

M Hanson Advisors – Real Estate & Finance

The Mortgage Pages - April 26th 2010

- [The Modification Bubble - New Vintage Subprime Gone Awry \(again\)](#)
- [Loan Restructuring and Modification Bubbles at Max Girth](#)

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

Intro

If you thought lenders lost the know-how or desire to make outrageously risky Subprime loans, think again. **March's HAMP results were startling** and go to show just how far they are willing to push the risk envelope for borrowers willing to write a nominal monthly check.

During the bubble years lenders got progressively easier as they ran out of qualified victims at which to throw easy refi or purchase money. With respect to the new-era Subprime loans -- loan restructurings and modifications -- the same exact thing is happening.

The banks and GSE's must continue aggressive Subprime lending disguised as *Restructurings* and *Modifications* in order for the default bubble to keep blowing because if they stop blowing, then millions of toxic loans finally come home to roost sooner *than* later.

Reshuffling the deck and changing the natural order of when and how *delinquency* and *default* occurs has worked well for the past few quarters in concealing the true health of "credit". But based upon the most recent HAMP borrower stats, mods may quickly be coming to the end of their leverage rope.

Bottom Line - March's HAMP results show why trying to compare HAMP or Portfolio mortgage mods to Subprime full-doc loans during the bubble years can't be done -- there is no comparison...the average mod is much more aggressive. **Today's mortgage mods make the average Subprime loan during the bubble years look relatively safe and sane.**

And because the wide-scale mortgage mod assault is so new -- ramped hard in Q3 and Q4 '09 -- we have only felt the benefits in increased cure rates and decreased early stage delinquencies. But over time, most will re-default and the leading redefault edge from initial HAMP mod surge is upon us now.

Additionally, the number of new mod offers and trial mods are down sharply over the past six months and look to be leveling out 50% below peak levels. At this pace -- accounting for redefaults and the average pace of new Notice-of-Defaults -- the default bubble actually grows each month only to be decreased through increased foreclosure activity.

Why -- Like Subprime Loans -- Most Mods Will Fail

There are **four important aspects of HAMP mods -- and all mods really -- that I focus upon**, all of which will plague all mod programs until such time they forgive a massive amount of principal, up-front and tax free.

At the end of the day, there is no reason whatsoever that modifications should perform any better than old vintage Subprime loans given they are structured worse. But unlike Subprime loans that mostly lasted two years from origination, mods will roll over much quicker.

Key Definitions:

Front-end DTI: Mortgage Principal, Interest, Taxes and Insurance (PITI)

Back-end DTI: PITI plus other debt listed on credit report only

Both of these are determined using pre-tax income. Prior to the bubble years 28/26 ratios were industry standard. During the bubble years, full-doc 50/50% ratios became the norm. And now with HAMP mods, the back-end ratio has moved above 61% in March.

1) In March the average applicant PRE-MOD back-end Debt-to-Income Ratio was an out-of-control 77.5%.

The average HAMP applicant is paying 77.5% of their gross PRE-TAX income out to debt listed on their credit report. And these are the good borrowers - the ones with income who really think they have a chance of owning their home one day.

This has much more to do with 'Default' than negative-equity alone and is also a great window into how massively over-levered the average homeowner really is. **This also underscores why defaulting on a mortgage is like getting a high paying second job at which you do not have to work.**

Diana Olick asked a great question last week in her blog in response to JPM denouncing principal balance reductions. Her question was "how could Principal Mods cause premeditated defaults if a hardship is needed to get a mod?"

Well, there ya' go. **Bottom line** - the majority of mortgaged American's are insanely over-levered by historical standards and *this* has become the hardship. This is a far cry from why mods were originally created.

2) In March the average applicant POST-MOD back-end Debt-to-Income Ratio was an out-of-control 61.3% of gross PRE-TAX income. .

These are supposed to be the good borrowers -- those with jobs and the conviction to repay a mortgage, as evidenced by making it all the way through the trial period. Just imagine the characteristics of those that do not make it.

This metric has gone up four months in a row from 55.4% in December **and indicates servicers are pushing the envelope with respect to getting people to qualify**, which is exactly the same as lenders did when they were running out of eligible victims in the housing bubble.

However, **not even New Century would do a 61.3% DTI loan in the day because they considered it too risky**. This is why mod re-default rates remain sky high and will not improve much even with the new three-year earn-out principal reductions.

3) Modified borrowers with 61.3% DTI's remain economic zombies indefinitely. When 61.3% of your gross income goes out to revolving and installment debt each month, irrespective of your equity position, you are an over-levered debt slave unable to shop, save, vacation or have any quality of life.

4) Missing a mortgage payment is the easiest and most effective way to de-lever and suddenly have a significant stream of disposable income.

Based upon March's stats, when the average homeowner defaults on their mortgage they go from keeping 22.5% of their pre-tax gross monthly income (100% less 77.5% back-end DTI) to keeping 67.3% of their pre-tax gross monthly income (100% less (77.5% back-end DTI less 44.8% front-end DTI)).

Bottom Line - Once a terminally over-levered borrower gets a taste of keeping 67.3% of their income each month, it is tough to bring them back into the realm of the over-levered for any length of time.

Loan Restructuring and Modification Bubbles at Max Girth

Select Median Characteristics of Permanent Modifications			
Loan Characteristic	Before Modification	After Modification	Median Decrease
Front-End Debt-to-Income Ratio ¹ Housing PITI Only	44.8%	31.0%	-13.9 pct pts
Back-End Debt-to-Income Ratio ² All Debt on credit rpt	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.

A 61.3% back-end DTI (and rising for the past four months) means that **a**) a large number of permanent mods will redefault within a year **b**) and they are running out of eligible victims after only 230k permanent mods through March.

As servicers push the qualification envelope harder to get more trial mods turned permanent, they get progressively loser, which is why the DTI keeps rising.

The same exact phenomenon was seen during the bubble years when lender got progressively easier with

underwriting guidelines in order to get more people to qualify for loans as house prices kept rising and incomes didn't. The solution was to begin offering expanded DTI's, stated income, teaser rates etc.

The problem with HAMP - it already is a teaser, interest only, high LTV, expanded DTI, balloon loan.

Other than waiving all income docs or cutting the rate to zero, which would help some but won't happen, HAMP is already as easy as it gets with respect to qualifying. Essentially the servicers have ground through a mountain of hay looking for the needle and all that is coming out now is rusty nails.

Servicers have gone beyond 'pushing the envelope' with respect to borrower qualifications and have fully entered the realm of **irresponsible lending**, as evidenced on page 6 of this month's HAMP report where the total **After-Mod Back-End DTI moved up to 61.3% from 59.8% last month and 55.1% in December**. This is based upon GROSS income and is the most important metric in discerning whether HAMP mods will make it for the duration.

At 61.3% DTI, which is massively over-levered for most not making seven figures, walking away from your house -- whether you are in a negative equity position or not -- and renting will happen eventually. **A 61.3% DTI is so far out of scope with the pre-bubble years safe and sound 36% total DTI -- and even typical bubble-years full-doc DTI's of 50% -- it is absolutely irresponsible.**

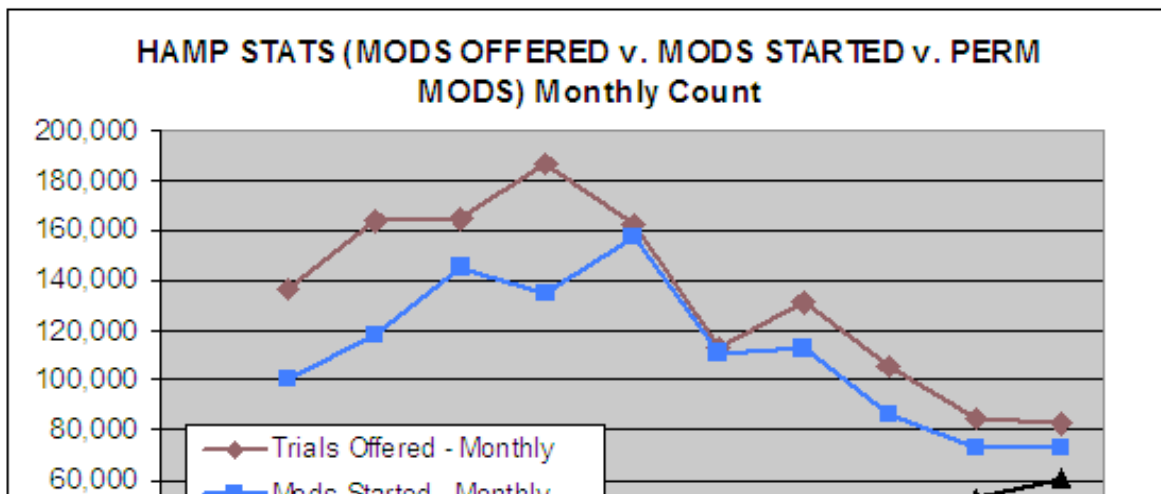
HAMP Participation Collapse Leveling Out at 50% of Peak Applications

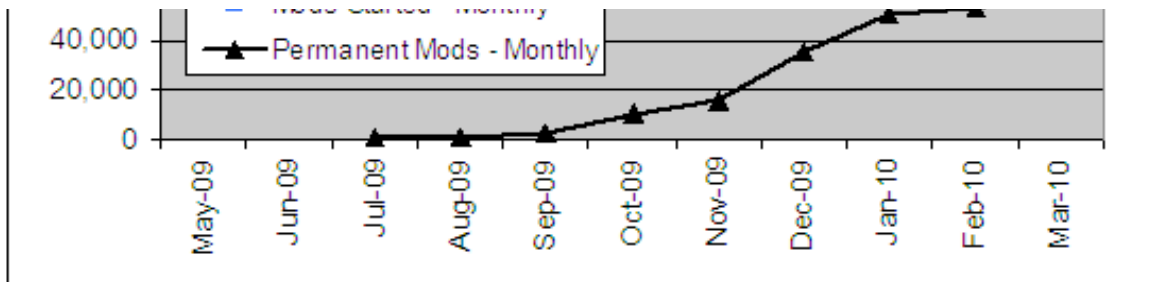
Each month since Obama's 'Permanent Loan Mod Drive' began in December, the primary takeaway from the monthly progress reports is that 'permanent mods are ramping up nicely'. While Perm Mods have ramped up since the Drive began, the *application to perm mod* rate is only 26% at first pass. Then, after factoring in a conservative 50% redefault rate it will drop to 13% based upon this month's numbers.

A closer examination of the numbers reveal that the HAMP participation is ramping down hard at the 'Offered' and 'Trial Mod Starts' stages as shown in the chart below. And the Perm Mod data point that everybody focuses upon as the most important is a very small piece of the HAMP story.

The chart below shows the MoM participation rate for trial mods offered, trials started and permanent mods granted. As you can see, new mods offered and mods started have dropped like a rock since Sept 2009, but leveled out in March.

The reason for the small jump in March Perm Mods (black) is that there were three additional business days in the month.





- 1) New monthly mod offers and trial mod starts declining steadily MoM but finally leveled out in Mar
- 2) Monthly Perm mods increasing steadily since Obama's Dec 1 'Perm Loan Mod Drive' began but over the past few months have leveled out (March slight rise due to more business days in the month)
- 3) Because Perm Mods (black) happen 4-5 mos following the trial start month (blue), then Mar's Perm Mods correlate with Oct/Nov when new Trial Mods started were much higher. This is a leading indicator into the rate of Perm Mods going forward
- 4) Given Trial Mods have fallen so sharply the rate of Perm Mods has likely peaked at the 50k a month rate and will start declining going forward.
- 5) If Perm mods end up at roughly 350k from the Trial Mods Started through March cohort, then over 750k houses will be funneled into Foreclosure or a HAFA liquidation in the near-term from the HAMP channel alone. On a go-forward basis, Foreclosure and HAFA will be channeled a fresh 50k houses per month (trial mods minus 26% success rate)
- 6) With only 900k Foreclosures in all of 2009 and 750k HAMP ready Foreclosures right now, it is obvious how large of a Foreclosure problem lies ahead

Of the 1.44mm trials offered and 1.17mm started as of March, only 230k has gone permanent. In Jan through March there were 50k, 53k, and 60k perm mods granted respectively.

Obviously (as reported), permanent mods have jumped considerably since the "Permanent Mod Drive" began on Dec 1st but should not get any greater on a monthly basis that the past few month's average of 53k, especially since new Trial Mods have dropped so sharply.

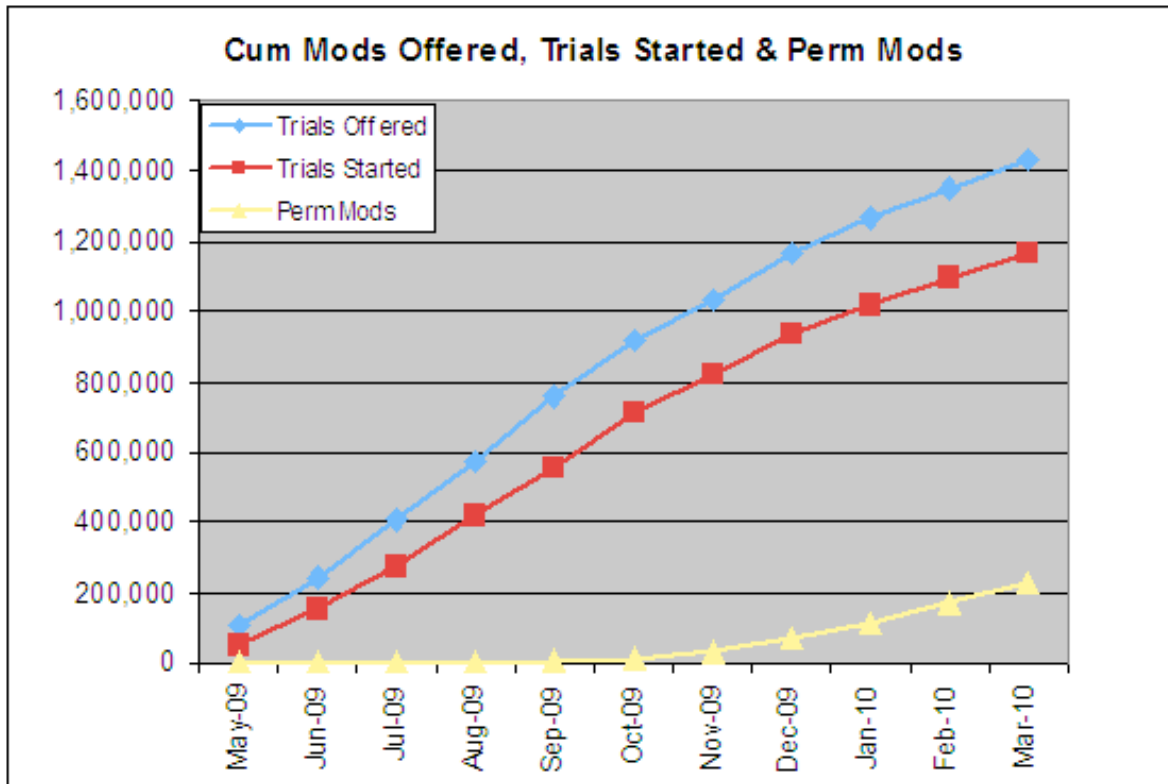
If new applicants have flattened out above the Perm Mod level -- i.e. we have more going into the program going forward than turning into Perm Mods -- then from this channel alone we have up to 1.2 million Foreclosures or HAFA solutions coming soon from this cohort alone.

To be fair though, the past few months of trial mod starts can't be counted in the denominator because the trial period is three months. Therefore, the denominator should be the average of November's 822k and December's 935k cum trial mods started and not March's 1.17mm, in which case 230k perm mods would equal 26%.

But when you count *Mods Offered*, then as of November the 1.032mm offers that turned into 230k permanent mods equal a 22% *HAMP offer to perm mod* ratio -- nothing to write home about.

Then when considering that 50% of the 230k perm mods will redefault -- based upon the 1.032 Offered Mod cum -- the true success rate is 11.1% or about where all other mod programs wind up.

This is a very important number because the immediate 74% non-starters and 88.9% final failure count is the Foreclosure and HAFA liquidation feed. This highlights what a significant program HAFA really is and just how many Foreclosures, short sales and deeds-in-lieu, which turn into bank REO, are on tap in the near-term.



Notes

- 1.435mm offers have been made
- 1.17mm trials have been started, average 74k a mo and declining
- 230k perm mods have been granted, averaging 53k per month and flat
- If perm mods lag trial mods (red) by 4-5 mos, then Mar perm mod results (yellow) correlate to Nov-Dec when between 822k and 923k cum trial mods were granted.
- Therefore, the true trial to perm mod rate is roughly 25%
- If half perm mods will re-default the true success rate will be 165k mods for 875k trials or about 19%
- more loans continue to go into trials each month than turn turn into perm mods then extrapolating forward 6 months, there will be 1.1mm loans that need to get liquidated through Foreclosure or a HAFA solution this year!

In summary, this gigantic can kick experiment that has served to re-lever bad borrowers in order to squeeze a few more months out of the default and foreclosure timeline is losing steam fast. Up until now, we have only felt the positive factors of mods in decreased delinquencies, defaults and Foreclosures. But, based upon when the modification application and trial mod surge began the leading edge of the modification redefault tide is upon and this additional channel of distressed loans and property is something few are expecting or modeling.

Best Regards,
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Select Median Characteristics of Permanent Modifications

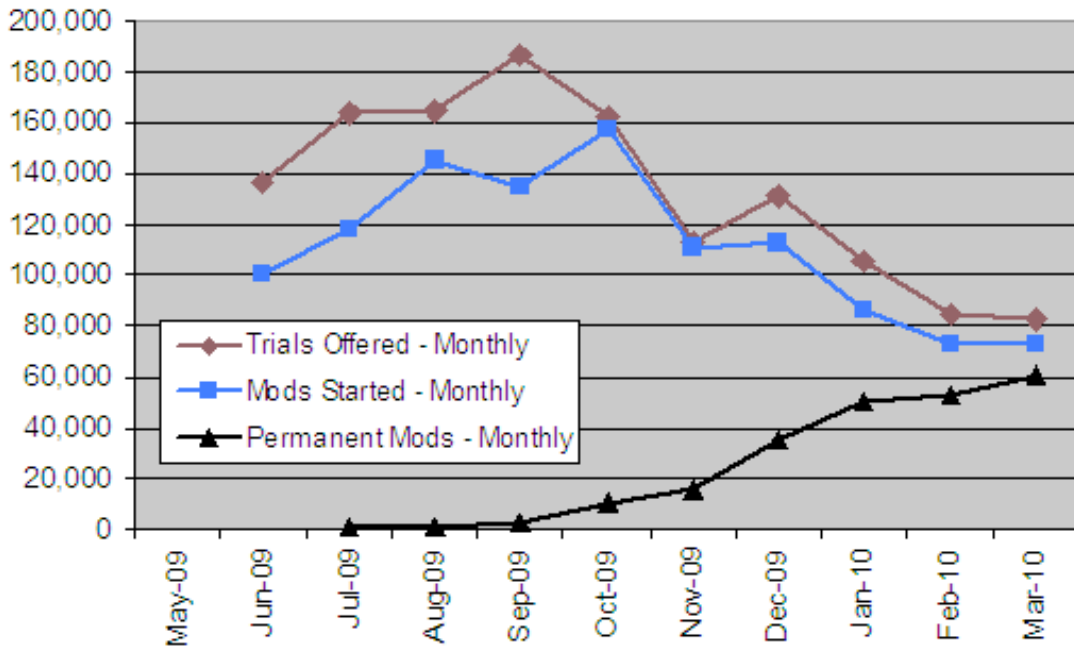
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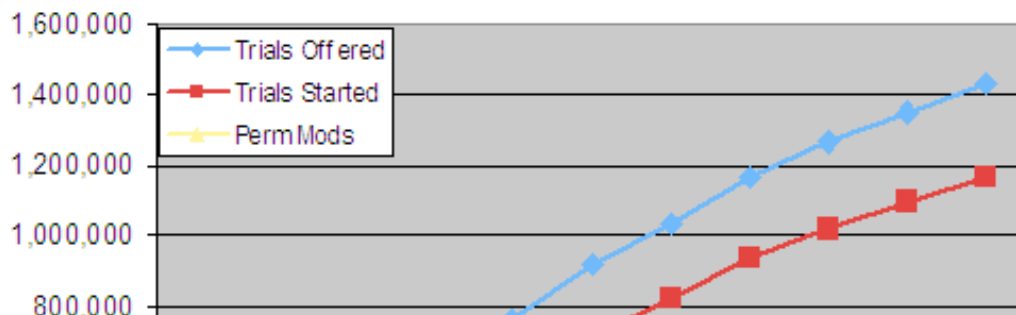
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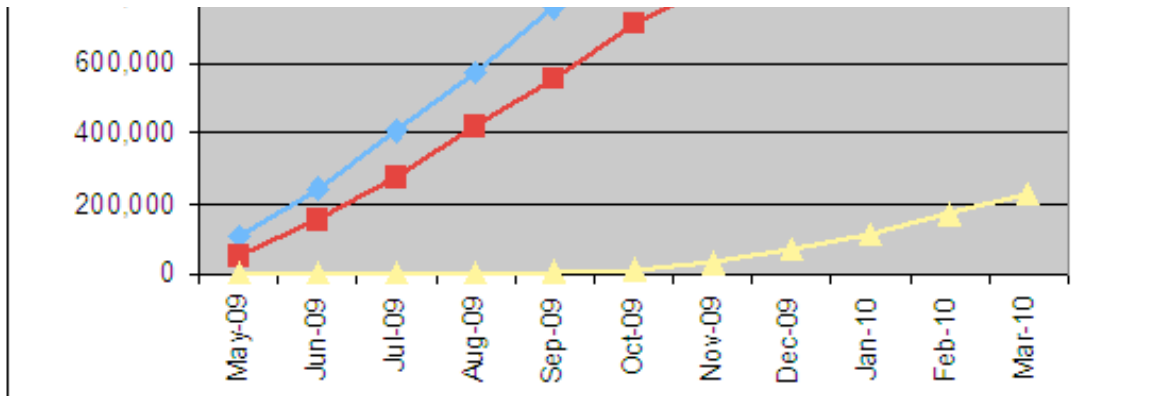
HAMP STATS (MODS OFFERED v. MODS STARTED v. PERM MODS) Monthly Count



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Cum Mods Offered, Trials Started & Perm Mods





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[4-26 Mark H...pdf \(90.9 KB\)](#)