

## The Month in Review

November 2008

### What's New?

Be sure to check out the Topic of the Month below on Considerations of Servicing!

Over the course of the next month, Compass's Webinar training series will include the following sessions:

- Due to popular demand, Compass will host a session on *Hedge Accounting* on Tuesday, December 9<sup>th</sup> at noon PT. The session will be hosted by Rob Kessel.
- On Tuesday, December 16<sup>th</sup>, at noon PT Compass will have a guest speaker discuss *M&A Services for Valuing Mortgage Companies*.

Please email Kellie Kramer at [kkramer@compass-analytics.com](mailto: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:

- Portfolio Delinquency Migration Reporting
- Expanded REO Calculations
- Expanded CF and Valuation Output Fields
- Stratification Enhancements
- Additional Convexity Calculation Options
- CC Forecast and Mortgage Spread Cash Flow Reporting
- Integrated Pipeline MSR and Excess Multiple Derivation
- Additional Unattended Batch Processing Options
- Filter Builder Enhancements

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](mailto:rkessel@compass-analytics.com).

## Market Update

Even a glimmer of good news for the global economy has been hard to come by of late. Seemingly every new report is described in terms of multi-decade lows. The October employment report could be fairly described as brutal and the weekly unemployment claims following the report only worsened. Manufacturing measures have dropped to levels not seen since the deep recession of the early eighties and the U.S. auto industry is on the verge of collapse.

With a recession as broad and deep as this one appears, lower interest rates would typically be thought of as a tool to drive investment and growth. But with the recession running in concert with the crippled credit markets, and the U.S. government running record deficits, rates along most of the curve have remained stubbornly high. As the treasury and others continue to push more debt into the market, it's left to a relatively cash-constrained world to absorb the supply.

It's safe to say that the President-elect has his work cut-out for him. Hopefully, patience will reign as this recession could last well into the new President's second year, if not beyond. Solutions will likely be needed beyond what's been put in place to this point as the housing market is still strangled by tight credit. If rates push higher, options for both homeowners and lenders will diminish further. *—Lindsay Hill*

## Topic of the Month: Servicing Options

Recent market developments have led more originators to reevaluate retaining servicing rights instead of selling loans on a service released basis. Some of these reasons include difficulty in working with aggregators, frustrating changes to SRP values as par rates have changed, increases in extra-agency price hits and the resurgence of FHA and VA originations. As part of this reevaluation, originators have increased their interest in co-issue programs where the originator has a direct relationship with the agencies (Fannie Mae, Freddie Mac and/or Ginnie Mae) but the mortgage servicing rights (MSR) are sold concurrently with the loan to a servicing buyer.

The following Table I will help to identify differences in originator delivery options with respect to servicing rights:

**Table I – Servicing Delivery Options**

<b>Description:</b>	<b>AOT-Direct</b>	<b>Co-Issue</b>	<b>Retain-Service</b>	<b>Retain-Subservice</b>
<b>Guarantee Fee</b>	Aggregators	Originator	Originator	Originator
<b>Excess Multiples</b>	Aggregators	Aggregators	Originator	Originator
<b>MSR Value</b>	Aggregators	Aggregators	Originator	Originator
<b>Servicing Cost</b>	Aggregators	Aggregators	Originator	Subservicer
<b>MSR Value Volatility</b>	Aggregators Rate Adjustors through assignment	Aggregators Rate Adjustors through assignment – typically less	Originator for duration of ownership	Originator for duration of ownership
<b>Pooling Schedule</b>	Aggregators	Originator	Originator	Originator
<b>Specifieds</b>	Aggregator	Originator	Originator	Originator
<b>LLPAs</b>	Agency + Aggregator	Agency + Aggregator MSR Adj.	Agency + Originator MSR Adj.	Agency + Originator MSR Adj.
<b>Economic Value</b>	Total Price for Loan and SRP	Price for Loan plus SRP	Price for Loan + Capitalized Value of MSR	Price for Loan + Capitalized Value of MSR

As the above table implies, originators must perform best execution analysis and assess their loan price (guarantee fee and misc. price adjustments) and servicing values compared to aggregator's total prices. Table II below highlights some of the more germane and practical considerations originators face when performing this analysis:

**Table II – Best Execution and Practical Considerations**

<b>Topic</b>	<b>Consideration</b>
<b>Guarantee Fees</b>	In practice, Originators need to negotiate a lower guarantee fee from the agencies (only applicable to Fannie and Freddie) than what the originator receives from the aggregator. The agencies are not always willing participants in this proposition.
<b>MSR Values</b>	When selling MSRs, originators receive the aggregator's economics which include very low costs of servicing and great cross-selling platforms. Aggregators are able to expense the SRP they pay at purchase whereas the originator who retains servicing rights must capitalize the initial MSR value and then write it off over time. In summary, the released MSRs are worth more to the aggregator than they are to the originator due to accounting and scale considerations. Originators who plan on retaining servicing and selling periodically, e.g. quarterly, should actively assess market conditions and interest in periodic flows and at what minimum sales levels. Recent market dislocation might make aggregate and sell strategies untenable and originators should make sure any market level MSR values they expect to be realistic with their sales volumes and current market levels.

<b>Earnings Volatility</b>	MSRs are sensitive to rate movement, the same as pipelines. Servicers must either hedge their MSR interest rate risk at a hedge cost (and with required expertise and scale) or go unhedged and accept income statement volatility and great risk should rates decline sufficient to cause accelerated prepayments from the MSR portfolio.
<b>Cash Requirements</b>	Many originators produce their rate sheet prices by taking total value of the loan (price + SRP) and back off their target profit margin. In recent years, originators have priced through the SRP, i.e. their target profit margins are less than their expected SPRs, often by sizable amounts. As an example, assume a conventional loan with an SRP of 1.5% where the originator is pricing in target profit margins of .75%. Before the originator started retaining servicing, the originator was generating .75% cash on every closed loan. After the originator began servicing, the originator now contributes .75% to every loan closing. They still book the MSR value (e.g. 1.5%) on their balance sheet and show profitable originations, but they now require significantly more cash investment in their originations.
<b>Portfolio Performance</b>	Many originators view aggregator add-on price adjustments (e.g. lower credit) as punitive and look to retaining servicing as one means to improve their execution. Those originators should keep in mind that agencies will compare the delinquency statistics on their portfolio to peer statistics. Those originator/servicers with sub-standard performance are likely to face higher guarantee fees and/or have their issuer status challenged. Originators are also encouraged to model the impact of credit statistics on MSR value, e.g., higher servicing costs and advances to identify applicable loan-feature impact on MSR values.

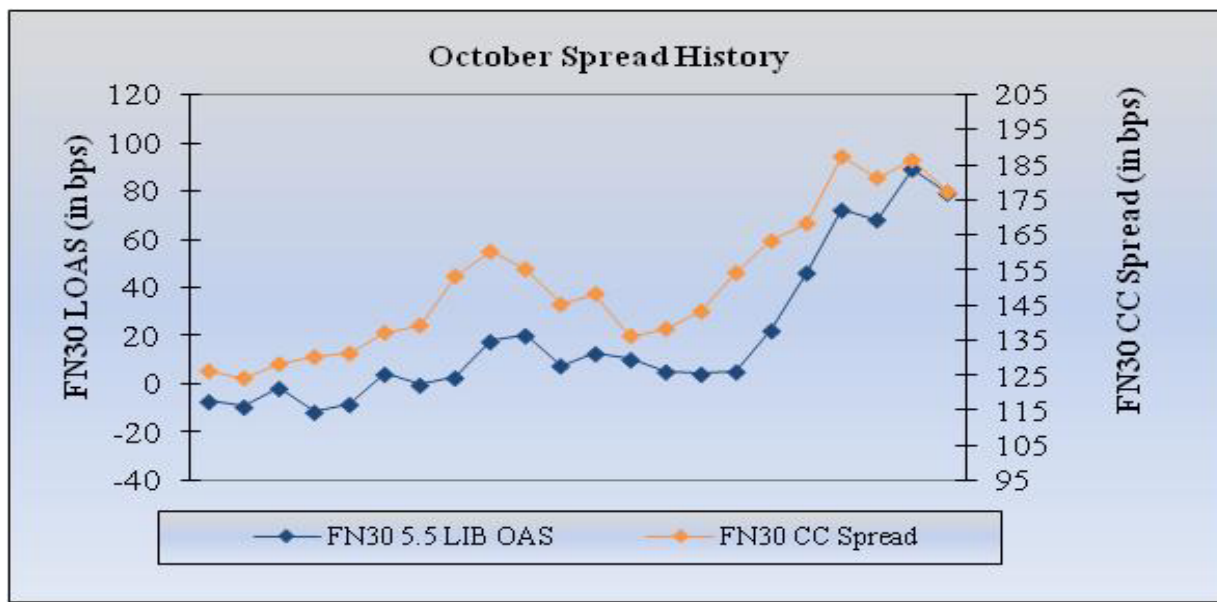
In practice, it takes low guarantee fees, servicing scale and lots of cash to compete with released options. The recent credit crunch, government activity and unpopularity of mortgages on the balance sheet has exacerbated the released/retained differential by creating confusion on the future of guarantee fees, reducing the number of co-issue buyers and increasing the cost of hedging servicing.

That being said, conscientious originators should continue to deepen their relationships with the agencies and servicing brokers and develop concrete, comprehensive plans for the considerations itemized above as well as become knowledgeable about servicing values and value drivers. Such originators will be ready to switch execution as market levels and developments favor such execution. –

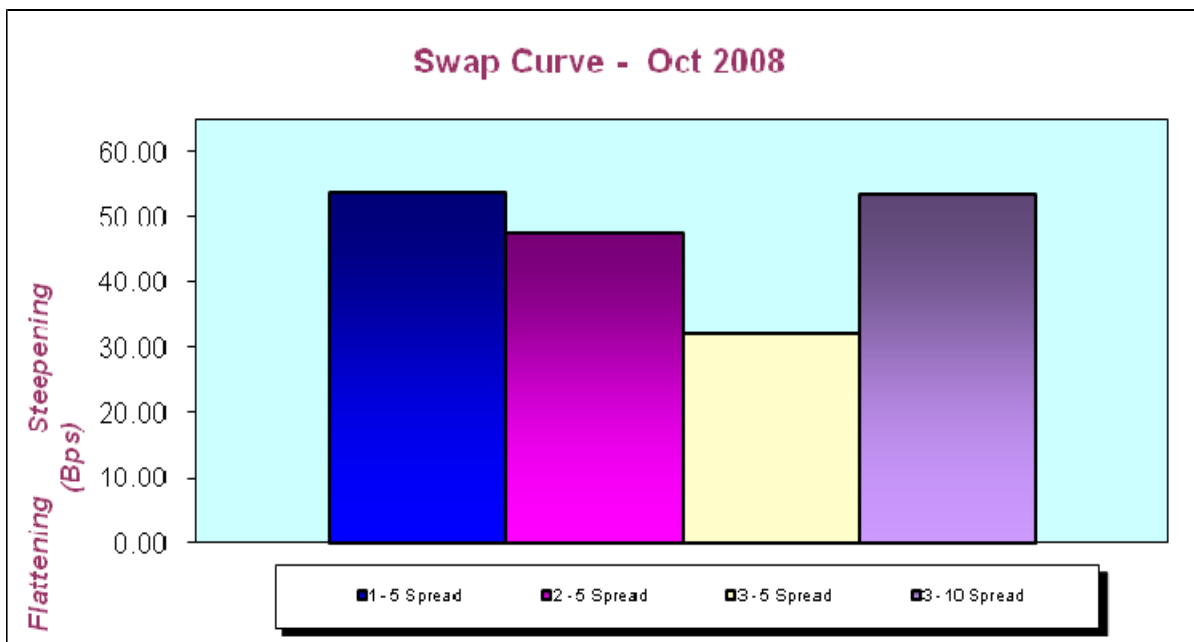
*Rob Kessel*

## Alt A and Jumbo Spreads

In another dramatic month, the focused moved away from specific companies and onto what specific countries were enacting to quell the markets. The month started off with Nonfarm Payrolls printing at -159K (-73K in August, revised up from -84K) vs. an expectation of -105K. The unemployment rate remained at 6.1%. Different governments used varying methods to combat the volatility: the UK gave a \$79B loan to their banks; Switzerland provided a \$59.2B lifeline to UBS; India cut rates for the first time since 2004; the Dutch government bailed out ING with \$13.4B; the Fed invested \$250B in the banking system; the Fed, ECB, BOE Bank of Canada and Sweden's Riksbank all concertedly lowered rates by 50bps; and China cut rates for the third time in 2 months. Countries began to struggle with the credit crunch: Iceland raised rates by 600bps to 18% to induce foreign lending; the IMF provided a \$16.5B loan to the Ukraine; and the Fed gave a \$30B loan in the form of a currency swap to Brazil, South Korea, Mexico and Singapore. Earnings continued to be poor: JP Morgan announced an 84% drop in 3Q profits; Citi announced a 4<sup>th</sup> straight quarterly loss; and Merrill declared a 5<sup>th</sup> straight quarterly loss. Worldwide writedowns now stand at \$955B and firms have raised \$824.2B in capital. All-in-all, there is a pretty bleak picture for the economy going forward. FN30 Current Coupon spreads and LIBOR OAS both showed persistent widening throughout the month. In treasuries, the bull-steepening rally left 2-10's at 248bps at the end of the month (started month at 192bps). *—Dave Bennett*

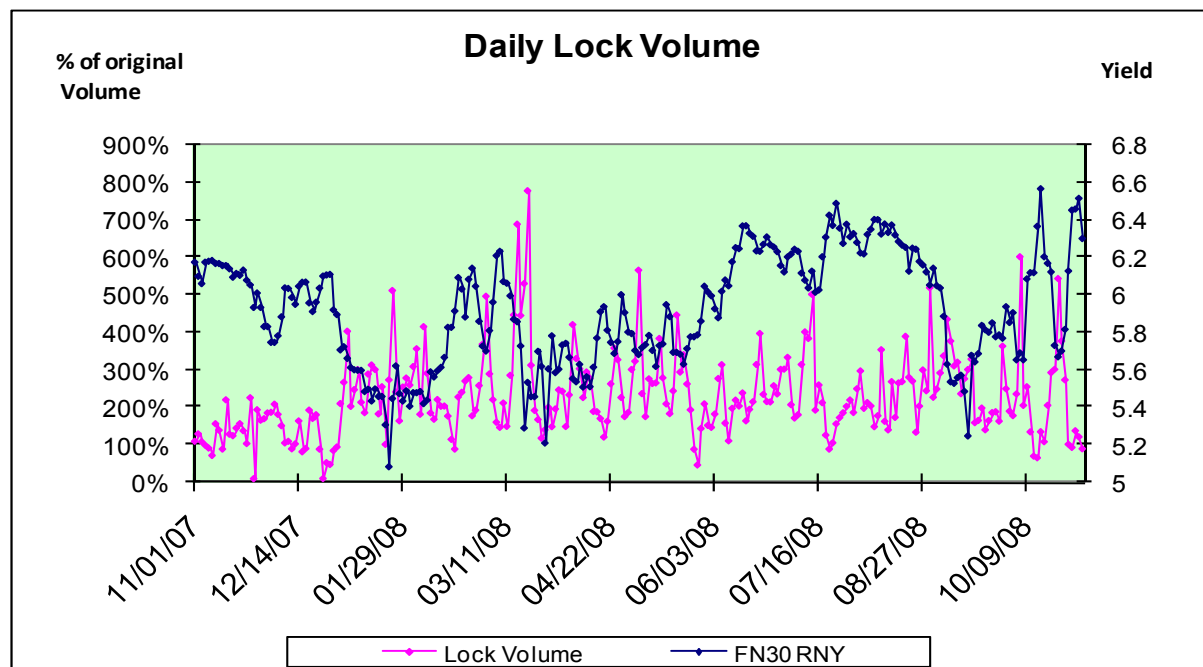


**Swap Curve Analysis**



LIBOR/Swap yields were lower in October with the short end experiencing the most pronounced move as short term credit markets began to thaw following Fed and Treasury action. One year LIBOR plummeted 79 bps, reversing September’s surge. Overall, the curve finished October much steeper as longer maturities saw moderate declines. With the Ten Year swap moving only slightly lower, the 1-10 spread steepened 75 bps to 128 bps. –Virgil Caselli

## Production Index



Production in October decreased while rates traded in a slightly wider range (91bp range in October versus 89bp in September), with the average yield increasing month over month. Average volume for the month was 216% of our base volume (vs. 258% in September) ranging from a low of 66% to a high of 602%. The average yield on the FN30 RNY in October was 6.05% (vs. 5.73% in September) ranging from a low of 5.65% to a high of 6.56%. -Dave Bennett