

The Month in Review

April 2009

What's New?

Radar Logic and Compass Analytics will present a joint Webinar on RPX HPI data and hedging functionality in CompassPoint™. This session will be hosted jointly by Michael Feder, President of Radar Logic and Rob Kessel, Managing Partner at Compass and will be held on Tuesday, April 28th at noon PT. For more information on Radar Logic, please visit their website at www.radarlogic.com.

New in CompassPoint™!

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

- MSR/SRP Implied CPR Derivation Tool
- Additional (Generalized) Libor/Swap Curve Points
- Ability to Pick Separate Data Sources in MSR/WL Scenario Modeling
- Price Load Derivation of TBA Key Rates
- Enhancements to TBA OAS Skew Functions and UI
- Improved Treatment of Pipeline Price Caps in Rate Shock
- Enhancements to Crystal Data Source Flexibility
- Enhancements to Pooling Group Organization
- 0VoOAS Output for OAS Valuations
- Additional Options on Timing of Defaults in Cash Flow Amortization

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.

Market Update

As another month passes, bonds continue to strengthen the trading range that has held since the beginning of February. While there has been volatility within the recent range, yields on 10-yr treasuries have remained between 2.50% and 3.00% for three months and counting. Tests of the rate range have been made, especially to the high side, but each has been repelled, strengthening the range for the time being. Mortgage prices have mostly followed suit with current coupon MBS seeing some short-term volatility but with larger directional moves remaining well-contained.

The range-bound landscape has not been lost on production channels, either. Over the last few months, as rates have dropped and prices have approached the top of the recent range, lock volumes have jumped and the renegotiation calls have started coming in. As the low end of the rate range approaches and prices begin to stall then drop, volumes begin to dry up as borrowers and their reps begin holding

out for the next move towards lower rates. It also appears that more borrowers are moving off the fence as prospects for conventional rates below 4.00% have dwindled recently.

To break the current range, it may take another significant move in the equity markets. With most economic data still coming in weak, albeit with some spotty improvement, stock prices may be the driver of a more significant move in rates. Insofar as the most significant tests to the rate range have been to the high side, it would seem more likely, at least in the case of treasuries, for rates to break-out to the upside than the downside. But if stocks hit another leg to the downside, then another test at the lows of the rate range may be in the offing. *—Lindsay Hill*

MI Corner: MI Industry Update and the Future of Contract Underwriting

As the MI industry continues to manage through the credit cycle, there are no significant signs of a recovery yet. The MIs are all managing for survival as the market moves through a bad mortgage product market into a deeper recession with 10% unemployment on the horizon.

The current topics in the MI industry

- Moody's downgraded the entire MI Industry recently stating their franchise value has weakened considerably in light of increasing frequency of claims and severity of loss. No MI is currently rated AA. Most Monoline MIs: PMI, Radian, & MGIC are not even rated investment grade currently.
- Genworth abandoned its request for capital from the TARP Program on April 9th, a day after Treasury said some life insurers were eligible for U.S. funds. The insurer canceled the dividend and cut 1,000 jobs, or about 14 percent of the workforce, after MTM declines in the investment portfolio and a spike in claims tied to mortgage insurance drained capital. The focus will be on asset sales going forward to manage its balance sheet. This is not good news since they will most likely not have enough capital to support its current MI business.
- Triad will change its paying claims process some time after June 1st, 2009. Triad's regulator is the Illinois Insurance commissioner. After June 1st, 2009, the Illinois Insurance Director stated that all valid claims under Triad's mortgage guaranty insurance policies will be paid 60% in cash and 40% by the creation of a deferred payment obligation (DPO). This is not good news for the industry with respect to their franchise value going forward. This is a large incentive to get all-in process claims paid before June 1st. So there might be a spike in foreclosures in order to get paid out 100% in cash by Triad before this deadline.

The Future of Contract Underwriting

The future of contract underwriting may look like a unique insurance policy in the future. The MIs have currently provide this service to many mortgage originators. All the MIs have set-up special purpose service companies to provide these services at a discounted fee schedule. These service companies are NOT insurance subsidiaries. They are thinly capitalized services companies of MIs. Many of the largest mortgage originators have leveraged these services from MIs.

The problem going forward is counter-party risk management. If the MIs are struggling to pay MI claims, then they are going to contest every contract underwriting claim according to their contractual liability. Contract underwriting contracts in general covers gross negligence underwriting errors, which is very hard to prove legally. Mortgage originators should carefully review all their high risk loans (EA, Alt-A, Jumbo, FICO >660, and LTV>70) from 2005-2008 vintages. The loan loss reserves on these high risk loans in high risk vintages should be increased even if there was contract underwriting coverage. This is not good news for originators dealing with legacy loan issues. Originators need to be proactive on managing this tail risk as repurchase requests are increasing from all investors in light of declining markets. In general, most originators have not properly modeled repurchase risk if they had contract underwriting coverage.

The market opportunity is for a new type of insurance policy to cover these risks. MIs could build a new business to take this risk as a discrete insurance policy separate for MI. The pricing of the policy may be considerably more than current contract underwriting fees, possibly 10x-20x larger. There should also be credit overlays to reduce frequency and severity – full doc, DU/LP approved eligible, 720>, DTI<45, min loan amount 100,000 - max loan amount 650,000, etc.

There is a need for this in the wholesale channel - the pricing of a separate insurance policy to review the underwriting package and collateral valuation on a loan level basis and charge a risk based premium. The loan documents would be reviewed by the 3rd party insurer at their office. The policy will cover all underwriting and collateral valuation errors including fraud and material misrepresentations. This type of insurance may bring back the wholesale channel and the private label MBS market. This is type of insurance currently needed in the market. The MIs can further broaden their franchise value by working a new and better contract underwriting insurance policy. *–Chris Kennedy*

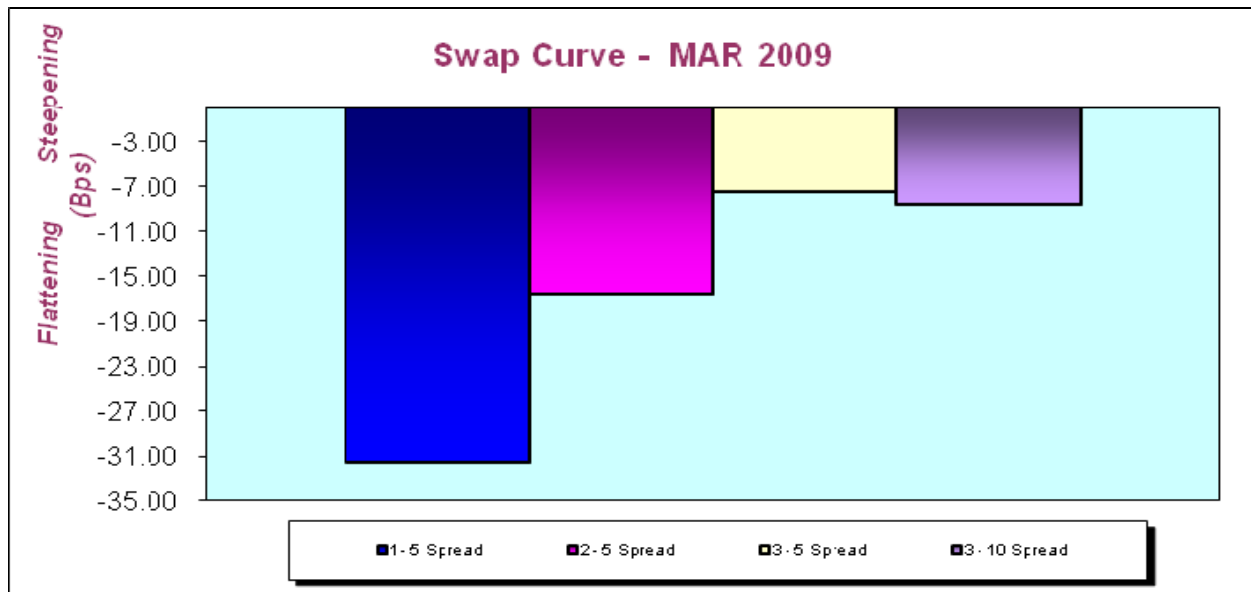
Alt A and Jumbo Spreads

In another dramatic month, the focus continued to be on Central Banks and governments around the world doing whatever they could to avoid a deeper than necessary downturn. The month started off with Nonfarm Payrolls printing at -651K (-655K in February, revised down from -598K) vs. an expectation of -650K. The unemployment rate jumped from 7.6% to 8.1%, the highest in 25 years. Global growth continued to crater at the end of 2008 as US GDP contracted by 6.3% in the fourth quarter, the largest pullback since 1982; the UK's GDP declined by 1.5%, the worst drop in 15 years. Different governments used varying methods to combat the volatility: the Bank of England lowered rates by 50bps to .5%; the ECB cut rates by 50bps to 1.5%; the Fed pledged to increase MBS purchases from a planned \$500B through June, to \$1.25T through the end of the year; the Treasury announced that they will purchase, or provide financing, for up to \$1T in distressed debt; fearing social unrest, China expanded their stimulus package; and the Fed will conduct "stress tests" on 19 of the biggest banks in the US and determine if they need to raise capital before the end of the year.

Earnings continued to be poor, but there was some positive guidance from financial firms (Citi, CSFB, Deutsche, and Wells all announced that the first 2 months of 2009 were very strong): Freddie Mac declared a 4Q loss of \$23.9B and said that they need another \$30.8B in federal aid; UBS posted an \$18B 2008 loss; and GM and Chrysler were both given specific targets and timelines for what they need to achieve or else they will have to declare bankruptcy. Controversy continued to swirl around AIG.

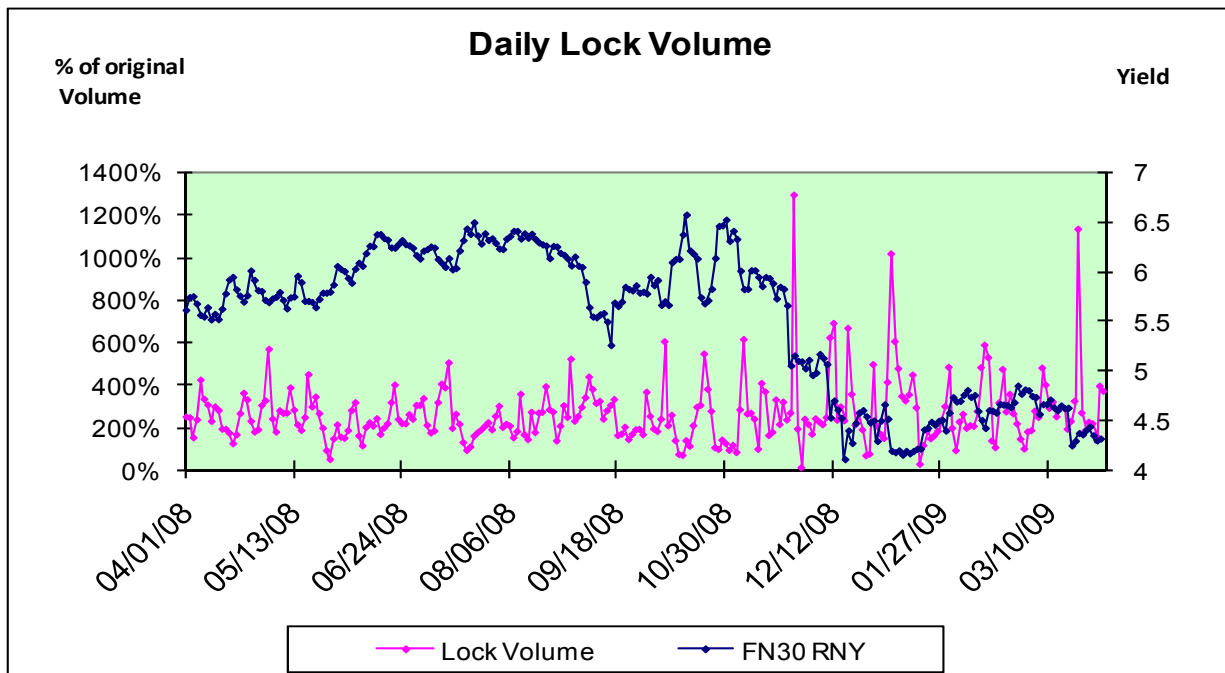
After recording a \$60.7B 4Q loss (the most ever by a US corporation), they composed a 21 page memo that if they didn't receive more bailout money, then money market funds would be crippled, competitors would fail, and the money that taxpayers had already given would most likely be erased. AIG still paid bonuses on 3/16, which caused much heated discussion in Washington. Worldwide writedowns now stand at \$1,293B and firms have raised \$1,110B in capital. All-in-all, the economic picture going forward is looking slightly more optimistic, although most economists are still very cautious. FN30 Current Coupon spreads and LIBOR OAS both showed volatility throughout the month. In treasuries, the bull-flattening rally left 2-10's at 187bps at the end of the month (started month at 199bps). *—Dave Bennett*

Swap Curve Analysis



The LIBOR/Swap curve reversed the steepening trend of the last two months, flattening across the curve with the front end showing the most pronounced tightening. Mid-month, the Fed announced it would purchase \$300 billion of long term Treasuries and an additional \$100 billion in agency debt and \$750 billion in MBS. The Ten year swap yield fell 47 bps while 1-yr LIBOR gave up 14 bps in yield, leaving the 1-10 spread 33 bps tighter at 91 bps. *—Virgil Caselli*

Production Index



Production in March increased while rates traded in a wider range (56bp range in March versus 43bp in February), with the average yield decreasing month over month. Average volume for the month was 311% of our base volume (vs. 270% in February) ranging from a low of 157% to a high of 1131%. The average yield on the FN30 RNY in March was 4.53% (vs. 4.66% in February) ranging from a low of 4.24% to a high of 4.80%. -Dave Bennett