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To the

U.S. Senate Committee on Banking, Housing and Urban Affairs

Subcommittee on Housing, Transportation and Community Development

TOPIC—Helping Responsible Homeowners Save Money through Refinancing

Chairman Menendez, Ranking Member DeMint, and Members of the Subcommittee, I thank you for your invitation to testify today. My name is Laurie Goodman and I am a Senior Managing Director at Amherst Securities Group, L.P., a leading broker/dealer specializing in the trading of residential and commercial mortgage-backed securities. We are a market maker in these securities, dealing with an institutional account base: financial institutions, money managers, insurance companies, and hedge funds. I am in charge of the Strategy area; we perform extensive, data-intensive studies as part of our efforts to keep ourselves and our customers informed of critical trends in the residential mortgage-backed securities market.

In my testimony today, I will discuss actions that can be taken to help responsible homeowners save money through refinancing, without disrupting the very well functioning Agency mortgage market. I will limit my comments to the refinancings of GSE mortgages, which are the mortgages in which the GSEs already bear the risk. My #1 suggestion will be to allow for competition by permitting a different servicer to refinance a borrower on the same terms that apply to the current servicer. This will result in much better rates to the borrower, and much more refinancing of the targeted Home Affordable Refinance Program (HARP) population.

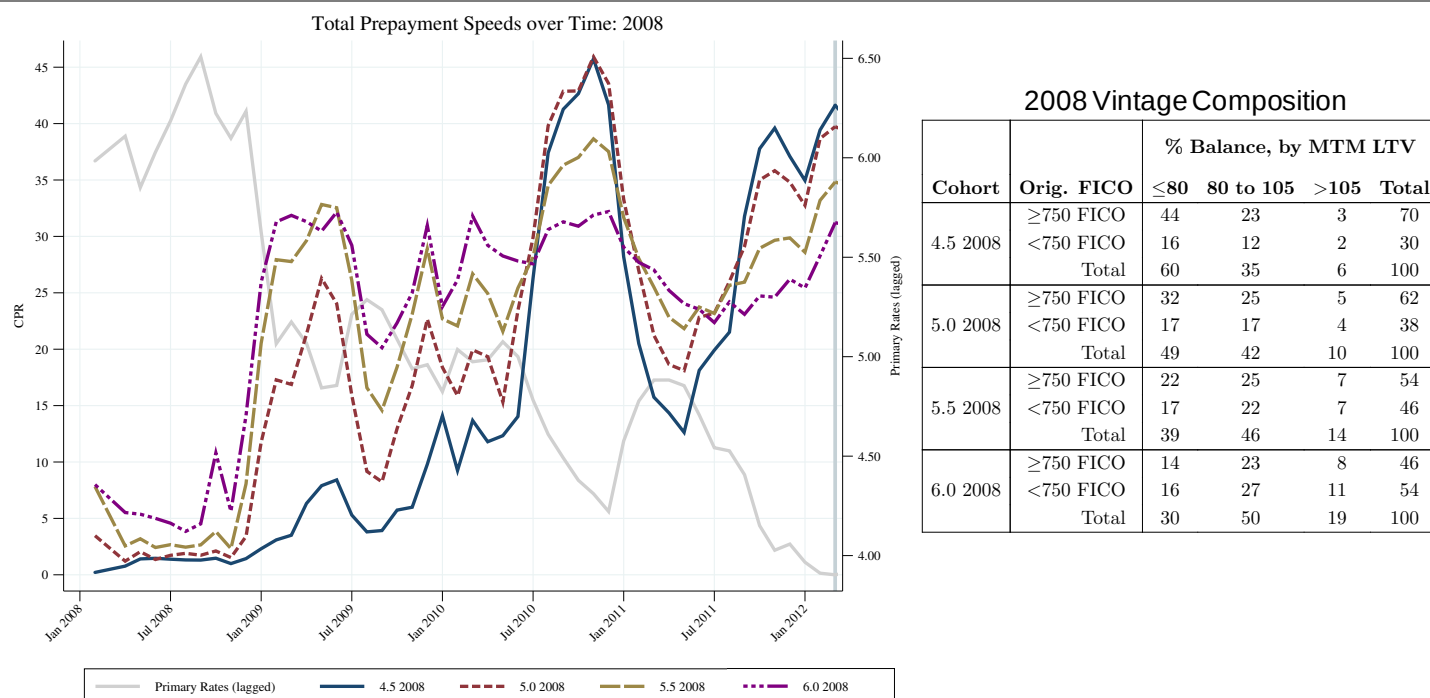
It is very clear that responsible borrowers with high loan-to-value ratios (many of whom are underwater) or low FICO scores, who do not hold a GSE or FHA/VA loan—have no or very limited refinancing opportunities. Their counterparts, with higher FICO scores and lower LTVs, can refinance through the GSEs; if such loans exceed the maximum loan size limits, then bank portfolios are willing to take the risk. ***We believe that a broader refinancing plan which allows the transfer of risk on higher loan-to-value ratio (i.e. underwater) mortgages owned by bank portfolios or investors in private label securities, to the government, would basically be a taxpayer bailout for both bank portfolios and private label investors.*** We believe this would be a very inefficient application of taxpayer money.

Sizing the Refinancing Opportunity

The Home Affordable Refinancing Program was initially rolled out on April 1, 2009. This program was designed to help GSE borrowers who have LTVs (loan to value ratios) greater than 80 refinance into another GSE mortgage. At the outset, the program was referred to by the industry as HARP 1.0, and included borrowers with LTV ratios of 80–125 who took out loans prior to June 1, 2009. It was initially hoped that this program would help 4–5 million borrowers. However, from April 1, 2009–February 28, 2012, only 1.12 million borrowers, a disappointingly low number, were aided by the program. As government officials and market participants scrutinized the data, it became very clear that higher LTV, lower FICO borrowers were still refinancing much more slowly than their more creditworthy (lower LTV, higher FICO) counterparts. This is best illustrated by looking at the prepayment speeds on 2008-issued FNMA and FHLMC 4.5, 5.0, 5.5 and 6.0 passthroughs during the period of low rates in late 2010, as shown on the left side of Exhibit 1 (next page). The lower

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Exhibit 1: 2008 Vintage Snapshot



Source: CoreLogic Prime Servicing Database, Fannie Mae, Freddie Mac, 1010Data, Amherst Securities

coupon borrowers—the 4.0s and 5.0s—prepaid more rapidly than the higher coupons—5.5s and 6.0s. This counter-intuitive behavior, where mortgages with less incentive to refinance (less potential savings) were prepaying more rapidly, clearly reflected the difference in credit-worthiness between the coupons. I.e., if two borrowers took out a mortgage at the same time, the less credit-worthy borrower would have had to pay more (a higher interest rate, translating into a higher coupon) for the mortgage. These differentials in borrower quality can be seen on the right side of Exhibit 1. For example, for the 2008 4.5s, 44% of borrowers are in the highest quality bucket—they have mark-to-market LTVs of ≤80 and a FICO of ≥750. However, only 14% of borrowers among the 2008 6.0s are in the highest quality bucket. By contrast, only 14% of the 2008 4.5s have an LTV >80 and a FICO <750, while the representation is 38% for the 6% coupon. In short—the higher coupon, more credit-impaired borrowers, who are more apt to default, were prepaying far less quickly than their non-credit impaired counterparts. The salient fact to bear in mind is that the borrowers that create the most risk for the GSEs, would benefit the most from a refinancing, and would benefit the taxpayers the most from a refinancing, were actually the least likely to get a refinance opportunity!

Armed with this information, the FHFA, Fannie Mae and Freddie Mac were determined to “correct” the situation. On October 24, 2011, the FHFA, Fannie Mae and Freddie Mac announced a series of HARP changes to allow the program to reach more borrowers. Effective December 1, 2011, the 125 LTV cap was lifted for new fixed rate loans, some “rep and warrant” features were relaxed (which also served to bring Fannie and Freddie more into line), and the program was extended for one more year to year-end 2013 to encourage banks to invest more in personnel and systems to ensure program success. For program eligibility HARP 1.0 required mortgages to be issued prior to the June 1, 2009; this cut-off date remained firmly intact. This revised program is often referred to as HARP 2.0.

It is useful at this point to take a step back and look at aggregate refinancing activity since HARP was introduced in April 2009. The FHFA, in their February 2012 Foreclosure Prevention and Refinance Report, noted that as of February 2012 the HARP program had cumulatively aided 1.12 million borrowers. (This refers only to refinances on mortgages with a

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mark-to-market (MTM) LTV >80, where the initial mortgage was issued before the 6/1/2009 cut-off date). In addition, another 1.98 million borrowers have taken advantage of streamlined refinance programs. These streamlined refinance programs essentially follow the HARP framework, and are targeted for borrowers with mark-to market LTVs ≤80, where the initial mortgage was issued before the 6/1/2009 cut-off date. (Both Fannie and Freddie had streamlined programs in place prior to the introduction of HARP. Fannie replaced theirs with a HARP look-alike when the HARP program was implemented in 2009. Freddie kept their streamlined program in place until early 2011). In addition to the 1.12 million HARP refinances, and the 1.98 million streamline refis, there have been another 7.63 million refis, raising total activity from 4/1/2009 to 12/31/2011 to a total of 10.73 million borrowers.

Now let's look forward. Exhibit 2 (below) sorts the universe of borrowers into groups. We classify borrowers first by whether they meet the HARP eligibility date (before June 1, 2009), then we sort according to mark-to-market LTV (the loan-to-value ratio based on valuing a home at today's actual, realistic current market price). We then sort each group by whether the pay history would conform to that required by the GSEs to be eligible for a HARP refi (i.e., no delinquencies in the past 6 months; no more than 1 delinquency in the past year). Finally, we sorted by whether the borrower is refinancable or not. For simplicity, we assume a cut-off mortgage rate of 4.75% or higher for a 30-year fixed rate loan; 4.25% on a 20-year; 4% for a 15-year; and 3.5% for an ARM. Essentially, we assume the borrower needs to have an incentive of 50–75 bps to be considered in-the-money (for a refinancing); we use this to determine willingness to refinance. (Our results should be regarded as an upper bound; we do not account for borrowers or loans that may be ineligible as the property was always used as an investor property).

The numbers are quite interesting. There are currently 10.9 million borrowers who took out loans before the June 1, 2009 cut-off date, are eligible for a streamline refinancing based on pay history (no delinquencies in the past 6 months, no more than 1 in the past year) and have an incentive to refinance. There are another 3.3 million borrowers who are eligible for HARP 1.0 and HARP 2.0, and have an incentive to refinance. In addition, due to the expansion of the 125 LTV ceiling, HARP 2.0 allowed for another almost 700,000 eligible and incented borrowers.

Exhibit 2: HARP Eligibility—Dimensioning the Market

2009 Cutoff/LTV							
HARP Cutoff	MTM LTV	Pay History	In-the-Money?	Count	Balance (\$mm)	% Count	% Balance
Pre-Cutoff	≤80	Poor History	OOTM	6,960	1,231	0	0
			ITM	525,126	58,007	2	1
		Good History	OOTM	317,711	70,846	1	2
			ITM	10,897,863	1,130,254	41	27
	80 to 125	Poor History	OOTM	5,823	1,086	0	0
			ITM	282,173	46,613	1	1
		Good History	OOTM	92,748	19,853	0	0
			ITM	3,302,502	545,412	12	13
	>125	Poor History	OOTM	2,354	415	0	0
			ITM	73,391	12,370	0	0
		Good History	OOTM	9,197	1,653	0	0
			ITM	690,957	114,135	3	3
Post-Cutoff	≤80	Poor History	OOTM	22,128	5,278	0	0
			ITM	78,118	14,821	0	0
		Good History	OOTM	2,664,985	607,812	10	15
			ITM	4,788,185	877,881	18	21
	80 to 125	Poor History	OOTM	6,567	1,538	0	0
			ITM	51,519	10,971	0	0
		Good History	OOTM	671,407	157,449	3	4
			ITM	2,052,185	429,480	8	10
	>125	Poor History	OOTM	39	7	0	0
			ITM	1,418	282	0	0
		Good History	OOTM	1,190	180	0	0
			ITM	28,539	5,455	0	0

Streamlined Refis

HARP 1.0/2.0

HARP 2.0 with >125 LTV Eligibility

Possible Expansion of Streamlined Refi

Possible Expansion of HARP 2.0

Source: CoreLogic Prime Servicing Database, Fannie Mae, Freddie Mac, 1010Data, Amherst Securities

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If we look after the cut-off date, there are another 4.8 million borrowers who have LTVs less than 80, a good credit history and are incented to refinance. These borrowers are not eligible for any streamlined program. However, given that 71.1% of the refinancings during the 4/1/2009–12/31/2011 period came from this borrower group (7.63 million non-streamlined refis/10.73 million total refis), it is clear that many of these borrowers will be able to refinance anyway. There are 2.1 million post cut-off borrowers with strong pay histories who are between 80–125 LTV and another 29K borrower who are over 125 LTV.

There are two separable issues. The first is what can be done to increase the penetration of the borrowers that HARP is meant to reach. The second is whether the scope of the HARP program should be increased. We feel that there are a number of definitive steps that should be taken to increase the penetration of the HARP program, and our feelings are much more mixed on increasing the scope of the program.

Allowing Different Servicers to Refinance on the Same Conditions as Same Servicers

We have long argued that the single most effective change that can be made to the HARP program is to encourage competition by allowing different servicers to refinance a borrower on the same terms as the current servicer is able to do. We believe this would create many more refinances for the targeted HARP-eligible population, and those refinances would be done at a considerably better rate to the borrower.

Under HARP 2.0, for both Fannie and Freddie, the current servicer is released from all borrower representations and warranties on both the old loan and the new loan if three conditions are met:

- The borrower has been current for the past 6 months and has no more than one delinquency in the past year.
- Employment (or a source of non-employment income) must be verified. Note that this is not a verification of income, just a verification that there is a source of income.
- The borrower must meet the net benefit provisions of a refinance (it must reduce his payment, term, or move him into a more stable product.)

By contrast, different servicers are required to gather more information on the borrower and are required to take the rep and warrant risk on the new loan. For Fannie, there is a maximum debt-to-income ratio in Desktop Underwriter (Fannie's automated underwriting program) and there are requirements for the servicer to gather income information. For self-employed borrowers, a federal tax return is required. For Freddie Mac, a different servicer refi requires that the borrower have no delinquencies in the past year (a same servicer refi allows one). In addition, the servicer must do a full underwrite, including a current pay stub, W-2 forms for the last 2 years, verbal verification of employment, as well as verification of assets to show the funds are available to close. Since the servicer is taking the rep and warrant risk on the new loan, most of the servicers we have talked to require the full underwrite on Fannie loans as well as Freddie loans.

To summarize the comparison between same and different servicer refis under HARP 2.0—different servicer refis require servicers to gather more information about the HARP 2.0 borrower than would be the case under a same servicer refinance. Moreover, under different servicer refis, the servicer is not released from borrower reps and warrants on the new loans. We also believe same servicers have greater access to Freddie Mac's Home Value Explorer and Fannie Mae's Automated Valuation Model, which entitles the servicer to greater relief from the property reps and warrants. Thus, same servicers have a huge advantage in doing refinancings. Essentially, HARP has a design flaw that eliminates put-back risks, to the detriment of the GSEs, while simultaneously prevents the borrower from obtaining a competitive rate.

The Menendez-Boxer Discussion Draft contains a much smarter method to handle the rep and warrant risk—allow different lenders/servicers to enjoy the same rep and warrant relief as is currently enjoyed by the current lender/servicer. Under that discussion draft, it does not matter who does the refinance—neither the current nor a different lender/servicer would have any put-back risk on the new loan, and the put-back risk on the old loan is waived. Thus, the GSEs are in the same position they are in now, but the borrower is able to obtain a competitive rate as there is competition to extend the new loan.

We have noted that as the program is currently structured, a same servicer refinancing is hugely advantaged, allowing the servicers to charge the borrowers a higher rate. The benefits of this accrue disproportionately to the top 3 servicers,

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who service well over 50% of the eligible loans. In actuality, a same servicer refinancing of a HARP loan should actually be less costly to the borrower than a non-advantaged refinancing because: (1) the servicer has less put-back risk, (2) less information collection is necessary, and (3) investors are willing to pay more to obtain these so called “Making Home Affordable” (“MHA”) loans, as these loans have limited ability to refinance again. Thus, the servicer is able to capture a specified pool pay-up on these loans. (The borrower has limited ability to refinance again; if his LTV is >95 he would be unable to refinance even with mortgage insurance. If his LTV is 80–95, he would need to take out mortgage insurance at current market levels, and the costs of this insurance would be high). The lack of competition has also exacerbated the capacity constraints in the system, as the most capacity constrained lenders are the only ones that can effectively refinance borrowers with LTV >80.

To give a hypothetical illustration of how profitable this operation is to a same servicer, let us assume the same servicer originates a 4.5% loan to a borrower with a 95–100 LTV. (This rate is about 35 basis points above the Freddie Survey Rate, and is typical of the rate charged to a borrower in this LTV bucket). The loan would typically have a 25 bps guarantee fee (ignoring loan level pricing adjustments), and the servicer would generally retain 25 bps of servicing. This retained servicing is worth \$1.25 per \$100 par to the servicer. Thus, this loan could be sold into a Fannie Mae pool, bearing a 4.0% coupon. This would command a price of \$105.58 per \$100 par in the secondary market. In addition, the investor would pay another \$1.15 for a pool consisting of refinance loans in the 95–100 LTV bucket, as the investor is betting that it is more difficult for these loans to refinance. Thus, the proceeds to the servicer are \$107.98 (\$105.58 + \$1.25 + \$1.15) for \$100 in debt; assuming a \$0.50 origination charge, the servicer is making \$7.48 on this loan. Thus, on a \$200,000 loan, the total profitability to the servicer is \$14,960. To put this into perspective, the profitability of mortgage originations over the past decade (taking into account variable but not fixed costs) has averaged in the neighborhood of 1–2 points or \$2,000–\$4,000 on a \$200,000 loan.

Loan Level Pricing Adjustments, Appraisal Fees, Bank Costs

Thus far in our example, we have ignored the loan level pricing adjustments charged by Fannie Mae and Freddie Mac. These are capped at 0.75 points (0.75% of the loan amount), or \$1,500 on a \$200,000 loan under HARP 2.0. (The loan level pricing adjustments are capped at 2.0 points for 30-year non-HARP, streamlined refis and uncapped for refis of loans originated post 6/1/2009). And if the loan had needed an appraisal this would cost another \$500–\$750. Compare this to the \$14,960 the originator/servicer is making because the borrower is paying above market rates. Yes, we are in favor of eliminating loan level pricing adjustments and all appraisals in situations where Fannie and Freddie already have the risk on the mortgage, but we believe the elimination of these items would result in a very marginally lower rate to the borrower. To significantly reduce the frictions in the system, it is necessary to recognize the fact that the largest banks have been given the opportunity to extract monopoly profits on HARP refis, and they have taken advantage of this. If you want to lower the cost of a refinancing to the borrower, allow different servicers to refinance on the same terms as the same servicer.

Program Inconsistencies between Fannie and Freddie

The Menendez-Boxer Discussion Draft would require FHFA to issue guidelines requiring that Fannie and Freddie make their refinancing programs consistent to ease lender compliance (especially with respect to loans below 80 LTV and to closing cost policies). We think this is a good idea.

The HARP program only covers loans with LTV >80, issued before the cut-off date. Fannie and Freddie were entitled to promulgate their own rules for loans with LTVs ≤80. Fannie and Freddie both decided to allow the same streamlined refinancing procedure for loans ≤80 LTV issued before the cut-off date as applies to HARP loans. However, Fannie opted to waive the lenders’ rep and warrant risk on same servicer refinances, whereas Freddie opted not to do so. Thus, for Freddie loans ≤80 LTV, there is no same servicer rep and warrant relief on the new loan. We have hypothesized that Freddie servicers would be incented to refinance the HARP 2.0 borrowers first, before their lower LTV counterparts, as they are able to shed the rep and warrant risk on the old and new loan. In any case, this is illogical and confusing to lenders.

There is also a small difference in the treatment of closing costs that should be made uniform. Fannie refinancings allow for the pay-off of the first lien mortgage, the financing of closing costs and no more than \$250 cash to the borrower. Freddie refinancings on >80 LTV loans are slightly less generous, capping closing costs at 4% of the current unpaid principal balance of the loan or \$5,000, whichever is less, and limiting the cash to the borrower to \$250. Freddie refinancing on ≤80 LTV loans are slightly more generous than Fannie, allowing for all closing costs to be financed (as with Fannie); while permitting up to 2% of the loan amount or \$2,000, whichever is less, to be taken as cash to the borrower.

Automatic Transfer of Mortgage Insurance and Second Liens

The Menendez-Boxer Discussion Draft provides for the automatic transfer of mortgage insurance and second liens. More precisely, it requires that second liens and mortgage insurance be automatically portable under the same terms to a newly refinanced loan if the second lien holder or mortgage insurer wants to sell loans to the GSEs. While we are in favor of these items, we do not believe the second lien issue has been a major obstacle to refinancing. We also believe that most of the mortgage insurers have voluntarily agreed to make the policies fully portable; it is our understanding that United Guaranty is the only hold-out.

It is important to realize that a refinancing on a first mortgage makes the second lien more valuable, as it makes the costs of home ownership more affordable, and hence makes the borrower less likely to default. Thus, the second lien holder is generally happy to resubordinate his interest. And the first lien holder rarely has a problem locating the second lien holder. In fact, our work has shown that, controlling for other factors, there was only a marginal difference in the prepayment speeds between borrowers who had a second lien and those that did not. Nonetheless, requiring subordination to assure continued GSE access seems reasonable, and would help at the margin.

Mortgage insurers will generally treat a refinance as a modification of the existing policy in order to port the policy to the new loan. In a same servicer refinancing, the reps and warrants made by the originator of the original loan to the MI provider remain in effect. However, this is only possible when the existing servicer refinances the loans; in a different servicer refi the risk to the MI provider is increased, as the MI provider loses the reps and warrants on the original loan. Under HARP 1.0, if there was a servicer change, some MIs required a new MI certificate at market rates, others charged a surcharge or imposed other costs, and others required increased documentation. During the negotiations for HARP 2.0, most of the major mortgage insurers voluntarily agreed to allow the insurance policies to be fully portable, in spite of the fact that it is not in their economic interest to do so. We are told there was only one hold out, United Guaranty, an AIG subsidiary, which imposes a surcharge on a different servicer refis. We believe that all mortgage insurers should allow for full portability, even in the event of a servicer change.

Moving the Cut-Off Date until 6/1/2010

The Menendez-Boxer Discussion Draft requires the cut-off date be moved from 6/1/2009 to 6/1/2010. This move was suggested because the latter date was approximately when 30 year fixed rates loans dropped below 5%, and would allow borrowers whose loans were originated at higher rates to take advantage of refinancing.

If we use the same framework as in Exhibit 2, it would raise the number of pre-cut off borrowers (≤80, 80–125, >125) who have good pay history and are in-the-money (have an economic incentive to refinance) from (10.9 million, 3.3 million and 700 thousand) to (13.0 million, 4.2 million and 700 thousand). Therefore the number of post-cut off borrowers (≤80, 80–125, >125) who have a good pay history and are in-the-money drops from (4.8 million, 2.1 million, 30 thousand) to (2.6 million, 1.1 million, 18 thousand).

We believe that the streamlined refinance program should be expanded for borrowers with LTVs ≤80, with or without rep and warrant relief. (Providing rep and warrant relief is expensive for the GSEs.) This action alone would increase the number of eligible borrowers by 2.1 million. However, these are borrowers who most likely would have been able to refinance anyway, this just makes the refinancing process easier. Would these borrowers be “crowding out” the pre-cutoff borrowers who need the help more? The answer to this is unclear. It might divert some resources, at the margin, but would allow for many more refinances.

For HARP loans, it is a much harder call; we have very mixed feelings about the proposal and are on balance negative. We recognize that it will give an extra 900 thousand borrowers the opportunity to refinance, and these are borrowers who would otherwise not be able to. This benefit has to be weighed against the “covenant with investors.” The FHFA has repeatedly reiterated the importance of the cut-off date. The date was also used as the FHA cut-off; the FHA decided to roll-back the Mortgage Insurance Premium for refinancing loans originated before the cut-off date. Investors have relied upon that date and developed a series of pay-ups on mortgages with this refinance friction. Changing the date would be very disruptive to this covenant. The Agency mortgage market is wide and deep, regarded as the second most liquid market in the world behind the US Treasury market. We believe that “breaking the covenant” with investors would be very damaging to the health of this market; if the date is moved once, market participants (investors, borrowers and originators/servicers) will assume it will be moved again.

This could, in turn, create a set of adverse incentives. If originators/servicers believe that an expansion of HARP 2.0 could allow reps and warrants to be stripped off future loans, it could entice originators to make more questionable loans, and then, a few months later, target those loans to get rep and warrant relief.

We believe there is a continuum. Changing the cut-off date for streamlined refinancings of loans with LTV ≤ 80 would be minimally disruptive. If there is a groundswell of support to move the HARP date forward by one year, we would suggest that it be done for purchase loans only. Since allowing re-HARPing, and changing the dynamics of specified pool trading would be extremely disruptive.

Increasing Homeowner Awareness

The Menendez-Boxer Discussion Draft would require the GSEs to send eligible borrowers an official notice that they are eligible for refinancing at a lower rate, with an indication as to how much they would save each month. The notice would include referrals to internet portals where the borrower could determine the type of loan they have, and get quotes from competing lenders. This is simply a notice to increase homeowner awareness. It is hard not to be in favor of this type of action.

Conclusion

HARP 1.0 clearly fell short of expectations. The verdict on HARP 2.0 is still out. However, we believe that HARP 2.0 (for borrowers >80 LTV, loans made before the cut-off date) and current streamlined refinancing programs (for borrowers less than 80 LTV, loans made before the cut-off date) could be much more effective if different servicer refinances were to be permitted on the same terms as the current servicer. We believe that promoting competition is the single most important action that can be taken to increase the impact of the program. It is also the single most powerful action that can be taken to decrease the mortgage rates and fees paid by the borrower.

We are very much in favor of a consistent set of guidelines for Fannie and Freddie in order to ease lender compliance. We would like to see pre-cut off Freddie loans with LTVs ≤ 80 LTV receive rep and warrant relief, consistent with pre-cut off Freddie loans with LTVs >80 and all pre-cut off Fannie loans. We would also like to see consistency on the financing of closing costs.

Other actions, such as eliminating loan level pricing adjustments and appraisals, are relatively minor. Borrowers are paying high fees because the banks are making oligopoly profits. These costs can be lowered by promoting competition. Similarly, requiring re-subordination of second liens and portability of all mortgage insurance policies are nice features, but will only help at the margin. It is in the economic interest of second lien holders to re-subordinate. Most mortgage insurers have already agreed to full portability.

We would like to see more penetration of the existing HARP program by promoting competition and making borrowers aware of their refinancing options before expanding the eligibility by moving the cut-off date forward by one year. If the cut-off date were to be changed, it can most easily be done for borrowers with LTVs ≤ 80 , as there was never a “covenant with investors” on these loans. If it is to be done on HARP loans, we would suggest doing it on purchase only loans. Allowing re-HARPing would be very detrimental to a well functioning market.

Thank you very much for the opportunity to testify on this important set of issues.

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