



The Impact (and Advisability) of the Homeowner Affordability and Stability Plan

The Homeowner Affordability and Stability Plan (HASP), a cornerstone of President Obama's "broad, comprehensive strategy to get the economy back on track," was unveiled on February 18 to much fanfare and debate. The plan focuses on the current environment mostly from the perspective of homeowners (more specifically, mortgage borrowers).

On the advisability of the HASP, we paraphrase Tennyson: ours is not to reason why, ours is but to analyze prepayment risk. While we have an opinion on whether the HASP is a good idea, opinions don't matter all that much. To date, we haven't weighed in on the matter of the large scale efforts to drive down mortgage rates or propel the refinancing machine into full motion, because these plans are driven by politics, not economics. Policymakers' headlong pursuit of a solution for what ails our financial infrastructure and economy is fraught with so many ambitions and risks that to criticize the practical and philosophical shortcomings of one plan seems almost pointless and petty, so we won't do it. The reality is that the HASP has the full reputational weight of a new, energetic administration behind it, it is going happen, and we have to deal with it.

But we will say this: Some of the policies that are being put in place right now are designed to fix things that are broken—capitalize banks, reduce the overhang of toxic assets, free up frozen markets—and we applaud them. Others, like the HASP or the stimulus package, are designed to change behavior. In a free and democratic society like ours, people cannot be forced to do what they do not want to do, so policy prescriptions must have the proper incentives to change behavior. Put cash in people's pockets as part of the stimulus package and they may choose to save it rather than spend it. Lower real deposit rates to zero or less, however, and people might not save as much or save for as long a period of time. Encourage people to buy American, but it won't change their desire for Toyotas or BMWs. Give huge tax incentives for buying GM cars, however, and it might make car buyers think twice about their preferences. (Even then it might not work, which leads to the wrong kind of incentives, like compensation caps, protectionism, restricting immigration or changing contract law by government fiat.) Without the proper incentives, people and companies may not behave the way they are supposed to, rendering these kinds of policy programs a waste of taxpayer money.

Likewise, lowering mortgage rates isn't guaranteed to spur refinancing or demand for homes, and here the Federal Reserve's \$500 billion purchase program and the HASP may fall short. Currently, the composite Housing Affordability Index, calculated by the National Association of Realtors, stands at an all-time high of 158.8, which means that a family earning the median family income has 158.8% of the income necessary to qualify for a conventional 30-year fixed-rate loan assuming 20% down on the median priced home (\$174,700 as of the latest release; we suspect the \$34,940 down payment is the real problem for most families given the savings rate over the last few years). The methodology for the Affordability Index calls for a debt-to-income (DTI) of just 25%, which means that monthly principal and interest cannot exceed 25% of the median family income. If we used the more current, HASP-related DTI of 38%, the Housing Affordability Index would be 241.4! Clearly, then, just as record lows in the Affordability Index in 2006 did not discourage



homebuyers from buying, high affordability today is no guarantee that homes will sell. Economic uncertainty and the deflationary undertow of home prices are apparently such powerful disincentives that homebuyers would still rather forsake a cheap purchase price today in favor of an even cheaper price tomorrow. (Note that the Administration is paying attention to incentives: the newly-minted stimulus package contains an \$8,000 credit for any first-time homebuyer, as defined, willing to step up and buy a home. It's "free" money; doesn't have to be paid back, at least not until it's taxed away by future municipal, federal and sales tax increases. But we digress.)

Back to the two pertinent issues we must evaluate: First, how will the HASP affect prepayment speeds? And second, how effective will it be in achieving its goals? Before we address these questions, let's briefly review the three main components of the plan (for readers who want more detail, it can be found on the Department of Treasury's website at <http://www.treas.gov/press/releases/tg33.htm>).

First, the plan focuses on creditworthy borrowers who have had difficulty refinancing into lower mortgage rates due to the effect of falling house values. Many conforming loan borrowers (i.e., borrowers with loans that conform to the size limits for Fannie or Freddie guarantees) have had difficulty taking advantage of today's lower mortgage rates—5.16% on the day the plan was released—because the value of their homes have declined, rendering their loan-to-value ratios too high for approval or requiring expensive mortgage insurance to obtain approval. The HASP essentially waives that requirement, raising the LTV limit to 105% for borrowers who can make the payments.

Second, the plan allocates \$75 billion to address the challenges facing borrowers who are not in bankruptcy yet need their mortgages modified in some way because they don't have sufficient income to make payments on their mortgage, even at today's lower rates. These borrowers need an even lower interest rate and possibly even a reduction in principal amount in order to manage their debt burden. The key metric in this process is reducing the borrower's debt service burden down to as low as 31%. This provision makes the lender responsible for reducing the interest rate down to a point that gets the borrowers DTI to 38%, and thereafter the Treasury and the lender will split the cost of reducing payments to lower the DTI to 31%, with a floor interest rate of 2%. The rate will stay at that level for 5 years, after which it will gradually adjust upward to the conforming rate. In addition, the lender has the ability to reduce a borrower's monthly payments by reducing principal balances; here, too, Treasury would share in the costs.

The loan modification part of this plan includes incentives for success. The borrower is incentivized to stay current after modification—further principal reductions of up to \$1,000 a year for five years. Loan servicers receive \$1,000 up front for modifying an eligible loan, and up to \$1,000 for each year that the borrower stays current (paid monthly, for up to three years). Servicers and lenders are also rewarded for identifying eligible loans and modifying them before they become delinquent—\$500 for the servicer and \$1,500 for the lender. Also included in the modification program is a \$10 billion insurance fund that is intended to keep lenders from foreclosing on mortgages due solely to declines in home prices.

The HASP also addresses the potential for modifying mortgage loans after the borrower has sought bankruptcy protection, aka judicial modification, aka cramdown. Under this part of the plan, the amount of the mortgage that is in excess of the current value of the home will now be treated as an unsecured debt, just like a credit card debt (but only if the borrower has already asked for a loan modification and has complied with all reasonable requests for information from the servicer), essentially "cramming down" the loan principal to the value of the house. Moreover, judicial



modification is only available to existing mortgages under the conforming Fannie/Freddie loan limits. The cramdown is intended to allow for a more reasonable payment plan for the homeowner.

Third, the HASP increases the explicit commitment to backstop Fannie Mae and Freddie Mac by stepping up the Preferred Stock Purchase Agreements to \$200 billion each from the current \$100 billion each. It also gives the GSEs the ability to increase their retained mortgage portfolios to \$900 billion each from the current \$850 billion each (at December 31, 2008, Fannie's and Freddie's retained portfolios totaled \$787.3 billion and \$804.8 billion, respectively).

So how will this plan affect prepayment speeds? In brief, for Agency MBS, the relaxation of LTV rules will likely increase speeds, but it is unclear how much faster and over what time period they will speed up. Speeds should increase because the plan expands the universe of potentially refinancable mortgages to include those that were unlikely or unable to refinance because LTVs were between 80% and 105% due to declines in housing values. According to Barclays, including this cohort would increase the number of potentially refinancable loans approximately 25% across the mortgage universe, or about four to five million loans. This is generally consistent with the estimate of the Obama Administration. ***All other things being equal***, then, if all of those loans refinanced, this would result in a 25% increase in the constant prepayment rate (CPR) of the mortgage universe. However, not all things are equal in this calculation, and therein lies the test of the marketplace. To begin with, the marginal percentage of loans refinancable would vary widely by coupon and vintage. For example, mortgages originated in 2007 and 2008 would be more likely to benefit because they have less equity built up than earlier vintages, and higher coupon mortgages like 6s and 6.5s will tend to have more eligible borrowers than lower coupon mortgages.

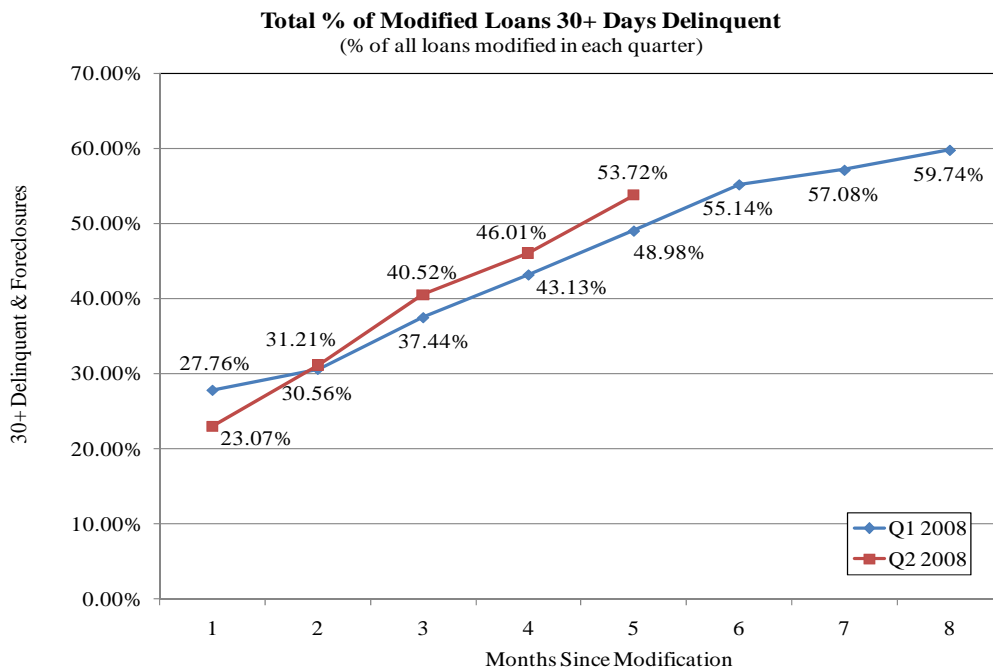
But more to the point is the overall efficacy of the plan itself. ***How effective will this plan be*** in putting people into new mortgages so they can avoid foreclosure? The headline objective of the HASP is that it will “help up to 7 to 9 million families restructure or refinance their mortgages to avoid foreclosure.” That process, it is hoped, will have ripple effects that will help to support the housing market by keeping people in their homes. We expect that the program will have a measurable effect on the market, but it will likely fall short of the hoped-for results. To date, prepayment speeds have come in far slower than predicted solely on rate-related refinancability. Despite the different features and incentives of this plan and the different circumstances today, we believe that the same will be true for HASP-related prepayment expectations, for the following reasons:

- The process of refinancing and modification is a frictional, granular, labor intensive process of identification, qualification and diligence by the servicers and lenders and self-identification by the borrowers. It will not be efficient, meaning it will take a long time and some deserving candidates will fall through the cracks.
- Not all borrowers will have the proper documentation or credit history to qualify for the program.
- The appraisal process for determining the current value of homes is unclear, but by the time borrowers get to the appraisal step of the refinancing several months from now, home values will likely have fallen even more, putting more borrowers outside of the 105% LTV limit.
- While it is okay for there to be a second lien on a house (the 105% limit only applies to the first mortgage), the second lien holder still must be consulted, providing a further step in the process.
- Fannie Mae and Freddie Mac upfront guarantee fees have increased significantly over the past year and are slated to increase again in April. These fees could knock out the refinancability of certain borrowers.



- The capacity of mortgage lenders to handle incoming calls, not to mention their willingness to make loans, will be tested and likely found wanting, at least initially.
- As pointed out by Laurie Goodman of Amherst Securities, in the last refinancing wave of 2002-2003, refinancing behavior was driven by equity extraction and the lure of no points. Neither of those options is likely to be obtainable in today's market, and may dampen the response to this program.
- While there are incentives to servicers, lenders and borrowers to make this program work, it remains to be seen whether the incentives are strong enough to make this program any more successful than programs that have already been tried or proffered. Hope for Homeowners, which was launched in October to help 400,000 homeowners avoid foreclosure, has only helped a tiny fraction of that amount.

Modifications have had mixed results at best. The Office of the Comptroller of the Currency and the Office of Thrift Supervision have gathered performance data on loan modifications, and its report of February 13, 2009 showed that there is a high incidence of re-default.



Source: OCC and OTS Mortgage Metrics Report

The graph above shows that of the loans modified in the first quarter of 2008, almost 60% of them are delinquent again 8 months later. Loans modified in the second quarter of 2008 are on a worse path, and the rates are even higher for subprime and Alt-A loans. Comptroller of the Currency John C. Dugan asked rhetorically why this recidivism rate was so high: "Is it because the modifications did not reduce monthly payments enough to be truly affordable to borrowers? Is it because consumers replaced lower mortgage payments with increased credit card debt? Is it because the mortgages were so badly underwritten that the borrowers simply could not afford them, even with reduced monthly payments? Or is it a combination of these and other factors?" The dominant answer to Comptroller Dugan is probably the first one. Assuming the borrower remains employed, ultimately the most likely determinant of the success of the HASP will be its ability to significantly reduce the monthly payment. If it fails in this regard, the government's capital commitment will be wasted.



In conclusion, the job of the mortgage investor is to assess the implications for the HASP on their portfolios. To an Agency MBS investor who will get back 100 cents on the dollar, the analysis begins and ends with the probability of borrowers with refinanceable loans actually closing on new loans. For a non-Agency MBS investor, the analysis is made more difficult by the need to weigh the potential loss in a principal modification against the protection offered by his portfolio's credit subordination and weighted average acquisition price. Politically and socially, we understand the appeal of efforts to keep people in their homes, but expectations must be adjusted appropriately. From a market perspective we should not expect the noble ambitions of the HASP to outweigh market forces and human behavior. There are just too many houses for sale right now.

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*Jeremy Diamond
Managing Director*

*Eric Szabo
Executive Vice President*

*Robert Calhoun
Vice President*

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