



Position Paper

Identifying Prepayment Speeds Used to Price Ginnie Mae Securities Backed by Pools Of Certain Types of Loans

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I. Introduction

The Mortgage Bankers Association¹ prepared this Position Paper at the recommendation of Ginnie Mae issuers/servicers (hereby issuers) regarding the prepayment speeds to be used for reporting, or making available, information on sales of certain Ginnie Mae securities under new IRS regulations, *Reporting for Widely Held Fixed Investment Trusts (WHFITs)*.² As the designated trustees for loans backing the securities, the regulations apply to all approved issuers under the Agency's programs. The regulations are effective as of January 1, 2007; however, penalties will not be imposed for noncompliance with certain provisions during the first year *if* certain conditions are met pursuant to regulations issued in December 2006.³

This paper describes certain reasonable prepayment speed assumptions that issuers may use in reporting under the regulations. Issuers are advised, however, to consult with their tax advisors regarding the advisability of using the prepayment assumptions described herein. It is recommended also that issuers document their reasons for selecting among prepayment assumptions for reporting on all past and future securities sales.

II. Background

MBA has sponsored numerous industry conference calls over the past year among issuers regarding their reporting responsibilities under the WHFIT regulations. The calls have covered a wide range of topics, and have included discussions of the data issuers will need to calculate and report, or make available, certain information to investors and other parties under the regulations. Those discussions have revealed that while most of the data that issuers will need are available to them, the prepayment speed data used in pricing sales of certain Ginnie Mae securities are not.

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 370,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

² See <http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-396.pdf>

³ See <http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-9924.pdf>

Specifically, issuers report there is little or no available data on the prepayment speed assumptions used in pricing sales of Ginnie Mae securities backed by one-to-four single-family residential adjustable rate mortgage loans (hereby ARM loans), including hybrid ARM loans,⁴ and multifamily loans, including construction loans that convert to permanent multifamily loans. This is because prospectuses for Ginnie Mae securities provide only general information about prepayments⁵ and the usual providers of securities trading information (e.g. Bloomberg Financial News, Moody's Investors Service) have little or no information on the speeds used to price past sales. Issuers have referred to the regulations for direction in determining the assumptions they should use in these circumstances.

In particular, issuers have referred to §1671-5 of the regulations, as amended by final regulations released on December 29, 2006, which permits the use of reasonable prepayment assumptions for Widely Held Mortgage Trusts (WHMTs) with start-up dates prior to January 24, 2006:

⁴ Hybrid ARM loans feature an initial fixed interest rate for a period of time after which it becomes an adjustable rate.

⁵ The following excerpt is from the Form 11772-II Prospectus for Ginnie Mae II Mortgage Backed Securities (ARMs):

"4. The yields to investors will be sensitive in varying degrees to the rate of prepayments (including liquidations and repurchases) on the Mortgages. In the case of Securities purchased at a premium, faster than anticipated rates of principal payments could result in actual yields to investors that are lower than the anticipated yields. In the case of Securities purchased at a discount, slower than anticipated rates of principal payments could result in actual yields to investors that are lower than the anticipated yields.

5. Rapid rates of prepayments on the Mortgages are likely to coincide with periods when prevailing interest rates are lower than the interest rates on the Mortgages. During such periods, the yields at which an investor may be able to reinvest amounts received as principal payments on the investor's Securities may be lower than the yield on those Securities. Slow rates of prepayments on the Mortgages are likely to coincide with periods when prevailing interest rates are higher than the interest rates on the Mortgages. During such periods, the amount of principal payments available to an investor for reinvestment at such high rates may be relatively low.

6. It is highly unlikely that the Mortgages will prepay at any constant rate until maturity or that all of the Mortgages will prepay at the same rate at any one time. The timing of changes in the rate of prepayments may affect the actual yield to an investor, even if the average rate of principal prepayments is consistent with the investor's expectation. In general, the earlier a prepayment of principal on the Mortgages, the greater the effect on an investor's yield. As a result, the effect on an investor's yield of principal prepayments occurring at a rate higher (or lower) than the rate anticipated by the investor during the period immediately following the Issue Date is not likely to be offset by a later equivalent reduction (or increase) in the rate of principal prepayments."

[See http://www.ginniemae.gov/guide/pdf/app_iv-21.pdf]

See also the following excerpt from the Form HUD 1731 Prospectus for Ginnie Mae I Mortgage Backed Securities (Construction and Permanent Loans):

"3. The yields to investors will be sensitive in varying degrees to the rate of prepayments (including liquidations and repurchases) on the Mortgage. In the case of Securities purchased at a premium, faster than anticipated rates of principal payments could result in actual yields to investors that are lower than the anticipated yields. In the case of Securities purchased at a discount, slower than anticipated rates of principal payments could result in actual yields to investors that are lower than the anticipated yields."

[See http://www.ginniemae.gov/guide/pdf/app_iv-10.pdf]

“(g)(1)(iv)(A)(2) In calculating the daily portion of OID, the trustee must use the prepayment assumption used in pricing the original issue of trust interests. If the WHMT has a start-up date prior to January 24, 2006, and the trustee, after a good faith effort to ascertain that information, does not know the prepayment assumption used in pricing the original issue of trust interests, the trustee may use any reasonable prepayment assumption to calculate OID provided it continues to use the same prepayment assumption consistently thereafter.

(g)(1)(v)(A)(3) *Computing the total amount of stated interest remaining to be paid and the total remaining OID at the beginning of the month.* To compute the total amount of stated interest remaining to be paid to the WHMT as of the beginning of the month and the total remaining OID as of the beginning of the month, the trustee must use the prepayment assumption used in pricing the original issue of trust interests. If the WHMT has a start-up date prior to January 24, 2006, and the trustee, after a good faith effort to ascertain that information, does not know the prepayment assumption used in pricing the original issue of trust interests, the trustee may use any reasonable prepayment assumption to calculate these amounts provided it continues to use the same prepayment assumption consistently thereafter.

(m)(2) *Penalties not imposed on trustees and middlemen of certain WHMTs for failure to report OID.* Penalties will not be imposed as a result of a failure to provide OID information for a WHMT that has a start-up date on or after August 13, 1998 and on or before January 24, 2006, if the trustee of the WHMT does not have the historic information necessary to provide this information and the trustee demonstrates that it has attempted in good faith, but without success, to obtain this information. For purposes of calculating a market discount fraction under paragraph (g)(1)(v) of this section, for a WHMT described in this paragraph, it may be assumed that the WHMT is holding mortgages that were issued without OID. A trustee availing itself of this paragraph must include a statement to that effect when providing information to requesting persons under paragraph (c) of these regulations.”

[See pages 78360 -78361 of final regulations at the site listed in footnote 3 of this Paper.]

In keeping with this guidance, issuers have referred to the following sources for reasonable proxies for prepayment speeds used to price securities issued prior to January 24, 2006:⁶

- Bloomberg Financial News, Moody’s Investors Service and other securities trading or rating agency services for assumptions about similar securities;
- Broker/dealers for assumptions about similar securities;
- Prospectuses for Real Estate Mortgage Investment Conduit (REMIC) securities, backed by securities which in turn are backed by ARM or multifamily loans, that were sold at or about the same time as the securities that are the subject of the reporting.

If published information is unavailable or considered unreasonable, issuers could:

- Calculate a weighted average prepayment speed for a pool by reference to the actual prepayment rates of loans in the same or similar pools;
- Rely on internal assumptions based on historical information on prepayment patterns for the same or similar loans.

Some issuers intend to rely on the above sources of prepayment information for identifying reasonable prepayment assumptions to use for reporting, and making available, information on Ginnie Mae securities backed by ARM loans and multifamily loans as described on the following pages.

⁶ Issuers of securities backed by multifamily loans intend to rely on their internal assumptions in identifying prepayment speeds used to price securities that were issued pre- and post-January 24, 2006, as described under Section III.B. of this Paper.

III. Prepayment Speed Assumptions

A. Securities backed by ARM and Hybrid ARM Loans

1. ARM Loans

Generally, issuers of Ginnie Mae securities backed by ARM loans have had difficulty obtaining prepayment assumptions that were used in pricing past sales of the same or similar securities. Consequently, in the absence of more specific information, issuers have referred to the next best source for the information: REMIC transactions that (1) occurred at about the same time and (2) are backed by securities that are similar to those that are the subject of the reporting. Issuers have noted that the prepayment assumptions used to price these transactions generally are within the range of 18-30 percent Constant Prepayment Rate⁷ (CPR) although the most commonly used rate is 25 percent CPR.

Some representative sources of a 25 percent CPR can be found in the REMIC prospectuses for the deals listed below:

- OCWAN 1998-OAC1
- Southern Pacific Securities Asset Corp Series 1998-1
- MASTR Adjustable Rate Mortgage Trust Series 2002-4, 2003-3, 2004-2, 2004-15, 2005-3, 2006-2, 2007-3
- CSFB Adjustable Rate Mortgage Trust Series 2004-1
- CSFB 2003-AR30
- Bear Stearns ARM Trust Series 2001-10, 2002-1, 2003-6, 2003-9, and series from years 2005, 2006, 2007

Therefore, where information about the speeds used to price past sales of Ginnie Mae securities backed by ARM loans is unavailable and estimates cannot be obtained through better sources, some issuers intend to use a 25 percent CPR as a reasonable prepayment assumption, consistent with the guidance in the regulations.

2. Hybrid ARM Loans

Issuers of Ginnie Mae securities backed by hybrid ARM loans report that they also have had difficulty obtaining prepayment assumptions for past sales of the same or similar securities. In many respects, the prepayment speeds for these securities are more challenging to determine because borrower responses to movements in interest rates are less predictable due to the combined fixed- and adjustable-rate features of the loans. Consequently, in the absence of more specific information, issuers may refer to the prepayment assumptions used to price securities backed by fixed-rate and ARM loans to determine reasonable speeds for reporting information on securities backed by hybrid ARMs.

⁷ MBA notes that the prepayment disclosure in the Form 11772-II Prospectus (see footnote 5 in this paper) includes a statement that: "6. It is highly unlikely that the Mortgages will prepay at any constant rate until maturity or that all of the Mortgages will prepay at the same rate at any one time." Nevertheless, in the absence of better information, MBA believes a 25% CPR is a reasonable assumption to use, particularly if it has been used in pricing securities backed by similar loans.

Because most securities backed by fixed-rate loans were priced using standard PSA⁸ rates, it is reasonable for issuers to rely on those rates for the fixed rate period of the hybrid ARMs. At the expiration of the fixed rate period, it is also reasonable for issuers to rely on a prepayment speed of 25 percent CPR for the adjustable rate period of the hybrid ARMs, consistent with the speed most commonly used to price REMIC securities backed by ARM loans, as described earlier in this paper. The speeds used to report under the regulations would therefore change when the fixed rate period expires.

B. Securities Backed by Multifamily Loans

Generally, issuers of Ginnie Mae securities backed by multifamily loans (including construction loans that convert to permanent loans) also have had difficulty obtaining prepayment assumptions from the usual sources (brokers/dealers and financial news/trading services) about past, or even current, sales of the securities. In considering alternative sources, they agree that their internal prepayment assumptions are reasonable given their familiarity with the historical prepayment patterns on the loans, which are consistent with general industry/investor expectations regarding the lives of the loans. Those expectations differ slightly for permanent loans and construction loans with conversion features as described below.

1. Permanent Loans

For purposes of determining prepayment assumptions on securities backed by multifamily loans, issuers believe that the greatest likelihood for prepayment of a permanent loan is at the expiration of any prepayment restrictions or prepayment premium period (i.e. the expiration of the yield maintenance period). Prior to the end of that period, borrowers have a sufficiently high disincentive to prepayment (in the form of a significant prepayment penalty) to ensure that prepayment is highly unlikely during that time. Moreover, because the loans are priced and the securities marketed based largely on the prepayment terms of the loans, these prepayment terms are the most commercially available estimates of an assumed prepayment speed.

Issuers considered an approach that would rely on prepayment assumptions used in pricing Ginnie Mae REMIC securities backed by Ginnie Mae multifamily securities, similar to the approach issuers of Ginnie Mae securities backed by ARM loans may use. This approach was rejected, however, because the vast majority of Ginnie Mae multifamily securities are backed by individual loans (rather than pools of loans) and therefore the prepayment terms of the loans themselves are most relevant to the pricing of the securities. By contrast, the prepayment assumptions used in pricing REMIC securities are relevant to determining prepayment rates for pools of loans.

Some issuers of Ginnie Mae multifamily securities intend to rely on the prepayment periods for securities backed by individual loans for transactions before and after January 24, 2006. For example, if the prepayment restriction or prepayment premium period on a loan is scheduled to

⁸ For a pool of mortgage loans, the PSA standard assumes that the mortgage prepayment rate increases at a linear rate over the first 30 months following origination then levels off at a constant rate for the remaining life of the pool. Under the PSA convention, prepayments are assumed to occur at a 0.2 percent annual rate in the first month, 0.4 percent annual rate in the second month, escalating to a 6.0 percent annual rate by month 30. The PSA annualized prepayment rate then remains at 6.0 percent over the remaining life of the mortgage pool.

expire at the end of year 7, the issuer would assume that the loan will prepay in the month following the end of that year. That assumption would be used regardless of whether similar securities are still outstanding beyond the expiration of the prepayment period on the underlying loans because the regulations require trustees to report based on the speed used in the original pricing of the securities.

In circumstances, however, where securities are backed by pools of multifamily loans, issuers should consider the relevance of prepayment speeds used in pricing Ginnie Mae REMIC securities (backed by pools of similar loans) that were sold at, or about, the same time as the securities that are the subject of reporting.

2. Construction Loans with Conversion Features

Issuers may use a similar approach in determining prepayment speeds used in pricing sales of Ginnie Mae securities backed by construction loans. More specifically, they may use the expected final endorsement date on the loans in determining those speeds. Consequently, if the final endorsement date is scheduled for the end of year two, the projected prepayment of the loan would be in the first month following the end of that year.

IV. Conclusion

In the absence of more specific information about the prepayment speeds used in pricing sales of Ginnie Mae securities, it would be reasonable for issuers to rely on one or more of the prepayment speeds described in this paper to report under the new WHFIT regulations.

In selecting among prepayment speed assumptions, issuers are advised to:

- Document the basis for their prepayment assumptions, regardless of whether they intend to use the prepayment assumptions described herein. All known data that supports or does not support these assumptions for specific transactions should be explained so differences in assumptions used to report similar transactions can be understood by tax examiners and others;
- Develop policies and procedures for documenting the speeds used to price Ginnie Mae securities at the time of their sales given all available evidence. Some issuers, for example, may work with their capital markets teams to obtain prepayment speeds from brokers for future transactions;
- Be consistent in using the same prepayment assumption in reporting information for a transaction;
- Consult with their tax advisors before undertaking to report under the regulations.

More information on reporting under the regulations by Ginnie Mae issuers can be found on the Ginnie Mae web site at <http://www.ginniemae.gov/>.