SECONDARY MARKETING EXECUTIVE

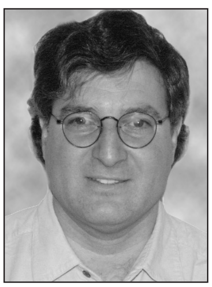
Reprinted with permission from the April 2003 issue

New Disclosures Are A Good Step, But Loan-Level Data Is Needed

BY ANDREW DAVIDSON

The additional disclosures agreed to by Fannie Mae and Freddie Mac as a result of staff reports produced by the Treasury Department, Office of Federal Housing Enterprise Oversight (OFHEO) and the Securities and Exchange Commission (SEC) are a positive step for the mortgage market.

Over the past 10 years, there has been some fragmentation of the TBA, "to be announced," or generic mortgage market. The large range of loan sizes and loan credit quality that qualifies for the Fannie Mae and Freddie Mac conventional 30-year loan programs means that investors cannot assume that all loans are interchangeable. Differences in pool composition can make a substantial difference in prepayments and, consequently, investment results.



DAVIDSON

As a result, investors have been seeking additional information about mortgage pools from a variety of sources. For example, we use the difference between weighted average gross coupon on the mortgages in a pool relative to the prevailing current coupon at the time of origination as a measure of pool characteristics.

Through this mechanism we may identify Alt-A, or low-point loans. Investors may also consider the servicer, state concentrations and seller of pools in evaluating expected performance. The additional disclosures will serve to level the playing field, somewhat, as more pool information will be made available.

The staff report correctly identified four types of loan information:

- loan terms,
- property information,
- borrower information and
- seller, originator and servicer identification.

Each type of information provides additional insight into prepayments, defaults and investment performance. Loan terms are valuable for identifying the borrower's current loan. Property information provides information on the sufficiency of the collateral and may help determine if a borrower is collateral-constrained, or if the borrower has the opportunity for cash-out refinancing.

Borrower information provides additional information on the range of options available to a borrower. Seller, originator and servicer identification provides additional information about underwriting standards and servicer actions that could impact prepayments.

This type of information is currently utilized in our loan-level models of jumbo and subprime loans. Until now, analysts have primarily incorporated information about the loan contract into our pool models. Analysts also indirectly incorporate information about the borrower based on the initial spread and information about collateral based on a national measure of home price appreciation.

The staff report also recommended additional disclosures for each pool, including:

- loan purpose,
- original LTV,
- standardized credit scores of borrowers,
- servicer of the pool,
- occupancy status and
- property type.

Beginning this month, Fannie Mae will provide the recommended disclosures. The company will also change the timing on some existing disclosures. In addition to the new disclosures, Fannie Mae publishes information about loan coupons, remaining term, weighted average loan age, weighted average loan term and original loan terms, original loan size and seller identity for each pool.

Freddie Mac will start to provide the recommended disclosures beginning

Andrew Davidson is president and founder of Andrew Davidson & Co. Inc., a New York-based consulting firm specializing in the application of analytical tools to investment management firms. The company advises financial institutions in the development and implementation of investment management and risk management strategies. He created the Vectors suite, a set of proprietary analytical tools including prepayment and option-adjusted spread models for mortgages and securities. He is co-author of the book "Mortgage-Backed Securities, Investment Analysis & Valuation Techniques."

with the June 2003 factor release date. In addition, Freddie Mac provides similar disclosures to Fannie Mae.

Unfortunately, the task force did not recommend and the GSEs have not agreed to loan-level disclosure. The task force found that "market participants generally sought aggregate pool information - as opposed to loan-level information - perhaps expressed in quartiles or other standardized breakdowns."

It would be surprising to us if modelers of prepayments did not request loan-level detail. Currently, such detail is available in the non-agency market. If we merely relied on pool information, we would find it much harder to construct prepayment models for jumbo and subprime mortgages.

Why it's needed

For example, if a pool contains half 70% LTV loans and half 90% LTV loans, it will have different prepayment characteristics than a pool with all 80% LTV loans. Even if quartile or other data is presented, it is difficult to determine whether the high-LTV or low-LTV loans prepaid in any given period. With loan-level data, it is possible to clearly see the impact of the varying LTVs. Loan-level information is also essential when multiple factors affect prepayments.

Without loan-level information, it is impossible to separate effects of coupon, loan size and LTV within a pool, since the pool averages do not show the relationship between these variables.

Yet, even without loan-level disclosures, mortgage trading and prepayment modeling will change over the next few years as the new data is integrated into prepayment models, valuation tools and market perceptions. While this new information does create the risk of impacting the liquidity of the TBA market, it is more likely that trading practices will develop that use the new information to enhance liquidity and overcome the current fragmentation of the market.

One possible scenario is the development of standard add-ons for valuable characteristics. With a more consistent source of pool characteristics, investors may have greater confidence on pay-ups based on factors that can be clearly identified and modeled. The Bond Market Association can play a valuable role in assuring the continued exceptional liquidity of the TBA market by carefully refining definitions of good delivery for TBAs and standard stipulations. (Stipulations are specifications for characteristics of pools delivered for a given trade.)

The new disclosures are a move in the right direction. We hope they will be followed by additional loan-level disclosures, which will help prepayment modelers provide tools to investors to fully harness the value of the new disclosures. SME