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Test Prepayment Model Release

Yield Book™ is planning to release a test prepayment model on October 21. New versus old model difference reports will be available on manifold MB788.

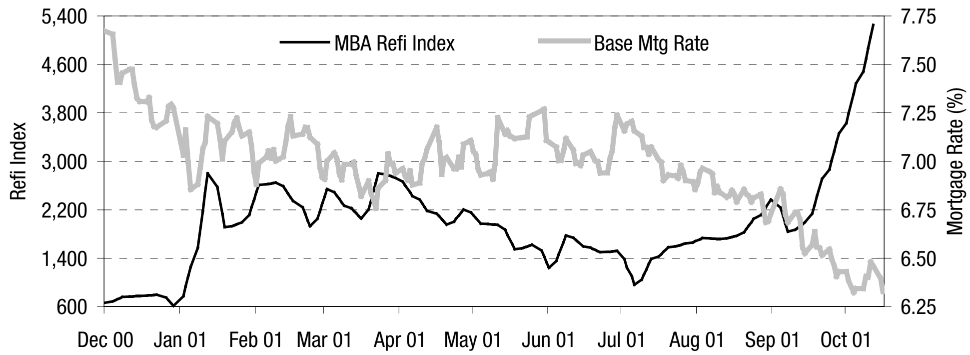
MBA Refinancing Index Sets a New Record

The MBA Refinancing Index broke the late-1998 record high and could easily move substantially higher in the next release.

The MBA Refinancing Index for the week ending October 12 was 5253, after adjusting for the Columbus Day holiday (the Index was 4727 unadjusted), up 23% week to week on an adjusted basis. Adjusted or unadjusted, this breaks the previous record high of 4389 reached on October 9, 1998. With mortgage rates declining back down near historic lows, the next release of the Index may rise to the high 5000s.

Meanwhile, lender color continues to indicate that capacity constraints due to enormous loan application volumes are causing primary rates to remain relatively wide to rates seen in the secondary markets and are causing interest rate change prepayment lags to lengthen.[7]

Figure 23. MBA Refinancing Index Versus Base Mortgage Rate, Dec 00-Oct 01



Sources: Mortgage Bankers Association and Salomon Smith Barney.

Production Prepayment Model Seems Too Fast

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While the record levels of the MBA Refinancing Index confirm that very fast speeds are on the way, the current production prepayment model still appears too fast. This is due to the following:[8]

➤ **Low short rates.** The Salomon Smith Barney Prepayment Model uses a combination of 30-year fixed-rate mortgage rates and short rates to gauge borrower incentive (with most of the weight placed on the 30-year rate). The enormous rally in short rates that has occurred does not appear to have reduced rates on short mortgage products like ARMs nearly as much, causing the model to overstate the incentive due to low short rates. Related to this factor are the wider-than-normal spreads between longer-maturity primary market mortgage rates (like the Freddie Mac 30-Year Survey Rate) and those implied by the secondary market (like the Base Mortgage Rate).

➤ **The media effect.** In particular, an assumed massive ramping up of speeds when a historical new rate low is reached may no longer be as applicable as it was in early 1998. (At that time, the MBA Refinancing Index ramped up so suddenly when mortgage rates fell below 7% that few believed the Index could be correct.) Increasing ease of borrower solicitation and greater available information suggest that exercise of the refinancing option is being based more on financial considerations than mass psychology and media coverage.

The test prepayment model attempts to address these issues as well as to adjust projections for some 2000-origination premiums, which have prepaid faster than expected for most of the year.

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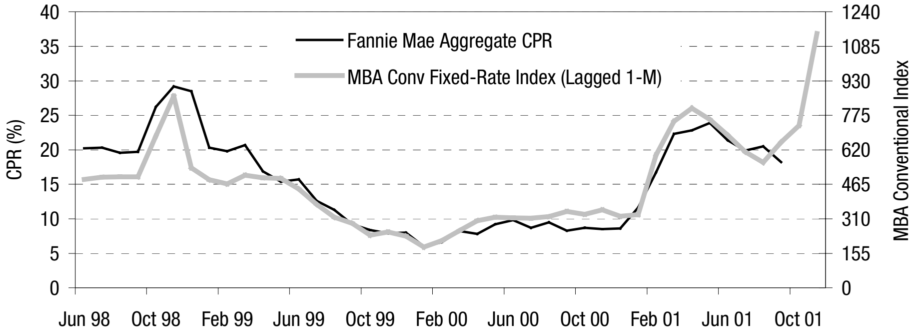
[7] The time to process a loan application is taking longer because many appraisers, attorneys, and mortgage lenders are swamped with business.

[8] See also "Is the Mortgage Market Complacent About Prepayments?," *Bond Market Roundup: Strategy*, September 28, 2001.

As a sanity check, Figure 24 compares aggregate conventional CPRs with the MBA Conventional Fixed-Rate Index (which includes mortgage applications for purchases and refinancings). To the extent that the MBA survey of mortgage application activity reflects overall prepayment activity, aggregate prepayment speeds should track it.[9] The Index appears to suggest that aggregate speeds will increase into the upper 30s CPR (in late 1998, a peak of 29% CPR was reached).

The test model projects aggregate conventional speeds of about 37% CPR, on average, in the October-December period, while the production model projects a three-month CPR of 45%. Based on Figure 24, the test model appears to be projecting more reasonable speeds. (While the MBA Index should move higher in the next release, if rates remain unchanged, it should then begin to decline after a couple of weeks. So the latest October MBA Index levels seem like a decent rough indicator of the average MBA level corresponding to three-month speed projections.)

Figure 24. Fannie Mae Aggregate CPR Versus Lagged MBA Conventional Fixed-Rate Index, Jun 99–Oct 01



Source: Salomon Smith Barney.