

M Hanson Advisors – Real Estate & Finance

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

Introduction

This report drills down on and summarizes only the HAMP principal balance reduction mod and the new FHA 115% short refinance programs, both of which in practice will end up far from consensus view of effectiveness, and their impact on mortgage and housing going forward.

Now that everybody has had a chance to put out 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 want to mandate 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 the course of millions presently in the delinquency-to-foreclosure pipeline and counter-intuitively -- combined with other aspects of the Treasury announcement -- should have the effect of increasing the count and velocity foreclosures and HAFA liquidations.

A successful, permanent solution would cram down borrower debt-to-income leverage, which no mods do. In fact, the average HAMP permanent mod **debt-to-gross income ratio in Feb was 59.8%.** This is a level never allowed by any lender on full-doc loans even at the height of bubble-years craziness.

The average level of troubled 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 this program to significantly

change the HAMP redefault results for truly troubled borrowers. In an instant gratification society a reward three years away -- that requires the borrower to remain in debtor's prison and that may lose some or all its benefit depending upon house prices -- is simply not a big enough carrot.

However, it could make a difference for a certain percentage of the **strategic defaulter and moral hazard cohorts**, the latter of which is those who would have otherwise never considered a mod, but with the new program in place becomes a wise decision. And by increasing the size of these two groups -- who are stronger candidates -- the overall program results will benefit even if the performance of the **primary distressed loan cohort** performs no better.

But the bottom line is that because home equity extraction has been virtually impossible for over two years, new purchase loans require much more cash down than they used to, and short sales are becoming widely accepted by homeowners and the banks, **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 they are both renters. And renters, who pay 60% of their **gross** income to debt each month, 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 to debunk this one like it did the original HAMP, it means a real solution is that much further away.

Principal Balance Reduction HAMP - 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 this market and before this housing crash made up most of defaulter universe.

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

There is absolutely no reason why -- based upon the way the new principal mod is structured -- it will perform measurably better with respect to no-qual and redefault rates than the present HAMP 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 hit today.

By virtue of the politicians doing nothing to make it easier to get the already Congressionally approved \$300bb spent and instead turned to this new mod, it screams loudly as to how they think the latter will perform.

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 ex-housing 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 for three years leading up to the final principal reduction, they were unable to save,

save, shop or vacation.

- C) Why is being 15% underwater or flat after three years of living in debtor's prison better than being 50% underwater when the borrower is still effectively underwater, the equity can't be spent and for years, the borrower has been unable to save or spend a dime outside of debt?

Bottom Line: Why would #3 perform any better than #2 when most in #2 mods don't complete their trial period or re-default within 12-months when at the end of the day, everything is mostly the same? How does #2, or #3 really help homeowners when deleveraging and saving money should be top priority? What happens to #3 if values drop a conservative 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 or 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				

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 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 bringing 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 'principal balance reduction' program?

It tells me it is a bunch of smoke and mirrors and the numbers in my chart above back it up. 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.

Who Will Benefit Most from the New HAMP?

Let's bucket the HAMP universe

- 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 will continue to make their payments and will only default due to traditional life circumstances
- 3) **Premeditated defaulters**

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 the new program, we would likely be sitting here right now talking about the sky-high redefault rates and ultra-low permanent modification rate.

However, **group 2)** would have kicked 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 results 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.

What will be the Greatest Effects of the New HAMP? Should Drive Increased Foreclosures & HAFA Liquidations

Clearly, the hype and misunderstanding of this program will drive interest in it, which is part of the master plan. Premeditated defaulters and the moral hazard cohort are the two groups likely to be the most piqued -- a big negative. It will also keep the likes of Barney Frank away for a while, a huge benefit to the banks.

For a certain percentage of the truly distressed this will be a deciding factor for 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 800k loans presently targeted for a HAFA liquidation, will be likely be the same with or without the new initiatives.

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

As part of the flurry of announcements on Friday 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 on their own and 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 first 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. Adopting these programs will help manage this chaos, but will not avoid it.

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 a dream for the distressed investor, servicer or bank to clear distressed loans they may have purchased for 60 cents of property value, inherited, or were forced to buy back, for 97.75% of the property value while not wiping out second mortgages, as the CLTV allowed is 115%. This is the key difference between the new program and H4H and why banks will like this one.

Granted some tactile servicing getting the distressed borrowers paying on time for a few months will be necessary if not already done, but to the borrower that's an easy sell. Basically, if the borrower can make six or so payments on time, their principal will be cut to 97.75% immediately plus any second mortgage - not a bad deal. And 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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This is a short, but necessary update to my 3-29 Principal HAMP Mod commentary (included below). My analysis, which I stand by fully, raised a lot of eyebrows mostly from those who, before I published, were leaning the way of consensus...that it is a game changer.

But I believe that consensus opinion has been born by comparing it to legacy HAMP for which we have limited perm-conversion and redefault data -- mainly because the permanent loan mod drive is only four months old and the program itself less than a year old -- and not to legacy Subprime, Alt-A or Pay Option loans themselves for which we have years of performance data. When it comes down to it, mods are just new loans, but much riskier, inbred, Frankenstein second cousins to anything ever dreamt up by the most radical lender during the height of the bubble years.

Most analysis gives negative equity as a stand-alone metric far too much weighting while not giving enough weighting to that fact that **a)** post-mod, there is no difference in DTI leverage or negative-equity position between the two HAMPs **b)** both HAMPs incorporate Debt-to-Income and LTV leverage that even the worst Subprime lenders during the bubble years thought was too risky **c)** and, if house prices don't increase or sentiment begins to turn down all mod performance, particularly new HAMP, will quickly become even worse.

With respect to the core group of truly troubled borrowers in mods to date putting them into a new high-leverage Subprime loan (HAMP) -- but with expanded parameters that make it an order of magnitude more risky than a 2005-2007 vintage Subprime loan -- ultimately will not be effective even with a principal balance reduction after three years (that still leaves them underwater).

After 20-years originating, approving, buying and selling 10s of thousands of loans and working with every investor that ever existed, I know mortgage loans and borrowers. And neither HAMP has any qualities of a good loan other than the 31% housing-only DTI. But by not regulating the total debt allowed (the back-end DTI which averages 59.8% of gross income for legacy HAMP), the 31% front DTI loses all it's punch.

Follow me for two minutes over a few bullet points so you fully understand why the new HAMP Principal Mod is more of the same and if in place from the beginning, would have not meaningfully changed the results or re-default rate for the average distressed borrower in a HAMP mod today.

Bottom line:

1) The three common characteristics of all legacy Subprime loans were high maximum LTV's up to 100%, high maximum full-doc debt-to-income ratios of 50%-55%, and low credit scores below 620.

2) Like most mods, the new HAMP Principal Mod is nothing more than a new Subprime loan but with greatly expanded LTV (115%) and DTI (59.8% +/-) thresholds and a lower credit score allowance than anything ever originated during the bubble years. We don't know the average CLTV of perm HAMP mods, but let's safely assume it is higher than the 100% max LTV that lenders allowed during the bubble years.

3) During the bubble years anybody alive or dead could get a loan and there was no investor -- not even New Century -- foolish enough to do a full doc loan to 60% debt-to-income ratios at 115% LTV. Why not? Because New Century and alike did not take that much risk.

4) Mods are meant as a permanent solution unlike legacy Subprime loans, which for the most part were gateway loans never intended to be permanent.

5) When a household pays out 60% of their GROSS income each month to debt listed on the credit report (before food, gas, clothes etc) they are renter debt-slaves. They need desperately to de-lever and home equity is an after thought. They surely won't quit paying their credit card, car payment, health insurance, or food, which they need. Certainly, the promise of a 115% LTV three years away -- provided house prices do not continue to fall -- is not enough to keep most people living this over-levered for any length of time. Massive DTI leverage accounts for the near 70% 12-month 30-day late re-default rate across the mod universe after a year per the most recent OTS report.

6) A deeper LTV cut will not work on its own either because it would have to be far to large and below the value of the house to bring the average 60% DTI HAMP mod in line with safe 40%-45% back-end DTI levels.

The only way mods are going to be permanently successful for truly distressed borrowers is to somehow cram down second mortgage and other debt down 40%-45% of the borrowers gross income. In fact, I argue that a 40% DTI loan at 150% LTV will perform better than a 60% DTI loan at 115% LTV as with the new HAMP.

7) In the real world -- 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 renters. 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.

However, for some -- particularly the premeditated defaulter and borderline risky borrower (moral hazard cohorts) -- it will be enough. But the lure of something for nothing will also drive many more into mods who would have otherwise not, which is a negative.

In addition, with all the press this program is getting and the fact that servicers are now required to get borrowers into HAMP much sooner in the default process, more loans will be headed for foreclosure or a HAFA solution quicker resulting in more distressed real estate on the market. Remember, over the past year HAMP has served as a de-facto moratorium. Loan default for many can be measured in years and actual foreclosures have been running at 50% potential. The new servicer protocol will change this dramatically by defining and streamlining the default and foreclosure process.

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