



AKROS CAPITAL, LLC

## Lend, Amend, Extend and Pretend

October 12, 2009

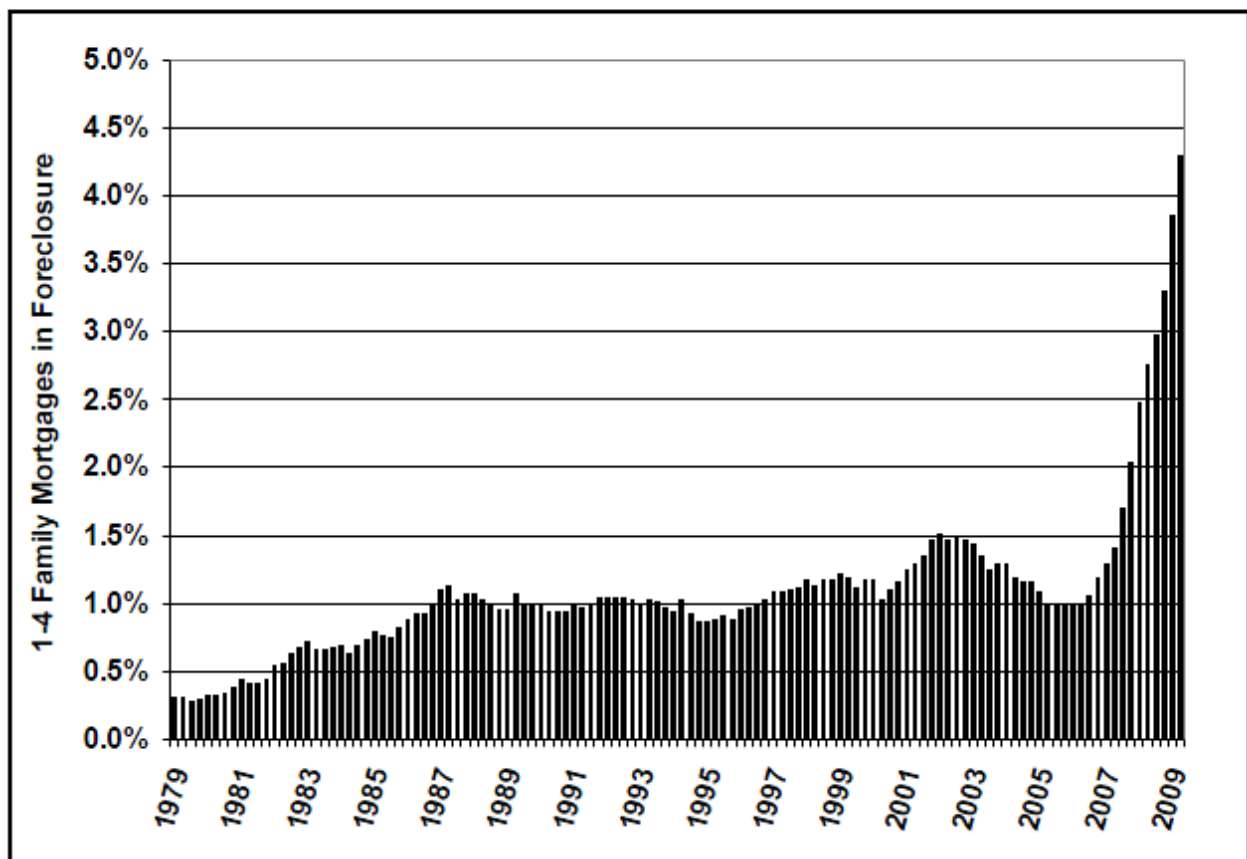
“With sustained high unemployment, even the most aggressive loan-modification program will not help where there is no income.”

– *Bank of America Corporation*

Loan-modification efforts will not be able to stem the rising tide of foreclosures. While some people will be helped at the margins, the root causes of foreclosure – negative equity and unemployment – will continue to exact their toll. Far too often, loan modifications merely delay the inevitable. In the meantime they allow the lender to pretend the loan will be repaid, while allowing the “homeowner” to pretend he or she is a net owner rather than a net debtor.

The graph below illustrates the dramatic acceleration in the home-foreclosure rate.

**Percentage of Single Family Residential Mortgages in Foreclosure**

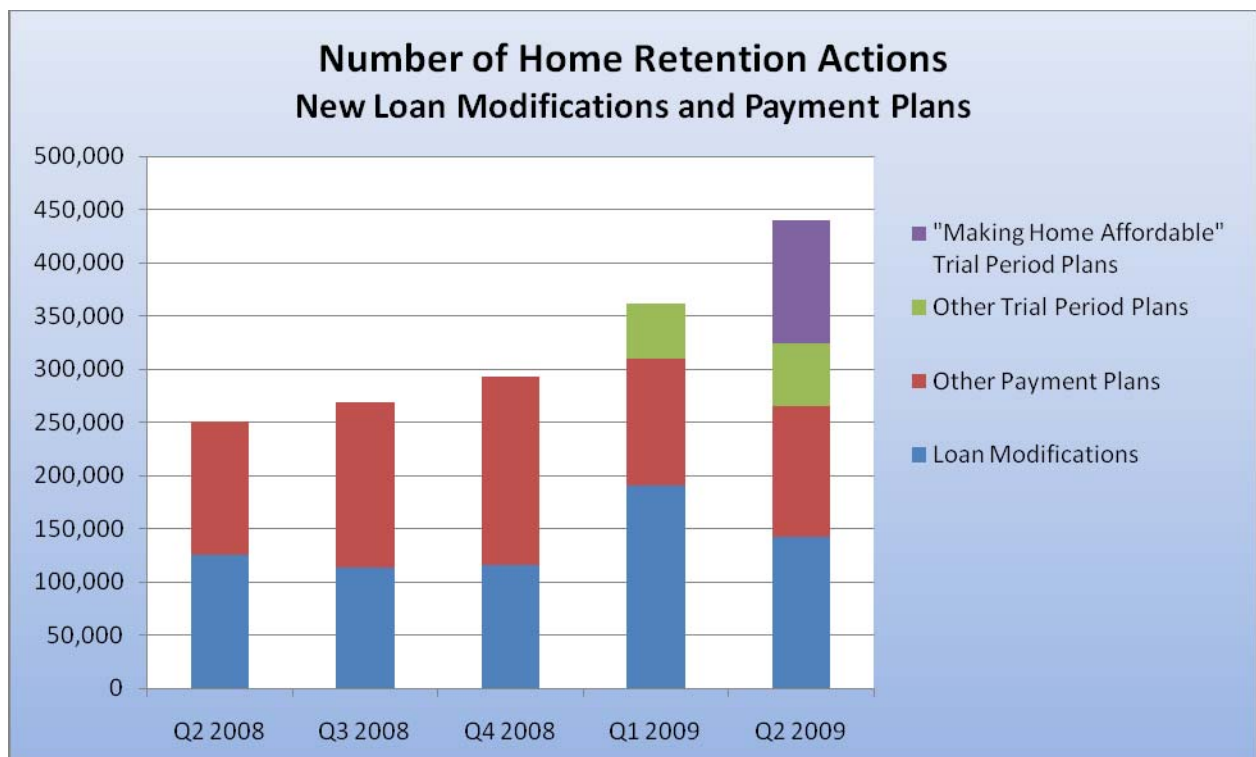


As of June 30, 2009, the Mortgage Bankers Association reported that 4.3% of mortgages were currently in foreclosure. The foreclosure rate was 15.05% for subprime loans and 24.40% for subprime adjustable-rate mortgages. These rates do not include people who avoid foreclosure by giving up their homes in preforeclosure sales (short sales) or deeds-in-lieu transactions.

Policymakers look at the high subprime default rates and conclude they must be attributable to the loans themselves. Accordingly, in early March the Treasury unveiled its "Making Home Affordable" (MHA) initiative. The idea was, since foreclosures were caused by "bad loans," modifying all those bad loans would stop foreclosures. Though the program has many complex elements, it essentially bribes lenders to modify mortgages and bribes borrowers to stay current on their payments. Because these subsidies are added to the national debt, the program effectively rewards bad decisions by transferring a portion of their cost to taxpayers.

The reason for using subsidies in the first place is loan modifications often do not make economic sense for any of the parties involved. From the lender's perspective, the benefits of a modification are reduced by the possibility of redefault, while the costs are increased by the fact that some borrowers would have repaid their loans anyway. For borrowers, often a modification merely offers them the "privilege" of making a stream of future payments whose net present value is more than the house is worth. And the disincentives for the borrower to make repairs to the property give the lender a reason to want to foreclose sooner rather than later.

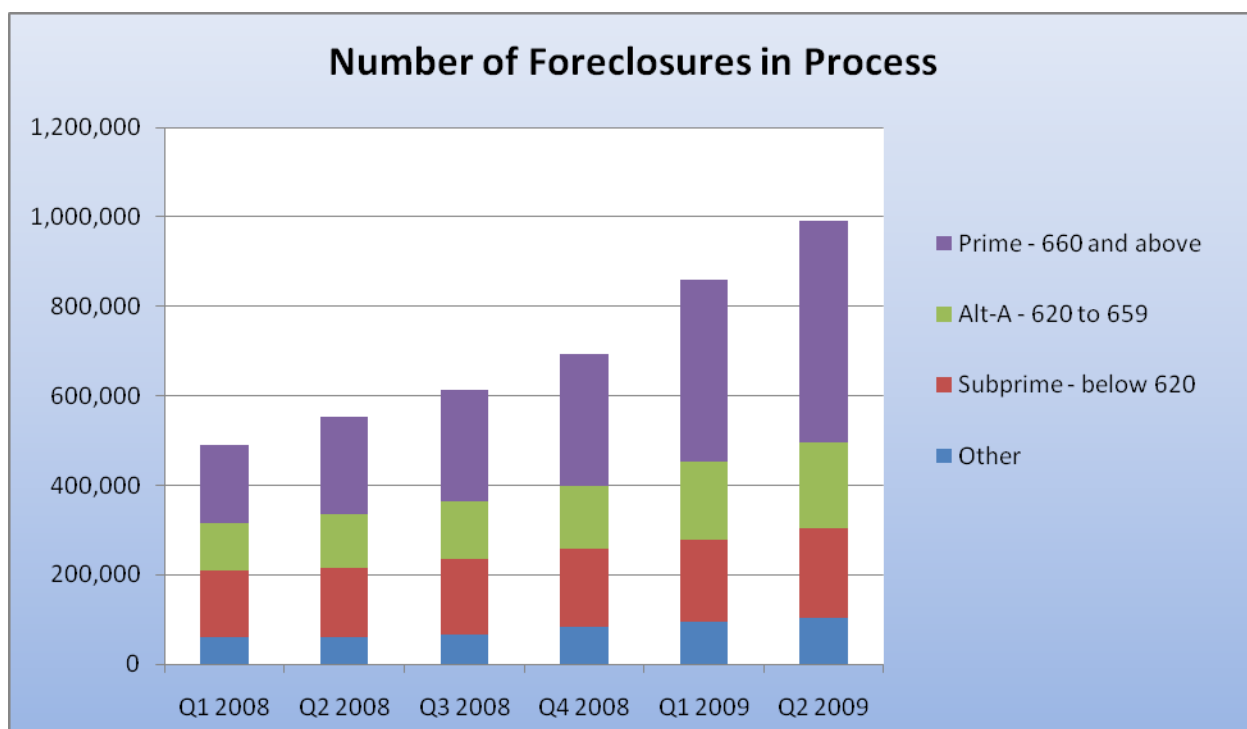
The next three graphs use data from the *Second-Quarter 2009 OCC and OTS Mortgage Metrics Report*, which covers approximately 64% of all first-lien U.S. mortgages. The first one plots home-retention actions by quarter.



As the graph shows, loan modifications actually fell during the second quarter, as lenders instead opted for so-called “trial-period plans” such as those included in the government’s MHA program. These plans are often just stalling techniques for lenders to postpone foreclosures and the write-downs that ensue. In the case of MHA the lender also becomes eligible for government subsidies if the loan is ultimately modified after a successful three-month trial. Apparently, the government’s subsidization of trial-period plans may have crowded out some of the economically sensible loan modifications that otherwise would have taken place.

Moreover, by attributing foreclosures to “bad loans,” foreclosure-mitigation efforts based solely on loan modifications are likely to meet with limited success. To see why, take another look at the graph on the first page and note the data encompasses several past recessions. Yet, the previous peak in the foreclosure rate was barely one-third of what it is now. The difference this time is negative equity – large numbers of homeowners whose remaining mortgages exceed the value of their homes. In previous recessions, when home values were rising, these people simply would have sold their homes and pocketed whatever remained after paying off the mortgage. That option is not available when the home is underwater.

The next graph drives this point home nicely. It breaks down foreclosures by category of loan, as defined by the borrower’s credit score at the time of mortgage origination.



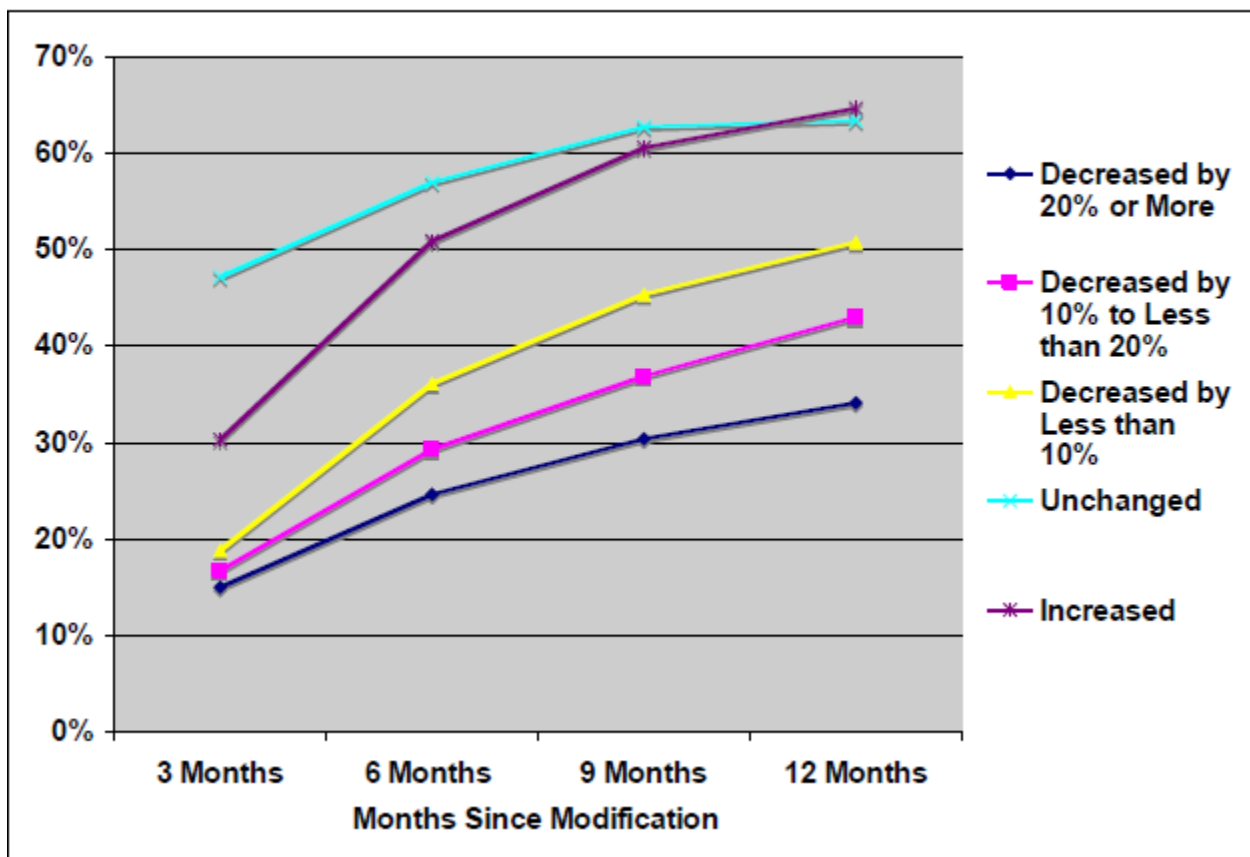
As the graph clearly shows, foreclosures cut across all categories. Most notably, prime loans now account for fully half of all foreclosures. The reason is foreclosures generally occur when a borrower with negative equity experiences a “triggering event,” but cannot sell because the house is underwater. Foreclosure-triggering events, such as unemployment, illness, death, divorce or retirement do not discriminate by borrower or type of loan.

As for why the foreclosure rate is higher among subprime borrowers, the graph's legend provides much of the explanation. Subprime borrowers are less creditworthy than prime borrowers, which is why they took out subprime loans in the first place. Subprime borrowers, on average, have lower incomes and less savings, and thus are less able to withstand foreclosure-triggering events without defaulting on their mortgage payments.

To be sure, unfavorable loan features can factor into many subprime defaults. But, regardless of borrower or loan type, the one-two punch of negative home equity combined with a triggering event remains the primary driver of foreclosures. Currently, about one-third of all residential mortgage borrowers have negative equity and another 5% have near-negative equity. With unemployment now pushing toward 10%, it is clear the foreclosure problem is not going to go away any time soon.

Unemployment, of course, remains the triggering event *du jour*. Unfortunately, an unemployed borrower may not be in a position to make any mortgage payment at all, even a modified one. If the home is underwater, the borrower has little incentive to sacrifice other areas of spending in order to pay the mortgage. This explains why over half of all loan modifications redefault within the first year after modification. The final graph breaks down the redefault rate by the change in mortgage payment resulting from the modification.

**Redefault Rates of Loans Modified in 2008 by Change in Payment  
(Redefault = 60+ Days Delinquent)**



As might be expected, the graph demonstrates that the redefault rate tends to decrease as the mortgage payment is reduced. However, even when the payment is decreased by 20% or more, a very high 34% of modified loans redefault within the first 12 months.

Clearly, loan modifications will not solve the foreclosure problem. For borrowers, loan modifications may make mortgages somewhat easier to bear, but they do not change the underlying factors that caused the defaults in the first place. And for lenders, to amend is often just a way to extend and pretend.

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