

AD&CO News – March '08

Save the Date for AD&Co's 16th Annual Conference

By Laura Gridley

We are pleased to announce that AD&Co's 16th Annual Conference will be held this year on Wednesday, June 11th at TheTimesCenter, a brand new elegant and dramatically designed performance venue that is part of the world class New York Times Tower headquarters located in the heart of vibrant Times Square. We will host the same event again on Monday, June 16th at the ultra hip W Hotel San Francisco in the heart of the SoMa district. Choose the date and location that is most convenient for you.

As always, we will provide a forum for discussions about the current state of the mortgage market and invaluable insight into how to tackle some of the challenges that we face. Last year, we welcomed over 300 attendees to New York and over 100 to San Francisco. There will be ample opportunity to network with industry leaders and many of our vendor partners. We hope to include you in this year's event.

Look for more details and registration soon in *The Pipeline* and on our website at www.ad-co.com. Registration is free for our clients and friends. Don't miss out!



The information contained in The Pipeline is believed to be reliable, but its accuracy and completeness are not guaranteed. All expressions of opinion are subject to change without notice. Pipeline is provided for informational purposes only and is not a solicitation, endorsement or a recommendation for purchase or sale of any particular security. An affiliate of Andrew Davidson & Co., Inc. engages in trading activities in securities that may be the same or similar to those discussed in this publication. All Rights Reserved.

Prepayment Update – March '08

The Conforming Loan Limit Increase: What it Means for Borrowers and Investors

By Dan Szakallas

There has been much discussion over the last couple months regarding the increase in the conforming loan limits as part of the 2008 Economic Stimulus bill that eventually passed through the House and Senate and was signed into law by President Bush on February 13th. There was much speculation on what the new limit would be, how different parts of the country would be affected, and ultimately when it would go into effect. Now that the law has been passed, we can answer those questions and discuss what the impact might be on the Agency MBS arena.

The increase in the conforming loan limit for 2008 is defined as the lesser of \$729,750 or 125% of the average home value within a given metropolitan statistical area (MSA). The increase has been introduced as temporary, but there is no timetable for a reduction. Fannie Mae and Freddie Mac are now allowed to purchase these loans for securitization into their mortgage-backed security pools that are sold to investors. Fannie Mae will only securitize these loans with other similar loans, meaning they will most likely receive their own pool type, and not be packaged into standard FNCL TBA deals.

From the borrower's perspective, this change greatly benefits those in top MSA areas, such as New York, Chicago, Los Angeles, etc., where the median home price can fall above that of the former conforming limit of \$417,000. For example, according to HousingTracker.net, the median asking price for a single family or condominium home in the NY-White Plains-Wayne metropolitan division of the NY-NJ-Long Island MSA was \$435,000. With the expanded limit, potential buyers in this market can now qualify for an interest rate on a mortgage that should be less than before, when they could only qualify for a jumbo mortgage. The typical spread between conforming and jumbo loans has historically been around 50bps, but in the last 6 months we have seen it widen to an average of about 125 bps. If lenders offer these potential borrowers the same rates that are offered on loans that currently fall under \$417,000, then this will be a great benefit to homebuyers/homeowners that live in the expensive MSA's. What remains to be seen is how welcoming the banks are to this new limit. On the one hand, many investors have been burned in the last 18 months by bad loans, and are still calculating losses on their mortgage portfolios; on the other hand is the liquidity issue for borrowers of prime jumbo loans. If these jumbo loans can now be sold to the agencies and are therefore guaranteed, mortgage pipelines could start flowing again.

From the investor's perspective, the big question is how to model prepayments for these new "conforming jumbos." We have observed prepayments for many years on jumbo loans, and it seems likely that underlying borrower behavior will not change simply because of lower interest rate availability. From a modeling perspective, it would be acceptable to use a jumbo model for the new pools, but with a slight tuning adjustment of the slide factor. By "sliding" the underlying refinancing thresholds to account for the new rate benchmark for the conforming jumbos, models should give accurate results. These loans will still be prime quality, so all of the concerns after the sub-prime fallout will be minimized here, since only credit-worthy borrowers will qualify for these loans. One behavior that might be observed is in the current jumbo market. How many borrowers will look to refi their jumbo loans into these new conforming jumbos in order to take advantage of the lower interest rates? Also, since there is no timetable given for these temporary limits to be changed, what happens to the non-agency jumbo market through 2008? What will

new origination volume levels be? Also, will lenders offer the same rates for a \$300,000 loan as they will for a \$650,000 loan?

While we know more today than we did three months ago, there are still several questions that remain unanswered. We will be monitoring this issue closely over the next several months and will offer more insight as our research continues.



The information contained in The Pipeline is believed to be reliable, but its accuracy and completeness are not guaranteed. All expressions of opinion are subject to change without notice. Pipeline is provided for informational purposes only and is not a solicitation, endorsement or a recommendation for purchase or sale of any particular security. An affiliate of Andrew Davidson & Co., Inc. engages in trading activities in securities that may be the same or similar to those discussed in this publication. All Rights Reserved.

Valuation Commentary – March '08

RiskProfiler™: Your Complete Valuation Solution

By Alex Levin

RiskProfiler™ is AD&Co's database-driven (MS SQL or Access) valuation solution that incorporates standard and advanced valuation technique including OAS, prOAS, credit OAS (with the LoanDynamics™ Model) and derivative pricing. A thoroughly designed front-end exposes market data, valuation options, tunings and results. Multi-dimensional risk measures can be compiled for large portfolios of MBS, ARMs, CMOs (including credit-impaired instruments) and standard rate derivatives to produce portfolio or strategy-level summary reports.

What Does RiskProfiler™ Do?

RiskProfiler™ is a complete option-adjusted valuation solution suitable for pricing MBS from both traditional OAS angles and under the logic flow of Credit OAS. For traditional OAS, the system operates with our suite of prepayment models and interest rate models. For Credit OAS, the role of the prepayment model is played by our LoanDynamics™ Model (LDM), and an interest rate model is complemented by our stochastic home price model. Hence, both prepayment and default options are captured in the analysis, in the best possible way.

Much like traditional MBS valuation systems, RiskProfiler™ converts market prices into OAS or other measures (like Yield) and produces dozens of Greeks: effective duration and convexity, key rates, Vega, sensitivity to prepayment tunings, etc. Unlike other systems, Risk Profiler™ can value instruments by forecasting default rates and losses and even measure exposures to short-term HPA or long-term HPA. It can combine every computed risk metric across portfolio instruments.

In addition, RiskProfiler™ is filled with built-in utilities and tools to load market rates and swaption matrix right off Bloomberg, alter prepay model tunings, set tasks that suit particular business regimen and safely keep positions along with all analytic assumptions in the database.

Instruments Covered

RiskProfiler™ supports most instruments used by MBS portfolio managers and risk managers.

“MBS”- all fixed rate pass-throughs or non-securitized loans. The cashflow generator is AD&Co's and includes computation of the principal, interest and loss components where relevant. No 3rd-party license is required, but you are responsible for loading MBS indicative data (WAM, WAC) and, optionally, enhanced collateral data (loans size, LTV, FICO, geography, etc.), or LDM-related credit data. The built-in Bloomberg link helps retrieve this data (Bloomberg license required).

“ARM”- all adjustable-rate pass-throughs or non-securitized loans. All that is stated for MBS applies except there are many more fields required that describe coupon resets (index, frequency, margin, caps).

“iCMO”- CMOs or ABS processed via a built-in Intex link (Intex licensed required). Since the entire deal’s structure is kept by Intex, you need only to provide the cusip and analytical assumptions. Intex also serves as the data source for LDM: LTV, FICO, loan status, etc. You can even inspect the completeness of loan data and provide your own default values for missing fields.

“Bond”- non-MBS interest rate derivatives like usual bonds and swaps, swaptions, caps and floors. Powered solely by AD&Co, no 3rd-party tools are needed. Bonds and swaps can have separate schedules for call, put, coupon (step-ups/downs) or explicit amortization (“sink”). Calls and puts can be European, American or Bermudan.

Regardless of the actual MBS or CMO type, you can “strip” the cashflow and compute the values of IOs, POs, MSR pieces or the IO Multiple. The same instrument can be processed via LDM or via AD&Co’s residential MBS prepayment model.

Valuation Methods

RiskProfiler™ implements all AD&Co’s rigor in understanding how MBS are priced in the marketplace.

Static Analysis: While our prepayment models and LDM can forecast prepayment, default and losses of loans, they can’t compute the resultant cashflows of complex financial instruments on their own. RiskProfiler™ can.

Traditional OAS Method: Option-adjusted valuation using AD&Co’s empirical prepayment model. For MBS and ARM pass-throughs, we can rely on the blazing speed of backward induction – thanks to the fine property of our active-passive decomposition (APD) modeling structure. For CMOs, an efficient Monte-Carlo, or even more accurate, quasi Monte-Carlo will be employed.

The AD&Co prOAS Method: An OAS method operating with a risk-neutral prepayment model instead of an empirical one. This method accounts for the prepay model risk priced by the market. It levels the playing field for instruments like TBA, IOs, POs and CMOs. The prOAS method is proven to be a more accurate predictor of price change than the traditional OAS.

The AD&Co Credit OAS Method: An OAS method operating in the space of two random risk factors, interest rates and home prices, and allows losses to be modeled explicitly. Rather than using a traditional OAS method with an artificially inflated discount spread (OAS), we rely on the LDM to directly forecast default rates and loss severities, along each path. Thus generated cashflows are discounted using a suitable liquidity spread (crOAS).

Each of these methods is available within one system, RiskProfiler™, and engaged by simple user selections.

Use the Full Power of Your Hardware

Running an MS SQL database means having nearly unlimited storage for positions and historical (daily) results. Everything you do with RiskProfiler™, from setting assumptions to computing risk measures, is stored in a database. Using these database records, you can add as many custom reports as you like. RiskProfiler™ doesn't restrict you in the way you want to aggregate, group and display results.

RiskProfiler™ (version 2.1 and above) is a multi-threaded, multi-processing application. This means that one can install it on a dedicated powerful server (with several processors) and take advantage of them all. CMOs (the most time consuming instruments) will be sent to various processors and computed simultaneously rather than sequentially.

Unique Credit Valuation Analytics

RiskProfiler™ loses nothing to other traditional OAS systems in its functionality, analytical depth or computational power. However, it is unique in that it includes truly unprecedented credit valuation analytics. Some of the highlights are:

- HPA is viewed as a random factor and modeled as a stochastic process. This feature is integral to our understanding the ways both default option and ABS capital structures should be objectively valued.
- The home price process is alterable by transparent tunings affecting the short-term forecast or the long-term equilibrium. These tunings can be used to achieve HPA risk-neutrality as well as to gauge ABS' exposure to home prices. Users don't have to agree with AD&Co on the HPA model – they can alter it.
- If you appreciate AD&Co's prepayment and credit models, RiskProfiler™ is their natural and direct extension. No vendor can integrate AD&Co's credit valuation analytics the way we have.

Look for other great features to come:

- Aggregation of path-wise portfolio losses and distribution of losses. Although this is not the only method to “see beyond the averages,” many credit players like to have it.
- Innovative loan sub-clustering, i.e. certain pre-aggregation within each collateral piece created by Intex. This relieves us from the necessity to run Monte-Carlo at the loan-level, which would be tedious, and lets us approximate one with reasonable accuracy and in a fraction of time.
- Automating AD&Co's “breakpoint” methodology that measures a bond's distance to its first loss.

- Other LDM functionality and utilities will be embedded like loan stratification and loan-level downloads from Intex.
-

Starting in April, AD&Co will hold a series of “WEBinars” on RiskProfiler™. Stay tuned!



The information contained in The Pipeline is believed to be reliable, but its accuracy and completeness are not guaranteed. All expressions of opinion are subject to change without notice. Pipeline is provided for informational purposes only and is not a solicitation, endorsement or a recommendation for purchase or sale of any particular security. An affiliate of Andrew Davidson & Co., Inc. engages in trading activities in securities that may be the same or similar to those discussed in this publication. All Rights Reserved.