Funny, how the past two weeks were riddled with rumor and *inyourendo* about various forms of additional Fed QE and mass street-level mortgage assistance...two of the equities market's favorite things right before the bomb of a jobs report.

With respect to the rumor of a wide-scale principal balance program, it is true. The next two weeks will be filled with headlines of such. But, of course, the headlines and reality are two completely different things.

1) Wide-Scale Principal Balance Reductions to be (Re)Introduced

Over the next two weeks leading up to the big Aug 17th GSE mixer the **Treasury will re-introduce HAMP 2.0**, already made public and detailed in March but widely forgotten. Over the next month you will be flooded with pr and more analysis from those who blindly think because the term "principal reduction" is in the title of the program, it is the one missing ingredient to success. It's hogwash.

I suspect this is what the recent Reuters article was referring to -- was the author really supposed to remember the day all of this was announced and then understand the differences between HAMP 1.0 and 2.0? To him, as to many when HAMP 2.0 is widely reintroduced in the next couple of weeks, it will be a fresh program full of possibilities. **But, as with it's predecessor, HAMP 2.0 is just more smoke and mirrors designed to protect the banks and kick the can a little further out.**

HAMP 2.0 comes with three new programs 1) a 3-year, earned principal balance reduction to 115% LTV 2) an FHA short-refi program 3) a temporary principal forbearance program for the unemployed.

The centerpiece is program #1), but as I detailed on March 29th **(reproduced as follows)** it is a bunch of smoke and mirrors hastily put out in March when Barney Frank was threatening the banks, hell-bent on mandating principal reductions for everybody. If you remember, there was real fear across financial's at the time.

The primary issues with HAMP 2.0 (program # 1) is that it **does not provide homeowners with functional equity in their property or any sort of debt-to-income ratio relief**, meaning borrowers still end up with a mod at a 65% DTI ratio. At the end of the 3-year term -- **provided house prices do not fall** -- they will just be a little less underwater.

As a long-time mortgage veteran, I can assure you that negative-equity as a stand-alone catalyst is not the primary reason for loan default. Rather, it is the massive monthly payment DTI ratio combined with negative equity. Remember, coming into HAMP **the average pre-mod DTI is over 80% (pre-tax)**, which is a much greater catalyst for loan default than a 150% LTV. Put simply, a borrower with a 20% DTI ratio and a 200% LTV is not at real risk of default. To them, being 100% underwater is more of a mental burden, surely not something they will walk away from from ruining their credit for years.

Bottom line - under HAMP 2.0 a borrower with a 65% DTI and 115% LTV (after 3-years) is in the exact same shape as a HAMP 1.0 borrower with a 150% LTV and 65% DTI...neither can sell, refi, rebuy, save, shop or vacation. Both are simply, over-levered, underwater, renters.

You have to ask yourself, why would a 65% DTI, 115% LTV HAMP 2.0 mod for a borrower with weak credit perform better than a New Century Subprime 100% LTV loan with 50% to 55% DTI ratios? It won't.

What HAMP 2.0 will accomplish. however, is make the HAMP aggregate stats look better. This is because HAMP 2.0 will create a moral hazard cohort (those over-levered homeowners who would have otherwise continued to make their payments just fine **and** strategic defaulters) that will perform much better than HAMP 1.0 borrowers. It will also create an immediate increase in HAMP application activity from said moral hazard cohort homeowners looking for their sump'n-sump'n and from the HAMP 1.0 no-quals run back through the machine as HAMP 2.0 applicants.

Below is a re-print of the report I put out on March 29th detailing why HAMP 2.0 is more of the same under a different name. Everything still holds true.

M Hanson Advisors – Real Estate & Finance

'The Mortgage Pages' *- March 29th 2010*

- **Final-Final - Principal Balance Reduction HAMP…A Step Backward**
- **FHA 115% Short Refi - Bank's and Distressed Investor's Dream Loan**

1) Introduction

This report drills down on the newly announced HAMP 2.0, which includes the i) 3-year buy-down to 115% LTV (principal balance reduction mod) for HAMP-eligible loans (mostly GSE) ii) the FHA instant 97.5% LTV/115% CLTV short refinance program designed mainly to help the banks and distress loan owners get top-dollar for their distressed loan assets, including a large sum for second mortgages in-line to be wiped-out, and iii) HAMP for unemployed borrowers, which provides short-term principal forbearance.

Because the HAMP 2.0 program summary contains the term "principal reduction" -- albeit a long-term, earned reduction which still leaves them significantly underwater and that does nothing to reduce the borrower's monthly payment debt-to-income rations, the primary catalyst for loan default -- it's being heralded as the final "solution". However, in practice its effectiveness and impact on mortgage and housing going forward will be a far cry from consensus view.

Now that everybody has had a chance to put forth an opinion, **a major goal of the principal mod** I highlighted in Thursday evening's report has **already been achieved**…the headlines are so good and most analysis and reporting so off-base, that it will likely keep legislator-istas who are actively pushing for a real first and second mortgage principal balance reduction -- that favors the homeowners and not the banks -- at bay for a while.

It is very important to get this one right because the 'principal balance' headlines have also fooled some of the top mortgage & housing analysts. It may force them to greatly improve their default, foreclosure, loss severity, bank earnings, or house sales and price assumptions, which would be a mistake.

Even though the new program has "principal balance reduction" in its title it does not get to the heart of the problem. Because of this, it should not have a meaningful impact on most of the millions presently in the delinquency-to-foreclosure pipeline. In fact, I believe that counter-intuitively -- combined with other aspects of the Treasury announcement -- it should have the effect of increasing the count and velocity foreclosures and HAFA liquidations ultimately hurting macro-housing.

A successful, permanent solution would cram down borrower debt-to-income leverage, which none do at present. In fact, the average HAMP permanent mod **debt-to-gross income ratio in Feb '10 was 59.8%.** This is a level never allowed by any lender on full-doc loans even at the height of bubble-years craziness.

Like its predecessor, HAMP 2.0 was born to protect the banks and as a can-kicking tool vs. a true homeowner assistance program, which is why it is already destined to fail. The average level homeowner indebtedness is far too great, the hurdles to achieve the principal reduction reward too high, and the reward itself too small, intangible, and far away, for it to significantly improve on the HAMP 1.0 results. In our instant gratification society and given the fact most distressed homeowners have leverage ratios that can't be maintained for any length of time, a reward three years away -- which requires the borrower to remain in debtor's prison the entire time, loses most or all its benefit if house prices are not at the bottom, and that at 115% LTV max benefit still leaves them underwater renters in their own home -- is simply not a big enough carrot.

However, it could make a difference for a certain percentage of the **strategic defaulter and borderline distressed groups (moral hazard cohorts),** the latter of which would have otherwise never defaulted or considered a mod, but with the new program in place becomes a wise decision. And by increasing the involvement of these two groups -- who are stronger candidates -- the overall program results will benefit even if the performance of the **primary distressed loan cohort**, which is currently all that HAMP 1.0 caters to, performs no better (by mixing in a bunch of better apples the apple-sauce will taste and smell better).

The bottom line is that because home equity extraction has been virtually impossible for three years, new purchase loans require much more cash down and higher borrower standards than ever, and short sales are becoming widely accepted by homeowners and the banks, ***effective*** **negative-equity (owing more than what is necessary to sell and re-buy given downpayment requirements for new-vintage loans) is far more pervasive than is commonly thought and home equity does not mean what it used to.**

Outside of the economist's fancy models, Joe Homeowner with 5% *positive* equity or his neighbor with 50% *negative* equity stand in the exact same position. Both are trapped. They can't cash-out or freely sell and re-buy, which requires paying off their mortgage, paying the Realtor 6% and putting 10-20% cash down on the new vintage loan.

At the end of the day both they are underwater, over-levered renters; renters who pay 60%+ of their **gross** income to debt each month and who will eventually be forced to downsize regardless of their equity position.

This new program could actually be looked at as a step backward because if it takes a year and a half to debunk this one like HAMP 1.0 then the original HAMP, it means a real solution is that much further away.

2) HAMP 2.0 (Principal Reductions) Misses the De-leveraging Target

Most analysts are looking in the wrong place by giving **'negative-equity'** as a stand-alone metric far too much weighting**.** Few understand that being over-levered with respect to DTI **and** being in a negative-equity position, together, make up the ideal conditions for loan default.

As an example, somebody who owes 50% more than their house is worse but only pays 20% of their income to service debt each month is at little risk of default. For them it is more of a mental than balance sheet burden. Yet, somebody who owes more, equal or even less than the house is worth but pays 60%+ of their gross income out each month to debt is at serious risk of default. Yes, people at par or with positive equity frequently default. In fact, before house prices crashed most all defaults were from those in a positive equity position.

HAMP 2.0 mod makes zero provisions for de-levering the borrower out of the gate when it counts, which is the same as its predecessor. It also makes no provisions for falling house prices.

With respect to the truly distressed and not the moral hazard cohorts, there is absolutely no reason why HAMP 2.0, based upon the way the principal balance reduction is structured, will perform measurably better with respect to no-qual and re-default rates than HAMP 1.0 given that the monthly payment amount and average DTI's for both are exactly the same.

This is in stark contrast to the **$300 billion FHA Hope-for-Homeowners loan program**, which has never been accepted for the simple reason it is a permanent, up-front solution that fully de-levers the borrower at closing and requires the lender to take the up-front.

3) HAMP Debtor's Prison Comparison - A Picture is Worth Thousands of Words

The following looks at 1) a before mod scenario 2) an old HAMP mod 3) a new principal mod typical scenario that would includes both a principal and rate reduction (note - final equity position is after 3 years) 4) a Hope-for-Homeowners refi using front and back DTI stats from the Feb HAMP report (note - final *positive* equity position is immediate).

A) **There is NO fundamental difference between the current HAMP (#2) and the Principal Reduction HAMP (#3)**. The average HAMP borrower is still severely over-levered because no provisions have been made to get rid of the back-end DTI ratio debt.

B) At the end of three years of making payments on time, **the principal mod is still underwater just not by as much**. And based upon the average HAMP DTI, for three years leading up to the final principal reduction, most were unable to save, save, shop or vacation, a tall order.

C) Why is being 15% underwater or flat after three years of living in debtor's prison as part of HAMP 2.0 better than being 50% underwater when the equity can't be spent, the borrower can't move or refi, and for years they have been unable to save or spend a dime outside of debt?

Bottom Line: Why would HAMP 2.0 (#3) perform any better than 1.0 (#2) when at the end of the day, the final metrics are the same? How does #2 or #3 really help homeowners when de-leveraging and saving money should be top priority and the homeowner's to save will win out? And what happens to #3 if values drop a conservative 2% to 5% per year for three years?

All of these scenarios except the Hope-for-homeowners suck the income right from the employers, through the borrowers and into the hands of the creditors leaving them nothing. The new Mod still leaves the borrower over-levered, underwater renters unable to sell, refi, re-buy, save, shop of vacation.

Comparing Modification Strategies and Borrower Leverage	1) Before Mod (based upon Feb HAMP rpt)	2) Old HAMP Mod (DTI's based upon Feb HAMP rpt)	3) New Hamp Principal Mod (Princip + Rate Reduction)	4) Hope-for-Homeowners (the right solution)
Current House Value	$300,000	$300,000	$300,000	$300,000
Current Loan Amt (incl fees etc)	$400,000	$400,000	$400,000	$400,000
Adjusted Loan Amount	na	na	$345,000 (115%)	$270,000
Interest Rate	5.50%	2.00%	4.13%	5.50%
Gross Income	$6,000	$6,000	$6,000	$6,000
Mortgage PITI	($2,700)	($1,878)	($1,878)	($2,280)
Front DTI	45%	31%	31%	38%
Total Mo. Payments (Mortgage + all debt on credit report only)	($4,584)	($3,588)	($3,588)	($3,000)
Back DTI (per HAMP report)	76.4%	59.8%	59.8%	50%
Income (Before Taxes & All Other Life Expenses)	$1,416	$2,412	$2,412	$3,000
Taxes	($1,500.00)	($1,500.00)	($1,500.00)	($1,500)
Mo Household Expenses	($1,000.00)	($1,000.00)	($1,000.00)	($1,000)
Net Income	($1,084.00)	($88.00)	($88.00)	$500.00
Re-default rate 3 mos		28%	?	?
Re-default rate 12 mos		58%	?	?
Ending Principal Balance	$384,000	$400,000	$328,000	$270,000
Equity Position	($84,000)	($100,000)	($28,000)	$30,000
data taken from OTS and HAMP reports				
ending balances assume fully amortized payments for 3 years				
equity position assumes house values stay flat for 3 years				

4) The Hope-for-Homeowners (H4H) Program is the Way it Should be Done

It is obvious by the chart above that the $300 billion H4H program is the winner hands-down and yet, nobody wants to talk about this $300bb, Congressionally-approved dinosaur.

This is because the day borrowers get a new H4H loan they are mostly de-levered and have their principal balance reduction in hand. The borrowers are once again free to sell, save, shop and vacation. With a little work growing income or through further de-leveraging brining down the 50% back-end DTI, they could be sitting really pretty. But this is also a loss here and now for the lender.

What does this tell you about the new HAMP 2.0 'principal balance reduction' program?

The numbers in the previous chart prove that this is more smoke and mirrors. If they really wanted to make an effective principal mod program, they could have tweaked H4H that has $300 billion behind it - many times the amount of backing as this new program.

The reason the HAMP principal mod was not done this way is because it would hurt the lenders too badly. So, to appease political pressure, they put the new HAMP program out calling it a 'principal balance reduction' program, knowing full well it will cost much less, few would make it three years, and on the few that do make it to term, the losses are spread out over three years.

5) Who Will Benefit Most from the New HAMP?

1) **Truly Distressed** for whatever reason (most of the 8 million delinquent, defaulted or in foreclosure now)

2) **Moral Hazard Cohort** - Those who are over levered and/or underwater who would have otherwise continued to make their payments and will only default due to traditional life circumstances

3) **Premeditated defaulters** (also part of Moral Hazard cohort)

Group 1) mostly represents **column 2)** in the chart above. This profile fits most of the borrowers who have gone through HAMP to date. If HAMP could start over again with the exact same group of borrowers run through HAMP 2.0 to begin with, we would likely be sitting here right now talking its failure vs the failure of the present HAMP 1.0.

However, **group 2)** would have been effective in increasing the total number of applicants, temp mods and the temp-to-perm mod rate for the entire program. The better results from the large moral hazard cohort, who would have never applied for HAMP otherwise, will change the program result metrics making the entire program look marginally better.

Group 3), who are beginning to become a force, is where the new HAMP may help some. And because this group is more like group #2 with respect to borrower strength, it will help better overall reported HAMP performance. But this group is smart and a large percentage will realize that this program is smoke and mirrors and only use it to mark time.

6) What will be the Greatest Effects of the New HAMP? -- Increased Foreclosures & HAFA Liquidations

Clearly, the hype and misunderstanding of this program will drive interest in it, which is part of the master plan. The moral hazard cohorts are the two groups likely to be the most piqued -- a big negative. It will also keep the likes of Barney Frank who has often talked about wide-scale principal reductions at bay for a while, a huge benefit to the banks.

For a certain percentage of the truly distressed this will be a deciding factor in applying, completing the trial and staying current for three years. It just will not be as large as most predict for reasons made clear at the beginning of this report.

The ultimate fate of most of the millions presently in the default and foreclosure pipeline, many for which the timeline can be measured in years, or the million+ loans, which are presently HAFA-liquidation eligible, will be likely be the same with or without the new initiatives.

I also believe that this program will inadvertently increase foreclosures and HAFA liquidations for the same reason I have argued for months.

As part of the flurry of announcements in late March was that servicers must begin to embark on a much earlier and more robust borrower outreach initiative than exists today, which is virtually nothing. This will define and streamline the default and foreclosure process.

The servicers can't do this in-house, so most are contracting with every large real estate shop and outsourced loss mitigation provider in the nation in order to serve as extensions of themselves in the field.

Because servicers, through their outsourced agents, will be hitting borrowers hard beginning at 31-days late -- to either apply for HAMP or formally reject it -- the pool of HAMP *no-quals, don't wants*and *busted trials* diverted to foreclosure or a HAFA solution will grow quickly and remain full.

For the past several months, indications have been that 2010 will be the fist year of a major asset liquidation phase but with so many millions of loans in the pipe and so many entering each month, it has to be managed or it will crush the housing market, especially post tax-credit when I expect resale volumes to plummet. Adopting these programs will help manage this chaos, but will not avoid it.

7) The FHA 115% Short Refinance - the Distressed Investor's and Bank's Dream Loan

The more I thought about the FHA 115% refi -- that I called 'interesting and 'a lot like Home for Homeowners' in my first report last week -- and the HUD secretary saying "it's nothing like H4H in an interview with Diana Olick last week", the more I got excited about it. However, I still stand by this one -- it is the cousin of H4H if used the right way.

This program was not designed for the retail loan officer and borrower because the lender will never just discount the principal balance on a current borrower in order to allow a refi.

But it is the ultimate liquidation channel for the distressed investor, servicer, or bank to clear distressed loans they may have purchased at a significant discount, inherited, or were forced to buy back. ,

This is because the FHA short-refi allows for a 97.75% LTV refi while not wiping out the second mortgage, as the CLTV allowed is 115%. This is the key difference between the new program and H4H and why banks will fully endorse it.

Granted, some medium to longer term tactile servicing will be involved in order to get them paying on-time for a few months -- a requirement of the program -- but that's an easy sell.

How can the homeowner turn it down? Basically, if they can make six or so payments on time, their first mortgage principal will be cut to 97.75% immediately. In addition, for the 40% to 50% with second mortgages, they will be reduced so as to not exceed 115% CLTV -- not a bad deal. The best part about the FHA short refi program is that the borrower walks away mostly de-levered at 31/50 debt-to-income ratios. This is the way mods should be done.

Now, we also know why certain funds have been buying up mortgage bankers across the country. It definitely was not for the organic mortgage growth in 2010 and beyond.

Best Regards,
Mark Hanson
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