CE, while those with a small simultaneous seconds transactions will require less CE. 80/20 loans will receive the same probability of default as a 100% LTV first lien. A 60/40 will have lower Loss Severity than the 80/20, yet they will have the same probability of default.

New in CompassPoint™!

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

- FAS 159 Support
- Beta SPIRE Integration
- Expanded Delinquency and Investor Advance Modeling
- Private Labeled Data Strats and Support for MS Excel 2007
- Expanded Cash Flow Detail Output (Avg. CPR, Price, Exp. Life, Others)

- Expand Loan Grouping Filters
- Configurable ODBC Time-Outs

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

Following a tough couple of months in December and January, bonds rebounded in February, with the 10-yr yield dropping from 4.79% on February 9th to 4.51% on March 2nd. Although the economic data released in the last month has still been mixed, with some sectors showing strength and others weakness, Fed chairman Bernanke helped bond holders with his semi-annual testimony before Congress. Many viewed Bernanke testimony as more dovish than expected, highlighted by his statement that there are "some indications that inflation pressures are beginning to diminish." The Fed is showing its patience and most participants now expect the Fed Funds rate to hold steady throughout 2007.

The improvement in treasuries over the last month has not necessarily translated into better pricing for mortgages, though, especially as one moves down the credit scale. Word of major problems, up to and including bankruptcies, have been coming out of the subprime sector for the last several weeks. The large aggregator/servicers have been slammed by delinquencies beyond expectation and many smaller sellers have been crushed by early payment defaults. Investor panic has crept into Alt-A programs, even at the higher end of the credit score continuum, with many lenders adjusting documentation standards and backing away from high CLTV programs.

It remains to be seen how deeply the recent credit implosion on the subprime side affects the broader mortgage market and the housing market as a whole. As credit standards tighten, it can be assumed that fewer people will qualify for home loans and demand for new and existing homes will be affected and housing price appreciation will struggle. That part of homeowner spending that has been fueled in recent years by home equity lines will also slip. It was apparent in the most recent recession that without the spending capability created by price appreciation and easily obtained credit that the economy would have suffered longer and deeper.

The Fed may have a tough road ahead in determining how deeply the fallout from the mortgage credit crunch will affect the broader economy. Job growth remains somewhat subdued and while average hourly earnings growth shows signs of picking-up, if home equity is tough to tap, then our consumer-driven economy is bound to take a hit. The Fed may have to come off the fence this year after all. *–Lindsay Hill*

Topic of the Month: FASB Statement No. 159 – An end to mandated "effectiveness testing".

The Financial Accounting Standards Board, on February 15, 2007, issued a standard that provides companies with an OPTION to report selected financial assets and liabilities at fair value. The Standard's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently.

Historically, generally accepted accounting principles have required different measurement attributes for assets such as loans in warehouse that are unsold (underlying assets) and the financial instruments used to hedge the potential change in value of those assets. This treatment not only created artificial volatility in earnings, but required extensive and often complicated effectiveness testing. Companies with hedging expertise, who elect to adopt FAS 159 should enjoy relatively subdued earnings volatility that results from having two offsetting instruments recorded at fair value. This Statement might be a welcome opportunity for companies to control their financial exposures and reduce their compliance paperwork at the same time.

Unlike current accounting practice, the fair value option established by this Statement permits companies to choose to measure eligible items at fair value at specified election dates. (See "Election Dates" below.) The company will report unrealized gains and losses on items for which the fair value option has been elected, in earnings at each subsequent reporting date. One of the most significant features of the Statement is that the fair value option may be applied instrument by instrument (with only a few exceptions, such as investments otherwise accounted-for by the equity method). The election is irrevocable (unless a new election date occurs) and the fair value option is applied only to entire instruments and not to portions of instruments.

The Statement is effective as of the beginning of a company's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the company ALSO elects to apply the provisions of FASB Statement No. 157 *Fair Value Measurements*. (FAS 157 defines fair value, establishes the framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements.) The Statement cannot be applied retrospectively to fiscal years preceding the effective date unless the company chooses early adoption. The choice to adopt early should be made after February 15, 2007, but within 120 days of the beginning of the fiscal year of adoption, provided the company has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The Statement **does** permit application of fair value treatment to eligible items existing at February 15, 2007 (or early adoption date).

Election Dates: A company may choose to elect the fair value option for an eligible item only on the date that one of the following occurs: 1) the company first recognizes the eligible item 2) the company enters into an eligible firm commitment 3) financial assets that have been reported at fair value with unrealized gains and losses included in earnings because of specialized accounting principles cease to qualify for that specialized accounting 4) the accounting treatment for an investment in another entity changes.

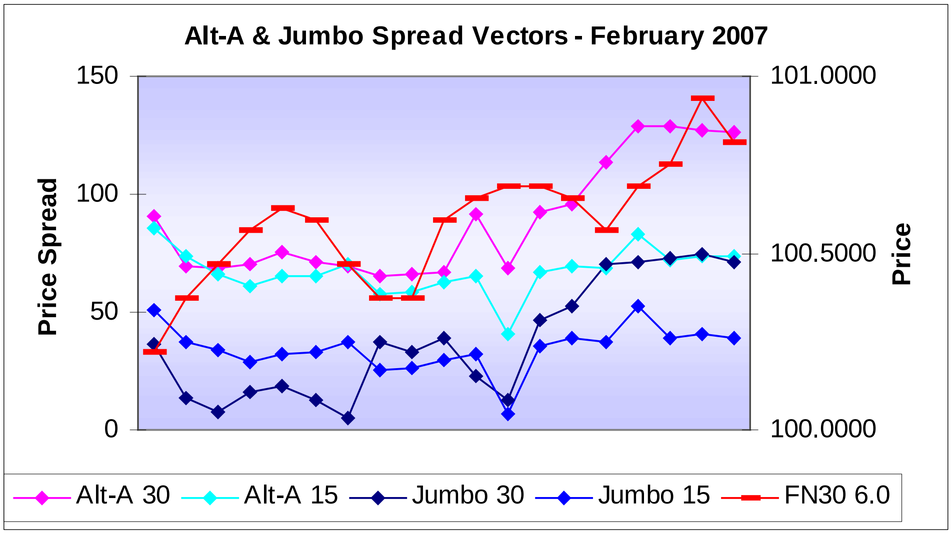
Conclusion: While there is some work to do in the year of adoption of FAS 159 (including the implementation of FAS 157) clearly the benefits of future reduced earnings volatility, combined with the elimination of cumbersome effectiveness testing, point to many companies electing early adoption of FAS 159. *– Teresa Wong*

(For more information, you can check out www.fasb.org. The accompanying Word document attached in the email has an illustrative example of the above with sample balance sheet entries as well.)

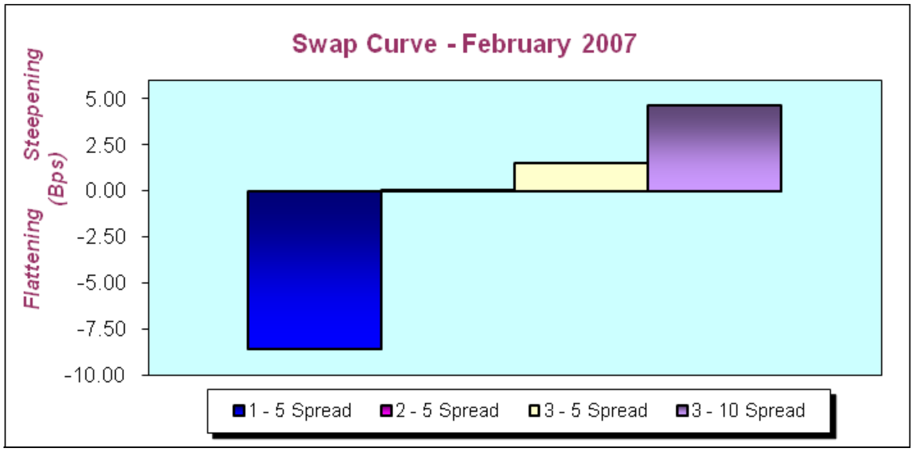
Alt A and Jumbo Spreads

After two months of a declining market, February ended with significantly higher MBS prices and spreads. FN30 6.0's increased 60 bps over the course of the month, with several spikes along the way. We saw a widening in Alt-A and Jumbo 30 year spreads; interestingly 15 year spreads moderately tightened. Spreads remained relatively stable through the first half of the month although the market continued to rise, then continued to fall. All spreads suddenly tightened on the short market Friday before the long weekend although the market remained relatively flat on PPI data coming in close to expectations. As can be seen in the graph below, all spreads returned to higher levels the following business day. We continued to see 30 year spreads widen through the rest of the month, most likely a result of the turmoil in the subprime market spilling into the Alt-A world. In the last week of February, several Alt-A investors weary of credit risk employed dramatic price hits to Alt-A collateral, clearly contributing to the widening of spreads.

Compass's valuation of the Alt-A and Jumbo Fixed bulks in February derived prices within a 30 bp average range from the winning bids. There was no notable pattern in investor performance this month, and the spread between investor bids remained relatively the same at an average range of 113 bps. *-Vimi Vasudeva*

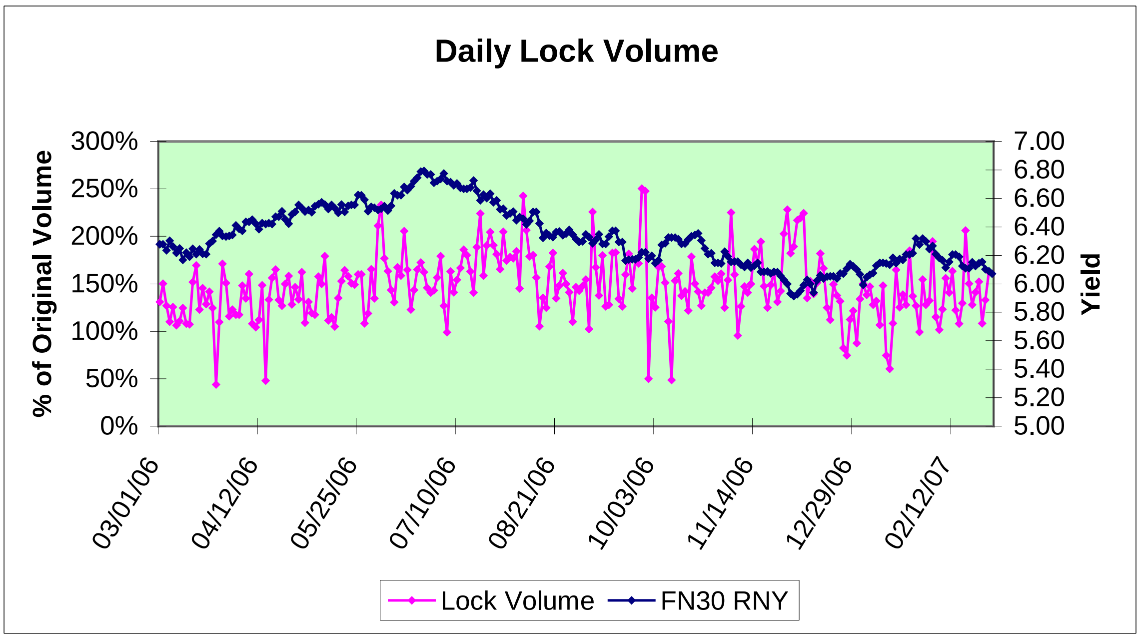


Hybrid Arm Hedge Analysis



Yields moved lower in three distinct rallies occurring in early, mid and late February. Events leading to the respective rallies included soft January employment data and Ben Bernanke's testimony before Congress in which he alluded to a moderating economy and a global equities shakeout, leading investors into high quality fixed income assets. Other than the 1 year LIBOR, yields fell in near uniform fashion across the swap curve, down an average of 28 bps, flattening the front end of the curve while leaving the belly unchanged. The 1-10 swap spread returned to a double-digit inversion, finishing February inverted by about 12 bps. *–Virgil Caselli*

Production Index



Production in February increased while rates, on average, stayed relatively unchanged month over month. Average volume for the month was 140% of our base volume (vs. 127% in January) ranging from a low of 102% to a high of 206%. The average yield on the FN30 RNY was 6.16% (vs. 6.16% in January) although trading in a tighter range than January with a low of 6.01% to a high of 6.27%. *–Bob Gundel*