

## The Month in Review

February 2009

### What's New?

Compass will be hosting a Webinar session with guest speaker, Larry Charbonneau, covering Mortgage Banking M&A Topics with some additional conversation on warehouse banking to be held on Tuesday, February 24<sup>th</sup> at noon PT. If you have not already RSVP'd for this session, please email Kellie Kramer at [kkramer@compass-analytics.com](mailto:kkramer@compass-analytics.com).

### New in CompassPoint™!

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

- HPA Scenarios w/Integrated Implied RPX HPA
- Misc. File Import and Workspace Manager Enhancements
- Expanded Options on Foreclosure Modeling
- Optimized Aggregation w/Passthrough Functionality
- Stratification Header Builder
- RPX Hedge Scenario Capability and Expanded Hedge Analytics

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

We finally got the stimulus package and so far, it has stimulated volatility, if nothing else. Both stocks and bonds have been volatile over the last week with treasury yields and mortgage rates pushing mostly lower on stock weakness and continued mortgage buying by the Treasury.

Prior to this week, mortgage rates had drifted higher over the previous few weeks and volatility remained relatively low. Mortgage locks volumes dried-up as borrowers and wholesalers held applications with the hope of a return to the rates seen in December and early January. Some may even be holding-out on the hope of a 4.00% mortgage or lower at a par price. With economic reports still painting a dismal picture, and the Treasury purchase program keeping a fairly consistent bid to the market, it was reasonable to assume that another push lower in rates would be in the offing. Given the slow volumes, many lenders and aggregators had begun trimming their margins to keep some minimum level of locks flowing in.

It didn't take much to reopen the flood gates as the recent rally brought in lock volumes not seen for over a month and lenders were once again faced with the decision of how aggressive or conservative their

pricing needed to be to drive a comfortable level of volume. While the magnitude of a rally from this spot would be unlikely to rival what was seen in November and December, given rates were still significantly lower at the start of this improvement than they were back in November, the specter of the rapid rate decline is still fresh in lenders' minds. Diligence in monitoring fallout behavior will again rise to the forefront as lenders work to avoid the level of pain most felt at the end of the year. *—Lindsay Hill*

### Topic of the month - MI Armageddon – Survival of the Fittest

As we begin 2009, no one will ever forget 2008, it truly is a year that will live in infamy. The sudden conservatorship of the GSEs surprised the market last year. Conventional wisdom assumed the MIs would fail before the GSEs, with the exception of Triad (Triad was put into run-off in 2008) this has not been the case although the industry is currently fighting for survival.

There is no current new issue market for Non-Agency MBS, but at some point this market will need to come back. There is only so much risk-based capital to support Jumbo whole-loan portfolios. The US covered bond market may help liquidity at the money-center banks, but the banks still own all the credit risk. The Federal Home Loan Banking system of secured collateral advances has helped liquidity, but again the banks still own this credit risk.

The Non-Agency MBS market is a future opportunity for the MIs to provide external credit enhancements by putting loan level MI on all LTVs as BULK LPMI on Non-Agency collateral (Jumbo) would be a start to restoring investor confidence. In addition, the originator needs to meet new rating agency guidelines on the reps and warrants for the credit underwriting and collateral valuation. This is another opportunity for the MIs to be relevant by putting on a special insurance policy to manage this risk of rep and warrants for certain select originators. The MIs have been managing this risk for years in contract underwriting.

#### **The Survivors**

The MIs that can raise capital will survive. So, who can raise capital in the MI industry or has recently raised capital?

1. AIG-UG (owned by the US Government) - spinoff or sale is not likely in this current environment
2. RMIC - Old Republic International is RMIC's parent and recently injected \$150MM in new capital into RMIC
3. Genworth (recently purchased a bank holding company in MN) - now can borrow money from TARP.
4. PMI – recently sold off their Australian MI business for approx. \$900mm
5. MGIC – raised capital in early 2008 and reinsured book with HCC Insurance in Houston, TX.
6. Radian – The SMART MI securitizations have helped their capital position
7. CMG (JV MI between PMI and CUNA) - only MI still AA rated; focused on only credit unions segment, PMI may need to sell off their interest in the JV to raise capital

In general, the mortgage market needs all the MIs to survive for capacity reasons, however, there are reasons to worry. MIs are regulated by their domicile state insurance regulator. North Carolina has the most with three MIs with UG, RMIC, and Genworth being domiciled in the state. Once the MI exceeds a risk in force to statutory capital ratio of 25:1 the MI is put into mandated run-off (no new risk being can be insured). This is what happened to Triad in 2008.

### Who is MICA?

Mortgage Insurance Companies of America is the trade group that represents the PMI industry in Washington, DC. They do have a historical loss severity database but they share it only with their membership. MICA has been reluctant to share this info with the public for a number of reasons, mainly that their actual loss severity was minimal over the last twenty years.

This has changed since 2006. The actual loss severity has been increasing over the last three years with the decline in home prices. Sharing this data with mortgage market participants would be a significant value-add since the MIs can leverage the value of mortgage insurance and its relevance today. The PMI industry paid out \$5.4B in losses in 2007 and an estimated \$17B in losses in 2008 with most of these claims covering losses at Fannie and Freddie.

### Contingency Reserves

The MIs business model is based on capital, a strong and liquid balance sheet, and a systemic process of building reserves for risk in force. The concept of contingency reserves is based upon the process of reserving 50% of all paid MI premiums (from day one for ten years) which are then placed in a special reserve trust account for 10 years. Only when the MI's loss ratio exceeds 100% can an MI access this capital. This conservative reserving methodology (first introduced by Max Carl, founder of MGIC) has helped MIs to survive the credit crisis so far.

This reserving process also enables MIs to set premiums based on estimates of losses over long periods, so premium rates change infrequently. This specific structure of reserving creates an incentive for long-term credit performance. MIs care about loan performance since they want to capture these reserves as income in the future. This is an incentive not to put too many high risk loans on their books since MIs can't accrue the benefits immediately.

### What is a Master Policy?

A Master Policy is a contractual relationship with your mortgage insurance provider. A Mortgage Insurer has a fiduciary relationship to the lender as its insured. Any firm with MI production over the last five years should carefully review each master policy in place with its respective MI providers. One key concept to understand is the period of incontestability. Usually this period is 12 months for most MIs. If there is a fraud or material misrep in the loan file, but the insured was not aware of these facts and the borrower made at least 12 consecutive payments, then MI is contractually obligated to pay the claim.

### Contract Underwriting

One great service the MIs offer is contract underwriting. In this current market environment using MI contract underwriting resources might be a good fit, except in the case of primarily FHA originations.

Most MIs still have underwriting offices and their current turn times with MI are 24 hours. From a quality control perspective using an MI underwriting office as a second set of eyes is a valuable quality control tool. MIs are good at underwriting the good risks, and denying the bad risks. There is more value in using the MI underwriting office than using on-site MI contract underwriters because of their independence. One thought is to use the MI contract underwriting offices to help wholesalers ferret out all the bad risks in this channel. Some large originators use contract underwriting solely to mitigate their

wholesale channel risk. Other large originators have their approved brokers submit all files directly to their MI partners for underwriting and mortgage insurance.

### **Loss Mitigation Opportunities**

MIs have the ability to rescind coverage due to fraud and material misrepresentations. This is their current primary loss mitigation tool. However, other loss mitigation tools are also being used actively by all MIs. Advanced claim payment and loan modification are being actively used to keep at risk borrowers in their homes. Most MIs are being proactive on their high risk mix of future claims. There is an opportunity for originators to review all its high risk MI loans produced from 2005-2008 vintages for potential loss mitigation outreach programs. Some examples of high risk loans are: Fannie Mae's EA-I/EA-II/EA-III; FICOs <680 and high LTV >95; reduced doc loans (NINJA – no Income no Asset no Job); IO, and Option-ARMs.

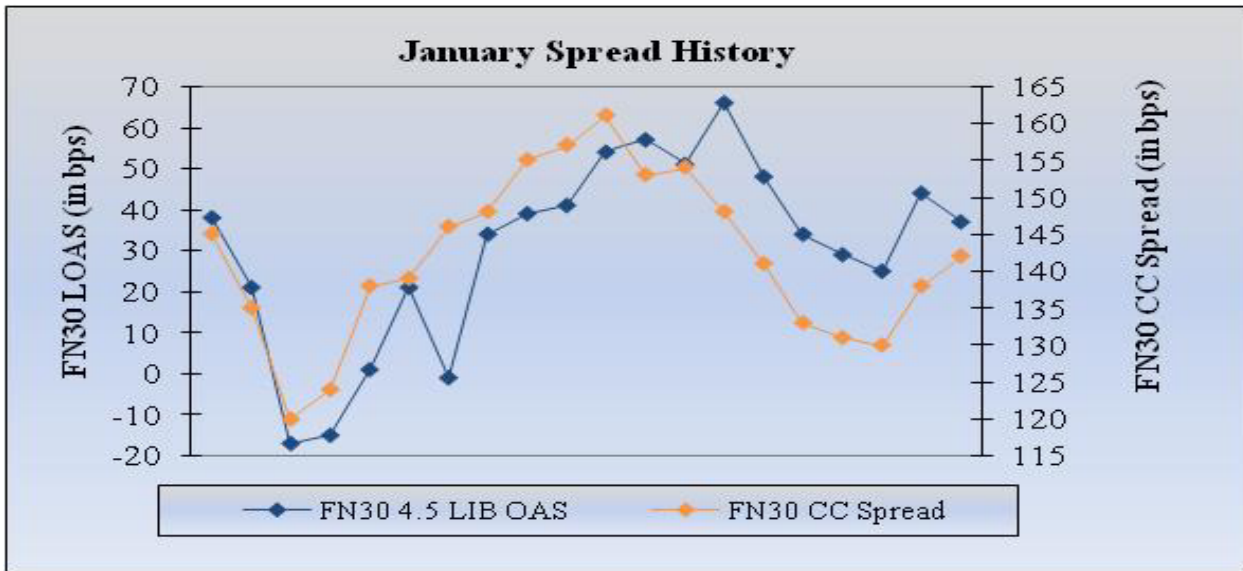
A loss mitigation strategy for servicers is charge-off loss mitigation strategy. If a servicer already has a number of REOs in a certain MSA/zip code, e.g., Detroit, MI, then they could ask the MI for a charge off payment today. Does a servicer want other REOs in a severely depressed market? Probably not, so the MIs will pay out a claim today at a 50% discount to the current covered loss. This is appealing to some servicers with large advances because they can get paid today rather than waiting for title to transfer back during the foreclosure process, then having to sell the house. If the servicer does not want title to the property, then they should pursue a charge-off strategy. MI claim payment is made after clear merchantable title is transferred back to the investor/servicer and the home is in the same condition as it was when the MI policy was first originated.

As the MIs continue to fight for survival and relevance there is light at the end of the tunnel. Home prices will stabilize and delinquencies will peak in the next two years and they do have the capital and reserves to make it to the other side of the market. *–Chris Kennedy*

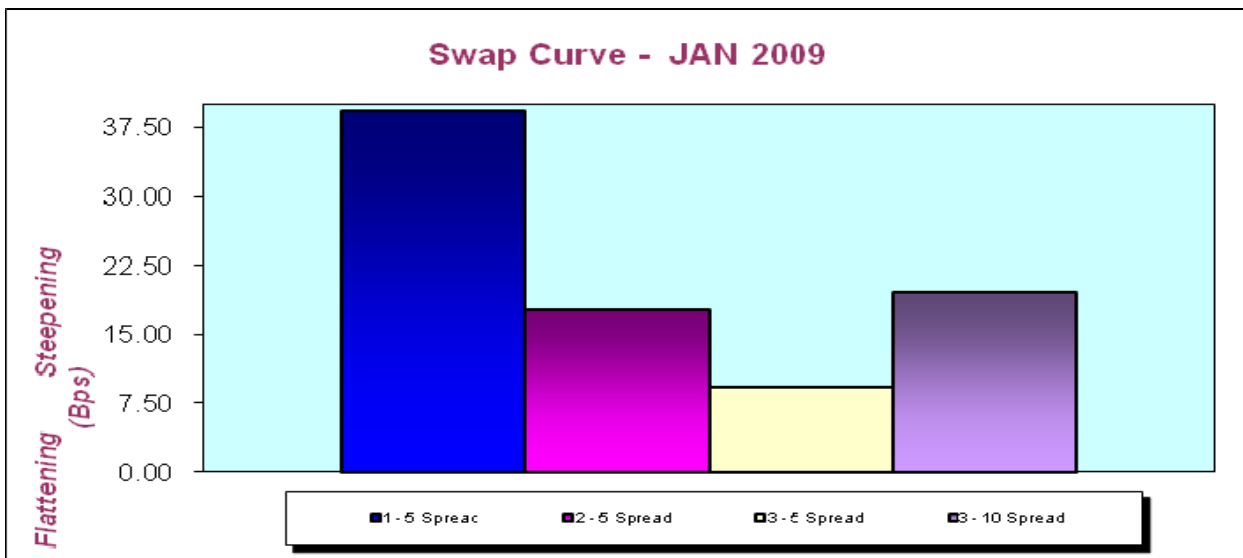
### **Alt A and Jumbo Spreads**

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 -524K (-584K in December, revised down from -533K) vs. an expectation of -525K. The unemployment rate jumped to 7.2%, the highest in 15 years. Global growth came to a screeching halt at the end of 2008 as US GDP contracted by 3.8% in the fourth quarter, the largest pullback since 1982; the UK's GDP declined by 1.5%, the worst drop since 1990. Different governments used varying methods to combat the volatility: England announced the second bank bailout in 3 months; the ECB lowered rates by 50bps to 2%; the Fed left rates unchanged between 0% and .25%; and the House passed President Obama's \$800+B stimulus package despite not having one Republican vote. The Federal Reserve also followed through on their promise to start buying Mortgage Backed Securities as they purchased about \$73B in January. Earnings continued to be poor: Cit posted a \$8.29B 4Q loss; Bank of America announced a \$1.79B 4Q loss, which did not include \$15.3B of losses at Merrill; JP Morgan reported a 76% drop in net income after \$2.9B in writedowns; and Deutsche Bank declared a \$6.3B 4Q loss. Worldwide writedowns now stand at \$1093B and firms have raised \$982B 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 volatility throughout the month. In treasuries, the bear-steepening sell-off left 2-10's at 189bps at the end of the month (started month at 145bps). *-Dave Bennett*

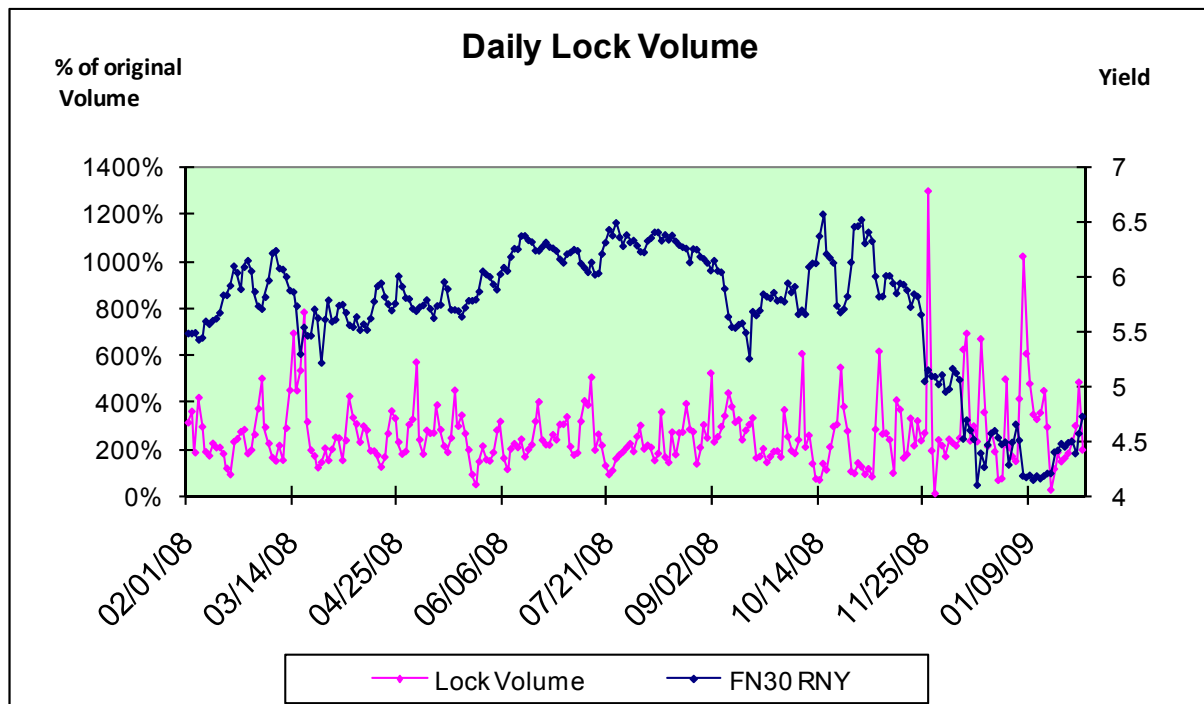


## Swap Curve Analysis



Plenty of uncertainty remained in the rates markets throughout January as President Obama took the reins and no definitive bailout plan had come together though the Fed was an active participant in MBS. The LIBOR/Swap curve steepened with the front end of the curve showing little movement while rates at the long end moved up. The Ten year swap moved up 47 bps while One Year LIBOR was down only 3 bps, leaving the 1-10 spread 50 bps wider at 109 bps. *-Virgil Caselli*

## Production Index



Production in January increased while rates traded in a tighter range (58bp range in January versus 106bp in December), with the average yield decreasing month over month. Average volume for the month was 313% of our base volume (vs. 278% in December) ranging from a low of 24% to a high of 1015%. The average yield on the FN30 RNY in January was 4.37% (vs. 4.68% in December) ranging from a low of 4.14% to a high of 4.72%. *-Dave Bennett*