

The Month In Review

February 2008

What's New?

The official announcement regarding Conventional Jumbos was released yesterday and it appears that Jumbo Agency's are going to trade as specified pools. This is discussed briefly in the Market Update section below and Compass will also be hosting a roundtable, training discussion on this topic on March 25th.

Compass's Webinar training sessions for March include:

- *The ABC's of AOT's on March 11th at 12:00 PST*
- *Roundtable on Hedging Conforming Jumbo's on March 25th at 12:00 PST*

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.

Profit Perspective: The value of a loan is a product of both its market price and its true cost. Ignore either one and valuation accuracy is lost.

New in CompassPoint™!

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

- Change Tracking
- SPIRE 2.2 Integration
- Levels 6.2 Integration
- Enhanced Stratification-Excel Output Options
- Stratification Numeric Auto-Distinct
- Multi-Client Trade Entry Task
- Roll/Swap TBA Functionality (Single, Multi-Trade, Multi-Ticket)
- Auto-Trade ID
- XML Export Option
- Expanded File Import Bulk Insert Options
- Sub-Deal Workflow Tracking
- Composite PDF Creator

- AD-CO Simulation/Start Date Options
- MSR Key Rate Duration Derivation & Output

Additional Risk Management Reports:

- Trade Confirmation
- Commitment Detail
- Position Overview - D&I
- Shock Summary D&I
- GL Summary - Gross

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 415-462-7500 or e-mail at rkessel@compass-analytics.com.

Topic of the Month: Measuring Fallout

With the volatility that has been experienced over the last few months in the market, fallout has re-taken its spot center stage as one of the most important issues facing a secondary marketing manager (SMM) today. Model based hedging programs try to predict pull-through functions so that lock value may be preserved. All models, from a dynamic pull-through to a delta-based model, have had their challenges in this latest environment due to a couple of factors: the further commoditization of the product-base and market volatility.

In order to hedge effectively, a mortgage banker must have a good handle on the pipeline and what is/isn't going to pull-through. To the extent that an SMM can accurately gauge the quality of the lock base and the respective values, the more accurately he/she can hedge the pipeline. This quality manifests itself through a sustained 2-way communication highway between the secondary department and the originators. If a lock that has 20 days remaining is really not going to close, and the SMM knows this, the loan clearly needs to be taken out of the pipeline and/or hedged position.

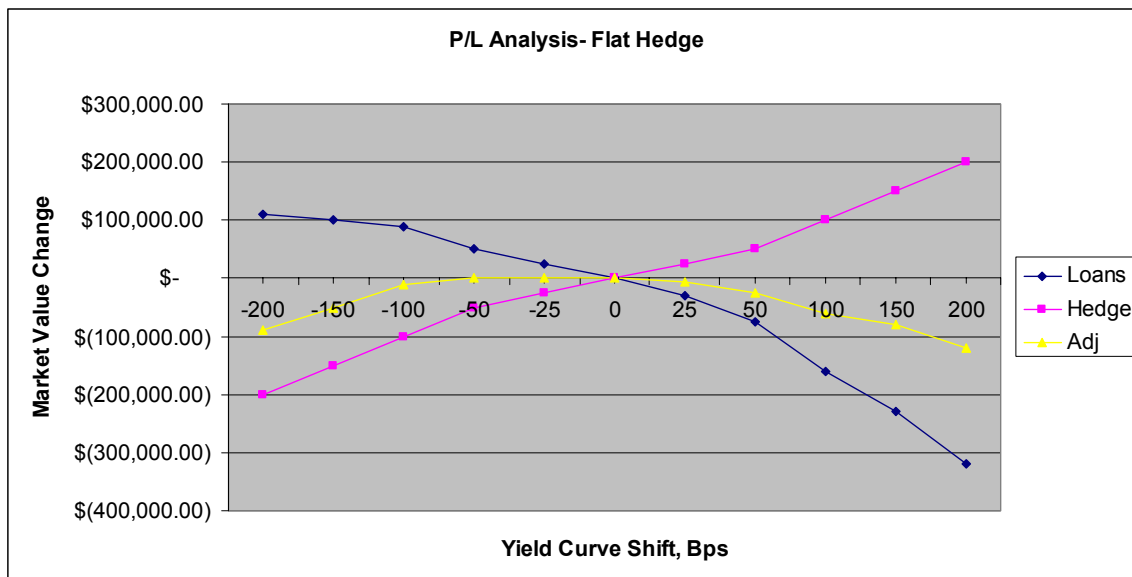
Aside from the very important aspect of knowing the pipeline, there are also myriad of other factors of the loans origination that affect the quality of the pull-through assumption. Some of these are:

1. Market Move
2. Product Type
3. Loan Purpose (Purchase vs. Refi)
4. Lock Period
5. Processing status
6. Source of Loan
 - Retail vs. Wholesale
 - Geographic
 - Branch
7. Other Considerations

- Rate Lock Policy
- Management Decisions

Any one of these attributes can substantially increase/decrease the effective pull-through and affect overall profitability. It is imperative that the SMM discovers through evaluation which of these attributes correlates with originator practices that are beneficial/non-beneficial to the company, and incent/disincent those behaviors. For instance, if the SMM discovers that all loans from a particular broker have a pull-through of 20% there needs to be serious repercussions imposed upon the broker at the very least which may include disincentives for continued low pull-through and/or a model change to a delta based approach to better match the risk of that broker.

The topic of fallout ultimately gets back to the hedging model that is employed. A hedging model in its most simplistic format is a static percent coverage strategy based on historic pull-through. Below is a chart of typical profit results from a static pull-through when the market shocks in one direction.



As you can see, when the market moves in either direction, the negative convexity of the underlying asset shines through and creates greater and greater losses when the yields move further away from zero change in either direction. Because SMM's face lower pull-throughs in a rallying market and higher pull-throughs in a declining market, the static coverage percentage performs its best in a flat market, where it only breaks even.

In order to counter this negative convexity, there are a couple of things that can be done such as moving to a more powerful model that adjusts its pull-through assumptions based on market movement like a dynamic pull-through model or a delta model that will treat the locks as a put option to the borrower. Other choices include more complex solutions such as adding options.

Finally, the last consideration in managing fallout is to evaluate the company's rate lock policy and its effects on fallout. Make no mistake; renegotiations are fallout because the SMM is giving away the inherent value of the lock in exchange for being able to close the loan. However, since the loan was hedged when the market rallied, the full value of the loss on the hedge is realized, thus resulting in a net loss. The rate lock policy has everything to do with controlling this slow bleed. The more renegotiations, the more the originators will come to expect it. It is imperative that originators understand that the rate lock policy is set in stone and that exceptions will be made only in rare circumstances. Not only do renegotiations cost money, they also are a major time sink in constantly negotiating with the sales force on price and rate. In the end, a rate lock policy that is fair, reasonable and promotes positive business relationships is ideal. It is to the advantage of the SMM to play up the business relationship with the originators as much as possible. – *Brandon Case*

Market Update

Bond market bulls had much to enjoy through the first few weeks of January. The Fed continued its aggressive move towards lower rates and further signs of recession helped bring the long end of the curve lower. Then, as January waned, the volatility kicked-in. Both bonds and equities had much to ponder with the Fed's double-whammy rate drop and prices in both markets experienced huge swings. While treasury yields continued lower in January, mortgages, and other credit products, were still faced with significant obstacles.

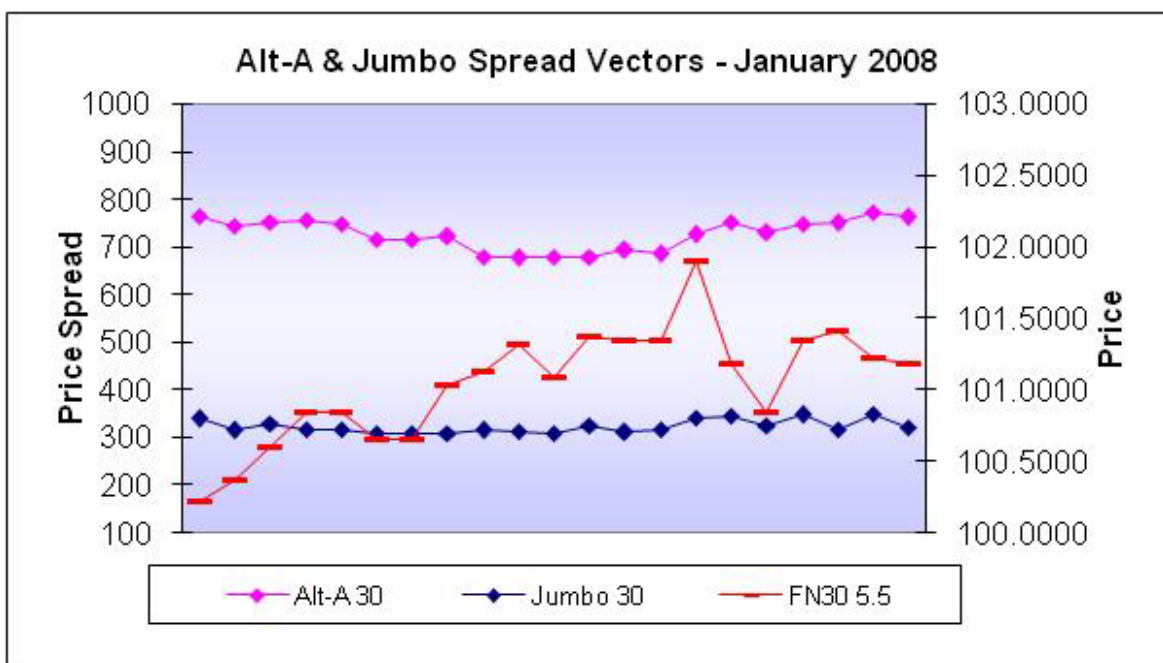
Among the latest on the hit list are bond insurers as MBIA and Ambac face uphill battles to remain solvent. Despite capital infusions and pledges by new participants like Berkshire Hathaway – in this case, on the municipal bond side – to reinsure certain products, the downgrading of products and participants seems far from over and much of these losses are still being pushed out to the future.

If there's some glimmer of light down the tunnel, it's in the form of the GSE loan-limit provision in the congressional stimulus package. An estimated 200,000 borrowers would be given the opportunity to obtain a FNMA/FHLMC mortgage under the new loan-limit guidelines.

Questions remain on how these agency jumbo loans will fit in the MBS market. The least disruptive option would be to keep jumbo loans in separate, specified pools which would then trade back from standard, agency TBAs. This should keep the standard TBAs trading in a similar spread range vs. other products like treasuries. Another option is to allow agency jumbo loans to be delivered alongside standard agency loans. The likely effect of this would be to widen the spreads on TBAs to a point somewhere between their typical levels and the levels that would be expected on separate, agency jumbo pools. In essence, standard loan-limit borrowers would likely subsidize

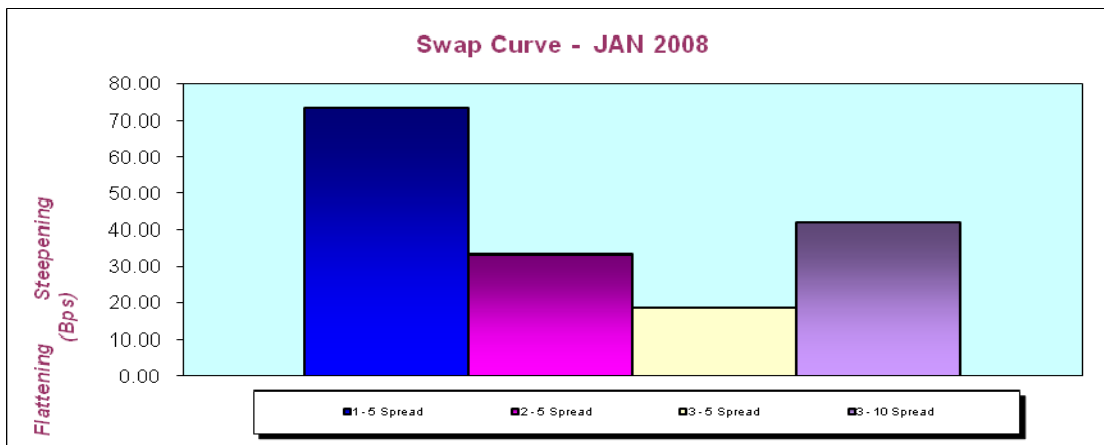
jumbo borrowers to some extent in this scenario. Either way, more options to obtain credit for more borrowers are at the least a positive step in the short term. *-Lindsay Hill*

Alt A and Jumbo Spreads



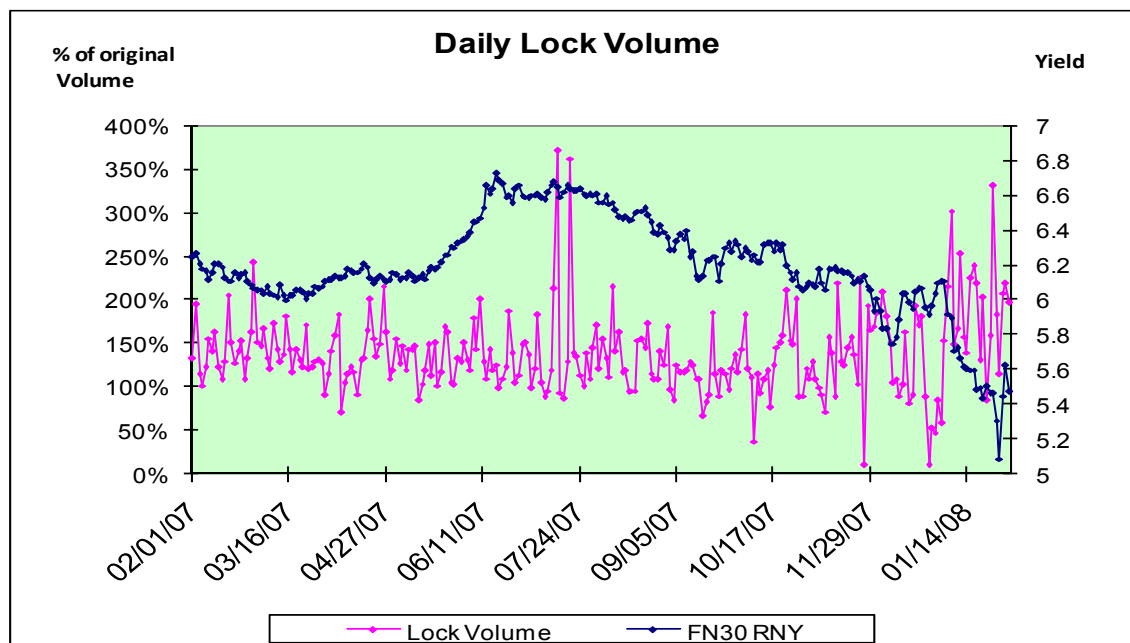
Alt-A and Jumbo spreads experienced relatively range-bound trading with a slight tightening during the month. FN30 5.5's chopped around in a very volatile month. The range widened in January (168bps vs. 97bps in December), as there were very pronounced swings. The month started off with Nonfarm Payrolls printing at 17K vs. an expectation of 70K, despite ADP coming in above expectations. The weaker labor outlook caused many economists to increase estimates that the economy could fall into a recession. Banks, builders and bond insurers continued to struggle as Citigroup was forced to raise \$10B from foreign investors, Lennar sold 11,000 homes at 40 cents on the dollar, and bankruptcy was priced into credit default swaps on Ambac and MBIA. On January 11th, Fed Chairman Bernanke promised, "substantive additional action" should the economy show further weakness. On January 22nd, the Fed acted on that promise with an emergency inter-meeting cut of 75bps when the Dow looked like it was going to open down 500 points. President Bush then proposed a \$150 Economic Stimulus Plan that would give money back to consumers and possibly raise GSE limits. At the January 30th meeting, the Fed lowered the Fed Funds rate another 50bps to 3%. In treasuries, the bull-steepening rally left 2-10's at 153bps at the end of the month (started month at 99bps). Although spreads appear to have leveled out, there is still a great deal of volatility in the market that could push spreads wider. *-Dave Bennett*

Swap Curve Analysis



January proved to be an extremely volatile month with yields plummeting and the LIBOR/Swap curve steepening in dramatic fashion. The short end of the curve fell faster than longer dated maturities, led by the LIBOR which fell 137 bps. The 1-10 LIBOR/Swap spread widened 96 bps leaving the spread at about 141 bps to end January. -Virgil Caselli

Production Index



Production in January increased while rates traded in a wider range (81bp range in January versus 36bp in December), with the average yield decreasing 44.5bps from December. Average volume for the month was 187% of our base volume (vs. 124% in December) ranging from a low of 59% to a high of 331%. The average yield on the FN30 RNY in January was 5.52% (vs. 5.965% in December) ranging from a low of 5.085% to a high of 5.895%. *-Dave Bennett*