

Prepayment Update – February '08

How Important are Involuntary Prepayments?

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In the past, mortgage prepayment models dealt primarily with total prepayment speeds. This included voluntary prepayments due to refinancing and turnover, and involuntary prepayments due to defaults leading to foreclosures and REO. This was mainly because data separating voluntary and involuntary terminations was not readily available. With the increase in loan origination and securitization in the non-agency mortgage sector, more data became available and investors started paying more attention to such issues. With the “sub-prime” crisis of last year, investors are now more focused on the default side of mortgage terminations, and are doing more loan level analysis than ever before. This is a healthy outcome of all the turmoil that we are seeing in the markets.

In this article we look at prepayment speeds broken down by voluntary and involuntary terminations. The data for this study was obtained from trustee data compiled by AD&Co. The charts below show total termination speeds and speeds for voluntary terminations. In all the charts the blue line shows the total (voluntary + involuntary) termination speed, the brown line shows total voluntary termination speed, and the green line shows the percent difference between the two (based on total speeds).

Charts 1 through 3 show speeds for adjustable-rate mortgages by vintage. Both y-axes for all three charts have the same scale so that it is easy to track both speeds and percent differences in speeds by vintage.

The 2004 vintage shows that the difference starts to increase after the first reset. The percent difference goes from about 6% in June 2006 to about 58% in October 2007. Speeds for the 2005 vintage is lower than the 2004 vintage and the percent difference in speeds is also lower. The percent difference in speeds start going up from about 12% in April 2007 to about 28% in October 2007. For the 2006 vintage we see that the percent difference has been rising steadily reaching about 31% in October 2007. These charts also show that the crisis started having an impact on speeds from the second quarter to the middle of 2007.

Chart 1

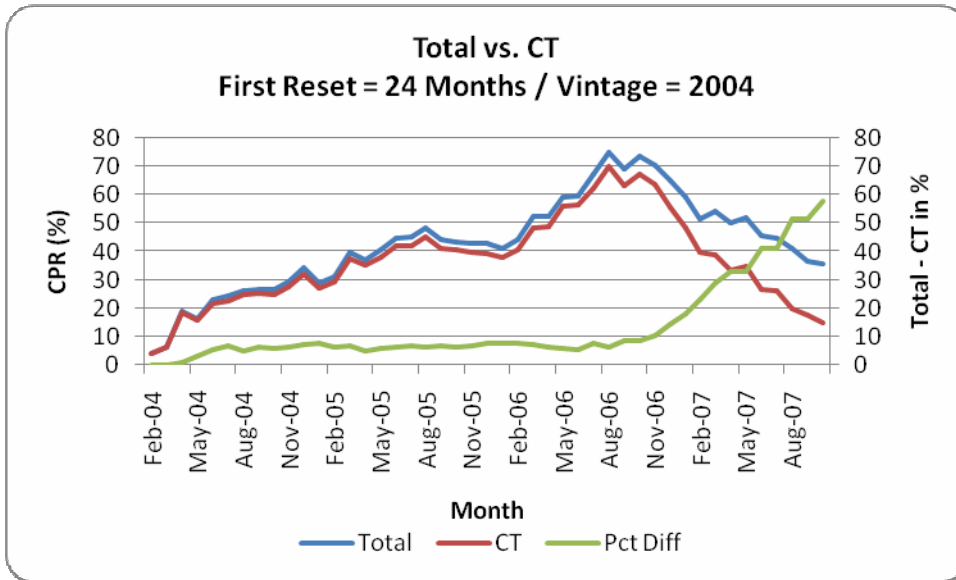


Chart 2

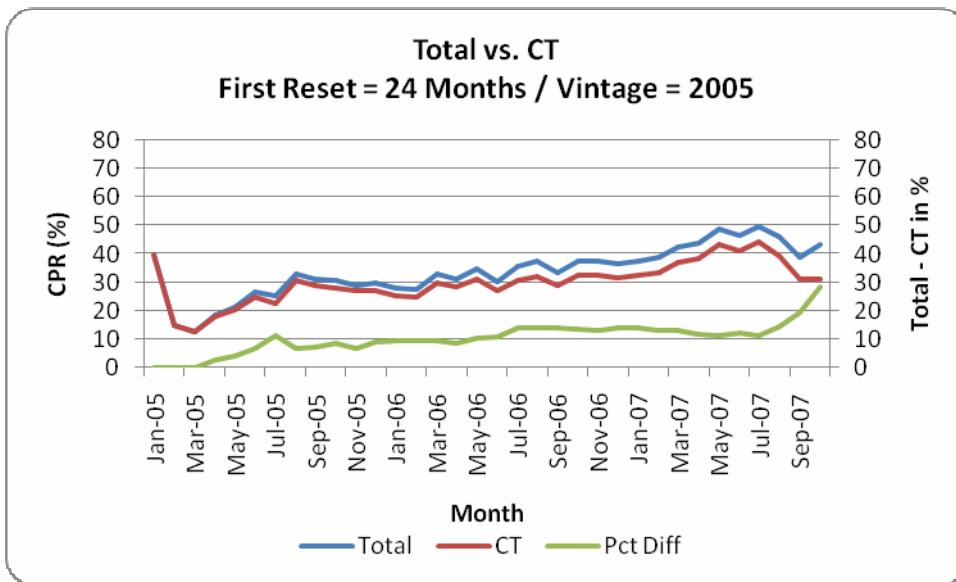
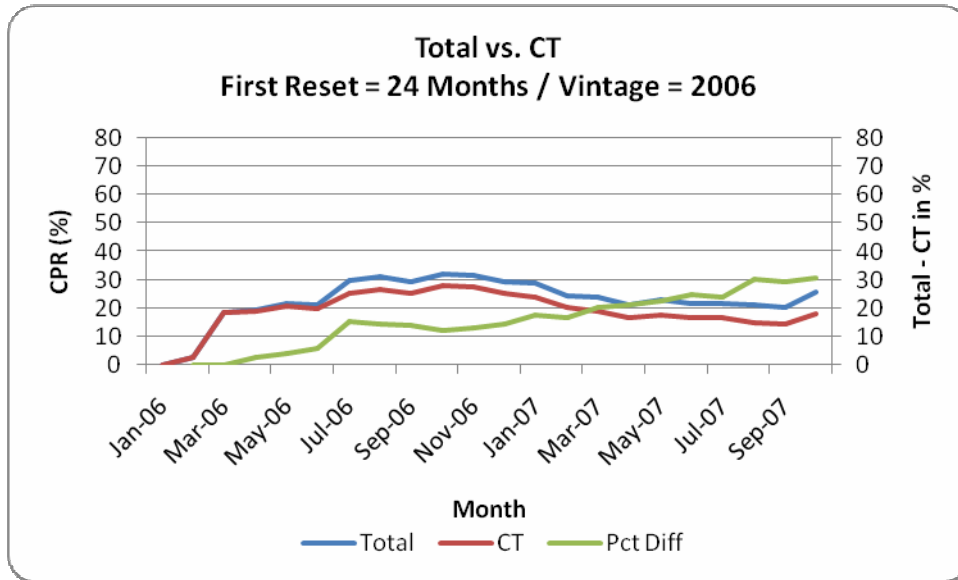


Chart 3



Charts 4 through 8 show speeds for fixed-rate mortgages by vintage. Here too, both y-axes for all three charts have the same scale so that it is easy to track speed levels as well as percent differences in speeds by vintage.

We see an interesting trend for the fixed rate mortgages. The percent difference in speeds start going up around July 2006. Except for the 2007 vintage, the percent difference in speeds goes from slightly over 10% in July 2006 to over 20% in October 2007. The increase is more gradual and happens over a longer time-period compared to ARMs.

Chart 4

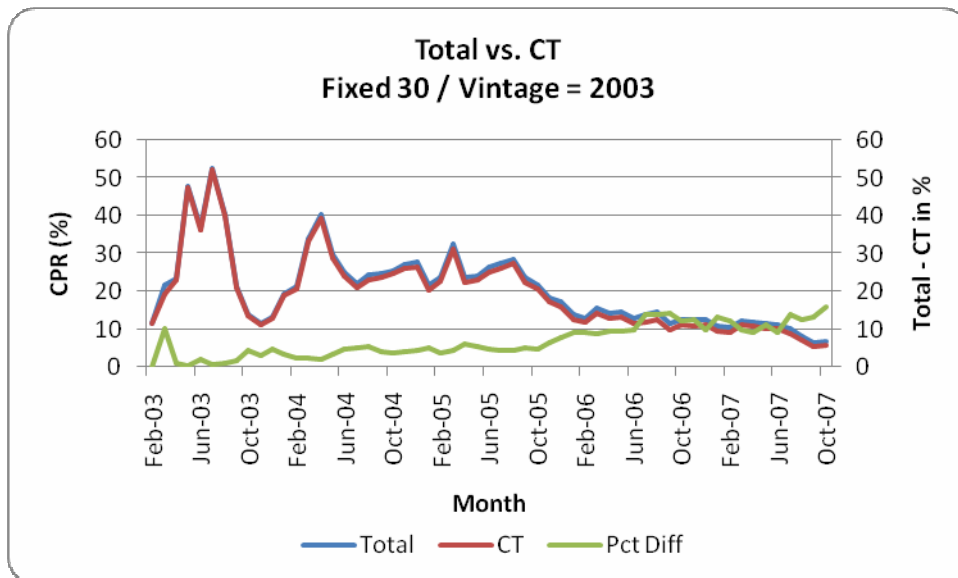


Chart 5

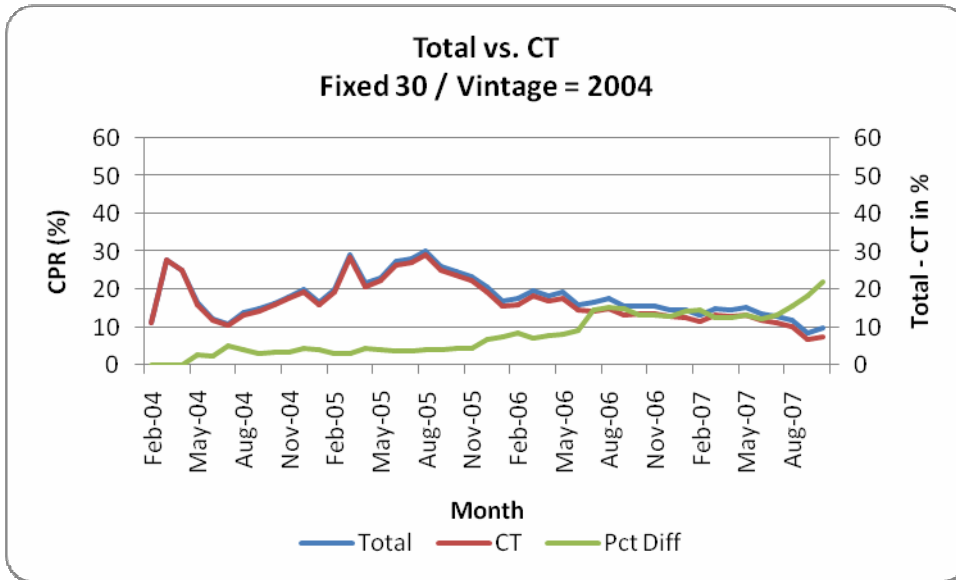


Chart 6

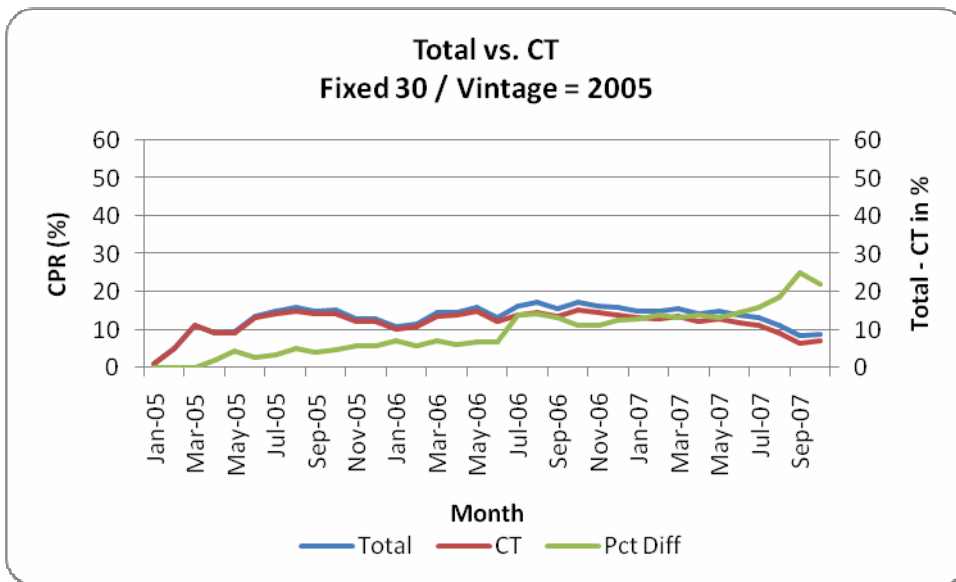


Chart 7

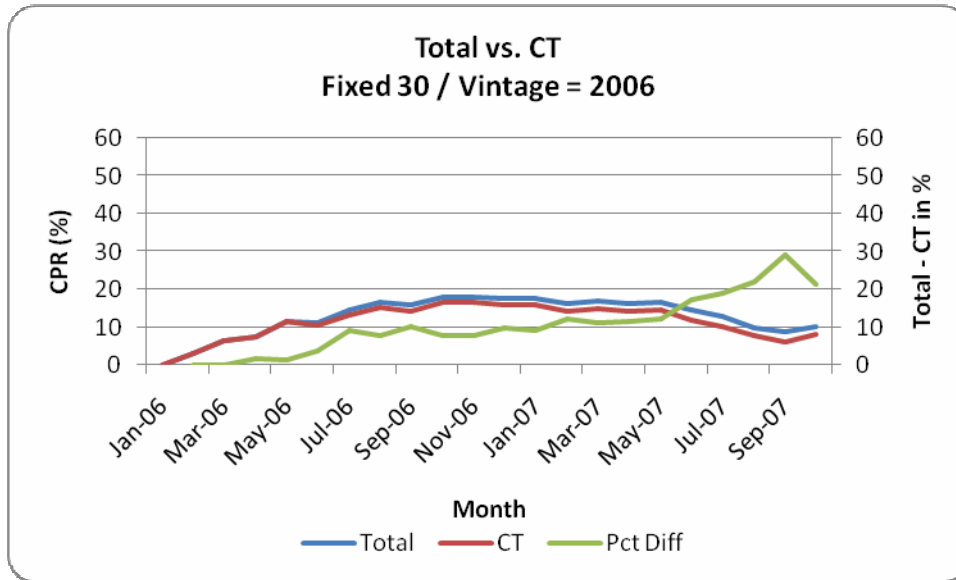
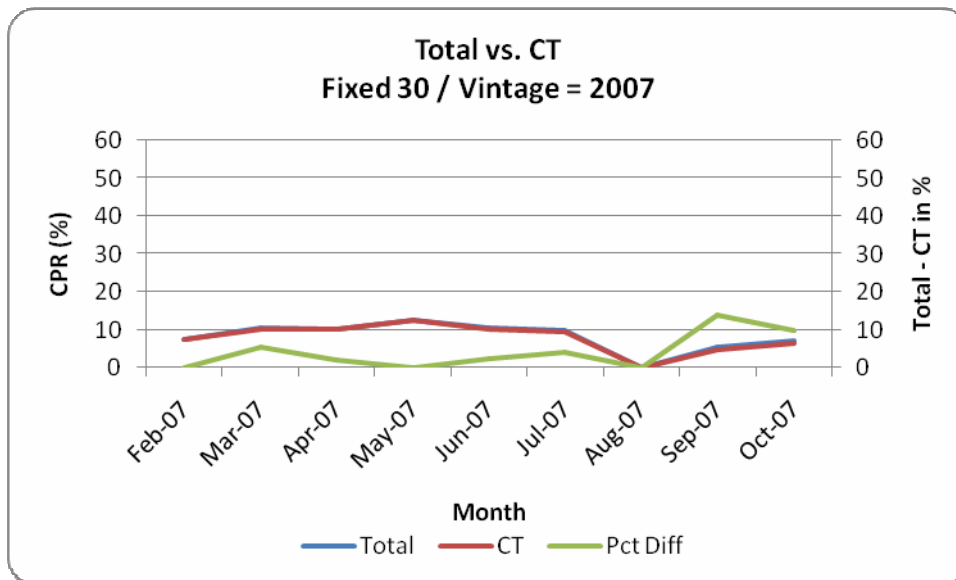


Chart 8



The above charts show that involuntary prepayments have increased over time to their highest levels in the third quarter of 2007. The percent difference between voluntary and involuntary prepayment speeds have ranged from 30% for ARMs to 20% for fixed-rate mortgages. We have moved from a period of an interest-rate driven environment to a credit-driven environment. This means that it is really important to have models that can accurately quantify and forecast involuntary terminations.

Andrew Davidson & Co., Inc. has developed models that can forecast both voluntary and involuntary terminations using a transition methodology. The models also generate loss and severity estimates and are an extremely important tool for valuing credit-sensitive instruments.

In an ideal world there would be standardized underwriting across issuers with minimal fraud. However, until that happens and in the current environment, investors in these credit-sensitive securities should continue to study data carefully and use credit models to accurately value the securities and make informed investment decisions.



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