

AD&CO News – April 08

Need Independent Valuations? AD&Co Can Help

By Rob Landauer

Over the last several months, AD&Co has been engaged by commercial, mortgage and home loan banks, as well as hedge funds and mortgage insurers to provide an independent third party valuation of the intrinsic and market value of their non-agency MBS holdings. These engagements provide an objective assessment of the current market value of these securities as well as a projection of future cashflows and losses under a variety of home price and interest rate scenarios. These results are then used by auditors, boards of directors and investors to make better portfolio and risk management decisions about their MBS holdings during these tumultuous times. To read more about the engagement AD&Co recently completed for Bank Hapoalim, please visit http://www.ad-co.com/announcements/press_releases.htm to access the bank's press release regarding the engagement.

AD&Co is uniquely positioned to provide expert advice on the valuation of credit-sensitive RMBS. Andy Davidson, Alex Levin and Rick Ellson lead a team of analysts that have significant experience in valuing these instruments using AD&Co's market standard credit model (LoanDynamics™), prepayment model and valuation solutions. Please contact Rob Landauer for more information on how our firms can work together.

16th Annual Client Conference

On line registration is now available for AD&Co's 16th annual Conference that will be held this year in New York City on June 11th and in San Francisco on June 16th. Agendas and presentations are now being finalized so visit www.ad-co.com to secure your spot at the location of your choice. Registration is free and there are plenty of recommendations for hotels if you need lodging.

V5.2d Prepayment Model Released

In March, AD&Co released a new version of the MBS Prepayment Model, v5.2d. This version provides heightened sensitivity to home prices for the fixed rate models. To obtain access to this version, please contact your account manager, Matt or Suzanne.



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Prepayment Update – April 08

A Look at Recent Non-Agency Prepayment Speeds

By Sanjeeban Chatterjee

In this article we look at prepayment speeds for non-agency prime and subprime mortgages through January 2008. Prepayment speeds here represent total termination speeds and include both voluntary and involuntary prepayments. Data in this study was obtained from Intex.

Sub-Prime ARM

Chart 1 shows the aging curves by quarter of origination for sub-prime 2/28 hybrids. It is interesting to see how much the 12-month and the first reset peak has gone down as we go from 2004Q1 to 2007Q1 origination. Chart 2 shows that the first reset peak has gone down from about 90 CPR for the 2004Q1 origination to about 30 CPR for the 2006Q1 origination. Chart 3 shows that the 12-month peak has gone down from the mid 50's CPR for 2004Q1 origination to below 10 CPR for the 2007Q1 origination. This shows that sub-prime ARM borrowers are having a harder time finding refinancing and credit-curing opportunities.

Chart 1

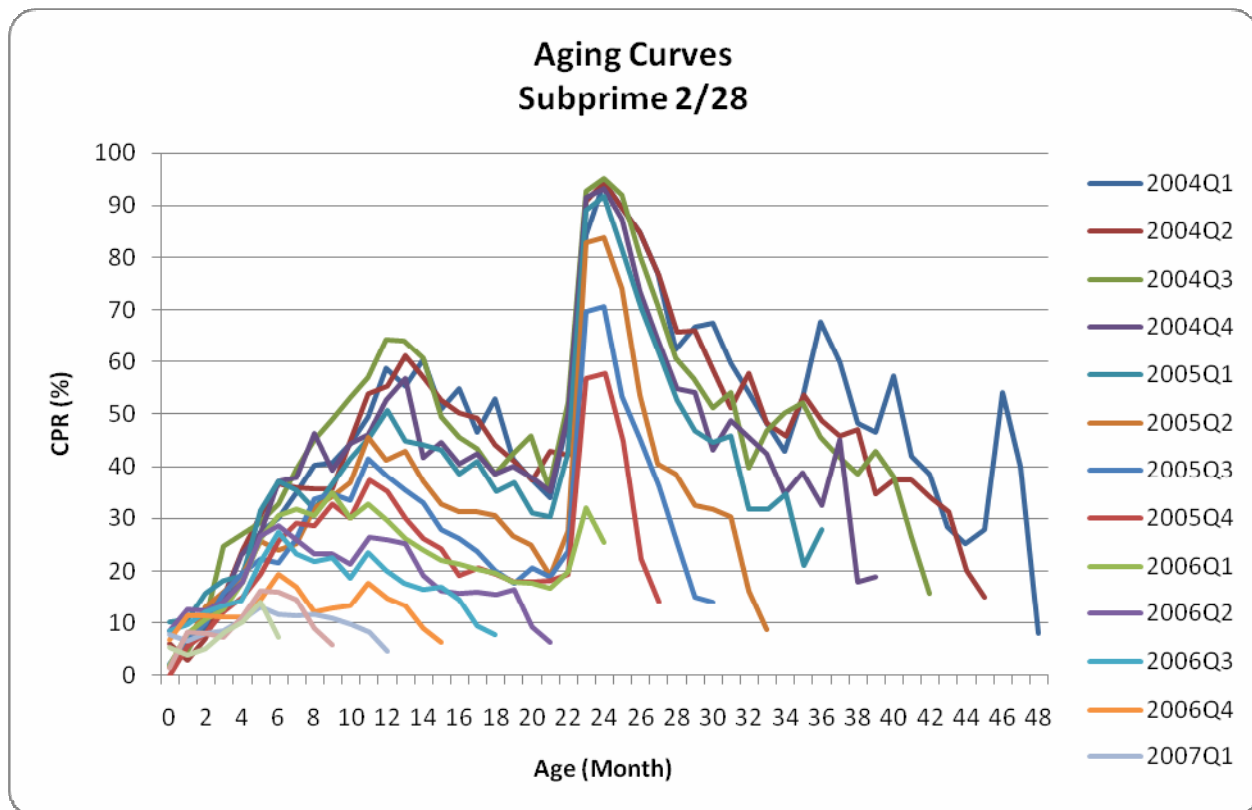


Chart 2

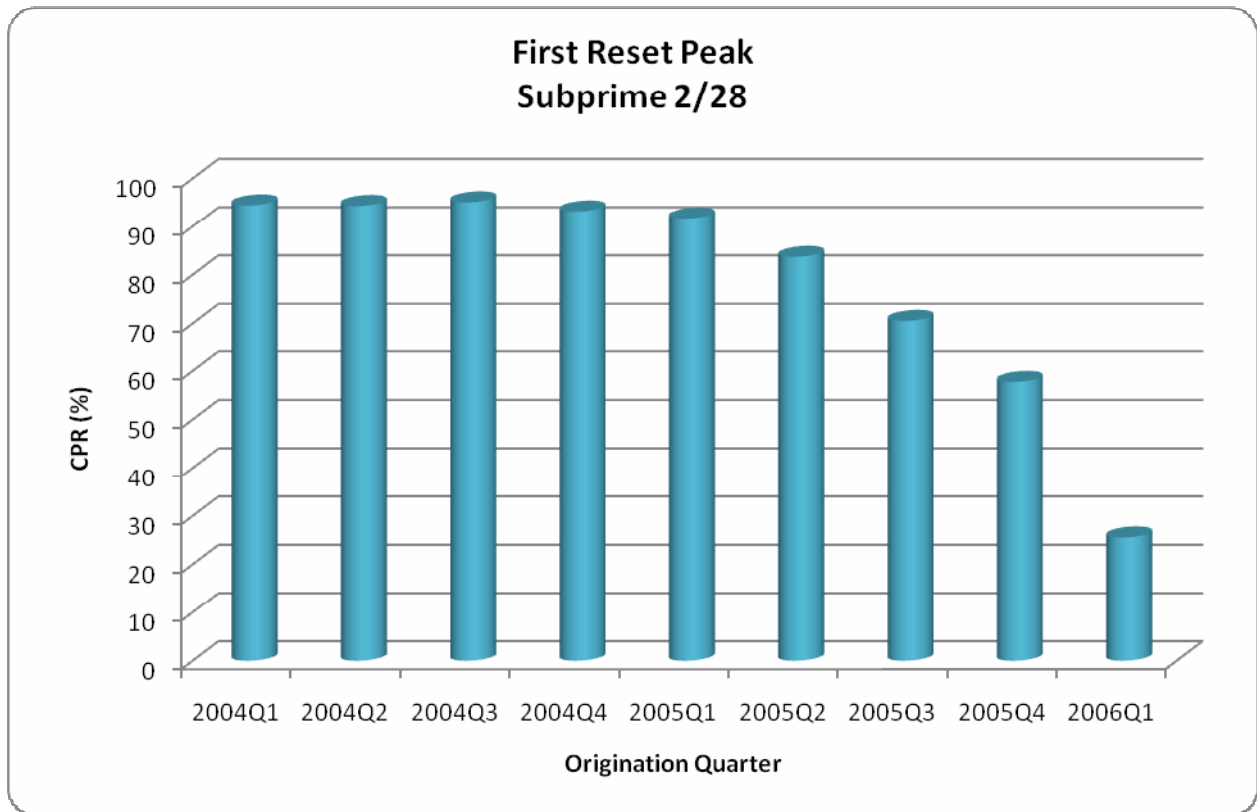
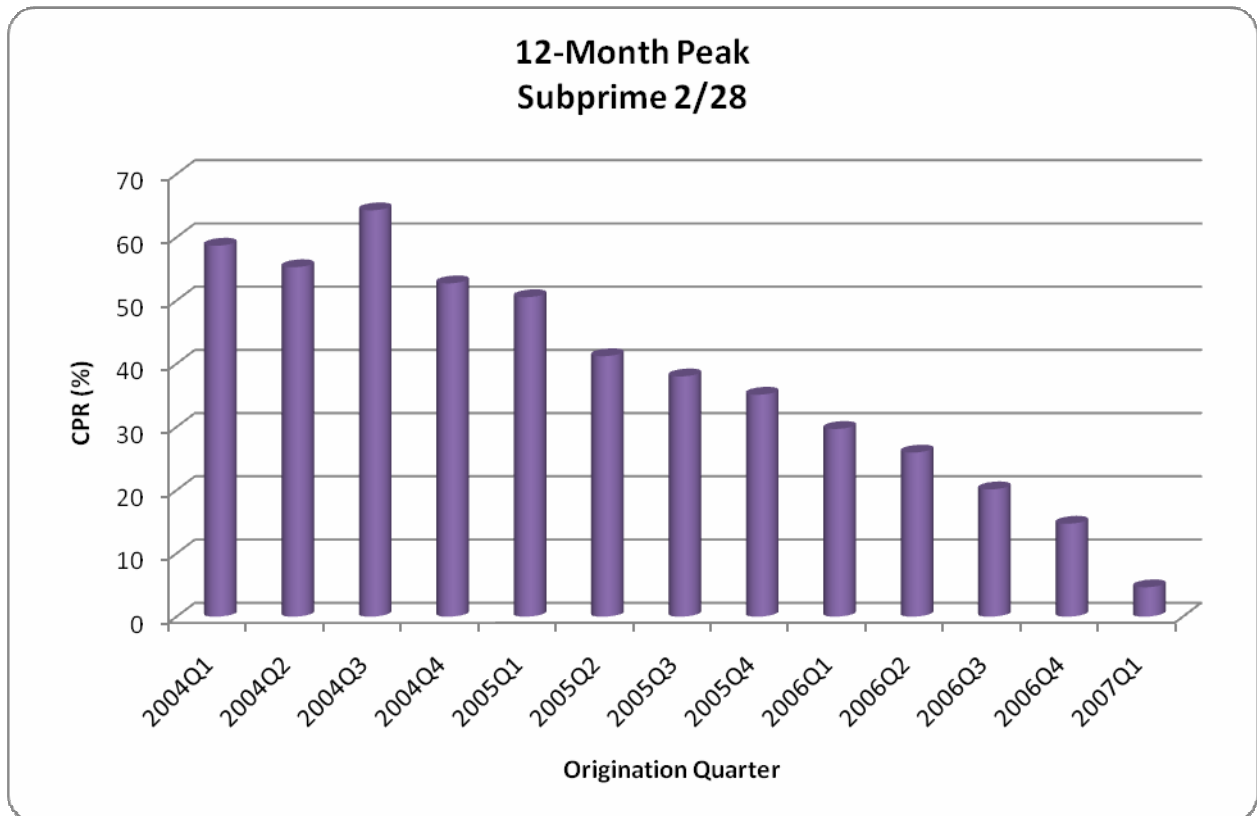


Chart 3



Sub-Prime Fixed

For both 30 and 15 year sub-prime fixed-rate loans, we see that aggregate speeds are trending towards the low teens.

Chart 4

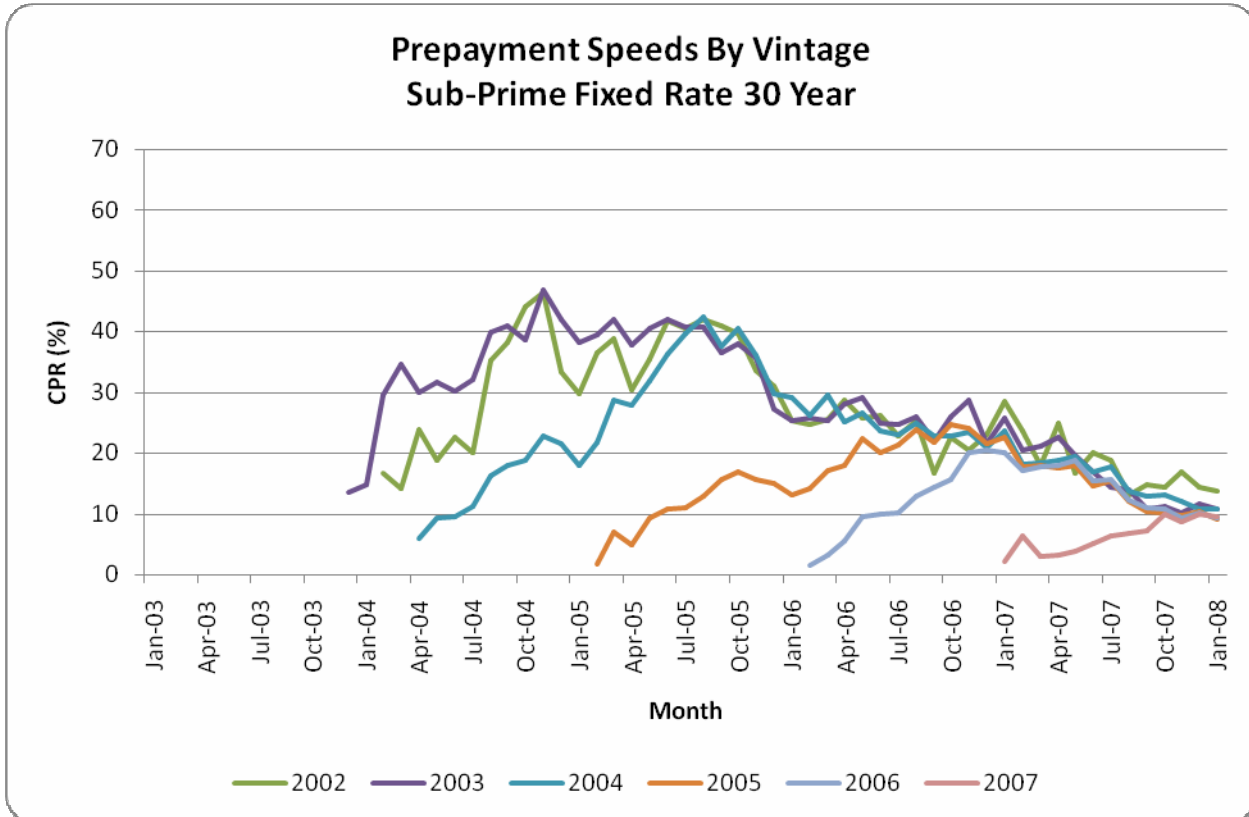
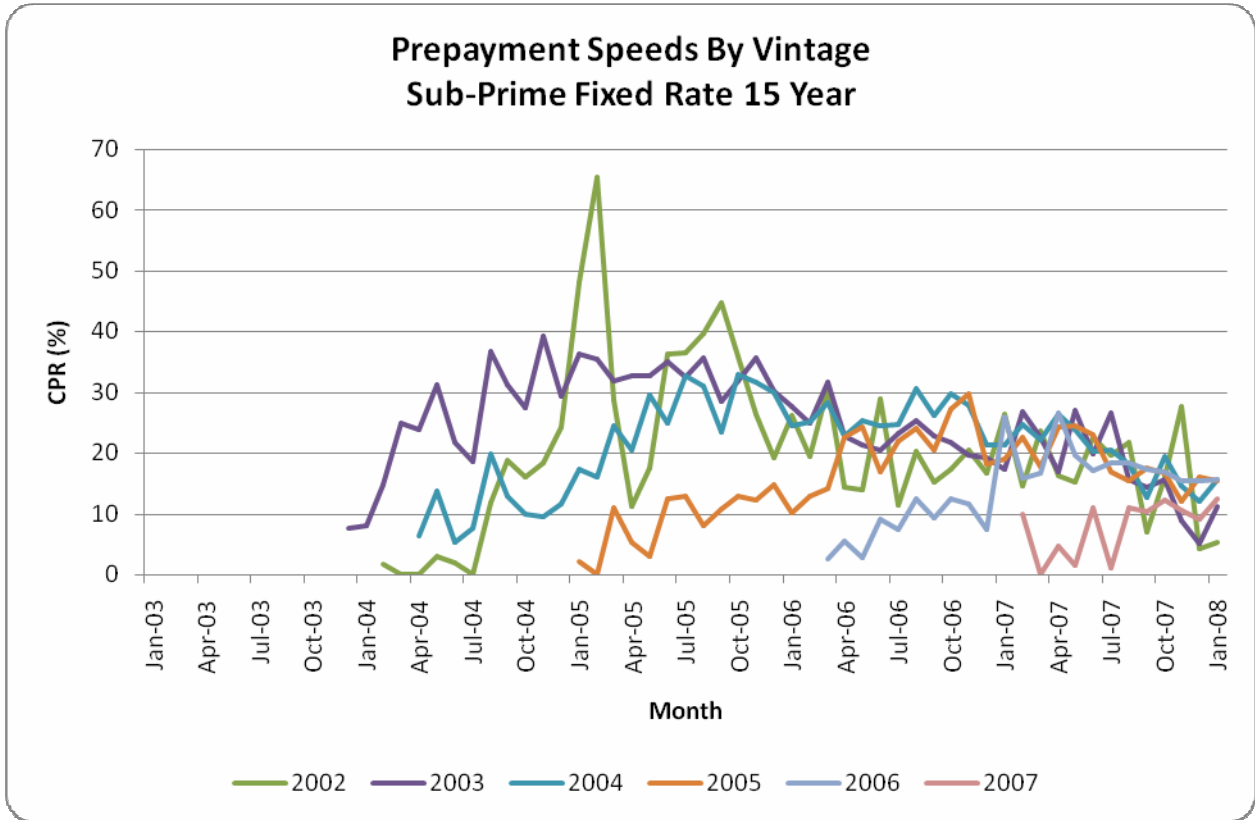


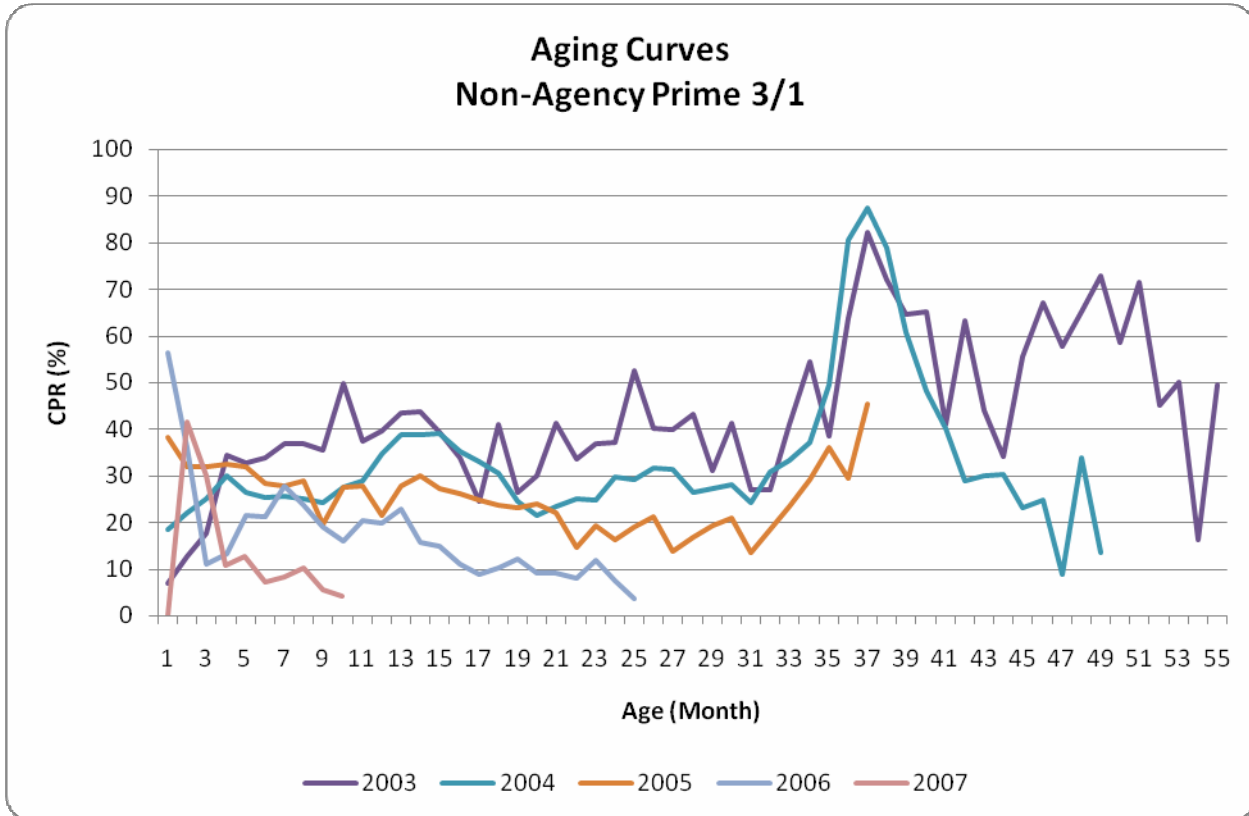
Chart 5



Non-Agency Prime ARM

For non-agency prime 3/1 hybrids we see that the 2003 and 2004 vintages prepaid between 80 – 90 CPR at first reset. We do not yet know how high the reset speeds for the 2005 vintage will go. However, speeds for the 2006 and 2007 vintages have been substantially slower than the earlier vintages.

Chart 6



Non-Agency Prime Fixed

For 30 and 15 year non-agency prime fixed-rate loans, aggregate speeds are coming in the 7 to 15 CPR range.

Chart 7

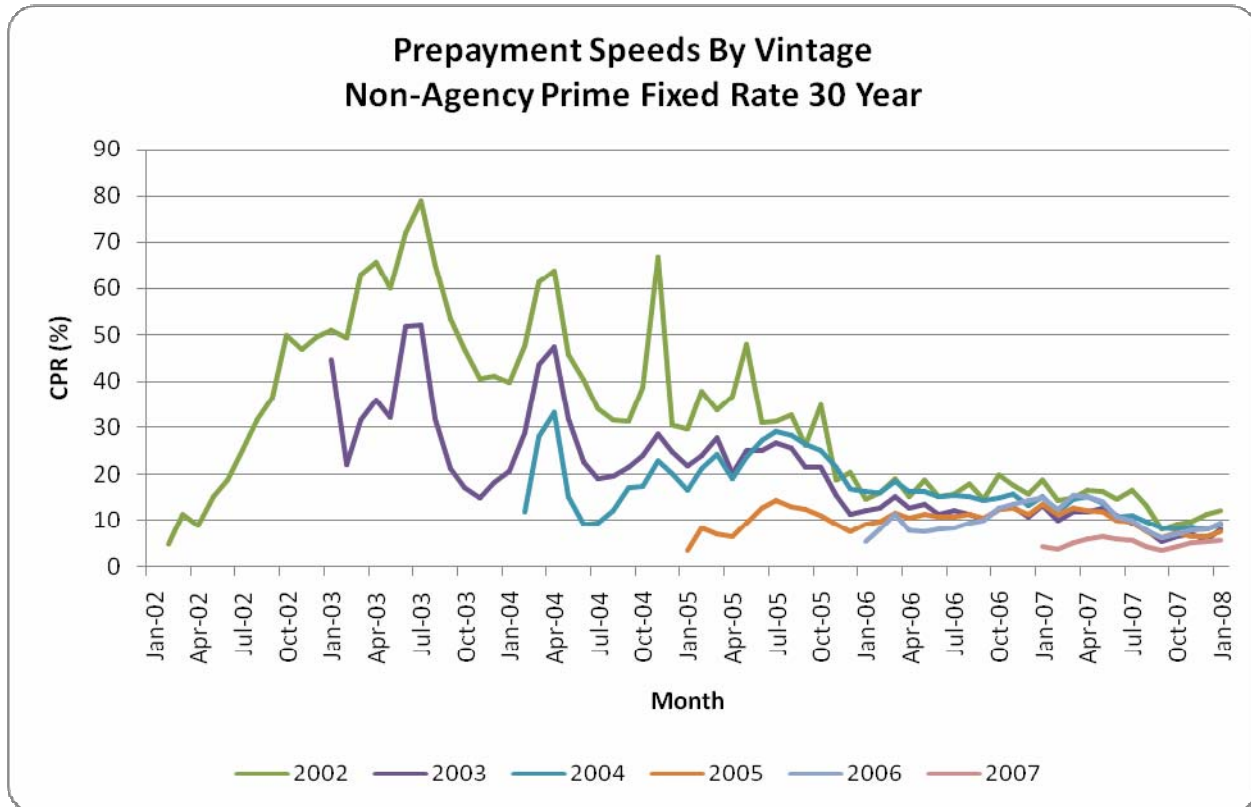
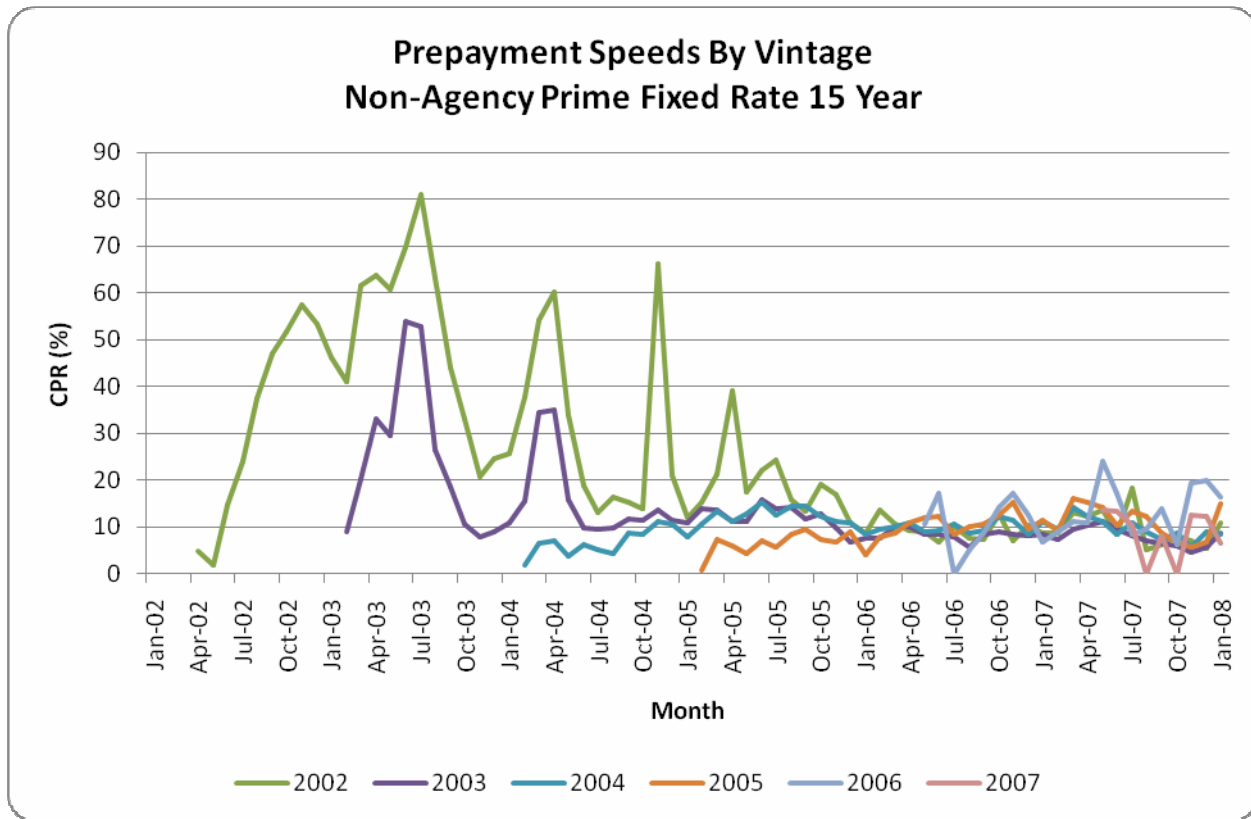


Chart 8



It is interesting to see the effect the current market environment is having on non-agency prepayment speeds. We are currently looking at our model performance and will recommend tunings shortly.



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Valuation Commentary – April 08

Six Myths of Credit Valuation

By Alex Levin

In recent months, AD&Co has been asked to help firms understand and manage risk relating to credit-sensitive MBS, both in the US and abroad. While it is not always easy to explain the market's rationale in times of panic or stagnation, we warn investors not to be misguided by some common myths that have surfaced.

Myth 1: Market prices of MBS and ABS reflect expected losses

“The market prices our portfolio to x% of losses. What does the LDM predict?” We have been approached with this exact question and it suggests, in itself, that the direct loss levels obtained from the LoanDynamics™ Model (LDM) can be employed to rationalize MBS prices.

First, the LDM gives us only projected losses for a market scenario given interest rates and home prices. The market certainly considers volatility and scenarios that are worse-than-average. Second, even the averaged outcome will be insufficient if we don't consider the price of risk. In scientific terms, the interest rates and home prices have to follow “risk-neutral dynamics.” Third, today's non-agency MBS market is not liquid and the liquidity premium is a big part of valuation.

In symbolic terms,

$$\text{Price (perfect MBS)} - \text{Price (actual MBS)} = \\ \text{Real-World Expected Loss} + \text{Risk Premium} + \text{Liquidity Premium}$$

The sum of Expected Loss and Risk Premium is also known to be equal to the Expected Loss under risk-neutral dynamics of the random market factors. Therefore, the same formula can be re-written as:

$$\text{Price (perfect MBS)} - \text{Price (actual MBS)} = \\ \text{Risk-Neutral Expected Loss} + \text{Liquidity Premium}$$

In the current market, the real-world expected loss may be just a small piece of the puzzle. According to our February 2008 *Pipeline* article, the liquidity spread was found to be 200-400 bps when an ABS structure was analyzed in September of 2007; liquidity has deteriorated since then.

Myth 2: The Price of credit risk should be close to the expected losses

Let us not forget that ABS, CDS and other structured instruments are financial derivatives. The underlying is loan losses. Let us think for a moment how a mortgage insurer (MI) or a GSE charges for the loan loss protection. They surely must charge more than the real-world losses because they protect against worst-case scenarios. AD&Co was asked to work on a project that involved this task; we found that the risk premium can be of the order of 40% to 70% of expected losses. This will define the risk-neutral loss assumptions, from the MI and the GSE stand-point.

However, tranches absorb losses in a highly non-linear fashion. If we expect cumulative losses of collateral to be 10%, our bond may be well and alive. But, if we increase the losses to 14% or 17%, the bond may vanish. Hence, the market may seriously discount tranches that otherwise experience small losses under seemingly “realistic” market assumptions. If this logic wasn’t in place, the investor could have sold bonds and bought protection on the underlying loans.

Myth 3: HPI derivatives reflect market expectation of future home prices

Certainly not more than the forward curve points to rate expectations, forward prices – price expectations, etc. We recently received a note from OFHEO announcing the release of a new paper, A. Leventis, *Real Estate Futures Prices as Predictors of Price Trends*. The author states, “For many commodities, futures markets provide informative, unbiased measures of anticipated prices for the underlying product. In mature futures markets with sufficient trading volume, contract prices will summarize overall market expectations of likely price patterns.” He finds the bias in the CME futures traded on the S&P/Case-Shiller Index, which “have tended to predict larger home price declines than ultimately occurred.”

To that I can only ask, “Since when have futures and forwards been used as predictors?” The price of risk – again – is the important constituent of traded instruments. In a market dominated by investors who are eager to heal the wounds and protect themselves from a complete collapse, is it surprising that the HPI derivatives are traded to pessimistic forwards?

Myth 4: The interest rate sensitivity of MBS is not related to credit modeling

As we demonstrated in the February issue of *The Pipeline*, the effective duration of an MBS with losses can be anything and is largely driven by the relationship between interest rates and home prices. In particular, we found the OAD for low-rated bonds to become by order of magnitude longer when we apply the Credit OAS method. We disclosed that this effect is due to a relatively strong negative relationship between interest rates and home prices existing in the AD&Co HPA model. This cannot be easily verified by daily prices.

In order to provide the common sense rationale, let us review the recent Fed’s steps. The Fed has lowered interest rate several times in hopes to provide a remedy for the ongoing mortgage crisis. These actions were praised by market players and considered, at least, a partial solution that should lower mortgage rates, improve housing affordability and ease tension. From the investor stand-point, if an ABS tranche is valued at 25 now, has the Fed lowered the rate just to move it to 26?

Myth 5: Home prices fall with interest rates

This is what they are doing now, but this is not an economic law. Historically, the home price appreciation rate had negative correlation to interest rates – see *Home Prices and Interest Rates* at www.ad-co.com.

Why are interest rates falling now? This is the Fed's action to remedy the crisis that should *improve* home prices after all (among other things). What would happen to home prices if the Fed retained or increased the interest rates? They would likely deteriorate deeper causing a devastating effect on the economy. With higher interest rates, troubled homeowners would have less chance to refinance, would experience a reset rate shock and would likely join the crowd of defaulters. This would further depress home prices.

Hence, home prices should be improving with falling interest rates - relative to what they would have been otherwise.

Myth 6: Homeowners default once their home's price falls below the loan

Default is an American put option on real estate. As we all know, American options should not be exercised when the option is just in the money. Hence, even if the default was a hassle-free, efficiently managed, option, it would not be exercised because the home price falls just below its strike (loan).

Furthermore, practical mortgage default is a hassle with negative long-term consequences: it lowers credit scores and makes it difficult or impossible to obtain another mortgage. This means a sizable deterioration of the living standards for our homeowner: the average quality of rental properties in the US is not comparable to that of owned homes.

People default after they become delinquent, but they become delinquent when they can't pay. Affluent borrowers don't quit paying just because they experience a home price decline. The eventual resolution to the delinquency problem is a tough one; at that point, the amount of equity becomes a factor.



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