

## Fixed Rate Interest-Only Mortgages

### *New Trends in the Agency CMO Market*

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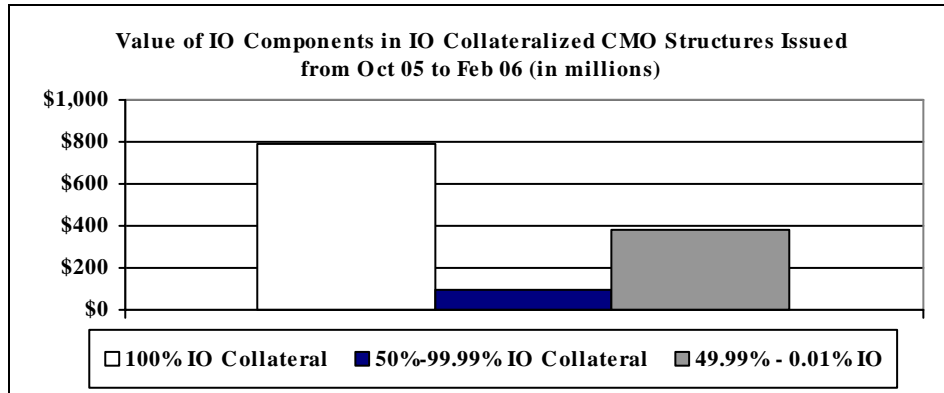
Structural change is occurring in the fixed rate MBS/CMO market. As this change occurs the astute investor will want to become more knowledgeable about fixed rate IO MBS and their characteristics. In this piece, we will examine this growing market and why investors should acquaint themselves with it.

The use of fixed rate IOs has been increasing steadily in recent years. In July 2004, \$80 million of agency fixed rate IO pools were issued. In Feb 2006 this number had grown to \$2.7 billion. The number of loan servicers has increased as well. In 2004, Countrywide Financial serviced 70% of fixed rate agency IO loans. In 2006 Countrywide's share had dropped to under 50% as competitors have entered the burgeoning market. Nearly 20% of the Fannie Mae fixed rate IO loan production to date has been pooled into CMOs. Freddie Mac is expected to change their collateralization rules to allow for fixed rate IOs to be included in their pools. This data helps illustrate the growing prevalence and market acceptance for this product.

We expect second quarter GDP to slow considerably from 5+% in first quarter to close to 3%. As the economy enters its slowing phase, and the housing market slows along with it, home prices can be expected to decline from their current levels. Despite slowing real estate prices, higher energy and food prices will impact consumer's purchases. According to a Bloomberg survey in January of this year, consumers said that they would cut their spending in other areas as energy costs increased.

We anticipate the demand for IO loans to remain high, as home ownership remains the American Dream. One factor in the growing popularity of interest only loans is the fact that their payments are lower than those of comparable amortizing loans. This allows homeowners to purchase homes that they otherwise would not be able to afford. As prices often chase flows, this characteristic has indirectly accelerated price appreciation in these markets. As this is a fairly new product, evolution in the market is expected. Currently federal regulators are recommending lenders take steps to carefully qualify IO loan applicants. This increased self-regulation should cause these products to be more attractive to more investors.

Fixed rate IO collateral was first used in a CMO structure in October 2005. The chart below illustrates the dollar amount of fixed rate IO collateral used to create CMO structures. Today, \$1.3 billion of IO loans are invested in CMOs.

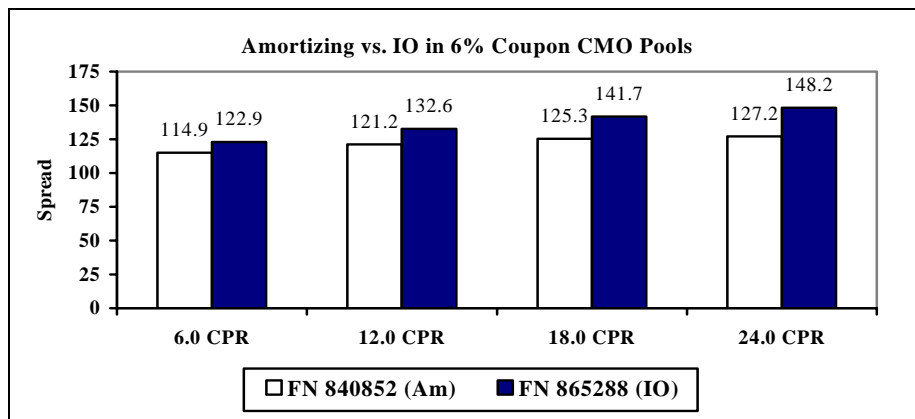


Source: UBS Mortgage Strategist – March 28, 2006

Data collected by mortgage companies indicate increases in the number of prime and sub-prime IO loans. According to mortgage data firm LoanPerformance, nearly 33% of home loans made last year nationwide included an interest-only option, up from 1.2% of prime and Alt-A<sup>1</sup> originations in 2003. In the hottest real estate markets in the country (particularly on the coasts) lenders say that as many as 70 percent of new loans are interest-only, due to the higher home price appreciation in these markets. The prevalence of IO mortgages in areas with higher home prices creates a tendency for fixed rate IO pools to include loans with larger sizes.

Agency fixed rate IOs are structured as 30 year with a 10 year IO period (the most common structure) or 30 year with a 15 year IO period. Fannie Mae, unlike Freddie Mac, allows fixed rate IOs in CMOs. This causes a price differential in Freddie and Fannie paper due to the “pool-ability” of the Fannie loans. Fixed rate IOs have been used to collateralize the most common structures (floater/inverse, sequential/Z and PAC) in CMOs.

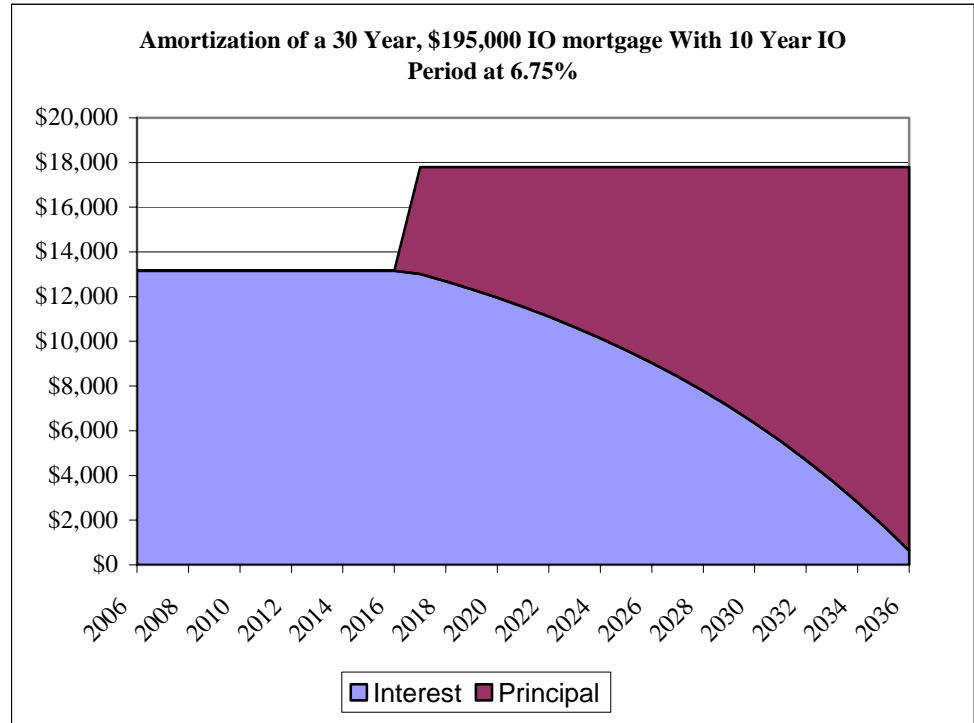
According to our trade desk, fixed rate IO loans trade an average of 5/8<sup>th</sup> of a point behind their TBA counterparts. The following chart shows how this translates into a yield pick up in 6% coupon pools, across a variety of CPR scenarios.



Source: Bloomberg

<sup>1</sup> Alt-A refers to loans that do not conform in very minor ways to prime documentation or property criteria.

Fixed rate IO CMOs exhibit longer durations than amortizing pools by approximately 8-10%. The reason for this is the fact that the principal cash flows on the IO mortgages come later in the loan rather than from the start as with a traditional amortizing mortgage. The following chart illustrates the amortization of a \$195,000 IO mortgage over 30 years with a 10 year interest only period at 6.75%.



Given the explosion of the supply of IO's, the savvy investor will recognize the need to become educated regarding the characteristics of this product. Although there are deflation and interest rate risk differences between conventional and IO based products, the yield enhancement and other qualities make this product a good diversification instrument for many institutional portfolio managers.

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