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The Month in Review

March 2008

What's New?

Despite the difficult market, companies continue to look for state-of-the-art analytics and quality service. As a result, Compass is proud to announce the addition of six new clients!

Compass continues its monthly Webinar training series. The following sessions will be hosted through the remainder of March and April:

- *Roundtable on Hedging Conforming Jumbo's on March 25th at 12:00 PT*
- *Advanced Topics on MSR's: Rate Shock & Accounting on April 1st at 12:00 PT*
- *Captive Reinsurance 101 on April 15th at 12:00 PT, with guest MI presenter*

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:

- Non-Parallel Rate Shock w/Twist Tools
- AD-CO HPI Editor
- Mortgage Spread Variable with Loan-Level and Simulate Date Adjustors
- Stratification .pdf Export
- Work set Clone Functionality on PP Models, Recourse & Severity Models
- Pay History Field Function
- Trade Tool Enhancements
- Multithreading on Whole Loan Tools

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 - The Three Cs of MI Relationship Management: Capital, Credit and Counterparty Risk

The US Mortgage Insurance Industry is going through another catastrophic credit cycle. The MI industry last saw its business models stressed some twenty years ago in the late 1980s and came through this challenging period just fine. In order to help us weather the current housing crisis, let's remember the three C's of an MI relationship management: Capital, Credit, and Counterparty Risk.

Capital

Capital is king going forward; all mortgage insurers will need to preserve their balance sheets by raising mortgage insurance premiums and tightening underwriting guidelines. The MI industry no longer has excess capital over its AA rating by the rating agencies -- Fitch, Moody's, and S&P. In fact, the rating agencies have started to put the MIs on their negative watch list for possible downgrades. The AA credit rating is important to MIs to maintain in order to continue insuring loans bought by Fannie and Freddie.

In some respect, paying claims makes the MI industry relevant again. The reason mortgage insurance exists is to protect mortgage lenders from credit defaults. In good markets, mortgage insurers build their balance sheets to pay out claims during catastrophic credit cycles.

MI penetration was 18% in the 4th quarter of 2007. This is a huge increase from the 6% penetration rate we saw in 2006. So the MIs are paying out claims at a historic rate and writing much more new MI business -- this is stressing mortgage insurers' balance sheets. It is quite possible by the 2nd half of 2008 that most mortgage insurers will need to start raising capital to maintain their AA credit ratings.

Credit:

As the credit markets continue to work through the hangover of mis-priced credit risk, mortgage insurers have been very diligently managing their credit risk exposure. Most mortgage insurers have made multiple credit policy tightenings in their underwriting guidelines, and have made MI premium rate increases.

In today's market, there is very little liquidity for high risk products. High risk products with multiple layered risks are an uninsurable product. Mortgage insurers have pulled back on high risk products with layered risks:

- Alt-A with LTVs>90,
- A- with LTVs>95 and,
- LTVs>97 due to poor loan performance.

The latest caveat is declining markets policy. It is critical for all mortgage bankers to fully understand both their investors and GSEs declining markets policies, and to enforce declining markets policies into their underwriting guidelines. A prudent strategy is to implement all GSE and investor declining market policies into your underwriting guidelines to protect your institution from repurchase risk.

Counterparty Risk:
As Secondary Marketing professionals, these credit policy changes have been so hard and so fast that you may still be waiting for the dust to settle, before adding new MI partners. This is a flawed strategy because counterparty risk is more important today than ever. MIs have failed in the past; for example, Ticor and Verex failed in the late 80's. Reducing your counterparty exposure to any one mortgage insurer is a prudent strategy. One thought is to use a quantitative model approach to allocate a maximum MI share of up to maximum of 25% for each MI partner.

Mortgage Bankers selling to the conduits may not care about their MI counterparty risk since they have no interest in the servicing. However, the investors' servicing departments care about MI counterparty risk and may counterparty adjust their SRPs based on your loan performance and scorecard results.

The good news is the current credit crisis will end. The market will get though this mess over the next 18-24 months and it will be a much better market for the coming years. *–Contributed from industry MI sources*

Market Update

Can you say, "volatility"? February and early March saw huge rallies and huge sell-offs, and that was just on any given day. Mortgage rates pushed higher through the first part of the month, fell towards the end of the month, only to rise and fall yet again in early March.

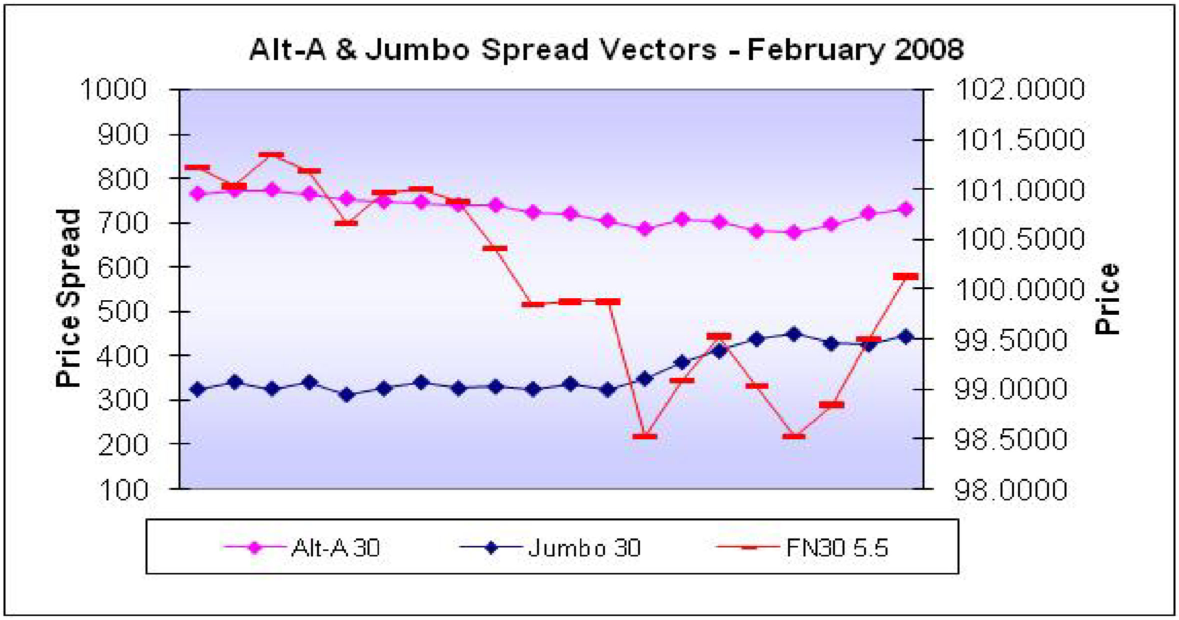
The markets are still feeling the credit pinch and the problem appears to be growing. Even so-called "prime" mortgages have been sold at fire-sale prices as investors deal with margin calls and capital requirements. Liquidity even in agency MBS has periodically dried-up over the last couple of weeks as dealers have been loath to buy and are having trouble finding anyone to sell to.

The Fed will continue to find hard sledding as commodity prices remain at record highs while the economy slips further. Creative solutions to the liquidity crunch have been offered by the Fed in recent weeks and have generally been well-accepted by the markets. But so far, everything seems to be a temporary fix to a worsening problem. More Fed cuts are most certainly in the offing but it's yet to be seen how much that will help mortgages.

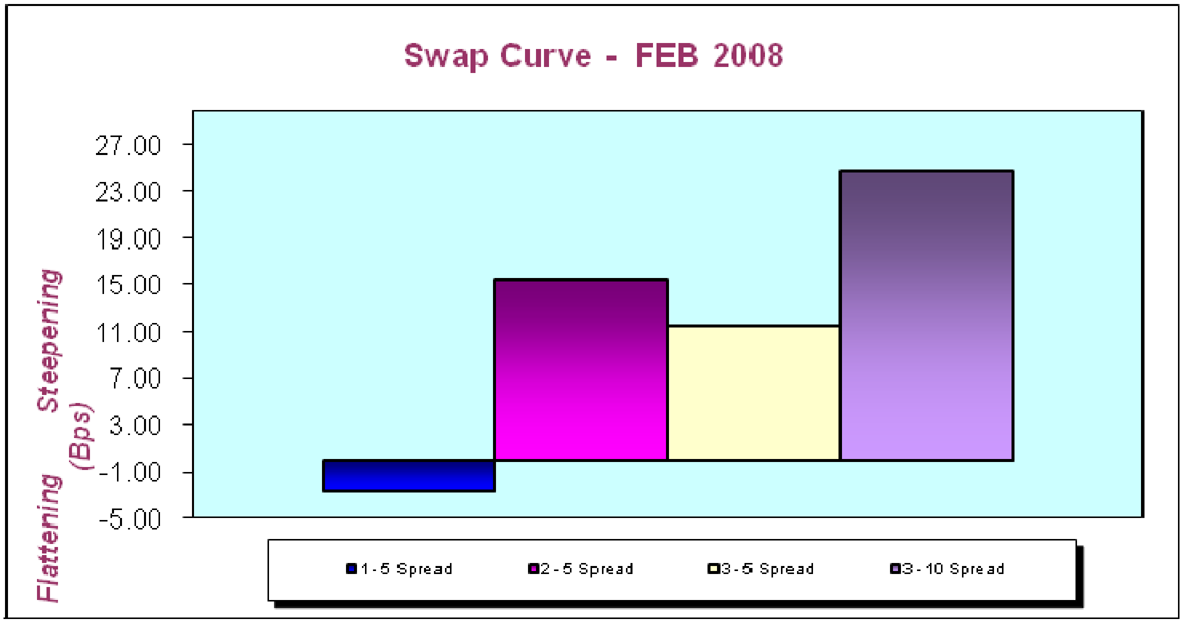
On the bright side, mortgage spreads have improved over the last week, at least in part to the Fed's recent liquidity moves. The Fed seems to know what's at stake here and notwithstanding the "no bailout" mantra from the administration, further action is likely in a variety of forms. It may be time for the Fed to put some money to work purchasing quality, performing assets to help put a bottom to prices in the prime market. The Fed's alternative to using all their available tools may be a further collapse that will bring the financial markets to their knees. *-Lindsay Hill*

Alt A and Jumbo Spreads

Alt-A and Jumbo spreads experienced relatively range-bound trading. FN30 5.5's chopped around in a very volatile month. The range widened in February (281bps vs. 168bps in January), as there were very pronounced swings. The month started off with Nonfarm Payrolls printing at -17K vs. an expectation of 70K. The weaker labor outlook caused many economists to increase estimates that the economy could fall into a recession. More announcements of losses were made: Toll Brothers—7th consecutive quarterly decline, Freddie Mac—$2.45B, and AIG—$5.29B. An Economic Stimulus Package was announced and signed by President Bush, which included an increase in the GSE loan limits (which will most likely be traded as spread product off of TBA's). Six lenders announced a 30 day moratorium on foreclosures to take time to work with borrowers; 5 states halted foreclosures because, due to hasty securitization, there are some cases where there is no clear owner of the mortgage note. Despite CPI and PPI prints at the upper end of the Fed's comfort zone, saving the housing market and propping up growth seems to be the Fed's more pressing concern, causing several economists to worry about stagflation. In treasuries, the bull-steepening rally left 2-10's at 189bps at the end of the month (month started at 153bps). 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*

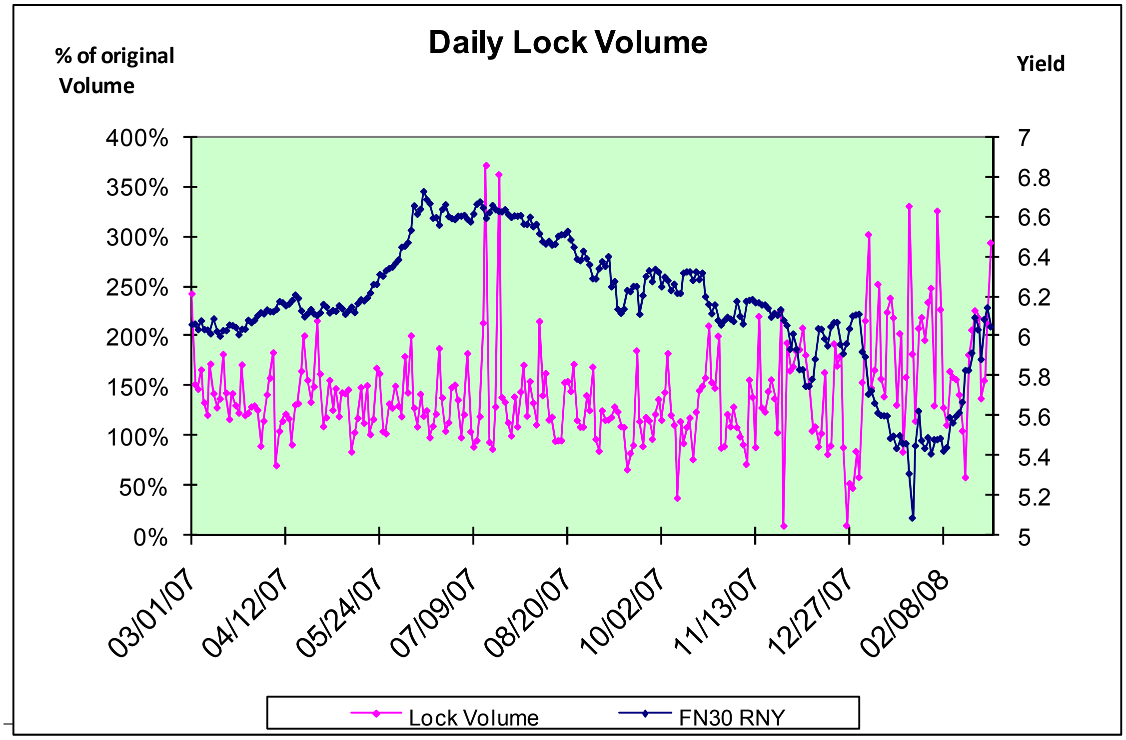


Swap Curve Analysis



Though the LIBOR/Swap curve did not move as violently as in January, heavy volatility continued through February. The liquidity crisis deepened and margin calls amassed. Swaps were led down by the 2 and 3 year yields which dropped an average of 30 bps. Though Swap yields were lower month-over-month, the spread over Treasury's widened significantly as investors shunned risky assets. The 1-10 LIBOR/Swap spread widened about 11 bps leaving the spread at about 152 bps to end February. *-Virgil Caselli*

Production Index



Production in February decreased while rates traded in a tighter range (72bp range in February versus 81bp in January), with the average yield increasing 23bps from January. Average volume for the month was 182% of our base volume (vs. 187% in January) ranging from a low of 59% to a high of 326%. The average yield on the FN30 RNY in February was 5.75% (vs. 5.52% in January) ranging from a low of 5.42% to a high of 6.14%. *-Dave Bennett*