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, 1998

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 Incorporation or Organization)	(I.R.S. Employer Identification No.)

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 common stock held by nonaffiliates of the registrant as of March 10, 1999 was approximately $24,352,294 (based on closing sales price of $4.5625 per share of common stock as reported for the American Stock Exchange).

The registrant had 6,126,899 shares of common stock outstanding as of March 10, 1999.

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, 1999 are incorporated by reference into Part III.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

FORM 10-K ANNUAL REPORT

FOR THE YEAR ENDED DECEMBER 31, 1998

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PART I

ITEM 1: BUSINESS

GENERAL

Background

In September 1997, Hanover Capital Mortgage Holdings, Inc. ("Hanover") raised net proceeds of approximately $79 million in its initial public offering (the "IPO"). In the IPO, Hanover 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' over-allotment 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 expire on September 15, 2000. As of December 31, 1998 there were 5,917,878 warrants outstanding including 172,500 warrants issued pursuant to the underwriters over-allotment option. Hanover utilized substantially all of the net proceeds of the IPO to fund leveraged purchases of mortgage assets.

In connection with the closing of the IPO, Hanover, acquired a 97% ownership interest (representing a 100% ownership of 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 Hanover's common stock. HCP 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.

Hanover was incorporated in Maryland on June 10, 1997. Hanover acquired three bankruptcy remote limited purpose finance subsidiaries in 1998 in order to complete two significant mortgage loan securitizations. In March 1998, Hanover acquired 100% of the common stock of Hanover Capital SPC, Inc., together with its wholly owned subsidiary Hanover Capital Repo Corp. and in October 1998 acquired 100% of the common stock of Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B Inc. Hanover is a real estate investment trust ("REIT"), formed to operate as a specialty finance company.

The principal business strategy of Hanover Capital Mortgage Holdings, Inc. and its wholly owned subsidiaries, Hanover Capital SPC, Inc., Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc. (together referred to as the "Company") and its unconsolidated subsidiaries 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 loans and (iv) acquire multifamily loans. Hanover's principal business objective is to generate increasing earnings and dividends for distribution to its stockholders. Hanover acquires single-family mortgage loans through a network of sales representatives targeting financial institutions throughout the United States. HCMC originates multifamily mortgage loans and commercial mortgage loans for government sponsored and private mortgage conduits. Hanover may also acquire multifamily mortgage loans from HCMC, but to date has not done so. Hanover operates as a tax-advantaged REIT and 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 Hanover, however, including HCP, HCMC and HCS, Hanover Capital Partners 2, Inc. and Hanover SPC-2, Inc. are subject to Federal income tax. Hanover has engaged HCP to render due diligence, asset management and administrative services pursuant to a Management Agreement.

Hanover Capital SPC, Inc., a wholly-owned subsidiary of Hanover, was incorporated in Delaware on March 24, 1998 for the sole purpose of issuing mortgage notes through a private placement real estate mortgage investment conduit ("REMIC") offering.

Hanover QRS-1 98-B, Inc., a wholly owned subsidiary of Hanover, was incorporated in Delaware on October 16, 1998 for the sole purpose of owning certain investment grade mortgage securities acquired from Hanover Capital Partners 2, Inc. ("HCP-2"), an unconsolidated subsidiary of Hanover.

Hanover QRS-2 98-B, Inc., a wholly owned subsidiary of Hanover, was incorporated in Delaware on October 19, 1998 for the sole purpose of owning certain investment grade and subordinated mortgage securities acquired from HCP-2.

On October 28, 1998 Hanover contributed $324.2 million of fixed rate mortgage loans (with a par value of $318 million) subject to $310.0 million of reverse repurchase agreement financing to HCP-2 in exchange for a 99% economic ownership of HCP-2 (representing a 100% ownership of the non-voting preferred stock in HCP-2).

COMPANY ORGANIZATION CHART

```
                          |-------------------------|
                          |HANOVER CAPITAL MORTGAGE |
                          |     HOLDINGS, INC.      |
                          |-------------------------|
                                       |
                                       |
                                       |
                           -----------------------------------|
                           |100%                              |
                     |                               |
        |------------------|---------------------|            |
--------|-------|    |-----|----------|   |------|--------|   |
|(1)            |    |(1)             |   |(1)            |   |
|HANOVER CAPITAL|    |    HANOVER     |   |   HANOVER     |   |
|   SPC, INC.   |    |QRS-1 98-B, INC.|   |QRS-2 98-B, INC|   |
|-------|-------|    |----------------|   |---------------|   |
        |                                                     |
        |   100%                                              |
|-------|-------|                          |------------------|---------------|
|(5)            |                          | 97%                             |       99%
|HANOVER CAPITAL|                   |---------------|                  |------|---------|
|   REPO CORP.  |                   |(2)            |                  |(2)             |
|---------------|                   |HANOVER CAPITAL|                  |HANOVER CAPITAL |
                                    |PARTNERS LTD.  |                  |PARTNERS 2, INC.|
                                    -------|--------|                  |------|---------|
                           |------------------|----------|                    |
                           |  100%                        |  100%               |    100%
                  |--------|------|             |--------|-------|     |------|---------|
                  |(3)            |             |(3)             |     |(4)             |
                  |HANOVER CAPITAL|             |HANOVER CAPITAL |     | HANOVER SPC-2, |
                  |    MORTGAGE   |             |SECURITIES, INC.|     |      INC.      |
                  |  CORPORATION  |             |                |     |                |
                  |---------------|             |----------------|     |----------------|
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(1)-Wholly-owned subsidiaries of Hanover

(2)-Majority owned unconsolidated taxable subsidiaries of Hanover

(3)-Wholly-owned subsidiaries of HCP

(4)-Wholly-owned subsidiary of HCP-2

(5)-Wholly-owned subsidiary of Hanover Capital SPC, Inc.

Hanover 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 Hanover 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 Hanover 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 Hanover 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 through HCMC, 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 that does not meet the originally intended credit quality due to documentation errors or credit deterioration.

Core Business Strategy

The Company's core business strategy is to pursue acquisitions 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:

- growing the Company's investment portfolio by utilizing the Company's single-family mortgage loan acquisition network to create attractive investment opportunities;

- securitizing the Company's investments in a manner that limits the Company's interest rate risk while earning an attractive return on equity; and

- 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 and mortgage securities secured by or representing an interest in mortgage loans. While the Company has not done so to date, it may in the future also invest in multifamily mortgage loans and commercial mortgage loans (single-family mortgage loans, mortgage securities, multifamily mortgage loans and commercial mortgage loans collectively referred to as 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 with a view to earning higher returns than could generally be earned from purchasing mortgage securities in the marketplace.

At December 31, 1998, the Company had invested $407,994,000 or 79.0% of the Company's total assets in the following types of single-family mortgage loans classified as held for sale, held to maturity and collateral for mortgage backed bonds in accordance with the operating policies established by the Board of Directors:

Mortgage Loan Summary

Fixed Rate Mortgage Loans	
Face or principal amount	$240,942,000
Carrying value	$246,780,000
Weighted average net coupon	8.339%
Weighted average maturity (1)	220
Number of loans	8,309
Average loan size	$28,988
Average loan to value ratio (2)	71.0%
Adjustable Rate Mortgage (ARM) Loans	
Face or principal amount	$160,046,000
Carrying value	$161,214,000
Weighted average net coupon	7.542%
Weighted average maturity (1)	264
Number of loans	1,498
Average loan size	$106,839
Average loan to value ratio (2)	70.0%

(1) weighted average maturity reflects the number of months to maturity and does not assume any prepayment speeds

(2) average loan to value ratio reflects the ratio of outstanding loan balances to the most recent appraisal on file for each applicable loan

The adjustable rate mortgage loans at December 31, 1998 had various index reference rates with a weighted average 13 month repricing period and a weighted average net life cap of 13.23%.

The weighted average effective yield for the combined fixed and adjustable rate mortgage portfolios for 1998 was 7.339%.

The Company's exposure to credit risk associated with its portfolio acquisition 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, 1998, the percent of total principal amount of all mortgage loans outstanding in any one state which exceeded 10% of the principal amount of the Company's total mortgage loan portfolio was as follows:

STATE	PERCENT
Florida	16%
California	16%

The Company experienced no mortgage loan losses during 1998.

In April 1998, the Company completed its first REMIC securitization and thereby transferred $103 million (par value) of mortgage loans to collateral for mortgage backed bonds. In August 1998, the Company converted approximately $17 million (par value) of adjustable rate mortgage loans into FNMA mortgage securities, and in October and December the Company converted $56 million and $55 million (par value) of fixed rate mortgage loans into FNMA mortgage securities. Lastly, in October 1998, the Company completed a $318 million (par value) REMIC securitization accomplished through a taxable subsidiary of the Company, HCP-2. Simultaneously, the Company acquired from HCP-2 in exchange for all of the preferred stock of HCP-2, through two newly created REIT qualified subsidiaries, all of the investment grade securities, (except for the "AAA" rated securities), the unrated securities, the interest-only securities and the principal only securities from the security transaction. The table below summarizes the Company's 1998 securitization transactions (dollars in thousands):

1998 SECURITIZATION TRANSACTIONS

Month Completed	Mortgage Principal Balance on Transaction Date	Transaction Type	Mortgage Security Created
April	$102,977	REMIC	Private Placement
August	17,404	Swap	FNMA
October	317,764	REMIC	Private Placement
October	55,650	Swap	FNMA
December	55,208	Swap	FNMA

In December 1997, the Company purchased 15 ARM securities from various "Wall Street" dealers and in March of 1998 purchased a fixed rate FNMA certificate from another dealer firm. The ARM securities were purchased at a price of 103.72% of par value or $349,186,000 and the FNMA fixed rate mortgage security was purchased at a price of 105.125% of par or $4,333,000. In October 1998, due to (1) market dislocation, (2) desire to increase liquidity and decrease leverage and (3) rapid prepayments experienced on the Agency ARM securities, the Company sold all of its Agency ARM securities at a loss of $5,989,000.

During 1998 the Company completed three separate swap transactions with FNMA. In August 1998, the Company exchanged $17.4 million (par value) of adjustable rate mortgage loans in exchange for a like amount of mortgage securities in the form of five FNMA certificates. All of the mortgage certificates were subsequently sold with recourse in October 1998. In October and December 1998, the Company exchanged $55.6 million and $55.2 million respectively of fixed rate mortgage loans for a like amount of mortgage securities in the form of 19 and 31 FNMA certificates, respectively. The $55.6 million of mortgage securities represented by the 19 FNMA certificates were sold with recourse in October, several days after the loans were securitized. At December 31, 1998 the Company owned the fixed rate FNMA mortgage security (purchased in March 1998) and the 31 fixed rate FNMA mortgage securities that were acquired in December 1998.

In October 1998, the Company completed its second private placement REMIC securitization transaction through its newly organized unconsolidated subsidiary, HCP-2. Hanover contributed $324.2 million of fixed rate mortgage loans (with a par value of $318 million) subject to $310.0 million of reverse repurchase agreement financing to HCP-2 in exchange for a 99% economic ownership of HCP-2 (representing a 100% ownership of the non-voting preferred stock in HCP-2). HCP-2 issued a REMIC mortgage security and sold all of the REMIC securities except the "AAA" rated notes to two newly created wholly-owned subsidiaries of the Company (Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc.). The Company's investment at December 31, 1998 includes nine investment grade ("AA", "A" and "BBB") notes and six interest only notes.

At December 31, 1998 the Company had invested $78,478,000 or 15.2% of the Company's total assets in the following types of mortgage securities, collateralized by single-family mortgage loans, in accordance with the operating policies established by the Board of Directors:

Agency Mortgage Securities (1)	
December 31, 1998 adjusted principal	$58,462,000
Amortized cost basis	$59,641,000
Market value	$59,595,000
Weighted average net coupon	7.55%
Weighted average maturity (4)	250
Private Placement Mortgage Securities (2)	
December 31, 1998 adjusted principal	$18,096,000
Amortized cost basis	$21,236,000
Market value	$18,883,000
Weighted average net coupon (3)	23.43%
Weighted average maturity (4)	264

(1) all fixed rate mortgage securities

(2) includes subordinated fixed rate mortgage securities (AA through unrated tranches) plus interest-only tranches and principal-only tranches

(3) includes interest income generated from six interest only notes; see also table on page 48 for effective yield on these mortgage securities

(4) weighted average maturity reflects the number of months to maturity and does not assume any prepayment speeds.

The weighted average effective yield for the combined mortgage securities portfolio for 1998 was 5.170%.

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 (FHA, FHLMC or GNMA) 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 (77%) of the Company's acquisitions of single-family mortgage loan pools to date have been fixed rate loans, with the balance made up of adjustable rate mortgage ("ARM") loans.

The Company uses seven sales representatives from HCP, located in Illinois, Minnesota, 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 March 10, 1999, the Company had purchased since inception in excess of $1 billion of single-family mortgage loan pools. Also, at March 10, 1999 the Company did not have any commitments outstanding to purchase single-family mortgage pools.

One of the Company's unconsolidated subsidiaries, HCP, has a due diligence and consulting staff, located in Edison, New Jersey, consisting of approximately ten full-time employees and access to a part-time pool of employees in excess of 500. 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 accumulating additional information on loan pools through its due diligence operations, the Company believes it is better able to assess the value of loan pools.

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. During 1998, the Company purchased approximately 22% of the Company's single-family mortgage loan portfolio from one source (Residential Funding Corporation). Management believes that the loss of any single financial institution from which the Company purchases mortgage loans would not have any detrimental effect on the Company. The Company does not service its single-family mortgage loans. The servicing is outsourced to unrelated third parties specializing in single-family loan servicing.

The acquisition of single-family mortgage loans and subsequent securitization of such mortgage loans is the core business strategy of the Company. The purchase of Agency ARM's securities is not a part of the Company's core business strategy and is not expected to be pursued in the near term. Because the Company has access to HCP's due diligence operations, the Company may in the future consider purchasing non-investment grade mortgage securities of other issuers after a thorough evaluation of the underlying mortgage loan collateral. The Company may in the future purchase non-investment grade mortgage 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, created mortgage securities and, to a lesser extent, the purchased 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.

The Company purchases mortgages in bulk, after its bid has been accepted, subject to the Company's due diligence work. 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, credit scores and types of the loans. The proprietary stratification and pricing system identifies pool characteristics and segments loans by product type (i.e., fixed or adjustable rate, interest rate change frequency, ARM index, etc.). The segments are then further divided by credit quality using a logic program, which uses credit bureau scores and other criteria to grade loans within numerous categories. These categories include subdivisions such as loans eligible for sale/securitization to Fannie Mae or Freddie Mac (the "Agencies"), and further subdivisions of loans that only meet some Agency requirements, loans without mortgage insurance, loans with certain LTV and delinquency characteristics, etc.

Upon completion of the product segmentation and loan grading phase, the resulting pools are individually priced and totaled to determine an overall portfolio value. The effective pricing would require information on gross weighted average coupon, servicing fee, original term, weighted average maturity, remittance data, settlement data and ARM data (i.e. index, margin, rate and payment reset frequency, etc.).

By examining the mortgage pool loan data, a prepayment speed is selected based primarily upon the gross coupons and seasoning of the subject pool. After determination of a prepayment speed, the pools' cash flow stream is modeled. The present value of the cash flow stream is determined by discounting the cash flow by the current market rate for loans with similar product type and credit characteristics.

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, in most cases, 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 on sale of the single-family mortgage loan portfolio.

SINGLE-FAMILY MARKET TRENDS. The Company focuses on purchasing its 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 generally retains subordinated or other interests (including, for example, interest only tranches and principal only tranches). The investment grade tranches typically are not retained.

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 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. If the Company contracts out to a servicer the servicing of a mortgage loan pool, the servicer's responsibilities would include collection of the borrower's remittances, proper application of the borrower's remittances to principal, interest and escrow, remitting collections to the master servicer and remitting advances to the master servicer on delinquent loans (for principal and interest only). The master servicer would then remit funds and loan level documentation to the Company, or if the loan is securitized - to the trustee. The trustee would then distribute the funds to the certificate holders. Neither the Company nor any of its affiliates are involved in any single-family servicing operations.

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, which are financial firms (generally Wall Street firms) that purchase loans on real estate with the specific intention to convert the underlying mortgages to securities in the form of bonds. The origination transaction is usually "table-funded" whereby HCMC does not provide the funds for the mortgage loan origination but rather the funds are provided by the conduit. From direct borrower originations and its network of third party brokers, HCMC 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 1998. However, the Company originates 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 while HCMC subsequently has sold the mortgage loans to investors, the Company may in the future hold them in its 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 with the specific intent 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. HCMC 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. HCMC 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 HCMC origination level, a separate credit committee will approve all multifamily mortgage loans and commercial mortgage loans purchased by the Company for its Investment Portfolio. To date no multifamily mortgage loans or commercial mortgage loans have been purchased by the Company. The Company believes that, with prudent underwriting and due diligence, combined with the securitization option, it will achieve a satisfactory reward/risk ratio in purchasing such loans 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 HCP's sales representatives concentrate primarily on sourcing pools of single-family mortgage loans for the Company, they also can find leads for the multifamily and commercial mortgage loan origination business of HCMC.

COMMERCIAL AND MULTIFAMILY UNDERWRITING GUIDELINES. HCMC's underwriting guidelines for commercial and multifamily mortgage loans focus on the origination of loans eligible for securitization. The due diligence process generally 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., 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. Upon securitization of a pool of loans, the credit risk retained by the Company is generally limited to the Company's net investment in the retained mortgage securities. 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, 1998, HCMC serviced approximately $46 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 1990's.

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 retained interests in the security after securitization. The Company is structured to take advantage of efficiencies in such a 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.

INVESTMENT PORTFOLIO ACQUISITIONS

The Company's core business strategy is to acquire primarily single-family mortgage loans, securitize the mortgage loans and retain interests therein. The process for identifying possible mortgage pools in the secondary market for acquisition, bidding, due diligence and closing is time consuming. Once a bid is accepted, the process to conclude a successful purchase generally takes 30-60 days depending upon the complexity of each mortgage loan pool purchase.

During the accumulation period (ramp up period subsequent to Hanover's initial public offering (IPO) in September 1997 to full investment of the proceeds of the IPO) the Company could not invest exclusively in mortgage loans and chose to invest a portion of its leveraged capital in Agency ARM securities. At December 31, 1997 the Company had invested $348,131,000 or 67.3% of the Company's total assets in Agency ARM securities, and $160,970,000 or 31.1% of the Company's total assets in mortgage loans.

In October 1998, the Company sold off all of its Agency ARM securities at a loss of $5,989,000. The sale of these mortgage securities was part of an action plan taken by Management to reduce leverage and increase liquidity in response to the severe unanticipated dislocation in the financial markets at that time. These mortgage securities, never the core business of the Company, suffered from historically high prepayments, causing accelerated premium amortization and depressed market pricing.

The core business strategy of purchasing single-family mortgage loans was initiated in late September 1997 and continued successfully in 1998 with the purchase of $851.1 million in par value of mortgage loans and the successful completion of five securitization transactions in 1998.

DUE DILIGENCE AND CONSULTING OPERATIONS

The Company conducts due diligence and consulting 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 loans serviced 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. Consulting services include loan sale advisory work and brokering of mortgage loans for third parties. HCP also performs due diligence on mortgage loans acquired by the Company. The Company plans to devote increased attention to enhancing HCP's due diligence and consulting operations in 1999.

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 as 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 some form of long term financing. The Company had established committed and uncommitted mortgage asset financing agreements from various financial institutions at December 31, 1998 and is currently negotiating additional line of credit agreements with several other major financial institutions.

Reverse Repurchase Agreements

A reverse repurchase agreement ("repo"), 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 97%. 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 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 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.

There exists a risk during the initial holding of the mortgage loan assets, when the mortgage loan assets are financed with repo agreements, that adverse developments in the mortgage market could cause the repo lenders to reduce the mark to market on the mortgage loans collateralizing the repo agreements. A reduction in the repo lender's market value calculations could result in margin calls that could be in excess of the Company's liquid assets. In this situation, the Company might be forced to sell other portfolio assets to meet the repo lender's margin call. There also exists a risk during the initial holding period of the mortgage loan assets that there might be no demand or very limited demand for the creation of new mortgage securitizations. If this situation were to exist for an extended time period, the Company might be forced to maintain repo financing on its mortgage assets for a longer than intended period, which might cause repo financing availability to become more scarce and might cause repo financing terms to become more onerous for the Company.

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 normally securitizes the mortgage loans through the issuance of mortgage-backed securities. Such securitization generally will be in the form of collateralized mortgage obligations ("CMOs") but may also be in the form of REMICs. 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.

The Company may from time to time issue REMICs. REMIC transactions are generally accounted for as sales of the mortgage loans for tax purposes and can be accounted for as sales or financing for accounting purposes depending upon various criteria. 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 Hanover'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 is declining due to increases in interest rates.

The Company may also pay 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

CMOs or REMICs 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-collaterization 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 by 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, securities rated below "AAA" 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 (5% to 40% depending on the rating). 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 (delinquencies, aging, liens etc.).

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. 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 corresponding leverage adjustments, should help 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 single-family or commercial 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 that the Company may acquire from HCMC are subject 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 can be transferred to the Company's 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

For accounting purposes, the Company has three basic types of mortgage loans: (i) mortgage loans held for sale, (ii) mortgage loans held to maturity and (iii) mortgage loans held in securitized form. Fixed rate mortgage loans held for sale are generally hedged. A variety of hedging instruments may be used, depending on the asset or liability to be hedged and the relative price of the various hedging instruments. Possible hedging instruments include forward sales of mortgage securities, and may also include interest rate futures or options, interest rate swaps, and caps 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 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 acquiring originated mortgage loans from HCMC with prepayment penalties and utilizing various financial hedging instruments. 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 or REMIC financing, 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 currently used 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 use, but as yet has not used, mortgage derivative securities. Mortgage derivative securities can be used as 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 Company will limit its purchases of mortgage derivative securities to investments that meet REIT requirements. To a lesser extent, the Company may also enter into, but again has not entered 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 currently utilizes interest rate caps and forward sales of Agency mortgage securities and may utilize other hedging strategies, including mandatory and optional forward selling of mortgage loans or mortgage-backed securities, interest rate 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.

As of December 31, 1998, the Company had entered into the following hedging mechanisms: forward sales of Agency mortgage securities and interest rate caps. The forward sales of Agency mortgage securities are used to provide hedge protection against potential changes in the market value of certain of the Company's fixed rate mortgage loan portfolio, due to potential changes in current market interest rates. The Company only hedges its fixed rate mortgage loan pools by selling short similar coupon and duration matched Agency securities, usually for 30 to 60 day periods. This hedging of mortgage assets should, if properly executed, adjust the carrying value of the hedged fixed mortgage loan pools to reflect current market pricing. The costs of the individual hedging transactions can vary greatly depending upon market conditions. Net hedging costs of fixed rate mortgage pools were $541,000, $1,287,000, $2,632,000 and $1,091,000 in the first, second, third and fourth quarters of 1998, respectively. Management is satisfied that the Company's hedging program has been utilized effectively as no charges relating to the impairment of mortgage loans were booked in 1998.

The Company also enters into interest rate hedge mechanisms (interest rate caps) to manage its interest rate exposure on certain reverse repurchase agreement financing. The cost of the interest rate caps is amortized over the life of the interest rate cap and is reflected as a portion of interest expense in the consolidated statement of operations.

The FASB issued SFAS 133 Accounting for Derivative Instruments and Hedging Activities ("SFAS 133") in June 1998. SFAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments imbedded in other contracts and for hedging activities. SFAS is effective for fiscal quarters beginning after June 15, 1993. Management's preliminary evaluation of SFAS 133 indicates the implementation of SFAS 133 will not result in any material changes to the Company's consolidated statement of operations.

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 by the Company (along with purchased single-family mortgage loans or purchased multifamily mortgage loans and commercial mortgage loans) or created by HCMC (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 respective entity.

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.

REGULATION

HCMC has mortgage-banking licenses in Arizona, Illinois, New Jersey, 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.

HCS is a registered broker/dealer with the Securities and Exchange Commission.

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 four employees (the "Principals") at December 31, 1998. 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, 1998, HCP employed 50 people on a full-time basis and 40 people on a part-time basis. HCP periodically hires additional employees on a temporary basis to perform due diligence and consulting service work on specific engagements. HCP maintains a database of approximately 500 individuals that can be employed for due diligence and consulting engagements. To date, the Company and its subsidiaries believe they have been successful in their efforts to recruit qualified employees, but there is no assurance that it will continue to be successful in the future. None of the 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.

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.

A REIT is subject to a 100% tax on the net income from prohibited transactions. The only "prohibited transaction" is the sale or disposition of property, that is not foreclosure property, held primarily for sale to customers in the ordinary course of a trade or business. Management believes that none of the 1998 sales transactions would be classified as prohibited transactions.

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 had 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.

After the closing of the initial public offering in September 1997, the Company acquired an Investment Portfolio, the composition of which has changed over time. HCP has continued to conduct the due diligence and consulting operations and, in addition, support the Company's acquisition and investment activities by providing due diligence services to the Company. HCMC 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. HCS facilitates the Company's trading activities by acting as a broker/dealer.

MANAGEMENT AGREEMENT

Effective as of January 1, 1998, Hanover entered into a Management Agreement (the "Management Agreement") with HCP. Under this agreement, HCP, subject to the direction and control of Hanover's Board of Directors, provides certain services for Hanover, including, among other things: (i) serving as Hanover's consultant with respect to formulation of investment criteria and preparation of policy guidelines by the Board of Directors; (ii) assisting Hanover in developing criteria for the purchase of mortgage assets that are specifically tailored to Hanover's investment objectives; (iii) representing Hanover 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 Hanover regarding Hanover's activities and the services performed for Hanover 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 Hanover 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 Hanover; and (ix) administering the day-to-day operations of Hanover. For these services, Hanover pays HCP for each month an amount equal to the sum of (a) 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 Hanover for such month, plus (b) twenty-five percent (25%) of (a). Hanover also is required to pay HCP for each month an amount equal to the sum of (c) the expenses 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 Hanover for any services provided by Hanover 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 resolve to terminate the Management Agreement.

FEDERAL INCOME TAX CONSIDERATIONS

General

Hanover 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 Hanover 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 Hanover's after-tax cash available for distribution to its shareholders would be reduced. Hanover believes it has satisfied the requirements for qualification as a REIT since commencement of its operations in September 1997. Hanover 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, Hanover must meet certain tests which are described briefly below.

Ownership of Common Stock

For all taxable years after its first taxable year, Hanover'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 Hanover may be owned directly or indirectly by five or fewer individuals. Hanover 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 Hanover has 200 or fewer shareholders of record, from persons holding 0.5% or more of Hanover's outstanding shares of capital stock) regarding their ownership of shares. Hanover must keep a list of those shareholders who fail to reply to such a demand. Hanover is required to use and does use the calendar year as its taxable year for income.

Nature of Assets

On the last day of each calendar quarter, Hanover must satisfy three tests relating to the nature of its assets. First, at least 75% of the value of Hanover'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. Hanover expects that substantially all of its assets will continue to be Qualified REIT Assets. Second, not more than 25% of Hanover'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 Hanover's total assets, and Hanover may not own more than 10% of any one issuer's outstanding voting securities. Pursuant to its compliance guidelines, Hanover intends to monitor closely the purchase and holding of its assets in order to comply with the above asset tests.

Sources of Income

Hanover must meet the following two separate income-based tests each year:

1. 75% INCOME TEST. At least 75% of Hanover'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 will also qualify under the 75% income test. The investments that Hanover 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 Hanover'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. Hanover intends to limit substantially all of the assets that it acquires to Qualified REIT Assets. The policy of Hanover to maintain REIT status may limit the types of assets, including hedging contracts and other securities, that Hanover otherwise might acquire.

Distributions

Hanover 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". Hanover intends to make distributions to its shareholders in sufficient amounts to meet this 95% distribution requirement.

Taxation of Hanover's Shareholders

For any taxable year in which Hanover is treated as a REIT for Federal income tax purposes, amounts distributed by Hanover 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 Hanover as capital gain dividends. Distributions of Hanover will not be eligible for the dividends received deduction for corporations. Shareholders may not deduct any net operating losses or capital losses of Hanover. Any loss on the sale or exchange of shares of the common stock of Hanover 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 Hanover 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 Hanover's shares. Hanover will withhold 30% of dividend distributions to shareholders that Hanover knows to be foreign persons unless the shareholder provides Hanover with a properly completed IRS form claiming a reduced withholding rate under an applicable income tax treaty.

Under the Code, if a portion of Hanover's assets were treated as a taxable mortgage pool or if Hanover were to hold REMIC residual interests, a portion of Hanover's dividends would be treated as unrelated business taxable income ("UBTI") for pension plans and other tax exempt entities. Hanover believes that it has not engaged in activities that would cause any portion of Hanover's income to be taxable as UBTI for pension plans and similar tax exempt shareholders. Hanover 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. Hanover 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 and its unconsolidated subsidiaries 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 ANNUAL RENTAL	EXPIRATION DATE	OFFICE USE
New York, New York (a)	7,863	$158,800	July 2009	Executive, Administration, Accounting, Investment Operations
Edison, New Jersey	5,834	75,900	June 2002	Accounting, Administration, Due Diligence Operations, Mortgage Loan Servicing, Investment Operations
Edison, New Jersey	1,182	25,000	August 2002	Due Diligence Operations
Chicago, Illinois (b)	1,151	49,500	February 2004	Due Diligence Operations, Investment Operations
St. Louis, Missouri	1,007	22,200	August 2001	Mortgage Origination Operations
Rockland, Massachusetts	300	6,000	Month to Month	Investment Operations
St. Paul, Minnesota	150	6,000	August 1999	Investment Operations
Total:	17,487	$343,400		

(a) HCP entered into an amendment to the existing office lease in December 1998 to relocate from its existing office space (2,328 sq. ft.) to larger office space (7,863 sq. ft.) in the same office building; the new office space is expected to be ready for occupancy once the construction of the space is completed (May 1999); the above minimum annual rent reflects 4 months of base rental costs for the existing office space and 8 months of base rental costs for the new office space.

(b) HCP entered into a new lease for office space (1,151 sq. ft.) effective February 1999; HCP is still obligated on its existing office lease (3,905 sq. ft.) through June 1999; the above minimum annual rent reflects 6 months of base rental costs for the existing office space and 10 months of base rental costs for the new office space.

Management of the Company believes that these facilities are adequate for the Company's and its unconsolidated subsidiaries foreseeable office space 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 proceeding. However, an affiliate of the Company, HCMC, was a party to the legal proceeding described below.

In November 1998, HCMC made a payment of $20,000 to Quarters on Melody Lane Partnership ("Quarters") in full and final settlement of a lawsuit brought against HCMC by Quarters in 1997, 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 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 prepayment penalties. The initial principal balance of the multifamily mortgage loan, which closed in June 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 were not 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. While HCMC denied that its representatives made any misrepresentations to Quarters, Quarters filed suit against HCMC and others as defendants, in District Court in Dallas County, Texas. The complaint alleged 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 and seeking punitive damages in the amount of $1,000,000.

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

Not applicable

PART II

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

In September 1997, Hanover raised net proceeds of approximately $79 million in its initial public offering (the "IPO"). In the IPO, Hanover sold 5,750,000 units (each unit consists of one share of common stock, par value $.01 and one stock warrant) including 750,000 units sold pursuant to the underwriters' over-allotment 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 expire on September 15, 2000. As of December 31, 1998, there were 5,917,878 warrants outstanding, including 172,500 warrants issued pursuant to the underwriters' over-allotment option. Hanover utilized substantially all of the net proceeds of the IPO to fund leveraged purchases of mortgage assets.

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 March 10, 1999, Hanover had 6,126,899 shares of common stock issued and outstanding, which was held by 84 holders of record and approximately 2,000 beneficial owners.

The following tables set forth, for the periods indicated, the high, low and closing sales price of Hanover's securities as reported on the American Stock Exchange in 1997 and 1998.

	UNIT PRICES		
	High	Low	Close
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
First Quarter Ended March 31, 1998	21 7/8	16 1/4	19 1/16
Second Quarter Ended June 30, 1998	20 13/16	10 5/8	10 5/8
Third Quarter Ended September 30, 1998	11 3/4	7 1/4	7 1/4
Fourth Quarter Ended December 31, 1998	7 1/4	3 1/2	4 3/16

	COMMON STOCK		
	High	Low	Close
First Quarter Ended March 31, 1998 (a)	16 1/2	16 1/8	16 1/4
Second Quarter Ended June 30, 1998	17 3/8	9 1/2	9 1/2
Third Quarter Ended September 30, 1998	10 3/8	6 7/8	6 7/8
Fourth Quarter Ended December 31, 1998	6 7/8	3 1/2	4

	WARRANTS		
	High	Low	Close
First Quarter Ended March 31, 1998 (a)	3 7/8	3 1/8	3 1/8
Second Quarter Ended June 30, 1998	3 3/4	1 1/8	1 1/8
Third Quarter Ended September 30, 1998	1 3/8	3/16	3/16
Fourth Quarter Ended December 31, 1998	3/8	5/16	1/8

The following table sets forth, for the periods indicated, Hanover's dividends declared for each quarter:

	DIVIDENDS DECLARED
Quarter Ended June 30, 1997 (b)	--
Quarter Ended September 30, 1997 (b)	--
Quarter Ended December 31, 1997	$0.16
Quarter Ended March 31, 1998	$0.21
Quarter Ended June 30, 1998	$0.21
Quarter Ended September 30, 1998	$0.17
Quarter Ended December 31, 1998	$0.11

(a) common stock and warrants were first listed on the American Stock Exchange on March 20, 1998
(b) Hanover was incorporated in June 1997; operations did not begin until September 1997

Hanover 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 quality for the tax benefits accorded to a REIT under the Code. To the extent that Hanover records capital gain income in future years, this income does not need to be distributed as dividends to shareholders to the extent of unutilized capital losses recorded in 1998 (approximately $6,700,000). All distributions will be made by Hanover at the discretion of the Board of Directors and will depend on the earnings of Hanover, financial condition of Hanover, 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 consolidated financial statements of Hanover for the year ended December 31, 1998 and for the period from June 10, 1997 (inception) to December 31, 1997. The selected financial data should be read in conjunction with the more detailed information contained in the Consolidated Financial Statements and Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Form 10-K (dollars in thousands, except per share data):

STATEMENT OF OPERATIONS HIGHLIGHTS	Year Ended December 31, 1998	Period from June 10 (inception) to December 31, 1997
Net interest income	$ 6,623	$ 1,676
Loan loss provision	(356)	(18)
Gain (loss) on sale of assets	(5,704)	35
Total revenues	563	1,693
Expenses	4,064	940
Operating income (loss)	(3,501)	753
Equity in (loss) of unconsolidated subsidiaries	(1,433)	(254)
Net income (loss)	$ (4,934)	$ 499
Basic earnings (loss) per share	$ (0.77)	$ 0.15
Diluted earnings (loss) per share	$ (0.77)	$ 0.14
Dividends declared per share	$ 0.70	$ 0.16

BALANCE SHEET HIGHLIGHTS	December 31, 1998	December 31, 1997
Mortgage loans	$ 407,994	$ 160,970
Mortgage securities	78,478	348,131
Cash and cash equivalents	11,837	4,022
Other assets	17,861	4,420
Total assets	$ 516,170	$ 517,543
Reverse repurchase agreements	$ 370,090	$ 435,138
Mortgage backed bonds	77,305	--
Other liabilities	2,995	4,307
Total liabilities	450,390	439,445
Stockholders' equity	65,780	78,098
Total liabilities and stockholders' equity	$ 516,170	$ 517,543
Number of common shares outstanding	6,321,899	6,466,677

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

OVERVIEW

Hanover Capital Mortgage Holdings, Inc. ("Hanover") was incorporated in Maryland on June 10, 1997. Hanover acquired three bankruptcy remote limited purpose finance subsidiaries in 1998 in order to complete two significant mortgage loan securitization transactions. In March 1998, Hanover acquired 100% of the common stock of Hanover Capital SPC, Inc. and in October 1998 acquired 100% of the common stock of Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc. Hanover is a real estate investment trust ("REIT"), formed to operate as a specialty finance company. The principal business strategy of Hanover and its wholly owned subsidiaries, Hanover Capital SPC, Inc., Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc. (together referred to as the "Company") and its unconsolidated subsidiaries 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 loans and (iv) acquire multifamily 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 an unconsolidated subsidiary of the Company.

Hanover Capital SPC, Inc., a wholly-owned subsidiary of Hanover, was incorporated in Delaware on March 24, 1998 for the sole purpose of issuing mortgage notes through a private placement (REMIC) offering. Hanover Capital SPC, Inc. transferred all of it retained securities to its wholly owned subsidiary, Hanover Capital Repo Corp. Hanover Capital Repo Corp. was incorporated in Delaware on March 26, 1998.

Hanover QRS-1 98-B, Inc., a wholly owned subsidiary of Hanover, was incorporated in Delaware on October 16, 1998 for the sole purpose of owning certain investment grade mortgage securities acquired from Hanover Capital Partners 2, Inc. ("HCP-2"), an unconsolidated subsidiary of Hanover.

Hanover QRS-2 98-B, Inc., a wholly owned subsidiary of Hanover, was incorporated in Delaware on October 19, 1998 for the sole purpose of owning certain investment grade and subordinated mortgage securities acquired from HCP-2.

RESULTS OF OPERATIONS

GENERAL

Hanover was organized on June 10, 1997, but did not commence operations until September 19, 1997 (the date of the IPO closing). The Company had a net loss in 1998 of $4,934,000 or a loss of $0.77 per share based on a weighted average of 6,418,305 shares of common stock outstanding. In the previous year, for the period from June 10, 1997, (inception) to December

31, 1997 the Company's net income was $499,000 or $0.15 per share based on a weighted average of 3,296,742 shares of common stock outstanding.

The core business of the Company, acquiring single-family mortgage loans and subsequently securitizing mortgage loans and retaining interests therein, generated net interest income of $6,880,000 in 1998 as compared to $1,051,000 in 1997, (the initial start-up year reflected only three full months of operations).

The Company's investment in purchased mortgage securities reflected negative net interest income of $1,335,000 in 1998. Most of the mortgage securities were held for a period of slightly more than nine months in 1998 as compared to a one month holding period in 1997, which generated net interest income of $202,000. The majority of the purchased mortgage securities were adjustable rate Agency mortgage securities collateralized by adjustable rate mortgages that experienced extremely high prepayment speeds during 1998.

Net interest income generated from notes receivable to affiliates and investments of excess cash and cash collateral on deposit with repo lenders aggregated $1,070,000 in 1998 (for a full 12 month period) compared to $423,000 in 1997 (a period of slightly more than 3 months).

The most significant contributor to the 1998 net loss was the loss on the sale of purchased mortgage securities. In October 1998, the Company sold all of its purchased adjustable rate Agency mortgage securities at a loss of $5,989,000. In October 1998, the Company also sold (i) certain adjustable rate FNMA mortgage securities (that the Company received in a swap for certain adjustable rate mortgage loans) at a loss of $161,000 and (ii) certain fixed rate FNMA mortgage securities (that the Company received in a swap for certain fixed rate mortgage loans) at a gain of $495,000. Lastly, the Company also sold a pool of mortgage loans in April 1998 at a loss of $49,000.

Operating expenses in 1998 totaled $4,064,000 (a full year) compared to $940,000 for the period September 19 to December 31, 1997. Expenses directly related to acquisitions of mortgage loans (management and administration, due diligence and commissions) totaled $1,706,000 in 1998 as compared to $523,000 in 1997. The Company reflected significant increases in certain operating expenses in 1998, particularly with respect to legal and professional and financing/commitment fees, as the Company began securitizing mortgage loans in different formats beginning in the second quarter of 1998.

Another significant contributor to the Company's net loss in 1998 was the loss recorded from the Company's investment in HCP (for a full year of operations) of $1,039,000 and HCP-2 (for a period in excess of two months) of $394,000. The net loss generated from the Company's investment in HCP in 1997 (for a period of approximately 3 1/2 months) was $254,000.

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(Loss)/ Equity	Gain (loss) on Sale of Assets/ Equity	Operating Expenses/ Equity	Equity in Earnings (Loss) of Subsidiaries/ 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%
March 31, 1998	10.78%	0.00%	4.37%	(0.03%)	6.38%
June 30, 1998	3.47%	(0.25%)	5.00%	(1.50%)	(3.28%)
September 30, 1998	8.23%	0.00%	4.89%	(1.52%)	1.82%
December 31, 1998	11.12%	(32.76%)	7.55%	(4.89%)	(34.08%)

(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 balance at September 19, 1997 (IPO date) and equity balance at September 30, 1997, excluding unrealized loss on investments available for sale.

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 periods shown below (dollars in thousands):

	Quarter Ended March 31, 1998		Quarter Ended June 30, 1998		Quarter Ended September 30 1998		Quarter Ended December 31, 1998	
	Average Balance	Effective Rate	Average Balance	Effective Rate	Average Balance	Effective Rate	Average Balance	Effective Rate
Interest Earning Assets								
Mortgage loans (1)	$216,275	7.410%	$370,811	7.371%	$566,456	7.489%	$465,445	7.392%
Collateral for mortgage backed bonds (1)			92,272	7.158%	91,980	7.071%	86,477	6.230%
Mortgage securities (2)	334,722	6.116%	281,933	3.992%	243,299	4.528%	72,938	7.520%
	$550,997	6.624%	$745,016	6.066%	$901,735	6.648%	$624,860	7.246%
Interest Bearing Liabilities								
Reverse repurchase borrowings on mortgage loans	$166,881	6.318%	$332,424	6.452%	$523,403	6.377%	$447,915	6.422%
Mortgage backed bonds			88,069	6.901%	87,524	6.916%	80,522	6.926%
Reverse repurchase borrowings on collateral for mortgage backed bonds			1,076	7.031%	203	6.145%	1,760	6.616%
Reverse repurchase borrowings on mortgage securities	324,305	5.597%	272,176	5.616%	241,388	5.701%	58,332	5.636%
	$491,186	5.842%	$693,745	6.241%	$852,518	6.364%	$588,529	6.535%
Net Interest Earning Assets	$ 59,811		$ 51,271		$ 49,217		$ 36,331	
Net Interest Spread		0.782%		(0.175%)		0.284%		0.711%
Yield on Interest Earning Assets (3)		13.046%		3.700%		11.562%		18.769%

	PERIOD FROM SEPTEMBER 30 TO DECEMBER 31, 1997	
	Average Balance	Effective Rate
Interest Earning Assets:		
Mortgage loans (1)	$ 83,776	7.317%
Mortgage securities (2)	116,375	6.268%
	$ 200,151	6.707%
Interest Bearing Liabilities		
Reverse repurchase borrowings on mortgage loans	$ 32,674	6.313%
Reverse repurchase borrowings on mortgage securities	113,803	5.723%
	$ 146,477	5.855%
Net Interest Earning Assets	$ 53,674	
		0.852%
Net Interest Spread		
Yield on Net Interest Earnings Assets (3)		9.034%

(1) Includes mortgage loans held for sale and mortgage loans held to maturity. Loan loss provisions are excluded in the above calculations.
(2) Loan loss provisions are excluded in the above calculations.
(3) Yield on Net Interest Earning Assets is computed by dividing the applicable net interest income by the average daily balance of Net Interest Earning Assets.

NET INTEREST INCOME

The combined 1998 net interest income generated from the Company's core business is reflected in the table below (dollars in thousands):

	Quarter Ended March 31, 1998	Quarter Ended June 30, 1998	Quarter Ended September 30, 1998	Quarter Ended December 31, 1998	Total
Mortgage loans	$1,371	$1,412	$2,076	$1,251	$6,110
Collateral for mortgage backed bonds		113	109	(77)	145
FNMA mortgage securities	--	--	41	65	106
Private placement mortgage securities	--	--	--	519	519
	$1,371	$1,525	$2,226	$1,758	$6,880

The following table reflects the average balances for each major category of the Company's core business interest earning assets as well as the Company's interest bearing liabilities with the corresponding effective rate of interest annualized for the periods shown below (dollars in thousands):

	Quarter Ended March 31, 1998		Quarter Ended June 30, 1998		Quarter Ended September 30 1998		Quarter Ended December 31, 1998	
	Average Balance	Effective Rate	Average Balance	Effective Rate	Average Balance	Effective Rate	Average Balance	Effective Rate
Interest Earning Assets								
Mortgage loans	$216,275	7.410%	$370,811	7.371%	$566,455	7.489%	$465,445	7.392%
Collateral for mortgage backed bonds			92,272	7.158%	91,980	7.071%	86,477	6.230%
Mortgage securities					11,665	7.429%	38,340	10.187%
	$216,275	7.410%	$463,083	7.329%	$670,100	7.429%	$590,262	7.403%
Interest Bearing Liabilities								
Reverse repurchase borrowings on mortgage loans	$166,882	6.318%	$332,424	6.452%	$523,403	6.377%	$447,915	6.422%
Mortgage backed bonds			88,069	6.901%	87,524	6.916%	80,522	6.926%
Reverse repurchase borrowings on collateral for mortgage backed bonds			1,076	7.031%	203	6.145%	1,760	6.616%
Reverse repurchase borrowings on mortgage securities					11,351	5.952%	26,947	5.824%
	$166,882	6.318%	$421,569	6.604%	$622,481	6.567%	$557,144	6.581%
Net Interest Earning Assets	$49,393		$41,514		$ 47,619		$33,118	
Net Interest Spread		1.092%		0.725%		0.862%		0.822%
Yield on Interest Earning Assets		11.099%		14.689%		18.698%		21.233%
Yield on Interest Earning Assets [after adjustment to include net interest income and capital (net interest earning assets) of HCP-2]		11.099%		14.689%		18.698%		14.978%

CORE BUSINESS - MORTGAGE LOANS

Net interest income generated from investments in mortgage loans (classified as held for sale and held to maturity) during 1998 is detailed below (dollars in thousands):

Mortgage Loans	Quarter Ended March 31, 1998	Quarter Ended June 30, 1998	Quarter Ended September 30, 1998	Quarter Ended December 31, 1998
Average asset balance	$216,275	$370,811	$566,455	$465,445
Average repo balance	166,882	332,424	523,403	447,915
Net interest earning assets	$ 49,393	$ 38,387	$ 43,052	$ 17,530
Average leverage ratio	77.162%	89.648%	92.400%	96.234%
Effective interest income rate	7.410%	7.371%	7.489%	7.392%
Effective interest expense rate	6.318%	6.452%	6.377%	6.422%
Net interest spread	1.092%	0.919%	1.112%	0.970%
Interest income	$ 4,006	$ 6,833	$ 10,606	$ 8,602
Interest expense	2,635	5,421	8,530	7,351
Net interest income	$ 1,371	$ 1,412	$ 2,076	$ 1,251
Yield on net interest earning assets	11.099%	14.712%	19.285%	28.543%

The Company's core business of acquiring single-family seasoned mortgage loans and holding the loans prior to making a determination as to whether the mortgage loans will be securitized generated net interest income of $6,110,000 in 1998.

The average mortgage loan balance increased on a quarter to quarter basis through September, as the Company purchased mortgage loan product at an average rate of approximately $250 million per quarter during this time. Only $91 million of mortgage loans were purchased in the fourth quarter of 1998. In April 1998, the Company completed its first REMIC securitization and thereby transferred $103 million (par value) of mortgage loans to collateral for mortgage backed bonds. In August 1998, the Company converted approximately $17 million (par value) of adjustable rate mortgage loans into FNMA mortgage securities, and in October and December 1998, the Company converted $56 million and $55 million (par value) of fixed rate mortgage loans into FNMA mortgage securities. Lastly, in October 1998, the Company completed a $318 million (par value) REMIC securitization accomplished through a taxable subsidiary of the Company, HCP-2. This transaction required the Company to contribute mortgage loans net of the respective reverse repurchase financing to HCP-2 in exchange for all of the preferred stock of HCP-2. Simultaneously, the Company acquired from HCP-2, through two newly created REIT qualified subsidiaries, all of the investment grade securities (except for the "AAA" rated securities), the unrated securities, the interest only securities and the principal only securities from the security transaction.

The purchase of mortgage loans was accomplished through reverse repurchase agreement financing and equity. In the early part of 1998 the Company used equity to the extent possible to fund the purchase of mortgage loans. The average leverage ratio increased significantly in the last half of 1998 as the Company implemented a plan to increase liquidity, which effectively reduced the amount of capital employed.

The effective interest income rate (after adjusting for the amortization of premium, discounts and certain deferred costs) on the mortgage loan portfolio remained fairly consistent during the year. Prepayments on various mortgage pools fluctuated during the year but overall the prepayment speed remained at slightly higher than expected levels (20%-25%). The financing costs on the mortgage pools varied from a low of 6.318% in the first quarter of 1998 to 6.452% in the second quarter of 1998. Interest rates are almost exclusively indexed to LIBOR. The decreases in interest rates in 1998 resulted in larger net interest spreads to the benefit of the Company, particularly in the third quarter of 1998. The Company's interest expense rates rose slightly in the fourth quarter as compared to the third quarter due to a short term financing agreement entered into in November. The interest rate charged on this financing agreement was 8.006% in the fourth quarter of 1998.

CORE BUSINESS - COLLATERAL FOR MORTGAGE BACKED BONDS

Net interest income generated from collateral for mortgage backed bonds during 1998 is detailed below (dollars in thousands):

Collateral for mortgage backed bonds	Quarter Ended March 31, 1998	Quarter Ended June 30, 1998	Quarter Ended September 30, 1998	Quarter Ended December 31, 1998
Average asset balance	0	$ 92,272	$ 91,980	$ 86,477
Average mortgage backed bonds balance	0	88,069	87,524	80,522
Average repo balance	0	1,076	203	1,760
Net interest earning assets	0	$ 3,127	$ 4,253	$ 4,195
Average leverage ratio	N/A	95.445%	95.155%	93.113%
Effective interest income rate	N/A	7.158%	7.071%	6.230%
Effective interest expense rate	N/A	6.903%	6.915%	6.919%
Net interest spread	N/A	0.255%	0.156%	(0.689)%
Interest income	0	$ 1,651	$ 1,625	$ 1,346
Interest expense	0	1,538	1,516	1,423
Net interest income	0	$ 113	$ 109	$ (77)
Yield on net interest earning assets	N/A	14.413%	10.291%	(7.346)%

In April 1998 the Company securitized (through a wholly owned subsidiary of the Company - Hanover Capital SPC, Inc.) $102,977,000 (par value) of mortgage loans. This securitization was accomplished in a REMIC format which was accounted for as a financing for GAAP purposes and as a sale for tax purposes.

In a financing, the Company continues to record 100% of the interest income, net of servicing fees, generated by the mortgage loans. The primary source of financing for these mortgage loans is the mortgage backed bonds. This financing represents the liability for the investment grade mortgage bonds not retained by the Company - $77,305,000 at December 31, 1998. The interest expense on this financing represents the coupon interest amount to be paid to the investment grade bond holders. The Company's net equity in the secured transaction represents the non-investment grade, interest only and principal only bonds. The Company's net equity investment in collateral for mortgage backed bonds can also be leveraged through reverse repurchase financing. At December 31, 1998 the Company had $1,911,000 of reverse repurchase financing on a portion of the collateral for mortgage backed bonds ($2,542,000). The coupon interest rates on the bonds, except for the interest only and principal only bonds, have fixed coupon interest rates of 6.75% and 7.00%. The interest only bonds generate monthly interest from the excess interest generated on the underlying mortgages after deducting all service fees and the coupon interest rate on the applicable bonds. The interest rate on each of the interest only bonds is based on a notional amount (the principal balance of those mortgage loans with an interest rate in excess of the related bonds coupon interest rate). The notional amounts decline each month to reflect the related normal principal amortization, curtailments and prepayments for the related underlying mortgage loans. Accordingly, the effective interest rate will decline as prepayments on the underlying mortgages with interest rates in excess of the coupon rates accelerate. The mortgage loans collateralizing the mortgage backed bonds experienced prepayment speeds over the last six months of 1998 of approximately 26%. These prepayment speeds were higher than anticipated. Accordingly, in the fourth quarter of 1998 the Company booked an additional premium amortization adjustment (decreasing interest income) of $145,000.

Interest expense includes the interest on the mortgage backed bonds, interest on the related reverse repurchase agreements and amortization of certain deferred financing costs.

CORE-BUSINESS - FNMA MORTGAGE SECURITIES (SWAPPED FOR THE COMPANY'S MORTGAGE LOANS)

Net interest income generated from investments in FNMA mortgage securities that were converted from the Company's mortgage loans during 1998, is detailed below (dollars in thousands):

FNMA mortgage securities (swapped)	Quarter Ended March 31, 1998	Quarter Ended June 30, 1998	Quarter Ended September 30, 1998	Quarter Ended December 31, 1998
Average asset balance	0	0	$11,665	$24,894
Average repo balance	0	0	11,351	24,163
Net interest earning assets	0	0	$ 314	$ 731
Average leverage ratio	N/A	N/A	97.311%	97.067%
Effective interest income rate	N/A	N/A	7.429%	5.778%
Effective interest expense rate	N/A	N/A	5.952%	5.693%
Net interest spread	N/A	N/A	1.477%	0.085%
Interest income	0	0	$ 213	$ 416
Interest expense	0	0	172	351
Net interest income	0	0	$ 41	$ 65
Yield on net interest earning assets	N/A	N/A	52.001%	35.457%

During 1998 the Company completed three separate swap transactions with FNMA. In August 1998, the Company exchanged $17.4 million (par value) of adjustable rate mortgage loans in exchange for a like amount of mortgage securities in the form of five FNMA certificates. All of the mortgage certificates were subsequently sold with recourse in October 1998. In October and December 1998, the Company exchanged $55.6 million and $55.2 million, respectively of fixed rate mortgage loans for a like amount of mortgage securities in the form of 19 and 31 FNMA certificates, respectively. The $55.6 million of mortgage securities represented by the 19 FNMA certificates was sold with recourse in October, several days after the loans were securitized.

CORE BUSINESS - PRIVATE PLACEMENT MORTGAGE SECURITIES (PURCHASED FROM A RELATED PARTY)

Net interest income generated from private placement securities purchased from an affiliate, HCP-2, in October 1998 is detailed below (dollars in thousands):

Private placement mortgage securities	Quarter Ended March 31, 1998	Quarter Ended June 30, 1998	Quarter Ended September 30, 1998	Quarter Ended December 31, 1998 (1)
Average asset balance	0	0	0	$13,446
Average - repo balance	0	0	0	2,784
Net interest earning assets	0	0	0	$10,662
Average leverage ratio	N/A	N/A	N/A	20.707%
Effective interest income rate	N/A	N/A	N/A	16.662%
Effective interest expense rate	N/A	N/A	N/A	5.729%
Net interest spread	N/A	N/A	N/A	10.933%
Interest income	0	0	0	$ 560
Interest expense	0	0	0	41
Net interest income	0	0	0	$ 519
Yield on net interest earning assets	N/A	N/A	N/A	19.484%

(1) This table does not reflect the Company's combined overall effective yield and the Company's total investment in private placement mortgage securities because the table does not reflect net interest income of and equity employed by the Company's unconsolidated subsidiary, HCP-2. See the table on page 48 that reflects the Company's combined overall yield and total net interest earning assets employed.

In October 1998 the Company completed its second private placement REMIC securitization transaction through its newly organized unconsolidated subsidiary, HCP-2. The Company contributed $324.2 million of fixed rate mortgage loans (with a par value of $318 million) subject to $310.0 million of reverse repurchase agreement financing to HCP-2 in exchange for a 99% economic ownership of HCP-2 (representing a 100% ownership of the non-voting preferred stock of HCP-2). HCP-2 issued a REMIC mortgage security and sold all of the REMIC securities except the "AAA" rated notes to two newly created wholly-owned subsidiaries of the Company (Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc.). The Company's investment at December 31, 1998 includes nine investment grade ("AA", "A" and "BBB") notes and six interest only notes. The interest rates on the investment grade notes are fixed and range from 6.25% to 6.75%. These notes generate normal principal and interest remittances to the Company on a monthly basis. The interest only notes generate monthly interest remittances to the Company (subject to the availability of funds) from the excess interest generated from the underlying mortgages after deducting all service fees and the coupon interest rate on the applicable notes. The interest rate on each of the interest only notes is based on a notional amount (the principal balance of those mortgage loans with an interest rate in excess of the related note coupon interest rate). The notional amounts decline each month to reflect the related normal principal amortization, curtailments and prepayments for the related underlying mortgage loans. At December 31, 1998 the interest only notes were divided into two major categories; the first group had an effective weighted average interest rate of 1.166% on a notional balance of $259,861,000 and the second group had an effective weighted average interest rate of 0.255% on a notional balance of $143,666,000.

The interest only notes serve to significantly increase the overall yield of the mortgage securities portfolio (16.662% for the fourth quarter of 1998). The interest only notes, however, will be adversely affected more than other notes by higher than expected prepayment speeds on underlying mortgage loans with interest rates in excess of the net coupon rate. In all likelihood mortgages with higher interest rates will be repaid more rapidly than mortgages with lower interest rates. Accordingly, the effective yield generated by this portfolio is expected to decrease over time. The underlying mortgage loans were prepaying at an annualized speed of approximately 29% in 1998, slightly higher than expected.

NON-CORE BUSINESS - PURCHASED AGENCY MORTGAGE SECURITIES

Net interest income (loss) generated from purchased Agency mortgage securities in 1998 is detailed below:

Purchased FNMA & FHLMC mortgage securities	Quarter Ended March 31, 1998	Quarter Ended June 30, 1998	Quarter Ended September 30, 1998	Quarter Ended December 31, 1998
Average asset balance	$334,722	$281,933	$231,634	$34,598
Average repo balance	324,305	272,176	230,037	31,385
Net interest earning assets	$ 10,417	$ 9,757	$ 1,597	$ 3,213
Average leverage ratio	96.888%	96.539%	99.310%	90.712%
Effective interest income rate	6.116%	3.992%	4.385%	4.564%
Effective interest expense rate	5.597%	5.616%	5.689%	5.584%
Net interest spread	0.519%	(1.624)%	(1.304)%	(1.020)%
Interest income	$ 5,118	$ 2,814	$ 2,541	$ 394
Interest expense	4,538	3,864	3,344	448
Net interest income (loss)	$ 580	$ (1,050)	$ (803)	$ (54)
Yield on net interest earning assets	22.273%	(43.054)%	(201.112)%	(6.608)%

In December 1997, the Company purchased 15 ARM securities from various "Wall Street" dealers and in March of 1998, purchased a fixed rate FNMA certificate from another dealer firm. The ARM securities were purchased at a price of 103.72% of par value or $349,286,000 and the FNMA fixed rate mortgage security was purchased at a price of 105.125% of par value or $4,333,000. These mortgage securities were financed with separate PSA reverse repurchase agreement financing with lender haircuts generally in the 3% range. Certain lenders require cash deposits to satisfy margin calls, while other lenders require a paydown of the reverse repurchase agreement financing to satisfy margin calls. In the third quarter of 1998 the net interest earning assets employed decreased dramatically from $9,757,000 in the second quarter to $1,597,000 in the third quarter. This decrease was attributable to (i) an increase in the negative mark to market (unrealized loss), (ii) a reduction in net premiums (due to rapid prepayments), and (iii) a significant increase in cash on deposit with certain lenders relating to margin calls. In October

1998 the Company sold all of the Agency ARM securities, leaving only the fixed rate FNMA mortgage security at year end.

The effective interest income rate was negatively affected by the rapid prepayments of the Agency ARM securities throughout 1998 (40-50% prepayment speeds), particularly in the second quarter, as the Company booked additional premium amortization to match the rapid prepayment speeds.

OTHER INTEREST INCOME

1998 interest income generated from non-mortgage assets is detailed below (dollars in thousands):

	Quarter Ended March 31, 1998	Quarter Ended June 30, 1998	Quarter Ended September 30, 1998	Quarter Ended December 31, 1998
Cash margin	$109	$157	$173	--
Overnight investing	81	82	3	209
Related party notes	17	61	94	84
	$207	$300	$270	$293

Interest income on cash deposited as additional cash collateral pursuant to reverse repurchase financing agreements with certain lenders earned interest at the respective borrowing rate charged by the lender generally 5.60%.

Interest income recorded on overnight investing was generated for the most part from investing excess cash in Federal Home Loan Bank discount notes with interest rates ranging from 4.2% to 4.5%. Overnight investing also includes, to a much lesser extent, investments in the highest rated commercial paper and savings accounts.

Notes receivable due from HCP earn interest at 1.00% below prime. During the year, notes receivable due from HCP ranged from $-0- to $7,312,000. The balance at December 31, 1998 was $713,000. Notes receivable due from Principals earn interest at the lowest applicable federal rate in effect at the time of the loan. The weighted average interest rate on notes due from Principals at December 31, 1998 was 5.58% on an outstanding balance of $3,181,000.

EXPENSES

1998 personnel costs reflect the salaries, payroll taxes, and employee benefit costs ($712,000) relating to the Principals, net of $360,000 allocated to an unconsolidated subsidiary, HCP, for management's actual and estimated time involved with the subsidiary. The personnel costs relating to the Principals for 1997 ($204,000) was reflected in the form of billings from HCP and was classified as management and administrative expense because no payroll function was established for the Company until January 1998.

The expenses (management and administrative, due diligence and commissions) directly related to acquisitions of mortgage loans totaled $1,706,000 in 1998. The similar figure for 1997 (period from September 30 to December 31, 1997) was $523,000 after deducting Principals' personnel costs of $204,000. Due diligence costs on mortgage loans acquired, as a percentage of par value of the mortgage loan acquired, decreased from 0.156% in 1997 to 0.075% in 1998. Commissions expense also decreased as a percentage of par value of mortgage loans acquired, from 0.042% in 1997 to 0.033% in 1998.

Legal and professional expenses including general legal, accounting, tax, investor relations and other professional fees ($545,000) reflected increases in 1998 compared to the prorata period in 1997 ($138,000). These increases were generally anticipated as the Company began implementing its strategic business plan of securitizing mortgage loans.

Financing/commitment fees reflected the single most significant increase from 1997 to 1998 ($804,000). During the short period of operation in 1997 the Company had two reverse repurchase agreement lines of credit in place. A portion of the commitment fees on these two lines of credit ($100,000 each), was expensed in 1998. The Company increased the number of lenders providing reverse repurchase agreement financing from two to five in 1997. One of these lines of credit was for a short term period at a time (in the fourth quarter) when credit sources were particularly scarce. The commitment fee expense relating to this lender was $500,000 in 1998.

For the year ended December 31, 1998 and for the short period ended December 31, 1997, the Company's ratio of operating expenses to average assets was 1.59% and 0.53%, respectively. The Company's 1998 and 1997 operating expenses 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%.

EQUITY IN (LOSS) OF UNCONSOLIDATED SUBSIDIARIES

On September 19, 1997 (the IPO date), Hanover acquired 100% of the non-voting preferred stock of HCP, which represents a 97% ownership interest in HCP and its wholly owned subsidiaries. Hanover's investment in HCP is accounted for on the equity method. Hanover recorded a loss of $1,039,000 in 1998 and $254,000 in 1997 from its equity investment in HCP. The HCP loss in 1997 reflected a significant decline in its due diligence revenue. Its loss in 1998 was a result of a decline in HCP's consulting and brokerage revenues and the second consecutive year of subpar mortgage origination production from HCMC. The 1998 operations of HCMC were negatively affected by the credit market changes in the third and fourth quarter of 1998 that essentially shut down the mortgage conduit origination market.

In October 1998, the Company completed its second private placement REMIC securitization transaction through its newly organized unconsolidated subsidiary, HCP-2. Hanover contributed $324.2 million of fixed rate mortgage loans (with a par value of $318 million) subject to $310.0 million of reverse repurchase agreement financing to HCP-2 in exchange for a 99% economic ownership of HCP-2 (representing a 100% ownership of the non-voting preferred stock in HCP-2). HCP-2 issued a REMIC security and sold all of the REMIC security except the "AAA" rated notes to two newly created wholly-owned subsidiaries of Hanover (Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc.). Hanover's investment in HCP-2 is accounted for on the equity method. Hanover recorded a loss of $394,000 in 1998 from its equity investment in HCP-2.

The loss generated by HCP-2 is a result of the unique securitization transaction entered into in October 1998. The REMIC security transaction effectively records all of the underlying mortgage loans as assets and the same amount of mortgage backed bonds as a liability. Accordingly, the gross interest income generated from the underlying mortgages will match exactly the interest expense relating to the mortgage backed bonds. The net loss generated by HCP-2 relates to (1) the amortization of net premiums and deferred hedge costs, reflected as a reduction of interest income, (2) the amortization of deferred financing fees and (3) a loan loss provision. Hanover reflected 99% of this net loss in 1998 - $394,000. It is expected that HCP-2 will continue to reflect decreasing losses in the future.

Management believes that the net interest income calculated relating to this securitization transaction should be adjusted to reflect the operating activity recorded from the equity in loss of HCP-2 to more fully comprehend the yield on the net interest earning assets. Accordingly, the table below reflects the adjusted net interest income generated from the $318 million securitization transaction:

Private placement mortgage securities	Quarter Ended March 31, 1998	Quarter Ended June 30, 1998	Quarter Ended September 30, 1998	Quarter Ended December 31, 1998
Average asset balance (as adjusted)	0	0	0	$ 17,917
Average repo balance	0	0	0	2,784
Net interest earning assets (as adjusted)	0	0	0	$ 15,133
Average leverage ratio (as adjusted)	N/A	N/A	N/A	15.540%
Effective interest income rate (as adjusted)	N/A	N/A	N/A	4.686%
Effective interest expense rate	N/A	N/A	N/A	5.729%
Net interest spread (as adjusted)	N/A	N/A	N/A	(1.043)%
Interest income (as adjusted)	0	0	0	$ 210
Interest expense	0	0	0	41
Net interest income (as adjusted)	0	0	0	$ 169
Yield on net interest earning assets (as adjusted)	N/A	N/A	N/A	4.471%

Hanover's 1998 taxable income is estimated at $1,517,000. Taxable income exceeds GAAP net loss for the following book/tax differences relating to the accounting for (1) equity in the loss of subsidiaries, (2) due diligence costs and commission expenses incurred to acquire mortgage loan pools, (3) REMIC securitization/sale transactions, (4) original issue discount adjustments, (5) amortization of premium/discounts, (6) recognition of capital losses and (7) other smaller items.

As a REIT, Hanover is required to declare dividends amounting to 85% of each year's taxable income by the end of each calendar year and to have declared dividends amounting to 95% of Hanover's taxable income for each year by the time Hanover 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. Hanover paid dividends of $0.70 per share for 1998, which exceeded 100.0% of taxable income.

LIQUIDITY

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, sale of certain mortgage securities, and other possible sources of financing, including CMOs and REMICs, additional equity generated by the exercise of some or all of the Company's outstanding stock warrants and additional equity offerings. The Company considers its ability to generate cash to be adequate to meet operating requirements both short-term and long-term. However, if a significant decline in the market value of the Company's investment portfolio should occur, the Company's available liquidity from existing sources and ability to access additional sources of credit may be reduced. As a result of such a reduction in liquidity, the Company may be forced to sell certain investments in order to maintain liquidity. If required, these sales could be made at prices lower than the carrying value of such assets, which could result in losses.

In October 1998, the volatility of the mortgage market caused certain repo lenders to widen their lending haircuts, increase borrowing rates and/or discontinue or reduce their lending activities. Further, the turmoil in the mortgage markets resulted in repo lenders taking a more conservative approach to valuing the underlying mortgage collateral, often resulting in higher margin calls. In an effort to increase liquidity and to reduce overall leverage the Company sold all of its adjustable rate Agency mortgage securities ($189 million) in October. The sale of the adjustable rate Agency mortgage securities resulted in a loss of $5,989,000. To further increase liquidity, the Company also sold certain other FNMA mortgage securities ($73 million) at a net gain of $334,000. If the Company were unable to meet the lenders's margin calls in the future or if lenders were reluctant to extend additional repo financing the Company would be forced to use its existing liquidity to satisfy margin calls. Further, the Company might be forced to sell certain investments in order to meet margin calls. The recent volatility in the mortgage markets has caused repo financing to become marginally more expensive and has reduced the number of lenders willing to extend repo lending to finance mortgage loan pool acquisitions.

The Company had four reverse repurchase agreement lines of credit in place at December 31, 1998. One of these lines of credit was renewed in December 1998 and another line of credit maturing in March 1998 is currently being renegotiated. A commitment for a new $50 million line of credit was agreed to in February 1999. Management is seeking to add several additional lines of credit by June of 1999. The Company sold certain of its private placement mortgage securities in early 1999. The mortgage securities that were sold were acquired pursuant to the $318 million securitization completed in October 1998. Typically investment grade mortgage securities would not be retained by the Company at the time of the securitization, however, due to market conditions that existed at the time of the securitization these mortgage securities were retained. The improvement in the mortgage market allowed the Company the option of selling these mortgage securities.

In November 1998 Hanover entered into a short term (three month) financing arrangement with Residential Funding Corporation ("RFC") for approximately $95 million. In connection with such financing arrangement, Hanover agreed to issue and deliver to RFC warrants to purchase approximately 300,000 shares of Hanover's common stock exercisable at a price per share equal to the closing price of Hanover's common stock on the American Stock Exchange on the date of the November agreement, which was $4.00 per share. In addition Hanover and RFC agreed to the following: (i) Hanover agreed to compensate RFC as an underwriter on certain future mortgage loan securitization deals, (ii) Hanover agreed to have the appropriate Hanover entity (HCMC) offer RFC the right to purchase any commercial loans originated or purchased by such entity through November 2000 on the same terms and conditions as it would offer such commercial loans to a third party, (iii) Hanover agreed to offer RFC the opportunity to act as master servicer on any loan securitization effected by it through November 2000 on the same terms and conditions as it would offer such to a third party and (iv) RFC agreed to offer the appropriate Hanover entity (HCP) the opportunity to undertake due diligence services for RFC on the same terms and conditions as it would offer such to a third party through November 2000.

Net cash provided by operations in 1998 was $3,898,000. Actual cash proceeds generated from operations adjusted for non cash items was $9,154,000 offset by net cash used for operating assets and liabilities ($1,845,000) and net loans to Principals ($2,698,000) and to HCP ($713,000).

Net cash used in investing activities amounted to $315,792,000 in 1998. The majority of the mortgage assets purchased were mortgage loans. The average purchase price of mortgage loans in 1998 was 101.26%. Offsetting the cash outlay for mortgage asset purchases were receipts of principal proceeds on the mortgage loans and mortgage securities of $296,806,000 and proceeds from the sale of mortgage assets of $276,582,000.

Cash flows from financing activities generated $319,709,000 in 1998. The majority of the cash flows from financing activities resulted from net borrowings on reverse repurchase agreements ($243,218,000), net borrowings on the mortgage backed bonds ($77,305,000), increased by dividends received from HCP-2 ($8,054,000), reduced by dividends paid ($4,826,000), an additional capital contribution to HCP ($2,700,000) and repurchases of the Company's common stock ($1,345,000).

Capital Resources

The Company had no capital expenditure in 1998 and management does not anticipate the need for any material capital expenditures for the future.

YEAR 2000 (Y2K) DISCLOSURE

The Y2K issue is the result of computer systems that use two digits rather than four to define the applicable year, which may prevent such systems from accurately processing dates ending in the year 2000 and thereafter. This could result in system failures or in miscalculations causing disruption of operations, including, but not limited to, an inability to process transactions, to send and receive electronic data, or to engage in routine activities and operations.

The following information is provided relating to the Company's Y2K issues:

1. Y2K-READINESS- The Company has reviewed the status of all of its information technology ("IT") systems and has determined that all of its computer hardware is Y2K compliant. In addition, the Company has received satisfactory certification from certain of its third party vendors and/or verified to its satisfaction that their IT systems are Y2K compliant or have indicated that they will be Y2K compliant prior to December 31, 1999.

The Company has prepared a detailed questionnaire for the remainder of the Company's significant other third party relationships:

Certain Third Party Vendors	Services Provided
Securities	dealer firms Financing, facilitate purchase and sale of mortgage assets, etc.
Information processing firms	Accounting, word processing, database software systems
Mortgage loan servicers	Mortgage loan servicing
Communications firms	Telephone, modems, fax, financial software, internet, postage
Facilities firms	Office space, storage, security
General	Legal and accounting, office supplies, etc.

The Company has sent letters requiring verification of compliance with Year 2000 matters and has followed up such letters with telephone calls as appropriate. An evaluation of these questionnaires as well as other Y2K readiness matters has been ongoing for several months. This process is scheduled to be completed by March 31, 1999. The Company will then determine the most cost-effective method to remedy any third party non-compliance. The Company does not own any non-IT systems (i.e. elevator systems, building air management systems, security and fire control systems).

2. Y2K-COSTS - The Company has not incurred any material costs to date related to its Y2K issues and believes its total Y2K costs to date have been less than $25,000. At this time it does not anticipate any material costs will be incurred on as yet unidentified Y2K issues. The costs of these projects and the dates on which the Company plans to complete modifications and replacements are based on management's best estimates, the estimates of third-party specialists, if any, who may assist the Company, the modification plans of third parties and other factors. However, these estimates of future Y2K related costs may change when the assessment of third-party issues is complete and actual results could differ materially from the above indication.

3. Y2K-RISKS- Currently the Company's most reasonably likely worst case scenario relating to the Y2K issue would occur if any of the companies which service its mortgage portfolios had Y2K problems that prohibited such companies from either (1) collecting and remitting funds or (2) providing the related loan data to the Company on a timely basis. A scenario of this type could, if existing for any significant length of time, create liquidity problems for the Company and could result in decreased net income through decreased net interest income and increased operating expenses. If the Company does not receive borrower remittances from its servicers on a timely basis it may have to (1) use existing capital, (2) sell other mortgage assets or (3) try to secure additional financing sources to satisfy lenders' margin calls. Although the likelihood of such an occurrence seems remote, a total cessation of borrower remittances to the Company could potentially lead to monetary defaults by the Company on its repo lending obligations. Additionally, the Company

estimates that expenses would increase as a result of legal and other actions taken to attempt to collect the funds due the Company. The third-party questionnaire described in Item 1 above is intended to assess these risks and the alternatives available to reduce or eliminate them. While the Company believes the probability of the above occurrences to be low, there can be no assurance at this time that the Company will not be materially adversely affected by possible Y2K problems.

4. Y2K-CONTINGENCY PLANS- The development of contingency plans to handle the most reasonably likely worst case Y2K scenario is dependent upon the completion of the assessment of the third-party questionnaires described above. The Company anticipates it will have such a contingency plan in place by June 30, 1999. When completed, it is intended that the Company's documented Y2K contingency plan will include identified "individuals" within the Company to contact in the event of a Y2K problem, as well as the availability of back-up systems. Due to the nature of the preliminary open issues at this time, which involve only third-party issues, the Company does not currently anticipate the need for any third-party consultants for remediation efforts.

OTHER MATTERS

REIT Requirements

Hanover has elected to be taxed as a REIT under the Code. Hanover believes that it was in full compliance with the REIT tax rules as of December 31, 1998 and intends to remain in compliance with all REIT tax rules. If Hanover fails to qualify as a REIT in any taxable year and certain relief provisions of the Code do not apply, Hanover 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 Hanover fails to qualify as a REIT would not be deductible by Hanover in computing its taxable income. As a result, Hanover could be subject to income tax liability, thereby significantly reducing or eliminating the amount of cash available for distribution to its stockholders. Further, Hanover 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 the 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.

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, 1998, Management calculates that the Company is in compliance with this requirement.

Proposed Legislation

The Clinton Administration's budget has modified some of the Administration's prior tax proposals directed at REITs. The current proposals, if enacted, would change the tax treatment of (i) a REIT's ownership of taxable subsidiary stock, (ii) closely-held REITs, and (iii) built-in gains on the conversion of a C corporation to a REIT or the merger of a C corporation into a REIT. While prior attempts by the Administration to make similar changes in the taxation of REITs were unsuccessful, and it is uncertain whether the changes outlined in the current proposals or some variation of them, ultimately will be enacted.

If adopted, these proposals could have an adverse effect on REITs in general and on Hanover. More specifically, the Administration's proposals would prohibit a REIT from owning, by vote or value, more than 10 percent of the capital stock of any corporation. (Current law only prohibits ownership of more than 10% of a company's voting stock.) The proposal is generally intended to prevent REITs from conducting, through a taxable subsidiary, any business that would be prohibited to the REIT itself.

The proposal, however, contains exceptions for two new types of taxable subsidiaries: a qualified business subsidiary ("QBS") and a qualified independent contractor subsidiary ("QIK"). A QBS would be permitted to earn income by providing non-tenant related services such as third party management services. A QIK, in addition to being permitted to earn income that could be earned by a QBS, would also be permitted to earn income providing non-customary and other presently prohibited services to a REIT's tenants.

Under the proposal, all taxable subsidiaries owned by a REIT could not exceed 15% of a REIT's total assets and of that total no more than 5% could represent the value of QIKs. Such subsidiaries would be denied the ability to deduct interest on debt funded by a REIT. The proposal also calls for a new 100% excise tax to ensure (i) arm's length pricing for services provided to a REIT's tenants (to ensure that tenants are not paying a REIT higher rent in exchange for a discount on services that would be taxable income to the service subsidiary) and (ii) arm's length allocations for shared expenses between a REIT and its taxable subsidiary. Additional limitations as well as unspecified limitations on intercompany rentals between a REIT and its taxable subsidiary will be proposed. These proposals would generally be effective on the date of the enactment although a transition period would be provided to permit any restructuring of taxable subsidiaries necessary to obtain a QBS or a QIK qualification.

Currently a REIT must have at least 100 shareholders and not more than 50% of the value of its stock can be owned by five or fewer individuals during the last half of the REIT's taxable year. The proposal would add a new ownership requirement that would prohibit ownership of more than 50% of a REIT's stock by vote or value by any person other than another REIT. This proposal would generally apply on a prospective basis for entities electing REIT status on or after the first date of committee action.

It is possible that if the proposal is adopted Hanover may be able to qualify its taxable subsidiaries as QBS entities and maintain its current method of conducting its business. However, until more details are available regarding the proposed statutory language, it is not clear whether QBS qualification would be obtainable. Additionally, obtaining QBS qualification may result in current taxation to the non-REIT shareholders of Hanover's taxable subsidiaries. Finally, certain restructurings of the credit lines of Hanover's taxable subsidiaries and their inter-company transactions with Hanover may be required to avoid the proposed excise taxes. Such restructuring may ultimately increase the taxes paid by Hanover's taxable subsidiaries and thereby affect the value of these subsidiaries to Hanover.

Currently regular or C corporations are subject to two levels of tax (first to the corporation on income earned and second to the shareholders when dividends are distributed). In the same manner, a dual tax situation applies on the liquidation of a C corporation or its conversion to a partnership since the corporation is taxed on its built-in gains and the shareholders are taxed on their built-in gain on the stock. Current tax law provides an exception to the double tax regime on the conversion of a C corporation to an S corporation (the "S corporation rule"). The S corporation rule avoids corporate level tax and instead the S corporation is taxed on such built-in gain for an asset that is sold within 10 years of the conversion. IRS permits C corporations that convert to REITs to avoid the immediate tax on built-in gains by electing to be subject to rules similar to the S corporation rule.

The Administration's proposal would repeal the S corporation rule for C corporations that have a value of $5 million or more at the time of conversion and subject such conversions to immediate tax on the built-in gains. Accordingly the conversion of a C corporation that has a value of at least $5 million would result in the immediate recognition of the C corporation's built-in gain. This proposal would generally apply for taxable years beginning after December 31, 1999.

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 reverse repurchase agreement financing; 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 other 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 7A: QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company uses certain derivative financial instruments (for purposes other than trading) as hedges of anticipated transactions relating to its Investment Portfolio.

The Company from time to time enters into interest rate hedge mechanisms (forward sales of Agency mortgage securities) to manage its exposure to market pricing changes in connection with the purchase, holding of, securitization and sale of its fixed rate mortgage loan portfolio. The Company generally closes out the hedge position to coincide with the related loan sale or securitization transactions and recognizes the results of the hedge transaction in determining the amount of the related loan sale gain or loss for loans sold, or as a basis adjustment to loans held to maturity.

At December 31, 1998 the Company had the following forward sales of Agency mortgage securities that had not yet settled (in thousands):

Mortgage Security	Fair Value of Derivative Financial Instrument	Notional Amount of Derivative Financial Instrument	Positive Change in Market Value	Settlement Date
FNMA/30YR/7.0%	$19,442	$19,468	$26	Jan 11, 1999
FNMA/30YR/6.5%	11,073	11,089	16	Jan 11, 1999
FNMA/15YR/7.0%	14,506	14,506	0	Jan 11, 1999
FNMA/15YR/6.5%	6,388	6,394	6	Jan 11, 1999
	$51,409	$51,457	$48	

The Company only hedges its fixed rate mortgage loan pools by selling short similar coupon and duration matched Agency securities, usually for 30 to 60 day periods. This hedging of mortgage assets should, if properly executed, adjust the carrying value of the hedged fixed mortgage loan pools to reflect current market pricing. The costs of the individual hedging transactions can vary greatly depending upon market conditions. Net hedging costs of fixed rate mortgage pools were $541,000, $1,287,000, $2,632,000 and $1,091,000 in the first, second, third and fourth quarters of 1998, respectively. Management is satisfied that the Company's hedging program has been utilized effectively as no charges relating to impairment of mortgage loans were booked in 1998.

The primary risk associated with selling short Agency securities relates to changes in interest rates. Generally, as market interest rates increase, the market value of the hedged asset (fixed rate mortgage loans) will decrease. The net effect of increasing interest rates will generally be a favorable or gain settlement on the forward sale of the Agency security; this gain will result in a negative basis adjustment to the hedged assets. Conversely, if interest rates decrease, the market value of the hedged asset will increase. The net effect of decreasing interest rates will generally be an unfavorable or loss settlement on the forward sale of the Agency security; this loss should be offset by a positive basis adjustment to the hedged assets. To mitigate interest rate risk an effective matching of Agency securities with the hedged assets needs to be monitored closely.

Senior Management continually monitors the changes in weighted average duration and coupons of the hedged assets and will appropriately adjust the amount, duration and coupon of future forward sales of Agency securities.

Mortgage loans that are identified for inclusion in the future securitizations are generally no longer hedged. The Company anticipates that it will have a lower volume of forward sales of Agency security hedging activity in the future as the Company plans to securitize mortgage loans on a more frequent basis than in 1998.

The Company also enters into interest rate hedge mechanisms (interest rate caps) to manage its interest rate exposure on certain reverse repurchase agreement financing. The cost of the interest rate caps is amortized over the life of the interest rate cap and is reflected as a portion of interest expense in the consolidated statement of operations.

At December 31, 1998 the Company had the following interest rate caps in effect (dollars in thousands):

Notional Amount	Index	Strike %	Maturity Date
$35,978	3 Month LIBOR	5.75%	March 31, 2001
34,610	3 Month LIBOR	5.75%	April 30, 2001
$70,588			

The primary risk associated with interest rate caps relates to interest rate increases. The interest rate caps provide a cost of funds hedge against interest rates that exceed 5.75%, subject to the limitation of the notional amount of financing.

ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements of the Company and the related notes, together with the Independent Auditors' Report thereon beginning on page F-1 and continuing through page F-56 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

All schedules omitted are inapplicable or the information required is shown in the Financial Statements or notes thereto. The auditors' reports of Deloitte & Touche LLP with respect to the Financial Statements are located at pages F-2, F-34 and F-46.

(3) Exhibits

Exhibits required to be attached by Item 601 of Regulation S-K are listed in the Exhibit Index attached hereto, which is incorporated herein by this reference.

(b) Reports on Form 8-K

The company filed no reports on Form 8-K during 1998.

(c) Exhibits

See Item 14(a) 3 above.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 30, 1999.

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

By /s/ Ralph F. Laughlin

Ralph F. Laughlin
Senior Vice President and Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Registrant and in the capacities indicated on March 30, 1999.

SIGNATURE	TITLE
/s/ John A. Burchett John A. Burchett	Chairman of the Board of Directors
/s/ Irma N. Tavares Irma N. Tavares	Managing Director and a Director
/s/ Joyce S. Mizerak Joyce S. Mizerak	Managing Director, Secretary and a Director
/s/ George J. Ostendorf George J. Ostendorf	Managing Director and a Director
/s/ John A. Clymer John A. Clymer	Director
/s/ Joseph J. Freeman Joseph J. Freeman	Director
/s/ Robert E. Campbell Robert E. Campbell	Director
/s/ Saiyid T. Naqvi Saiyid T. Naqvi	Director
/s/ John N. Rees John N. Rees	Director
/s/ Ralph F. Laughlin Ralph F. Laughlin	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)

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INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated balance sheets of Hanover Capital Mortgage Holdings, Inc. and Subsidiaries (the "Company") as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity and cash flows for the year ended December 31, 1998 and for the period from 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 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, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Hanover Capital Mortgage Holdings, Inc. and Subsidiaries as of December 31, 1998 and 1997, and the consolidated results of their operations and their cash flows for the year ended December 31, 1998 and for the period from June 10, 1997 (inception) through December 31, 1997 in conformity with generally accepted accounting principles.

DELOITTE & TOUCHE LLP
Parsippany, New Jersey
March 19, 1999

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except as noted)

ASSETS	DECEMBER 31, 1998	DECEMBER 31, 1997
Mortgage loans:		
Held for sale	$256,833	$160,970
Held to maturity	69,495	--
Collateral for mortgage backed bonds	81,666	--
Mortgage securities:		
Available for sale	74,000	348,131
Held to maturity	4,478	--
Cash and cash equivalents	11,837	4,022
Accrued interest receivable	3,940	3,597
Equity investments	7,489	100
Notes receivable from related parties	3,893	482
Due from related parties	313	--
Other receivables	1,621	--
Prepaid expenses and other assets	605	241
TOTAL ASSETS	$516,170	$517,543

LIABILITIES AND STOCKHOLDERS' EQUITY

LIABILITIES:		
Reverse repurchase agreements	$370,090	$435,138
Mortgage backed bonds	77,305	--
Accrued interest payable	1,394	2,250
Dividends payable	695	1,035
Due to related party	--	540
Accrued expenses and other liabilities	906	482
Total liabilities	450,390	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; 6,321,899 and 6,466,677 shares outstanding at December 31, 1998 and 1997, respectively	65	65
Additional paid-in-capital	78,069	79,411
Retained (deficit)	(9,955)	(536)
Accumulated other comprehensive (loss)	(2,399)	(842)
Total stockholders' equity	65,780	78,098
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$516,170	$517,543

See notes to consolidated financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	YEAR ENDED DECEMBER 31, 1998	PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
REVENUES:		
Interest income	$47,799	$4,880
Interest expense	41,176	3,204
Net interest income	6,623	1,676
Loan loss provision	356	18
Net interest income after loan loss provision	6,267	1,658
Gain (loss) on sale of assets	(5,704)	35
Total revenues	563	1,693
EXPENSES:		
Personnel	712	--
Management and administrative	733	400
Due diligence	687	266
Commissions	286	61
Legal and professional	545	138
Financing/ commitment fees	836	32
Other	265	43
Total expenses	4,064	940
Operating income (loss)	(3,501)	753
Equity in (loss) of unconsolidated subsidiaries	(1,433)	(254)
NET INCOME (LOSS)	$(4,934)	$ 499
BASIC EARNINGS (LOSS) PER SHARE	$ (0.77)	$ 0.15
DILUTED EARNINGS (LOSS) PER SHARE	$ (0.77)	$ 0.14

See notes to consolidated financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEAR ENDED DECEMBER 31, 1998 AND
PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
(in thousands, except share data)

	COMMON STOCK SHARES	COMMON STOCK AMOUNT	ADDITIONAL PAID-IN CAPITAL	COMPREHENSIVE (LOSS)	RETAINED EARNINGS (DEFICIT)	ACCUMULATED OTHER COMPREHENSIVE (LOSS)	TOTAL
Issuance of common stock	6,466,677	$65	$79,411				$79,476
Comprehensive income (loss):							
Net income				$ 499	$ 499		499
Other comprehensive income (loss)							
Unrealized (loss)				(842)		$ (842)	(842)
Comprehensive (loss)				$ (343)			
Dividends declared					(1,035)		(1,035)
BALANCE, DECEMBER 31, 1997	6,466,677	65	79,411		(536)	(842)	78,098
Adjustment of Initial public offering expenses			11				11
Exercise of Warrants	2,122		32				32
Costs associated with registration of warrants			(40)				(40)
Repurchase of common stock	(146,900)		(1,345)				(1,345)
Comprehensive income (loss):							
Net (loss)				(4,934)	(4,934)		(4,934)
Other comprehensive (loss)							
Unrealized (loss)				(1,557)		(1,557)	(1,557)
Comprehensive (loss)				$(6,491)			
Dividends declared					(4,485)		(4,485)
BALANCE, DECEMBER 31, 1998	6,321,899	$65	$78,069		($9,955)	($2,399)	$65,780

See notes to consolidated financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	YEAR ENDED DECEMBER 31, 1998	PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$(4,934)	$ 499
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of net premium and deferred costs	6,594	361
Loan loss provision	356	18
Gain on sale of securities	--	(35)
Net loss on sale of mortgage assets	5,705	--
Equity in loss of unconsolidated subsidiaries	1,433	254
(Increase) in accrued interest receivable	(343)	(3,597)
(Increase) in loans to related parties	(3,411)	(482)
(Increase) in other receivables	(1,621)	--
(Increase) in prepaid expenses and other assets	(364)	(241)
Increase in accrued interest payable	842	2,250
Increase (decrease) in due to related party	(782)	540
Increase in accrued expenses and other liabilities	423	482
Net cash provided by operating activities	3,898	49
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of mortgage loans	(863,324)	(349,287)
Purchase of Agency mortgage securities	(4,333)	(163,030)
Purchase of private placement mortgage securities	(21,523)	--
Principal payments received on mortgage securities	150,543	--
Principal payments received on mortgage loans	123,098	1,995
Proceeds from sale of mortgage assets	276,582	--
Proceeds from sale of securities	--	35
Principal payments received on collateral for mortgage backed bonds	23,165	--
Net cash (used in) investing activities	(315,792)	(510,287)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings from reverse repurchase agreements	243,218	435,138
Borrowings from mortgage backed bonds	100,675	--
Payments on mortgage backed bonds	(23,370)	--
Net proceeds of initial public offering	11	79,122
Exercise of stock warrants - net	(8)	--
Equity investment in HCP	(2,700)	--
Dividends received - unconsolidated subsidiary	8,054	--
Payment of dividends	(4,826)	--
Repurchase of common stock	(1,345)	--
Net cash provided by financing activities	319,709	514,260
NET INCREASE IN CASH AND CASH EQUIVALENTS	7,815	4,022
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	4,022	0
CASH AND CASH EQUIVALENTS, END OF PERIOD	$11,837	$ 4,022

See notes to consolidated financial statements

HANOVER CAPITAL MORTGAGE HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEAR ENDED DECEMBER 31, 1998 AND PERIOD FROM JUNE 10 (INCEPTION)
TO DECEMBER 31, 1997

1. BUSINESS DESCRIPTION

GENERAL

Hanover Capital Mortgage Holdings, Inc. ("Hanover") was incorporated in Maryland on June 10, 1997. Hanover acquired three bankruptcy remote limited purpose finance subsidiaries in 1998 in order to complete two significant mortgage loan securitizations in 1998. In March 1998, Hanover acquired 100% of the common stock of Hanover Capital SPC, Inc. and in October 1998, it acquired 100% of the common stock of Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc. Hanover is a real estate investment trust ("REIT"), formed to operate as a specialty finance company. The principal business strategy of Hanover and its wholly owned subsidiaries, Hanover Capital SPC, Inc., Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc. (together referred to as the "Company") and its unconsolidated subsidiaries 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 loans and (iv) acquire multifamily 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 an unconsolidated taxable subsidiary of the Company.

Hanover Capital SPC, Inc. ("HCSPC"), a wholly-owned subsidiary of Hanover, was incorporated in Delaware on March 24, 1998 for the sole purpose of issuing mortgage notes through a private placement (REMIC) offering. HCSPC transferred all of its retained securities to its wholly owned subsidiary, Hanover Capital Repo Corp. Hanover Capital Repo Corp. was incorporated in Delaware on March 26, 1998.

Hanover QRS-1 98-B, Inc., a wholly-owned subsidiary of Hanover, was incorporated in Delaware on October 16, 1998 for the sole purpose of owning certain investment grade mortgage securities acquired from Hanover Capital Partners 2, Inc. ("HCP-2"), an unconsolidated subsidiary of Hanover.

Hanover QRS-2 98-B, Inc., a wholly-owned subsidiary of the Company, was incorporated in Delaware on October 19, 1998 for the sole purpose of owning certain investment grade and subordinated mortgage securities acquired from HCP-2.

CAPITALIZATION

In September 1997, Hanover raised net proceeds of approximately $79 million in its initial public offering (the "IPO"). In the IPO, Hanover 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' over-allotment 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 expire on September 15, 2000. As of December 31, 1998 there were 5,917,878 warrants outstanding, including 172,500 warrants issued pursuant to the underwriters' over-allotment option. Hanover utilized substantially all of the net proceeds of the IPO to fund leveraged purchases of mortgage assets.

In connection with the closing of the IPO, Hanover 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 Hanover'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.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of Hanover Capital Mortgage Holdings, Inc. and its wholly-owned subsidiaries, Hanover Capital SPC, Inc. and Subsidiary, Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc. All significant intercompany accounts and transactions have been eliminated.

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.

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, 1998 management had made the determination that $256,833,000 of mortgage loans were 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 also determined during 1998 that certain mortgage loans ($69,495,000 at December 31, 1998) would be held to maturity. 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. Mortgage loans designated as held to maturity are reported at cost.

Premiums, discounts and certain deferred costs 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 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.

The accrual of interest on impaired loans is discontinued 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 borrower's 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.

MORTGAGE SECURITIES

The Company's policy is to classify its mortgage securities as available for sale as they are acquired 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, 1998 management has made the determination that $74,000,000 of mortgage securities are available for sale in order to be prepared to respond to potential future opportunities in the market, to sell mortgage 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 mortgage securities on a quarterly basis. At December 31, 1998 mortgage securities classified as held to maturity were $4,478,000. Mortgage securities classified as held to maturity are carried at the fair value of the security at the time the designation is made. Any fair value adjustment is reflected as a separate component of stockholders' equity and as a cost basis adjustment of the mortgage security as of the date of the classification and is amortized into interest income as a yield adjustment. All mortgage 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.

The Company makes periodic evaluations of all mortgage securities to determine whether an other-than-temporary impairment is considered to have occurred. If a decline in the fair value is judged to be other than temporary, the cost basis of the mortgage security will be marked to fair value resulting in a current period loss in the statement of operations. The new cost basis shall not be changed for future increases in market value; however, future increases in market value will be reflected separately in the equity section of the Company's balance sheet.

Premiums, discounts and certain deferred costs associated with the acquisition of mortgage securities are amortized into interest income over the lives of the securities using the effective yield method adjusted for the effects of estimated prepayments. Mortgage securities transactions are recorded on the date the mortgage securities are acquired or sold. Purchases of new issue mortgage 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 mortgage securities transactions are determined on the specific identification basis.

The Company has limited its exposure to credit losses on its portfolio of purchased mortgage securities by only purchasing mortgage securities from third parties 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"). Because the Company has access to HCP's due diligence operations, the Company may in the future consider purchasing non investment grade mortgage securities of other issuers after a thorough evaluation of the underlying mortgage loan collateral. The Company monitors the delinquencies and losses on the underlying mortgages of its mortgage securities and, if the credit performance of the underlying loans is not as good as expected, makes a provision for possible credit losses as well as unidentified potential future losses in its mortgage securities portfolio. The provision is based on management's assessment of numerous factors affecting its portfolio of mortgage 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.

FINANCIAL INSTRUMENTS

The Company from time to time enters into interest rate hedge mechanisms (forward sales of Agency mortgage securities) to manage its exposure to market pricing changes in connection with the purchase, holding of, securitization and sale of its fixed rate mortgage loan portfolio. The Company generally closes out the hedge position to coincide with the related loan sale or securitization transactions. Gains and losses on such hedge positions are either (i) deferred as an adjustment to the carrying value of the related loans until the loan has been funded and securitized, after which the gains or losses will be amortized into income over the remaining life of the loan using a method that approximates the effective yield method, or (ii) deferred until such time as the related loans are sold.

The Company also enters into interest rate caps to manage its interest rate exposure on certain reverse repurchase agreement financing. The cost of the interest rate caps is amortized over the life of the interest rate cap and is reflected as a portion of interest expense in the consolidated statement of operations. Any payments received under the interest rate cap agreements would be recorded as a reduction of interest expense on the reverse repurchase agreement financing.

For derivative financial instruments designated as hedge instruments, the Company periodically evaluates the effectiveness of these hedges against the financial instrument being hedged under various interest rate scenarios. The Company utilized hedge deferral accounting procedures in accounting for its hedging program so long as there is adequate correlation between the hedged result and the change in value of the hedged financial instrument. If the hedge instrument performance does not result in adequate correlation between the changes in value of the hedge instrument and the related hedged financial instrument, the Company will terminate hedge deferral accounting and mark the carrying value of the hedge instrument to market. If a hedge instrument is sold or matures, or the criteria that was anticipated at the time the hedge instrument was entered into no longer exists, the hedge instrument is no longer accounted for as a hedge. Under these circumstances, the accumulated change in the market value of the hedge is recognized in current period income or loss to the extent that the effects of interest rate or price changes of the hedged item have not offset the hedged results.

EQUITY INVESTMENT

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

Hanover's 99% economic ownership investment in HCP-2 is also accounted for by the equity method of accounting. Hanover generally has no right to control the affairs of HCP-2, however management believes that Hanover has the ability to exert significant influence over HCP-2 and therefore the investment in HCP-2 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.

INCOME TAXES

Hanover 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, Hanover 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

Basic earnings or loss per share excludes dilution and is computed by dividing income or loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings or loss 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 and losses. Shares issued during the period and shares reacquired during the period are weighted for the period they were outstanding.

RECENT ACCOUNTING PRONOUNCEMENTS

The FASB issued SFAS 133 Accounting for Derivative Instruments and Hedging Activities ("SFAS 133") in June 1998. SFAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. SFAS 133 is effective for fiscal quarters beginning after June 15, 1999. Management's preliminary evaluation of SFAS 133 indicates the implementation of SFAS 133 will not result in any material changes to the Company's consolidated statement of operations.

The FASB issued SFAS No. 134 Accounting For Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise ("SFAS 134") in October 1998. SFAS 134 amends FAS 65 Accounting for Certain Mortgage Banking Activities, and FAS 115 Accounting for Certain Investments in Debt and Equity Securities to require that after the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed securities or other retained interests based on its ability and intent to sell or hold those investments. SFAS 134 is effective for fiscal quarters beginning after December 15, 1998. Management does not expect the adoption of SFAS 134 to have any significant effect on the Company.

3. MORTGAGE LOANS

Investments in single-family mortgage loans consist of fixed rate mortgages and adjustable rate mortgages. The following tables summarize the Company's single-family mortgage loan pools as of December 31, 1998 and 1997 (dollars in thousands):

Held for sale

The following table summarizes the Company's single-family mortgage loan pools, held for sale at December 31, 1998 and 1997 which are carried at the lower of cost or market (dollars in thousands):

	DECEMBER 31, 1998		DECEMBER 31, 1997	
Mortgage Loans	Cost	Mix	Cost	Mix
Fixed rate	$ 93,615	36.93%	$106,397	67.01%
Adjustable rate	159,901	63.07%	52,392	32.99%
Subtotal	253,516	100.00%	158,789	100.00%
Net premiums, discounts and deferred costs	3,567		2,199	
Loan loss provision	(250)		(18)	
Carrying value	$256,833		$160,970	

The following table summarizes certain characteristics of the Company's single-family fixed rate and adjustable rate mortgage loans, held for sale portfolio at December 31, 1998 and 1997 (dollars in thousands):

	DECEMBER 31, 1998			
	Carrying Value of Mortgage Loans	Principal Amount of Mortgage Loans	Weighted Average Net Coupon	Weighted Average Maturity (1)
Fixed rate	$ 95,763	$ 93,615	8.545%	187
Adjustable rate	161,070	159,901	7.542%	264
	$256,833	$253,516	7.912%	235

The adjustable rate mortgage loans at December 31, 1998 had various reference rate indexes with a weighted average 13 month repricing period and a weighted average net life cap of 13.23%.

	DECEMBER 31, 1997			
	Carrying Value of Mortgage Loans	Principal Amount of Mortgage Loans	Weighted Average Net Coupon	Weighted Average Maturity (1)
Fixed rate	$107,953	$106,397	8.265%	242
Adjustable rate	53,017	52,392	7.925%	319
	$160,970	$158,789	8.153%	267

Virtually all of the adjustable rate mortgage loans had a 1 year CMT based reference rate with a weighted average 12 month repricing period and a weighted average net life cap of 12.56%.

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

Held to maturity

The following table summarizes the Company's single-family mortgage loans, held to maturity at December 31, 1998 which are carried at cost (dollars in thousands):

	DECEMBER 31, 1998	
Mortgage Loans	Cost	Mix
Fixed rate	$67,515	99.79%
Adjustable rate	144	.21%
Subtotal	67,659	100.00%
Net premiums, and deferred costs	1,878	
Loan loss provision	(42)	
Carrying value	$69,495	

The following table summarizes certain characteristics of the Company's single-family fixed rate and adjustable rate mortgage loans, held to maturity portfolio at December 31, 1998 (dollars in thousands):

	DECEMBER 31, 1998			
	Carrying Value of Mortgage Loans	Principal Amount of Mortgage Loans	Weighted Average Net Coupon	Weighted Average Maturity (1)
Fixed rate	$69,350	$67,515	8.707%	253
Adjustable rate	145	144	7.625%	302
	$69,495	$67,659	8.705%	253

The adjustable rate mortgage loans had a 1 year CMT based reference rate with a 12 month repricing period and a net life cap of 10.25%.

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

The average effective yields, which include the amortization of net premium, discounts and certain deferred costs for periods shown in 1998 and 1997 on the combined held for sale and held to maturity mortgage loan portfolios were as follows:

	1998	1997
Quarter Ended March 31	7.410%	N/A
Quarter Ended June 30	7.371%	N/A
Quarter Ended September 30	7.489%	N/A
Quarter Ended December 31	7.392%	7.317%
	7.424%	7.317%

Collateral for mortgage backed bonds

In April 1998, the Company issued its first REMIC (real estate mortgage investment conduit) security. $102,977,000 of single family fixed rate residential loans (par value) were assigned as collateral for the Company's mortgage backed bond (REMIC) securitization. The Company has limited exposure to credit risk retained on loans it has securitized through the issuance of collateralized bonds. All mortgage loans held as collateral for mortgage backed bonds are reported at cost. Premiums, discounts and all deferred costs associated with the mortgage loans held as collateral for mortgage backed bonds are amortized into interest income over the lives of the mortgage loans using the effective yield method adjusted for the effects of prepayments.

The following table summarizes the Company's single-family fixed rate mortgage loan pools, classified as held to maturity (and held as collateral for mortgage backed bonds), which are carried at cost at December 31, 1998 (dollars in thousands):

	DECEMBER 31, 1998
Mortgage Loans	Cost
Fixed rate	$79,812
Net premiums and deferred costs	1,934
Loan loss provision	(80)
Carrying value	$81,666

The following table summarizes certain characteristics of the Company's single-family fixed rate mortgage loans held as collateral for mortgage backed bonds at December 31, 1998 (dollars in thousands):

DECEMBER 31, 1998			
Carrying Value of Collateral for Mortgage Backed Bonds	Principal Amount of Collateral for Mortgage Backed Bonds	Weighted Average Net Coupon	Weighted Average Maturity (1)
$81,666	$79,812	7.787%	231

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

The average effective yields, which include amortization of net premiums, discounts and deferred costs for 1998 on the collateral for the mortgage backed bond portfolio were as follows:

	1998
Quarter Ended March 31	N/A
Quarter Ended June 30	7.158%
Quarter Ended September 30	7.071%
Quarter Ended December 31	6.230%
	6.832%

4. MORTGAGE SECURITIES

Available for sale

At December 31, 1998 the Company had $74,000,000 of fixed rate mortgage securities classified as available for sale. These mortgage securities are secured by fixed rate mortgage loans on single-family residential housing. The following table summarizes the Company's mortgage securities classified as available for sale as of December 31, 1998 and 1997, which are carried at their fair value (dollars in thousands):

	DECEMBER 31, 1998	
		Mix
Amortized cost:		
FNMA certificates (a)	$ 3,425	4.48%
FNMA certificates (b)	56,216	73.58%
Private placement notes (c)	16,758	21.94%
Total amortized cost	76,399	100.00%
Gross unrealized (loss)	(2,399)	
Fair Value	$74,000	

	DECEMBER 31, 1997	Mix
Amortized cost:		
FNMA certificates (d)	$207,898	59.58%
FHLMC certificates (e)	141,075	40.42%
Total amortized cost	348,973	100.00%
Gross unrealized (loss)	(842)	
Fair Value	$348,131	

(a) Represents one FNMA certificate with a fixed coupon interest rate of 9.0% purchased from a "Wall Street" dealer firm. This certificate generates normal principal and interest remittances to the Company on a monthly basis.

(b) Represents 31 fixed rate FNMA certificates that the Company received (swapped) for a like amount of fixed rate mortgage loans in December 1998. The coupon interest rates range from 6.00% to 10.50%. These certificates generate normal principal and interest remittances to the Company on a monthly basis.

(c) Represents nine investment grade ("AA", "A" and "BBB") notes and six interest only notes purchased from an affiliate, Hanover Capital Partners 2, Inc. ("HCP-2") in a private placement offering in October 1998. Investment grade ratings were obtained from Standard and Poors and Fitch. The interest rates on the investment grade notes are fixed and range from 6.25% to 6.75%. These notes generate normal principal and interest remittances to the Company on a monthly basis. The interest only notes generate monthly interest remittances to the Company (subject to the availability of funds) from the excess interest generated from the underlying mortgages after deducting all service fees and the coupon interest rate on the applicable notes. The interest rate on each of the interest only notes is based on a notional amount (the principal balance of those mortgage loans with an interest rate in excess of the related note coupon interest rate). The notional amounts decline each month to reflect the related normal principal amortization, curtailments and prepayments for the related underlying mortgage loans. At December 31, 1998 the interest only notes were divided into two major categories; the first group had an effective weighted average interest rate of 1.166% on a notional balance of $259,861,000 and the second group had an effective weighted average interest rate of 0.25% on a notional balance of $143,666,000.

(d) Represents eight adjustable rate FNMA certificates purchased from "Wall Street" dealers in December 1997. At December 31, 1997 the coupon interest rates ranged from 7.292% to 8.081%. These certificates generate normal principal and interest remittances to the Company on a monthly basis. These mortgage securities had a 1 year CMT based reference rate with a weighted average 12 month repricing period and a weighted average net life cap of 11.25%.

(e) Represents seven adjustable rate FHLMC certificates purchased from "Wall Street" dealers in December 1997. At December 31, 1997 the coupon interest rates ranged from 7.538% to 8.041%. These certificates generate normal principal and interest remittances to the Company on a monthly basis. These mortgage securities had a 1 year CMT based reference rate with a weighted average 12 month repricing period and a weighted average net life cap of 10.53%.

Held to maturity
- ----------------

At December 31, 1998 the Company had $4,478,000 of fixed rate mortgage securities classified as held to maturity. These mortgage securities are secured by fixed rate mortgage loans on single-family residential housing. The following table summarizes the Company's fixed rate mortgage securities classified as held to maturity as of December 31, 1998, carried at cost (dollars in thousands):

Amortized cost:	
Private placement notes (a)	$4,478
	======

(a) Represents nine below investment grade notes purchased from an affiliate, HCP-2, in October 1998. The coupon interest rates on the notes are fixed and range from 6.25% to 6.75%. These notes generate normal principal and interest remittances to the Company on a monthly basis.

The amortized cost at December 31, 1998 of the Company's available for sale and held to maturity mortgage securities by contractual maturity dates are presented below (dollars in thousands):

	DECEMBER 31, 1998	
	Available for Sale	Held to Maturity
	Amortized Cost	Amortized Cost
Due in one year or less	$ 1,314	$ 92
Due from one to five years	6,476	457
Due from five to ten years	12,048	836
Due after ten years	56,561	3,093
	-------	-----
Total	$76,399	$4,478
	=======	======

As mentioned above, actual maturities may differ from scheduled maturities because borrowers usually 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.

The average effective yields which include amortization of net premiums and deferred costs for periods shown in 1998 and 1997 on the combined available for sale and held to maturity mortgage securities portfolios were as follows:

	1998	1997
Quarter Ended March 31	6.116%	N/A
Quarter Ended June 30	3.992	N/A
Quarter Ended September 30	4.528	N/A
Quarter Ended December 31	7.520	6.268%
	------	------
	5.170%	6.268%
	======	======

The proceeds, gross realized gains and losses from sales of available for sale mortgage securities in October 1998 were as follows (dollars in thousands):

	PROCEEDS	GROSS REALIZED GAIN (LOSS)
Adjustable rate FNMA and FHLMC certificates (a)	$189,057	$(5,989)
Adjustable rate FNMA certificates (b)	17,172	(161)
Fixed rate FNMA certificates (c)	56,740	495
	$262,969	$(5,655)

(a) - relates to the sale of eight FNMA certificates and seven FHLMC certificates purchased in December 1997

(b) - relates to the sale of five FNMA certificates acquired from a swap of mortgage loans in August 1998

(c) - relates to the sale of nineteen FNMA certificates acquired from a swap of mortgage loans in October 1998

5. CONCENTRATION OF CREDIT RISK

Mortgage Loans

The Company's exposure to credit risk associated with its investment 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 mortgage portfolio for the loans in certain geographic areas. At December 31, 1998 and 1997, the percent of total principal amount of loans outstanding in any one state, exceeding 5% of the principal amount of mortgage loans are as follows:

	AT DECEMBER 31, 1998		AT DECEMBER 31, 1997
	Mortgage Loans		Mortgage Loans
	Held for Sale	Held to Maturity	Held for Sale
California	13%	17%	10%
Texas	7	13	6
Florida	10	8	25
Missouri	--	6	--
Illinois	5	--	--
South Carolina	--	--	13
Ohio	--	--	9
	35%	44%	63%

	AT DECEMBER 31, 1998 Collateral for Mortgage Backed Bonds
Florida	26%
Ohio	12
California	11
Hawaii	6
	55%

During 1998 the Company purchased approximately 75.2% of its total principal amount of mortgage loans from six financial institutions, the largest of which represented approximately 21.7% of the total principal amount of mortgage loans purchased in 1998. During the period from September 30, 1997 to December 31, 1997 the Company purchased approximately 61.9%

of its total 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 purchased in 1997. Management believes that the loss of any single financial institution from which the Company purchased mortgage loans would not have any material detrimental effect on the Company.

Mortgage Securities

The Company's exposure to credit risk associated with its investment activities is measured on an individual customer basis as well as by groups of customers that share similar attributes. In certain instances, the Company has concentrations of credit risk in its mortgage securities portfolio for the mortgage loans collateralizing the mortgage securities in certain geographic areas. Management believes exposure to credit risk associated with purchased Agency mortgage securities is minimal due to the guarantees provided by FNMA. At December 31, 1998 the percent of total principal amount of mortgage loans collateralizing mortgage securities in any one state, exceeding 5% of the principal amount of mortgage securities are shown below:

	DECEMBER 31, 1998	
	Mortgage Securities Received in Swap for Mortgage Loans	Mortgage Securities Purchased from an Affiliate
Illinois	--	25%
Florida	23%	11
Michigan	13	--
California	--	12
South Carolina	12	--
North Carolina	10	--
Ohio	8	6
Arizona	--	7
Kentucky	--	6
Texas	6	--
Oklahoma	5	--
	77%	67%

The Company has cash and cash equivalents in a major financial institution which is insured by the Federal Deposit Insurance Corporation (FDIC) up to $100,000. At December 31, 1998, the Company had amounts on deposit with the financial institution in excess of FDIC limits. At December 31, 1998 the Company had overnight investments of $11,209,000 in Federal Home loan discount notes. The Company limits its risk by placing its cash and cash equivalents in a high quality financial institution, Federal Agency notes or in the highest rated commercial paper.

6. LOAN LOSS PROVISION

The provision for loan loss charged to expense is based upon actual credit loss experience and management's estimate and evaluation of potential losses in the existing mortgage loan and mortgage securities portfolio, including the evaluation of impaired loans. The following table summarizes the activity in the loan loss provision for the following periods (dollars in thousands):

	YEAR ENDED DECEMBER 31, 1998	PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
Balance beginning of period	$ 18	$ - 0 -
Loan loss provision	356	18
Transfers/sales	(2)	--
Charge-offs	--	--
Recoveries	--	--
	--	--
	$372	$ 18

7. EQUITY INVESTMENTS

Hanover recorded its investment in HCP on the equity method. Accordingly, Hanover records 97% of the earnings or losses of HCP through its ownership of all of the non-voting preferred stock of HCP. HCP and its subsidiaries operate as a specialty finance company which is principally engaged in performing due diligence, consulting and mortgage investment banking services. A wholly-owned subsidiary of HCP, Hanover Capital Mortgage Corporation, is an originator and servicer of multifamily mortgage loans. Another wholly-owned subsidiary of HCP, Hanover Capital Securities, Inc. is a registered broker/dealer with the Securities and Exchange Commission.

In October 1998, the Company completed its second private placement REMIC securitization transaction through its newly organized unconsolidated subsidiary, HCP-2. Hanover contributed $324.2 million of fixed rate mortgage loans (with a par value of $318 million) subject to $310 million of reverse repurchase agreement financing to HCP-2 in exchange for a 99% economic ownership of HCP-2 (representing a 100% ownership of the non-voting preferred stock in HCP-2). HCP-2 issued a REMIC mortgage security and sold all of the REMIC mortgage securities except the AAA notes to two newly created wholly-owned subsidiaries of Hanover (Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc.). Hanover recorded its investment in HCP-2 on the equity method. Accordingly, Hanover records 99% of the earnings or losses of HCP-2 through its ownership of all the non-voting preferred stock of HCP-2.

HCP-2 was organized to acquire single-family residential mortgage loans from Hanover pursuant to its formation transaction and to finance the purchase of these mortgage loans through a REMIC securitization. The table below reflects the activity recorded in Hanover's equity investments for the following periods (dollars in thousands):

	YEAR ENDED DECEMBER 31, 1998			PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997		
	HCP	HCP-2	Total	HCP	HCP-2	Total
Beginning balance	$ 100	--	$ 100			
Applicable % of net (loss)	(1,039)	$ (394)	(1,433)	$(254)	--	$(254)
Additional capital contribution	2,700		2,700	--	--	--
Formation transaction		14,176	14,176	354	--	354
Dividends received (a)		(8,054)	(8,054)	--	--	--
Ending balance	$1,761	$5,728	$7,489	$ 100	$--	$ 100

(a) represents a return of capital

8. NOTES RECEIVABLE FROM RELATED PARTIES

In connection with the Hanover's original formation transactions in September 1997, Hanover 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 personal income taxes on the gains they must recognize upon contributing their HCP preferred stock to Hanover for shares of Hanover's common stock. The loans are secured solely by 116,667 shares of Hanover'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, 1998 Hanover had loaned the Principals the full $1,750,000. The loans bear interest at 6.02% (on $482,600 of loans) and 5.70% (on $1,267,400 of loans).

In March 1998, Hanover agreed to lend up to an additional $1,500,000 in unsecured loans to the Principals, in lieu of incurring the costs and expenses Hanover was required to pay associated with the registration of 100,000 shares of Hanover's common stock owned by the Principals. Pursuant to such agreement, Hanover loaned the Principals an additional $1,203,880 in April 1998. The additional loans are due and payable on March 31, 1999 and bear interest at 5.51%.

In November 1998, Hanover agreed to lend an additional $226,693 in unsecured loans to the Principals. These loans are due and payable in November 2002 and bear interest at 4.47% (the lowest applicable Federal tax rate in November 1998). A portion of these loans ($44,223) was repaid in February 1999.

During 1998 Hanover advanced funds to HCP pursuant to an unsecured loan agreement. The loans to HCP bear interest at 1.00% below the prime rate. At December 31, 1998 the loans outstanding to HCP totaled $712,824.

9. REVERSE REPURCHASE AGREEMENTS

Reverse repurchase agreements are accounted for as collateralized financing transactions and recorded at their contractual amounts. At December 31, 1998 the Company had a total of $520 million of committed and uncommitted mortgage asset reverse repurchase agreement financing available pursuant to master reverse repurchase agreements with four lenders. All borrowings pursuant to the master repurchase agreements are secured by mortgage loans or other securities.

The reverse repurchase agreements collateralized by mortgage loans are short term borrowings with interest rates that vary from LIBOR plus 60 basis points to LIBOR plus 100 basis points. The lender will typically finance an amount equal to 80% to 97% of the market value of the pledged collateral (mortgage loans) depending on certain characteristics of the collateral (delinquencies, liens, aging, etc.). The reverse repurchase agreement financing rates for mortgage securities, accomplished through individual Public Securities Associates (PSA) agreements, bear interest rates that vary from LIBOR to LIBOR plus 50 basis points. The lender will typically finance an amount equal to 60% to 97% of the market value of the mortgage securities, depending on the nature of the collateral.

At December 31, 1998 the Company had outstanding borrowings on mortgage loans of $306,239,000 under the above mentioned reverse repurchase agreements with a weighted average borrowing rate of 6.802% and a weighted average remaining maturity of less than one month. The reverse repurchase financing agreements at December 31, 1998 were collateralized by mortgage loans with a cost basis of $320,759,000.

The Company also uses the above repurchase agreement financing to finance a portion of the collateral for mortgage backed bonds. At December 31, 1998, the Company had outstanding borrowings of $1,911,000 with a weighted average borrowing rate of 6.318% and a weighted average remaining maturity of less than three months. The reverse repurchase financing agreements at December 31, 1998 were collateralized by mortgage assets with a cost basis of $2,542,000.

At December 31, 1998, the Company had outstanding mortgage securities reverse repurchase agreement financing of $61,940,000 with a weighted average borrowing rate of 5.336% and a remaining maturity of less than one month. The repurchase agreement financing at December 31, 1998 was collateralized by mortgage securities with a cost basis of $64,938,000.

The table below details the scheduled maturities of the Company's committed and uncommitted master reverse repurchase agreements at December 31, 1998:

Committed	Uncommitted	Maturity Date
--	$70 million	(a)
$100 million	--	February 1999
100 million	100 million	March 1999
150 million	--	June 1999

(a) the lender did not extend the term of the master reverse repurchase agreement at the maturity date (September 1998) but has agreed to continue to provide uncommitted financing to the Company for an unspecified short-term period.

Information pertaining to reverse repurchase agreements for 1998 and 1997 is summarized as follows (dollars in thousands):

Reverse Repurchase Agreements	1998 Mortgage Loans (a)	1998 Collateral for Mortgage Backed Bonds	1998 Mortgage Securities
Balance at year-end	$306,239	$1,911	$ 61,940
Average balance during the period	$367,656	$ 760	$224,050
Average interest rate during the period	6.511%	6.853%	5.695%
Maximum month-end balance during the period	$659,319	$2,331	$249,450
Collateral Underlying the Agreements			
Balance at year-end - carrying value	$320,759	$2,542	$ 64,938

Reverse Repurchase Agreements	1997 Mortgage Loans (a)	1997 ARM Securities
Balance at period-end	$ 93,731	$341,407
Average balance during the period (b)	$ 93,674	$341,407
Average interest rate during period (b)	6.313%	5.723%
Maximum month-end balance during the period	$ 93,731	$341,407
Collateral Underlying the Agreements		
Balance at period-end - carrying balance	$160,970	$348,131

(a) collateral includes mortgages held for sale and mortgages held to maturity.
(b) reflects the period beginning September 30, 1997 (the date of the first mortgage asset purchase) through December 31, 1997.

Additional information pertaining to individual reverse repurchase agreement lenders at December 31, 1998 is summarized as follows (dollars in thousands):

Lender	Type of Collateral	Reverse Repurchase Financing	Accrued Interest	Total Financing	Underlying Collateral	Weighted Average Maturity Date
Morgan Stanley Mortgage Capital	Mortgage loans	$118,195	$ 466	$118,641	$130,520	Feb 4, 1999
Lender A	Mortgage loans	91,190	0	91,190	93,696	Feb 9, 1999
Lender B	Mortgage loans	70,135	49	70,184	67,902	Feb 15, 1999
Lender C	Mortgage loans	26,719	358	27,077	28,641	Feb 7, 1999
Lender C	Mortgage loans	1,911	449	2,360	2,542	Mar 2, 1999
Morgan Stanley Mortgage Capital	Mortgage securities	$ 58,707	$ 88	58,795	61,559	Jan 25, 1999
Lender D	Mortgage securities	3,233	4	3,237	3,379	Jan 22, 1999
		$370,090	$ 1,394	$371,484	$388,239	

10. MORTGAGE BACKED BONDS

The Company, through a wholly owned subsidiary, Hanover Capital SPC, Inc. has issued non-recourse debt in the form of mortgage backed bonds. Borrower remittances received on the collateral for mortgage backed bonds are used to make payments on the mortgage backed bonds. The obligations under the mortgage backed bonds are payable solely from the collateral for mortgage backed bonds and are otherwise non-recourse to the Company. The maturity of the bonds is directly affected by the rate of principal prepayments on the related collateral. The bonds are subject to redemption according to specific terms of the respective indentures, generally when the remaining balance of the bonds equals 20% or less of the original principal balance of the bonds. As a result, the actual maturity of any class of mortgage backed bonds is likely to occur earlier than its stated maturity.

Information pertaining to mortgage backed bonds financing for 1998 is summarized as follows (dollars in thousands):

	Mortgage Backed Bonds
Balance at year-end	$77,305
Average balance during the period	$63,764
Average interest rate during period	6.914%
Interest rate at year-end	6.940%
Maximum month-end balance during the period	$98,391

Collateral for Mortgage Backed Bonds	
Balance at year end - carrying value	$81,666

Aggregate annual repayments of mortgage backed bonds based upon contractual amortization of the underlying mortgage loan collateral at December 31, 1998 were as follows (dollars in thousands):

YEAR	AMOUNT
1999	$ 1,729
2000	1,875
2001	2,035
2002	2,207
2003	2,394
Thereafter	67,065
Total	$77,305

11. COMMON STOCK REPURCHASES

In July 1998, the Board of Directors of the Company authorized a share repurchase program pursuant to which the Company was authorized to repurchase up to 646,880 shares of the Company's outstanding common stock. The repurchases will be made from time to time in open market transactions. During the period from August through October 1998, the Company repurchased a total of 146,900 shares of its common stock at an average price of $9.16 per share for a total cost of $1,345,000.

12. 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 ($10,000 in 1998 and $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.

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").

The 1997 Stock Option Plan authorizes the grant of options to purchase an aggregate of up to 325,333 shares of the Company's 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 the 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 ISO's 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"). No vesting occurred on the first Earn-Out Measuring Date (September 30, 1998) as the Company did not meet or exceed the vesting requirements. 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.

A summary of the status of the Company's 1997 Stock Option Plan as of December 31, 1998 and changes during the period from September 19, 1997 to December 31, 1997 and for the year ended December 31, 1998, is presented below:

Stock Option Activity - 1997	# of Options for Shares	Exercise Price	Weighted Average 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
Stock Option Activity - 1998			
Granted - January 14, 1998	2,000	$15.94	
Granted - March 9, 1998	2,000	18.13	
Cancelled	(1,750)	15.75	
Outstanding at December 31, 1998	322,574		$15.39

No shares were exercisable at December 31, 1998 and 1997.

The per share weighted average fair value of stock options granted during the period ended December 31, 1998 and 1997 was $0.95 and $0.27, respectively at the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	1998	1997
Expected life (years)	9	5
Risk-free interest rate	5.10%	5.77%
Volatility	60.0%	12.0%
Expected dividend yield	10.0%	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 for 1998 and 1997. 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 for the period indicated below (dollars in thousands, except per share data):

	YEAR ENDED DECEMBER 31, 1998	PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
Net earnings (loss):		
As reported	$(4,934)	$ 499
Pro forma	$(4,938)	417
Earnings (loss) per share - basic:		
As reported	$ (0.77)	$0.15
Pro forma	$ (0.77)	0.13
Earnings (loss) per share - diluted :		
As reported	$ (0.77)	$0.14
Pro forma	$ (0.77)	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 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 allows 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 1998 and 1997.

13. AFFILIATED PARTY TRANSACTIONS

The Company engaged HCP pursuant to a Management Agreement to render among other things, due diligence, asset management and administrative services. The 1998 consolidated statement of operations of the Company includes management and administrative expenses of $733,000, due diligence expenses of $687,000 and commission expenses of $286,000 relating to billings from HCP. The 1998 consolidated statement of operations also reflects a reduction in personnel expenses for a portion of salaries allocated (and billed) to HCP. During 1998 the Company recorded $129,300 of interest income generated from loans to the Principals and $126,200 of interest income from loans to HCP. 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, 1998 the consolidated balance sheet of the Company included an amount due from HCP-2 of $304,800 and an amount due from HCP of $8,200. The term of the Management Agreement continues until December 31, 1999 with subsequent renewal provisions.

14. EARNINGS PER SHARE

In 1997 the Company adopted SFAS 128 for calculating earnings per share for the periods shown below: (dollars in thousands, except per share data)

	YEAR ENDED DECEMBER 31, 1998	PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
Earnings (loss) per share - basic:		
Net income (loss) (numerator)	$ (4,934)	$ 499
Average common shares outstanding (denominator)	6,418,305	3,296,742
Per share	$ (0.77)	$ 0.15
Earnings (loss) per share-diluted:		
Net income (loss) (numerator)	$ (4,934)	$ 499
Average common shares outstanding	6,418,305	3,296,742
Add: Incremental shares from assumed conversion of warrants	--	374,943
Dilutive potential common shares	--	374,943
Adjusted weighted average shares (denominator)	6,418,305	3,671,685
Per share	$ (0.77)	$ 0.14

15. SUPPLEMENTAL DISCLOSURES FOR STATEMENTS OF CASH FLOWS (in thousands except share data):

	YEAR ENDED DECEMBER 31, 1998	PERIOD FROM JUNE 10 (INCEPTION) TO DECEMBER 31, 1997
Supplemental Cash Flow Information:		
Cash paid during the period for:		
Income taxes	$ 1	--
Interest	$39,876	$844

Supplemental Schedule of Noncash Activities

Dividends of $695 and $1,035 were declared in December 1998 and December 1997 but not paid until January 1999 and January 1998, respectively.

Acquisition of a 99% economic ownership in Hanover Capital Partners 2, Inc. in October 1998 from the contribution of $324,210 (book value) of mortgage loans net of $309,963 of reverse repurchase agreement financing less funds to be returned to Hanover of $71.

Acquisition of a 97% economic ownership in Hanover Capital Partners Ltd. in September 1997 from the issuance of 716,667 shares of Hanover's common stock.

16. COMMITMENTS AND CONTINGENCIES

Hanover entered into employment agreements with the Principals in 1997. Such agreements are for five year terms which expire in 2002, and provide for initial aggregate annual base salaries of $975,000 (subject to cost of living increases). A portion of the aggregate base salaries ($360,000) is allocated to one of Hanover's taxable subsidiaries, HCP, 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 Hanover, Hanover has agreed to (1) issue to the Principals up to 216,667 additional shares of Hanover'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 Hanover's IPO Prospectus dated September 15, 1997.

Hanover has guaranteed a bank line-of-credit for HCP. The maximum line-of-credit obligation and the actual line-of-credit obligation at December 31, 1998 were $1,400,000 and $-0-, respectively.

Hanover has guaranteed the obligations of HCP with respect to an amendment to an office lease entered into by HCP. The office lease (anticipated to be effective on or about May 1, 1999) is for a period of 10 years and 3 months and obligates HCP for $2,162,300 of base rental expense plus escalation, electric and other billings over the lease term.

Pursuant to a short-term (3 month) reverse repurchase financing agreement entered into in November 1998, Hanover has agreed to issue and deliver to the lender warrants to purchase approximately 300,000 shares of Hanover's common stock. The warrants will be exercisable at a price per share equal to the closing price of Hanover's common stock on the American Stock Exchange on the date of the November agreement, which was $4.00. In addition, Hanover agreed to (1) retain and compensate the lender as an underwriter on certain future mortgage loan securitization deals, (2) have HCMC offer the lender the right to purchase any originated commercial loans through November 2000 on the same terms and conditions as it would offer such to a third party and (3) offer the lender the opportunity to act as master servicer on any mortgage loan securitization effected by the Company through November 2000 on the same terms and conditions as it would offer such to a third party. The lender in turn will offer HCP the opportunity to undertake due diligence services for portfolio transactions or for securitization transactions in which the lender is not undertaking or is otherwise contracting with third parties for such due diligence services on the same terms and conditions as it would offer such to a third party through November 2000.

In October 1998, the Company sold 15 adjustable rate FNMA certificates and 19 fixed rate FNMA certificates that the Company received in a swap for certain adjustable rate and fixed rate mortgage loans. These securities were sold with recourse. Accordingly, the Company retains credit risk with respect to the principal amount of these mortgage securities.

17. 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, 1998 and 1997 are as follows (dollars in thousands):

	DECEMBER 31, 1998		
	Carrying Amount		Fair Value
Assets:			
Mortgage loans	$407,994		$407,694
Mortgage securities	78,478		78,473
Cash and cash equivalents	11,837		11,837
Accrued interest receivable	3,940		3,940
Notes receivable	3,893		3,893
Total	$506,142		$505,837
Liabilities:			
Reverse repurchase agreements	$370,090		$370,090
Mortgage backed bonds	77,305		77,831
Accrued interest payable	1,394		1,394
Other liabilities	1,601		1,601
Total	$450,390		$450,916
	Carring Value	Notional Amount	Fair Value
Off-Balance Sheet:			
Forward commitments to sell mortgage securities	$ --	$ 51,457	$ 51,409
Interest rate caps	$ 394	$ 69,939	$ 200

	DECEMBER 31, 1997	
	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 Amount	Fair Value
Commitments to purchase loans	$111,092	$111,132
Forward commitments to sell securities	$122,650	$122,378

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

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

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

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

Mortgage securities available for sale - The fair values of these financial instruments are based upon either or all of the following: actual prices received upon recent sales of securities to investors, projected prices which could be obtained through investors, estimates considering interest rates, 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 securities held to maturity - The fair values of these financial instruments are based upon either or all of the following: actual prices received upon recent sales of securities to investors, projected prices which could be obtained through investor estimates considering interest rates, 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.

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.

Mortgage backed bonds - The fair values of these financial instruments are based upon either or all of the following: actual prices received upon recent sales of securities to investors, projected prices which could be obtained through investor estimates considering interest rates, 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.

Commitments to purchase mortgages - The Company had outstanding commitments to purchase 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 loans held for sale.

Forward commitments to sell securities - The Company has outstanding forward commitments to sell mortgage securities into mandatory delivery contracts with investment bankers, private investors and agency-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 loans held for sale.

Interest rate caps - The fair values of these financial instruments are estimated based on dealer quotes and is the estimated amount the Company would pay to execute a new agreement with similar terms.

18. SUBSEQUENT EVENT

On January 25, 1999 an $0.11 cash dividend previously declared by the Board of Directors was paid to stockholders of record as of December 31, 1998.

In February and March 1999, Hanover purchased an additional 195,000 shares of its common stock at a cost of $983,000 pursuant to the stock repurchase program initiated in July 1998.

In March 1999, Hanover agreed to amend the notes receivable from Principals ($1,203,880) that had a scheduled maturity date of March 31, 1999, by extending the maturity date for two additional years at the lowest applicable Federal rate. The notes were also modified to provide for accelerated repayment by a Principal in the event of such Principal's voluntary termination of employment.

In March 1999, the Company completed a $132,254,000 private placement securitization of fixed rate and adjustable rate single-family residential mortgage loans.

19. QUARTERLY FINANCIAL DATA - UNAUDITED

Selected quarterly financial data are as follows (dollars in thousands, except per share data):

	Three Months Ended December 31, 1998	Three Months Ended September 30, 1998	Three Months Ended June 30, 1998	Three Months Ended March 31, 1998
Net interest income	$ 1,998	$1,692	$ 774	$2,154
Net income (loss)	$(5,884)	$ 346	$ (644)	$1,248
Basic earnings (loss) per share (2)	$ (0.93)	$ 0.05	$(0.10)	$ 0.19
Diluted earnings (loss) per share (2)	$ (0.93)	$ 0.05	$(0.10)	$ 0.17
Dividends declared	$ 0.11	$ 0.17	$ 0.21	$ 0.21

	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.

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, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. 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 consolidated financial position of Hanover Capital Partners Ltd. and Subsidiaries at December 31, 1998 and 1997, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1998 in conformity with generally accepted accounting principles.

DELOITTE & TOUCHE LLP
Parsippany, New Jersey
March 19, 1999

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 1998 AND 1997

ASSETS	1998	1997
CURRENT ASSETS:		
Cash	$ 635,484	$ 208,315
Investment in marketable securities	17,992	17,394
Accounts receivable	517,245	133,829
Receivables from related parties	213,779	757,384
Accrued revenue on contracts in progress	247,100	35,413
Prepaid expenses and other current assets	192,580	118,552
Total current assets	1,824,180	1,270,887
PROPERTY AND EQUIPMENT -- Net	141,459	213,137
MORTGAGE SERVICING RIGHTS	--	49,449
DEFERRED TAX ASSET	801,351	20,081
OTHER ASSETS	128,572	166,670
INCOME TAX RECEIVABLE	219,563	292,885
DUE FROM OFFICER	--	53,766
TOTAL ASSETS	$3,115,125	$2,066,875
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accrued appraisal and subcontractor costs	$ 20,730	$ 131,978
Accounts payable and accrued expenses	466,697	334,591
Deferred revenue	89,625	104,950
Note payable to related party	712,824	--
Total current liabilities	1,289,876	571,519
LONG-TERM LIABILITIES		
Note payable to bank	--	1,405,000
Minority interest	--	616
Total long-term liabilities	--	1,405,616
Total liabilities	1,289,876	1,977,135
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock; $.01 par value, 100,000 shares authorized, 97,000 shares outstanding at December 31, 1998 and 1997	970	970
Common Stock:		
Class A: $.01 par value, 5,000 shares authorized, 3,000 shares outstanding at December 31, 1998 and 1997	30	30
Additional paid-in capital	2,839,947	56,442
Retained earnings (deficit)	(1,015,698)	32,298
Total stockholders' equity	1,825,249	89,740
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$3,115,125	$2,066,875

See note to consolidated financial statements.

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

	1998	1997	1996
REVENUES:			
Due diligence fees	$ 5,001,047	$4,058,609	$ 8,323,789
Mortgage sales and servicing	701,574	826,486	970,757
Loan brokering/asset management fees	654,748	3,027,319	2,469,378
Other income (loss)	(12,609)	58,151	355,715
Total revenues	6,344,760	7,970,565	12,119,639
EXPENSES:			
Personnel expense	4,364,725	5,373,331	4,227,226
Subcontractor expense	1,537,294	1,386,979	2,919,509
Occupancy expense	578,512	495,285	536,520
Travel and subsistence	555,382	302,936	616,795
General and administrative expense	532,006	419,543	525,143
Appraisal, inspection and other professional fees	223,262	618,059	3,128,225
Interest expense	155,128	117,894	134,393
Depreciation and amortization	107,971	117,675	125,928
Reversal of reserve for IRS assessment	--	(23,160)	(277,600)
Total expenses	8,054,280	8,808,542	11,936,139
INCOME (LOSS) BEFORE INCOME TAX PROVISION (BENEFIT)	(1,709,520)	(837,977)	183,500
INCOME TAX PROVISION (BENEFIT)	(661,524)	(325,959)	73,870
NET INCOME (LOSS)	$(1,047,996)	$ (512,018)	$ 109,630
BASIC EARNINGS (LOSS) PER SHARE	$ (349.33)	$ (525.79)	$ 658.74

See notes to consolidated financial statements.

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

	PREFERRED STOCK SHARES	PREFERRED STOCK AMOUNT	COMMON STOCK NEW CLASS A SHARES	COMMON STOCK NEW CLASS A AMOUNT	COMMON STOCK OLD CLASS A SHARES	COMMON STOCK OLD CLASS A AMOUNT	COMMON STOCK CLASS B SHARES	COMMON STOCK CLASS B AMOUNT	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS (DEFICIT)	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)		(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	(166.424)	(2)			(998)	--	--
BALANCE, DECEMBER 31, 1997	97,000	970	3,000	30					56,442	32,298	89,740
Capital contributions									2,783,505	--	2,783,505
Net (loss)										(1,047,996)	(1,047,996)
BALANCE DECEMBER 31, 1998	97,000	$970	3,000	$30					$2,839,947	$(1,015,698)	$ 1,825,249

See notes to consolidated financial statements

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

	1998	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	$(1,047,996)	$ (512,018)	$ 109,630
Adjustments to reconcile net income (loss) to net cash (used in) operating activities:			
Depreciation and amortization	107,971	117,675	125,928
Gain on sale of mortgage servicing rights	(371,977)	(16,916)	(52,318)
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	--
Loss on disposal of securities	100,750	--	--
Loss on sale of trading securities	--	--	1,360
Purchase of trading securities	(598)	(951)	(1,931)
Sale of trading securities	--	--	26,593
Distribution of subsidiary to stockholders	--	--	6,972
Changes in assets - (increase) decrease:			
Accounts receivable	(383,416)	3,550,036	(2,150,117)
Receivables from related parties	597,371	(315,097)	(308,808)
Accrued revenue on contracts in progress	(211,687)	514,368	(384,880)
Income tax receivable	73,322	(292,885)	--
Prepaid expenses and other current assets	(74,028)	24,474	(49,871)
Deferred tax asset	(781,270)	(20,081)	--
Other assets	37,348	(12,254)	(22,914)
Changes in liabilities - increase (decrease):			
Accrued appraisal and subcontractor costs	(111,248)	(2,675,194)	2,741,014
Accounts payable and accrued expenses	132,106	(343,799)	104,018
Income taxes payable	--	(89,477)	(90,490)
Deferred income taxes	--	(12,993)	(17,222)
Deferred revenue	(15,325)	(89,384)	(14,946)
Minority interest	(616)	366	(26,935)
Net cash (used in) operating activities	(1,949,293)	(260,834)	(282,517)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(33,841)	(43,060)	(133,317)
Sale of property and equipment	--	--	4,592
Proceeds from sale of mortgage servicing rights	418,974	34,446	94,043
Purchase of securities	(100,000)	--	--
Capitalization of mortgage servicing rights	--	(43,783)	(37,451)
Net cash provided by (used in) investing activities	285,133	(52,397)	(72,133)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net proceeds from (repayment of) note payable to bank	(1,405,000)	360,000	(330,000)
Net proceeds from note payable to related party	712,824	--	--
Redemption of Class A common stock	--	--	(66,000)
Capital contributions	2,783,505	--	--
Net cash provided by (used in) financing activities	2,091,329	360,000	(396,000)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	427,169	46,769	(750,650)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	208,315	161,546	912,196
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 635,484	$ 208,315	$ 161,546

SUPPLEMENTAL SCHEDULE OF NONCASH ACTIVITIES:
Loans of $13,930,000, $25,649,378 and $35,831,617 were originated by HCMC and funded by investors in 1998, 1997 and 1996, respectively
Noncash dividends of $73,132, were distributed to the Company's stockholders on September 19, 1997

	1998	1997	1996
SUPPLEMENTAL CASH FLOW INFORMATION			
Cash paid during the year for:			
Income taxes	$ 5,671	$ 129,359	$ 205,075
Interest	$ 689,779	$ 116,993	$ 125,748

See notes to consolidated financial statements.

HANOVER CAPITAL PARTNERS LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

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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 wholly-owned subsidiaries (the "Company"). The wholly-owned subsidiaries include HCMC and HCS. 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 amounts 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 investments 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, 1998 and 1997 is detailed below:

	1998	1997
Alpine/Hanover, LLC	1.0%	1.0%
ABH-I, LLC	1.0%	1.0%

c. Revenue Recognition - Revenues from due diligence contracts in progress are recognized for the services provided as they are earned and billed.

d. 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 and servicing.

e. 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.

f. 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.

g. Income Taxes - The Company files a consolidated Federal income tax return. The Company has not been subject to an examination of its income tax returns by the Internal Revenue Service. The Company's tax sharing policy provides that each member of the Federal consolidated group receive an allocation of income taxes as if each filed a separate Federal income tax return.

HCP, HCMC and HCS generally file their state tax returns on a separate Company basis.

Deferred income taxes are provided for the effect of temporary timing differences between the tax basis of an asset or liability and its reported amount in the consolidated financial statements.

h. 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.

i. 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, 1998 and 1997.

j. 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.

k. 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"). 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 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.

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.

l. Basic Earnings per Share - 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.

4. CONCENTRATION RISK

For the years ended December 31, 1998, 1997 and 1996, the Company received revenues from certain customers, which are subject to change annually, which exceeded 10% of total revenues as follows:

	1998	1997	1996
Major Customer #1	28%	24%	46%
Major Customer #2	13%	18%	26%

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, 1998 and 1997, HCMC was servicing 13 and 43 loans, respectively, with unpaid principal balances of $46,329,000 and $120,736,400 including loans subserviced for others of $27,533,700 and $40,055,200 respectively. Escrow balances maintained by HCMC were $1,316,400 and $3,087,400 at December 31, 1998 and 1997, respectively. The aforementioned servicing portfolio and related escrow accounts are not included in the accompanying consolidated balance sheets as of December 31, 1998 and 1997.

Activity in mortgage servicing rights for the years ended December 31, 1998 and 1997 was as follows:

	1998	1997
Beginning balance	$ 49,449	$ 30,587
Capitalization	-	43,783
Sales	(46,997)	(17,530)
Scheduled amortization	(2,452)	(7,391)
	$ -	$ 49,449

The fair value of the Company's capitalized servicing rights at December 31, 1997 was $79,504.

6. MORTGAGE OPERATIONS

In September 1998, the Company purchased a portfolio of single family mortgage loans with a principal balance of $101,586,036. This balance was comprised of fixed rate loans ($22,752,341) and adjustable rate loans ($78,833,695). The mortgage loan portfolio was purchased at 101.395% of par value. The Company sold this portfolio of loans at book value to Hanover Capital Mortgage Holdings, Inc. During the period in which the Company owned the loan portfolio, net interest income of $121,585 was recognized and is reported as a component of other income (loss) in the 1998 consolidated statement of operations.

7. RELATED PARTY TRANSACTIONS

Receivables from related parties at December 31, 1998 and 1997 consist of the following:

	1998	1997
Due from Hanover Capital Mortgage Holdings, Inc. (1)	$ 82,782	$540,044
Due from ABH-I, LLC (includes $9,005 and $28,984 of asset management fees at December 31, 1998 and 1997, respectively) (2)	16,015	51,321
Due from Hanover Asset Services, Inc. (3)	--	8,070
Due from Alpine/Hanover, LLC (2)	--	9,273
Due from Alpine/Hanover II, LLC (3)	--	5,000
Due from Hanover Mortgage Capital Corporation (3)	9,342	5,962
Due from AGR Financial, LLC (4)	44,192	80,813
Due from Hanover Investment Fund (3)	2,250	--
Due from Hanover Capital Partners 2, Inc. (6)	5,150	--
Due from related entities	159,731	700,483
Due from officers (5)	54,048	110,667
Receivables from related parties	$213,779	$811,150

(1) The Company entered into a Management Agreement in 1998 to provide, among other services, 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 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 and $1,370,000 for the years ended December 31, 1997 and 1996, respectively.

(3) Amounts due from entities that are owned by certain of the Company's officers/owners 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 software operating systems, processing capabilities and accounting services.

(5) Amounts due from officers at December 31, 1998 include $53,766 from the Company's President which is scheduled to be repaid in August 1999.

(6) Amounts due reflect certain costs that the Company paid for Hanover Capital Partners 2, Inc. in connection with a security transaction completed by Hanover Capital Partners 2, Inc. in October 1998.

8. PROPERTY AND EQUIPMENT

Property and equipment at December 31, 1998 and 1997 consists of the following:

	1998	1997
Office machinery and equipment	$ 415,032	$ 381,189
Furniture and fixtures	111,246	111,246
Leasehold improvements	68,553	68,553
	594,831	560,988
Less accumulated depreciation	(453,372)	(347,851)
Property and equipment - net	$ 141,459	$ 213,137

Depreciation expense for the years ended December 31, 1998, 1997 and 1996 was $105,519, $110,284, and $113,885, respectively.

9. INCOME TAXES

The components of deferred income taxes as of December 31, 1998 and 1997 are as follows:

	1998	1997
Deferred tax assets	$ 813,003	$ 44,499
Deferred tax liabilities	(11,652)	(24,418)
Net deferred tax assets	$ 801,351	$ 20,081

The items resulting in significant temporary differences for the years ended December 31, 1998 and 1997 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, 1998, 1997 and 1996 consist of the following:

	1998	1997	1996
Current - Federal, state and local	$ --	$(292,885)	$ 91,092
Deferred - Federal, state and local	(661,524)	(33,074)	(17,222)
Total	$(661,524)	$(325,959)	$ 73,870

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

	1998	1997	1996
Federal income taxes (benefit) at statutory rate	$(595,554)	$(285,167)	$ 56,518
State and local income taxes (benefit) net of Federal benefit	(76,256)	(59,486)	14,836
Unconsolidated subsidiary's net income (loss)	--	1,177	(12,793)
Meals and entertainment	6,002	4,052	3,719
Officer's life insurance	4,273	9,613	8,576
Other, net	11	3,852	3,014
Total	$(661,524)	$(325,959)	$ 73,870

The Company has a Federal net operating loss carryforward of approximately $1.4 million which begins to expire in the year 2012.

10. 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.

11. 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 consisted of a short-term note of $1,405,000 with an annual interest rate at the prime rate as of December 31, 1997. The interest rate in effect at December 31, 1997 was 8.50%. 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 was 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. The Line was subsequently paid down in full in July 1998.

12. NOTE PAYABLE TO RELATED PARTY

At December 31, 1998 the Company had a principal balance outstanding on a note payable to Hanover Capital Mortgage Holdings, Inc. in the amount of $712,824. The note bears interest at the prime rate minus 1% and interest is calculated on the daily principal balance outstanding. At December 31, 1998 the interest rate in effect was 7.0%. Included in the 1998 consolidated statement of operations is interest expense in the amount of $126,158 related to this note payable.

13. COMMITMENTS AND CONTINGENCIES

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

YEAR	AMOUNT
1999	$ 276,322
2000	358,531
2001	351,721
2002	299,586
2003	262,220
Thereafter	1,211,137
Total	$2,759,517

Rent expense for the years ended December 31, 1998, 1997 and 1996 amounted to $250,684, $310,814 and $339,421, respectively.

HCHI has guaranteed the obligations of the Company with respect to an amendment to an office lease entered into by the Company. The office lease (anticipated to be effective on or about May 1, 1999) is for a period of 10 years and 3 months and obligates the Company for $2,162,300 of base rental expense plus escalation, electric and other billings over the lease term.

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Hanover Capital Partners 2, Inc.
New York, New York

We have audited the accompanying consolidated balance sheet of Hanover Capital Partners 2, Inc. and Subsidiary (the "Company") as of December 31, 1998 and the related consolidated statements of operations, stockholders' equity and cash flows for the period from October 7, 1998 (inception) through December 31, 1998. 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Hanover Capital Partners 2, Inc. and Subsidiary as of December 31, 1998, and the results of their consolidated operations and their consolidated cash flows for the period from October 7, 1998 (inception) through December 31, 1998 in conformity with generally accepted accounting principles.

DELOITTE & TOUCHE LLP
Parsippany, New Jersey
March 19, 1999

HANOVER CAPITAL PARTNERS 2, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEET
(in thousands, except as noted)

ASSETS	DECEMBER 31, 1998
Mortgage loans:	
Collateral for mortgage backed bonds	$300,599
Cash and cash equivalents	143
Accrued interest receivable	1,868
Deferred financing costs	3,191
TOTAL ASSETS	$305,801
LIABILITIES AND STOCKHOLDERS' EQUITY	
LIABILITIES:	
Mortgage backed bonds	$297,682
Accrued interest payable	1,868
Due to related parties	310
Accrued expenses and other liabilities	154
Total liabilities	300,014
STOCKHOLDERS' EQUITY	
Preferred stock, par value $.01 authorized, 9,900 shares, issued and outstanding, 9,900 shares	--
Common stock, par value $.01 authorized, 100 shares, issued and outstanding, 100 shares	--
Additional paid-in-capital	14,319
Retained (deficit)	(8,532)
Total stockholders' equity	5,787
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$305,801

See notes to consolidated financial statements.

HANOVER CAPITAL PARTNERS 2, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF OPERATIONS PERIOD FROM OCTOBER 7 (INCEPTION) TO DECEMBER 31, 1998 (in thousands, except per share data)

REVENUES:	
Interest income	$ 5,611
Interest expense	5,965
Net interest expense	(354)
Loan loss provision	38
Net interest expense after loan loss provision	(392)
EXPENSES:	
Operating	5
NET (LOSS)	$ (397)
BASIC (LOSS) PER SHARE	$(3,974.00)

See notes to consolidated financial statements.

HANOVER CAPITAL PARTNERS 2, INC. AND SUBSIDIARY

STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM OCTOBER 7 (INCEPTION) TO DECEMBER 31, 1998
(in thousands, except share data)

	PREFERRED STOCK		COMMON STOCK		ADDITIONAL PAID-IN-	RETAINED	
	SHARES	AMOUNT	SHARES	AMOUNT	CAPITAL	(DEFICIT)	TOTAL
Issuance of common stock	--	--	100	--	$ 143		$ 143
Issuance of preferred stock	9,900	--	--	--	14,176	$	14,176
Net (loss)						(397)	(397)
Dividends declared						(8,135)	(8,135)
BALANCE, DECEMBER 31, 1998	9,900	--	100	--	$14,319	$(8,532)	$ 5,787

See notes to consolidated financial statements.

HANOVER CAPITAL PARTNERS 2, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CASH FLOWS PERIOD FROM OCTOBER 7 (INCEPTION) TO DECEMBER 31, 1998 (in thousands, except share data)

CASH FLOWS FROM OPERATING ACTIVITIES:	
Net (loss)	$ (397)
Adjustments to reconcile net (loss) to net cash provided by operating activities:	
Amortization of net premium and deferred costs	353
Loan loss provision	38
(Increase) in accrued interest receivable	(1,868)
Increase in accrued interest payable	1,868
Increase in due to related parties	241
Increase in accrued expenses and other liabilities	73
Net cash provided by operating activities	308
CASH FLOWS FROM INVESTING ACTIVITIES:	
Principal payments received on collateral for mortgage backed bonds	20,082
Transfer of premium and deferred hedge	3,320
Net cash provided by investing activities	23,402
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from mortgage backed bonds	317,764
Payoff of reverse repurchase agreements	(309,963)
Payments on mortgage backed bonds	(20,082)
Deferred financing costs	(3,375)
Capital contributions	143
Payment of dividends	(8,054)
Net cash (used in) financing activities	(23,567)
NET INCREASE IN CASH AND CASH EQUIVALENTS	$ 143
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	$ --
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 143

SUPPLEMENTAL SCHEDULE OF NON-CASH ACTIVITIES

9,900 shares of preferred stock were issued in exchange for $324,210 (book value) of mortgage loans net of $309,963 of reverse repurchase financing in October 1998.

SUPPLEMENTAL CASH FLOW INFORMATION	
Cash paid during the year for interest	$ 3,913

See notes to consolidated financial statements

HANOVER CAPITAL PARTNERS 2, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
PERIOD FROM OCTOBER 7 (INCEPTION) TO DECEMBER 31, 1998

1. BUSINESS DESCRIPTION

GENERAL

Hanover Capital Partners 2, Inc. (the "Company") was incorporated in Delaware on October 7, 1998. The Company was formed to acquire single-family residential mortgage loans from Hanover Capital Mortgage Holdings, Inc. pursuant to its formation transaction and to finance the purchase of these mortgage loans through a REMIC securitization.

Hanover SPC-2, Inc., a wholly owned subsidiary of the Company, was incorporated in Delaware on October 9, 1998 for the sole purpose of selling certain investment grade and subordinated securities to Hanover Capital Mortgage Holdings, Inc., through its wholly-owned subsidiaries, Hanover QRS-1 98-B, Inc. and Hanover QRS-2 98-B, Inc.

CAPITALIZATION

At the time of incorporation, the Company was authorized to issue 9,900 shares of preferred stock at $.01 per share and 100 shares of common stock at $.01 per share.

In October 1998, the Company received $324.2 million of fixed rate mortgage loans (with a par value of $318 million) subject to $310.0 million of reverse repurchase agreement financing from Hanover Capital Mortgage Holdings, Inc. in exchange for the issuance of 9,900 shares of non-voting preferred stock (representing a 99% economic ownership of the Company). In October 1998, the Company also received cash proceeds of $143,189 for the issuance of 100 shares of common stock (representing a 1% economic ownership of the Company).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of Hanover Capital Partners 2, Inc. and its wholly-owned subsidiary, Hanover SPC-2, Inc. All significant inter-company accounts and transactions have been eliminated.

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

REVENUE RECOGNITION

Mortgage loan interest income is recognized on the accrual method based on the net coupon after deducting service fees.

DEFERRED FINANCING COSTS

Deferred financing costs incurred ($3,375,000) in connection with the securitization were capitalized and are being amortized as part of interest expense over the life of the mortgage backed bonds.

EARNINGS PER SHARE

Basic earnings or losses per share excludes dilution and is computed by dividing income or loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings or loss 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 and losses. Shares issued during the period and shares reacquired during the period are weighted for the period they were outstanding.

3. MORTGAGE LOANS

Collateral for mortgage backed bonds

In October 1998 the Company issued its first real estate mortgage investment conduit ("REMIC") security. $317,764,000 of par value single family fixed rate residential mortgage loans were assigned as collateral for the Company's mortgage backed bond (REMIC) security. The Company has limited exposure to credit risk retained on loans it has securitized through the issuance of collateralized bonds. All mortgage loans held as collateral for mortgage backed bonds are reported at cost. Premiums, discounts and all deferred costs associated with the mortgage loans held as collateral for mortgage backed bonds are amortized into interest income over the lives of the mortgage loans using the effective yield method adjusted for the effects of prepayments.

The following table summarizes the Company's single-family fixed rate mortgage loan pools classified as held to maturity (and held as collateral for mortgage backed bonds), which are carried at cost at December 31, 1998 (dollars in thousands):

Fixed rate	$297,682
Net premiums, and deferred costs	2,955
Loan loss provision	(38)
Carrying value	$300,599

The following table summarizes certain characteristics of the Company's single-family fixed rate mortgage loans held as collateral for mortgage backed bonds at December 31, 1998 (dollars in thousands):

Carrying Value of Collateral for Mortgage Backed Bonds	Principal Amount of Collateral for Mortgage Backed Bonds	Weighted Average Net Coupon	Weighted Average Maturity (1)
$300,599	$297,682	7.549%	307

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

The average effective yield after amortization of net premiums, discounts and deferred costs for 1998 on the collateral for the mortgage backed bond portfolio was 7.004%.

4. CONCENTRATION OF CREDIT RISK

The Company's exposure to credit risk associated with its investment 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 mortgage portfolio for loans in certain geographic areas. At December 31, 1998, the percent of total principal amount of loans outstanding in any one state, exceeding 5% of the principal amount of mortgage loans are as follows:

State	
Illinois	18%
California	10
Florida	10
Ohio	8
Indiana	7
Texas	6
Arizona	6
Kentucky	6
	71%

5. AFFILIATED PARTY TRANSACTIONS

In October 1998, the Company received $324.2 million of fixed assets mortgage loans (with a per value of $318 million) subject to $310.0 million of reverse repurchase agreement financing from Hanover Capital Mortgage Holdings, Inc. in exchange for the issuance of 9,800 shares of non-voting preferred stock (representing a 99% economic ownership of the Company).

At December 31, 1998 the Company reflected amounts due to Hanover Capital Mortgage Holdings, Inc. of $304,800 and Hanover Capital Partners, Ltd. of $5,200 for the payment of operating expenses and securitization costs.

6. MORTGAGE BACKED BONDS

The Company, through a wholly owned subsidiary, Hanover SPC-2, Inc. has issued non- recourse debt in the form of mortgage backed bonds. Borrower remittances received on the collateral for mortgage backed bonds are used to make payments on the mortgage backed bonds. The obligations under the mortgage backed bonds are payable solely from the collateral for mortgage backed bonds and are otherwise non-recourse to the Company. The maturity of the bonds is directly affected by the rate of principal prepayments on the related collateral. The bonds are subject to redemption according to specific terms of the respective indentures, generally when the remaining balance of the bonds equals 20% or less of the original principal balance of the bonds. As a result, the actual maturity of any class of mortgage backed bonds is likely to occur earlier than its stated maturity.

Information pertaining to mortgage backed bonds financing for 1998 is summarized as follows (dollars in thousands):

	Mortgage Backed Bonds
Balance at period-end	$297,682
Average balance during the period	$307,843
Average interest rate during the period	7.512%
Interest rate at period end	7.543%
Maximum month-end balance during the period	$317,764
Collateral for Mortgage Backed Bonds	
Balance at period end - carrying value	$300,599

Aggregate annual repayments of mortgage backed bonds based upon contractual amortization of the underlying mortgage loan collateral at December 31, 1998 were as follows (dollars in thousands):

YEAR	AMOUNT
1999	$ 3,738
2000	4,045
2001	4,378
2002	4,738
2003	5,127
Thereafter	275,656
Total	$297,682

7. INCOME TAXES

The Company and its wholly owned subsidiary file a consolidated Federal income tax return. They each file separate income tax returns. Deferred income taxes are provided for the effects of temporary differences between the basis of an asset or liability and its reported amount in the financial statements. The significant differences between the statutory income tax rate result primarily from state income taxes and the recording of a valuation allowance for the entire tax benefit including the deferred tax asset. The significant differences giving rise to deferred tax assets and liabilities result primarily from the treatment of the REMIC transaction as a sale for income tax purposes.

The Company had a net deferred tax asset of approximately $2,725,000 which is fully reserved by a valuation allowance. This deferred tax asset is substantially the result of a net operating loss carryforward in the amount of $3,800,000 which expires in the year 2013 for Federal income tax purposes and a capital loss carryforward of $3,063,000.

8. 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 at December 31, 1998 is as follows (dollars in thousands):

	Carrying Amount	Fair Value
Assets:		
Mortgage loans		
Collateral for mortgage backed bonds	$300,599	$297,367
Cash and cash equivalents	143	143
Accrued interest receivable	1,868	1,868
Total	$302,610	$299,378
Liabilities:		
Mortgage backed bonds	$297,682	$297,367
Accrued interest payable	1,868	1,868
Other liabilities	464	464
Total	$300,014	$299,699

The Company had no off-balance sheet financial instruments at December 31, 1998.

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

Collateral for mortgage backed bonds - The fair values of mortgage loans are based upon actual prices received upon recent sales of loans and securities to investors and projected prices which could be obtained through investors considering interest rates, loan type, and credit quality.

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

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

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 Amendment, 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 Agreement, 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 Stanley Mortgage Capital Inc., dated as of December 8, 1997
***10.31	Master Loan and Security Agreement by and between Greenwich Capital Financial Products, Inc. and Hanover Capital Mortgage Holdings, Inc., dated March 30, 1998
10.32	Amended and Restated Master Loan and Security Agreement between the Company, HCP and Morgan Stanley Mortgage Capital Inc., dated January 8, 1999.
10.33	Purchase Price and Terms Letter agreement between Residential Funding Corporation and the Company, dated November 10, 1998.

21	Subsidiaries of the Company
27	Financial Data Schedule

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* 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.

*** Incorporated herein by reference to the Company's Form 10-Q, for the quarter ended March 31, 1998, as filed with Securities and Exchange Commission.

**** Incorporated herein by reference to the Company's Form 10-K for the year ended December 31, 1997, as filed with the Securities and Exchange Commission.

CWT Draft December 29, 1998

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AMENDED AND RESTATED
MASTER LOAN AND SECURITY AGREEMENT

DATED AS OF JANUARY 8, 1999

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.
AS BORROWER

AND

HANOVER CAPITAL PARTNERS, LTD
AS BORROWER

AND

MORGAN STANLEY MORTGAGE CAPITAL INC.
AS LENDER

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EXHIBIT D Form of Request for Borrowing

EXHIBIT E-1 Form of Borrower's Release Letter

EXHIBIT E-2 Form of Warehouse Lender's Release Letter

EXHIBIT F Underwriting Guidelines

EXHIBIT G Form of Blocked Account Agreement
EXHIBIT H Form of Servicer Notice

AMENDED AND RESTATED MASTER LOAN AND SECURITY AGREEMENT

AMENDED AND RESTATED MASTER LOAN AND SECURITY AGREEMENT, dated as of January 8, 1999, between HANOVER CAPITAL MORTGAGE HOLDINGS, INC., ("HCMH"); a Maryland corporation, HANOVER CAPITAL PARTNERS, LTD, a New York corporation ("HCP", together with HCMH, the "BORROWERS"), and MORGAN STANLEY MORTGAGE CAPITAL INC., a Delaware corporation (the "LENDER").

RECITALS

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

Hanover Capital Mortgage Holdings, Inc. entered into that certain Master Loan and Security Agreement, dated December 8, 1997 (the "EXISTING AGREEMENT") with the Lender to finance certain mortgage loans on the terms and conditions as set forth in the Existing Agreement. Pursuant to that certain Amendment #3 and Joinder, dated as of September 21, 1998, Hanover Capital Mortgage Holdings, Inc. and the Lender agreed to add Hanover Capital Partners, LTD as an additional Borrower. The Borrowers and the Lender desire to amend and restate the Existing Agreement to provide terms and conditions under which the Lender is prepared to make further loans to the Borrowers from and after the date hereof.

NOW, THEREFORE, the Existing Agreement is hereby amended and restated in its entirety, as provided in the heading and recitals hereto, to read in its entirety 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 with respect to any Person, any "affiliate" of such Person, as such term is defined in the Bankruptcy Code.

"AMENDED AND RESTATED 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.

"APPLICABLE COLLATERAL PERCENTAGE" shall mean (a) with respect to all Eligible Mortgage Loans other than Second Lien Mortgage Loans and Delinquent Mortgage Loans, 96%, (b) with respect to all Eligible Mortgage Loans that are Second Lien Mortgage Loans, 90%, (c) with respect to all Eligible Mortgage Loans that are 30 Day Delinquent Mortgage Loans, 85% and (d) with respect to all Eligible Mortgage Loans that are 60 Day Delinquent Mortgage Loans, 80%.

"APPLICABLE MARGIN" shall mean (a) with respect to all Eligible Mortgage Loans that are not Delinquent Mortgage Loans, 100 basis points (1.00%) and (b) with respect to all Eligible Mortgage Loans that are Delinquent Mortgage Loans, 150 basis points (1.50%).

"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.

"ASSIGNMENT OF MORTGAGE" means, with respect to any mortgage, an assignment of the mortgage, notice of transfer or equivalent instrument in recordable form, sufficient under the laws of the jurisdiction wherein the related mortgaged property is located to reflect the assignment and pledge of the mortgage.

"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, the Borrowers 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.

"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 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.

"CASH EQUIVALENTS" shall mean (a) securities with maturities of 90 days or less from the date of acquisition issued or fully guaranteed or insured by the United States Government or any agency thereof, (b) certificates of deposit and eurodollar time deposits with maturities of 90 days or less from the date of acquisition and overnight bank deposits of any commercial bank having capital and surplus in excess of $1,000,000,000, (c) repurchase obligations of any commercial bank satisfying the requirements of clause (b) of this definition, having a term of not more than seven days with respect to securities issued or fully guaranteed or insured by the United States Government, (d) commercial paper of a domestic issuer rated at least A-1 or the equivalent thereof by S&P or P-1 or the equivalent thereof by Moody's and in either case maturing within 90 days after the day of acquisition, (e) securities with maturities of 90 days or less from the date of acquisition issued or fully guaranteed by any state, commonwealth or territory of the United States, by any political subdivision or taxing authority of any such state, commonwealth or territory or by any foreign government, the securities of which state, commonwealth, territory, political subdivision, taxing authority or foreign government (as the case may be) are rated at least A by S&P or A by Moody's, (f) securities with maturities of 90 days or less from the date of acquisition backed by standby letters of credit issued by any commercial bank satisfying the requirements of clause (b) of this definition, or (g) shares of money market, mutual or similar funds which invest exclusively in assets satisfying the requirements of clauses (a) through (f) of this definition.

"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) 96% of the outstanding principal balance of such Mortgage Loan; provided that the following additional limitations on Collateral Value shall apply:

(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 180 days after the date on which it is first included in the Collateral (other than Outstanding Mortgage Loans) or (3) which is an Outstanding Mortgage Loan which remains pledged to the Lender hereunder later than 180 days after the date hereof, unless waived by the Lender in its sole discretion; provided the additional limitations on Collateral Value set forth herein shall apply, (4) 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 (5) which has been released from the possession of the Custodian under the Custodial Agreement to a 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.

"COLLECTION ACCOUNT" shall mean one or more accounts established by the Borrowers 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.

"CUSTODIAL AGREEMENT" shall mean the Amended and Restated Custodial Agreement, dated as of the date hereof, among the Borrowers, 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 a 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 a Borrower is a member.

"EURODOLLAR RATE" shall mean, 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.

"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, 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.

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

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

"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, sale/buy-back 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 one month, except as otherwise provided in this definition. 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. 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.

"LOAN" shall have the meaning provided in Section 2.01(a) hereof.

"LOAN AGREEMENT" shall mean this Amended and Restated 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 Amended and Restated 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, with respect to either Borrower, a material adverse effect on (a) the Property, business, operations, financial condition or prospects of such Borrower, (b) the ability of such 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 CREDIT" shall mean $150,000,000.

"MOODY'S" shall mean Moody's Investors Service.

"MORTGAGE" shall mean the mortgage, deed of trust or other instrument securing a Mortgage Note, which creates a first or second 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 applicable 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 updated as of the close of business of the last business day of the preceding month containing such fields as shall be mutually agreed upon by the Borrowers and the Lender with respect to each Mortgage Loan to be delivered by the Borrowers to the Lender pursuant to Section 2.03(a) hereof.

"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 a 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 applicable Borrower for such period as determined in accordance with GAAP.

"1934 ACT" shall mean the Securities and Exchange Act of 1934, as amended.

"OUTSTANDING MORTGAGE LOAN" shall mean a Mortgage Loan pledged to the Lender prior to the date hereof which remains pledged to the Lender on the date hereof.

"PAYMENT DATE" shall mean (a) the first Business Day of each calendar month, 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 either 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 Amended and Restated 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 4% 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.

"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 T, U AND X" shall mean Regulations 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).

"REQUIREMENT OF LAW" shall mean as to any Person, the certificate of incorporation and by-laws or other organizational or governing documents of such Person, and any law, treaty, rule or regulation or determination of an arbitrator or a court or other Governmental Authority, in each case applicable to or binding upon such Person or any of its property or to which such Person or any of its property is subject.

"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.

"S&P" shall mean Standard and Poor's Ratings Services.

"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,

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

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

"TERMINATION DATE" shall mean July 8,1999 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 applicable Borrower during such period LESS the amount of any nonspecific balance sheet reserves maintained in accordance with GAAP.

"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, AMENDED AND RESTATED 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 (each, a "LOAN") to the Borrowers 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 Credit as in effect from time to time.

(b) Each existing loan outstanding as of the date hereof under the Existing Loan Agreement (each, an "EXISTING LOAN") shall continue and be deemed a Loan made under this Agreement, subject to all the provisions of this Agreement and the outstanding principal amount of such Loans shall be counted against the Maximum Credit. All collateral pledged to the Lender to secure the Existing Loans under the Existing Loan Agreement shall continue to be pledged to the Lender to secure the Loans hereunder and shall be Collateral under this Agreement.

(c) Subject to the terms and conditions of this Loan Agreement, during such period the Borrowers may borrow, repay and reborrow hereunder; PROVIDED that, notwithstanding the foregoing, the Lender shall have no obligation to make Loans to the Borrowers in excess of the then current Maximum Credit and, in the event the obligation of the Lender to make Loans to the Borrowers is terminated as permitted hereunder, the Lender shall have no further obligation to make additional Loans hereunder.

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

2.02 AMENDED AND RESTATED NOTES.

(a) The Loans made by the Lender shall be evidenced by a single amended and restated promissory note of the Borrowers substantially in the form of EXHIBIT A hereto (the "AMENDED AND RESTATED 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 Amended and Restated 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 Borrowers, 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 Amended and Restated 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 Borrowers to make a payment when due of any amount owing hereunder or under the Amended and Restated Note in respect of the Loans.

2.03 PROCEDURE FOR BORROWING.

(a) The Borrowers 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 Borrowers propose to pledge to the Lender and to be included in the Borrowing Base in connection with such borrowing, (ii) the requested Funding Date, (iii) include a Mortgage Loan Tape containing information with respect to the Eligible Mortgage Loans that the Borrowers propose to pledge to the Lender and to be included in the Borrowing Base in connection with such borrowing, and (iv) attach an officer's certificate signed by a Responsible Officer of each of the Borrowers as required by Section 5.02(b) hereof.

(b) Upon the Borrowers' 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 Loan to the Borrowers on the requested Funding Date, in the amount so requested.

(c) The Borrowers 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 Borrowers 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.

(d) Pursuant to the Custodial Agreement, the Custodian shall deliver to the Lender and the Borrowers, 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 Borrowers 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 Borrowers.

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;

then the Lender shall give the Borrowers 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 Borrowers 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 2.50%.

2.05 REPAYMENT OF LOANS; INTEREST.

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

(b) The Borrowers hereby promise 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 Borrowers hereby promise 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 Borrowers hereunder or under the Amended and Restated 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.

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

2.06 MANDATORY PREPAYMENTS; ADDITIONAL PLEDGE.

(a) The Borrowers 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 Borrowers 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 Borrowers on any Business Day, the Borrowers 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 (together with interest thereon) until paid in full. Amounts repaid may be reborrowed in accordance with the terms of this Loan Agreement. If the Borrowers intend to prepay a Loan in whole or in part from a source other than the proceeds of the Mortgage Loans, the Borrowers 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 Borrowers make a prepayment of the Loans on any day which is not a Payment Date, the Borrowers 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 any arrangements from which such funds were obtained. This Section 2.08 shall survive termination of Loan Agreement and payment of the Amended and Restated Note.

2.09 EXTENSION OF TERMINATION DATE

Commencing four months after the date hereof, the Lender shall carry out a review for the purpose of determining, in its sole discretion, whether to extend the then current Termination Date for a period to be determined by Lender in its sole discretion. Within two weeks of initiating such review, the Lender shall give written notice of any extension of the then current Termination Date. At the time of such notice, Lender shall notify the Borrower of any further fees which shall be payable in connection with any extension, including without limitation, any additional Commitment Fee which the Lender may charge as a condition to such extension. Any failure by the Lender to deliver such notice of extension shall be deemed to be the Lender's determination not to extend the then current Termination Date.

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 Borrowers under this Loan Agreement and the Amended and Restated 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 MSMCI, 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 Borrowers acknowledge that they have 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 Amended and Restated 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 REQUIREMENTS OF LAW.

(a) If any Requirement of Law (other than with respect to any amendment made to the Lender's certificate of incorporation and by-laws or other organizational or governing documents) or any change in the interpretation or application thereof or compliance by the Lender with any request or directive (whether or not having the force of law) from any central bank or other Governmental Authority made subsequent to the date hereof:

(i) shall subject the Lender to any tax of any kind whatsoever with respect to this Loan Agreement, the Amended and Restated Note or any Loan made by it (excluding net income taxes) or change the basis of taxation of payments to the Lender in respect thereof;

(ii) shall impose, modify or hold applicable any reserve, special deposit, compulsory Loan or similar requirement against assets held by, deposits or other liabilities in or for the account of, advances, Loans or other extensions of credit by, or any other acquisition of funds by, any office of the Lender which is not otherwise included in the determination of the Eurodollar Rate hereunder, or;

(iii) shall impose on the Lender any other condition;

and the result of any of the foregoing is to increase the cost to the Lender, by an amount which the Lender deems to be material, of making, continuing or maintaining any Loan or to reduce any amount due or owing hereunder in respect thereof, then, in any such case, the Borrowers shall promptly pay the Lender such additional amount or amounts as will compensate the Lender for such increased cost or reduced amount receivable.

(b) If the Lender shall have determined that the adoption of or any change in any Requirement of Law (other than with respect to any amendment made to the Lender's certificate of incorporation and by-laws or other organizational or governing documents) regarding capital adequacy or in the interpretation or application thereof or compliance by the Lender or any corporation controlling the Lender with any request or directive regarding capital adequacy (whether or not having the force of law) from any Governmental Authority made subsequent to the date hereof shall have the effect of reducing the rate of return on the Lender's or such corporation's capital as a consequence of its obligations hereunder to a level below that which the Lender or such corporation could have achieved but for such adoption, change or compliance (taking into consideration the Lender's or such corporation's policies with respect to capital adequacy) by an amount deemed by the Lender to be material, then from time to time, the Borrowers shall promptly pay to the Lender such additional amount or amounts as will compensate the Lender for such reduction.

(c) If the Lender becomes entitled to claim any additional amounts pursuant to this Section, it shall promptly notify the Borrowers of the event by reason of which it has become so entitled. A certificate as to any additional amounts payable pursuant to this Section submitted by the Lender to the Borrowers shall be conclusive in the absence of manifest error.

3.04 COMMITMENT FEE. The Borrowers agree to pay to the Lender a one-time commitment fee equal to $75,000, such payment to be made in Dollars, in immediately available funds, without deduction, set-off or counterclaim, to the Lender upon the execution of the Loan Agreement and the Custodial Agreement. The Lender may, in its sole discretion, net such commitment fee from the proceeds of any Loan advanced to the Borrowers on the date of such execution.

3.05 EXIT FEE. The Borrowers agree to pay to the Lender an exit fee equal to 0.25% (the "EXIT FEE") of the outstanding principal balance of each Mortgage Loan pledged to the Lender, calculated as of the date the Mortgage Loan was pledged to the Lender, for each Mortgage Loan which is no longer pledged to the Lender hereunder (each such Mortgage Loan, a "SUBSEQUENTLY RELEASED MORTGAGE LOAN"). The Exit Fee as adjusted for the Underwriting Fees (as defined below) shall be due and payable on the Termination Date and payment shall be made in Dollars, in immediately available funds, without deduction, set-off or counterclaim, to the Lender at the account set forth in Section 3.01(a) hereof. Without limiting the generality of the foregoing, any Exit Fee for any Subsequently Released Mortgage Loan shall accrue upon any Borrower: (i) placing such Subsequently Released Mortgage Loan in a transaction resulting in the issuance of securities backed in whole or in part by such Subsequently Released Mortgage Loan ; (ii) selling such Subsequently Released Mortgage Loan; (iii) refinancing all or a portion of the Loans extended hereunder and secured in whole or in part by such Subsequently Released Mortgage Loan; or (iv) terminating the Loans or this Loan Agreement (whether due to an Event of Default, the occurrence of the Termination Date or otherwise). The Exit Fee payable on the Termination Date shall be reduced by the aggregate amount of underwriting fees (net of expenses) received by Lender or Lender's Affiliates in transactions where the Lender or Lender's Affiliate, acting as the lead or co-lead underwriter or placement agent, placed Subsequently Released Mortgage Loans in transactions resulting in the issuance of securities backed in whole or in part by such Subsequently Released Mortgage Loans (the "UNDERWRITING FEES"). In the event that any Mortgage Loan becomes a Subsequently Released Mortgage Loan solely because the Lender fails to extend the Termination Date in accordance with Section 2.09 hereof, no Exit Fee shall be payable on account of such Subsequently Released Mortgage Loans.

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 Borrowers' 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, relating to or constituting any and all of the foregoing;

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

(vii) all collateral, however defined, under any other agreement between the Borrower or any of its Affiliates on the one hand and the Lender or any of its Affiliates on the other hand;

(viii) all "general intangibles", "accounts" and "chattel paper" as defined in the Uniform Commercial Code relating to or constituting any and all of the foregoing; and

(ix) any and all replacements, substitutions, distributions on or proceeds of any and all of the foregoing.

(c) The Borrowers hereby assign, pledge and grant a security interest in all of their 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 Amended and Restated Note and under the other Loan Documents (collectively, the "SECURED OBLIGATIONS"). The Borrowers agree to mark their 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 Borrowers, the Borrowers will promptly and duly 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 Borrowers also hereby authorize the Lender to file any such financing or continuation statement without the signature of the Borrowers 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. Neither Borrower shall (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) Each of the Borrowers 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 such Borrower and in the name of such 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, such Borrower hereby gives the Lender the power and right, on behalf of such Borrower, without assent by, but with notice to, such Borrower, if an Event of Default shall have occurred and be continuing, to do the following:

(i) in the name of such 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 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 Borrowers hereby ratify 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 Borrowers also authorize 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 Borrowers for any act or failure to act hereunder, except for its own gross negligence or willful misconduct.

4.05 PERFORMANCE BY LENDER OF BORROWERS' OBLIGATIONS. If either 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 Borrowers 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 Borrowers consisting of cash, checks and other near-cash items shall be held by the Borrowers in trust for the Lender, segregated from other funds of the Borrowers, and shall forthwith upon receipt by the Borrowers be turned over to the Lender in the exact form received by the Borrowers (duly endorsed by the applicable Borrower to the Lender, if required) and (b) any and all such proceeds received by the Lender (whether from the Borrowers 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 Borrowers 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 a Default shall occur and be continuing, the Lender may, at its option, enter into one or more Interest Rate Protection Agreements covering all or a portion of the Mortgage Loans pledged to the Lender hereunder, and the Borrowers shall be responsible for all 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 such Interest Rate Protection Agreements; including without limitation any losses resulting from such Interest Rate Protection Agreements. 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 Borrowers 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 Borrowers, which right or equity is hereby waived or released. The Borrowers further agree, 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 Borrowers' 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 Borrowers waive all claims, damages and demands they 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 Borrowers 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 PRESERVATION 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 Borrowers 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) AMENDED AND RESTATED NOTE. The Amended and Restated Note, duly completed and executed;

(ii) CUSTODIAL AGREEMENT. The Custodial Agreement, duly executed and delivered by the Borrowers, the Lender and the Custodian. In addition, the Borrowers 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 Borrowers and of all corporate or other authority for the Borrowers with respect to the execution, delivery and performance of the Loan Documents and each other document to be delivered by the Borrowers from time to time in connection herewith (and the Lender may conclusively rely on such certificate until it receives notice in writing from the Borrowers to the contrary);

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

(d) TRUST RECEIPT AND MORTGAGE LOAN SCHEDULE AND EXCEPTION REPORT. A Trust Receipt, substantially in the form of ANNEX 2 of the Custodial Agreement, dated the Effective Date, from the Custodian, duly completed, with a Mortgage Loan Schedule and Exception Report attached thereto;

(e) SERVICING AGREEMENT(S). Any Servicing Agreement, certified as a true, correct and complete copy of the original with a letter attached thereto acknowledged by the applicable Servicer directing the Servicer to remit all payments on account of the Mortgage Loans directly to the Lender upon receipt of notice from the Lender of the occurrence of an Event of Default;

(f) SECURITIZATION LETTER. A letter agreement between the Borrowers and MS & Co. granting MS & Co. the exclusive option to act as lead or co-lead underwriter or placement agent in connection with any debt or equity offering made by the Borrowers with respect to the Mortgage Loans, duly executed and delivered by the Borrowers and MS & Co., which shall be satisfactory to the Lender in form and substance, provided, that Borrower shall have the right to employ an alternate lead or co-lead underwriter and pay an Exit Fee pursuant to Section 3.05.

(g) OTHER DOCUMENTS. Such other documents as the Lender may reasonably request; and

(h) PAYMENT OF COMMITMENT FEE. The Borrowers shall pay the commitment fee pursuant to Section 3.04 hereof.

5.02 INITIAL AND SUBSEQUENT LOANS. The making of each Loan to the Borrowers (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:

(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 Borrowers 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 Borrowers certifying as to the truth and accuracy of the above, which certificate shall specifically include a statement that the Borrowers are 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 Mortgage Loan Schedule and Exception Report 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;

(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 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 or an event or events shall have occurred resulting 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 Borrowers hereunder shall constitute a certification by the Borrowers 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 Borrowers due solely to any of the circumstances set forth in Section 5.02(g) hereof, then, upon request of the Borrowers, the Lender shall refund to the Borrower that portion of the commitment fee paid pursuant to Section 3.04 hereof, pro-rated over the number of days (notwithstanding any extension of the Termination Date pursuant to Section 2.09, such amount shall be calculated based upon the original term of this Loan Agreement) during which the Lender fails to make Loans requested by the Borrowers solely because of the circumstances set forth in Section 5.02 (g) hereof.

Section 6. REPRESENTATIONS AND WARRANTIES. The Borrowers represent and warrant to the Lender that throughout the term of this Loan Agreement:

6.01 EXISTENCE. Each of the Borrowers (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; 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.

6.02 FINANCIAL CONDITION. HCMH has heretofore furnished to the Lender a copy of (a) its consolidated balance sheet and the consolidated balance sheets of its consolidated Subsidiaries for the fiscal year of HCMH ended December 31, 1997 and the related consolidated statements of income and retained earnings and of cash flows for HCMH and its consolidated Subsidiaries for such fiscal year, setting forth in each case in comparative form the figures for the previous year, with the opinion thereon of a nationally recognized accounting firm and (b) its consolidated balance sheet and the consolidated balance sheets of its consolidated Subsidiaries for the quarterly fiscal periods of HCMH ended March 31, 1998, June 30, 1998 and September 30, 1998 and the related consolidated statements of income and retained earnings and of cash flows for HCMH and its consolidated Subsidiaries for such quarterly fiscal periods, setting forth in each case in comparative form the figures for the previous year. All such financial statements are complete and correct and fairly present, in all material respects, the consolidated financial condition of HCMH and its Subsidiaries and the consolidated results of their operations as at such dates and for such fiscal periods, all in accordance with GAAP applied on a consistent basis. Since September 30, 1998, there has been no material adverse change in the consolidated business, operations or financial condition of HCMH and its consolidated Subsidiaries taken as a whole from that set forth in said financial statements.

6.03 LITIGATION. There are no actions, suits, arbitrations, investigations (including, without limitation, any of the foregoing which are pending or threatened) or other legal or arbitrable proceedings affecting either Borrower or any of its Subsidiaries or affecting any of the Property of any of them before any Governmental Authority that (i) questions or challenges the validity or enforceability of any of the Loan Documents or any action to be taken in connection with the transactions contemplated hereby, (ii) makes a claim or claims in an aggregate amount greater than $1,000,000.00, (iii) which, individually or in the aggregate, if adversely determined, could reasonably be likely to have a Material Adverse Effect, or (iv) requires filing with the Securities and Exchange Commission in accordance with the 1934 Act or any rules thereunder.

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 provisions thereof will conflict with or result in a breach of the charter or by-laws of either 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 either Borrower or any of its Subsidiaries is a party or by which any of them or any of their Property is bound or to which any of them 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 either Borrower or any of its Subsidiaries pursuant to the terms of any such agreement or instrument.

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

6.08 TAXES. The Borrowers have 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 Borrowers in respect of taxes and other governmental charges are, in the opinion of the Borrowers, adequate.

6.09 INVESTMENT COMPANY ACT. Neither the Borrowers nor any of their Subsidiaries is 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 Borrowers have 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 applicable 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 purchase or otherwise) by the applicable 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 Borrowers in, to and under the Collateral.

(c) Upon receipt by the Custodian of each Mortgage Note, endorsed in blank by a duly authorized officer of the applicable Borrower, the Lender shall have a fully perfected first priority security interest therein, in the Mortgage Loan evidenced thereby and in the Borrowers' 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 Borrowers 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 Borrowers in, to and under such Collateral which can be perfected by filing under the Uniform Commercial Code.

6.11 CHIEF EXECUTIVE OFFICE. On the Effective Date, and during the four months immediately preceding the Effective Date, the Borrowers' chief executive offices, are, and have been, located at 90 West Street, Suite 1508, New York, NY 10006.

6.12 LOCATION OF BOOKS AND RECORDS. The location where the Borrowers keeps their books and records, including all computer tapes and records relating to the Collateral is their chief executive office.

6.13 HEDGING. The Borrowers have 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 Borrowers 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 Borrowers 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 Borrowers, 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 of HCMH is not less than $65,000,000.

6.16 ERISA. Each Plan to which the Borrowers or their Subsidiaries make direct contributions, and, to the knowledge of the Borrowers, 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 Borrowers would be under an obligation to furnish a report to the Lender under Section 7.01(d) hereof.

6.17 PERCENTAGE OWNERSHIP. No Person beneficially owns (directly or indirectly) more than 49% of HCMH.

6.18 SOLVENCY. The actions taken by the Borrowers pursuant to this Loan Agreement are not undertaken with the intent to hinder, delay or defraud the Borrowers' creditors. The Borrowers are not insolvent within the meaning of 11 U.S.C. Section 101(32) and the consummation of the transactions contemplated herein (a) will not cause the Borrowers to become insolvent, (b) will not result in any property remaining with the Borrowers to be unreasonably small capital, and (c) will not result in debts that would be beyond the Borrowers' ability to pay as same mature. The Borrowers are receiving reasonably equivalent value in exchange for the transfer and pledge of the Borrowers' interest in the Collateral made pursuant to this Loan Agreement.

Section 7. COVENANTS OF THE BORROWERS. The Borrowers covenant and agree 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 Borrowers 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 HCMH, the unaudited consolidated balance sheets of HCMH and its consolidated Subsidiaries as at the end of such period and the related unaudited consolidated statements of income and retained earnings and of cash flows for HCMH and its consolidated Subsidiaries 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 HCMH, which certificate shall state that said consolidated financial statements fairly present the consolidated financial condition and results of operations of HCMH and its consolidated Subsidiaries 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 HCMH, the consolidated balance sheets of HCMH and its consolidated Subsidiaries as at the end of such fiscal year and the related consolidated statements of income and retained earnings and of cash flows for HCMH and its consolidated Subsidiaries 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 consolidated financial statements fairly present the consolidated financial condition and results of operations of HCMH and its consolidated Subsidiaries 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 Borrowers 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 Borrowers or any of their Subsidiaries make 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 applicable Borrower setting forth details respecting such event or condition and the action, if any, that the applicable 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 such Borrower or an ERISA Affiliate with respect to such event or condition):

(i) any reportable event, as defined in Section 4043(c) 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, 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 a 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 a 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 a 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 a 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 a 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 would result in the loss of tax-exempt status of the trust of which such Plan is a part if a Borrower or an ERISA Affiliate fails to provide timely security to such Plan in accordance with the provisions of Section 401(a)(29) of the Code or Section 307 of ERISA.

HCMH 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 HCMH to the effect that, to the best of such Responsible Officer's knowledge, the Borrowers during such fiscal period or year have 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 Borrowers 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 litigation, actions, suits, arbitrations, investigations (including, without limitation, any of the foregoing which are pending or threatened) or other legal or arbitrable proceedings affecting either Borrower or any of its Subsidiaries or affecting any of the Property of any of them before any Governmental Authority that (i) questions or challenges the validity or enforceability of any of the Loan Documents or any action to be taken in connection with the transactions contemplated hereby, (ii) makes a claim or claims in an aggregate amount greater than $1,000,000.00, (iii) which, individually or in the aggregate, if adversely determined, could be reasonably likely to have a Material Adverse Effect, or (iv) requires filing with the Securities and Exchange Commission in accordance with the 1934 Act and any rules thereunder.

7.03 EXISTENCE, ETC. The Borrowers will:

(a) preserve and maintain their legal existence and all of their 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;

(c) keep adequate records and books of account, in which complete entries will be made in accordance with GAAP consistently applied;

(d) not move their chief executive office from the address referred to in Section 6.11 unless they 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 their 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 their books and records, to inspect any of their Properties, and to discuss their business and affairs with their officers, all to the extent reasonably requested by the Lender.

7.04 PROHIBITION OF FUNDAMENTAL CHANGES. The Borrowers shall not enter into any transaction of merger or consolidation or amalgamation, or liquidate, wind up or dissolve themselves (or suffer any liquidation, winding up or dissolution) or sell all or substantially all of their assets; PROVIDED, that the Borrowers may merge or consolidate with (a) any wholly owned subsidiary of HCMH, or (b) any other Person if the respective 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 Borrowers shall cure same in accordance with Section 2.06 hereof.

7.06 NOTICES. The Borrowers 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.

Each notice pursuant to this Section shall be accompanied by a statement of a Responsible Officer of the Borrowers setting forth details of the occurrence referred to therein and stating what action the Borrowers have taken or propose to take with respect thereto.

7.07 HEDGING. The Borrowers 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 Borrowers shall deliver to the Lender monthly a written summary of the notional amount of all outstanding Interest Rate Protection Agreements.

7.08 REPORTS. The Borrowers shall provide the Lender with a quarterly report, which report shall include, among other items, (a) a summary of the Borrowers' delinquency and loss experience with respect to mortgage loans serviced by the Borrowers, any Servicer or any designee of either, plus any such additional reports as the Lender may reasonably request with respect to the Borrowers' or any Servicer's servicing portfolio and (b) a mark to market summary of any residual securities held by the Borrowers or any of their Subsidiaries.

7.09 UNDERWRITING GUIDELINES. Without the prior written consent of the Lender, the Borrowers shall not amend or otherwise modify the Underwriting Guidelines. Notwithstanding the preceding sentence, in the event that the Borrowers make any amendment or modification to the Underwriting Guidelines, the Borrowers shall promptly deliver to the Lender a complete copy of the amended or modified Underwriting Guidelines.

7.10 TRANSACTIONS WITH AFFILIATES. Neither Borrower will 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 such Borrower's business and (c) upon fair and reasonable terms no less favorable to such 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 Borrowers pledge to the Lender hereunder any Mortgage Loan acquired by any Borrower from an Affiliate of such Borrower (other than a co-Borrower).

7.11 LIMITATION ON LIENS. The Borrowers 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 Borrowers 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 Borrowers 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 Default, the Borrowers 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 Borrowers, whether now or hereafter outstanding, or make any other distribution in respect of any of the foregoing or to any shareholder or equity owner of the Borrowers, either directly or indirectly, whether in cash or property or in obligations of the Borrowers or any of the Borrowers' consolidated Subsidiaries.

7.14 MAINTENANCE OF TANGIBLE NET WORTH. HCMH shall not permit Tangible Net Worth at any time to be less than the sum of (i) $60,000,000 plus (ii) an amount equal to 75% of the aggregate or positive Net Income (without deduction for quarterly losses).

7.15 MAINTENANCE OF RATIO OF TOTAL INDEBTEDNESS TO TANGIBLE NET WORTH. HCMH 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 Borrowers 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 Borrowers shall provide to the Lender on the fifth Business Day of each month a computer readable file containing servicing information updated as of the close of business of the last business day of the preceding month, 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 Borrowers or any Servicer. The Borrowers shall not cause the Mortgage Loans to be serviced by any servicer other than a servicer expressly approved in writing by the Lender.

7.18 MAINTENANCE OF LIQUIDITY. HCMH shall ensure that, as of the end of each calendar month, it has unencumbered Cash Equivalents in an amount of not less than $4,000,000.

7.19 REQUIRED FILINGS. The Borrowers shall promptly provide the Lender with copies of all documents which the Borrowers or any Affiliate of the Borrowers is required to file with the Securities and Exchange Commission in accordance with the 1934 Act or any rules thereunder.

7.20 NO ADVERSE SELECTION. The Borrowers have not selected the Collateral in a manner so as to adversely affect the Lender's interests.

7.21 LIMITATION ON SUBSIDIARY FORMATION. Except with respect to those Subsidiaries formed solely for the purpose of issuing collateralized mortgage obligations, the Borrowers 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 Borrowers 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 Borrowers 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 Borrowers 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 (i) the Borrowers shall have made any such representations and warranties with knowledge that they were materially false or misleading at the time made or (ii) any such representations and warranties have been determined by the Lender in its sole discretion to be materially false or misleading on a regular basis); or

(d) either Borrower shall fail to comply with the requirements of Section 7.03(a), Section 7.04, Section 7.05, Section 7.06, or Sections 7.09 through 7.22 hereof; 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 either 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 any Borrower or any of its Affiliates by one or more courts, administrative tribunals or other bodies having jurisdiction and the same shall not be satisfied, discharged (or provision shall not be made for such discharge) or bonded, or a stay of execution thereof shall not be procured, within 30 days from the date of entry thereof, and such Borrower or any such Affiliate shall not, within said period of 30 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) either Borrower shall admit in writing its inability to pay its debts as such debts become due; or

(g) either Borrower or any of its Affiliates 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 either Borrower or any of its Affiliates, 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 such Borrower or any such Affiliate or of all or any substantial part of its property, or (iii) similar relief in respect of such Borrower or any such Affiliate 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 30 or more days; or an order for relief against such Borrower or any such Affiliate 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 either Borrower; or

(j) either 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

(k) either Borrower or any of such Borrower's Affiliates shall be in default under any note, indenture, loan agreement, guaranty, swap agreement or any other contract to which it is a party, which default (i) involves the failure to pay a matured obligation, or (ii) permits the acceleration of the maturity of obligations by any other party to or beneficiary of such note, indenture, loan agreement, guaranty, swap agreement or other contract; or

(l) any materially adverse change in the Property, business, financial condition or prospects of either Borrower or any of its Affiliates 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 either Borrower's ability to perform its obligations under this Loan Agreement, the Amended and Restated Note or any other Loan Document; or

(m) any person shall beneficially own (directly or indirectly) more than 49% of HCMH; or

(n) either Borrower or any Affiliate of such Borrower shall default under any other agreement with the Lender or an Affiliate of the Lender.

Section 9. REMEDIES UPON DEFAULT.

(a) An Event of Default shall be deemed to be continuing unless expressly waived by the Lender in writing. Upon the occurrence of one or more Events of Default hereunder, the Lender's obligation to make additional Loans to the Borrowers shall automatically terminate without further action by any Person. 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 Amended and Restated 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 Amended and Restated 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 Borrowers.

(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 Borrowers relating to the Collateral and all documents relating to the Collateral which are then or may thereafter come in to the possession of the Borrowers or any third party acting for the Borrowers and the Borrowers 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 Borrowers 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 Borrowers 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 (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. Any notice delivered to either Borrower shall be deemed to have been delivered notice to both Borrowers.

11.03 INDEMNIFICATION AND EXPENSES.

(a) The Borrowers agree to hold the Lender, and its Affiliates and their officers, directors, employees, agents and advisors (each an "INDEMNIFIED PARTY") harmless from and indemnify any Indemnified Party against all liabilities, losses, damages, judgments, costs and expenses of any kind which may be imposed on, incurred by or asserted against such Indemnified Party (collectively, the "COSTS") relating to or arising out of this Loan Agreement, the Amended and Restated 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 Amended and Restated Note, any other Loan Document or any transaction contemplated hereby or thereby, that, in each case, results from anything other than such Indemnified Party's gross negligence or willful misconduct. Without limiting the generality of the foregoing, the Borrowers agree to hold any Indemnified Party harmless from and indemnify such Indemnified Party against all Costs with respect to all Mortgage Loans relating to or arising out of any violation or alleged violation of any environmental law, rule or regulation or any consumer credit laws, including without limitation the Truth in Lending Act and/or the Real Estate Settlement Procedures Act, that, in each case, results from anything other than such Indemnified Party's gross negligence or willful misconduct. In any suit, proceeding or action brought by an Indemnified Party in connection with any Mortgage Loan for any sum owing thereunder, or to enforce any provisions of any Mortgage Loan, the Borrowers will save, indemnify and hold such Indemnified Party 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 Borrowers 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 Borrowers The Borrowers also agree to reimburse an Indemnified Party as and when billed by such Indemnified Party for all such Indemnified Party's costs and expenses incurred in connection with the enforcement or the preservation of such Indemnified Party's rights under this Loan Agreement, the Amended and Restated Note, any other Loan Document or any transaction contemplated hereby or thereby, including without limitation the reasonable fees and disbursements of its counsel. The Borrowers hereby acknowledges that, notwithstanding the fact that the Note is secured by the Collateral, the obligations of the Borrowers under the Amended and Restated Note are recourse obligations of the Borrowers.

(b) The Borrowers agree 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 Amended and Restated Note, any other Loan Document or any other documents prepared in connection herewith or therewith. The Borrowers agree 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 Borrowers and the Lender and any provision of this Loan Agreement may be waived by the Lender.

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 Borrowers 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. EACH BORROWER HEREBY IRREVOCABLY AND UNCONDITIONALLY:

(A) SUBMITS FOR ITSELF AND ITS PROPERTY IN ANY LEGAL ACTION OR PROCEEDING RELATING TO THIS LOAN AGREEMENT, THE AMENDED AND RESTATED 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

(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 BORROWERS 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. Each Borrower hereby acknowledges that:

(a) it has been advised by counsel in the negotiation, execution and delivery of this Loan Agreement, the Amended and Restated Note and the other Loan Documents;

(b) the Lender has no fiduciary relationship to the Borrower, and the relationship between such Borrower and the Lender is solely that of debtor and creditor; and

(c) no joint venture exists between the Lender and such 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, transferring, 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 Borrowers.

11.14 SERVICING.

(a) The Borrowers covenant 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 Borrowers provide for mortgage loans which they own. 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 Borrowers.

(b) If the Mortgage Loans are serviced by a 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.

(c) If the Mortgage Loans are serviced by a third party servicer (such third party servicer, the "SERVICER"), the Borrowers (i) shall provide a copy of the servicing agreement to the Lender, which shall be in form and substance acceptable to the Lender (the "SERVICING AGREEMENT"); (ii) shall provide a Servicer Notice to the Servicer substantially in the form of EXHIBIT H hereto, and (iii) hereby irrevocably assigns to the Lender and the Lender's successors and assigns all right, title, interest of the Borrowers in, to and under, and the benefits of, any Servicing Agreement with respect to the Mortgage Loans. Any successor to the Servicer shall be approved in writing by the Lender prior to such successor's assumption of servicing obligations with respect to the Mortgage Loans.

(d) If the servicer of the Mortgage Loans is a Borrower or the Servicer is an Affiliate of the Borrower, such Borrower shall provide to the Lender a letter from such Borrower or the Servicer, as the case may be, to the effect that upon the occurrence of an Event of Default, the Lender may terminate any Servicing Agreement and transfer servicing to its designee, at no cost or expense to the Lender, it being agreed that such Borrower will pay any and all fees required to terminate the Servicing Agreement and to effectuate the transfer of servicing to the designee of the Lender.

(e) After the Funding Date, until the pledge of any Mortgage Loan is relinquished by the Custodian, the Borrowers will have no right to modify or alter the terms of such Mortgage Loan and the Borrowers will have no obligation or right to repossess such Mortgage Loan or substitute another Mortgage Loan, except as provided in the Custodial Agreement.

(f) In the event a Borrower or its Affiliate is servicing the Mortgage Loans, such Borrower shall permit the Lender to inspect such Borrower's or its Affiliate's servicing facilities, as the case may be, for the purpose of satisfying the Lender that such Borrower or its Affiliate, as the case may be, has the ability to service the Mortgage Loans as provided in this Loan Agreement.

11.15 PERIODIC DUE DILIGENCE REVIEW. The Borrowers acknowledge that the Lender has the right to perform continuing due diligence reviews with respect to the Mortgage Loans, for purposes of verifying compliance with the representations, warranties and specifications made hereunder, or otherwise, and the Borrowers agree that upon reasonable (but no less than two (2) Business Days') prior notice, unless an Event of Default shall have occurred and is continuing, in which case no notice is required, to the Borrowers, the Lender or its authorized representatives will be permitted during normal business hours to examine, inspect, and make copies and extracts of, the Mortgage Files and any and all documents, records, agreements, instruments or information relating to such Mortgage Loans in the possession or under the control of the Borrowers and/or the Custodian. The Borrowers also shall make available to the Lender a knowledgeable financial or accounting officer for the purpose of answering questions respecting the Mortgage Files and the Mortgage Loans. Without limiting the generality of the foregoing, the Borrowers acknowledge that the Lender may make Loans to the Borrowers based solely upon the information provided by the Borrowers to the Lender in the Mortgage Loan Tape and the representations, warranties and covenants contained herein, and that the Lender, at its option, has the right at any time to conduct a partial or complete due diligence review on some or all of the Mortgage Loans securing such Loan, including without limitation ordering new credit reports and new appraisals on the related Mortgaged Properties and otherwise re-generating the information used to originate such Mortgage Loan. The Lender may underwrite such Mortgage Loans itself or engage a mutually agreed upon third party underwriter to perform such underwriting. The

Borrowers agree to cooperate with the Lender and any third party underwriter in connection with such underwriting, including, but not limited to, providing the Lender and any third party underwriter with access to any and all documents, records, agreements, instruments or information relating to such Mortgage Loans in the possession, or under the control, of the Borrowers. The Borrowers further agree that the Borrowers shall reimburse the Lender for any and all out-of-pocket costs and expenses incurred by the Lender in connection with the Lender's activities pursuant to this Section 11.15 ("DUE DILIGENCE COSTS"); provided that such Due Diligence Costs shall not exceed $20,000 per annum (the "DUE DILIGENCE CAP") unless a Default shall have occurred and be continuing, in which case, no Due Diligence Cap shall apply.

11.16 SET-OFF. In addition to any rights and remedies of the Lender provided by this Loan Agreement and by law, the Lender shall have the right, without prior notice to the Borrowers, any such notice being expressly waived by the Borrowers to the extent permitted by applicable law, upon any amount becoming due and payable by the Borrowers hereunder (whether at the stated maturity, by acceleration or otherwise) to set-off and appropriate and apply against such amount any and all deposits (general or special, time or demand, provisional or final), in any currency, and any other credits, indebtedness or claims, in any currency, in each case whether direct or indirect, absolute or contingent, matured or unmatured, at any time held or owing by the Lender or any Affiliate thereof to or for the credit or the account of the Borrowers. The Lender agrees promptly to notify the Borrowers after any such set-off and application made by the Lender; PROVIDED that the failure to give such notice shall not affect the validity of such set-off and application.

11.17 INTENT. The parties recognize that each Loan is a "securities contract" as that term is defined in Section 741 of Title 11 of the United States Code, as amended.

11.18 JOINT AND SEVERAL LIABILITY. Each Borrower hereby acknowledges and agrees that such Borrower shall be jointly and severally liable for all representations, warranties, covenants, obligations and indemnities of the Borrowers hereunder.

[SIGNATURE PAGE FOLLOWS]

IN WITNESS WHEREOF, the parties hereto have caused this Loan Agreement to be duly executed and delivered as of the day and year first above written.

BORROWER

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

By________________________________
Title:

ADDRESS FOR NOTICES:

90 West Street
Suite 1508
New York, New York 10006

Attention: Joyce Mizerak
Telecopier No.: 212-732-4728
Telephone No.: 212-732-5086

BORROWER

HANOVER CAPITAL PARTNERS, LTD

By________________________________
Title:

ADDRESS FOR NOTICES:

90 West Street
Suite 1508
New York, New York 10006

Attention: Joyce Mizerak
Telecopier No.: 212-732-4728
Telephone No.: 212-732-5086

LENDER

MORGAN STANLEY MORTGAGE
CAPITAL INC.

By________________________________
Title:

ADDRESS FOR NOTICES:

1585 Broadway
New York, New York 10036
Attention: Mr. Marc Flamino
Telecopier No.: 212-761-0093
Telephone No.: 212-761-2418

SCHEDULE 1

REPRESENTATIONS AND WARRANTIES RE: MORTGAGE LOANS

Part I. ELIGIBLE MORTGAGE LOANS

As to each Mortgage Loan included in the Borrowing Base on a Funding Date (and the related Mortgage, Mortgage Note, Assignment of Mortgage and Mortgaged Property), the applicable Borrower shall be deemed to make the following representations and warranties to the Lender as of such date and as of each date Collateral Value is determined (certain defined terms used herein and not otherwise defined in the Loan Agreement appearing in Part II to this Schedule 1):

(a) MORTGAGE LOANS AS DESCRIBED. The information set forth in the Mortgage Loan Schedule with respect to the Mortgage Loan is complete, true and correct in all material respects.

(b) PAYMENTS CURRENT. Except with respect to 30 Day Delinquent Mortgage Loans and 60 Day Delinquent Mortgage Loans, all payments required to be made up to the Funding Date for the Mortgage Loan under the terms of the Mortgage Note have been made and credited. No payment required under the Mortgage Loan is delinquent in excess of 89 days. The first Monthly Payment shall be made, or shall have been made, with respect to the Mortgage Loan on its Due Date or within the grace period, all in accordance with the terms of the related Mortgage Note.

(c) NO OUTSTANDING CHARGES. There are no defaults in complying with the terms of the Mortgage securing the Mortgage Loan, and all taxes, governmental assessments, insurance premiums, water, sewer and municipal charges, leasehold payments or ground rents which previously became due and owing have been paid, or an escrow of funds has been established in an amount sufficient to pay for every such item which remains unpaid and which has been assessed but is not yet due and payable. Neither the Borrower nor the Qualified Originator from which the Borrower acquired the Mortgage Loan has advanced funds, or induced, solicited or knowingly received any advance of funds by a party other than the Mortgagor, directly or indirectly, for the payment of any amount required under the Mortgage Loan, except for interest accruing from the date of the Mortgage Note or date of disbursement of the proceeds of the Mortgage Loan, whichever is earlier, to the day which precedes by one month the Due Date of the first installment of principal and interest thereunder.

(d) ORIGINAL TERMS UNMODIFIED. The terms of the Mortgage Note and Mortgage have not been impaired, waived, altered or modified in any respect, from the date of origination; except by a written instrument which has been recorded, if necessary to protect the interests of the Lender, and which has been delivered to the Custodian and the terms of which are reflected in the Mortgage Loan Schedule. The substance of any such waiver, alteration or modification has been approved by the title insurer, to the extent required, and its terms are reflected on the Mortgage Loan Schedule. No Mortgagor in respect of the Mortgage Loan has been released, in whole or in part, except in connection with an assumption agreement approved by the title insurer, to the extent required by such policy, and which assumption agreement is part of the Mortgage File delivered to the Custodian and the terms of which are reflected in the Mortgage Loan Schedule.

(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 Emergency Management Agency 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 National Flood Insurance Act of 1968, as amended by the Flood Disaster Protection Act of 1974. 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.

(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 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;

(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; and

(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 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 100%. 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 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.

(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 Funding 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 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 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.

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.

"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 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

EXHIBIT A

[FORM OF AMENDED AND RESTATED PROMISSORY NOTE]

$150,000,000

December 8, 1997
as amended and restated as of January 8, 1999
New York, New York

FOR VALUE RECEIVED, HANOVER CAPITAL MORTGAGE HOLDINGS, INC., a Maryland corporation, and HANOVER CAPITAL PARTNERS, LTD, a New York corporation (each a "BORROWER", collectively the "BORROWERS"), hereby promise 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 FIFTY MILLION DOLLARS ($150,000,000) (or such lesser amount as shall equal the aggregate unpaid principal amount of the Loans made by the Lender to the Borrowers 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 Borrowers, 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 Amended and Restated Promissory 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 Borrowers 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 Amended and Restated Promissory Note is the Amended and Restated Note referred to in the Amended and Restated Master Loan and Security Agreement dated as of January___, 1999 (as amended, supplemented or otherwise modified and in effect from time to time, the "LOAN AGREEMENT") between Hanover Capital Mortgage Holdings, Inc., Hanover Capital Partners, LTD and the Lender, and evidences Loans made by the Lender thereunder. Terms used but not defined in this Amended and Restated Promissory Note have the respective meanings assigned to them in the Loan Agreement.

The Borrowers agree 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 Amended and Restated Promissory Note when incurred, including, without limitation, reasonable attorneys' fees through appellate proceedings.

Notwithstanding the pledge of the Collateral, the Borrowers hereby acknowledge, admit and agree that the Borrowers' obligations under this Amended and Restated Promissory Note are recourse obligations of the Borrowers to which each Borrower pledges its full faith and credit. Each Borrower hereby acknowledges and agrees that such Borrower shall be jointly and severally liable hereunder.

The Borrowers, and any endorsers or guarantors hereof, (a) severally waive diligence, presentment, protest and demand and also notice of protest, demand, dishonor and nonpayments of this Amended and Restated Promissory Note, (b) expressly agree that this Amended and Restated Promissory 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 Amended and Restated Promissory 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 Amended and Restated Promissory 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 Amended and Restated Promissory Note. No extension of time for the payment of this Amended and Restated Promissory Note, or any installment hereof, made by agreement by the Lender with any person now or hereafter liable for the payment of this Amended and Restated Promissory Note, shall affect the liability under this Amended and Restated Promissory Note of the Borrowers, even if the Borrower is not a party to such agreement; PROVIDED, HOWEVER, that the Lender and the Borrowers, by written agreement between them, may affect the liability of the Borrowers.

Any reference herein to the Lender shall be deemed to include and apply to every subsequent holder of this Amended and Restated Promissory Note. Reference is made to the Loan Agreement for provisions concerning optional and mandatory prepayments, Collateral, acceleration and other material terms affecting this Amended and Restated Promissory Note.

This Amended and Restated Promissory Note amends and restates in its entirety the Promissory Note dated December 8, 1997 (the "EXISTING PROMISSORY NOTE") and is given as a continuation, rearrangement and extension, and not a novation, release or satisfaction, of the Existing Promissory Note. The issuance and delivery of this Amended and Restated Promissory Note is in substitution for the Existing Promissory Note. The Borrowers hereby acknowledge and agree that simultaneously with the Borrowers' execution and delivery of this Amended and Restated Promissory Note to the Lender, the Lender has delivered to the Borrowers the Existing Promissory Note.

THIS AMENDED AND RESTATED PROMISSORY 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 AMENDED AND RESTATED PROMISSORY NOTE. THE BORROWER AGREES THAT ANY ACTION OR PROCEEDING BROUGHT TO ENFORCE OR ARISING OUT OF THIS AMENDED AND RESTATED PROMISSORY 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:

HANOVER CAPITAL PARTNERS, :LTD

By: ___________________________________
Name:
Title:

SCHEDULE OF LOANS

This Amended and Restated Promissory Note evidences Loans made under the within-described Loan Agreement to the Borrowers, on the dates, in the principal amounts and bearing interest at the rates set forth below, and subject to the payments and prepayments of principal set forth below:

DATE MADE	PRINCIPAL AMOUNT OF LOAN	INTEREST RATE	AMOUNT PAID OR PREPAID	UNPAID PRINCIPAL AMOUNT	NOTATION MADE BY

EXHIBIT B

[FORM OF CUSTODIAL AGREEMENT]

EXHIBIT C

[FORM OF OPINION OF COUNSEL TO BORROWERS]

(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 ("HCMH") and Hanover Capital Partners, LTD, a New York corporation ("HCP" and, with HCMH, a "BORROWER", collectively, the "BORROWERS"), with respect to certain matters in connection with that certain Amended and Restated Master Loan and Security Agreement, dated as of January 8, 1999 (the "LOAN AND SECURITY AGREEMENT"), by and between the Borrowers and Morgan Stanley Mortgage Capital Inc. (the "LENDER"), being executed contemporaneously with an Amended and Restated Promissory Note dated January 8, 1999 from the Borrowers to the Lender (the "NOTE"), and an Amended and Restated Custodial Agreement, dated as of January 8, 1999 (the "CUSTODIAL AGREEMENT"), by and among the Borrowers, 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 Borrowers 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 Borrowers 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. HCMH is a Maryland corporation duly organized, validly existing and in good standing under the laws of Maryland and is qualified to transact business in, and is in good standing under, the laws of the state of Maryland. HCP is a New York corporation duly organized, validly existing and in good standing under the laws of New York and is qualified to transact business in, and is in good standing under, the laws of the state of New York.

2. Each of the Borrowers has the corporate power to engage in the transactions contemplated by the Loan and Security Agreement, the Note, and the Custodial Agreement and all requisite corporate 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. Each of the Borrowers has all requisite corporate power to borrow under the Loan and Security Agreement and to grant a security interest in the Collateral under the Loan and Security Agreement.

3. The execution, delivery and performance by the Borrowers of the Loan and Security Agreement, the Note, and the Custodial Agreement, and the borrowings by the Borrowers and the pledge of the Collateral under the Loan and Security Agreement have been duly authorized by all necessary corporate action on the part of the Borrowers. Each of the Loan and Security Agreement, the Note and the Custodial Agreement have been executed and delivered by the Borrowers and are legal, valid and binding agreements enforceable in accordance with their respective terms against the Borrowers, 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 Collateral.

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 Borrowers of the Loan and Security Agreement, the Note and the Custodial Agreement or for the borrowings by the Borrowers under the Loan and Security Agreement or the granting of a security interest to the Lender in the Collateral, under the Loan and Security Agreement.

5. The execution, delivery and performance by the Borrowers 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 Borrowers' charters 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 Borrowers 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 Borrowers are a party or by which they are 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 Borrowers 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 Borrowers 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 Borrowers or in any material impairment of the right or ability of the Borrowers 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 Borrowers 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 Borrowers 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, and (b) the security interests in Collateral in which the Borrowers acquires rights after the commencement of a case under the Bankruptcy Code in respect of the Borrowers 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 applicable 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 Borrowers therein, in the Mortgage Loan evidenced thereby and in the Borrowers' 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 Borrowers 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 Borrowers 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

Amended and Restated Master Loan and Security Agreement, dated as of January 8, 1999 (the "LOAN AND SECURITY AGREEMENT"), by and between the Borrowers and Morgan Stanley Mortgage Capital Inc. (the "LENDER"),

Lender:	Morgan Stanley Mortgage Capital Inc.
Borrower:	Hanover Capital Mortgage Holdings, Inc.
	Hanover Capital Partners, LTD
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:

HANOVER CAPITAL PARTNERS, LTD

By:____________________________________
Name:
Title:

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: Amended and Restated Master Loan and Security Agreement, dated as of January 8, 1999 (the "LOAN AND SECURITY AGREEMENT"), by and among Hanover Capital Mortgage Holdings, Inc. and Hanover Capital Partners, LTD. (the "BORROWERS") 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: _________________________

HANOVER CAPITAL PARTNERS, LTD

By: _________________________
Name: _________________________
Title: _________________________

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.][Hanover Capital Partners, LTD]

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:_____________________________

EXHIBIT F

UNDERWRITING GUIDELINES

EXHIBIT G

FORM OF BLOCKED ACCOUNT AGREEMENT

January __, 1999

____
____
____

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 __________, 199__, 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 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. Marc Flamino

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:

EXHIBIT H

FORM OF SERVICER NOTICE

__________ __, 199__

[SERVICER], as Servicer
[ADDRESS]
Attention: ___________

Re: Amended and Restated Master Loan and Security Agreement, dated as of January ___, 1999 (the "LOAN AND SECURITY AGREEMENT"), by and between Hanover Capital Mortgage Holdings, Inc. and Hanover Capital Partners, LTD (the "BORROWERS") and Morgan Stanley Mortgage Capital Inc. (the "LENDER").

Ladies and Gentlemen:

[SERVICER} (the "SERVICER") is servicing certain mortgage loans for the Borrowers pursuant to certain Servicing Agreements between the Servicer and the Borrowers. Pursuant to the Loan and Security Agreement between the Lender and the Borrowers, the Servicer is hereby notified that the Borrowers have pledged to the Lender certain mortgage loans which are serviced by Servicer which are subject to a security interest in favor of the Lender.

Upon receipt of a Notice of Event of Default from the Lender in which the Lender shall identify the mortgage loans which are then pledged to Lender under the Loan Agreement (the "MORTGAGE LOANS"), the Servicer shall segregate all amounts collected on account of such Mortgage Loans, hold them in trust for the sole and exclusive benefit of the Lender, and remit such collections in accordance with the Lender's written instructions. Following such Notice of Event of Default, Servicer shall follow the instructions of Lender with respect to the Mortgage Loans, and shall deliver to Lender any information with respect to the Mortgage Loans reasonably requested by Lender.

Notwithstanding any contrary information which may be delivered to the Servicer by the Borrowers, the Servicer may conclusively rely on any information or Notice of Event of Default delivered by the Lender, and the Borrowers shall indemnify and hold the Servicer harmless for any and all claims asserted against it for any actions taken in good faith by the Servicer in connection with the delivery of such information or Notice of Event of Default.

Please acknowledge receipt of this instruction letter by signing in the signature block below and forwarding an executed copy to the Lender promptly upon receipt. Any notices to the Lender should be delivered to the following address: 1585 Broadway, New York, New York 10036; Attention: Mr. Steven Rudner, with a copy to Mr. Greg Walker; Telephone: (212) 761-2144; Facsimile: (212) 761-0747.

Very truly yours,

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

By:_______________________________
Name:
Title:

HANOVER CAPITAL PARTNERS, LTD

By:_______________________________
Name:
Title:

ACKNOWLEDGED:

___________________________________, as Servicer

By:____
Name:
Title:
Telephone:
Facsimile:

Hanover Capital Mortgage Holdings, Inc.

November 10, 1998

Residential Funding Corporation

8400 Normandale Lake Boulevard, Suite 600

Minneapolis, MN 55437

Attention: Mr. Rod McGinniss

Re: Purchase Price and Terms Letter

Ladies and Gentleman:

Hanover Capital Mortgage Holdings, Inc. (the "Seller") hereby confirms its intent to sell and Residential Funding Corporation (the "Purchaser") hereby confirms its intent to purchase, without recourse (except as expressly agreed by the parties), certain residential 1-4 family mortgage loans as identified on Exhibit A attached hereto (the "Mortgage Loans"), on a servicing retained basis on the terms and conditions set forth below. The parties acknowledge and agree that consummation of the transactions contemplated herein shall be subject to further documentation in form and substance satisfactory to the parties hereto.

The sale of the Mortgage Loans shall be made pursuant to a purchase agreement (the "Purchase Agreement") which sets forth further the terms and provisions with respect to the sale and servicing of the Mortgage Loans. Ownership of the Mortgage Loans shall be evidenced by delivery of the Mortgage Loans as whole loans pursuant to the Purchase Agreement and Custody Agreement, each in form and substance satisfactory to the parties hereto.

1. Term of this Commitment

The Mortgage Loans shall be purchased by the Purchaser and sold by the Seller on such date as shall be mutually agreed upon by the parties, which date shall be no later than November 10, 1998 (the "Closing Date").

2. Aggregate Amount of Mortgage Loans

The aggregate outstanding principal balance as of the Cut-off Date (as defined below) of the Mortgage Loans shall be approximately $98,057,542 with a final reconciliation to be reflected on Exhibit 6 to the Purchase Agreement.

3. Purchase Price

The purchase price (the "Purchase Price") for the Mortgage Loans shall be 97.5% of the aggregate outstanding scheduled principal balance of the Mortgage Loans as of November 1, 1998 (the "Cut-off Date") (after application of payments due on the Mortgage Loans on or before the Cut-off Date, whether or not such payments were actually made), plus no more than thirty days accrued interest at the mortgage interest rate minus the applicable Servicing Fee Rate from the Cut-off Date through the day prior to the Closing Date, inclusive. The Purchase Price shall be paid to the Seller in immediately available federal funds by wire transfer on the Closing Date.

4. Mandatory Repurchase

On or after the 90th day following the Closing Date (such 90th day, the "Termination Date"), with at least one business day's prior written notice to the Seller, the Purchaser shall have the right to require the Seller to repurchase all of the Remaining Mortgage Loans at a price equal to 98% of the aggregate outstanding scheduled principal balance of the Remaining Mortgage Loans as of the date of repurchase plus accrued and unpaid interest from the last scheduled due date up to but not including the date of repurchase (the "Repurchase Price"). For purposes hereof, "Remaining Mortgage Loans" shall mean the Mortgage Loans, as of any date of determination, not sold, paid in full or otherwise liquidated by the Purchaser.

5. Optional Repurchase

On or prior to the Termination Date, with at least one business day's prior written notice to the Purchaser, the Seller shall have the right at any time to repurchase all of the Remaining Mortgage Loans from the Purchaser at the Repurchase Price. In addition, on or prior to the Termination Date, with at least one business day's prior written notice to the Purchaser, the Seller shall have the right to repurchase a portion of the Remaining Mortgage Loans with an aggregate outstanding principal balance of at least $10,000,000. Any such partial repurchase of the Remaining Mortgage Loans shall be subject, however, to the following conditions: (a) that the Mortgage Loans shall be repurchased by the Seller only if the Seller has secured a commitment for the purchase of such Mortgage Loans for a price equal to or in excess of the aggregate outstanding principal balance of such Mortgage Loans, and (b) that the Seller shall cause the buyer of such Mortgage Loans to deposit in the Reserve Fund (defined below) an amount equal to the excess of the Resale Price (defined below) with respect to such Mortgage Loans over the Repurchase Price. In the event however, that the Seller sells any portion of the Mortgage Loans it has repurchased for the purpose of resale to Household Bank f.s.b. ("Household") in accordance with the terms of the Mortgage Loan Sale Agreement by and between Household and Hanover Capital Partners, Ltd. ("Hanover Partners"), the Seller shall cause Household to wire such resale amount to the Reserve Fund. Within one business day following receipt of such funds into the Reserve Fund, the Purchaser shall remit to the Seller from the Reserve Fund the positive difference, if any, between the Resale Price and the aggregate outstanding principal balance of such Mortgage Loans.

Any excess of the aggregate outstanding principal balance of such Mortgage Loans over the Repurchase Price shall remain in the Reserve Fund.

6. Right of First Refusal

On or prior to the Termination Date, prior to entering any sale transaction with any third party counterparty (the "Offering Party") for the purchase of any portion of the Mortgage Loans at a price equal to, or greater than, the then aggregate outstanding principal balance of such portion of the Mortgage Loans (the "Offer Price"), the Purchaser shall, at the point in time at which the Purchaser first receives a bona fide purchase offer, first offer the Seller the right to purchase such Mortgage Loans at the Repurchase Price, in lieu of such sale by the Purchaser to the applicable Offering Party. Notwithstanding the foregoing, on or prior to the Termination Date, the Purchaser shall in no event agree to sell, or accept an offer to sell, the Mortgage Loans to an Offering Party at an Offer Price below the then aggregate outstanding principal balance of any or all of the Mortgage Loans.

7. Reserve Fund; Profits and Losses; Resale Fee

Except as described in paragraph 5, if at any time while the Purchaser owns any Remaining Mortgage Loans, the Seller sells any portion of the Mortgage Loans it has repurchased pursuant to paragraphs 5 or 6 above for a price (the "Resale Price") equal to an amount which exceeds the Repurchase Price, the Seller shall cause the buyer of such Remaining Mortgage Loans to deposit the excess of the Resale Price over the Repurchase Price into a segregated account in the name of the Purchaser (the "Reserve Fund").

Following the Termination Date, in the event the Purchaser sells all Remaining Mortgage Loans to one or more parties (other than an affiliate of the Purchaser), the Purchaser shall determine its aggregate Sales Loss or Net Profit, as applicable, as follows. In the event that the Purchaser has realized a Sales Loss, then the Purchaser shall be entitled to receive from the Reserve Fund (to the extent that funds are available therein) an amount up to such Sales Loss (as defined below). For purposes hereof, the "Sales Loss" shall be an amount equal to the excess, if any of (a) the Repurchase Price for all Remaining Mortgage Loans over (b) the Resale Price for all Remaining Mortgage Loans derived by the Purchaser from any resale of all of the Remaining Mortgage Loans minus the Purchaser's reasonable out of pocket expenses incurred in connection with the resale. In the event that the Purchaser has realized a Net Profit, then the Purchaser shall be entitled to retain such Net Profit. For purposes hereof, "Net Profit" shall mean the excess, if any, of (i) the Resale Price for all Remaining Mortgage Loans minus the Purchaser's reasonable out of pocket expenses incurred in connection with the resale over (ii) the Repurchase Price for all Remaining Mortgage Loans. In the event that the Purchaser shall fail to resell all Remaining Mortgage Loans within 180 days following the Termination Date, then the Resale Price for such Remaining Mortgage Loans shall be deemed to be the Repurchase Price therefor, and the Purchaser shall promptly calculate any Sales Loss or Net Profit, as applicable in accordance with this paragraph.

Notwithstanding and in addition to the foregoing, in the event that the Seller fails to repurchase the Remaining Mortgage Loans on or prior to the Termination Date, the Purchaser shall be entitled to receive from the Seller, within 2 business days following the Termination Date, a resale fee equal to $500,000 which shall constitute liquidated damages hereunder and which amount may be netted by the Purchaser from the Reserve Fund to the extent not paid by the Seller.

Subject to the preceding paragraphs herein, within two business days following the consummation of the sale (or deemed sale) of all Remaining Mortgage Loans by the Purchaser (including any resale back to the Seller as contemplated in paragraphs 4, 5 and 6 above) the Seller shall be entitled to receipt of all amounts then remaining in the Reserve Fund.

8. Servicing

The Seller shall service the Mortgage Loans on a "scheduled/scheduled" basis in accordance with the Purchaser's Servicing Guide and shall cause any Subservicer (as defined below) to remit all amounts received on account of the Mortgage Loans directly to the Purchaser at an account designated by the Purchaser and shall cause a remittance report to be delivered to the Seller. Within 5 business days of receipt of any such remittance report, the Seller shall provide the Purchaser with an accounting of the excess over 98% of any amounts received on account of prepayments of principal, which amount shall be deposited into the Reserve Fund by the Purchaser within 2 business days of receipt of such accounting and instruction from the Seller. The Seller shall be entitled to contract with Fleet Mortgage Corp., f/k/a Fleet Real Estate Funding Corp. for the subservicing of the Mortgage Loans or any other subservicer expressly approved by the Purchaser which approval shall not be unreasonably withheld (each a "Subservicer").

The servicing fee with respect to the Mortgage Loans shall be paid by the Purchaser on a monthly basis at a rate per annum equal to (a) 0.25% of the aggregate outstanding principal balance of all Mortgage Loans which have a fixed mortgage interest rate, and (b) 0.375% of the aggregate outstanding principal balance of all Mortgage Loans which have an adjustable mortgage interest rate.

9. Warrants

On or prior to the 30th day following the Closing Date, the Seller shall issue and deliver to the Purchaser warrants to purchase that number of shares of the Seller's common stock equal to 4.7454% of the number of shares of the Seller's common stock issued and outstanding on the date of the exercise of such warrants on a fully diluted basis; provided that those warrants identified on Exhibit B attached hereto shall be excluded from such calculation. Such warrants will be exercisable at a price equal to the closing price of the Seller's shares of common stock on the American Stock Exchange on the date hereof. The terms of such warrants shall be set forth in a Warrant Agreement and related Registration Rights Agreement between the Seller and the Purchaser and will include, but not be limited to, (i) an exercise period running for five years from the date of issuance during which the Purchaser may exercise the warrants in whole or in part, (ii) registration rights with respect to the shares of the Seller's common stock to be issued upon exercise of the warrants, with the costs and expenses of any registration thereunder to be borne by the Seller and (iii) antidilution provisions mutually agreeable to the parties.

10. Letter Agreement Terms

On or prior to the Termination Date, the Purchaser and the Seller shall enter into a letter agreement which shall set forth the following agreements:

a) Securitization

The Seller, Hanover Capital Mortgage Corporation, or any of the Seller's affiliates (each a "Hanover Entity"), shall retain and compensate Residential Funding Securities Corporation (the "Broker") (such compensation to be mutually agreed upon by applicable Hanover Entity and the Broker) as a co-lead underwriter in connection with the consummation of the greater of (i) two securitization transactions backed by residential mortgage loans (each a "Securitization Transaction"), or (ii) the number of Securitization Transactions that have in the aggregate a total par amount of residential mortgage loans of at least $500,000,000.

b) Commercial Loan Origination

For a period of two years from the Closing Date, prior to entering any sale transaction with any third party for the purchase by such third party of any commercial mortgage loans (the "Commercial Loans") originated or purchased by any Hanover Entity, such Hanover Entity shall, within one business day's notice prior to any such sale, first offer the Purchaser the right to purchase such Commercial Loans at the same purchase price and on the same terms and conditions as it would offer such third party, in lieu of such sale by such Hanover Entity to any third party. In the event that the Purchaser declines such offer, such Hanover Entity shall have no further obligation to the Purchaser with respect to such offered Commercial Loans.

c) Master Servicing

For a period of two years from the Closing Date, prior to entering into any agreement with any third party to act as master servicer on any loan securitization effected by any Hanover Entity, such Hanover Entity shall, within one business day's notice prior to entering such agreement, first offer such right to act as master servicer on any loan securitization effected by the Seller to the Purchaser on the same terms and conditions as it would offer such master servicing to such third party. In the event that the Purchaser declines such offer, such Hanover Entity shall have no further obligation to the Purchaser with respect to such master servicing offered with respect to the related loan securitization.

d) Due Diligence

For a period of two years from the Closing Date, prior to entering into any agreement with any third party to undertake whole loan due diligence services for Portfolio Transactions or for Securitization Transactions in which the Broker is not undertaking the due diligence or is otherwise contracting with third parties for such due diligence services (the "Broker-Contracted Due Diligence"), the Purchaser or Broker, as applicable, shall, within one business day's notice prior to entering into any agreement, first offer such right to undertake such due diligence services to the Seller on the same terms and conditions as it would offer to such third party. In the event the Broker contracts with the Seller for due diligence services hereunder, the Seller shall not be permitted to bid on any Portfolio Transaction unless such bid is made jointly with the Purchaser. For the purposes hereof, "Portfolio Transactions" shall mean residential whole loan acquisition opportunities pursued by the Purchaser's Institutional Client Segment Portfolio Transaction Group and which represent loan pools containing loan characteristics or features that do not conform with program eligibility criteria specified within Purchaser's Client Guide.

11. Commitment Fee

Seller shall pay the Purchaser $500,000.00 upon Purchaser's execution and delivery of this letter (the "Commitment Fee"). The Commitment Fee shall be reimbursed to the Seller upon the last to occur of the execution and delivery by all parties of the final documentation of all of the transactions contemplated by this Purchase Price and Terms Letter, and the purchase of the Mortgage Loans by the Purchaser. In the event that such final documentation has not been executed and delivered by all parties prior to the Termination Date, the Purchaser shall be entitled to retain the Commitment Fee as liquidated damages hereunder.

12. Legal Fees; Costs

The Seller shall pay all reasonable out-of-pocket expenses of the Purchaser associated with the preparation, execution and delivery of this letter and all documents contemplated by this letter not to exceed $50,000. The Seller shall pay all delivery and recording costs, if any, associated with the sale, resale or repurchase of the Mortgage Loans between the Seller and the Purchaser.

13. Termination of Obligations

In the event that the Purchaser shall fail to purchase the Mortgage Loans by the Closing Date for any reason whatsoever, all obligations pursuant to this Purchase Price and Terms Letter (other than the Purchaser's obligation to reimburse the Commitment Fee to the Seller in accordance with paragraph 11 herein) shall terminate.

14. Survival; Governing Law

The parties acknowledge and agree that the provisions of this letter, other than paragraphs

1 through 8 which shall be superseded by the Purchase Agreement, shall survive the Closing Date. This letter shall be construed in accordance with the laws of the State of Minnesota, and the obligations, rights and remedies of the parties hereunder shall be determined in accordance with the laws of the State of Minnesota except to the extent preempted by Federal law.

[signatures commence on the following page]

Kindly acknowledge receipt of this confirmation by signing and promptly returning the enclosed duplicate of this letter on or before November 10, 1998. Your failure to return a countersigned duplicate of this letter to us within the time indicated shall give us the right, at our sole option, to declare the oral agreement confirmed hereby null and void.

Very truly yours,

HANOVER CAPITAL MORTGAGE HOLDINGS, INC.

By: ___________________________________

Name: ___________________________________

Title:___________________________________

Receipt of this confirmation is

hereby acknowledged:

RESIDENTIAL FUNDING CORPORATION

By: __________________________________

Title: __________________________________

Date: __________________________________

EXHIBIT A

Mortgage Loan Characteristics

EXHIBIT B

Excluded Warrants

The 5,920,378 outstanding warrants (the "Warrants") issued in connection with the September 1997 initial public offering of Hanover Capital Mortgage Holdings, Inc. (the "Company"), each of which allows for the purchase of one share of Common Stock, par value $.01 per share (the "Common Stock") of the Company at a price of $15.00 per share of Common Stock and expires in September 2000, shall be excluded from the antidilution calculations otherwise called for by Section 9 of the Purchase Price and Terms Letter to which this Exhibit is attached.

EXHIBIT 21

Consolidated Subsidiaries of Hanover

Capital Mortgage Holdings, Inc.	Jurisdiction	d/b/a
Hanover Capital SPC, Inc.	Delaware	None
Hanover Capital Repo Corp.	Delaware	None
Hanover QRS-1 98-B, Inc.	Delaware	None
Hanover QRS-2 98-B, Inc.	Delaware	None

Unconsolidated Subsidiaries of Hanover

Capital Mortgage Holdings, Inc.	Jurisdiction	d/b/a
Hanover Capital Partners Ltd.	New York	None
Hanover Capital Mortgage Corporation	Missouri	California d/b/a Missouri Hanover Capital Mortgage Corporation
Hanover Capital Securities, Inc.	New York	None
Hanover Capital Partners 2, Inc.	Delaware	None
Hanover SPC-2, Inc.	Delaware	None

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 JANUARY 1, 1998 TO DECEMBER 31, 1998 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

1,000

12-MOS
DEC-31-1998
JAN-01-1998
DEC-31-1998
11,837
486,472
4,253
0
0
516,170
0
0
516,170
450,390
0
0
0
65
65,715
516,170
0
47,799
0
0
4,064
356
41,176
(4,934)
0
(4,934)
0
0
0
(4,934)
(0.77)
(0.77)

AS A REAL ESTATE INVESTMENT TRUST OUR BALANCE SHEET IS NOT CLASSIFIED.
INCLUDES RETAINED EARNINGS AND PAID IN CAPITAL.