PART One

Reverse Mortgage Basics

CHAPTER 1

Reverse Mortgage Primer

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A *reverse mortgage* is a longevity-linked loan that allows senior citizens, age 62 and older, to release the equity in their home without meeting any credit or income requirements. As opposed to traditional mortgages, there is no obligation to repay a reverse mortgage loan until the borrower passes away or no longer uses the home as a primary place of residence. Upon the death of the borrower(s), sale of the home, or breech of contract, the loan plus interest and fees must be repaid by the sale of the home. It is up to the reverse mortgage lender to sell the home at the time of the borrower's death, as the lender is the rightful owner of the residence at that time.

If at the time of loan expiration (death, or sale) the sale price of the home exceeds the loan amount extended to the senior, the senior (if still living) or his or her heirs (if the senior has passed away) will receive the difference in value. If at the time the sale of the home is insufficient to repay the debt, then the lender must take a loss on the transaction or make a claim to the insurer of the loan, which in the case of Home Equity Conversion Mortgages (HECM) is the Department of Housing and Urban Development (HUD). Although there are a number of varying reverse mortgage products in the market, HECM reverse mortgages make up almost 90 percent of the loans in the current marketplace. Other types of reverse mortgages will be described in later chapters.

For seniors, the requirements to obtain a reverse mortgage are fairly simple:

- The person must be at least 62 years of age for an FHA HECM loan; however, this age minimum may be at the discretion of the lender for nonconforming mortgages.

- The senior's home must be owned outright or have an existing mortgage that may be paid off by the proceeds of the reverse mortgage loan at closing.
- The property must be the borrower's primary residence.
- The senior must not be delinquent on any federal debt.
- The senior must participate in a consumer information session given by an approved HECM counselor.

The FHA HECM program will be discussed in further detail in the next chapter, and other agency loans as well as nonconforming jumbo reverse mortgages will be discussed in later chapters; however, the majority of principles apply to both conforming and nonconforming mortgages. Currently, *conforming* mortgages, according to the FHA HECM program, are loans equal to or less than $625,000 (which had been increased from $200,000 to $417,000 in 2008). Conversely, mortgages above $625,000 would be considered *nonconforming*, or *jumbo*, reverse mortgages.

LOAN DISBURSEMENTS

It is important to remember that (FICO) scores and income requirements are *not* a prerequisite for many reverse mortgages, especially HECM loans; however, in the case where the senior moves out of the home, repayment risk does exist. Although the senior is not required to make principal or interest payments on the loan, the borrower(s) are responsible for paying all maintenance costs, homeowners insurance, and property taxes associated with the home. In that respect, it should be noted that a lender should be confident that a borrower has the means to maintain the quality of the property and stay current on all taxes.

Since the credit profile of a borrower is of less importance in a reverse mortgage than in traditional mortgages, there is a significant weight put on the life expectancy of a borrower. Up-to-date and sufficient actuarial data is needed in order to develop accurate pricing models for reverse mortgage loans. Although HUD-insured reverse mortgage loans protect the lender from "longevity risk" (the risk that a borrower lives longer than expected), it is in the best interest of the lender to utilize accurate mortality tables. HECM-issued loans, which are made to seniors age 62 and older, are structured using outdated and inaccurate actuarial data. These loans are priced to be losing investments, no matter whose balance sheet the loss ends up on.

The concept of marrying actuarial underwriting to the capital markets is not new, and is best illustrated in the secondary market for life insurance, where investors analyze pools of life insurance for purchase. These investors are developing increasingly more sophisticated actuarial views. Unfortunately, the reverse mortgage market is lagging behind the life settlements market in this regard. Underwriting will be discussed in detail in Part Three of this book.

In all reverse mortgages, the lender calculates the amount to be disbursed to the senior(s) by considering the following:

- The age and life expectancy of the borrower, or the age of the younger borrower in the case of a married couple.
- Current interest rates. (FHA HECM interest rate calculations will be explained in the next chapter.)
- The appraised value of the home, with consideration of ongoing maintenance costs and geographic location.
- How the loan is to be made to the borrower (i.e., lump sum, credit line, etc.).

Loans may be disbursed to the borrower in a number of ways. Although the FHA offers many types of loan programs, the most common ones are shown in Table 1.1. Private lenders may introduce variations on these programs or entirely new products to the marketplace.

A reverse mortgage loan may be costly for certain seniors. In the case of HECM-insured loans, the borrower's origination and servicing fees are highly regulated and limited in many cases. For example, HECM loans are limited to roughly a $6,000 origination fee, which, at the time of this writing, has been reduced even further. No such cap on origination fees exists in nonconforming reverse mortgage loans, which are not insured by HUD or any other government agency. From an investor's standpoint, this may present a tremendous opportunity in the nonconforming sector of the market, as longevity and real estate risk maybe more favorably and accurately priced.

TABLE 1.1 Reverse Mortgage Disbursement Options—U.S. Department of Housing & Urban Development

Tenure	Equal monthly payments as long as at least one borrower lives and continues to occupy the property as a principal residence.
Term	Equal monthly payments for a fixed period of months selected.
Line of credit	Unscheduled payments or installments, at times and in amounts of your choosing, until the line of credit is exhausted.
Modified tenure	Combination of line of credit with monthly payments for as long as you remain in the home.
Modified term	Combination of line of credit plus monthly payments for a fixed period of months selected by the borrower.

OVERVIEW OF LENDER CHALLENGES

Because senior citizens are responsible for the upkeep of the house they are living in, but do not own, a reverse mortgage can present a lender with a number of challenges. Among those challenges is the case of *default* on the part of the senior. A senior may allow the home's pipes to freeze, landscape to run wild, and roof to weaken without giving much thought to making repairs. Although homeowner's insurance covers the majority of these issues, seniors may still not want to deal with deductible payments or premium increases or may be just generally apathetic to the appearance and structural quality of the home. The senior may even unknowingly fall behind on property taxes or insurance payments. In these very delicate situations, where the senior is in direct breach of the loan agreement, the lender may be forced to remove the senior from his or her home. Clearly, the sight of a sheriff evicting a 75-year-old woman from her home does not sit well with anyone, so careful attention must be given to the systems in place to monitor and manage a portfolio of reverse mortgage loans. Although this ethical and headline risk may not be the norm, it is something all potential reverse mortgage participants should be well aware of.

SUMMARY

Many institutional investors are currently examining various ways to participate in this marketplace, aside from traditional mortgage lenders such as Wells Fargo and Bank of America (Countrywide), which have reverse mortgage platforms. One group, KBC Financial Products, a unit of the Belgium-based KBC Bank, has actively participated in this space by purchasing an entire reverse mortgage lender at one point, and reselling the firm's \$800 million reverse mortgage pool in February 2010. Another notable market participant is Knight Capital Group (NASDAQ: NITE), which purchased Urban Financial in March 2010.

The securitization of reverse mortgages is the ultimate "holy grail" that has been eluding both this asset class and other *life-linked* assets such as life settlements. In both cases, with focus on reverse mortgages, the unpredictability of cash flows seems to be one of the most important hurdles to overcome in the structuring of these loans. Although there has been a Ginnie Mae reverse mortgage–backed security, it has experienced limited demand. The development of more widely accepted actuarial and pricing methodologies for reverse mortgages should give rise to a more successfully structured product. This would allow investors to participate in the demographic shifts occurring here in the United States as well as in other parts of the world, such as Japan.

Securitization of reverse mortgages and opportunities for the reverse mortgage product in Japan are both discussed in further detail in later chapters.