



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

The Month in Review

January 2011

Don't Miss!

Check out our timely Topic of the Month: "**Tips on Planning for Lower Originations and Tighter Profit Margins**". Now that higher rates and lower origination volumes have arrived, profit margins and overall company profitability must rise to the central focus of originators and their secondary marketing managers. Bob Gundel covers tips for outperforming in a rising rate environment in the article below.

What's New?

Be sure to notice in our January articles below that our graphs and analysis's now cover data for the first portion of the current month (up to January 10th), as well as the month of December. Moving forward, all of our newsletters will include data from the first portion of the current month, so that our newsletter information is more current and relevant to our readers.

We hope you had a great holiday season and a Happy New Year!

New in CompassPoint™!

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

- Interactive Pooling Screen - Multi--trade allocation
- Interactive Pooling Screen - MBS outright and pairoff options
- Interactive Pooling Screen - Pooling Flag and Export streamlined
- Interactive Pooling Screen - Streamlined MTT processing
- Interactive Pooling Screen - Expanded investor default settings
- Export Definition - Date suffix option
- Further streamlining of locked SRP adjusters and grids

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.



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

Market Update

Over the last few weeks, the bond markets have taken somewhat of a breather from the rapid rate rise of the last couple of months. While still volatile at times, rates have traded mostly sideways since the middle of December, possibly helped by holiday-light trade desks. The yield on 10-yr treasuries has recently bounced around in a range contained by approximately 3.50% to the upside and 3.30% to the downside. Mortgage rates, while still significantly higher than a few months ago, have recently shown some improvement, albeit in an often volatile way. Lock volumes remain sluggish and even recent improvements and the days defined by price spikes have not done much to pump-up loan pipelines.

Most of the recent data on the economy have pointed to a pick-up in momentum. Surveys such as the ISM reports, factory orders and construction spending reports have shown solid gains of late, with some posting multi-year highs in November. The Conference Board's consumer confidence reading took a dip in December but consumer spending has picked-up, if in a sometimes uneven way. With employment usually garnering the most attention, the December non-farm payroll report grabbed the headlines, and helped keep rates temporarily contained, with a job growth number well below expectations. The headline unemployment rate dropped significantly, even with the anemic job growth, but that number was mostly dismissed by market participants. Many expect the unemployment rate to pop back up in coming months if job growth doesn't display noticeable improvement.

While mortgage rates have taken a breather from their recent spike, with economic reports improving, on balance, and the Fed still firmly in the mode of reflation of asset prices, the most likely scenario still seems to point to higher rates in the coming months. Still providing a drag on economic growth, and potentially sharper rate increases, are the employment picture and the housing market. Whether the continued weakness in those sectors continues, and whether they are enough to keep rates contained, remains to be seen.

-Lindsay Hill



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

Topic of the Month: Tips on Planning for Lower Originations and Tighter Profit Margins

Now that higher rates and lower origination volumes have arrived, profit margins and company overall profitability must rise to the central focus of originators and their secondary marketing managers (SMMs).

DO's	DON'Ts
Survey competitive landscape to ensure sufficiently competitive pricing	Keep profit margins the same
Update and shock company cash flow and net profit models	Fail to model impact of lower unit count and tighter profit margins on company profitability until too late
Coordinate principals, production and SMMs to set sustainable profit margins	Match best pricing without regard for company profitability
Reevaluate balance sheet planning including retained earnings, retained servicing and leverage covenants	Fail to model production, margin and cash flow impact on future cash position and leverage ratios

As rates increase, particularly in this environment, it creates an environment of stress and tough decisions. Nonetheless, tough decisions must be made through thorough planning and coordination of key personnel. Now is the time to avoid any disconnects between Secondary Marketing Managers (SMM's) and the principals of their firm. When SMMs and company principals are aligned through appropriate planning, SMM's will be less influenced by Loan Officer and Broker chatter and consequently less stressed. SMM's need to evaluate all margin levels and decisions in the context of overall company profitability and avoid arbitrary reduction in margins simply to match other suicide pricing (other companies will not - and will implode). However, SMM's can't sit back and not react to the changing rate environment, not adjust margins, and therefore suffer the consequences associated with substantially reduced lock volume. By over-reacting or not reacting at all, SMM's can severely impact the financial stability and solvency of the firm. This article will discuss ways that SMM's can utilize tools within CompassPoint™ in order to make better informed decisions when faced with a rising rate environment.

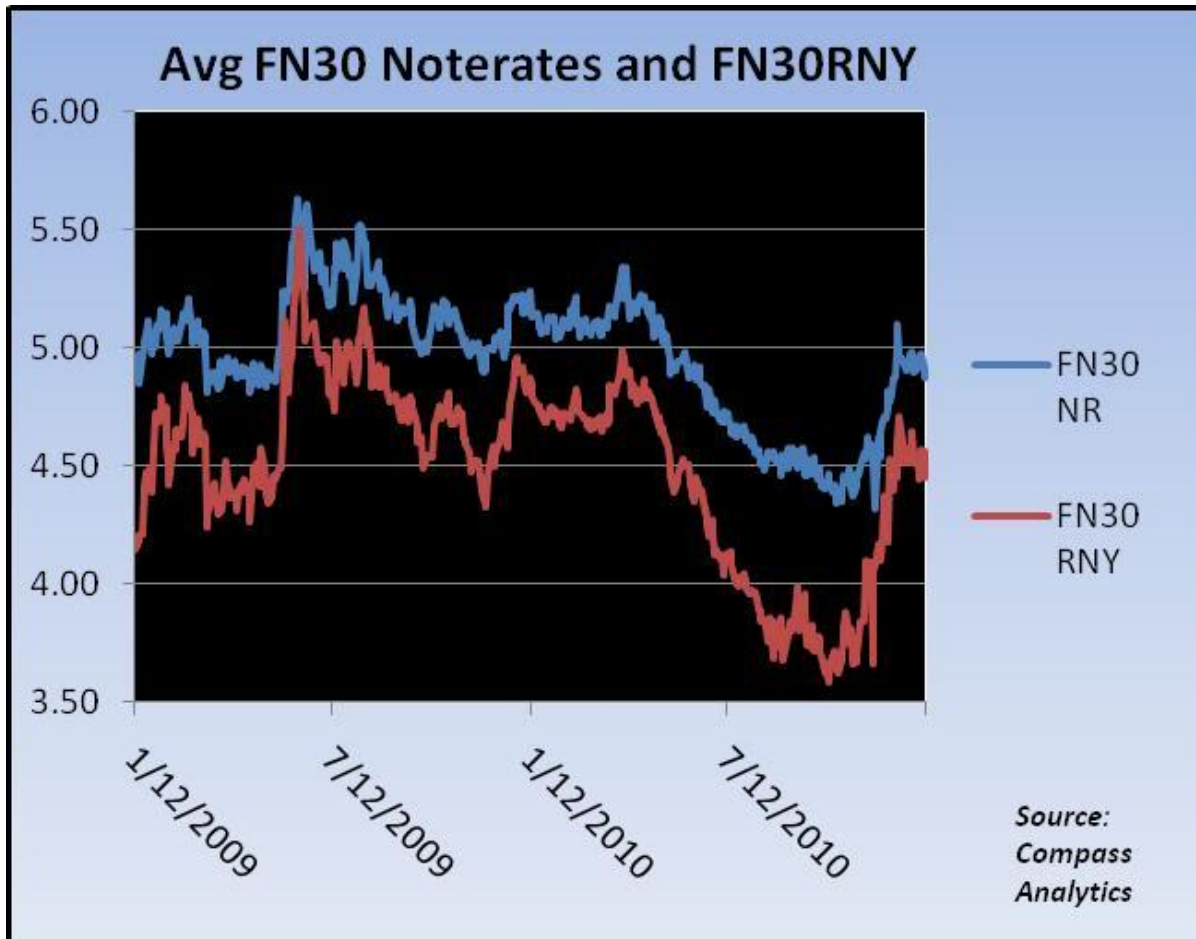
After 2 years of historically low rates, wide best efforts to mandatory spreads and high volume resulting from a seemingly never ending refi-boom, the perfect storm hit the mortgage origination market in recent months. The bond market's response to the Fed announcing their second round of quantitative easing



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

was to plunge into a nose dive and send rates skyrocketing. As the graph below clearly shows, our FN30NR, which measures the average FNMA 30-year note rates across a basket of clients, has increased about 50 bps from the 4.30-4.40% range in mid October, settling in around the 4.90-5.00% range we've observed as of late. Additionally, the graph clearly shows how the spread between the average FN30NR and the FN30RNY (the required net yield on FN30) widens in declining rate environments, and tightens in rising rate environments.

Example 1: FN30NR and FN30RNY - 1/12/2009 to Present



As a result of the sharp rise in rates, the high percentage of refinance loans that have been driving pipelines to robust volumes have dramatically tapered off. This push higher in rates, coupled with the



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

seasonally slower origination volume is having a fairly severe impact on production volumes and profitability, leaving conscientious SMMs scrambling to find ways to maintain pipeline volumes.

As most SMMs realize, the relationship between a Lender's origination volume and profitability is not linear. This means that a 30% reduction in origination volume does not result in a 30% reduction in profitability, but as the example below illustrates, the impact to retained earnings can be far greater. In this example a 30% decrease in pipeline volume from 55M/Month to 38.5Million/Month causes the Net Gain per month to drop from \$104,340 to \$42,400, which equals a 59.4% reduction in profitability. This "Mortgage Company Convexity" is in part due to the fact that there are many fixed costs associated with running a successful mortgage bank. This is especially exasperated by the fact that many lenders hired on additional staff in their underwriting and post closing departments in order to handle the increased origination volumes they experienced when rates were at historic lows.

Example 2: Company Cash Flow Tool displaying the effect of a 30% reduction in volume

Change in Lock Volume (%)	Pipeline (M)	Closed Volume (M)	Revenues (K)	Expenses (K)	Net \$ (K)	BPS (%)
-30	38.5	33.16	338.14	-295.74	42.40	12.8
-20	44.0	37.90	386.45	-321.21	65.24	17.2
-10	49.5	42.64	434.76	-347.66	87.10	20.4
0	55.0	47.38	483.06	-378.72	104.34	22.0

So what changes can lender's implement in order to help offset reduced volume and profitability? One necessary, yet painful way to reduce overhead is to terminate employees that are no longer needed with lower production levels. However, this can be very costly, as firms spend great amounts of human resources and capital in training employees and getting them up to speed. If rates head lower in the near term and spark a new round of refinance originations, lenders may be forced to turn around and scramble to quickly hire and train additional staff in order to keep operations flowing smoothly. Although some terminations may eventually be a necessary evil, perhaps a better way to address the issue is to find ways to stimulate new profitable originations.

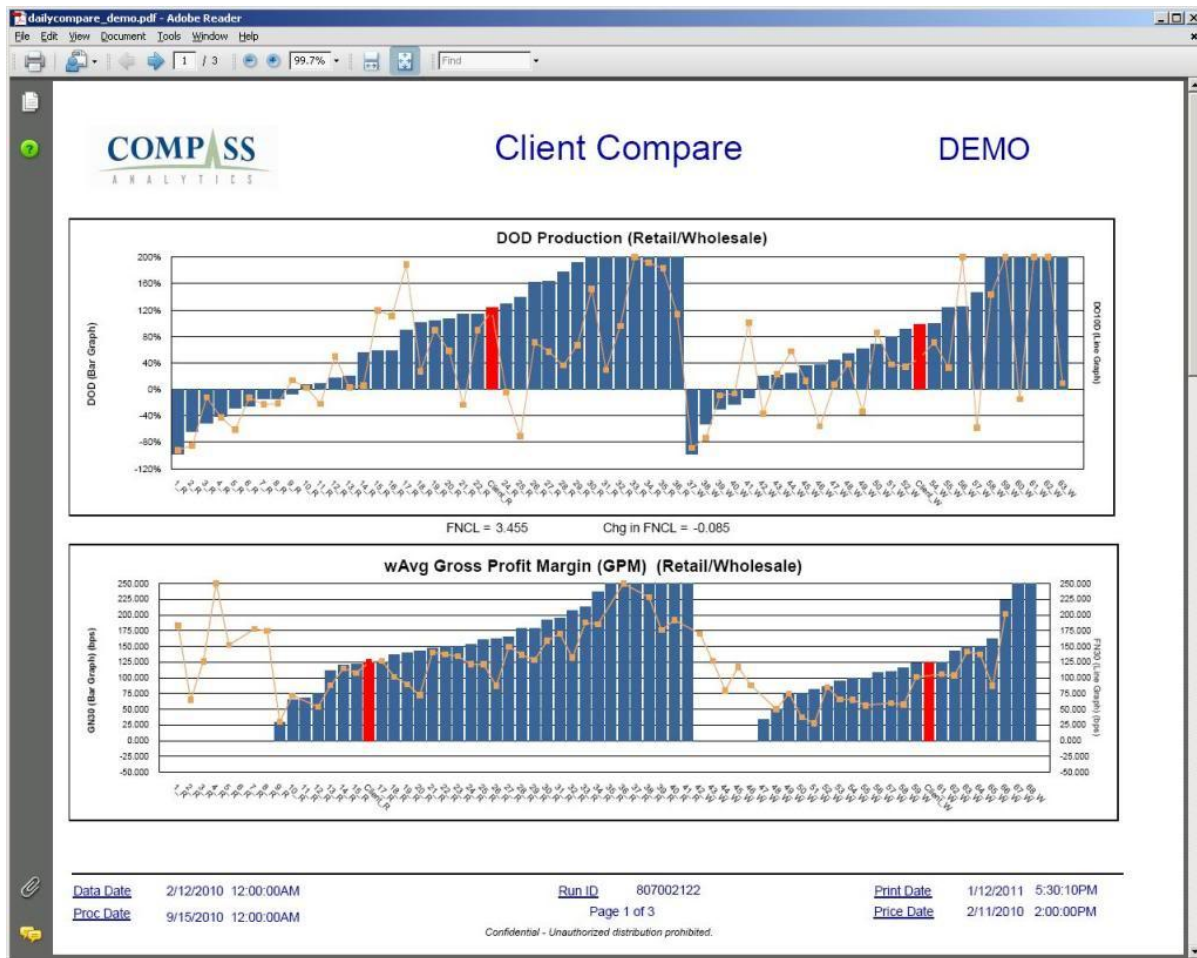
Another way to increase volumes is to reduce the amount of margin built into a loan on Day-1 in order to push more attractive pricing out to origination channels. There is no confusion regarding the impact that pricing has on origination volume. The key here is being able to understand the firm's price elasticity (the relationship between price and volume) and finding the sweet spot where reducing margins increases volume to the point where profitability increases the most, without over doing it. This can be trickier than it seems, and using a trial and error method could be disastrous to a lenders future. Fortunately there are several tools that Compass has in place that allow lender's to make educated decisions around setting base/corporate margins. One powerful tool that Compass clients can utilize in planning for lower origination volumes and tighter profit margins is the Peer Benchmarking/Daily Compare report. This report anonymously displays data on day over day and day over ten day



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

production volume percentages, weighted average gross profit margin, FICO and fund to settlement timing, weighted average note rates, month-to-date (MTD) gain/loss and day-over-day (DOD) weighted average profit margin in graphs for clients choosing to participate and allows clients to compare their data to other lenders. This allows SMM's to observe how increasing rates affect their pipelines and how that reduction in volume appears relative to other mortgage originators. The tool is also particularly helpful to lenders considering changes to margin as it helps SMM's understand how their margin values compare to what others market participants are charging. Lenders utilizing this tool can use this data in order to make better informed decisions around adjustments to profit margin and the affect that has on lock volume.

Example 3: Daily Compare report displaying Production and Margin Data across clients





Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

Another powerful tool that Compass clients can utilize in planning for lower origination volumes and tighter profit margins is the Company Cash Flow tool. This tool allows SMM's and/or senior management to enter key pieces of business data including origination assumptions, revenue projections, as well as variable expenses and fixed costs, and then manipulates the data across several different screens including a production shock (see Example 2), rate sensitivity, and gross profit/production shock. In the below example, SMM's and senior management can use the tool to model different rate environments and determine the effect changing rates have on production, ROE and cash reserves. In this example a 0.25 increase in rate causes a steep reduction in pipeline volume which results in negative Return on Equity.

Example 4: Company Cash Flow Tool displaying the effect of a 0.375 increase in rates

Rate Shock (Bps)	Pipeline (M)	Closed Volume (M)	Revenues (K)	Expenses (K)	Net \$ (K)	ROE-M (%)	ROE-Yr (%)	Cash Reserve (M)
0	55	47.375	483.06	-378.72	104.34	3.2	46.1	0.439
12.5	48.125	41.453	387.54	-340.3	47.24	1.5	18.9	0.634
25	41.25	35.531	302.06	-308.47	-6.41	-0.2	-2.3	0.829

In Example 5, the CCF Tool gross profit/production shock screen allows SMM's and senior management to model the results of reducing profit margins. As the example shows, a 30% reduction to margin results in negative return on equity and eats into cash reserves. In this case, an SMM arbitrarily slashing margin by 30% with the hopes of increasing profitability would actually do substantial damage to the firm.

Example 5: Company Cash Flow Tool displaying the effect of a 30% reduction in margin

Chg in Profit Margin (%)	Pipeline (M)	Closed Volume (M)	Revenues (K)	Expenses (K)	Net \$ (K)	ROE-M (%)	ROE-Yr (%)	Cash Reserve (M)
-30	71.5	61.587	471.37	-494.66	-23.29	-0.7	-8.3	-0.029
-20	66	56.85	483.3	-450.5	32.8	1	12.8	0.127
-10	60.5	52.113	487.2	-410.89	76.31	2.3	32.1	0.283
0	55	47.375	483.06	-378.72	104.34	3.2	46.1	0.439

Naturally each lender will have its own production/margin/rate elasticity, break-even points and profit/loss and balance sheet dynamics. A rising rate environment is always challenging for lenders to navigate through. SMM's can easily get caught up in the minutia of day to day activities and as a result



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

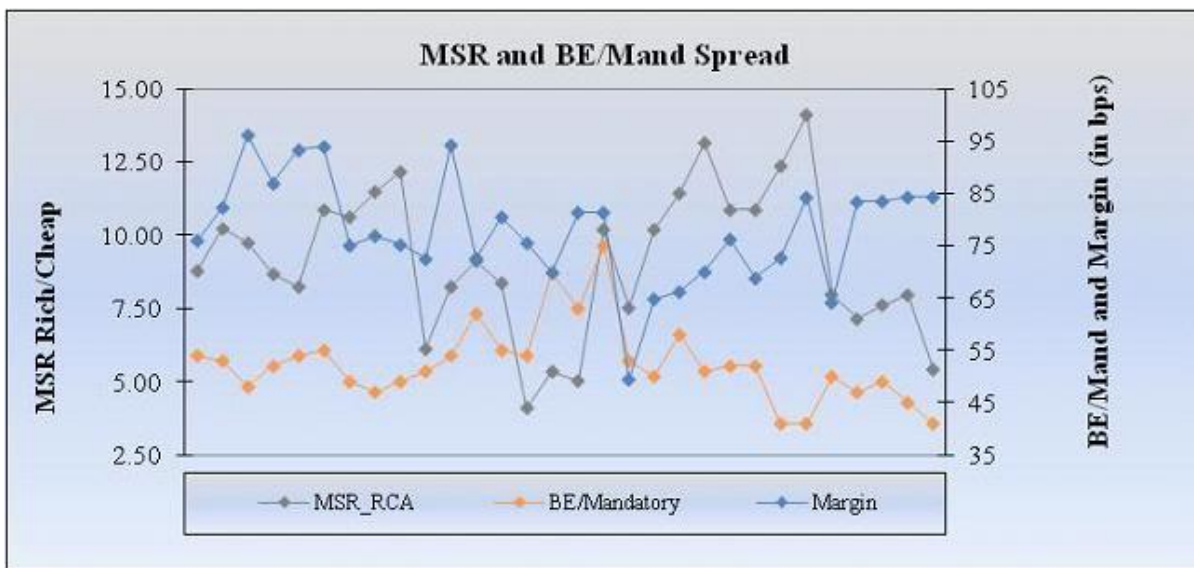
sometimes can't see the forest through the trees, overlooking their key mandates which include maximizing profitability, increasing equity and preserving the financial health of the company. SMM's that do not proactively address their reduced pipeline volume when faced with a rising rate environment are subject to the will of fate. They may live to fight another day, but few could argue that as a sound business model. Conversely, those that respond with a knee jerk reaction without performing the proper analysis can generate results that are the exact opposite of what they are hoping for, reducing profitability rather than maintaining or increasing it. By utilizing the proper analytics and performing the proper analysis before implementing changes to margin, SMM's and senior management can ensure that they are making the right decision at the right time in order to keep their firm profitable and solvent.

-Bob Gundel



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

Margin Tracker



The FN30 CC Spread is the difference between the FN30 Note Rate and the FN30 Current Coupon, in basis points. **During December, there was a 29bp peak to trough differential. Shown in the chart above, there is a noticeable negative correlation between rates and spreads. As rates chopped around over the course of the month (from a low of 3.85% to a high of 4.43%), spreads showed similar volatility. The tightest the spread got was 58bps; the widest was 87bps; the average was 74bps.** 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.

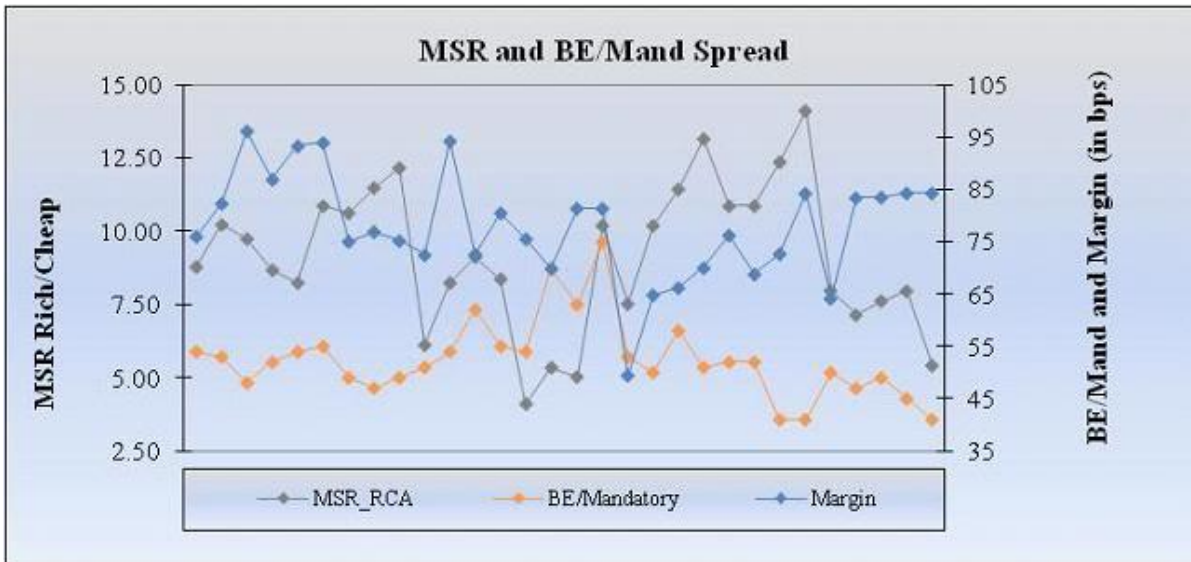
-David Bennett



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

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 9.1% with a peak of 14.1% and a low of 4.1%. The BE/Mandatory Spread averaged 53bps with a peak of 75bps and a trough of 41bps. 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 78bps with a peak of 96bps and a trough of 50bps.



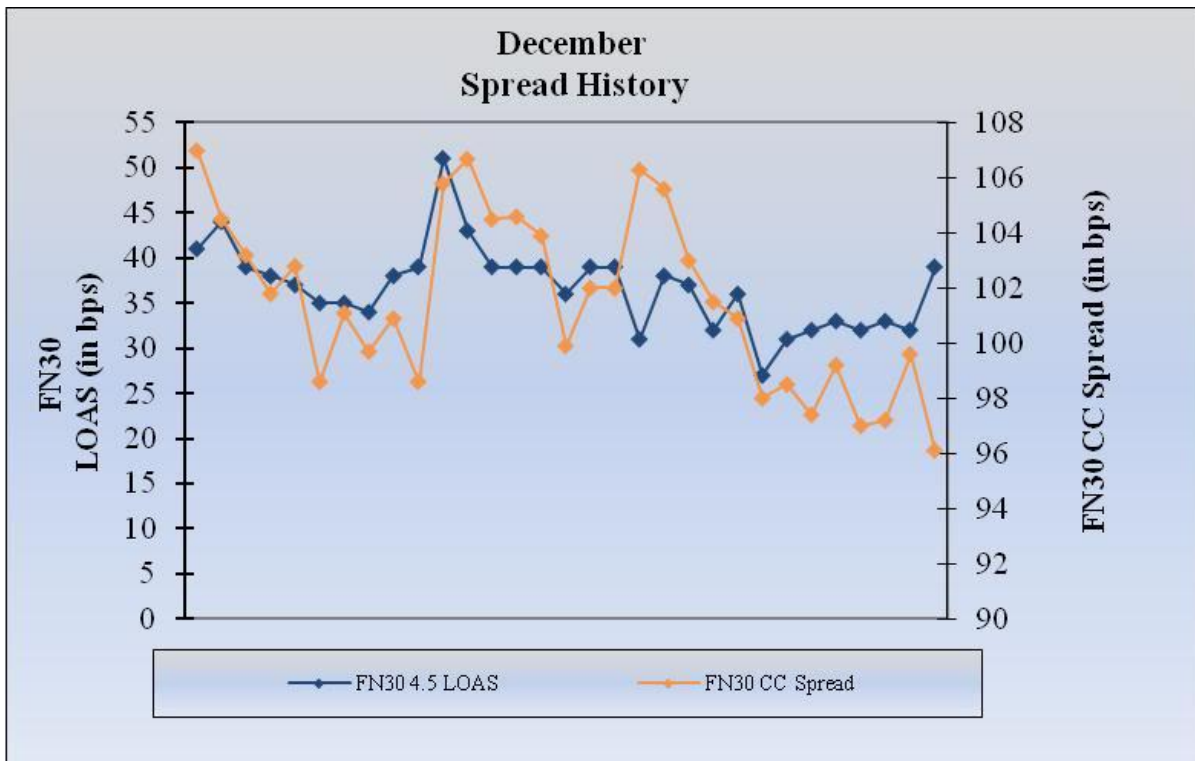
The MSR Rich/Cheap gives the internal rate of return for retaining servicing and provides a general measure of how aggressive aggregators are in their servicing bid. If a client is considering retaining servicing, or is deciding between retaining or selling servicing-released on any given day, this number 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



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

Monthly Spreads



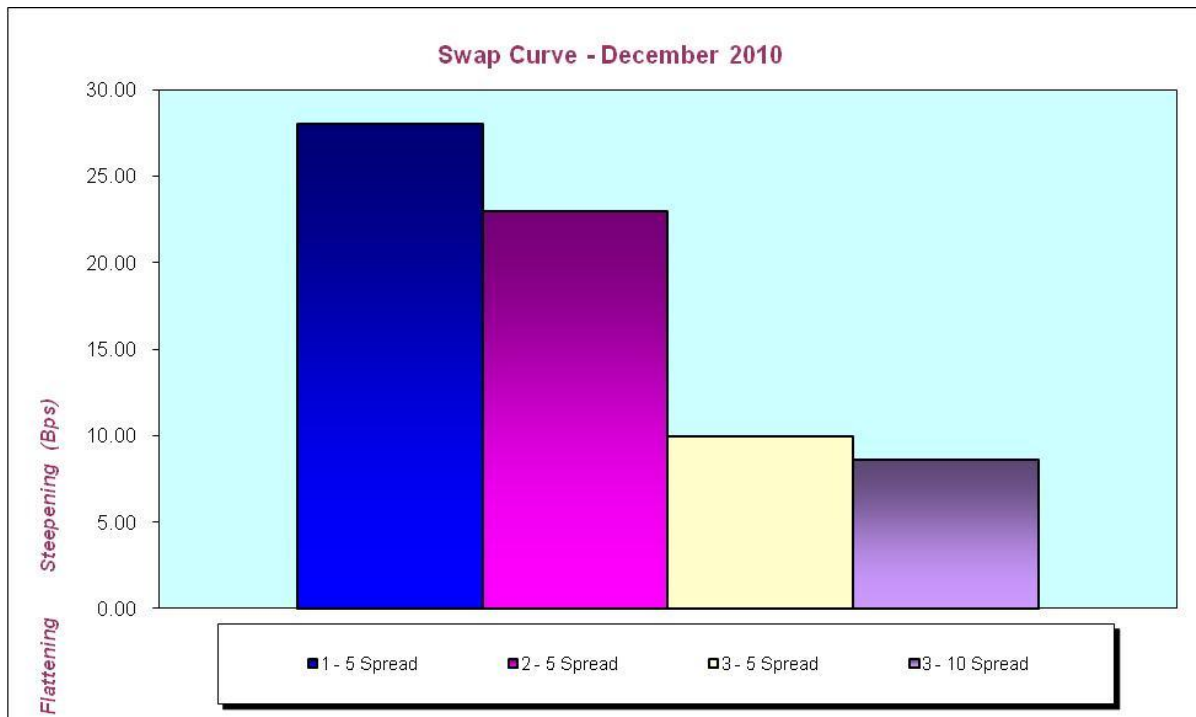
The Treasury 2-10 spread widened 28 bps in December and early January, closing January 10th at 271 bps. On a LIBOR-OAS basis, mortgages drifted wider and then narrowed midmonth before settling back to December 1st levels. As yields increased and prepayment speeds declined, mortgages became more attractive to investors on this OAS basis. Mortgage yield, measured as a spread over a blend of the 2 and 10 year swap curve yields, tightened 12 bps at the beginning of the month before widening out as year-end approached. In January, the tightening has continued as the spread closed January 10th 11 bps below the December 1st level. With year-end behind us, investors appear to have an increased appetite for mortgages.

-Dylan Faerstein



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

Swap Curve Analysis



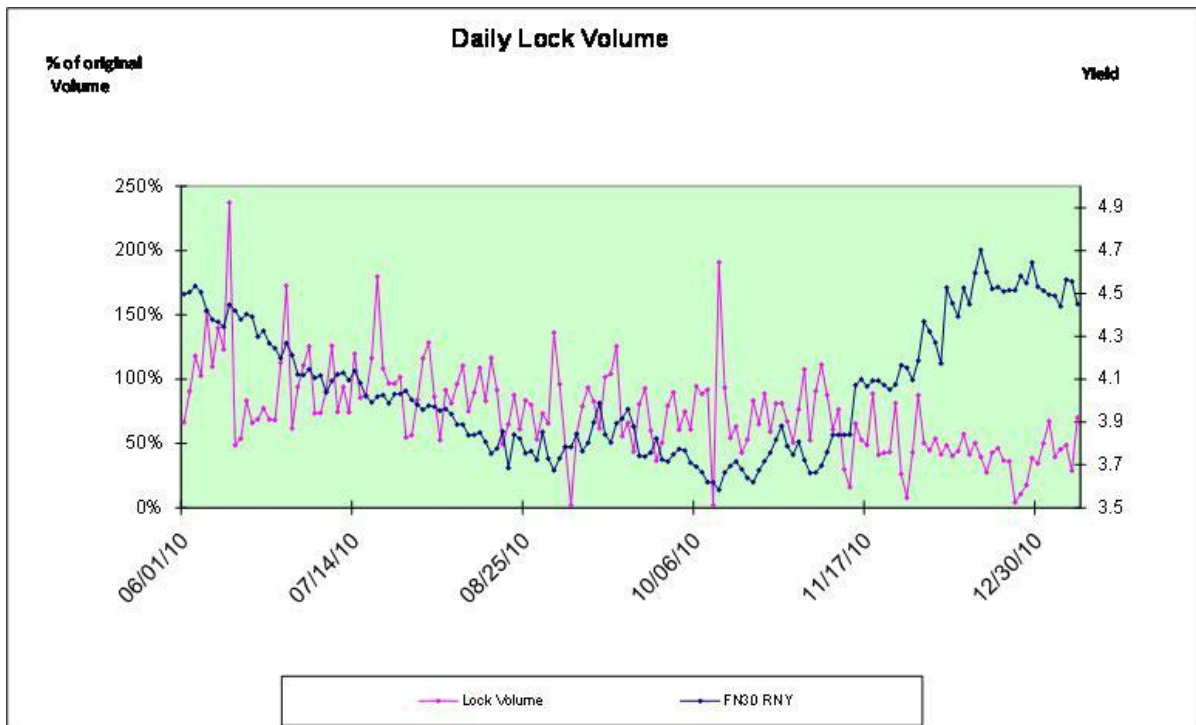
12 month LIBOR remained steady over the past 5 weeks while long-end swap yields increased significantly. On January 10th, The 3 year swap yield closed up 17 bps and the 5 and 10 year swap yields each closed up 27 bps from their December 1st marks. The 1-5 LIBOR/swap spread widened 28 bps while the 2-10 swap spread widened 22 bps. Despite all this steepening, the 5-10 spread remained unchanged at 123 bps. In December's biggest daily move, the 2 year yield jumped 11 bps and the 10 year surged 22 bps on December 7th, following President Obama's somewhat unexpected extension of Bush-era tax cuts.

-Dylan Faerstein



Compass Analytics | 580 California Street, Suite 1725 | San Francisco, CA 94104 | 415-462-7500 | www.compass-analytics.com

Production Index



Production in the 30-day period ending Jan 10, 2011 decreased while rates traded in a narrower range (26 bp range in this period versus 50 bp in the prior period), with the average yield increasing month over month by 60 bps. Average volume for the last 30 days was 40% of our base volume (vs. 60% in the prior period) ranging from a low of 4% to a high of 70%. The average yield on the FN30 RNY in November was 4.54% (vs. 3.93% in the prior period) ranging from a low of 4.44% to a high of 4.70%.

-Brandon Case