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The Month in Review

July 2010

Don't Miss!

Compass has moved! Please update your records with our new contact information:

580 California Street
Suite 1725
San Francisco, CA 94104

Phone, fax, and email remain the same.

What's New?

Check out our July Topic of the Month, **Tips for Improving Secondary Marketing Efficiency and Effectiveness**. In a preview to an article to be published in the August issue of The Secondary Marketing Executive, Bob Gundel revisits the importance of knowing your day-1 profit margin.

Rob Kessel's next Fannie Mae Housing Finance Institute (HFI) **Secondary Marketing Class** for 2010 is in Dallas, TX from October 5-6. If you would like more information about these sessions please send an email to rkessel@compass-analytics.com.

New in CompassPoint™!

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

- BETA release of user-defined workflow email alerts.
- Standardized email bug reporting.
- SRP position/P&L change reconciliation processes and reporting.



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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

When the current rally in mortgages began back in April, it seemed that the US economy was on increasingly strong footing and external concerns, including the European debt crisis, were the cause of a push to lower rates. Now, a few months later, concern over a faltering of US growth has helped sustain the rally. Several recent production and manufacturing indexes have slipped from the levels seen earlier this year and job growth, while showing some improvement this year, has remained sluggish.

Given that it has been the consumer that has contained and brought the US out of most recent downturns, there should be some concern that retail sales and consumer confidence remains weak at this stage in the cycle. Can businesses be expected to lead the recovery in an environment lacking consumer spending growth? It's difficult to tell which is the chicken and which is the egg when comparing business and consumer input to the recovery, let alone which will come first.

The government's hope that low interest rates would spur home buying just isn't panning out. The tax credit provided some boost, but now, even with mortgage rates approaching their lowest point, buyers are once again on the sidelines in large numbers. While mortgage origination volumes have improved recently, absent a strengthening of consumer confidence, volumes may once again slip, even at these rates. Those in the government taxed with the job of creating growth in the economy may once again find themselves short on bullets. *-Lindsay Hill*



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Topic of the Month

Tips for Improving Secondary Marketing Efficiency and Effectiveness: Revisiting the Importance of Knowing your Day-1 Profit Margin

This is a preview of an article to be published in the August issue of *Secondary Marketing Executive*.

Do you know what your profit margin is when you originate a loan? Profit margin, the most important driver of a Lender's profitability, is often an obscure topic for most Secondary Marketing Managers (SMM's), and surprisingly, many can't answer the above question with 100% confidence. Control over profit margins equates to better control of a firm's overall profitability, however many SMM's unknowingly have effectively given up control of their Day-1 Margin.

One of the biggest mistakes we see both new and seasoned Secondary Marketing Manager's make when originating loans is using an Investor's Best Efforts ratesheet to price the loans and set their margin, while selling the loans on a Mandatory execution. Why do we say this is a mistake? Because by doing so, these managers are allowing the most important driver of profit to be manipulated by a third party and thus have effectively given up control of their Day-1 Margin. When a Lender uses Best Efforts pricing to originate a loan he/she plans to hedge and sell using a Mandatory execution, a portion of the Day-1 margin built into the loans when they are originated is attributed to the spread between the all-in Best Efforts price, and the all-in Mandatory price. Let's use the following hypothetical data to illustrate:

| FNMA 30-Yr (30-day Locks) | | | | | |
|---------------------------|-----------------|-------------------|-------------------|----------------------|--------------|
| Noterate | Rank 1 BE Price | Rank 1 Mand Price | BE to Mand Spread | Base Margin | Total Margin |
| 4.625 | 101.25 | 101.62 | 0.37 | 0.45 | 0.82 |
| 4.750 | 101.77 | 102.04 | 0.27 | 0.45 | 0.72 |
| 4.875 | 102.17 | 102.63 | 0.46 | 0.45 | 0.91 |
| 5.000 | 102.76 | 103.10 | 0.34 | 0.45 | 0.79 |
| 5.125 | 103.35 | 103.79 | 0.44 | 0.45 | 0.89 |
| 5.250 | 103.95 | 104.47 | 0.52 | 0.45 | 0.97 |
| Average BE-Mand Spread | | | 0.4 | Average Total Margin | 0.85 |

Using the data in the table above, let's say that an originator prices the Jones loan, a FNMA 30-Yr 4.750% noterate using a Best Efforts ratesheet, with the intention of hedging that loan and selling on a Mandatory execution. The Total Effective Margin on the day the loan is originated is equal to the Base Margin of 45bps plus the difference between the All-In Best Efforts execution and the All-In Mandatory



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execution of 27bps, or 72bps. Seems like a healthy margin, so what's the problem? The problem is that the Best Efforts to Mandatory spread is a moving target; on any given day the spread can vary by product, delivery term and as observed in the table above, by noterate. So if the SMM is assuming that the Jones loan is receiving the Average Total Margin of 85bps (the average BE-Mand Spread of 40bps plus the 45bps of base margin), in reality they are already underperforming by 13bps on Day-1 just due to variation in BE-Mand spread between the average and value of the 4.750% noterate. For an SMM pricing loans in this manner, unless they are performing this analysis every day, by product, noterate and delivery term, their Day-1 profit margin is an unknown, or at best inaccurate.

Additionally, the average BE-Mand spreads expand and contract given different market environments and changes to investor demand for product. Below is a graph of some observed Best Efforts to Mandatory Spread average values for the month of May:





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As clearly expressed in the chart, the spread is volatile and contracts and expands day over day. This means that the 72bps of Total Margin that was built into the Jones loan on Day-1 could be more or less than 72bps on the day the loan is sold on a Mandatory Execution. For example let's say 23 days have passed and the Jones loan has closed. Today when the SMM goes to sell the loan Mandatory, the Best Efforts to Mandatory spread on the 4.750% noterate is now only 17bps, and his/her effective margin on the loan is now 62bps, a reduction of 10bps from the day of origination and 23bps worse than the average total margin expected across all noterates. Add in 5 to 10bps of hedge cost to this scenario, and allowing a third-party to influence your margin has proven very costly.

| Day N BE to Mand Spread | Day N+23 BE to Mand Spread | Base Margin | Day N Expected Total Margin | Day N+23 Realized Total Margin |
|-------------------------|----------------------------|-------------|-----------------------------|--------------------------------|
| 0.27 | 0.17 | 0.45 | 0.72 | 0.62 |

Aside from increasing P&L volatility, there are several other problems caused by pricing to Best Efforts and selling Mandatory. We'll discuss in greater detail the most important of these problems, which include setting the correct amount of hedge coverage in a dynamic pullthrough model, as well as improper reporting of pipeline profitability and understanding the effectiveness of the hedging strategy employed to protect the Day-1 Margin.

In a Dynamic Pullthrough model, originators assume that loans with positive P&L above and beyond the Day-1 margin, (we'll refer to this as positive Secondary Marketing P&L) have a lower percentage chance of closing since increased market prices means rates are lower and the borrower is more likely to get a more favorable rate elsewhere. Conversely, when loans have negative Secondary marketing P&L, the model assumes that a higher percentage of these loans will close as lower prices drive market rates higher and the rates and terms of the existing loan lock are more attractive to borrowers. This means that originators pricing to Best Efforts and valuing loans with a mark-to-market Mandatory execution will have the true Secondary Marketing P&L of the loans distorted by the amount of the Best Efforts to Mandatory spread. Using the Jones loan above as an example, in a flat market, we show that it is 27bps in-the-money on Day-1. Since loans that are in-the-money are covered at a lower percentage, the loan is effectively underhedged starting on Day-1. This situation stays true the entire time the loan is in the pipeline assuming that the Best Efforts to Mandatory spread is > 0. Using an average to proxy the Best Efforts to Mandatory spread won't work in this situation because the spread varies by product, noterate and delivery term and those spread values can change from one day to the next. In a down market, improper hedge coverage can be extremely costly.

Additionally, pricing loans in this manner leads to distortions in profitability reporting and hedge effectiveness testing. If an originator doesn't know what his or her profit margin is for each loan, how well can they determine how effective their hedge is? Going back to the Jones loan, which had a Total Effective Margin of 62bps on the day it was sold, how is this P&L being reported in the financial statements? Most likely the originator is booking the 45bps of Base Margin as P&L from Margin and the



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additional 17bps that's attributed to the BE-Mand spread as P&L from execution, thereby understating the Effective Total Margin and overstating the gain on sale from market movement. In this scenario, loans will almost always have a negative hedge cost, unless the cost to hedge is greater than the BE to Mand spread on the day the loan was sold. Not only is this unrealistic, it's dangerous. Understanding hedge cost allows managers to make prudent decisions about which products to hedge and sell Mandatory and which products are better sold as Best Efforts.

Again, using an average to proxy the Best Efforts to Mandatory spread won't work in this situation because the spreads vary by product, noterate and delivery term and can change day over day, leading to distortions in hedge performance. A manager assuming that they'll make the average Total Margin of 85bps on the Jones loan introduces 13bps of noise on the day of origination (85bps vs. the 72 bps of actual Total Margin built in on Day-1) and 23bps of noise on day N+23 when the loan is sold, (85bps vs. the actual Total Margin of 62bps on the day it was sold). Add in 10bps of hedgecost, and an SMM using averages to determine their Day-1 Margin would be left scratching their head as to how the hedge performed so poorly in the case of the Jones loan.

So if all this is true, why do SMM's price loans that they plan to hedge and sell Mandatory using Best Efforts ratesheets, when they would clearly benefit from pricing the loans to a Mandatory execution on Day-1? The answer is, because it's easy. It's very simple to take a listed Best Efforts price from an investor's ratesheet, back out a base margin and put out pricing to the street. Conversely, without the right technology and tools, it can be extremely difficult to produce a ratesheet based on Mandatory executions. In the past originators pricing to a Mandatory execution had to update the investor model with live MBS prices, update applicable pricing components, such as par noterates, noterate adjusters, buyup and buydown grids, early delivery bonuses and various other spiffs, some of which can change daily in order to produce a base set of rates. As if that's not enough, they would then have to perform a Best Execution analysis among different Investor's Mandatory executions to determine the best prices to put out to the street. With such an extensive process, there is a lot of room for human error, making it difficult to train backup individuals within the department to generate rates in this manner.

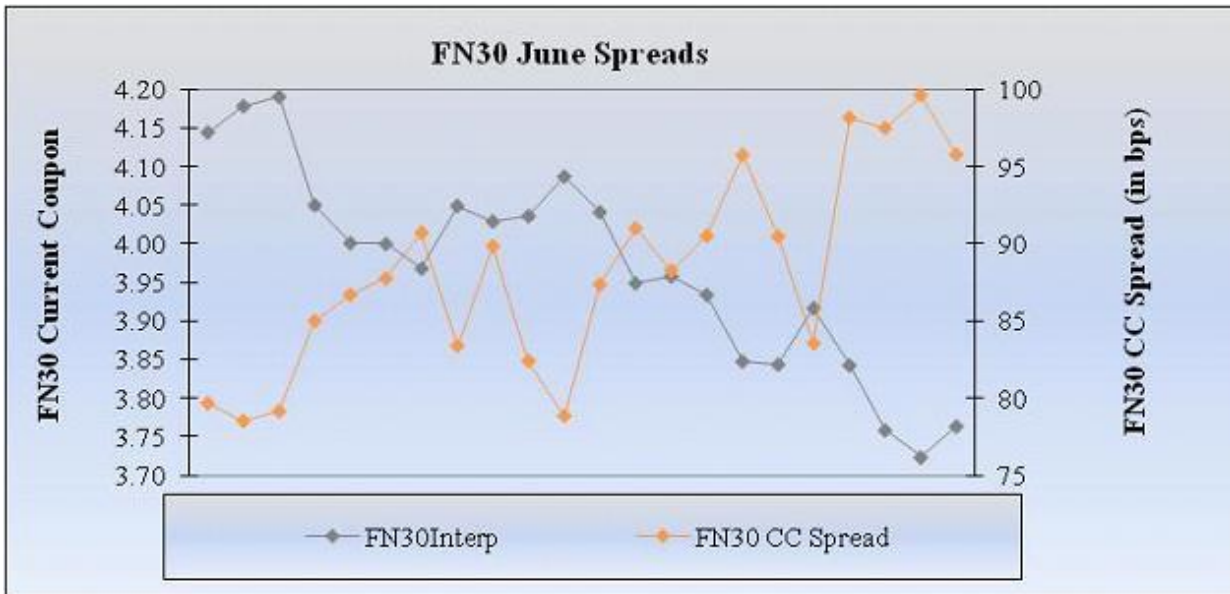
Luckily, there are tools out there that make pricing to a Mandatory execution simple and time-effective. By using tools that automate and streamline the process, SMM's can reduce the time it takes to generate rates, while removing much of the human error element involved in pricing to a Mandatory execution, allowing SMM's to take advantage of all the benefits of pricing loans Mandatory without all the hassle. By pricing Mandatory and selling Mandatory, SMM's take back control of their profit margins, giving themselves the ability to either put out better pricing to the street, or increase their base margin as they see fit. Without the distortions caused by variations in the BE-Mand spread, originators can accurately track their historical pullthrough in different market scenarios allowing them to implement more accurate pullthrough assumptions based on those real-life observations. Additionally, pricing Mandatory provides SMM's with the ability to track hedgecost and pullthrough at the loan level. This enables identification of profitable originators, thereby giving SMM's the control to adjust margins for these originators in order to set the optimal level of profitability. Conversely, identifying originators with lower pullthrough and higher hedge cost allows originators to pad margins where necessary, such as offsetting increased hedge cost in longer dated locks by increasing margins incrementally as the lock terms increase.



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With the right tools and technology in place, Secondary Marketing Managers can greatly reduce the time and effort expended in generating rates using Mandatory execution. By pricing hedged loans with a Mandatory execution on Day-1, SMM's can take back control of their margins and will have more accurate data and therefore better metrics in place to identify what's working well and what areas need to be improved upon. Additionally, when asked, "Do you know what your profit margin is when you originate a loan?" SMM's pricing hedged loans to a Mandatory execution can answer "Yes" with confidence and conviction. *-Bob Gundel*

Margin Tracker

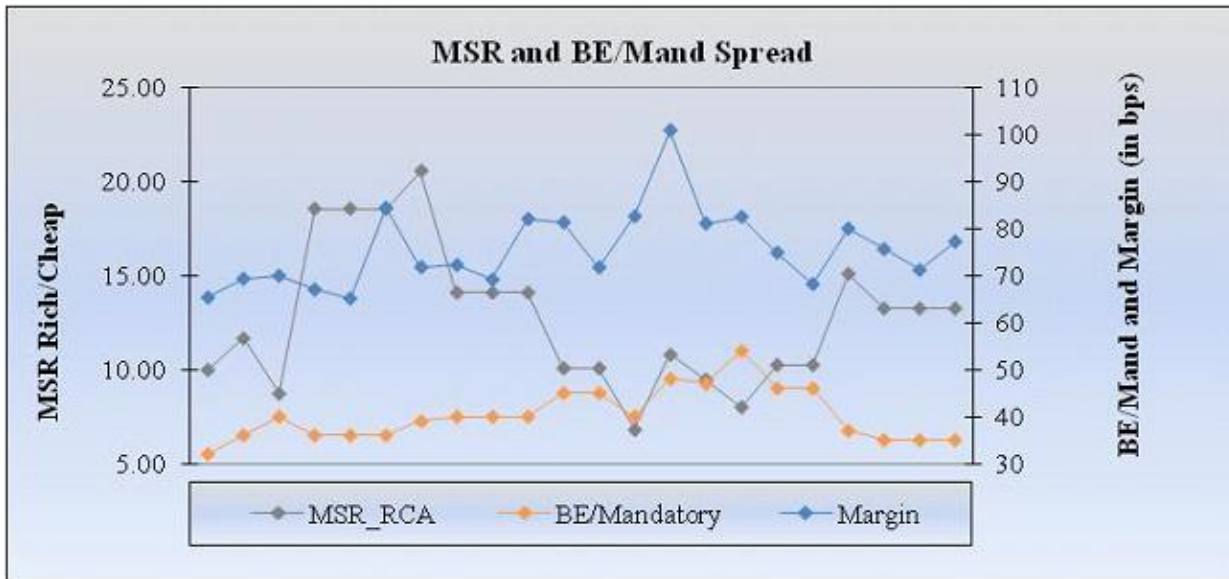


The FN30 CC Spread is the difference between the FN30 Note Rate and the FN30 Current Coupon, in basis points. The FN30 NR is the average conventional note rate across a subset of Compass's client base normalized for volume. The FN30 CC is the Fannie 30-year Mortgage Backed Security yield at par 30 days 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 June, 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 chopped around throughout the month, there is an inverse relationship to the spread. The tightest the spread got was 79bps; the widest was 100bps; the average was 88bps. *-David Bennett*



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MSR Rich/Cheap and Mandatory/Best Efforts Spread

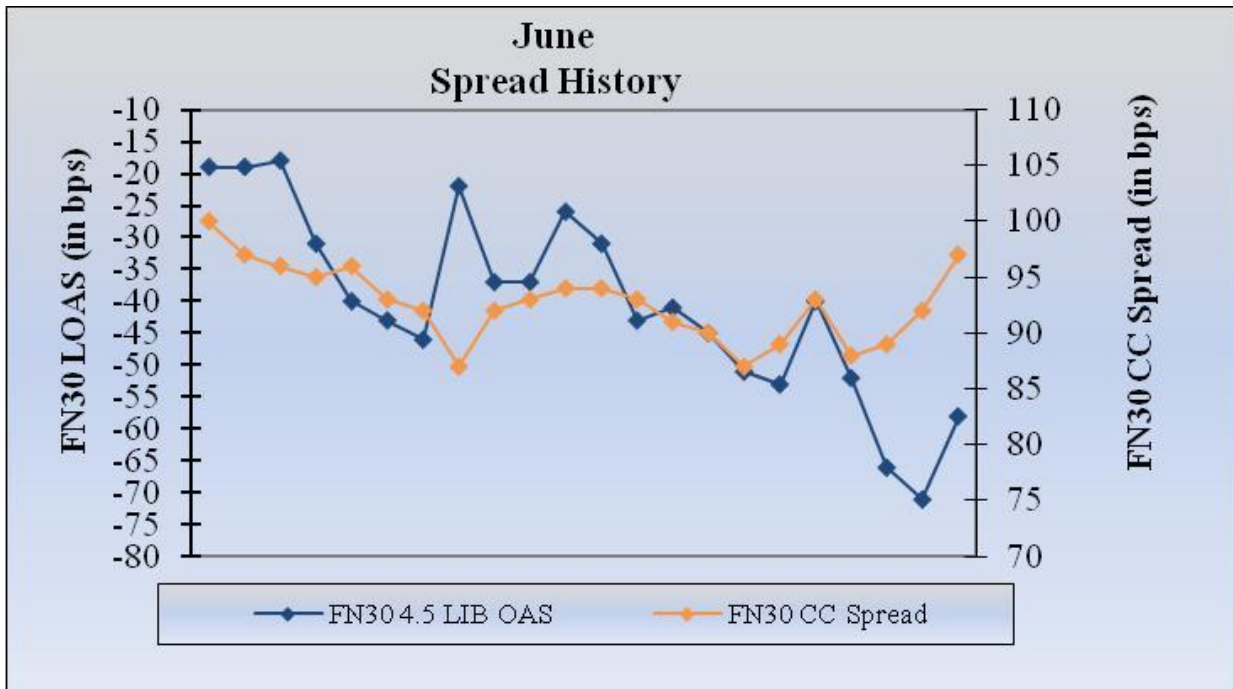


The MSR Rich/Cheap gives the internal rate of return for retaining servicing and provides a general measure of how aggressive aggregators are in their servicing bid. If a client is considering retaining servicing, or is deciding between retaining or selling servicing-released on any given day, this number 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. The Conventional 30-year average gross profit margin tracks the originator's gross profit margin, i.e. the difference between what the originator pays for the loan (what is posted on a rate sheet) and what the originator could sell the loan for into the secondary market. There was considerable volatility for all three numbers over the course of the month. The MSR Rich/Cheap averaged 12.7% with a peak of 20.5% and a low of 6.8%. The BE/Mandatory Spread averaged 40bps with a peak of 54bps and a trough of 32bps. The 30-year gross profit margin averaged 76bps with a peak of 101bps and a trough of 65bps. *-David Bennett*



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Monthly Spreads

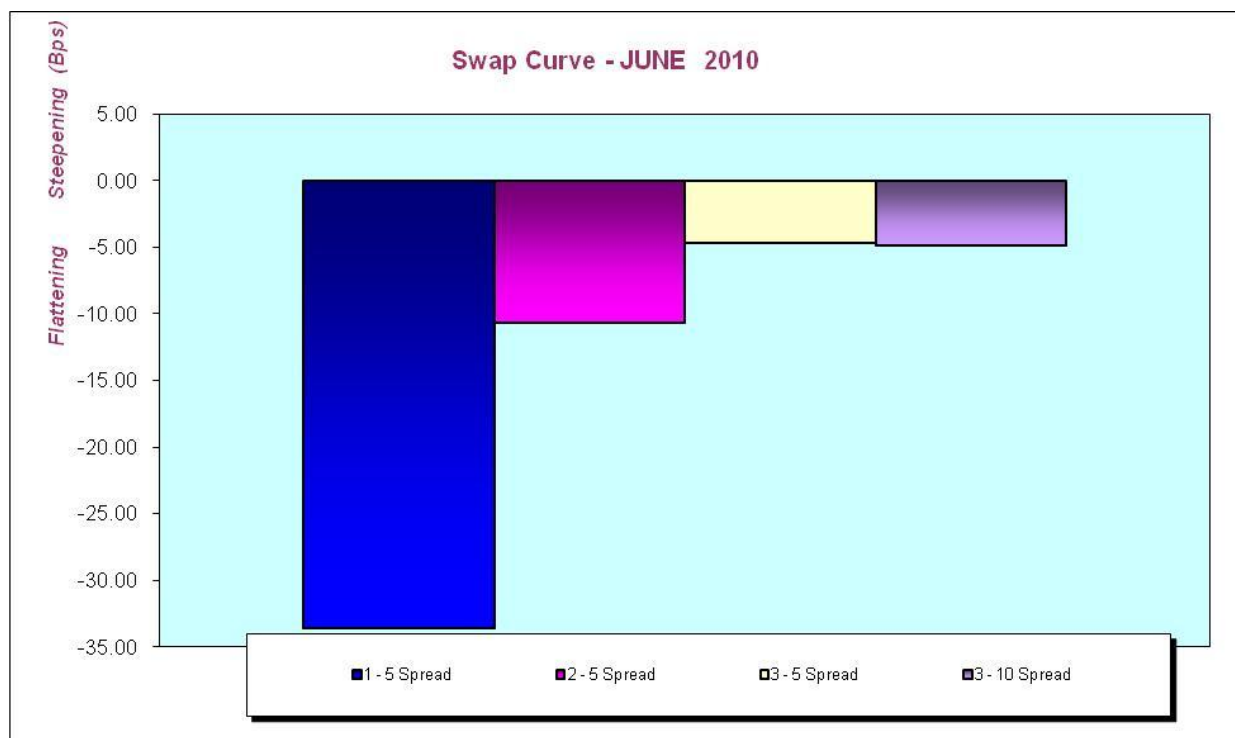


The Treasury 2-10 spread tightened from the previous month at 233bps vs. 252bps at the end of May.
-Glen Brown



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Swap Curve Analysis

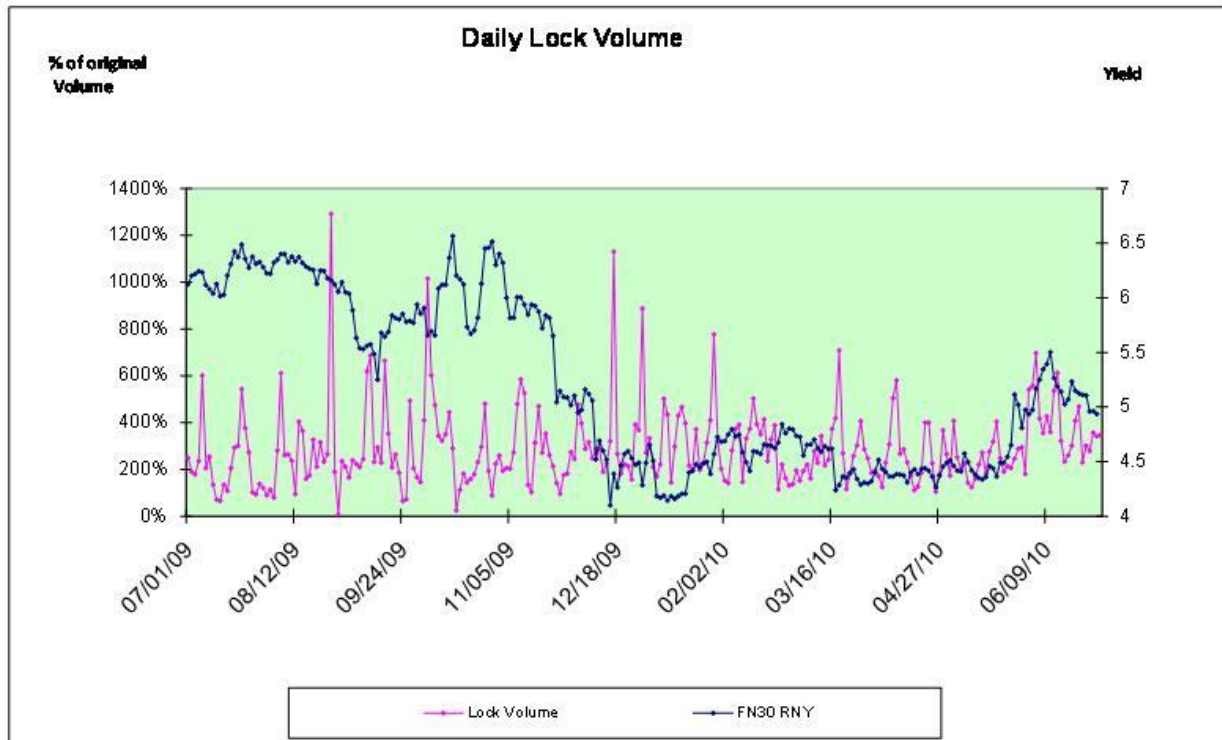


The 1 year LIBOR yield decreased 3.5 bps during June, closing the month at 1.173%. The rest of the curve had a much more dramatic drop in yield, with the 2 year swap down 26 bps, the 3 year down 32 bps and the 5 and 10 years each down 37 bps. The result was flattening in the short end and a nearly parallel drop in the long end. The 1-5 LIBOR/Swap spread tightened 34 bps while the 3-10 swap spread tightened only 5 bps. In June's biggest daily move, the 3 year yield fell 10 bps, the 5 year fell 14 bps and the 10 year fell 17 bps on June 4, following the disappointing May payroll figures and comments from the Hungarian prime minister that talks of default were "not an exaggeration". *-Dylan Faerstein*



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Production Index



Production in June decreased while rates traded in a wider range (42 bp range in June versus 40 bp in May), with the average yield increasing month over month by 23 bps. Average volume for the month was 108% of our base volume (vs. 142% in May) ranging from a low of 62% to a high of 291%. The average yield on the FN30 RNY in June was 4.35% (vs. 4.58% in May) ranging from a low of 4.12% to a high of 4.53%. **-Brandon Case**