

The Month in Review

January 2010

What's New?

Take a look at our Topic of the Month for January on "**Making the Leap from Best Efforts to Mandatory Deliveries**". This is part 1 of a 2 part "notes from the field" series. Topics covered this month will include implementing appropriate lock-in and hedging policies and strategies, setting up relationships with appropriate counterparties, managing loan data and transfers, managing interest rate risk, best execution analysis and implementation of hedge accounting.

Compass will be continuing its monthly Webinar training series in January with a session on "**How to Read Daily Market Color Emails**" with Dave Bennett. The Webinar will be held on Wednesday, January 27th from 10-11am PST (1-2pm EST). If you receive our Daily Color emails and would like to attend, please send an email to lpoule@compass-analytcs.com. We will be sending out a WebEx link with log-in information to those of you who are interested the week of the Webinar. Look forward to chatting with you on the 27th!

New in CompassPoint™!

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

- Expanded Roll Matrix Adjusters (grid and row level)
- Beta Version of Originator Company Cash Flows/Scenarios
- Expanded OAS Result Fields (MSR and WL)
- Greatly Enhanced Scenario System Data Source
- Additional Term Structure Derivation Method for Static/Forward Mode
- Additional Cash Flow Elements on Reverse Mortgage Cash Flows
- CMM Hedge Template and Analytics
- Strat Tool 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.

Market Update

As the final month of 2009 unfolded, treasury and mortgage rates pushed higher, breaking through ranges that had held for several months. Yields on 10-yr treasuries had remained at or below 3.60% since August, but the latest push higher brought the yield back to the 3.90% area. To this point, the 4.00% yield has not been seriously tested and it provides a new ceiling for the time being.

Leading into, and following, the January 8th release of the December unemployment report, yields have stabilized and a push back to the middle of the new range has brought 10-yr yields back below 3.80%. The December change in non-farm payrolls showed an unexpected drop of 85,000 jobs. Expectations were for a flat reading following a slight growth in November. The headline unemployment rate remained at 10.0%, so not much there for either bulls or bears to hang their hats on.

As far as the 10% unemployment rate goes, while having a reported one in ten people out of work sounds bad enough, the real rate is likely much higher. The survey used to calculate the number asks people whether they are currently working or currently looking for work. Given the length and depth of the current downturn, many individuals that were previously looking for work have dropped from the search and others may have accepted part-time employment when they'd rather work full-time. When these individuals are added to those counted as out of work, the unemployment rate balloons to around 17%.

Given that all market participants are aware of the understatement of the unemployment rate, it then becomes a matter of how the various numbers will affect Fed policy and rate expectations going forward. Recent statements by Fed policy makers have not added much clarity to the Fed's intentions nor to what triggers they may be looking for before beginning the unwinding of the rock-bottom Fed Funds rate. *-Lindsay Hill*

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

Notes from the Field: Part I 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/noterate 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. The topics covered will include implementing appropriate lock-in and hedging policies and strategies, setting up relationships with the appropriate counterparties, managing loan data and transfers, managing interest rate risk (in-house as well as outsourced), best execution analysis and implementation of hedge accounting.

Developing and applying updated policies and procedures is essential to a successful transition from Best Efforts to Mandatory selling. Originators should review investor guidelines and internal operational parameters in order to identify which products they will choose to hedge, what lock-terms they will offer to brokers, loan officers and borrowers, what extension fees will apply when necessary, what types of Mandatory deliveries will be utilized and what the appropriate hedge instruments and application of that hedge are for each product. Rather than jumping in head first, and hedging the entire portfolio of products, many originators choose to begin with a sub-group of "vanilla" products in order to familiarize themselves with the nuances of Mandatory delivery and the hedging process and then add products to the hedge as they see fit.

The next essential step when transitioning from Best Efforts to Mandatory is to set up the appropriate counterparty relationships required to deliver loans on a Mandatory basis. This requires developing relationships with whole loan Investors and entering into Assignment of Trade (AOT) or other types of Mandatory agreements. Investors typically will review the product mix, monthly origination assumptions (based on historical data), financial health and equity of the company as well as the hedge policy and risk management strategies or relationships, and based on that data provide terms of the mandatory agreements. If existing Best Efforts relationships are in place with investors that provide Mandatory execution, the transition to deliver loans to these investors on a Mandatory basis is typically faster and easier as the investor is already familiar with the company's operations. Additionally, it is essential to establish credit lines with Broker Dealer securities counterparties in order to execute trades to hedge the interest rate risk inherent with selling loans Mandatory. Again, Dealers will require specific information regarding the company's operations and financial health when determining the how much credit to provide and any stipulations that will be applied.

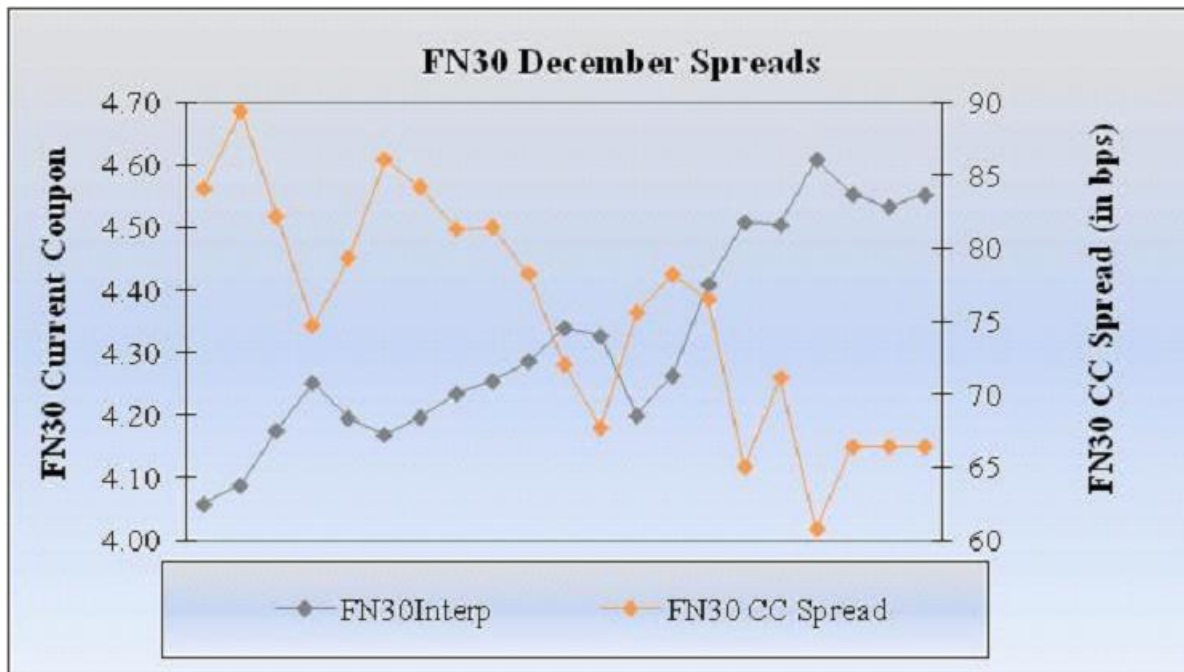
Another key element required for originators making the move to Mandatory delivery is Data Integrity and the accurate transfer of data from the Loan Origination System (LOS) to a Risk Management System that models the value of the loan pipeline and hedge instruments. Data integrity is important for several reasons when Selling Mandatory ranging from hedge coverage ratios to accurate accounting

entries. The accuracy of lock terms, product types, noterates, loan level price adjustment triggers such as FICO and LTV as well as Lender Cost and Day-1 Profit Margin are essential to the pricing of the loan. Since many originators use pullthrough assumptions based on a loan's in or out-of-the-moneyness to drive hedge coverage applied at the loan level, accurate pricing of each loan is critical to the success of the hedging strategy.

By implementing lock-in and hedging policies and procedures, establishing relationships with whole loan investors and Broker Dealer counterparties and managing Data Integrity and the transfer of that data to a risk management system, originators are well on the way to making the switch from Best Efforts to Mandatory selling. In next month's newsletter we'll continue this article, covering additional topics such as the management of interest rate exposure, best execution analysis and choosing the appropriate loan delivery methods, and the implementation of hedge accounting procedures. -**Bob Gundel**

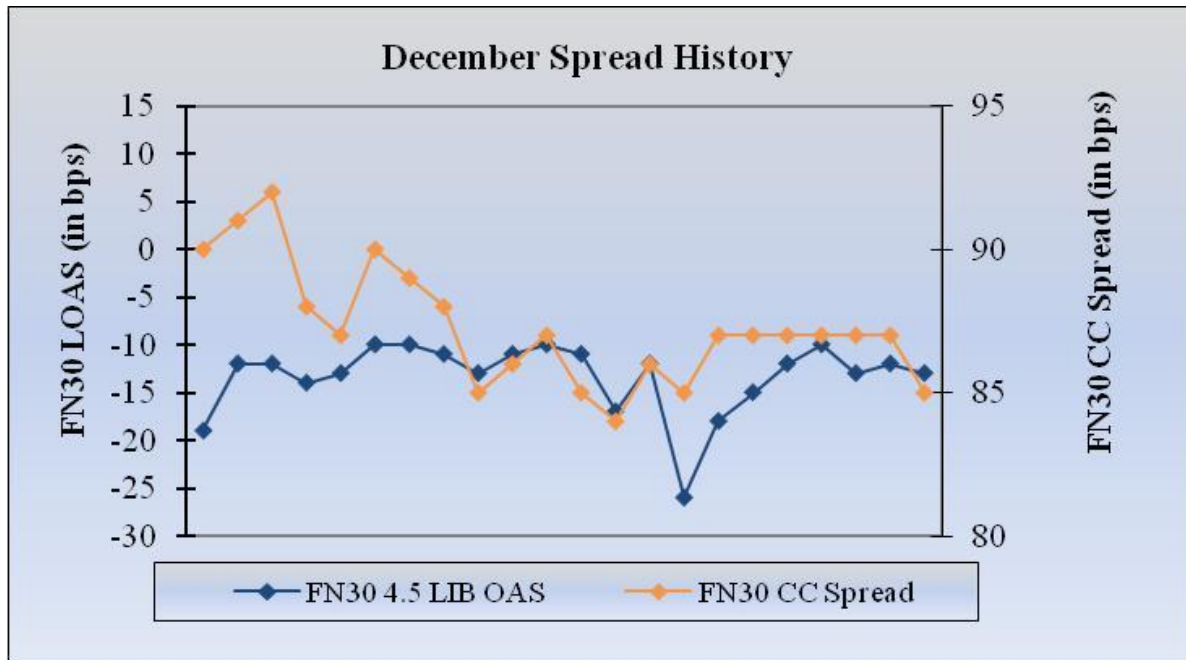
*Actual Best Efforts/Mandatory spread may vary by originator and is subject to change.

Margin Tracker



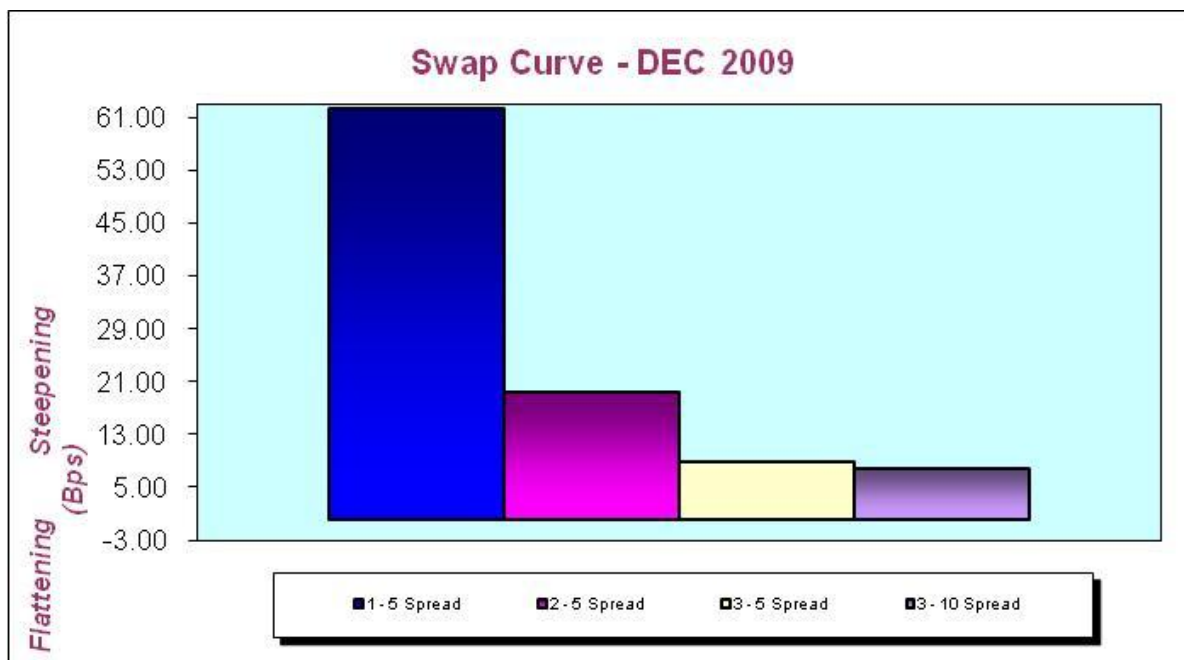
The FN30 CC Spread is the difference between the FN30 Note Rate and the FN30 Current Coupon, in basis points. The FN30 NR is the average conventional note rate across a subset of Compass's client base normalized for volume. The FN30 CC is the Fannie 30-year Mortgage Backed Security yield at par 30 days 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 28bp peak to trough differential. Shown in the chart above, there is a noticeable negative correlation between rates and spreads. As rates increased throughout the month, there is a noticeable decrease in margins. The tightest the spread got was 61bps; the widest was 89bps; the average was 76bps. *-David Bennett*

Monthly Spreads



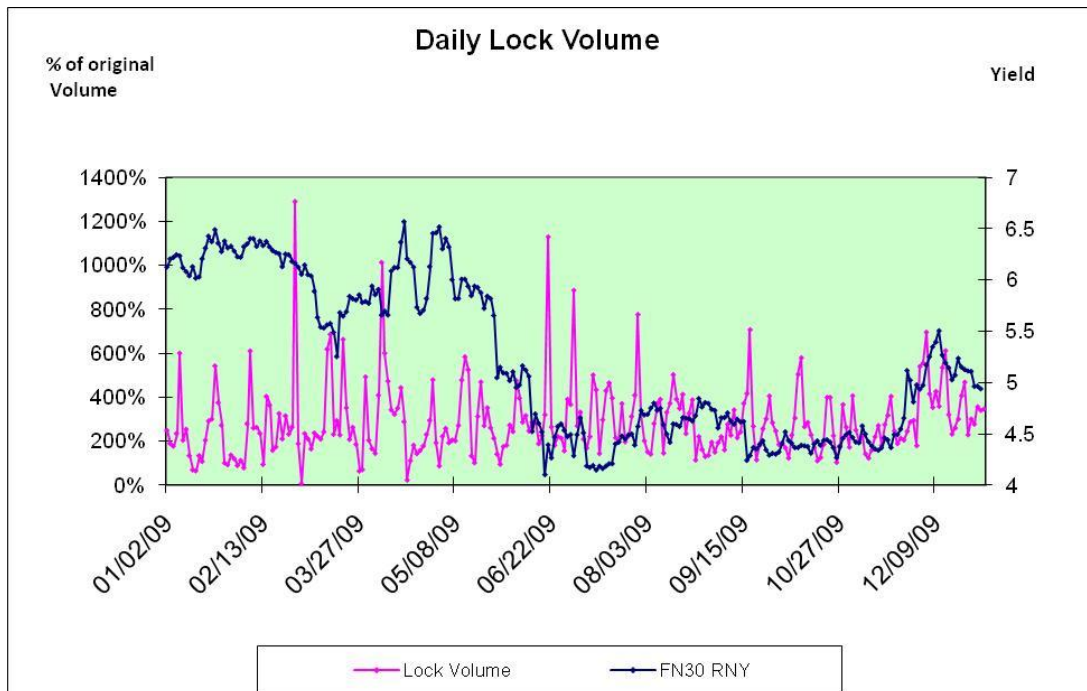
The Treasury 2-10 spread increased substantially from the previous month at 270bps vs 249bps at the end of November. -Glen Brown

Swap Curve Analysis



Yields increased consistently across all tenors throughout December, except for the 1 year, which fell by 2 bps. The 2 year increased by 41 bps, followed by the 3, 5, and 10 year swap yields, each of which rose by 50-60 bps from November to December, resulting in a steeper curve. This steepening reflects investors' belief that short-term rates will remain subdued but that the Fed will eventually have to raise rates to combat inflationary pressures (evidenced by the PPI and CPI releases). In December's biggest daily move, the 10 year swap yield was up 17 bps. The 1-10 LIBOR/Swap spread widened 61 bps to 299 bps. *-Dylan Faerstein*

Production Index



Production in December decreased while rates traded in a wider range (64bp range in December versus 41bp in November), with the average yield decreasing month over month by 2 bps. Average volume for the month was 203% of our base volume (vs. 313% in November) ranging from a low of 26% to a high of 417%. The average yield on the FN30 RNY in December was 4.68% (vs. 4.57% in November) ranging from a low of 4.32% to a high of 4.96%. **-Brandon Case**