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Mortgage Modification Program Falls Short

December 21, 2009

“The banks are not doing a good enough job. Some of the firms ought to be embarrassed, and they will be. They’re not getting a penny from the federal government until they move forward.”

– *Michael S. Barr, Asst. Sec. for Financial Institutions, U.S Dept. of Treasury*

Earlier this month the Treasury reported results for its Home Affordable Modification Program (HAMP). The numbers were not encouraging. Of an estimated 3.3 million borrowers eligible for the program, only 31,382 permanent mortgage modifications had been completed. Officials in the administration and in Congress expressed outrage at the banks as typified in the above quote from an Assistant Treasury Secretary.

While such expressions of indignation may have scored a few points with an angry public, they soon were exposed as political posturing. In sworn testimony before the House Financial Services Committee, a different Assistant Treasury Secretary revealed the HAMP eligibility estimates had been wildly overstated:

“Based on a recent survey of servicers, we estimate that as of the beginning of November there were fewer than 1.5 million homeowners who were both 60+ days delinquent and likely to meet the HAMP requirements. This puts the approximately 650,000 borrowers who had begun trial modifications as of the beginning of November in a more complete context. As we have continually stressed, while no one wants to see foreclosures, not all delinquent borrowers will qualify for HAMP modifications.”

– *Herbert Allison, Asst. Sec. for Financial Stability, U.S Dept. of Treasury*

By this measure the banks would appear to be doing a fine job: Out of fewer than 1.5 million eligible homeowners, trial modifications already were underway for about 650,000, or 43%.

Supporting this view is an estimate from Bank of America, which accounts for nearly one-third of all loans targeted by the program. According to the bank’s credit-loss mitigation strategies executive, 55% of borrowers aren’t eligible because they are unemployed, don’t live in the home or their mortgage payment is less than 31% of gross monthly income. Applying the corresponding eligibility rate of 45% to the estimated 3,219,192 borrowers listed in the Treasury’s HAMP report as of the beginning of November yields $.45 \times 3,219,192 = 1,448,636$.

This agrees closely with Assistant Secretary Allison's estimate of "fewer than 1.5 million." Despite tough talk from an administration supposedly outraged at the banking industry for "not doing a good enough job," there appears to be little or no disagreement as to the basic fact that far fewer borrowers qualify for the program than originally had been claimed.

Paperwork, Paperwork

In today's world of securitized loans, mortgage modifications are critical for underwater borrowers and for those whose incomes are low in relation to their mortgage payments. Refinancing generally is not an option for such people because the current holders of the note would be paid off, and no new lender would underwrite a loan greater than the value of the collateral or to a borrower with insufficient income. So, for many, a modification is the only way to take advantage of historically low interest rates.

That being said, obtaining a permanent HAMP modification requires proving one's income, submitting tax returns and essentially divulging one's entire finances. Unfortunately, many borrowers may not want to turn over all of the required documentation. This may be especially true for those who originally took out so-called "no-doc loans" or "liar loans" using false information. Others may have income not reflected on their tax returns.

J.P. Morgan Chase & Co. Chairman and CEO Jamie Dimon addressed the missing-paperwork mystery at the Goldman Sachs U.S. Financial Services Conference on December 8. Below is a section from one of his slides, which indicates documentation problems in $51 / 71 = 72\%$ of otherwise-successful HAMP modifications. Bank of America reports this ratio as 50,000 out of 65,000 customers, or 77%. These figures are supported by Assistant Secretary Allison's testimony that only about 30% of borrowers in trial-period plans have turned in the necessary paperwork to qualify for a permanent loan modification. That's another way of saying 70% have not. Here again the facts do not seem to be in dispute, only their interpretation.

For every 100 seasoned⁴ HAMP trial modifications offered:

- 29 customers do not make required payments
- 71 customers make all 3 required payments
 - 51 do not submit all documents required or submitted documents that require refinement for underwriting
 - 20 submit documentation required for underwriting
 - Most will be approved for HAMP modification
 - Failures a result of inconsistent documentation
 - Failures could qualify for Chase modification due to expanded underwriting and product set

⁴ Seasoned population are those HAMP modifications with first payments due April – September, therefore all required payments were complete by November 30

Thanks, But No Thanks

In addition to those with something to hide, a significant portion of HAMP participants may be deliberately failing to complete trial modifications in an attempt to extract better deals from their lenders. Note that the above percentages from Jamie Dimon are based on trial-modification *offers*, not on trial modifications *started*. Of the 29 customers who receive modification offers but do not make the required payments, roughly 18 of them reject the modification offer outright, while only 11 or so default during the trial period.

There are any number of reasons why a delinquent borrower might be inclined to balk at a HAMP loan modification. Two of the most compelling factors are second mortgages and negative equity. Most HAMP participants must contend with one or both of these issues, and as many as 50% have second mortgages.

Second Mortgages Remain Untouched

In what might at first blush seem like a paradox, HAMP calculations do not consider second mortgages when determining a borrower's "affordable" mortgage payment. However, this begins to make sense as soon as one realizes that toxic first mortgages were largely securitized and sold to investors, while massive portfolios of second mortgages remain on the balance sheets of U.S. banks. Bank of America, Wells Fargo, J.P. Morgan Chase and Citigroup alone hold \$442 billion in second mortgages and home-equity lines of credit. As four of the largest loan servicers, these banks are more than willing to modify first mortgages held by others as long as their own second liens remain untouched. The government's policy of considering only first mortgages for HAMP modifications is yet another backdoor bailout for the banks, as it circumvents the basic principle that the second mortgage must bear the first losses.

*"I did not run for office to be helping out a bunch of fat-cat bankers on Wall Street."
– President Barak Obama*

While the exclusion of second liens from HAMP helps out the large banks, investors in mortgage-backed securities are not the only ones who suffer. The unmodified second lien adds to the borrower's debt load and typically carries a significantly higher interest rate. If the combined payments on the first and second mortgages remain too high for the borrower's liking or ability to pay, he or she may decide to remain delinquent, or to passively reject a permanent HAMP modification by withholding the required documentation.

Negative Equity: The Other Elephant in the Room

Regardless of low interest rates and other modest incentives offered by HAMP, many participants no longer want to be saddled with a loan for substantially more than their house is worth. More than a few very likely have entered HAMP with the ultimate goal of being approved for a so-called "short sale," in which the lender allows the house to be sold for less than the amount owed and accepts the proceeds in satisfaction of the loan. For borrowers who meet the eligibility criteria for HAMP but who are unable or unwilling to complete the loan-modification

process, new short-sale incentives for loan servicers and lenders are scheduled to take effect in April 2010. If that part of the program “succeeds,” a huge wave of distressed sales may follow.

Meanwhile, underwater borrowers not eligible for HAMP may be entering the program anyway in an effort to appear distressed to their lenders. After all, borrowers who default on a loan in order to erase a negative-equity position are going to try to make it look as if they had no choice.

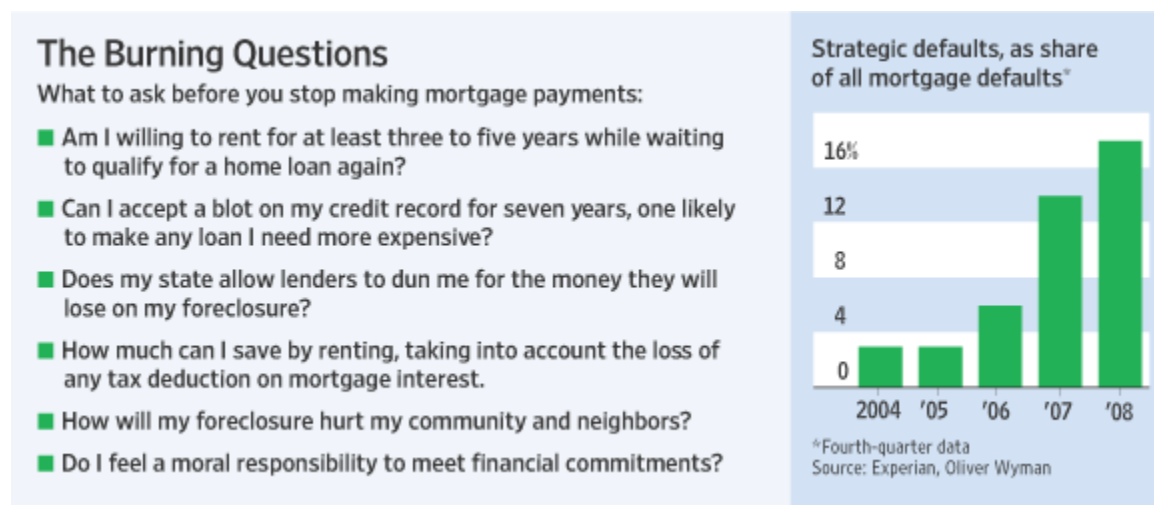
“We will try to reduce people's payments if they have a hardship. But we have a financial responsibility to get people to pay what they owe if they can afford it.”

– Thomas Kelly, J.P. Morgan Chase & Co.

Unqualified short-sale seekers are free to enter HAMP trial-period plans with only a verbal declaration as to their eligibility. They then have up to five months to submit the required documentation. This group may account for a significant portion of the 70%+ of borrowers who make their trial-modification payments, but then mysteriously fail to submit the required documentation. Certainly they have every incentive *not* to submit their paperwork, as doing so would document not only their ineligibility for HAMP, but also their ability to pay.

Mortgage Walking on the Rise

The Wall Street Journal ran the following graphic in a recent article entitled “Debtor's Dilemma: Pay the Mortgage or Walk Away.” It includes a list of questions intended to help the reader make an informed decision.



The article reports a growing number of people are considering what is known as a "strategic default," walking away from their mortgages not out of necessity but because they believe it is in their best financial interests. According to a study by researchers at Northwestern and the University of Chicago, as many as one in four defaults may be strategic. With so many borrowers deeply underwater and perhaps a home-equity line of credit sitting on top of the mortgage, it is easy to see why strategic defaults are growing not only in popularity but also in

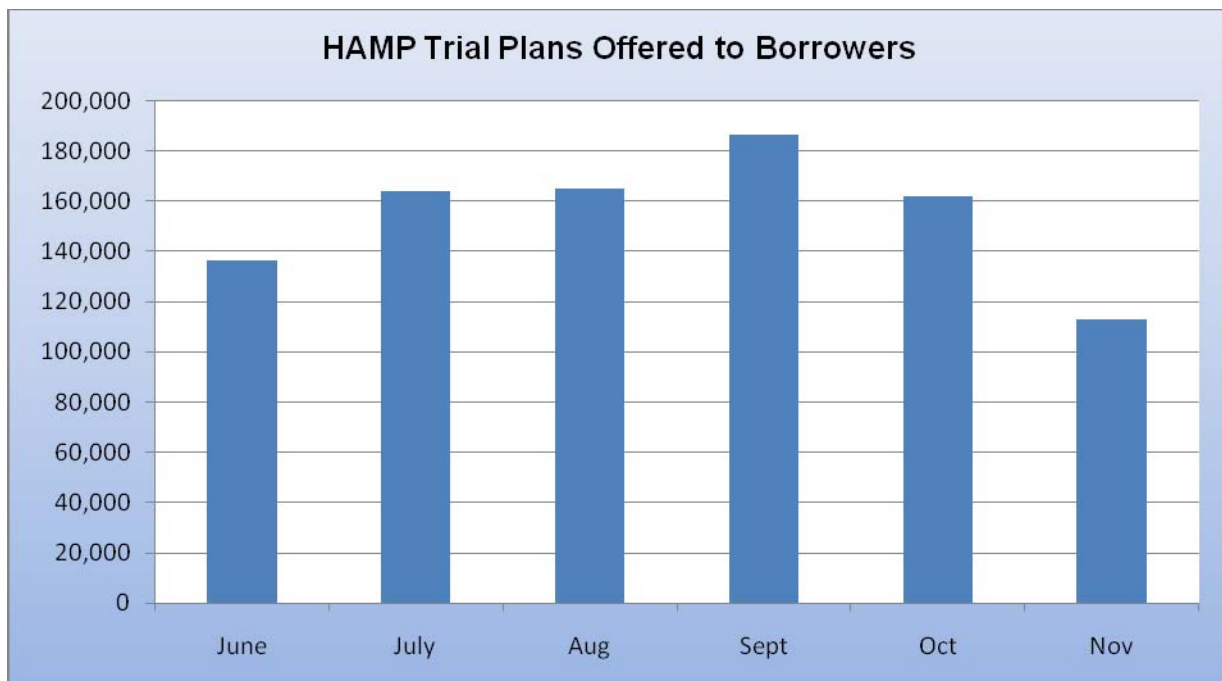
social acceptance. Surely the steady flow of anti-bank rhetoric from government officials will only serve to encourage this practice and undermine HAMP's purpose, which is to entice borrowers to stay and pay, instead of walking away.

Outlook and Projections

It seems reasonable to assume a substantial portion of HAMP trials have been entered into by borrowers who are unwilling or unable to document their eligibility for the program. That is the only logical explanation for the missing paperwork. Politicians and housing advocates assert the documentation is being repeatedly misplaced or intentionally discarded by the banks, but that does not seem likely. The problem appears too uniform and too pervasive to be attributable to widespread bank incompetence or dishonesty.

Nevertheless, the number of permanent HAMP modifications reported so far clearly understates the program's eventual success rate. In addition to the 31,382 permanent modifications already completed, there undoubtedly are many thousands more that have been approved but not yet finalized. As these modifications work their way through the pipeline, the number of permanent modifications should increase dramatically.

Applying the J.P. Morgan Chase success rate of 20% to the 1,032,837 offers extended by all loan servicers suggests that around 200,000 eventually will become permanent HAMP modifications. Assistant Secretary Allison has testified that around 375,000 trial modifications are on track to conclude with timely payments by the end of this year. Assuming 30% of these will be successfully documented yields a total of about 112,500 permanent modifications from that subgroup. While these estimates are several times greater than the 31,382 permanent modifications already reported, they fall far short of the program's goal of three-to-four million.



As for progress in reaching its targeted group of borrowers, HAMP appears to be entering the late innings. As the graph above illustrates, the number of trial modifications offered per month peaked in September and then fell 13% in October and another 30% in November. Though new participants continue to enter the program, the declining rate of offers does not bode well for HAMP's ultimate success.

The importance of residential real estate to the financial system and broader economy cannot be overstated. Defaults have spread from subprime loans to all types of mortgage loans and are on the rise even among borrowers who can afford to pay. If the number of strategic defaults continues to escalate, the outcome will be additional millions of distressed sales. Early results from HAMP are not encouraging and indicate the balance sheets of banks may be at significant risk. Problems arising from missing, incomplete and falsified loan documentation have plagued the real-estate industry for years and continue to do so. Despite the righteous anger voiced by government officials, banks continue to benefit from current policy, and further losses ultimately will be borne by taxpayers if another round of bailouts is initiated.

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