

M Hanson Advisors – Real Estate & Finance

The Mortgage Pages - April 22nd 2010

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Our mission is to provide our clients a significant edge. This is done by turning the daily, market-moving real estate and mortgage news flow and events into old news by the time it makes headlines. - Mark Hanson

Introduction - This Ain't *Credit* You're Lookin' At

There is an LA Times story making the rounds based upon DataQuick Notice-of-Default data showing a 40% YoY drop and making a case "credit" is improving.

For many, this combined with banks hanging their hats on a sudden marginal improvement in early stage delinquencies, has driven them mad. Relax - you are not crazy. It's a conspiracy...they are absolutely out to get you.

The fact is that 30, 60 and 90-day late mortgage payments and new official Notice-of-Defaults stopped reflecting trends in *credit* a long time ago.

Over the past year, residential mortgage *Credit* and *Default* have been more about exogenous influences, mostly along the lines of loss mitigation and foreclosure prevention efforts, than with borrowers missing monthly payments.

Instead of making new loans, lenders have focused energy on their legacy portfolios reshuffling the deck and changing the natural order of when and how *default* occurs...but most will still occur. This has created both a **massive default and a debt restructuring bubble**.

Every single month I detail the official CA and national official default and Foreclosure figures and key upon how the natural flow of the distressed pipe has been significantly interrupted since September 2008 when CA passed its first can-kicking law, SB1137.

The amount of control a few large banks have had over their assets -- and the shape of the delinquency, default and Foreclosure curve -- has been ominous.

So, let's go over this from soup to nuts, including what I think has taken the place of early stage delinquencies in best determining residential mortgage credit trends.

The following report details why mortgage *credit* - at least how it has been defined over the past couple of quarters - has temporarily and artificially improved since Q4 while the latter stages of the default and Foreclosure process, which are perhaps an even better gauge of *credit* and ultimately where the losses lie, sit at **record highs**.

Early Stage Delinquencies a Lagging Indicator

What we are seeing in **early stage delinquencies and defaults right now is a lagging indicator**; a result of a variety of things put in motion in 2009, which created the bubbles and that I highlight in this report.

It is also very important to note as a backdrop to this report that as 2009 progressed and servicer's got fully geared up, **troubled borrower outreach moved progressively forward in the delinquency process completely hiding a certain percentage of borrowers who in prior years would have shown up as an early stage delinquency or NOD**. Most will show up again at some point but the whole mortgage mod push is so new that the leading re-default edge is only upon us now.

But we are already past all this now and to a point at which the default and Foreclosure pipe is so jam-packed that plugging one hole immediately creates a leak somewhere else. Because of this mortgage *credit* is likely as good as it gets for now.

Although named something else or completely dismissed temporarily through modifications or restructurings, most troubled borrowers still exists and will rear their heads eventually. Remember, up to 70% of mods and debt restructurings ultimately fail within nine months to a year and the big mod push only began mid-year 2009. Additionally, the Obama 'Permanent Loan Mod Drive' has resulted in millions of loans being put in a state of suspended default'amation' since December.

Lastly, with such large delinquency and default bubbles -- and until only recently with the surge in Foreclosures little consequence to being in default -- there is between \$8 and \$12bb in additional monthly household savings of which some is most certainly going to other creditors. With a fraction of a mortgage payment one can keep five credit cards, a car and boat creditor at bay for a month.

“Credit” (How it’s Defined Today) Improved in Q1 QoQ and YoY. We Know This

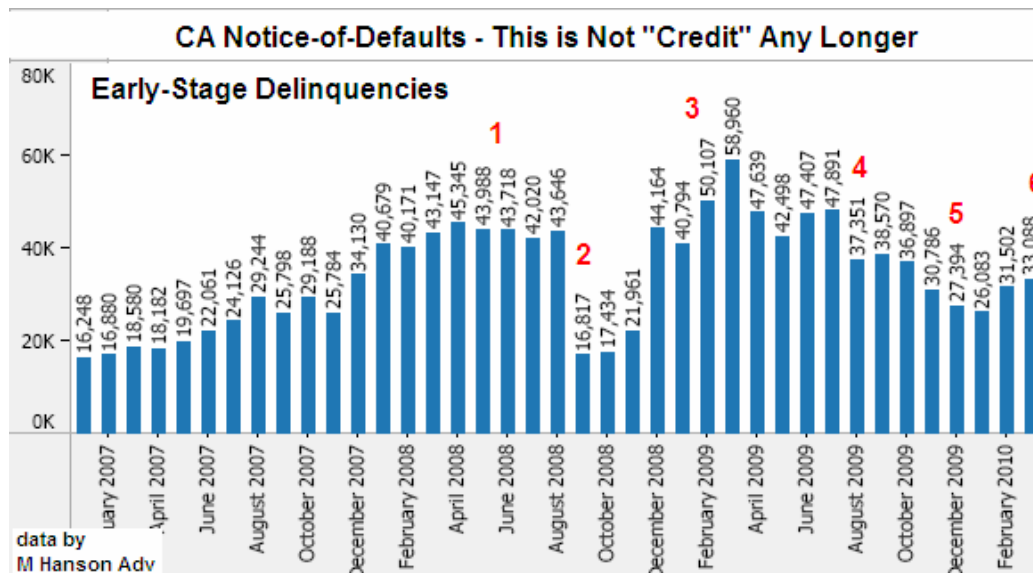
First, let’s review official CA **Notice-of-Defaults** that are filed on every resi and C&I property at a minimum of 90-days late if the bank is smart. Putting a borrower on notice allows the bank to legally take the property through Foreclosure after a certain number of months have passed. **There is no reason a bank would not file an NOD other than if the borrower is actively in the process of a loss mitigation effort.**

Based upon Q110, Q4 09 and Q109 NOD counts of 90,673, 95617, and 149,861 respectively, resi *credit* statistically improved significantly in Q110 but not necessarily fundamentally, as things were simply reshuffled.

The past three quarters of declines in this chart correlate perfectly with the implementation of the various wide-scale home retention efforts. And it is simply too soon to begin to add back 50-70% of these due to redefaults.

Because of these events, there can be no apples-to-apples comparisons here. In fact, based upon the average count of 38,200 over the past two years with nowhere near as much gov’t interference as now, March’s 33k is a very strong number.

The chart below is of the highly volatile three-year CA NOD pipe. The highlighted numbers 1 through 7 each correlate to an event that suddenly changed the pace of *credit*. Definitions are below the chart. This also details why the LA Times story is comparing apples to peanuts in their YoY analysis.



- 2007 - 8/08: NODs surge then suddenly flatten out.** In mid-2008, NODs surged over a short period of time and housing was falling apart. This is the first point at which banks began kicking the can, as evidenced by the sudden flattening. At this point the servicers were struggling with internal capacity and political forces and had to slow it down knowing they could never actually foreclose on this many NODs.
- 9/08: NODs suddenly crash.** Can kicking was born. CA SB1137 was passed forcing servicers to perform certain tasks before an NOD can be filed. The effectively delayed the lion's share of the Default pipe by 90-days.
- 2/09: NODs suddenly surge.** In Jan when Obama was elected he promised a Foreclosure prevention plan we now know as HAMP to be released at the end of March. What did the servicers do? They jammed the mailbox full of NODs in Feb and March front running any decision by the Admin, which would give them less control of the assets.
- 8/09: NODs Plunge by over 20% in a month.** In July 2009 HAMP had been underway 4 months. It was not doing well, and Obama called all the servicers to DC for a 'come to Jesus' meeting. At this point the decisions were made to **1)** allow anybody with a good story into a HAMP trial mod vs fully qualifying them prior to trial **2)** only foreclose on props when it is completely necessary until Jan 31st 2010 in order to give the Admin time to figure out the next step.
- 11/09 - 1/09: NODs suddenly drop by 25% in two months.** Obama's "Permanent Loan Mod Drive" that began in December and the GSE led Holiday Moratoriums in Dec and Jan led to a final collapse in NODs in Q4 2009.
- 3/09: NODs suddenly rise by 30% in two months.** Now, things have changed again. A couple of unintended consequences of the 'Permanent Loan Mod Drive' are a dramatic fall in new modification offers and trial mods started and also a sharp rise in Foreclosure activity.

Bottom line - not much of a dent has been made in the absolute NOD count over the past two years despite hundreds of billions of dollars and complete large scale servicer efforts with 10s of thousands of personnel being thrown at it. They have just reshuffled the deck, artificially and temporarily changing the natural pace at which they occur through modifications, but most will still occur.

A Better Look at Credit - Notice-of-Trustee Sales...Foreclosure Imminent Stage

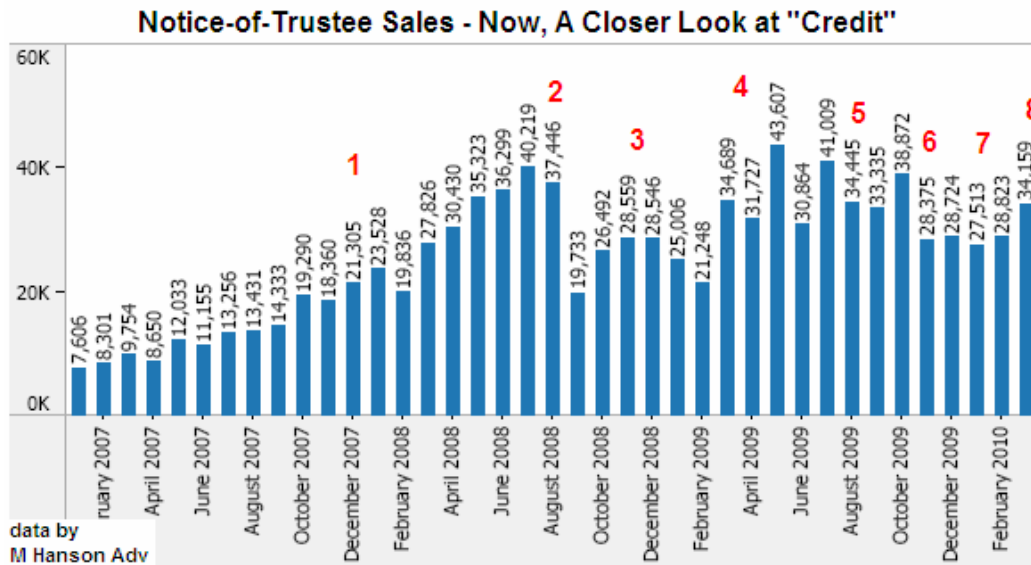
Now, let's look at **Notice-of-Trustee Sales** (NTS) - the last stage just a few weeks before a property is taken back through Foreclosure. An NTS is only filed when a lender fully plans on foreclosing. There is no need to otherwise. The NTS bucket consists of borrowers who have no intention of modifying, failed trial mods, borrowers who do not qualify for a mod etc.

Because of the obfuscation at the front of the delinquency and default curve, this stage may have now become the most important... **a catch-all credit bucket**. Since January 2008 the average monthly pace of NTS' has been 31k. In March we saw 34k.

In the past -- and in a world with no interference -- this bucket tracked NODs lagged about four months and adjusted for a certain cure rate. But now NODs and NTS's have diverged, especially at a national level, which I highlight following.

This bucket is also where the largest unintended consequence of modifications and the recent Permanent Loan Mod Drive will be felt. Remember, when they dig through all the mods looking for the permanent needles in the haystack they will find far more cow patties than anything else.

But even so, this bucket has also been greatly affected by exogenous events detailed below.

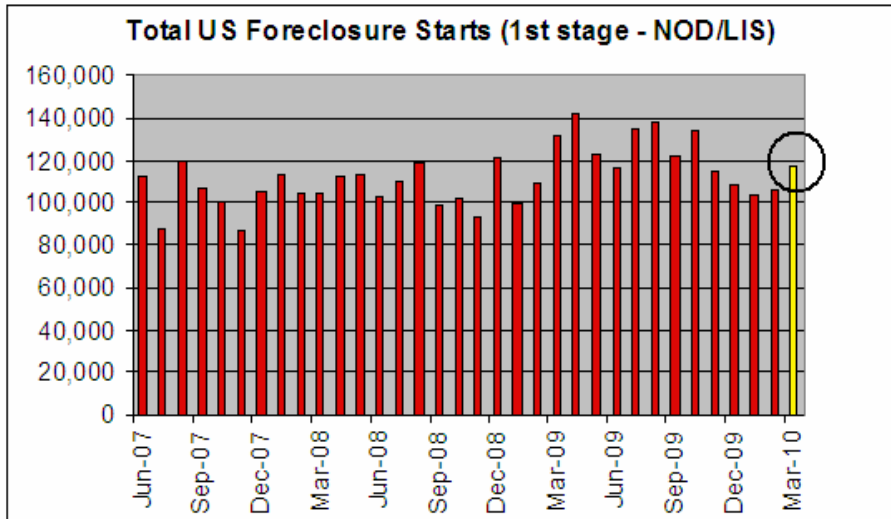


- 1) **2007 - 8/08: A Perfect NTS Slope in a perfect - pre-interference world** -- that tracks NODs perfectly four months lagged.
- 2) **8/08: NTS peak out exactly at the NOD peak** adjusted for the cure rate at the time - again a perfect world.
- 3) **9/08 - 2/09: NTS suddenly plummet** due to CA SB1137 law which dumped NODs as shown in the first chart. Can kicking is born.
- 4) **5/09: NTS suddenly spike in May** - correlates to the Feb and March NOD spike.
- 5) **6/09 - 10/09: NTS remain highly volatile**, as the servicers are pulled in different directions by internal capacity and political forces. Then, on July 28th Obama's 'come to Jesus' meeting has the same effect here as it did with NODs.
- 6) **11/09: NTS suddenly tumble again** on Obama's "Permanent Loan Mod Drive", as the lion's share of trial mods are put in a state of suspended animation due to the servicers
- 7) **12/09 - 2/09: The Holiday Foreclosure Moratorium** by the large servicers and GSE's can really be seen here, as there is no reason to spend the money to file an NTS unless a Foreclosure is imminent with a few weeks.
- 8) **3/09: NTS suddenly spike** for a couple of reasons least of which is an unintended consequence of the 'Permanent Loan Mod Drive', which will uncover many more Foreclosures than it does permanent mortgage mods.

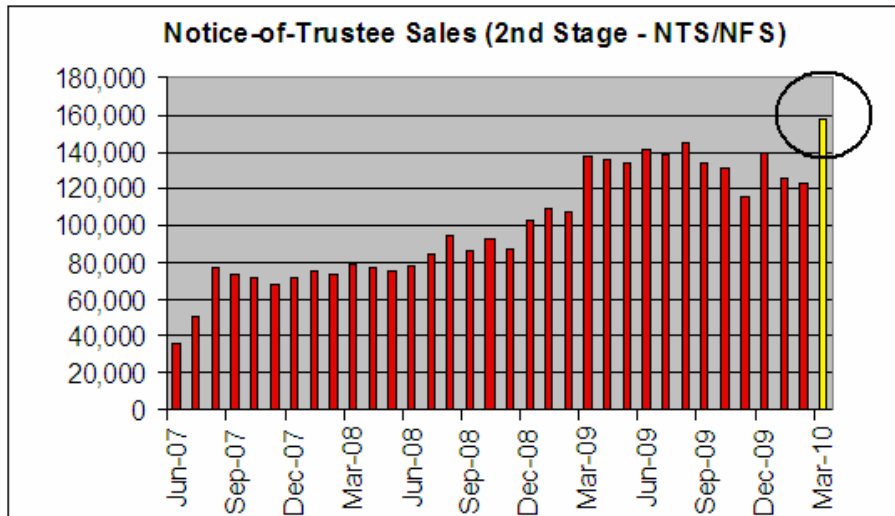
The amount of control a few large banks have over their assets -- and the shape of the delinquency, default and Foreclosure curve -- is ominous. But, based upon years of research these data at every level, I believe we are at an inflection point at which the bubble has blown so big, control is being lost quickly.

National Mortgage Default and Foreclosure Stats Far Worse Than CA

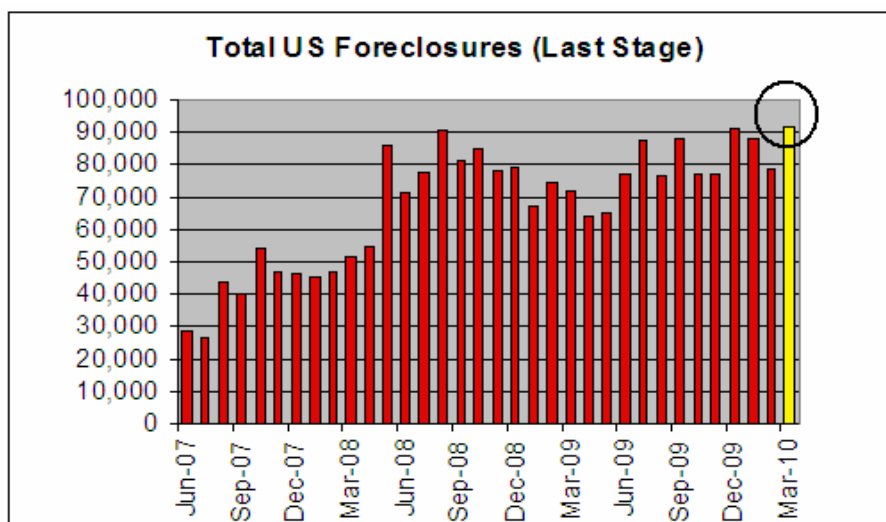
1) The first chart is of National NOD's. Like in CA, the past three quarters of notable declines correlate perfectly with the implementation of the various wide scale home retention efforts. Also like in CA, March brought a spike. And again, it is just too early in the process to begin to add back 70% of the drop due to redefaults.



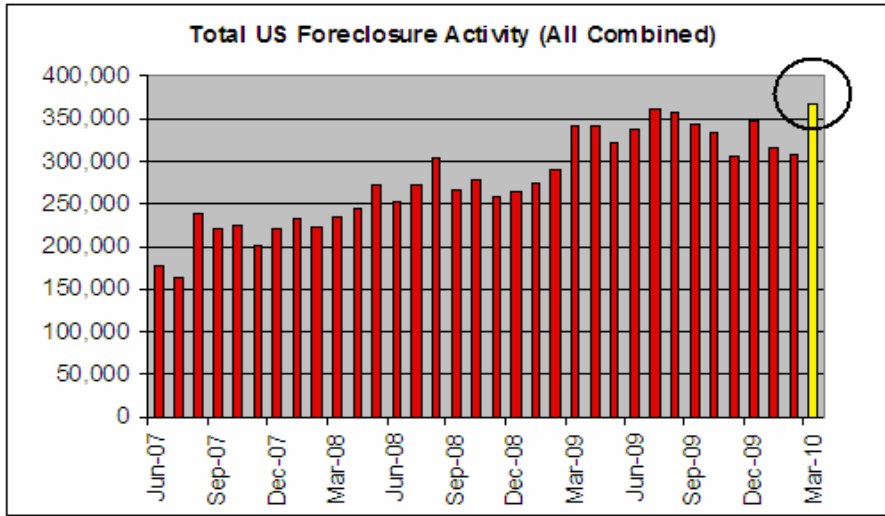
2) The second chart is of Notice-of-Trustee Sales -- Foreclosure ready properties -- but unlike CA, **they are at record highs.** Again, I believe this catch-all bucket is more a reflection of *credit* than NODs.



3) Actual Foreclosures in March hit record highs. As I revealed in my "Foreclosures Forever" report earlier this week, if Foreclosures doubled to 180k in April from March's record 92k, it will take nearly five years to clear the system when factoring in the average pace of NODs, mortgage mods and modification redefaults.



4) Total Default and Foreclosure activity in March hit record highs



The Big Loan Modification Lie

If all this was permanent, hey party-on with the bank pe expansion thingy. But restructured resi debt is mostly trash. For example, the average HAMP permanent modification in March had an after-mod DTI of 61.3% after taxes. This means the average HAMP mod will fail and once again become an early stage credit event in many cases.

Select Median Characteristics of Permanent Modifications			
Loan Characteristic	Before Modification	After Modification	Median Decrease
Front-End Debt-to-Income Ratio ¹	44.8%	31.0%	-13.9 pct pts
Back-End Debt-to-Income Ratio ²	77.5%	61.3%	-14.4 pct pts
Median Monthly Payment ³	\$1,428.46	\$841.61	-\$512.39

¹ Ratio of housing expenses (principal, interest, taxes, insurance and homeowners association and/or condo fees) to monthly gross income.
² Ratio of total monthly debt payments (including mortgage principal and interest, taxes, insurance, homeowners association and/or condo fees, plus payments on installment debts, junior liens, alimony, car lease payments and investment property payments) to monthly gross income. Borrowers who have a back-end debt-to-income ratio of greater than 55% are required to seek housing counseling under program guidelines.
³ Principal and interest payment.

Bill Black Testimony...Sums Up Mortgage Mods Too

When testifying to Congress this week about Lehman and Alt-A loans, Bill Black unintentionally summed up the debt restructuring bubble perfectly.

Mortgage mods are nothing more than new high-leverage, exotic loans. In fact, New Century would have never considered going a 61% DTI loan in the day - it was too risky.

Right now we are experiencing a loan default and modification bubble and I suspect his conclusions below will hold true for mods as well.

“Lehman’s principal source of (fictional) income and real losses was making (and selling) what the trade accurately called “liar’s loans” through its subsidiary, Aurora. (The bland euphemism for liar’s loans was “Alt-A.”) Liar’s loans are “criminogenic” (they create epidemics of mortgage fraud) because they create strong incentives to provide false information on loan applications. The FBI began warning publicly about the epidemic of mortgage fraud in 2004 (CNN). Liar’s loans also produce intense “adverse selection” – even the borrowers who are not fraudulent will tend to be the least creditworthy. The combination of these two perverse incentives means that liar’s loans, in economics jargon, have a deeply “negative expected value” to the lender. In English, that means that the average dollar lent on a liar’s loan creates a loss ranging from 50 – 85 cents.

Gambling against the casino creates a negative expected value, but making liar’s loans creates inevitable, catastrophic losses.

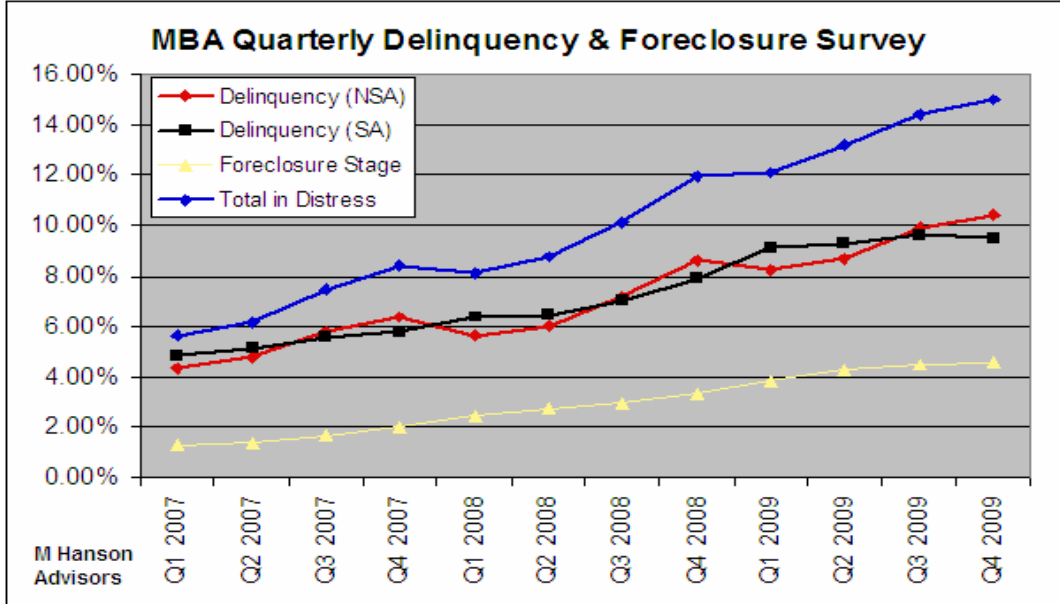
That loss, however, may not be recognized for many years – particularly if the liar’s loans become so large that they help hyper-inflate a financial bubble . In the near-term, **making massive amounts of liar’s losses loans creates a mathematical guarantee of producing record (albeit fictional) accounting income.** (As long as the bubble inflates, the liar’s loans can be refinanced – creating additional fictional income and delaying (but increasing) the eventual loss.

“Other” Credit Improving as a Result of Mortgage Mod Bubble?

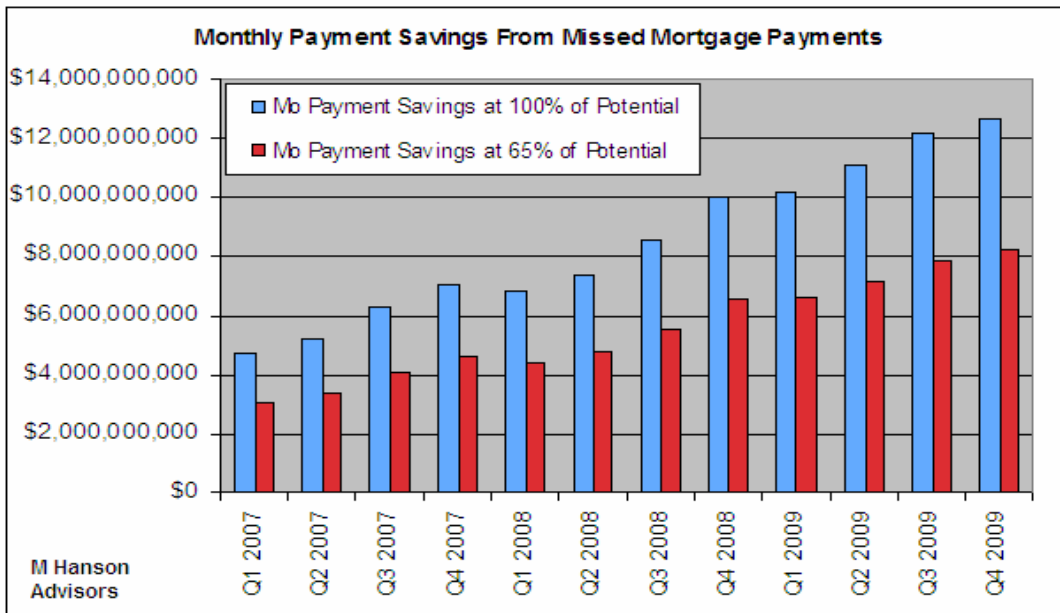
The default bubble has also produced an immediate household stimulus to the tune of over \$12bb per month. Many speculate that some of this is going to consumer spending, which make perfect intuitive sense especially after so long with little consequences to being in default.

But with all this extra cash flow from missing mortgage payments, be sure some is going to other creditors in order to keep revolving credit cards working, car payments up to date, and the terrifying phone calls from coming.

The banks are easy on revolving too - the workout plans for a several thousand dollar card balance may be only \$50 a month. That is a small price to pay to be able to use the card and stop the relentless calls at all hours of the day to the borrower, family and friends.



Based upon the number of borrowers in some stage of default, over \$12bb per month is being saved. If 65% of the total number delinquent or in foreclosure are not making payments -- assumes 35% in a mod plan of some sort -- then over \$8bb monthly is being saved. This is a large stimulus.



**Best Regards,
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