



# Weekly Market Commentary



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## Mortgage Modification May Move Markets

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#### Highlights

This week, key details of the Homeowner Affordability and Stability Plan are to be released. The specifics of this mortgage modification plan may be market moving.

While home prices are likely to continue to fall in the coming months, this plan may slow the number of foreclosed homes being added to unsold inventory and may limit the risk of an overshoot to the downside.

The new plan may offer clarity and confidence by standardizing how much the loans need to be written down by lenders to become higher quality mortgages and may result in a modest improvement in confidence in the solvency of the banking system.

If the plan does offer such clarity and confidence, the stock market may welcome it with a bounce.

Market participants are unhappy to have to wait for specifics on the Obama administration's recovery policy initiatives. We expect the administration to release the details on one of these initiatives this week, the Homeowner Affordability and Stability Plan. Although the details of this plan to limit foreclosures and reduce the number of bad loans are less eagerly awaited than those of other initiatives such as the Public-Private Investment Fund, the specifics of this mortgage modification plan may be market moving.

The core of the crisis comes down to housing. A home is most families' the biggest asset. Falling home prices undermine consumers' confidence to spend and drag down the economy. The financial crisis was the result of financial institutions' high degree of leverage to mortgages of questionable quality. As delinquency and foreclosures rise, losses mount for lenders and jeopardize their ability to make new loans.

The mortgage modification measures in the administration plan are presented as a way to aid distressed mortgage holders stay in their homes. However, it may also impact the number of houses for sale due to foreclosure or distress, the value of the mortgage-backed debt, and the capital adequacy of the financial institutions that hold the mortgages. When the mortgage modification plan overview was released on February 12, backed by an agreement to suspend foreclosures by banks until the plan was put in place, the stock market welcomed the news with a bounce. Subsequently, when some of the details were announced on February 18 the market was mixed, since many questions were left unanswered.

While more details on eligibility and the standardized rules for modification will be forthcoming on Wednesday—the date the plan goes into effect—from what is known of the plan so far, it is likely to reduce the number of foreclosures by a substantial amount. With about 2 million mortgages, or about 4-5% of all mortgages, seriously delinquent, and with more on the way, this plan has the potential to impact millions of loans totaling hundreds of billions of dollars. The pace of foreclosures is likely to subside almost immediately.

The main provisions of the plan:

- The services would reduce the payments to 38% of income. If the lender chose to reduce the payments further, the government would pay half the cost of reducing the payment to 31% of income. The lower payment would be in effect for five years.



- Servicers would receive \$1,000 to modify the loan and \$1,000 per year for three years if the loan stays current. Servicers would get \$500 for modifying an “at-risk” mortgage that is not delinquent.
- Borrowers who stay current after loan modification would receive up to \$1,000 per year applied to the balance of the mortgage.
- Lenders would receive a \$1,500 incentive to modify loans that have not yet been delinquent.
- Conventional mortgages held by Fannie Mae and Freddie Mac can be refinanced even if the amount owed is in excess of the home price—up to 105%—in contrast to the standard 80% loan-to-value ratio.

Here is the White House’s example of how the modification portion might work:

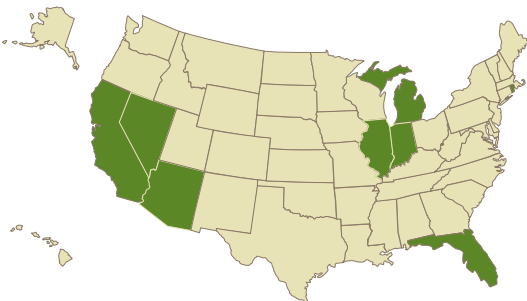
*Consider a family that took out a 30-year fixed rate mortgage of \$207,000 with an interest rate of 6.50% on a house worth \$260,000 at the time. Today, that family has about \$200,000 remaining on their mortgage, but the value of that home has fallen 15 percent to \$221,000 - making them ineligible for today’s low interest rates that now generally require the borrower to have 20 percent home equity. Under this refinancing plan, that family could refinance to a rate near 5.16% - reducing their annual payments by over \$2,300.*

The House is likely to vote this week on legislation to allow bankruptcy judges to reduce the principal balance of mortgage loans, known as a “cramdown”—the final version of this bill is likely to apply only to borrowers who were denied modification of their subprime and Alt-A mortgages. Given the strong incentive to avoid cramdown, lenders are likely to modify loans consistent with the program.

The specific eligibility requirements and modification standards could turn out to be good news for lenders, particularly those with a high exposure to the weakest regions. The plan has the potential to turn bad loans into better loans. The benefit to the banks is a lower likelihood that at-risk mortgage holders will default. In many cases, a mortgage at a 7.5% rate with a high probability of default is worth less than the same mortgage at a lower rate; as long as the lower rate mortgage is affordable to the mortgage holder and avoids default. Generally, banks do not write down the mortgages they own until they become seriously delinquent.

The write-down needs to encompass the likelihood and timing of the default in addition to the sale value of the foreclosed home—amounting to layers of uncertainty. The new standardized plan may offer clarity and confidence on how much the loans may need to be written down by the lenders to become higher quality mortgages without the uncertainty of the foreclosure and resale process. This clarity may result in a modest improvement in confidence in the solvency of the banking system and may be welcomed by the stock market with a bounce.

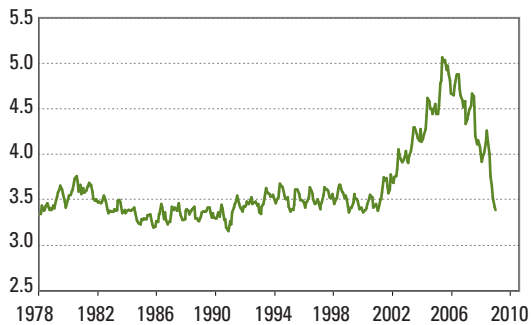
#### 1 Nine States Have Above Average Foreclosures



Source: LPL Financial, Mortgage Bankers Association



## 2 Housing Bubble Has Burst *Median Home Price divided by Median Family Income*



Source: LPL Financial, Bloomberg

Home prices are likely to continue to fall in the coming months. The inventory of unsold homes is high, buyers are cautious, and home prices remain above the long-term equilibrium relative to incomes. However, the foreclosure mitigation plan may limit the risk of an overshoot to the downside in home prices and may, along with other policy actions, begin to stabilize confidence in the solvency of the large banks.

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\*Such a plan involves continuous investment in securities. An investor should consider their ability to continue purchasing through periods of low price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.

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