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An following is an excerpt from the Compass Analytics November 2010 *Month in Review*

Topic of the Month: Update on IR Futures Markets for Mortgage Hedgers

Pipeline:

In mortgage origination hedging, Eurodollar and treasury futures/options have historically been used as adjunctive tools to address issues of adjustable and fixed pipeline convexity & pullthrough. While a range of products are available, durations of the 10 yr Treasury futures market most closely match typical pipeline duration (current 10yr Tsy future mod. dur. ~5.8years). That said, risks and opportunities are presented by the inherent spread between mortgages, swaps and the treasury curve. While the crisis of recent years have seen periods of acute volatilities in these spreads, the past 90days have seen the CC TBA/Tsy spread quiet to a ~10-15bps range, with a standard deviation under 5bps. Risk management comes through understanding.

Purchasing OTM treasury puts can cover aspects of pullthrough; offsetting the put writing that is inherent to rate locks. Conversely, OTM Tsy calls on an overlying TBA forward hedge can be used to address excessive fallout/convexity.

Servicing:

In these days of FinReg; the universe of exchange traded Interest Rate products is quickly expanding beyond the long established markets of Eurodollars and Treasury futures. In the past year, 5 and 10 year Swap futures contracts have gained usable liquidity and open interest, and this Fall 2010 has seen the launch of a centrally cleared swap futures exchange (The Eris Exchange) allowing a continuous tenor of vanilla swaps out to 30 years; as well as the CBOT 'On-the-run' ("OTR") Treasury futures products, offering a new points of duration on the treasury curve.

The benefits of these products, especially for mid-tier and closely held firms, are three fold:

- Swap futures (5s, 10s, and Eris) are centrally cleared, backed by the CME clearinghouse which supports nearly all of the US futures/options volume. This 'mutual' clearing has never had a loss of client funds in it's 100+ year history - despite even the turmoil and bankruptcies of recent years.
- Margins requirements are further reduced by any offsetting futures positions a client may have. (think Asset/Liability hedging v. Mortgage hedging)
- Swa futures can be utilized using simply a futures account; no ISDA negotiation/agreement is needed.

While this is only a brief overview of some keys aspects of these products, we're always happy to assist in incorporating these into your hedging toolkit. Our Institutional team at MF Global can be reached at 312/261-7322.

-Don Soldatis, MF Global