

The Month in Review

February 2010

What's New?

Take a look at our Topic of the Month for February on "**Making the Leap from Best Efforts to Mandatory Deliveries**". This is part 2 of a 2 part "notes from the field" series. Topics covered this month include management of interest rate exposure, best execution analysis and choosing the appropriate loan delivery methods, and the implementation of hedge accounting procedures.

To all of our Customers for whom we perform trade execution: Over the next few weeks we will begin to scan client trade confirms after receipt from the broker/dealer and confirmation of terms. These scanned confirms will be copied to secure client FTP sites so they can be accessed by clients at any time. Stay tuned for more information from your Account Manager on how to have direct access to your checked-out confirmations.

Rob Kessel will be teaching a series of classes in the upcoming months for Fannie Mae's Housing Finance Institute (HFI). His **HFI Secondary Marketing Classes** for 2010 are as follows:

- March 9-10: Pasadena, CA
- July 13-14: Boston, MA
- October 5-6: Chicago, IL

If you would like more information about these sessions please send an email to rkessel@compass-analytics.com.

Finally, Both JP Morgan and RBS (Greenwich Capital) are ramping up agency (FN/FH/GN) **gestation repos**. If you have any interest we can provide contact information.

New in CompassPoint™!

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

- Production Version of Originator Company Cash Flows/Scenarios
- Daily Benchmarking (Production, Profit Margin, Fund-to-Purchase, FICO)
- Expanded Interactive Position and Daily Recon Tool Capabilities
- Additional Strat Formatting Options
- Misc. File Import Changes

Compass will shortly release a greatly expanded, reorganized and indexed web help file on our web site. Account managers will provide access information.

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

Following December's sell-off, that pushed rates beyond the range that had held since the summer, January saw rates drop once again, falling back towards the upper end of the previous range. As stocks have worked their way through a correction from their recent rally, bonds have benefitted. Although many domestic economic reports have shown improvement of late, recent global weakness has put equities on edge.

The European Union has had to deal with the possibility that some of their weaker members may face default on sovereign debt. The PIGS (Portugal, Ireland, Greece and Spain) each face a debt crisis of varying degrees and the real possibility of bailouts provided by the stronger members exists. Stock markets have been volatile as individual news items on sovereign debt hit the wires and while a flight-to-quality bid has helped bonds at times, the fact remains that the U.S. is also hitting the markets with 10s of billions in new debt on a regular basis. The bond market's ability to take advantage of woes in the stock market may slow as we move forward.

The January employment picture added some additional uncertainty to the interest rate and equity markets. Is a drop in the headline unemployment rate to 9.7% cause for celebration for stock bulls or is another drop in non-farm payrolls, along with persistent unemployment claim numbers cause for concern. Notwithstanding some improvement in several economic activity reports, the economy still appears to have a long way to go, especially as it relates to employment and housing. It's still tough to see rates rising too quickly or too far given the challenges still being faced at home and abroad.

-Lindsay Hill

Topic of the Month: Making the Leap from Best Execution to Mandatory

Notes from the Field: Part II of II

For mortgage originators, maximizing profits while minimizing risk is the key to operating a successful business. One way originators selling and delivering loans on a Best Efforts basis can increase profitability is by transitioning to Mandatory Deliveries and managing the interest rate risk themselves or with the help of a third-party vendor. Recent observations have shown that the spread between the all-in Best Efforts price and the all-in Mandatory price has increased from the typical 20-30 basis-points to over 60+ basis-points* on some product/note rate combinations, making the switch from Best Efforts to Mandatory deliveries more appealing than ever before. This article will identify and discuss the key factors that are required to make a successful transition from Best Efforts to Mandatory selling. In last month's article we identified the need for developing appropriate lock-in and hedging policies and procedures, establishing relationships with Broker Dealers and Whole Loan Investors, and the need for accuracy when transferring data from the Loan Origination System to the Risk Management System. In the conclusion of this article we will discuss different methods of managing Pipeline Risk, the importance of performing Best Execution Analysis and the selection and implementation of hedge accounting methodology.

One vital step when considering the switch from Best Efforts to Mandatory is developing a hedging strategy to manage the interest rate risk inherent with Mandatory execution. Mortgage originators granting a loan's rates and terms weeks and sometimes months in advance of its actual closing, expose themselves to changes in market interest rates and mortgage pricing from the lock-in date until the loan is allocated to a mandatory commitment and the sale price is set. The risk being that a lender grants rates and terms on day N at price X and when the loan has closed on day N+15, interest rates in the market are higher, and the loan is sold mandatory at a price of X-0.25, with the worse execution eroding the expected profit margin on the loan by 25bps. In order to offset this risk, avoid market losses and preserve the loans expected profit margin, originators can sell forward or otherwise enter into short positions in various fixed income instruments to hedge their pipeline's exposure to fluctuations in rates. Rather than offset the market risk on every individual loan, hedging is performed in aggregate, in an attempt to reduce the overall market exposure of the pipeline. Among the more popular hedge instruments are Agency MBS, MBS Options, Treasury Futures, Treasury Future Options, EuroDollar Futures and Mandatory Forwards. Originators choosing to hedge can do so with the help of a third-party vendor like Compass, or with the proper tools, analytics and expertise, hedging can be performed in-house.

Another form of Pipeline risk is Fallout Risk, or the risk that a hedged loan lock fails to close. This typically occurs when interest rates fall after loan terms and rates are set, and can result in the pair-off transaction of a hedging instrument, at a possible loss to the originator. The conundrum faced by lenders choosing to sell loans Mandatory is that in a rising rate environment, when loans in the pipeline are out of the money, we expect a high percentage of the loans to close, whereas conversely in a declining rate environment, when loans in the pipeline are in the money, we would expect a lower percentage of the loans to close. This situation where loans carrying losses are more likely to close, and

vice versa, requires lenders that are hedging to adjust the amount of hedge coverage applied to the pipeline depending whether a loan is in or out of the money to the originator. By observing historical fallout across different market environments, lenders can implement dynamic pullthrough assumptions by market move and apply coverage based on the percentage of loans that they expect will close. For example, a loan that has a Mark-to-Market value that is 50bps underwater might be covered at ~75%, while a loan that is 50bps in the money might be covered at ~60%. By conducting regular pullthrough analysis, originators can reduce their exposure to Fallout risk by ensuring that they have the optimal level of coverage applied to the pipeline.

In order to maximize profits, lenders need to search for ways to squeeze every last dollar out of each loan. One way to do this is to conduct Best Execution analysis on loans ready for allocation to Mandatory commitments. Since most lenders have several delivery channels for selling loans mandatory, originators must price out each individual loan using the different investor's models to ensure that the maximum mandatory price available to the lender is captured. It is important to conduct the analysis every day, as even in the event that the market levels remain unchanged day over day, a loan's Best Execution can change, since most whole loan investors publish daily changes to their model's pricing components, such as par note rates, note rate adjusters and buy up, buy down schedules. It is also important to analyze execution at the loan level in order to take Loan Level Price Adjustments (LLPA's) into consideration. For example, let's assume we have 2 Conforming 30 year 5.375% loans, one with escrows and one without, that are eligible for Mandatory sale with 2 different investors. The loan with escrows Best Exes to Investor A because the all-in price is better than Investor B's by 10bps. However, the loan without escrows Best Exes to Investor B because Investor B only charges 12.5 bps for no escrows, while Investor A charges 25bps, making investor B the better execution by 2.5 bps. By diligently conducting daily Best Execution analysis, originators ensure that they are maximizing profits on a loan by loan basis.

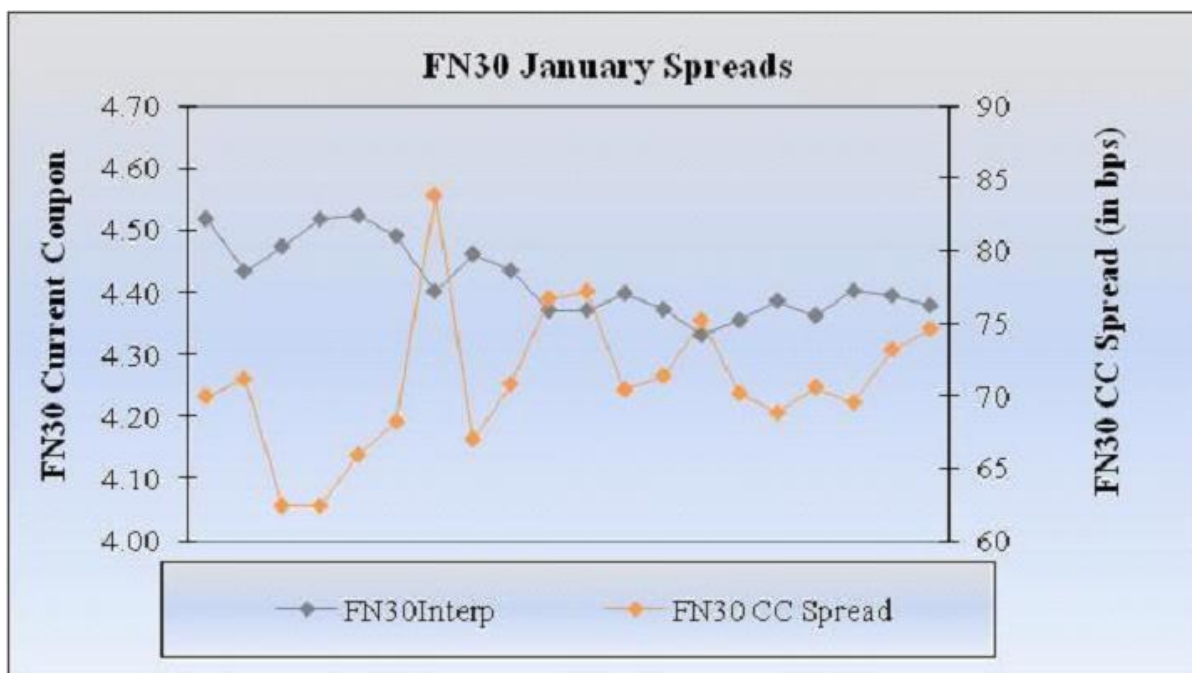
Now that we've discussed ways to reduce risk and maximize profits, we need to determine the best way of recording and reporting financial results. The final topic covered in this article will be the selection and implementation of hedge accounting methodology. Today, most lenders have moved away from FAS 133, which required somewhat complicated effectiveness testing and was known to cause volatility in earnings from one month to the next, and have switched to some form of Fair Value Accounting. Companies wishing to use fair value accounting must first elect to apply the provisions of FASB 157, "Fair Value Measurements" before they can adopt FASB 159 or other variations of fair value accounting. The main difference between hedge accounting and best efforts accounting is that in hedge accounting, the lender is able to book the change in mark-to-market value of their liabilities and assets on their balance sheet while in best efforts accounting, only cash accounts from purchased loans are reported on.

By tracking historical fallout and managing pullthrough assumptions, modeling the changes in duration and convexity of the loan pipeline and hedging instruments that result from rate shocks and applying a hedge strategy, mortgage originators can reduce the pipeline risk inherent with selling loans mandatory. By accurately deriving the true market value of the loans on a daily basis, and determining the best method of reporting financial results, lenders can ensure that they are maximizing profits and reporting their financial results in a way that reduces earnings volatility month over month. Investors interested in

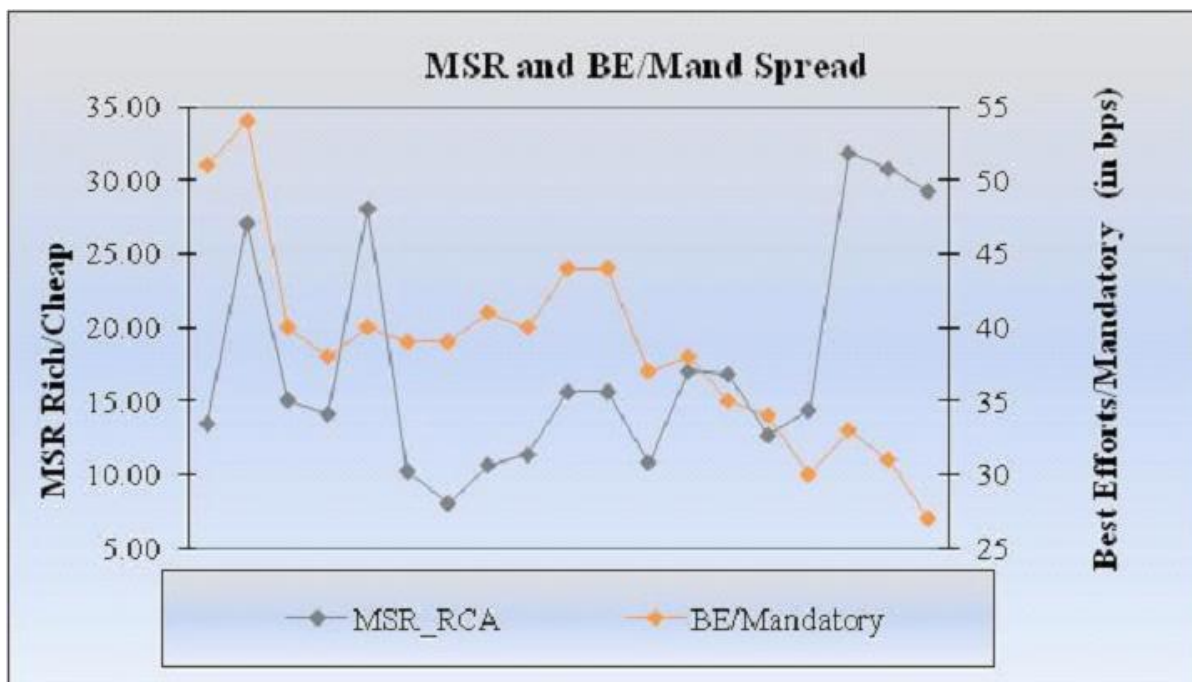
making the leap from best efforts to mandatory sales can use the steps identified in parts I and II of this article as a guide in order to help facilitate a smooth transition. -**Bob Gundel**

*Actual Best Efforts/Mandatory spread may vary by originator and is subject to change.

Margin Tracker

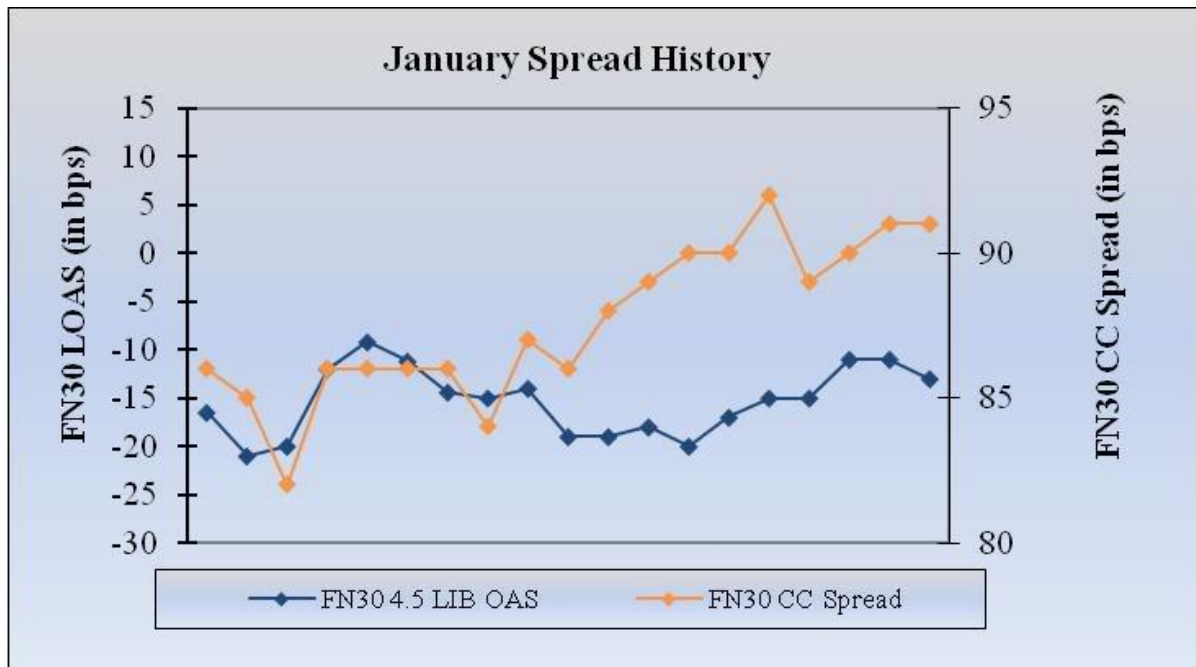


The FN30 CC Spread is the difference between the FN30 Note Rate and the FN30 Current Coupon, in basis points. The FN30 NR is the average conventional note rate across a subset of Compass's client base normalized for volume. The FN30 CC is the Fannie 30-year Mortgage Backed Security yield at par 30 days out. The difference between these numbers gives an indication as to how much margin is priced into the secondary market. The primary factors are interest rates and warehouse line constraints. Lenders may also be slower to improve rates during a rally, and quick to drop their pricing during a sell-off. During December, there was a 21bp peak to trough differential. Shown in the chart above, there is a noticeable negative correlation between rates and spreads. As rates decreased throughout the month, there is a noticeable increase in margins. The tightest the spread got was 62bps; the widest was 83bps; the average was 71bps.



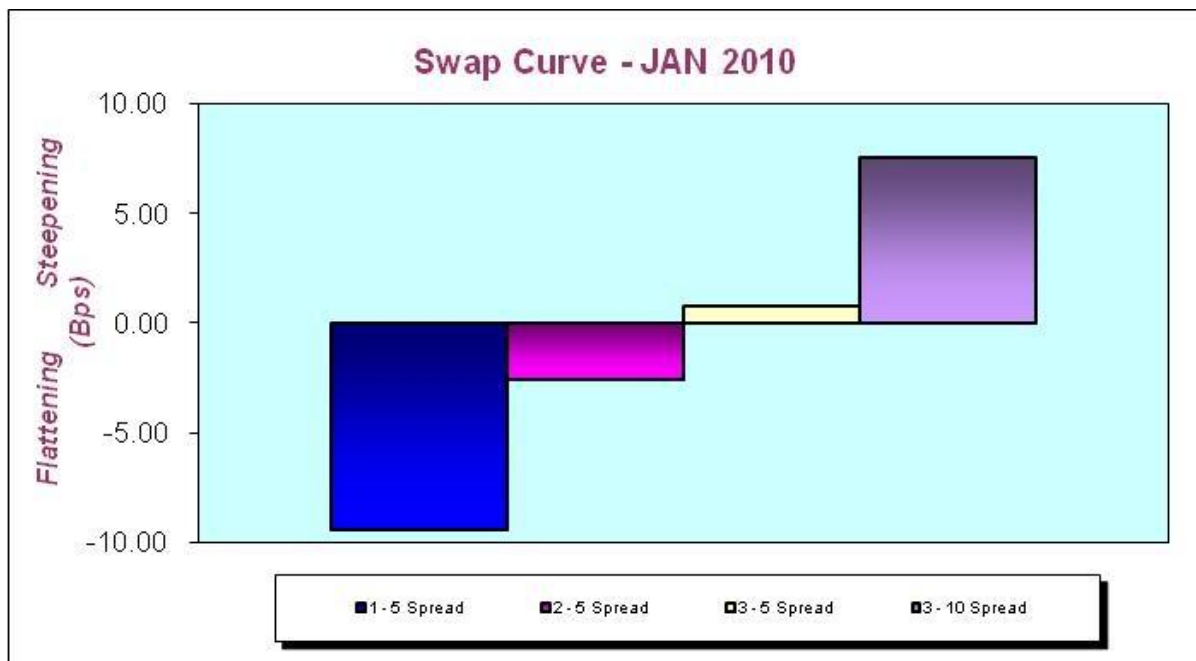
The MSR Rich/Cheap gives the internal rate of return for retaining servicing and provides a general measure of how aggressive aggregators are in their servicing bid. If a client is considering retaining servicing, or is deciding between retaining or selling servicing-released on any given day, this number can serve as a guide. Compass uses best execution across aggregators each day for note rates bracketing the FN30NR. The Mandatory/BE spread tracks the difference of a representative seller's basis point pick-up using mandatory delivery instead of best efforts. Compass uses several investors, for best efforts and mandatory, and compares the best execution of each of the two delivery methods for note rates flanking the FN30NR. There was considerable volatility for both numbers over the course of the month. The MSR Rich/Cheap averaged 17.5% with a peak of 31.9% and a low of 8.1%. The BE/Mandatory Spread averaged 39bps with a peak of 54bps and a trough of 27bps. *-David Bennett*

Monthly Spreads



The Treasury 2-10 spread increased slightly from the previous month at 277bps vs 270bps at the end of December. -Glen Brown

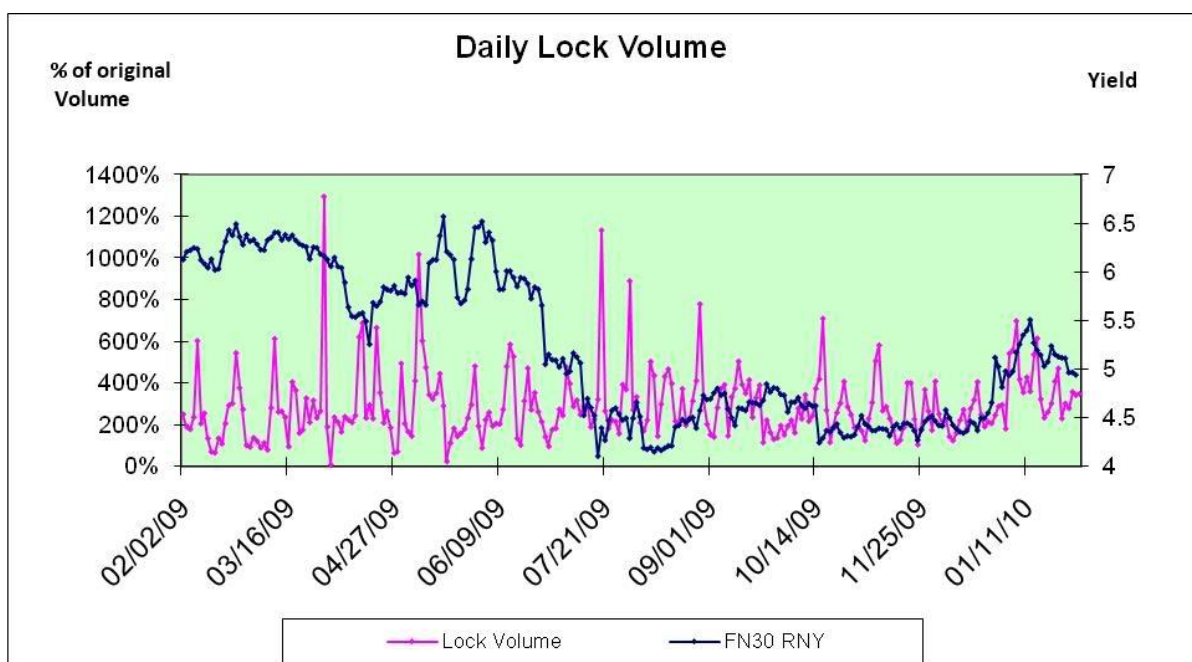
Swap Curve Analysis



Yields decreased across all tenors throughout January, led by the belly of the curve. The 1 year LIBOR yield fell 15bps and the 10 year swap yield decreased by 18bps. The 2, 3, and 5 year swap yields each fell by 22-25bps in January. The result was a steepening of the long end and flattening of the short end of the curve. In January's biggest daily move, both the 5 and 10 year swap yields were down 10 bps. The 1-5 LIBOR/Swap spread tightened 9 bps to 185 bps and the 3-10 Swap spread widened 7.5bps.

-Dylan Faerstein

Production Index



Production in January increased while rates traded in a narrower range (24bp range in January versus 64bp in December), with the average yield increased month over month by 10 bps. Average volume for the month was 241% of our base volume (vs. 203% in December) ranging from a low of 75% to a high of 416%. The average yield on the FN30 RNY in January was 4.76% (vs. 4.68% in December) ranging from a low of 4.68% to a high of 4.92%. **-Brandon Case**