

The Month in Review

June 2008

What's New?

We look forward to seeing many of you at the Western Secondary Conference in San Francisco and be sure to read the MI Corner piece below.

Compass continues its monthly Webinar training series with the following sessions:

- For Compass customers, we will be holding a report training session covering our *Risk Position and Best Execution Reports* on Tuesday, June 24th at noon PT, and
- *Principals of Co-Issue Delivery* on Tuesday, July 15th at noon PT

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.

New in CompassPoint™!

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

- Flexible HPI Vector Imports
- Adjusted LTV Vectors as Variables Exposed for Model Adjustors (e.g. Delinquency and Severity)
- Improved REO/Foreclosure Timing and Control
- Current Property Value and Property Value Vector System Variables
- Best Execution of Loan Modification Options
- Shock Scenarios Exposed in Portfolio Valuation
- Expanded Report Batch with Ability to Call Base, Scenario and Shock Reports and Cash Flows.
- Expanded LMM Swaption Fitting Diagnostics
- Expanded Pool Grouping
- Enhanced Key Rate Durations

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.

MI Corner – Managing through the Credit Abyss - State of the Market

The US mortgage insurance industry is vastly different today than it was twelve months ago. The industry’s credit risk appetite has diminished precipitously. Most high risk products are gone from the market. Once MIs emerge from the abyss of credit losses in 2010, it will be a very different MI Industry going forward.

The rating agencies have recently started to downgrade the monoline MIs from the AA credit en. Triad, Radian, PMI, and MGIC are no longer AA rated MI counter-parties. Instead, UG (AA+), Genworth (AA), and RMIC (AA-) are the only three AA rated MI counter-parties. The table below provides details on the rating status of each of these seven companies.

		Fitch	S&P	Moody's
Mortgage Guaranty Insurance Corp.	Rating Outlook / Watch Status Date of Last Update / Affirmation	A+ Rating Watch Negative 6/5/2008	A Negative Outlook 4/8/2008	Aa2 Watch Possible Downgrade 1/31/2008
PMI Mortgage Insurance Co.	Rating Outlook / Watch Status Date of Last Update / Affirmation	A+ Rating Watch Negative 6/5/2008	A+ Negative Outlook 4/8/2008	Aa2 Watch Possible Downgrade 1/31/2008
Radian Guaranty Inc.	Rating Outlook / Watch Status Date of Last Update / Affirmation	Rating Withdrawn 5/2/2008	A Credit Watch Negative 4/8/2008	Aa3 Watch Possible Downgrade 1/31/2008
Republic Mortgage Insurance Co.	Rating Outlook /	AA- Rating Watch	AA- Negative Outlook	Aa3 Negative Outlook

	Watch Status Date of Last Update / Affirmation	Negative 6/5/2008	4/8/2008	1/31/2008
Genworth Mortgage Insurance Corp.	Rating Outlook / Watch Status Date of Last Update / Affirmation	AA Rating Watch Negative 6/5/2008	AA Negative Outlook 2/13/2008	Aa2 Negative Outlook 1/31/2008
United Guaranty Residential Insurance Co.	Rating Outlook / Watch Status Date of Last Update / Affirmation	AA+ Rating Watch Negative 5/5/2008	AA+ Credit Watch Negative 5/5/2008	Aa2 Watch Possible Downgrade 5/9/2008
Triad Guaranty Insurance Corp.	Rating Outlook / Watch Status Date of Last Update / Affirmation	BB Rating Watch Negative 5/2/2008	BBB Credit Watch Negative 4/3/2008	Baa3 Watch Possible Downgrade 4/2/2008

MI Loss Ratios are calculated as paid losses plus the change in incurred losses, calculated from increasing or decreasing delinquencies. Any loss ratio number over 80% is at best break-even to the P&L. Most MIs run an expense ratio in the 20% range. The combined ratio is the loss ratio plus the expense ratio, where any number below 100% shows an underwriting profit and any number above 100% shows an underwriting loss. The MIs can still be profitable at higher combined ratios of over 100% due to float income of their investment portfolios and the lag of paid claims to incurred claims. Most insurance companies earn the float income off their investment portfolios of another 5%-7% in yield.

So as a measure of MI industry health, the loss ratio is a key driver in profitability and return on equity. The lower the loss ratio is, the better the underwriting performance. As you can see in the chart below, the MI industry is paying and reserving for future claims. Premiums must increase across the board in order to rebuild the industry's balance sheet.

MI Loss Ratios

	Q4 2007	Q1 2008
Mortgage Guaranty Insurance Corp.	400%	200%
PMI Mortgage Insurance Co.	252%	258%
Radian Guaranty Inc.	294%	264%
Republic Mortgage Insurance Co.	167%	181%
Genworth Mortgage Insurance Corp.	109%	142%
Triad Guaranty Insurance Corp.	262%	307%
United Guaranty Residential Insurance Co.	248%	235%

In the past, the MI industry has enabled our clients to roll-out high risk products for two reasons: cure rates (cure rate is delinquency brought current by selling the home or refinancing the mortgage) in 85%+ range, and such high risk products were captive eligible. This is no longer the case. Cure rates are much lower since the borrower can no longer quickly sell their home or refinance into high LTV Sub-prime loan program.

Most seasoned mortgage professionals knew this day was coming due to poor underwriting decisions. Credit assessment of employment and asset verification was lax and the housing market was overvalued relative rents. The market conditions for the past several years did not encourage or support strong underwriting principles. Strong property appreciation masked underwriting deficiencies. The use of exotic loan structures, especially with LTVs of greater than 95%, increased risk layering.

As the market manages through the current credit abyss, what will be next for the US MI Industry? The industry is paying out historically high rates of paid claims and incurred claims (delinquency reserves). The market desperately needs a healthy MI industry.

Below is the current strategy that most MIs are employing to improve their P&L and Balance Sheet.

Rule #1: Improve Credit Quality

The first step the MI industry needs to take is a prudent and disciplined underwriting strategy so that we can underwrite the good risks and deny the bad risks or uninsurable risks. A back-to-basics approach is warranted. The MI industry is refocusing its efforts on the 3 C's of underwriting – Capacity, Collateral, Collateral:

- ▶ **Capacity – Can the borrower pay?**
 - > Determine if the borrower has sufficient income to pay all of his monthly debt obligations – including the house payment.
 - > The Debt to Income (DTI) ratio is the best metric for borrower affordability. This ratio measures gross monthly income for net mortgage, credit, and car payment.
- ▶ **Credit – Will the borrower pay?**
 - > If the Borrower has the “capacity” to pay, does his/her experience indicate the self-discipline to make payments in a timely fashion?
 - > Can the underwriter analyze certain credit trends in a credit report besides looking at a FICO?
- ▶ **Collateral – What if the borrower doesn’t pay?**
 - > If the borrower stops making payments, is the property value sufficient to cover the subject loan?
 - > Is the 90% LTV really going to be a 90% LTV 6 months from now? (In other words, is the property value appreciating, or depreciating, and how quickly?)

Rule #2: Increase MI pricing

The next step the MI industry needs to take is systematically re-pricing credit risk for the current market going forward. The MI industry’s pricing models were built on lower default curves, lower loss severity, higher cure rates, and home price appreciation. This is not the case today where most markets are in a decline.

MI premiums need to increase for the industry to stabilize its balance sheet and build capital to again open up underwriting/pricing guidelines. The practice of deeply discounting LPMI relative to published BPMI rates is no longer viable. **Financed MI is now the best MI execution to the borrower in the market.**

The good news is that most new production in 2008 is of very clean product. However, there are significant systemic risks to the health of the MI industry. Declining markets in California, Arizona, Nevada, and Florida, layered with a pending recession in the US, are two major concerns for the MI industry.

Rule #3: Cleanse the Portfolio

The last step for the MI industry to return to profitability is to cleanse its portfolio of high risk products through pro-active loss mitigation efforts. Most MIs allow loan modifications, temporary indulgence, short-sales, and short-refinances on their at-risk book. This is the tail risk hurts the MI business model. This credit risk optimization process of cleansing high risk mix off the portfolio is very important so the industry can start to rebuild its capital.

As we manage through the credit abyss let’s remember why we got here – poor underwriting practices, lending to high risk credits, exotic loan products, and inflated appraisals -- and learn from these past mistakes. If we do not learn from these errors, we are doomed to repeat them again during the next cycle. –Contributed by a leading MI Industry Expert

Market Update

Bonds yields continued to rise over the last month, with a good measure of volatility thrown in, as inflation fears accelerated. The previous resistance level on the 10-yr yield, at 3.92%, is no longer in play at this point as yields have pushed well over 4.00% in recent days. Mortgage yields fared no better, often widening to treasuries during the sell-off, and new origination volumes stagnated as rates hit recent highs.

In the face of continuing climbs in fuel and food prices, Fed-speak has moved rather firmly into the camp of inflation concerns trumping recession concerns. Bernanke, among others, has expressed doubts that the Fed Funds target can remain at the current 2.00% for long, given the climb in prices. Traders have taken the cue and have begun pricing-in an expectation of a Fed increase of at least 0.25% by year-end and some believe the Fed will move a quarter higher as soon as September's meeting.

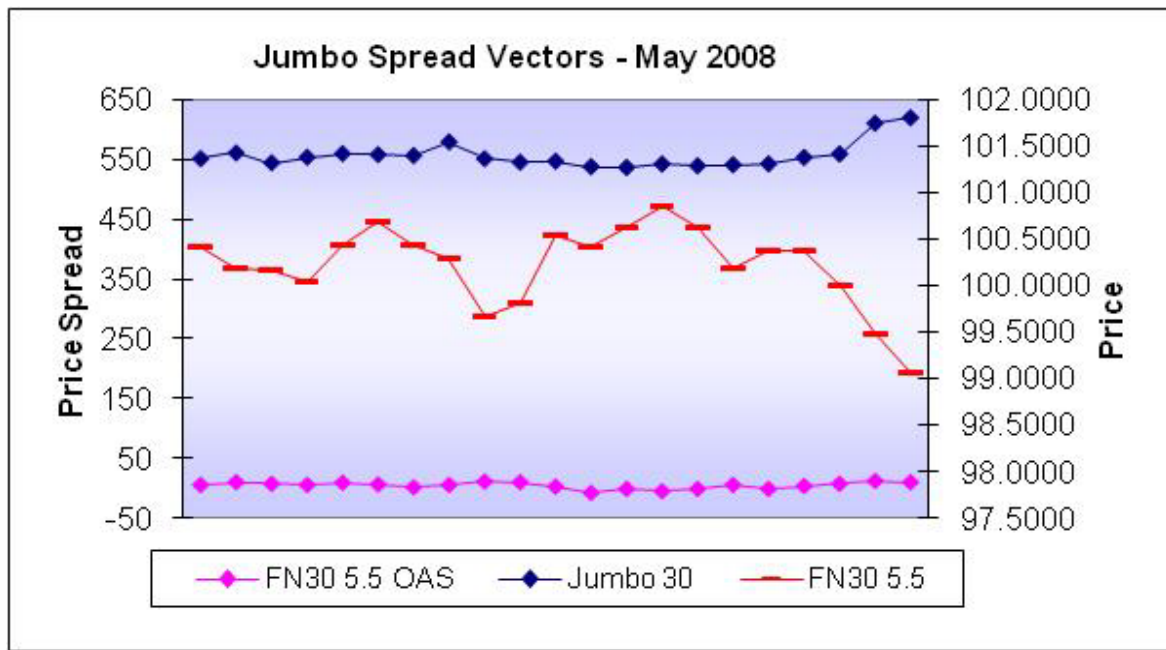
In addition to the ongoing climb in commodity prices, recent economic growth indicators came in at or above expectations, for the most part. The ISM reports, both for manufacturing and services, as well as the factory orders and construction spending reports, all came in stronger than expected. Even with consumer confidence still low, retail sales for the last month came in well above expectations. Obviously, IRS rebates helped fuel the surge but the magnitude of the increase was still a surprise.

The only dark cloud for the economy in recent reports was the May employment report that saw a jump in the headline unemployment rate from 5.00% to 5.50%. Equity markets have been on nervous footing since, although the retail sales spike has helped quell the panic.

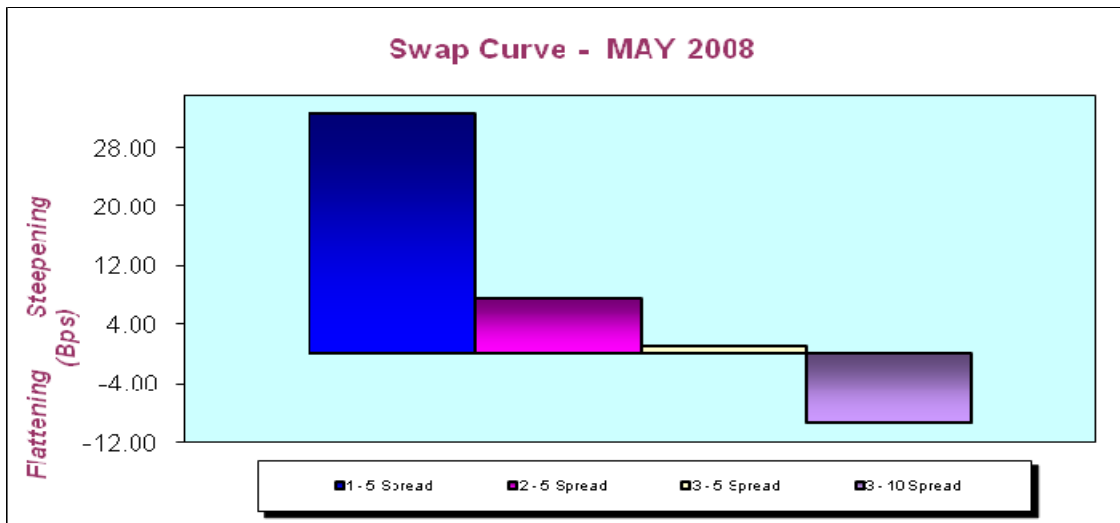
Volatility, both intraday and interday, will likely continue in bonds in the near future but it's reasonable to think that higher rates will be the prevailing direction for the time being. While the strength of the economy going forward is a somewhat murky picture, a pick-up in inflation, at least in the near term, seems crystal clear. *-Lindsay Hill*

Alt A and Jumbo Spreads

Jumbo spreads experienced relatively range-bound trading. FN30 5.5's chopped around in another volatile month. The range widened in May (178bps vs. 134bps in April) as there continued to be pronounced swings. The month started off with Nonfarm Payrolls printing at -20K vs. an expectation of -75K. The unemployment rate dropped to 5.0% from 5.1% in April, causing some economists to say that the economy is near the bottom and may be close to rebounding. But bad news continued to come from corporate America, especially entities tied to the housing industry. Fannie Mae reported a \$2.19B 1Q loss and announced plans to raise \$6B in capital; Freddie Mac recorded a \$151MM loss and will raise \$5.5B. AIG declared a 1Q loss and is going to raise \$20B in capital. Financial firms have now written down \$392.3B in assets and have raised \$291.5B in capital. Vallejo, CA declared bankruptcy due to the housing downturn. Inflation concerns continued as the Fed minutes were relatively hawkish in the face of increasing commodity prices - Oil from \$112/barrel to \$127/barrel, CPI increase of 3.9% yoy, and Import prices up 15.4% yoy. All-in-all, not a very positive outlook for the economy as evidence of stagflation continues to mount. In treasuries, the bear-steepening sell-off left 2-10's at 142bps at the end of the month (started month at 140bps). 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*

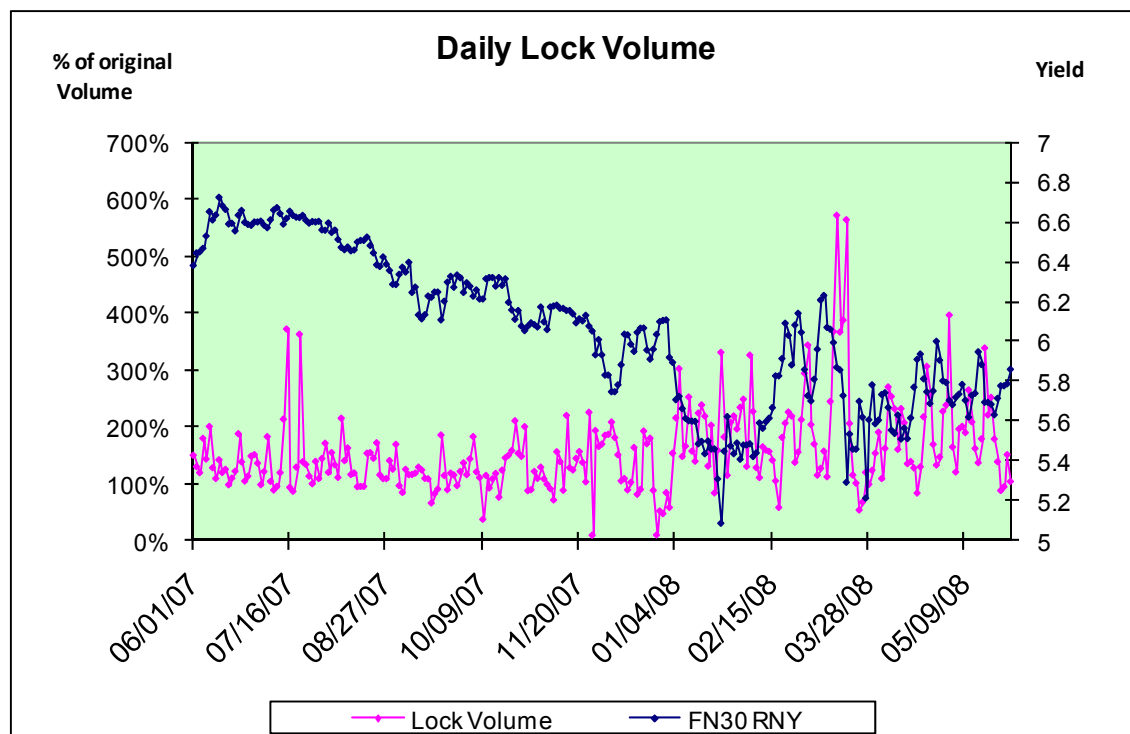


Swap Curve Analysis



Volatility came in and out of the market in May, with periods of calm followed by periods of uncertainty. One year LIBOR gained only 8 bps while the middle of the Swap curve picked up about 40 bps in yield. This led to a sharp steepening at the front end of the curve while the long end experienced a slight flattening. By the end of May, the LIBOR/10Yr Swap spread steepened about 22 bps, leaving the spread at about 152 bps. -Virgil Caselli

Production Index



Production in May increased while rates traded in a tighter range (43bp range in May versus 49bp in April), with the average yield increasing slightly month over month. Average volume for the month was 192% of our base volume (vs. 184% in April) ranging from a low of 88% to a high of 396%. The average yield on the FN30 RNY in May was 5.77% (vs. 5.72% in April) ranging from a low of 5.62% to a high of 6.05%. -Dave Bennett