CENTER for RETIREMENT RESEARCH at BOSTON COLLEGE

January 2014, Number 14-1

# THE GOVERNMENT'S REDESIGNED REVERSE MORTGAGE PROGRAM

By Alicia H. Munnell and Steven A. Sass*

## Introduction

Accessing home equity will become increasingly important in a world where retirement needs are expanding – people are living longer and face rapidly rising health care costs – and the retirement system is contracting – Social Security replacement rates are declining and employer-provided pensions have shifted from defined benefit plans to 401(k)s where balances are modest. Reverse mortgages offer a mechanism for tapping home equity for those who want to stay in their home.

Nearly all reverse mortgages today are government-insured Home Equity Conversion Mortgages (HECMs). The financial crisis put pressure on both the insurance program and on the borrowers. Declining home prices meant that lenders could not recoup the full amount of the loan when the houses were sold, requiring the government to make up the difference. And financially troubled borrowers withdrew much of their money at closing, leaving them with few resources to sustain homeownership, which led a number to default. In response, the government has redesigned the HECM program. This *brief* describes this redesign and its impact on borrowers and government finances.

The discussion proceeds as follows. The first section describes the HECM program. The second section covers the impact of the financial crisis on how borrowers used the program and on the program's finances. The third section reviews the recent changes and their likely effects. The final section concludes that the redesigned HECM program should make reverse mortgages better for borrowers and significantly improve the solvency of the HECM insurance program.

## A Reverse Mortgage Primer

A reverse mortgage is a mortgage: a loan with the borrower's home as collateral. But unlike a conventional mortgage, it is designed as a way for homeowners age 62 and over, with substantial home equity, to tap that equity as a source of funds to pay bills or health care expenses or to provide additional retirement income. Unlike conventional mortgages, borrowers are not required to make monthly payments.[1] The loan must be repaid only when the borrower moves or dies. This is the key advantage for retirees who need more

* Alicia H. Munnell is director of the Center for Retirement Research at Boston College (CRR) and the Peter F. Drucker Professor of Management Sciences at Boston College's Carroll School of Management. For full disclosure, she is also an investor in and a member of the Board of Advisors of Longbridge, LLC, a startup company that has been formed to provide reverse mortgages in a socially responsible fashion. Steven A. Sass is a research economist at the CRR.

income: so long as they live in the house, a reverse mortgage does not add a claim on the income they already have.

The most widely used reverse mortgage is the HECM, which provides government-insured loans on assessed home values up to the Federal Housing Administration current limit of $625,500.[2] Under this program, the government provides insurance (for a fee) to the borrower, against the risk that the lender can no longer make the contracted payments; and to the lender, against the risk that the loan balance will exceed the property value when sold.

Homeowners can take a HECM loan in the form of monthly payments, a lump sum, or a line of credit. A unique feature of a HECM line of credit is that it rises over time by the interest rate on the line. This feature is especially valuable to retirees who want to use their home equity as a reserve, and until recently had been the most popular HECM option.

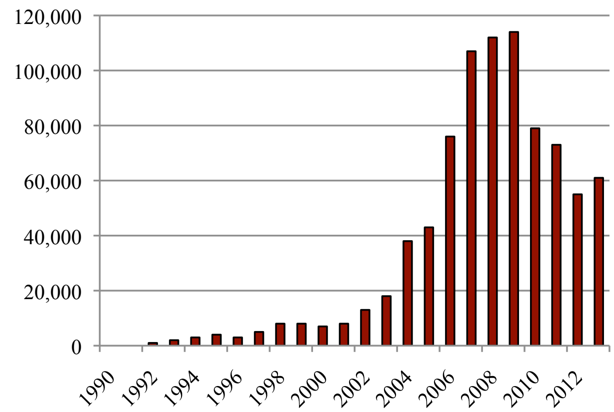
The amount available to a homeowner depends on three factors:

- *Home value*: the more valuable the home (up to the current cap of $625,500), the larger the available amount.
- *Interest rate*: the lower the interest rate, the more slowly the outstanding balance will increase, so the larger the available amount as a proportion of the value of the house.
- *Age of borrower*: the older the borrower, the less time for interest to accrue, so the larger the available amount.

## The Growth of HECM Loans

Reverse mortgage originations initially grew slowly when the government launched the HECM program in 1989.[3] After the turn of the century, however, several factors produced a dramatic increase in originations, from less than 10,000 in 1999 to more than 110,000 in 2008 and 2009, before falling back in recent years (see Figure 1). Fueling the expansion initially was a sharp increase in house prices (see Figure 2), which significantly raised the equity of eligible homeowners, and lower interest rates, which increased the share of their equity that borrowers could tap.[4] With the onset of the financial crisis, home prices dropped rapidly but reverse mortgage levels rose further during 2007-2009 as the deteriorating economy forced some people to turn to their home as a source of income.

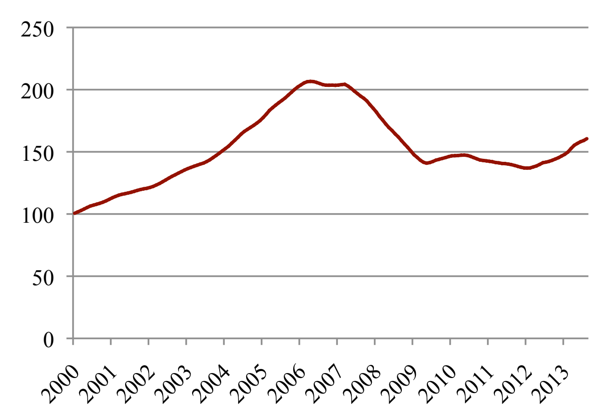
Figure 1. HECM Loan Originations, FY 1990-2013




*Source:* U.S. Department of Housing and Urban Development (HUD)(2013b, 2013c).

Design changes also made HECM loans more attractive to borrowers. First, and least important, the government introduced the "HECM Saver" in 2010 to offer a product with lower up-front costs. In exchange for a reduction in the maximum loan amount, the Saver reduced the mortgage insurance premium at closing from 2 percent of the house value backing the loan to a trivial 0.01 percent. Nevertheless, in FY 2011, Savers accounted for only 6 percent of HECM originations, most likely because borrowers pay more attention to the size of the available proceeds than to the fees.[5]

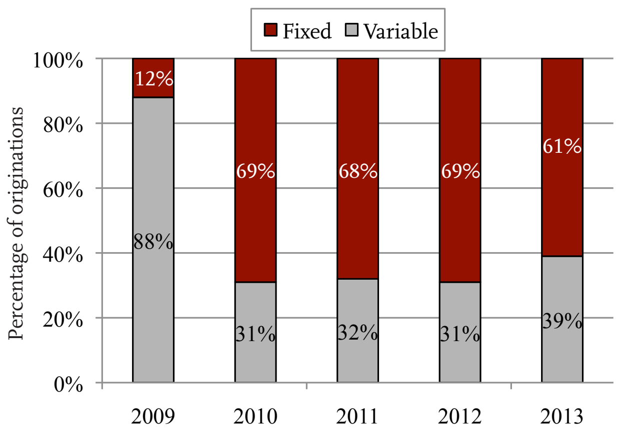
Figure 2. U.S. House Price Index, 2000-2013 (January 2000 = 100)




*Source:* S&P Case-Shiller 20-City Home Price Index (2013).

A second, and more important, change was a 2008 regulatory ruling that allowed lenders to offer fixed-rate mortgages on lump-sum loans. Fixed-rate HECM mortgages quickly became the norm. Such loans, with borrowers typically taking out the maximum amount available, accounted for about 70 percent of HECM originations during 2010-2012 (see Figure 3).[6]

Figure 3. HECM Interest Rate Type, FY 2009-2013




*Source:* HUD (2013d).

Taking the maximum loan amount at closing significantly increased the risk to both the borrower and the government. So did the fact that recent borrowers were younger, giving interest accruals more time to mount and requiring lenders to wait longer to be repaid. The finances of these younger borrowers were also weaker. The major reason recent borrowers gave for taking out a HECM loan was to pay off an existing mortgage, rather than to "increase income for every day expenses," "enhance quality of life," or "plan ahead for emergencies."[7] This shift in motive reflects the impact of the Great Recession, which sharply cut the incomes of a large number of eligible homeowners, especially homeowners in their early 60s who lost jobs or had their hours or wages reduced.

This increased risk soon produced increased losses. Nearly 10 percent of HECM borrowers in 2012 were in default, having failed to pay property taxes or homeowners' insurance premiums. The sharp fall in house prices had also reduced the value of the collateral backing HECM loans.[8] Despite government insurance to cover their losses, lenders needed to engage in collections and foreclosures, making the business much less attractive. The three largest HECM lenders – Bank of America, MetLife, and Wells Fargo – all withdrew from the market.[9]

# The HECM Redesign

To make the HECM insurance program financially viable, and to insure that HECM reverse mortgages provide retirees with a reliable source of retirement income, the government recently announced three key reforms to the HECM program.[10]

## *Replace the Standard and Saver Options with a Single HECM*

The program now has a single maximum loan amount, based on the borrower's age and current interest rates. The new maximum is about 10-15 percent less than in the HECM Standard, though somewhat higher than in the Saver. Borrowers are now charged 0.5 percent of that amount as the mortgage insurance premium at closing – much less than the Standard though more than the Saver's trivial charge. Since very few borrowers had taken out HECM Saver loans, the new program reduces the premiums the government collects and aims to make the program viable by reducing the government's risk (see Table 1).[11]

Table 1. New HECM Program and the HECM Standard and Saver Programs It Replaced

| Program | Maximum loan* | Insurance premiums: Up-front | Insurance premiums: Ongoing |
|---|---|---|---|
| | (% of house value) | (% of house value) | (% of loan balance) |
| New program | 57.5% | 0.50% | 1.25% |
| Programs replaced: | | | |
| HECM Standard | 67.7 | 2.00 | 1.25 |
| HECM Saver | 55.4 | 0.01 | 1.25 |

* Maximum loan for a borrower age 72 on a 5-percent interest rate loan.
*Source:* U.S. Department of Housing and Urban Development (2013d and 2013e).

### *Reduce Initial Withdrawals*

The new program limits homeowners from borrowing more than 60 percent of the maximum loan amount at closing, or in the first year after closing. Borrowers can take out more only to cover "mandatory obligations," such as paying off an existing mortgage or making repairs required by the lender.[12] Such borrowers pay a much higher up-front mortgage insurance premium – 2.5 percent of the house value backing the loan.

### *Introduce Underwriting*

Beginning in January 2014, lenders will be required to assess a prospective borrower's ability to pay property taxes and homeowner's insurance premiums. The assessment is based on credit reports and an estimate of the homeowner's "residual income" after paying basic expenses.[13]

A homeowner's finances are considered sufficient for a HECM loan if their "residual income," depending on where they live, equals or exceeds $886 to $998 a month for a couple or $540 to $589 for an individual. If their residual income is below these benchmarks or their credit history is spotty, homeowners can still get a HECM loan *if* the proceeds will be large enough to cover the tax and insurance charges for the expected life of the loan *and* the homeowner authorizes the lender to reserve the amount needed and to pay these charges directly.[14]

## Conclusion

All these changes should be viewed as positive. Consolidating the Standard and the Saver will make the program easier to understand. The lower maximum loan amounts and the limit on first-year withdrawals will take pressure off the insurance fund by reducing the likelihood that borrowers default. The financial assessment will ensure that the people taking out a reverse mortgage will not lose their homes by failing to pay taxes and insurance. A better customer experience combined with lower fees will also make reverse mortgages a more attractive option for retirees.

# Endnotes

1 HECM reverse mortgages are secured only by a claim on the house. Should the amount owed exceed the proceeds from the sale of the house when the borrower moves or dies, the lender has no further claim on the borrower or the borrower's estate.

2 While the federal government recently announced reductions in the FHA loan limits for conventional mortgages for 2014, the limit for HECMs will remain unchanged at $625,500. See U.S. Department of Housing and Urban Development (2013a).

3 The 1989 launch was a pilot program. A full-scale launch of the program occurred in 1998.

4 The government also raised the maximum house value that borrowers could use as collateral, in 2008 and again in 2009, to the current $625,500.

5 U.S. Consumer Financial Protection Bureau (CFPB) (2012).

6 Earlier this year, the government discontinued the fixed-rate loan option for the HECM Standard, while retaining it for the HECM Saver. Under the new HECM loan, which replaces both the Standard and the Saver, there will be a fixed-rate option.

7 CFPB (2012).

8 These developments produced an estimated $2.8 billion deficit in the HECM insurance program (U.S. Department of Housing and Urban Development (HUD), 2013d).

9 CFPB (2012).

10 HUD (2013d).

11 The lower up-front fee continues a transition to basing premiums on the outstanding balance rather than the house value at closing. The first step came in 2010, when the government raised the premium on the outstanding balance from 0.5 to 1.25 percent, which the recent redesign retained (CFPB, 2012). To the extent that the government's risk is tied more closely to the amount lent out than the initial maximum loan amount, this transition produces a closer alignment between risk and risk charges. Since maximum loan amounts are based on the interest rate that includes the on-going mortgage insurance premium, the transition also reduces maximum loan amounts – with much larger reductions for younger homeowners.

12 Other examples of mandatory obligations are second liens/home equity lines of credit, federal tax liens or property tax arrears. In addition to the amount needed to pay mandatory obligations, the borrower can take out 10 percent of the maximum loan amount so long as the total is less than the maximum loan amount. HUD (2013d).

13 The government has specified a detailed process for making this estimate – for measuring different types of income, including income from assets, and for listing basic expenses, including income taxes, debt payments, alimony and child support, home maintenance and utility costs, as well as real estate tax and homeowners insurance.

14 HUD (2013e). A borrower with insufficient residual income must agree to either a Life Expectancy Set-Aside – a reserve estimated to cover the property charges over the borrower's expected lifetime – or an arrangement that authorizes the lender to pay their property charges out of their monthly payments or line of credit, with the lender reserving an amount similar to the Life Expectancy Set-Aside for these payments.

# References

S&P Case-Shiller 20-City Home Price Index. 2013. Federal Reserve Bank of St. Louis FRED Database. Available at: http://research.stlouisfed.org/fred2/series/SPCS20RSA?cid=32261.

U.S. Consumer Financial Protection Bureau (CFPB). 2012. *Reverse Mortgages: Report to Congress*. Washington, DC.

U.S. Department of Housing and Urban Development (HUD). 2013a. *Mortgagee Letter 2013-43*. Washington, DC.

U.S. Department of Housing and Urban Development. 2013b. "FHA HECM Update." Presented at NRMLA 15th Annual Meeting and Expo. Washington, DC.

U.S. Department of Housing and Urban Development. 2013c. *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund HECM Loans for Fiscal Year 2013*. Washington, DC.

U.S. Department of Housing and Urban Development. 2013d. *Mortgagee Letter 2013-27*. Washington, DC.

U.S. Department of Housing and Urban Development. 2013e. *HECM Financial Assessment and Property Charge Guide*. Washington, DC.

CENTER *for*
RETIREMENT
RESEARCH
*at* BOSTON COLLEGE

## About the Center

The mission of the Center for Retirement Research at Boston College is to produce first-class research and educational tools and forge a strong link between the academic community and decision-makers in the public and private sectors around an issue of critical importance to the nation's future. To achieve this mission, the Center sponsors a wide variety of research projects, transmits new findings to a broad audience, trains new scholars, and broadens access to valuable data sources. Since its inception, the Center has established a reputation as an authoritative source of information on all major aspects of the retirement income debate.

## Affiliated Institutions

The Brookings Institution
Massachusetts Institute of Technology
Syracuse University
Urban Institute

## Contact Information


Center for Retirement Research
Boston College
Hovey House
140 Commonwealth Avenue
Chestnut Hill, MA 02467-3808
Phone: (617) 552-1762
Fax: (617) 552-0191
E-mail: crr@bc.edu
Website: http://crr.bc.edu



*The Center for Retirement Research thanks Advisory Research, Inc. (an affiliate of Piper Jaffray & Co.), Charles Schwab & Co. Inc., Citigroup, ClearPoint Credit Counseling Solutions, Fidelity & Guaranty Life, Goldman Sachs, Mercer, National Council on Aging, National Reverse Mortgage Lenders Association, Prudential Financial, State Street, TIAA-CREF Institute, and USAA for support of this project.*





The research reported herein was supported by the Center's Partnership Program. The findings and conclusions expressed are solely those of the authors and do not represent the views or policy of the partners or the Center for Retirement Research at Boston College.