

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10 -K

[X] Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the year ended December 31, 1997

OR

[] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission file number: 001-13417

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

MARYLAND 13-3950486
(State or other Jurisdiction of (I.R.S. Employer Identification No.)
Incorporation or Organization)

90 WEST STREET, SUITE 1508, NEW YORK, NY 10006
(Address of principal executive offices) (Zip Code)

(212) 732-5086
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, \$.01 Par Value per Share - American Stock Exchange

Warrants - American Stock Exchange

Units - American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K []

The aggregate market value of units held by nonaffiliates of the registrant as of February 20, 1998 was approximately \$112,777,025 (based on closing sales price of \$19.625 per unit as reported for the American Stock Exchange).

The registrant had 6,466,677 shares of common stock outstanding as of February 20, 1998.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to shareholders in

connection with the Annual Meeting of Shareholders to be held May 21, 1998 are incorporated by reference into Part III.

2

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

FORM 10-K ANNUAL REPORT

FOR THE YEAR ENDED DECEMBER 31, 1997

INDEX

PART I	PAGE

Item 1. Business.....	1
Item 2. Properties.....	22
Item 3. Legal Proceedings.....	23
Item 4. Submission of Matters to a Vote of Security Holders.....	24
PART II	
Item 5. Market for Registrant's Common Equity and Related Stockholder Matters.....	25
Item 6. Selected Financial Data.....	25
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations....	26
Item 8. Financial Statements and Supplementary Data.....	33
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures....	33
PART III	

Item 10. Directors and Executive Officers of the Registrant.....	34
Item 11. Executive Compensation.....	34
Item 12. Security Ownership of Certain Beneficial Owners and Management.....	34
Item 13. Certain Relationships and Related Transactions.....	34

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K.....	35
Signatures.....	36

PART I

ITEM 1: BUSINESS

GENERAL

Background

In September 1997, Hanover Capital Mortgage Holdings, Inc. (the "Company") raised net proceeds of approximately \$79.1 million in its initial public offering, pursuant to which the Company sold 5,750,000 units at \$15.00 per unit. Each unit consisted of one share of common stock, par value \$.01, and one stock purchase warrant. Each warrant entitles the holder to purchase one share of common stock at \$15.00 per share (subject to adjustment in certain events). The warrants became exercisable on March 19, 1998 and remain exercisable until September 15, 2000.

In connection with the initial public offering, the Company acquired a 97% ownership interest (representing a 100% ownership of the non-voting preferred stock) in Hanover Capital Partners Ltd. ("HCP") and its wholly-owned subsidiaries, Hanover Capital Mortgage Corporation ("HCMC") and Hanover Capital Securities, Inc. ("HCS"), in exchange for 716,667 shares of the Company's common stock.

The Company is a specialty finance company the activities of which include (i) acquiring primarily single-family subprime mortgage loans (as defined below), (ii) securitizing mortgage loans and retaining interests therein, (iii) offering due diligence services to buyers, sellers and holders of mortgage loans, and (iv) originating, holding, selling and servicing multifamily mortgage loans and commercial mortgage loans. The Company's principal business objective is to generate increasing earnings and dividends for distribution to stockholders. The Company acquires single-family mortgage loans through a network of sales representatives targeting financial institutions throughout the United States. The Company originates multifamily mortgage loans and commercial mortgage loans through HCMC. The Company operates as a tax-advantaged REIT. The Company is generally not subject to Federal income tax to the extent that it distributes its earnings to its stockholders and maintains its qualification as a REIT. Taxable affiliates of the Company, however, including HCP, HCMC and HCS, are subject to Federal income tax. The Company has engaged HCP to render due diligence, asset management and administrative services pursuant to a Management

Agreement.

The Company elected REIT status primarily for the tax advantages. Management believes that the REIT structure is the most desirable structure for owning mortgage assets because it eliminates corporate-level Federal income taxation. In addition, as the Company is not a traditional lender which accepts deposits, it is subject to substantially less regulatory oversight and incurs lower operating expenses than banks, thrifts and many other originators of mortgage assets. Management believes that the Company will generate attractive earnings and dividends per share for stockholders through the combination of (i) purchasing subprime single-family mortgage loans which generally have higher yields than newly originated mortgage loans, (ii) using long-term financing that allows the Company to realize net interest income over time as REIT-qualified income, as opposed to fully taxable gain-on-sale income, and (iii) its focus on originating multifamily mortgage loans and commercial mortgage loans, which generally have higher yields than conforming single-family mortgage loans. As used herein, the term "subprime single-family mortgage loan" means a single-family mortgage loan that is either twelve months or older or

4

that does not meet the originally intended credit quality due to documentation errors or credit deterioration. Although HCP has previously rendered advisory services in connection with securitization transactions, neither it nor HCMC has securitized any significant amount of mortgage loans.

Business Strategy

The Company's strategy is to pursue acquisitions and originations of mortgage loans where it believes it can receive acceptable rates of return on invested capital and effectively utilize leverage. Key elements of this strategy include:

- o growing the Company's investment portfolio by utilizing the Company's single-family mortgage loan acquisition network and multifamily and commercial origination operation to create attractive investment opportunities;
- o financing the Company's investments in a manner that limits the Company's interest rate risk while earning an attractive return on equity; and
- o owning mortgage assets in the REIT structure and thereby eliminating a layer of taxes relative to most traditional real estate lenders.

The Company's principal executive offices are located at 90 West Street, Suite 1508, New York, New York 10006.

INVESTMENT PORTFOLIO

General

The primary business of the Company is investing, generally on a long-term basis, in first lien single-family mortgage loans, multifamily mortgage loans and commercial mortgage loans and mortgage securities secured by or representing an interest in mortgage loans (the "Investment Portfolio"). The percentage of the Company's mortgage assets which is invested in various sectors of the Investment Portfolio may vary significantly from time to time depending upon the availability of mortgage loans and mortgage securities. The Company utilizes its organization to acquire and securitize single-family mortgage loans and originate commercial mortgage loans to earn higher returns than could generally be earned from purchasing mortgage securities in the marketplace.

Single Family Mortgage Operations

Single-Family Mortgage Loans. The Company focuses on the purchase of pools of whole single-family mortgage loans that do not fit into the large government-sponsored or private conduit programs. Single-family mortgage loans generally are acquired in pools from a wide variety of sources, including private sellers such as banks, thrifts, finance companies, mortgage companies and governmental agencies. The majority (65% - 70%) of the Company's acquisition of single-family mortgage loan pools to date have been fixed rate loans, with the balance made up of adjustable rate mortgage ("ARM") loans. At December 31, 1997, the Company had an investment in mortgage securities of \$348 million. The

Company intends to liquidate these investments over the next twelve months as it identifies and purchases additional single-family mortgage loan pools.

2

5

The Company uses seven sales representatives from HCP, located in Illinois, Minnesota, California, Massachusetts and New York, to source single-family mortgage loan products. For the foreseeable future, the Company believes that there will be an adequate supply of mortgage loan product that can be sourced by the existing HCP sales force.

At December 31, 1997, the Company had invested \$160,970,000 or 31.1% of the Company's total assets in the following types of single-family mortgage loans in accordance with the operating policies established by the Board of Directors.

Whole Loan Mortgage Loan Summary
Fixed Rate Mortgage Loans

Face or principal amount	\$106,424,000
Carrying value	107,953,000
Weighted average net coupon	8.265%
Weighted average maturity (in months)	242
Number of loans	1,763
Average loan size	\$60,365
Average loan-to- value ratio (LTV)	67.13%

Adjustable Rate Mortgage (ARM) Loans

Face or principal amount	\$52,365,000
Carrying value	\$53,017,000
Weighted average net coupon	7.925%
Weighted average maturity (in months)	319
Number of loans	439
Average loan size	\$119,281
Average loan-to- value ratio (LTV)	76.98%

At March 6, 1998, the Company had purchased since inception in excess of \$286 million of single-family mortgage loan pools and had committed to purchase an additional \$153 million of single-family mortgage loan pools.

In addition, HCP has a due diligence and underwriting staff, located in Edison, New Jersey, consisting of approximately seven full-time employees. The due diligence staff contributes to the single-family mortgage loan acquisition process by providing expertise in the analysis of many characteristics of the single-family mortgage loans. It has been Management's experience that buyers generally discount the price of a single-family mortgage loan if there is a lack of information. By having additional information on loan pools through its due diligence operations, the Company is better able to assess the value of loan pools.

3

6

Because mortgage loan pools can be purchased from virtually any bank, insurance company or financial institution, the Company is not dependent upon any one source. At December 31, 1997, the Company had purchased approximately 29% of the Company's single-family mortgage loan portfolio from one source. Management does not believe this concentration of purchases is indicative of future trends. The Company does not service its single-family mortgage loans.

The servicing is outsourced to unrelated third parties specializing in loan servicing.

The Company purchases ARM securities from broker-dealers and financial institutions that regularly make markets in these securities. The Company can also purchase mortgage-backed securities from other mortgage suppliers, including mortgage bankers, banks, savings and loans, investment banking firms, home builders and other firms involved in originating, packaging and selling mortgage loans.

The mortgage loans and to a lesser extent the mortgage securities held in the Investment Portfolio generally will be held on a long-term basis, so that the returns will be earned over the lives of the mortgage loans and mortgage securities rather than from sales of the investments.

Single-family mortgage loan pools are usually acquired through competitive bids or negotiated transactions. The competition for larger single-family mortgage loan portfolios is generally more intense, while there is less competition for smaller single-family mortgage loan portfolios. Management believes that the Company's funding flexibility, personnel, proprietary due diligence software and single-family mortgage loan trading relationships provide it with certain advantages over competitors in pricing and purchasing certain single-family mortgage loan portfolios.

Prior to making an offer to purchase a single-family mortgage loan portfolio, HCP employees conduct an extensive investigation and evaluation of the loans in the portfolio. This examination typically consists of analyzing the information made available by the portfolio seller (generally, an outline of the portfolio with the credit and collateral files for each loan in the pool), reviewing other relevant material that may be available, analyzing the underlying collateral (including reviewing the Company's single-family mortgage loan database which contains, among other things, listings of property values and loan loss experience in local markets for similar assets), and obtaining opinions of value from third parties (and, in some cases, conducting site inspections). The Company's senior management determines the amount to be offered for the portfolio using a proprietary stratification and pricing system which focuses on, among other things, rate, term, location and types of the loans. The Company also reviews information on the local economy and real estate markets (including the amount of time and procedures legally required to foreclose on real property) where the loan collateral is located.

In conducting due diligence operations, HCP often discovers non-conforming elements of single-family mortgage loans, such as: (i) problems with documents, including missing or lost documentation, errors on documents, nonstandard forms of documents and inconsistent dates between documents, (ii) problems with the real estate, including inadequate initial appraisals, deterioration in property values or economic decline in the general geographic area, and (iii) miscellaneous problems, including poor servicing, poor credit history of the borrower, poor payment history by the borrower and current delinquency status. The price paid for such loans is adjusted to compensate for these non-conforming elements.

The Company maintains a process to improve the value of its single-family mortgage loan portfolio, including updating data, obtaining lost note affidavits in the event that a note has been misplaced, updating property values with new appraisals, assembling historical records, obtaining mortgage insurance if the value of a loan is in question, grouping similar loans in

packages for securitization, and segmenting portfolios for different buyers. However, Management believes any value created will be extracted by financing or securitizing the single-family mortgage loans and then realizing the enhanced spread on the retained pool, as opposed to recognizing a gain upon sale of the single-family mortgage loan portfolio.

Single-Family Market Trends. The Company focuses on subprime mortgage loans which are generally available in bulk from loan originators such as mortgage bankers, banks and thrifts that originate primarily for sale and from mortgage portfolio holders as they restructure their holdings.

Single-Family Acquisition Strategy. The Company believes that it can

continue to acquire single-family mortgage loans that have a relatively high yield when compared to the applicable risk of loss. In many cases, portions of a pool may be made eligible for inclusion in agency pools, which will raise the credit level of the Investment Portfolio, while preserving the higher yield obtained at the time of purchase. In addition, the Company may securitize a single-family mortgage loan pool. In structuring a securitization, the Company retains subordinated or other interests.

Single-Family Underwriting Guidelines. The Company has developed an underwriting approval policy to maintain uniform control over the quality of the single-family mortgage loans it purchases. This policy sets forth a three step review process: (i) collateral valuation, (ii) credit review, and (iii) property valuation. Prior to pricing a bid or final purchase of a portfolio, a senior manager of the Company reviews the results of all three underwriting evaluations. The collateral valuation entails a check on the collateral documents (i.e., the note, mortgage, title policy and assignment chain). The documents are examined for conformity among the documents and adherence to secondary market standards. The credit review involves an analysis of the credit of the borrower, including an examination of the origination and credit documents, credit report and payment history. For more seasoned single-family mortgage loans, the analysis may be more directed at payment histories and credit scores. The property valuation involves an analysis of the loan-to-value of the collateral, including an examination of the original appraisal in the context of the current regional property market conditions and often a drive-by valuation of the subject property and review of recent comparable sales.

Single-Family Servicing. Pools of single-family mortgage loans are purchased with servicing retained or released by the seller. In the case of pools purchased with servicing retained by the seller, the Company considers the reputation and the servicing capabilities of the servicer. In some instances, the Company requires a master servicer to provide the assurance of quality required. A master servicer provides oversight of its subservicers and stands ready, and is contractually obligated, to take over the servicing if there is a problem with the subservicer. In the case of pools purchased with servicing released, the Company places the servicing with a qualified servicer. In some cases, the Company may retain the servicing and contract with a qualified servicer to provide subservicing. In this case, the Company keeps the risk of ownership of the servicing with respect to any change in value as a result of prepayment of the underlying single-family mortgage loans or other factors. No single-family mortgage loans are currently serviced by the Company.

Commercial Mortgage Loans and Multifamily Mortgage Loans

The Company's affiliate HCMC was one of the first commercial mortgage banking operations to originate multifamily mortgage loans for sale to conduits. From direct borrower originations and its network of third party brokers, it can provide multifamily mortgage loans and commercial mortgage loans of sufficient credit quality to meet the requirements for securitization, as well as sales to third party investors and purchases by the Company for the

Investment Portfolio. Due to low interest spreads, no multifamily mortgage loans or commercial mortgage loans were purchased by the Company in 1997. However, in the future, the Company may originate multifamily mortgage loans and commercial mortgage loans, including mortgage loans secured by income-producing commercial properties such as office, retail, warehouse and mini-storage facilities, through HCMC and subsequently either sell the mortgage loans to investors or hold them in the Investment Portfolio. Management of the Company believes that the Company has certain competitive advantages in the commercial mortgage market due to the speed, consistency and flexibility with which it can act as a vertically integrated company (acting as originator, servicer, and owner of commercial mortgage loans).

Commercial Production Process. The commercial process differs from the single-family mortgage loan acquisition process because HCMC operates as a direct originator of loans. HCMC has been engaged in this process since 1992 and has been an active supplier to the Wall Street conduit/securitization firms, which are Wall Street dealer firms that have set up a conduit to purchase multifamily mortgage loans and commercial mortgage loans from national brokers and mortgage bankers for the purpose of issuing commercial mortgage-backed securities. HCMC has the ability to source new commercial mortgage loans

directly and through brokers, to process and underwrite the loans to the Company's standards and to service the loans.

Commercial and Multifamily Loan Acquisition/Production Strategies. The Company adheres to specified underwriting and due diligence requirements for the origination of multifamily and commercial mortgage loans, such that they will qualify for sale to third party conduits or for inclusion in securitizations. The Company continually monitors the underwriting criteria by contacting rating agencies and the third party conduit purchasers. In addition to the underwriting and due diligence completed at the origination level, a separate credit committee approves all multifamily mortgage loans and commercial mortgage loans purchased for the Investment Portfolio. The Company intends that, with prudent underwriting and due diligence, combined with the securitization option, it will achieve a satisfactory reward/risk ratio; however, there are no assurances that it will be able to do so.

HCMC originates new multifamily and commercial mortgage loans through originators that call on brokers, real estate developers and owners. While the Company's sales force concentrates primarily on sourcing pools of single-family mortgage loans, it also can find leads for the multifamily and commercial mortgage loan origination business of HCMC and the due diligence operations of HCP.

Commercial and Multifamily Underwriting Guidelines. The Company's underwriting guidelines for commercial and multifamily mortgage loans focus on the origination of loans eligible for securitization. The due diligence process focuses on four main areas: (i) a property level review, (ii) borrower credit issues, (iii) cash flow structures, and (iv) adequacy of legal documentation. The property level review begins with a review of the on-site inspection report and includes an analysis of the third party reports, including the appraisal, engineering report and environmental report. The borrower credit issues include an analysis of the borrower's legal structure, a review of financial statements, past credit history of principals, management's ability and experience and prior/existing relationships. The cash flow structures include an analysis of the loan-to-value ratio, the expense ratio, the debt service coverage, the value per unit, the occupancy levels and the historical expense records. The legal documentation review includes a review of any changes to the approved program loan documents, including the note, mortgage, reserve agreements, assignments of leases and any borrower certifications. The program loan documents will be structured in order to meet the requirements of securitization with respect to such matters as prepayment penalties, recourse carve-outs and the overall soundness of the documents. In addition, the Company obtains a "Phase I" environmental site assessment (i.e.,

6

9

generally a record search with no invasive testing) of the property that will secure a commercial or multifamily mortgage loan. Depending on the results of the Phase I assessment, the Company may require a Phase II assessment. The Company's loan servicing guidelines require that the Company obtain a Phase I assessment (which includes invasive testing) of any mortgaged property prior to the Company acquiring title to or assuming operation of the mortgaged property. This requirement effectively precludes the Company from enforcing the rights under the mortgage loan until a satisfactory Phase I environmental site assessment is obtained or until any required remedial action is thereafter taken, but also decreases the likelihood that the Company will become liable for any material environmental condition at a mortgaged property.

Commercial and Multifamily Mortgage Loan Servicing. To control the credit risk of retained interests in securitized loans, HCMC will retain the servicing rights on any commercial mortgage loans and multifamily mortgage loans held in the Investment Portfolio. HCMC may also retain the servicing rights on loans originated and sold to third party conduits. HCMC, as servicer, will have the risks associated with operating a mortgage servicing business as well as the risk of ownership of the servicing.

At December 31, 1997, HCMC serviced approximately \$121 million of multifamily mortgage loans. The servicing of mortgage loans involves processing and administering the mortgage loan payments for a fee. It involves collecting mortgage payments on behalf of investors, reporting information to investors and maintaining escrow accounts for the payment of principal and interest to investors and property taxes and insurance premiums on behalf of borrowers.

The primary risk of operating a servicing business is failing to service the loans in accordance with the servicing contracts, which exposes the servicer to liability for possible losses suffered by the owner of the loans. The operational requirements include proper handling and accounting for all payment and escrow amounts, proper borrower and periodic credit reviews, proper value and property reviews and proper payment of all monies due to third parties, such as real estate taxing authorities and insurance companies.

The primary risks of ownership of servicing rights include the loss of value through faster than anticipated loan prepayments (even though there may be prepayment penalties) or improper servicing as outlined above.

Commercial Market Trends. The market for commercial and multifamily mortgage loans has undergone dramatic changes in recent years with the advent of securitizations. Financing of income-producing property has evolved from a traditional two-party lending relationship, with the borrower obtaining funding from a traditional lending institution, to a market in which lenders with expertise in the creation of mortgage-backed securities offer borrowers an alternative source of competitive financing. Securitization involves multiple parties, each with specialized roles and responsibilities creating profitable lending opportunities for those with experience in commercial mortgage finance and the capital markets. Securitizations of commercial and multifamily mortgage loans have grown rapidly during the 1990s.

The growth in securitization has been the result of two market forces. First, during the recession of the early 1990s, traditional lenders withdrew from the real estate credit market. Securitization filled the resulting void. Second, Congress established the Resolution Trust Corporation ("RTC") in 1989 in order to liquidate the commercial and single-family mortgage assets of failed financial institutions. After unsuccessfully trying to sell the mortgages, the RTC began securitizing commercial mortgages. The RTC's enormous securitization program stimulated the growth of the private sector securitization market by providing experience and knowledge to participants such as investment bankers, rating agencies, mortgage companies,

7

10

attorneys, accountants and loan servicers. These participants have applied the experience and knowledge gained in the securitization of RTC assets to the securitization of non-governmental, private-label securities. The RTC's program also helped create an informed and active investor base for the securities created from the securitization of commercial mortgage assets.

The Company believes that success in the commercial market depends on a vertically integrated strategy, which includes origination of commercial and multifamily mortgage loans, servicing, securitization and investment in the residual security after securitization. The Company is structured to take advantage of efficiencies in the vertically integrated strategy, which it anticipates will result in attractive returns to equity. However, there can be no assurance that such returns will be achieved.

ACCUMULATION PERIOD ACQUISITIONS

The Company initially allocated a majority of the net proceeds of its initial public offering to build a portfolio of mortgage assets, primarily composed of adjustable rate mortgage pass-through securities of high investment quality to provide income during the time required to acquire mortgage loans. The Company acquires mortgage loans in the secondary mortgage market as soon as attractive opportunities are identified. Management anticipates that the Company will earn an acceptable level of return on the initial portfolio until the net proceeds from the initial public offering can be fully invested in higher yielding mortgage assets. A similar portfolio acquisition strategy will be employed whenever the Company obtains new financing or capital.

At December 31, 1997, the Company had invested \$348,131,000 or 67.3% of the Company's total assets in the following types of mortgage securities in accordance with the operating policies established by the Board of Directors.

Par value at purchase date	\$200,524,000
December 31, 1997 adjusted principal	\$200,524,000
Amortized cost basis	\$207,898,000
Market value	\$207,397,000
Weighted average net coupon	7.761%
Weighted average maturity (in months)	291

FEDERAL HOME LOAN MORTGAGE BANK (FHLMC) SECURITIES

Par value at purchase date	\$136,237,000
December 31, 1997 adjusted principal	\$136,237,000
Amortized cost basis	\$141,075,000
Market value	\$140,734,000
Weighted average net coupon	7.891%
Weighted average maturity (in months)	305

8

11

DUE DILIGENCE OPERATIONS

The Company conducts due diligence operations through HCP for commercial banks, government agencies, mortgage banks, credit unions and insurance companies. The operations consist of the underwriting of credit, analysis of loan documentation and collateral, and analysis of the accuracy of the accounting for mortgage loan servicing by third party servicers. The due diligence analyses are performed on a loan by loan basis. Audits of the accuracy of the interest charged on adjustable rate mortgage loans are frequently a part of the due diligence services provided to customers. HCP performs due diligence on mortgage loans acquired by the Company and by unrelated third parties.

FINANCING

General

The Company's purchases of mortgage assets are initially financed primarily with equity and short-term borrowings through reverse repurchase agreements until long-term financing is arranged or the assets are securitized. Generally, upon repayment of each borrowing in the form of a reverse repurchase agreement, the mortgage asset used to collateralize the financing will immediately be pledged to secure a new reverse repurchase agreement or long term financing. The Company had established mortgage asset financing agreements with various financial institutions at December 31, 1997 and is currently negotiating a back-up line of credit agreement with several major financial institutions.

Reverse Repurchase Agreements

A reverse repurchase agreement, although structured as a sale and repurchase obligation, is a financing transaction in which the Company pledges its mortgage assets as collateral to secure a short-term loan. Generally, the other party to the agreement will loan an amount equal to a percentage of the market value of the pledged collateral, typically 80% to 98%. At the maturity of the reverse repurchase agreement, the Company is required to repay the loan and correspondingly receives back its collateral. Under reverse repurchase agreements, the Company generally retains the incidents of beneficial ownership, including the right to distributions on the collateral and the right to vote on matters as to which certificate holders vote. If the Company defaults in a payment obligation under such agreements, the lending party may liquidate the collateral.

In the event of the insolvency or bankruptcy of the Company, certain reverse repurchase agreements may qualify for special treatment under the United States Bankruptcy Code, which permits the creditor to avoid the automatic stay provisions of the Bankruptcy Code and to foreclose on the collateral without delay. In the event of the insolvency or bankruptcy of a lender during the term of a reverse repurchase agreement, the lender may be permitted, under the Bankruptcy Code, to repudiate the contract, and the Company's claim against the lender for damages therefrom may be treated simply as that of an unsecured

creditor. In addition, if the lender is a broker or dealer subject to the Securities Investor Protection Act of 1970 or an insured depository institution subject to the Federal Deposit Insurance Act, the Company's ability to exercise its rights to recover its mortgage assets under a reverse repurchase agreement or to be compensated for damages resulting from the lender's insolvency may be limited by those laws. The effect of these various statutes is, among other things, that a bankrupt lender, or its conservator or receiver, may be permitted to repudiate or disaffirm its reverse repurchase agreements, and the Company's claims against the bankrupt lender may be treated as an unsecured claim. Should this occur, the Company's claims would be subject to significant delay

9

12

and, if and when paid, could be in an amount substantially less than the damages actually suffered by the Company.

To reduce its exposure to the credit risk of reverse repurchase agreements, the Company enters into the arrangements with several different parties. The Company monitors the financial condition of its reverse repurchase agreement lenders on a regular basis, including the percentage of its mortgage loans that are the subject of reverse repurchase agreements with a single lender. Notwithstanding these measures, no assurance can be given that the Company will be able to avoid such third party risks.

The reverse repurchase borrowings bear short-term fixed (one year or less) interest rates varying from LIBOR to LIBOR plus 125 basis points depending on the credit of the related mortgage assets. Generally, the borrowing agreements require the Company to deposit additional collateral in the event the market value of existing collateral declines, which, in dramatically rising interest-rate markets, could require the Company to sell assets to reduce the borrowings.

SECURITIZATION AND SALE PROCESS

General

When the Company acquires a sufficient volume of mortgage loans with similar characteristics, generally \$50 million to \$100 million or more, the Company plans to securitize them through the issuance of mortgage-backed securities in the form of REMICs or CMOs. Alternatively, to a lesser extent and to the extent consistent with the Company's qualification as a REIT, the Company may resell loans in bulk whole loan sales. The length of time from when the Company commits to purchase a mortgage loan to when it sells or securitizes the loan will generally range from 30 days to one year or more, depending on certain factors, including the length of the purchase commitment period, the amount and type of the mortgage loan, and the securitization process. Any decision by the Company to issue CMOs or REMICs or to sell mortgage loans in bulk will be influenced by a variety of factors.

For accounting and tax purposes, mortgage loans financed through the issuance of CMOs are treated as assets of the Company, and the CMOs are treated as debt of the Company. The Company earns the net interest spread between the interest income on the mortgage loans and the interest and other expenses associated with the CMO financing. The net interest spread will be directly affected by prepayments of the underlying mortgage loans and, to the extent the CMOs have variable interest, may be affected by changes in short-term interest-rates.

As an alternative to CMOs, the Company may issue REMICs. REMIC transactions are generally accounted for as sales of the mortgage loans. REMIC securities consist of one or more classes of "regular interests" and a single "residual interest." The regular interests are tailored to the needs of investors and may be issued in multiple classes with varying maturities, average lives and interest-rates. These regular interests are predominantly senior securities but, in conjunction with providing credit enhancement, may be subordinated to the rights of other regular interests. The residual interest represents the remainder of the cash flows from the underlying mortgage loans over the amounts required to be distributed on the regular interests. In some cases, the regular interests may be structured so that there is no significant residual cash flow. In such a REMIC transaction, the Company sells its entire interest in the mortgage loans, and all of the capital originally invested in the mortgage loans may be redeployed. The

Company may retain regular and residual interests on a short-term or long-term basis. Income from REMIC issuances is not treated as REIT qualifying income. Accordingly, REMIC issuances are not the Company's primary securitization technique and will generally be undertaken through the taxable subsidiaries.

The Company expects that its retained interests in securitizations will be subordinated to the securities issued to third party investors with respect to losses of principal and interest on the underlying mortgage loans. Accordingly, any such losses on underlying mortgage loans will be applied first to reduce the remaining amount of the Company's retained interest, until reduced to zero. Any retained regular interest may include "principal only" or "interest only" securities or other interest rate or prepayment sensitive securities or investments. Any retained securities may subject the Company to credit, interest rate and/or prepayment risks. The Company anticipates it will retain securities only on terms which it believes are sufficiently attractive to compensate it for assuming the associated risks.

The Company may also retain subordinated mortgage backed securities, with ratings ranging from AA to unrated, generally fixed-rate. The fixed-rate securities generally evidence interests in 30-year single-family mortgage loans. Securities backed by multifamily mortgage loans and commercial loans are generally interests in 7 or 10 year balloon loans with 25 or 30 year amortization schedules. In general, subordinated classes bear all losses prior to the related senior classes. Losses in excess of losses anticipated at the time subordinated securities are purchased would adversely affect the Company's yield on the securities and, in extreme circumstances, could result in the failure of the Company to recoup its initial investment.

Except in the case of breach of the representations and warranties made by the Company when mortgage loans are securitized, the securitization of mortgage loans will be non-recourse to the Company. As a result, the Company is able to maintain the economic benefit of financing the mortgage assets and earning a positive net interest spread, while limiting its potential risk of credit loss to its investment in the subordinated or residual securities (generally approximately 5% to 10% of the loan pool amount). A second advantage to the CMO structure is that it is permanent financing and, therefore not subject to margin calls during periods in which the value of the pool assets are declining due to increases in interest rates.

The Company typically pays a monoline bond insurer a monthly fee to assume a portion of the credit risk in a pool of mortgage loans. The monoline insurer would generally require the issuer to retain a portion of the credit risk and over-collateralize a particular pool of mortgage loans.

Proceeds from securitizations will be available to support new loan originations and acquisitions. In addition to providing relatively less expensive long-term financing, Management believes that the Company's securitizations will reduce the Company's interest-rate risk on mortgage assets held for long-term investment.

Credit Enhancement

REMICs or CMOs created by the Company are structured so that one or more of the classes of the securities are rated investment grade by at least one nationally recognized rating agency. The ratings for the Company's mortgage assets will be based on the rating agency's view of the perceived credit risk of the underlying mortgage loans, the structure of the mortgage assets and

the associated level of credit enhancement. Credit enhancement is designed to provide protection to the holders of the securities in the event of borrower defaults and other losses including reductions in the principal or interest as required by law or a bankruptcy court. The Company can utilize multiple forms of credit enhancement, including special hazard insurance, monoline insurance,

reserve funds, letters of credit, surety bonds and subordination or any combination thereof. A decline in the credit quality of the mortgage loans backing any mortgage securities or of any third party providing credit enhancement, or adverse developments in general economic trends affecting real estate values or the mortgage industry, could result in ratings being downgraded.

In determining whether to provide credit enhancement, the Company takes into consideration the costs associated with each method. The Company generally provides credit enhancement through the issuance of mortgage-backed securities in senior/subordinated structures or by over-collateralization of its mortgage assets. The need for additional collateral or other credit enhancements will depend upon factors such as the type of collateral provided and the interest-rates paid thereon, the geographic concentration of the mortgaged property and other criteria established by the rating agency. The pledge of additional collateral would reduce the capacity of the Company to raise additional funds through short-term secured borrowings or additional CMOs and will diminish the potential expansion of the Investment Portfolio. Accordingly, collateral would be pledged for CMOs only in the amount required to obtain the highest rating category of a nationally-recognized rating agency. The subordinated mortgage securities may be sold, retained by the Company or accumulated for sale in subsequent transactions.

Other Mortgage-Backed Securities

As an additional alternative for the financing of the Investment Portfolio, the Company may cause to be issued other mortgage-backed securities if the issuance of such other securities is advantageous and consistent with the Company's qualification as a REIT. In particular, mortgage pass-through certificates representing undivided interests in pools of mortgage loans formed by the Company may prove to be attractive vehicles for raising funds.

The holders of mortgage pass-through certificates receive their pro rata share of the principal payments made on a pool of mortgage loans and interest at a pass-through interest rate that is fixed at the time of the offering. The Company intends to retain significant portions of the undivided interests in the mortgage loans underlying pass-through certificates. The retained interest may also be subordinated so that, in the event of a loss, payments to certificate holders will be made before the Company receives its payments. Unlike the issuance of CMOs, the issuance of mortgage pass-through certificates will not create an obligation of the Company to security holders in the event of a borrower default. However, as in the case of CMOs, the Company may be required to obtain credit enhancement in order to obtain a rating for the mortgage pass-through certificates in one of the top two rating categories established of a nationally-recognized rating agency.

Capital Allocation Guidelines (CAG)

The Company has adopted capital allocation guidelines ("CAG") in order to strike a balance between the under-utilization of leverage and excess dependence on leverage, which could reduce the Company's ability to meet its obligations during adverse market conditions. Modifications to the CAG require the approval of a majority of the Company's Board of

Directors. The CAG are intended to keep the Company's leverage balanced by (i) matching the amount of leverage to the riskiness (return and liquidity) of each mortgage asset, and (ii) monitoring the credit and prepayment performance of each mortgage asset to adjust the required capital. This analysis takes into account the Company's various hedging and other risk containment programs discussed below. In this way, the use of balance sheet leverage is optimized through the implementation of the CAG controls. The lender haircut indicates the minimum amount of equity the lender requires with a mortgage asset. There is some variation in haircut levels among lenders from time to time. From the lender's perspective, the haircut is a "cushion" to protect capital in case the borrower is unable to meet a margin call. The size of the haircut depends on the liquidity and price volatility of each mortgage asset. Agency securities are very liquid, with price volatility in line with the fixed income markets which means a lender requires a smaller haircut, typically 3%. On the other extreme, "B" rated securities and securities not registered with the Securities and Exchange Commission are substantially less liquid, and have more price

volatility than agency securities, which results in a lender requiring a larger haircut. Particular securities that are performing below expectations would also typically require a larger haircut. The haircut for residential whole loan pools will generally range between 3% and 5% depending on the documentation and delinquency characteristics of the pool. Certain whole loan pools may have haircuts which may be negotiated with lenders in excess of 5% due to other attributes of the pool.

Implementation of the CAG -- Mark to Market Accounting

Each quarter, for financial management purposes, the Company marks its mortgage assets to market. This process consists of (i) valuing the Company's mortgage assets acquired in the secondary market, and (ii) valuing the Company's non-security investments, such as retained interests in securitizations. For the purchased mortgage assets, the Company obtains benchmark market quotes from traders who make markets in securities similar in nature to the mortgage assets. The Company then adjusts for the difference in pricing between securities and whole loan pools. Market values for the Company's retained interests in securitizations are calculated internally using market assumptions for losses, prepayments and discount rates.

The face amount of the financing used for the securities and retained interests is subtracted from the current market value of the mortgage assets (and hedges). This is the current market value of the Company's equity positions. This value is compared to the required capital as determined by the CAG. If the actual equity of the Company falls below the capital required by the CAG, the Company must prepare a plan to bring the actual capital above the level required by the CAG.

Periodically, Management presents to the Board of Directors the results of the CAG compared to actual equity. Management may propose changing the capital required for a class of investments or for an individual investment based on its prepayment and credit performance relative to the market and the ability of the Company to predict or hedge the risk of the mortgage asset.

As a result of these procedures, the leverage of the balance sheet will change with the performance of the Company's mortgage assets. Good credit or prepayment performance may release equity for purchase of additional mortgage assets, leading to increased earnings. Poor credit or prepayment performance may cause additional equity to be allocated to existing investments, forcing a reduction in mortgage assets on the balance sheet and lower future earnings. In either case, the constant mortgage asset performance evaluation, along with the

13

16

corresponding leverage adjustments, helps to maintain the maximum acceptable leverage (and earnings) while protecting the capital base of the Company.

RISK MANAGEMENT

The Company believes that its portfolio income is subject to three primary risks: credit risk, interest rate risk and prepayment risk.

Credit Risk Management

The Company reduces credit risk through (i) the review of each mortgage loan prior to purchase to ensure that it meets the guidelines established by the Company, (ii) use of early intervention, aggressive collection and loss mitigation techniques in the servicing process, (iii) use of insurance in the securitization process, (iv) maintenance of appropriate capital and reserve levels, and (v) obtaining representations and warranties, to the extent possible, from originators. Although the Company does not set specific geographic diversification requirements, the Company closely monitors the geographic dispersion of the mortgage loans and makes decisions on a portfolio by portfolio basis about adding to specific concentrations.

Commercial mortgage loans held by the Company generally are originated by HCMC to underwriting standards established by the Company. These underwriting standards reflect the experience of HCMC in its past originations as well as the requirements of the rating agencies for commercial mortgage loans. The credit underwriting includes a financial and credit check of the borrower, technical reports including appraisal, engineering and environmental reports, as well as a review of the economic status of the geographic area where the mortgaged

property is located. In addition, a separate credit sign-off is required before commercial mortgage loans are transferred to the Investment Portfolio from HCMC. The commercial mortgage loans in the Investment Portfolio will be monitored by the servicing department of HCMC, which includes a periodic review of financial statements of the mortgaged property as well as property inspections.

Single-family mortgage loans are generally purchased in bulk pools of \$2 million to \$100 million. The credit underwriting process varies depending on the pool characteristics, including seasoning, loan-to-value ratios and payment histories. For a new pool of single-family mortgage loans, a full due diligence review is undertaken, including a review of the documentation, appraisal reports and credit underwriting. Where required, an updated property valuation is obtained. The bulk of the work is performed by employees in the due diligence operations of HCP.

Interest Rate Risk Management

There are two basic types of mortgage loans held by the Company: mortgage loans held for securitization or sale and mortgage loans held in securitized form. Mortgage loans held for securitization or sale are generally hedged. A variety of hedging instruments may be used, depending on the asset to be hedged and the relative price of the various hedging instruments. Hedging instruments include forward sales of mortgage securities, and may also include interest rate futures or options, interest rate swaps, and cap and floor agreements. Mortgage loans held in securitized form are generally financed in a manner designed to maintain a consistent spread in a variety of interest rate environments and therefore do not require any hedging.

The Company may purchase interest rate caps, interest rate swaps and similar instruments to attempt to mitigate the risk of the cost of its variable rate liabilities increasing at a faster rate than the earnings on its mortgage assets during a period of rising interest rates. The Company

14

17

generally hedges as much of the interest rate risk as management determines is reasonable, given the cost of such hedging transactions and the need to maintain the Company's status as a REIT, among other factors. The Company may also, to the extent consistent with its qualification as a REIT and Maryland law, utilize financial futures contracts, options and forward contracts and other instruments as a hedge against future interest rate changes. See "Business - Hedging."

Prepayment Risk Management

With respect to commercial and multifamily mortgage loans, the Company will seek to minimize the effects of faster or slower than anticipated prepayment rates by originating mortgage loans with prepayment penalties and utilizing various financial hedging instruments. With respect to single-family mortgage loans, the Company utilizes various financial instruments as a hedge against prepayment risk. Prepayment risk is monitored by senior management and through periodic review of the impact of a variety of prepayment scenarios on the Company's revenues, net earnings, dividends, cash flow and net balance sheet market value.

Although the Company believes it has developed a cost-effective asset/liability management program to provide a level of protection against interest rate and prepayment risks, no strategy can completely insulate the Company from the effects of interest rate changes, prepayments and defaults by counterparties. Further, certain of the Federal income tax requirements that the Company must satisfy to qualify as a REIT limit the Company's ability to fully hedge its interest rate and prepayment risks.

HEDGING

Investment Portfolio

The Company's primary method of addressing interest rate risk on its mortgage assets is through its strategy of securitizing mortgage loans with collateralized mortgage obligation ("CMO") borrowings, which are designed to provide long term financing while maintaining a consistent spread in a variety of interest-rate environments. The Company believes that its primary interest rate risk relates to mortgage assets that are financed with reverse repurchase

agreements and are held for securitization.

The Company uses certain hedging strategies in connection with the management of the Investment Portfolio. To the extent consistent with the Company's REIT status, the Company follows a hedging program intended to protect against interest rate changes and to enable the Company to earn net interest income in periods of generally rising, as well as declining or static, interest rates. Specifically, the goal of the hedging program is to offset the potential adverse effects of changes in interest rates relative to the interest rates of the mortgage assets held in the Investment Portfolio. As part of its hedging program, the Company also monitors prepayment risks that arise in fluctuating interest rate environments.

The Company may use a variety of instruments in its hedging program. One example is an interest rate cap. In a typical interest rate cap agreement, the cap purchaser makes an initial lump sum cash payment to the cap seller in exchange for the seller's promise to make cash payments to the purchaser on fixed dates during the contract term if prevailing interest rates exceed the rate specified in the contract. The Company may also purchase mortgage derivative securities. Mortgage derivative securities can be effective hedging instruments in certain situations as the value and yields of some of these instruments tend to increase as interest rates rise and to decrease as interest rates decline, while the experience for others is the converse. The

15

18

Company will limit its purchases of mortgage derivative securities to investments that must meet REIT requirements. To a lesser extent, the Company may also enter into interest rate swap agreements, financial futures contracts and options on financial futures contracts, and forward contracts. However, the Company will not invest in these instruments unless the Company is exempt from the registration requirements of the Commodity Exchange Act or otherwise complies with the provisions of that Act. The REIT rules may restrict the Company's ability to purchase certain instruments and may restrict the Company's ability to employ other strategies. In all its hedging transactions, the Company deals only with counterparties that the Company believes are sound credit risks.

In connection with securitizations of mortgage loans, the Company is subject to the risk of rising mortgage interest rates between the time it commits to a fixed price purchase and the time it sells or securitizes the mortgage loans. To mitigate this risk, the Company may utilize hedging strategies, including mandatory and optional forward selling of mortgage loans or mortgage-backed securities, interest rate caps and floors, and buying and selling of futures and options on futures. The nature and quantity of these hedging transactions is determined by the management of the Company based on various factors, including market conditions and expected volume of mortgage loan purchases.

Costs and Limitations

The Company believes that it has implemented a cost-effective hedging policy to provide an adequate level of protection against interest-rate risks. However, maintaining an effective hedging strategy is complex, and no hedging strategy can completely insulate the Company from interest-rate risks. Moreover, as noted above, certain of the REIT rules limit the Company's ability to fully hedge its interest rate risks. The Company monitors carefully, and may have to limit, its hedging strategies to assure that it does not violate the REIT rules, which could result in disqualification and/or payment of penalties.

In addition, hedging involves transaction and other costs, which can increase dramatically as the period covered by the hedge increases and also increase in periods of rising and fluctuating interest-rates. Therefore, the Company may be prevented from effectively hedging its interest-rate risks without significantly reducing the Company's return on equity.

SERVICING RIGHTS

Whether servicing is purchased (along with purchased single-family mortgage loans) or created (by the origination of multifamily mortgage loans and commercial mortgage loans), a value is placed on the servicing as a purchased mortgage servicing right ("PMSR") or an originated mortgage servicing right ("OMSR"), as the case may be, and recorded as an asset on the books of the Company.

The valuation of a PMSR and an OMSR includes an analysis of the characteristics of the size, rate, escrow amounts, type, maturity, etc. of the loan, as well as an estimate of the mortgage loan's remaining life. To the extent the characteristics change or the estimate of remaining life changes, the value of the PMSR or OMSR will be adjusted. For example, if mortgage loans are repaid more quickly than originally forecasted (increased speed), the value of the OMSR or PMSR will be reduced.

16

19

REGULATION

There are various state and local laws and regulations affecting the Investment Portfolio. HCMC has mortgage-banking licenses in Arizona, Illinois, New Jersey, Vermont and Wisconsin. In addition, the Company's activities are subject to the rules and regulations of HUD. Mortgage operations also may be subject to applicable state usury and collection statutes. The Company believes that it is currently in compliance with all material rules and regulations to which it is subject and has all required licenses.

COMPETITION

The Company participates on a national level in the mortgage market, which is estimated at \$3.8 trillion for single-family mortgage loans and \$1.0 trillion for multifamily mortgage loans and commercial loans. In purchasing mortgage loans and issuing mortgage-backed securities, the Company competes with other REITs, established mortgage conduit programs, investment banking firms, savings and loan associations, banks, thrift and loan associations, finance companies, mortgage bankers, insurance companies, other lenders and other entities purchasing mortgage assets. In addition, there are several mortgage REITs similar to the Company and others may be organized in the future. Continued consolidation in the mortgage banking industry may reduce the number of sellers of mortgage loans, which would reduce the Company's potential customer base and result in the Company purchasing a larger percentage of mortgage loans from a smaller number of sellers. These changes could negatively impact the Company. As an issuer of mortgage securities, the Company will face competition for investors from other investment opportunities.

Increasingly, mortgage lending is being conducted by mortgage lenders who specialize in the origination and servicing of mortgage loans and then sell these loans to other mortgage investment institutions, such as the Company. The Company believes it has a competitive advantage because of the low cost of its operations relative to traditional mortgage investors such as banks and savings and loans. Like traditional financial institutions, the Company seeks to generate income for distribution to its shareholders primarily from the difference between the interest income on its mortgage assets and the financing costs associated with carrying the mortgage assets.

EMPLOYEES

The Company had no employees at December 31, 1997. The Principals became employees of the Company as of January 1, 1998. The Company engages the services of HCP to provide management expertise, product sourcing, due diligence support, and general and administrative services to assist the Company in accomplishing its business objectives. At December 31, 1997, HCP employed 50 people on a full-time basis. To date, HCP believes it has been successful in its efforts to recruit qualified employees, but there is no assurance that it will continue to be successful in the future. None of HCP's employees are subject to collective bargaining agreements.

SERVICE MARKS

HCP owns two service marks that have been registered with the United States Patent and Trademark Office, each of which expires in the year 2003.

17

20

FUTURE REVISIONS IN POLICIES AND STRATEGIES

The Board of Directors has established the Company's investment and operating policies, which can be revised only with the approval of the Board of Directors, including a majority of the unaffiliated directors. Except as otherwise restricted, the Board of Directors may revise the policies without the consent of stockholders if the Board of Directors determines that the change is in the best interests of stockholders. Developments in the market which affect the policies and strategies mentioned herein or which change the Company's assessment of the market may cause the Board of Directors to revise the Company's policies and financing strategies.

The Company has elected to qualify as a REIT for tax purposes (see "Federal Income Tax Considerations"). The Company has adopted certain compliance guidelines which include restrictions on the acquisition, holding and sale of assets. Prior to the acquisition of any asset, the Company determines whether the asset meets REIT requirements. Substantially all of the assets that the Company has acquired and will acquire for investment are expected to qualify as REIT assets. This requirement limits the Company's investment strategies.

The Company closely monitors its purchases of mortgage assets and the sources of its income, including from its hedging strategies, to ensure at all times that it maintains its qualifications as a REIT. The Company has developed certain accounting systems and testing procedures to facilitate its ongoing compliance with the REIT provisions of the Code. No changes in the Company's investment policies and operating strategies, including credit criteria for mortgage asset investments, may be made without the approval of the Company's Board of Directors, including a majority of the unaffiliated directors.

The Company intends to conduct its business so as not to become regulated as an investment company under the Investment Company Act of 1940. The Investment Company Act exempts entities that are "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" ("Qualifying Interests"). Under current interpretation of the staff of the Securities and Exchange Commission, in order to qualify for this exemption, the Company must maintain at least 55% of its assets directly in Qualifying Interests. In addition, unless certain mortgage securities represent all the securities issued with respect to an underlying pool of mortgages, the securities may be treated as securities separate from the underlying mortgage pool and, thus, may not be considered Qualifying Interests for purposes of the 55% requirement. The Company closely monitors its compliance with this requirement and intends to maintain its exempt status. As of this date, the Company has been able to maintain its exemption through the purchase of mortgage loan pools and certain whole pool government agency securities that qualify for the exemption.

RELATIONSHIPS WITH AFFILIATES AND PRIOR BUSINESS

HCP has rendered asset management services in connection with the short-term trading of seasoned (more than one year since origination) single-family mortgage loans since 1995. In managing mortgage activities, HCP typically targeted mortgage loan pools containing subprime single-family mortgage loans with deficiencies that could be corrected so as to permit resales on favorable terms. In managing sale activities, HCP generally has pursued a strategy of selling single-family mortgage loans within eighteen months after their acquisition. The Company, on the other hand, generally holds mortgage loans on a long-term basis, so that returns are earned over the lives of mortgage loans rather than from their sales.

In the past, HCP has engaged in single-family mortgage loan acquisition, financing, hedging and sale activities pursuant to private management arrangements with (i) Alpine Associates, a Limited Partnership ("Alpine Associates"), (ii) a limited liability company formed by HCP, Alpine Associates and an affiliate of Bankers Trust New York Corp. and (iii) certain affiliates of Bankers Trust New York Corp. The objective in each of those arrangements was to profit from purchasing and reselling mortgage loans rather than, as in the case of the Company, from holding, financing and securitizing mortgage loans.

Alpine Associates and HCP formed Alpine/Hanover LLC in May of 1996, as a successor to a partnership formed by them in February of 1994, to trade in portfolios of subprime single-family mortgage loans. In October of 1995, HCP, Alpine/Hanover LLC and BAHT 1995-1 Corp., an affiliate of Bankers Trust New York

Corp., formed ABH-I LLC to trade in subprime single-family mortgage loans. Pursuant to separate asset management contracts with BT Realty Resources, Inc., HCP has rendered management services similar to those it has rendered for ABH-I LLC. HCP intends to wind down and terminate Alpine/Hanover LLC and ABH-I LLC at such time as all of the ABH-I LLC assets have been sold. As of February 28, 1998, the remaining assets of ABH-I LLC had an aggregate principal amount of approximately \$300,000. HCP intends to wind down and terminate its management arrangement with BT Realty Resources, Inc. at such time as all of the assets under management have been sold. As of February 28, 1998, the remaining assets under management had an aggregate principal amount of approximately \$100,000.

After the closing of the initial public offering, the Company acquired and holds the Investment Portfolio. HCP has continued to conduct the due diligence operations and, in addition, support the Company's acquisition and investment activities by providing due diligence services to the Company. HCP has continued to originate, sell and service multifamily mortgage loans and commercial mortgage loans and, in addition, may in the future support the Company's acquisition and investment activities by serving as a source of multifamily mortgage loans and commercial mortgage loans. HCP facilitates the Company's trading activities by acting as a broker/dealer.

MANAGEMENT AGREEMENT

Effective as of January 1, 1998, the Company entered into a Management Agreement (the "Management Agreement") with HCP. Under this agreement, HCP, subject to the direction and control of the Company's Board of Directors, provides certain services for the Company, including, among other things: (i) serving as the Company's consultant with respect to formulation of investment criteria and preparation of policy guidelines by the Board of Directors; (ii) assisting the Company in developing criteria for the purchase of mortgage assets that are specifically tailored to the Company's investment objectives; (iii) representing the Company in connection with the purchase and commitment to purchase or sell mortgage assets; (iv) arranging for the issuance of mortgage securities from a pool of mortgage loans; (v) furnishing reports and statistical and economic research to the Company regarding the Company's activities and the services performed for the Company by HCP; (vi) monitoring and providing to the Board of Directors on an ongoing basis price information and other data; (vii) investing or reinvesting any money of the Company in accordance with its policies and procedures and the terms and conditions of the Management Agreement; (viii) providing the executive and administrative personnel office space and services required in rendering such services to the Company; and (ix) administering the day-to-day operations of the Company. For these services, the Company pays HCP for each month an amount equal to the sum of (a)

19

22

the wages and salaries of the personnel employed by HCP and/or its affiliates (other than independent contractors and other third parties rendering due diligence services in connection with the acquisition of any mortgage assets) apportioned to the Company for such month, plus (b) twenty-five percent (25%) of (a). The Company also is required to pay HCP for each month an amount equal to the sum of (c) the expense of HCP for any due diligence services provided by independent contractors and other third parties in connection with the acquisition of any mortgage assets during such month plus (d) three percent (3%) of (c). Any amount that may become payable by HCP to the Company for any services provided by the Company to HCP, including the services of the Principals, is offset against amounts payable to HCP.

Subject to other contractual limitations, the Management Agreement does not prevent HCP from acting as an investment advisor or manager for any other person, firm or corporation. The term of the Management Agreement continues until December 31, 1999 and thereafter is automatically renewed for successive one-year periods unless the Unaffiliated Directors (as defined therein) resolve to terminate the Management Agreement.

FEDERAL INCOME TAX CONSIDERATIONS

General

The Company has elected to be treated as a REIT for tax purposes. In brief, if certain detailed conditions imposed by the REIT provisions of the Code are met, entities that invest primarily in real estate investments and mortgage

loans, and that otherwise would be taxed as corporations are, with certain limited exceptions, not taxed at the corporate level on their taxable income that is currently distributed to their shareholders. This treatment eliminates most of the "double taxation" (at the corporate level and then again at the shareholder level when the income is distributed) that typically results from the use of corporate investment vehicles. In the event that the Company does not qualify as a REIT in any year, it would be subject to federal income tax as a domestic corporation and the amount of the Company's after-tax cash available for distribution to its shareholders would be reduced. The Company believes it has satisfied the requirements for qualification as a REIT since commencement of its operations in September 1997. The Company intends at all times to continue to comply with the requirements for qualification as a REIT under the Code, as described below.

Requirements for Qualification as a REIT

To qualify for tax treatment as a REIT under the Code, the Company must meet certain tests which are described briefly below.

Ownership of Common Stock

For all taxable years after its first taxable year, the Company's shares of capital stock must be held by a minimum of 100 persons for at least 335 days of a 12 month year (or a proportionate part of a short tax year). In addition, at all times during the second half of each taxable year, no more than 50% in value of the capital stock of the Company may be owned directly or indirectly by five or fewer individuals. The Company is required to maintain records regarding the actual and constructive ownership of its shares, and other information, and to demand statements from persons owning above a specified level of the REITs shares (if the Company has 200 or fewer shareholders of record, from persons holding 0.5% or more of the Company's outstanding shares of capital stock) regarding their ownership of shares. The Company must keep a list of those shareholders who fail to reply to such a demand. The Company is required to use and does use the calendar year as its taxable year for income.

20

23

Nature of Assets

On the last day of each calendar quarter, the Company must satisfy three tests relating to the nature of its assets. First, at least 75% of the value of the Company's assets must consist of mortgage loans, certain interests in mortgage loans, real estate, certain interests in real estate (the foregoing, "Qualified REIT Assets"), government securities, cash and cash items. The Company expects that substantially all of its assets will continue to be Qualified REIT Assets. Second, not more than 25% of the Company's assets may consist of securities that do not qualify under the 75% asset test. Third, of the investments in securities not included in the 75% asset test, the value of any one issuer's securities may not exceed 5% by value of the Company's total assets, and the Company may not own more than 10% of any one issuer's outstanding voting securities. Pursuant to its compliance guidelines, the Company intends to monitor closely the purchase and holding of its assets in order to comply with the above asset tests.

Sources of Income

The Company must meet the following three separate income-based tests each year:

1. 75% INCOME TEST. At least 75% of the Company's gross income for the taxable year must be derived from Qualified REIT Assets including interest on obligations secured by mortgages on real property or interests in real property. During the first year of operations certain temporary investment income also qualify under the 75% income test. The investments that the Company has made and will continue to make will give rise primarily to mortgage interest qualifying under the 75% income test.

2. 95% INCOME TEST. In addition to deriving 75% of its gross income from the sources listed above, at least an additional 20% of the Company's gross income for the taxable year must be derived from those sources, or from dividends, interest or gains from the sale or disposition of stock or other securities that are not dealer property. The Company intends to limit substantially all of the assets that it acquires to Qualified REIT Assets. The

policy of the Company to maintain REIT status may limit the types of assets, including hedging contracts and other securities, that the Company otherwise might acquire.

3. 30% INCOME LIMIT. Through the close of 1997, the Company must also derive less than 30% of its gross income from the sale or other disposition of (i) Qualified REIT Assets held for less than four years, other than foreclosure property or property involuntarily or compulsorily converted through destruction, condemnation or similar events, (ii) stock or securities held for less than one year (including hedges) and (iii) property in a prohibited transaction (generally, a sale of dealer property that is not foreclosure property).

Distributions

The Company must distribute to its shareholders on a pro rata basis each year an amount equal to at least (i) 95% of its taxable income before deduction of dividends paid and excluding net capital gains, plus (ii) 95% of the excess of the net income from foreclosure property over the tax imposed on such income by the Code, less (iii) certain "excess noncash income". The Company intends to make distributions to its shareholders in sufficient amounts to meet this 95% distribution requirement.

21

24

Taxation of the Company's Shareholders

For any taxable year in which the Company is treated as a REIT for federal income purposes, amounts distributed by the Company to its shareholders out of current or accumulated earnings and profits will be includable by the shareholders as ordinary income for federal income tax purposes unless properly designated by the Company as capital gain dividends. Distributions of the Company will not be eligible for the dividends received deduction for corporations. Shareholders may not deduct any net operating losses or capital losses of the Company. Any loss on the sale or exchange of shares of the common stock of the Company held by a shareholder for six months or less will be treated as a long-term capital loss to the extent of any capital gain dividends received on the common stock held by such shareholder.

If the Company makes distributions to its shareholders in excess of its current and accumulated earnings and profits, those distributions will be considered first a tax-free return of capital, reducing the tax basis of a shareholder's shares until the tax basis is zero. Such distributions in excess of the tax basis will be taxable as gain realized from the sale of the Company's shares. The Company will withhold 30% of dividend distributions to shareholders that the Company knows to be foreign persons unless the shareholder provides the Company with a properly completed IRS form claiming a reduced withholding rate under an applicable income tax treaty.

Under the Code, if a portion of the Company's assets were treated as a taxable mortgage pool or if the Company were to hold REMIC residual interests, a portion of the Company's dividends would be treated as unrelated business taxable income ("UBTI") for pension plans and other tax exempt entities. The Company believes that it has not engaged in activities that would cause any portion of the Company's income to be taxable as UBTI for pension plans and similar tax exempt shareholders. The Company believes that its shares of stock will be treated as publicly offered securities under the plan asset rules of the Employment Retirement Income Security Act ("ERISA") for Qualified Plans.

The provisions of the Code are highly technical and complex and are subject to amendment and interpretation from time to time. This summary is not intended to be a detailed discussion of all applicable provisions of the Code, the rules and regulations promulgated thereunder, or the administrative and judicial interpretations thereof. The Company has not obtained a ruling from the Internal Revenue Service with respect to tax considerations relevant to its organization or operations.

ITEM 2: PROPERTIES

The Company's operations are conducted in several leased office facilities throughout the United States. A summary of the office leases is shown below:

LOCATION -----	OFFICE SPACE (SQ.FT.) -----	MINIMUM		OFFICE USE -----
		ANNUAL RENTAL -----	EXPIRATION DATE -----	
New York, New York	2,300	\$42,800	November 2001	Executive, Administration, Investment Operations

22

25

Edison, New Jersey	5,850	75,400	June 2002	Accounting, Administration, Due Diligence Operations, Mortgage Loan Servicing, Investment Operations
Chicago, Illinois	3,900	58,900	June 1999	Due Diligence Operations, Investment Operations
St., Louis, Missouri	1,007	26,800	August 1998	Mortgage Origination Operations
Rockland, Massachusetts	300	6,000	Month to Month	Investment Operations
Sacramento, California	150	7,400	Month to Month	Due Diligence Operations, Investment Operations
St. Paul, Minnesota	150	5,600	July 1998	Investment Operations
Total:	13,657	\$222,900		

Management of the Company believes that these facilities are adequate for the Company's foreseeable needs and that lease renewals and/or alternate space at comparable rental rates is available, if necessary.

ITEM 3: LEGAL PROCEEDINGS

The Company is not engaged in any material legal proceedings. However, two affiliates have been parties to certain proceedings described below. To the extent that the results of these proceedings are adverse to the affiliates, the proceedings could also adversely affect the Company.

On or about January 15, 1997, Quarters on Melody Lane Partnership ("Quarters") brought suit against HCMC in the District Court in Dallas County, Texas (titled Quarters on Melody Lane Partnership v. Hanover Capital Mortgage Corporation et al.) In a letter dated December 17, 1996, Quarters threatened to sue HCMC and others unless Quarters was permitted to repay a multifamily mortgage loan, which had been originated by HCMC, without pre-payment penalties. The initial principal balance of the multifamily mortgage loan, which closed on June 28, 1994, was approximately \$1.76 million. A portion of the proceeds of the loan was retained in an escrow account to fund the cost of repairs, replacements and improvements. Quarters alleged that HCMC personnel orally represented before the closing that funds would be disbursed from the escrow account other (and more favorably to the obligor) than as provided in the loan documents. Disbursements have not been made in accordance with such alleged representations. HCMC sold the loan on the day of closing and sold the servicing rights to the loan in December 1994. In a written response to the letter, HCMC denied that its representatives made any misrepresentations to Quarters. Thereafter, Quarters filed suit against HCMC and others as defendants, in District Court in Dallas County, Texas. The complaint alleges that HCMC is guilty of fraudulent misrepresentation, breach of contract, fraudulent withholding of funds, breach of fiduciary duty and conversion. On July 17, 1997, Quarters filed an amended petition, alleging actual damages in the amount of \$300,000.00 and seeking punitive damages in the amount of \$1,000,000.00. On August 29, 1997, a court-ordered mediation between all parties was held, at which time it was believed that a settlement had been reached. In exchange for a complete release, HCMC agreed to pay Quarters \$20,000.00. However, as of this date, a final settlement agreement has not yet been executed and other defendants have not yet agreed to the settlement. In early January 1998, Quarters requested certain defendants, including HCMC, to settle separately. However, HCMC elected not to settle separately. HCMC has retained counsel and is defending itself in such action. Management of the Company does not believe

23

that this claim will have a material adverse effect on the Company's financial condition and results of operations.

In August 1992, the IRS proposed a tax deficiency against HCP arising from HCP's treatment of certain alleged employees as independent contractors for tax purposes. HCP negotiated a closing agreement with the IRS and, on October 6, 1997, accepted a settlement offer of \$99,240 from the IRS, which also requires HCP to treat the individuals in question as employees on a prospective basis beginning in 1998. The treatment of the individuals as employees requires HCP to withhold income and employment taxes from payments made to them and to make certain matching employment tax payments.

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable

24

27

PART II

ITEM 5: MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

In September 1997, the Company raised net proceeds of approximately \$79.1 million in its initial public offering (the "IPO"). In the IPO, the Company sold 5,750,000 units at \$15.00 per unit. Each unit consists of one share of common stock, par value \$.01 and one stock purchase warrant. Each warrant entitles the holder to purchase one share of common stock at \$15.00 per share (subject to adjustment in certain events). The warrants became exercisable on March 19, 1998 and remain exercisable until September 15, 2000.

On September 19, 1997 the units began trading on the American Stock Exchange under the trading symbol HCM.U or HCM/U. Commencing March 19, 1998, the warrants became detachable from the common stock and, commencing March 20, 1998, the common stock and warrants began trading separately on the American Stock Exchange under the trading symbols HCM and HCM.WS, respectively. As of February 24, 1998, the Company had 6,466,677 shares of common stock issued and outstanding, which was held by 86 holders of record and approximately 2,900 beneficial owners.

The following table sets forth, for the periods indicated, the high, low and closing sales price per unit as reported on the American Stock Exchange.

	Unit Prices			Dividends
	High	Low	Close	Declared Per Share
	----	---	-----	-----
Third Quarter Ended September 30, 1997	17 1/4	15	17 1/8	--
Fourth Quarter Ended December 31, 1997	18 7/8	15 1/8	16 1/2	\$0.16

The Company intends to pay quarterly dividends and other distributions to its shareholders of all or substantially all of its taxable income in each year in order to qualify for the tax benefits accorded to a REIT under the Code. All distributions will be made by the Company at the discretion of the Board of Directors and will depend on the earnings of the Company, financial condition of the Company, maintenance of REIT status and such other factors as the Board of Directors deems relevant.

ITEM 6: SELECTED FINANCIAL DATA

The following selected financial data are derived from audited financial statements of the Company for the period from inception (June 10, 1997) through December 31, 1997. The selected financial data should be read in conjunction

with the more detailed information contained in the Financial Statements and Notes thereto and "Management's Discussion and Analysis of Financial Conditions and Results of Operations" included elsewhere in this Form 10-K.

25

28

OPERATIONS STATEMENT HIGHLIGHTS

	1997

Net interest income	\$1,676,000
Net income	499,000
Basic earnings per share	0.15
Diluted earnings per share	0.14
Dividends declared per share	\$0.16

BALANCE SHEET HIGHLIGHTS

	December 31
	1997

Adjustable-rate mortgage securities	\$348,131,000
Mortgage loans	160,970,000
Total assets	517,543,000
Shareholders' Equity	78,098,000
Number of common shares outstanding	6,466,677

ITEM 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

The Company is a specialty finance company the activities of which include (i) acquiring primarily subprime single-family mortgage loans, (ii) securitizing mortgage loans and retaining interests therein, (iii) offering due diligence services to buyers, sellers and holders of mortgage loans and (iv) originating, holding, selling and servicing multifamily mortgage loans and commercial mortgage loans. The Company's principal business objective is to generate increasing earnings and dividends for distribution to stockholders. The Company acquires single-family mortgage loans through a network of sales representatives targeting financial institutions throughout the United States. The Company originates multifamily mortgage loans and commercial mortgage loans through HCMC.

RESULTS OF OPERATIONS

The Company was organized on June 10, 1997, but did not commence operations until September 19, 1997 (the date of the IPO closing). For the period from June 10, 1997 to December 31, 1997, the Company's net income was \$499,000 or

26

29

\$0.15 per share based on a weighted average of 3,296,742 shares of common stock outstanding. The Company's net income for the period September 19, 1997 to December 31, 1997 was \$499,000 or \$.08 per share based on a weighted average of 6,466,677 shares of common stock outstanding.

Net interest income for 1997 totaled \$1,676,000. Net interest income is interest income earned on mortgage securities, fixed rate and adjustable rate mortgage loans, and other temporary investments less interest expense from borrowings related to the investments.

General and administration expenses for 1997 totaled \$940,000. The majority

of general and administrative expenses relate to management and administrative expenses, due diligence acquisition costs, commission expenses, and legal and professional fees. Due diligence acquisition costs averaged .156 % of the principal balance of the mortgage loans purchased in 1997.

On September 19, 1997 (the IPO date), the Company acquired 100% of the nonvoting preferred stock of HCP, which represents a 97% ownership interest in HCP and its wholly owned subsidiaries. While the Company will generally have no right to control the affairs of HCP because the Company owns only the preferred stock of HCP, management believes that the Company has the ability to exert significant influence over HCP and therefore the investment in HCP is accounted for on the equity method. The Company recorded a loss of \$254,000 in 1997 for its equity investment in HCP. The HCP loss was a result of a decline in consulting (due diligence/ARMS audit) revenues and a slowdown in the mortgage originations division during the fourth quarter of 1997.

The table below highlights the Company's brief historical trends and components of return on average equity.

COMPONENTS OF ANNUALIZED RETURN ON AVERAGE EQUITY (1)

For the Quarter Ended -----	Net Interest Income/ Equity -----	Gain on Sale of Securities/ Equity -----	G & A Expense/ Equity -----	Equity in Earnings (Loss) of Subsidiary/ Equity -----	Annualized Return on Equity -----
June 30, 1997 (2)	0.00%	0.00%	0.00%	0.00%	0.00%
September 30, 1997(3)	4.85%	0.00%	3.59%	0.97%	2.23%
December 31, 1997	7.71%	0.18%	4.26%	(1.41%)	2.22%

(1) Average equity excludes unrealized loss on investments available for sale.

(2) The Company was organized on June 10, 1997, but did not begin operations until September 19, 1997.

(3) Average equity is based on equity balances at September 19, 1997 (IPO date), and equity balances at September 30, 1997, excluding unrealized loss on investments available for sale.

For the period from inception through December 31, 1997, the Company's taxable income was \$1,077,000 or \$0.167 per weighted average share outstanding. Taxable income is higher than GAAP net income primarily because taxable income does not include the equity in the loss of HCP (\$254,000), and due diligence costs and

commission expenses incurred to acquire mortgage loan pools (\$324,000) that are expensed under GAAP, but capitalized and amortized for tax purposes.

As a REIT, the Company is required to declare dividends amounting to 85% of each years taxable income by the end of each calendar year and to have declared dividends amounting to 95% of the Company's taxable income for each year by the time the Company files its federal tax return. Therefore, a REIT generally passes through substantially all of its earnings to shareholders without paying federal income tax at the corporate level. The Company paid a fourth quarter dividend of \$0.16 per share, which was equivalent to a dividend of approximately 96.0% of taxable income.

The following table reflects the average balances for each major category of the Company's interest earning assets as well as the Company's interest bearing liabilities with the corresponding effective rate of interest annualized for the period September 30, 1997 (initial purchase of mortgage assets) through December 31, 1997:

Average Balance	Effective Rate
--------------------	-------------------

	-----	----
Interest Earning Assets:		
Mortgage Loans (1)	\$ 83,776,000	7.317%
Mortgage Securities	116,375,000	6.268%
	-----	----
	\$200,151,000	6.707%
	=====	=====
Interest Bearing Liabilities		
Reverse repurchase borrowings on mortgage loans	\$ 32,674,000	6.313%
Reverse repurchase borrowings on mortgage securities	113,803,000	5.723%
	-----	----
	\$146,477,000	5.855%
	=====	----
Net Interest Earning Assets	\$ 53,674,000	
Net Interest Spread	=====	0.852%
		=====
Yield on Net Interest Earnings Assets (2)		9.034%
		=====

(1) Loan loss reserves are excluded in above calculations.

(2) Yield on Net Interest Earning Assets is computed by dividing annualized net interest income by the average daily balance of net interest earnings assets.

For the year ended December 31, 1997, the Company's ratio of operating expenses to average assets was 1.59%. The Company's 1997 operating expense did not include any incentive bonus compensation. In order for the eligible participants to earn incentive bonus compensation, the rate of return on shareholders' investment must exceed the average ten-year U.S. Treasury rate during the year plus 4.0%.

FINANCIAL CONDITION

At December 31, 1997, the Company had total assets of \$517,543,000. Mortgage loans totaled \$160,970,000 or 31.1% of total assets, while mortgage securities totaled \$348,131,000 or 67.3% of total assets.

28

31

The following table presents a schedule of mortgage loans at December 31, 1997, classified by fixed rate mortgage and adjustable rate mortgages:

	Carrying Value -----	Portfolio Mix ---
Fixed rate mortgages	\$107,953,000	67.1%
Adjustable rate mortgages	53,017,000	32.9%
	-----	----
	\$160,970,000	100.0%
	=====	=====

The following table presents a schedule of mortgage securities at December 31, 1997, classified by type of issue:

	Carrying Value -----	Portfolio Mix ---
FNMA	\$207,397,000	59.6%
FHLMC	140,734,000	40.4%

-----	-----
\$348,131,000	100.0%
=====	=====

LIQUIDITY AND CAPITAL RESOURCES

The Company expects to meet its short-term and long-term liquidity requirements generally from its existing working capital, cash flow provided by operations, reverse repurchase agreements and other possible sources of financings, including CMO's and REMICs, additional equity generated by the exercise of some or all of the outstanding warrants and additional equity offerings. The Company considers its ability to generate cash to be adequate to meet operating requirements both in the short-term and long-term.

Net cash provided by operating activities for the period June 10, 1997 to December 31, 1997 was \$49,000. The cash flows generated from operating activities (mainly from net income (\$499,000), non cash expense items such as amortization of mortgage loans and mortgage security premiums, and the increase of certain liability accounts) were reduced by amounts expended for the purchase of accrued interest on mortgage loan pools and by loans (\$482,000) made to John A. Burchett, Irma N. Tavares and Joyce S. Mizerak (together with George J. Ostendorf, the "Principals").

Net cash used in investing activities for the period from June 10, 1997 to December 31, 1997 was \$510,287,000. The majority of the cash used in investing activities related to the purchase of FNMA securities and FHLMC securities (\$349,287,000) and mortgage loan pools (\$163,030,000).

Cash flows from financing activities generated \$514,260,000 during the period from June 10, 1997 to December 31, 1997. The cash flows from financing activities represent net proceeds from reverse repurchase agreements used to finance the purchase of mortgage securities (\$341,407,000), pools of single-family mortgage loans (\$93,731,000), and the net proceeds of the IPO (\$79,122,000).

Management anticipates that the Company will continue to purchase single family mortgage loan pools and will finance the purchase of the mortgage loan pools through existing equity,

29

32

reverse repurchase agreements, and other sources of financing including CMO's and REMICs. The Company may also realize additional liquidity beginning in March 1998 when the warrants become exercisable.

The Company is obligated to make additional loans to the Principals (\$1,268,000) at their request. It is anticipated that the Principals will request additional loans in April 1998 for tax purposes. Further, in lieu of their exercise of certain registration rights, the Principals have also requested additional loans in the aggregate amount of \$1,500,000, which was approved by the Board of Directors. The Company has guaranteed HCP's line of credit facility. The Company has advanced \$900,000 to HCP in February 1998 for working capital purposes and Management anticipates that the Company may advance additional funds in 1998 to HCP.

OTHER MATTERS

REIT Requirements

The Company has elected to be taxed as a REIT under the Code. The Company believes that it was in full compliance with the REIT tax rules as of December 31, 1997 and intends to remain in compliance with all REIT tax rules. If the Company fails to qualify as a REIT in any taxable year and certain relief provisions of the Code do not apply, the Company will be subject to Federal income tax as a regular, domestic corporation, and its stockholders will be subject to tax in the same manner as stockholders of a regular corporation. Distributions to its stockholders in any year in which the Company fails to qualify as a REIT would not be deductible by the Company in computing its taxable income. As a result, the Company could be subject to income tax liability, thereby significantly reducing or eliminating the amount of cash available for distribution to its stockholders. Further, the Company could also be disqualified from re-electing REIT status for the four taxable years

following the year during which it became disqualified.

Investments in Certain Mortgage Assets

The Company takes certain risks in investing in subprime single-family mortgage loans. If these mortgage loans are missing relevant documents, such as the original note, they may be difficult to enforce. These mortgage loans may also have inadequate property valuations. In addition, if a single-family mortgage loan has a poor payment history, it is more likely to have future delinquencies because of poor borrower payment habits or a continuing cash flow problem.

Defaults on Mortgage Assets

The Company makes long-term investments in mortgage assets. During the time it holds mortgage assets for investment, the Company is subject to the risks of borrower defaults and bankruptcies and hazard losses (such as those occurring from earthquakes or floods) that are not covered by insurance. If a default occurs on any mortgage loan held by the Company, the Company will bear the risk of loss of principal to the extent of any deficiency between the value of the mortgaged property, plus any payments from an insurer or guarantor, and the amount owing on the mortgage loan.

With respect to commercial mortgage loans, the Company may be subject to certain additional risks. Commercial properties tend to be unique and more difficult to value than single-family residential properties. Commercial mortgage loans often have shorter maturities

than single-family mortgage loans and often have a significant principal balance or "balloon" due on maturity. A balloon payment creates a greater risk for the lender because the ability of a borrower to make a balloon payment normally depends on its ability to refinance the loan or sell the related property at a price sufficient to permit the borrower to make the payment. Commercial mortgage lending is generally viewed as exposing the lender to a relatively greater risk of loss than single-family mortgage lending because it usually involves larger mortgage loans to single borrowers or groups of related borrowers and the repayment of the loans is typically dependent upon the successful operation of the related properties.

Negative Effects of Fluctuating Interest Rates

Changes in interest rates may impact the Company's earnings in various ways. While the Company anticipates that over the long term less than 25% of its mortgage loans will be ARMs, rising short term interest rates may negatively affect the Company's earnings in the short term. Increases in the interest rate on an ARM loan are generally limited to either 1% or 2% per adjustment period. ARM loans owned by the Company are subject to such limitations, while adjustments in interest rate on the Company's borrowings are not correspondingly limited. As a result, in periods of rising interest rates, the Company's net interest income could temporarily decline.

The rate of prepayment on the Company's mortgage loans may increase if interest rates decline, or if the difference between long-term and short-term interest rates diminishes. Increased prepayments would cause the Company to amortize any premiums paid on the acquisition of its mortgage loans faster than currently anticipated, resulting in a reduced yield on its mortgage loans. Additionally, to the extent proceeds of prepayments cannot be reinvested at a rate of interest at least equal to the rate previously earned on the prepaid mortgage loans, the Company's earnings may be adversely affected.

Insufficient Demand for Mortgage Loans and the Company's Loan Products

The availability of mortgage loans that meet the Company's criteria depends on, among other things, the size of and level of activity in the residential, multifamily and commercial real estate lending markets. The size and level of activity in these markets, in turn, depends on the level of interest rates, regional and national economic conditions, inflation and deflation in property values and the general regulatory and tax environment as it relates to mortgage lending. If the Company can not obtain sufficient mortgage loans that meet its criteria, its business will be adversely affected.

Year 2000 Compliance

The inability of computers, software and other equipment utilizing microprocessors to recognize and properly process data fields containing a two digit year is commonly referred to as the Year 2000 Compliance issue. As the year 2000 approaches, such systems may be unable to accurately process certain date-based information.

The Company has identified all significant applications that will require modification to ensure Year 2000 Compliance. Internal resources are primarily being used to make the required modifications and test Year 2000 Compliance. The modification process of all significant applications is substantially complete. The Company plans to complete the testing process of all significant applications by December 31, 1998.

31

34

In addition, the Company has communicated with others with whom it does significant business to determine their Year 2000 readiness and the extent to which the Company may be vulnerable to any third party Year 2000 issues. However, there can be no guarantee that the systems of other companies on which the Company's systems rely will be timely converted, or that a failure to convert by another company, or a conversion that is incompatible with the Company's systems, would not have a material adverse effect on the Company.

The total cost to the Company of these Year 2000 Compliance activities has not been and is not anticipated to be material to the Company's financial position or results of operations in any year. These costs and the date on which the Company plans to complete the Year 2000 modification and testing processes are based on management's best estimates, which were derived utilizing numerous assumptions of future events including the continued availability of certain resources, third party modification plans and other factors. However, there can be no guarantee that these estimates will be achieved and actual results could differ from those plans.

Investment Company Act

The Company at all times intends to conduct its business so as not to become regulated as an investment company under the Investment Company Act. If the Company were to become regulated as an investment company, the Company's use of leverage would be substantially reduced. The Investment Company Act exempts entities that are "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on interest in real estate" ("Qualifying Interests"). Under current interpretation of the staff of the Securities and Exchange Commission, in order to qualify for this exemption, the Company must maintain at least 55% of its assets directly in Qualifying Interests. As of December 31, 1997, Management calculates that the Company is in compliance with this requirement.

IMPORTANT FACTORS RELATED TO FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS

The preceding section, "Management's Discussion and Analysis of Financial Condition and Results of Operations," and other sections of this Annual Report on Form 10-K contain various "forward-looking statements" within the meaning of Section 27A of the Securities Act 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements represent the Company's expectations or beliefs concerning future events, including, without limitation, statements containing the words "believes," "anticipates," "expects" and words of similar import; and also including, without limitation, the following: statements regarding the Company's continuing ability to target and acquire mortgage loans; expected availability of the master repurchase agreement; the sufficiency of the Company's working capital, cash flows and financing to support the Company's future operating and capital requirements; results of operations and overall financial performance; the expected dividend distribution rate; and the expected tax treatment of the Company's operations. Such forward-looking statements relate to future events and the future financial performance of the Company and the industry and involve known and unknown risks, uncertainties and other important factors which could cause actual results, performance or achievements of the Company or industry to differ materially from the future results, performance or achievements expressed or implied by such forward-looking statements.

Investors should carefully consider the various factors identified in "Management's Discussion and Analysis of Financial Condition and Results of Operation - Other Matters," and elsewhere in this Annual Report that could cause actual results to differ materially from the results predicted in the forward-looking statements. Further, the Company specifically cautions investors to consider the following important factors in conjunction with the forward-looking statements: the possible decline in the Company's ability to locate and acquire mortgage loans; the possible adverse effect of changing economic conditions, including fluctuations in interest rates and changes in the real estate market both locally and nationally; the effect of severe weather or natural disasters; the effect of competitive pressures from other financial institutions, including mortgage REITs; and the possible changes, if any, in the REIT rules. Because of the foregoing factors, the actual results achieved by the Company in the future may differ materially from the expected results described in the forward-looking statements.

ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements of the Company and the related notes, together with the Independent Auditors' Report thereon begin on pages F-1 through F-34 of this Form 10-K.

ITEM 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

ITEM 10: DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Incorporated herein by reference to the Company's definitive proxy statement to be filed with the Securities and Exchange Commission.

ITEM 11: EXECUTIVE COMPENSATION

Incorporated herein by reference to the Company's definitive proxy statement to be filed with the Securities and Exchange Commission.

ITEM 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Incorporated herein by reference to the Company's definitive proxy statement to be filed with the Securities and Exchange Commission.

ITEM 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Incorporated herein by reference to the Company's definitive proxy statement to be filed with the Securities and Exchange Commission.

PART IV

ITEM 14: EXHIBITS, FINANCIAL STATEMENTS AND REPORTS ON FORM 8-K

(a) 1. Financial Statements

See Part II, Item 8 hereof.

2. Financial Statements and Auditors' Reports

/s/ Joseph J. Freeman Director

Joseph J. Freeman

/s/ Robert E. Campbell Director

Robert E. Campbell

/s/ Saiyid T. Naqvi Director

Saiyid T. Naqvi

/s/ Ralph F. Laughlin Senior Vice President and Chief Financial Officer
----- (Principal Financial and Accounting Officer)
Ralph F. Laughlin

39

EXHIBIT INDEX

- * 3.1 Articles of Incorporation of the Company, as amended
- * 3.2 By-Laws of the Company
- * 4.1 Specimen Common Stock Certificate
- * 4.2 Warrant Agreement pursuant to which Warrants are to be issued
(including form of Warrant)
- * 4.3 Representatives' Warrant Agreement pursuant to which the
Representatives' Warrants are to be issued.
- * 4.4 Specimen Unit Certificate
- *10.3 Registration Rights Agreement
- *10.4 Shareholders' Agreement of HCP
- *10.5 Agreement and Plan of Recapitalization
- *10.6 Bonus Incentive Compensation Plan
- *10.7 1997 Executive and Non-Employee Director Stock Option Plan
- *10.8 Employment Agreement by and between the Company and John A. Burchett
- *10.9 Employment Agreement by and between the Company and Irma N. Tavares
- *10.10 Employment Agreement by and between the Company and Joyce S. Mizerak
- *10.11 Employment Agreement by and between the Company and George J. Ostendorf
- *10.12 Standard Form of Office Lease, dated as of May 6, 1991, by and between
Irwin Kahn and HCP, as amended by the First Amendment of Lease, dated
as of July 1, 1996
- *10.13 Office Lease Agreement, dated as of March 1, 1994, by and between
Metroplex Associates and HCMC, as amended by the First Modification
and Extension of Lease Agreement, dated as of February 28, 1997
- *10.14 Indenture, dated as of June 28, 1993, by and between LaSalle National
Bank, N.A., as Trustee, and HCP, as amended by the Lease Amendment
dated as of August 23, 1995
- *10.15 Office building space, dated as of February 5, 1993, by and between
Bonhomme Place Associates, Inc. and HCMC, as amended by Lease
Amendment #1, dated as of December 1, 1993 and as further amended
by Second Amendment and Extension of Lease, dated as of March 1,
1996

- *10.16 Office Lease and Service Agreement, dated as of August 28, 1995 by and between Federal Deposit Insurance Receiver for Merchants Bank and HCP
- *10.17 Agreement of Lease, dated as of January 8, 1997 by and between Saint Paul Executive Office Suites, Inc., d.b.a. LesWork Inc. and HCP
- *10.18 Revolving Credit Agreement, dated as of December 10, 1996 between Fleet National Bank and HCP
- *10.19 Guaranty, dated as of December 10, 1996, by John A. Burchett to Fleet National Bank
- *10.20 Guaranty, dated as of December 10, 1996, by HCMC to Fleet National Bank
- *10.21 Guaranty, dated as of December 10, 1996, by HCMF to Fleet National Bank
- *10.22 Guaranty, dated as of December 10, 1996, by HCA to Fleet National Bank
- *10.23 Guaranty, dated as of December 10, 1996, by HCS to Fleet National Bank
- *10.24 Modification Agreement, dated as of June , 1997, among Fleet National Bank, HCP, HCMC, HCMF, HCS, HCA and John A. Burchett
- *10.25 Contribution Agreement
- *10.26 Participation Agreement
- *10.27 Loan Agreement
- *10.28 Master Repurchase Agreement Governing Purchases and Sales of Mortgage Loans, between Nomura Asset Capital Corporation and the Company, dated September 29, 1997
- 10.29 Management Agreement, dated as of January 1, 1998, by and between the Company and HCP
- 10.30 Master Loan and Security Agreement between the Company and Morgan Stanely Mortgage Capital Inc., dated as of December 8,1997
- *21 Subsidiaries of the Company
- 27 Financial Data Schedule

- -----
 * Incorporated herein by reference to the Company's Registration Statement No. 333-29261, as amended, as filed with the Securities and Exchange Commission.

** Incorporated herein by reference to the Company's Form 10-Q, as amended, for the quarter ended September 30, 1997, as filed with the Securities and Exchange Commission.

	PAGE

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.	
Independent Auditors' Report.....	F-2
Financial Statements as of December 31, 1997 and for the Period from June 10, 1997 (inception) through December 31, 1997:	
Balance Sheet.....	F-3
Statement of Operations.....	F-4
Statement of Stockholders' Equity.....	F-5
Statement of Cash Flows.....	F-6
Notes to Financial Statements.....	F-7
HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES	
Independent Auditors' Report.....	F-22
Consolidated Financial Statements as of December 31, 1997 and December 31, 1996 and for each of the Three Years in the Period Ended December 31, 1997:	
Balance Sheet.....	F-23
Statements of Operations.....	F-24
Statements of Stockholders' Equity.....	F-25
Statements of Cash Flows.....	F-26
Notes to Consolidated Financial Statements.....	F-27

F-1

41

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Hanover Capital Mortgage Holdings, Inc.
New York, New York

We have audited the accompanying balance sheet of Hanover Capital Mortgage Holdings, Inc. (the "Company") as of December 31, 1997 and the related statements of operations, stockholders' equity and cash flows for the period June 10, 1997 (inception) through December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Hanover Capital Mortgage Holdings, Inc. as of December 31, 1997 and the results of its operations and its cash flows for the period June 10, 1997 (inception) through December 31, 1997, in conformity with generally accepted accounting principles.

DELOITTE & TOUCHE LLP

Parsippany, New Jersey
March 20, 1998

F-2

42

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

BALANCE SHEET

(in thousands, except as noted)

DECEMBER 31,
1997

ASSETS

ARM securities, available for sale	\$ 348,131
Mortgage loans, held for sale	160,970
Cash and cash equivalents	4,022
Accrued interest receivable	3,597
Equity investment	100
Notes receivable from related parties	482

Prepaid expenses and other assets	241
-----------------------------------	-----

TOTAL ASSETS	\$ 517,543
--------------	------------

LIABILITIES AND STOCKHOLDERS' EQUITY

LIABILITIES:

Reverse repurchase agreements	\$ 435,138
Accrued interest payable	2,250
Dividends payable	1,035
Due to related party	540
Accrued expenses and other liabilities	482

Total liabilities	439,445
-------------------	---------

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS' EQUITY

Preferred stock, par value \$.01 authorized, 10 million shares, issued and outstanding, -0- shares	--
Common stock, par value \$.01 authorized, 90 million shares, issued and outstanding, 6,466,677 shares	65
Additional paid-in-capital	79,411
Available for sale securities: Unrealized (loss) on investments available for sale	(842)
Retained earnings (deficit)	(536)

Total stockholders' equity	78,098
----------------------------	--------

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 517,543
--	------------

See notes to financial statements

F-3

REVENUES:	
Interest income	\$ 4,880
Interest expense	3,204

Net interest income	1,676
Loan loss provision	18

Net interest income after loan loss provision	1,658

Gain on sale of securities	35

Total revenues	1,693

EXPENSES:	
General and administrative expenses	
Management and administrative	400
Due diligence	266
Commissions	61
Legal and professional	170
Other	43

Total expenses	940

Operating income	753
Equity in (loss) of unconsolidated subsidiary	(254)

NET INCOME	\$ 499
	=====
BASIC EARNINGS PER SHARE	\$ 0.15
	=====
DILUTED EARNINGS PER SHARE	\$ 0.14
	=====

See notes to financial statements

F-4

44

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

STATEMENT OF STOCKHOLDERS' EQUITY

PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
(in thousands)

	COMMON STOCK SHARES	STOCK AMOUNT	ADDITIONAL PAID-IN CAPITAL	AVAILABLE FOR SALE SECURITIES UNREALIZED (LOSS)	RETAINED EARNINGS (DEFICIT)	TOTAL

Issuance of common stock	6,466,677	\$ 65	\$ 79,411			\$ 79,476
Unrealized (loss) on available-for-sale securities				\$ (842)		(842)
Net income					\$ 499	499
Dividends declared					(1,035)	(1,035)

BALANCE, DECEMBER 31, 1997	6,466,677	\$ 65	\$ 79,411	\$ (842)	\$ (536)	\$78,098

See notes to financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

STATEMENT OF CASH FLOWS

PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
(in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES:

Net income	\$ 499
Adjustments to reconcile net income to net cash provided by operating activities:	
Amortization of net premium - ARM securities	314
Amortization of net premium - mortgage loans	47
Loan loss provision	18
Gain on sale of securities	(35)
Equity in loss of unconsolidated subsidiary	254
Increase in accrued interest receivable	(3,597)
Loans to officers/stockholders	(482)
Increase in prepaid expenses and other assets	(241)
Increase in accrued interest payable	2,250
Increase in due to related party	540
Increase in accrued expenses and other liabilities	482

Net cash provided by operating activities	49

CASH FLOWS FROM INVESTING ACTIVITIES:

Purchase of ARM securities	(349,287)
Purchase of mortgage loans	(163,030)
Principal payments on mortgage loans	1,995
Proceeds from sale of securities	35

Net cash (used in) investing activities	(510,287)

CASH FLOWS FROM FINANCING ACTIVITIES:

Net borrowings from reverse repurchase agreements	435,138
Net proceeds of initial public offering	79,122

Net cash provided by investing activities	514,260

NET INCREASE IN CASH AND CASH EQUIVALENTS 4,022

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD 0

CASH AND CASH EQUIVALENTS, END OF PERIOD 4,022

SUPPLEMENTAL SCHEDULE OF NONCASH ACTIVITIES

Operating activity - increase in dividends payable (\$1,035,000) relating to the declaration of dividends in December 1997.

Investing activity - acquisition of a 97% ownership interest in Hanover Capital Partners Ltd (\$354,000).

Financing activities - issuance of 716,667 shares of the Company's common stock used to acquire an equity investment in HCP (\$354,000), and the declaration of \$1,035,000 of dividends in December 1997 that was paid in January 1998.

SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid during the period for:

Income taxes	\$ -0-
	=====
Interest	\$ 884
	=====

See notes to financial statements

F-6

46

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
NOTES TO FINANCIAL STATEMENTS
PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997

1. BUSINESS DESCRIPTION

GENERAL

Hanover Capital Mortgage Holdings, Inc. (the "Company") was incorporated in Maryland on June 10, 1997. The Company is a self-managed real estate investment trust ("REIT"), formed to operate as a specialty finance company. The principal business strategy of the company is to (i) acquire primarily single-family mortgage loans that are at least twelve months old or that were intended to be of certain credit quality but that do not meet the originally intended market parameters due to errors or credit deterioration, (ii) securitize the mortgage loans and retain interests therein, (iii) originate, hold, sell and service multifamily mortgage loans and commercial mortgage loans and (iv) acquire multifamily mortgage loans. The Company's principal business objective is to generate increasing earnings and dividends for distribution to its stockholders. The Company acquires single-family mortgage loans through a network of sales representatives targeting financial institutions throughout the United States. The Company may also acquire multifamily mortgage loans from a taxable subsidiary of the Company.

CAPITALIZATION

In September 1997, the Company raised net proceeds of approximately \$79 million in its initial public offering (the "IPO"). In the IPO, the Company sold 5,750,000 units (each unit consists of one share of common stock, par value \$.01 and one stock warrant) at \$15.00 per unit including 750,000 units sold pursuant to the underwriters' overallotment option, which was exercised in full. Each warrant entitles the holder to purchase one share of common stock at the original issue price - \$15.00. The warrants became exercisable on March 19, 1998 and remain exercisable until September 15, 2000. The Company will utilize substantially all of the net proceeds of the IPO to fund leveraged purchases of mortgage assets.

In connection with the closing of the IPO the Company acquired a 97% ownership interest (representing a 100% ownership of the non-voting preferred stock) in Hanover Capital Partners Ltd. and its wholly-owned subsidiaries: Hanover Capital Mortgage Corporation and Hanover Capital Securities, Inc., in exchange for 716,667 shares of the Company's common stock. Hanover Capital Partners Ltd. and its wholly-owned subsidiaries offer due diligence services to buyers, sellers and holders of mortgage loans and originate, sell and service multifamily mortgage loans and commercial loans.

F-7

47

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
NOTES TO FINANCIAL STATEMENTS
PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

RISKS AND UNCERTAINTIES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that

affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company's estimates and assumptions primarily arise from risks and uncertainties associated with interest rate volatility, credit exposure and regulatory changes. Although management is not currently aware of any factors that would significantly change its estimates and assumptions in the near term, future changes in market trends and conditions may occur which could cause actual results to differ materially.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash on hand, overnight investments deposited with banks and government securities with maturities less than 30 days.

ADJUSTABLE RATE MORTGAGE SECURITIES

The Company's policy is to classify its adjustable rate mortgage ("ARM") securities as available-for-sale as they are purchased and each asset is monitored for a period of time, generally three to six months, prior to making a determination whether the asset will be classified as held-to-maturity. At December 31, 1997 management has made the determination that all ARM securities are available-for-sale in order to be prepared to respond to potential future opportunities in the market, to sell ARM securities in order to optimize the portfolio's total return and to retain its ability to respond to economic conditions that require the Company to sell assets in order to maintain an appropriate level of liquidity. Management re-evaluates the classification of the ARM securities on a quarterly basis. ARM securities classified as held-to-maturity are carried at the fair value of the security at the time the designation is made and any fair value adjustment to the cost basis as of the date of the classification is amortized into interest income as a yield adjustment. All ARM securities designated as available-for-sale are reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity.

Premiums and discounts associated with the purchase of ARM securities are amortized into interest income over the lives of the securities using the effective yield method adjusted for the effects of estimated prepayments. ARM securities transactions are recorded on the date the ARM securities are purchased or sold. Purchases of new issue ARM securities are recorded when all significant uncertainties regarding the characteristics of the securities are removed, generally on or shortly before settlement date. Realized gains and losses on ARM securities transactions are determined on the specific identification basis.

F-8

48

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

The Company has limited its exposure to credit losses on its portfolio of ARM securities by only purchasing ARM securities that have some form of credit enhancement and that are either guaranteed by an agency of the federal government or have an investment grade rating at the time of purchase, or the equivalent, by at least one of two nationally recognized rating agencies, Moody's or Standard & Poor's (the "Rating Agencies"). The Company monitors the delinquencies and losses on the underlying mortgages of its ARM securities and, if the credit performance of the underlying mortgage loans is not as good as expected, makes a provision for possible credit losses as well as unidentified potential future losses in its ARM securities portfolio. The provision is based on management's assessment of numerous factors affecting its portfolio of ARM securities including, but not limited to, current and projected economic conditions, delinquency status, credit losses to date on underlying mortgages and remaining credit protection. The provision is made by reducing the cost basis of the individual security and the amount of such write-down is recorded as a realized loss, thereby reducing earnings. Provisions for credit losses do not reduce taxable income and therefore do not affect the dividends paid by the Company to stockholders in the period the provisions are taken. Actual losses realized by the Company reduce taxable income in the period the actual loss is realized and would affect the dividends paid to stockholders for that tax year.

MORTGAGE LOANS

The Company's policy is to classify each of its mortgage loans as held for sale as they are purchased and each asset is monitored for a period of time, generally four to nine months, prior to making a determination as to whether the asset will be classified as held-to-maturity. At December 31, 1997 management has made the determination that all mortgage loans are held for sale in order to be prepared to respond to potential future opportunities in the market, to sell mortgage loans in order to optimize the portfolio's total return and to retain its ability to respond to economic conditions that require the Company to sell mortgage loans in order to maintain an appropriate level of liquidity. Management re-evaluates the classification of mortgage loans on a quarterly basis. All mortgage loans designated as held for sale are reported at the lower of cost or market, with unrealized losses reported as a charge to earnings in the current period.

Premiums and discounts associated with the purchase of mortgage loans are amortized into interest income over the lives of the mortgage loans using the effective yield method adjusted for the effects of estimated prepayments. Mortgage loan transactions are recorded on the date the mortgage loans are purchased or sold. Purchases of new mortgage loans are recorded when all significant uncertainties regarding the characteristics of the mortgage loans are removed, generally on or shortly before settlement date. Realized gains and losses on mortgage loan transactions are determined on the specific identification basis.

F-9

49

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

The accrual of interest on impaired loans is discounted when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received.

The Company has limited its exposure to credit losses on its portfolio of mortgage loans by performing an in-depth due diligence on every loan purchased. The due diligence encompasses the borrowers credit, the enforceability of the documents, and the value of the mortgage property. In addition many mortgage loans are guaranteed by an agency of the federal government or private mortgage insurance. The Company monitors the delinquencies and losses on the underlying mortgages and makes a provision for known losses as well as unidentified potential losses in its mortgage loan portfolio if the impairment is deemed to be other than temporary. The provision is based on management's assessment of numerous factors affecting its portfolio of mortgage loans including, but not limited to, current and projected economic conditions, delinquency status, losses to date on mortgages and remaining credit protection.

FINANCIAL INSTRUMENTS

The Company from time to time enters into interest rate hedge mechanisms to manage its exposure to interest rate changes in connection with the purchase, securitization and sale of its mortgage loans. The Company closes out the hedge position to coincide with the related mortgage loan sale and securitization transactions and recognizes the results of the hedge transaction in determining the amount of the related mortgage loan sale gain for loans sold or, as a basis adjustment to mortgage loans held to maturity.

EQUITY INVESTMENT

The Company's 97% ownership investment in Hanover Capital Partners Ltd. ("HCP") is accounted for by the equity method of accounting. The Company generally has no right to control the affairs of HCP because the Company's investment in HCP is based solely on a 100% ownership of HCP's non-voting preferred stock. Even though the Company has no right to control the affairs of HCP, management believes that the Company has the ability to exert significant influence over HCP and therefore the investment in HCP is accounted for by the equity method of accounting.

REVERSE REPURCHASE AGREEMENTS

Reverse repurchase agreements are accounted for as collateralized financing transactions and recorded at their contractual amounts, plus accrued interest.

F-10

50

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

INCOME TAXES

The Company has elected to be taxed as a real estate investment trust ("REIT") and intends to comply with the provisions of the Internal Revenue Code of 1986, as amended (the "Code") with respect thereto. Accordingly, the Company will not be subject to Federal income tax to the extent of its distributions to stockholders as long as certain asset, income and stock ownership tests are met.

EARNINGS PER SHARE

At December 31, 1997 the Company adopted Statement of Financial Accounting Standards No. 128 "Earnings per Share" ("SFAS 128"). Under SFAS 128 basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock that then shared in earnings. Shares issued during the period and shares reacquired during the period are weighted for the period they were outstanding.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 1997, the FASB issued SFAS No. 130, Reporting Comprehensive Income ("SFAS 130"). SFAS 130 establishes standards for reporting and displaying of comprehensive income and its components (revenues, expenses, gains and losses) in a full set of general purpose financial statements. SFAS 130 requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. SFAS 130 is effective for fiscal years beginning after December 15, 1997. Reclassification of financial statements for earlier periods provided for comparative purposes is required.

The FASB issued SFAS No. 131 Disclosures About Segments of an Enterprise and Related Information ("SFAS 131") in June 1997. SFAS 131 establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports issued to stockholders. It also establishes standards for related disclosures about products and services, geographic areas and major customers. SFAS 131 is effective for financial statements for periods beginning after December 15, 1997. Management has not yet determined what effect, if any, adoption will have on the Company's financial condition and results of operations.

3. ADJUSTABLE RATE MORTGAGE SECURITIES

ARM securities consist of FNMA and FHLMC mortgage certificates secured by ARM loans on single-family residential housing. The following table summarizes the Company's ARM

F-11

51

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

securities classified as available-for-sale as of December 31, 1997, which are carried at their fair value (dollars in thousands):

AVAILABLE-FOR-SALE

PORTFOLIO MIX

Amortized cost :		
FNMA certificates	\$ 207,898	59.6%
FHLMC certificates	141,075	40.4%
	-----	-----
Total amortized cost	348,973	100.0%
		=====
Gross unrealized (losses)	(842)	

Fair value	\$ 348,131	
	=====	

The scheduled maturities of ARM securities available for sale at December 31, 1997, were as follows:

	AMORTIZED COST	FAIR VALUE
	-----	-----
Due in one year or less	\$ -0-	\$ -0-
Due from one to five years	-0-	-0-
Due from five to ten years	-0-	-0-
Due after ten years	348,973	348,131
	-----	-----
Total	\$ 348,973	\$ 348,131
	=====	=====

As mentioned above, actual maturities may differ from scheduled maturities because borrowers may have the right to prepay certain obligations, often times without penalties. Maturities of mortgage securities depend on the repayment characteristics and experience of the underlying obligations.

As of December 31, 1997, the average effective yield on the ARM securities including the amortization of the net premiums paid for the ARM securities, was 6.268%.

4. MORTGAGE LOANS HELD FOR SALE

Investments in single-family mortgage loans held for sale consist of fixed rate mortgages and adjustable rate mortgages. The following table summarizes the Company's single-family mortgage loan pools as of December 31, 1997, which are carried at the lower of cost or market (dollars in thousands):

F-12

52

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

	COST	MIX
	----	---
Fixed rate	\$ 106,397	67.1%
Adjustable rate	52,392	32.9%
	-----	-----
Subtotal	158,789	100.0%
		=====
Net deferred loan fees,		
Premiums and discounts	2,199	
Loan loss provision	(18)	

Total	\$ 160,970	
	=====	

An analysis of the change in the loan loss provision is as follows:

Balance beginning of period	\$ 0
Loan loss provision	18

Balance at December 31, 1997	\$18
	===

The following table summarizes certain characteristics of the Company's single-family fixed rate and adjustable rate mortgage loan portfolios as of December 31, 1997 (dollars in thousands):

	CARRYING VALUE OF MORTGAGE LOANS	PRINCIPAL AMOUNT OF MORTGAGE LOANS	WEIGHTED AVERAGE NET COUPON	WEIGHTED AVERAGE MATURITY (1)
	-----	-----	-----	-----
Fixed Rate	\$107,953	\$106,424	8.265%	242
Adjustable Rate	53,017	52,365	7.925%	319
	-----	-----	-----	-----
	\$160,970	\$158,789	8.153%	267
	=====	=====	=====	=====

(1) weighted average maturity reflects the number of months remaining until maturity

As of December 31, 1997 the average effective yield on the mortgage loan portfolio, including the amortization of the net premiums paid for the mortgage loans, was 7.317%.

5. CONCENTRATION OF CREDIT RISK

The Company's exposure to credit risk associated with its lending activities is measured on an individual customer basis as well as by groups of customers that share similar attributes. In the normal course of its business, the Company has concentrations of credit risk in its portfolio for the mortgage loans in certain geographic areas. At December 31, 1997, the percent of total principal amount of mortgage loans outstanding in any one state, exceeding 5% of the principal amount of mortgage loans held for sale, are as follows:

F-13

53

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
 NOTES TO FINANCIAL STATEMENTS
 PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

STATE	PERCENT
-----	-----
Florida	25%
South Carolina	13%
California	10%
Ohio	9%
Texas	6%

The Company's management believes exposure to credit risk associated with agency ARM securities is minimal due to the guarantees provided by FNMA and FHLMC.

During 1997 the Company purchased approximately 61.9% of its total outstanding principal amount of mortgage loans from three financial institutions (the largest of which represented approximately 29.1% of the total outstanding principal amount of mortgage loans). Management attributes the high concentration of purchases from these three financial institutions to the initial ramp up phase of mortgage loan acquisitions and does not foresee that this is a trend that will continue into the future.

ARM securities were purchased from six securities firms in 1997. The largest concentration of ARM purchases from one firm represented approximately 22.8% of the total principal amount of ARM securities outstanding at December 31, 1997.

The company has cash and cash equivalents in a financial institution which is insured by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000 per institution. As of December 31, 1997, the Company had amounts on deposit with the financial institution in excess of FDIC limits. The Company limits its risk by placing its cash and cash equivalents in a high quality financial institution.

6. REVERSE REPURCHASE AGREEMENTS

In September 1997, the Company entered into a master repurchase agreement with a lender in an amount up to \$200 million (\$100 million committed and \$100 million uncommitted) for a period of one year. Any borrowings under this facility will be secured by mortgage loans, or other securities, and will bear interest at the six-month LIBOR, plus a spread ranging from 0.70% to 1.25%.

In December 1997 the Company entered into a second master repurchase agreement with another lender in an amount up to \$125 million (\$100 million committed and \$25 million uncommitted) for a period of one year. Any borrowings under this facility will be secured by mortgage loans, or other securities and will bear interest at the six-month LIBOR, plus a spread of 60 basis points.

At December 31, 1997 the Company had outstanding borrowings of \$93,731,000 under the above mentioned reverse repurchase agreements with a weighted average borrowing rate of 6.313% and a weighted average remaining maturity of approximately one month. The reverse

F-14

54

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

repurchase agreements at December 31, 1997 were collateralized by mortgage loans with a cost basis of \$160,970,000 (which approximates market value).

In November 1997 the Company entered into six separate reverse repurchase agreements to finance all of its ARM securities purchases. Each of the reverse repurchase agreements are secured by the market value of the Company's ARM securities (\$348,131,000) at December 31, 1997 and bear interest at LIBOR.

As of December 31, 1997, the Company had outstanding ARMS securities reverse repurchase agreements of \$341,407,000 with a weighted average borrowing rate of 5.723 % and a weighted average remaining maturity of less than one month.

Information concerning the reverse repurchase agreements and the pledged collateral at December 31, 1997 is summarized as follows: (dollars in thousands):

	Collateral (dollars in thousands)	
	ARM Securities	Mortgage Loans
Reverse Repurchase Agreements		
Average balance during the period (1)	\$113,803	\$ 32,674
Average interest rate during period (1)	5.723%	6.313%
Maximum month-end balance during the period	\$341,407	\$ 93,731

Collateral Underlying the Agreements

Carrying balance	\$348,131	\$160,970
Estimated fair value	\$348,131	\$160,970

(1) above table reflects the period beginning September 30, 1997 (the date of the first mortgage asset purchase) through December 31, 1997.

7. EMPLOYEE BENEFIT PLANS

401(k) PLAN

The Company participates in the HCP non-contributory retirement plan ("401(k) Plan"). The 401(k) plan is available to all full-time company employees with at least six months of service. The 401(k) Plan is designed to be tax deferred in accordance with provisions of Section 401(k) of the Internal Revenue Code. The 401(k) Plan provides that each participant may contribute 15.0% of his or her salary subject to the maximum allowable each fiscal year (\$9,500 in 1997). Under the 401(k) Plan, an employee may elect to enroll on January 1, or July 1, provided that the employee has met the six month employment service requirement.

F-15

55

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

1997 STOCK OPTION PLAN

The Company's 1997 Executive and Non-Employee Director Stock Option Plan (the "1997 Stock Option Plan") provides for the grant of qualified incentive stock options ("ISOs") which meet the requirements of Section 422 of the Internal Revenue Code, stock options not so qualified ("NQSOs"), deferred stock, restricted stock, performance shares, stock appreciation rights and limited stock awards ("Awards") and dividend equivalent rights ("DERs").

Subject to anti-dilution provisions of stock splits, stock dividends and similar events, the 1997 Stock Option Plan authorizes the grant of options to purchase, and Awards of, an aggregate of up to 325,333 shares of the common stock. If an option granted under the 1997 Stock Option Plan expires or terminates, or an Award is forfeited, the shares subject to any unexercised portion of such option or Award will again become available for the issuance of further options or Awards under the 1997 Stock Option Plan.

Unless previously terminated by the Board of Directors, the 1997 Stock Option Plan will terminate ten years from the date of approval (or five years in the case of ISO's granted to an employee who is deemed to own in excess of 10% of combined voting power of the Company's outstanding equity stock) and no options or Awards may be granted under the 1997 Stock Option Plan thereafter, but existing options or Awards remain in effect until the options are exercised or the options or the Awards are terminated by their terms. The aggregate fair market value (determined as of the time of grant) of the shares of the common stock with respect to which ISOs are exercisable for the first time by an employee during any calendar year may not exceed \$100,000.

All stock options granted by the Compensation Committee pursuant to the 1997 Stock Option Plan will be contingent and may vest, subject to other vesting requirements imposed by the Compensation Committee in full or in part on any September 30 beginning with September 30, 1998 and ending with September 30, 2002 (each, an "Earn-Out Measuring Date"). Subject to any other applicable vesting restrictions, any outstanding stock options will vest in full as of any Earn-Out Measuring Date through which the return on a unit (a unit is composed of one common stock certificate and one warrant certificate) is at least equal to the initial public offering price of the unit. In addition, subject to any other applicable vesting restrictions, one-third of any outstanding stock options will vest as of any Earn-Out Measuring Date through which the return on a unit is at least equal to a 20% annualized return on the initial public offering price of the unit. The return on a unit is determined by adding (i) the appreciation in the value of the unit since the closing of the initial public offering and (ii) the amount of distributions made by the Company on the share

of common stock included in the unit since the closing of the initial public offering. The appreciation in the value of a unit as of any Earn-Out Measuring Date is the average difference, during the 30 day period that ends on the Earn-Out Measuring Date, between the market price of the share of common stock included in the unit and the initial public offering price of the unit multiplied by two to take into account the value of the stock warrant included in the unit. In determining whether such stock options have vested, appropriate adjustments will be made for stock splits, recapitalizations, stock dividends and transactions having similar effects.

F-16

56

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

A summary of the status of the Company's 1997 Stock Options Plan as of December 31, 1997 and changes during the period from September 19, 1997 through December 31, 1997 is presented below:

STOCK OPTION - - - - -	SHARES -----	EXERCISE PRICE -----
Granted - September 19, 1997	162,664	\$15.00
Granted - September 28, 1997	160,660	15.75
Cancelled	(3,000)	15.75
	-----	-----
Outstanding at December 31, 1997	320,324	\$15.37
	=====	=====

No shares were exercisable at December 31, 1997.

The per share weighted average fair value of stock options granted during the period ended December 31, 1997 was \$0.27 at the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	1997 -----
Expected life (years)	5
Risk-free interest rate	5.77%
Volatility	12.0%
Expected dividend yield	10.0%

The Company applies APB opinion No. 25 in accounting for its 1997 Stock Option Plan and, accordingly, no compensation cost has been recognized for its stock options in the financial statements. Had the Company determined compensation cost based on the fair value at the grant date for its stock options under Statements of Financial Accounting Standards No. 123, Accounting For Stock-Based Compensation, the Company's net income would have been reduced to the pro forma amounts indicated below (in thousands, except per share data):

YEAR ENDED
DECEMBER 31, 1997

Net earnings:	
As reported	\$ 499
Pro forma	417
Earnings per share - basic:	
As reported	\$0.15
Pro forma	0.13
Earnings per share - diluted	

As reported	\$0.14
Pro forma	0.11

BONUS INCENTIVE COMPENSATION PLAN

A bonus incentive compensation plan was established in 1997, whereby an annual bonus will be accrued for eligible participants of the Company. The annual bonus will be paid one-half in cash

F-17

57

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

and (subject to ownership limits) one-half in shares of common stock in the following year. The Company must generate annual net income before bonus accruals that allow for a return of equity to stockholders in excess of the average weekly ten-year U.S. Treasury rate plus 4.0% before any bonus accrual is recorded. No such accrual was recorded in 1997.

8. AFFILIATED PARTY TRANSACTIONS

The Company has engaged HCP pursuant to a Management Agreement to render, among other things, due diligence, asset management and administrative services. The 1997 statement of operations of the Company includes management and administrative expenses of \$400,000, due diligence expenses of \$266,000 and commission expenses of \$61,000 relating to billings from HCP. At December 31, 1997 the balance sheet of the Company included an amount due HCP of \$540,000. The term of the Management Agreement continues until December 31, 1999 with subsequent renewal provisions.

The Company has agreed to lend (a maximum of) \$1,750,000 collectively, to four officer/stockholders (collectively referred to as the "Principals") to enable the Principals to pay tax on the gains they must recognize upon contributing their HCP preferred stock to the Company for shares of the Company's common stock. The loans will be secured solely by 116,667 shares of the Company's common stock owned by the Principals, collectively. The loans bear interest at the lowest applicable federal tax rate during the month the loans are made. At December 31, 1997 loans outstanding to three of the Principals totaled \$482,000.

9. EARNINGS PER SHARE

On December 31, 1997 the Company adopted SFAS 128 for calculating earnings per share as shown below: (dollars in thousands, except per share data)

Earnings per share - basic:	
Net income (numerator)	\$ 499
	=====
Average common shares	
outstanding (denominator)	3,296,742
	=====
Per share	\$ 0.15
	=====
Earnings per share - diluted:	
Net income (numerator)	\$ 499
	=====
Average common shares outstanding	3,296,742
Add: Incremental shares from	
assumed conversion of	
warrants	374,943

Dilutive potential common shares	374,943

Adjusted weighted average shares	

(denominator) 3,671,685

=====

Per share \$ 0.14

=====

F-18

58

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

10. COMMITMENTS AND CONTINGENCIES

At December 31, 1997 the Company had committed to purchase approximately \$111,092,000 of fixed and ARM loans.

The Company entered into employment agreements with the Principals. Such agreements are for five year terms which expire in 2002, and provide for aggregate annual base salaries of \$975,000. A portion of the aggregate base salaries is allocated to the Company's taxable subsidiary based on management's actual and estimated time involved with the subsidiary's activities.

As additional consideration to the Principals for their contribution of their HCP preferred stock to the Company, the Company has agreed to (1) issue to the Principals up to 216,667 additional shares of the Company's common stock and (2) forgive a maximum of \$1,750,000 in loans made to the Principals; if certain financial returns to stockholders are met, at certain Earn-Out Measuring Dates as described in the Company's IPO Prospectus dated September 15, 1997.

The Company has guaranteed the line-of-credit of its majority owned subsidiary, Hanover Capital Partners Ltd. The maximum line-of-credit obligation and the actual line-of-credit obligation at December 31, 1997 was \$1,700,000 and \$1,405,000, respectively.

11. FINANCIAL INSTRUMENTS

In accordance with SFAS No. 107, Disclosure about Derivative Financial Instruments, and SFAS No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments, the Company has provided fair value estimates and information about valuation methodologies. The estimated fair value amounts have been determined using available market information or appropriate valuation methodologies. However, considerable judgment is required in interpreting market data to develop estimates of fair value, so the estimates are not necessarily indicative of the amounts that would be realized in a current market exchange. The effect of using different market assumptions and/or estimation methodologies may materially impact the estimated fair value amounts.

The estimated fair value of the Company's assets and liabilities classified as financial instruments and off-balance sheet financial instruments at December 31, 1997 are as follows (dollars in thousands):

F-19

59

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

	CARRYING AMOUNT	FAIR VALUE
	-----	-----
Assets:		
ARM securities	\$348,131	\$348,131
Mortgage loans	160,970	160,970
Cash and cash equivalents	4,022	4,022
Accrued interest receivable	3,597	3,597
Notes receivable	482	482
	-----	-----

Total	\$517,202	\$517,202
	=====	=====
Liabilities:		
Reverse repurchase agreements	435,138	435,138
Accrued interest payable	2,250	2,250
Other liabilities	2,057	2,057
	-----	-----
Total	\$439,445	\$439,445
	=====	=====
Off-Balance Sheet:	Notional	

Commitments to purchase loans	\$111,092	\$111,132
	=====	=====
Forward commitments to sell mortgage securities	\$122,650	\$122,378
	=====	=====

The following methods and assumptions were used to estimate the fair value of the Company's financial instruments:

Cash and cash equivalents, accrued interest receivable, notes receivable, reverse repurchase agreements, accrued interest payable, other liabilities - The fair value of these financial instruments was determined to be their carrying value due to their short-term nature.

ARM securities - The fair values of these financial instruments are based upon either or all of the following: actual prices received upon recent sales of mortgage securities to investors, projected prices which could be obtained through investor estimates considering interest rates, mortgage loan type, quality and discounted cash flow analysis based on prepayment and interest rate assumptions used in the market place for similar securities with similar credit ratings.

Mortgage loans held for sale - The fair values of these financial instruments are based upon actual prices received upon recent sales of mortgage loans and securities to investors and projected prices which could be obtained through investors considering interest rates, mortgage loan type, an credit quality.

Commitments to purchase/originate mortgages - The Company has outstanding commitments to purchase mortgage loans at market terms at the time of commitment. The fair value of these financial instruments was determined through a review of published market information associated with similar instruments. These commitment obligations are considered in conjunction with the Company's lower of cost or market valuation of its mortgage loans held for sale.

F-20

60

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
NOTES TO FINANCIAL STATEMENTS

PERIOD FROM JUNE 10, 1997 (INCEPTION) TO DECEMBER 31, 1997 - (CONTINUED)

Forward commitments to sell mortgage securities - The Company has outstanding forward commitments to sell mortgages and/or mortgage securities into mandatory delivery contracts with investment bankers, private mortgage investors and agency mortgage-backed securities. The fair value of these financial instruments was determined through review of published market information associated with similar instruments. These commitment obligations are considered in conjunction with the Company's lower of cost or market valuation of its mortgage loans held for sale.

12. SUBSEQUENT EVENT

On January 12, 1998 a \$0.16 cash dividend previously declared by the Board of Directors was paid to stockholders of record as of December 31, 1997.

13. QUARTERLY FINANCIAL DATA - UNAUDITED

Selected quarterly financial data are as follows (dollars in thousands, except

per share data):

Period from June 10, 1997 (inception)
through December 31, 1997

	THREE MONTHS ENDED DECEMBER 31, 1997	(1) THREE MONTHS ENDED SEPTEMBER 30, 1997	(1) JUNE 10, 1997 THROUGH JUNE 30, 1997
Net interest income	\$ 1,548	\$ 128	\$ 0
Net income	440	59	0
Basic earnings per share(2)	0.07	0.07	0.00
Diluted earnings per share(2)	0.07	0.07	0.00
Dividends declared	0.16	0.00	0.00

(1) - the Company was organized on June 10, 1997, however operations did not begin until the IPO date - September 19, 1997

(2) - earnings per share are computed independently for each of the quarters presented; therefore the sum of the quarterly earnings per share do not equal the earnings per share total for the year

F-21

61

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Hanover Capital Partners Ltd.

We have audited the accompanying consolidated balance sheets of Hanover Capital Partners Ltd. and Subsidiaries (the "Company") as of December 31, 1997 and 1996, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Hanover Capital Partners Ltd. and Subsidiaries at December 31, 1997 and 1996, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1997 in conformity with generally accepted accounting principles.

DELOITTE & TOUCHE LLP

Parsippany, New Jersey

March 20, 1998

F-22

62

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 1997 AND 1996

ASSETS	1997	1996
	----	----
CURRENT ASSETS:		
Cash	\$ 208,315	\$ 161,546
Investment in marketable securities	17,394	16,443
Accounts receivable	133,829	3,683,865
Receivables from related parties	757,384	521,539
Accrued revenue on contracts in progress	35,413	549,781
Prepaid expenses and other current assets	118,552	143,026
	-----	-----
Total current assets	1,270,887	5,076,200
PROPERTY AND EQUIPMENT - Net	213,137	316,057
MORTGAGE SERVICING RIGHTS	49,449	30,587
DEFERRED TAX ASSET	20,081	--
OTHER ASSETS	166,670	227,548
INCOME TAX RECEIVABLE	292,885	--
DUE FROM OFFICER	53,766	107,532
	-----	-----
TOTAL ASSETS	\$2,066,875	\$5,757,924
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accrued appraisal and subcontractor costs	\$ 131,978	\$2,807,172
Accounts payable and accrued expenses	334,591	678,390
Income taxes payable	--	89,477
Deferred revenue	104,950	194,334
Notes payable to related parties	--	133,018
Deferred income taxes	--	12,993
Other liabilities	--	122,400
	-----	-----
Total current liabilities	571,519	4,037,784
	-----	-----
LONG-TERM LIABILITIES		
Note payable to bank	1,405,000	1,045,000
Minority interest	616	250
	-----	-----
Total long-term liabilities	1,405,616	1,045,250
	-----	-----
Total liabilities	1,977,135	5,083,034
	-----	-----
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock: \$.01 par value, 100,000 shares authorized, 97,000 shares outstanding at December 31, 1997	970	--
Common stock: Class A: \$.01 par value, 5,000 and 1,000 shares authorized at December 31, 1997 and 1996, 3,000 and 166.424 shares outstanding at December 31, 1997 and 1996	30	2
Additional paid-in capital	56,442	57,440
Retained earnings	32,298	617,448
	-----	-----
Total stockholders' equity	89,740	674,890
	-----	-----

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$2,066,875	\$5,757,924
	=====	=====

See notes to consolidated financial statements.

F-23

63
HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

	1997	1996	1995
	----	----	----
REVENUES:			
Due diligence fees	\$ 4,058,609	\$ 8,323,789	\$ 7,525,620
Loan brokering/asset management fees	3,027,319	2,469,378	1,770,665
Mortgage sales and servicing	826,486	970,757	2,289,440
Other income	58,151	355,715	295,944
	-----	-----	-----
Total revenues	7,970,565	12,119,639	11,881,669
	-----	-----	-----
EXPENSES:			
Personnel expense	5,373,331	4,227,226	3,831,426
Appraisal, inspection and other professional fees	618,059	3,128,225	2,593,001
Subcontractor expense	1,386,979	2,919,509	2,738,903
Travel and subsistence	302,936	616,795	860,253
Occupancy expense	495,285	536,520	437,830
General and administrative expense	419,543	525,143	1,066,220
Reversal of reserve for IRS assessment	(23,160)	(277,600)	--
Interest expense	117,894	134,393	160,439
Depreciation and amortization	117,675	125,928	114,174
	-----	-----	-----
Total expenses	8,808,542	11,936,139	11,802,246
	-----	-----	-----
INCOME (LOSS) BEFORE INCOME TAX PROVISION (BENEFIT)	(837,977)	183,500	79,423
INCOME TAX (BENEFIT) PROVISION	(325,959)	73,870	51,165
	-----	-----	-----
NET INCOME (LOSS)	\$ (512,018)	\$ 109,630	\$ 28,258
	=====	=====	=====
BASIC EARNINGS (LOSS) PER SHARE	\$ (525.79)	\$ 658.74	\$ 169.80
	=====	=====	=====

See notes to consolidated financial statements.

F-24

64
HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 1997 AND 1996

	Preferred Shares	Stock Amount	Common Stock New Class A Shares Amount	Common Stock Old Class A Shares Amount	Common Stock Class B Shares Amount	Additional Paid-in Capital	Retained Earnings	Total		
BALANCE, DECEMBER 31, 1995				\$165,800	\$1	41,600	\$1	\$165,999	\$500,846	\$666,847
Net income									109,630	109,630
Distribution of subsidiary to stockholders									6,972	6,972
Shareholders' Exchange Agreement: Redemption of Class A shares				(40,836)						(108,559)
Exchange of Class B shares for Class A shares				41,460	1	(41,600)	(1)	--	--	--
BALANCE, DECEMBER 31, 1996				166,424	2		57,440		617,448	674,890
Net(loss)									(512,018)	(512,018)
Dividends (noncash)									(73,132)	(73,132)
Agreement and Plan of Recapitalization: Exchange of "old" Class A shares for "new" Class A shares and Series A preferred Stock	97,000	\$970	3,000	\$30	(166,474)	(2)		(998)	--	--
BALANCE, DECEMBER 31, 1997	97,000	\$970	3,000	\$30	--	--		\$ 56,442	\$ 32,298	\$ 89,740

See notes to consolidated financial statements.

F-25

65

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

	1997	1996	1995
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$ (512,018)	\$ 109,630	\$ 28,258
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:			
Depreciation and amortization	117,675	125,928	114,174
Gain on sale of mortgage servicing rights	(16,916)	(52,318)	(232,587)
Reversal of reserve for IRS assessment	(23,160)	(277,600)	--
IRS payroll tax settlement	(99,240)	--	--
Loss on disposal of property and equipment	35,696	--	10,261
Loss on sale of trading securities	--	1,360	753
Purchase of trading securities	(951)	(1,931)	(29,951)
Sale of trading securities	--	26,593	100,016
Distribution of subsidiary to stockholders	--	6,972	--
Changes in assets - (increase) decrease:			
Accounts receivable	3,550,036	(2,150,117)	862,364
Receivables from related parties	(315,097)	(308,808)	22,582
Accrued revenue on contracts in progress	514,368	(384,880)	1,011,785
Income tax receivable	(292,885)	--	--
Prepaid expenses and other current assets	24,474	(49,871)	(39,169)
Deferred tax asset	(20,081)	--	--
Other assets	(12,254)	(22,914)	(154,108)
Changes in liabilities - increase (decrease):			
Accrued appraisal and subcontractor costs	(2,675,194)	2,741,014	21,931
Accounts payable and accrued expenses	(343,799)	104,018	(913,692)
Income taxes payable	(89,477)	(90,490)	15,634
Deferred income taxes	(12,993)	(17,222)	(114,326)
Deferred revenue	(89,384)	(14,946)	113,855
Minority interest	366	(26,935)	(147,057)
Net cash (used in) provided by operating activities	(260,834)	(282,517)	670,723
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(43,060)	(133,317)	(43,421)
Sale of property and equipment	--	4,592	1,704
Proceeds from sale of mortgage servicing rights	34,446	94,043	423,563
Capitalization of mortgage servicing rights	(43,783)	(37,451)	(264,141)
Net cash (used in) provided			

by investing activities	(52,397)	(72,133)	117,705

CASH FLOWS FROM FINANCING ACTIVITIES:			
Net proceeds from (repayment of) note payable to bank	360,000	(330,000)	(125,000)
Redemption of Class A common stock	--	(66,000)	--
Repayment of subordinated debt	--	--	(51,299)

Net cash provided by (used in) financing activities	360,000	(396,000)	(176,299)

NET INCREASE (DECREASE) WITH IN CASH AND CASH EQUIVALENTS	46,769	(750,650)	612,129
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	161,546	912,196	300,067

CASH AND CASH EQUIVALENTS, END OF YEAR	\$ 208,315	\$ 161,546	\$ 912,196
=====			

SUPPLEMENTAL SCHEDULE OF NONCASH ACTIVITIES:

Loans of \$25,649,378 and \$35,831,617 were originated by HCMC and funded by investors in 1997 and 1996, respectively. Noncash dividends of \$73,132, were distributed to the Company's stockholders on September 19, 1997.

SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid during the year for:

Income taxes	\$ 129,359	\$ 205,075	\$ 176,119
=====			
Interest	\$ 116,993	\$ 125,748	\$ 164,420
=====			

See notes to consolidated financial statements.

F-26

66

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

1. BUSINESS DESCRIPTION

Hanover Capital Partners Ltd. ("HCP") and its subsidiaries operate as a specialty finance company which is principally engaged in performing due diligence services, mortgage and investment banking services and, prior to September 1997, asset management services. A wholly-owned subsidiary of HCP, Hanover Capital Mortgage Corporation ("HCMC"), is an originator and servicer of multifamily mortgage loans. HCMC's operations are conducted from multiple branches located throughout the United States. HCMC is approved by the U.S. Department of Housing and Urban Development (HUD) as a Title II Nonsupervised Mortgagee under the National Housing Act. Another wholly-owned subsidiary of HCP, Hanover Capital Securities, Inc. ("HCS") is a registered broker/dealer with the Securities and Exchange Commission.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

- a. Principles of Consolidation - The consolidated financial statements include the accounts of HCP and its majority and wholly-owned subsidiaries (the "Company"). The wholly owned subsidiaries include HCMC, HCS, Hanover Capital Advisors, Inc. (through September 1997) and Hanover Capital Mortgage Fund, Inc. (through September 1997). Majority owned subsidiaries include Hanover Joint Ventures, Inc. (75% owned) and Hanover On-Line Mortgage Edge, LLC (50% owned, through September 1997). All significant intercompany accounts and transactions have been eliminated.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities at the date of the financial statements and the required

amounts of revenues and expenses during the reporting period.

- b. Investments in Limited Liability Companies - Minority ownership interests in limited liability companies are accounted for by the equity method of accounting. HCP's investment in limited liability companies are classified as other assets in the accompanying consolidated balance sheets. The ownership of each limited liability company at December 31, 1997 and 1996 is detailed below:

	1997	1996
	----	----
AGR Financial, LLC	-	25.0%
Alpine/Hanover, LLC	1.0%	1.0%
ABH-I, LLC	1.0%	1.0%
Alpine/Hanover II, LLC	-	1.0%

- c. Minority Interests - Minority interests, representing other stockholders' interests in majority-owned companies are consolidated in the accompanying balance sheets.

F-27

67

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995 (CONTINUED)

- d. Revenue Recognition - Revenues from due diligence contracts in progress are recognized for the services provided as they are earned and billed.
- e. Loan Origination Fees and Costs - Loan origination fees and costs are deferred until the sale of the loan. The Company sells all originated loans to investors at the time of origination, and accordingly, recognizes loan origination fees at that time. Direct loan origination costs and loan origination fees are offset and included in mortgage sales revenue.
- f. Loan Servicing Fees - Loan servicing fees consist of fees paid by investors for the collection of monthly mortgage payments, maintenance of required escrow accounts, remittance to investors, and ancillary income associated with those activities. The Company recognizes loan servicing fees as payments are collected.
- g. Deferred Revenue - Cash advances received for certain service contracts are recorded in the accompanying consolidated balance sheets as deferred revenue and are recognized during the period the services are provided and the related revenue is earned.
- h. Income Taxes - The Company records deferred taxes in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ("SFAS 109"). Under SFAS 109 a current or deferred tax liability or asset is recognized for the current or deferred tax effects of all events recognized in the financial statements. Those effects are measured based on provisions of current tax law to determine the amount of taxes payable or refundable currently or in future years. The tax effects of earning income or incurring expenses in future years or the future enactment of a change in tax laws or rates are not anticipated in determining deferred tax assets or liabilities.
- The Company files a consolidated Federal income tax return. The Company has not been subject to an examination of their income tax returns by the Internal Revenue Service.
- i. Property and Equipment - Property and equipment is stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets, generally three to seven years. Leasehold improvements are depreciated over the terms of the respective leases or their estimated useful lives, whichever is shorter.

- j. Investment in Marketable Securities - Investment in marketable securities which the Company has classified as trading securities are reported in the accompanying consolidated balance sheets at market value at December 31, 1997 and 1996.
- k. Cash and Cash Equivalents - For cash flow purposes, the Company considers highly liquid investments, purchased with an original maturity of three months or less, to be cash equivalents. There were no cash equivalents at December 31, 1997 and 1996.
- l. Mortgage Servicing Rights - Effective January 1, 1997, the Company adopted Statement of Financial Accounting Standards No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities ("SFAS 125"). SFAS 125 supersedes Statement of Financial Accounting Standards No. 122, Accounting for Mortgage Servicing Rights, an amendment of FASB Statement No. 65. Under SFAS 125, after the transfer of a financial asset, the Company recognizes the financial assets it controls and the liabilities it has incurred. Furthermore, the Company no longer recognizes the financial assets for which control has been

F-28

68

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995 (CONTINUED)

surrendered and liabilities have been extinguished. The adoption of SFAS 125 did not have an effect on the financial position or results of operations of the Company.

In December 1996, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 127, Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125 ("SFAS 127"). SFAS 127 defers for one year the effective date of certain sections of SFAS 125, including those relating to repurchase agreement, dollar-roll, securities lending and similar transactions, as prescribed by SFAS 125. The adoption of SFAS 127 will not have a material effect on the Company's financial position or results of operations.

Prior to January 1, 1997, the Company accounted for mortgage servicing rights in accordance with SFAS 122. For purposes of assessing impairment, the lower of carrying value or fair value of servicing rights is determined on an individual loan basis. Capitalized servicing rights are amortized in proportion to projected net servicing revenue. The fair value of servicing rights is determined using a discounted cash flow method.

- m. Basic Earnings per Share - The Company computes earnings per share in accordance with statement of Financial Accounting Standards No. 128, Earnings per Share ("SFAS 128"). Basic earnings per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period. Shares issued during the period and shares reacquired during the period are weighted for the portion of time they were outstanding.

3. PAYROLL TAX SETTLEMENT

In 1994, the Internal Revenue Service ("IRS") began an examination of the Company's payroll tax withholding practices with respect to independent contractors who provided services to HCP's due diligence business.

Pursuant to the IRS Classification Settlement Program ("CSP"), HCP settled all disputed payroll taxes relating to the IRS examination of HCP's payroll withholding practices with respect to independent contractors. In October 1997, management agreed to the terms of the CSP which required HCP to pay the United States Government \$99,240 in full discharge of any federal employment tax liability and to further treat the workers as employees (rather than independent contractors) on a prospective basis

effective April 1, 1998.

At December 31, 1995, HCP had recorded an accrual of \$400,000 for payroll withholding tax for independent contractors. HCP recorded a reversal of reserve of \$23,160 and \$277,600 for the payroll tax matter in the accompanying consolidated statements of operations for the years ended December 31, 1997 and 1996, respectively, to adjust the previously established reserve to the actual and expected settlement amounts.

F-29

69

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995 (CONTINUED)

4. CONCENTRATION RISK

For the years ended December 31, 1997, 1996 and 1995, the Company received revenues from certain customers, which are subject to change annually, which exceeded 10% of total revenues as follows:

1997	1996	1995
----	----	----
24%	46%	32%
18%	26%	16%

5. MORTGAGE SERVICING

The Company, through its wholly-owned subsidiary HCMC, services multifamily mortgage loans on behalf of others. Loan servicing consists of the collection of monthly mortgage payments on behalf of investors, reporting information to those investors on a monthly basis and maintaining custodial escrow accounts for the payment of principal and interest to investors and property taxes and insurance premiums on behalf of borrowers. As of December 31, 1997 and 1996, HCMC was servicing 43 and 46 loans, respectively, with unpaid principal balances of \$120,736,400 and \$129,315,400, including loans subserviced for others of \$40,055,200 and \$44,241,919, respectively. Escrow balances maintained by HCMC were \$3,087,400 and \$4,352,400 at December 31, 1997 and 1996, respectively. The aforementioned servicing portfolio and related escrow accounts are not included in the accompanying consolidated balance sheets as of December 31, 1997 and 1996.

Activity in mortgage servicing rights for the years ended December 31, 1997 and 1996 was as follows:

	1997	1996
	-----	-----
Beginning balance	\$ 30,587	\$ 46,904
Capitalization	43,783	37,451
Sales	(17,530)	(41,725)
Scheduled amortization	(7,391)	(12,043)
	-----	-----
	\$ 49,449	\$ 30,587
	=====	=====

The fair value of the Company's servicing rights at December 31, 1997 and 1996 was \$79,504 and \$46,606, respectively.

F-30

70

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

6. RELATED PARTY TRANSACTIONS

Receivables from related parties at December 31, 1997 and 1996 consist of the following:

	1997	1996
	-----	-----
Due from Hanover Capital Mortgage Holdings, Inc. (1)	\$540,044	\$ --
Due from ABH-I, LLC (includes \$28,984 and \$431,118 of asset management fees at December 31, 1997 and 1996, respectively) (2)	51,321	451,604
Due from Hanover Asset Services, Inc. (3)	8,070	6,420
Due from Alpine/Hanover, LLC (2)	9,273	4,361
Due from Alpine/Hanover II, LLC (3)	5,000	--
Due from Hanover Mortgage Capital Corporation (3)	5,962	--
Due from AGR Financial, LLC (4)	80,813	--
	-----	-----
Due from related entities	700,483	462,385
Due from officers (5)	110,667	166,686
	-----	-----
Receivables from related parties	\$811,150	\$629,071
	=====	=====

- (1) The Company entered into a Management Agreement in 1998 to provide, among other things, due diligence, asset management and administrative services to Hanover Capital Mortgage Holdings, Inc. ("HCHI") in connection with acquiring single-family mortgage loan pools and managing and servicing HCHI's investment portfolio. The term of the Management Agreement continues until December 31, 1999 with subsequent renewal provisions.
- (2) Amounts due from entities that the Company had a minority ownership percentage in for all of 1997 represent receivables resulting primarily from fees generated from asset management services and out-of-pocket expenses. The Company ceased providing asset management services to these entities in September 1997. Asset management fees are recognized in the period earned and amounted to \$2,446,000, \$1,370,000 and \$1,362,000 for the years ended December 31, 1997, 1996 and 1995, respectively.
- (3) Amounts due from entities that are owned by certain of the Company's officers/owners at December 31, 1997 represent receivables resulting primarily from accounting fees and out-of-pocket expenses.
- (4) Amounts due from AGR Financial, LLC represent unpaid billings for services that the Company provides to AGR Financial, LLC pursuant to an agreement dated August 1996. The services include but are not limited to providing AGR Financial, LLC with office space, office equipment, software operating systems, processing capabilities and accounting services.
- (5) Amounts due from officers in 1997 include \$107,532 from the Company's President which will be repaid in annual amounts of \$53,766 in August 1998 and August 1999.

F-31

Notes payable to related parties at December 31, 1996 consisted of the following:

	1996

Note payable to officer	\$ 42,559
Notes payable to ABH-I, LLC	90,459

Notes payable to related parties	\$133,018
	=====

On January 1, 1996, HCP and its stockholders entered into an Exchange Agreement (see Note 9) whereby HCP redeemed 40.836 shares of Class A common stock from one of its stockholders in exchange for cash (\$66,000) and a term note in the amount of \$42,559. The note was paid in full, with interest at the prime rate plus 2.0% in January 1997.

Notes payable to ABH-I, LLC at December 31, 1996 consisted of three (3) promissory notes totaling \$90,459. All of the promissory notes bear interest at the prime rate (8.25% at December 31, 1996). The promissory notes were paid in full in 1997.

7. PROPERTY AND EQUIPMENT

Property and equipment at December 31, 1997 and 1996 consists of the following:

	1997	1996
	-----	-----
Office machinery and equipment	\$ 381,189	\$ 388,123
Furniture and fixtures	111,246	111,246
Leasehold improvements	68,553	68,553
	-----	-----
	560,988	567,922
Less accumulated depreciation and amortization	(347,851)	(251,865)
	-----	-----
Property and equipment - net	\$ 213,137	\$ 316,057
	=====	=====

Depreciation expense for the years ended December 31, 1997, 1996 and 1995 was \$110,284, \$113,885 and \$87,913, respectively.

8. INCOME TAXES

The components of deferred income taxes as of December 31, 1997 and 1996 are as follows:

	1997	1996
	-----	-----
Deferred tax assets	\$ 44,499	\$ 52,409
Deferred tax liabilities	(24,418)	(65,402)
	-----	-----
Net deferred tax assets (liabilities)	\$ 20,081	\$ (12,993)
	=====	=====

The items resulting in significant temporary differences for the years ended December 31, 1997 and 1996 that generate deferred tax assets relate primarily to the recognition of deferred revenue, accounts payable and accrued liabilities for financial reporting purposes. Temporary differences that generate

deferred tax liabilities relate primarily to the Company's change from the cash method to the accrual method of accounting for income tax reporting purposes.

The components of the income tax provision (benefit) for the years ended December 31, 1997, 1996 and 1995 consist of the following:

	1997 -----	1996 -----	1995 -----
Current - Federal, state and local	\$(292,885)	\$ 91,092	\$ 165,491
Deferred - Federal, state and local	(33,074)	(17,222)	(114,326)
Total	\$ (325,959) =====	\$ 73,870 =====	\$ 51,165 =====

The income tax provision (benefit) differs from amounts computed at statutory rates, as follows:

	1997 -----	1996 -----	1995 -----
Federal income taxes at statutory rate	\$(285,167)	\$ 56,518	\$ 27,006
State and local income taxes net of Federal benefit	(59,486)	14,836	9,417
Unconsolidated subsidiary's net income	(12,793)	--	1,177
Meals and entertainment	4,052	3,719	6,291
Officer's life insurance	9,613	8,576	9,114
Other, net	3,852	3,014	(663)
Total	\$ (325,959) =====	\$ 73,870 =====	\$ 51,165 =====

9. STOCKHOLDERS' EQUITY

On September 19, 1997, the Company entered into an Agreement and Plan of Recapitalization ("Agreement") with its four stockholders to recapitalize the Company. The Agreement provided for the tax-free exchange of the stockholders 166.424 Class A "old" common stock shares for 3,000 shares of "new" Class A common stock shares, \$0.01 par value (representing a 3% economic interest in the Company and 97,000 shares of Series A preferred stock, \$0.01 par value (representing a 97% economic interest in the Company). The preferred stock has no dividend rate or preference over the common stock. Dividend distributions will be made in the same amount on a per share basis of the common stock as for the preferred stock. Dividend distributions will be made to the common stockholders and the preferred stockholders in proportion to the number of outstanding shares. The preferred stockholder has the right to receive \$10,750,005 upon liquidation of the Company before common stockholders receive any liquidating distributions.

On January 1, 1996, HCP entered into an exchange agreement ("Exchange Agreement") with its stockholders in order to restructure the ownership of HCP so that HCP had only 166.424 Class A shares of common stock outstanding. The terms of the Exchange Agreement required HCP to: (1) redeem 40.836 shares of Class A common stock; (2) exchange 41.460 shares of Class B common stock for Class A common stock; (3) effect an exchange of 8.468 shares of Class A common stock among certain stockholders; and (4) transfer the ownership of Hanover Mortgage Capital Corporation (formerly a wholly-owned subsidiary of HCP) to HCP's stockholders.

On January 1, 1996, pursuant to the Exchange Agreement, HCP transferred its total ownership interests in its wholly-owned subsidiary, Hanover Mortgage Capital Corporation to HCP's stockholders. Hanover Mortgage Capital Corporation had a retained earnings deficiency at the time of transfer.

10. NOTE PAYABLE TO BANK

In December 1996, HCP entered into a \$2.0 million Line of Credit Facility Agreement ("Line") with a bank that extends through December 31, 1999. The note payable to the bank at December 31, 1997 and 1996 consisted of a short-term note of \$1,405,000 and \$1,045,000, respectively, with an annual interest rate at the prime rate as of December 31, 1997. In October 1997, the terms of the Line were amended to decrease the interest rate on the Line from the prime rate plus 1.5% to the prime rate. The interest rate in effect at December 31, 1997 and 1996 was 8.50% and 9.75%, respectively. The maximum borrowing capacity under the terms of the Line reduce every six (6) months, beginning at June 30, 1997, by \$150,000. The line is collateralized by all of the assets of HCHI and guaranteed by HCHI. Prior to September 1997, the line was collateralized by all of the assets of the Company and guaranteed by the President and all of the wholly-owned subsidiaries of HCP.

At December 31, 1997, the Company was in violation of certain financial debt covenants of the Line that required the Company (on a stand-alone basis) to: (1) maintain a maximum debt to net worth ratio of 3 to 1 at December 31, 1997 and (2) to maintain a minimum debt service coverage ratio of 1.25 to 1.00 at December 31, 1997. To mitigate the above violations, the Company agreed to make a voluntary paydown on the Line of \$860,000 on February 17, 1998, thereby reducing the outstanding borrowings on the line to \$505,000.

11. COMMITMENTS AND CONTINGENCIES

The Company is involved in ongoing litigation regarding a mortgage loan and a related reserve agreement. The Company has retained the services of outside counsel. As of the date of this report, an evaluation of the likelihood of success or an unfavorable outcome could not be performed. As such, no amount has been provided for in the accompanying financial statements. The Company intends to attempt to achieve final settlement of the matter and if for any reason, the final settlement cannot be effectuated, the Company intends to respond vigorously and will evaluate the progress of the litigation as information becomes available.

The Company has noncancelable operating lease agreements for office space. Future minimum rental payments for such leases are as follows:

YEAR	AMOUNT
----	-----
1998	\$187,414
1999	104,882
2000	37,714

Total	\$330,010
	=====

Rent expense for the years ended December 31, 1997, 1996 and 1995 amounted to \$310,814, \$339,421, and \$345,716 respectively.

MANAGEMENT AGREEMENT

THIS MANAGEMENT AGREEMENT (this "AGREEMENT") is made as of the 1st day of January, 1998 (the "EFFECTIVE DATE"), by and between Hanover Capital Mortgage Holdings, Inc., a Maryland corporation (the "COMPANY"), and Hanover Capital Partners Ltd., a New York corporation (the "MANAGER").

WHEREAS, the Company intends to (i) invest in Mortgage Assets (as such term is defined herein) using the proceeds of borrowings and equity offerings; (ii) borrow against and securitize Mortgage Loans (as such term is defined herein) and retain interests therein; and (iii) qualify as a "real estate investment trust" under the Internal Revenue Code of 1986, as amended (the "CODE");

WHEREAS, since the time of the Company's initial public offering, the Manager has been acting on the Company's behalf subject to the direction and oversight of the Company's Board of Directors (the "BOARD OF DIRECTORS");

WHEREAS, the Company desires to have the Manager continue to undertake, on the Company's behalf, the duties and responsibilities set forth in this Agreement, subject to the direction and oversight of the Board of Directors on the terms and conditions set forth in this Agreement;

WHEREAS, the Manager desires to continue to undertake, on the Company's behalf, the duties and responsibilities set forth in this Agreement, subject to the direction and oversight of the Board of Directors, on the terms and conditions set forth in this Agreement; and

WHEREAS, the Company and the Manager desire to formalize their relationship by executing and delivering to each other this Agreement.

NOW, THEREFORE, in consideration of the mutual agreements set forth in this Agreement and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Company and the Manager agree as follows:

1. DEFINITIONS. Capitalized terms used but not defined in this Agreement shall have the respective meanings assigned to them below:

1.1 "AFFILIATE" means, when used with reference to a specified person, any person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with the specified person. For purposes of this definition, the term "PERSON" means and includes individuals, corporations, limited liability companies, general and limited partnerships, stock companies, land trusts, business trusts and other entities and governments and agencies and political subdivisions thereof. For purposes of this definition, "CONTROL" (including the correlative meanings of the terms "CONTROLLED BY" and "UNDER COMMON CONTROL WITH"), as used with respect to any

person, shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of such person, through the ownership of voting securities, partnership interests or other equity interests.

1.2 "AGENCY CERTIFICATES" means Pass-Through Certificates guaranteed by FNMA, FHLMC or GNMA.

1.3 "AGREEMENT" means this Management Agreement.

1.4 "BOARD OF DIRECTORS" has the meaning set forth in the Recitals to this Agreement.

1.5 "CODE" has the meaning set forth in the Recitals to this

Agreement.

1.6 "COMMERCIAL MORTGAGE ASSETS" means Commercial Mortgage Loans and Commercial Mortgage Securities.

1.7 "COMMERCIAL MORTGAGE LOANS" means Mortgage Loans secured by commercial property.

1.8 "COMMERCIAL MORTGAGE SECURITIES" means Mortgage Securities representing an interest in, or secured by, Commercial Mortgage Loans.

1.9 "COMPANY" means Hanover Capital Mortgage Holdings, Inc., a Maryland corporation, and its successors.

1.10 "CMO" means an adjustable or fixed-rate debt obligation (bond) that is collateralized by Mortgage Loans or mortgage certificates and issued by private institutions or issued or guaranteed by FNMA, FHLMC or GNMA.

1.11 "FHLMC" means the Federal Home Loan Mortgage Corporation.

1.12 "FNMA" means the federally chartered and privately owned corporation organized and existing under the Federal National Mortgage Association Charter Act (12 U.S.C. ss. 1716 et seq.), formerly known as the Federal National Mortgage Association.

1.13 "FEDERAL RESERVE BOARD" means the Board of Governors of the Federal Reserve System.

1.14 "GAAP" means generally accepted accounting principles.

1.15 "GNMA" means the Governmental National Mortgage Association.

1.16 "GOVERNING INSTRUMENTS" means the articles or certificate of incorporation or charter, as the case may be, and the bylaws of the Company.

2

3

1.17 "INVESTMENT ADVISERS ACT" means the Investment Advisers Act of 1940, as amended from time to time.

1.18 "MANAGEMENT COMPENSATION" has the meaning set forth in Section 6 of this Agreement.

1.19 "MANAGER" means Hanover Capital Partners Ltd., a New York corporation, and its successors hereunder.

1.20 "MORTGAGE ASSETS" means Single-Family Mortgage Assets, Multifamily Mortgage Assets, Commercial Mortgage Assets and Short-Term Investments.

1.21 "MORTGAGE LOANS" means Single-Family Mortgage Loans, Multifamily Mortgage Loans and Commercial Mortgage Loans.

1.22 "MORTGAGE SECURITIES" means (i) Pass-Through Certificates, (ii) CMOs, and (iii) REMICs.

1.23 "MULTIFAMILY MORTGAGE ASSETS" means Multifamily Mortgage Loans and Multifamily Mortgage Securities.

1.24 "MULTIFAMILY MORTGAGE LOANS" means Mortgage Loans secured by multifamily (in excess of four units) residential property.

1.25 "MULTIFAMILY MORTGAGE SECURITIES" means Mortgage Securities representing an interest in, or secured by, Multifamily Mortgage Loans.

1.26 "PASS-THROUGH CERTIFICATES" means securities (or interests therein) which are Qualified REIT Assets evidencing undivided ownership interests in a pool of Single-Family Mortgage

Loans, the holders of which receive a "pass-through" of the principal and interest paid in connection with the underlying Single-Family Mortgage Loans in accordance with the underlying Single-Family Mortgage Loans in accordance with the holders' respective, undivided interests in the pool.

1.27 "QUALIFIED HEDGE" means an interest rate swap or cap agreement, option, futures contract, forward rate agreement or similar financial instrument entered into to reduce the interest rate risks with respect to indebtedness incurred or to be incurred to acquire or carry Real Estate Assets and the payments on (or gain on the disposition of) which qualify under Section 856(c)(2) of the Code.

1.28 "QUALIFIED REIT ASSETS" means Pass-Through Certificates, Mortgage Loans, Agency Certificates and other assets qualifying as "real estate assets" under Code Section 856(c)(5)(B).

3

4

1.29 "REAL ESTATE ASSETS" means interests in real property, interests in mortgages on real property, regular and residual interests in REMICs and stock in qualifying REITs.

1.30 "REIT" means real estate investment trust as defined under Section 856 of the Code.

1.31 "REIT PROVISIONS OF THE CODE" means Sections 856 through 860 of the Code. 1.32 "REMIC" means serially maturing debt securities secured by a pool of Mortgage Loans, the payments on which bear a relationship to the debt securities and the issuer of which qualifies as a "real estate investment conduit" as defined under Section 860D of the Code.

1.33 "SHORT-TERM INVESTMENTS" means short-term bank certificates of deposit, short-term United States Treasury securities, short-term United States government agency securities, commercial paper, repurchase agreements, short-term CMOs, short-term asset-backed securities and other similar types of short-term investment instruments, all of which will have maturities or average lives of less than one (1) year.

1.34 "SINGLE-FAMILY MORTGAGE ASSETS" means Single-Family Mortgage Loans and Single-Family Mortgage Securities.

1.35 "SINGLE-FAMILY MORTGAGE LOANS" means Mortgage Loans secured by single-family (one to four unit) residential property.

1.36 "SINGLE-FAMILY MORTGAGE SECURITIES" means Mortgage Securities representing an interest in, or secured by, Single-Family Mortgage Loans.

1.37 "TEN-YEAR U.S. TREASURY RATE" means the arithmetic average of the weekly average yield to maturity for actively traded current coupon U.S. Treasury fixed interest rate securities (adjusted to a constant maturity of ten years) published by the Federal Reserve Board during a quarter, or, if such rate is not published by the Federal Reserve Board, any Federal Reserve Bank or agency or department of the federal government selected by the Company. If the Company determines in good faith that the Ten-Year U.S. Treasury Rate cannot be calculated as provided above, then the rate shall be the arithmetic average of the per annum average yields to maturities, based upon closing asked prices on each business day during a quarter, for each actively traded marketable U.S. Treasury fixed interest rate security with a final maturity date not less than eight nor more than twelve years from the date of the closing asked prices as chosen and quoted for each business day in each quarter in New York City by at least three recognized dealers in U.S. government securities selected by the Company.

1.38 "UNAFFILIATED DIRECTORS" means a director who is not affiliated directly or indirectly, with the Manager, whether by

ownership of, ownership interest in,

4

5

employment by, any material business or professional relationship with, or serving as an officer or director of the Manager, and are not employed by or officers of the Company.

2. GENERAL DUTIES OF THE MANAGER.

2.1 SERVICES TO BE PROVIDED BY THE MANAGER. Subject to the direction and oversight of the Board of Directors and in accordance with the Governing Instruments, the Manager shall, during the term of this Agreement, perform such services as may be required from time to time for the management of the Company and such other activities relating to the assets of the Company as the Board of Directors shall reasonably request or the Manager in good faith shall deem appropriate under the particular circumstances, including the following:

2.1.1 serving as the Company's consultant with respect to formulation of investment criteria and preparation of policy guidelines by the Board of Directors;

2.1.2 assisting the Company in developing criteria for the purchase of Mortgage Assets that are specifically tailored to the Company's investment objectives;

2.1.3 representing the Company in connection with the purchase and commitment to purchase or sell Mortgage Assets, including the accumulation of Mortgage Loans for securitization and the incurrence of debt;

2.1.4 arranging for the issuance of Mortgage Securities from a pool of Mortgage Loans;

2.1.5 furnishing reports and statistical and economic research to the Company regarding the Company's activities and the services performed for the Company by the Manager;

2.1.6 monitoring and providing to the Board of Directors on an ongoing basis price information and other data, obtained from certain nationally recognized dealers that maintain markets in Mortgage Assets identified by the Board of Directors from time to time, and providing data and advice to the Board of Directors in connection with the identification of such dealers;

2.1.7 investing or reinvesting any money of the Company in accordance with its policies and procedures and the terms and conditions of this Agreement;

2.1.8 providing the executive and administrative personnel, office space and services required in rendering such services to the Company;

2.1.9 administering the day-to-day operations of the Company and performing and supervising the performance of such other administrative functions

5

6

necessary for the management of the Company as may be agreed upon by the Manager and the Board of Directors, including the collection of revenues and the payment of the Company's debts and obligations and maintenance of appropriate computer systems to perform such administrative functions;

2.1.10 providing the Company with general data

processing, legal and administrative services to the extent required to implement the business strategy of the Company;

2.1.11 counseling the Company in connection with policy decisions made by the Board of Directors;

2.1.12 communicating on behalf of the Company with the holders of the securities of the Company as required to satisfy the reporting and other requirements of any governmental bodies or agencies and to maintain effective relations with such holders;

2.1.13 evaluating and recommending hedging strategies to the Board of Directors and, upon approval by the Board of Directors, engaging in hedging activities on behalf of the Company, in all cases consistent with the Company's status as a REIT;

2.1.14 supervising compliance with the REIT Provisions of the Code and maintenance of an exemption from the Investment Company Act and from any state or other laws requiring the registration of investment companies;

2.1.15 qualifying and causing the Company to qualify to do business in all applicable jurisdictions;

2.1.16 causing the Company to retain qualified independent public accountants and tax experts to assist in developing appropriate accounting procedures and testing systems and conducting quarterly compliance reviews;

2.1.17 providing all actions necessary for compliance by the Company with all federal, state and local regulatory requirements applicable to the Company in respect of its business activities, including preparing or causing to be prepared all financial statements required under applicable regulations and contractual undertakings and all reports, filings and documents, if any, required under the Securities Exchange Act of 1934, as amended;

2.1.18 providing all actions necessary to enable the Company to make required federal, state and local tax filings and reports and generally enable the Company to maintain its status as a REIT, including soliciting stockholders for required information to the extent provided in the REIT Provisions of the Code;

6

7

2.1.19 performing such other services as may be required from time to time for management and other activities relating to the assets of the Company as the Board of Directors shall reasonably request or the Manager shall deem appropriate under the particular circumstances; and

2.1.20 complying with and using commercially reasonable efforts to cause the Company to comply with all applicable laws.

2.2 ADDITIONAL OBLIGATIONS OF THE MANAGER.

2.2.1 VERIFY CONFORMITY WITH ACQUISITION CRITERIA. The Manager shall use commercially reasonable efforts to ensure that each Mortgage Asset acquired by the Company conforms to the acquisition criteria of the Company and shall require each seller or transferor of Mortgage Assets to the Company to make such representations and warranties regarding such Mortgage Assets as may, in the judgment of the Manager, be necessary and appropriate for such purpose. With respect to Mortgage Loans and consistent with prevailing industry practices, the Manager shall use commercially reasonable efforts to require

the seller or transferor to repurchase any Mortgage Loan with respect to which there is fraud or misrepresentation. In addition, the Manager shall take any and all such other actions as it deems necessary or appropriate with regard to the protection of the Company's investments.

2.2.2 CONDUCT ACTIVITIES IN CONFORMITY WITH REIT STATUS AND ALL APPLICABLE RESTRICTIONS. The Manager shall refrain from any action which, in its judgment made in good faith or in the judgment of the Board of Directors and communicated to the Manager, would adversely affect the status of the Company as a REIT or which, in the Manager's judgment made in good faith or in the judgment of the Board of Directors and communicated to the Manager, would violate any material law, rule or regulation of any governmental body or agency having jurisdiction over the Company or which would otherwise not be permitted by the Company's Governing Instruments; any operating policies adopted by the Company; or any agreements to which the Company or any of its assets is subject or bound, including without limitation any action which would result in the requirement that the Company register as an Investment Company under the Investment Company Act or under any state or other law. If the Manager is ordered to take any such action by the Board of Directors, the Manager shall promptly notify the Board of Directors of the Manager's good faith judgment that such action would adversely affect such status or violate any such law, rule or regulation or the Governing Instruments; operating policies adopted by the Company; or any agreements to which the Company is a party or by or to which it is bound or any of its assets are subject. Notwithstanding the foregoing, the Manager, its directors, officers, stockholders and employees shall not be liable to the Company, the Unaffiliated Directors or any security holders of the Company for any act or omission by the Manager, its directors, officers, stockholders or employees except as provided in Section 8 of this Agreement.

2.2.3 REPORTS. The Manager shall prepare an annual compliance report to be reviewed for each fiscal year by a firm independent of the Manager and its

7

8

Affiliates and having the proper expertise to determine compliance with the REIT Provisions of the Code and related matters. The Manager shall deliver such report to the Company no later than March 31 of the following year. In addition, the Manager will prepare regular reports for the Company's Board of Directors that will review the Company's acquisitions of Mortgage Assets, portfolio composition and characteristics, credit quality, performance and compliance with the policies approved by the Company's Board of Directors.

2.2.4 PORTFOLIO TRANSACTIONS. In placing portfolio transactions and selecting brokers or dealers, the Manager shall endeavor to obtain on behalf of the Company commercially reasonable terms. In assessing commercially reasonable terms for any transaction, the Manager shall consider all factors it deems relevant, including the breadth of the market in the security, the price of the security, the financial condition and execution capability of the broker or dealer, and the reasonableness of the commission, if any, both for the specific transaction and on a continuing basis. Notwithstanding anything contained herein, the Manager shall place portfolio transactions with Hanover Capital Securities, Inc., a New York corporation ("HCS"), whenever feasible.

2.3 COMPLIANCE WITH THE INVESTMENT ADVISERS ACT. The Manager shall operate in compliance with the provisions of the Investment Advisers Act applicable to the performance of the Manager's duties hereunder, including without limitation the anti-fraud provisions of Section 206 of such Act.

2.4 COOPERATION OF THE COMPANY. The Company agrees to take all actions reasonably required to permit the Manager to carry out its duties and obligations under this Agreement. The Company further agrees to make available to Manager all materials reasonably requested by the Manager to enable the Manager to satisfy its obligations to deliver financial statements and any other

information or reports with respect to the Company.

3. ADDITIONAL ACTIVITIES OF THE MANAGER AND ITS AFFILIATES.

3.1 OTHER ACTIVITIES OF THE MANAGER. Nothing in this Agreement shall prevent the Manager, its Affiliates, or any of the officers, directors or employees of the Manager or its Affiliates, from engaging in other businesses or from rendering services of any kind to any other person or entity, including the purchase of, or advisory service to others investing in, any type of real estate investment, including investments that meet the principal investment objectives of the Company. Directors, officers, employees and agents of the Manager and of Affiliates of the Manager may serve as trustees, directors, officers, employees, agents, nominees or signatories for the Company or any subsidiary of the Company, to the extent permitted by their Governing Instruments, as from time to time amended, or by any resolutions duly adopted by the Board of Directors pursuant to the Company's or such subsidiary's Governing Instruments. When executing documents or otherwise acting in such capacities for the Company or such subsidiary, such persons shall use their respective titles in the Company.

8

9

3.2 OTHER INVESTMENT ADVISORY ACTIVITIES OF THE MANAGER.

Subject to any applicable contractual limitations, nothing contained in this Agreement shall prevent the Manager, or any Affiliate of the Manager, from acting as investment advisor or manager for any other person, firm or corporation (including any investment company), whether or not the investment objectives or policies of any such other person, firm or corporation are similar to those of the Company, and shall not in any way bind or restrict the Manager or any such Affiliate from buying, selling or trading any securities or commodities for their own accounts or for the account of others for whom the Manager or any such Affiliate may be acting. The Company acknowledges that the Manager will base allocation decisions on the procedures the Manager considers fair and equitable, including without limitation, such considerations as investment objectives, restrictions and time horizon, availability of cash and the amount of existing holdings. While information and recommendations supplied to the Company shall, in the Manager's good faith judgment, be appropriate under the circumstances and in light of the investment objectives and policies of the Company, they may be different from the information and recommendations supplied by the Manager or its Affiliates to investment companies, funds and advisory accounts. The Company shall be entitled to equitable treatment under the circumstances in receiving information, recommendations and any other services, but the Company recognizes that it is not entitled to receive preferential treatment as compared with the treatment given by the Manager to any investment company, fund or advisory account.

4. BANK ACCOUNTS. At the direction of the Board of Directors, the Manager may establish and maintain one or more bank accounts in the name of the Company, and may collect and deposit into any such account or accounts, and disburse funds from any such account or accounts, under such terms and conditions as the Board of Directors may approve. The Manager shall from time to time render appropriate accountings of such collections and payments to the Board of Directors and, upon request, to the auditors of the Company.

5. RECORDS; CONFIDENTIALITY. The Manager shall maintain appropriate books of account and records relating to services performed under this Agreement, and such books of account and records shall be accessible for inspection by representatives of the Company at any time during normal business hours. Except in the ordinary course of business of the Company, the Manager shall keep confidential any and all information it obtains from time to time in connection with the services it renders under this Agreement and shall not disclose any portion thereof to non-affiliated third-parties (other than lenders to, and holders of stock of, the Manager) except with the prior written consent of the Company.

6. COMPENSATION OF THE MANAGER.

6.1 MANAGEMENT COMPENSATION. For services rendered under this Agreement, the Company shall pay to the Manager, commencing on the Effective Date and payable as described below, the following (together, the "MANAGEMENT Compensation"):

6.1.1 PAYROLL COMPENSATION. The Company shall pay the Manager for each month an amount equal to the sum of (x) the salaries and wages (excluding payroll taxes and benefits) of the personnel employed by the Manager and/or its Affiliates (other than independent contractors and other third parties rendering due diligence services in connection with the acquisition of any Mortgage Assets) apportioned to providing services under this Agreement to the Company (as reasonably determined by the Manager) for such month plus (y) twenty-five percent (25%) of (x); and

6.1.2 THIRD PARTY DUE DILIGENCE SERVICES. The Company shall also pay the Manager for each month an amount equal to the sum of (x) the expenses of the Manager for any due diligence services provided by independent contractors and other third parties in connection with the acquisition of any Mortgage Assets during such month plus (y) three percent (3%) of (x).

6.2 BILLING AND OFFSET. The Manager shall prepare, for each month during the term of this Agreement, a statement documenting the Management Compensation for such month, and shall deliver such statement to the Company. Management Compensation for any month as set forth on the statement for such month shall be due and payable by the Company thirty (30) days after the receipt by the Company of the statement for such month. Any amount that may become payable by the Manager to the Company for any services provided by the Company to the Manager, including without limitation the services of John A. Burchett, Joyce S. Mizerak, Irma N. Tavares and George J. Ostendorf, shall be offset against amounts payable to the Manager as provided in this Section 6.

6.3 STOCK OPTION. The Manager and the Company agree and acknowledge that the Company shall grant to the Manager a non-qualified stock option under the Company's 1997 Stock Option Plan for 72,509 shares (or such lesser number as is available for grant under such Stock Option Plan) of the Company's Common Stock, par value \$.01 per share, at an exercise price of \$15.75 per share with the understanding that such option may be transferred, directly or indirectly, in whole or in part, including by the Manager's grant of options with respect to such option, by the Manager to its officers, directors and employees and such other persons who are expected to provide significant services to the Manager provided that any such transfer has been registered or qualified under the Securities Act of 1933, as amended, and any state or other securities laws or, in the opinion of counsel to the Manager and reasonably satisfactory to the Company, the transfer is exempt from the registration or qualification requirements of such Act and such state and other securities laws.

7. EXPENSES OF THE MANAGER AND THE COMPANY.

7.1 EXPENSES OF THE MANAGER. Without regard to the compensation received under this Agreement by the Manager, the Manager shall bear the following expenses: rent, telephone, utilities, office furniture, equipment, machinery, and other

office expenses of the Manager and/or its Affiliates required for the Company's day-to-day operations, including bookkeeping, clerical and back-office services provided by the Manager or its Affiliates.

7.2 EXPENSES OF THE COMPANY. The Company shall pay all of its expenses except those that are the responsibility of the Manager pursuant to Section 7.1 of this Agreement, and without limiting the generality of the foregoing, it is specifically agreed that the following expenses of the Company shall be paid by the Company and shall not be paid by the Manager or Affiliates of the Manager:

7.2.1 the cost of money borrowed by the Company, including interest;

7.2.2 all taxes and license fees applicable to the Company, including interest and penalties thereon;

7.2.3 legal, audit, accounting, underwriting, brokerage, listing, filing, rating agency, registration and other fees, printing, engraving, clerical, personnel and other expenses and taxes incurred in connection with the issuance, distribution, transfer, registration and stock exchange listing of the Company's securities;

7.2.4 fees and expenses paid to advisors and independent contractors, consultants, managers, and other agents engaged directly by the Company or by the Manager at the Company's request for the account of the Company or any subsidiary of the Company (other than the Manager or its Affiliates);

7.2.5 expenses connected with the acquisition, disposition, financing and ownership of the Company's investment assets, including, but not limited to, commitment fees, brokerage fees or commissions, guaranty fees, ad valorem taxes, costs of foreclosure, maintenance, repair and improvement of property and premiums for insurance on property owned by the Company;

7.2.6 costs related to hedging transactions;

7.2.7 the expenses of organizing, modifying or dissolving the Company;

7.2.8 all insurance costs incurred by the Company, including any costs to obtain liability or other insurance to indemnify the Manager and underwriters of any securities of the Company;

7.2.9 expenses connected with payments of dividends or interest or distributions in any other form made or caused to be made by the Board of Directors to holders of the securities of the Company;

11

12

7.2.10 expenses connected with the structuring, issuance and administration of Mortgage Securities by the Company, including, but not limited to, legal fees, trustee's fees, insurance premiums, and costs of required credit enhancements;

7.2.11 expenses of third parties connected with communications to holders of securities issued by the Company and the other bookkeeping and clerical work necessary in maintaining relations with holders of such securities and in complying with the continuous reporting and other requirements of governmental bodies or agencies, including any costs of computer services in connection with this function, the cost of printing and mailing certificates for such securities and proxy solicitation materials and reports to holders of the Company's securities and reports to third parties required under any indenture to which the Company is a party;

7.2.12 custodian's, transfer agent's and registrar's fees and charges;

7.2.13 compensation, fees and expenses paid to Unaffiliated Directors of the Company, the cost of director and officer liability insurance and premiums for errors and omissions insurance;

7.2.14 legal, accounting and auditing fees and expenses relating to the Company's operations (excluding litigation-related fees and expenses described in Section 7.2.15);

7.2.15 legal, expert and other fees and expenses relating to any actions, proceedings, lawsuits, demands, causes of action and claims, whether actual or threatened, made by or against the Company, or which the Company is authorized or obligated to pay under applicable law or its Governing Instruments or by the Board of Directors;

7.2.16 any judgment rendered against the Company, or against any director or officer of the Company in his capacity as such for which the Company is required to indemnify such director or officer by any court or governmental agency, or settlement of pending or threatened litigation;

7.2.17 expenses relating to any office or office facilities maintained by the Company exclusive of the office of the Manager and/or its Affiliates;

7.2.18 expenses related to the accumulation, servicing and subservicing of Mortgage Loans;

7.2.19 travel and related expenses of directors, officers and employees of the Manager and of directors, officers and employees of the Company who are also directors, officers or employees of the Manager, incurred in connection with attending meetings of the Board of Directors or holders of securities of the Company or performing other business activities that relate to the Company, including, where

12

13

applicable, a proportionate share of such expenses as reasonably determined by Manager where such expenses were not incurred solely for the benefit of the Company;

7.2.20 costs associated with computer hardware and software, third party information services and office expenses that relate solely to the business activities of the Company;

7.2.21 any extraordinary or non-recurring costs or charges incurred by the Company; and

7.2.22 other expenses of the Company that are not expenses of the Manager under Section 7.1 of this Agreement.

7.3 EXPENSE REIMBURSEMENT TO THE MANAGER. Expenses incurred by the Manager on behalf of the Company shall be reimbursed monthly to the Manager within thirty (30) days after the end of each month. The Manager shall prepare a statement documenting the expenses of the Company and those incurred by the Manager on behalf of the Company during each month, and shall deliver such statement to the Company within fifteen (15) days after the end of the month to which the expenses relate. Expense reimbursement to the Manager shall be subject to adjustment at the end of each fiscal year in connection with the annual audit of the Company. Any amount that may become payable by the Manager pursuant to such an annual adjustment shall be offset against future Management Compensation amounts payable to the Manager pursuant to Section 6 hereof.

8. LIMITS OF MANAGER RESPONSIBILITY. The Manager assumes no responsibility under this Agreement other than to render the services specifically called for under this Agreement and shall not be responsible for any action of the Board of Directors in following or declining to follow any advice or recommendations of the Manager, including as set forth in Section 2.2.2 of this Agreement. The Manager, its directors, officers, stockholders and employees will not be liable to the Company, any issuer of Mortgage Securities or the Unaffiliated Directors for any acts or omissions, errors of judgment or mistakes of law by the Manager, its directors, officers, stockholders or employees under or in connection with this Agreement, except by reason of acts or omissions, errors of judgment or mistakes of law constituting bad faith, willful misconduct, gross negligence or reckless disregard of their duties under this Agreement. The Company shall reimburse, indemnify and hold harmless the Manager, its directors, officers, stockholders and employees of and from any and all expenses, losses, damages, liabilities, demands, charges and claims of any nature whatsoever (including, without limitation, reasonable attorneys' fees) in respect of or arising from any acts or omissions, errors of judgment or mistakes of law of the Manager, its stockholders, directors, officers and employees made in good faith in the performance of the Manager's duties under this Agreement or pursuant to any underwriting agreement or similar agreement to which the Manager is a party in connection with any debt or equity sales of the Company's securities and not constituting bad faith, willful misconduct, gross negligence or reckless disregard of their duties under this Agreement or any such underwriting agreement. The

13

14

Manager shall be indemnified by the Company as an agent of the Company in accordance with the terms of the Company's Governing Instruments.

9. NO JOINT VENTURE. The Company and the Manager are not partners or joint venturers with each other, and nothing in this Agreement shall be construed to make them such partners or joint venturers or impose any liability as such on any of them. The Manager is an independent contractor and, except as expressly provided or authorized in this Agreement, shall have no authority to act for or represent the Company.

10. TERM AND TERMINATION. This Agreement shall commence on the Effective Date and shall continue in force until December 31, 1999 and thereafter it shall be subject to successive one-year renewal periods upon the review and approval of the Unaffiliated Directors. If the Unaffiliated Directors do not resolve to renew or terminate this Agreement within at least sixty (60) days prior to the end of the then-current period of this Agreement, this Agreement shall be automatically extended for a one-year period. The Company and the Manager shall have the right, following the initial term of this Agreement, to terminate this Agreement at any time upon not less than sixty (60) days prior written notice.

11. ASSIGNMENTS. Upon not less than sixty (60) days prior written notice to the Board of Directors of the Company, this Agreement may be assigned by the Manager to an Affiliate of the Manager without the consent of the Company. Except in the event of an assignment by the Manager to an Affiliate of the Manager or as otherwise set forth in this Section 11, this Agreement shall terminate automatically in the event of its assignment, in whole or in part, by the Manager (other than the pledge of amounts payable to the Manager under this Agreement to secure the Manager's obligations to its lenders), unless such assignment is consented to in writing by the Company with the consent of a majority of the Unaffiliated Directors. The Company shall not withhold its consent to any assignment of this Agreement by the Manager in connection with any acquisition, consolidation or merger of the Manager, to the extent such consent is required by the Investment Advisers Act. Any assignment shall bind the assignee under this Agreement in the same manner as the Manager is bound. In addition, the assignee shall execute and deliver to the Company a counterpart of this Agreement naming such assignee as Manager. This Agreement shall not be assigned by the Company without the prior written consent of the Manager, except in the case of assignment by the Company to a REIT or other organization which is a successor (by merger, consolidation or purchase of assets) to the Company, in which case such successor organization shall be bound under this Agreement and by the terms of such assignment in the same manner as the Company is bound under this Agreement.

12. TERMINATION BY COMPANY FOR CAUSE. At the option of the Company, this Agreement shall be and become terminated immediately (subject to any opportunity to cure set forth below) upon written notice of termination from the Board of Directors to the Manager if any of the following events shall occur (termination for any of such events shall constitute termination for "cause"):

14

15

12.1 if a majority of the Unaffiliated Directors determines that the Manager has violated this Agreement in any material respect and, after written notice of such violation, the Manager has failed to cure such violation within thirty (30) days, unless during such thirty (30)-day period the Manager has commenced to cure such violation and thereafter diligently prosecutes to cure such violation; or

12.2 there is entered an order for relief or similar decree or order with respect to the Manager by a court having competent jurisdiction in an involuntary case under the federal bankruptcy laws as now or hereafter constituted or under any applicable federal or state bankruptcy, insolvency or other similar laws; or the Manager (i) admits in writing its inability to pay its debts as they become due and payable, or makes a general assignment for the benefit of, or enters into any composition or arrangement with, creditors; (ii) applies for, or consents (by admission of material allegations of a petition or otherwise) to the appointment of a receiver, trustee, assignee, custodian, liquidator or sequestrator (or other similar official) of the Manager or of any substantial part of its properties or assets, or authorizes such an application or consent, or proceedings seeking such appointment are commenced without such authorization, consent or application against the Manager and continue undismissed for thirty (30) days; (iii) authorizes or files a voluntary petition

in bankruptcy, or applies for or consents (by admission of material allegations of a petition or otherwise) to the application of any bankruptcy, reorganization, arrangement, readjustment of debt, insolvency, dissolution, liquidation or other similar law of any jurisdiction, or authorizes such application or consent, or proceedings to such end are instituted against the Manager without such authorization, application or consent and are approved as properly instituted and remain undismissed for thirty (30) days or result in adjudication of bankruptcy or insolvency; or (iv) permits or suffers all or any substantial part of its properties or assets to be sequestered or attached by court order and the order remains undismissed for thirty (30) days; provided, however, that in the event the Manager becomes the subject of a case under federal bankruptcy or similar federal or state laws and remains in possession of its property and continues to operate its business (as a debtor in possession or otherwise), the Company shall not have the option to terminate this Agreement unless the Unaffiliated Directors determine in good faith that as a result of such proceeding the Manager cannot reasonably be expected to fulfill its obligations under this Agreement. If any of the events specified in Section 12.2 of this Agreement shall occur, the Manager shall give prompt written notice thereof to the Board of Directors upon the happening of such event.

13. ACTION UPON TERMINATION. From and after the effective date of termination of this Agreement, pursuant to Sections 10, 11 or 12 of this Agreement, the Manager shall not be entitled to compensation for further services under this Agreement, but shall be paid all Management Compensation accruing to the date of termination. Upon such termination, the Manager shall forthwith:

13.1 after deducting any accrued Management Compensation and reimbursement for its expenses to which it is then entitled, pay over to the Company all money collected and held for the account of the Company pursuant to this Agreement;

15

16

13.2 deliver to the Board of Directors, upon their request therefor, a full accounting, including a statement showing all payments collected by it and a statement of all money held by it, covering the period following the date of the last accounting furnished to the Board of Directors with respect to the Company; and

13.3 deliver to the Board of Directors all property and documents of the Company then in the custody of the Manager.

14. RELEASE OF MONEY OR OTHER PROPERTY UPON WRITTEN REQUEST. The Manager agrees that any money or other property of the Company held by the Manager under this Agreement shall be held by the Manager as custodian for the Company, and the Manager's records shall be appropriately marked clearly to reflect the ownership of such money or other property by the Company. Upon the receipt by the Manager of a written request signed by a duly authorized officer of the Company requesting the Manager to release to the Company any money or other property then held by the Manager for the account of the Company under this Agreement, the Manager shall release such money or other property to the Company within a reasonable period of time, but in no event later than the later to occur of (i) thirty (30) days following such request and (ii) the earliest time following such request that remittance will not cause the Manager to violate any law or breach any agreement to which it or the Company is a party. The Manager shall not be liable to the Company, the Unaffiliated Directors, or the Company's stockholders for any acts performed or omissions to act by the Company in connection with the money or other property released to the Company in accordance with this Section 14 and not constituting bad faith, willful misconduct, gross negligence or reckless disregard of its duties under this Agreement. The Company shall indemnify the Manager, its directors, officers, stockholders and employees against any and all expenses, losses, damages, liabilities, demands, charges and claims of any nature whatsoever, which arise in connection with the Manager's release of such money or other property to the Company in accordance with the terms of this Section 14 unless such expenses, losses, damages, liabilities, demands, charges and claims arise in connection with acts or omissions which constitute bad faith, willful misconduct, gross negligence or reckless disregard of its duties under this Agreement. Indemnification pursuant to this provision shall be in addition to any right of the Manager to indemnification under Section 8 of this Agreement.

15. REPRESENTATIONS AND WARRANTIES.

15.1 COMPANY IN FAVOR OF THE MANAGER. The Company hereby represents and warrants to the Manager as follows:

15.1.1 DUE FORMATION. The Company is duly organized, validly existing and in good standing under the laws of the state of Maryland and has the power to own its assets and to transact the business in which it is now engaged.

15.1.2 POWER AND AUTHORITY. The Company has the requisite corporate power and authority to execute, deliver and perform this Agreement and all

16

17 obligations required under this Agreement and has taken all necessary action to authorize this Agreement on the terms and conditions hereof and the execution, delivery and performance of this Agreement and all obligations required under this Agreement. Except as shall have been obtained, no consent of any other person, including without limitation, stockholders and creditors of the Company, and no license, permit, approval or authorization of, exemption by, notice or report to, or registration, filing or declaration with, any governmental authority is required by the Company in connection with this Agreement or the execution, delivery, performance, validity or enforceability of this Agreement and all obligations required under this Agreement. This Agreement has been, and each instrument or document required under this Agreement will be, executed and delivered by a duly authorized officer of the Company, and this Agreement constitutes, and each instrument or document required under this Agreement when executed and delivered under this Agreement will constitute, the legally valid and binding obligation of the Company enforceable against the Company in accordance with its terms.

15.1.3 EXECUTION, DELIVERY AND PERFORMANCE. The execution, delivery and performance of this Agreement and the documents or instruments required under this Agreement will not violate any provision of any existing law or regulation binding on the Company, or any order, judgment, award or decree of any court, arbitrator or governmental authority binding on the Company, or the Governing Instruments of, or any securities issued by, the Company or of any mortgage, indenture, lease, contract or other agreement, instrument or undertaking to which the Company is a party or by which the Company or any of its assets may be bound, the violation of which would have a material adverse effect on the business operations, assets or financial condition of the Company and its subsidiaries, taken as a whole, and will not result in, or require, the creation or imposition of any lien on any of its property, assets or revenues pursuant to the provisions of any such mortgage, indenture, lease, contract or other agreement, instrument or undertaking (other than the pledge of amounts payable to the Manager under this Agreement to secure the Manager's obligations to its lenders).

15.2 MANAGER IN FAVOR OF THE COMPANY. The Manager hereby represents and warrants to the Company as follows:

15.2.1 DUE FORMATION. The Manager is duly organized, validly existing and in good standing under the laws of the state of New York and has the corporate power to own its assets and to transact the business in which it is now engaged.

15.2.2 POWER AND AUTHORITY. The Manager has the corporate power and authority to execute, deliver and perform this Agreement and all obligations required under this Agreement and has taken all necessary corporate action to authorize this Agreement on the terms and conditions hereof and the execution, delivery and performance of this Agreement and all obligations required under this Agreement. Except as shall have been obtained, no consent of any other person including, without limitation, stockholders and creditors of the Manager, and no license, permit, approval or authorization of, exemption by, notice or report to, or registration, filing or declaration with, any governmental authority is required by the Manager in connection with this

17

18 Agreement or the execution, delivery, performance, validity or enforceability of this Agreement and all obligations required under this Agreement. This

Agreement has been and each instrument or document required under this Agreement will be executed and delivered by a duly authorized officer of the Manager, and this Agreement constitutes, and each instrument or document required under this Agreement when executed and delivered under this Agreement will constitute, the legally valid and binding obligation of the Manager enforceable against the Manager in accordance with its terms.

15.2.3 EXECUTION, DELIVERY AND PERFORMANCE. The execution, delivery and performance of this Agreement and the documents or instruments required under this Agreement will not violate any provision of any existing law or regulation binding on the Manager, or any order, judgment, award or decree of any court, arbitrator or governmental authority binding on the Manager, or the governing instruments of, or any securities issued by, the Manager or of any mortgage, indenture, lease, contract or other agreement, instrument or undertaking to which the Manager is a party or by which the Manager or any of its assets may be bound, the violation of which would have a material adverse effect on the business operations, assets, or financial condition of the Manager and its subsidiaries, taken as a whole, and will not result in, or require, the creation or imposition of any lien on any of its property, assets or revenues pursuant to the provisions of any such mortgage indenture, lease, contract or other agreement, instrument or undertaking.

16. NOTICES. Unless expressly provided otherwise in this Agreement, all notices, requests, demands and other communications required or permitted under this Agreement shall be in writing and shall be deemed to have been duly given, made and received when (i) delivered by hand, (ii) otherwise delivered against receipt therefor, or (iii) upon actual receipt of registered or certified mail, postage prepaid, return receipt requested. The parties may deliver to each other notice by electronically transmitted facsimile copies, provided that such facsimile notice is followed within 24 hours by any type of notice otherwise provided for in this Section 16. Any notice shall be duly addressed to the parties as follows:

(a) If to the Company:

90 West Street
Suite 1508
New York, New York 10006
Attn: President
Telecopy: (212) 732-4728

(b) If to the Manager:

90 West Street
Suite 1508
New York, New York 10006
Attn: President

18

19

Telecopy: (212) 732-4728

Any party may alter the address to which communications or copies are to be sent by giving notice of such change of address in conformity with the provisions of this Section 16 for the giving of notice.

17. BINDING NATURE OF AGREEMENT; SUCCESSORS AND ASSIGNS. This Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, personal representatives, successors and assigns as provided in this Agreement.

18. ENTIRE AGREEMENT. This Agreement contains the entire agreement and understanding among the parties hereto with respect to the subject matter hereof, and supersedes all prior and contemporaneous agreements, understandings, inducements and conditions, express or implied, oral or written, of any nature whatsoever with respect to the subject matter hereof. The express terms hereof control and supersede any course of performance and/or usage of the trade inconsistent with any of the terms hereof. This Agreement may not be modified or amended other than by an agreement in writing.

19. CONTROLLING LAW. This Agreement and all questions relating to its validity, interpretation, performance and enforcement shall be governed by and

construed, interpreted and enforced in accordance with the laws of the State of New York notwithstanding any New York or other conflict of law provisions to the contrary.

20. INDULGENCES, NOT WAIVERS. Neither the failure nor any delay on the part of a party to exercise any right, remedy, power or privilege under this agreement shall operate as a waiver thereof, nor shall any single or partial exercise of any right, remedy, power or privilege preclude any other or further exercise of the same or of any right, remedy, power or privilege, nor shall any waiver of any right, remedy, power or privilege with respect to any occurrence be construed as a waiver of such right, remedy, power or privilege with respect to any other occurrence. No waiver shall be effective unless it is in writing and is signed by the party asserted to have granted such waiver.

21. TITLES NOT TO AFFECT INTERPRETATION. The titles of paragraphs and subparagraphs contained in this Agreement are for convenience only, and they neither form a part of this Agreement nor are they to be used in the construction or interpretation hereof.

22. EXECUTION IN COUNTERPARTS. This Agreement may be executed in any number of counterparts, each of which shall be deemed to be an original as against any party whose signature appears thereon, and all of which shall together constitute one and the same instrument. This Agreement shall become binding when one or more counterparts hereof, individually or taken together, shall bear the signatures of all of the parties reflected hereon as the signatories.

23. PROVISIONS SEPARABLE. The provisions of this Agreement are independent of and separable from each other, and no provision shall be affected or rendered invalid or

19

20

unenforceable by virtue of the fact that for any reason any other or others of them may be invalid or unenforceable in whole or in part.

24. GENDER. Words used herein regardless of the number and gender specifically used shall be deemed and construed to include any other number, singular or plural, and any other gender, masculine, feminine or neuter, as the context requires.

25. ATTORNEYS' FEES. Should any action or other proceeding be necessary to enforce any of the provisions of this Agreement or the various transactions contemplated hereby, the prevailing party will be entitled to recover its actual reasonable attorneys' fees and expenses from the non-prevailing party.

26. AMENDMENTS. This Agreement may not be amended, modified or changed (in whole or in part), except by a formal, definitive written agreement expressly referring to this Agreement, which agreement is executed by all of the parties. The parties hereto expressly acknowledge that no consent or approval of the Company's stockholders is required in connection with any amendment, modification or change to this Agreement.

27. AUTHORITY. Each signatory to this Agreement warrants and represents that he is authorized to sign on behalf of and to bind the party on whose behalf he, she or it is signing.

[Remainder of Page Intentionally Left Blank]

20

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the effective date.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

By: _____
Title:

HANOVER CAPITAL PARTNERS LTD.

By: _____
Title:

MASTER LOAN AND SECURITY AGREEMENT

MASTER LOAN AND SECURITY AGREEMENT, dated as of December 8, 1997, between HANOVER CAPITAL MORTGAGE HOLDINGS, INC., a Maryland corporation (the "BORROWER"), and MORGAN STANLEY MORTGAGE CAPITAL INC., a Delaware corporation (the "LENDER").

RECITALS

The Borrower has requested that the Lender from time to time make revolving credit loans to it to finance certain residential mortgage loans owned by the Borrower, and the Lender is prepared to make such loans upon the terms and conditions hereof. Accordingly, the parties hereto agree as follows:

Section 1. DEFINITIONS AND ACCOUNTING MATTERS.

1.01 CERTAIN DEFINED TERMS. As used herein, the following terms shall have the following meanings (all terms defined in this Section 1.01 or in other provisions of this Loan Agreement in the singular to have the same meanings when used in the plural and VICE VERSA):

"AFFILIATE" shall mean, (i) with respect to the Lender, MS & Co. and Morgan Stanley, Dean Witter, Discover & Co., and Morgan Stanley Group Inc. and MS & Co. and (ii) with respect to the Borrower, any "affiliate" of the Borrower as such term is defined in the United States Bankruptcy Code in effect from time to time.

"APPLICABLE COLLATERAL PERCENTAGE" shall mean (a) with respect to all Eligible Mortgage Loans other than Second Lien Mortgage Loans and Delinquent Mortgage Loans, 97%, (b) with respect to all Eligible Mortgage Loans that are Second Lien Mortgage Loans, 90%, and (c) with respect to all Eligible Mortgage Loans that are Delinquent Mortgage Loans, 85%.

"APPLICABLE MARGIN" shall mean 60 basis points (0.60%).

"APPRAISED VALUE" shall mean the value set forth in an appraisal made in connection with the origination of the related Mortgage Loan as the value of the Mortgaged Property.

"BANKRUPTCY CODE" shall mean the United States Bankruptcy Code of 1978, as amended from time to time.

"BLOCKED ACCOUNT AGREEMENT" shall mean an agreement between the Servicer and the Lender, substantially in the form of EXHIBIT G hereto, as the same may be amended, supplemented or otherwise modified from time to time, in which the Servicer acknowledges the Lender's lien on the Collection Account, and agrees that, in the event that it receives notice that an Event of Default hereunder has occurred and until such notice is rescinded by the Lender, the Servicer shall only withdraw funds from the Collection Account on instruction from the Lender.

"BORROWER" shall have the meaning provided in the heading hereof.

-1-

"BORROWING BASE" shall mean the aggregate Collateral Value of all Eligible Mortgage Loans.

"BORROWING BASE DEFICIENCY" shall have the meaning provided in Section 2.06 hereof.

"BUSINESS DAY" shall mean any day other than (i) a Saturday or Sunday or (ii) a day on which the New York Stock Exchange, the Federal Reserve Bank of New York or the Custodian is authorized or obligated by law or executive order to be closed.

"CAPITAL EXPENDITURES" shall mean, as to any Person for any period, the

aggregate amount paid or accrued by such Person and its Affiliates for the rental, lease, purchase (including by way of the acquisition of securities of any Person), construction or use of any Property during such period, the value or cost of which, in accordance with GAAP, would appear on such Person's consolidated balance sheet in the category of property, plant or equipment at the end of such period.

"CAPITAL LEASE OBLIGATIONS" shall mean, for any Person, all obligations of such Person to pay rent or other amounts under a lease of (or other agreement conveying the right to use) Property to the extent such obligations are required to be classified and accounted for as a capital lease on a balance sheet of such Person under GAAP, and, for purposes of this Loan Agreement, the amount of such obligations shall be the capitalized amount thereof, determined in accordance with GAAP.

"CODE" shall mean the Internal Revenue Code of 1986, as amended from time to time.

"COLLATERAL" shall have the meaning provided in Section 4.01(b) hereof.

"COLLATERAL VALUE" shall mean, with respect to each Eligible Mortgage Loan, the lesser of (a) the Applicable Collateral Percentage of the Market Value of such Mortgage Loan, and (b) the outstanding principal balance of such Mortgage Loan; provided that,

(a) the Collateral Value shall be deemed to be zero with respect to each Mortgage Loan (1) in respect of which there is a breach of a representation and warranty set forth on SCHEDULE 1 (assuming each representation and warranty is made as of the date Collateral Value is determined), (2) which is an Eligible Mortgage Loan which remains pledged to the Lender hereunder later than 270 days after the date on which it is first included in the Collateral, (3) in respect of which there is a delinquency in the payment of principal and/or interest which continues for a period of 90 days or more (without regard to any applicable grace periods), or (4) which has been released from the possession of the Custodian under the Custodial Agreement to the Borrower for a period in excess of 14 days;

(b) the aggregate Collateral Value of Eligible Mortgage Loans which are Second Lien Mortgage Loans may not exceed 4% of the aggregate principal amount outstanding under the Loans;

(c) the aggregate Collateral Value of Eligible Mortgage Loans which are 30 Day Delinquent Mortgage Loans may not exceed 7% of the aggregate principal amount outstanding under the Loans; and

(d) the aggregate Collateral Value of Eligible Mortgage Loans which are 60 Day Delinquent Mortgage Loans may not exceed 3% of the aggregate principal amount outstanding under the Loans.

-2-

3

"COLLECTION ACCOUNT" shall mean one or more accounts established by the Borrower with the Servicer subject to a security interest in favor of the Lender and to the Blocked Account Agreement, into which all Collections shall be deposited by the Servicer.

"COLLECTIONS" shall mean, collectively, all Principal Collections, all Sale Proceeds and other collections and proceeds on or in respect of the Mortgage Loans, excluding collections required to be paid to the Servicer or a mortgagor on the Mortgage Loans.

"COMBINED LTV" OR "CLTV" shall mean with respect to any Mortgage Loan, the ratio of (a) the outstanding principal balance as of the related date of origination of such Mortgage Loan of (i) the Mortgage Loan plus (ii) the mortgage loan constituting the first lien (if any) to (b) the Appraised Value of the Mortgaged Property.

"COMMITTED LOAN" shall have the meaning assigned thereto in Section 2.01(a) hereof.

"CUSTODIAL AGREEMENT" shall mean the Custodial Agreement, dated as of the

date hereof, among the Borrower, the Custodian and the Lender, substantially in the form of EXHIBIT B hereto, as the same shall be modified and supplemented and in effect from time to time.

"CUSTODIAN" shall mean First Chicago National Processing Corp., as custodian under the Custodial Agreement, and its successors and permitted assigns thereunder.

"DEFAULT" shall mean an Event of Default or an event that with notice or lapse of time or both would become an Event of Default.

"DELINQUENT MORTGAGE LOAN" shall mean a 30 Day Delinquent Mortgage Loan or a 60 Day Delinquent Mortgage Loan, as applicable.

"DOLLARS" and "\$" shall mean lawful money of the United States of America.

"DUE DILIGENCE REVIEW" shall mean the performance by the Lender of any or all of the reviews permitted under Section 11.15 hereof with respect to any or all of the Mortgage Loans, as desired by the Lender from time to time.

"EFFECTIVE DATE" shall mean the date upon which the conditions precedent set forth in Section 5.01 shall have been satisfied.

"ELIGIBLE MORTGAGE LOAN" shall mean a Mortgage Loan secured by a first or second mortgage lien on a one-to-four family residential property, as to which the representations and warranties in Section 6.10 and Part I of Schedule 1 hereof are correct.

"ERISA" shall mean the Employee Retirement Income Security Act of 1974, as amended from time to time.

"ERISA AFFILIATE" shall mean any corporation or trade or business that is a member of any group of organizations (i) described in Section 414(b) or (c) of the Code of which the Borrower is a member and (ii) solely for purposes of potential liability under Section 302(c)(11) of ERISA and Section 412(c)(11) of the Code and the lien created under Section 302(f) of ERISA and Section 412(n) of the Code, described in Section 414(m) or (o) of the Code of which the Borrower is a member.

-3-

4

"EURODOLLAR BASE RATE" shall mean:

(a) for any One-Month LIBOR Loan, with respect to each day such Loan is outstanding (or if such day is not a Business Day, the next succeeding Business Day), the rate per annum equal to the rate appearing at page 5 of the Telerate Screen as one-month LIBOR on the first day of such Interest Period, and if such rate shall not be so quoted, the rate per annum at which the Lender is offered Dollar deposits at or about 10:00 A.M., New York City time, on such date by prime banks in the interbank eurodollar market where the eurodollar and foreign currency and exchange operations in respect of its Loans are then being conducted for delivery on such day for a period of thirty (30) days and in an amount comparable to the amount of the Loans to be outstanding on such day; and

(b) for any Loan other than a One-Month LIBOR Loan, with respect to each day during each Interest Period pertaining to such Loan, the rate per annum as of the first day of such Interest Period equal to the interpolated percentage based on the rates appearing at page 5 of the Telerate screen as the LIBOR rates closest to the number of days in the applicable Interest Period, and if such rates shall not be so quoted, the rates per annum at which the Lender is offered Dollar deposits at or about 10:00 A.M., New York City time, on the first day of such Interest Period, by prime banks in the interbank eurodollar market where the eurodollar and foreign currency and exchange operations in respect of its Loans are then being conducted for delivery on the first day of such Interest Period for the number of days comprised therein and in an amount comparable to the amount of the Loans to be outstanding during such Interest Period.

"EVENT OF DEFAULT" shall have the meaning provided in Section 8 hereof.

"FEDERAL FUNDS RATE" shall mean, for any day, the weighted average of the rates on overnight federal funds transactions with members of the Federal

Reserve System arranged by federal funds brokers, as published on the next succeeding Business Day by the Federal Reserve Bank of New York, or, if such rate is not so published for any day which is a Business Day, the average of the quotations for the day of such transactions received by the Lender from three federal funds brokers of recognized standing selected by it.

"FIRST LIEN MORTGAGE LOAN" shall mean an Eligible Mortgage Loan secured by the lien on the Mortgaged Property, subject to no prior liens on such Mortgaged Property.

"FUNDING DATE" shall mean the date on which a Loan is made hereunder.

"GAAP" shall mean generally accepted accounting principles as in effect from time to time in the United States.

"GOVERNMENTAL AUTHORITY" shall mean any nation or government, any state or other political subdivision thereof, any entity exercising executive, legislative, judicial, regulatory or administrative functions of or pertaining to government and any court or arbitrator having jurisdiction over the Borrower, any of its Subsidiaries or any of its properties.

"GUARANTEE" shall mean, as to any Person, any obligation of such Person directly or indirectly guaranteeing any Indebtedness of any other Person or in any manner providing for the payment of any Indebtedness of any other Person or otherwise protecting the holder of such Indebtedness against loss (whether by virtue of partnership arrangements, by agreement to keep-well,

-4-

5

to purchase assets, goods, securities or services, or to take-or-pay or otherwise); provided that the term "Guarantee" shall not include (i) endorsements for collection or deposit in the ordinary course of business, or (ii) obligations to make servicing advances for delinquent taxes and insurance or other obligations in respect of a Mortgaged Property, to the extent required by the Lender. The amount of any Guarantee of a Person shall be deemed to be an amount equal to the stated or determinable amount of the primary obligation in respect of which such Guarantee is made or, if not stated or determinable, the maximum reasonably anticipated liability in respect thereof as determined by such Person in good faith. The terms "GUARANTEE" and "GUARANTEED" used as verbs shall have correlative meanings.

"INDEBTEDNESS" shall mean, for any Person: (a) obligations created, issued or incurred by such Person for borrowed money (whether by loan, the issuance and sale of debt securities or the sale of Property to another Person subject to an understanding or agreement, contingent or otherwise, to repurchase such Property from such Person); (b) obligations of such Person to pay the deferred purchase or acquisition price of Property or services, other than trade accounts payable (other than for borrowed money) arising, and accrued expenses incurred, in the ordinary course of business so long as such trade accounts payable are payable within 90 days of the date the respective goods are delivered or the respective services are rendered; (c) Indebtedness of others secured by a Lien on the Property of such Person, whether or not the respective Indebtedness so secured has been assumed by such Person; (d) obligations (contingent or otherwise) of such Person in respect of letters of credit or similar instruments issued or accepted by banks and other financial institutions for account of such Person; (e) Capital Lease Obligations of such Person; (f) obligations of such Person under repurchase agreements or like arrangements; (g) Indebtedness of others Guaranteed by such Person; (h) all obligations of such Person incurred in connection with the acquisition or carrying of fixed assets by such Person; and (i) Indebtedness of general partnerships of which such Person is a general partner.

"INTEREST PERIOD" shall mean, either (i) with respect to One-Month Libor Loans, one month or (ii) with respect to Loans other than One-Month Libor Loans, an interest period requested by the Borrower under Section 2.03(a), and approved by the Lender in its sole discretion, which interest period shall be a minimum of thirty-one (31) days. With respect to One-Month Libor Loans, each such Interest Period shall (a) initially commence on the Funding Date and continue to

but excluding the first Payment Date; and (b) thereafter, commence on a Payment Date and continue to but excluding the next Payment Date. With respect to Loans other than One-Month Libor Loans, each such Interest Period shall continue to the last day of such Interest Period and thereafter, commence on the day following the last day of the previous Interest Period. Notwithstanding the foregoing, no Interest Period may end after the Termination Date.

"INTEREST RATE PROTECTION AGREEMENT" shall mean, with respect to any or all of the Mortgage Loans, any short sale of US Treasury Security, or futures contract, or mortgage related security or Eurodollar futures contract, or options related contract, or interest rate swap, cap or collar agreement or similar arrangements providing for protection against fluctuations in interest rates or the exchange of nominal interest obligations, either generally or under specific contingencies, entered into by the Borrower and reasonably acceptable to the Lender.

"LENDER" shall have the meaning provided in the heading hereto.

"LIEN" shall mean any mortgage, lien, pledge, charge, security interest or similar encumbrance.

-5-

6

"LOAN" shall mean any Committed Loan or Uncommitted Loan, as applicable, and collectively "Loans" shall mean the sum of all Committed Loans and Uncommitted Loans.

"LOAN AGREEMENT" shall mean this Master Loan and Security Agreement, as the same may be amended, supplemented or otherwise modified from time to time.

"LOAN DOCUMENTS" shall mean, collectively, this Loan Agreement, the Note, the Custodial Agreement, and the Blocked Account Agreement.

"MARKET VALUE" shall mean, as of any date in respect of an Eligible Mortgage Loan, the price at which such Eligible Mortgage Loan could readily be sold as determined in good faith by the Lender, which price may be determined to be zero. The Lender's determination of Market Value shall be conclusive upon the parties absent manifest error on the part of the Lender.

"MATERIAL ADVERSE EFFECT" shall mean a material adverse effect on (a) the Property, business, operations, financial condition or prospects of the Borrower, (b) the ability of the Borrower to perform its obligations under any of the Loan Documents to which it is a party, (c) the validity or enforceability of any of the Loan Documents, (d) the rights and remedies of the Lender under any of the Loan Documents, (e) the timely payment of the principal of or interest on the Loans or other amounts payable in connection therewith or (f) the Collateral.

"MAXIMUM COMMITTED AMOUNT" shall mean \$100,000,000.

"MAXIMUM CREDIT" shall mean the sum of the Maximum Committed Amount and the Maximum Uncommitted Amount, which shall equal \$125,000,000.

"MAXIMUM UNCOMMITTED AMOUNT" shall mean \$25,000,000.

"MORTGAGE" shall mean the mortgage, deed of trust or other instrument securing a Mortgage Note, which creates a first lien on the fee in real property securing the Mortgage Note.

"MORTGAGE FILE" shall have the meaning assigned thereto in the Custodial Agreement.

"MORTGAGE LOAN" shall mean a mortgage loan which the Custodian has been instructed to hold for the Lender pursuant to the Custodial Agreement, and which Mortgage Loan includes, without limitation, (i) a Mortgage Note and related Mortgage and (ii) all right, title and interest of the Borrower in and to the Mortgaged Property covered by such Mortgage.

"MORTGAGE LOAN DOCUMENTS" shall mean, with respect to a Mortgage Loan, the documents comprising the Mortgage File for such Mortgage Loan.

"MORTGAGE LOAN SCHEDULE" shall have the meaning assigned thereto in the Custodial Agreement.

"MORTGAGE LOAN SCHEDULE AND EXCEPTION REPORT" shall mean the mortgage loan schedule and exception report prepared by the Custodian pursuant to the Custodial Agreement.

"MORTGAGE LOAN TAPE" shall mean a computer-readable magnetic tape containing such fields as shall be mutually agreed upon by the Borrower and the Lender with respect to each Mortgage Loan to be delivered by the Borrower to the Lender pursuant to Section 2.03(a) hereof.

-6-

7

"MORTGAGE NOTE" shall mean the original executed promissory note or other evidence of the indebtedness of a mortgagor/borrower with respect to a Mortgage Loan.

"MORTGAGED PROPERTY" shall mean the real property (including all improvements, buildings, fixtures, building equipment and personal property thereon and all additions, alterations and replacements made at any time with respect to the foregoing) and all other collateral securing repayment of the debt evidenced by a Mortgage Note.

"MORTGAGOR" shall mean the obligor on a Mortgage Note.

"MS & CO." shall mean Morgan Stanley & Co. Incorporated, a registered broker-dealer.

"MULTIEMPLOYER PLAN" shall mean a multiemployer plan defined as such in Section 3(37) of ERISA to which contributions have been or are required to be made by the Borrower or any ERISA Affiliate and that is covered by Title IV of ERISA.

"NET INCOME" shall mean, for any period, the net income of the Borrower for such period as determined in accordance with GAAP.

"NOTE" shall mean the promissory note provided for by Section 2.02(a) hereof for Loans and any promissory note delivered in substitution or exchange therefor, in each case as the same shall be modified and supplemented and in effect from time to time.

"ONE-MONTH LIBOR LOANS" shall mean Loans that bear interest at rates based on the rate referred to as the rate for One-Month LIBOR Loans in the definition of Eurodollar Base Rate.

"PAYMENT DATE" shall mean (a) the first Business Day of each calendar month, commencing with January 2, 1998, and (b) the Termination Date.

"PBGC" shall mean the Pension Benefit Guaranty Corporation or any entity succeeding to any or all of its functions under ERISA.

"PERSON" shall mean any individual, corporation, company, voluntary association, partnership, joint venture, limited liability company, trust, unincorporated association or government (or any agency, instrumentality or political subdivision thereof).

"PLAN" shall mean an employee benefit or other plan established or maintained by the Borrower or any ERISA Affiliate and covered by Title IV of ERISA, other than a Multiemployer Plan.

"POST-DEFAULT RATE" shall mean, in respect of any principal of any Loan or any other amount under this Loan Agreement, the Note or any other Loan Document that is not paid when due to the Lender (whether at stated maturity, by acceleration, by optional or mandatory prepayment or otherwise), a rate per annum during the period from and including the due date to but excluding the date on which such amount is paid in full equal to 2% per annum PLUS the Prime

Rate.

"PRIME RATE" shall mean the prime rate announced to be in effect from time to time, as published as the average rate in THE WALL STREET JOURNAL.

-7-

8

"PRINCIPAL COLLECTIONS" shall mean collections on the Mortgage Loans attributable to principal payments thereon.

"PROPERTY" shall mean any right or interest in or to property of any kind whatsoever, whether real, personal or mixed and whether tangible or intangible.

"REGULATIONS G, T, U AND X" shall mean Regulations G, T, U and X of the Board of Governors of the Federal Reserve System (or any successor), as the same may be modified and supplemented and in effect from time to time.

"REQUEST FOR BORROWING" shall have the meaning provided in Section 2.03(a).

"RESPONSIBLE OFFICER" shall mean, as to any Person, the chief executive officer or, with respect to financial matters, the chief financial officer of such Person.

"SALE PROCEEDS" shall mean (i) any proceeds of any sales, transfers or dispositions of any Mortgage Loan, net of reasonable and customary costs, including reasonable and necessary attorneys' fees, and (ii) any proceeds of any sales, dispositions, condemnations, casualty insurance and other amounts from any disposition, taking, damage or destruction of all or any portion of any real property acquired upon foreclosure (or deed in lieu of foreclosure) of Mortgage Loans, net of reasonable and customary costs of closing, including brokerage commissions, make-ready expenses, title insurance, financing costs, recording fees, transfer taxes, tax certificates, title and closing agent fees and pro-rated items.

"SECOND LIEN MORTGAGE LOAN" shall mean an Eligible Mortgage Loan secured by the lien on the Mortgaged Property, subject to only one prior lien on such Mortgaged Property.

"SECURED OBLIGATIONS" shall have the meaning provided in Section 4.01(c) hereof.

"SERVICER" shall have the meaning provided in Section 11.14(c) hereof.

"SERVICING AGREEMENT" shall have the meaning provided in Section 11.14(c) hereof.

"SERVICING RECORDS" shall have the meaning provided in Section 11.14(b) hereof.

"60 DAY DELINQUENT MORTGAGE LOAN" shall mean an Eligible Mortgage Loan which is at least 60 days, but not more than 89 days, delinquent with respect to the payment of principal or interest (without regard to any applicable grace period).

"SUBSIDIARY" shall mean, with respect to any Person, any corporation, partnership or other entity of which at least a majority of the securities or other ownership interests having by the terms thereof ordinary voting power to elect a majority of the board of directors or other persons performing similar functions of such corporation, partnership or other entity (irrespective of whether or not at the time securities or other ownership interests of any other class or classes of such corporation, partnership or other entity shall have or might have voting power by reason of the happening of any contingency) is at the time directly or indirectly owned or controlled by such Person or one or more Subsidiaries of such Person or by such Person and one or more Subsidiaries of such Person.

"TANGIBLE NET WORTH" shall mean, as of a particular date,

9

(a) all amounts which would be included under capital on a balance sheet of the Borrower at such date, determined in accordance with GAAP, LESS

(b) (i) amounts owing to the Borrower from Affiliates and (ii) intangible assets.

"TERMINATION DATE" shall mean December 8, 1998 or such earlier date on which this Loan Agreement shall terminate in accordance with the provisions hereof or by operation of law.

"TEST PERIOD" shall have the meaning provided in Section 7.16 hereof.

"30 DAY DELINQUENT MORTGAGE LOAN" shall mean an Eligible Mortgage Loan which is at least 30 days, but not more than 59 days, delinquent with respect to the payment of principal or interest (without regard to any applicable grace period).

"TOTAL INDEBTEDNESS" shall mean, for any period, the aggregate Indebtedness of the Borrower during such period LESS the amount of any nonspecific balance sheet reserves maintained in accordance with GAAP.

"UNCOMMITTED LOAN" shall have the meaning assigned thereto in Section 2.01(b) hereof.

"UNDERWRITING GUIDELINES" shall mean the underwriting guidelines attached as EXHIBIT F hereto.

"UNIFORM COMMERCIAL CODE" shall mean the Uniform Commercial Code as in effect on the date hereof in the State of New York; provided that if by reason of mandatory provisions of law, the perfection or the effect of perfection or non-perfection of the security interest in any Collateral is governed by the Uniform Commercial Code as in effect in a jurisdiction other than New York, "Uniform Commercial Code" shall mean the Uniform Commercial Code as in effect in such other jurisdiction for purposes of the provisions hereof relating to such perfection or effect of perfection or non-perfection.

1.02 ACCOUNTING TERMS AND DETERMINATIONS. Except as otherwise expressly provided herein, all accounting terms used herein shall be interpreted, and all financial statements and certificates and reports as to financial matters required to be delivered to the Lender hereunder shall be prepared, in accordance with GAAP.

Section 2. LOANS, NOTE AND PREPAYMENTS.

2.01 LOANS.

(a) Subject to fulfillment of the conditions precedent set forth in Sections 5.01 and 5.02 hereof, and provided that no Default shall have occurred and be continuing hereunder, the Lender agrees from time to time, on the terms and conditions of this Agreement, to make loans (individually, a "COMMITTED LOAN"; collectively, the "COMMITTED LOANS") to the Borrower in Dollars, from and including the Effective Date to and including the Termination Date in an aggregate principal amount at any one time outstanding up to but not exceeding the Maximum Committed Amount as in effect from time to time.

10

(b) In addition to the foregoing, the Lender may from time to time in its

sole discretion, on the terms and conditions of this Agreement, make loans (individually, an "UNCOMMITTED LOAN"; collectively, the "UNCOMMITTED LOANS") to the Borrower in Dollars during the period from and including the Effective Date to and including the Termination Date in an aggregate principal amount at any one time outstanding up to but not exceeding the Maximum Uncommitted Amount as in effect from time to time. In determining whether Loans outstanding secured by Eligible Mortgage Loans are Committed Loans or Uncommitted Loans, such Loans shall first be deemed Committed Loans up to the Maximum Committed Amount, and then the remainder shall be deemed Uncommitted Loans.

(c) Subject to the terms and conditions of this Loan Agreement, during the term of the Loan Agreement the Borrower may borrow, repay and reborrow hereunder.

(d) In no event shall a Loan be made when any Default or Event of Default has occurred and is continuing.

2.02 NOTES.

(a) The Loans made by the Lender shall be evidenced by a single promissory note of the Borrower substantially in the form of EXHIBIT A hereto (the "NOTE"), dated the date hereof, payable to the Lender in a principal amount equal to the amount of the Maximum Credit as originally in effect and otherwise duly completed. The Lender shall have the right to have its Note subdivided, by exchange for promissory notes of lesser denominations or otherwise.

(b) The date, amount and interest rate of each Loan made by the Lender to the Borrower, and each payment made on account of the principal thereof, shall be recorded by the Lender on its books and, prior to any transfer of the Note, endorsed by the Lender on the schedule attached to the Note or any continuation thereof; PROVIDED that the failure of the Lender to make any such recordation or endorsement shall not affect the obligations of the Borrower to make a payment when due of any amount owing hereunder or under the Note in respect of the Loans.

2.03 PROCEDURE FOR BORROWING.

(a) The Borrower may request a borrowing hereunder, on any Business Day during the period from and including the Effective Date to and including the Termination Date, by delivering to the Lender, with a copy to the Custodian, an irrevocable written request for borrowing, substantially in the form of EXHIBIT D attached hereto (a "REQUEST FOR BORROWING"), which request must be received by the Lender prior to 3:00 p.m., New York City time, one (1) Business Day prior to the requested Funding Date. Such Request for Borrowing shall (i) attach a schedule identifying the Eligible Mortgage Loans that the Borrower proposes to pledge to the Lender and to be included in the Borrowing Base in connection with such borrowing, (ii) specify if the requested Loan shall be a One-Month LIBOR Loan, and if not a One-Month LIBOR Loan, specify the applicable Interest Period requested, which Interest Period shall be at least thirty-one (31) days, and subject to the approval of the Lender in the Lender's sole discretion, (iii) the requested Funding Date, and (iv) include a Mortgage Loan Tape containing information with respect to the Eligible Mortgage Loans that the Borrower proposes to pledge to the Lender and to be included in the Borrowing Base in connection with such borrowing, and (v) attach an officer's certificate signed by a Responsible Officer of the Borrower as required by Section 5.02(b) hereof.

(b) Upon the Borrower's request for a borrowing pursuant to Section 2.03(a), the Lender shall, assuming all conditions precedent set forth in Section 5.01 and 5.02 have been met and provided no Default shall have occurred and be continuing, make a Committed Loan to the Borrower on the requested Funding Date, in the amount so requested.

(c) Upon the Borrower's request for a borrowing pursuant to Section 2.03(a), the Lender may at its sole option, assuming all conditions precedent set forth in Section 5.01 and 5.02 have been met and provided no Default shall

have occurred and be continuing, make an Uncommitted Loan to the Borrower on the requested Funding Date, in the amount so requested.

(d) The Borrower shall release to the Custodian no later than 12:00 p.m., New York City time, two (2) Business Days prior to the requested Funding Date, the Mortgage File pertaining to each Eligible Mortgage Loan to be pledged to the Lender and included in the Borrowing Base on such requested Funding Date, so long as there are no more than two hundred such Mortgage Files delivered on such Business Day (if the number of Mortgage Files equals or exceeds two hundred, the Borrower shall deliver to the Custodian such Mortgage Files in as many Business Days prior to the Funding Date as is reasonably acceptable to the Custodian), as in accordance with the terms and conditions of the Custodial Agreement.

(e) Pursuant to the Custodial Agreement, the Custodian shall deliver to the Lender and the Borrower, no later than 11:00 a.m. on a Funding Date, a Trust Receipt (as defined in the Custodial Agreement) in respect of all Mortgage Loans pledged to the Lender on such Funding Date, and a Mortgage Loan Schedule and Exception Report. Subject to Section 5 hereof, such borrowing will then be made available to the Borrower by the Lender transferring, via wire transfer, to the account set forth in the applicable Request for Borrowing, in the aggregate amount of such borrowing in funds immediately available to the Borrower.

2.04 LIMITATION ON TYPES OF LOANS; ILLEGALITY. Anything herein to the contrary notwithstanding, if, on or prior to the determination of any Eurodollar Rate:

(a) the Lender determines, which determination shall be conclusive, that quotations of interest rates for the relevant deposits referred to in the definition of "Eurodollar Rate" in Section 1.01 hereof are not being provided in the relevant amounts or for the relevant maturities for purposes of determining rates of interest for Loans as provided herein; or

(b) the Lender determines, which determination shall be conclusive, that the relevant rate of interest referred to in the definition of "Eurodollar Rate" in Section 1.01 hereof upon the basis of which the rate of interest for Loans is to be determined is not likely adequately to cover the cost to the Lender of making or maintaining Loans; or

(c) it becomes unlawful for the Lender to honor its obligation to make or maintain Loans hereunder using a Eurodollar Rate;

-11-

12

then the Lender shall give the Borrower prompt notice thereof and, so long as such condition remains in effect, the Lender shall be under no obligation to make additional Loans, and the Borrower shall, either prepay all such Loans as may be outstanding or pay interest on such Loans at a rate per annum equal to the Federal Funds Rate plus 1%.

2.05 REPAYMENT OF LOANS; INTEREST.

(a) The Borrower hereby promises to repay in full on the Termination Date the then aggregate outstanding principal amount of the Loans.

(b) The Borrower hereby promises to pay to the Lender interest on the unpaid principal amount of each Loan for the period from and including the date of such Loan to but excluding the date such Loan shall be paid in full, at a rate per annum equal to the Eurodollar Rate PLUS the Applicable Margin. Notwithstanding the foregoing, the Borrower hereby promises to pay to the Lender interest at the applicable Post-Default Rate on any principal of any Loan and on any other amount payable by the Borrower hereunder or under the Note that shall not be paid in full when due (whether at stated maturity, by acceleration or by mandatory prepayment or otherwise) for the period from and including the due date thereof to but excluding the date the same is paid in full. Accrued interest on each Loan shall be payable monthly on the first Business Day of each month following the month for which it accrues and for the last month of the

Loan Agreement on the first Business Day of such last month and on the Termination Date, except that interest payable at the Post-Default Rate shall accrue daily and shall be payable upon such accrual. Promptly after the determination of any interest rate provided for herein or any change therein, the Lender shall give notice thereof to the Borrower.

(c) It is understood and agreed that, unless and until a Default shall have occurred and be continuing, the Borrower shall be entitled to the proceeds of the Mortgage Loans pledged to the Lender hereunder.

2.06 MANDATORY PREPAYMENTS; ADDITIONAL PLEDGE.

(a) The Borrower shall prepay the principal of the Loans on each Payment Date in an amount equal to all Principal Collections with respect to the Mortgage Loans received during the calendar month ended most recently prior to such Payment Date.

(b) The Borrower shall prepay the principal of the Loans on each Payment Date in an amount equal to all Sale Proceeds with respect to the Mortgage Loans received during the calendar month ended most recently prior to such Payment Date.

(c) If at any time the aggregate outstanding principal amount of Loans exceeds the Borrowing Base (a "BORROWING BASE DEFICIENCY"), as determined by the Lender and notified to the Borrower on any Business Day, the Borrower shall no later than one Business Day after receipt of such notice, either prepay the Loans in part or in whole or pledge additional Eligible Mortgage Loans (which Collateral shall be in all respects acceptable to the Lender) to the Lender, such that after giving effect to such prepayment or pledge the aggregate outstanding principal amount of the Loans does not exceed the Borrowing Base.

2.07 OPTIONAL PREPAYMENTS. The Loans are prepayable on any Payment Date without premium or penalty, in whole or in part, and may be prepaid on any other date subject to Section 2.08 hereof. Any amounts prepaid shall be applied to repay the outstanding principal amount of any Loans

-12-

13

(together with interest thereon) until paid in full. Amounts repaid may be reborrowed in accordance with the terms of this Loan Agreement. If the Borrower intends to prepay a Loan in whole or in part from a source other than the proceeds of the Mortgage Loans, the Borrower shall give three (3) Business Days' prior written notice thereof to the Lender. If such notice is given, the amount specified in such notice shall be due and payable on the date specified therein, together with accrued interest to such date on the amount prepaid. Partial prepayments shall be in a minimum aggregate principal amount of \$1,000,000.

2.08 INDEMNITY

If the Borrower makes a prepayment of the Loans on any day which is not a Payment Date, the Borrower shall indemnify the Lender and hold the Lender harmless from any actual loss or expense which the Lender may sustain or incur arising from the reemployment of funds obtained by the Lender to maintain the Loans hereunder or from fees payable to terminate the deposits from which such funds were obtained. This Section 2.08 shall survive termination of Loan Agreement and payment of the Note.

Section 3. PAYMENTS; COMPUTATIONS; ETC.

3.01 PAYMENTS.

(a) Except to the extent otherwise provided herein, all payments of principal, interest and other amounts to be made by the Borrower under this Loan Agreement and the Note, shall be made in Dollars, in immediately available funds, without deduction, set-off or counterclaim, to the Lender at the following account maintained by the Lender: Account No. 40615114, For the A/C of Morgan Stanley Mortgage Capital Inc., ABA# 021000089, not later than 1:00 p.m.,

New York City time, on the date on which such payment shall become due (and each such payment made after such time on such due date shall be deemed to have been made on the next succeeding Business Day). The Borrower acknowledges that it has no rights of withdrawal from the foregoing account.

(b) Except to the extent otherwise expressly provided herein, if the due date of any payment under this Loan Agreement or the Note would otherwise fall on a day that is not a Business Day, such date shall be extended to the next succeeding Business Day, and interest shall be payable for any principal so extended for the period of such extension.

3.02 COMPUTATIONS. Interest on the Loans shall be computed in arrears on the basis of a 360-day year for the actual days elapsed (including the first day but excluding the last day) occurring in the period for which payable.

3.03 COMMITMENT FEE. The Borrower agrees to pay to the Lender a one-time commitment fee equal to \$100,000, such payment to be made in Dollars, in immediately available funds, without deduction, set-off or counterclaim, to the Lender on or prior to the Effective Date. The Lender may, in its sole discretion, net such commitment fee from the proceeds of any Loan advanced to the Borrower on the Effective Date.

-13-

14

Section 4. COLLATERAL SECURITY.

4.01 COLLATERAL; SECURITY INTEREST.

(a) Pursuant to the Custodial Agreement, the Custodian shall hold the Mortgage Loan Documents as exclusive bailee and agent for the Lender pursuant to terms of the Custodial Agreement and shall deliver to the Lender Trust Receipts (as defined in the Custodial Agreement) each to the effect that it has reviewed such Mortgage Loan Documents in the manner and to the extent required by the Custodial Agreement and identifying any deficiencies in such Mortgage Loan Documents as so reviewed.

(b) All of the Borrower's right, title and interest in, to and under each of the following items of property, whether now owned or hereafter acquired, now existing or hereafter created and wherever located, is hereinafter referred to as the "COLLATERAL":

(i) all Mortgage Loans;

(ii) all Mortgage Loan Documents, including without limitation all promissory notes, and all Servicing Records (as defined in Section 11.14(b) below), servicing agreements and any other collateral pledged or otherwise relating to such Mortgage Loans, together with all files, documents, instruments, surveys, certificates, correspondence, appraisals, computer programs, computer storage media, accounting records and other books and records relating thereto;

(iii) all mortgage guaranties and insurance (issued by governmental agencies or otherwise) and any mortgage insurance certificate or other document evidencing such mortgage guaranties or insurance relating to any Mortgage Loan and all claims and payments thereunder;

(iv) all other insurance policies and insurance proceeds relating to any Mortgage Loan or the related Mortgaged Property;

(v) all Interest Rate Protection Agreements;

(vi) the Collection Account and all monies from time to time on deposit in the Collection Account;

(vii) all "general intangibles" as defined in the Uniform Commercial Code relating to or constituting any and all of the foregoing; and

(viii) any and all replacements, substitutions, distributions on or

proceeds of any and all of the foregoing.

(c) The Borrower hereby assigns, pledges and grants a security interest in all of its right, title and interest in, to and under the Collateral to the Lender to secure the repayment of principal of and interest on all Loans and all other amounts owing to the Lender hereunder, under the Note and under the other Loan Documents (collectively, the "SECURED OBLIGATIONS"). The Borrower agrees to mark its computer records and tapes to evidence the interests granted to the Lender hereunder.

4.02 FURTHER DOCUMENTATION. At any time and from time to time, upon the written request of the Lender, and at the sole expense of the Borrower, the Borrower will promptly and duly

-14

15

execute and deliver, or will promptly cause to be executed and delivered, such further instruments and documents and take such further action as the Lender may reasonably request for the purpose of obtaining or preserving the full benefits of this Loan Agreement and of the rights and powers herein granted, including, without limitation, the filing of any financing or continuation statements under the Uniform Commercial Code in effect in any jurisdiction with respect to the Liens created hereby. The Borrower also hereby authorizes the Lender to file any such financing or continuation statement without the signature of the Borrower to the extent permitted by applicable law. A carbon, photographic or other reproduction of this Loan Agreement shall be sufficient as a financing statement for filing in any jurisdiction.

4.03 CHANGES IN LOCATIONS, NAME, ETC. The Borrower shall not (i) change the location of its chief executive office/chief place of business from that specified in Section 6 hereof or (ii) change its name, identity or corporate structure (or the equivalent) or change the location where it maintains its records with respect to the Collateral unless it shall have given the Lender at least 30 days prior written notice thereof and shall have delivered to the Lender all Uniform Commercial Code financing statements and amendments thereto as the Lender shall request and taken all other actions deemed necessary by the Lender to continue its perfected status in the Collateral with the same or better priority.

4.04. LENDER'S APPOINTMENT AS ATTORNEY-IN-FACT.

(a) The Borrower hereby irrevocably constitutes and appoints the Lender and any officer or agent thereof, with full power of substitution, as its true and lawful attorney-in-fact with full irrevocable power and authority in the place and stead of the Borrower and in the name of the Borrower or in its own name, from time to time in the Lender's discretion, for the purpose of carrying out the terms of this Loan Agreement, to take any and all appropriate action and to execute any and all documents and instruments which may be necessary or desirable to accomplish the purposes of this Loan Agreement, and, without limiting the generality of the foregoing, the Borrower hereby gives the Lender the power and right, on behalf of the Borrower, without assent by, but with notice to, the Borrower, if an Event of Default shall have occurred and be continuing, to do the following:

(i) in the name of the Borrower or its own name, or otherwise, to take possession of and endorse and collect any checks, drafts, notes, acceptances or other instruments for the payment of moneys due under any mortgage insurance or with respect to any other Collateral and to file any claim or to take any other action or proceeding in any court of law or equity or otherwise deemed appropriate by the Lender for the purpose of collecting any and all such moneys due under any such mortgage insurance or with respect to any other Collateral whenever payable;

(ii) to pay or discharge taxes and Liens levied or placed on or threatened against the Collateral; and

(iii) (A) to direct any party liable for any payment under any Collateral to make payment of any and all moneys due or to become due thereunder directly to the Lender or as the Lender shall direct; (B) to ask or demand for, collect, receive payment of and receipt for, any and all moneys, claims

and other amounts due or to become due at any time in respect of or arising out of any Collateral; (C) to sign and endorse any invoices, assignments, verifications, notices and other documents in connection with any of the Collateral; (D) to commence and prosecute any suits, actions or proceedings at law or in equity in any court of

-15-

16

competent jurisdiction to collect the Collateral or any thereof and to enforce any other right in respect of any Collateral; (E) to defend any suit, action or proceeding brought against the Borrower with respect to any Collateral; (F) to settle, compromise or adjust any suit, action or proceeding described in clause (E) above and, in connection therewith, to give such discharges or releases as the Lender may deem appropriate; and (G) generally, to sell, transfer, pledge and make any agreement with respect to or otherwise deal with any of the Collateral as fully and completely as though the Lender were the absolute owner thereof for all purposes, and to do, at the Lender's option and the Borrower's expense, at any time, and from time to time, all acts and things which the Lender deems necessary to protect, preserve or realize upon the Collateral and the Lender's Liens thereon and to effect the intent of this Loan Agreement, all as fully and effectively as the Borrower might do.

The Borrower hereby ratifies all that said attorneys shall lawfully do or cause to be done by virtue hereof. This power of attorney is a power coupled with an interest and shall be irrevocable.

(b) The Borrower also authorizes the Lender, at any time and from time to time, to execute, in connection with any sale provided for in Section 4.07 hereof, any endorsements, assignments or other instruments of conveyance or transfer with respect to the Collateral.

(c) The powers conferred on the Lender are solely to protect the Lender's interests in the Collateral and shall not impose any duty upon the Lender to exercise any such powers. The Lender shall be accountable only for amounts that it actually receives as a result of the exercise of such powers, and neither the Lender nor any of its officers, directors, or employees shall be responsible to the Borrower for any act or failure to act hereunder, except for its own gross negligence or willful misconduct.

4.05. PERFORMANCE BY LENDER OF BORROWER'S OBLIGATIONS. If the Borrower fails to perform or comply with any of its agreements contained in the Loan Documents and the Lender may itself perform or comply, or otherwise cause performance or compliance, with such agreement, the expenses of the Lender incurred in connection with such performance or compliance, together with interest thereon at a rate per annum equal to the Post-Default Rate, shall be payable by the Borrower to the Lender on demand and shall constitute Secured Obligations.

4.06. PROCEEDS. If an Event of Default shall occur and be continuing, (a) all proceeds of Collateral received by the Borrower consisting of cash, checks and other near-cash items shall be held by the Borrower in trust for the Lender, segregated from other funds of the Borrower, and shall forthwith upon receipt by the Borrower be turned over to the Lender in the exact form received by the Borrower (duly endorsed by the Borrower to the Lender, if required) and (b) any and all such proceeds received by the Lender (whether from the Borrower or otherwise) may, in the sole discretion of the Lender, be held by the Lender as collateral security for, and/or then or at any time thereafter may be applied by the Lender against, the Secured Obligations (whether matured or unmatured), such application to be in such order as the Lender shall elect. Any balance of such proceeds remaining after the Secured Obligations shall have been paid in full and this Loan Agreement shall have been terminated shall be paid over to the Borrower or to whomsoever may be lawfully entitled to receive the same. For purposes hereof, proceeds shall include, but not be limited to, all principal and interest payments, all prepayments and payoffs, insurance claims, condemnation awards, sale proceeds, real estate owned rents and any other income and all other amounts received with respect to the Collateral.

4.07. REMEDIES. If an Event of Default shall occur and be continuing, the Lender may exercise, in addition to all other rights and remedies granted to it in this Loan Agreement and in any other instrument or agreement securing, evidencing or relating to the Secured Obligations, all rights and remedies of a secured party under the Uniform Commercial Code. Without limiting the generality of the foregoing, the Lender without demand of performance or other demand, presentment, protest, advertisement or notice of any kind (except any notice required by law referred to below) to or upon the Borrower or any other Person (each and all of which demands, presentments, protests, advertisements and notices are hereby waived), may in such circumstances forthwith collect, receive, appropriate and realize upon the Collateral, or any part thereof, and/or may forthwith sell, lease, assign, give option or options to purchase, or otherwise dispose of and deliver the Collateral or any part thereof (or contract to do any of the foregoing), in one or more parcels or as an entirety at public or private sale or sales, at any exchange, broker's board or office of the Lender or elsewhere upon such terms and conditions as it may deem advisable and at such prices as it may deem best, for cash or on credit or for future delivery without assumption of any credit risk. The Lender shall have the right upon any such public sale or sales, and, to the extent permitted by law, upon any such private sale or sales, to purchase the whole or any part of the Collateral so sold, free of any right or equity of redemption in the Borrower, which right or equity is hereby waived or released. The Borrower further agrees, at the Lender's request, to assemble the Collateral and make it available to the Lender at places which the Lender shall reasonably select, whether at the Borrower's premises or elsewhere. The Lender shall apply the net proceeds of any such collection, recovery, receipt, appropriation, realization or sale, after deducting all reasonable costs and expenses of every kind incurred therein or incidental to the care or safekeeping of any of the Collateral or in any way relating to the Collateral or the rights of the Lender hereunder, including without limitation reasonable attorneys' fees and disbursements, to the payment in whole or in part of the Secured Obligations, in such order as the Lender may elect, and only after such application and after the payment by the Lender of any other amount required or permitted by any provision of law, including without limitation Section 9-504(1)(c) of the Uniform Commercial Code, need the Lender account for the surplus, if any, to the Borrower. To the extent permitted by applicable law, the Borrower waives all claims, damages and demands it may acquire against the Lender arising out of the exercise by the Lender of any of its rights hereunder, other than those claims, damages and demands arising from the gross negligence or willful misconduct of the Lender. If any notice of a proposed sale or other disposition of Collateral shall be required by law, such notice shall be deemed reasonable and proper if given at least 10 days before such sale or other disposition. The Borrower shall remain liable for any deficiency (plus accrued interest thereon as contemplated pursuant to Section 2.05(b) hereof) if the proceeds of any sale or other disposition of the Collateral are insufficient to pay the Secured Obligations and the fees and disbursements of any attorneys employed by the Lender to collect such deficiency.

4.08. LIMITATION ON DUTIES REGARDING PRESENTATION OF COLLATERAL. The Lender's duty with respect to the custody, safekeeping and physical preservation of the Collateral in its possession, under Section 9-207 of the Uniform Commercial Code or otherwise, shall be to deal with it in the same manner as the Lender deals with similar property for its own account. Neither the Lender nor any of its directors, officers or employees shall be liable for failure to demand, collect or realize upon all or any part of the Collateral or for any delay in doing so or shall be under any obligation to sell or otherwise dispose of any Collateral upon the request of the Borrower or otherwise.

4.09. POWERS COUPLED WITH AN INTEREST. All authorizations and agencies herein contained with respect to the Collateral are irrevocable and powers coupled with an interest.

4.10 RELEASE OF SECURITY INTEREST. Upon termination of this Loan Agreement and repayment to the Lender of all Secured Obligations and the performance of all obligations under the Loan Documents the Lender shall release its security

interest in any remaining Collateral.

Section 5. CONDITIONS PRECEDENT.

5.01 INITIAL LOAN. The obligation of the Lender to make its initial Loan hereunder is subject to the satisfaction, immediately prior to or concurrently with the making of such Loan, of the condition precedent that the Lender shall have received all of the following documents, each of which shall be satisfactory to the Lender and its counsel in form and substance:

(a) LOAN DOCUMENTS.

(i) NOTE. The Note, duly completed and executed;

(ii) CUSTODIAL AGREEMENT. The Custodial Agreement, duly executed and delivered by the Borrower, the Lender and the Custodian. In addition, the Borrower shall have taken such other action as the Lender shall have requested in order to perfect the security interests created pursuant to the Loan Agreement;

(iii) BLOCKED ACCOUNT AGREEMENT. A Blocked Account Agreement, duly executed by the parties thereto;

(b) ORGANIZATIONAL DOCUMENTS. A good standing certificate and certified copies of the operating agreement and by-laws (or equivalent documents) of the Borrower and of all corporate or other authority for the Borrower with respect to the execution, delivery and performance of the Loan Documents and each other document to be delivered by the Borrower from time to time in connection herewith (and the Lender may conclusively rely on such certificate until it receives notice in writing from the Borrower to the contrary);

(c) LEGAL OPINION. A legal opinion of counsel to the Borrower, substantially in the form attached hereto as EXHIBIT C.

(d) MORTGAGE LOAN SCHEDULE AND EXCEPTION REPORT. A Mortgage Loan Schedule and Exception Report, dated the Effective Date, from the Custodian, duly completed;

(e) SERVICING AGREEMENT(S). Any Servicing Agreement, certified as a true, correct and complete copy of the original;

(f) OTHER DOCUMENTS. Such other documents as the Lender may reasonably request.

(g) PAYMENT OF COMMITMENT FEE. The Borrower shall pay the commitment fee pursuant to Section 3.03 hereof.

5.02 INITIAL AND SUBSEQUENT LOANS. The making of each Loan to the Borrower (including the initial Loan) on any Business Day is subject to the satisfaction of the following further conditions precedent, both immediately prior to the making of such Loan and also after giving effect thereto and to the intended use thereof:

-18-

19

(a) no Default or Event of Default shall have occurred and be continuing;

(b) both immediately prior to the making of such Loan and also after giving effect thereto and to the intended use thereof, the representations and warranties made by the Borrower in Section 6 and Schedule 1 hereof, and elsewhere in each of the Loan Documents, shall be true and complete on and as of the date of the making of such Loan in all material respects (in the case of the representations and warranties in Section 6.10 and Schedule 1, solely with respect to Mortgage Loans included in the Borrowing Base) with the same force and effect as if made on and as of such date (or, if any such

representation or warranty is expressly stated to have been made as of a specific date, as of such specific date). The Lender shall have received an officer's certificate signed by a Responsible Officer of the Borrower certifying as to the truth and accuracy of the above, which certificate shall specifically include a statement that the Borrower is in compliance with all governmental licenses and authorizations and is qualified to do business and in good standing in all required jurisdictions.

(c) the aggregate outstanding principal amount of the Loans shall not exceed the Borrowing Base;

(d) subject to the Lender's right to perform one or more Due Diligence Reviews pursuant to Section 11.15 hereof, the Lender shall have completed its due diligence review of the Mortgage Loan Documents for each Loan and such other documents, records, agreements, instruments, mortgaged properties or information relating to such Loans as the Lender in its sole discretion deems appropriate to review and such review shall be satisfactory to the Lender in its sole discretion;

(e) the Lender shall have received from the Custodian a Trust Receipt with exceptions as are acceptable to the Lender in its sole discretion in respect of Eligible Mortgage Loans to be pledged hereunder on such Business Day and a Mortgage Loan Schedule and Exception Report, in each case dated such Business Day and duly completed;

(f) the Lender shall have received from the Borrower a Warehouse Lender's Release Letter substantially in the form of EXHIBIT E-2 hereto (or such other form acceptable to the Lender) or a Seller's Release Letter substantially in the form of EXHIBIT E-1 hereto (or such other form acceptable to the Lender) covering each Mortgage Loan to be pledged to the Lender;

(g) none of the following shall have occurred and/or be continuing:

(i) an event or events shall have occurred resulting in the effective absence of a "repo market" or comparable "lending market" for financing debt obligations secured by mortgage loans or securities for a period of (or reasonably expected to be) at least 30 consecutive days or an event or events shall have occurred resulting in the Lender not being able to finance any Loans through the "repo market" or "lending market" with traditional counterparties at rates which would have been reasonable prior to the occurrence of such event or events;

(ii) an event or events shall have occurred resulting in the effective absence of a "securities market" for securities backed by mortgage loans for a period of (or reasonably expected to be) at least 30 consecutive days or an event or events shall have occurred resulting

-19-

20

in the Lender not being able to sell securities backed by mortgage loans at prices which would have been reasonable prior to such event or events; or

(iii) there shall have occurred a material adverse change in the financial condition of the Lender which effects (or can reasonably be expected to effect) materially and adversely the ability of the Lender to fund its obligations under this Loan Agreement.

Each request for a borrowing by the Borrower hereunder shall constitute a certification by the Borrower that all the conditions set forth in this Section 5 have been satisfied (both as of the date of such notice, request or confirmation and as of the date of such borrowing). In the event that the Lender fails to make a Loan to the Borrower due solely to any of the circumstances set forth in Section 5.02(g) hereof, then, upon request of the Borrower, the Lender shall refund to the Borrower that portion of the commitment fee paid pursuant to Section 3.03 hereof, pro-rated over the number of days during which the Lender fails to make Loans requested by the

Borrower solely because of the circumstances set forth in Section 5.02 (g) hereof.

Section 6. REPRESENTATIONS AND WARRANTIES. The Borrower represents and warrants to the Lender that throughout the term of this Loan Agreement:

6.01 EXISTENCE. The Borrower (a) is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its organization, (b) has all requisite corporate or other power, and has all governmental licenses, authorizations, consents and approvals necessary to own its assets and carry on its business as now being or as proposed to be conducted, except where the lack of such licenses, authorizations, consents and approvals would not be reasonably likely to have a material adverse effect on its Property, business or financial condition or prospects; and (c) is qualified to do business and is in good standing in all other jurisdictions in which the nature of the business conducted by it makes such qualification necessary, except where failure so to qualify would not be reasonably likely (either individually or in the aggregate) to have a material adverse effect on its Property, business or financial condition or prospects.

6.02 FINANCIAL CONDITION. The Borrower has heretofore furnished to the Lender a copy of its Form 10Q (as filed with the SEC) showing its balance sheet for the quarterly fiscal periods of the Borrower ended September 30, 1997 and the related consolidated statements of income and retained earnings and of cash flows for the Borrower for such quarterly fiscal periods. All such financial statements are complete and correct and fairly present, in all material respects, the financial condition of the Borrower and the results of its operations as at such dates and for such fiscal periods, all in accordance with GAAP applied on a consistent basis. Since September 30, 1997, there has been no material adverse change in the business, operations or financial condition of the Borrower from that set forth in said financial statements.

6.03 LITIGATION. There are no actions, suits, arbitrations, investigations or proceedings pending or, to its knowledge, threatened against the Borrower or affecting any of its Property before any Governmental Authority (i) as to which there is a reasonable likelihood of an adverse decision which would be reasonably likely to have a material adverse effect on its Property, business or financial condition or prospects or (ii) which questions the validity or enforceability of any of the Loan Documents or any action to be taken in connection with the transactions contemplated hereby.

6.04 NO BREACH. Neither (a) the execution and delivery of the Loan Documents nor (b) the consummation of the transactions therein contemplated in compliance with the terms and

-20-

21

provisions thereof will conflict with or result in a breach of the operating agreement or by-laws of the Borrower, or any applicable law, rule or regulation, or any order, writ, injunction or decree of any Governmental Authority, or any Servicing Agreement or other material agreement or instrument to which the Borrower is a party or by which it or any of its Property is bound or to which it is subject, or constitute a default under any such material agreement or instrument or result in the creation or imposition of any Lien (except for the Liens created pursuant to this Loan Agreement) upon any Property of the Borrower pursuant to the terms of any such agreement or instrument.

6.05 ACTION. The Borrower has all necessary corporate or other power, authority and legal right to execute, deliver and perform its obligations under each of the Loan Documents; the execution, delivery and performance by the Borrower of each of the Loan Documents have been duly authorized by all necessary corporate or other action on its part; and each Loan Document has been duly and validly executed and delivered by the Borrower and constitutes a legal, valid and binding obligation of the Borrower, enforceable against the Borrower in accordance with its terms.

6.06 APPROVALS. No authorizations, approvals or consents of, and no

filings or registrations with, any Governmental Authority or any securities exchange are necessary for the execution, delivery or performance by the Borrower of the Loan Documents or for the legality, validity or enforceability thereof, except for filings and recordings in respect of the Liens created pursuant to this Loan Agreement.

6.07 MARGIN REGULATIONS. Neither the making of any Loan hereunder, nor the use of the proceeds thereof, will violate or be inconsistent with the provisions of Regulation G, T, U or X.

6.08 TAXES. The Borrower has filed all Federal income tax returns and all other material tax returns that are required to be filed by it and has paid all taxes due pursuant to such returns or pursuant to any assessment received by it, except for any such taxes as are being appropriately contested in good faith by appropriate proceedings diligently conducted and with respect to which adequate reserves have been provided. The charges, accruals and reserves on the books of the Borrower in respect of taxes and other governmental charges are, in the opinion of the Borrower, adequate.

6.09 INVESTMENT COMPANY ACT. The Borrower is not an "investment company", or a company "controlled" by an "investment company," within the meaning of the Investment Company Act of 1940, as amended.

6.10 COLLATERAL; COLLATERAL SECURITY.

(a) The Borrower has not assigned, pledged, or otherwise conveyed or encumbered any Mortgage Loan to any other Person, and immediately prior to the pledge of such Mortgage Loan to the Lender, the Borrower was the sole owner of such Mortgage Loan and had good and marketable title thereto, free and clear of all Liens, in each case except for Liens to be released simultaneously with the Liens granted in favor of the Lender hereunder. No Mortgage Loan pledged to the Lender hereunder was acquired by the Borrower from an Affiliate of the Borrower

(b) The provisions of this Loan Agreement are effective to create in favor of the Lender a valid security interest in all right, title and interest of the Borrower in, to and under the Collateral.

-21-

22

(c) Upon receipt by the Custodian of each Mortgage Note, endorsed in blank by a duly authorized officer of the Borrower, the Lender shall have a fully perfected first priority security interest therein, in the Mortgage Loan evidenced thereby and in the Borrower's interest in the related Mortgaged Property.

(d) Upon the filing of financing statements on Form UCC-1 naming the Lender as "Secured Party" and the Borrower as "Debtor", and describing the Collateral, in the jurisdictions and recording offices listed on Schedule 2 attached hereto, the security interests granted hereunder in the Collateral will constitute fully perfected first priority security interests under the Uniform Commercial Code in all right, title and interest of the Borrower in, to and under such Collateral which can be perfected by filing under the Uniform Commercial Code.

6.11 CHIEF EXECUTIVE OFFICE. The Borrower's chief executive office on the Effective Date is located at 90 West Street, Suite 1508, New York, NY 10006.

6.12 LOCATION OF BOOKS AND RECORDS. The location where the Borrower keeps its books and records, including all computer tapes and records relating to the Collateral is its chief executive office.

6.13 HEDGING. The Borrower has entered into Interest Rate Protection Agreements, having a notional amount not less than 80% of the aggregate unpaid principal amount of the fixed-rate Mortgage Loans having terms with respect to protection against fluctuations in interest rates reasonably acceptable to the Lender.

6.14 TRUE AND COMPLETE DISCLOSURE. The information, reports, financial

statements, exhibits and schedules furnished in writing by or on behalf of the Borrower to the Lender in connection with the negotiation, preparation or delivery of this Loan Agreement and the other Loan Documents or included herein or therein or delivered pursuant hereto or thereto, when taken as a whole, do not contain any untrue statement of material fact or omit to state any material fact necessary to make the statements herein or therein, in light of the circumstances under which they were made, not misleading. All written information furnished after the date hereof by or on behalf of the Borrower to the Lender in connection with this Loan Agreement and the other Loan Documents and the transactions contemplated hereby and thereby will be true, complete and accurate in every material respect, or (in the case of projections) based on reasonable estimates, on the date as of which such information is stated or certified. There is no fact known to a Responsible Officer of the Borrower, after due inquiry, that could reasonably be expected to have a Material Adverse Effect that has not been disclosed herein, in the other Loan Documents or in a report, financial statement, exhibit, schedule, disclosure letter or other writing furnished to the Lender for use in connection with the transactions contemplated hereby or thereby.

6.15 TANGIBLE NET WORTH. On the Effective Date, the Tangible Net Worth is not less than \$65,000,000.

6.16 ERISA. Each Plan to which the Borrower or its Subsidiaries make direct contributions, and, to the knowledge of the Borrower, each other Plan and each Multiemployer Plan, is in compliance in all material respects with, and has been administered in all material respects in compliance with, the applicable provisions of ERISA, the Code and any other Federal or State law. No event or condition has occurred and is continuing as to which the Borrower would be under an obligation to furnish a report to the Lender under Section 7.01(d) hereof.

-22-

23

6.17 PERCENTAGE OWNERSHIP. No Person beneficially owns (directly or indirectly) more than 49% of the Borrower.

Section 7. COVENANTS OF THE BORROWER. The Borrower covenants and agrees with the Lender that, so long as any Loan is outstanding and until payment in full of all Secured Obligations:

7.01 FINANCIAL STATEMENTS. The Borrower shall deliver to the Lender:

(a) as soon as available and in any event within 45 days after the end of each of the first three quarterly fiscal periods of each fiscal year of the Borrower, the unaudited balance sheets of the Borrower as at the end of such period and the related unaudited statements of income and retained earnings and of cash flows for the Borrower for such period and the portion of the fiscal year through the end of such period, setting forth in each case in comparative form the figures for the previous year, accompanied by a certificate of a Responsible Officer of the Borrower, which certificate shall state that said consolidated financial statements fairly present the financial condition and results of operations of the Borrower in accordance with GAAP, consistently applied, as at the end of, and for, such period (subject to normal year-end audit adjustments);

(b) as soon as available and in any event within 90 days after the end of each fiscal year of the Borrower, the balance sheets of the Borrower as at the end of such fiscal year and the related statements of income and retained earnings and of cash flows for the Borrower for such year, setting forth in each case in comparative form the figures for the previous year, accompanied by an opinion thereon of independent certified public accountants of recognized national standing, which opinion shall not be qualified as to scope of audit or going concern and shall state that said financial statements fairly present the financial condition and results of operations of the Borrower as at the end of, and for, such fiscal year in accordance with GAAP, and a certificate of such accountants stating that, in making the examination necessary for their opinion, they obtained no knowledge, except as specifically stated, of any Default or Event of Default;

(c) from time to time such other information regarding the financial condition, operations, or business of the Borrower as the Lender may

reasonably request; and

(d) as soon as reasonably possible, and in any event within thirty (30) days after a Responsible Officer of the Borrower knows, or with respect to any Plan or Multiemployer Plan to which the Borrower or any of its Subsidiaries makes direct contributions, has reason to believe, that any of the events or conditions specified below with respect to any Plan or Multiemployer Plan has occurred or exists, a statement signed by a senior financial officer of the Borrower setting forth details respecting such event or condition and the action, if any, that the Borrower or its ERISA Affiliate proposes to take with respect thereto (and a copy of any report or notice required to be filed with or given to PBGC by the Borrower or an ERISA Affiliate with respect to such event or condition):

(i) any reportable event, as defined in Section 4043(b) of ERISA and the regulations issued thereunder, with respect to a Plan, as to which PBGC has not by regulation waived the requirement of Section 4043(a) of ERISA that it be notified within thirty (30) days of the occurrence of such event (PROVIDED that a failure to meet the minimum funding standard of Section 412 of the Code or Section 302 of ERISA,

-23-

24

including without limitation the failure to make on or before its due date a required installment under Section 412(m) of the Code or Section 302(e) of ERISA, shall be a reportable event regardless of the issuance of any waivers in accordance with Section 412(d) of the Code); and any request for a waiver under Section 412(d) of the Code for any Plan;

(ii) the distribution under Section 4041(c) of ERISA of a notice of intent to terminate any Plan or any action taken by the Borrower or an ERISA Affiliate to terminate any Plan;

(iii) the institution by PBGC of proceedings under Section 4042 of ERISA for the termination of, or the appointment of a trustee to administer, any Plan, or the receipt by the Borrower or any ERISA Affiliate of a notice from a Multiemployer Plan that such action has been taken by PBGC with respect to such Multiemployer Plan;

(iv) the complete or partial withdrawal from a Multiemployer Plan by the Borrower or any ERISA Affiliate that results in liability under Section 4201 or 4204 of ERISA (including the obligation to satisfy secondary liability as a result of a purchaser default) or the receipt by the Borrower or any ERISA Affiliate of notice from a Multiemployer Plan that it is in reorganization or insolvency pursuant to Section 4241 or 4245 of ERISA or that it intends to terminate or has terminated under Section 4041A of ERISA;

(v) the institution of a proceeding by a fiduciary of any Multiemployer Plan against the Borrower or any ERISA Affiliate to enforce Section 515 of ERISA, which proceeding is not dismissed within 30 days; and

(vi) the adoption of an amendment to any Plan that, pursuant to Section 401(a)(29) of the Code or Section 307 of ERISA, would result in the loss of tax-exempt status of the trust of which such Plan is a part if the Borrower or an ERISA Affiliate fails to provide timely security to such Plan in accordance with the provisions of said Sections.

The Borrower will furnish to the Lender, at the time it furnishes each set of financial statements pursuant to paragraphs (a) and (b) above, a certificate of a Responsible Officer of the Borrower to the effect that, to the best of such Responsible Officer's knowledge, the Borrower during such fiscal period or year has observed or performed all of its covenants and other agreements, and satisfied every condition, contained in this Loan Agreement and the other Loan Documents to be observed, performed or satisfied by it, and that such Responsible Officer has obtained no knowledge of any Default or Event of Default except as specified in such certificate (and, if any Default or Event of Default has occurred and is continuing, describing the same in reasonable

detail and describing the action the Borrower has taken or proposes to take with respect thereto).

7.02 LITIGATION. The Borrower will promptly, and in any event within 10 days after service of process on any of the following, give to the Lender notice of all legal or arbitrable proceedings affecting the Borrower that questions or challenges the validity or enforceability of any of the Loan Documents or as to which there is a reasonable likelihood of adverse determination which would result in a Material Adverse Effect.

-24-

25

7.03 EXISTENCE, ETC. The Borrower will:

(a) preserve and maintain its legal existence and all of its material rights, privileges, licenses and franchises (provided that nothing in this Section 7.03(a) shall prohibit any transaction expressly permitted under Section 7.04 hereof);

(b) comply with the requirements of all applicable laws, rules, regulations and orders of Governmental Authorities (including, without limitation, all environmental laws) if failure to comply with such requirements would be reasonably likely (either individually or in the aggregate) to have a material adverse effect on its Property, business or financial condition, or prospects;

(c) keep adequate records and books of account, in which complete entries will be made in accordance with GAAP consistently applied;

(d) not move its chief executive office from the address referred to in Section 6.11 unless it shall have provided the Lender 30 days' prior written notice of such change;

(e) pay and discharge all taxes, assessments and governmental charges or levies imposed on it or on its income or profits or on any of its Property prior to the date on which penalties attach thereto, except for any such tax, assessment, charge or levy the payment of which is being contested in good faith and by proper proceedings and against which adequate reserves are being maintained; and

(f) permit representatives of the Lender, during normal business hours, to examine, copy and make extracts from its books and records, to inspect any of its Properties, and to discuss its business and affairs with its officers, all to the extent reasonably requested by the Lender.

7.04 PROHIBITION OF FUNDAMENTAL CHANGES. The Borrower shall not enter into any transaction of merger or consolidation or amalgamation, or liquidate, wind up or dissolve itself (or suffer any liquidation, winding up or dissolution) or sell all or substantially all of its assets; PROVIDED, that the Borrower may merge or consolidate with (a) any wholly owned subsidiary of the Borrower, or (b) any other Person if the Borrower is the surviving corporation; and PROVIDED FURTHER, that if after giving effect thereto, no Default would exist hereunder.

7.05 BORROWING BASE DEFICIENCY. If at any time there exists a Borrowing Base Deficiency the Borrower shall cure same in accordance with Section 2.06 hereof.

7.06 NOTICES. The Borrower shall give notice to the Lender:

(a) promptly upon receipt of notice or knowledge of the occurrence of any Default or Event of Default;

(b) with respect to any Mortgage Loan pledged to the Lender hereunder, immediately upon receipt of any principal prepayment (in full or partial) of such pledged Mortgage Loan;

(c) with respect to any Mortgage Loan pledged to the Lender hereunder, immediately upon receipt of notice or knowledge that the underlying Mortgaged Property has

been damaged by waste, fire, earthquake or earth movement, windstorm, flood, tornado or other casualty, or otherwise damaged so as to affect adversely the Collateral Value of such pledged Mortgage Loan; and

(d) promptly upon receipt of notice or knowledge of (i) any default related to any Collateral, (ii) any Lien or security interest (other than security interests created hereby or by the other Loan Documents) on, or claim asserted against, any of the Collateral or (iii) any event or change in circumstances which could reasonably be expected to have a material adverse effect on the Property, business or financial condition or prospects of the Borrower.

Each notice pursuant to this Section shall be accompanied by a statement of a Responsible Officer of the Borrower setting forth details of the occurrence referred to therein and stating what action the Borrower has taken or proposes to take with respect thereto.

7.07 HEDGING. The Borrower shall at all times maintain Interest Rate Protection Agreements, having a notional amount not less than 80% of the aggregate outstanding principal balance of all fixed-rate Mortgage Loans having terms with respect to protection against fluctuations in interest rates reasonably acceptable to the Lender. The Borrower shall deliver to the Lender monthly a written summary of the notional amount of all outstanding Interest Rate Protection Agreements.

7.08 REPORTS. The Borrower shall provide the Lender with a quarterly report, which report shall include, among other items, a summary of the Borrower's delinquency and loss experience with respect to mortgage loans serviced by the Borrower, if applicable, any Servicer or any designee of either, if applicable, plus any such additional reports as the Lender may reasonably request with respect to the Borrower's or any Servicer's servicing portfolio.

7.09 UNDERWRITING GUIDELINES. Without the prior written consent of the Lender, the Borrower shall not amend or otherwise modify the Underwriting Guidelines.

7.10 TRANSACTIONS WITH AFFILIATES. The Borrower will not enter into any transaction, including without limitation any purchase, sale, lease or exchange of property or the rendering of any service, with any Affiliate unless such transaction is (a) otherwise permitted under this Loan Agreement, (b) in the ordinary course of the Borrower's business and (c) upon fair and reasonable terms no less favorable to the Borrower than it would obtain in a comparable arm's length transaction with a Person which is not an Affiliate, or make a payment that is not otherwise permitted by this Section 7.10 to any Affiliate. In no event shall the Borrower pledge to the Lender hereunder any Mortgage Loan acquired by the Borrower from an Affiliate of the Borrower.

7.11 LIMITATION ON LIENS. The Borrower will defend the Collateral against, and will take such other action as is necessary to remove, any Lien, security interest or claim on or to the Collateral, other than the security interests created under this Loan Agreement, and the Borrower will defend the right, title and interest of the Lenders in and to any of the Collateral against the claims and demands of all persons whomsoever.

7.12 LIMITATION ON GUARANTEES. The Borrower shall not create, incur, assume or suffer to exist any Guarantees, except with respect to those Guarantees previously disclosed to and approved by the Lender guaranteeing Indebtedness in amounts previously disclosed to and approved by the Lender to Hanover Capital Partners, Ltd.

7.13 LIMITATION ON DISTRIBUTIONS. After the occurrence and during the continuation of any Event of Default, the Borrower shall not make any payment on account of, or set apart assets for, a sinking or other analogous fund for the purchase, redemption, defeasance, retirement or other acquisition of any equity or partnership interest of the Borrower, whether now or hereafter outstanding, or make any other distribution in respect thereof, either directly or indirectly, whether in cash or property or in obligations of the Borrower.

7.14 MAINTENANCE OF TANGIBLE NET WORTH. The Borrower shall not permit Tangible Net Worth at any time to be less than \$60,000,000.

7.15 MAINTENANCE OF RATIO OF TOTAL INDEBTEDNESS TO TANGIBLE NET WORTH. The Borrower shall not permit the ratio of Total Indebtedness to Tangible Net Worth at any time to be greater than 10:1.

7.16 MAINTENANCE OF PROFITABILITY. The Borrower shall not permit, for any period of three consecutive fiscal quarters (each such period, a "TEST PERIOD"), Net Income for such Test Period, before income taxes for such Test Period and distributions made during such Test Period, to be less than \$1.00.

7.17 SERVICING TAPE. The Borrower shall provide to the Lender on a monthly basis a computer readable magnetic tape containing servicing information, including without limitation those fields specified by the Lender from time to time, on a loan-by-loan basis and in the aggregate, with respect to the Mortgage Loans serviced hereunder by the Borrower or any Servicer.

7.18 LIMITATION ON SUBSIDIARY FORMATION. Except with respect to those Subsidiaries formed solely for the purpose of issuing collateralized mortgage obligations, the Borrower shall not form any Subsidiaries.

Section 8. EVENTS OF DEFAULT. Each of the following events shall constitute an event of default (an "EVENT OF DEFAULT") hereunder:

(a) the Borrower shall default in the payment of any principal of or interest on any Loan when due (whether at stated maturity, upon acceleration or at mandatory prepayment); or

(b) the Borrower shall default in the payment of any other amount payable by it hereunder or under any other Loan Document after notification by the Lender of such default, and such default shall have continued unremedied for five Business Days; or

(c) any representation, warranty or certification made or deemed made herein or in any other Loan Document by the Borrower or any certificate furnished to the Lender pursuant to the provisions hereof or thereof shall prove to have been false or misleading in any material respect as of the time made or furnished (other than the representations and warranties set forth in Schedule 1, which shall be considered solely for the purpose of determining the Collateral Value of the Mortgage Loans; unless the Borrower shall have made any such representations and warranties with knowledge that they were materially false or misleading at the time made); or

(d) the Borrower shall fail to comply with the requirements of Section 7.03(a), Section 7.04, Section 7.06, or Sections 7.09 through 7.18 hereof; or the Borrower shall default in the performance of its obligations under Section 7.05 hereof and such default shall continue

unremedied for a period of one (1) Business Day; or the Borrower shall otherwise fail to comply with the requirements of Section 7.03 hereof and such default shall continue unremedied for a period of five Business Days; or the Borrower shall fail to observe or perform any other covenant or agreement contained in this Loan Agreement or any other Loan Document and such failure to observe or perform shall continue unremedied for a period of seven Business Days; or

(e) a final judgment or judgments for the payment of money in excess of \$5,000,000 in the aggregate shall be rendered against the Borrower by one or more courts, administrative tribunals or other bodies having jurisdiction and the same shall not be discharged (or provision shall not be made for such discharge) or bonded, or a stay of execution thereof shall not be procured, within 60 days from the date of entry thereof, and the Borrower shall not, within said period of 60 days, or such longer period during which execution of the same shall have been stayed or bonded, appeal therefrom and cause the execution thereof to be stayed during such appeal; or

(f) the Borrower shall admit in writing its inability to pay its debts as such debts become due; or

(g) the Borrower shall (i) apply for or consent to the appointment of, or the taking of possession by, a receiver, custodian, trustee, examiner or liquidator or the like of itself or of all or a substantial part of its property, (ii) make a general assignment for the benefit of its creditors, (iii) commence a voluntary case under the Bankruptcy Code, (iv) file a petition seeking to take advantage of any other law relating to bankruptcy, insolvency, reorganization, liquidation, dissolution, arrangement or winding-up, or composition or readjustment of debts, (v) fail to controvert in a timely and appropriate manner, or acquiesce in writing to, any petition filed against it in an involuntary case under the Bankruptcy Code or (vi) take any corporate or other action for the purpose of effecting any of the foregoing; or

(h) a proceeding or case shall be commenced, without the application or consent of the Borrower, in any court of competent jurisdiction, seeking (i) its reorganization, liquidation, dissolution, arrangement or winding-up, or the composition or readjustment of its debts, (ii) the appointment of, or the taking of possession by, a receiver, custodian, trustee, examiner, liquidator or the like of the Borrower or of all or any substantial part of its property, or (iii) similar relief in respect of the Borrower under any law relating to bankruptcy, insolvency, reorganization, liquidation, dissolution, arrangement or winding-up, or composition or adjustment of debts, and such proceeding or case shall continue undismissed, or an order, judgment or decree approving or ordering any of the foregoing shall be entered and continue unstayed and in effect, for a period of 60 or more days; or an order for relief against the Borrower shall be entered in an involuntary case under the Bankruptcy Code; or

(i) the Custodial Agreement or any Loan Document shall for whatever reason be terminated or cease to be in full force and effect, or the enforceability thereof shall be contested by the Borrower; or

(j) the Borrower shall grant, or suffer to exist, any Lien on any Collateral except the Liens contemplated hereby; or the Liens contemplated hereby shall cease to be first priority perfected Liens on the Collateral in favor of the Lender or shall be Liens in favor of any Person other than the Lender; or

-28-

29

(k) any materially adverse change in the Property, business, financial condition or prospects of the Borrower shall occur, in each case as determined by the Lender in its sole discretion, or any other condition shall exist which, in the Lender's sole discretion, constitutes a material impairment of the Borrower's ability to perform its obligations under this Loan Agreement, the Note or any other Loan Document; or

(l) any person shall beneficially own (directly or indirectly) more than 49% of the Borrower; or

(m) the Borrower or any Affiliate of the Borrower shall default

under any other agreement with the Lender or an Affiliate of the Lender.

Section 9. REMEDIES UPON DEFAULT.

(a) Upon the occurrence of one or more Events of Default other than those referred to in Section 8(g) or (h), the Lender may immediately declare the principal amount of the Loans then outstanding under the Note to be immediately due and payable, together with all interest thereon and fees and expenses accruing under this Loan Agreement. Upon the occurrence of an Event of Default referred to in Sections 8(g) or (h), such amounts shall immediately and automatically become due and payable without any further action by any Person. Upon such declaration or such automatic acceleration, the balance then outstanding on the Note shall become immediately due and payable, without presentment, demand, protest or other formalities of any kind, all of which are hereby expressly waived by the Borrower.

(b) Upon the occurrence of one or more Events of Default, the Lender shall have the right to obtain physical possession of the Servicing Records and all other files of the Borrower relating to the Collateral and all documents relating to the Collateral which are then or may thereafter come in to the possession of the Borrower or any third party acting for the Borrower and the Borrower shall deliver to the Lender such assignments as the Lender shall request. The Lender shall be entitled to specific performance of all agreements of the Borrower contained in this Loan Agreement.

Section 10. NO DUTY OF LENDER. The powers conferred on the Lender hereunder are solely to protect the Lender's interests in the Collateral and shall not impose any duty upon it to exercise any such powers. The Lender shall be accountable only for amounts that it actually receives as a result of the exercise of such powers, and neither it nor any of its officers, directors, employees or agents shall be responsible to the Borrower for any act or failure to act hereunder, except for its or their own gross negligence or willful misconduct.

Section 11. MISCELLANEOUS.

11.01 WAIVER. No failure on the part of the Lender to exercise and no delay in exercising, and no course of dealing with respect to, any right, power or privilege under any Loan Document shall operate as a waiver thereof, nor shall any single or partial exercise of any right, power or privilege under any Loan Document preclude any other or further exercise thereof or the exercise of any other right, power or privilege. The remedies provided herein are cumulative and not exclusive of any remedies provided by law.

11.02 NOTICES. Except as otherwise expressly permitted by this Loan Agreement, all notices, requests and other communications provided for herein and under the Custodial Agreement

-29-

30

(including without limitation any modifications of, or waivers, requests or consents under, this Loan Agreement) shall be given or made in writing (including without limitation by telex or telecopy) delivered to the intended recipient at the "Address for Notices" specified below its name on the signature pages hereof or thereof); or, as to any party, at such other address as shall be designated by such party in a written notice to each other party. Except as otherwise provided in this Loan Agreement and except for notices given under Section 2 (which shall be effective only on receipt), all such communications shall be deemed to have been duly given when transmitted by telex or telecopy or personally delivered or, in the case of a mailed notice, upon receipt, in each case given or addressed as aforesaid.

11.03 INDEMNIFICATION AND EXPENSES.

(a) The Borrower agrees to hold the Lender harmless from and indemnify the Lender against all liabilities, losses, damages, judgments, costs and expenses of any kind which may be imposed on, incurred by or asserted

against the Lender relating to or arising out of this Loan Agreement, the Note, any other Loan Document or any transaction contemplated hereby or thereby, or any amendment, supplement or modification of, or any waiver or consent under or in respect of, this Loan Agreement, the Note, any other Loan Document or any transaction contemplated hereby or thereby, that, in each case, results from anything other than the Lender's gross negligence or willful misconduct. In any suit, proceeding or action brought by the Lender in connection with any Mortgage Loan for any sum owing thereunder, or to enforce any provisions of any Mortgage Loan, the Borrower will save, indemnify and hold the Lender harmless from and against all expense, loss or damage suffered by reason of any defense, set-off, counterclaim, recoupment or reduction or liability whatsoever of the account debtor or obligor thereunder, arising out of a breach by the Borrower of any obligation thereunder or arising out of any other agreement, indebtedness or liability at any time owing to or in favor of such account debtor or obligor or its successors from the Borrower. The Borrower also agrees to reimburse the Lender as and when billed by the Lender for all the Lender's costs and expenses incurred in connection with the enforcement or the preservation of the Lender's rights under this Loan Agreement, the Note, any other Loan Document or any transaction contemplated hereby or thereby, including without limitation the reasonable fees and disbursements of its counsel. The Borrower hereby acknowledges that, notwithstanding the fact that the Note is secured by the Collateral, the obligation of the Borrower under the Note is a recourse obligation of the Borrower.

(b) The Borrower agrees to pay as and when billed by the Lender all of the out-of-pocket costs and expenses incurred by the Lender in connection with the development, preparation and execution of, and any amendment, supplement or modification to, this Loan Agreement, the Note, any other Loan Document or any other documents prepared in connection herewith or therewith. The Borrower agrees to pay as and when billed by the Lender all of the out-of-pocket costs and expenses incurred in connection with the consummation and administration of the transactions contemplated hereby and thereby including without limitation (i) all the reasonable fees, disbursements and expenses of counsel to the Lender and (ii) all the due diligence, inspection, testing and review costs and expenses incurred by the Lender with respect to Collateral under this Loan Agreement, including, but not limited to, those costs and expenses incurred by the Lender pursuant to Sections 11.03(a), 11.14 and 11.15 hereof.

11.04 AMENDMENTS. Except as otherwise expressly provided in this Loan Agreement, any provision of this Loan Agreement may be modified or supplemented only by an instrument in writing signed by the Borrower and the Lender and any provision of this Loan Agreement may be waived by the Lender.

-30-

31

11.05 SUCCESSORS AND ASSIGNS. This Loan Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and permitted assigns.

11.06 SURVIVAL. The obligations of the Borrower under Sections 3.03 and 11.03 hereof shall survive the repayment of the Loans and the termination of this Loan Agreement. In addition, each representation and warranty made or deemed to be made by a request for a borrowing, herein or pursuant hereto shall survive the making of such representation and warranty, and the Lender shall not be deemed to have waived, by reason of making any Loan, any Default that may arise because any such representation or warranty shall have proved to be false or misleading, notwithstanding that the Lender may have had notice or knowledge or reason to believe that such representation or warranty was false or misleading at the time such Loan was made.

11.07 CAPTIONS. The table of contents and captions and section headings appearing herein are included solely for convenience of reference and are not intended to affect the interpretation of any provision of this Loan Agreement.

11.08 COUNTERPARTS. This Loan Agreement may be executed in any

number of counterparts, all of which taken together shall constitute one and the same instrument, and any of the parties hereto may execute this Loan Agreement by signing any such counterpart.

11.09 LOAN AGREEMENT CONSTITUTES SECURITY AGREEMENT; GOVERNING LAW. This Loan Agreement shall be governed by New York law without reference to choice of law doctrine, and shall constitute a security agreement within the meaning of the Uniform Commercial Code.

11.10 SUBMISSION TO JURISDICTION; WAIVERS. THE BORROWER HEREBY IRREVOCABLY AND UNCONDITIONALLY:

(A) SUBMITS FOR ITSELF AND ITS PROPERTY IN ANY LEGAL ACTION OR PROCEEDING RELATING TO THIS LOAN AGREEMENT, THE NOTE AND THE OTHER LOAN DOCUMENTS, OR FOR RECOGNITION AND ENFORCEMENT OF ANY JUDGMENT IN RESPECT THEREOF, TO THE NON-EXCLUSIVE GENERAL JURISDICTION OF THE COURTS OF THE STATE OF NEW YORK, THE FEDERAL COURTS OF THE UNITED STATES OF AMERICA FOR THE SOUTHERN DISTRICT OF NEW YORK, AND APPELLATE COURTS FROM ANY THEREOF;

(B) CONSENTS THAT ANY SUCH ACTION OR PROCEEDING MAY BE BROUGHT IN SUCH COURTS AND, TO THE EXTENT PERMITTED BY LAW, WAIVES ANY OBJECTION THAT IT MAY NOW OR HEREAFTER HAVE TO THE VENUE OF ANY SUCH ACTION OR PROCEEDING IN ANY SUCH COURT OR THAT SUCH ACTION OR PROCEEDING WAS BROUGHT IN AN INCONVENIENT COURT AND AGREES NOT TO PLEAD OR CLAIM THE SAME;

(C) AGREES THAT SERVICE OF PROCESS IN ANY SUCH ACTION OR PROCEEDING MAY BE EFFECTED BY MAILING A COPY THEREOF BY REGISTERED OR CERTIFIED MAIL (OR ANY SUBSTANTIALLY SIMILAR FORM OF MAIL), POSTAGE PREPAID, TO ITS ADDRESS SET FORTH UNDER ITS SIGNATURE BELOW OR AT SUCH OTHER ADDRESS OF WHICH THE LENDER SHALL HAVE BEEN NOTIFIED; AND

-31-

32

(D) AGREES THAT NOTHING HEREIN SHALL AFFECT THE RIGHT TO EFFECT SERVICE OF PROCESS IN ANY OTHER MANNER PERMITTED BY LAW OR SHALL LIMIT THE RIGHT TO SUE IN ANY OTHER JURISDICTION.

11.11 WAIVER OF JURY TRIAL. EACH OF THE BORROWER AND THE LENDER HEREBY IRREVOCABLY WAIVES, TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, ANY AND ALL RIGHT TO TRIAL BY JURY IN ANY LEGAL PROCEEDING ARISING OUT OF OR RELATING TO THIS LOAN AGREEMENT, ANY OTHER LOAN DOCUMENT OR THE TRANSACTIONS CONTEMPLATED HEREBY OR THEREBY.

11.12 ACKNOWLEDGMENTS. The Borrower hereby acknowledges that:

(a) it has been advised by counsel in the negotiation, execution and delivery of this Loan Agreement, the Note and the other Loan Documents;

(b) the Lender has no fiduciary relationship to the Borrower, and the relationship between the Borrower and the Lender is solely that of debtor and creditor; and

(c) no joint venture exists between the Lender and the Borrower.

11.13 HYPOTHECATION OR PLEDGE OF LOANS. The Lender shall have free and unrestricted use of all Collateral and nothing in this Loan Agreement shall preclude the Lender from engaging in repurchase transactions with the Collateral or otherwise pledging, repledging, hypothecating, or rehypothecating the Collateral. Nothing contained in this Loan Agreement shall obligate the Lender to segregate any Collateral delivered to the Lender by the Borrower.

11.14 SERVICING.

(a) The Borrower covenants to maintain or cause the servicing of the Mortgage Loans to be maintained in conformity with accepted and prudent

servicing practices in the industry for the same type of mortgage loans as the Mortgage Loans and in a manner at least equal in quality to the servicing the Borrower provides for mortgage loans which it owns. In the event that the preceding language is interpreted as constituting one or more servicing contracts, each such servicing contract shall terminate automatically upon the earliest of (i) an Event of Default, (ii) the date on which all the Secured Obligations have been paid in full or (iii) the transfer of servicing approved by the Borrower.

(b) If the Mortgage Loans are serviced by the Borrower, (i) the Borrower agrees that the Lender is the collateral assignee of all servicing records, including but not limited to any and all servicing agreements, files, documents, records, data bases, computer tapes, copies of computer tapes, proof of insurance coverage, insurance policies, appraisals, other closing documentation, payment history records, and any other records relating to or evidencing the servicing of Mortgage Loans (the "SERVICING RECORDS"), and (ii) the Borrower grants the Lender a security interest in all servicing fees and rights relating to the Mortgage Loans and all Servicing Records to secure the obligation of the Borrower or its designee to service in conformity with this Section and any other obligation of the Borrower to the Lender. The Borrower covenants to safeguard such Servicing Records and to deliver them promptly to the Lender or its designee (including the Custodian) at the Lender's request.

-32-

33

(e) NO DEFENSES. The Mortgage Loan is not subject to any right of rescission, set-off, counterclaim or defense, including without limitation the defense of usury, nor will the operation of any of the terms of the Mortgage Note or the Mortgage, or the exercise of any right thereunder, render either the Mortgage Note or the Mortgage unenforceable, in whole or in part and no such right of rescission, set-off, counterclaim or defense has been asserted with respect thereto, and no Mortgagor in respect of the Mortgage Loan was a debtor in any state or Federal bankruptcy or insolvency proceeding at the time the Mortgage Loan was originated. The Borrower has no knowledge nor has it received any notice that any Mortgagor in respect of the Mortgage Loan is a debtor in any state or federal bankruptcy or insolvency proceeding.

(f) HAZARD INSURANCE. The Mortgaged Property is insured by a fire and extended perils insurance policy, issued by a Qualified Insurer, and such other hazards as are customary in the area where the Mortgaged Property is located, and to the extent required by the Borrower as of the date of origination consistent with the Underwriting Guidelines, against earthquake and other risks insured against by Persons operating like properties in the locality of the Mortgaged Property, in an amount not less than the greatest of (i) 100% of the replacement cost of all improvements to the Mortgaged Property, (ii) either (A) the outstanding principal balance of the Mortgage Loan with respect to each First Lien Mortgage Loan (as identified on the Mortgage Loan Tape) or (B) with respect to each Second Lien Mortgage Loan (as identified on the Mortgage Loan Tape), the sum of the outstanding principal balance of the First Lien Mortgage Loan and the outstanding principal balance of the Second Lien Mortgage Loan, or (iii) the amount necessary to avoid the operation of any co-insurance provisions with respect to the Mortgaged Property, and consistent with the amount that would have been required as of the date of origination in accordance with the Underwriting Guidelines. If any portion of the Mortgaged Property is in an area identified by any federal Governmental Authority as having special flood hazards, and flood insurance is available, a flood insurance policy meeting the current guidelines of the Federal Insurance Administration is in effect with a generally acceptable insurance carrier, in an amount representing coverage not less than the least of (1) the outstanding principal balance of the Mortgage Loan, (2) the full insurable value of the Mortgaged Property, and (3) the maximum amount of insurance available under the Flood Disaster Protection Act of 1973, as amended. All such insurance policies (collectively, the "hazard insurance policy") contain a standard mortgagee clause naming the Borrower, its successors and assigns (including without limitation, subsequent owners of the Mortgage Loan), as mortgagee, and may not be reduced, terminated or canceled without 30 days' prior written notice to the mortgagee. No such notice has been received by the Borrower. All premiums on

such insurance policy have been paid. The related Mortgage obligates the Mortgagor to maintain all such insurance and, at such Mortgagor's failure to do so, authorizes the mortgagee to maintain such insurance at the Mortgagor's cost and expense and to seek reimbursement therefor from such Mortgagor. Where required by state law or regulation, the Mortgagor has been given an opportunity to choose the carrier of the required hazard insurance, provided the policy is not a "master" or "blanket" hazard insurance policy covering a condominium, or any hazard insurance policy covering the common facilities of a planned unit development. The hazard insurance policy is the valid and binding obligation of the insurer and is in full force and effect. The Borrower has not engaged in, and has no knowledge of the Mortgagor's having engaged in, any act or omission which would impair the coverage of any such policy, the benefits of the endorsement provided for herein, or the validity and binding effect of either including, without limitation, no unlawful fee, commission, kickback or other unlawful compensation or value of any kind has been or will be received, retained or realized by any attorney, firm or other Person, and no such unlawful items have been received, retained or realized by the Borrower.

Schedule 1-2

34

(g) COMPLIANCE WITH APPLICABLE LAWS. Any and all requirements of any federal, state or local law including, without limitation, usury, truth-in-lending, real estate settlement procedures, consumer credit protection, equal credit opportunity or disclosure laws applicable to the Mortgage Loan have been complied with, the consummation of the transactions contemplated hereby will not involve the violation of any such laws or regulations, and the Borrower shall maintain or shall cause its agent to maintain in its possession, available for the inspection of the Lender, and shall deliver to the Lender, upon demand, evidence of compliance with all such requirements.

(h) NO SATISFACTION OF MORTGAGE. The Mortgage has not been satisfied, canceled, subordinated or rescinded, in whole or in part, and the Mortgaged Property has not been released from the lien of the Mortgage, in whole or in part, nor has any instrument been executed that would effect any such release, cancellation, subordination or rescission. The Borrower has not waived the performance by the Mortgagor of any action, if the Mortgagor's failure to perform such action would cause the Mortgage Loan to be in default, nor has the Borrower waived any default resulting from any action or inaction by the Mortgagor.

(i) LOCATION AND TYPE OF MORTGAGED PROPERTY. The Mortgaged Property is located in an Acceptable State as identified in the Mortgage Loan Schedule and consists of a single parcel of real property with a detached single family residence erected thereon, or a two- to four-family dwelling, or an individual condominium unit in a low-rise condominium project, or an individual unit in a planned unit development or a de minimis planned unit development, provided, however, that any condominium unit or planned unit development shall conform with the applicable FNMA and FHLMC requirements regarding such dwellings and that no residence or dwelling is a mobile home or a manufactured dwelling. No portion of the Mortgaged Property is used for commercial purposes.

(j) VALID FIRST LIEN. The Mortgage is a valid, subsisting, enforceable and perfected (A) first lien and first priority security interest with respect to each Mortgage Loan which is indicated by such Borrower to be a First Lien Mortgage Loan (as reflected on the Mortgage Loan Tape), or (B) second lien and second priority security interest with respect to each Mortgage Loan which is indicated by such Borrower to be a Second Lien Mortgage Loan (as reflected on the Mortgage Loan Tape), in either case, on the real property included in the Mortgaged Property, including all buildings on the Mortgaged Property and all installations and mechanical, electrical, plumbing, heating and air conditioning systems located in or annexed to such buildings, and all additions, alterations and replacements made at any time with respect to the foregoing. The lien of the Mortgage is subject only to:

(1) the lien of current real property taxes and assessments not yet due and payable;

(2) covenants, conditions and restrictions, rights of way,

easements and other matters of the public record as of the date of recording acceptable to prudent mortgage lending institutions generally and specifically referred to in the lender's title insurance policy delivered to the originator of the Mortgage Loan and (a) referred to or otherwise considered in the appraisal made for the originator of the Mortgage Loan or (b) which do not adversely affect the Appraised Value of the Mortgaged Property set forth in such appraisal; and

(3) other matters to which like properties are commonly subject which do not materially interfere with the benefits of the security intended to be provided by the Mortgage or the use, enjoyment, value or marketability of the related Mortgaged Property.

Schedule 1-3

35

(4) with respect to each Mortgage Loan which is indicated by such Borrower to be a Second Lien Mortgage Loan (as reflected on the Mortgage Loan Tape) a prior first mortgage lien on the Mortgaged Property.

Any security agreement, chattel mortgage or equivalent document related to and delivered in connection with the Mortgage Loan establishes and creates a valid, subsisting and enforceable (A) first lien and first priority security interest with respect to each Mortgage Loan which is indicated by such Borrower to be a First Lien Mortgage Loan (as reflected on the Mortgage Loan Tape), or (B) second lien and second priority security interest with respect to each Mortgage Loan which is indicated by such Borrower to be a Second Lien Mortgage Loan (as reflected on the Mortgage Loan Tape), in either case, on the property described therein and the Borrower has full right to pledge and assign the same to the Lender. The Mortgaged Property was not, as of the date of origination of the Mortgage Loan, subject to a mortgage, deed of trust, deed to secure debt or other security instrument creating a lien subordinate to the lien of the Mortgage.

(k) VALIDITY OF MORTGAGE DOCUMENTS. The Mortgage Note and the Mortgage and any other agreement executed and delivered by a Mortgagor or guarantor, if applicable, in connection with a Mortgage Loan are genuine, and each is the legal, valid and binding obligation of the maker thereof enforceable in accordance with its terms. All parties to the Mortgage Note, the Mortgage and any other such related agreement had legal capacity to enter into the Mortgage Loan and to execute and deliver the Mortgage Note, the Mortgage and any such agreement, and the Mortgage Note, the Mortgage and any other such related agreement have been duly and properly executed by such related parties. No fraud, error, omission, misrepresentation, negligence or similar occurrence with respect to a Mortgage Loan has taken place on the part of any Person, including, without limitation, the Mortgagor, any appraiser, any builder or developer, or any other party involved in the origination of the Mortgage Loan. The Borrower has reviewed all of the documents constituting the Servicing File and has made such inquiries as it deems necessary to make and confirm the accuracy of the representations set forth herein.

(l) FULL DISBURSEMENT OF PROCEEDS. The Mortgage Loan has been closed and the proceeds of the Mortgage Loan have been fully disbursed and there is no further requirement for future advances thereunder, and any and all requirements as to completion of any on-site or off-site improvement and as to disbursements of any escrow funds therefor have been complied with. All costs, fees and expenses incurred in making or closing the Mortgage Loan and the recording of the Mortgage were paid, and the Mortgagor is not entitled to any refund of any amounts paid or due under the Mortgage Note or Mortgage.

(m) OWNERSHIP. The Borrower is the sole owner and holder of the Mortgage Loan. The Mortgage Loan is not assigned or pledged, and the Borrower has good, indefeasible and marketable title thereto, and has full right to transfer, pledge and assign the Mortgage Loan to the Lender free and clear of any encumbrance, equity, participation interest, lien, pledge, charge, claim or security interest, and has full right and authority subject to no interest or participation of, or agreement with, any other party, to assign, transfer and pledge each Mortgage Loan pursuant to this Loan Agreement and following the

pledge of each Mortgage Loan, the Lender will hold such Mortgage Loan free and clear of any encumbrance, equity, participation interest, lien, pledge, charge, claim or security interest except any such security interest created pursuant to the terms of this Loan Agreement.

(n) DOING BUSINESS. All parties which have had any interest in the Mortgage Loan, whether as mortgagee, assignee, pledgee or otherwise, are (or, during the period in which they held

Schedule 1-4

36

and disposed of such interest, were) (i) in compliance with any and all applicable licensing requirements of the laws of the state wherein the Mortgaged Property is located, and (ii) either (A) organized under the laws of such state, (B) qualified to do business in such state, (C) a federal savings and loan association, a savings bank or a national bank having a principal office in such state, or (D) not doing business in such state.

(o) LTV. No First Lien Mortgage Loan has an LTV greater than 125%. No Second Lien Mortgage Loan has a Combined LTV greater than 100%.

(p) TITLE INSURANCE. The Mortgage Loan is covered by either (i) an attorney's opinion of title and abstract of title, the form and substance of which is acceptable to prudent mortgage lending institutions making mortgage loans in the area wherein the Mortgaged Property is located or (ii) an ALTA lender's title insurance policy or other generally acceptable form of policy or insurance acceptable to FNMA or FHLMC and each such title insurance policy is issued by a title insurer acceptable to FNMA or FHLMC and qualified to do business in the jurisdiction where the Mortgaged Property is located, insuring the Borrower, its successors and assigns, as to the first priority lien of the Mortgage in the original principal amount of the Mortgage Loan (or to the extent a Mortgage Note provides for negative amortization, the maximum amount of negative amortization in accordance with the Mortgage), subject only to the exceptions contained in clauses (1), (2) and (3) , and with respect to each Mortgage Loan which is indicated by the Borrower to be a Second Lien Mortgage Loan (as reflected on the Mortgage Loan Schedule) clause (4) of paragraph (j) of this Part I of Schedule 1, and in the case of adjustable rate Mortgage Loans, against any loss by reason of the invalidity or unenforceability of the lien resulting from the provisions of the Mortgage providing for adjustment to the Mortgage Interest Rate and Monthly Payment. Where required by state law or regulation, the Mortgagor has been given the opportunity to choose the carrier of the required mortgage title insurance. Additionally, such lender's title insurance policy affirmatively insures ingress and egress and against encroachments by or upon the Mortgaged Property or any interest therein. The title policy does not contain any special exceptions (other than the standard exclusions) for zoning and uses and has been marked to delete the standard survey exception or to replace the standard survey exception with a specific survey reading. The Borrower, its successors and assigns, are the sole insureds of such lender's title insurance policy, and such lender's title insurance policy is valid and remains in full force and effect and will be in force and effect upon the consummation of the transactions contemplated by this Loan Agreement. No claims have been made under such lender's title insurance policy, and no prior holder or servicer of the related Mortgage, including the Borrower, has done, by act or omission, anything which would impair the coverage of such lender's title insurance policy, including, without limitation, no unlawful fee, commission, kickback or other unlawful compensation or value of any kind has been or will be received, retained or realized by any attorney, firm or other Person, and no such unlawful items have been received, retained or realized by the Borrower.

(q) NO DEFAULTS. There is no default, breach, violation or event of acceleration existing under the Mortgage or the Mortgage Note and no event has occurred which, with the passage of time or with notice and the expiration of any grace or cure period, would constitute a default, breach,

violation or event of acceleration, and neither the Borrower nor its predecessors have waived any default, breach, violation or event of acceleration. With respect to each Mortgage Loan which is indicated by such Borrower to be a Second Lien Mortgage Loan (as reflected on the Mortgage Loan Schedule) to the best of Borrower's knowledge (i) the prior mortgage is in full force and effect, (ii) there is no default, breach, violation or event of acceleration existing under such prior mortgage or the related mortgage note, (iii) no event which, with the passage of time or with notice and the expiration of any grace or cure period, would constitute a default, breach, violation or event of acceleration

Schedule 1-5

37

thereunder, and either (A) the prior mortgage contains a provision which allows or (B) applicable law requires, the mortgagee under the Second Lien Mortgage Loan to receive notice of, and affords such mortgagee an opportunity to cure any default by payment in full or otherwise under the prior mortgage.

(r) NO MECHANICS' LIENS. There are no mechanics' or similar liens or claims which have been filed for work, labor or material (and no rights are outstanding that under the law could give rise to such liens) affecting the Mortgaged Property which are or may be liens prior to, or equal or coordinate with, the lien of the Mortgage.

(s) LOCATION OF IMPROVEMENTS; NO ENCROACHMENTS. All improvements which were considered in determining the Appraised Value of the Mortgaged Property lie wholly within the boundaries and building restriction lines of the Mortgaged Property, and no improvements on adjoining properties encroach upon the Mortgaged Property. No improvement located on or being part of the Mortgaged Property is in violation of any applicable zoning and building law, ordinance or regulation.

(t) ORIGINATION; PAYMENT TERMS. The Mortgage Loan was originated by or in conjunction with a mortgagee approved by the Secretary of Housing and Urban Development pursuant to Sections 203 and 211 of the National Housing Act, a savings and loan association, a savings bank, a commercial bank, credit union, insurance company or similar banking institution which is supervised and examined by a federal or state authority. Principal payments on the Mortgage Loan commenced no more than 60 days after funds were disbursed in connection with the Mortgage Loan. The Mortgage Interest Rate is adjusted, with respect to adjustable rate Mortgage Loans, on each Interest Rate Adjustment Date to equal the Index plus the Gross Margin (rounded up or down to the nearest .125%), subject to the Mortgage Interest Rate Cap. The Mortgage Note is payable on the first day of each month in equal monthly installments of principal and interest, which installments of interest, with respect to adjustable rate Mortgage Loans, are subject to change due to the adjustments to the Mortgage Interest Rate on each Interest Rate Adjustment Date, with interest calculated and payable in arrears, sufficient to amortize the Mortgage Loan fully by the stated maturity date, over an original term of not more than 30 years from commencement of amortization; provided, however, in the case of a balloon Mortgage Loan, the Mortgage Loan matures at least five years after the first payment date thereby requiring a final payment of the outstanding principal prior to full amortization of the Mortgage Loan. The due date of the first payment under the Mortgage Note is no more than 60 days from the date of the Mortgage Note.

(u) CUSTOMARY PROVISIONS. The Mortgage Note has a stated maturity. The Mortgage contains customary and enforceable provisions such as to render the rights and remedies of the holder thereof adequate for the realization against the Mortgaged Property of the benefits of the security provided thereby, including, (i) in the case of a Mortgage designated as a deed of trust, by trustee's sale, and (ii) otherwise by judicial foreclosure. Upon default by a Mortgagor on a Mortgage Loan and foreclosure on, or trustee's sale of, the Mortgaged Property pursuant to the proper procedures, the holder of the Mortgage Loan will be able to deliver good and merchantable title to the Mortgaged Property. There is no homestead or other exemption available to a

Mortgagor which would interfere with the right to sell the Mortgaged Property at a trustee's sale or the right to foreclose the Mortgage.

(v) CONFORMANCE WITH UNDERWRITING GUIDELINES AND AGENCY STANDARDS. The Mortgage Loan was underwritten in accordance with the Underwriting Guidelines. The Mortgage Note and Mortgage are on forms similar to those used by FHLMC or FNMA and the Borrower has not made any representations to a Mortgagor that are inconsistent with the mortgage instruments used.

Schedule 1-6

38

(w) OCCUPANCY OF THE MORTGAGED PROPERTY. As of the Funding Date the Mortgaged Property is lawfully occupied under applicable law. All inspections, licenses and certificates required to be made or issued with respect to all occupied portions of the Mortgaged Property and, with respect to the use and occupancy of the same, including but not limited to certificates of occupancy and fire underwriting certificates, have been made or obtained from the appropriate authorities. The Borrower has not received notification from any governmental authority that the Mortgaged Property is in material non-compliance with such laws or regulations, is being used, operated or occupied unlawfully or has failed to have or obtain such inspection, licenses or certificates, as the case may be. The Borrower has not received notice of any violation or failure to conform with any such law, ordinance, regulation, standard, license or certificate.

(x) NO ADDITIONAL COLLATERAL. The Mortgage Note is not and has not been secured by any collateral except the lien of the corresponding Mortgage and the security interest of any applicable security agreement or chattel mortgage referred to in clause (j) above.

(y) DEEDS OF TRUST. In the event the Mortgage constitutes a deed of trust, a trustee, authorized and duly qualified under applicable law to serve as such, has been properly designated and currently so serves and is named in the Mortgage, and no fees or expenses are or will become payable by the Custodian or the Lender to the trustee under the deed of trust, except in connection with a trustee's sale after default by the Mortgagor.

(z) DELIVERY OF MORTGAGE DOCUMENTS. The Mortgage Note, the Mortgage, the Assignment of Mortgage and any other documents required to be delivered under the Custodial Agreement for each Mortgage Loan have been delivered to the Custodian. The Borrower or its agent is in possession of a complete, true and accurate Mortgage File in compliance with the Custodial Agreement, except for such documents the originals of which have been delivered to the Custodian.

(aa) TRANSFER OF MORTGAGE LOANS. The Assignment of Mortgage is in recordable form and is acceptable for recording under the laws of the jurisdiction in which the Mortgaged Property is located.

(bb) DUE-ON-SALE. The Mortgage contains an enforceable provision for the acceleration of the payment of the unpaid principal balance of the Mortgage Loan in the event that the Mortgaged Property is sold or transferred without the prior written consent of the mortgagee thereunder.

(cc) NO BUYDOWN PROVISIONS; NO GRADUATED PAYMENTS OR CONTINGENT INTERESTS. The Mortgage Loan does not contain provisions pursuant to which Monthly Payments are paid or partially paid with funds deposited in any separate account established by the Borrower, the Mortgagor, or anyone on behalf of the Mortgagor, or paid by any source other than the Mortgagor nor does it contain any other similar provisions which may constitute a "buydown" provision. The Mortgage Loan is not a graduated payment mortgage loan and the Mortgage Loan does not have a shared appreciation or other contingent interest feature.

(dd) CONSOLIDATION OF FUTURE ADVANCES. Any future advances made to the Mortgagor prior to the Cut-off Date have been consolidated with the outstanding principal amount secured by the Mortgage, and the secured principal amount, as consolidated, bears a single interest rate and single repayment term.

The lien of the Mortgage securing the consolidated principal amount is expressly insured as having (A) first lien priority with respect to each Mortgage Loan which is

Schedule 1-7

39

indicated by such Borrower to be a First Lien Mortgage Loan (as reflected on the Mortgage Loan Schedule), or (B) second lien priority with respect to each Mortgage Loan which is indicated by such Borrower to be a Second Lien Mortgage Loan (as reflected on the Mortgage Loan Schedule), in either case, by a title insurance policy, an endorsement to the policy insuring the mortgagee's consolidated interest or by other title evidence acceptable to FNMA and FHLMC. The consolidated principal amount does not exceed the original principal amount of the Mortgage Loan.

(ee) MORTGAGED PROPERTY UNDAMAGED. The Mortgaged Property is undamaged by waste, fire, earthquake or earth movement, windstorm, flood, tornado or other casualty so as to affect adversely the value of the Mortgaged Property as security for the Mortgage Loan or the use for which the premises were intended and each Mortgaged Property is in good repair. There have not been any condemnation proceedings with respect to the Mortgaged Property and the Borrower has no knowledge of any such proceedings.

(ff) COLLECTION PRACTICES; ESCROW DEPOSITS; INTEREST RATE ADJUSTMENTS. The origination and collection practices used by the originator, each servicer of the Mortgage Loan and the Borrower with respect to the Mortgage Loan have been in all respects in compliance with Accepted Servicing Practices, applicable laws and regulations, and have been in all respects legal and proper. With respect to escrow deposits and Escrow Payments (other than with respect to each Mortgage Loan which is indicated by such Borrower to be a Second Lien Mortgage Loan and for which the mortgagee under the prior mortgage lien is collecting Escrow Payments (as reflected on the Mortgage Loan Schedule)), all such payments are in the possession of, or under the control of, the Borrower or the Servicer and there exist no deficiencies in connection therewith for which customary arrangements for repayment thereof have not been made. All Escrow Payments have been collected in full compliance with state and federal law. An escrow of funds is not prohibited by applicable law and has been established in an amount sufficient to pay for every item that remains unpaid and has been assessed but is not yet due and payable. No escrow deposits or Escrow Payments or other charges or payments due the Borrower have been capitalized under the Mortgage or the Mortgage Note. All Mortgage Interest Rate adjustments have been made in strict compliance with state and federal law and the terms of the related Mortgage Note. Any interest required to be paid pursuant to state, federal and local law has been properly paid and credited.

(gg) OTHER INSURANCE POLICIES. No action, inaction or event has occurred and no state of facts exists or has existed that has resulted or will result in the exclusion from, denial of, or defense to coverage under any applicable special hazard insurance policy, PMI Policy or bankruptcy bond, irrespective of the cause of such failure of coverage. In connection with the placement of any such insurance, no commission, fee, or other compensation has been or will be received by the Borrower or by any officer, director, or employee of the Borrower or any designee of the Borrower or any corporation in which the Borrower or any officer, director, or employee had a financial interest at the time of placement of such insurance.

(hh) SOLDIERS' AND SAILORS' CIVIL RELIEF ACT. The Mortgagor has not notified the Borrower, and the Borrower has no knowledge, of any relief requested or allowed to the Mortgagor under the Soldiers' and Sailors' Civil Relief Act of 1940.

(ii) APPRAISAL. The Mortgage File contains an appraisal of the related Mortgaged Property signed prior to the approval of the Mortgage Loan application by a qualified appraiser, duly appointed by the Borrower, who had no interest, direct or indirect in the Mortgaged Property or in any loan made on the security thereof, and whose compensation is not affected by the approval or

disapproval of the Mortgage Loan, and the appraisal and appraiser both satisfy the requirements of FNMA or FHLMC and Title XI of the Federal Institutions Reform, Recovery, and Enforcement Act of 1989 as amended and the regulations promulgated thereunder, all as in effect on the date the Mortgage Loan was originated.

(jj) DISCLOSURE MATERIALS. The Mortgagor has executed a statement to the effect that the Mortgagor has received all disclosure materials required by applicable law with respect to the making of adjustable rate mortgage loans, and the Borrower maintains such statement in the Mortgage File.

(kk) CONSTRUCTION OR REHABILITATION OF MORTGAGED PROPERTY. No Mortgage Loan was made in connection with the construction or rehabilitation of a Mortgaged Property or facilitating the trade-in or exchange of a Mortgaged Property.

(ll) NO DEFENSE TO INSURANCE COVERAGE. No action has been taken or failed to be taken, no event has occurred and no state of facts exists or has existed on or prior to the Funding Date (whether or not known to the Borrower on or prior to such date) which has resulted or will result in an exclusion from, denial of, or defense to coverage under any private mortgage insurance (including, without limitation, any exclusions, denials or defenses which would limit or reduce the availability of the timely payment of the full amount of the loss otherwise due thereunder to the insured) whether arising out of actions, representations, errors, omissions, negligence, or fraud of the Borrower, the related Mortgagor or any party involved in the application for such coverage, including the appraisal, plans and specifications and other exhibits or documents submitted therewith to the insurer under such insurance policy, or for any other reason under such coverage, but not including the failure of such insurer to pay by reason of such insurer's breach of such insurance policy or such insurer's financial inability to pay.

(mm) CAPITALIZATION OF INTEREST. The Mortgage Note does not by its terms provide for the capitalization or forbearance of interest.

(nn) NO EQUITY PARTICIPATION. No document relating to the Mortgage Loan provides for any contingent or additional interest in the form of participation in the cash flow of the Mortgaged Property or a sharing in the appreciation of the value of the Mortgaged Property. The indebtedness evidenced by the Mortgage Note is not convertible to an ownership interest in the Mortgaged Property or the Mortgagor and the Borrower has not financed nor does it own directly or indirectly, any equity of any form in the Mortgaged Property or the Mortgagor.

(oo) PROCEEDS OF MORTGAGE LOAN. The proceeds of the Mortgage Loan have not been and shall not be used to satisfy, in whole or in part, any debt owed or owing by the Mortgagor to the Borrower or any Affiliate or correspondent of the Borrower.

(pp) WITHDRAWN MORTGAGE LOANS. If the Mortgage Loan has been released to the Borrower pursuant to a Request for Release as permitted under Section 5 of the Custodial Agreement, then the promissory note relating to the Mortgage Loan was returned to the Custodian within 10 days (or if such tenth day was not a Business Day, the next succeeding Business Day).

(qq) NO EXCEPTION. The Custodian has not noted any material exceptions on an Exception Report (as defined in the Custodial Agreement) with respect to the Mortgage Loan which

Schedule 1-9

41

would materially adversely affect the Mortgage Loan or the Lender's security interest, granted by the Borrower, in the Mortgage Loan.

(rr) QUALIFIED ORIGINATOR. The Mortgage Loan has been originated by, and, if applicable, purchased by the Borrower from, a Qualified Originator.

(ss) MORTGAGE SUBMITTED FOR RECORDATION. The Mortgage either has been or will promptly be submitted for recordation in the appropriate governmental recording office of the jurisdiction where the Mortgaged Property is located.

Schedule 1-10

42

Part II DEFINED TERMS

In addition to terms defined elsewhere in the Loan Agreement, the following terms shall have the following meanings when used in this Schedule 1:

"ACCEPTABLE STATE" shall mean any state notified by the Borrower to the Lender from time to time and approved in writing by the Lender, which approval has not been revoked by the Lender in their sole discretion, any such notice of revocation to be given no later than 10 Business Days prior to its intended effective date.

"ACCEPTED SERVICING PRACTICES" shall mean, with respect to any Mortgage Loan, those mortgage servicing practices of prudent mortgage lending institutions which service mortgage loans of the same type as such Mortgage Loans in the jurisdiction where the related Mortgaged Property is located.

"ALTA" means the American Land Title Association.

"APPRAISED VALUE" shall mean the value set forth in an appraisal made in connection with the origination of the related Mortgage Loan as the value of the Mortgaged Property.

"BEST'S" means Best's Key Rating Guide, as the same shall be amended from time to time.

"COMBINED LTV" OR "CLTV" shall mean with respect to any Mortgage Loan, the ratio of (a) the outstanding principal balance as of the related Cut-off Date of (i) the Mortgage Loan plus (ii) the mortgage loan constituting the first lien to (b) the Appraised Value of the Mortgaged Property.

"CUT-OFF DATE" means the first day of the month in which the related Funding Date occurs.

"DUE DATE" means the day of the month on which the Monthly Payment is due on a Mortgage Loan, exclusive of any days of grace.

"ESCROW PAYMENTS" means with respect to any Mortgage Loan, the amounts constituting ground rents, taxes, assessments, water rates, sewer rents, municipal charges, mortgage insurance premiums, fire and hazard insurance premiums, condominium charges, and any other payments required to be escrowed by the Mortgagor with the mortgagee pursuant to the Mortgage or any other document.

"FHLMC" means the Federal Home Loan Mortgage Corporation, or

any successor thereto.

"FNMA" means the Federal National Mortgage Association, or any successor thereto.

"GROSS MARGIN" means with respect to each adjustable rate Mortgage Loan, the fixed percentage amount set forth in the related Mortgage Note.

"INDEX" means with respect to each adjustable rate Mortgage Loan, the index set forth in the related Mortgage Note for the purpose of calculating the interest rate thereon.

Schedule 1-11

43

"INSURANCE PROCEEDS" means with respect to each Mortgage Loan, proceeds of insurance policies insuring the Mortgage Loan or the related Mortgaged Property.

"INTEREST RATE ADJUSTMENT DATE" means with respect to each adjustable rate Mortgage Loan, the date, specified in the related Mortgage Note and the Mortgage Loan Schedule, on which the Mortgage Interest Rate is adjusted.

"LOAN-TO-VALUE RATIO" or "LTV" means with respect to any Mortgage Loan, the ratio of the original outstanding principal amount of the Mortgage Loan to the lesser of (a) the Appraised Value of the Mortgaged Property at origination or (b) if the Mortgaged Property was purchased within 12 months of the origination of the Mortgage Loan, the purchase price of the Mortgaged Property.

"MONTHLY PAYMENT" means the scheduled monthly payment of principal and interest on a Mortgage Loan as adjusted in accordance with changes in the Mortgage Interest Rate pursuant to the provisions of the Mortgage Note for an adjustable rate Mortgage Loan.

"MORTGAGE INTEREST RATE" means the annual rate of interest borne on a Mortgage Note, which shall be adjusted from time to time with respect to adjustable rate Mortgage Loans.

"MORTGAGE INTEREST RATE CAP" means with respect to an adjustable rate Mortgage Loan, the limit on each Mortgage Interest Rate adjustment as set forth in the related Mortgage Note.

"MORTGAGEE" means the Borrower or any subsequent holder of a Mortgage Loan.

"ORIGINATION DATE" shall mean, with respect to each Mortgage Loan, the date of the Mortgage Note relating to such Mortgage Loan, unless such information is not provided by the Borrower with respect to such Mortgage Loan, in which case the Origination Date shall be deemed to be the date that is 40 days prior to the date of the first payment under the Mortgage Note relating to such Mortgage Loan.

"PMI POLICY" or "PRIMARY INSURANCE POLICY" means a policy of primary mortgage guaranty insurance issued by a Qualified Insurer.

"QUALIFIED INSURER" means an insurance company duly qualified as such under the laws of the states in which the Mortgaged Property is located, duly authorized and licensed in such states to transact the applicable insurance business and to write the insurance provided, and approved as an insurer by FNMA and FHLMC and whose claims paying ability is rated in the two highest rating categories by any of the rating agencies with respect to primary mortgage insurance and in the two highest rating categories by Best's with respect to hazard and flood insurance.

"QUALIFIED ORIGINATOR" means an originator of Mortgage Loans reasonably acceptable to the Lender.

"SERVICING FILE" means with respect to each Mortgage Loan, the file retained by the Borrower consisting of originals of all documents in the Mortgage File which are not delivered to a Custodian and copies of the Mortgage Loan Documents set forth in Section 2 of the Custodial Agreement.

Schedule 1-12

44

SCHEDULE 2

FILING JURISDICTIONS AND OFFICES

Secretary of State of the State of Maryland
Secretary of State of the State of New Jersey
Secretary of State of the State of New York

Schedule 2-1

45

Exhibit A

[FORM OF PROMISSORY NOTE]

\$125,000,000

December 8, 1997
New York, New York

FOR VALUE RECEIVED, HANOVER CAPITAL MORTGAGE HOLDINGS, INC., a Maryland corporation (the "BORROWER"), hereby promises to pay to the order of MORGAN STANLEY MORTGAGE CAPITAL INC. (the "LENDER"), at the principal office of the Lender at 1585 Broadway, New York, New York, 10036, in lawful money of the United States, and in immediately available funds, the principal sum of ONE HUNDRED TWENTY-FIVE MILLION DOLLARS \$125,000,000 (or such lesser amount as shall equal the aggregate unpaid principal amount of the Loans made by the Lender to the Borrower under the Loan Agreement), on the dates and in the principal amounts provided in the Loan Agreement, and to pay interest on the unpaid principal amount of each such Loan, at such office, in like money and funds, for the period commencing on the date of such Loan until such Loan shall be paid in full, at the rates per annum and on the dates provided in the Loan Agreement.

The date, amount and interest rate of each Loan made by the Lender to the Borrower, and each payment made on account of the principal thereof, shall be recorded by the Lender on its books and, prior to any transfer of this Note, endorsed by the Lender on the schedule attached hereto or any continuation thereof; PROVIDED, that the failure of the Lender to make any such recordation or endorsement shall not affect the obligations of the Borrower to make a payment when due of any amount owing under the Loan Agreement or hereunder in respect of the Loans made by the Lender.

This Note is the Note referred to in the Master Loan and Security Agreement dated as of December 8, 1997 (as amended, supplemented or otherwise modified and in effect from time to time, the "LOAN AGREEMENT") between the Borrower and the Lender, and evidences Loans made by the Lender thereunder. Terms used but not defined in this Note have the respective meanings

assigned to them in the Loan Agreement.

The Borrower agrees to pay all the Lender's costs of collection and enforcement (including reasonable attorneys' fees and disbursements of Lender's counsel) in respect of this Note when incurred, including, without limitation, reasonable attorneys' fees through appellate proceedings.

Notwithstanding the pledge of the Collateral, the Borrower hereby acknowledges, admits and agrees that the Borrower's obligations under this Note are recourse obligations of the Borrower to which the Borrower pledges its full faith and credit.

The Borrower, and any indorsers or guarantors hereof, (a) severally waive diligence, presentment, protest and demand and also notice of protest, demand, dishonor and nonpayments of this Note, (b) expressly agree that this Note, or any payment hereunder, may be extended from time to time, and consent to the acceptance of further Collateral, the release of any Collateral for this Note, the release of any party primarily or secondarily liable hereon, and (c) expressly agree that it will not be necessary for the Lender, in order to enforce payment of this Note, to first institute or exhaust the Lender's remedies against the Borrower or any other party liable hereon or against any Collateral for this Note. No extension of time for the payment of this Note, or any installment hereof, made by

A-1

46

agreement by the Lender with any person now or hereafter liable for the payment of this Note, shall affect the liability under this Note of the Borrower, even if the Borrower is not a party to such agreement; PROVIDED, HOWEVER, that the Lender and the Borrower, by written agreement between them, may affect the liability of the Borrower.

Any reference herein to the Lender shall be deemed to include and apply to every subsequent holder of this Note. Reference is made to the Loan Agreement for provisions concerning optional and mandatory prepayments, Collateral, acceleration and other material terms affecting this Note.

A-2

47

THIS NOTE SHALL BE GOVERNED BY AND CONSTRUED UNDER THE LAWS OF THE STATE OF NEW YORK (WITHOUT REFERENCE TO CHOICE OF LAW DOCTRINE) WHOSE LAWS THE BORROWER EXPRESSLY ELECTS TO APPLY TO THIS NOTE. THE BORROWER AGREES THAT ANY ACTION OR PROCEEDING BROUGHT TO ENFORCE OR ARISING OUT OF THIS NOTE MAY BE COMMENCED IN THE SUPREME COURT OF THE STATE OF NEW YORK, BOROUGH OF MANHATTAN, OR IN THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

By: _____
Name:
Title:

[FORM OF CUSTODIAL AGREEMENT]

[to be stored as a separate document]

B-1

50

[FORM OF OPINION OF COUNSEL TO BORROWER]

(date)

Morgan Stanley Mortgage Capital Inc.
1585 Broadway
New York, New York 10036

Dear Sirs and Mesdames:

You have requested [our] [my] opinion, as counsel to Hanover Capital Mortgage Holdings, Inc., a Maryland corporation (the "BORROWER"), with respect to certain matters in connection with that certain Master Loan and Security Agreement, dated as of December 8, 1997 (the "LOAN AND SECURITY AGREEMENT"), by and between the Borrower and Morgan Stanley Mortgage Capital Inc. (the "LENDER"), being executed contemporaneously with a Promissory Note dated December 8, 1997 from the Borrower to the Lender (the "NOTE"), a Custodial Agreement, dated as of December 8, 1997 (the "CUSTODIAL AGREEMENT"), by and among the Borrower, First Chicago National Processing Corp. (the "CUSTODIAN"), and the Lender. Capitalized terms not otherwise defined herein have the meanings set forth in the Loan and Security Agreement.

[We] [I] have examined the following documents:

1. the Loan and Security Agreement;
2. the Note;
3. Custodial Agreement;
4. unfiled copies of the financing statements listed on SCHEDULE 1 (collectively, the "FINANCING STATEMENTS") naming the Borrower as Debtor and the Lender as Secured Party and describing the Collateral (as defined in the Loan and Security Agreement) as to which security interests may be perfected by filing under the Uniform Commercial Code of the States listed on SCHEDULE 1 (the "FILING COLLATERAL"), which I understand will be filed in the filing offices listed on SCHEDULE 1 (the "FILING OFFICES");
5. the reports listed on SCHEDULE 2 as to UCC financing statements (collectively, the "UCC SEARCH REPORT"); and
6. such other documents, records and papers as we have deemed necessary and relevant as a basis for this opinion.

To the extent [we] [I] have deemed necessary and proper, [we] [I] have relied upon the representations and warranties of the Borrower contained in the Loan and Security Agreement. [We] [I] have assumed the authenticity of all documents submitted to me as originals, the genuineness of all signatures, the legal capacity of natural persons and the conformity to the originals of all documents.

Based upon the foregoing, it is [our] [my] opinion that:

1. The Borrower is a Maryland corporation duly organized, validly existing and in good standing under the laws of _____ and is qualified to transact business in, and is in good standing under, the laws of the state of _____.
2. The Borrower has the power to engage in the transactions contemplated by the Loan and Security Agreement, the Note, and the Custodial Agreement and all requisite power, authority and legal right to execute and deliver the Loan and Security Agreement, the Note, and the Custodial Agreement and observe the terms and conditions of such instruments. The Borrower has all requisite power to borrow under the Loan and Security Agreement and to grant a security interest in the Collateral pursuant to the Loan and Security Agreement.
3. The execution, delivery and performance by the Borrower of the Loan and Security Agreement, the Note, and the Custodial Agreement, and the borrowings by the Borrower and the pledge of the Collateral under the Loan and Security Agreement have been duly authorized by all necessary action on the part of the Borrower. Each of the Loan and Security Agreement, the Note and the Custodial Agreement have been executed and delivered by the Borrower and are legal, valid and binding agreements enforceable in accordance with their respective terms against the Borrower, subject to bankruptcy laws and other similar laws of general application affecting rights of creditors and subject to the application of the rules of equity, including those respecting the availability of specific performance, none of which will materially interfere with the realization of the benefits provided thereunder or with the Lender's security interest in the Mortgage Loans.
4. No consent, approval, authorization or order of, and no filing or registration with, any court or governmental agency or regulatory body is required on the part of the Borrower for the execution, delivery or performance by the Borrower of the Loan and Security Agreement, the Note and the Custodial Agreement or for the borrowings by the Borrower under the Loan and Security Agreement or the granting of a security interest to the Lender in the Collateral, pursuant to the Loan and Security Agreement.
5. The execution, delivery and performance by the Borrower of, and the consummation of the transactions contemplated by, the Loan and Security Agreement, the Note and the Custodial Agreement do not and will not (a) violate any provision of the Borrower's charter or by-laws, (b) violate any applicable law, rule or regulation, (c) violate any order, writ, injunction or decree of any court or governmental authority or agency or any arbitral award applicable to the Borrower of which I have knowledge (after due inquiry) or (d) result in a breach of, constitute a default under, require any consent under, or result in the acceleration or required prepayment of any indebtedness pursuant to the terms of, any agreement or instrument of which I have knowledge (after due inquiry) to which the Borrower is a party or by which it is bound or to which it is subject, or (except for the Liens created pursuant to the Loan and Security Agreement) result in the creation or imposition of any Lien upon any Property of the Borrower pursuant to the terms of any such agreement or instrument.
6. There is no action, suit, proceeding or investigation pending or, to the best of [our] [my] knowledge, threatened against the Borrower which, in [our] [my] judgment, either in any one instance or in the aggregate, would be reasonably likely to result in any material adverse change in the properties, business or financial condition, or prospects of the Borrower or in any material impairment of the right or ability of the Borrower to carry on its business substantially as now conducted or in any material liability on the part of the Borrower or which would draw into question

the validity of the Loan and Security Agreement, the Note, the Custodial Agreement or the Mortgage Loans or of any action taken or to be taken in connection with the transactions contemplated thereby, or which would be reasonably likely to impair materially the ability of the Borrower to perform under the terms of the Loan and Security Agreement, the Note, the Custodial Agreement or the Mortgage Loans.

7. The Loan and Security Agreement is effective to create, in favor of the Lender, a valid security interest under the Uniform Commercial Code in all of the right, title and interest of the Borrower in, to and under the Collateral as collateral security for the payment of the Secured Obligations (as defined in the Loan and Security Agreement), except that (a) such security interests will continue in Collateral after its sale, exchange or other disposition only to the extent provided in Section 9-306 of the Uniform Commercial Code, (b) the security interests in Collateral in which the Borrower acquires rights after the commencement of a case under the Bankruptcy Code in respect of the Borrower may be limited by Section 552 of the Bankruptcy Code.

8. When the Mortgage Notes are delivered to the Custodian, endorsed in blank by a duly authorized officer of the Borrower, the security interest referred to in paragraph 7 above in the Mortgage Notes will constitute a fully perfected first priority security interest in all right, title and interest of the Borrower therein, in the Mortgage Loan evidenced thereby and in the Borrower's interest in the related Mortgaged Property.

9. (a) Upon the filing of financing statements on Form UCC-1 naming the Lender as "Secured Party" and the Borrower as "Debtor", and describing the Collateral, in the jurisdictions and recording offices listed on SCHEDULE 1 attached hereto, the security interests referred to in paragraph 7 above will constitute fully perfected security interests under the Uniform Commercial Code in all right, title and interest of the Borrower in, to and under such Collateral, which can be perfected by filing under the Uniform Commercial Code.

(b) The UCC Search Report sets forth the proper filing offices and the proper debtors necessary to identify those Persons who have on file in the jurisdictions listed on SCHEDULE 1 financing statements covering the Filing Collateral as of the dates and times specified on SCHEDULE 2. Except for the matters listed on SCHEDULE 2, the UCC Search Report identifies no Person who has filed in any Filing Office a financing statement describing the Filing Collateral prior to the effective dates of the UCC Search Report.

10. The Assignments of Mortgage are in recordable form, except for the insertion of the name of the assignee, and upon the name of the assignee being inserted, are acceptable for recording under the laws of the state where each related Mortgaged Property is located.

Very truly yours,

Exhibit D

FORM OF REQUEST FOR BORROWING

Master Loan and Security Agreement, dated as of December 8, 1997
(the "LOAN AND SECURITY AGREEMENT"), by and between the

Borrower and Morgan Stanley Mortgage Capital Inc. (the "LENDER"),

Lender: Morgan Stanley Mortgage Capital Inc.
Borrower: Hanover Capital Mortgage Holdings, Inc.
Requested Fund Date: _____
Transmission Date: _____
Transmission Time: _____
Number of Mortgage Loans to be Pledged: _____
UPB: \$ _____
Requested Wire Amount: \$ _____
Wire Instructions:

Requested by:
HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

By: _____
Name:
Title:

D-1

Exhibit E-1

FORM OF BORROWER'S RELEASE LETTER

[Date]

Morgan Stanley Mortgage Capital Inc.
1585 Broadway
New York, New York 10036
Attention: _____
Facsimile: _____

Re: Master Loan and Security Agreement, dated as of December 8, 1997 (the "LOAN AND SECURITY AGREEMENT"), by and between Hanover Capital Mortgage Holdings, Inc. (the "BORROWER") and Morgan Stanley Mortgage Capital Inc. (the "LENDER")

Ladies and Gentlemen:

With respect to the mortgage loans described in the attached SCHEDULE A (the "MORTGAGE LOANS") (a) we hereby certify to you that the Mortgage Loans are not subject to a lien of any third party and (b) we hereby release all right, interest or claim of any kind with respect to such Mortgage Loans, such release to be effective automatically without further action by any party upon payment from Morgan Stanley Mortgage Capital Inc., of the amount of the Loan contemplated under the Loan and Security Agreement (calculated in accordance with the terms thereof) in accordance with the wiring instructions set forth in the Loan and Security Agreement.

Very truly yours,

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

By: _____
Name: _____
Title: _____

E 1-1

55

Exhibit E-2

FORM OF WAREHOUSE LENDER'S RELEASE LETTER

(Date)

Morgan Stanley Mortgage Capital Inc.
1585 Broadway
New York, New York 10036
Attention: _____
Facsimile: _____

Re: Certain Mortgage Loans Identified on SCHEDULE A hereto and
owned by Hanover Capital Mortgage Holdings, Inc.

The undersigned hereby releases all right, interest, lien or
claim of any kind with respect to the mortgage loan(s) described in the attached
SCHEDULE A, such release to be effective automatically without any further
action by any party upon payment in one or more installments, in immediately
available funds of \$ _____, in accordance with the following wire
instructions:

Very truly yours,

[WAREHOUSE LENDER]

By: _____
Name: _____
Title: _____

E-2-1

56

Exhibit F

UNDERWRITING GUIDELINES

F-1

57

HANOVER CAPITAL

CREDIT AND RISK MANAGEMENT

POLICIES AND PROCEDURES

1

58

HANOVER CAPITAL

CREDIT AND RISK MANAGEMENT

POLICIES AND PROCEDURES

TABLE OF CONTENTS

- I. General Policy Statement & Summary of Policies
- II. Business Description- Overview
- III. Commitment Procedures and Risk Limits
- IV. Counterparty Approval
- V. Asset Quality Evaluation
- VI. Interest Rate Risk Management

Exhibits

- i. Bid Sheet
- ii. Standard Bid Letter
- iii. Standard Commitment Letter
- iv. Approved BPO Providers
- v. Approved Credit Scoring Companies
- vi. Standard Position Report
- vii. Credit Grades

2

GENERAL POLICY STATEMENT & SUMMARY OF POLICIES

1. General Policy Statement

The primary business is investing in pools of residential mortgage loans. Pools may be unrated or rated and traded in either the private or public markets. Loan types eligible for purchase include fixed and adjustable rate performing, sub-performing and non-performing mortgage loans of varying lien positions. The strategy is to optimize financing by securitizing loans conforming to agency standards as Fannie Mae or Freddie Mac securities and non-eligible pools as private-label securities or whole loans. Subordinated tranches of securitized loan pools may be retained.

2. Summary of Policies

- a) Loans types eligible for purchase are approved by the Chief Executive Officer ("CEO"), Head of Trading and Head of Operations. Eligible loan types are updated on a quarterly basis.
- b) Monitoring and reporting of inventory levels is the responsibility of the Head of Trading and is reported to the CEO on a weekly basis.
- c) Credit exposure is the responsibility of the Chief Credit Officer and is reported to the CEO on a monthly basis.
- d) Inventory delinquency statistics and servicer performance is the responsibility of the Head of Operations and is reported to the CEO and the Head of Trading on a monthly basis.
- e) Due diligence reviews are performed on all loan pools purchased unless waived jointly by the CEO, Head of Trading and Head of Operations. The nature and level of the reviews is detailed in Section V - Asset Quality Evaluation. Any changes to the review process must be approved by the Head of Trading and the Head of Operations.
- f) All credit risks including the risks associated with servicers, buying and selling loans and holding subordinated tranches must be approved by the Chief Credit Officer or CEO. Counterparties are initially approved and then reviewed on an annual basis, or more frequently as appropriate.

GENERAL POLICY STATEMENT & SUMMARY OF POLICIES (CON'T)

- g) Legal documentation for all transactions is approved by the Head of Operations or outside law firms approved by the Head of Operations.
- h) Exceptions to policy as it relates to eligible loan types and the due diligence process must be approved the Head of Trading and the Head of Operations. Exceptions to counterparty credit and servicing risk policy must be approved by the Chief Credit Officer or CEO.

BUSINESS DESCRIPTION - OVERVIEW

- * The primary business is investing in pools of residential mortgage loans. Loan types eligible for purchase in the private and public markets include:
 - rated and unrated loan pools
 - fixed and adjustable rate mortgage loans
 - performing, sub-performing and non-performing loans
- * Within the above categories mortgages may vary in terms of seasoning, credit quality, geographic location and lien position.
- * Portfolios of mortgage loans are identified through Hanover's salesforce and from broker/dealers. Portfolios may be available from asset sales by federal or state governmental agencies (e.g. FDIC and HUD).
- * In order to evaluate a portfolio a bid sheet is completed and loan level data obtained (see Exhibit i). For portfolios of genetic product being sold by established counterparties summary pool data may be substituted for loan level detail. Financial and non-financial information on the selling and servicing entity(s) is required for credit approval.
- * Purchased portfolios are hedged with respect to both financing risk and adverse interest rate movement. Financing is secured for the expected portfolio holding period, to the extent possible. Interest rate caps may be purchased to protect against cap risk in ARM portfolios. Fixed-rate loans are hedged with similar coupon mortgage-backed securities issued by Fannie Mae or Freddie Mac to minimize interest rate and basis risk. ARMs may be hedged with a combination of mortgage-backed and US treasury securities and options. Prepayment rates are projected and monitored during the holding period (see Section VI - Interest Rate Risk Management).
- * Due diligence is performed on all portfolios unless waived jointly by the CEO, Head of Trading and Head of Operations. Due diligence concentrates on validating loan level data and obtaining missing information. Particular focus is paid to credit underwriting for loans with less than 5 years of seasoning and to loan-to-value ratios for mortgages in volatile real estate markets, both current and historically. (see Section V - Asset Quality Evaluation)

BUSINESS DESCRIPTION - OVERVIEW (CON'T)

- * The strategy is to optimize financing by securitizing agency eligible product as Fannie Mae or Freddie Mac securities and non-eligible pools as private-label securities or whole loans. Hanover may retain subordinated tranches of securitized mortgage pools.

COMMITMENT PROCEDURES AND RISK LIMITS

1. Eligible Loan Types and Risk Limits

a) Loan types eligible for purchase are jointly approved by the CEO, Head of Trading and Head of Operations and are updated on a quarterly basis. Exceptions must be approved by the CEO, Head of Trading and Head of Operations.

b) Residential mortgage loan types eligible for purchase are:

Rate Classes: Fixed and Adjustable

Indexes: US Treasury, Cost of Funds, Libor, Prime

Lien Types: 1st, 2nd, 3rd & 4th

Credit Grades: A,B,C & D

Performance

Status: Performing
Current paid-to-status
Sub-Performing
30 & 60 day delinquent
Non-Performing
90 days or greater delinquent

Amortization

Types: Fully Amortizing
Balloon
Open-ended lines of credit

Property

Locations: United States of America
Puerto Rico

2. Risk limits (based upon current UPB per transaction)

Senior Vice President of Trading ("SVP"): \$10 mm of performing loans

Head of Trading: \$50 mm of performing loans
\$25 mm of sub-performing loans

COMMITMENT PROCEDURES AND RISK LIMITS (CON'T)

Any 2 of: CEO, Head of Trading or SVP: \$100 mm of performing loans
\$ 50 mm of sub-performing loans

CEO, Head of Trading and SVP jointly: > \$100 mm of performing loans
> \$ 50 mm of sub-performing loans
all non-performing loan pools

3. Commitment Procedures

a) A Bid Sheet is completed for each pool of loans being considered for purchase (see Exhibit i). The Bid Sheet must be signed by the person responsible for identifying the loan pool.

- b) The selling institution, investor and servicer is identified, financial statements received and submitted to the Chief Credit Officer or CEO for approval (see Section IV - Counterparty Approval). Credit approval must be obtained before a commitment can be issued.
- c) A bid letter is submitted for all trades and must be executed by the SVP, Head of Trading or CEO.
- d) Forward trades are limited to maximum of 45 days. Approval for trade settlement beyond 45 days must be obtained from the CEO.
- e) The bid letter will contain at a minimum the following (see Exhibit ii):
 - i. Name and address of the selling institution (or loan sale advisor if applicable)
 - ii. Bid Price or Yield
 - iii. Trade Date
 - iv. Time and Date Bid Price is valid until
 - v. Settlement Date
 - vi. Servicing status: released or retained
 - vii. Description of the loan pool
 - viii. All conditions of the trade
 - ix. Name and Title of Signatory

COMMITMENT PROCEDURES AND RISK LIMITS (CON'T)

- f) If a pool is purchased on a firm price basis a hedge is calculated by the SVP of Trading and approved by the Head of Trading (see Section VI - Interest Rate Risk Management). No hedging is required for loan pools purchased on a yield spread basis.
- g) If a loan pool is sold on a firm price basis the corresponding hedge is closed out. Hedges remain in place for sales on a yield spread basis.
- h) Within 48 hours of the acceptance of a bid or offer a commitment letter is issued by the Operations Department. The commitment letter must be approved by the Head of Operations, trading officer responsible for the transaction and the Chief Credit Officer or CEO.
- i) The commitment letter is sent out in duplicate with one original to be returned to the Head of Operations within 48 hours after receipt by the counterparty. The CEO and Head of Trading must be notified if a countersigned commitment is not received within the 48 hour period.
- j) The commitment letter will contain at a minimum (see Exhibit iii):
 - i. Counterparty Name and Address
 - ii. Price or Yield Spread
 - iii. Current Unpaid Principal Balance
 - iv. Settlement Date
 - v. Servicing Status-retained or released
 - vi. Loan Types
 - vii. Property Types and Locations
 - viii. Number of Loans
 - ix. Maximum Loan Balance
 - x. Average Loan Balance
 - xi. Weighted Average Remaining Term
 - xii. Weighted Average Gross Rate
 - xiii. Servicing Fee (if applicable)
 - xiv. Servicing Type-actual/actual; scheduled/scheduled (if applicable)
 - xv. Remittance Date (if applicable)
 - xvi. Pool Description-underwriting standards

- xvii. Due Diligence Requirements
- xviii. Representations & Warranties-standard;
"where-is-as-is"
- xix. Closing Conditions - documents to be delivered vs.
funding
- xx. Any other conditions of the trade

9

66

COUNTERPARTY APPROVAL

1. Trading Counterparties

- a) Trading counterparties are purchasers and sellers of loans or securities. Prior to issuing a commitment counterparties must be approved by the Chief Credit Officer or the CEO.
- b) Forward trades are limited to a maximum of 45 days unless an exception is approved by the CEO.
- c) Approval is based upon both financial and non-financial information.
- d) Non-financial information is the counterparty's reputation in the market and reasons for the type of transaction involved.
- e) The maintenance and ongoing monitoring of financial information is the responsibility of the Credit Department.
- f) Required financial information is:

A. Banks & Thrifts

1) Public Institutions

a) Audited Reports

- i. Two most current fiscal years with complete attached footnotes.
- ii. Quarterly SEC 10Q reports to be submitted on a current and ongoing basis.

b) Regulatory Reports

- i. FDIC reports (cumulative year-end statements will suffice) for the two most current calendar years with all inclusive schedules attached.
- ii. FDIC reports to be submitted on an ongoing basis.

10

67

COUNTERPARTY APPROVAL (CON'T)

2) Private Institutions

a) Audited Reports

- i. Two most current fiscal years with complete attached footnotes.
- ii. Most recent interim statement (unaudited acceptable if audited is unavailable).
- iii. Quarterly financial statements on an ongoing basis (unaudited acceptable if audited not available).

b) Regulatory Reports

- i. FDIC reports (cumulative year-end statements

- will suffice) for the two most current calendar years with all inclusive schedules attached.
- ii. FDIC reports to be submitted on an ongoing basis.

B. Insurance Companies

Insurance companies are typically subsidiaries of publicly traded holding companies. Insurance companies are regulated by state authorities and file statements on a statutory basis. Financial statements on both companies are required:

- 1) Public Institutions
 - a) Audited Reports
 - i. Two most current fiscal years with complete attached footnotes.
 - ii. Quarterly SEC 10Q reports to be submitted on a current and ongoing basis.
 - b) Statutory Statements
 - i. Two most current fiscal years with complete attached footnotes.
 - ii. Interim statutory statements, if available, for the current year.
 - iii. Statutory reports to be submitted on an ongoing basis.
- 2) Private Institutions
 - a) Audited Reports
 - i. Two most current fiscal years with complete attached footnotes.
 - ii. Most recent interim statement (unaudited acceptable if audited is unavailable).

11

68

COUNTERPARTY APPROVAL (CON'T)

- iii. Quarterly financial statements on an ongoing basis (unaudited acceptable if audited not available).
- b) Statutory Statements
 - i. Two most current fiscal years with complete attached footnotes.
 - ii. Interim statutory statements, if available, for the current year.
 - iii. Statutory reports to be submitted on an ongoing basis.

C. Other Companies

- 1) Public Institutions
 - a) Audited Reports
 - i. Two most current fiscal years with complete attached footnotes.
 - ii. Quarterly SEC 10Q reports to be submitted on a current and ongoing basis.
- 2) Private Institutions
 - b) Audited Reports
 - i. Two most current fiscal years with complete attached footnotes.
 - ii. Most recent interim statement (unaudited acceptable if audited is unavailable).

- iii. Quarterly financial statements on an ongoing basis (unaudited acceptable if audited not available).

2. Servicing Counterparties

- a) Servicers are approved by the Head of Trading, Head of Operations and the Chief Credit Officer or CEO. The Operations Department will monitor compliance with servicing obligations. Servicing exceptions are reported to the Head of the Operations and Head of Trading on a monthly basis.
- b) The maintenance and ongoing monitoring of financial and non-financial servicing information is the responsibility of the Credit Department.
- c) Servicers must submit the following information:

12

69

COUNTERPARTY APPROVAL (CON'T)

A. Financial

- 1) Public Institutions
 - a) Audited Reports
 - i. Two most current fiscal years with complete attached footnotes.
 - ii. Quarterly SEC 10Q reports to be submitted on a current and ongoing basis.
- 2) Private Institutions
 - b) Audited Reports
 - i. Two most current fiscal years with complete attached footnotes.
 - ii. Most recent interim statement (unaudited acceptable if audited is unavailable).
 - iii. Quarterly financial statements on an ongoing basis (unaudited acceptable if audited not available).

B. Non-Financial (for servicers of non-subordinated pools of loans):

- a) Most recent two years of Fannie Mae/Freddie Mac audits
- b) List of loans in foreclosure, bankruptcy or delinquency as of most recent quarter-end.
- c) Property valuation process.
- d) Name of tax service company

C. Non-Financial (for servicers of subordinated tranches):

- a) Most recent two years of Fannie Mae/Freddie Mac audits
- b) Name of Tax Service Company and copy of contract
- c) List of loans with past due tax dates and no tax due dates
- d) List of loans with past due insurance dates or no insurance expiration date
- e) Force Place Insurance Carrier and force place procedures
- f) Schedule of Foreclosure and REO losses from the past year
- g) Copy of most recent escrow analysis
- h) Geographic breakdown of the portfolio
- i) Geographic breakdown of delinquencies
- j) Timeframes from 90 day delinquency to foreclosure to REO sale
- k) Missing document inventory listing

13

70

COUNTERPARTY APPROVAL (CON'T)

- 1) List of loans in foreclosure, bankruptcy or delinquency as of most recent quarter-end
- m) Flood zone determination process
- n) Property valuation process
- o) Quality control program
- p) Attorney and broker approval process and tracking procedures
- q) Current portfolio segregated by loan delinquency and REO
- r) REO Reports:
 - i. Current REO inventory breakdown by state
 - ii. Average marketing time statistics
 - iii. Property type breakdown
 - iv. Average maintenance costs
 - v. Initial make-ready and rehab costs
 - vi. Sales price to BPO percentage
 - vii. Expenses as a percent of BPO value
 - viii. Time from foreclosure sale to property disposition
 - ix. REO tracking reports.

14

71

ASSET QUALITY EVALUATION

- - Due Diligence is required on all loan portfolios prior to settlement unless waived by the Head of Operations, Head of Trading and Chief Credit Officer (or CEO).
- - The scope of due diligence is determined by the Head of Operations and Head of Trading and is a function of seasoning, missing information and the terms and conditions of the trade.
- - The following Due Diligence procedures are minimum standards and additional due diligence may be required by the Head of Operations and Head of Trading.
- - All exceptions from due diligence as directed by the Head of Operations and Head of Trading must be approved.

DUE DILIGENCE PROCEDURES

A. Loans with less than 18 months seasoning:

1. Sample Size: Entire pool is underwritten.
2. Documentation

- a) Legal Documents: The following documents are checked for completeness, discrepancies such as white outs and internal consistency between the various documents themselves. Additionally, information contained in the documents such as mortgagor name, property address, etc., is compared to the delivery schedule.
 - i. Original recorded mortgage required; must be FNMA/HLMC standard.
 - ii. Original note required; must be FNMA/FHLMC standard.
 - iii. All original modifications, riders, and assumptions required; must be FNMA/FHLMC

- iv. standard.
Original title policy required for all loans. ARM, PUD, condo endorsement is required. Policy coverage other than the standard ALTA policy (the FNMA/FHLMC standard) must be reviewed and approved.

15

72

ASSET QUALITY EVALUATION (CON'T)

- v. If required per terms of the trade, original mortgage insurance certificate for loans with a current LTV in excess of 80%. Mortgage insurance must be from a FNMA/HLMC approved MI company.

b) Closing Documents

- i. Truth-in-Lending disclosure is required with ARM disclosure.
- ii. Settlement Statement (HUD-1).
- iii. Right of Rescission (Cancellation Notice) for refinances.
- iv. Current hazard insurance required with correct mortgagee clause and coverage at least equal to the loan amount or the maximum amount of insurance available. This requirement is waived where the Seller has acceptable Errors and Omissions and Blanket Hazard Insurance policies in amounts and from insurance companies acceptable to the Chief Credit Officer. Flood insurance is required for properties in Flood Zone A and
- v. Earthquake insurance must also be checked for in recognized earthquake areas.

c) Credit Documents

- i. Application required; must be FNMA/FHLMC standard for all loans.

(Contents of a credit package will depend on the terms of the trade, however, deviations from the following "Full credit package" must be documented.)

- ii. Full credit package, including standard factual credit report and verifications of employment, rental income if needed to qualify, and deposit/downpayment may be required. All debts "to be paid" must be verified as having been paid. All verifications must not have been in excess of 90 days old at closing.

16

73

ASSET QUALITY EVALUATION (CON'T)

- iii. Appraisal required; must be FNMA/FHLMC

standard and include photographs of the property. Property must be verified as complete including any noted repairs. Final value and marketability must be substantiated through the appraisal valuation process. Appraisal must not have been more than 6 months old at loan closing.

- iv. Final sales agreement with any and all modifications is required.

3. Pool Criteria

a) General

- i. Borrower must be an individual unless, in such instances as Trust Estates, the Beneficiary is an individual.
- ii. Fee simple title is required. Leaseholds are allowed as long as the term of the lease expires at least ten years after the loan maturity date and only in areas where leases are common.
- iii. "Add-on" second mortgages are not allowed if the combined loan-to-value ratio of the first and second liens is in excess of 85%.
- iv. Loans for investment properties and second homes are limited to two per borrower per pool. Investment properties are those not occupied by the borrower and for which rental income is necessary to qualify the loan. Second homes, are those occupied on a part-time basis by the borrower and for which the borrower can support the monthly payment without rental income.
- v. Co-signers (signers of the note and not co-title holders) are not allowed.
- vi. The properties securing the loans must be located in the states agreed upon by the commitment letter. All property types must meet FNMA/FHLMC requirements and in the case of condos, be FNMA approved or approvable.

17

74

ASSET QUALITY EVALUATION (CON'T)

- vii. Gifts are allowed if the borrowers made a minimum of 5% cash downpayment. The gift must be made prior to closing and the relationship of the donor to the borrower must be documented by Lender.
- viii. The loan purpose may be purchase, refinance, home-improvement or construction/permanent.
- ix. Remaining and original loan terms may not exceed 360 months.
- x. The Delivery Schedule must be accurate.

b) Underwriting Criteria

- i. Loans are underwritten for borrower's ability to pay, borrower's willingness to pay and property valuation. Loans then assigned a credit grade based upon the borrower's ability and willingness to pay

(see Exhibit vii for credit grade criteria). All loans graded "A" are further analyzed for conformance to agency standards (see Fannie Mae/Freddie Mac underwriting manuals).

- ii. Ability to pay is measured by the housing ratio and total debt ratio. The housing ratio is the sum of the proposed monthly P&I payment, property taxes and hazard insurance divided by gross monthly income. The total debt ratio is the sum of monthly housing expenses (as defined in the housing ratio) plus all installment debt with contractual maturities of greater than 6 months divided by gross monthly income. For ARM loans the proposed monthly P&I is calculated using the fully indexed interest rate.
- iii. Willingness to pay is determined from credit scores (see Exhibit v), bankruptcy and delinquency history of mortgage and consumer debt.
- iv. Adverse property quality/condition is grounds for rejection. Any repairs noted and/or required by the appraiser must be certified complete. The appraisal must be no more than 6 months old at time of loan closing. Loans in areas subject to earthquakes, radon problems, mud slides must be approved by the Head of Operations and the Head of Trading.

18

75

ASSET QUALITY EVALUATION (CON'T)

4. Current Conditions

- a) Payment histories are examined for all of the pool. Current delinquency status and delinquency history must conform to the terms of the trade.
- b) Drive-by property inspection ("BPO") performed on 10% random sample of the pool. The BPOs must be obtained from an approved BPO provider (see Exhibit iv).
- c) Desk reviews of the original appraisals and property inspections on the 10% sample selected above. Reviews focus on overall quality of the portfolio and highlight potentially negative trends.

B. Loans with 18 through 60 months seasoning.

1. Sample Size: Selected based on the quality of the counterparty, terms of the transaction, and particulars of the package. Minimum sample size for credit underwriting purposes is 10% of the pool. Should the underwriting yield a large number of rejects then sample size should be increased. For example, in a large package if the rejection rate is 5% or greater (for reasons other than delinquency then the sample size should be doubled. If the rejects run 10% on the expanded sample then Hanover will (a) do a 100% underwriting, (b) stop there and not close the package or (c) restructure the package with consideration given to asking for collateral from the seller/servicer.
2. Documentation

- a) Legal Documents-a 100% review is performed, identical to the review for new loans.

19

76

ASSET QUALITY EVALUATION (CON'T)

- b) Closing Documents

- i. Truth-in-Lending disclosure is required.
- ii. Absence of Settlement Statement is noted.
- iii. Right of Recission (Cancellation Notice) for refinances is required.
- iv. Current hazard insurance is required with correct mortgagee clause and coverage at least equal to the loan amount. The requirement is waived where the Seller has acceptable Errors and Omissions and Blanket Hazard Insurance policies in amounts and from insurance companies acceptable to the Chief Credit Officer. Flood insurance is required for properties in Flood Zone A and V. Earthquake insurance must also be checked for in recognized earthquake areas.

- c) Credit Package-A complete review of the sample is performed using the same requirements as for new loans.

3. Pool Criteria - Same as for new loans.

4. Current Conditions - Same as for new loans.

- C. Loans with 61 months or more seasoning

1. Sample Size-The entire pool is examined for legal documents only. No credit underwriting is done.
2. Documentation-Legal documents and Closing documents-same as for new loans except that non-standard documents may be frequent and are acceptable if approved by the Head of Operations and the Head of Trading.
3. Pool Criteria-Same as for new loans except the requirements regarding co-signers, gifts and add-on seconds are waived due to the

20

77

ASSET QUALITY EVALUATION (CON'T)

4. Current Conditions

- a) Payment histories are examined for all of the pool. Current delinquency status and delinquency history must conform to the terms of the trade.
- b) Drive-by property inspection ("BPO") performed on 10% random sample of the pool. The BPOs must be obtained from an approved BPO provider (see Exhibit iv).

INTEREST RATE RISK MANAGEMENT

- a) Hedging strategies and amounts are calculated by the Senior Vice President of Trading and approved by the Head of Trading.
- b) Fixed rate loans are hedged with agency mortgage-backed securities of similar coupon and duration. Treasury hedges are allowed only when an investor has committed to a trade based on a yield spread to treasuries.
- c) ARM portfolios may be hedged using a combination of mortgage-backed, treasury securities and options.
- d) Hedge counterparties are approved by the Chief Credit Officer or CEO.
- e) Actual and forecasted prepayment rates are monitored on a monthly basis and hedges are adjusted to reflect revised prepayment assumptions. Should the Senior Vice President of Trading decide more frequent hedge revisions are necessary such adjustments may be made with the approval of the Head of Trading.
- f) Hedge amounts are adjusted monthly to reflect the paydown of mortgage loan balances.
- g) Financing terms are matched with the expected holding period of the loan portfolio, to the extent possible. Financing counterparties are approved by the Chief Credit Officer or CEO.
- h) For ARM portfolios interest rate caps may be purchased to attempt to limit or partially offset adverse changes in interest rates on ARM portfolios. The decision to purchase interest rate caps must be approved by the Head of Trading.
- i) Financing of hedges is matched with the expected holding period of the corresponding loan portfolio and is approved by either the Head or Senior Vice President of Trading.
- j) Positions are marked on a weekly basis by the Senior Vice President of Trading and reported to the Chief Executive Officer and Head of Trading.

INTEREST RATE RISK MANAGEMENT (CON'T)

- k) Position reports will include the following information (see Exhibit vi):

Profitability Analysis

- i. Deal Number
- ii. Deal name
- iii. Asset Gain/Loss
- iv. Hedge Gain/Loss
- v. Coupon interest earned on Asset
- vi. Financing cost on hedge
- vii. Net Gain Loss (sum of the above)

Assets

- i. Deal Number
- ii. Deal Name
- iii. Rate Class (Fixed or ARM)
- iv. Indexcode (ARM only)

- v. Current Unpaid Principal Balance
- vi. Gross Weighted Average Coupon
- vii. Net Weighted Average Coupon
- viii. Weighted Average Remaining Term
- ix. Gross Margin (ARM only)
- x. Periodic and Lifetime Interest Rate Caps (ARM only)
- xi. Purchase Price
- xii. Prepayment Assumption
- xiii. Average Life
- xiv. Duration
- xv. Benchmark Security
- xvi. Yield Spread to Benchmark Security
- xvii. Mark-to-Mark Price
- xviii. Finance Rate
- xix. Financed Amount
- xx. Expiration Date of Financing

Hedges

- i. Security type
- ii. Amount
- iii. Coupon
- iv. Maturity
- v. Settlement Date
- vi. Initial Price

INTEREST RATE RISK MANAGEMENT (CON'T)

- vii. Strike Price (if option)
- viii. Expiration Date (if option)
- ix. Prepayment Assumption
- x. Average Life
- xi. Duration
- xii. Mark-to-Market Price
- xiii. Finance Rate
- xiv. Financed Amount
- xv. Expiration Date of Financing

EXHIBIT i

BID SHEET

DATE: _____

DEAL# _____

(TERM SHEET IF APPLICABLE FROM CUSTOMER MUST BE ATTACHED!!!)

BID DATE: / /

UPB _____

PRICE EXPECTATION _____

PRODUCT TYPE (ARMS/FIXED/OTHER-EXPLAIN) _____

INSTITUTION NAME _____

SALES PERSON _____

IS BROKER INVOLVED? YES _____ NO _____

IF YES, BROKERS NAME: _____

WHO PAYS FEE? _____ FEE AMOUNT _____

WHOLE LOAN _____ PARTICIPATION _____
IF YES% _____

SERVICING: RETAINED _____ RELEASED _____

IF RETAINED, FEES ARE: IF RELEASED:
FIXED _____ TRANSFER DATE _____
ARM _____

WHO IS CURRENTLY SERVICING? _____

IF RELEASED, WILL SELLER SUB-SERVICE ON AN INTERIM BASIS? YES _____ NO _____

TAPE RECEIVED? YES _____ NO _____ (SEE ATTACHMENT A FOR REQUIRED DATA
FIELDS.)

IF NO WHEN / /

IS BID BASED ON SELLER TERM SHEET ONLY? YES _____ NO _____

SELLER'S FINANCIALS RECEIVED: YES _____ NO _____

SELLER'S REQUIRED SETTLEMENT DATE: / /

HOW MANY OTHER BIDDERS? _____

TYPE OF ACCOUNTS: _____

ANY PRE-BID DUE DILIGENCE ALLOWED: _____

EXHIBIT i

WHAT ARE LTV'S BASED ON? ORIGINAL APPRAISAL _____ BPO'S _____

WILL SELLER PROVIDE BPO DATA? _____

LIEN STATUS:

FIRST ONLY _____
SECONDS ONLY _____
MIXED _____

ARE FORECLOSURES OR BANKRUPTCIES INCLUDED? _____

REPRESENTATIONS:

AS IS WHERE IS _____
ENFORCEABILITY _____
OTHER LIMITED REPS _____
FULL REPS _____

UNDERWRITING STANDARDS:

FNMA/FHLMC _____

B CREDITS
EXPLAIN:

C CREDITS
EXPLAIN:

D CREDITS
EXPLAIN:

OTHER (e.g. "WHOOPS")
EXPLAIN: (If "WHOOPS" LOAN BY LOAN COMMENTS REQUIRED)

DUE DILIGENCE:

DO WE NEED TO TRAVEL TO SELLER'S SITE? _____

SELLER WILL DELIVER LOANS TO FIRST CHICAGO _____
*BAILEE ARRANGEMENT REQUIRED.

EXHIBIT i

RIGHT TO REJECT LOANS THAT DO NOT MEET
PARAMETERS OF TRADE. _____

SELLER PREPARES MORTGAGE ASSIGNMENTS IN BLANK
AND PAYS FOR RECORDING OF MORTGAGE ASSIGNMENTS. _____

ADDITIONAL COMMENTS:

ATTACHMENT A

REQUESTED LOAN LEVEL DATA

ACCOUNT NUMBER
BORROWER NAME
ADDRESS
CITY
STATE
ZIP
ORIGINATION DATE
MATURITY DATE
ORIGINAL TERM
ORIGINAL BALANCE
CURRENT BALANCE
RATE CLASS (FIXED OR ARM)
INDEX TYPE
MONTHLY P&I PAYMENT & T&I PAYMENT
CURRENT NOTE RATE
ESCROW BALANCE
SERVICING FEE
ORIGINAL LTV
CURRENT LTV (CURRENT UPB/ORIGINAL APPRAISAL)
CURRENT PROPERTY VALUE (IF AVAILABLE)
PAID TO DATE
CUT OFF DATE
DELINQUENCY COUNTER FOR PAST 12 MONTHS
OCCUPANCY STATUS
LIEN POSITION
PROPERTY TYPE
NOTE TYPE (FHA/VA/CONVENTIONAL)
MORTGAGE INSURANCE (IF APPLICABLE)
ARM INFO INDEX
 MARGIN
 PERIODIC RATE CAP
 LIFETIME RATE CAP
 ADJUSTMENT FREQUENCY
 NEGATIVE AMORTIZATION LIMIT(S)
 NEXT INTEREST CHANGE DATE
 ORIGINAL RATE
 FIRST RATE CHANGE DATE
 CONVERTIBILITY
AMORTIZATION TYPE (e.g. BALLOON)
LOAN PURPOSE
NO. OF UNITS
BANKRUPTCY/FORECLOSURE
CREDIT SCORE (IF AVAILABLE)

STANDARD BID LETTER

Date: _____

Counterparty Name & Address

Dear _____:

Hanover Capital Partners is pleased to submit to _____ the following servicing released/retained bid:

POOL. DESCRIPTION	PRICE	UPB	NO. LOANS

The bid is subject to the following conditions:

(conditions will vary on a deal by deal basis)

- First mortgage liens on single family, owner occupied primary residences.
- A mutually acceptable purchase and sale agreement.
- A mutually acceptable interim servicing agreement.
- Due diligence of the loan files which may include verification of current property values and reunderwriting of the loans.
- All legal documentation is on FHLMC/FNMA approved forms with exception of Notes. Notes will be fully enforceable and comply with all Federal, State and Local laws and regulations.
- Loans over 80% LTV are eligible for mortgage insurance.
- Accuracy of the mortgage loan data.
- Funding within 30 days and all loans current at funding.
- Material market movement.
- Review of payment histories.
- Credit review of the selling institution.

- Repurchase of any loan that goes 90 days delinquent during the first 12 months.
- Valid title.

Should you have any questions please contact me at _____. Thank you for the opportunity to bid on your portfolios.

Sincerely,

Name

Title

87

EXHIBIT iii

STANDARD COMMITMENT LETTER

Date: _____

Counterparty Name
and Address

COMMITMENT LETTER

Dear _____:

This letter is to confirm the intention of _____ (the "Seller" or "Buyer") to sell/purchase to/from Hanover Capital (the "Purchaser" or "Seller") approximately \$(UNPAID PRINCIPAL BALANCE) in (LOAN DESCRIPTION) residential mortgage loans (the "Mortgage Loans" or "Loans") which are described on the schedule attached as Exhibit A.

The Mortgage Loans and the characteristics of the transaction are further described as follows:

- SETTLEMENT DATE: The Mortgage Loans shall be purchased by the Purchaser and sold by the Seller on _____ or such other date as shall be mutually agreed upon by the parties (the "Closing Date").
- LOAN TYPE: The loans are backed by (FIXED RATE OR ADJUSTABLE RATE) mortgage loans.
- PROPERTY TYPE: All of the Mortgage Loans are (OCCUPANCY and secured by (PROPERTY TYPE)).
- LOCATION: The mortgaged properties are located in the States of _____.
- NUMBER OF LOANS: Approximately _____ Loans.
- LOAN SIZE: The average current loan balance is approximately \$_____.

WEIGHTED AVERAGE
REMAINING TERM TO
MATURITY: _____ months.

WEIGHTED AVERAGE
GROSS RATE: Approximately _____%.

SERVICING: The Loans will be sold on a (SERVICING RELEASED/
RETAINED) basis (for _____basis points). (Remittances
will be made by wire transfer on an (SERVICING TYPE)
basis on the _____ day of the month.)

WEIGHTED AVERAGE
NET RATE: Approximately _____%.

PURCHASE PRICE: The purchase price for the Loans is _____of the
unpaid principal balance of the Loans based upon a
Gross/Net Weighted Average Coupon ("WAC") of _____
and a weighted average remaining term to maturity
("WAM") of _____ months. Should the final WAC
and/or WAM differ from the current WAC and WAM a
revised purchase price for the Loans will be computed
by discounting the mortgage pool's final WAC and WAM
by a _____% semi-annual yield, using a _____ day
payment delay and _____% prepayment rate.

FINANCIAL
STATEMENTS: Purchaser's/Seller's commitment to purchase/sell the
Loans is subject to credit review of Seller's/
Purchaser's most recent audited financial statements.

UNDERWRITING: Loans have been underwritten in accordance with
generally accepted underwriting standards. All legal
documentation is on FHLMC/FNMA approved forms.

DUE DILIGENCE: The Purchaser's obligation to buy and the Seller's
obligation to sell the Loans is subject to the
Purchaser's, or its designee's, due diligence review
of the Loans and the Collateral Files to the
satisfaction of the Purchaser, in its sole
discretion, no later than _____, unless an extension
of time is mutually agreed upon by Purchaser and
Seller

(the "Final Review Date"). (Due diligence may include
the Purchaser's verification of current property
values and re-underwriting of the Loans.) The Seller
will arrange for the availability of the Collateral
Files, payment histories and any additional
documentation reasonably requested by Purchaser for
Purchaser's review and due diligence at the
_____ 's document custodian location on
_____. No later than five (5) days after such
Final Review Date, the Purchaser may notify Seller of
those Loans that do not meet the Purchaser's
standards for purchase ("Rejected Loans"). The Seller

will then have the ability to either promptly cure such Rejected Loan deficiencies or substitute a Loan that conforms to the requirements of this Commitment Letter and is found to be acceptable for purchase by Purchaser.

FORM OF SALE:

The Loans will be sold, conveyed, transferred and assigned under a Loan Sale Agreement and (INTERIM) Servicing Agreement mutually agreeable to the Seller and Purchaser. The Loan Sale Agreement will contain secondary marketing representations and warranties which shall include, but not be limited to, the items that follow. The Seller represents and warrants that: (1) they are the owner of the loans being conveyed; (2) they have the authority to sell the loans; (3) the notes are fully enforceable and comply with all Federal, State and Local laws and regulations; (4) all mortgage loans sold are first liens on the mortgaged property; (5) the coupon rate and balances established at the time of closing are accurate; (6) the loans have been underwritten in accordance with generally accepted underwriting standards; (7) all loans are current and have not been over 30 days delinquent in the last 12 month period; (8) they will repurchase any loan that become 90 days delinquent during the 12 month period following the closing of this transaction; and (9) all loans over 80% LTV are eligible for mortgage insurance; (10) all loans conform to the same delinquency profile as of the bid date.

CLOSING CONDITIONS:

The Seller shall provide to the Purchaser, or its designees, contemporaneously with the payment of the Purchase Price by the Purchaser to the Seller on the Closing Date, the following mortgage loan documents for each Loan (in each circumstance to be satisfactory to Purchaser): a) an original note; b) an original recorded security instrument (Mortgage, Deed of Trust or Security Deed); c) an original title policy; d) original recorded interim assignments, if

EXHIBIT iii

any; e) an assignment from the Seller to blank; and f) an endorsement from the Seller to blank. Where applicable, modification agreements, extension agreements, assumption agreements, mortgage insurance certificates, HUD-1 settlement statement, and all other appropriate legal documentation relating to each underlying mortgage loan (the "Collateral File") will also be provided. In addition, credit and servicing files are to be provided to the full extent available.

FEES:

Purchaser and Seller will each bear its own incurred costs, fees and expenses.

Sincerely,

HANOVER CAPITAL

By: _____

Name:
Title:

Agreed and accepted:

(Counterparty)

By: _____

Name:

Title:

4

91

EXHIBIT iii

SCHEDULE A

Mortgage Loan Schedule

5

92

EXHIBIT iv

APPROVED BPO PROVIDERS
(AS OF 5/97)

1. Property & Appraisal Services Corp.
2. Spectrum Field Services
3. Market Intelligence
4. MGIC
5. Westfall & Company
6. New City Asset Management Inc.
7. Case Schiller Weiss Inc.
8. Mortgage Risk Assessment Corp.
9. Greenthlal/Harlan Realty Services
10. PHH Asset Management
11. HNC Software
12. PMI

FORM OF BLOCKED ACCOUNT AGREEMENT

December 8, 1997

- -----
- -----
- -----

Attn: _____

Re: Collection Account Established by _____
("Servicer") Pursuant to that Certain Servicing
Agreement (as amended, supplemented or otherwise
modified from time to time, the "Servicing
Agreement"), dated _____, 1997, between
Servicer and Hanover Capital Mortgage Holdings,
Inc. ("Borrower")

Ladies and Gentlemen:

We refer to the collection account established by the Servicer
pursuant to the Servicing Agreement, at _____, _____, _____,
Account No. _____, ABA# _____ (the "Blocked Account"), which
Servicer maintains in the Servicer's name in trust for Morgan Stanley Mortgage
Capital Inc. (the "Lender").

The Servicer will, from time to time, deposit funds received in
accordance with the Servicing Agreement into the Blocked Account. Lender has
established a secured loan arrangement with the Borrower. By its execution of
this letter, the Servicer acknowledges that the Borrower has granted a security
interest in all of the Borrower's right, title and interest in and to the
Blocked Account and any funds from time to time on deposit therein, that such
funds are received by the Servicer in trust for the benefit of Lender and,
except as provided below, are for application against the Borrower's liabilities
to Lender.

By the Servicer's execution of this letter, it agrees: (a) that all
funds from time to time hereafter in the Blocked Account are the property of the
Borrower held in trust for the benefit of the Lender and that unless and until
the Servicer receives notice from the Lender that an event of default has
occurred and is continuing under the Lender's secured lending arrangement with
the Borrower (a "Notice of Event of Default"), the Servicer shall transfer funds
from the Blocked Account in accordance with the Borrower's instructions; (b)
that Servicer will not exercise any right of set-off, banker's lien or any
similar right in connection with such funds PROVIDED, that in the event any
check is returned to the Servicer because of insufficient funds (or is otherwise
unpaid) the Servicer shall be entitled to set off the amount of any such
returned check; (c) that until the Servicer receives written notification from
the Lender to the contrary, the Servicer will not withdraw (other than as
expressly set forth in the Servicing Agreement or herein) or permit any person
or entity to withdraw or transfer funds from the Blocked Account; and (d) that
if the Servicer receives a Notice of Event of Default from the Lender, the
Servicer shall not withdraw or permit the Borrower to withdraw or transfer funds
from

H-1

the Blocked Account and shall cause or permit withdrawals from the Blocked
Account in any manner as the Lender may instruct.

All bank statements in respect to the Blocked Account shall be sent

to the Borrower with copies to:

Morgan Stanley Mortgage Capital Inc.
1585 Broadway
New York, New York 10036
Attention: Mr. Peter Mozer

H-2

98

Kindly acknowledge your agreement with the terms of this agreement by signing the enclosed copy of this letter and returning it to the undersigned.

Very truly yours,

MORGAN STANLEY MORTGAGE CAPITAL INC.

By: _____
Title:

Agreed and acknowledged:

By: _____
Title:

H-3

<ARTICLE> 5

<LEGEND>

THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE HANOVER CAPITAL MORTGAGE HOLDINGS, INC'S ANNUAL REPORT ON FORM 10-K FOR THE PERIOD FROM JUNE 10, 1997 TO DECEMBER 31, 1997 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

</LEGEND>

<MULTIPLIER> 1,000

<PERIOD-TYPE>	OTHER	
<FISCAL-YEAR-END>		DEC-31-1997
<PERIOD-START>		JUN-10-1997
<PERIOD-END>		DEC-31-1997
<CASH>		4,022
<SECURITIES>		509,101
<RECEIVABLES>		3,597
<ALLOWANCES>		0
<INVENTORY>		0
<CURRENT-ASSETS>		517,543
<PP&E>		0
<DEPRECIATION>		0
<TOTAL-ASSETS>		517,543
<CURRENT-LIABILITIES>		439,445<F1>
<BONDS>		0
<PREFERRED-MANDATORY>		0
<PREFERRED>		0
<COMMON>		65
<OTHER-SE>		78,033<F2>
<TOTAL-LIABILITY-AND-EQUITY>		517,543
<SALES>		0
<TOTAL-REVENUES>		4,898
<CGS>		0
<TOTAL-COSTS>		0
<OTHER-EXPENSES>		940
<LOSS-PROVISION>		18
<INTEREST-EXPENSE>		3,204
<INCOME-PRETAX>		499
<INCOME-TAX>		0
<INCOME-CONTINUING>		499
<DISCONTINUED>		0
<EXTRAORDINARY>		0
<CHANGES>		0
<NET-INCOME>		499
<EPS-PRIMARY>		.15
<EPS-DILUTED>		.14

<FN>

<F1>As a Real Estate Investment Trust our balance sheet is not classified.

<F2>Includes Retained Earnings and Paid In Capital.

</FN>

<ARTICLE> 5

<LEGEND>

THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE HANOVER CAPITAL MORTGAGE HOLDINGS, INC. DECEMBER 31, 1997 ANNUAL REPORT ON FORM 10-K RELATING TO HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

</LEGEND>

<MULTIPLIER> 1

<PERIOD-TYPE>	YEAR	
<FISCAL-YEAR-END>	DEC-31-1997	
<PERIOD-START>	JAN-01-1997	
<PERIOD-END>	DEC-31-1997	
<CASH>		208,315
<SECURITIES>		17,394
<RECEIVABLES>		133,829
<ALLOWANCES>		0
<INVENTORY>		0
<CURRENT-ASSETS>		1,270,887
<PP&E>		560,988
<DEPRECIATION>		347,851
<TOTAL-ASSETS>		2,066,875
<CURRENT-LIABILITIES>		571,519
<BONDS>		0
<PREFERRED-MANDATORY>		0
<PREFERRED>		970
<COMMON>		30
<OTHER-SE>		88,740<F1>
<TOTAL-LIABILITY-AND-EQUITY>		2,066,875
<SALES>		0
<TOTAL-REVENUES>		7,970,565
<CGS>		0
<TOTAL-COSTS>		0
<OTHER-EXPENSES>		8,808,542
<LOSS-PROVISION>		0
<INTEREST-EXPENSE>		117,894
<INCOME-PRETAX>		(837,977)
<INCOME-TAX>		(325,959)
<INCOME-CONTINUING>		(512,018)
<DISCONTINUED>		0
<EXTRAORDINARY>		0
<CHANGES>		0
<NET-INCOME>		(512,018)
<EPS-PRIMARY>		(525.79)
<EPS-DILUTED>		.0

<FN>

<F1>Includes Retained Earnings and Paid In Capital.

</FN>