

January 12, 2011

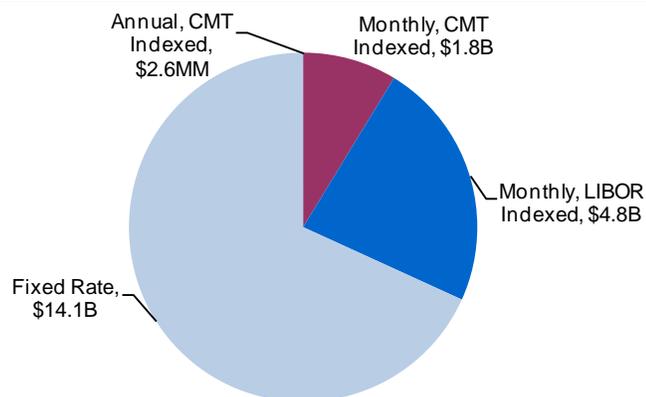
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Reverse MBS

Update on Prepay Sensitivities

- One of the problems when examining a relatively new market such as Ginnie Mae's reverse mortgage backed securities (HMBS) is the lack of comparable data. This dearth of data has been exacerbated in this market by several significant, evolutionary changes that have occurred, even over its short life span.
- In 2007 and 2008, changes were made to HUD's home equity conversion mortgage (HECM) program, enabling new loans, such as fixed rate mortgages and a broader array of adjustable rate ones to be part of HMBSs.¹ Existing loan data from HUD shed some light; however, much of market's historical data is from mortgages that have seen limited origination since the HMBS program's inception. Therefore, historical loan level data may be misleading to gauge future prepayment performance.
- HUD reports that 6.8% of HECM loans endorsed in FYE October 2010 were refinancings, nearly all of which were adjustable rate mortgages. This figure compared with FY 2009's 7.8% refinancing, though a lower proportion were adjustable rate loans.
- These figures compare to some of the observations we have made on HECM mortgage-backed securities (HMBS), and we believe adjustable rate loans will be refinanced due to recent changes in the product, specifically improvements in principal limit factors (PLFs) for younger borrowers (i.e., younger than the historical average age of 73 years). To date, floating rate securities have seen higher prepayment rates generally than fixed rate ones.

Figure 1. Types of HECM Mortgages in Outstanding HMBS, as of 31 Dec 10



Sources: Bloomberg and Knight.

¹ For background information, see *Reverse Mortgages: A Look at a Burgeoning MBS Asset Class*, Knight, 28 July 2010.

Twists on the Product

In October, HUD made several significant changes to the HECM product. These modifications and addition of the new Saver HECM mortgage likely will increase the attractiveness of HECM, but they could have follow-on effects for prepayments due to refinancing.

First, PLFs for the Standard HECM were changed again last October in what seemed to be an annual event. The moniker 'Standard' became part of the mortgage terminology when the Saver HECM was introduced as a concept over the summer and formally launched in October. This time, increases were announced on Standard HECM PLFs that were targeted at the younger end of the borrower base, improving the amount of proceeds available. However, PLFs on the mortgages were decreased for virtually all borrowers with interest rates above 5%. This change moved the "PLF floor" from 5.5% in the older PLF schedules to the new 5% one in the latest tables, meaning no additional benefit of higher proceeds accrues for borrowers with rates lower than 5%.

Simultaneous with announcing the new PLF schedule, HUD also announced changes in its insurance premiums.

Figure 2. Comparison of the Old vs New Standard and Saver HECM Mortgages

Mortgage Insurance Premia	Standard		
	Old	New	Saver
Origination	2.0%	2.0%	0.01%
On-going (Annualized)	0.50%	1.25%	1.25%
Principal Limit Factors (by interest rate, age)			
5%			
62 years old	56.3%	61.9%	52.3%
73	64.4%	68.1%	55.7%
85	73.7%	74.7%	59.4%
5.5%			
62 years old	56.3%	54.8%	45.6%
73	64.4%	62.2%	50.1%
85	73.7%	70.3%	55.4%
6%			
62 years old	50.8%	49.4%	39.9%
73	60.2%	57.6%	45.3%
85	71.3%	66.7%	51.5%

Source: HUD.

Beginning in early October, FHA also raised its ongoing, monthly insurance premiums on newly originated HECM loans from an annualized 50bp to 125bp, somewhat removing the euphoric effect that might have been produced by the new PLF schedule and the new Saver HECM product. In our view, this 150% increase in insurance premiums may have removed part of the refinancing incentive.

Most loans now are being originated below 6% (and closer to 5%); therefore, borrowers who were offered mortgages that closed after October 3rd should have been able to take advantage of the new schedule with mostly higher proceeds available and a lower PLF floor but higher ongoing monthly premiums. As a result, a spate of refinancing of older HECMs could follow, but borrowers will have to weigh the additional loan principal generated by potentially higher PLFs against higher running costs of the new insurance, even with potentially lower rates.

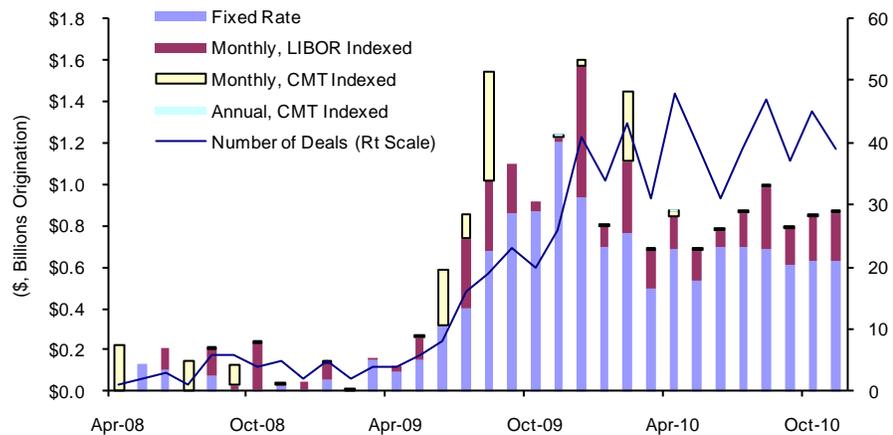
In addition to a so-called Standard HECM, borrowers will be able to take advantage of a federally-insured Saver HECM, which incorporates significantly lower *initial* insurance premiums but lower

PLFs. This mortgage was structured for those who did not need access to great deal of funds, at least at the start of the mortgage.

This product is targeted to fill a part of the market where some borrowers only took a small draw from their HECM. HUD had studied the drawn-down rates for HECM loans, going back to the program's inception, and found that the number of borrowers had actually drawn a smaller amount than the PLF's limit of the maximum claim value. The agency had conceived of a product that offered a mortgage with a lower initial cost, thereby reducing the effect of a negatively perceived feature.

Many pundits had noted the decline of the origination in HECM product, and clearly decisive action had to be taken to facilitate HUD's desire to serve the senior citizen market with products that made sense. According to recent surveys by pro-senior lobbyists such as RetireSafe, many senior citizens fear having inadequate resources to meet rising healthcare and housing costs, but want to be able to live independently.

Figure 3. Ginnie Mae HMBS Issuance: 1 Jan 08–31 Dec 10



Sources: Bloomberg LLP and Knight.

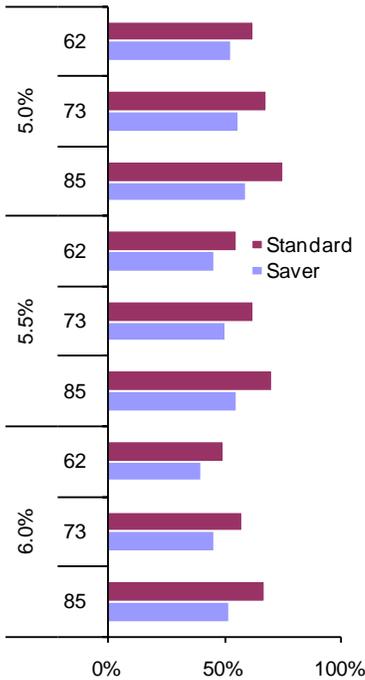
Despite these concerns, the origination of HECM loan product has struggled in recent months. Part of the absolute origination volume decline may be traced to uncertainty over what and when changes might have been made to the program prior to the October announcement. With more certainty following the announcement and new appropriations afforded to HUD by Congress for HECMs, more potential borrowers may find the mortgage more attractive.

While slower origination volume has translated into less HMBS issuance in aggregate, the number of transactions has actually increased in 2010 over that in 2009. As a result, the average deal size has fallen. Some investors may perceive smaller deal sizes as providing a less liquid market; however, it does offer investors the advantage of being able to diversify by choosing pools that make investment sense, given their constraints.

Too, the development of the Re-REMIC market in HMBS should create appetite for smaller deals to be packaged up into more diverse pools. Ginnie Mae currently does not allow more than one issuer per HMBS. Therefore, deal sizes tend to be erratic depending on mortgage origination. By bundling pools into larger transactions, investors would benefit from larger transactions and more diverse collateral within deals.

HECM Savers – More Than a Scaled Back Version

Figure 4. Principal Limit Factor Comparison Between Saver and Standard HECMs at Various Ages, as of Oct 2010



Source: HUD.

The HECM Saver was announced in mid-September, incorporating extremely low initial insurance premiums as an encouragement to borrowers who were looking for a scaled back version of the standard HECM.

According to discussions with HUD officials, the agency felt that many potential borrowers were discouraged by the initial costs of the HECM, and that, by offering a low-cost alternative, the market for the HECM product could grow. In exchange for lower initial premiums, these mortgages carry lower PLFs than the Standard product. HUD's view was that the lower risk required lower insurance premiums, especially initially.

These Saver mortgages feature the same ongoing mortgage insurance premiums as the Standard product – monthly premiums on new mortgages that were raised the same time the Saver product was introduced.

We believe that this product will stimulate more seniors' interest in HECMs, especially among younger potential borrowers. In many ways, this product could become a "taster" for borrowers seeking additional cash, but unwilling to take on a larger debt burden. Use of this product as a precursor to a Standard HECM has been strongly discouraged by industry leaders. However, if this product became a stepping stone onto a Standard HECM, then we would expect refinancing activity to be considerably higher than that found in the Standard product.

The product appears more targeted toward a younger borrower. The Saver HECM PLFs run as high as nearly 85% of that for the Standard product, but less than 80% for older borrowers (see Figure 4). The difference between younger and older borrowers diminishes considerably in higher interest rate environments and actually inverts due to potential interest accretion over a longer period for younger borrowers. On the whole, the Saver HECM's PLFs average about 79% those of the Standard product.

In designing the new HECM products, HUD spent considerable time evaluating refinancing potential between products. In its guidance for brokers, it offers several examples of how refinancing should work and refinancing software was made available.

Ginnie Mae President, Ted Tozer, stated during the annual NRMLA conference in November that he envisioned seeing this type of HECM at about 30% of loan endorsements. We believe that this estimate may be optimistic; however, it sets a gauge of how important the product is to the industry and to HUD to ensure its success.

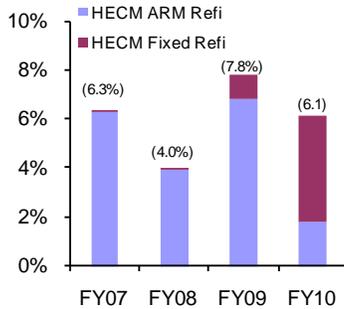
One of the offsets to this product, in our view, lies in the high ongoing insurance premiums. While the initial premium is a virtually nonexistent 0.01%, or one basis point, the ongoing premium is still an expensive 1.25%. Borrowers switching from a Saver HECM to a Standard HECM will be required to pay the difference between the 1bp initial premium and the 2% for the Standard mortgage.

For refinancing, the dollar-value of the initial mortgage insurance premiums (MIPs) are offset against each other, which would benefit the borrower to a degree if house prices fell (and the maximum claim value with it), but for most borrowers we believe that a drop in house prices would prove less motivating to switch, thereby keeping refinance rates lower than might be expected.

Certainly, borrowers looking to switch from a Saver HECM to a Standard one would see virtually no benefit from offsetting initial mortgage insurance premiums, given the small initial MIP the borrower pays for the Saver HECM.

Analyzing Prepay Performance in HECM Pools

Figure 5. Pct. HECM Endorsements for Refinancing, FY07-FY10



(%) indicates Pct. HECM Total. Source: FHA.

One of the problems with current prepayment assumptions around HECM loans has been the lack of data with respect to the currently available reverse mortgages. The purpose of this section is to establish a framework to better assess risk to prepayment performance in HECM pools. Though HECMs have been available since 1989, much of the paper that has been originated until 2008 was annually adjustable CMT-indexed loans and therefore unlike the mortgages originated today. Too, much of the paper originated prior to 2008 was purchased mostly by Fannie Mae.

In 2007 and 2008, several dramatic changes were made to the program, including offering fixed-rate and a broader array of floating-rate mortgages. The product, too, began being targeted toward a younger borrower, especially with more recent loan offerings.

With these factors in mind, prepayments can occur in HECMs found in Ginnie Mae HMBS for essentially four reasons:

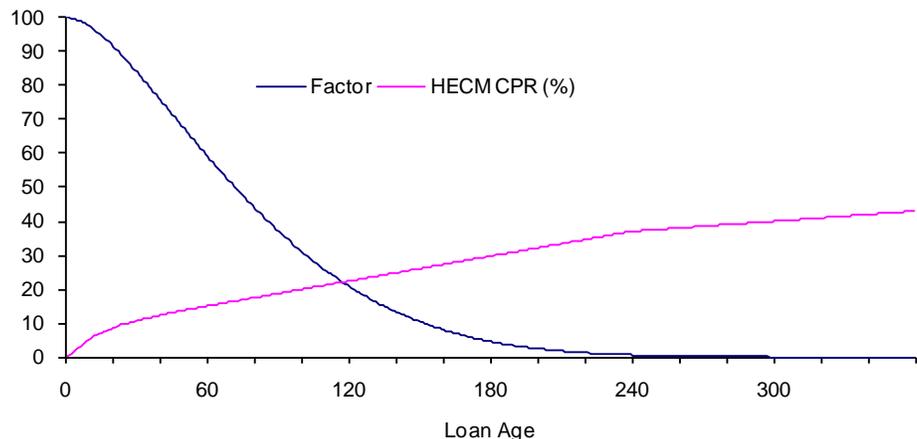
- Mortality
- Mobility, defined as a borrower's long-term exit from the home
- Refinance
- HUD Put, defined as when the negatively amortized loan balance reaches 98% of maximum claim value of the loan

The easiest variable to determine is the HUD put option, where the mortgage may be put back to the FHA when the loan reaches 98% of the maximum claim value of the loan at origination. The other three require varying degrees of analysis.

The current market standard HECM prepayment curve is based solely on loan age. In most cases, loans in loan pools are originated close to the HMBS offering date, making the difference between pool age and loan age very close. This curve is based on a rapidly rising CPR that begins to level out at 13 months, then 25 months, 49 months and 240 months (see Figure 6).

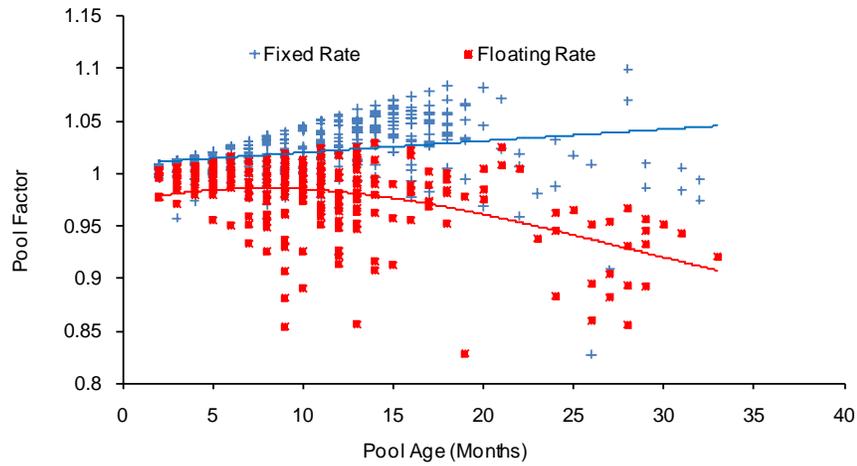
This standard prepayment curve is generally used for fixed-rate pools, where loans are generally lump-sum distributions. However, we can draw some conclusions as to what the principal factor may look like. This rising CPR causes the principal factors assumption to decline quickly then later decelerate.

Figure 6. HECM CPR Assumptions by Loan Age and Implied Fixed Rate Pool Factor



Source: Knight.

Figure 7. Comparison of Pool Factors of Fixed Rate and Floating Rate HMBS as of 31 Dec 2010



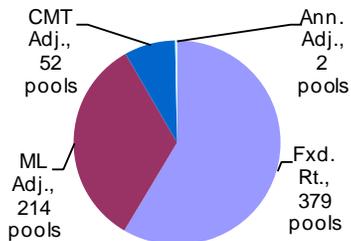
Sources: Bloomberg and Knight.

For non-fixed rate loans, HECM distributions are offered in several different formats: tenure, term, line of credit, modified tenure, and lump-sum. Often, lines of credit HECMs are not fully drawn at the first take-down, and future takedowns often are sold later as participations in the same loan, similar to later draws in the other formats. Lines of credit, term and tenure HECMs must be floating-rate loans that can be converted into floating rate securities, and there is a standard HECM draw assumption that is used by the market when determining how loans accrete towards the 98% HUD put value.

When we assessed how pools were performing, we noticed some interesting trends.

In Figure 7, the current pool factors for the outstanding fixed-rate and floating-rate HMBS pools are plotted against the age of the pool. Floating-rate HMBS pools have made up 41% of the numbers of securities issued since the Ginnie Mae program began. To better determine direction, we ran trendlines through each of the two types of pools. We found that fixed-rate HBMS tended to show far slower prepayment rates than floating-rate HMBS. This difference may be partly explained by the multiple participations sold on floating-rate mortgages, due to further draws by the borrower. These multiple participations likely would be spread through several securities, and a single prepayment on one loan could have repercussions for several pools.

Figure 8. Types of HMBS Pools, by Number of Pools, 31 Dec 10



ML Monthly LIBOR. Source: Knight.

Also, lower rates found on floating-rate HECMs in the recent environment could cause lower interest accretion. With the lower accretion, the same amount of prepayments would have a greater affect than on fixed-rate HECMs.

Of the floating-rate pools, we found substantial variance among the different types of pools, with annual and monthly CMT-indexed mortgages paying down faster than monthly LIBOR-indexed pools. To date, no annually adjustable LIBOR floating-rate with 2/5 caps HMBS have been issued. However, annually adjusted CMT-indexed mortgage pools suffered from few observations (see Figure 8), so it is difficult to assume a trend from so few data points for this particular type of security.

Of the two predominant adjustable-rate pools -- monthly LIBOR- and CMT-indexed mortgages -- our observations showed that both types were relatively close; however, at any given pool age, we found that the speeds seem to be slightly faster in the CMT-indexed loans.

Figure 9. Analysis of Pool Factors by Product Type

	Fixed Rate	Monthly LIBOR	Monthly CMT	Annual CMT
Number of Observations	379	214	52	2
WA Pool Age	9.4	8.9	11.4	10.6
WA Principal Factor	1.021	0.983	0.973	0.920

WA Weighted average. Sources: Bloomberg and Knight.

In Figure 9, our summary analysis illustrates how the pools performed. Given the limited variance in weighted-average pool age, the principal factors show more significant differences, suggesting that the data is not time-biased. Again, the limited number of observations in annual-adjusted CMT HMBS does not offer as a solid conclusion as we might draw with more data.

Much of the market data used in prepayment analysis comes from HUD. The vast majority of the loans originated through 2007 were annual-adjusted CMT HECMs. Therefore, prepayment data from that era likely is less valuable when comparing to products that began in earnest in 2008.

Anecdotally, we also found that a number of the paid-down pools had outsized T&I defaults. According to a study by Reverse Mortgage Insight, T&I defaults made up the largest portion of paydowns, reaching 4.3% for the pools studied (see Figure 10). What was remarkable was not only were these defaults occurring in the smaller balance loans, but they were also aggressively so in the 2007 and 2008 origination vintage. T&I defaults were a regular discussion topic at the annual NRMLA conference in many of the sessions and are proving a worry for the industry.

T&I defaults appeared to have a disproportionate effect in real estate distressed states such as Florida and California (though these tended to be high loan origination volume states as well) and in smaller loans. Intriguingly, a termination event from death of the borrower seem to be driving the majority of larger loans' prepayments.

Not unsurprisingly, loans that are experiencing T&I defaults also had higher utilization rates (defined as loan balance divided by principal limit) than that for other termination events and clearly higher than that for active loans.

A high rate of T&I defaults may account for a significant amount of prepayments, and the trend clearly bears watching given the current economic climate.

According to HUD rules governing HECMs, borrowers are responsible for paying "taxes, hazard insurance, ground rents and assessments in a timely manner."² If a pattern of missed payments occurs, lenders may establish procedures to pay the property charges from borrowers' funds,

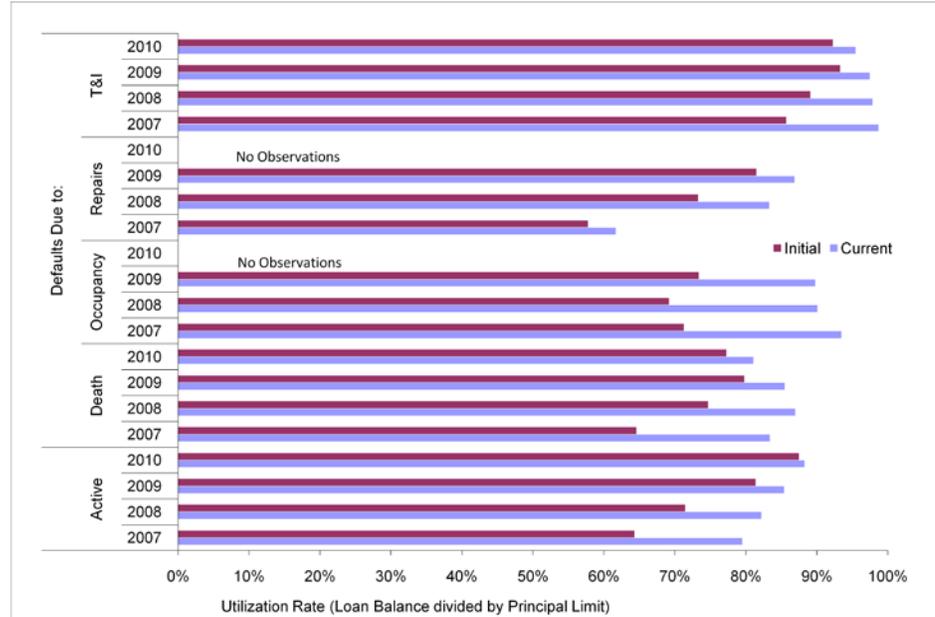
Figure 10. Non-Terminated HECMs by Loan Status -- Initial Principal Limit, All Available Vintages, as of 31 Jul 10

	\$0-\$100K	\$100K's	\$200K's	\$300K's	\$400K's	\$500K's	All
Active	89.78%	91.93%	92.06%	94.56%	95.98%	89.22%	91.61%
Active: Termination Event in Process	0.53%	0.30%	0.19%	0.22%	0.12%	0.00%	0.34%
Default: Death	1.81%	1.63%	1.86%	1.62%	1.19%	8.33%	1.73%
Default: Occupancy	0.16%	0.17%	0.11%	0.13%	0.04%	0.00%	0.15%
Default: Repairs	0.20%	0.12%	0.18%	0.24%	0.12%	0.00%	0.16%
Default: T&I	5.39%	4.07%	4.11%	2.37%	2.31%	1.96%	4.30%
Default: REO, Foreclosure, DIL in Process	2.13%	1.77%	1.50%	0.86%	0.24%	0.49%	1.71%

Source: Reverse Mortgage Insight.

² David H. Stevens. "Home Equity Conversion Mortgage Property Charge Loss Mitigation", Mortgagee Letter 2011-01 to HUD Approved Mortgagees and Housing Counseling Agencies, HUD, 2 January 2011.

Figure 11. Loan Utilization Rates for Active and Defaulted HECMs, by Vintage and Reason for Default – As of 31 Jul 10.



Source: Reverse Mortgage Insight.

but once exhausted, the lender will make efforts, including loss mitigation strategies, to collect on funds due and protect HUD's interests. In January, HUD announced definitive guidelines on collecting delinquent T&I payments, including guidance on loss mitigation strategies. Lenders are also required to report delinquent loans to HUD to ensure that coverage is maintained. Once all applicable loss mitigation strategies have been exhausted, the lender may submit a due and payable request to HUD. HUD's policy goal is to avoid foreclosure as a result of unpaid property charges; however, the agency wishes to ensure the viability of the program.

More recently, news reports suggest a number of reverse mortgage borrowers have begun to pay down loans once certain expenses are completed. In the same way that borrowers might curtail forward mortgages, these borrowers also begin to pay back loans on a monthly basis.

These efforts, we believe, result in part from seniors' concerns about remaindermen in their own estates. By curtailing mortgages, borrowers may pass on a greater portion of the equity to their heirs, especially important should house prices rise. Though difficult to tell based on the limited data thus far, these curtailments seem to hit floating-rate securities harder than fixed-rate ones.

Economic incentives behind refinancing must weigh two factors: additional proceeds that may be generated from higher PLFs (and possibly, though less likely, higher home prices) and costs of refinancing. Depending on which type of mortgage a borrower might choose, the initial cost may be higher or lower, but the ongoing running costs will likely be higher.

This latter factor should deter borrowers who are psychologically geared toward curtailment. The running costs of mortgages originated under the standards announced in October will be higher than those originated prior, given equal interest rates, likely deterring borrowers looking to create larger remaindermen in their estates. Not surprisingly, one other potential causality of these accelerated prepayments may be found in higher weighted average coupons. This trend was more apparent in fixed-rate pools, but oddly less so in floating-rate ones.

We expect to see higher prepayments as borrowers begin to look at the advantages of the new PLF changes. These changes may bring about more prepayments over the coming months as borrowers assess the economic benefits of refinancing versus holding current mortgages.

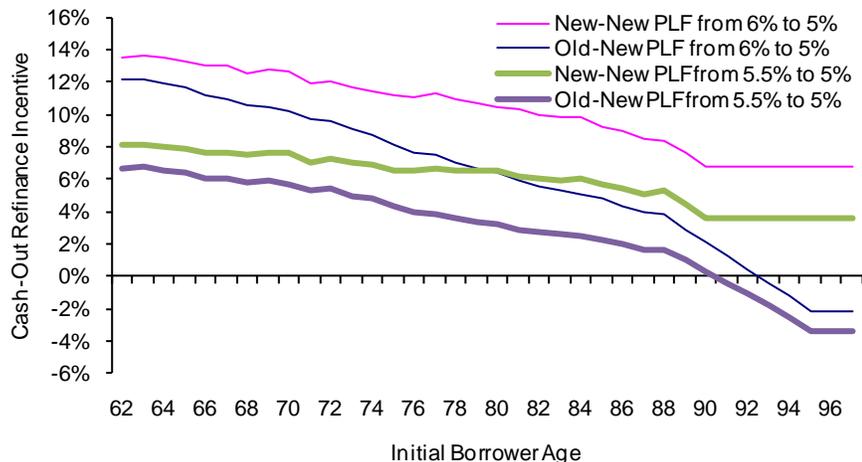
Cash Out Refi – Analyzing the Potential Effects of PLF Changes

When comparing the refinancing incentives from the PLF tables, we find a larger cash-out incentive for borrowers under the October 2010 (new) PLF tables over borrowers who took out mortgages under the 2009/2010 (old) PLF tables and refinancing under the new ones.

This incentive stems from the fact that the old PLF table was actually lowered by 10% from the previous one, whereas, in the new PLF table, there was a more substantial increase for younger borrowers than for older ones. Under both tables, the annual accretion, or the additional amount offered to borrowers for each increase in year of age, is roughly the same – holding interest rates constant – at approximately 80bp per year. However, at higher interest rates, the annual incentive is higher than it is for lower rates.

We believe that the real value for many borrowers to refinance will be found in the lower rates for HECMs currently on offer versus a year ago. With interest rates dropping by one percentage point, the incentive to refinance becomes stronger along with higher PLFs for cash-out refinance. However, the new PLF floor at 5% means there is little cash-out refinancing incentive below that level.

Figure 12. Cash-Out Refinancing Incentive for a Standard HECM-HECM Refinance, Based on Oct 10 and Oct 09 Principal Limit Factor Tables



NB: New PLF - table effective October 2010; Old PLF - table in effect from October 2009-2010. Source: Knight

In Figure 12, we show the pure cash-out refinance incentive based on borrower age, interest rates and time of origination, assuming the maximum claim value remained constant. We assumed a refinancing two years after origination, applying a commensurate increase in borrower age over that period. In this analysis, we ignored the potential effect of higher ongoing costs from increased monthly MIPs,

In the first scenario, we assumed a refinancing using the new PLF tables and interest rates falling from 6% to 5%.

In the second scenario, we assumed a borrower had received maximum proceeds under the old PLF tables and had refinanced under the new PLF tables from a 6% interest rate to a 5% rate.

In our third scenario, we assumed a borrower refinanced using the new PLF tables, but interest rates moved from 5.5% to a 5% rate.

For our last scenario, we assumed a borrower refinanced from the old PLF tables to the new one, using a similar rate scenario as the third.

We believe that the most realistic scenarios are the middle two. As HECM interest rates have compressed in the last year, there are fixed-rate pools backed by loans in excess of 6%. Many recent fixed-rate pools have been originated with coupons of 5%.

Under the new PLF tables, factors begin to flatten out once a borrower reaches age 90, but the old PLF tables showed a flattening beginning at age 95. Therefore, most attention needs to be focused on refinancing by younger borrowers (sub-76 years), but a strong incentive remains when interest rates drop towards the 5% floor.

Under HUD guidelines, an initial MIP on a HECM refinancing may be used to offset the value of the new initial MIP on the refinanced mortgage. However, borrowers with mortgages originated prior to October 2010 have to weigh the benefits of immediate cash out from a refinancing against higher on-going insurance premiums (75bp of increased premium).

For a more complete analysis, we analyzed the cash-out value of a 62 year old borrower rolling into a new mortgage (see Figure 12). First, we used a scenario that had a borrower refinancing

Figure 13. Simplified Examples of HECM to HECM Refinancing

Initial House Price	\$250,000						
Oct 2009 PLF Table Refinance to Oct 2010 PLF Table							
Initial PLF (62 yrs, 6% Int. Rate)	50.7%						
Initial Loan Advance	\$126,750						
Initial MIP (2% of Max. Claim Amt.)	\$5,000						
Accreted Loan Value	\$143,205						
New PLF (64, 5% Int. Rate)	62.9%						
HPA	-15%	-10%	-5%	+0%	+5%	+10%	+15%
House Price	\$212,500	\$225,000	\$237,500	\$250,000	\$262,500	\$275,000	\$287,500
Net Loan Proceeds (excluding MIP)	-\$9,542	-\$1,680	\$6,183	\$14,045	\$21,908	\$29,770	\$37,633
New Net MIP	\$0	\$0	\$0	\$0	\$250	\$500	\$750
Oct 2010 PLF Table Refinance to Oct 2010 PLF Table							
Initial PLF (62 yrs, 6% Int. Rate)	49.4%						
Initial Loan Advance	\$123,500						
Initial MIP (2% of Max. Claim Amt.)	\$5,000						
Accreted Loan Value	\$141,383						
New PLF (64, 5% Int. Rate)	62.9%						
HPA	-15%	-10%	-5%	+0%	+5%	+10%	+15%
House Price	\$212,500	\$225,000	\$237,500	\$250,000	\$262,500	\$275,000	\$287,500
Net Loan Proceeds (excluding MIP)	-\$7,721	\$142	\$8,004	\$15,867	\$23,729	\$31,592	\$39,454
New Net MIP	\$0	\$0	\$0	\$0	\$250	\$500	\$750
Oct 2009 PLF Table Refinance to Oct 2010 PLF Table							
Initial PLF (62 yrs, 5.5% Int. Rate)	56.2%						
Initial Loan Advance	\$140,500						
Initial MIP (2% of Max. Claim Amt.)	\$5,000						
Accreted Loan Value	\$157,337						
New PLF (64, 5% Int. Rate)	62.9%						
HPA	-15%	-10%	-5%	+0%	+5%	+10%	+15%
House Price	\$212,500	\$225,000	\$237,500	\$250,000	\$262,500	\$275,000	\$287,500
Net Loan Proceeds (excluding MIP)	-\$23,674	-\$15,812	-\$7,949	-\$87	\$7,776	\$15,638	\$23,501
New Net MIP	\$0	\$0	\$0	\$0	\$250	\$500	\$750

Source: Knight.

a 6% HECM into a new mortgage at 5% under different house price appreciation/depreciation scenarios, using first the old PLF table then the new one. In this manner, the economic effects of a refinancing could be analyzed for borrowers who originated loans at different times.

We also calculated the net increase in initial MIP that would offset some of the cash-out proceeds under these different scenarios and that would be required to be paid by the mortgagee.

Lastly, we examined refinancing a 5.5% mortgage under the old PLF table into a 5% mortgage under the new one to show the marginal increase in cash-out proceeds for borrowers. Because of the annual accretion, a 62 year old borrower refinancing a 5% mortgage two years later for the same rate to get more proceeds would require an 11% increase in the maximum claim amount to realize an earnest benefit, ignoring the consequences of the increased on-going MIP.

Summing It All Up

First, we believe that data on loans originated prior to 2008 (and the inception of the Ginnie Mae HMBS program) will have limited analytical value when determining likely prepayment patterns in HMBS. Clearly, death and mobility prepayments may be actuarially established and analysis of these characteristics should not be discarded; however, the product usage has changed and borrowers have become younger, providing a new set of analytical challenges around prepayment analysis.

Second, we believe that the Saver HECM will have very different prepayment characteristics and should be shorter in duration than the Standard HECM. It remains to be seen whether deals will include both Saver and Standard mortgage products in the same transaction, or whether Saver mortgages will be portfolioed by lenders. The first public deal with a Saver-only pool was priced last week.

Third, several factors will begin impacting HECMs' prepayments and thereby creating a competing effect on the average lives of HMBSs, in our view. Newer HECM products are more targeted toward younger borrowers, which likely cause longer tails in transactions. Borrowers are also using extra cash to curtail mortgages, reversing a broadly accepted precept that HECM borrowers would not try to repay loans except in "normal" situations (i.e., death, mobility, or refinancing).

Fourth, T&I defaults have become a major problem for the industry. With efforts to establish stronger ground rules, HUD offers lenders a more restrictive procedure, but a safe harbor if steps are carefully followed.

Lastly, we have noted that floating rate HMBS has been paying faster than fixed rate ones. We believe that this difference in prepayment speeds deserves further study, but also explains the smaller premium ascribed to these types of securities.

Important Disclaimer Regarding Strategy Letter

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