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## Floating-rate Reverse Mortgage Pools

Depository investors remain locked in a seemingly endless battle between earnings and duration. As a result, cash balances remain very high relative to historical measures and margin pressures continue to build.

While floating-rate securities provide the short duration most balance sheet managers require, characteristics such as interim caps or cash flow variability often lead investors in another direction. One sector of the short duration space that depository investors should consider closely is floating-rate reverse mortgage pools.

GNMA reverse mortgage pools are backed by Home Equity Conversion Mortgages (HECM), loans that allow borrowers to tap equity that, in many cases, is inaccessible without selling their property –borrowers who are “house-rich”, but “cash-poor”. The characteristics of these borrowers, and the resulting pools, provide good diversification within the mortgage space along with reset properties that are beneficial from an asset/liability perspective.

**Consider G2 894145 (Cusip 3620E0KQ8), a new issue pool that resets monthly at Libor +174.6bp. Unlike many ARM pools, there are no interim caps and the life cap is a very high 12.179%. The current coupon of 2.007% is significantly above cash yields, and importantly, it will adjust monthly.**

Table 1 – G2 894145 – Floating-rate Reverse Mortgage Pool

Collateral		4/18/11:	8,199,778	next pay	5/20/11 (monthly)	created	4/13/11
-NO History-		3/20/11:	8,199,778	reset	5/ 1/11 (19 Delay)	1stProj	4/20/11
factor		1.000000000000		accrual	4/ 1/11- 4/30/11	1st INDEX	0.213
4/25/11		DISCOUNT MARGIN BP		Fxd		Index= 0.21260	
QUOTED	30/360 DSCNTG	50	75	125	150	175	200
Vary PRICE	100 PPC	50 PPC	75 PPC	125 PPC	150 PPC	175 PPC	200 PPC
CLASS: *CASHFLOWS PROVIDED BY CANTOR FITZGERALD 212-829-5290							
DEAL: * Information is preliminary and subject to change.							
105-20	89.0	116.4	102.4	75.9	63.2	50.8	38.6
AvgLife	7.04	10.76	8.48	6.04	5.30	4.74	4.29
Index Dur	0.23	0.34	0.28	0.20	0.18	0.16	0.15
DATE Window	6/20/11-	10/20/11-	8/20/11-	6/20/11-	5/20/11-	5/20/11-	5/20/11-
VARY INDEX?	3/20/38	10/20/49	9/20/42	9/20/34	1/20/32	1/20/30	7/20/28
preliminary cashflows based upon dealer representations. "PRO-SUP" UNAVAILABLE.							
NON-CALLABLE							

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Now, this is not a typical GNMA mortgage pool. As mentioned, the collateral underlying this security has characteristics that differ from generic loans. This difference is a good thing.

Consider the following:

1. In order to be eligible for the loan, a borrower must be at least 62 years of age, must occupy the home as a primary residence and must own the home outright,
2. The maximum amount that a borrower can obtain is formulaic is determined based on borrower age, an accrual rate and available equity,
3. A reverse mortgage does not have to be repaid until the borrower no longer occupies the house and it is sold.

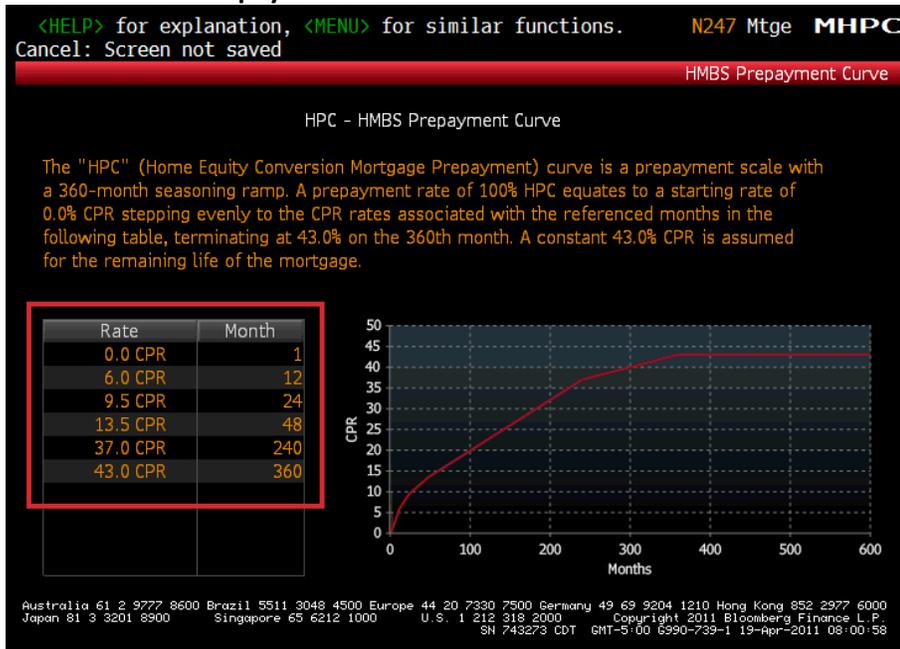
This last point is key. As a result of point 3, the loan balance grows over time with the accretion of interest, service charges, fees and draws. When the property is sold, the proceeds are used to pay off the accreted loan balance. **In today's environment, when calls and prepayments compound the liquidity problem for balance sheet managers, this accretion characteristic is important – there is little cash flow produced by these assets on a month-to-month basis. This serves to reduce monthly reinvestment risk.**

One concern that this characteristic raises is the potential for cash flow extension risk. Frankly, this risk should be mollified by the fact that the average borrower age on the loans underlying this pool is about 77 years. For investors in this pool, the age of these borrowers will serve to likely limit potential extension on this pool. This demographic is captured in a different prepayment assumption than the one used to evaluate a generic mortgage asset.

The yield table above uses a HECM prepayment curve assumption to produce the yield and average life. This curve is described below:

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**Table 2 – HECM Prepayment curve**



Source: Bloomberg

This curve assumption directly addresses the turnover characteristics of these assets – because of the borrower ages, prepayments will increase over time. This attribute, in addition to the floating rate coupon and very high life cap, **makes clear that investors in G2 894145 should be less concerned about longer cash flows than investors in new issue, generic mortgage assets.**

Finally, Table 3 below shows the impact of the forward curve on the potential return on this security. As fixed income investors know, an upward sloping yield curve implies that short rates will increase over time. Today's current very steep curve is "pricing-in" increases in the 1-month Libor rate of about 175bp over the next two years, and another 100bp the following year.

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Table 3 – Yield Table Incorporating Forward Curve

Mtge YT

Contributed Cashflows B TEMP CF-R11 HMBS 2.007% LEGAL MTY N/A ADU <PAGE>  
S BCC1Q6NN1 CMO:FLOATING RATE BOND NO Notes  
(1xLIBOR01M)+174.6BP CAP:FLR= 12.19:1.746 88 <Go>

collateral 4/18/11: 8,199,778 next pay 5/20/11 (monthly) CASHFLOWS  
3/20/11: 8,199,778 reset 5/ 1/11 (19 Delay) 1stProj 4/20/11  
-NO History- factor 1.000000000000 accrual 4/ 1/11- 4/30/11 CONTRIB cashflows  
1st INDEX 0.21260

4/25/11 30/360 DSCNTNG YIELD TABLE Fxd Index=0.21260  
100 50 200 300  
Vary PRICE 1/32 100 PPC 50 PPC 200 PPC 200 PPC PPC PPC

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105-20	3.755	4.487	2.584	2.584
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AvgLife	7.04	10.76	4.29	4.29
Index Dur	0.50	0.77	0.26	0.26
DateWindow	6/11- 3/20/38	10/11- 10/20/49	5/11- 7/20/28	5/11- 7/20/28

NON-CALLABLE Preliminary cashflows based upon dealer representations. "PRO-SUP" UNAVAILABLE.  
Format# 3-IPY

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SN 743273 CDT GMT-5:00 6990-739-1 19-Apr-2011 08:09:56

Source: Bloomberg

This floating rate reverse mortgage pool will provide investors with the **full benefit of increasing short rates (no periodic caps), will reduce portfolio reinvestment risk (balance accrual) and will provide capital benefits as a 0% risk-weighted asset.**

**Demand for reverse mortgage pools has increased significantly in recent months as depository investors have recognized the benefits of owning these assets. Balance sheet managers will find that it is well worth their time to understand these assets and how they can add value to a portfolio**

Karl Schwab, CFA  
Managing Director

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