The Reverse Mortgage Puzzle

By David Lindorff *Thu, Mar 31, 2016*

With so many Boomers retiring with low average savings but high average home equity, demand for government-insured reverse mortgages, or HECMs, should be growing. Instead, it's shrinking. Here's why.

You've probably heard of the "annuity puzzle," which refers to the public's unexplained neglect of life annuities. But there's another financial conundrum in the retirement world, which one might call "the reverse mortgage puzzle."

In theory, demand for reverse mortgages should be high. Retiring babyboomers are, on average, cash poor, with tax-deferred savings of only about $100,000. But collectively, they're house-rich, with combined home equity of about $5.76 trillion. Reverse mortgages, which let borrowers tap equity without selling their homes, could help millions of people. And today's low interest rates allow maximum loan balances.

But the 18-year-old federal Home Equity Conversion Mortgage (HECM) program, whose loans are provided by private lenders and insured by the Department of Housing and Urban Development, is shrinking, not growing. After writing 114,400 reverse mortgages in 2009, HCEM lenders wrote only 58,000 in 2015, or just 3% of all mortgages that year.

So, what's stopping reverse mortgages from being a major retirement income source for Boomers? Quite a lot. As *RIJ* discovered after talking to participants in the HECM industry, problems include:

- Regulatory changes since 2009, in response to early abuses and unanticipated failings of the program, that have made the HECM product less generous.
- High costs, especially for borderline borrowers.
- A vacuum left by the disappearance of the program's former intended market.
- The decisions by major distributors like Bank of America, Wells Fargo, and MetLife to discontinue their HECM operations in 2011 and 2012.
- A requirement that borrowers get pre-loan counseling from a licensed Department of Housing and Urban Development counselor.
- A history of bad publicity, including media images of evictions of elderly HECM borrowers from their homes for failure to pay their taxes or homeowner's insurance premiums.

"The basic idea behind a reverse mortgage is good, but they have to be completely revamped," says Nobel Prize-winning economist Robert C. Merton of MIT's Sloan School of

Management, who has published papers on combining reverse mortgages with Treasury Inflation-Protected Securities in retirement, and has seen them work well overseas.

In this first of a series, *RIJ* will begin to examine the hurdles, kinks, and broken links that prevent the reverse mortgage market from realizing its potential and contributing efficiently to retirement security in the U.S.

An incredible shrinking product

Today’s reverse mortgages are a lot less rich than they were before 2008. That alone explains a lot of the shrinkage in the program. HECMs are no longer a panacea for the financially desperate who at one time constituted much of the program’s market.

“Until September of 2009, homeowners could access a ton up front,” said Dan Hultquist (below right), branch manager at Open Mortgage in Atlanta and author of the book, Understanding Reverse. “At the time, why *wouldn’t* you get a reverse mortgage and invest the money? It was insured up to 90% of the property value. It was almost too good to be true.”

In fact, it was too good to last. The recession that followed the 2008 financial crisis exposed a lot of weak borrowers. People consumed lump sum loans quickly and couldn’t, or didn’t, pay their property taxes and insurance bills. That led to foreclosures, losses at FHA, and a tightening of limits, fees and standards. [See box below.]

Between 2009 and today, FHA and HUD has reduced the loan amount, restricted the amount that could be taken out in an upfront lump sum, raised insurance fees and toughened financial assessments. “The changes in 2013 were massive. I remember when the September 3, 2013 letter came. It was devastating in the way in the shook up the industry. Now most borrowers could only access 60% on Day One without paying a large initial mortgage insurance fee. People couldn’t get a quick fix for cash. And that was what had been driving the volume,” Hultquist told *RIJ*.

“The changes that HUD made strengthened the program,” he added, “but they reduced the number of people wanting the program. A lot has to do with delayed gratification.” The original terms of the program offered immediate gratification, the new terms don’t.

“The ironic part is that the new safeguards to make the HECM safer and more desirable, especially the financial assessment, have screened out the borrowers of last resort,” agreed Mike Gruley, director of reverse mortgage operations for First Financial Reverse Mortgage, in Northville, Michigan.

“HUD said, ‘We don’t want borrowers of last resort,’ so they cut off those borrowers,” he told *RIJ*. “They were gone in a month. Now we’re in a transition to a new borrower, the kind of borrower who uses it as a tool for retirement planning. They aren’t direly in need of [a HECM], and they still harbor some of the old negative misinformation about reverse mortgages. In my view, the transition will take some time.”

‘Complexity and opacity’

Like many insured products, reverse mortgages are difficult for the uninitiated to quickly or easily understand. Concepts like compound interest, which are essential to gauging the money’s worth of a HECM, are, for example, mysteries to many Americans.

“A major problem holding back reverse mortgages is their complexity and opacity,” Deborah Lucas, director MIT’s Sloan School Center for Finance and Policy, told *RIJ*. “The product needs to be simplified, and the options made more standard so that people can comparison-shop.”

Partly because of that complexity, the government requires anyone who wants to take out a reverse mortgage to undergo a few hours of counseling from a HUD-approved housing counselor. This process costs about $125 and involves an assessment of the borrowers’ ability to pay taxes and insurance and to maintain the house so that it keeps its value for the life of the loan. Amy Ford, director of home equity initiatives at the National Council on Aging (NCOA), one of several groups licensed by HUD to counsel those seeking a HECM, agrees that the product is too complicated. “It can be daunting to dive into,” she said.

TIMELINE OF HECM RULE CHANGES

- **2009**: Principal Limit Factors were reduced.
- **2010**: Principal Limit Factors were further reduced.
- **2013**: Initial Disbursement Limits added and Initial Mortgage Insurance Premiums restructured. Most borrowers had to pay 2.5% of the property value if they wanted to access more than 60% of their Principal Limit in the first year.
- **2014**: Lien seasoning added. Most liens, including conventional lines-of-credit, that were established in the preceding 12 months could no longer be satisfied with a HECM.
- **2015**: Financial Assessment. Originators must examine credit history and history of paying taxes and insurance bills. If borrowers don't meet "residual income" requirements, a Life Expectancy Set Aside may be created to ensure that taxes and insurance will be covered.

Source: Dan Hultquist, Open Mortgage.

HUD's counseling requirement itself has added an extra step to HECM sales. On HUD's website, *RIJ* found, the search engine for locating counselors by Zipcode was not functioning. A few years ago, the brokers arranged the counseling and even attended the counseling sessions. New rules forbid such coziness. Today, counselors walk a fine-line. They aren't supposed to interfere in the commercial process, but their job is clearly to prevent inappropriate loans.

One broker told RIJ that she has a sense that HUD hires counselors with a "watchdog" frame of mind. Another said that, because counselors often have a history of working for nonprofit firms or social service agencies, they often look at brokers with suspicion. They may for instance urge borrowers to negotiate harder with a broker or shop around for additional quotes. HUD rules prevent them from recommending one type of HECM loan or loan originator over another. "We're prohibited as counselors from steering people to certain lenders," Ford told *RIJ*.

Costlier than a forward mortgage

Another significant obstacle to popularizing HECMs is the cost of setting them up, financing them, and insuring them. "Right now HECMs are pretty expensive," said Merton. "The costs need to come down."

A HECM mortgage, like a forward mortgage, can involve inspections, title searches and assessments. At best, a homeowner can borrow an amount equal to about half of the equity in the home; the other half will gradually be consumed by compounding interest—that is, the cost of financing the loan over the borrower's remaining ten, twenty or 30 remaining years of life.

Greater transparency and competition should reduce HECM costs, said Lucas, who has undertaken a formal study of HECMs. She believes that interest rates on borrowed funds from a HECM should be much lower than they are. "With HECMs, the government takes 100% of the credit risk and the lenders are really just middlemen," she told *RIJ*, "Yet they have high fees and high interest rates. That makes no sense."

There are several layers in the HECM food chain. There are independent brokers who work directly with clients, there are originators or lenders (such as banks and mortgage lending companies, that underwrite the loans and may also act as brokers and wholesalers), then there are wholesalers (often called issuers) who buy the loans, bundle them into securities and sell them to institutional investors. In addition, lenders hire servicing companies to monitor the loans and maintain the client relationships.

The costs of a HECM include all of the usual closing costs associated with a forward mortgage, including fees for appraisals and title searches. The lender's origination fee is capped at $6,000. Current fixed interest rates on HECM loans are between 4.75% and 5.06%, or about one percent above the current 30-year fixed FHA rate. The adjustable rate, which is the rate used for HECM lines of credit, is between 3% and 4%.

The insurance costs can make the terms onerous. If borrowers want to take more than 60% of the loan in the first year as a lump sum, they must pay 2.5% of the property value as an initial mortgage insurance premium instead of the usual 0.5%. (That's separate from the annual insurance premium of 1.25% of the loan balance.) If the borrower has difficulty qualifying, part of the home equity can be set aside for future taxes and insurance. All of these costs can be financed, but if they are, they can substantially reduce the available capital. Certain borrowers may, in practice, be able to access only about a quarter of their home equity in the first year of the loan.

To illustrate the costs associated with HECMs, Hultquist described a recent discussion with a borrower. The homeowner has decided to borrow $70,000 to pay for a new kitchen in her home, rather than dip into savings to pay for the improvement. Since $70,000 was less than 60% of her borrowing limit, she paid a half-percent (0.5%) of the $250,000 property value for the initial mortgage insurance premium of $1,275 (rather than 2.5%, or $6,250) and closing costs of $2,788. In this case, Hultquist knew that he would earn premium from an investor, so he did not charge the homeowner an origination fee, which saved her almost $4,500. (Unwary borrowers, Hultquist said, may not know that the origination fee may be waived incertain situations.)

NEXT WEEK: The holes in HECM distribution.