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The Month in Review

March 2011

Don't Miss!

Check out part 2 of our Topic of the Month: "**Key Drivers of Pipeline Gain/Loss and Tips for Managing and Reducing Hedge Cost**". In the second part of an excerpt from the March issue of *Secondary Marketing Executive*, Bob Gundel examines hedge cost and ways to maximize the realized Best Efforts to Mandatory Spread.

What's New?

Compass is excited to announce the opening of our Washington, DC office! The new office in Potomac, Maryland will be led by Jeff Casella, formerly Senior Account Executive at Fannie Mae's Capital Markets desk. We are also pleased to announce the addition of Wayne Brown as East Coast Sales, Managing Director. Brown was formerly the Director of Cash Sales & Trading at Freddie Mac. We are excited to better serve East Coast customers with a DC area office which we intend to grow quickly.

Compass is heading to New York for the National Secondary Market Conference in May, we hope to see many of you there!

New in CompassPoint™!

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

- Beta Release of new ULDD XML Agency Delivery Extracts
- Rate Sheet Review Capability Integrated to Rate Sheet Batch
- Rate Sheet - Originator/Product Margin Grids
- Rate Sheet - Further Generalization of Lock Terms
- Pooling Summary - Ability to Change Reserved on Allocate w/o Trade
- Pooling Summary - Integrated Auto-Pooling and Re-ranking Functionality
- MSR - Tiered Excess Servicing - OAS Shocks

- E-Mail Workflow Alerts - Email Recipient from Data Query
- Pipeline - Ship Date Now Usable for Cutoff Calendars
- Pipeline - Commitment Price Adjustments with Applies To Logic

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

The month of March saw a rather volatile pattern in treasury and mortgage rates with a sharp early-month dip quickly followed by a late-month jump. By the middle of April, not much ground was gained or lost and rates have re-entered the range they been in for most of the last four months. In the near term, it appears that the 10-year treasury yield will have some difficulty pushing above 3.60% and also find some resistance to dropping below 3.40%. Longer term, there's little reason to believe that the trend towards higher rates hasn't remained intact.

While some recent domestic economic measures have slipped slightly from previous month's levels, by and large the recovery from the trough of this recession appears to continue. Retail sales posted their 9th consecutive month-over-month gain and job growth accelerated in March. The headline unemployment rate dropped to 8.8% on 216,000 new payroll jobs and the U6 rate - the broader measure that also includes workers that have temporarily given up the search or are currently under-employed - dropped from 15.9% to 15.7%. The U6 measure stood at 17.1% last September.

News items from overseas have likely driven more of the recent volatility than domestic concerns. The status of the nuclear plant situation in Japan has changed from bad to worse to better and back to worse again over the last few weeks. The recent decision to increase the incident to a level-7 accident -- the highest severity level on the recognized international scale - pushed equities and interest rates lower. In addition, news out of Europe points to concern over the continued support of some weaker economies, including that of Greece, and whether additional measures would be needed.

In all, it adds up to some recent market volatility and yet not much discernable direction for rates. It also adds up to a lot for a FOMC voting member, or a secondary marketing manager, to consider.

-Lindsay Hill

Topic of the Month: Key Drivers of Pipeline Gain/Loss and Tips for Managing and Reducing Hedge Cost, Part 2 of 2

The following is the second part of an excerpt from the March 2011 issue of Secondary Marketing Executive:

Another critical element in successful pipeline hedging is having multiple delivery channels for loans. Lenders with several options will typically deliver to the Investor with the best price in order to squeeze every last basis point out of the loan and maximize profits. This means that Investors are competing with one another for the lender's business and product. The need to keep pricing competitive means that lenders with multiple delivery options tend to see better Investor pricing than lenders that have a single delivery option. More competitive mandatory pricing means an increase to the spread over Best Efforts, which should result in increased profitability all other things equal. Multiple delivery options then create

another level of Best Execution for SMM's to model and analyze when selling loans. SMM's should consider Investor, Coupon and Delivery Month best execution when calculating MTM on locks and inventory as well as when preparing to sell funded loans to Investors. With the proper technology, deriving accurate MTM pricing that factors in all applicable noterate, occupancy and credit adjustments, delivery cutoffs, early bonuses and price spiffs across multiple Investors can be achieved in a timely and accurate manner. Lenders failing capture Best Execution at the time of sale create opportunity cost which results in higher hedge cost, since the full Best Efforts to Mandatory spread value isn't realized.

Certainly relevant given then recent market activity over the past two months is the effect of market volatility on hedge cost. The volatility of the mortgage market is positively correlated to hedge cost, and typically increased volatility means an increased cost of hedge. There are a number of factors contributing to this, one being a widening of the bid/ask spread for hedge securities in volatile markets. In a volatile market, Broker Dealers want to pad their theoretic edge over fair value and do so by bidding securities at slightly lower levels and offering securities at slightly higher levels, thereby widening the bid/ask spread. Lenders hedging a pipeline and paying the bid/ask spread feel the effect of worse hedge execution on their bottom lines. In highly volatile markets, it also becomes difficult to market time hedge security transactions and loan sales. Pair off timing is always a critical factor of effective hedging, but it becomes extremely difficult in high volatility situations. For example, assume that a SMM sells a FN30 4.0 FEB direct trade to an investor at a price of 99:10 (99 and 10/32 or 99.3125). Immediately after the trade is executed, the SMM places an order to pair out of their FN30 4.0 FEB hedge, but the market has rallied 7/32 since the direct trade was executed and the pair off is executed at 99:17 (99 and 17/32 or 99.53125). Due to a fast moving market, the SMM loses out on 20+bps of execution because the market rallied before they could buy back their hedges.

Direct Trade Price (32nds)	Direct Trade Price (decimal)	Hedge Pair Off Price (32nds)	Hedge Pair Off Price (decimal)	Price Difference (32nds)	Price Difference (bps)
99:10	99.3125	99:17	99.53125	7/32	21.9bps

High market volatility also has adverse effects on pullthrough (typically decreasing) and renegotiations (typically increasing). One positive result of market volatility is the effect it has on the Best Efforts to Mandatory spread. Typically we expect the spread to widen as market volatility increases. This is due to the fact that Investors are expecting that their hedge costs will increase and therefore they reduce what they are willing to pay for unclosed loans to offset the increased cost. This widening of the Best Efforts to Mandatory spread helps to somewhat off-set the increased hedge cost we expect lenders to experience in a volatile market.

The last key components SMM's need to manage in order to maximize profitability lie in the post-closing processes. Poor delivery performance and purchase reconciliation inadequacies can both lead to reduced performance. Once a loan is committed, the loan documentation must be delivered in a timely manner in order to allow Investors time to review the loan prior to purchase. Meeting delivery dates and making sure that all the required documentation is included in the file is critical in order to avoid extensions and the fees associated with rolling trades. When purchase advice is received from Investors, it must be addressed and resolved in a timely fashion. Failing to do so will result in the need to roll commitments subjecting the lender to fees. SMM's should monitor loans aging on the Warehouse line in order to avoid any unnecessary costs associated with rolling commitments. They should also monitor and analyze purchase advice, looking for common themes in order to find areas where processes and procedures need improvement. Finally, SMM's should monitor and analyze any discrepancies between anticipated gain on sale and realized gain on sale in order to improve MTM valuations and to ensure that the loan was in fact purchased at the correct price.

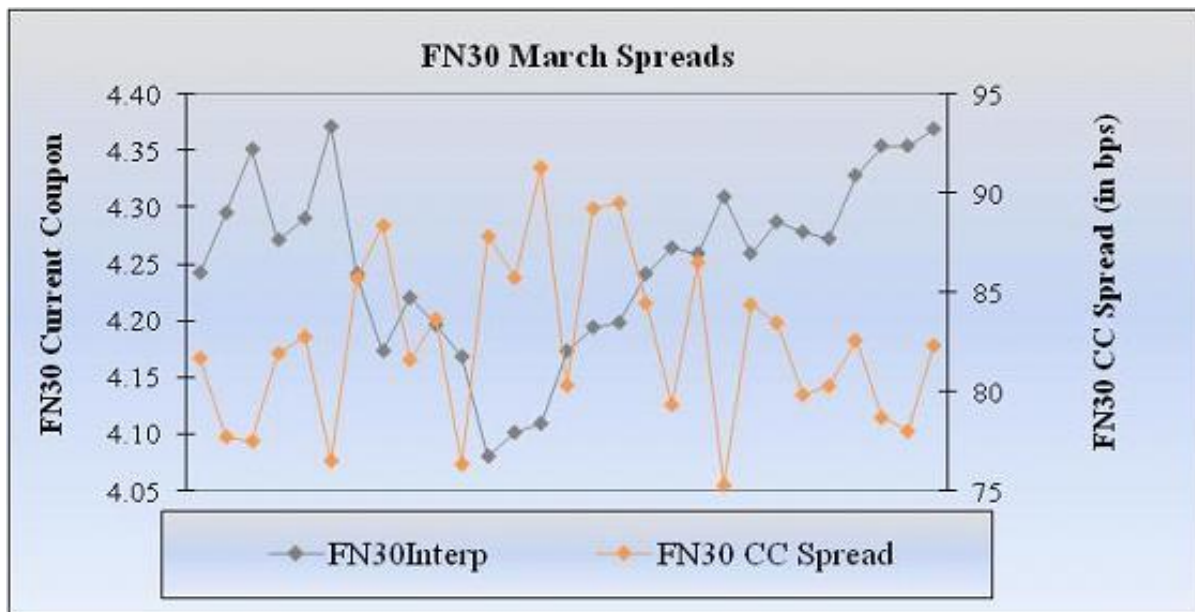
By finding ways to moderate and reduce hedge cost, lenders hedging loans for mandatory delivery ensure that they maximize their realized Best Efforts to Mandatory spread, thereby increasing their hedge value proposition. Successful Secondary Marketing Managers wear many hats and oversee each loan lock from the time of origination until it is purchased by an Investor. They are intimately familiar with

each step along the way and have a hand in overseeing multiple departments, from sales and marketing all the way through to the post-closing team. By applying the correct technology and pricing methodology, while maintaining a high level of data integrity, lenders can avoid the perils associated with inaccurate Cost, and Margin data and incorrect MTM pricing. By performing regular fallout analysis and updating pullthrough assumptions while monitoring originator-level hedge cost, lenders can ensure that they have accurate coverage levels and are taking steps to off-set excessive hedge cost associated with specific originators. Establishing and maintaining multiple Investor relationships and performing comprehensive and accurate Best Execution Analysis ensures that a lender's mandatory pricing is competitive and that they are capturing the full Best Efforts to Mandatory Spread value. Finally, managing the post closing process helps SMM's avoid the costs associated with pairing out of and rolling commitments, and ensures that the loan is purchased at the anticipated MTT price. By constantly searching for ways to improve processes, procedures and best practices, SMM's can continue to find ways to maximize profits and reduce costs.

If you missed part 1 of this article in our March 2011 newsletter, please contact Lucy at lpole@compass-analytics.com to receive a copy.

-Bob Gundel

Margin Tracker



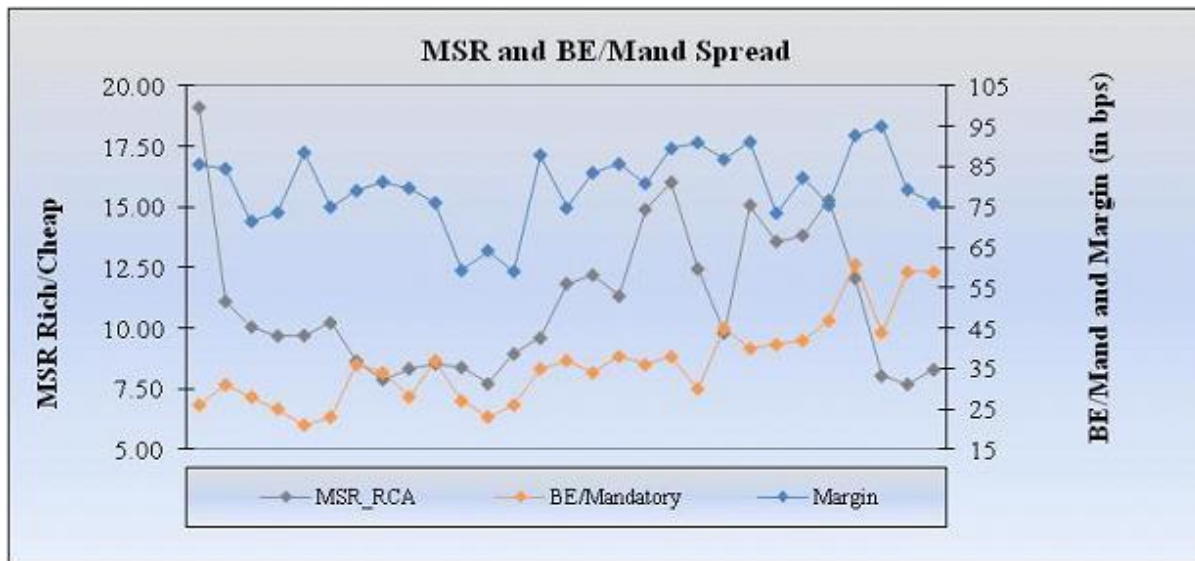
The FN30 CC Spread is the difference between the FN30 Note Rate and the FN30 Current Coupon, in basis points. During March, there was a 16bp peak to trough differential. Shown in the chart above, there is a noticeable negative correlation between rates and spreads. As rates ground higher over the course of the month (from a low of 4.08% to a high of 4.37%), spreads tightened a fair amount. The tightest the spread got was 75bps; the widest was 91bps; the average was 83bps. 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.

-David Bennett

MSR Rich/Cheap and Mandatory/Best Efforts Spread

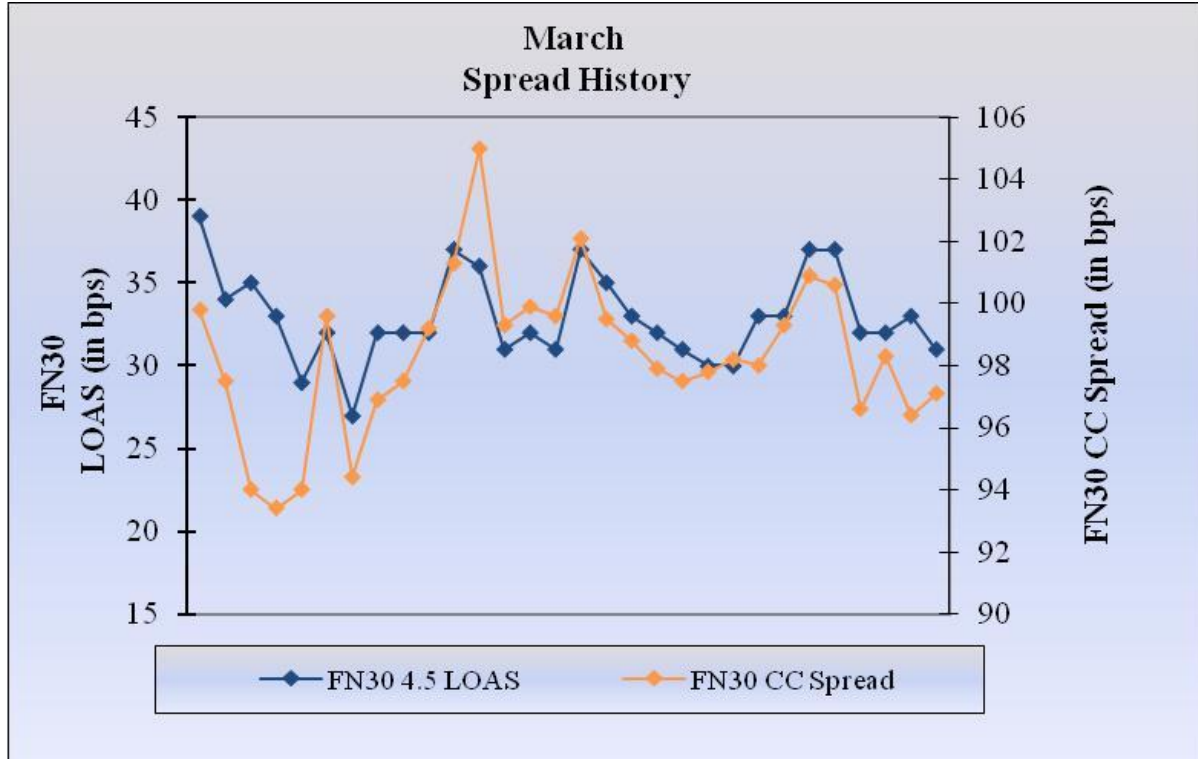
There was considerable volatility for Retain/Release Rich/Cheap IRR, Mandatory-Best Efforts Spreads and Profit Margins over the course of the month. The MSR Rich/Cheap averaged 11.0% with a peak of 19.1% and a low of 7.7%. The BE/Mandatory Spread averaged 36bps with a peak of 61bps and a trough of 21bps. Similar to past rate cycles where interest rates went up, spreads, particularly the BE/Mand, has shown a steady tightening as pipeline volume has declined. This spread will be worth tracking as the cycle progresses. The 30-year gross profit margin averaged 80bps with a peak of 95bps and a trough of 59bps.



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.

-David Bennett

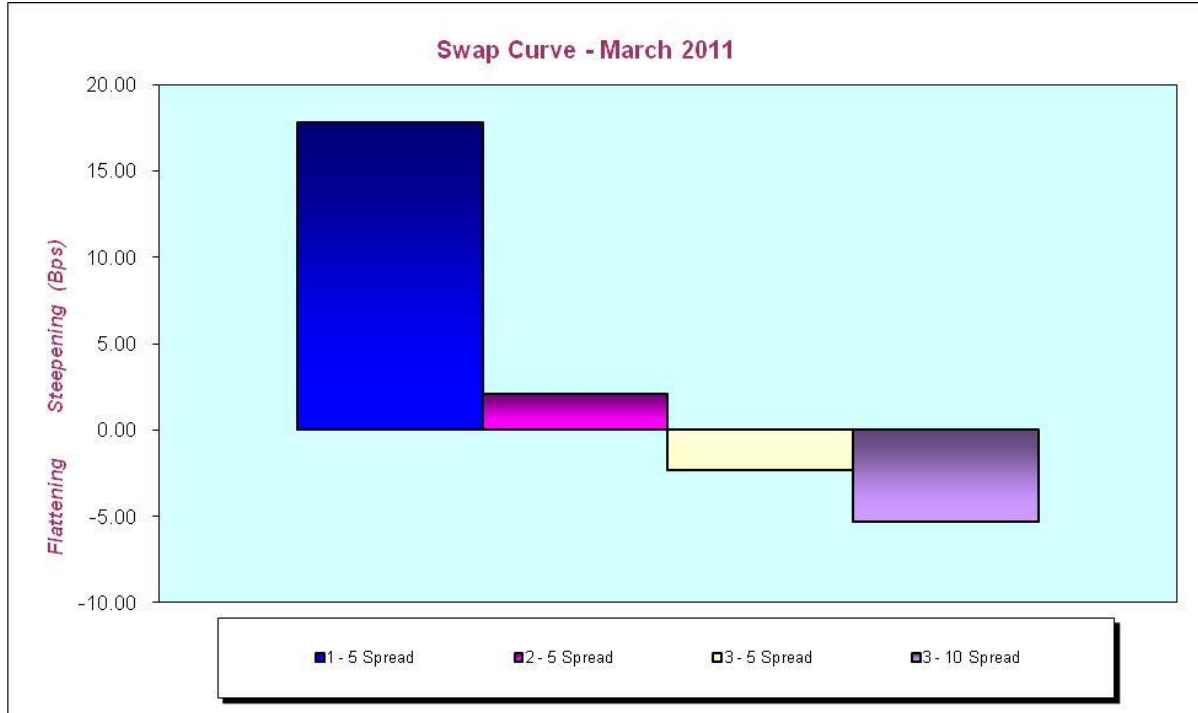
Monthly Spreads



The Treasury 2-10 spread widened one basis point over the past six weeks, closing April 11th at 276 bps. On a LIBOR-OAS basis, mortgages narrowed sharply to begin March and then trended up over the next few weeks as mortgage rates increased. Global event risk seemed to abate and strong economic data caused equities to rally, temporarily reducing investor appetite for bonds. Mortgage yield, measured as a spread over a blend of the 2 and 10 year swap curve yields, spiked in mid-March before tightening to close the month. It closed April 11th at 97 bps, a decrease of 3 bps from March 1st. This tightening trend reflects constant demand and a decreasing supply of mortgages.

-Dylan Faerstein

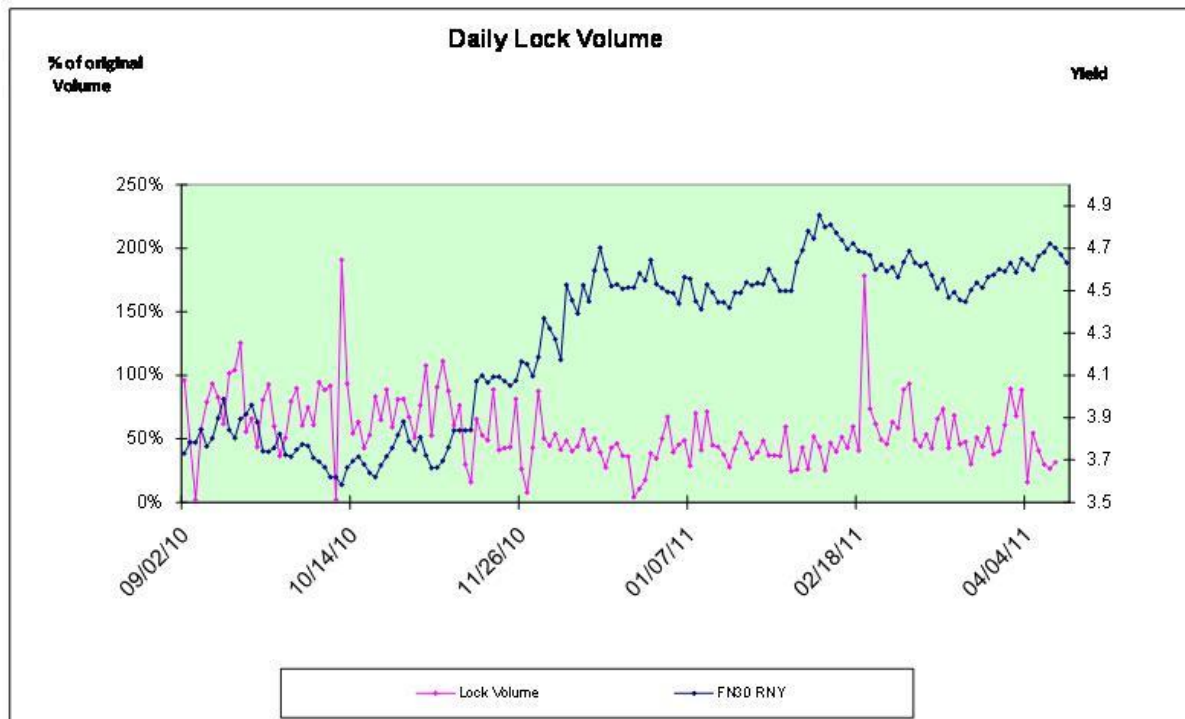
Swap Curve Analysis



12 month LIBOR remained unchanged over the past 6 weeks while swap yields, led by the belly of the curve, increased steadily. On April 11th, The 3 year swap yield closed up 19 bps and the 2, 5 and 10 year swap yields each closed up 15 bps from their March 1st levels. The 1-5 LIBOR/swap spread widened 18 bps while the 3-10 spread continued its tightening trend, decreasing 5 bps. Despite this flattening and steepening in the tails, the 2-10 spread remained nearly unchanged at 267 bps. In the period's biggest daily move, the 2 year yield jumped 10 bps and the 3, 5, and 10 year rates surged 13 bps on March 3rd, following a sharp drop in initial jobless claims. The yields gave back these gains the following day due to weaker-than-expected Nonfarm Payroll.

-Dylan Faerstein

Production Index



Production in the 30-day period ending April 11, 2011 decreased while rates traded in a wider range (28 bp range in this period versus 25 bp in the prior period), with the average yield decreasing month over month by 8 bps. Average volume for the last 30 days was 50% of our base volume (vs. 62% in the prior period) ranging from a low of 16% to a high of 89%. The average yield on the FN30 RNY in this period was 4.58% (vs. 4.66% in the prior period) ranging from a low of 4.48% to a high of 4.72%.

-Brandon Case