

The Month In Review

January 2008

What's New?

In an effort to keep on top of important hot topics in this volatile market, Compass will be augmenting its monthly newsletter content with visiting contributor pieces on mortgage insurance, credit market updates and mortgage servicing rights valuations with an *MI Moment*, *Credit Corner* and *Servicing Segment*, respectively. In keeping with our alliterative segments, there will also be a very brief Profit Perspective where Compass will share a couple of quick tips on maximizing Secondary performance. These pieces will begin showing up next month so stay tuned...

Compass kicks off its 2008 training series with two new Webinars sessions in February:

- *Measuring Fallout*, Tuesday, February 12th at 12:00 PST
- *Valuing Mortgage Servicing Rights*, Tuesday, February 26th 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.

New in CompassPoint™!

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

- Loan-Level Servicing Fee.
- Expanded Directed Coupon Capability
- Expanded Deal Management/Tracking
- Improved MSR Accounting
- Improved Model Maintenance
- Recourse Model Enhancements
- Automatic Assumption Grouping in WL and MSR Valuation Grids
- Composite Forward Current Coupon Forecasts for Prepayment Models
- Optimization of Large Data Update Processes
- Expanded Error Reporting on WL/MSR Valuations

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: Risks & Opportunities in Hedging Jumbo Loans in 2008

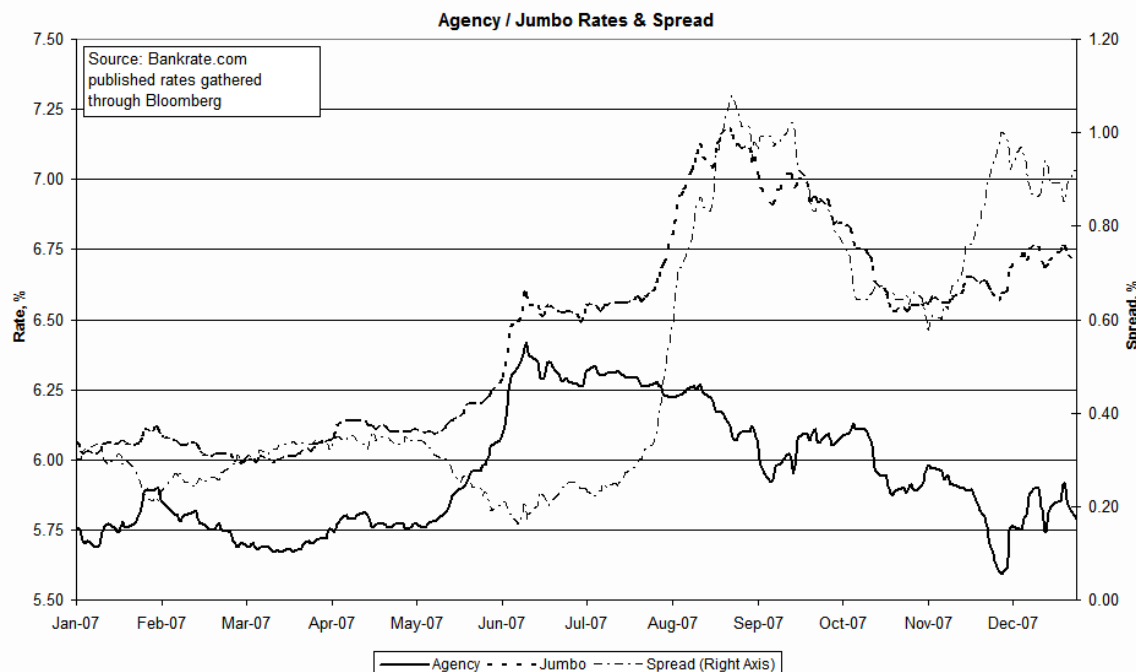
The following is a preview of an article that will be published in the *Secondary Marketing Executive* in February, 2008.

So, you've asked yourself "when will it be time to start hedging Jumbo loans again?" You know that the margins are bigger, and you know there is a demand out there, especially in high cost areas where the median loan is above the \$417,000 conforming limit. In answering the hedging question, a natural place to start is by identifying the value proposition, more specifically what is the current pickup in price you might expect by selling loans on a closed, mandatory basis versus selling loans upon lock on an individual, best efforts basis. Another question you might ask yourself is what additional volume, market share and profits can you generate by offering more competitive pricing? Current market conditions suggest possible pick-ups in price in excess of 30 basis points (bps) by selling Jumbo loans on a mandatory flow or bulk basis, so it might seem tempting to get back into the game. Even more tempting is the fact that the rate spread between agency and Jumbo loans are at or near historically wide levels with the chance of any narrowing of this spread during the hedging period accruing straight to your bottom line.

Besides identifying the possible gains associated with hedging your Jumbo production again, you also need to be comfortable with where you will be on the Risk/Reward continuum. Since July of 2007, as you went out on the risk curve, i.e. lower credit quality loans, your risk has grown significantly. Memories are still fresh from last summer when locked, hedged pipelines suffered dramatically as investors systematically stopped accepting certain credit features and Jumbo spreads quickly widened (prices dropped). Before deciding on whether or not to hedge your Jumbo production again, you need to understand what caused last summer's "value realignment" and the best place to start is by dissecting what went wrong and how the mortgage crisis began.

The common themes from the prolific analysis on "what went wrong" include: underwriting standards were too loose, inappropriate loans were too easy to come by, and the default potential of mortgage loans was grossly underestimated – all due to overly optimistic expectations of future housing appreciation. The housing bubble was fueled by low rates, easy underwriting standards, and the promise of spectacular profits to be made in real estate. Prior to the meltdown, the economy was chugging along, inflation was in check, and everyone was making money in subprime and Alt-A origination. Then, within short order, subprime delinquencies ticked up appreciably, home sales inventories started their steady climb, lending standards tightened, and the secondary market for Subprime and Alt-A evaporated as liquidity for all non-agency products disappeared.

Now that we've laid the foundation as to why the crisis occurred, we can start to identify what signals we might observe to help us decide when to get back into hedging Jumbo loans. One of the first things to look for is stabilization and/or a narrowing of the Jumbo to Agency rate spread. Below is a chart showing the average spread of conforming A Paper to Jumbo rates for 2007. It is highlighted how much wider spreads have become since the mortgage crisis began.



So what does this chart mean to you? One of the most common practices when hedging Jumbo Loans is to hedge them with TBA (To Be Announced) Agency Mortgage Backed Securities (MBS), because that hedge represents the most correlated hedge instrument available to hedge fixed Jumbo production. This choice of hedge works well as long as the spreads between Conventional and Jumbo pricing remain stable. Whenever spreads widen significantly, as they did as the mortgage crisis unfolded (see July-September period on the chart above), this correlation goes sour, and the hedge performance using this method performs poorly. In other words, hedge gains/losses do not offset loan gains/ losses. In the July-September period of 2007, TBA hedges and loans both lost money!

Now that spreads have widened out, they have to narrow again eventually, right? To appreciate the ups and downs of spreads, talk to the secondary marketing managers who resumed hedging Jumbos last November. Ongoing analysis should rest on whether the best efforts-mandatory spread, potential bulking opportunities, and other hedging pickups available are large enough to warrant the risks of spreads widening out after locks are accepted. To get a better handle on what may cause Jumbo-conforming spreads to widen, we need to take a deeper look as the fundamentals underlying the spreads. Currently, the primary reason for Jumbo pool pricing diverging from agency pricing is the utter lack of liquidity in non-agency product. When the crisis began, agencies widened to treasuries initially, Jumbo widened to agency, and Alt-A widened to Jumbos. Agencies have since tightened back to treasuries, but non-agency products have not tightened back to pre-July 2007 levels. When there is no difference in credit quality or prepayment assumptions between Jumbo and conventional loans, shouldn't they have reasonably similar

pricing? We have observed the answer to that question - the agencies government-backed principal guarantee and portfolio bid has translated into substantially different perceptions of risk. Non-agency investors do not have principal guarantees and fear rating agency accuracy and future housing depreciation will translate into principal losses. More important than principal loss concerns, investors still remember last summer when no traders would even bid on non-agency loans or bonds. In today's environment, few investors want to commit to owning loans or bonds to maturity or until the market recovers. This is the biggest hurdle with regards to a return to an increased Jumbo loan bid. The investor community, having been recently burned, has to feel comfortable with their risk in Jumbo loans, and the models that value them. As of the date of this article, traders have described the trading and liquidity of AAA bonds backed by Jumbo product as "spotty", meaning that there is still a substantial amount of uncertainty in valuation and potential for price volatility in the near term.

What does this tell us? It suggests to us a laundry list of events that need to happen to portend the tightening or stabilization of spreads and a return of liquidity. Credit rating agencies need to regain investor confidence while at the same time gaining confidence in the underlying fundamentals and assumptions that impact their credit ratings. In other words, the rating agencies have to see what they have not seen to date, predictability in delinquency rates and house values, to feel confident about their ratings and models. This will start to happen as new Jumbo production with far tighter underwriting guidelines starts to outperform previous vintages and the housing market starts to stabilize.

More specifically, what signs should you watch for to pick your point of re-entry? Ultimately, your point of entry will depend on your risk tolerance, but the following signals should provide useful guidance in picking that point:

- Stabilization of Jumbo-conforming spreads, e.g., several months of consistent or tightening spreads.
- Predictability of Case-Schiller or OFHEO home price indexes, e.g., results consistent with or better than expectations for several months.
- Delinquency and foreclosure data on newer Jumbo vintages start to show markedly better delinquency performance.
- Older vintage production exhibits improved or more predictable delinquency and foreclosure performance.
- Cessation of rating agency downgrades.
- Cessation of bank loan-reserve write-downs.
- Growth in the number of Jumbo investors.

At this time, 2008 looks like a year fraught with risk. As loan reserve write-downs and the street settle down, we hope reason will prevail and street research will start to focus more narrowly on the performance of high credit quality Jumbo production. This research and color should help investors regain confidence in Jumbo production, which will drive the tightening of spreads and the return of liquidity. The market remains intimidating but paying diligent attention to market conditions will present significant opportunities to those willing to resume hedging their Jumbo production.

—Brandon Case and Rob Kessel

Market Update

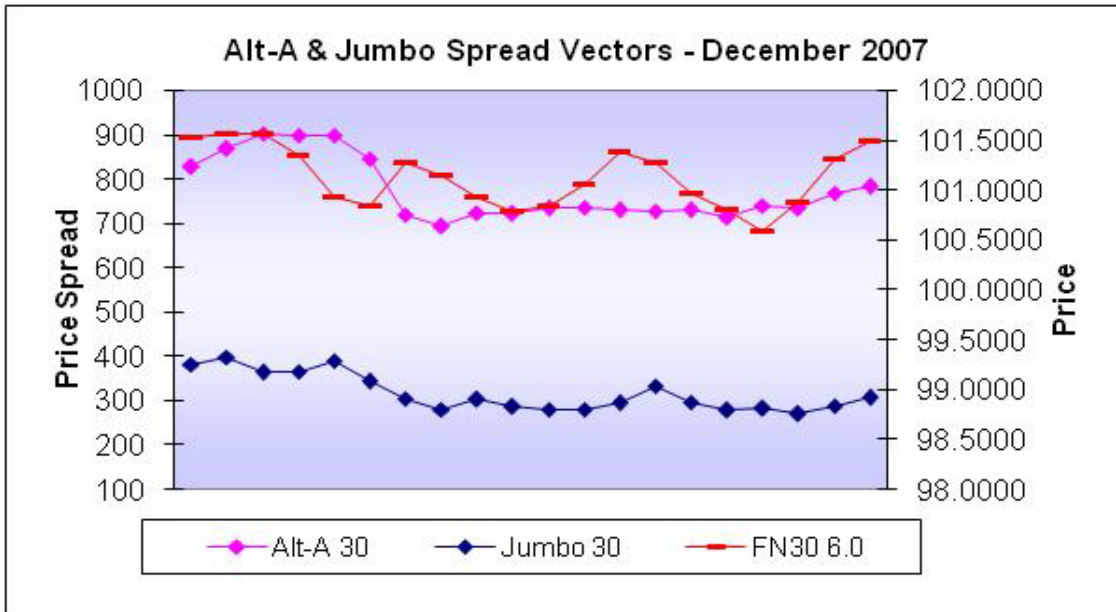
Following an increase in rates during the first half of December, treasury and mortgage rates began falling once again as the Fed continues to signal the likelihood of deeper rate cuts ahead. Following another weak employment report for December, the Fed, including Bernanke, have apparently moved off of the “balanced risks” stance and are adopting a policy to combat further slowing in the economy. Fed Funds futures point strongly towards a 50 basis point move by the Fed at their next meeting and many economists are now predicting at least a brief recession in 2008.

Although the Fed is concerned about growth prospects going forward, they also remain concerned about inflation as commodity prices continue to rise; obviously, not a great recipe. But, as the economy slows, inflation should dip back into the comfort zone and the Fed now sees the weak economy as being the more urgent issue. Mortgage rates approached their recent lows as support for this position increases.

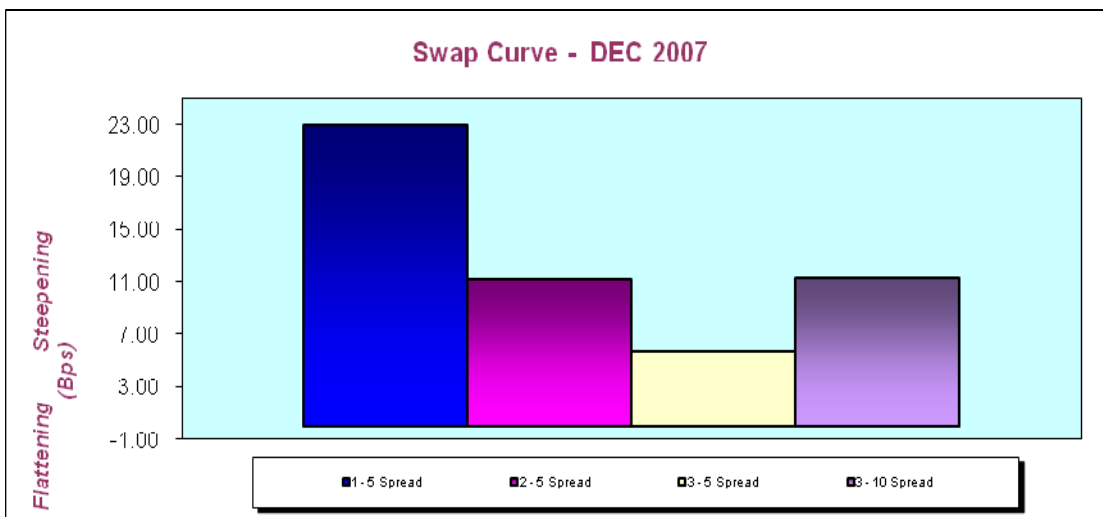
Bank of America's proposed purchase of Countrywide grabbed the recent headlines and many wonder whether BofA is making a wise move. There are certainly losses still to be realized in Countrywide's assets but BofA grabs a huge share of the mortgage market for that time when things stabilize. The aggressive move by BofA may lead to other big deals as Wall Street tries to pick up market share at a discount. Among possible deals, it appears that JP Morgan Chase may be looking closely at WAMU. Suffice to say that a market that has taken the hits that the mortgage market has taken over the last year is ripe for consolidation. If a slow economy drives us into a refinance boom, those that bucked the trend and increased market share will likely look back fondly on their decision. *—Lindsay Hill*

Alt A and Jumbo Spreads

Alt-A and Jumbo spreads experienced relatively range-bound trading and tightened a small amount after widening in November. FN30 6.0's chopped around in a very volatile month. Even though the range was tighter (97bps vs. 122bps in November), there were much more pronounced swings. The month started off with Nonfarm Payrolls printing at 94K vs. an expectation of 80K, along with upward revisions to previous months, showing a much more robust job market than many economists had forecasted. On the heels of this release, the Fed announced that there would be only a 25bp cut to the Fed Funds Rate when the market was looking more for an extra quarter point on top of that. Then the write-downs continued to filter out: Toll Brothers - \$81.8MM, first quarterly loss in 21 years as a public company, Bear Stearns - \$854MM 4th quarter loss (\$6.91/share), and IndyMac - announced that they would not be profitable until the second half of 2008. These announcements left a gloomier outlook for growth in the economy. So, even though inflationary data is prevalent - gold hitting new highs, oil briefly breaking above \$100/barrel, and Import Prices increasing 11.4% year over year - the Fed seems much more leery about having the economy fall into a recession. In treasuries, the bull-steepening rally left 2-10's at 97.5bps at the end of the month (2-10's started the month at 94bps). Although spreads appear to have leveled out, there is still a great deal of volatility in the market that could push spreads even wider. *—Dave Bennett*



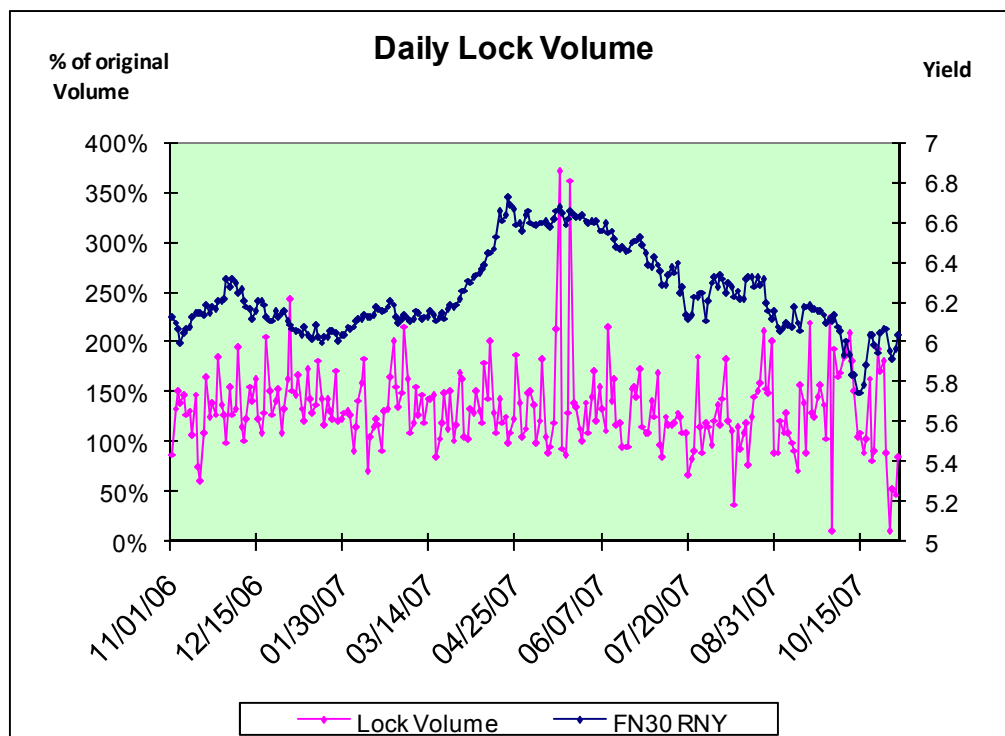
Swap Curve Analysis



The LIBOR Swap curve moved in less dramatic fashion through December versus the prior two months. The curve showed moderate steepening with the 1 year LIBOR yield continuing its

decline, falling 23 bps, while mid-curve swap yields dropped an average of only 6 bps. The 1-10 LIBOR/Swap spread widened 28 bps as the 10 year swap yield picked up 5 bps, leaving the spread at about 45 bps to end December. -Virgil Caselli

Production Index



Production in December decreased while rates traded in a wider range (36bp range in December versus 35bp in November), with the average yield decreasing 13.5bps from November. Average volume for the month was 124% of our base volume (vs. 132% in November) ranging from a low of 10% to a high of 209%. The average yield on the FN30 RNY in December was 5.965% (vs. 6.10% in November) ranging from a low of 5.75% to a high of 6.11%. -Dave Bennett