

**OVERSIGHT OF THE FEDERAL HOUSING  
ADMINISTRATION'S REVERSE MORTGAGE  
PROGRAM FOR SENIORS**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
INSURANCE, HOUSING AND  
COMMUNITY OPPORTUNITY  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED TWELFTH CONGRESS  
SECOND SESSION

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# OVERSIGHT OF THE FEDERAL HOUSING ADMINISTRATION'S REVERSE MORTGAGE PROGRAM FOR SENIORS

Wednesday, May 9, 2012

U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON INSURANCE, HOUSING  
AND COMMUNITY OPPORTUNITY,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. Judy Biggert [chairwoman of the subcommittee] presiding.

Members present: Representatives Biggert, Hurt, Dold, Stivers; Gutierrez, Sherman, and Capuano.

Chairwoman BIGGERT. This hearing of the Subcommittee on Insurance, Housing and Community Opportunity will come to order.

Good afternoon, everyone. I am glad to see all of the witnesses here. We have quite a distinguished panel here.

And let me just say, without objection, all Members' opening statements will be made a part of the record, and I am going to recognize myself for an opening statement.

I would like to welcome our panel of witnesses today for the hearing entitled, "Oversight of the Federal Housing Administration's Reverse Mortgage Program for Seniors."

During the 112th Congress, this subcommittee has been systematically reviewing the Federal Housing Administration, or FHA, in today's mortgage financial market. We also have examined ways to reduce the government's role and increase private sector participation in mortgage finance.

Today, we will continue our work with an examination of FHA's Home Equity Conversion Mortgage Program, or HECM. This program offers seniors a 100 percent government-backed reverse mortgage product.

For some seniors, reverse mortgages are a great financial tool that will allow them to convert the equity in their home into cash for a variety of uses. That said, reverse mortgages are not for everyone. That is why seniors are required to secure housing counseling prior to obtaining a reverse mortgage.

In recent years, more seniors, particularly baby boomers, have used the program to turn the equity they have in their home into income. The HECM program also has seen an increase in delinquencies and claims which have consistently exceeded the FHA's original projections.

Today, we will hear from witnesses about the strengths and weaknesses of this government program as well as reverse mortgage products, and we will address a number of questions including: Is the private sector willing to offer seniors a reverse mortgage product without a government guarantee? Are the FHA's underwriting standards, premiums, and rates sufficient to ensure the solvency and sustainability of the HECM program for seniors and taxpayers alike? Finally, should Congress or HUD make any statutory or regulatory changes to this program?

As the saying goes, there is always room for improvement; and I am eager to hear if there are recommendations that we can act on to better serve those seeking financial security in their golden years. I look forward to an informative discussion, and I welcome our witnesses.

And, with that, I will turn things over to our ranking member, Mr. Gutierrez.

Mr. GUTIERREZ. Thank you, Madam Chairwoman.

I am very pleased that we are here today to discuss the Federal Housing Administration's Home Equity Conversion Mortgage Program. Reverse mortgages can be a critical tool for seniors to help pay off debt or simply ease the strains of monthly expenses. That being said, seniors have long been a population that is targeted by fraudsters, and strong consumer protections are essential to the success of this product.

When I see famous celebrities on TV acting as spokespersons for reverse mortgages, I can't help but wonder how many seniors are misled into believing that this product is appropriate for them when it may not be at all or it may create financial problems instead of solving them. How many seniors who see these commercials and like the celebrity spokesperson know enough about reverse mortgages to be able to make an informed decision about what is a very complex product?

This is one of the many reasons that I believe improving the reverse mortgage counseling protocol was an important and very positive development. Seniors are now required to participate in a counseling session and obtain counseling certificates before they can secure a reverse mortgage. HUD has required that, in these sessions, the seniors' financial needs and obligations are assessed and ultimate options are evaluated to see if a reverse mortgage is right for them.

In addition, if the seniors are below 200 percent of the Federal poverty level, the counselor will also conduct a review to determine if they are eligible for any benefits that they are not currently accessing to ease their financial strain.

It has been suggested that the consistency of reverse mortgage counseling can be improved by requiring face-to-face counseling. While I am concerned that this might not be possible given the current number of counselors, I am looking forward to discussing this issue further.

I am looking forward to hearing about the steps that HUD has taken to reduce the risk to the program. This includes foreclosure mitigation counseling and requiring that lenders notify HUD of property tax and insurance default.



As baby boomers reach the age of eligibility for a reverse mortgage, it is critical that the program has stronger consumer protection and remains financially sound.

I thank you, Madam Chairwoman, and I yield back the balance of my time.

Chairwoman BIGGERT. Thank you, Mr. Gutierrez.

Now, I will recognize Mr. Hurt, our vice chairman, for 1½ minutes.

Mr. HURT. Thank you.

I would like to add my welcome to the witnesses today as you all help us understand this important issue a little better.

I want to also thank the Chair for yielding and for holding this important hearing today. I want to commend the chairwoman for her continued commitment to conducting extensive oversight of the programs within our jurisdiction.

My constituents in Virginia's Fifth District understand how critical oversight is to effective stewardship of precious taxpayer resources.

Today's oversight hearing focuses on the FHA's Home Equity Conversion Mortgage Program, which backs loans to seniors commonly known as reverse mortgages. Financial security during one's retirement years is of critical importance to all Americans, and we must encourage people to plan and save for their retirement. For some seniors, reliance upon the equity in one's home is a potentially viable option for ensuring financial stability as they grow older. That said, we must be mindful of the risks which taxpayers and seniors are exposed to by the reverse mortgage program and the FHA's overall portfolio.

This subcommittee has conducted substantial oversight of FHA's financial stability over the last year-and-a-half, finding that its outsized role in the mortgage market has placed it on precarious footing. Similarly, the overwhelming majority of reverse mortgages are guaranteed by FHA at present. Given these trends, we must carefully consider the extent to which the Federal Government should be involved in this market. We must also ensure that the program is efficiently and effectively administered so it is capable of dealing with adverse challenges and conditions like declining home values and longer life spans, without creating losses for the taxpayers or for our seniors.

And I hope our witnesses can express their views about how private capital can return to the reverse mortgage marketplace, which will reduce taxpayers' exposure to that risk.

Again, I want to thank the chairwoman for holding this hearing today, and I look forward to the witnesses. And I yield back my time.

Chairwoman BIGGERT. The gentleman from Illinois, Mr. Dold, is recognized for 2 minutes.

Mr. DOLD. Thank you, Madam Chairwoman.

I want to thank you all for taking your time to be with us today.

I am confident that both the Democrats and the Republicans share fundamental objectives that relate to this hearing. First, we need to create a legal and regulatory framework that promotes financial security and financial independence for our seniors. Second, our most vulnerable seniors should have significant or sufficient re-

sources to retire and age in a dignified way with adequate living accommodations. Third, in these very challenging fiscal circumstances, we need to reduce government spending and diminish taxpayer risk wherever possible without compromising our fundamental values. And, finally, we need to promote the private sector's return to the market as our primary mortgage financing vehicle.

As we consider strategies for achieving those common fundamental objectives, we must recognize that we are faced with certain challenging environmental realities. Our fiscal environment includes multiple and ongoing trillion dollar deficits with an unsustainable national debt. We have a challenging economic and job creation environment, along with a challenging housing market and mortgage finance market, and we also have a rapidly aging population, with tens of millions of baby boomers retiring over the next 15 years while 401(k) plans have been significantly diminished and pension plans have become increasingly unavailable.

Within that contextual framework, the ultimate question is, how can the reverse mortgage help us achieve our fundamental objectives while also accounting for the challenging environmental realities that we are facing.

Essentially, reverse mortgages seem to be a largely private sector solution that is uniquely situated to help seniors use their own resources to establish and maintain financial independence and security. And while I know many of us in Congress and many taxpayers are deeply troubled by the GSE bailouts, I don't think that this situation is a zero-sum tradeoff between an FHA guarantee with some inevitable default costs and eliminating the guarantee and having no costs.

If we prematurely eliminate the guarantee, I think we can safely assume that many seniors who would have otherwise remained financially independent would need to resort to government assistance and significantly diminished living standards.

So we have costs either way, and the question becomes, how do we improve the reverse mortgage regulatory framework with the objective of constantly increasing the private sector's role while diminishing the taxpayers' role?

I want to thank the witnesses for being here today, and I want to thank the Chair for the time.

Chairwoman BIGGERT. With that, I would like to recognize that we have some members of the Parliament of Moldova sitting over here. Please stand. They are our counterparts in the financial services in the Parliament of Moldova. Thank you so much for being here.

I would now like to introduce our witnesses: Mr. Charles Coulter, Deputy Assistant Secretary for Single Family Housing, U.S. Department of Housing and Urban Development; Mr. Peter Bell, president and chief executive officer, the National Reverse Mortgage Lenders Association; Mr. Daniel Fenton, housing director, Money Management International, Inc.; Mr. Jeffrey M. Lewis, chief executive officer and chairman, Generation Mortgage; Dr. Anthony Sanders, distinguished professor of real estate finance, George Mason University, and senior scholar, Mercatus Center at George Mason University; Professor Houman Shadab, associate professor of law, New York Law School; Dr. Barbara Stucki, vice president,

Home Equity Initiatives, National Council on Aging; and Dr. Lori Trawinski, senior strategic policy advisor, AARP Policy Public Institute.

Now, you have heard the bells go off, and you will see up here that we are now having votes on the Floor, which happens in the afternoon sometimes. And we have to attend to those pesky votes.

So, we are going to recess for a few minutes. We only have two votes. We will be back as soon as we can. It shouldn't be very long, and then we will start with your testimony. Thank you.

[recess]

Chairwoman BIGGERT. Thank you for being here. It seems like you have a little more room. Everybody was really sitting shoulder to shoulder there for a while.

I would ask unanimous consent that the following materials be inserted in the hearing record: one, an April 2012 Center for Retirement Research at Boston College study entitled, "How Important is Asset Allocation to Financial Security in Retirement?"; two, an April 2012 study entitled, "Reversing the Conditional Wisdom: Using Home Equities to Supplement Retirement Income"; and three, a letter dated May 7, 2012, to Congressman Miller from the Community Associations Institute.

Without objection, it is so ordered.

We will now hear from our panel.

The witnesses' written statements will be made a part of the record, and you will each be recognized for a 5-minute summary of your testimony.

With that, we will recognize Mr. Coulter for 5 minutes.

**STATEMENT OF CHARLES COULTER, DEPUTY ASSISTANT SECRETARY FOR SINGLE FAMILY HOUSING, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

Mr. COULTER. Thank you. Chairwoman Biggert and members of the subcommittee, thank you for the opportunity to testify today regarding FHA's Home Equity Conversion Mortgage, or HECM program. The Housing and Community Development Act of 1987 authorized HUD to conduct a demonstration of HECM loans, and the program became a permanent FHA insurance program in Fiscal Year 1998. The HECM is a government-insured reverse mortgage which enables seniors ages 62 and older to convert a portion of the equity in their homes into cash. The proceeds of the loans can be used for a variety of needs faced by seniors, including healthcare costs, subsistence income, and other such needs.

Since the establishment of the program, HUD has endorsed approximately 750,000 HECM loans. The HECM program includes statutory consumer protections to protect homeowners, including mandatory counseling to ensure that the applicant understands the HECM product and to determine whether less costly alternatives are available; a guarantee of timely cash advances to borrowers in case their lenders cannot make the payments to them, caps on fees, anti-churning disclosures to ensure that borrowers are not induced to refinance without benefits or solely for the benefit of lenders; and a prohibition on cross-selling HECMs and annuities by anyone who participates in the origination or counseling for a HECM.

To protect borrowers, as with its forward mortgage programs, HUD has established servicing guidelines for HECMs, including a requirement that borrowers be offered loss mitigation alternatives. If an HECM borrower is unable to retain their home, options are available to avoid foreclosure.

The mandatory counseling requirement is perhaps the most important consumer feature of the HECM program. This safeguard is especially important because counseling assists the borrower in understanding the HECM loan product, and provides in-depth information to help seniors make informed decisions. Counseling is provided by certified HECM counselors at HUD-approved counseling agencies.

In the past few years, FHA has made a number of improvements to the program. First, to help diversify and strengthen the HECM portfolio. In Fiscal Year 2011, HUD created a new HECM product, the HECM Saver. HECM Saver is a lower-cost loan option for borrowers who may not require as much equity coming out of their home. This product is an important complement to the HECM standard option, and permits borrowers to choose the HECM product that best meets their particular needs.

Another improvement to the program that has contributed to the value of the HECM portfolio was the imposition of new controls on the potential claim costs of tax and insurance arrears. HUD's regulations require an HECM borrower to maintain hazard insurance on the mortgaged property and to pay all pertinent property charges, such as local real estate taxes, in a timely manner. Failure to make those payments puts the loan in default. This guidance instituted controls for the level to which those arrears may grow before the loan must be declared due and payable.

Madam Chairwoman, in the more than 3 decades since its creation, the HECM program has allowed approximately three-quarters of a million senior citizens to age in place and meet their healthcare, subsistence, and other needs. And thanks to the work this Administration has done to strengthen and improve this program, FHA's independent actuaries have stated that the program is actuarially sound.

The HECM program is giving senior citizens who have worked hard to achieve the American dream the opportunity to live their remaining years with dignity and confidence. Thank you, and I would be happy to answer any questions you may have.

[The prepared statement of Mr. Coulter can be found on page 45 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Coulter.

Mr. Bell, you are recognized for 5 minutes.

**STATEMENT OF PETER H. BELL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL REVERSE MORTGAGE LENDERS ASSOCIATION (NRMLA)**

Mr. BELL. Thank you. Madam Chairwoman and members of the subcommittee, thank you for convening this hearing on FHA's HECM program and its role in helping fund longevity. This subcommittee has been sensitive to reverse mortgage issues and has continually taken steps to improve the program. For that, we are

appreciative, as are the three-quarters of a million households that have used HECMs.

Presently, there are 578,000 senior households with these loans, and \$11.8 billion was made available through loans endorsed under the program in Fiscal Year 2011, an amount that stimulates consumer spending. HECM helps individuals address a key challenge—how to finance longevity. With life carrying on for decades beyond our earning years, we must manage assets and resources to sustain ourselves longer. The equity in a home is often the largest component of personal wealth. Congress recognized this when enacting the HECM program in 1987 in a bill signed into law by President Reagan. My written statement presents the history of reverse mortgages in the United States, as well as the legislative history of HECM. I will leave that to be read, rather than use my limited time here on that.

The HECM statute strikes a balance by assuring the industry the ability to offer reverse mortgages in exchange for agreeing to consumer fairness and fiscal soundness. A thoughtful and responsible partnership of stakeholders, including Congress, HUD, senior advocates, housing counselors, and the lending industry, has worked together to keep this program true to its objectives. Over the years, Congress has amended the HECM statute nine times, sometimes to clarify wording, other times to alter substance. The program has resulted in the development of an important financial management tool that we are able to offer because of the sharing of risk between the public and private sectors.

Reports by HUD and AARP, as well as our own research, have shown strong consumer satisfaction among those who have taken out these loans. Initially created to help supplement retirement income, use of the loan has evolved to help in a number of different circumstances. HECMs are used to pay off mortgages and debts, enabling borrowers to eliminate monthly payments and deploy their regular cash flow for day-to-day living expenses. In other cases, HECMs are used to cover costs for in-home care, allowing borrowers to avoid a costly stay in a nursing home.

With the introduction of the HECM Saver, which provides lower costs to consumers and lower risk to FHA, the program has drawn interest from financial planners. Many retirees experience peaks and troughs in their cash needs. As a result, they are often forced to liquidate assets at inopportune times, selling stocks into a down market or cashing in certificates of deposit before maturity. A HECM Saver can provide cash for immediate needs and then be repaid when investment returns are higher. The net result, according to models run by leading financial planners, is that the client will have a larger amount of money available to meet their funding needs throughout their retirement.

There are several issues that need to be addressed on the HECM program. First and foremost is the authorization cap. The program was made permanent in 1998, but there has been a statutory limit on the number of loans FHA can insure. Although the cap has been routinely raised or suspended, its existence deters some industry participants. NRMLA urges this subcommittee to support permanently removing the cap to minimize any possible disruption of HECM. The review undertaken annually in the budget process pro-

vides the opportunity to monitor program performance. There are also opportunities for review whenever this subcommittee or the full Financial Services Committee conducts its periodic and helpful oversight of the program, or of FHA generally.

The next issue is a Qualified Mortgage. This is a concept that has emerged in the Dodd-Frank Act to identify characteristics of mortgages that may be originated and sold into the secondary market without a risk retention requirement. The Consumer Financial Protection Bureau is promulgating rules on this concept. We are requesting they create a definition of "Qualified Mortgage" specifically for reverse mortgages so they may qualify for an exemption from risk retention. This will help bring back a proprietary reverse mortgage market, taking some of the burden off of FHA in serving seniors' needs. It is healthy for the reverse mortgage industry to be able to offer a range of products, including proprietary reverse mortgages, in addition to FHA-insured HECMs.

I had other issues to get to here, but I see my clock is running out, so I will refer you to the written testimony for those, and, in conclusion, basically state that HECM has been a useful tool helping hundreds of thousands of seniors maintain their homes and lead more financially stable lives. The program has been administered thoughtfully, carefully, and responsibly by a partnership of stakeholders. This has allowed the reverse mortgage concept to gain a foothold and prove the value of this important personal financial management tool as a component of retirement finance and funding longevity. We thank members of the subcommittee for your interest in this program, and hope that we can count upon Congress to demonstrate its support by further suspending, or preferably removing, the cap on the number of mortgages FHA can insure. Thank you for the opportunity to appear here today.

[The prepared statement of Mr. Bell can be found on page 32 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Bell.

Mr. Fenton, you are recognized for 5 minutes.

**STATEMENT OF DANIEL FENTON, SENIOR HOUSING DIRECTOR, MONEY MANAGEMENT INTERNATIONAL, INC. (MMI)**

Mr. FENTON. Thank you. Chairwoman Biggert, Ranking Member Gutierrez, and members of the subcommittee, my name is Daniel Fenton, and I am senior housing director for Money Management International, or MMI. MMI is a nonprofit HUD-approved housing counseling agency, providing a range of financial counseling services including foreclosure prevention, and reverse mortgage counseling by telephone and in person in more than 100 branch offices nationwide. We are the largest reverse mortgage counseling agency in the country, with more than 100 certified counselors, accounting for approximately 10 percent of all HUD-certified reverse mortgage counselors.

Thank you for the opportunity to share the perspective of counselors who, on a daily basis, provide education and resources to seniors considering the use of a reverse mortgage.

Also, I would like to thank you, Chairwoman Biggert, for your work in founding the Financial and Economic Literacy Caucus, and your work in establishing the Office of Housing Counseling at

HUD. We in the housing counseling and financial literacy community really appreciate your support of our work.

In our experience, seniors choose reverse mortgages for a variety of reasons. However, the majority do so to better handle their day-to-day expenses and continue living independently in their own homes for as long as is practically possible. While it is extremely helpful to many seniors, a reverse mortgage is a complex loan, and details of exactly how it works are generally not well understood. It is essential that seniors have a thorough understanding of reverse mortgages before taking out a loan to avoid pitfalls described in my written testimony. Congress and FHA sought to ensure that seniors avoid such pitfalls by requiring that all borrowers participate in a counseling session with a HUD-approved agency counselor before making a loan application. The counselor's role is not to encourage or discourage the use of a reverse mortgage, but to ensure that seniors considering doing so are able to make an informed choice for themselves. MMI's counseling process typically takes about 2 hours. It includes the development of personalized loan example documents, general education on reverse mortgages and their alternatives, the creation of an individualized budget, and a welfare-benefits analysis relating to the client's individual circumstances.

In the last 3 years, HUD has strengthened the effectiveness of the counseling program nationwide, with a major overhaul of counseling standards. Major enhancements include a mandatory exam-based certification for all counselors, and a mandated use of a standardized test of understanding designed to ensure that all borrowers demonstrate a basic understanding of how a reverse mortgage works.

However, while HUD has developed a robust consumer protection process, Congress has inadvertently created a counseling-funding model that actually undermines counselors' ability to meet seniors' needs. We are very grateful for HUD's reverse mortgage counseling grant funding; however, it does not nearly cover the cost of counseling services provided nationwide. We believe that the cost of consumer protection should not be the exclusive responsibility of government, and that both seniors receiving reverse mortgages and the reverse mortgage lending industry should help cover the cost of these efforts.

Sadly, current legislation makes this impossible. In particular, language in the Housing and Economic Recovery Act of 2008, or HERA, specifically prohibits reverse mortgage lenders from funding reverse mortgage counseling. This was intended to avoid a conflict of interest. But in reality, it forces the cost of non-HUD-funded counseling sessions directly onto all clients seeking counseling. The problem with this is that prospective borrowers are usually seeking additional funds to help pay for living expenses, so an up-front fee for counseling prior to receiving loan proceeds is often a significant deterrent to seeking counseling at all. Counseling entities can eliminate the need for an up-front fee by charging a fee as part of closing costs, but this creates a situation where counseling organizations are paid on a per loan-closed basis, which is not ideal, as it makes the agencies dependent on loan volume for their financial survival.

To address this problem, we suggest amending HERA to allow for the establishment of a blind trust or funding pool to compensate counseling agencies on a per client-counseled basis, irrespective of whether their clients enter into a reverse mortgage. This could be funded by a standard closing cost levied on all reverse mortgages, coupled with contributions from the reverse mortgage industry and government as needed. If Congress allows the pooling of funds from lenders to support counseling, the potential conflict of interest is removed and counseling agencies can adapt to meet the capacity needs of this industry without relying solely on government funds to meet the needs of seniors.

In closing, MMI believes that counseling is necessary to protect the interests of the seniors, as well as the financial integrity of the reverse mortgage program. We commend HUD for its efforts to strengthen counseling standards, and we urge action to improve counseling funding availability so that all seniors of every income level can receive the education they need as they evaluate their financial options.

Thank you for this opportunity to present my testimony. I will be pleased to respond to any questions you may have.

[The prepared statement of Mr. Fenton can be found on page 55 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Fenton.

Mr. Lewis, you are recognized for 5 minutes.

**STATEMENT OF JEFFREY M. LEWIS, CHAIRMAN AND CHIEF  
EXECUTIVE OFFICER, GENERATION MORTGAGE**

Mr. LEWIS. Thank you. I would like to thank you, Chairwoman Biggert, Congressman Gutierrez, and the other members of the subcommittee for holding this hearing on the HECM program and for inviting me to participate. I am the chairman and CEO of Atlanta-based Generation Mortgage, a mortgage banking firm originating and servicing reverse mortgages exclusively.

I also serve as the chairman of the Coalition for Independent Seniors, which is a nonpartisan public policy coalition dedicated to preserving seniors' financial independence.

Chairwoman Biggert, you asked me to address several issues: the current state of the HECM program, its administration; the benefits to borrowers; the safety and soundness of the program; and to provide suggestions for regulatory and statutory changes. I will take each of these in turn.

First, what is the current state of the program? Recently, MetLife announced their departure from the industry, making them the third major company to depart the business in the last 15 months. RMS, Urban Financial, Generation Mortgage, One Reverse, and others, have stepped into the void to continue to make the product fully available across the country.

To provide some perspective, I would note that from 1989 to 2006, no major financial brands participated in the reverse mortgage industry, yet the marketplace grew steadily. None of the companies that departed expressed any concerns over the quality of the HECM product itself.

A concern for those who left and a continued concern for those who remain is tax and insurance, or T and I defaults. The reverse



mortgage is not suitable for every borrower. The benefits of the product are not outweighed by the financial and psychological costs of a foreclosure. The industry is working with FHA, and expects fair and consistent guidelines in the coming months, that will allow the industry to identify unsuitable borrowers.

In the future, we also expect to see program modifications, such as mandated escrow payments, that will protect both consumers and the FHA insurance fund. A cornerstone of consumer protection unique to the HECM remains mandatory counseling, which we strongly support. The new measures being taken on financial assessment, combined with the existing counseling requirements, will help ensure the program's future integrity and sustainability.

Declining home values have certainly had an impact on overall volume, which is currently running at about half of what it was 3 years ago. With the changes being implemented, favorable demographic trends, and some stability in the housing market, the industry is well-positioned to reverse the down trend.

FHA and Ginnie Mae have done a fine job administering and enabling the program to operate in a consumer-friendly and financially sound manner. Recently, we have seen an overhaul of both the counseling protocols and the servicing protocols for defaulted loans. Twice in the last 3 years, FHA has altered the economic terms of the HECM, reducing the principal limit factors, and increasing the mortgage insurance premiums charged on the product. We recognize that the product must support and sustain itself through the insurance premiums collected, and that these changes were a good and necessary response to changes in the housing market.

The current version of the HECM standard, along with the new HECM Saver, will provide attractive options to the widest possible range of eligible borrowers. While the reverse mortgage is not for every borrower, for those seniors who do meet the criteria, the product can be life-transforming, especially if it is utilized as part of a comprehensive retirement plan. The product allows seniors to retire with dignity, security, comfort, and independence.

I would like to briefly address the question of whether or not it is healthy for the government to be so dominant in this market. After all, the Federal Government currently insures more than 99 percent of all new reverse mortgage originations. In the traditional mortgage space, the economic difference between a government loan and a jumbo is marginal. In the reverse mortgage space, the difference between a government loan and a private loan is immense. The difference is not a reflection of increased risk on the part of the government. Rather, it is a function of the fact that the government's cost of capital is dramatically less than the private sector's.

FHA's proactive changes to the program have put it on solid financial footing. We expect the program to stand on its own without subsidy. And if the housing market were to deteriorate meaningfully, we would expect FHA to act accordingly and increase the costs of the loan. At the same time, if the housing market improves, we would be delighted to see the terms of the loan improve as well.

You asked me to also suggest regulatory and statutory changes. On the regulatory front, the industry has been actively engaged with the new CFPB in their ongoing reverse mortgage study. We look forward to their findings and any changes they suggest that will truly protect consumers.

As the only originator of jumbo reverse mortgages, Generation would enthusiastically support a definition of “Qualified Mortgage” that includes all reverse mortgages. This would increase the probability that our jumbo product could be distributed broadly to investors.

There is one final issue I would like to touch on—comprehensive retirement planning. A provision in the 2008 Housing and Economic Recovery Act designed to protect consumers from the bundling of inappropriate financial products for the HECM has had the unintended consequence of limiting consumer choice. It might be prudent to examine ways to allow licensed and competent professionals to provide comprehensive planning, while continuing to protect consumers. Such a change would benefit consumers and also serve as an incentive for major companies to get back into the reverse mortgage space.

Last month, the Center for Retirement Research at Boston College released a study on how important asset allocation is to financial security and retirement. The study concludes by noting that, “Financial advisers would be of greater help to their clients if they focused on a broad array of tools, including working longer, controlling spending, and taking out a reverse mortgage.”

Thank you for the opportunity to participate today, and I look forward to answering your questions.

[The prepared statement of Mr. Lewis can be found on page 63 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Lewis.  
Dr. Sanders, you are recognized for 5 minutes.

**STATEMENT OF ANTHONY B. SANDERS, DISTINGUISHED PROFESSOR OF REAL ESTATE FINANCE, GEORGE MASON UNIVERSITY, AND SENIOR SCHOLAR, MERCATUS CENTER AT GEORGE MASON UNIVERSITY**

Mr. SANDERS. Chairwoman Biggert, Ranking Member Gutierrez, and members of the subcommittee, thank you for inviting me to testify today. My name is Anthony B. Sanders. I am a professor of finance at George Mason University in the school of management, and senior scholar at the Mercatus Center. I was previously director of asset-backed and mortgage-backed securities research at Deutsche Bank, and the author of “Securitization” with Andrew Davidson, as well as numerous economic and finance publications on housing and the housing finance system.

The FHA, HUD, and the Federal Government face enormous challenges going forward. Federal debt held by the public is currently \$10.9 trillion, and has increased by \$6 trillion since January 2007, and \$4.6 trillion since President Obama took office on January 20, 2009. The Federal Government has been running, with the exception of 1 month, trillion-dollar deficits, and will continue to do so, which will result in even more Federal debt. Student loan debt

is over \$1 trillion and growing, which is another federally-guaranteed program.

On the housing front, Fannie Mae, Freddie Mac, and the FHA have captured the mortgage insurance industry with over a 90 percent share. Fannie and Freddie have cost taxpayers \$170 billion and counting. And we do not know the final costs of the 14 loan modification programs of the Administration, including the Attorney General's settlement.

The Administration and Congress are pressuring FHA to allow Fannie and Freddie to perform principal writedowns, and the costs could be staggering.

This brings us to the FHA. The FHA, according to Ed Pinto at the American Enterprise Institute, is deeply insolvent, with insufficient capital, although I know HUD does not agree with that sentiment. The FHA is estimated to have a current net worth of minus \$12 billion, and an estimated capital shortfall between \$31 billion and \$50 billion. The good news is that the total delinquency rate in March declined to 15.78 percent, while the serious delinquency rate declined to 9.47 percent. The bad news is, today the FHA announced that 50 percent of their loan modifications have gone into redefault.

Though the U.S. housing market and disarray in housing prices have continued to decline in many markets, the losses could mount for the FHA and American taxpayers even further. And with housing prices declining and the FHA continuing to insure and subsidize 3.5 percent down mortgages, the question remains as to why the Federal Government is guaranteeing and subsidizing reverse mortgages for seniors. Stated differently, why do taxpayers have to subsidize seniors who want to stay in their homes when the simple solution is to let seniors sell their home and either rent a dwelling or purchase a smaller dwelling that meets their needs when there is also the possibility of a private market without insurance for reverse mortgage?

I am not against reverse mortgages as an equity extraction tool. In fact, I advised the Chancellor of the Exchequer in the United Kingdom about equity extraction tools over there for their retirees. But I do not see any reason for the Federal Government to guarantee and subsidize it. We need to stop micromanaging the homeownership decisions for American households. The Clinton Administration tried it in 1995 with the National Homeownership Strategy that took all the safeties off the housing finance system, and that contributed to the housing bubble and burst. Now Fannie, Freddie, and FHA are raising credit standards, encouraging those who can't get credit to rent, creating a rental bubble. Residual residential rents are rising rapidly in urban areas. In other words, our policies just keep shifting bubbles from one sector to the other.

At a minimum, the Federal Government should get out of the reverse mortgage insurance and subsidization business, or at least do some sort of loss-sharing agreement that is stronger than what it is now, which is one of the proposals for Fannie Mae and Freddie Mac going forward. We have thrown enormous subsidies at the housing market, have tried to steer households into ownership, then renting, now steering seniors toward equity extraction. We need to think about how much the housing market should be sub-

sidized. Mortgage interest deductions, subsidized housing insurance, low-downpayment loans, clearly the massive subsidization has distorted housing and the housing finance market, and changes should be made.

There are numerous proposals for ending the housing government monopoly, including eliminating Fannie and Freddie, converting them to a public utility and reinsurance company. But no matter how we deal with the government housing monopolies, we need to address how much we want to subsidize it. So, a reverse mortgage for seniors is a reasonable idea, but it should not be guaranteed by the Federal Government. It is an ownership decision, and the Federal Government should stop trying to micro-manage this decision, particularly since there is an easy alternative: either private market reverse mortgages; or just selling their dwelling and moving into rental or a new home.

Thank you very much for the opportunity to testify.

[The prepared statement of Dr. Sanders can be found on page 76 of the appendix.]

Chairwoman BIGGERT. Thank you, Dr. Sanders.

Mr. Shadab, you are recognized for 5 minutes.

**STATEMENT OF HOUMAN B. SHADAB, ASSOCIATE PROFESSOR  
OF LAW, NEW YORK LAW SCHOOL**

Mr. SHADAB. Madam Chairwoman and members of the subcommittee, thank you for inviting me here to testify on the Federal Housing Administration's HECM program for reverse mortgages. My name is Houman Shadab, and I am an associate professor of law at New York Law School. A significant portion of my research focuses on instruments that transfer credit risk, including mortgage-backed securities and credit default swaps. My testimony will focus on the financing of reverse mortgages, and not consumer protection issues.

Based upon my research, I find that as housing prices stabilize and the broader economy recovers, a reverse mortgage market would likely be sustainable without FHA insurance. This is primarily because the securitization of conventional non-HECM reverse mortgages can likely take place on a large scale even without a government guarantee.

By way of background, the Department of Housing and Urban Development is involved in the reverse mortgage market in two fundamental ways. At the loan level, FHA insures and regulates qualifying reverse mortgages under the HECM program. This insurance protects lenders against the risk that the value of the home will be less than what is owed when payment comes due. HECM loans currently comprise 95 percent of the market. As of year-end 2011, the estimated outstanding balance of all HECM loans was approximately \$87 billion.

HUD is also involved in reverse mortgage securitization through Ginnie Mae, which guarantees the principal and interest payments of HECM mortgage-backed securities. Through year-end 2011, a total of \$27.7 billion in HECM mortgage-backed securities had been issued.

Now, there are several reasons why a private reverse mortgage market could exist even without FHA insurance or Ginnie Mae-

sponsored securitization. First, prior to the financial crisis of 2008, conventional reverse mortgages were widely available, and the market was steadily growing. After peaking in 2007, about 16 percent of the volume of reverse mortgages were conventional loans. Lenders stopped making conventional reverse mortgages during the financial crises due to the economic shock that caused the secondary market to collapse.

Second, the overall demand for reverse mortgages is likely to increase dramatically in the next several years due to an aging population, growing healthcare costs, and a lack of sufficient savings for retirement. Indeed, a 2009 estimate by Reverse Mortgage Insights found that only 2 percent of the potential reverse mortgage market was being served.

As the demand for reverse mortgages grows, the demand for conventional reverse mortgages will grow as well. The small market share of conventional reverse mortgages is likely also due to their inability to compete with HECM loans. Indeed, Fannie Mae's 2008 decision to stop offering a conventional reverse mortgage product was due to Congress expanding the scope of the HECM program. Most importantly, a substantial market for private mortgage—reverse mortgage-backed securities without governmental guarantees likely to develop and support the growth of the conventional reverse mortgage market. Although private reverse mortgage securitization volumes have been modest, they have already taken place without any governmental guarantees.

Indeed, the first securitization of reverse mortgages in 1999 was a private transaction. In 2005, Lehman Brothers privately securitized conventional reverse mortgages in a \$503 million deal. In 2006 and 2007, \$2.7 billion of private reverse mortgage-backed securities were issued. The private market thus seems to have been growing when the financial crisis caused the market for all private securitizations to collapse.

Putting things in perspective, we should keep in mind that there is currently a multibillion-dollar securitization market that operates without any governmental guarantees—2011 saw the issuance of \$30 billion in private commercial mortgaged-backed securities, \$12.3 billion of securities backed by commercial loans, and \$60.2 billion of securities backed by credit card receivables.

Even in 2000, prior to the development of recent housing and securitization bubbles, \$57.8 billion of private forward mortgage-backed securities were issued. This large, private securitization market reflects a strong appetite among investors for structured debt securities that do not have governmental guarantees. Over time, this appetite is likely to extend to reverse mortgage securitization as well.

Importantly, private securitizations of commercial mortgages, credit cards, and loans began in the mid-1980s to early 1990s, and it took several years for those markets to mature and grow. By contrast, private securitizations of reverse mortgages were in their infancy before the financial crisis hit. Accordingly, Congress should not expand the HECM program. Instead, Congress should consider reducing FHA insurance for HECM loans, and also consider reducing the guarantee provided by Ginnie Mae for securities backed by HECMs. These reductions would likely not pose a long-term prob-

lem for borrowers seeking reasonably priced reverse mortgages. As the private securitization market grows, the availability of lower-cost conventional mortgages will grow as well.

In addition, reducing the role of FHA and Ginnie Mae will help to ensure that taxpayer funds are not put at risk by being used to subsidize the activities of financial institutions.

Thank you very much for the opportunity to share my views. I look forward to any questions you may have.

[The prepared statement of Professor Shadab can be found on page 85 of the appendix.]

Chairwoman BIGGERT. Thank you, Mr. Shadab.

Dr. Stucki, you are recognized for 5 minutes.

**STATEMENT OF BARBARA STUCKI, PH.D., VICE PRESIDENT,  
HOME EQUITY INITIATIVES NATIONAL COUNCIL ON AGING  
(NCOA)**

Ms. STUCKI. Chairwoman Biggert, Ranking Member Gutierrez, and esteemed members of the committee, on behalf of the National Council on Aging, I appreciate the opportunity to testify today. NCOA is a nonprofit service and advocacy organization whose mission is to improve the health and economic security of millions of older adults, especially those who are vulnerable and disadvantaged. I am here to talk about ways to sustain and improve the HECM program. My remarks are grounded in our research and our experience as a HUD-approved HECM counseling intermediary.

There are three issues that I will discuss today. First, as you examine the HECM program, remember that it was designed for seniors with modest incomes, many of whom are underserved by the financial industry. We estimate that about 44 percent of reverse mortgage counseling clients have incomes under 200 percent of the Federal poverty level. As people live longer, they need to take more responsibility to safeguard their health and financial security. Home equity is becoming part of the solution due to the widespread inadequacy of retirement savings. As a result, the issue for many low- to moderate-income seniors today is not whether to tap this asset, but when and how.

Older homeowners consider HECM loans for many reasons, including additional income to plan ahead for emergencies, and to pay for home repairs or improvements. These loans can also strengthen the capacity for independent living. Among counseling clients, about 46 percent are widowed or divorced; 12 percent have had a hospital or nursing home stay in the 6-month period before counseling. Almost 1 in 10 consider this loan to pay for out-of-pocket health expenses.

A growing number of older homeowners will need guidance on reverse mortgages, so we urge you to adequately fund HECM counseling. Additional support for research, using data collected through the counseling process, will also help to strengthen consumer protections and reduce the risk of loan default.

Second, keep in mind that reverse mortgage borrowers are at the leading edge of a new trend to use home equity. Several years ago, 73 percent of borrowers took out this loan to improve their quality of life. Now, 67 percent of counseling clients want to lower debt. Seniors who take out a reverse mortgage when they face serious fi-

nancial difficulties are at a higher risk of defaulting. These findings suggest that the long-term sustainability of the HECM program rests on increasing the use of these loans as more than a tool for crisis management. As the baby-boomer generation ages, reverse mortgages may become part of retirement planning. The average age of HECM borrowers has declined from about 77 in 1990 down to 72 in 2012. About 1 in 5 counseling clients are baby boomers age 62 to 64. Borrowers must meet their ongoing obligations, including paying property taxes and insurance.

However, it will be important to ensure that HUD regulations, such as the financial assessments lenders may conduct at origination, do not become overly restrictive so that the HECM program remains a viable option for the cash-poor seniors for whom it was originally intended.

Third, it is important to understand that the HECM program serves as an important platform for innovation. Over the past 10 years, reverse mortgages have evolved as a product and as a financing solution. Declines in loan endorsements indicate that HECMs must continue to evolve.

To meet these challenges, HUD should be encouraged to continue collaborative efforts with the mortgage industry, housing programs, and the aging services community. For example, efforts are under way to integrate HECM counseling with assistance from social service agencies to support borrowers in default. These efforts could be expanded to help those with chronic conditions to stay at home and avoid the need to rely on Medicaid.

HUD has also made it easier for homeowners to learn about public benefits by requiring that HECM counselors conduct a benefits check-up screening for clients with incomes under 200 percent of poverty. This has helped more than 71,000 seniors find over \$378 million worth of annual benefits.

In conclusion, NCOA believes that the long-term viability of the HECM program will be enhanced through a balanced approach that ensures strong oversight but also supports continuing collaborative research and development. We need strong consumer protections, but also want to give older homeowners the flexibility to meet their evolving financial needs.

Thank you again for this opportunity to share NCOA's research and insights into the HECM program and older homeowners who consider these loans. I would be happy to answer any questions you may have.

[The prepared statement of Dr. Stucki can be found on page 92 of the appendix.]

Chairwoman BIGGERT. Thank you, Dr. Stucki.

Dr. Trawinski, you are recognized for 5 minutes.

**STATEMENT OF LORI A. TRAWINSKI, PH.D., SENIOR STRATEGIC POLICY ADVISOR, AARP PUBLIC POLICY INSTITUTE**

Ms. TRAWINSKI. Chairwoman Biggert, Ranking Member Gutierrez, and members of the subcommittee, thank you for the opportunity to testify on behalf of AARP on the oversight of the Federal Housing Administration's reverse mortgage program. As the largest nonprofit, nonpartisan membership organization representing peo-

ple age 50 and older, AARP advocates for policies that enhance and protect the economic security of older individuals.

AARP's history of involvement with the HECM program dates back to the 1980s. We believed then, as we do now, that older Americans should have a means by which to access their home equity without having to sell their homes or take on loans that will stretch their already tight budgets. Housing counseling is a major component of the consumer protections for HECM loans. Despite recent improvements to the counseling protocol, it appears that problems remain. Some counselors tell us they need 2 or more hours to cover all the topics required by the protocol. In contrast, other counselors, mainly telephone counselors, manage to conduct the session in less than 1 hour. We believe that this discrepancy may highlight a problem with the quality of counseling, and we urge HUD to investigate.

We also believe that the housing counseling program should be fully funded by Congress, particularly since counseling is required by law, and lenders are prohibited from paying for counseling on behalf of borrowers.

Additional funds should be allocated to foreclosure mitigation counseling to assist borrowers who have the capacity to become current on their obligations and avoid foreclosure. As a result of continuing problems with technical defaults for nonpayment of taxes and insurance, HUD plans to propose a rule requiring financial assessments for borrowers. AARP understands the need to examine a borrower's ability to pay property charges and to be able to maintain their property. However, we do not believe that credit scores, payment history, or the existence of a bankruptcy filing or foreclosure should be part of the financial assessment. The determination should be whether borrowers have the ability to meet their basic living expenses, financial obligations, and property charges. And this should be determined after taking the cash flow from the potential reverse mortgage into consideration.

Disclosures play an important role in consumer protection. AARP looks forward to working with the Consumer Financial Protection Bureau on the forthcoming redesign of disclosures for reverse mortgages. AARP also recommends that statements from mortgage servicers for borrowers who have a line-of-credit option should be required to provide more detailed information on credit-line growth and available credit.

We have all seen the television commercials. It is unlikely that the designers of the HECM program ever envisioned that "the Fonz" and "I Dream of Jeannie" would appear in American living rooms to enlighten people about the benefits of a reverse mortgage. Some advertisements may create the impression that a reverse mortgage is a Federal benefit rather than a loan. While it is appropriate to educate the public about the availability of reverse mortgages, mass marketing should not be misleading or deceptive. It should be clear that celebrities are paid spokesmen. Despite guidance from the Reverse Mortgage Lenders Association, that is always not clear in the advertisements.

Another area of concern is the free-lunch seminar. It appears that investment salespersons may be presenting reverse mortgages as a means of paying for their products. This cross-selling may not



be in the best interests of consumers. AARP urges the Consumer Financial Protection Bureau and the State financial regulators to monitor reverse mortgage advertising and the use of free-lunch seminars to ensure that there is no inappropriate marketing or cross-selling. AARP continues to believe that older Americans should have a means by which to access their home equity without having to sell their homes, and we believe that a reverse mortgage can be an appropriate financial product for some people.

AARP urges HUD to act in a timely manner to promulgate rules that prohibit cross-selling and to promulgate rules for financial assessments of borrowers. In addition, we support the development of a wider-reaching program to assist borrowers who are in default before the loan reaches the foreclosure stage.

AARP also urges the following statutory changes: removal of the statutory limit on the number of loans that can be insured by FHA; and an appropriation of sufficient funds to make sure that borrowers have access to the housing counselors they require and the capital they need.

AARP supports the continuation of the HECM program, and we look forward to working with you and other stakeholders to ensure that older Americans can tap their home equity with safe, affordable, government-insured mortgage loans.

Thank you for the opportunity to share AARP's views. I would be happy to answer any questions.

Chairwoman BIGGERT. Thank you so much.

[The prepared statement of Dr. Trawinski can be found on page 99 of the appendix.]

Chairwoman BIGGERT. We will now turn to the Members for questions. And we will do a 5-minute clip. I will begin by recognizing myself for 5 minutes.

Mr. Coulter, the FHA-HECM product was created and made available to the public in 1989, with the intent of meeting the special needs of the elderly homeowners. In the past 6 months, Congress has learned that the FHA is in a precarious financial position, admitting that it could lose up to \$688 million but for the settlement that was just reached.

Can you tell us why the government should support a 100 percent taxpayer-guaranteed reverse mortgage product?

Mr. COULTER. Thank you for the question. And as you pointed out, the \$688 million figure was before the Department of Justice settlement on servicing. That is our aggregate portfolio.

With regard to the HECM portfolio, we are required to have each book be actuarially sound. So we in our budgeting process, we estimate the net present value or the net economic benefit of each book. And to the extent that book is not actuarially sound, we are required to ask for an appropriation.

What has happened in the past is at times, that appropriation has not been granted, and so FHA has taken definitive steps to address the economic circumstances of the book, specifically by addressing the principal limit factor and raising the premiums on the book. So the bottom line is on a go-forward basis. We expect each book to at least pay for itself on a year-in, year-out basis, if not draw positive economic value to the insurance fund.

Chairwoman BIGGERT. All right. Thank you. So, the book that you speak of is your book of business?

Mr. COULTER. That is correct, yes.

Chairwoman BIGGERT. Thank you. Then, Mr. Bell—and I will come back to Mr. Coulter on this too—you mentioned in your testimony that Wells Fargo, or that some of the banks, Bank of America and MetLife, withdrew from the reverse mortgage market in the past 2 years, with MetLife withdrawing as recently as in this past month. Why did they leave? Mr. Bell?

Mr. BELL. Well, each case is very different. And I was not privy to the deliberations that went on internally in each of those companies that led to this. But on the high level, the public reporting in each case was about a broad set of issues that were not particular to the HECM program, but really had to do with their overall business model. In the case of MetLife, they exited mortgage banking and banking entirely. And the reverse mortgage exit was just part of that whole overall effort to—

Chairwoman BIGGERT. It seems that the media reports have indicated that some of these entities withdrew because they were not able to underwrite using the borrowers' ability to make timely payments on insurance and taxes.

Mr. Coulter, would you—

Mr. COULTER. Sure, I would be happy to take the question. Certainly, when lenders exit a program, we are very concerned about that, and we do talk to these lenders about why they are making those decisions. Mr. Bell's comments around the strategic misalignment with the business is certainly a driving factor for MetLife, and to a lesser degree with Wells Fargo.

But there are other underlying issues that we are looking at very carefully. One example is tax and insurance defaults. Lenders are concerned about the number of tax and insurance defaults, and the fact that those could lead to circumstances where foreclosure on a senior borrower is required. And obviously, that creates risk, reputation risk to the lender. So, addressing that issue is something on which we are very focused.

The other factor that is a consideration for some of these larger institutions is the fact that they don't get—in some cases, their auditors are making the determination. They don't get true sale treatment when they originate and securitize and sell a Ginnie Mae security. That means in essence, instead of getting those loans off of their books, they are required to hold capital against that, against those HECM loans, despite the fact that they sold them away.

Chairwoman BIGGERT. Early on, we heard that some of these reverse mortgages were used, there was just a bulk delivery of the money to use for their income, and then it was spent right away. This was fixed, wasn't it?

Mr. COULTER. There are a number of different options that a senior has. And it is at their option that they—they make a determination as to whether to take a lump sum payment up front. Or to receive a payment over a period of time up through the time that they are 100 is one alternative. So they can either realize it on an annuity payment or they can realize an up-front payment.

To be candid with you, many seniors do opt for an up-front payment. And our experience right now is that most of these loans are drawn down to 80 percent of the maximum at the time of origination.

Chairwoman BIGGERT. Okay. Thank you. I now recognize the gentleman from Illinois, Mr. Gutierrez.

Mr. GUTIERREZ. Thank you. I had one follow-up on your question. So Mr. Coulter, in 2010 the HUD IG identified 13,000 defaults where lenders had essentially granted unlimited forbearance to borrowers who had defaulted because they did not pay their property taxes and insurance rather than comply with the terms of the HECM program.

Can you tell us what risks this posed to the program and what steps HUD is taking to minimize that risk?

Mr. COULTER. Certainly. Thank you for the question. In early 2011, HUD put out a mortgagee letter to address this issue around tax and insurance defaults. You can imagine that, when going back prior to the housing crisis, there was substantial equity in many of these homes. So, servicers were advancing on behalf of borrowers, and there weren't huge issues associated with that.

Mr. GUTIERREZ. What are we doing so that—

Mr. COULTER. Today what is happening is, we lay out very clear criteria for how much a servicer can advance, and we ask the servicers to work very closely with the borrowers to ensure that they are either put on some sort of payment plan or we work through other loss mitigation measures to ensure that an issue of tax and insurance—

Mr. GUTIERREZ. Why don't we just avoid it altogether? Why isn't just an escrow account established to pay property taxes? That is the way I bought my first house. If I didn't—I had to establish, first of all, when I bought the house back in 1980—I know that is a long time ago—I had to establish it, first of all, and fund it, and then I had to continue to fund it. And if it was underfunded at any time because of my property taxes, there was an immediate demand for me to comply with that escrow account.

Why isn't that done?

Mr. COULTER. Let me say that we do believe that we have to address this issue around tax and insurance defaults. And one alternative is an escrow account. We don't have the authority to require escrows at this point.

Mr. GUTIERREZ. We don't have the authority to address escrow accounts, but we are going to back the mortgages?

Mr. COULTER. I missed the last part of the question.

Mr. GUTIERREZ. But we are involved in backing the mortgages?

Mr. COULTER. We don't have the authority in the case—in the case of a forward mortgage, we do require escrow accounts. In the case of a reverse mortgage, we do not have the authority to require it. We are looking at a potential rule that would address this by virtue of doing a set-aside to make tax and insurance payments. And we believe that is an appropriate next step.

Mr. GUTIERREZ. So we just continue talking; there are 13,000, and there is no sense of urgency in getting this done?

Mr. COULTER. Oh, there is absolutely a sense of urgency in getting it done. Yes, sir.

Mr. GUTIERREZ. But we are continuing to back the mortgages irrespective of this—it seems like a pretty easy way to make sure someone is going to pay that.

Mr. COULTER. There are two things that we are doing to address this. One is—

Mr. GUTIERREZ. I get it. But it seems—so maybe you could write to us and tell us and give us a timeframe in which this is going to be addressed so that we don't continue. Because it just seems to me that for the viability of the program, I don't see why the Federal Government should be there, the taxpayers, anybody should be, unless you are going to put some pretty good—so somebody is using this because they need the money. And we find more and more that people are getting a lump sum. That is, here is your money.

What is the guarantee, if you are not keeping any of the money, to make sure that potential property taxes and insurance are being paid?

Mr. COULTER. You are highlighting a need for a set-aside to pay taxes and insurance and for a financial assessment at the time the loan is made. We agree with you wholeheartedly on both of those points, and we will respond back to you in writing with regard to when that will happen.

Mr. GUTIERREZ. Do you find that more and more people are taking the whole amount, or are they taking an annuity?

Mr. COULTER. As I mentioned a moment ago, our experience today is that, on average, borrowers are drawing down 80 percent at the time of origination.

Mr. GUTIERREZ. 80 percent?

Mr. COULTER. Yes.

Mr. GUTIERREZ. So they are drawing down 80 percent of the money?

Mr. COULTER. That is correct. But understand that the principal limit factors to draw down 80 percent—they are doing that on our standard HECM program. The principal limit factors on those programs would restrict the amount that they could draw, such that the principal balances should not grow beyond the appraised value of the property over the life of the borrower.

Mr. GUTIERREZ. I don't have any further questions.

Chairwoman BIGGERT. Thank you. I hope that will be for the record in writing. That will be helpful.

Mr. Lewis, can you explain the definition of true sale as it relates to reverse mortgages? And how does it affect reverse mortgage lenders and securitization?

Mr. LEWIS. Sure. I am not an accountant, and I don't play one on television, but I will do my best.

Chairwoman BIGGERT. All right.

Mr. LEWIS. The basic issue surrounding true sale is whether—when the loans have been placed into the securitization, into the Ginnie Mae HMBS—whether from an accounting perspective the assets leave the books of the seller. So what we are doing in fact is selling loans, putting them into a trust. The trust is then being sold to an investor. So, they are physically leaving our balance sheet. But from an accounting perspective, the accountants are saying this is really essentially a financing rather than a sale. So that

when we look at the books of an originator, those loans are still on their books.

If you look at our company, Generation Mortgage, we have issued about \$3 billion in Ginnie Mae HMBS. And even though our real economic balance sheet is probably \$100 million of assets and liabilities, the way that our accounting presently represents the books of Generation Mortgage, it looks like we have \$3 billion of assets and liabilities. That is a significant impediment to certain kinds of institutions participating in the marketplace.

Chairwoman BIGGERT. So what would happen to the financing available for reverse mortgages if securitors cannot get true sale treatment when they sell reverse mortgage securitizations to investors?

Mr. LEWIS. Certain kinds of regulated institutions are going to be required to post capital against the size of their balance sheet. So you are unlikely to get widespread participation by financial institutions like the companies which have already left the industry. And I am sure that—again, I am not privy to the internal discussions that took place at MetLife—that this was definitely probably an issue for them.

And as we look at people looking entering the space and joining the market, even parties that are not financial institutions are given pause by this lack of sale treatment, because at the end of the day, if they make an investment, it is probably with an idea that at some point, they would exit it. And to whom are you going to sell the business if whoever you are going to sell the business to has to take on this very large parent balance sheet?

Chairwoman BIGGERT. As long as we don't start slicing and dicing. Thank you.

Dr. Sanders, the HECM program has shown an explosive growth in the last 6 years, and more than 78 percent of total HECMs endorsed since 2006. The New York Times said in 2010 that the increase is due partly to the recession, which has squeezed retirees, and partly to more aggressive marketing.

Wall Street investors have recently become bigger buyers of the reverse mortgages that are packaged into these securities. And that has made reverse lending more profitable, causing lenders to push the loans harder. And they also said, "If all this sounds chillingly familiar, it should."

What do you make of the growth in the program? And does it spell a retreat of what we went through in the forward mortgage market in 2007 and 2008?

Mr. SANDERS. Thank you for the question. First of all, I want to point out that everyone loves a guarantee, particularly if someone else pays for it. That was part of the problem we had with the original housing bubble, is that we had subsidies and guarantees galore, and then the market blew out of control. The market has collapsed. Now, here we are, sitting on this one. And so, that is my fear.

Now, there is a solution for Freddie and Fannie, and one can be applied here as well. How about a simple risk-sharing rule if you are not willing to get rid of the guarantee? That way, you have the lender—Mr. Lewis already mentioned the capital issue related to securitization. Why not have a stronger risk-sharing role that the

lenders have to take a big piece of this if they don't do this properly? And I would even suggest maybe a little risk-sharing role for the counselors, since they are the ones who are advocating or advising people to get into this. How about if they take a piece of the action if this doesn't work out so well?

Say "yes." I didn't think that would go over too well at the table, but I just thought I would throw it out there.

Chairwoman BIGGERT. Thank you. Then Mr. Fenton, do you think that this committee can do anything to further consumer protection improvements in the HECM program? What suggestions would you have?

Mr. FENTON. Thank you for the question. I think at this stage, that the regulating body, HUD, has the tools to effectively oversee the reverse mortgage counseling program. Specifically, they have detailed data going down to a per-counseling session basis on the time involved with each session. They have powers to provide agency reviews and review individual files. They have a specific reverse mortgage review process for housing counseling agencies. Quite honestly, I think the tools are there. It is really a question of energetic enforcement.

Chairwoman BIGGERT. When you have a 2- or 2½-hour counseling session, is this done generally on the phone or in person?

Mr. FENTON. Thank you. For our particular organization, the majority of sessions are done over the telephone. The 2½ hours is really split into three different parts. As you can imagine, sitting on the phone for 2½ hours would be challenging for anyone.

It is actually done in three parts. There is a kind of document introductory, document preparation session; there is a general education session around the reverse mortgage and alternatives and so on; and then the final piece is the individualized budgeting welfare benefits analysis. The process is the same on the phone or face-to-face. For our organization, there is literally no difference in the way we approach that.

Chairwoman BIGGERT. How do you measure the effectiveness or define the effectiveness of the counseling?

Mr. FENTON. For our organization, the process we use is an internal quality control process. We regularly monitor counseling sessions and score the performance of those counseling sessions. We record them, I should say. We record them and score them against a pre-set template, which is basically tracking the necessary scores. It gets used on a monthly basis to either "attaboy" good counselors or look for improvements where there is work that needs doing.

Chairwoman BIGGERT. Thank you. Mr. Shadab, in your testimony, you note that the demand for reverse mortgages is likely to grow substantially over the next several years due to an aging population and growing healthcare costs and lack of savings for retirement.

Do you believe that the private market can support this growing demand? Or if so, how do you explain that less than 5 percent of the reverse mortgages are currently privately provided?

Mr. SHADAB. Yes. Thanks for the question. I do believe that the private markets can support what will most likely be a growing demand for reverse mortgages of all kinds. And primarily because a secondary market for reverse mortgages will likely develop as the

credit markets sort of heal, including the securitization markets. The reason right now there is such a small market share for non-HECM reverse mortgages is because there is no secondary market for conventional and reverse mortgages, and also to some extent HECM mortgages are basically crowding out and outcompeting conventional reverse mortgages because of the subsidy that they get from governmental involvement.

Chairwoman BIGGERT. Thank you. Mr. Dold is recognized for 5 minutes.

Mr. DOLD. Thank you, Madam Chairwoman. I appreciate the time. And again, I want to thank you all for taking your time to be with us today.

Mr. Lewis, if I may, I would like to just start with you. Many of us in Congress, along with many of our constituents, are very concerned about Fannie and Freddie and the ongoing GSE bailout and the possible future losses at FHA.

How would you distinguish the HECM product from the GSEs and other FHA products? And what, if anything, distinguishes the HECM product as a largely private sector solution that can help us address our growing public policy challenges related to the increasingly aging population.

Mr. LEWIS. Thanks for the question, Congressman. I think that this is sort of an example of government working in a fantastic way to reward people for good behavior. The only people who can use a reverse mortgage are people whose debt balances are sufficiently low, that the principal limit factors are sufficient to completely retire their existing debt. The only people who are going to have access to this product, the way it is currently set up, are people who have behaved responsibly. And what we are allowing them to do is utilize their own funds in a way in which the insurance fund acts and the way an insurance fund is supposed to, which is that the people who pay too much insurance premium because the government doesn't pay any claims, they end up subsidizing the people where there are claims paid.

And again, our position is that the product should be priced and should be structured as it is today, in such a manner that there is no direct cost to the taxpayer.

Mr. DOLD. Again Mr. Lewis, if I may, I am just going to continue with you for a minute.

Mr. LEWIS. Sure.

Mr. DOLD. All of us on both sides of the aisle support adequate consumer protection. I think that is safe to say, especially with respect to financial products. And my understanding is that the CFPB is conducting a consumer protection study on the reverse mortgage industry. Of course all of us understand that regulatory compliance necessarily has costs, and those costs generally are passed along to the consumer in the form of higher prices, diminished product access and availability, or limited service, or product options and innovations. So we are always looking for that optimal point where we are adequately protecting consumers, but we are not unduly restricting legitimate product availability or imposing unnecessarily high costs on consumers.

Now, with that in mind, let me ask you a few related questions and then get your reaction, if I may, after I ask a few of them. And then we can go from there.

First, what regulatory burdens is the industry facing today, if any? And what role do you see the CFPB playing in your industry?

Second, given the industry's small size and the expected future growth to meet our aging population's future demands, what types of potential regulations do you think would unnecessarily harm the industry and, by extension, the seniors who rely upon reverse mortgages for financial independence?

And finally, do you think that the existing housing counseling requirement diminishes or eliminates the need for additional broad-based or detailed regulations; or are there possible improvements to the counseling program that could make it more effective than an entirely new and broad regulatory framework?

Mr. LEWIS. Okay. I will take the first question in terms of the regulatory burden that we face today. One of the interesting aspects to the departure of the national banking companies that have left is that they only worked with one layer of supervision, basically at the Federal level. The rest of us who remain are generally mortgage banking companies. And so, we have State regulators, and we are a national company, so we are basically dealing with every State, as well as the Federal authorities. One of the largest components of our expense budget is for regulatory compliance, and we are essentially living in a constant state of examination by one party or another.

The industry was started in 1989, and has been Federally dominated in terms of the market share ever since then. And as such, the Federal Government really has created the regulatory framework from the beginning. And the industry has always accepted the understanding that it will be a very highly regulated, very closely scrutinized industry. We know who you are our clients are. We know what their circumstances are. And we understand that no behavior is ever going to be tolerated in this industry that is not appropriate.

And so we always welcome anything that comes from a regulatory perspective that is protective of our consumers, as well as gives them, frankly, more confidence that when they are involved in this industry, they will be safe.

With respect to the CFPB, I can't speculate on where they are going to come out. My understanding is that some of what they are working on is a simplification of disclosures to consumers generally in mortgage transactions. And I can say that, as a person who has refinanced my own mortgage and sat at the table with a thicker pile of papers than this one that was designed to protect me, I am not sure that the effect of an ever-increasing stack of paper is ultimately that which is intended. It ends up actually making it very difficult for people, I think, to understand what significantly should be disclosed to them. To the extent that we can simplify disclosures, make them clearer, or make them more substantive, I think that would be very, very useful in protecting consumers.

You talk about the size of the companies that are left in the industry, relatively small companies bearing this regulatory burden. I think that we all recognize that it is a cost of doing business, and



we all accept the fact, given who our consumers are, given the fact that we are primarily making government loans, that we are going to have to deal with a very high level of regulation.

It is interesting to note that when the conventional market was operating more effectively prior to the housing debacle, as well as today with us making the only jumbo mortgage available nationally right now, all the lenders have generally, on a voluntary basis, adopted all the protections that are inherent in the FHA program in nongovernment loans.

The last question was about existing requirements. We have a tremendous amount of work that is required of us, but we accept that in the interests of making sure that consumers are protected.

Chairwoman BIGGERT. The gentleman yields back.

The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. Madam Chairwoman, I want to thank you for holding these hearings.

Reverse mortgages are particularly important for us in high-cost areas like the San Fernando Valley. In other areas of the country, you may have your savings, and then you may have some equity in your home. In my area, when you get to retirement age, your savings is your home. And a reverse mortgage is the only way to stay in your home and tap into your savings. And so, I thank the gentlemen here for being part of an industry that allows people in my area to do that.

Mr. Bell, in just about every part of our economy, it is good for consumers to have competition. And now and then, the government will make life so uncertain that, without actually providing any consumer protection, just by being uncertain and not making up our minds, or having something that has to renew every year and everybody thinks it is going to renew and maybe it will or maybe it won't, you get a lot of companies outside of the industry and you reduce the amount of competition and that is bad for consumers.

What impact does the need to deal with the authorization cap each year have on the reverse mortgage market, and what effect does it have on consumers?

Mr. BELL. It has a lot of impacts.

First of all, from the side of businesses, it makes it hard to plan long range and to make a long-term commitment to investing in the infrastructure that one needs to enter this business. You can't be a mortgage lender in forward mortgages and just decide overnight to become a reverse mortgage lender. It requires a different operating platform for origination, a different servicing platform. So, there is a big capital investment and intellectual investment required to make that transition. And the fact that the program could disappear by a lapse in the authorization authority is a deterrent.

From the consumer side, I think the problem is even greater. Because one of the things that we stress as an industry is we want consumers to make an informed decision at a comfortable pace. We want them to take all of the time that they need to figure out whether the reverse mortgage really serves their needs. And, for instance, what we face right now, come September 30th, we could see this program disappear. So a consumer who is thinking about

this as we get into the fall is forced to accelerate their decision-making process. That is an unfair position to put them in.

Mr. SHERMAN. It seems to be one of the many areas in which Congress would serve the public if we just made a decision and made a permanent decision.

I want to commend Mr. Fitzpatrick—since he is not here, we will tell him I went on and on commending him—and I join with him in an amendment that we offered and withdrew to strike the current volume cap on this program since it has been suspended continuously since 2007.

Mr. Bell, are you seeing any progress in addressing the widely reported tax and insurance default industry?

Mr. BELL. Yes, there is a lot of progress there. Deputy Assistant Secretary Coulter referred to some of it earlier. But there is a bit of activity under way.

First of all, HUD has required the lenders to report more expeditiously on the status of cases that might be heading to or in a technical default. The Department has worked with the counseling community to create a task force of 125 counselors who have been specifically trained in remedial approaches to dealing with the tax and default issue. The Department is also at work on a rule on financial assessment which will give lenders the ability and guidance on how to underwrite borrowers to ascertain that they will be able to meet their obligations once they have their reverse mortgage. And we are also hoping that rule will give lenders the ability to use their discretion to either limit the payouts that potential borrowers might face if they are constrained on their cash flow or to be able to require a set-aside of some of the funds to be used for that.

So, there is a lot of progress in that area.

We are also finding that remedial counseling for those people who are already in a technical default oftentimes result in being able to find other resources to help them handle other obligations such as home heating fuel assistance, which could free up money that could then be used to pay taxes, and food stamps in some cases. So, there has been a lot of progress in the area and a very strong leadership in that direction.

Mr. SHERMAN. I am going to see if the chairwoman will let me sneak in one more question; and that is, can you explain your organization's Borrow with Confidence campaign?

Mr. BELL. Sure. One of the challenges with reverse mortgages is that they are a product that is very highly misunderstood by the general public, and we believe in order for us to really reach the broad number of people who could benefit from it, that people have to become comfortable with the concept, comfortable with the companies that deliver the reverse mortgages, and that there has to be a very transparent process for which reverse mortgages are delivered. So our Borrow with Confidence program is designed to achieve those objectives.

We have put out a number of tools to help consumers shop for reverse mortgages to give them information in a non-sales environment. We have a Web site, Reversemortgage.org, that takes them through every aspect of reverse mortgage from originally inquiring about it right through the loan termination phase. We have put out

a document called the “Roadmap to Reverse Mortgages” that gives them a very comprehensive guide. And we also have all of our members committed to a pledge to consumers that lays out a number of activities that they can expect from their lender to help them fully understand the reverse mortgage they are contemplating.

Chairwoman BIGGERT. I am going to recognize myself again.

Dr. Stucki, you noted in your testimony that the average age of a HECM borrower has fallen from 76.7 years in 1990 to 72 years in 2012, and the percentage of prospective borrowers aged 62 to 64 has increased 15 percent since 1999. And it seems like this group is more prone—the 62 to 64 group is more prone to delinquency than the older borrowers with the most technical defaults occurring in the first 4 years of the loan. Is there any implication between this age shift and delinquency increase?

Ms. STUCKI. Thank you for the question.

To the extent that younger borrowers are primarily interested in managing debt and reducing debt, there is clearly going to be a greater risk of default. They are more likely be taking out those lump sums that leave very little to sustain themselves in the future and to deal with their borrower obligations.

I think that is why we really need to take generational differences into account as we think about counseling and some of the other protections for borrowers. Clearly, older borrowers more likely to want to be using this to maintain their health standards, pay for those out-of-pocket health expenses and others, in contrast with the younger borrowers being more focused on debt.

I think it is very important that we stress the retirement planning element of home equity in general and reverse mortgages in particular so people really understand both how to use these loans for immediate needs as well as for long-term sustainability.

Chairwoman BIGGERT. Thank you very much.

And, Dr. Trawinski, why are the—it is like the phone-based and in-person counseling sessions are of such different duration, with the in-person sessions seeming to last significantly longer. Is there a difference in quality between the two types?

Ms. TRAWINSKI. Thank you for the question.

I just would like to clarify. My testimony is questioning the time spent with the client and the idea that sometimes it seems that the telephone counseling sessions don’t seem to take as long. The issue is time spent with the client, and whether in less than an hour, you can cover all of the topics.

I have been through the counseling training offered by NeighborWorks and I can tell you that it would seem to me to be relatively impossible to cover all of the protocol topics in less than an hour. So that was the issue.

Chairwoman BIGGERT. Okay. Thank you.

I think that GAO looked at this issue in 2009, didn’t they? Should they review it again? Is it necessary?

Ms. TRAWINSKI. I think that would in fact be a good idea, because we hear from counselors all the time, and they have raised issues with us in this regard.

Chairwoman BIGGERT. Thank you.

Mr. Coulter, when will HUD publish new regulations or guidance for lenders? You mentioned these earlier. I think it is rumored that

the CFPB is working on a study, and that was mentioned here, regarding reverse mortgages. Are you or other FHA officials familiar with this effort and are you working with CFPB and what will the study specifically entail.

Mr. COULTER. I am not specifically familiar with the work that CFPB is doing. I can tell you, however, that the issues we have talked about here, in particular assessing—doing a financial assessment, that is something that we are focused on and we are looking to publish a rule on that on or around the fourth quarter of this year.

Chairwoman BIGGERT. Don't you think it is kind of odd that you are not hearing anything from the CFPB since this is obviously in HUD, that you haven't talked to them about it or anything, the study?

Mr. COULTER. I would need to follow up and determine exactly the nature of the study and what the nature of their focus is.

Chairwoman BIGGERT. All right.

When are you going to publish the regulations or guidance for lenders?

Mr. COULTER. As I mentioned around financial assessments, we are targeting the fourth quarter of this year.

Chairwoman BIGGERT. I guess there are no further questions.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit questions to these witnesses and to place their responses in the record.

And I would like to thank you all. It has been a great panel, with a lot of information from a lot of different groups, and that is very important to us. So I thank you all for being here.

And with that, this hearing is adjourned.

[Whereupon, at 4:13 p.m., the hearing was adjourned.]

# **A P P E N D I X**

May 9, 2012



Testimony  
of  
Peter H. Bell, President & CEO  
National Reverse Mortgage Lenders Association  
before the  
Subcommittee on Insurance, Housing & Community Opportunity  
House Financial Services Committee

May 9, 2012  
2128 Rayburn House Office Building

Madam Chairwoman and Members of the Subcommittee:

Thank you for convening this hearing to look into the important issue of Federal Housing Administration's (FHA's) Home Equity Conversion Mortgages and their role in helping to fund longevity for America's seniors. I am here today in my capacity as President & CEO of the National Reverse Mortgage Lenders Association (NRMLA), a trade association of over 300 companies involved in the origination, funding and servicing of reverse mortgages. Our organization has been serving the reverse mortgage industry as a policy advocate and educational resource since 1997. It also provides information about reverse mortgages to consumers and members of the press.

NRMLA member companies are responsible for over 90% of the reverse mortgages made in the United States. All NRMLA member companies commit themselves to our Code of Ethics & Professional Responsibility. A core value of our organization is our commitment to independent third-party counseling as an integral part of the reverse mortgage origination process.

This Subcommittee, including members from both sides of the aisle, has been consistently sensitive to reverse mortgage issues and has continually taken steps to improve and enhance FHA's Home Equity Conversion Mortgage (HECM) program. For that, we are very appreciative, as are the three-quarters of a million senior households who have utilized the HECM program since its inception. At the present time, there are approximately 578,000 senior households utilizing HECMs to help meet their financial needs.

The issues surrounding reverse mortgages bring several key questions into consideration.

The most striking is simply: how do we finance our longevity? With life carrying on for decades beyond our earning years, we must manage assets and resources to sustain ourselves longer. This requires the strategic use of home equity as a means of financial support.

Housing wealth, the equity accumulated in a home, to many American families, represents the largest component of personal wealth. Typical retiree households might have one or two incomes from Social Security, a modest pension and/or limited income from low-yielding fixed-income instruments, and, perhaps, a diminished 401(k) account. The equity they have built up in their home is often, by far, their greatest asset, an important resource for funding their future.

Congress recognized this when initially authorizing the HECM program as part of the Housing & Community Development Act of 1987, signed into law by President Ronald Reagan.

Before moving on to a discussion of current issues, I would like to provide an overview of the program's history.

**A Brief History of the HECM Program**

The development and implementation of the Home Equity Conversion Mortgage program was a deliberate and thoughtful process.

The first reverse mortgage loan is generally thought to have been made privately in 1961 by Nelson Haynes of Deering Savings & Loan in Portland, Maine to a widow named Nellie Young. Over the next 20 years, various studies and surveys were conducted to explore the viability of such a product, most notably those by Yung-Ping Chen of UCLA and Jack Guttentag of The Wharton School and largely driven by Ken Scholen, then working with the Wisconsin Board on Aging, who wrote three books on the subject.

In 1980, the concept was first presented to the Federal government by Scholen who received funding from the Administration on Aging for a Home Equity Conversion project. The following year, the White House Conference on Aging, attended by leaders of organizations serving the senior sector, endorsed the creation of a Federal Housing Administration mortgage insurance program for reverse mortgage loans. It was another nine years before the first FHA-insured reverse mortgage was issued. During this time more studies and hearings on the viability and need for such a program continued both in Washington and in many states.

In 1983, the Senate approved a proposal by Senator John Heinz, (R-PA) for the creation of FHA insurance for reverse mortgages and a Senate/House conference committee called for a Department of Housing and Urban Development study of the idea. In 1985, HUD held a conference on the subject, but when they issued their study in 1986, it opposed a federal reverse mortgage demonstration program. The following year, AARP offered a critique of HUD's decision, written by Scholen. And then in 1987, in the 100<sup>th</sup> Congress' mammoth Housing and Community Development Act, the HUD Secretary was directed to conduct a demonstration program for insuring reverse mortgages. President Reagan signed the act into law.

The National Housing Act of 1987, Section 255 outlined the specifics of the demonstration program. The purpose of the program was "to meet the special needs of elderly homeowners by reducing the effect of the economic hardship caused by increasing costs of meeting health, housing and subsistence needs at a time of reduced income, through insurance of home equity conversion mortgages to permit the conversion of a portion of accumulated home equity into liquid assets." Among the requirements contained in the original statute were:

- Adequate third party counseling including explaining other financial options;
- A fixed or variable interest rate or future sharing between the mortgagor and the mortgagee of the appreciation in value of the property, as agreed upon by the mortgagor and the mortgagee;



- A list of disclosures to be delivered at least 10 days before closing;
- A guarantee to borrowers that they would be protected against disappearance of their lender and obligations beyond the value of their home at sale by the General Insurance Fund;
- Scheduled reports to Congress.

To create the new product, HUD created a development team under the auspices of Judith V. May. The team was led by economist and mathematician Ed Szymanoski, Jr., who at the time ran the annual actuarial review of HUD's home mortgage insurance fund, and included Patrick Quinton, Donald Alexander and Mary Kay Roma. They had no model to work from. So they built a simulation model to analyze the actuarial risks the FHA insurance fund would be exposed to under various scenarios. As Szymanoski later told reporter Atare Agbamu, "Innovations from our initial design recommendations included the first-ever two-part premium structure for an FHA program (two per cent up front and 50 basis points annually), a two dimensional "principal limit" factor (by borrower age and interest rate) that is used as an effective limit on HECM LTVs (Loan-to-value), and formulas for borrowers to set up their own customized payment plans—allowing maximum flexibility in choice among monthly payment streams, lines of credit or combination plans with both." All of this initial modeling remains a working part of the program today.

The pilot program was careful and initially limited to 2500 loans through 1991. The first FHA-insured Home Equity Conversion Mortgage (HECM) was issued October 19, 1989 to Marjorie Mason of Fairway, Kansas. HUD selected 50 lenders by lottery to make the first HECMs. The FHA sponsored fourteen two-day counselor training sessions conducted by Scholen and Bronwyn Belling of AARP. And Fannie Mae announced its intention to purchase the mortgages insured by the FHA. In the first year (1990), 157 loans were closed. In the second year (1991), 389 loans were closed. The program grew slowly as it found its footing.

The original statute had called for evaluations of the program by HUD staff on a timely basis. The first one in 1992 was followed by further evaluation in 1995.

The goals of the demonstration were to (1) permit the conversion of home equity into liquid assets to meet the special needs of elderly home owners, (2) encourage and increase participation by the mortgage markets in converting home equity into liquid assets, and (3) determine the extent of demand for home equity conversions and types of home equity conversion mortgages that best serve the needs of elderly home owners.

The 1995 report stated "the Demonstration has made significant progress toward achieving each of these goals, although more time will be necessary to complete the work. "

This report also addressed the adequacy of the mortgage insurance premium for the first time and concluded the present value of the premiums collected exceeded the value of insurance claim losses.

When the program was launched, deliberation continued and it was closely observed. Over the subsequent 20 years, Congress would amend the statute nine times, sometimes simply to clarify wording, others to alter substance. Changes would include:

- In 1990, the volume cap was changed from 2500 loans by the end of Fiscal Year (FY) 1991 to 25,000 loans by the end of FY 1995;
- In 1996, the restriction on securing the loan with a single-family residence was changed to also include a 1-4 family residence in which the mortgagor occupies one of the units; the aggregate number of loans insured was changed twice from 25,000 through FY 1995 to 30,000 through FY 1996 and then to 50,000 through FY 2000;
- In 1998, in the HUD Appropriations Act, the word “demonstration” program was struck and the program became permanent; the aggregate number of mortgages that could be insured was raised to 150,000;
- In 2000, refinance of existing HECMs was authorized and rules created for implementation including requiring a good faith estimate of costs and permitting a credit for previous upfront mortgage insurance premium against the new premium;
- In 2005, the volume cap was raised from 150,000 loans to 250,000 loans;
- In 2006, the volume cap was raised from 250,000 loans to 275,000 loans; in the Home Equity Act of 2006, regional loan limits for HECMs were eliminated and a single national loan limit equal to that of the Freddie Mac loan limit (then \$417,000) was created;
- In 2008, the Housing and Economic Recovery Act included provisions introduced by Senator Claire McCaskill (D-MO). Limits were placed on origination fees; cross selling of other financial products as a condition for obtaining a reverse mortgage were prohibited; rules assuring independence of counselors from lenders were strengthened; the establishment of qualification standards for counselors and a new counseling protocol by mid 2009 was called for; HECM insurance was shifted from the General Insurance Fund to the Mutual Mortgage Insurance Fund (MMI); a provision to permit a waiver of upfront insurance premiums when proceeds are used to purchase a qualified long-term care insurance policy was eliminated; and the HECM for Purchase program, which authorized use of these funds for purchase of principal residences, was created;

- In 2009, as part of the American Relief and Recovery Act, loan limits were increased to 150% of the Freddie Mac limit or \$625,500.

In 1997, just prior to the program being made permanent, the reverse mortgage lending community sought a voice to represent its interests in Washington and the National Reverse Mortgage Lenders Association was formed. With a new promise of a prolonged future, and perhaps partially due to the existence of an industry-wide professional organization, the business began to multiply rapidly. In 2001, NRMLA had 32 member companies and about 7800 loans were closed. By 2005, we had 370 members and over 43,000 loans were closed. By 2007, volume would go over 100,000 loans per year, where it remained for three years.

In 2007, Ginnie Mae introduced its HECM Mortgage-Backed Securities program (HMBS). In November of that year, the first HMBS pool was offered by Goldman Sachs.

In Ed Szymanoski's last report on the demonstration program written in 2000, he reported a high level of satisfaction among HECM borrowers. In 2007, AARP reported that 93% of borrowers surveyed had a good experience with their loans. In 2010, research conducted by Marttila Strategies for NRMLA reported that 90% of surveyed borrowers felt no pressure to proceed, 90% did not feel they were misled in any way or given wrong information, 80% said they were likely to recommend the product to a family member and more than 50% said they could not meet their monthly expenses without their HECM.

Despite the rapid growth of the industry and the high level of contentment among borrowers, HUD and the industry did not retreat from the responsibility of perpetual re-evaluation and frequent refinements. During this past decade of growth:

- Loan Limits have been frequently adjusted to keep up with home prices and needs;
- Loan to value ratios (Principal Limit Factors) have been adjusted to protect the FHA Mutual Mortgage Insurance Fund (MMI);
- The counseling process has been enhanced by the new protocol requiring the addition of the Financial Interview Tool to evaluate a potential borrower's means to live up to the loan's obligations and [benefitscheckup.org](http://benefitscheckup.org), to see what other financial help might be available to them;
- Introduction of an exam and continuing education requirements for all HECM counselors to make sure they fully understand the mechanics of the product, as well as changes that are implemented over time;
- New products, including the HECM Saver and the HECM for Purchase, have been designed and introduced to serve consumers with different needs;
- The Mortgage Insurance Premium has been increased to protect the MMI;

- HUD, FTC and NRMLA have worked together to discourage inappropriate and misleading advertising language.

Both our government partners and our members have had a laser focus on providing the most helpful product to America's seniors delivered with the highest ethical values and integrity. At the same time, they have adjusted the program when necessary to keep it aligned with the requirements of and maintain the security provided by FHA insurance.

The history of the HECM program demonstrates that its participants have been admirably thoughtful, careful and responsible. The program has resulted in the growth and development of an important financial management tool that we are able to offer because of the sharing of risk between the public and private sectors.

#### **Emergence of HECM as a Proactive Tool for Personal Financial Management**

While HECM was initially created to help older homeowners supplement their retirement income by simply adding in a stream of monthly payments to the homeowner, or creating a stand-by line of credit, use of the loan has evolved to help a number of homeowners facing differing circumstances. In some cases, a HECM is utilized to pay off an onerous mortgage and/or other debts, enabling the homeowner to eliminate monthly payments and deploy their regular cash flow to cover day-to-day living expenses, while being able to remain living in the home, rather than having to sell it and move. In other cases, reverse mortgages have been utilized to cover costs for in-home care, allowing borrowers to avoid a costly stay in a nursing home.

With the introduction of the HECM Saver, which provides lower costs to consumers and lower risk to the FHA insurance fund, the program has drawn interest from financial planners working with older clients. Many retirees experience peaks and troughs in their cash needs over time. As a result, they are often forced to liquidate assets at inopportune times. Rather than selling stocks into a down market, or cashing in Certificates of Deposit or other financial instruments before maturity and possibly incurring a penalty for doing so, utilization of a HECM Saver can provide cash for immediate needs and then be repaid back into the HECM line of credit when investment values are higher or when instruments mature. The net result, according to models run by leading financial planners, is that the client will have a larger amount of money available to meet their funding needs through retirement.

Another innovation in the application of this important tool has been the introduction of a HECM for Purchase variation of the loan that enables homeowners to purchase a new home that better fits their needs, without having to take on a new monthly payment. A classic example of this application would be a homeowner living in an older, two-story home with high maintenance requirements moving to a home that better fits his/her needs. By utilizing a HECM for Purchase to move into a newer, single-story home, perhaps even closer to family members, homeowners can set themselves up to be able to age in place.

**Importance of Counseling for Reverse Mortgage Borrowers**

A challenge with reverse mortgages is that, to many, the notion is somewhat counter-intuitive. How a reverse mortgage works, how the amount of money available to a homeowner is determined, how HECMs are priced and why, or how a lender earns its revenue are topics that are often not fully understood by homeowners considering utilizing this helpful tool. As a result, Congress wisely established a statutory requirement that every prospective borrower must meet with an independent third-party reverse mortgage counselor before actually completing a formal application for a HECM loan.

Analyzing how a reverse mortgage might fit into the picture for any particular borrower and learning how to assess various options available is not an easy task -- particularly for older homeowners who might not have been in the financial markets for awhile, for newly widowed individuals whose loss of their spouse's Social Security creates financial insecurity, for seniors struggling to make ends meet, or those trying to plan ahead to maximize their resources and sustain their financial independence.

Counseling has become a hallmark of the HECM program. It is a very effective consumer safeguard and its impact can be seen in the limited and isolated number of instances where there has been evidence of fraud or elder financial abuse within the HECM program. NRMLA regularly surveys Attorneys General offices in all states, Divisions of Banks, and Departments of Consumer and Elderly Affairs, and all report a very low incidence of complaints about reverse mortgages. NRMLA suggests that the mandatory counseling is a significant contributor to the integrity of the HECM program.

The opportunity for every prospective reverse mortgage client to consult with an independent, professional reverse mortgage counselor prior to formally submitting an application for a reverse mortgage is a critical step for helping consumers make a sound decision. The reverse mortgage counselors are employed by HUD-approved, community-based and nationally-designated nonprofit housing and credit counseling organizations, and each individual counselor must be qualified by passing a HUD-administered exam and meeting continuing education requirements.

The counseling covers several key aspects as delineated in the statute that created the HECM program. First of all, Sec. 255(d)(2)(b) of the National Housing Act requires that:

“To be eligible for insurance under this section, a mortgage shall have been executed by a mortgagor who has received adequate counseling as provided in subsection (f), by an independent third party that is not, either directly or indirectly, associated with or compensated by a party involved in originating or servicing the mortgage, funding the loan underlying the mortgage or engaged in the sale of annuities, investments, long-term care insurance or any other type of insurance or financial product.”

Sec. 255(f) further requires:

“The Secretary shall provide or cause to be provided adequate counseling for the mortgagor, as described in Subsection (d)(2)(b). Such counseling shall be provided by counselors that meet qualification standards and follow uniform counseling protocols.

“The protocols shall require a qualified counselor to discuss with each mortgagor information which shall include –

- 1.) Options other than a home equity conversion mortgage that are available to the homeowner, including housing, social service, health and financial options;
- 2.) Other home equity conversion options that are or may become available to the homeowner, such as sale-leaseback financing, deferred payment loans, and property tax deferral;
- 3.) The financial implications of entering into a home equity conversion mortgage;
- 4.) A disclosure that a home equity conversion mortgage might have tax consequences, affect eligibility for assistance under Federal and State programs, and have an impact on the estate and heirs of the homeowner; and
- 5.) Any other information that the Secretary may require.”

The result of this has been the development of a robust network of committed counseling organizations and qualified individuals to deliver the HECM counseling, either in face-to-face sessions or via telephone, depending on each client’s personal choice and mobility. This counseling network has ably served the needs of older homeowners considering HECM loans and has grown in capacity and sophistication as the decisions that go into evaluating a HECM get ever more complex.

One particular area that has emerged, and both NeighborWorks and National Council on Aging (NCOA), two of the primary providers of reverse mortgage counseling and training are to be commended for stepping up to the plate to deal with the issue, is providing remedial counseling to reverse mortgage borrowers who have had setbacks in their financial affairs and have had difficulties meeting their obligations to pay property taxes and insurance. Failure to pay these so-called “property charges” represents a technical default under the HECM program.

When a borrower falls into technical default, the loan servicer is obligated to pay such charges on their behalf to protect the FHA insurance fund and begin working with the borrower to bring the account current. HECM counselors play an integral role in providing remedial assistance and advice for borrowers in technical default.

As a result of these remedial counseling services, a growing percentage of households facing this situation have been able to be put on a repayment plan to reimburse the lender's advances, protecting FHA from possible payouts for claims, while preserving the homeowner's ability to continue living in his/her home – a win-win solution for all involved

Standards for housing counseling criteria, in the HECM arena, are very specific and stringent. They are the product of an ongoing collaborative effort among a varied group of stakeholders including HUD, senior advocacy groups, gerontology experts, housing counseling professionals and experienced lenders. They have proven to be very effective to date and have been considerably enhanced with the introduction of updated HECM counseling protocols two years ago.

#### **Current Issues Impacting HECM Program**

##### **1.) Authorization Cap**

A major issue faced by the reverse mortgage industry is that, while the HECM program was made permanent back in 1998, there has been a statutory limit on the number of loans FHA is authorized to insure. Although the cap has been routinely raised or suspended by Congress annually, its existence deters some industry participants from making the commitment required to fully embrace reverse mortgage lending, thus keeping competition in the market at a minimal level.

NRMLA urges the Members of this Subcommittee to support the continued availability of Home Equity Conversion Mortgages by permanently removing the cap on the number of HECMs that FHA may insure to minimize any possible disruption in the availability of this important personal financial management tool.

While there might be some concern about monitoring the program periodically to assure that it is operating on an fiscally sound basis, the review undertaken annually in the budget process provides that opportunity. There are also opportunities for review whenever this Subcommittee, or the full Financial Services Committee, conducts its periodic and helpful oversight of the program, or of FHA generally.

##### **2.) Qualified Mortgage**

A "Qualified Mortgage" is a concept that has emerged from the Dodd-Frank act to identify characteristics of mortgages that may be originated and sold into the secondary market without a risk retention requirement for the lender. The Consumer Financial Protection Bureau (the Bureau) is promulgating rules on this concept and, because the definition of Qualified Residential Mortgage under separate agency rulemaking on risk retention in securitizations is tied to the definition of Qualified Mortgage under the Ability to Repay – Qualified Mortgage Rule (hereinafter "ATR-QM"), we have been urging the Bureau to specifically create criteria for reverse mortgages.

We are requesting they create a definition of a qualified mortgage under its ATR-QM rule to assure that reverse mortgages, other than FHA-insured HECMs, have an opportunity to qualify for an exemption from the risk retention requirements. We have made similar comments to the agencies engaged in risk retention rulemaking.

The reverse mortgage market currently is comprised primarily of FHA-insured Home Equity Conversion Mortgage loans (or HECMs). This was not always the case. In 2006, conventional reverse mortgage securitizations reached approximately \$1 billion. At the peak of reverse mortgage activity in 2007, conventional reverse mortgage were as much as 16% of the dollar volume of the reverse mortgage industry.

The conventional reverse mortgage securitization market showed robust signs of growth throughout the 2002-2007 timeframe, but receded parallel to the overall fall-off in demand for mortgage-backed securities.

We believe it is healthy for the reverse mortgage industry to be able to offer a range of product options, including proprietary (non-FHA-insured) reverse mortgages, in addition to HECMs. Having a specific definition of a "QM" for reverse mortgages will help facilitate the return of a conventional market with proprietary products.

Our recommendation is that reverse mortgages that are either FHA-insured, or meet the guidelines of the FHA HECM program, should be deemed to be a qualified mortgage for purposes of the ATR-QM rule. More explicitly, to be considered a "QM," a reverse mortgage should (1) require no regular monthly repayment of principal or interest; (2) require mandatory counseling prior to origination; (3) require a limited underwriting of the borrower according to procedures consistent with those to be established by HUD for the HECM program (or other similar procedures appropriate for proprietary reverse mortgage products that are designed to accomplish these same objectives) based on financial resources that are verified and documented and taking into consideration applicable taxes, insurance and assessments affecting the collateral property; and (4) carry no prepayment penalty.

### 3.) Improve Disclosures & Reduce Paperwork

NRMLA fully supports the revision of mortgage disclosures as required by the Dodd-Frank Act. However, we believe it is imperative that a disclosure for reverse mortgages be developed independently of the effort on forward mortgages and that a format devised explicitly for reverse mortgages be utilized.

By fully understanding the terms and conditions of a reverse mortgage through clear and concise disclosures, qualified applicants will be able to make better informed decisions. Historically, reverse mortgages have often been "shoe-horned" into disclosures developed for other products, which do not necessarily provide the information required to make an informed decision about a reverse mortgage in a comprehensible manner.



NRMLA has drafted a model disclosure format and is submitting it to the Bureau for its consideration. Our model disclosure provides all of the salient information in a simplified, easy to read, yet comprehensive, format.

#### 4.) HECM for Purchase

As part of the Housing and Economic Recovery Act of 2008, Congress authorized the use of HECMs to fund the purchase of a home. FHA implemented the HECM for Purchase program initially through the publication of Mortgagee Letter 2008-33, and subsequently Mortgagee Letter 2009-11.

At closing, a HECM for Purchase borrower must provide a monetary investment which will be applied to satisfy the difference between the HECM principal limit and the sale price for the property, plus any HECM loan related fees that are not financed into the loan, minus the amount of the earnest deposit.

In Mortgagee Letter 2009-11, FHA prohibits seller contributions (also known as “seller concessions”), the use of loan discount points, interest rate buy downs, closing cost down payment assistance, builder incentives, gifts or personal property given by the seller or any other party involved in the transaction. This includes customary charges that are normally paid on behalf of the borrower by the seller.

Given the large monetary investment already required by the senior homebuyer in a HECM for Purchase transaction, the new rule limiting seller concessions impedes the utility of this financing tool. We urge FHA to adopt a more accommodating approach, allowing seller concessions in connection with a HECM for Purchase. As a safeguard, we would recommend that seller concessions not be used to otherwise qualify a senior for a HECM for Purchase transaction.

#### 5.) Tax & Insurance Defaults

Homeowners with HECM loans are required to keep their property properly insured, plus pay taxes and any applicable homeowner association fees. If they fail to do so, the loan servicer is required to advance such funds on their behalf, from the borrower’s line of credit, if funds are available, or from the loan servicer’s own funds, if not. Once the loan servicer advances its own funds, it is required to work with the borrower to recover the funds advanced through a repayment plan. If the borrower continues to fail to meet that obligation, the loan is in “technical default” and the loan servicer must go to HUD and request permission to call the loan due and payable.

Earlier on, some HECMs were made to homeowners who eventually proved to be unable to meet these obligations. This has resulted in several new initiatives to minimize issues caused by technical defaults. FHA now requires loan servicers to report delinquent borrowers in a more timely fashion and to work with them and a special task force of counselors trained in remedial strategies for dealing with such defaults.

Counseling protocols have been enhanced to make sure that the responsibility for paying these so-called “property charges” is explicitly discussed upfront in counseling sessions with all borrowers. Lenders have become much more direct in discussing this obligation with prospective borrowers and are beginning to implement procedures designed to identify applicants who might not be able to meet their obligations.

FHA is at work collecting data to identify the types of situations that lead to technical defaults and craft a financial assessment rule for lenders to utilize in underwriting HECM applicants. We understand that a Proposed Rule on this will be published in the months ahead.

Our members are hopeful that the Proposed Rule will also provide the flexibility to require the establishment of a “set-aside” of some of the reverse mortgage proceeds to be used as a reserve account for paying taxes and insurance, or to limit the options available for drawing down funds, for those prospective borrowers who appear to pose a risk of technical default.

In the interim, NRMLA has developed guidance for our members on the elements of a responsible and prudent limited underwriting approach for HECM applicants, which they follow as they await more formal guidance from HUD.

#### **Conclusion**

The FHA Home Equity Conversion Program has been a useful tool, helping hundreds of thousands of seniors maintain their homes and lead more financially stable lives. The program has been administered thoughtfully, carefully and responsibly by a partnership of stakeholders including HUD, the lending community, senior advocacy groups like AARP and National Council on Aging, and the housing counseling network. This has allowed the reverse mortgage concept to gain a foothold and prove the value of this important personal financial management tool as a component of retirement finance and funding longevity.

We thank the Members of this Subcommittee for your continual interest in the HECM program and hope that we can count upon Congress to demonstrate its support by further suspending or, preferably, removing the cap on the number of reverse mortgages FHA is authorized to insure.

Thank you for the opportunity to appear before this Subcommittee. I would be pleased to answer any questions.



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, DC 20410

**Written Testimony of Charles Coulter  
Deputy Assistant Secretary for Single Family Housing  
U.S. Department of Housing and Urban Development (HUD)**

**Hearing before the House Financial Services Committee  
Subcommittee on Insurance, Housing and Community Opportunity**

*Oversight of the Federal Housing Administration's Reverse Mortgage Program for Seniors*

**Wednesday, May 9, 2012**

Thank you, Madam Chairman for inviting me here today to testify about the Home Equity Conversion Mortgage (HECM) program. The HECM is a government insured reverse mortgage which enables seniors, age 62 and older, to convert a portion of the equity in their homes into cash. The proceeds of the loans can be used for a variety of purposes, including the purchase of a new principal residence which better suits the senior's needs, health costs and subsistence needs at a time of reduced income.

#### **Reverse Mortgages and the Evolution of the HECM**

The Housing and Community Development Act of 1987 authorized HUD to conduct a demonstration of HECM loans for older homeowners. The original HECM demonstration allowed HUD to originate 2,500 loans under the program. The intent of the program was to provide FHA mortgage insurance on reverse mortgage loans to help facilitate origination of these loans, which enable "house rich, cash poor" seniors to tap the equity in their homes while remaining in their homes. The first HECM loan was made in October 1989.

The reverse mortgage offers an opportunity for seniors to age in place while also having access to cash at a time in life when many experience a reduction in income. Traditional debt, such as first- or second-lien home equity loans or lines of credit, can also provide cash, but the requirement for periodic repayment and an income sufficient to service the debt make this alternative approach less than an ideal solution for lower income seniors wishing to age in place. While the sale of a home may provide cash, it also entails moving to alternate housing where studies<sup>1</sup> have shown that most older Americans prefer aging in place. As a result of these

<sup>1</sup> Bayer, Ada-Helen, and Leon Harper. 2000. *Fixing to Stay: A National Survey on Housing and Home Modification Issues*. Washington, DC: AARP, available at: [http://assets.aarp.org/rgcenter/il/home\\_mod.pdf](http://assets.aarp.org/rgcenter/il/home_mod.pdf)

considerations, the question of how retirees might be best able to use home equity—often their largest asset—to help fund their retirement has been brought to the forefront of financial planning discourse.

For older Americans, equity in the home has come to represent a major share of their total wealth. However, owner-occupied housing, as an asset, is largely indivisible—a home cannot easily be sold in increments as can a stock portfolio or have equity withdrawn gradually like a savings account. Thus, liquidating housing wealth to help meet cash needs during retirement is not easily accomplished. Converting home equity to cash generally requires the sale of the entire asset or the ability to issue debt against home equity.

A reverse mortgage is debt issued against home equity which can provide significant sums of cash without the sale of the home and without the need to make periodic repayments. Because no repayment of the mortgage balance is due until the borrower no longer occupies the home as his or her principal residence, traditional underwriting is not required to demonstrate the borrower's financial capacity (income) to service the debt. Reverse mortgages are secured only by the equity in the property and not by the borrower's capacity to repay.

The HECM loan is a reverse mortgage that offers lenders an FHA insured mortgage insurance guarantee. The HECM loan program was originally designed to meet the special needs of elderly homeowners by reducing the effect of the economic hardship caused by the increasing costs of meeting health, housing, and subsistence needs at a time of reduced income and to encourage and increase the involvement of mortgagees and participants in the mortgage markets in the making and servicing of reverse mortgages for elderly homeowners. The FHA guarantee, which is available so long as the loan is originated following FHA guidelines, enables lenders provide better loan terms to borrowers than would be available without the FHA mortgage insurance guaranty.

The HECM became a permanent FHA Single Family Mortgage Insurance Program in the FY1998 HUD Appropriations Act. Since that time, HUD has endorsed approximately 739,000 HECM loans. In recent fiscal years, Congress has included language in HUD's appropriation that waives the cap of allowable HECM endorsements each year. In doing so, Congress has acknowledged the importance of continued availability of FHA HECM loans and worked with HUD to avoid the potential of a moratorium in endorsements for this product. In the President's FY 2013 Budget, HUD proposes to permanently eliminate the statutory cap on the number of HECM loans which can be endorsed for FHA insurance. Removing this cap, which is a remnant of the original demonstration project, along with the securitization of HECM loans through Ginnie Mae, will ensure that HUD continues to contribute to meeting the needs of seniors age 62 years and older who want to age in place. The Administration's proposal will not impact the commitment authority limitations that this and all other FHA insurance programs are subject to.

#### **HECM Consumer Protections**

The authors of the HECM legislation recognized that while there were clear and worthy objectives to meet in establishing this product, in order to ensure that the needs of this vulnerable population are met and also to protect the FHA, the HECM program should include built in

statutory consumer protections. The protections built into the FHA HECM mortgage are not required for private sector products and they include:

- Mandatory counseling for prospective HECM applicants from a HUD-approved independent source. Such counseling serves a dual purpose: it ensures that the applicant understands the HECM product and also determines whether less costly alternatives such as local deferred payment loans or grant programs are available before proceeding with the HECM loan.
- A statutory guaranty of cash advances to borrowers, in a timely manner, in case their lenders become bankrupt or face temporary disruptions in operations due to emergencies. This is an important benefit to the senior homeowner, especially in turbulent and uncertain economic times.
- Prohibition on excessive referral fees. Origination fees for a HECM are capped at 2% of the maximum claim amount (MCA) of up to \$200,000 plus 1% of MCA for any portion greater than \$200,000. The total origination fee on any loan may not exceed \$6,000.
- Required anti-churning disclosures from the lender to the borrower to ensure that HECM borrowers are not being induced to refinance without benefits and/or solely for the benefit of lenders.
- Prohibition on cross-selling HECMs and annuities by any party that participates in the origination of the mortgage or in the counseling for the HECM. This is a significant benefit for HECMs since it expressly addresses a major concern that consumer groups have had with reverse mortgages in general. The use of the proceeds from a reverse mortgage to fund a long term annuity defeats the purpose of the reverse mortgage by tying up the senior's assets and often leaving them with insufficient payments from the reverse mortgage for making ends meet. Additionally, this cross-selling results in two sets of fees being paid by the borrower. Also, since payments from an annuity are counted as income for the purposes of Social Security Insurance and Medicaid, this is a further drain on borrower finances.

### **HECM Counseling**

The requirement that consumers receive mandatory counseling from a HUD-approved counselor is perhaps the most important consumer protection feature of the HECM program. This safeguard is especially important because the counseling assists the borrower in understanding the HECM loan product and provides in depth information to help seniors make informed decisions. The objectives of reverse mortgage counseling are to educate potential borrowers on the different types of reverse mortgages available; the suitability of a reverse mortgage for their personal and financial situation, and alternatives to reverse mortgages. Counseling is also important because it is provided by certified HECM counselors at HUD-approved housing counseling agencies, independent third-party organizations that are not involved in the HECM

loan transaction. Receiving counseling from a HECM certified counselor at a HUD-approved counseling agency ensures seniors have unbiased information to guide them.

In FY 2009, HUD amended HUD's HECM program regulations to incorporate new testing standards to qualify individuals to provide HECM counseling. The regulation also established a HECM counselor roster. The rule was intended to standardize and improve the quality of HECM counseling.

In order to be placed on the HECM Counselor Roster a counselor must:

- Be employed by a HUD approved housing counseling agency;
- Successfully pass a standardized exam;
- Receive training and education every two years.

Currently there are approximately 900 HECM counselors providing face to face or telephone counseling to homeowners across the country. In November 2011, the HECM counselor exam was updated to reflect program changes.

HECM counselors are required to utilize a standard protocol as part of the HECM Counseling Program. It contains detailed information on the topics to be covered in a reverse mortgage session as well as all policy guidance and program requirements issued by HUD relating to HECM counseling. In 2010, the HECM Counseling Protocol was substantially revised with input from a variety of stakeholders including HUD-approved counseling agencies, HECM counselors and FHA lenders. The revised protocol includes new elements added to strengthen and standardize HECM counseling and enhance consumer protections.

For instance, the new protocol requires that counselors provide all clients with a standard information packet. Except for emergency counseling, counselors must provide this packet to clients prior to conducting the session and must allow for sufficient time to enable clients to read the materials before the counseling session. The packet contains:

- A HUD one page document titled "Preparing for Your Counseling Session";
- National Council on Aging's Booklet, "Use Your Home to Stay at Home-A Guide for Homeowners";
- A print out of loan comparisons;
- Loan amortization schedule;
- Total Annual Loan Costs (TALC) Disclosure.

In addition, the new protocol requires HECM counselors to complete a budget review for each client using a standardized financial assessment. In order to complete the budget, counselors use a tool created by the National Council on Aging (NCOA), the Financial Interview Tool (FIT). This tool helps prospective borrowers consider the immediate financial needs and long term challenges that can make it hard to stay at home and benefit from a reverse mortgage. FIT helps older homeowners consider all of their financial obligations and how they will meet them on an ongoing basis. In addition, the new protocol requires that seniors falling below 200 percent of the federal poverty level to use NCOA's web based application, BenefitsCheckUp, to learn of

services and benefits that can be an alternative source of income or reducing expenses either in lieu of or as a supplement to a reverse mortgage.

Counselors must also assess a client's level of understanding of the information being provided during the counseling session. HUD's new counseling protocols mandate that a counseling agency must withhold a counseling certificate from a client who cannot successfully answer five of ten review questions that are asked during the course of the counseling session. This aspect of the protocol is designed to ascertain the client's comprehension of the counseling session content. Clients can schedule another appointment to complete the counseling session at a later time if they are still interested in successfully completing the session and obtaining a certificate.

HUD is very concerned about the potential of financial fraud related to the HECM transaction. The revised protocol and other HUD counseling policies require counselors to caution clients against signing HECM loan proceeds to loan officers or other parties involved in the mortgage transaction and ensure clients understand the standard ways in which they can access their loan proceeds. In addition, the protocol includes information for counselors on how to report to the appropriate government agencies on suspected elder abuse.

Over the years, HUD has worked to create a strong network of expert HECM counselors as well as an ongoing training and support system for these counselors. Currently, HUD provides grant funding to NeighborWorks America to:

- Offer the standardized HECM exam in a manner that is secure, cost-effective and accessible to all current and prospective HECM counselors and that accurately reflects HUD HECM counseling requirements;
- Make available reverse mortgage loan analysis and comparison software and training and job aids on the technical tools utilized by HECM counselors;
- Provide technical assistance and peer-to-peer learning opportunities;
- Provide on-line and face to face training opportunities for HECM counselors.

In FY2011, FHA established a counseling initiative to assist HECM borrowers who are delinquent in taxes, insurance and other property charges. A working group was established with representatives from five national housing counseling intermediaries that provide HECM counseling services, the National Reverse Mortgage Lenders Association (NRMLA) and HUD. One hundred and twenty five counselors from these five intermediary organizations were selected to participate in this initiative. HECM borrowers that faced this particular challenge were referred to counselors in these five national organizations. These counselors are responsible for: 1) analyzing clients' financial situation, ability to support repayment and future property charges; 2) assisting clients with identifying options to resolve delinquency, obtaining additional financial assistance and/or support for transition out of home; 3) communicating and coordinating with clients' servicers; and 4) providing an action plan to clients and relevant follow-up.

A standard protocol was developed for this type of counseling and these counselors received specialized training during FY2011 related to this protocol. HUD also partnered with the Department of Health and Human Services and the Agency on Aging to identify Local Area

Agencies on Aging organizations in communities across the country that could also assist HECM borrowers facing this challenge to identify viable options and local resources. Over 4,307 counseling sessions have occurred since January 2011.

Complementing this effort, the Philadelphia Homeownership Center is coordinating a pilot, now in the planning phase, to assist seriously delinquent Philadelphia area HECM borrowers with mortgages deemed 'due and payable' because of unpaid property taxes or property insurance. Participating in the pilot are the Philadelphia HUD Offices of Field Policy and Management, Public Housing, and Community Planning and Development, the HHS Administration on Aging and the National Council on Aging. The pilot will begin with housing counselors contacting the borrowers by telephone. If telephone contact fails, follow-up will include a post card or home visit. Borrowers will be assisted to review options and find sources to supplement their income, for example by enrolling in state or federal benefits to which they are entitled. If they are unable to stay in their homes or find housing with relatives, attempts will be made to identify alternative housing. Local Area Agencies on Aging will help the borrowers to identify and assess options.

#### **Managing the HECM Program in Today's Market**

The FHA HECM product serves a critical market demographic. Although the private market for reverse mortgage programs reached approximately 15% of the market prior to the housing crises, it now serves approximately 2% of the market and these private programs are generally geared toward the jumbo market, where FHA loans are not available.

Although FHA has experienced a decline in the number of HECMs insured since its peak of 115,000 endorsements in 2009, the demand potential for HECM going forward remains significant. According to the 2009 American Housing Survey, 18.5 million US homeowners were headed by persons age 65 or over, of whom 16.3 million are potential HECM borrowers; 13.9 million had no mortgage debt and 2.4 million had mortgage debt estimated to be less than 40% of home value. Further, the Joint Center for Housing Studies of Harvard University projects the number of households aged 65-74 will increase by 6.5 million between 2010 and 2020. HECM insurance endorsements in FY 2011 were down by seven percent from FY 2010 levels, to 73,098 loans. This was the second straight decline in HECM endorsements, though it was not as significant as the 31 percent decline experienced in FY 2010. That larger fall in activity was likely due to reductions in equity take-out limits imposed in October 2009. The decline in FY 2011 can be attributed to a number of factors – the change in FHA mortgage insurance premiums from 0.50 to 1.25 percent, the exit of lenders from the program mid-year and a general reduction in capacity and home price declines. Despite these declines, HUD continues to see this as a vital and important program for seniors. In fact, according to current estimates, aggregate home equity held by older homeowners remains substantial. Studies by the National Reverse Mortgage Lenders Association show that for the third quarter of 2011, seniors had \$3.19 trillion in aggregate home equity, down from the peak estimate of \$4.02 trillion in 2006. Clearly, a large potential demand still exists in the reverse mortgage market today.



**FHA Policy Changes**

As with Forward mortgages, the HECM program has been impacted by the housing and financial crises. The decline in home values and resulting decrease in home equity, reduction in value of seniors' assets and investments, loss of income and increased defaults due to property charges, have all required FHA to make a number of significant changes to the HECM program. These changes focus on credit quality, risk management and sustainability of the program for HUD and for seniors. In making effective policy changes to address these risk issues, FHA has focused on:

- The FHA statutory requirement to manage stability of the MMI Fund (HECM endorsements were moved from the General Insurance Fund to the Mutual Mortgage Insurance Fund (MMI) by HERA)
- The importance of the program to meeting the needs of seniors by providing access to home equity to replace decreasing savings, asset losses and investment income and supporting aging in place.
- Creating policies that will provide clear guidance for Lenders and Servicers and reduce uncertainty regarding certain aspects of the program
- Addressing issues related to default in complying with the terms of the HECM mortgage
- The evolving use of the product and the changing borrower profile

**Servicing of HECM Mortgages**

As with FHA-insured forward mortgages, FHA has established guidelines for the servicing of reverse mortgages which must be followed in order for lenders to be eligible to file a claim. This includes a requirement that HECM borrowers are offered loss mitigation options.

Recently HUD issued guidance to mortgagees indicating loss mitigation tools available to them when working with seniors. The loss mitigation tools available are Repayment Plans and HECM refinance loans. Under a repayment plan, the borrower has up to two years to repay the advanced funds necessary to cover the delinquent taxes and insurance. In order for a borrower to benefit from the refinancing of a delinquent HECM to a new HECM, borrowers must have sufficient equity in their homes to satisfy the existing mortgage and cover delinquent taxes and insurance.

If a HECM borrower is unable to retain their home, options are available to avoid a foreclosure, including the ability for the borrower to sell their property for the lesser of the mortgage balance, or 95% of the current appraised value. Under this option, once the property is sold, the borrower has no further liability under the mortgage. A defaulted HECM borrower also has the option of signing a deed in lieu of foreclosure. This option helps seniors avoid the stress of foreclosure if they are unable to sell their property.

### **Risk Management and the HECM Program**

HECM has consistently maintained a negative credit subsidy rate – that is, the program is estimated to be self-supporting through its premium revenues. However, HUD has needed to increasingly tighten HECM program terms over the last several years to make this possible.

HUD has two main policy levers available to manage the credit risk inherent to the HECM loan. The first is through the mortgage insurance premiums (MIP) charged to the borrower. The second is by limiting the amount of equity take-out available to the borrower. These limitations are defined and administered through principal limit factor (PLF) tables for each interest rate and borrower age. The equity take-out in the PLF tables increases with borrower age, and decreases with higher interest rates.

Based upon estimated valuations of the HECM portfolio, in September 2009, HUD announced a 10 percent reduction in the PLFs for all loans originated in FY 2012. This 10 percent reduction in equity take-out eligibility eliminated the need for an appropriation of credit subsidy to operate the program. Continued weakness in the housing market required additional action to maintain the HECM program without a subsidy appropriation for FY 2011

Furthermore, HUD established an industry working group to assist with the development of a new HECM product, the HECM *Saver*, to help diversify the HECM portfolio by encouraging borrowers to accept lower equity take-out limits. HECM *Saver* is an alternative for borrowers who need less cash and will use HECMs as an ongoing line of credit and source of funds for retirement planning. The traditional one-size fits all HECM product that existed from the program's inception was replaced by two new HECM products, *Standard* and *Saver*, for Fiscal Year 2011. *Standard* raised the annual mortgage insurance premium from 0.5% of the outstanding loan balance to 1.25%, and maintained the original upfront premium of 2% of the loan's maximum claim amount. *Standard* also utilized an enhanced actuarial modeling and assumptions to produce a new principal limit factor table. The new *Standard* factors reduced PLFs by 10 to 15 percent from the 2010 levels. This *Standard* product is designed to appeal to older seniors who need the most cash from HECM and who are less concerned about upfront loan costs.

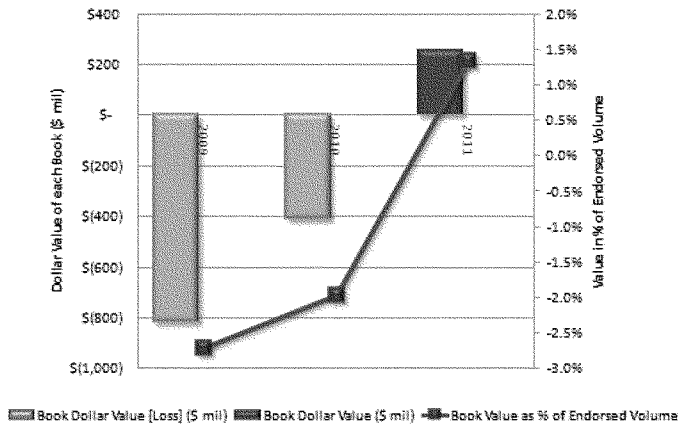
HECM *Saver*, on the other hand, also raised the annual premium to 1.25%, but reduced the upfront premium to 0.01%, and applied an enhanced model and assumptions to produce new factors that are lower than the *Standard* factors. *Saver* is designed to minimize upfront costs to appeal to younger seniors who need less cash, and who may want a shorter term "bridge" loan to meet current needs.

### **HECM Independent Actuarial Reviews**

The Housing and Economic Recovery Act of 2008 (HERA) moved all new HECM endorsements from the General Insurance (GI) Fund to the Mutual Mortgage Insurance (MMI) Fund beginning with endorsements made during FY 2009. The MMI Fund, which is the principal insurance fund for all of FHA single family program mortgage insurance products,

including the Section 203(b) program which is FHA’s main Forward mortgage program. Under the National Affordable Housing Act (NAHA) passed in 1990, the MMI Fund is subject to an annual independent actuarial study. The review is required to estimate the economic value of the MMI Fund to determine whether the NAHA capital requirements have been met.

**Figure 1. Estimated Lifetime Value of Each HECM Book-of-Business, 2009 – 2011**



The FY 2011 book is actuarially sound and we expect, due to recent policy changes, that the future books of business will also yield positive economic value. The economic value of the FY 2011 book represents 1.34 percent of the FHA endorsement volume. The HECM program was substantially righted in 2011 through a more than doubling of the annual premium rate (from 0.50 to 1.25 percent), the introduction of the *Saver* option (which has a better economic value per dollar), and additional reductions in equity take-out percentages under the *Standard* option mean that HUD.

**Taxes and Insurance Defaults**

Another factor contributing to the improved value of the HECM portfolio in the FY 2011 actuarial review was new controls on the potential claim costs of tax-and-insurance arrears. HUD’s regulations require a HECM borrower to maintain hazard insurance on the mortgaged property and to pay all pertinent property charges (e.g., local real estate taxes) in a timely manner. Failure to make those payments puts the loan in default.

HUD is taking the Property Charge default situation very seriously. We are aware of the challenges to borrowers in paying them. Prior to the housing crisis, increasing property values provided increased equity for seniors to access in obtaining a HECM loan. A requirement of the

HECM program is that seniors are responsible for the payment of taxes and insurance (as is required for forward mortgages). However, with the drop in property values and financial crises, the borrower's access to funds to meet the obligations of the mortgage have become more challenging.

This year, for the first time, HUD was able to make loan-level data on such defaults available to the independent actuaries. With information on incidence of default and post-default repayment plans, the actuaries estimated a statistical model that was used to forecast loan terminations due to such defaults. The requirement to call defaulted loans due-and-payable has always been HUD policy, but in January 2011 formal guidance was issued so that lenders have clear rules regarding how to address the arrearages in an equitable manner.

In this policy guidance, HUD instituted controls for the level to which those arrearages may grow before the loan must be declared due-and-payable. Under the new guidance, such actions occur when the lender/servicer determines that, despite counseling support, all loss mitigation options for repayment have been exhausted. This new guidance also has the effect of reducing projected losses on HECM loans because, without that guidance, the FY 2010 actuarial study projected accumulating arrearages subject to possible HUD claim payments up to the time of borrower exit from the home. Now, under the guidance, projected claim payments are effectively capped at two years of such arrearages.

#### **The Future of the HECM Program**

The Department is working on additional rulemaking to address risk issues and enhance program sustainability, including:

- A Servicing/Claims Proposed Rule to codify many of the changes that have been implemented through Mortgagee Letters and FAQs and to provide broader solutions/authority to ensure mortgagees comply with HUD servicing requirements on HECMs.
- A Financial and Credit Capacity Assessment Federal Register Notice with Comment Period proposing credit and financial capacity evaluation at loan approval to ensure that the senior has sufficient access to income, assets (including proceeds from the HECM) to comply with the obligations of the mortgage and living costs.
- A Mortgagee Letter clarifying and consolidating published policy, and
- Deployment of a new integrated data system to support HECM origination, servicing and claims

Although some major players have left the HECM market for varying reasons, there is tremendous need and opportunity for the HECM product. We believe that as the market stabilizes and HUD is able to complete policy and process guidance this will address risk issues to ensure sustainability of the program and address "uncertainty" issues for originators and servicers.

TESTIMONY  
OF  
DANIEL FENTON  
SENIOR HOUSING DIRECTOR, MONEY MANAGEMENT INTERNATIONAL  
BEFORE THE  
FINANCIAL SERVICES SUBCOMMITTEE ON  
INSURANCE, HOUSING, AND COMMUNITY OPPORTUNITY  
UNITED STATES HOUSE OF REPRESENTATIVES

REGARDING  
“OVERSIGHT OF THE FEDERAL HOUSING ADMINISTRATION’S  
REVERSE MORTGAGE PROGRAM FOR SENIORS”

MAY 9, 2012

**Testimony of Daniel Fenton**

Chairman Biggert, Ranking Member Gutierrez, and Members of the Subcommittee, my name is Daniel Fenton, and I am Senior Housing Director for Money Management International, Inc. (“MMI”). MMI is a tax-exempt, nonprofit, U.S. Department of Housing and Urban Development (“HUD”) approved housing counseling agency. MMI provides a range of financial counseling services including foreclosure prevention and reverse mortgage counseling through over 120 community-based branch offices and by telephone nationwide. MMI is the largest reverse mortgage counseling agency in the United States. We have in excess of 100 Home Equity Conversion Mortgage (or “HECM”) certified counselors, accounting for approximately 10% of all U.S. Department of Housing and Urban Development (“HUD”) certified reverse mortgage counselors nationwide.

Thank you for this opportunity to share with you the perspective of reverse mortgage counselors providing education, information and resources to senior homeowners considering the use of a reverse mortgage. Housing counseling is an important consumer protection as part of the reverse mortgage program and can serve as model for a way to protect consumers before entering into a substantial financial transaction involving debt. Mandatory housing counseling – prior to applying for a reverse mortgage – has been part of the HECM program since its inception in the 1987 Housing & Community Development Act. We believe that reverse mortgage counseling is a critical safeguard for seniors, in that it ensures that borrowers receive objective information to assist them in comparing the features of various reverse mortgage products. As unbiased third parties, reverse mortgage counselors educate homeowners about the benefits and costs of a reverse mortgage loan.

MMI counselors see firsthand the benefits of financial counseling to seniors seeking reverse mortgages. Our experience and other evidence tells us that a number of seniors seeking reverse mortgages are usually financially vulnerable, much like the millions of people who sought subprime mortgages and those that are burdened by student loan debt. And, like subprime borrowers and those that become saddled with student loan debt, people looking for a reverse mortgage are often not wealthy. While we serve a spectrum of consumers that are struggling

with debt and provide remedial counseling, the big difference here is the required counseling provided prior to the mortgage transaction.

Borrowers choose reverse mortgages for a variety of reasons; however, the majority does so in order to improve their day to day standard of living. Whether by eliminating existing first mortgage payments or to pay for in-home care services or other living expenses, the use of a reverse mortgage provides the ability to better handle day to day expenses and improves the ability of many seniors to continue living independently in their own homes. Our clients' needs and planned use of funds correspond with national findings reported by the National Coalition on Aging which indicate that 75% of seniors report incomes of less than \$40,000 per year. Further, 67% of seniors specify that their primary use of reverse mortgage proceeds is to pay off existing debt obligations.

**Potential Pitfalls for Client of Reverse Mortgage Program.**

The principle feature of reverse mortgages that are so attractive to seniors – the deferral of interest payments – can, if not understood fully, lead to significant problems. If seniors do not understand the terms of the mortgage up front, later they may be shocked later to discover that they have exhausted their loan proceeds earlier than expected. Moreover, when repayment of the reverse mortgage loan becomes necessary some other household members can be forced to initiate the sale of what they considered to be their family home. Similarly potential heirs to the property can be shocked to find a substantial reduction in equity that they will inherit.

Understanding repayment triggers is not only a critical part of ensuring that a reverse mortgage is economically feasible, but it is also essential so that borrowers and their families understand the future impact before and not after committing to a reverse mortgage.

In addition, in a small number of cases borrowers have taken out reverse mortgages without being able to afford property tax and homeowners' insurance payments thereby causing them to default on their reverse mortgage. It is vital that borrowers understand their ongoing financial responsibilities in order to maintain their reverse mortgage.

There is also risk of elder abuse and financial exploitation of clients seeking reverse mortgages. While there are many good players; unscrupulous salespeople can and do misrepresent the nature of the reverse mortgage, at times describing it as a government entitlement program. Others gloss over the responsibilities of repayment and the true cost of the loan in order to make a quick sale. We have also seen other attempts to couple a reverse mortgage with solicitations through a third party (e.g. home improvement contractor) to make use of the loan proceeds in such a way that the borrowers do not understand the true cost of their participation.

Uninformed seniors can be persuaded to believe that the program represents “free money” and can be tricked into the unwise use of funds. Sadly, some seniors are under undue pressure to take out a reverse mortgage to provide quick funds to a family member or other third party who may seek to “help” the senior acquire the mortgage so the third party can make use of the loan proceeds.

#### **Role of HECM Counseling in Mitigating Consumer Risk**

Congress and the Federal Housing Administration (“FHA”) anticipated these potential pitfalls, including the risk of abuse, and sought to ensure that seniors are equipped to avoid them by requiring that they participate in a reverse mortgage counseling session with an independent counselor employed by a nonprofit HUD-approved housing counseling agency prior to submitting a reverse mortgage application.

The role of a reverse mortgage counselor is not to promote or discourage the use of the reverse mortgage program, but rather to ensure that seniors considering a reverse mortgage are properly educated so that they can make an informed choice. A typical counseling session covers the following:

- Detailed education on loan characteristics, focusing especially on the rights and responsibilities of the borrower after the loan is closed.
- Individualized loan and budgeting analysis to help the senior see in practical terms how the loan will help meet current and future needs.
- Specialized web-based analysis tools to help check the senior’s eligibility for other welfare benefits.



- Review of a comprehensive set of resources and other programs which can act as a supplement or sometimes an alternative to the need to take out a reverse mortgage.

Today, MMI's typical interaction with our reverse mortgage counseling client totals two to two and a half hours, including the development of individualized loan example documents, general education on reverse mortgages, the creation of an individualized budget, and a welfare benefits analysis relating to the client's particular circumstances.

#### **Major Steps to Strengthen Counseling and Consumer Protection**

In the last three years, HUD with the support of counseling agencies and other stakeholders has strengthened the effectiveness of the reverse mortgage counseling program significantly. In a major overhaul of counseling practices, HUD introduced several requirements to ensure that reverse mortgage counseling fully meets the needs of seniors and promote consistency among counseling agencies. Major enhancements include:

- Mandatory certification of all counselors with a requirement that all counselors successfully pass a third-party administered exam before they are allowed to counsel. This certification also includes continuing education requirements and complete recertification (i.e., taking an updated exam) every three years.
- An improved, 140 page counseling protocol, updating and clarifying the educational content required within a counseling session.
- A standardized "test of understanding" which must be successfully completed as part of the counseling session. This test uses standardized questions to establish whether the senior has a basic understanding of how a reverse mortgage works. It is not presented in a "test format" but should the senior be unable to answer the majority of questions proficiently this prompts the counselor to re-review material, and, if the senior is still unable to understand the material, the counselor must withhold the certificate to provide the senior with additional opportunities to gain a better understanding of the reverse mortgage program.
- A requirement that all seniors receive a personalized loan "work up" prior to counseling to allow discussion of how a reverse mortgage is likely to work in their

case, helping to show to what extent a reverse mortgage is likely to meet their individual needs.

- An enhanced HUD review process in monitoring the work of HUD-approved housing counseling agencies. This additional layer of review and oversight focuses specifically on the work of an agency's reverse mortgage counseling program and compliance with standards outlined in HUD regulations.

#### **Flawed Funding Model Poses Potential Risk to Soundness of the Counseling Program**

Despite the importance and success of the reverse mortgage program, providing reverse mortgage counseling is not without some challenges. Chief among them is agencies' ability to provide services to seniors that are unable to pay for their own counseling session when government funding is not adequate to meet demand. As we are all well aware, federal financial support for reverse mortgage counseling has declined in recent years and the level of support for this coming fiscal year is uncertain.

HUD and the housing counseling sector have developed a robust process to protect consumers. The prescribed content and accountability of counseling agencies is stronger than in any other area of housing counseling. Nonetheless, we believe that in an effort to maintain the independence of counseling agencies Congress may have inadvertently created a funding model that actually undermines the ability of counseling agencies to meet seniors' needs as effectively as possible.

We are grateful for Congress and HUD's support of reverse mortgage counseling through its Housing Counseling Program grants; however, it is widely acknowledged that grant funds do not and cannot wholly fund the cost of counseling. The cost of consumer protection for reverse mortgages should not be the exclusive responsibility to the government. We believe that both the seniors acquiring reverse mortgages, when there is an ability to pay, and reverse mortgage lenders should help cover the cost of these efforts. However, the current regulatory environment makes this very problematic.

- *The Housing and Economic Recovery Act of 2008* (HERA) specifically prohibits any reverse mortgage lender or related party from funding reverse mortgage counseling. We

believe that the intention of this language was to avoid a conflict of interest, but what it actually does is force the cost of non-HUD funded counseling directly onto the clients seeking reverse mortgage counseling.

- As described earlier in my testimony, prospective reverse mortgage borrowers are usually seeking additional funds to help pay for living expenses. Therefore, requiring a client to pay a substantial fee for counseling prior to receiving the proceeds from a reverse mortgage (if they receive a reverse mortgage at all) is often a significant hardship and acts as a disincentive to seek counseling. Seniors are unwilling to participate unless they are already certain they wish to proceed with a reverse mortgage, have the funds to make the up-front payment and have likely already interacted with a lender and decided upon a specific loan product (without the benefit of counseling).

Counseling agencies may also charge a fee as part of closing costs, removing the need for an up-front payment; however, this creates a financial model where independent HUD-approved counseling organizations are paid on a “per-loan closed” basis and not a per counseling session basis. We believe this situation is less than ideal because specific agencies can become dependent on loan volumes related to specific lenders for their financial survival.

In this environment we believe that an inadequate funding model leads to a negative impact on the very seniors we are trying hardest to protect: seniors with low incomes that may or may not actually need a reverse mortgage.

#### **Suggestion for Change**

We urge that members of the Subcommittee continue the dialogue on developing a sustainable model for funding for reverse mortgage counseling. In addition to working with appropriators, we respectfully ask that members of the Subcommittee also consider ways to improve the funding model for reverse mortgage counseling.

One alternative that we suggest be considered is amending HERA to allow the establishment of a **blind trust** that will compensate counseling agencies **on a per-client counseled basis**, irrespective of whether the client enters into a reverse mortgage. The trust could be funded by a

standardized closing cost on all reverse mortgages and contributions from the reverse mortgage industry and government as needed. If Congress were to allow the pooling of funds from lenders to support reverse mortgage, the potential conflict of interest is removed and the counseling service sector can adapt to meet the capacity needs of this industry without the need to rely wholly on grant funds to meet the needs of the seniors they serve.

\* \* \* \* \*

MMI believes that financial counseling is a necessary consumer protection and that it protects not only the interests of the seniors it seeks to serve but also the financial integrity of the reverse mortgage program. We commend HUD for its efforts to strengthen the counseling program and to ensure it is properly meeting the needs of seniors. We urge action to increase counseling funding so seniors of every income level can receive the education they need as they evaluate their financial options.

Thank you for the opportunity to present my testimony; I would be pleased to respond to any questions you might have.

**Testimony of Jeffrey M. Lewis before the House Financial Services Subcommittee on  
Insurance, Housing and Community Opportunity  
May 9, 2012**

My name is Jeffrey Lewis and I am the Chairman and CEO of Generation Mortgage, a mortgage banking firm based in Atlanta, GA that originates and services Reverse Mortgages exclusively. I also serve as the Chairman of the Coalition for Independent Seniors (CIS), which is a non-partisan public policy coalition dedicated to preserving seniors' financial independence.

On behalf of Generation Mortgage & CIS, I want to thank Chairwoman Biggert, Congressman Gutierrez and the other members of the subcommittee for holding this hearing on the Home Equity Conversion Mortgage (HECM) program and for inviting us to testify.

Generation Mortgage was started in 2006, has originated over 29,000 Reverse Mortgages (both HECM and private jumbo Reverse Mortgages) and currently services a portfolio of over 27,000 Reverse Mortgages. We employ more than 250 people, mostly in our Atlanta headquarters. Generation Mortgage has also issued over \$3 Billion in GNMA HMBS. We are extremely gratified to be working alongside FHA and GNMA in helping older Americans utilize the HECM to improve their quality of life and extend their time in their homes. With the demographic shifts currently taking place, and homeowners' other incomes and assets strained, we expect to be able to continue serving homeowners in the coming decades with a product that offers a fantastic value proposition for the consumer, their families, the FHA and the country.

The HECM is an example of the best kind of government program. A program that utilizes the reach and financial heft of the government to leverage private sector involvement, pays for itself, is run largely by the private sector and provides a life-transforming financial product to consumers.

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Chairwoman Biggert, you asked me to address several issues in your invitation to participate today: the current state of the HECM program – its administration, the benefits to borrowers, the safety and soundness and provide suggestions for regulatory and statutory changes. I will take each of these in turn.

First, what is the current state of the HECM program? In the past few weeks our industry lost a valued colleague and aggressive competitor in MetLife, when they announced their departure from the Reverse Mortgage industry. This departure followed closely on the heels of the announced closure of their MetLife Bank and traditional mortgage origination business. MetLife is the third major company to depart the business in the last 15 months. Yet, we have seen most of the slack in the marketplace taken up by the independent mortgage bankers who remain. RMS, Urban Financial, Generation Mortgage, One Reverse and others have stepped into the void to continue to make the HECM product available across the country. The table in Exhibit 1 clearly illustrates this fact. We at Generation Mortgage and CIS are confident that the independent mortgage bankers will continue to provide excellent and full service to consumers.

To provide some perspective, from 1989 to 2006, no major financial brands participated in the Reverse Mortgage industry, yet the marketplace grew steadily. Please see Exhibit 2 for a breakdown of the annual endorsement and growth rate in the industry from 1990 to Present.

While each of the companies that left the industry had different reasons for their decision, among these reasons were: the complexity of the product, the small size of their Reverse Mortgage businesses relative to their other businesses, their inability to market to their existing customers, and the challenges associated with declining home values. Concerns over the quality of the product from a consumer standpoint were not a factor in their departures. One issue that was problematic for those originators that have recently left the space, and remains a key issue, was dealing with tax and insurance (or T&I) defaults. When a consumer fails to fulfill their obligations

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under the HECM, that failure can result in the unpleasant scenario of a possible foreclosure on an older American. It also exposes both the issuer/servicer and the FHA to potential losses.

Redress of this issue will benefit all stakeholders in the HECM program – borrowers, originators and the federal government. Action is being taken to address the issue. A Reverse Mortgage is not suitable for every potential borrower. The benefits of the product are not outweighed by the financial and psychological costs of a foreclosure. FHA has made it clear to the industry that we can now try to identify unsuitable borrowers. The industry is working with FHA on financial assessment guidelines that will hopefully limit the pool of HECM applicants to those who are in a financial position to meet the borrower obligations of the HECM. We expect the guidelines to be finalized in the coming month, and that these guidelines will ensure that the financial assessments are conducted in a consistent and fair manner. In addition, we expect to see modifications to the program itself that could allow originators to mandate monthly escrow payments for tax and insurance or to set aside some portion of the proceeds as a contingency fund, should the borrower struggle to keep up with their obligations. These changes will protect consumers, as well as the FHA insurance fund going forward.

When combined with a unique cornerstone of the HECM program, mandatory counseling, these modifications provide a robust foundation for the program – one that enhances the program's sustainability and also bolsters its integrity as a valuable and sound consumer financial product. This is why Generation Mortgage and CIS strongly support full federal funding of HUD's HECM counseling program.

The FHA and GNMA have done a fine job administering and enabling the Reverse Mortgage program to operate in a consumer-friendly and financially sound manner. Recently we have seen an overhaul of both the counseling protocols and of the servicing protocols for defaulted loans. Twice in the last three years, the FHA, with the support and participation of the industry, has

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altered the economic terms of the HECM by reducing the principal limit factors (PLFs) and increasing the mortgage insurance premiums charged on the HECM product. We in the industry recognize that the product must sustain itself through the insurance premiums collected.

These two modifications of the HECM product were a necessary response to the significant changes in the housing market that have occurred since the product was first designed. Both declining home values and longer life-expectancies increase the FHA's risk, so the steps taken to alter the product were good and necessary. The current version of the HECM Standard, along with the new HECM Saver, will provide attractive options to the widest possible range of eligible borrowers.

While the Reverse Mortgage is not for every borrower, for those seniors who meet the criteria, and who utilize a Reverse Mortgage as part of a well-thought out long-term financial strategy, the product can be life-transforming. For example, Charlene M., a borrower from Melrose Park, IL, who took out a HECM in 2008, wrote us a moving letter relating how her Reverse Mortgage changed her life. She wrote, in part, *"...I had resigned myself to living quietly and cheaply on my Social Security income, augmented with 2 small rent amounts from the rental units. I was afraid that, like some of the women I knew who were divorced or widowed, I would have to (HAVE TO) either re-marry or find a live-in partner to help pay the bills. That was not an easy thing to contemplate for me. Getting a Reverse Mortgage opened doors for me that I had thought forever locked..."* Please see Exhibit 3 for additional excerpts on how the HECM program has impacted this borrower's life. The HECM program allows seniors to age in place with dignity, comfort and independence. In these hard economic times, it is vital to ensure that this unique financial instrument remain available for those who truly need it.

The changes mentioned above will have a major impact on the future integrity and sustainability of the HECM program. Unfortunately, the recent decline in home values has contributed to a



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downtrend in overall volume. Current annualized endorsement volume for the first half of 2012 (57,840) is running at about 50 percent of the volume experienced three years ago (114,692). But, again, with financial assessment, product adjustments, growing consumer understanding and acceptance of the HECM Saver and perhaps most importantly, stability in the housing market, the industry is well-positioned to reverse the downtrend in volumes.

In addition, the demographic data bodes well for the industry in terms of the explosive growth in the number of Americans age 62 or older in the coming decades and the amount of home equity they will hold. For example, between 2015 and 2030, the number of Americans age 62 or older is projected to grow from 57.7 million to 83.8 million. During that time frame it is expected that the number of Americans in that age group who own and occupy their homes will grow from 27.6 million to 40.2 million. Equally as significant is the fact that the average home value for Americans age 65 and older is projected to increase from \$193,580 in 2015 to \$332,334 in 2030. This data, combined with the other factors outlined earlier give us confidence that the industry is well-positioned to increase volume in the coming years. For a complete view of the demographic data, please see Exhibit 4.

I would like to briefly address the question of whether or not it is healthy for the government to be so dominant in this market – after all, the federal government currently insures more than 99% of all new Reverse Mortgage originations. In the traditional mortgage space the economic difference between a government loan and a jumbo is marginal. In the Reverse Mortgage space, the difference between a government loan and a private loan is immense. This difference is not a reflection of increased risk on the part of the government. Rather, it is a function of the fact that the government's cost of capital is dramatically less than the private sector's.

Earlier in my remarks I referred to program changes necessitated by the market environment. FHA has kept a watchful eye on the terms of the program to ensure its fiscal soundness. FHA's

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proactive changes to the program have put it on solid financial footing. From the industry's perspective, we expect the program to stand on its own, without subsidy, and if the housing market was to deteriorate meaningfully, we would expect FHA to act accordingly and increase the cost of the loan. At the same time, if the housing market improves, we would be delighted to see the terms of the loan improve as well.

You also asked me to suggest regulatory and statutory changes that will help the marketplace, and keep FHA in a sound financial position. Many changes are currently underway. We already discussed impending financial assessment guidelines and possible alterations to the HECM program, which would combine to reduce tax and insurance defaults, and help ensure that unsuitable borrowers do not use Reverse Mortgages.

On the regulatory front, Generation Mortgage, CIS, and others in the industry have been actively engaged with the new CFPB in their ongoing Reverse Mortgage study. We look forward to their findings and to any changes they suggest that will truly protect our borrowers.

As the only originator of jumbo Reverse Mortgages, Generation Mortgage would enthusiastically support a definition of "Qualified Mortgage" that includes all Reverse Mortgages. This would increase the probability that our jumbo product could be broadly distributed to investors.

In examining possible statutory and regulatory changes, it's important to stay focused on the consumer. I would like to point out that abuse by lenders is extraordinarily rare in the Reverse Mortgage industry. Most of the bad actors we encounter want to get their hands on the borrower's proceeds. They might be the borrowers' children, other relatives, or purveyors of goods and services. Our borrowers have earned the right to use their home equity to improve their quality of life, and nobody should have the opportunity to take advantage of them.

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The 2008 Housing and Economic Recovery Act (HERA) included a provision designed to protect consumers from the bundling of inappropriate financial products with a HECM. The unintended consequence of this provision has been to prevent competent financial professionals from offering comprehensive planning to their clients. This was certainly a contributing factor to the departures that our industry has recently experienced. Congress may want to consider changes to the statute that would allow financial professionals to offer comprehensive financial planning to clients – including HECMs – in a manner that ensures full disclosure and continues to fully protect consumers from fraudulent and unethical practices.

In closing I would like to refer to a study that was released last month by the Center for Retirement Research at Boston College (<http://crr.bc.edu/wp-content/uploads/2012/04/wp-2012-13.pdf>). This study effectively examined a number of issues related to asset allocation, financial planning, and retirement security. Most significantly, the report dispelled the myth that a Reverse Mortgage should only be used as a last resort for struggling seniors. Indeed, one of the study's conclusions is that, when utilized as part of a thoroughly researched and thoughtful financial planning process, a Reverse Mortgage can significantly increase a senior's retirement security and income. The study concludes by noting that "... financial advisers will be of greater help to their clients if they focus on a broad array of tools – including working longer, controlling spending, and taking out a Reverse Mortgage."

Thank you for the opportunity to participate today and I am happy to provide detailed answers to any questions you might have.

**EXHIBIT 1**

\*\*NationStar amounts reflect the pools transferred (as of 3/31/2012) as part of their purchase of Bank of America's Reverse Mortgage portfolio

\*\*Reverse IT amounts represent those issued by Urban Financial

\*\*Data as of 3/31/2012

\*\* Source: GNMA Monthly HMBS Disclosure

Historical HMBS Issuance Volume						
Issuer Name	Total Fixed	Market	Total ARM	Market	Total HMBS	Market
	Amount Issued	Share	Amount Issued	Share	Amount Issued	Share
METLIFE BANK, N.A.	5,931,841,955	26.1%	1,717,095,536	16.9%	7,648,937,491	23.3%
NATIONSTAR MORTGAGE LLC	3,480,742,377	15.3%	3,652,688,486	35.9%	7,133,430,863	21.7%
WELLS FARGO BANK, N.A.	3,307,788,382	14.6%	2,092,836,872	20.6%	5,400,625,254	16.4%
GENERATION MORTGAGE COMPANY	2,917,970,665	12.9%	111,541,849	1.1%	3,029,512,514	9.2%
REVERSE MORTGAGE SOLUTIONS, IN C	2,944,295,391	13.0%	0	0.0%	2,944,295,391	9.0%
BANK OF AMERICA	904,009,066	4.0%	1,684,665,462	16.6%	2,588,674,528	7.9%
REVERSE IT	1,715,202,864	7.6%	311,494,234	3.1%	2,026,697,098	6.2%
SUNWEST MORTGAGE COMPANY, INC	956,580,729	4.2%	182,401,549	1.8%	1,138,982,278	3.5%
ONEWEST BANK, FSB	532,907,375	2.3%	417,843,198	4.1%	950,750,573	2.9%
	22,691,338,804	100.0%	10,170,567,186	100.0%	32,861,905,990	100.0%

2012 Q1 HMBS Issuance Volume						
Issuer Name	Total Fixed	Market	Total ARM	Market	Total HMBS	Market
	Amount Issued	Share	Amount Issued	Share	Amount Issued	Share
METLIFE BANK, N.A.	295,916,285	20.1%	305,823,608	38.9%	601,739,893	26.7%
REVERSE MORTGAGE SOLUTIONS, IN C	472,818,359	32.2%	0	0.0%	472,818,359	21.0%
REVERSE IT	372,129,397	25.3%	98,288,875	12.5%	470,418,272	20.9%
GENERATION MORTGAGE COMPANY	188,596,836	12.8%	49,728,020	6.3%	238,324,856	10.6%
WELLS FARGO BANK, N.A.	29,451,390	2.0%	182,349,386	23.2%	211,800,776	9.4%
NATIONSTAR MORTGAGE LLC	17,629,750	1.2%	90,193,866	11.5%	107,823,616	4.8%
SUNWEST MORTGAGE COMPANY, INC	87,795,278	6.0%	14,542,375	1.9%	102,337,653	4.5%
BANK OF AMERICA	3,437,587	0.2%	41,623,191	5.3%	45,060,778	2.0%
ONEWEST BANK, FSB	1,187,817	0.1%	3,504,391	0.4%	4,692,208	0.2%
	1,468,962,699	100.0%	786,053,712	100.0%	2,255,016,411	100.0%

2011 HMBS Issuance Volume						
Issuer Name	Total Fixed	Market	Total ARM	Market	Total HMBS	Market
	Amount Issued	Share	Amount Issued	Share	Amount Issued	Share
METLIFE BANK, N.A.	1,912,219,248	26.3%	764,204,418	28.9%	2,676,423,666	27.0%
WELLS FARGO BANK, N.A.	1,262,840,726	17.3%	939,571,670	35.6%	2,202,412,396	22.2%
REVERSE IT	1,343,073,467	18.4%	213,205,359	8.1%	1,556,278,826	15.7%
GENERATION MORTGAGE COMPANY	983,938,157	13.5%	61,813,829	2.3%	1,045,751,986	10.5%
NATIONSTAR MORTGAGE LLC	521,390,315	7.2%	459,852,108	17.4%	981,242,423	9.9%
REVERSE MORTGAGE SOLUTIONS, IN C	870,964,221	12.0%	0	0.0%	870,964,221	8.8%
SUNWEST MORTGAGE COMPANY, INC	314,524,568	4.3%	39,957,099	1.5%	354,481,667	3.6%
ONEWEST BANK, FSB	67,046,608	0.9%	61,719,877	2.3%	128,766,485	1.3%
BANK OF AMERICA	6,179,744	0.1%	99,867,257	3.8%	106,047,001	1.1%
	7,282,177,054	100.0%	2,640,191,617	100.0%	9,922,368,671	100.0%

2010 HMBS Issuance Volume						
Issuer Name	Total Fixed		Total ARM		Total HMBS	
	Amount Issued	Market Share	Amount Issued	Market Share	Amount Issued	Market Share
NATIONSTAR MORTGAGE LLC	1,902,714,821	24.2%	1,205,767,435	41.0%	3,108,482,256	28.8%
WELLS FARGO BANK, N.A.	1,163,181,655	14.8%	878,835,087	29.9%	2,042,016,742	18.9%
METLIFE BANK, N.A.	1,595,049,825	20.3%	426,597,261	14.5%	2,021,647,086	18.7%
REVERSE MORTGAGE SOLUTIONS, IN C	1,230,487,411	15.7%	0	0.0%	1,230,487,411	11.4%
GENERATION MORTGAGE COMPANY	1,140,590,360	14.5%	0	0.0%	1,140,590,360	10.6%
BANK OF AMERICA	265,767,257	3.4%	344,556,360	11.7%	610,323,617	5.7%
SUNWEST MORTGAGE COMPANY, INC	318,765,680	4.1%	5,700,102	0.2%	324,465,782	3.0%
ONEWEST BANK, FSB	235,432,760	3.0%	76,393,837	2.6%	311,826,597	2.9%
REVERSE IT	0	0.0%	0	0.0%	0	0.0%
	7,851,989,769	100.0%	2,937,850,082	100.0%	10,789,839,851	100.0%

2009 HMBS Issuance Volume						
Issuer Name	Total Fixed		Total ARM		Total HMBS	
	Amount Issued	Market Share	Amount Issued	Market Share	Amount Issued	Market Share
NATIONSTAR MORTGAGE LLC	915,425,063	16.0%	1,506,452,062	53.4%	2,421,877,125	28.4%
METLIFE BANK, N.A.	2,096,553,382	36.7%	0	0.0%	2,096,553,382	24.6%
BANK OF AMERICA	628,624,478	11.0%	1,198,618,654	42.5%	1,827,243,132	21.4%
WELLS FARGO BANK, N.A.	852,314,611	14.9%	92,080,729	3.3%	944,395,340	11.1%
GENERATION MORTGAGE COMPANY	604,845,312	10.6%	0	0.0%	604,845,312	7.1%
REVERSE MORTGAGE SOLUTIONS, IN C	370,025,400	6.5%	0	0.0%	370,025,400	4.3%
SUNWEST MORTGAGE COMPANY, INC	229,723,832	4.0%	6,615,493	0.2%	236,339,325	2.8%
ONEWEST BANK, FSB	20,544,924	0.4%	15,607,671	0.6%	36,152,595	0.4%
REVERSE IT	0	0.0%	0	0.0%	0	0.0%
	5,718,057,002	100.0%	2,819,374,609	100.0%	8,537,431,611	100.0%

2008 HMBS Issuance Volume						
Issuer Name	Total Fixed		Total ARM		Total HMBS	
	Amount Issued	Market Share	Amount Issued	Market Share	Amount Issued	Market Share
NATIONSTAR MORTGAGE LLC	123,582,428	33.4%	390,423,015	39.6%	514,005,443	37.9%
ONEWEST BANK, FSB	208,695,266	56.4%	260,617,422	26.4%	469,312,688	34.6%
METLIFE BANK, N.A.	32,103,215	8.7%	220,470,249	22.3%	252,573,464	18.6%
SUNWEST MORTGAGE COMPANY, INC	5,771,371	1.6%	115,586,480	11.7%	121,357,851	8.9%
REVERSE MORTGAGE SOLUTIONS, IN C	0	0.0%	0	0.0%	0	0.0%
WELLS FARGO BANK, N.A.	0	0.0%	0	0.0%	0	0.0%
GENERATION MORTGAGE COMPANY	0	0.0%	0	0.0%	0	0.0%
BANK OF AMERICA	0	0.0%	0	0.0%	0	0.0%
REVERSE IT	0	0.0%	0	0.0%	0	0.0%
	370,152,280	100.0%	987,097,166	100.0%	1,357,249,446	100.0%

**EXHIBIT 2**

\*\* Source: HUD Endorsement Reports &amp; FHA Outlook Reports

<i>Fiscal Year</i>	<i>Endorsements</i>	<i>YoY Growth</i>	<i>CAGR</i>
1990	157	N/A	N/A
1991	389	148%	148%
1992	1,019	162%	155%
1993	1,964	93%	132%
1994	3,365	71%	115%
1995	4,165	24%	93%
1996	3,596	-14%	69%
1997	5,208	45%	65%
1998	7,896	52%	63%
1999	7,982	1%	55%
2000	6,640	-17%	45%
2001	7,781	17%	43%
2002	13,049	68%	45%
2003	18,097	39%	44%
2004	37,829	109%	48%
2005	43,131	14%	45%
2006	76,351	77%	47%
2007	107,558	41%	47%
2008	112,154	4%	44%
2009	114,692	2%	41%
2010	79,106	-31%	36%
2011	73,145	-8%	34%
2012 YTD	28,924	N/A	N/A

**EXHIBIT 3**

*\*\* Excerpts from a letter provided to Generation Mortgage by Charlene M. of Melrose Park, IL, who took out a HECM in 2008*

"...I had inherited a huge old (emphasis here on OLD) house in a Chicago suburb that has been in my family for 5 generations. It had many things wrong with it that needed to be addressed, but nobody had seen fit to address them."

...

"Meanwhile, in my apartment here on the 1st floor, pieces of the drywall ceiling started falling on my head whenever we had a heavy rain. Part of the 2nd floor extends out beyond the 1st floor of the house, and it was the roofing on that piece that was in bad shape and was leaking onto my 1st floor ceiling. Everything above my head was getting mushy every time it rained.

I had several companies come and give me estimates on the roof repairs, and to my horror I discovered that there were 4 layers of shingles on the roof, with a cedar shake layer beneath it all. All rotted. There are 2 extra buildings on the property, a garage and a workshop, and all were in the same state of disrepair."

...

"The repair estimates, including tear-off and new materials from the bottom up, were over \$20,000 to do it properly. For a single, retired person like me, it might as well have been a million; I just didn't have it.

I had no large bills, but could not show enough income to qualify for a bank loan to get the work done. My financial system was simple---what came in, went out, and pretty fast.

That is when I started looking into reverse mortgages."

...

"The process was fast and painless, and went through without a hitch. Of the options offered, I decided to have all the money escrowed and whenever I need or want any of it, I just fill out a request sheet and the money shows up promptly in my bank account, like magic.

The first thing I did was get the roofs fixed, then the foundation work done. On a roll at that point, I had the electric all brought up to code and the plumbing all renovated. The inside ceiling came next, along with a complete re-do of the ugly, cracked ceiling and walls in my living-room, the room where my Grandpa used to sit and watch TV while exhaling huge clouds of icky cigar smoke.

All this time I had resigned myself to living quietly and cheaply on my Social Security income, augmented with 2 small rent amounts from the rental units.

I was afraid that, like some of the women I knew who were divorced or widowed, I would have to (HAVE TO) either re-marry or find a live-in partner to help pay the bills. That was not an easy thing to contemplate for me.

Getting the Reverse Mortgage opened doors for me that I had thought forever locked."

...

"I cannot even begin to describe the difference it has all made on my health and my outlook. I am no longer tied up in knots, worrying about what problem will come up next. Having money at my disposal when needed is a blessing. Knowing it is there in case of an emergency is so very reassuring. My worry level has evaporated and I face each day with peace and a feeling that I can take whatever financial things life might throw at me."



**EXHIBIT 4**

<b>62+ Population and Home Equity Estimates and Projections</b>									
	Current <sup>(1)</sup>			Projected <sup>(2)</sup>					
	2015	2020	2025	2030	2035	2040	2045	2050	
62+ Population (MM)	46.09	57.7	67.1	76.68	83.84	89.51	93.09	97.74	102.3
62+ Owner Occupied Homes (MM) <sup>(3)</sup>	22.98	27.64	32.14	36.73	40.16	42.88	44.59	46.82	49
Home Price Appreciation <sup>(4)</sup>	n/a	3.50%	3.70%	3.60%	3.60%	3.50%	3.40%	3.40%	3.30%
65+ Average Home Value <sup>(5)</sup>	\$163,316	\$193,580	\$234,218	\$279,392	\$332,334	\$386,555	\$447,544	\$518,156	\$599,909
<b>62+ Home Value (\$Trillion)</b>	<b>3.6</b>	<b>5.4</b>	<b>7.3</b>	<b>10.3</b>	<b>13.3</b>	<b>16.6</b>	<b>20</b>	<b>24.3</b>	<b>29.4</b>

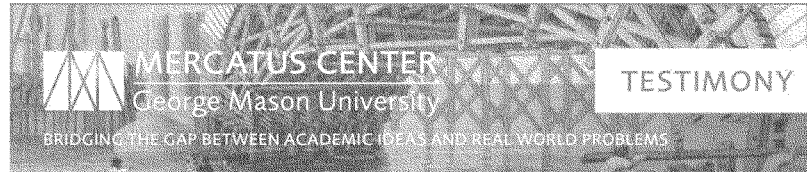
(1) 2006-2008 American Community Survey 3-Year Estimates

(2) Population Division, U.S. Census Bureau

(3) 2006-2008 American Community Survey 3-Year Estimates. Assumes constant 48% of 62+ Population

(4) Compounded annual growth rate, Moody's Economy.com Base forecast for Case-Shiller Home Price Index

(5) National Association of REALTORS, U.S. Census Bureau. Assumes 13.6% discount to median for 65+ homeowners and that average is 13.8% greater than median



**“OVERSIGHT OF THE FEDERAL HOUSING ADMINISTRATION’S REVERSE  
MORTGAGE PROGRAM FOR SENIORS”  
MAY 9, 2012**

Anthony B. Sanders  
Distinguished Professor of Real Estate Finance, George Mason University and Senior Scholar,  
Mercatus Center at George Mason University

House of Representatives Committee on Financial Services  
Subcommittee on Housing, Insurance and Community Opportunity

Chairman Biggert, Ranking Member Gutierrez and Members of the Subcommittee, thank you for inviting me to testify today. My name is Anthony B. Sanders. I am Professor of Finance at George Mason University in the School of Management and senior scholar at the Mercatus Center. I was previously Director of asset-backed and mortgage-backed securities research at Deutsche Bank and the co-author of “Securitization” (with Andrew Davidson) as well as numerous economic and finance publications on housing and the housing finance system.

EQUITY EXTRACTION IN HOUSING

Beginning in 1995, American households began extracting equity from their housing in ever growing numbers (see Figure 1). This effectively removed the equity cushion and increased the loss severity on mortgages when the housing bubble burst.<sup>1</sup>

In the mid-to-late 1990s, the U.K. was trying to find a way to increase equity extraction from their housing market for seniors, ostensibly to diversify their senior’s investments towards bonds and equities and away from housing which tends to form bubbles that burst. The Bank of Scotland and Barclays used a shared appreciation mortgage structure that generated cash for seniors in exchange for forgoing a percentage of the appreciation of their house, enabling seniors to extract equity while staying in their homes.<sup>2</sup> While it was enormously popular with seniors at first, complaints from consumer groups and family heirs removed some of the sparkle from this innovative approach to home equity extraction. But the real problem was that neither Bank of Scotland nor Barclays could successfully raise additional capital to fund this product by securitizing them.<sup>3</sup> The rapid rise in housing prices in the UK (See Figure 2: from an index of 2,693.7 on December 31, 1995 to 9,738.6 on September 30, 2007 – almost a fourfold increase) resulted in seniors owing, for example, 75% of the gain in price of their house to the lender. But if house prices had dropped, the borrowers would have owed nothing and the lenders would have suffered losses.

The loan balance can increase over time if an interest rate is charge on the equity extraction amount. The UK reverse mortgage (or shared appreciation mortgage) had little default risk since the borrower was receiving payments rather than making them. But default or acceleration could be triggered by failure to pay property taxes or maintain the dwelling (since the lender can have up to a 75% share in the appreciation). The latter is

<sup>1</sup> [https://files.nyu.edu/sml8/public/Laufer\\_EquityExtractionDefault\\_111611.pdf](https://files.nyu.edu/sml8/public/Laufer_EquityExtractionDefault_111611.pdf)

<sup>2</sup> <http://www.telegraph.co.uk/finance/personalfinance/borrowing/mortgages/5329469/Shared-appreciation-mortgages-cheap-money-backfires-on-borrowers.html>

<sup>3</sup> <http://www.sciencedirect.com/science/journal/10511377/14/3>

the moral hazard risk that borrowers, once they have their equity extraction, have less of an incentive to maintain their property.

#### THE FHA'S REVERSE MORTGAGE PROGRAM FOR SENIORS

The FHA has a similar reverse mortgage program for seniors to the UK SAM. With the home equity conversion mortgage (HECM), the borrower must still repay the amount owed to the lender. If the borrower has insufficient funds to pay off the HECM, the house is sold and the proceeds go to pay off the borrowed amount.<sup>4</sup> So in this respect, the FHA's HECM program is a UK SAM without saying so: house prices still determine the amount owed to the lender by the borrower as well as the amount that the borrower can extract.

FHA insurance for HECMs protects the lender rather than the borrower. In the event that the amount owed by the borrower exceeds the value of the property, the loss to the lender will be covered by FHA. But under the reverse mortgage program, any payments due the borrower are also protected. HUD has a legal obligation to make such payments in the event that the lender does not. So, HUD is "on the hook" for negative equity in a home (as well as defaults due to failure to pay property taxes and maintain property insurance).<sup>5</sup>

The costs to seniors, aside from the usual fees associated with lending are that FHA guaranteed HECMs may have an initial FHA Mortgage Insurance Premium (2% for HECM Standard product) as well as Annual FHA mortgage insurance (1.25% of reverse mortgage balance).<sup>6</sup>

The costs to taxpayers are the losses absorbed by HUD for the housing price shortfall, default and support. As our population ages and reverse mortgages become more common, we have to be careful about projected losses to taxpayers from yet another housing subsidy program.

#### THE FHA'S DILEMMA

The FHA, HUD and the Federal government face enormous challenges going forward. Federal debt held by the public is currently \$10.9 trillion which has increased \$6 trillion since January 2007 and \$4.6 trillion since President Obama took office on January 20, 2009 (See Figure 4). The Federal government has been running trillion dollar plus deficits and will continue to do so (See Figure 5) which will result in even more Federal debt. Student loan debt is over \$1 trillion and growing, another federally guaranteed program.

On the housing finance front, Fannie Mae, Freddie Mac and the FHA have captured the mortgage insurance industry with over a 90% market share. Fannie Mae and Freddie Mac have cost taxpayers \$170 billion thus far and counting.<sup>7</sup> And we do not yet know the final costs of the 14 loan modification programs from the Administration, including the Attorneys General Settlement. The Administration and Congress are pressuring

<sup>4</sup> HUD announced on December 2, 2011 the extension of the \$625,500 limit for Home Equity Conversion Mortgages (HECM) through calendar year 2012.

<sup>5</sup> When the reverse mortgage loan balance gets to 98% or more of the "maximum claim amount", which is the maximum amount that can be collected, lenders are allowed to assign the loan to HUD and be paid the balance. HUD then assumes responsibility for making any additional payments that are due the borrower. HUD will also take over responsibility if, for some reason, the lender cannot make the required payments.

<sup>6</sup> [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/sfh/hecm/hecmabou](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/hecmabou) and <http://www.genworthreversemortgage.com/genworth/fees>

<sup>7</sup> [http://www.washingtonpost.com/business/mortgage-giant-freddie-mac-asks-government-for-19m-posts-12b-loss-in-q1/2012/05/03/gIQAkplyT\\_story.html](http://www.washingtonpost.com/business/mortgage-giant-freddie-mac-asks-government-for-19m-posts-12b-loss-in-q1/2012/05/03/gIQAkplyT_story.html)

FHFA to allow Fannie Mac and Freddie Mac to perform principal write downs and the costs could be staggering.<sup>8</sup>

This brings us to the FHA. The FHA is deeply insolvent with insufficient capital. The FHA is estimated to have a current net worth of -\$12.05 billion and an estimated capital shortfall of \$31–50 billion. The good news is that the total delinquency rate in March declined to 15.78% while the serious delinquency rate declined to 9.47%. But with the U.S. housing market in disarray and house prices continuing to decline in many markets (see Figure 6), the losses could mount for the FHA and American taxpayers even further. And with housing prices declining, the FHA continues to insuring and subsidizing 3.5% down payment mortgages.<sup>9</sup>

The question remains as to why the Federal government is guaranteeing and subsidizing reverse mortgages for seniors. Stated differently, why do taxpayers have to subsidize seniors who want to stay in their homes when the simple solution is to let seniors sell their home and either rent another dwelling or purchase a smaller dwelling that meets their needs?

I am not against reverse mortgages as an equity extraction tool. But I do not see any reason for the Federal government to guarantee and subsidize it. And we need to stop micromanaging the home ownership decisions for American households. The Clinton Administration tried it in 1995 with the National Homeownership Strategy that contributed to a housing bubble and burst.<sup>10</sup> Now Fannie Mac, Freddie Mac and FHA are raising credit standards encouraging those who can't get credit to rent.<sup>11</sup> And now residential rents are rising rapidly in urban areas.<sup>12</sup>

#### SUGGESTIONS

At a minimum, the Federal government should get out of the reverse mortgage insurance and subsidization business, particularly since there is an easy alternative: seniors sell their home and buy a smaller dwelling or rent.

We have thrown enormous subsidies at the housing market and have tried to steer households into ownership, then renting and now steering seniors toward equity extraction. We need to think about how much of the housing market should be subsidized (mortgage interest deductions, subsidized mortgage insurance, low down payment loans, etc.). Clearly, the massive subsidization has distorted housing and housing finance market and changes should be made.

There are numerous proposals for ending the government housing monopoly.<sup>13</sup> These include eliminating Fannie Mae and Freddie Mac or converting them to a public utility and reinsurance company. But no matter

<sup>8</sup> <http://confoundedinterest.wordpress.com/2012/05/03/cummings-letter-to-demarco-why-fanniefreddie-should-do-principal-writedowns-please-be-careful/>

<sup>9</sup> <http://confoundedinterest.wordpress.com/2012/04/27/fhas-instant-undertow-mortgages-3-5-down-in-a-declining-home-price-environment/>

<sup>10</sup> <http://confoundedinterest.wordpress.com/2012/05/01/homeownership-falls-to-15-year-low-after-clintons-great-leap-forward/>

<sup>11</sup> <http://confoundedinterest.wordpress.com/2012/05/01/the-tightening-of-the-credit-noose-in-housing/>

<sup>12</sup> <http://www.latimes.com/business/la-fi-renters-nightmare-20120506.0.7137775.story>

<sup>13</sup> See <http://mercatus.org/publication/house-cards>, <http://mercatus.org/events/reforming-gses-fannie-freddie-and-future>, <http://reason.org/news/show/trust-in-mortgage-backed-securities>

how we deal with the government housing monopolies, we must address how much we want to subsidize housing going forward.

SUMMARY

A reverse mortgage for seniors is a reasonable idea, but should not be guaranteed by the Federal government. It is an ownership decision and the Federal government must stop trying to micromanage this decision, particularly since there is an easy alternative that does not require government guarantees.

APPENDIX: FIGURES

Figure 1.

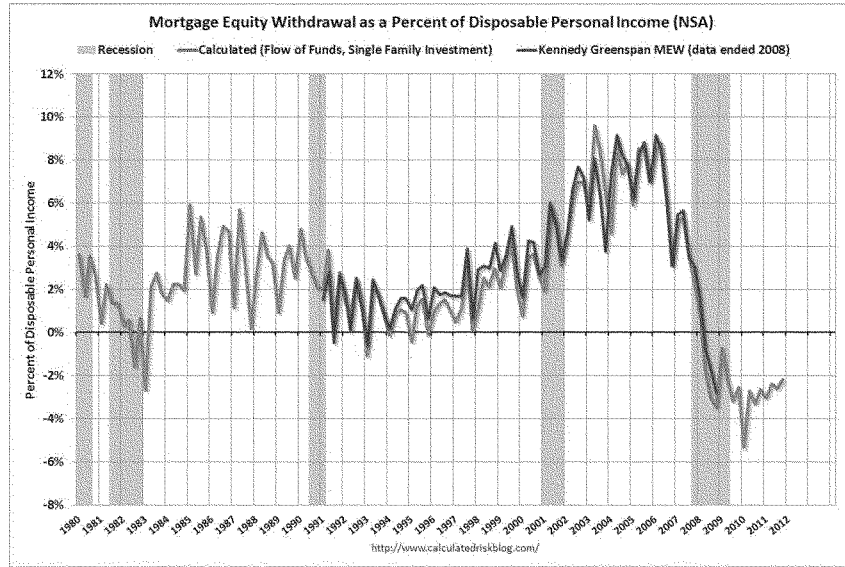


Figure 2.

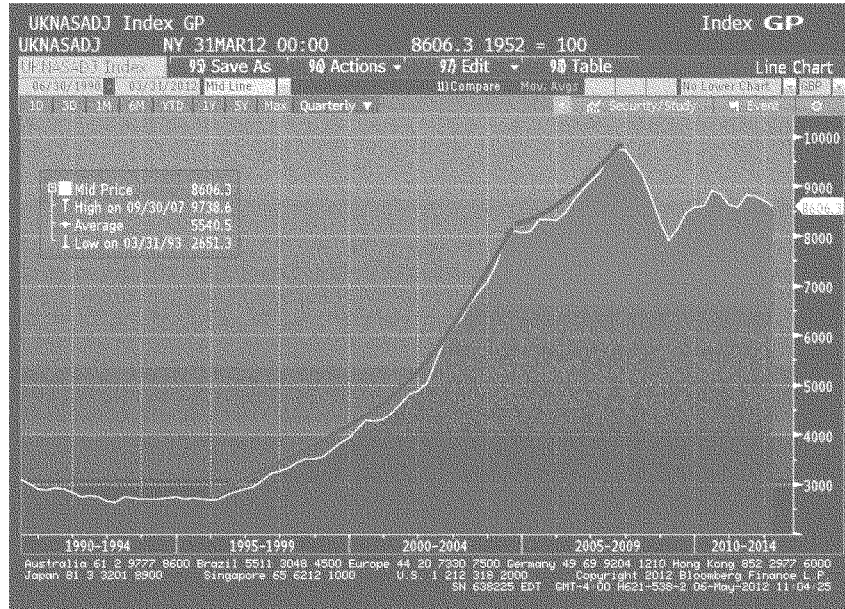


Figure 3. U.S. Debt Held By Public as of May 7, 2012

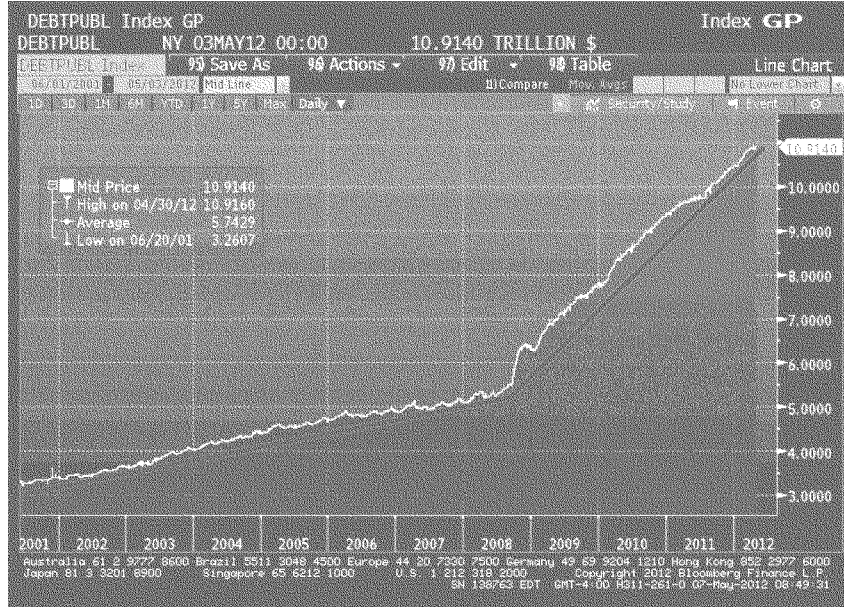
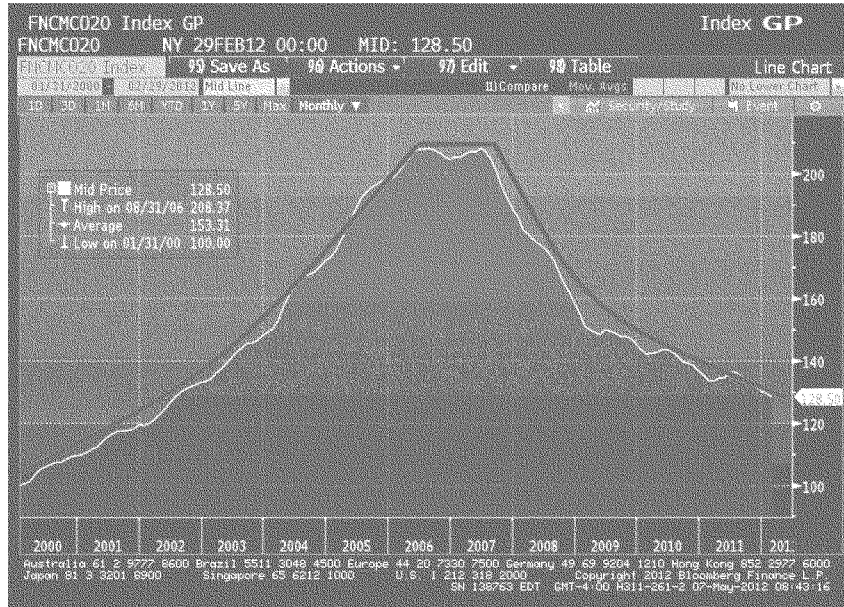




Figure 4. Federal Deficits



Figure 6. U.S. House Prices (FNC RPI 20 Metro)



Written Testimony of

**Houman B. Shadab**  
**Associate Professor of Law**  
**New York Law School**

“Oversight of the Federal Housing Administration’s Reverse Mortgage Program for Seniors”

Before the House Financial Services Committee  
Subcommittee on Insurance, Housing and Community Opportunity

May 9, 2012

Madam Chairwoman and Members of the Subcommittee:

My name is Houman Shadab and I am an Associate Professor of Law at New York Law School located in lower Manhattan, where I teach courses in contracts, corporations, and financial law and regulation. I also serve as an Associate Director of the Center on Financial Services Law at New York Law School and as the Editor-in-Chief of the *Journal of Taxation and Regulation of Financial Institutions*. A significant portion of my research focuses on instruments that transfer credit risk including mortgage-backed securities and credit derivatives. The views I express in this testimony are my own.

I was invited to testify on the Home Equity Conversion Mortgage (HECM) program sponsored by the Federal Housing Administration (FHA). My testimony will focus on the financing of reverse mortgages and not consumer protection issues. Based upon my research, I find that as housing prices stabilize and the broader economy recovers, a reverse mortgage market would likely be sustainable without FHA insurance. This is primarily because the securitization of non-HECM reverse mortgages can likely take place on a large scale even without a government guarantee such as the one Ginnie Mae provides to HECM mortgage-backed securities. Accordingly, Congress should not expand the HECM program and should consider decreasing the loan amounts borrowable under the program. Doing so would likely not pose a long-term problem for borrowers seeking reasonably priced reverse mortgages and would help to ensure that taxpayer funds are not used to subsidize risk taking by the financial institutions involved in reverse mortgage markets.

**Background: Reverse Mortgages and Securitization**

A reverse mortgage is a loan made against a borrower’s home equity and typically does not require repayment until the borrower moves or is deceased. Payments to the borrower may be made as a lump sum, in monthly payments, or through a line of credit. The loans may be made at a fixed or adjustable rate. Repayment of the loan requires sale of the home to cover the loan amount. Accordingly, the primary risk to a reverse mortgage lender is so-called collateral or crossover risk, which occurs when the value of the home drops below the amount owed.

Reverse mortgages can be divided into two categories. One category consists of reverse mortgages insured and regulated under the FHA’s HECM program. HECM loans require borrowers to purchase insurance from the FHA, which consists of insurance for lenders that

protect them from collateral risk, and also insurance that protects homeowners if the lender defaults.<sup>1</sup> Borrowers must be at least 62 years old and are required to obtain approved counseling services prior to obtaining a HECM loan. The amount borrowable under a HECM loan is determined by multiplying a principal limit factor<sup>2</sup> by the maximum claim amount, which is the lesser of the appraisal value of the home or FHA's mortgage limit. This mortgage limit has increased in recent years, from \$362,790 to \$417,000 in 2008, and to \$625,000 in 2009. At the same time, the FHA took steps in 2010 to decrease the amount borrowed under HECM loans by reducing its principal limit factors by 10% and raising the mortgage insurance premium from 0.5 to 1.25%. These actions were taken in response to projected negative cash flows from the HECM program in 2010 and 2011.<sup>3</sup>

The other category of reverse mortgages consists of those not regulated or insured pursuant to the HECM program. These loans are typically referred to as conventional (or proprietary) reverse mortgages and may be uninsured or insured privately. Conventional reverse mortgages are typically provided on terms not available under the HECM program, and for that reason are typically larger than HECM loans (so-called "jumbo reverse mortgages"). Compared to HECM loans, conventional reverse mortgages typically have higher interest rates, lower fees, and lower loan-to-value ratios.<sup>4</sup>

HECM loans currently dominate the reverse mortgage market. In 2011, only an estimated 5% of all reverse mortgages were conventional.<sup>5</sup> As of November 2011, the estimated total outstanding balance of all HECM loans was approximately \$87.6 billion.<sup>6</sup>

Reverse mortgages may be held by lenders or sold to buyers that seek to hold them in portfolio or pool them together for securitization. Prior to the financial crisis, most reverse mortgages were sold to Fannie Mae and not securitized. Securitization of reverse mortgages first took place in 1999 with a fully private deal, the Lehman Brothers SASCO 99-RM1.<sup>7</sup> However, private securitization of reverse mortgages has ceased since the financial crisis. Since late 2009, sales of reverse mortgages have been to issuers of HECM mortgage backed securities (HMBS). Ginnie Mae supports the underlying HECM loan market by guaranteeing the principal and interest payments of HMBS with the full faith and credit of the U.S. government. As of March 14, 2012, there were 17 approved HMBS issuers.<sup>8</sup> Since the first HMBS were issued in 2007, through 2011 a total of \$27.7 billion in HMBS have been issued and hence guaranteed by Ginnie Mae. Currently, \$800 million to \$1 billion in HMBS are issued per month.<sup>9</sup> The viability of both HECM and conventional reverse mortgages depends on secondary market support through securitization. Securitization supports the primary market by increasing the willingness and ability of lenders to make reverse mortgages in the first place since they can sell the loans to securitization vehicles.

#### **The Conventional (Non-HECM) Reverse Mortgage Market**

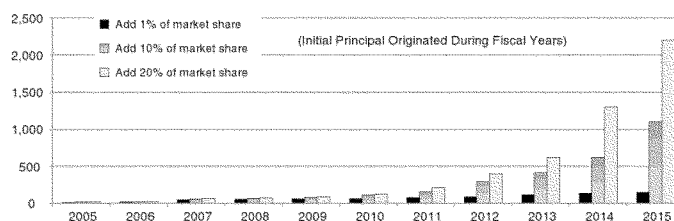
There are several reasons that suggest a private reverse mortgage market can exist without FHA insurance.

First, prior to the financial crisis of 2008, conventional reverse mortgages were widely available and the market for conventional reverse mortgages was steadily growing. Private reverse mortgage programs came to the market just prior to the Department of Housing and Urban Development (HUD) launching its pilot HECM program in 1989.<sup>10</sup> According to data from

Reverse Mortgage Insight, at their peak in 2007 about 16% of the volume of reverse mortgages were conventional loans.<sup>11</sup> According to an estimate by the Government Accountability Office, approximately 43% of HECM lenders made non-HECM reverse mortgages in early 2008.<sup>12</sup> Lenders stopped making conventional reverse mortgages during the financial crisis due primarily to the overall economic shock that caused the secondary (securitization) market for the products to collapse.<sup>13</sup>

Second, conventional reverse mortgages will likely increase in market share as the economy recovers, housing prices stabilize, and credit conditions improve. Currently, the most important obstacles to the development of private reverse mortgages seem to be continued uncertainties regarding housing prices and the willingness of lenders, insurers, and investors to assume housing price risk.<sup>14</sup>

Third, the demand for reverse mortgages is likely to substantially increase over the next several years due to an aging population, growing health care costs, and a lack of sufficient savings for retirement.<sup>15</sup> And there is certainly room for the reverse mortgage market grow. A 2009 estimate by Reverse Mortgage Insights found that only 2% of the potential market was using reverse mortgages.<sup>16</sup> Another estimate found that the potential size of the reverse mortgage market is \$1 trillion,<sup>17</sup> or more than 10 times its current size. The following figure shows that the projected growth for reverse mortgage issuance through 2015 is dramatic even with modest increases in market share.<sup>18</sup>



**FIGURE 5.1** Reverse Mortgage Issuance Projections  
*Source:* RBS Greenwich Capital, U.S. Census Bureau.

The likelihood of the conventional reverse mortgage market growing is also supported by the fact that conventional reverse mortgages have several features attractive to borrowers, including lower fees than HECM loans and more flexible terms.<sup>19</sup> Currently, there are reportedly new conventional reverse mortgage products may become available in 2012. For example, the large life insurance company New York Life may be developing a conventional reverse mortgage in conjunction with AARP.<sup>20</sup>

Fourth, the relatively small market share of conventional reverse mortgages is likely due in large part to the inability of conventional reverse mortgages to compete with HECM loans. In other words, FHA insurance of reverse mortgages may be “crowding out” private market participation. Two separate studies by Fannie Mae economists found that FHA provision of insurance in forward mortgage markets to some extent crowds out private insurance.<sup>21</sup> Although I am unaware of any studies of crowding out in the reverse mortgage market, these findings indicate that crowding out likely takes place in the reverse mortgage market as well. Lenders seem to take

it as axiomatic that conventional reverse mortgages need to have some characteristic that HECM loans do not have to be able to compete with HECMs.<sup>22</sup> As one industry insider recently wrote, “there is little incentive...to create proprietary [i.e., conventional] reverse mortgage programs when the FHA limit” covers most of the housing stock in the United States.<sup>23</sup> In addition, the Congressional Research Service found that Fannie Mae’s decision in 2008 to stop offering its own conventional reverse product was due to the expansion of HECM loans.<sup>24</sup>

Finally, there now seems to be a market consensus developing around how to better underwrite and produce what could become a standardized privately insured reverse mortgage. For example, an underwriter of life insurance and similar products has recently argued that the reverse mortgage market could greatly expand if actuarial methods used in other industries were applied to reverse mortgages.<sup>25</sup> Indeed, life insurance companies already have significant experience in underwriting products based upon mortality and related issues, and such knowledge could likely help the reverse mortgage industry to grow.<sup>26</sup> In addition, more sophisticated underwriting would allow for larger reverse mortgages to be made and thereby draw more lenders to the market.<sup>27</sup>

#### **Private Reverse Mortgage-Backed Securitization**

Conventional reverse mortgages do not qualify for Ginnie Mae’s securitization program. Accordingly, the existence of a robust conventional reverse mortgage market requires the loans to be purchased and securitized through private reverse mortgage-backed securities (MBS) that do not have federal guarantees. There are several reasons which suggest that a substantial market for such securities may develop.

First, private reverse mortgage securitizations have taken place without any government guarantee and preceded by several years the existence of Ginnie Mae guaranteed HMBS. In 2005, Lehman Brothers securitized conventional reverse mortgages in a \$503 million in a private deal, and in 2006 Lehman closed a \$598 million securitization that included conventional reverse mortgages and HECMs.<sup>28</sup> In terms of overall volume, in 2006 and 2007 \$2.7 billion of private reverse MBS were issued.<sup>29</sup> Reverse mortgage securitization was only in its infancy when the financial crisis caused the market for private securitizations of all types to collapse.

Second, although the growth of the HMBS market is due to investors finding Ginnie Mae’s guarantee attractive, the growth of HMBS likely also indicates a growing demand for reverse MBS more generally, including those without a government guarantee. There is currently little or no demand for private reverse MBS due in part to a lack of investor knowledge about reverse mortgage securitization.<sup>30</sup> However, reverse private MBS have features that investors are likely to find attractive as they become more knowledgeable, including less prepayment risk than forward MBS.<sup>31</sup> A 2008 report by HUD also noted that investor interest in private reverse MBS would likely increase due to their preference for the 2007 policy change that allowed adjustable HECMs to be indexed off of LIBOR.<sup>32</sup>

Third, there is currently a robust multibillion dollar securitization market that operates without any government guarantees. 2011 saw the issuance of \$30 billion in private commercial mortgage-backed securities,<sup>33</sup> \$12.3 billion of securities backed by commercial loans (collateralized loan obligations),<sup>34</sup> and \$16.2 billion of securities backed by credit card receivables.<sup>35</sup> Even in 2000, prior to the ramping up of the recent housing and securitization bubble, \$57.8 billion of private forward MBS were issued.<sup>36</sup> Securitization markets are able to

operate without government guarantees because parties adopt a wide variety of governance mechanisms that reduce risks for investors. As I noted in a recent paper, these mechanisms include performing individualized due diligence on underlying collateral, structuring the securities with payment priorities, and setting aside cash reserves in the event that cash flows are unable to pay investors.<sup>37</sup> The existence of a large and robust private securitization market suggests that the lack of a private reverse MBS market is more likely due to the market failing to mature before the financial crisis hit than investors requiring a government guarantee to invest in the securities.

In addition, current difficulties in the private forward MBS market are likely temporary, and thus do not reflect a fundamental problem with securitizing reverse mortgages without a government guarantee. The failure of private MBS to revitalize is due primarily to government sponsored entities expanding the scope of their activities so as to crowd out private markets, ongoing uncertainty about housing prices, and the slow and uncertain pace of regulatory reform in housing and securitization markets. In addition, due to the financial crisis lenders and investors are still very wary of mortgages and related assets. Lenders are currently imposing very strict underwriting standards on borrowers, and investors and credit ratings agencies are taking a highly guarded approach to mortgage risk which has resulted in only a very small amount of conservatively structured private MBS being issued in recent years. This reaction to the subprime crisis will likely decrease over the next few years, however, and further support the development of private securitization for both forward and reverse mortgages.

### **Conclusion**

Based upon the foregoing research, Congress should not expand the HECM program. Rather, Congress should consider reducing the loan amounts borrowable under the HECM program and reducing Ginnie Mae's HMBS guarantee. Doing so will likely not pose a long-term threat to the reverse mortgage market and will help ensure that taxpayer funds are not used to subsidize risk taking by financial institutions.

Although conventional reverse mortgages have higher interest rates than HECM loans, there is good reason to believe that interest rates for such loans would likely decline over time due to the competition that would accompany a growing conventional reverse mortgage market. In addition, securitization of conventional reverse mortgages would also likely cause borrowing costs to decrease. Notably, a 2007 HUD estimate found that securitization of HECM loans could cause borrower interest rates to decrease by 0.5% or more.<sup>38</sup> The primary and secondary markets for reverse mortgages seem to have been just getting off the ground when the financial crisis hit, and public policy should not be predicated on the assumption that current market conditions are permanent.

FHA and Ginnie Mae support of reverse mortgage markets subsidize the businesses of private lenders and issuers. Congress should therefore closely scrutinize industry-based claims that reverse mortgage markets cannot operate without federal assistance.

- <sup>1</sup> Bruce E. Foote, Reverse Mortgages: Background and Issues 8, Congressional Research Service (2010), <http://aging.senate.gov/crs/aging14.pdf>.
- <sup>2</sup> The principal limit factor is based upon borrower age and projected interest rates and is between zero and 1. It ranges anywhere between 0.30 to 0.74.
- <sup>3</sup> Government Accountability Office, Reverse Mortgages: Policy Changes Have Had Mostly Positive Effects on Lenders and Borrowers, But These Changes and Market Developments Have Increased HUD's Risk 29-31, July 2009, <http://www.gao.gov/assets/300/293312.pdf>; Elizabeth Decker, Premiums Increase for FHA Forward Loans, No Change for Reverse Mortgages, Reverse Mortgage Daily, Feb. 13, 2012, <http://reversmortgagedaily.com/2012/02/13/premiums-increase-for-fha-forward-loans-no-change-for-reverse-mortgages/>.
- <sup>4</sup> Nemo Perera, Risk Mitigation from Existing and Proposed Financial Products, in Reverse Mortgages and Linked Securities: The Complete Guide to Risk, Pricing, and Regulation 51 (Vishaal Bhuyan ed. 2011); Elizabeth Ecker, Reverse Mortgage Industry Poised for New Product in 2012?, Reverse Mortgage Daily, Jan. 9, 2012, <http://reversmortgagedaily.com/2012/01/09/reverse-mortgage-industry-poised-for-new-product-in-2012/>; AARP, Reverse Mortgages: Borrowing Against Your Home 20, Oct. 2010, [http://assets.aarp.org/www.aarp.org/\\_articles/money/financial\\_pdfs/hmm\\_hires\\_nocrops.pdf](http://assets.aarp.org/www.aarp.org/_articles/money/financial_pdfs/hmm_hires_nocrops.pdf)
- <sup>5</sup> Bonne Heudorfer, Reverse Mortgage Lending Project: An investigation into the existing state of consumer protections, issues, and practices relative to reverse mortgage lending in the Commonwealth of Massachusetts. Prepared for the Massachusetts Community and Banking Council 21, May 1, 2011, <http://www.mcbc.info/files/REVERSE-MORTGAGE-LENDING-PROJECT-REV-B.pdf>.
- <sup>6</sup> FHA's Underwater Problem – Is the Worst Over? New View Advisors, Jan. 30, 2012, <http://newviewadvisors.com/commentary/fhas-underwater-problem-is-the-worst-over/>.
- <sup>7</sup> Atare E. Agbamu, The HECM at 20 Series: The Engineers of Reverse Mortgage Securitization, National Mortgage Professional, April 20, 2010 <http://nationalmortgageprofessional.com/news/17118/hecm-20-series-engineers-reverse-mortgage-securitization>.
- <sup>8</sup> Ginnie Mae, List of Ginnie Mae Approved HMBS Issuers As of 3/14/2012, [http://www.ginniemae.gov/issuers/hmbs\\_issuers.pdf](http://www.ginniemae.gov/issuers/hmbs_issuers.pdf).
- <sup>9</sup> Marty Bell, Financial Ingenuity: A Guide to the Creation of HMBS and a Secondary Market, Reverse Mortgage 14-15, March-April 2012.
- <sup>10</sup> Peter M. Mazonas, The History of Reverse Mortgages: An Insider's View, in Reverse Mortgages and Linked Securities: The Complete Guide to Risk, Pricing, and Regulation 8-9 (Vishaal Bhuyan ed. 2011).
- <sup>11</sup> National Reverse Mortgage Lenders Association, Credit Risk Retention Comment Letter, Aug. 1, 2011, <http://www.sec.gov/comments/s7-14-11/s71411-222.pdf>.
- <sup>12</sup> Government Accountability Office, Reverse Mortgages: Policy Changes Have Had Mostly Positive Effects on Lenders and Borrowers, But These Changes and Market Developments Have Increased HUD's Risk 18, July 2009, <http://www.gao.gov/assets/300/293312.pdf>.
- <sup>13</sup> Id. at 18; Heudorfer, supra note 5, at 21.
- <sup>14</sup> Elizabeth Ecker, Reverse Mortgage Industry Poised for New Product in 2012?, Reverse Mortgage Daily, Jan. 9, 2012.
- <sup>15</sup> Perera, supra note 4, at 43.
- <sup>16</sup> Mazonas, supra note 10, at 12.
- <sup>17</sup> Charles A. Stone & Anne Zissu, The Secondary Market in Home Equity Conversion Mortgages, in Reverse Mortgages and Linked Securities: The Complete Guide to Risk, Pricing, and Regulation 145 (Vishaal Bhuyan ed. 2011).
- <sup>18</sup> Perera, supra note 4, at 44.
- <sup>19</sup> Id at 47-48, 51.
- <sup>20</sup> John Yedinak, New York Life Making Move Into Reverse Mortgages, Reverse Mortgage Daily, Jan. 5, 2012, <http://reversmortgagedaily.com/2012/01/05/new-york-life-making-move-into-reverse-mortgages/>.
- <sup>21</sup> See Frank E. Nothhaft & Penka T. Trentcheva, Does FHA 'Crowd-Out' Private Mortgage Insurance?, Working Paper Presented at the AREUEA Mid-year Meetings, Washington, D.C. (2003); Statement of Frank E. Nothhaft, Vice President and Chief Economist at Freddie Mac, Before the Subcommittee on Housing and Community Opportunity, U.S. House Representatives, June 16, 2005, <http://archives.financialservices.house.gov/media/pdf/061604fn.pdf>.
- <sup>22</sup> Elizabeth Ecker, Reverse Mortgage Industry Poised for New Product in 2012?, Reverse Mortgage Daily, Jan. 9, 2012.
- <sup>23</sup> Mazonas, supra note 10, at 15.
- <sup>24</sup> Foote, supra note 1, at 8.



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<sup>25</sup> Michael V. Fasano, Underwriting Reverse Mortgages, in *Reverse Mortgages and Linked Securities: The Complete Guide to Risk, Pricing, and Regulation* 42 (Vishal Bhuyan ed. 2011).

<sup>26</sup> *Id.* at 86.

<sup>27</sup> Fasano, *supra* note 25, at 38.

<sup>28</sup> Lorna M. Neill & Steven Kaplan, Nuts and Bolts of Reverse-Mortgage Lending, *Mortgage Banking*, May 2007.

<sup>29</sup> \$2.2 billion was HECM collateral; \$500 million was conventional. Ed Szymanoski and Colin Cushman, US Department of Housing and Urban Development, Presentation Slides at 36, December 2008.

<sup>30</sup> Atare E. Agbamu, Forward on Reverse Mortgages, *National Mortgage Professional Magazine*, Vol. 2 March 2012.

<sup>31</sup> Perera at 45; New View Commentary, Understanding Reverse Mortgage Prepayments: Focus on HECMs, July 26, 2010, <http://newviewadvisors.com/commentary/60/>.

<sup>32</sup> U.S. Department of Housing and Urban Development, A Turning Point In The History of HUD's Home Equity Conversion Mortgage Program 10, March 2008, <http://www.huduser.org/periodicals/ushmc/spring08/ch1.pdf>.

<sup>33</sup> Commercial Real Estate Direct Staff Report, U.S. Private-Label CMBS Issuance Hits \$30Bln in 2011, Tripling 2010's Volume, Dec. 29, 2011,

[http://www.crenews.com/index.php?option=com\\_content&task=view&id=74547&Itemid=1](http://www.crenews.com/index.php?option=com_content&task=view&id=74547&Itemid=1).

<sup>34</sup> Ruth McGavin, While US CLO Market Booms, 'Skin-in-Game' Rule Keeps European Volume at Zero, <http://www.leveragedloan.com/while-us-clo-market-booms-skin-in-game-rule-keeps-european-volume-at-zero/>.

<sup>35</sup> Standard and Poor's, U.S. Credit Card ABS Issuer Report: Issuance Exceeded Expectations And Collateral Performance Steadily Improved In Fourth-Quarter 2011; Outlook For 2012 Is Positive, Feb. 2, 2012,

<http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245328632525>.

<sup>36</sup> SIFMA, U.S. Mortgage-Related Securities Issuance, <http://www.sifma.org/research/statistics.aspx>.

<sup>37</sup> For a comprehensive overview of credit risk transfer governance mechanisms see Housman B. Shadab, *Credit Risk Transfer: The Good, the Bad, and the Savvy*, *Seton Hall Law Review*, Vol. 42 (2012), <http://ssrn.com/abstract=1919922>.

<sup>38</sup> Ginnie Mae Report to Congress, Fiscal Year 2007 at 19, Nov. 13, 2007, [http://www.ginniemae.gov/about/ann\\_rep/ReportToCongress07.pdf](http://www.ginniemae.gov/about/ann_rep/ReportToCongress07.pdf).



**Statement of Barbara Stucki, PhD**

**Vice President, Home Equity Initiatives, National Council on Aging**

**House Financial Services Subcommittee on Insurance, Housing and Community Opportunity**

**Hearing on Oversight of the Federal Housing Administration's**

**Reverse Mortgage Program for Seniors**

**May 9, 2012**

Chairwoman Biggert, Ranking Member Gutierrez, esteemed members of the Subcommittee, my fellow witnesses, and guests. On behalf of the National Council on Aging (NCOA), I appreciate the opportunity to testify today.

NCOA ([www.ncoa.org](http://www.ncoa.org)) is a nonprofit service and advocacy organization headquartered in Washington, DC. NCOA's mission is to improve the health and economic security of millions of older adults, especially those who are vulnerable and disadvantaged. NCOA is a national voice for older Americans and the community organizations that serve them. Working with nonprofit organizations, businesses, and government, NCOA develops creative solutions to help seniors find jobs and benefits, improve their health, live independently, and remain active in their communities.

I am here to talk about the current FHA Home Equity Conversion (HECM) program and to share with you our recommendations for sustaining and improving this program. My remarks are grounded in research, including what NCOA has learned about the motivations and potential risks facing older homeowners who consider these loans. My comments also reflect our experience as a U.S. Department of Housing and Urban Development (HUD) HECM Counseling Intermediary over the past five years. In this capacity, our counselors have listened to the hopes and concerns of thousands of older homeowners nationwide, and have educated them about reverse mortgages.

My goal is to highlight the benefits and challenges of the ways in which older homeowners use these loans to cope with the shifting financial landscape. The aim is to provide a broad framework to appraise the current HECM program, and consider its potential for the future. Specifically, it will be important to consider the following:

- **Greater oversight and regulation of the HECM program should not come at the expense of seniors of modest means for whom the program was originally designed.** Reverse mortgages are not suitable for everyone. However, any new financial assessments at origination should not be so restrictive that they exclude lower-income older homeowners, most of whom are already underserved by the financial industry.
- **Increasing the strength and sustainability of the HECM program requires greater collaboration.** Limited budgets leave little room for “cash poor” reverse mortgage borrowers to cope when things do not go as planned. Financial advisors can make sure that these loans are part of retirement planning and not just a last resort for those in financial crisis. Social service agencies can help vulnerable borrowers consider their options and access public benefits to stretch their limited loan funds.
- **The HECM program can be a platform for innovation to help address the emerging financial challenges of our aging society.** Declines in loan endorsements indicate that HECMs must continue to evolve, both as a product and as a financing solution. Additional collaborative research and development can find affordable solutions for those with limited home equity, and help reduce default rates for reverse mortgages. Older homeowners with special needs, such as those with chronic health conditions, could also benefit from public-private partnerships that can leverage this resource.

Due to the widespread inadequacy of retirement savings, home equity is becoming an increasingly critical component of economic security in later life. As a result, the issue for many low-to-moderate income seniors today is not whether to tap this asset, but when and how. NCOA believes that the HECM program serves a unique and important role in meeting these emerging needs.

**The HECM program is an important financing option for lower- to middle-income older homeowners.**

As people live longer, they need to take on increasing responsibility to safeguard their health and financial security. At the same time, many older Americans have seen their hard-earned retirement savings and assets diminish, with no guarantees for the future. When their financial management strategies are limited, seniors’ capacity to stay at home becomes fragile.

Older homeowners are looking for solutions to help manage their financial situation. If used wisely, a reverse mortgage can play an important role in helping them do so. These loans are especially important for lower- to middle-income families. Financial Interview Tool (FIT) data collected by HECM

counselors<sup>1</sup> suggest that about 44% of reverse mortgage borrowers have incomes under 200% of the federal poverty level.<sup>2</sup> By increasing liquidity, these loan funds can fill unmet needs and buffer against cash flow shortages that may disrupt the family budget.

Reverse mortgage counseling session data also show that reverse mortgages are not a “one size fits all” solution. Instead, older homeowners consider these loans for a wide range of reasons, including:

- Additional income to support household consumption (33%)
- To plan ahead for emergencies (23%)
- To pay for home repairs or improvements (22%)

Reverse mortgage can also play an important role in strengthening the capacity for independent living. Among counseling clients:

- About 46% were widowed or divorced. Among those under age 70, 40% reported that they no longer have a spouse.
- 12% had a hospital or nursing home stay in the 6-month period before counseling.
- 9% were considering a reverse mortgage to deal with out-of-pocket health expenses. Among those aged 80 and older, 21% were considering a HECM for this purpose.

Small infusions of cash can help older homeowners remain flexible and adaptive, so they can respond to problems while these are still manageable. Increasing seniors’ discretionary income may encourage them to maintain their home and participate in social activities and wellness programs that can lead to healthier lifestyle choices.

There are other potential benefits of these loans. By refinancing with a reverse mortgage, borrowers can defer making principal and interest payments on their existing home mortgage until they move out of the home. In some situations, a reverse mortgage may stabilize a difficult financial situation, such as forestall a foreclosure, and allow time for the homeowners to find more effective solutions to their cash flow problems.

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<sup>1</sup> Demographic and other counseling client information presented here are based on NCOA calculations using data from Financial Interview Tool (FIT) reviews that were conducted by HECM counselors from September to November 2010. All responses reflect self-reported data. HUD requires all reverse mortgage counselors to collect systematic data on the risks and financial shortfalls facing their HECM counseling clients during the counseling session, using the Financial Interview Tool.

<sup>2</sup> In 2012, gross incomes at 200% of the federal poverty level are \$22,340 for single households and \$30,260 for couples. NCOA calculations based on the 2012 HHS Poverty Guidelines (<http://aspe.hhs.gov/poverty/12poverty.shtml>)

**Recommendations to support older homeowners of modest means:**

1. **Adequately fund HECM counseling, so seniors can understand their options and the financial implications of these loans.** It is a hardship for many lower-income homeowners to pay for counseling upfront. Charging fees for this counseling also discourages seniors from getting unbiased information from a HUD-approved counselor before they talk to a lender.
2. **Support ongoing consumer research to enhance the safety and soundness of the HECM program.** FIT data collected through the counseling process can be used to:
  - a. Rapidly assess the changing needs and vulnerabilities of seniors who are considering a reverse mortgage.
  - b. Enhance consumer protections for different sub-groups of borrowers and identify factors that could reduce the risk of loan default.
  - c. Explore ways to appropriately use HECMs to help borrowers with chronic conditions stay at home and avoid impoverishment that can lead to reliance on Medicaid.

**Reverse mortgage borrowers are at the leading edge of a new trend to use home equity to deal with cash shortfalls.**

The reverse mortgage marketplace is very dynamic and must be understood within the broader perspective of our nation's current housing and economic situation. Several years ago, many older homeowners took out this loan as a way to improve their quality of life (73%).<sup>3</sup> But now, people who consider these loans are more concerned about urgent financial needs, including lowering debt. Among HECM counseling clients in 2010, most of these homeowners (67%) wanted to lower household debt. Only 27% were considering a reverse mortgage to enhance their lifestyle.

The aging of the Baby Boomer generation is another important demographic trend, which is already reflected in the declining age of reverse mortgage borrowers and counseling clients. Despite lower available loan limits at younger ages, the average age of all HECM borrowers has continued to decline, from 76.7 years old in 1990 to 72.0 years old in 2012.<sup>4</sup> Among homeowners who went through HECM counseling between September and November 2010, one in five (21%) were Baby Boomers aged 62 to 64.

<sup>3</sup> Redfoot, D.L., Sholen, K., and Brown, S.K. (2007). *Reverse Mortgages: Niche Product or Mainstream Solution?* Washington, DC: AARP.

<sup>4</sup> HUD Office of Evaluation. *Home Equity Conversion Mortgage Characteristics— March 2012*. Available at [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/rmra/oe/rpts/hecm/hecmmenu](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/hecm/hecmmenu).

The consequences of these market shifts are still unclear. On one hand, as the Baby Boomer generation ages, reverse mortgages may be part of a growing trend to include home equity as part of retirement planning. For some older homeowners, orderly liquidation of home equity could be a better option to sustain community living than preserving this asset for financial emergencies. On the other hand, using a reverse mortgage to address income shortfalls can also increase financial risks if borrowers do not manage their spending or if they rapidly draw down their home equity.

Based on FIT data, about two-thirds (67%) of counseling clients in 2010 had a conventional mortgage that would need to be repaid if they decided to take out a reverse mortgage.<sup>5</sup> For about one-third (32%) of these counseling clients, their existing mortgage exceeded 50% of the value of their home. About one in four (27%) reported having both housing and non-housing debt. Borrowers with sizable existing debt may rapidly deplete home equity by taking out a HECM loan to repay debt. The challenges of meeting borrower obligations on a limited income are already reflected in the numbers of reverse mortgage borrowers in default.

Growing numbers of older homeowners will benefit from additional support and guidance, since the decisions that they make about this valuable asset will have long-term ramifications for the well-being of older Americans and for our nation. Policymakers are concerned that older adults who tap their home equity to pay for everyday expenses early in their retirement years will have fewer resources to deal with declining health in later life. Many states already struggle to pay for public programs, such as Medicaid, that assist older adults with low incomes and those who are impoverished by health expenses. Financial shortfalls among middle-income older adults that accelerate the need for public assistance could make these fiscal pressures even greater.

HUD does not have specific income requirements for HECM reverse mortgage borrowers. However, HUD now allows HECM lenders to conduct a financial assessment of the applicant as part of the process of qualifying them for these loans. This assessment could include a review of their credit history, income, debts, and cash flow situation. Applicants who do not meet the lender's requirements may have their loan application denied by the lender. This assessment can vary among lenders, depending on the different reverse mortgage products that they offer.

It is important that borrowers have the ability to meet the obligations of HECM loans, including paying ongoing property taxes and homeowner's insurance. However, we are concerned that these financial assessments may become overly restrictive. This could reduce access to HECMs among "cash poor" seniors who may have few other options to tap the equity in their home.

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<sup>5</sup> Stucki, B. *Changing Attitudes, Changing Motives. The MetLife Study of How Aging Homeowners Use Reverse Mortgages*. Westport, CT: MetLife Mature Market Institute, 2012.

**Recommendations to ensure wise decision-making:**

1. **Ensure that HUD regulations, such as the financial assessments lenders may conduct at origination, are not allowed to become overly restrictive to ensure that the HECM program remains a viable option for “cash poor” seniors.** Reverse mortgages can bring new risks to people who may have limited experience dealing with large sums of money. However, seniors with modest incomes who do not qualify for conventional home loans may have few alternatives besides a HECM to tap home equity.
2. **Support and strengthen consumer education to ensure that older homeowners make informed decisions about the most appropriate use of their “nest egg” of home equity.** Younger borrowers would especially benefit from working more closely with financial advisors, senior advocates, housing specialists, and other experts.

**The HECM program is a platform for innovation.**

Over the past 10 years, reverse mortgages have evolved both as a product and as a solution for many financial security concerns. We can expect that both the reverse mortgage industry and the marketplace will continue to change as the Baby Boomers represent a growing portion of the pool of potential borrowers. With older Americans increasingly relying on home equity to manage cash flow, our strategies for using HECMs will need to shift from product-focused solutions to comprehensive financial plans that include reverse mortgages as an integral part of retirement security.

Older homeowners are often advised that home equity should only be used as a “last resort.” However, our counseling experiences suggest that cash-poor seniors who take out a reverse mortgage when they face serious financial difficulties are at higher risk of defaulting on these loans. Therefore, we believe that the long-term sustainability of the HECM program rests on increasing the use of home equity as more than a tool for crisis management.

Older homeowners also need multiple, affordable HECM products that can meet both their long- and short-term financial goals. For example, the HECM Saver loan, with its lower upfront costs, could be an option for those who cannot stay in their home for many years. This approach may be helpful for seniors with chronic conditions, so they can pay out-of-pocket health expenses without disrupting their budget.

Meeting these challenges opens the door to a wide array of opportunities for collaboration. For example, financial services professionals could work with consumer advocates to find ways to assist lower- and middle-income families who have not traditionally used financial planning services. New tools and

supports will be essential to address the problems these older homeowners face as they shift from a financial planning strategy that aims to preserve housing wealth to one that uses this asset as a retirement resource.

Reverse mortgage counseling also offers a new pathway to reach seniors who need help to live independently. Integrating this counseling with assistance from social service agencies will be important for older homeowners who are unlikely to tap home equity without guidance on how to use this asset for community living. As trusted local resources, Area Agencies on Aging and Aging and Disability Resource Centers can help older homeowners access community programs. These agencies can also facilitate the transition from the home to other living arrangements, should these borrowers need to move.

For many “cash poor” homeowners, combining a reverse mortgage with public benefits could also improve their chances of keeping up with their borrower obligations and staying at home. In August 2010, HUD began requiring that all reverse mortgage counselors conduct a BenefitsCheckUp® screening as a part of HECM counseling for clients with incomes under 200% of poverty. Since the implementation of the mandate, reverse mortgage counselors have used this web-based service to screen eligibility for public and private benefits for over 71,000 clients. We estimate that these screenings could help these older homeowners find over \$378 million worth of annual benefits in total, which could serve as a supplement or alternative to a reverse mortgage.<sup>6</sup>

**Recommendations to promote innovation:**

1. **Encourage HUD to continue using the HECM program as a platform to foster innovation through collaborative efforts with the mortgage industry, housing programs, and aging services community.** There is an urgent need to break down service silos and address problems holistically to promote consumer confidence in these loans and sustain them in their homes.
2. **Enhance the long-term viability of the HECM program through a balanced approach that ensures strong oversight to promote responsible lending, but also supports continued collaborative research and development of this emerging financial solution.** We need strong consumer protections to reduce fraud and mitigate risk, but also want to give older homeowners the flexibility to meet their evolving financial needs.

Thank you again for this opportunity to share NCOA’s research and insights into the HECM program and older homeowners who consider these loans. For more information on our work in this area, please visit [www.ncoa.org/HomeEquity](http://www.ncoa.org/HomeEquity). I welcome the opportunity to answer any questions you may have.

<sup>6</sup> NCOA data from the Reverse Mortgage Counseling Toolkit website for HUD-approved HECM counselors. To view the consumer version of BenefitsCheckUp®, visit: [www.benefitscheckup.org](http://www.benefitscheckup.org).





Written Testimony of Lori A. Trawinski, Ph.D., CFP®  
Senior Strategic Policy Advisor  
AARP Public Policy Institute

“Oversight of the FHA Reverse Mortgage Program for Seniors”

Hearing before the Subcommittee on Insurance, Housing and Community  
Opportunity

U.S. House Committee on Financial Services

May 9, 2012

For further information contact:  
Mary Wallace  
Government Affairs  
202-434-3954

Chairwoman Biggert, Ranking Member Gutierrez, and Members of the Subcommittee:

Thank you for the opportunity to testify on behalf of AARP on the oversight of the Federal Housing Administration's reverse mortgage program. I am Lori Trawinski, Senior Strategic Policy Advisor in AARP's Public Policy Institute.

As the largest nonprofit, nonpartisan membership organization representing people age 50 and older, AARP advocates for policies that enhance and protect the economic security of older individuals. AARP has a long history of involvement with the Home Equity Conversion Mortgage (HECM) program. In the mid-1980's, AARP supported the creation of the HECM pilot program. We believed then, as we do now, that older Americans should have a means by which to access their home equity without having to sell their homes or take on loans that will stretch their already tight budgets. Recognizing the need to protect older, potentially vulnerable consumers from loss of home equity, AARP advocated for the requirement that HECM borrowers obtain housing counseling from HUD-certified providers prior to applying for a reverse mortgage loan. In addition, the AARP Foundation helped develop the original HECM housing counseling protocol and ran the housing counselor training program until transferring those responsibilities to NeighborWorks in 2008.

Throughout the life of the HECM program, AARP has continued to monitor developments, advocate for consumer protections, conduct research on reverse mortgage issues, and develop policy recommendations to address the changes in this market. We are honored to be here today to present our views.

#### **HECM Program**

The HECM program has changed over the past 23 years. Throughout the 1990's, HECM volume remained well below 10,000 loans per year. In the early 2000's volume picked up and accelerated strongly until 2009, when annual HECM volume reached a record level of 114,639 loans. By then, the housing market had collapsed and home prices continued to fall. The crisis took a toll on mortgage lending of all types, including reverse mortgages, as decreased home values kept many reverse mortgage borrowers on the sidelines. In response to the increased risk to the FHA insurance fund, FHA lowered the amount of money that could be borrowed in a reverse mortgage transaction in 2010, while also increasing the ongoing mortgage insurance premium. Loan volumes declined 30 percent in 2010 and declined further in 2011.

Also notable has been a decrease in the average age of borrowers from 76 years old in fiscal year 2000 to 72 years old as of February 2012, and the increasing use of lump-sum full-draw payouts at closing. These changes may indicate that people have a need for higher amounts of money earlier in retirement, or even prior to retirement. Some of this need derives from higher amounts of forward mortgage debt being carried longer than in the past, and an increase in the overall indebtedness of Americans in general. Increasing use of full-draw lump-sum payouts could also reflect a change in how reverse mortgages

are marketed. Whatever the underlying reason, borrowers who take the full draw on day one of the reverse mortgage loan exhaust their borrowing capacity immediately and accrue interest on a large balance. Younger borrowers who take out reverse mortgages have access to a smaller percentage of their home's value, since the amount that can be borrowed is based on the life expectancy of the youngest borrower. The concern is that by drawing down home equity earlier, people will have no access to additional cash later in life when they may encounter major health problems or other emergencies that require financial resources. Also, had they waited until later to take out the reverse mortgage loan, they would have had access to a larger amount of funds.

Another recent development is the continuing exit of the largest reverse mortgage lenders from the market. Financial Freedom, Bank of America and Wells Fargo exited last year, and MetLife, the largest lender in 2011, recently announced its departure. While loans are still available to people across the country, processing efficiencies have been lost, and increased costs to borrowers are likely to result.

#### **Proprietary Reverse Mortgages**

Proprietary reverse mortgages are loans made by lenders and are not insured by FHA. They have been around in many forms and have been offered by over 150 different lenders. However, proprietary reverse mortgage loan volume has never approached the level of HECM issuance, nor have private lenders been able to offer competitive rates within the HECM loan limit space. Proprietary reverse volume peaked in 2007 at 2599 loans for a total of approximately \$2.6 billion.<sup>1</sup> Proprietary loans have typically served the "jumbo" sector of the reverse mortgage market, which is the high home value sector where loans are made on homes that far exceed the FHA home value limit.

Proprietary loans have not been made within the range of home values served by HECM program, nor are they likely to be. Consumers seek the safety of the government guarantee, particularly in the case of reverse mortgages. The FHA insurance guarantees that payments will be made to the borrower in the event of the lender's demise. Lenders in the proprietary market take on the risk that the loan will exceed the value of the home at termination. Even when home prices were rising rapidly, few lenders were willing or able to take on that risk. Currently, there are very few proprietary reverse mortgage loans being made, as depressed home values and the recent recession have weighed heavily on this market. A major downside of proprietary loans is that they lack many of the consumer protections that are mandatory in the HECM market. Therefore, these loans are riskier to the consumer.

I would now like to offer AARP's views on several key issues relating to the HECM program.

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<sup>1</sup> Source: Gerald C. Wagner, Ibis Software Corporation; Active loans as of March 31, 2011.

### **Housing Counseling**

Housing counseling is a major component of the consumer protections for reverse mortgages. Reverse mortgages are complex financial loans and are not easily understood even by the most sophisticated borrowers; and they are not suitable for all homeowners age 62 and older. HUD has implemented changes to the HECM counseling program that are designed to improve the quality of HECM housing counseling, including: requiring HECM counselors to attend training courses every two years and to take a certification exam every three years; introduction of the Financial Interview Tool (FIT) which consists of ten questions designed to test a borrowers' comprehension of important aspects of a reverse mortgage loan; and the requirement that both spouses attend the counseling session—even if only one spouse is on the title and applying for the loan. In addition, counselors must offer clients the opportunity to go through a Benefits CheckUp to see if they are eligible for any public benefit programs; Benefits CheckUp is mandatory for clients who are below 200 percent of the federal poverty level or are disabled.

Despite these improvements, we believe that opportunities to improve HECM counseling remain. HECM counselors tell us that they often require two or more hours to cover all topics required by the HECM counseling protocol. In contrast, other counselors, and specifically many who conduct counseling via telephone, manage to conduct a session in less than one hour. We believe that this discrepancy may highlight a potential problem with the consistency and quality of counseling, and we urge HUD to investigate this difference.

The HECM housing counseling program should be fully funded by Congress, particularly since HECM housing counseling is required by law and lenders are prohibited from paying for counseling on behalf of borrowers. AARP was pleased to see some housing counseling funds restored for FY 2012, but believe the lower funding level is not adequate and may cause some counseling agencies to run out of funds before year-end, which will lead to a curtailment of services. When funding runs out, borrowers must pay the counseling fees themselves or defer their counseling sessions until funding is restored. High quality counseling is one of the strongest consumer protections available to potential borrowers, and grants to nonprofit housing counseling agencies are vital to the effective functioning of the HECM program.

Additional funds should be allocated to foreclosure mitigation counseling. Every effort must be made to assist borrowers who have the capacity to become current on their property taxes and homeowners insurance so that they will not lose their home to foreclosure. The current program has not reached the vast majority of borrowers who are in technical default for failure to pay property taxes, homeowners insurance premiums, or both. Attention must also be paid to borrowers who have failed to pay their homeowners

association dues and assessments, as these payments are vital to the ongoing operation and maintenance of condominium associations.

#### **Financial Assessments**

One of the main features in the design of the HECM loan was that income and credit history were not part of the underwriting process. The thought was that older Americans who have accumulated equity in their homes over a period of many years should have access to that equity without having to sell their home or take out a home equity loan. Many older homeowners with limited incomes would not qualify for a traditional home equity loan, since it would require monthly payments. Since the HECM loan did not require repayment as long as the borrower lived in their home, the underwriting process was largely based on the life expectancy of the youngest borrower, existence of current liens on the property, and a verification that the borrower was not in default on any federal debt.

Reverse mortgages were often recommended as loans of last resort for use when there were no other options available. As a result, low income households who were facing financial difficulty—such as a foreclosure on a forward mortgage—used the reverse mortgage to stave off the foreclosure. With a forward mortgage, monthly payments often include escrows for property taxes and homeowners insurance, but with a reverse mortgage, the borrower is responsible for making those payments—as well as homeowners association dues and assessments. It appears, however, that many borrowers are having difficulty making those payments. According to data provided by HUD, 54,000—or 9.4 percent of active HECM loans—were in technical default for nonpayment of taxes and/or homeowners insurance as of February 2012.

HUD plans to propose a rule requiring financial assessments for HECM borrowers in the near future. AARP understands the need to examine a borrowers' financial ability to pay property taxes, homeowners insurance, homeowners' association dues and assessments, and to be able to maintain the property. However, we do not believe that credit scores, payment history, or the existence of a bankruptcy filing or foreclosure should be part of the financial assessment. Rather, the determination should be whether borrowers have the ability to meet their basic living expenses, financial obligations and property charges, and this should be determined after taking the cash flow from the potential reverse mortgage into consideration.

AARP believes that is important to make sure that following a reverse mortgage, a borrower will have the ability to maintain payments for their obligations; if not, the reverse mortgage should not be made. Denying a loan may enable some homeowners to retain any equity they may have, instead of merely staving off the inevitable loss of a home with a loan that is destined to fail. AARP also believes that older homeowners should have access to reverse mortgage loans when they make financial sense and the borrower can

maintain payments on their financial obligations. Imposition of additional requirements that go beyond household budgeting should not be included in these assessments.

### **Consumer Disclosures**

AARP looks forward to the Consumer Financial Protection Bureau's forthcoming redesign of consumer disclosures for reverse mortgages.

AARP recommends the following change regarding statements from mortgage servicers that are periodically provided to borrowers. For borrowers who choose the line-of-credit payout option and have a creditline that grows over time, servicers should be required to:

1. Disclose the rate at which the creditline will grow; and
2. Provide a monthly or quarterly statement specifying:
  - a. Creditline amount available at the close of the previous period;
  - b. Withdrawals from the creditline during the current period;
  - c. Creditline growth during the period; and
  - d. Creditline amount remaining at the end of the period.

### **Advertising**

We have all seen the television commercials. It is unlikely that the designers of the HECM program ever envisioned that the "The Fonz" and "I Dream of Jeannie" would appear in American living rooms to enlighten the masses about the benefits of a reverse mortgage. Some advertisements may inadvertently create the impression that a reverse mortgage is a federal benefit rather than a financial product. The decision to tap home equity is not a decision to be taken lightly and it should not be presented as anything other than a loan. These loans are not risk free or cost free and should not be presented as such. While it is appropriate to inform and educate the public about the availability of reverse mortgage loans, mass marketing of reverse mortgage loans should not be misleading or deceptive. Reverse mortgages are not appropriate for every homeowner over the age of 62. At a minimum, it should be clear that celebrities are paid spokesmen. Despite guidance in this area from the Reverse Mortgage Lenders Association, that is not always clear in the advertisements.

Another possible area of concern is the "free lunch" seminar. These seminars are often used to present sales pitches to audiences in exchange for a free meal. In the investment sales arena, this practice has garnered the attention of the Securities and Exchange Commission and the Financial Industry Regulatory Authority. AARP conducted a survey in 2009 that examined who was invited, who attended, and what the expectations were of

those who attended a free lunch seminar.<sup>2</sup> The report also presented information obtained from seminar attendees regarding what types of information were discussed when attending these events. Reverse mortgages were mentioned in the presentation or in the marketing materials 24 percent of the time. It appears that the investment product sales people may be presenting reverse mortgages as a means of paying for their products. While cross-selling of a financial product as a condition of obtaining a reverse mortgage is prohibited for lenders, this practice by investment salespersons appears to be a different means of cross-selling products that may not be in the best interest of consumers.

AARP has also been contacted by several of our members who have expressed concern with reverse mortgage lunch seminars being offered in their retirement communities. AARP urges the Consumer Financial Protection Bureau and state financial regulators to monitor reverse mortgage advertising and the use of free lunch seminars to ensure that no inappropriate marketing, including no inappropriate cross-selling, is occurring.

#### **Statutory Loan Limit**

To guarantee continuity of the HECM program, AARP supports legislation that would remove the statutory limit on the number of loans that can be insured by HUD in a given year. Loan limits were imposed when the HECM program was a pilot program. The loan number cap has been raised several times over the years and has, at times, led to a halt in originations when the cap was reached. Lifting the statutory loan limit would be helpful in encouraging lenders to offer reverse mortgages and remain committed to this market.

#### **Conclusion**

AARP continues to believe that older Americans should have a means by which to access their home equity without having to sell their homes or take out a home equity loan, and that a reverse mortgage can be an appropriate financial product for some people. AARP urges HUD to act in a timely manner to provide guidance in areas where there is uncertainty, such as: promulgating rules that prohibit cross-selling; and promulgating rules for financial assessments of borrowers. In addition, we support the development of a wider reaching program to assist borrowers who are in default, before the loan reaches the foreclosure stage. AARP also urges the following statutory changes: removal of the statutory limit on the number of loans that can be insured by HUD; and appropriation of sufficient funds to make sure that borrowers have access to the housing counselors they require and to the capital they need. AARP supports the continuation of the HECM program and we look forward to working with you and other stakeholders to ensure that older Americans can tap their home equity with safe, affordable, government-insured reverse mortgage loans that enhance their financial security.

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<sup>2</sup> Lona Choi-Allum, "Protecting Older Investors: 2009 Free Lunch Seminar Report," AARP, Knowledge Management, November 2009.

Thank you for the opportunity to share AARP's views. I would be happy to answer any questions.





**HOW IMPORTANT IS ASSET ALLOCATION  
TO FINANCIAL SECURITY IN RETIREMENT?**

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**Abstract**

Financial advice tends to focus on financial assets, but other levers may be more important for most households. This paper proceeds in three stages. The first section reports a simple Excel spreadsheet exercise that provides a stylized example of the tradeoff between returns and time spent in the labor force. The second section uses data from the *Health and Retirement Study* (HRS) on pre-retirees aged 51-64 to see how the gap between retirement needs and retirement resources is affected by working longer, taking out a reverse mortgage, controlling spending, and shifting all assets to equities with no risk. The third section uses a simple dynamic programming model to calculate a risk-adjusted measure of the value for the average household of moving from a typical conservative portfolio to an optimal portfolio. The answer from all three exercises is the same: the focus on asset allocation is misplaced.

**Introduction**

The motivation for this paper is the concern that financial advice – the topic of this conference – tends to focus on financial assets, applying tools that give prominence to the asset allocation decision. But most people have little financial wealth, and financial tools are often silent on the levers that will have a much larger effect on retirement security for the majority of Americans. These levers include delaying retirement, tapping housing equity through a reverse mortgage, and controlling spending. Moreover, even for many with substantial assets, these non-financial levers may be as powerful as asset allocation in attaining retirement security.

This paper proceeds in three stages. The first section reports a simple Excel spreadsheet exercise that provides a stylized example of the tradeoff between returns and time spent in the labor force. The second section uses data from the *Health and Retirement Study* (HRS) on pre-retirees aged 51-64 to see how the gap between retirement needs and retirement resources is affected by working longer, taking out a reverse mortgage, controlling spending, and shifting all assets to equities with no risk. The third section uses a simple dynamic programming model to calculate a risk-adjusted measure of the value for the average household of moving from a typical conservative portfolio to an optimal portfolio.

The answer from all three exercises is the same. The focus on asset allocation is misplaced. Households have much more potent levers for achieving retirement security.

**A Simple Model**

This simple model estimates what percent of earnings individuals must save to ensure a financially secure retirement, depending on when they start saving, when they retire, and how they invest their retirement savings. It shows that the age at which one begins to save and the age at which one retires are pivotal decisions in determining the required saving rate and can make the difference between a secure or insecure retirement. These factors dominate the impact of asset allocation.

The exercise uses replacement rates – the ratio of retirement income to earnings before retirement – to gauge the extent to which older people can maintain their pre-retirement levels of

consumption once they stop working.<sup>1</sup> People clearly need less than their full pre-retirement earnings to maintain their standard of living once they stop working. First, they pay less tax. They no longer pay Social Security and Medicare payroll tax, and they pay lower federal income tax because – at most – only a portion of their Social Security benefits are taxable.<sup>2</sup> Second, they no longer need to save for retirement. Finally, most households pay off their mortgage before they retire, or soon thereafter.

The RETIRE Project at Georgia State University has been calculating required replacement rates for decades.<sup>3</sup> As of 2008, the Project estimated that households with earnings of \$50,000 and over needed about 80 percent of pre-retirement earnings to maintain the same level of consumption (see Table 1). Households earning less needed more, because they generally save very little for retirement and pay much less tax while working.

The amount that individuals would have to save to end up with an 80-percent replacement rate depends on a number of factors.

- Earnings level. The lower the earnings, the greater the portion provided by Social Security and the less that the individual would have to save on his own.
- Rate of return. The higher the rate of return, the lower the required saving rate.
- Age when savings begins. The earlier the individual starts saving, the lower the required rate for any given retirement age.
- Age of retirement. The later the individual retires, the lower the required saving rate.

The Social Security Trustees publish the percent of earnings that Social Security will replace at age 65 and at the eventual Full Retirement Age of 67 for low, medium, high, and

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<sup>1</sup> Technically, people are interested in smoothing marginal utility, not consumption. If additional leisure enables the household to attain the same marginal utility at lower levels of consumption, it may be optimal to accept lower consumption after retirement. This is one explanation for what the literature calls the 'retirement-consumption puzzle' – namely, the fact that consumption appears to drop as people retire. See Bernheim, Skinner and Weinberg (2001), Banks, Blundell and Tanner (1998), and Hurd and Rohwedder (2003).

<sup>2</sup> The taxation treatment of Social Security benefits is as follows. First, the household calculates its 'combined income.' Combined income is regular taxable income plus 50 percent of Social Security benefits. The taxable amount of Social Security benefits is the minimum of three tests: (1) 50 percent of combined income over the first threshold (\$25,000 for singles and \$32,000 for married couples) plus 35 percent of combined income over the second threshold (\$34,000 for singles and \$44,000 for married couples); (2) 50 percent of benefits plus 85 percent of combined income over the second threshold; or (3) 85 percent of benefits (Internal Revenue Service 2012).

<sup>3</sup> For an array of pre-retirement earnings levels, they calculate federal, state, and local income taxes and Social Security taxes before and after retirement. They also use the Bureau of Labor Statistics *Consumer Expenditure Survey* to estimate consumer savings and expenditures for different earnings levels. Further details are reported in Palmer (2008).

maximum earners (see Table 2).<sup>4</sup> Replacement rates for other ages from 62 to 70 were calculated using the appropriate actuarial adjustment for early retirement or delayed retirement credit for later retirement.<sup>5</sup> Subtracting Social Security's replacement rate from 80 percent determines the percent of earnings that must be replaced by individual savings.

The final issue is to determine the income drawn from retirement savings. The calculations assume the '4-percent rule.' That is, an individual who retires at age 65 annually withdraws 4 percent of savings attained in that year. Those who retire earlier would withdraw somewhat less and those who retire later somewhat more.<sup>6</sup> Another option would be to purchase an inflation-indexed annuity, which yields very similar results.

The required saving rate will depend on the real return earned on accumulated assets, when the individual begins saving, and when the individual retires.<sup>7</sup> The real rates of return are assumed to range from 1 percent to 7 percent; all individuals are assumed to be age 25 in 2010 and start saving at ages 25, 35, or 45, and retirement ages are assumed to range from 62 to 70.<sup>8</sup> A wage growth assumption of 1.2 percent above inflation is used.<sup>9</sup>

An example will illustrate. Consider an individual who is 25 in 2010, earns Social Security's medium earnings of \$43,000, and retires at the Full Retirement Age of 67 in 2052. Under current law, Social Security will replace 41 percent of this individual's final inflation-adjusted earnings of \$71,000; so the individual has to save enough to replace 39 percent (80 percent minus 41 percent), or about \$27,700. With the 4-percent rule, the individual needs just

<sup>4</sup> United States Social Security Administration (2008).

<sup>5</sup> The low earner has career average earnings equal to about 45 percent of the national average wage index (AWI). The medium earner has career average earnings equal to about 100 percent of the AWI. The high earner has career average earnings equal to about 160 percent of the AWI. The average wage index in 2010 was \$43,084 and maximum taxable earnings were \$106,800. Thus, the low-wage worker would earn \$19,388 and the high-wage worker would earn \$68,934.

<sup>6</sup> Bengen (1994) shows that households adopting this strategy and who invest in a mixed stock-bond portfolio face a relatively low risk of outliving their wealth. Although sub-optimal, we assume that the appropriate percentage drawdown rate is not affected by realized returns during the accumulation phase (i.e. that realized returns do not provide information about the distribution of prospective returns).

<sup>7</sup> As most saving in the United States is done through employer-sponsored plans – primarily 401(k)s – the required saving rate should be viewed as the combined employer-employee contribution rate.

<sup>8</sup> The calculation abstracts from investment risk; in reality, an expected 7-percent real return can only be earned at the cost of assuming very considerable risk. It also abstracts from the notion of optimal saving. Indeed, for households that are middle-aged and have yet to start saving for retirement, the optimal strategy will likely be not only to delay retirement but also to cut the target level of post-retirement consumption (Kotlikoff 2008).

<sup>9</sup> This assumption is used by the United States Social Security Administration (2011) for the economy as a whole. Individual workers may experience more rapid increases as they gain seniority in jobs. More rapid wage growth will increase the required saving rate, all else equal.

under \$660,000 in 2052. If the individual starts saving at 35 and earns a real return of 4 percent, he will need to save 18 percent of earnings each year.

The required saving rates for the medium earner, assuming a rate of return of 4 percent are presented in Table 3. Two messages stand out. First, starting to save at age 25, rather than age 45, cuts the required saving rate by about two thirds. Second, delaying retirement from age 62 to age 70 also reduces the required saving rate by about two thirds. As a result, the individual who starts at 25 and retires at 70 needs to save only 7 percent of earnings to achieve an 80-percent replacement rate at retirement, one tenth of the rate required of an individual who starts at 45 and retires at 62 – an impossible 65 percent.<sup>10</sup> But note that even that individual who starts at 45 has a plausible 18 percent required saving rate if he postpones retirement to age 70.

Retiring later is an extremely powerful lever for several reasons. First, because Social Security monthly benefits are actuarially adjusted, they are over 75 percent higher at age 70 than age 62. As a result, they replace a much larger share of pre-retirement earnings at later ages – 28.6 percent at 62 and 51.5 percent at 70 in our example – reducing the amount required from savings. Second, by postponing retirement people have additional years to contribute to their 401(k) and allow their balances to grow. Finally, a later retirement age means that people have fewer years to support themselves on their accumulated retirement assets. This simple model highlights the impact of delayed retirement on the required saving rates.

Up to now, the rate of return on assets has been held at 4 percent. Table 4 shows the impact of lower and higher rates of return for individuals who start at age 35. The 2-percent return is slightly less than the long-run rate of return on intermediate-term government bonds and the 6-percent return is slightly less than the long-run rate of return on large capitalization stocks.<sup>11</sup> While higher returns require smaller contribution rates, they also come with increased risk. Even ignoring risk, the required saving differentials are less than those associated with ages for starting to save and the age of retirement. In fact, an individual can offset the impact of a 2-percent return instead of a 6-percent return by retiring at 67 instead of 62.

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<sup>10</sup> A more sophisticated analysis would adjust the target replacement rate. That is, if an individual were indeed saving 48 percent of earnings, he would be living on 52 percent. The 80-percent target would no longer be appropriate.

<sup>11</sup> Ibbotson (2010) data show that, over the period 1926-2010, real stock returns have averaged 6.5 percent and the real return on the 10-year Treasury was 2.4 percent.

In summary, starting early and working longer are far more effective levers for gaining a secure retirement than earning a higher return. This strategy of saving for a longer period of time is especially effective given the greater risk that comes from attempting to earn that higher return. And the further along people are in their career, the more effective working a few years longer becomes. The next section moves from hypothetical individuals to examining the effects of alternative strategies on actual households in the HRS.

### **Retirement Income Targets and Resources for HRS Households**

The *Health and Retirement Study* (HRS) is a nationally representative panel of older American households, which began in 1992 by interviewing about 12,650 individuals from about 7,600 households ages 51-61 and their spouses (regardless of age).<sup>12</sup> The survey has been re-administered every two years since 1992. Over time, other cohorts have been added to the survey, substantially increasing the sample size. War Babies (born between 1942 and 1947) were added in 1998; Early Boomers (born between 1948 and 1953) were added in 2004; and Mid Boomers (born between 1954 and 1959) were added in 2010. Like the original sample, these three additional cohorts are interviewed every two years.

The sample for this analysis is derived by transforming the RAND HRS data into households and focusing on those households with a working head under age 65. All individuals who reported being single are defined as household heads. For couples, the male is identified as the head. In case of same sex couples, the higher earning spouse is the head or the older one if earnings were equivalent.

The sample is used in cross section, so households for which complete data are available may be observed repeatedly until they reach age 64. As a result, the sample begins with 21,423 observations of households with heads under age 65 at waves 5 to 9 of the HRS (2000 to 2008). From that total, 7,193 observations were dropped because the household head was not working and a further 1,604 observations were dropped because the data were incomplete or inconsistent.

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<sup>12</sup> The HRS is conducted by the Institute for Social Research (ISR) at the University of Michigan and is made possible by funding from the National Institute on Aging. More information is available at the ISR website: <http://hrsonline.isr.umich.edu/>.



These deletions produced a final sample of 12,626 observations.<sup>13</sup> Table 5 compares our sample with age-eligible households. The sample is of somewhat higher socioeconomic status than the population as a whole, because working households tend to have more education and better health than those not working.<sup>14</sup>

The goal is to create, for each household observation, target replacement rates and projected replacement rates for each age from 60 to 70. Once constructed, the levers can be applied to test their relative power in helping households achieve a secure retirement income.

### **Target Replacement Rates**

Once the sample is constructed, the next step is to calculate a target replacement rate that will enable the household, at each retirement age from 60 to 70, to maintain its current standard of living, covering both pre-retirement consumption and making any required mortgage payments.

#### *Consumption*

The original plan was to measure each household's current consumption using Consumption and Activities Mail Survey (CAMS) data and to impute consumption data for those households not participating in the CAMS. Initial tabulations, however, showed low-income households consuming substantially in excess of their income, while high-income households were spending implausibly small percentages of their income on consumption. An econometric model in which consumption was the dependent variable and income the explanatory variable produced implausibly small estimates of the marginal propensity to consume, even if one were to adjust for taxes and 401(k) contributions. So the initial plan was aborted in favor of using the replacement rates from Georgia State University's 2008 *RETIRE Project Report* discussed above.

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<sup>13</sup> The primary reason for dropping observations was that the head reported working, but having zero earnings. We retained the observation if the head reported that he was in the same job as in the previous wave, and reported non-zero earnings in the previous wave.

<sup>14</sup> Wealth levels are similar to those reported in Moore and Mitchell (2000), after making allowance for inflation.

*Mortgage payments*

CAMS is the only source of households' mortgage payments in the HRS. Although HRS households are asked about their mortgage balance outstanding, they are not asked about their remaining mortgage term. The remaining mortgage term was calculated from data on balances and annual payments assuming a 6-percent nominal interest rate, which approximates the average interest rate on a 30-year fixed mortgage during the survey period. The term was set to one year if the reported annual payment was greater than debt and to 30 years if the ratio of payments to outstanding balance was less than or equal to the interest, or if the term was greater than 30 years.

The next step was to estimate mortgage payments and mortgage term for people not included in CAMS. Again, an attempt was made to impute mortgage payments based on data for the CAMS subsample. Initial tabulations showed that the ratio of mortgage payments to debt was tightly clustered around the median of 0.12, implying a median remaining mortgage term of about 12 years. An econometric model, in which the ratio of mortgage payments to mortgage balance outstanding was the dependent variable and explanatory variables included house value, age, and socioeconomic characteristics, produced statistically insignificant coefficients. Therefore, the assumption was made that non-CAMS households all had a remaining term of 12 years.

*Income Targets*

Georgia State University's RETIRE Project provides four sets of retirement income replacement rates that vary by marital status, age, and labor force participation status. Each set of replacement rates is for incomes of \$20,000 to \$90,000 in increments of \$10,000. HRS households were assigned target replacement rates based on these factors. The assumption was that households were aiming to replace the relevant percentage of the average of the last 10 years' earnings.<sup>15</sup>

The RETIRE report does not explicitly model mortgage debt, so the targets need to be adjusted to reflect our projection that a significant proportion of the sample will have either repaid their mortgage by retirement or be able to repay all or part of the balance outstanding at

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<sup>15</sup> The 10-year period refers to the decade before the observation, not the 10 years prior to retirement.

that time by drawing on financial assets. The adjustment involved subtracting annual mortgage payments reported by respondents from their target retirement incomes, then adding annual mortgage payments multiplied by the ratio of remaining mortgage debt (mortgage debt less financial assets) to initial debt at retirement. The adjusted targets were calculated for each household observation for ages 60 through 70.

### **Projected Retirement Replacement Rates**

Armed with retirement income targets, the next step is to calculate the projected retirement replacement rate that the household will achieve if it continues on its present course, maintaining its current saving rate and asset allocation and not taking a reverse mortgage. Total income at retirement in this baseline scenario consists of Social Security, employer pensions, and income from financial assets.

#### *Social Security*

Projected Social Security benefits are calculated using the HRS Social Security earnings records, available to qualified researchers on a restricted basis. When the Social Security earnings records are not available, earnings histories were imputed using current earnings, earnings at the first HRS interview, and final earnings in previous job.<sup>16</sup> Wages between the age the household is observed and the retirement age are projected using Social Security's Average Wage Index (United States Social Security Administration 2011). The entire wage history is then indexed by the Average Wage Index, and the highest 35 years of indexed wages are used to calculate the Average Indexed Monthly Earnings (AIME). The benefit formula is then applied to the AIME to derive the individual's Primary Insurance Amount.

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<sup>16</sup> When the Social Security earnings records are not available, the procedure followed Gustman and Steinmeier (2001) and estimate earnings histories based on HRS data on previous jobs and wages, using the estimated returns to tenure from Anderson, Gustman, and Steinmeier (1999).

*Pension Income*

Pension income is based on the 1998 and 2004 HRS imputed data for employer-sponsored pension plan wealth in current jobs.<sup>17</sup> Households in waves 7 through 9 (2004, 2006, and 2008) were assigned pensions from the 2004 data set; households in waves 5 and 6 (2000 and 2002) from the 1998 data. The data sets differ slightly. The 2004 data set includes values for retirement ages 60, 62, 65 and 70. For the 1998 data set, pension values were available only for ages 60, 62, and 65. The 2004 data set discounts defined benefit pension wealth to the survey year, while the 1998 data set projects defined benefit wealth to the retirement age. The 1998 values are extrapolated to age 70 based on the average increase in retirement wealth from 65 to 70 in the 2004 data. For both data sets, values for ages 61, 63, 64, and 66 through 69 are interpolated based on the reported numbers.

Defined benefit pension wealth is converted into pension income using the interest and inflation rate assumptions embedded in the pension wealth calculations.<sup>18</sup> In the case of defined contribution pension wealth, the starting point is the account balance. Balances then grow as participants contribute 6 percent of salary, receive a 50-percent employer match, and earn a 4.6 percent real return until retirement. People who started their jobs after 1998 (waves 5 and 6) or 2004 (waves 7, 8 and 9) are assumed to receive no pension benefits on their new job. The conversion of defined contribution wealth to income is discussed in the next section on financial assets.

*Financial Assets*

Household financial wealth invested in stocks, bonds, and short-term deposits is assumed to earn returns of 6.5, 3.0 and 1.0 percent, respectively, from the date of the interview until retirement. These rates approximate the long-run average rates of return on each of the three asset classes. Importantly, these assumptions are used throughout for projecting asset returns rather than incorporating any actual fluctuations. The objective is to assess whether households

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<sup>17</sup> Participants in the HRS are asked about projected benefits from employer pensions. The HRS also obtains pension plan data from participants' employers. The HRS pension data collected from participants suffers from high levels of non-response and mis-reporting of pension type. We considered using data that the HRS has collected from respondents' employers. But these data are only available for about two thirds of participants.

<sup>18</sup> The interest rate assumption is irrelevant, provided that the same assumption is used to both calculate pension wealth from respondents' estimates of their pension income, and then recover pension income from pension wealth.

are on track to meet their replacement rate targets, not whether they actually succeeded in meeting them.

At retirement, the household is assumed to purchase a nominal joint or single life annuity with all its financial assets, including 401(k) and IRA balances. Currently, annuity rates are extremely low, reflecting depressed interest rates. The objective of this exercise is to calculate financial preparedness for retirement, given the beliefs of respondents at the date of the HRS interviews. Therefore, the assumed annuity rates are based on a 5.1 percent 10-year Treasury Bond interest rate, projected mortality improvements based on Social Security Administration cohort mortality tables, and current expense loads.<sup>19</sup> At this point, target and projected replacement rates are available for each household observation for ages 60 through 70.

#### **Applying the Levers**

The difference between the target replacement rates and projected replacement rates measures the extent to which each household's needs fall short of resources, and provides the baseline against which to assess the respective contributions of four possible interventions to bridge the gap. These interventions may not be utility maximizing; the best strategy may be to accept lower consumption, both now, and in retirement. But the objective is not to identify an optimal strategy, but to calculate the effectiveness of each of the interventions at bridging the gap between post-retirement needs and resources.

#### *Reverse Mortgage Income*

The first intervention is to have the household take out a reverse mortgage. Reverse mortgage income was calculated as follows. For homeowners without a mortgage, the household takes the maximum available loan, given the age of the younger spouse and the house value, and exercises the lifetime income option. The proceeds from that option are based on January 2012 interest rates and typical closing costs and expenses. For homeowners with a mortgage, the household uses its financial assets to clear its mortgage debt at retirement. If financial assets are insufficient to clear the mortgage, the household takes part of its reverse mortgage in the form of a lump sum, reducing the amount payable under the reverse mortgage

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<sup>19</sup> To simplify the calculations, the spouse is assumed to be the same age as the head of the household.

lifetime income option. These reverse mortgage calculations produced a new set of projected retirement income for those households who own a home.

#### *Delay Retirement*

The second intervention is to postpone retirement and the claiming of Social Security benefits. Postponing retirement gives the household the opportunity to make additional 401(k) contributions, earn additional returns on its investments, and increase its Social Security benefits, and also reduces the period that accumulated assets must finance. The baseline results provide the required information of the effect of later retirement on the gap because they present targets and projected replacement rates for each age.

#### *Asset Allocation*

For this portion of the project, the asset allocation exercise was simply to allow each household to invest all its assets in equities, earning a 6.5 percent real return, and face no costs associated with the increased risk. Investing 100 percent in 'riskless equities' will have an impact on both projected wealth at retirement and the amount that the household can consume during the course of retirement. The notion is that if asset allocation does not dominate the other levers with 'riskless equities,' it would never dominate.

#### *Control Spending*

The fourth intervention is to control spending, using the money saved to increase savings. This intervention has two effects. First, the additional 401(k) contributions increase the household's retirement wealth and retirement income. Second, it reduces post-retirement needs, by reducing the level of pre-retirement consumption that the household must maintain in retirement. For this exercise, the household increases its 401(k) contribution by five percentage points, which produces a commensurate decline in the replacement rate target.

#### *Results*

The results of the interventions for the sample as a whole are shown in Table 6. Under the base case, 74 percent of households fall short of their target at age 62. If households work to

age 67, Social Security's ultimate Full Retirement Age, that share drops to 46 percent. If households who own a home take out a reverse mortgage, the share falling short reaches 46 percent at age 65.5. If households cut their spending by five percentage points – thereby increasing their saving and lowering their targets – the percent at risk falls to 46 percent at age 66. If households invest 100 percent of their assets in 'riskless equities' from the date first observed until they retire, they reach the 46-percent figure six months earlier than the base case – at age 66.5. In other words, working six months longer – from 66.5 to 67 – produces the same outcome as having all assets invested in 'riskless equities.' As shown in the following section, taking risk into consideration shifts the balance in favor of working longer. The fact that asset allocation has only a minor impact is not surprising given that most households do not have significant financial wealth (see Table 7).

A second set of results focuses just on the top decile of the wealth distribution, which includes households with more than \$500,000 of financial wealth. Since these households are wealthier, a lower percentage of households fall short at 62 even in the base case – 39 percent for the top decile versus 74 percent for the population as a whole (see Table 8). If top-decile households worked to 67, the share falling short drops to 17 percent. If these households take out a reverse mortgage, the 17-percent threshold is reached at age 66. The relative impact of a reverse mortgage is smaller for the wealthy because their home is a much smaller component of their total wealth. If households control their spending, the percent at risk falls to 17 percent at age 66. Finally, investing all assets in 'riskless equities' allows the top decile to reach the 17-percent threshold at about 66.5. Thus, even for the top decile, asset allocation is not a particularly powerful lever.

### **Dynamic Modeling**

The final exercise uses dynamic programming techniques to calculate a risk-adjusted measure of the potential gain from portfolio rebalancing. The analysis focuses first on the typical household approaching retirement and then on a household that is typical of those in the top financial wealth decile.

The typical household is aged 57, has a household income of \$62,600 and financial wealth of \$60,500. The household's portfolio is held in tax-deferred accounts, and the portfolio

allocation is 36 percent in stocks, 16 percent in bonds, and 50 percent in cash.<sup>20</sup> The assumption is that stock returns are independent and identically distributed (i.i.d.) with a mean of 6.5 percent and a standard deviation of 20 percent, the average for the period 1926-2010. Bonds and short-term deposits are both assumed to be risk free, with real returns of 3 and 1 percent, respectively.<sup>21</sup>

Following Scholz, Seshadri, and Surachai (2006), earnings follow an autoregressive process of order one (AR(1)).<sup>22</sup> The retirement age is 66, and the household's 401(k) deferral is nine percent of salary. The household will receive Social Security benefits of \$20,800 a year, the median for this birth cohort.<sup>23</sup> Earnings before retirement are subject to federal income and payroll taxes, and withdrawals from tax-deferred accounts and Social Security benefits are subject to federal income taxation after retirement. Prior to retirement, the household's consumption equals labor market earnings, minus taxes and 401(k) deferrals.

The first step is to calculate an optimal decumulation of financial assets in retirement from the typical portfolio allocation described above. For this calculation, the household is assumed to have a constant relative risk aversion utility function over consumption in excess of the federal poverty guideline. The household has a coefficient of relative risk aversion (CRRA) of 5 or 2 and population average mortality for the 1950 birth cohort.<sup>24</sup> The rate of time preference is assumed to be 3 percent.

The second step is to have the household switch from the typical portfolio described above to an optimal portfolio, which varies with age. The goal is to calculate the dollar amount

<sup>20</sup> Introducing both taxable and tax-deferred accounts and allowing households to choose the order in which the household draws on these accounts would greatly complicate the model without yielding any important insights.

<sup>21</sup> In a single period model, both stocks and bonds carry risk. Campbell and Viceira (2002) argue that over a long time horizon, bonds, and in particular, Treasury Inflation Protected Securities are the true risk-free asset, because they guarantee return on capital. If a long-term investor knew his consumption requirements with certainty, he could fund them by buying a portfolio of bonds of appropriate maturities. We therefore assume that corporate bonds yield a fixed three percent return, approximating the yield on corporate bonds, after deducting anticipated inflation. Our assumed real rate of return is considerably in excess of the current negative real interest rates, reflecting an assumption that short-term interest rates will eventually revert to more normal levels.

<sup>22</sup> An alternative would be to assume that the household experiences both permanent and transitory wage shocks, as in Chai, Horneff, Maurer, and Mitchell (2011).

<sup>23</sup> Given our assumption of labor income uncertainty, the household also faces some small level of uncertainty as to the amount of its Social Security benefits.

<sup>24</sup> Estimates of coefficients of risk aversion in the academic literature range between 2 and 10, depending in part on whether the estimates are derived from portfolio theory, purchases of insurance, economic experiments, or preferences over lotteries (Chetty 2003).



by which the wealth of the household retaining the typical portfolio must be increased, so that the household is as well-off in expected utility terms as when it adopts the optimal allocation.

The third step is to have the household switch from the typical portfolio to one invested entirely in stocks and calculate the dollar amount, if any, by which the current wealth of a household retaining the typical portfolio must be increased, so that it is as well off in expected utility terms as when it switches to a portfolio invested exclusively in stocks.

The results for the typical household for two levels of risk aversion are reported in the upper panel of Table 9. One piece of information that helps provide some intuition behind the findings is that a large portion of the total wealth of the typical household is the present discounted value of future Social Security benefits. Since Social Security wealth is a bond-like asset, under the assumption of CRRA utility, the optimal allocation for these households involves a large share of financial wealth invested in equities (see Table 10).

Assuming a CRRA of 5, the amount required to compensate the household for retaining a typical portfolio (where 36 percent of assets are invested in equities), rather than switching to an optimal portfolio allocation (where 51 percent of assets are invested in equities), is \$5,600, or approximately the additional amount the household would earn if it delayed retirement by one month. In contrast, when the comparison is between a typical portfolio and an all-stock portfolio, the household is better off retaining the typical portfolio by approximately \$3,600, or under one month's salary. That is, an all-stock portfolio is even more sub-optimal than the typical conservative portfolio. The key message, however, is that the dollar amounts are small, suggesting that asset allocation is relatively unimportant for the typical risk-averse household. Even if the household is less risk averse (CRRA equals 2), the story is similar. In this case, as shown in Table 10, the optimal portfolio is all in stocks. The cost of retaining a typical portfolio (57 percent in equities), rather than switching to an optimal portfolio (100 percent in equities), is \$25,700, or just over four months' salary. As the optimal portfolio is 100 percent in equities, the cost of retaining a typical portfolio relative to an all-stock portfolio is also \$25,700. In short, regardless of the degree of risk aversion, asset allocation is relatively unimportant for the typical household.

The lower panel of Table 9 reports results for the household in the top decile of financial wealth. This household has income of \$137,800 and financial assets of \$889,000, 57 percent in

stocks, 22 percent in bonds, and 21 percent in short-term deposits. Because Social Security wealth is a much smaller share of the wealth of this household, the optimal equity holdings are lower than for the typical household (see Table 10). If the household has a CRRA of 5, the cost of retaining a typical portfolio (36 percent in equities), rather than switching to an optimal portfolio (29 percent in equities), is \$87,000. Again, as in the example of the typical household, the top-decile household is *better off* retaining a typical portfolio rather than switching to an all-stock portfolio; the benefit is \$302,700. The comparable amounts for a household with a CRRA of 2 are a cost of \$20,000 and a benefit of \$11,100. Although the amounts required as compensation are larger for the top-decile household than for the typical household, with the exception of imposing an all-stock portfolio they are still small relative to working longer.

### **Conclusion**

Financial planning tools frequently highlight the asset allocation decision, suggesting that individuals have a lot to gain by adopting a more optimal allocation of stocks and bonds. In contrast, they are often silent on the benefits of other options, such as delaying retirement, controlling spending, or taking out a reverse mortgage. Strikingly, the typical 401(k)/IRA balance of households approaching retirement is less than \$100,000, which suggests that the net benefits of portfolio reallocation have to be modest for the typical household. Although it is possible that higher income households have more to gain.

A simple Excel exercise aimed at determining the required saving rates for individuals with different starting ages, ending ages, and asset returns showed that the difference between earning a real return of 2 percent instead of 6 percent could be offset by working five years longer. This finding suggests a minor role for asset allocation in creating a secure retirement.

The second piece of analysis moved from hypothetical individuals to examining the effects of alternative strategies on actual households in the HRS. The exercise consisted of estimating target and projected replacement rates for each household for ages 60 through 70. The metric of interest was the percent of households falling short. The baseline results showed that working longer substantially reduced that metric. Three other levers were evaluated against working longer – tapping home equity through a reverse mortgage, controlling spending, and investing 100 percent in ‘riskless equities.’ The results showed that, for the typical household,

asset allocation was unimportant. The importance of asset allocation was somewhat greater for households in the top decile, but less than one would expect.

Since the second exercise abstracted from risk, the third exercise used dynamic programming techniques to calculate a risk-adjusted measure of the potential gain from portfolio rebalancing for both the typical household and the household in the top 10 percent of the financial wealth distribution. In all but one case, the dollar amount of the cost or benefit was equal to only a few additional months of work. In other words, asset allocation was not important.

Given the relative unimportance of asset allocations, financial advisers will be of greater help to their clients if they focus on a broad array of tools – including working longer, controlling spending, and taking out a reverse mortgage.

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Table 1. *Percent of Pre-Retirement Salary Required to Maintain Living Standards, 2008*

Pre-retirement earnings	Two-earner couples	Single workers
\$20,000	94%	88%
\$50,000	81	80
\$90,000	78	81

Source: Palmer (2008).

Table 2. *Current Law Social Security Replacement Rates, 2030 and Later*

Earnings level	Age	
	67	65
Low	55.2%	48.9%
Medium	40.9	36.3
High	33.9	30.0
Maximum	27.2	23.9

Source: Social Security Administration (2010): Table F10.

Table 3. *Saving Rate Required for a Medium Earner to Attain an 80-Percent Replacement Rate with a 4-Percent Rate of Return*

Retire at:	Start saving at:		
	25	35	45
62	22%	35%	65%
65	15	24	41
67	12	18	31
70	7	11	18

Source: Authors' calculations.

Table 4. *Saving Rate Required for a Medium Earner to Attain an 80-Percent Replacement Rate with a Starting Age of 35, by Rate of Return*

Retire at:	Real rate of return		
	2 percent	4 percent	6 percent
62	46%	35%	26%
65	32	24	17
67	26	18	13
70	16	11	7

Source: Authors' calculations.

Table 5. *Comparison of Workers with All HRS Households Under Age 65*

	Working (our sample)	All
Age	56.9 ***	57.4
Married couple	0.644 ***	0.605
Ethnicity:		
Black	0.098 ***	0.120
Hispanic	0.078 ***	0.085
Education:		
Less than high school	0.094 ***	0.143
Some college	0.602 ***	0.542
Home owner	0.838 ***	0.796
Median house value (home owners only)	\$180,000 ***	\$171,000
Has mortgage	0.546 ***	0.468
Median mortgage balance (households with mortgages only)	\$89,750 **	\$85,500
Pension:		
DB or both	0.286 ***	0.096
DC	0.277 ***	0.134
Earnings:		
Median	\$62,600	\$36,300
75 <sup>th</sup> percentile	\$103,800	\$77,500
Financial assets:		
Median	\$60,500 ***	\$34,000
75 <sup>th</sup> percentile	\$223,000 ***	\$174,000
Sample	12626	21423

Notes: HRS sample weights. \*\* and \*\*\* denote that the values are significantly different at the 5% and 1% level, adjusted for household level clustering.

Source: Authors' tabulations from the HRS.



Table 6. *Percent of Households Falling Short of Target, Full Sample*

Lever	Age										
	60	61	62	63	64	65	66	67	68	69	70
Base case	89.7	89.0	74.0	69.9	65.0	58.5	52.7	46.5	40.4	33.9	28.0
With reverse mortgage	89.7	89.0	67.2	61.8	55.2	48.2	42.1	35.9	30.4	25.3	20.4
Control spending	88.8	88.0	71.2	66.6	60.5	53.3	47.4	40.9	34.7	28.4	22.5
All 'riskless equities'	89.4	88.5	73.1	68.9	63.3	56.7	50.5	44.1	37.6	31.2	25.3

Source: Authors' estimates.

Table 7. *Wealth by Wealth Deciles, 2008 Dollars*

Wealth	Financial wealth	
	Min	Max
Decile 1	0	400
Decile 2	419	3,989
Decile 3	4,000	13,678
Decile 4	13,679	32,039
Decile 5	32,039	60,482
Decile 6	60,515	103,593
Decile 7	103,593	168,686
Decile 8	168,748	298,240
Decile 9	298,620	554,000
Decile 10	554,115	--

Source: Authors' tabulations from the HRS.

Table 8. *Percent of Households Falling Short of Target, Top Wealth Decile*

Lever	Age											
	60	61	62	63	64	65	66	67	68	69	70	
Base case	56.6	54.6	38.8	34.4	29.5	24.5	20.1	17.3	14.4	11.4	8.4	
With reverse mortgage	56.6	54.6	37.3	31.6	26.0	20.6	17.1	14.5	11.4	8.7	5.8	
Control spending	54.4	51.7	36.1	30.8	25.6	20.1	17.8	14.1	11.3	8.1	5.1	
All 'riskless equities'	56.2	53.4	37.4	32.9	26.4	21.6	18.7	13.6	10.0	7.0	4.0	

Source: Authors' estimates.

Table 9. *Amount Required as Compensation for Retaining Typical Portfolio Allocation, 2008 Dollars*

Household type and risk aversion	Retaining typical portfolio rather than switching to optimal portfolio	Retaining typical portfolio rather than switching to all-stock portfolio
Typical household		
CRRA = 5	\$5,600	-\$3,600
CRRA = 2	25,700	25,700
Top decile household		
CRRA = 5	\$87,000	-\$302,700
CRRA = 2	20,000	-11,100

Source: Authors' calculations.

Table 10. *Typical and Optimal Portfolio Allocations, Percentage*

Household type and risk aversion	
Typical household	
Typical stock allocation	36%
Optimal stock allocation - CRRA = 5	51
Optimal stock allocation - CRRA = 2	100
Top decile household	
Typical stock allocation	57%
Optimal stock allocation - CRRA = 5	29
Optimal stock allocation - CRRA = 2	70

Note: Optimal stock allocations are calculated at age 65.  
Source: Authors' calculations.

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## Laguna Woods Village

May 7, 2012

Congressman Gary Miller  
1800 E. Lambert Road  
Suite 150  
Brea, CA 92821

Dear Congressman Miller,

It is my understanding that On May 9 at 2:00, the House Financial Services Subcommittee on Housing is holding a hearing to examine the Federal Housing Administration's reverse mortgage insurance program. This program impacts the 6,413 condominium units and 6,323 stock cooperative units in Laguna Woods Village. None of our housing corporations can obtain FHA project certifications, thereby keeping our seniors out of the reverse mortgage market. In addition, our stock cooperatives have not had access to HUD backed reverse mortgages due to a glitch in language that was included in HR 3221 - The Housing and Economic Recovery Act of 2008, and was signed by the President on July 30, 2008.

FHA has not made any major announcements to its condominium project approval guidelines since the release of Mortgagee Letter 2011-22 on June 30 2011. It is our understanding that it was anticipated that FHA will release proposed changes to guidelines in Spring 2012 and will be accepting public comment as requested by CAI.

Primary FHA issues in summary:

- FHA has not made significant modifications to its condominium project approval guidelines since publication of Mortgagee Letter.
- FHA continues to work on a proposed rule to provide a formal regulatory basis for the condo program, but has made no significant progress.
- FHA has modified its interpretation of fidelity bond purchase requirements per the ML 2011-22 confirming that an association's fidelity insurance policy naming the Management company satisfies the fidelity insurance requirement.
- FHA project certification requirements have had a significantly negative impact on the number of condominiums (50% decrease from 2010 to 2012) mortgages insured by FHA.
- FHA has announced a regulatory review of its HECM program and we are still waiting incorporating the required changes into the FHA guidelines and finalizing the mortgage letter required to give our stock cooperative access to reverse mortgages.
- Communities with income restrictions are not eligible for Project approval because of an FHA rule requiring no "legal restrictions on conveyance" of property. We have income requirements due to the size of our assessments, which are all inclusive of items such as cable, water, etc). It is my understanding that there are preliminary discussions to include ability to pay HOA assessments in future FHA and conventional mortgage loans.

I am sending this correspondence in anticipation that this information may be helpful to you for the House Financial Services Subcommittee on Housing hearing on Wednesday. Please contact me if you have any questions or require further info.

LAGUNA WOODS VILLAGE COMMUNITY CENTER  
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Sincerely,

Wendy Bucknum  
Governmental & Public Affairs Manager

Cc: Scott Canady, Tambala Strategy/Community Associations Institute



## Reversing the Conventional Wisdom: Using Home Equity to Supplement Retirement Income

by Barry H. Sacks, J.D., Ph.D., and Stephen R. Sacks, Ph.D.

*Barry H. Sacks, J.D., Ph.D., is a practicing tax attorney in San Francisco, California. He has specialized in pension-related legal matters since 1973 and has published numerous articles in legal journals. Stephen R. Sacks, Ph.D., is professor emeritus of economics at the University of Connecticut. He maintains an economics consulting practice in New York and has published articles on operations research.*

### Executive Summary

- This paper examines three strategies for using home equity, in the form of a reverse mortgage credit line, to increase the safe maximum initial rate of retirement income withdrawals.
- These strategies are: (1) the conventional, passive strategy of using the reverse mortgage as a last resort after exhausting the securities portfolio; and two active strategies: (2) a coordinated strategy under which the credit line is drawn upon according to an algorithm designed to maximize portfolio recovery after negative investment returns, and (3) drawing upon the reverse mortgage credit line first, until exhausted.
- A three-spreadsheet stochastic model is described, with one spreadsheet incorporating each strategy. The three spreadsheets are run simultaneously, with the same investment performance and withdrawal amounts in each. The cash flow survival probability over 30 years is determined for each strategy, and the comparisons are presented graphically for a range of initial withdrawal rates. We find substantial increases in the cash flow survival probability when the active strategies are used as compared with the results when the conventional strategy is used. For example, the 30-year cash flow survival probability for an initial withdrawal rate of 6 percent is only 55 percent when the conventional strategy is used, but is close to 90 percent when the coordinated strategy is used.
- The model also shows that the retiree's residual net worth (portfolio plus home equity) after 30 years is about twice as likely to be greater when an active strategy is used than when the conventional strategy is used.

The overriding objective for many retirees is to maintain cash flow throughout their retirement years, to avoid "running out of money" in their later years. Cash flow survival is the central theme of this article.

Although more than half of retirees age 65 and older (64 percent) get at least half of their retirement income from Social Security,<sup>1</sup> there is a significant portion of the population of retirees whose primary source of retirement income is a portfolio of securities, often in a pre-tax account such as a 401(k) plan or a rollover individual retirement account (IRA). We will refer to any such account, whether pre-tax or after-tax, as an "account."<sup>2</sup>

It has long been accepted that the maximum safe (or "safemax") annual withdrawal from an account begins with a first year's withdrawal equal to between 4.0 percent and 4.25 percent of the initial portfolio value. Subsequent years' withdrawals then continue at the same dollar amount each year, adjusted only for inflation (thus maintaining constant purchasing power). In this context, the term "safe" means a 90 percent or greater probability that the account will have sufficient assets to make such annual payments for at least 30 years.<sup>3</sup>

Many retirees find that the safemax amount of annual withdrawal is uncomfortably limiting and therefore tend to draw more than that amount. This article considers three strategies for coping with the economic risk, the risk of exhausting cash flow, that derives from taking withdrawals in excess of the safemax amount.

The three strategies considered all involve the use of home equity as a supplement to withdrawals from the account. The conventional wisdom holds that home equity, drawn upon in the form of a reverse mortgage (discussed below) or similar product,<sup>4</sup> should be used as a last resort, only if and when the account is exhausted.<sup>5</sup> This is a rather passive approach. We show that the probability of cash flow survival is substantially enhanced by reversing the conventional wisdom. In particular, we show that cash flow drawn from home equity using either of two more "active strategies," in conjunction with withdrawals from the account, yields cash flow survival probability *substantially greater* than the more passive approach of using home equity as the last resort (the "conventional strategy").

One of the active strategies is quite simple: a straightforward reversal of the conventional wisdom. In this strategy, a reverse mortgage credit line is established at the outset of retirement, and the credit line is drawn upon every year to provide the retirement income until it is exhausted. Only after the reverse mortgage credit line is exhausted are withdrawals taken from the account. This is the "reverse-mortgage-first strategy."

The other active strategy is more sophisticated. It also uses a reverse mortgage credit line, but withdrawals from the credit line are taken in some years and not others. The withdrawals are taken according to an algorithm described later in this paper. Because the algorithm consists of coordination between the account and the line of credit, this strategy is termed the "coordinated strategy."

### Some Fundamental Considerations

Before we examine the effect of these strategies, it is important to emphasize that a reverse mortgage is not necessarily a useful vehicle for every retiree who has substantial home equity. A retiree whose primary source of retirement income is a securities portfolio and who also has substantial home equity must decide early in retirement whether to live within the safemax limit set by his or her portfolio. This decision is a fundamental component of overall retirement planning.

The decision process includes, among other things, the balance between the desired consumption level, on the one hand, and the bequest motive and/or the economic safety net of the home equity, on the other hand. The decision process also must take into account the degree of economic discipline required to live within the safemax limit.

If the retiree *does* conclude that he or she would, on balance, prefer to live beyond the safemax level and wants to remain in his or her home as long as possible, a reverse mortgage, including its substantial costs, is one tool to consider. Although the costs do not affect the retiree's cash flow, they become part of the debt, along with the cash drawn and interest accrued, to significantly reduce the equity remaining when the retiree ultimately leaves the home.

The thrust of this article is not whether a retiree *should* take a reverse mortgage. Rather, if the retiree has determined to live beyond the safemax level of the portfolio *and* consequently needs to rely on home equity for cash flow to supplement the cash from the portfolio, this paper shows how the active strategies provide substantially greater long-term cash flow survival probability than the passive conventional strategy.

### The Rationales for the Two Active Strategies

In the cases in which withdrawals from a securities portfolio lead to exhaustion of the portfolio, it is most often because the investment performance in the *early years* of withdrawal has been weak or negative. Thus, the losses or even the weak gains in the early "down" years, coupled with the withdrawals in those years, lead to the portfolio's not having enough assets to recover in the later "up" years. The two active strategies are designed to offset that situation by either: (1) allowing the portfolio to grow by *taking no withdrawals* from it during any of the early years of retirement until the reverse mortgage credit line is exhausted (the reverse-mortgage-first strategy); or (2) allowing the portfolio to grow during the early years of retirement by taking no withdrawals from it only in those early years that follow years in which the portfolio's performance was negative (the coordinated strategy).

**Rationale for the Reverse-Mortgage-First Strategy.** The reverse-mortgage-first strategy allows the account to grow during the early years of retirement. Generally, over the years that the reverse mortgage credit line is drawn upon and exhausted, the portfolio will grow at an average rate greater than inflation. Therefore, in the year following the one in which the reverse mortgage credit line is exhausted, the withdrawal will be a smaller percentage of the portfolio than the initial withdrawal would have been at the outset of retirement. Furthermore, by that time, the retiree's life expectancy is less than it was at the outset of retirement. These two factors together favor the lifetime cash flow survival of the portfolio.

**Rationale for the Coordinated Strategy.** The coordinated strategy is based on the following algorithm: at the end of each year, the investment performance of the account during that year is determined; if the performance was positive, the next year's income withdrawal is from the account, and if the performance was negative, the next year's income withdrawal is from the reverse mortgage credit line.<sup>6</sup> In this way, the account is spared any drain (resulting from withdrawal) when it is "down" because of its investment performance. This leaves the account more assets to "recover" in subsequent "up" years. This is done when most necessary—in the early years of retirement, so the account grows before the reverse mortgage credit line is exhausted.<sup>7</sup>



It is not obvious whether the cash flow would survive just as long, or longer, under the reverse-mortgage-last strategy as under either of the active strategies. The only way to compare the results of the three strategies is with a quantitative test.

### The Analytic Technique

To compare the two active strategies with the reverse-mortgage-last strategy, we have constructed a spreadsheet model. The model has the following input parameters:

1. The initial value of the retiree's account
2. The value of the retiree's home (we assume that the home is not encumbered by any mortgage debt)
3. The initial withdrawal rate as a percentage of the account value

The model uses three worksheets run simultaneously. The three worksheets are identical in all respects (including the investment performance of the account, the rate of inflation, and the amount drawn by the retiree) *except* for the *strategy* used to determine whether retirement income is withdrawn from the account and/or the reverse mortgage credit line.

On each worksheet, the calculations of investment gain or loss, and of retirement income withdrawal, are performed for each year in a 30-year period. The investment gain or loss is determined stochastically, as is the inflation adjustment to the withdrawal amount.<sup>8</sup> In the course of the calculations, the cash flow either survives or it does not survive. It survives if there is enough money from the account and/or the reverse mortgage credit line to make the required income withdrawals for all 30 years.

The 30-year calculation is repeated 1,000 times. In a certain number of those repetitions, the cash flow will survive for 30 years, and in the other repetitions it will not. (As noted above, the two most significant determinants of cash flow survival are the initial withdrawal rate and whether the higher investment earning years occur early or late in the 30-year sequence.) In each of the 1,000 repetitions, the initial withdrawal rate is the same, and the average investment return is the same, but the sequence of investment returns, being randomly selected, is not the same in each repetition of the calculation. A simple count is made of cash flow survival over the 1,000 trials (with the three worksheets run simultaneously in each trial and results of the 1,000 trials shown on a histogram for each worksheet). The percentage of the repetitions in which the cash flow survives is termed the "cash flow survival probability."<sup>9</sup>

Our primary focus is on the *comparison* of the cash flow survival probabilities of the three strategies. A secondary focus is on the comparison among the three strategies of the retiree's residual net worth at the end of 30 years.

### The Portfolio

The securities portfolio held by the account, in all the analyses and results shown, is a 60/40 portfolio comprised of the following indices, in the following proportions:

- Equities (60 percent): S&P 500, 40 percent; CRSP 6-10, 10 percent; and MSCI EAFE, 10 percent
- Fixed Income (40 percent): Bar Cap Int.-Term Gov't./Credit Bond Index, 15 percent; U.S. 1 Year Const. Maturity, 15 percent; Bar Cap Long-Term Gov't./Credit Bond Index, 10 percent

In our Monte Carlo simulations, we used investment return data on these indices from the 37-year period from 1973 through 2009. This captured several periods of significant volatility in the securities markets, including the most recent decline in 2008. Although this inclusion may be excessively pessimistic, we feel that failure to include it would be unrealistically optimistic.

We assumed a normal distribution of the investment returns from each asset class. The geometric means and standard deviations derived from the annual performance of each asset class over the 37-year period are set out in Appendix A. Also, a correlation matrix from the asset classes' annual investment performances over that period was constructed and incorporated into the simulation program.

Because the portfolio composition was the same in each of the 30 years of each trial, the portfolio was, in effect, rebalanced each year.

We repeated all the calculations and analyses, but with a 70/30 asset allocation in the portfolio, and with an 80/20 asset allocation. The results were essentially the same. This finding is consistent with Bengen's observation that "for a wide range of stock allocations—between 40 percent and 70 percent—the *safemax* is virtually constant."<sup>10</sup>

We also repeated all the calculations and analyses, but using the investment return data for the same indices from the 32-year period of 1973 through 2004 instead of the 37-year period from 1973 through 2009. The geometric mean value of the return of each index for the 32-year period is higher than for the 37-year period; that is not surprising, because the 32-year period did not include the significant decline of 2008 and its aftermath. (The mean values and the standard deviation values of the returns for the 32-year period are set out in Appendix B.) Some results of using these higher investment returns are shown later in the paper.

### The Reverse Mortgage

Reverse mortgages come in several forms, each with its own set of features and parameters.<sup>11</sup> The basic feature for the strategies we explore is the reverse mortgage credit line. The credit line is available as a feature of the home equity conversion mortgage (HECM), with the largest credit line coming from the "standard" HECM. Therefore, we use the reverse mortgage parameters of the standard HECM. The parameters most directly relevant to cash flow considerations are the home value limit and the "expected rate."

The home value limit is the maximum home value that can be considered in determining the amount of loan (or line of credit) available. Since 2009 it has been set at \$625,500. Although it had been anticipated to revert to its 2008 value of \$417,000 on January 1, 2012, the current figure has now been extended at least through December 31, 2012.<sup>12</sup>

HUD uses the expected rate to determine factors (called "principal limit factors") that multiply the home value (or home value limit) to calculate the amount of the loan (or line of credit) available as a function of the borrower's age.<sup>13</sup> We use the expected rate only once in each 30-year simulation trial, at the time the loan (or line of credit) is established. It is equal to the 10-year constant maturity U.S. Treasury rate.<sup>14</sup> The lower the expected rate and the older the borrower, the greater the amount of credit available. We ran our simulations using the "mean expected rate" and the "current expected rate." The mean expected rate is the geometric mean of the 10-year constant maturity Treasury rates for the period from which the investment return data is taken. (The mean rate for the 37-year period is 6.9 percent and the mean rate for the 32-year period is 7.5 percent.) Using mean rates has the advantage of internal consistency. The current expected rate, in effect in December 2011, is 5 percent (because it is defined as the greater of 5 percent or the actual rate). Although this figure is not from the same period as the investment return data, its use has the advantage of more realistically reflecting the amounts available currently and likely to be available during the next several years.

Table 1 sets out the range of approximate amounts available under each expected rate used in this paper, for ages 65 through 90. These figures are for home values equal to the pre-2009 HECM limit of \$417,000 or greater. For home values greater or less than this limit, the available credit line amounts are essentially proportional. Thus, a home worth \$300,000 would give rise to a credit line amount equal to about  $300/417 = 72$  percent of the amount set out in Table 1. Likewise, a home worth \$600,000 would give rise to a credit line equal to about  $600/417 = 144$  percent of the amount set out in Table 1. When interest rates are higher, and hence amounts of credit available are lower, the effect on our calculations would be the same as lowering the home value, as described later in the paper.

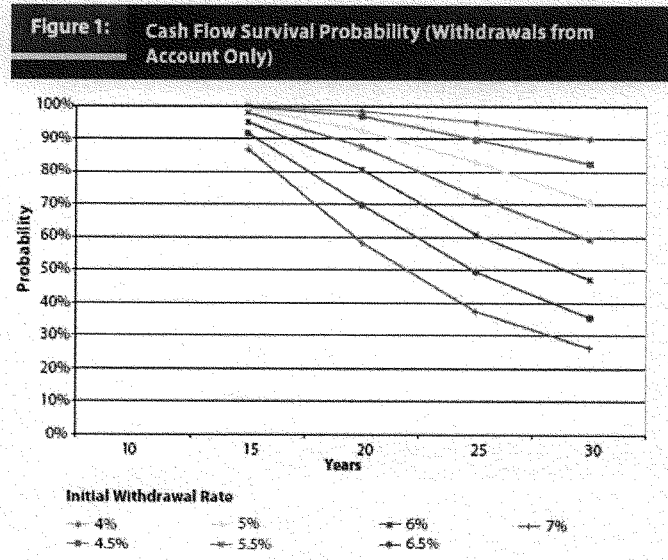
	<b>At Current Expected Rate</b>	<b>At 37-year Mean Expected Rate</b>	<b>At 32-year Mean Expected Rate</b>
Age 65	\$266,000	\$183,000	\$163,000
Age 90	\$324,000	\$277,000	\$264,000

### Results

The essential result shown by our analysis is the substantial increase in cash flow survival probabilities that comes from reversing the conventional wisdom. This result holds true across a wide range of portfolio asset allocations, of home value to account value ratios, and of expected rates, and both with and without the use of safeguards similar to those described by Guyton (2004).

To best illustrate these results, we choose a specific example, described below. The results are a set of figures showing the cash flow survival probability for a range of 15 years to 30 years, under the set of assumptions described. There is a figure for each of three initial withdrawal rates, 5.0 percent, 6.0 percent, and 6.5 percent. The results in this example are indicative of both the qualitative and quantitative results of using a wide range of assumptions.

Before examining the results of the three strategies of using the reverse mortgage credit line, we first consider the results when the reverse mortgage credit line is not used at all. When the account is the only source of the retiree's income, cash flow is not likely to survive very long if the initial withdrawal rate is much above the safe-max level of 4 percent of the initial account value. Figure 1 shows the probabilities of cash flow survival for a range of initial withdrawal rates from 4 percent to 7 percent of the initial account value.



It is clear from Figure 1 that the probability of cash flow survival for 30 years falls below 90 percent when the initial withdrawal rate is 4.5 percent or more. Similarly, the probability of cash flow survival for 25 years falls below 90 percent when the initial withdrawal rate is 5 percent or more. At initial withdrawal rates of 5.5 percent or more, the cash flow survival probabilities fall to levels that should generate serious concern for the retirees whose life expectancies are greater than 25 years.

**Results When the Reverse Mortgage Credit Line Is Added.** We now illustrate the cash flow survival probabilities when the reverse mortgage credit line is used in addition to the account, in all three strategies. The illustrative example uses the following input data:

1. The initial account value is \$800,000.<sup>15</sup>
2. The home value is equal to the pre-2009 HECM limit of \$417,000. (We are not aware of any reverse mortgages currently available that provide loans based on home values higher than the HECM limit and provide the loans in the form of a credit line.)
3. The initial withdrawal rate is the primary variable used in our comparison of the three withdrawal strategies. We show results for initial withdrawal rates of 5.0 percent, 6.0 percent, and 6.5 percent.

In this example, we assume the retiree is age 65, and the resulting credit line available is approximately \$266,000 in the initial year at the current expected rate and approximately \$183,000 at the 37-year mean expected rate. In both the reverse-mortgage-last strategy and the coordinated strategy, the reverse mortgage credit line is established later in the 30-year sequence, so the amount available is greater.

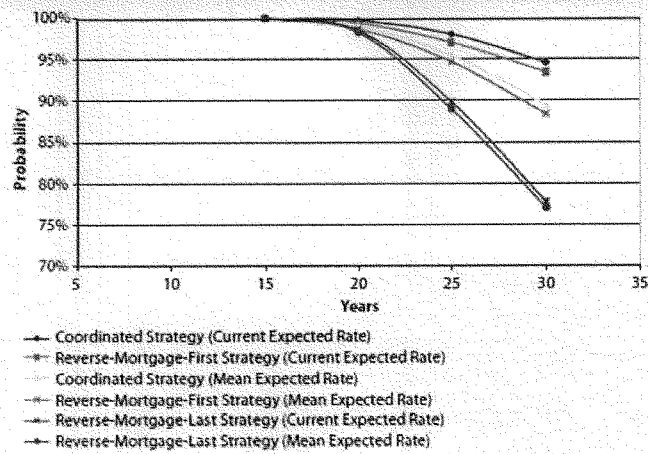
In considering this example, it is important to note that the home value used to determine the reverse mortgage amount is approximately equal to 52 percent of the account value. If the home value were lower, or the account value were higher, the ratio of home value to account value would be lower; as a result, the effect of the reverse mortgage credit line on the probability of cash flow survival would also be lower. We show below a quantitative measure of the impact on our results of the ratio of home value to account value, both above and below this 52 percent ratio.

**Results from Withdrawals Near the SafeMax Rate.** Because the probability of cash flow survival for 30 years with initial withdrawal rates in the range of 4 percent to 4.5 percent is near 90 percent even without the use of the reverse mortgage, the use of the reverse mortgage credit line makes little difference. That is true irrespective of which of the three withdrawal strategies is used.

**Results with a 5 Percent Initial Withdrawal Rate.** The first initial withdrawal rate we examine, as we compare the three withdrawal strategies, is 5.0 percent. This initial withdrawal rate yields a significant increase in the annual withdrawal amounts over the safemax rate. In dollar terms, with an \$800,000 initial account value, it reflects an \$8,000 increase in initial annual withdrawal over the safemax amount. In percentage terms, it is an increase of 25 percent over the 4.0 percent safemax rate.

Figure 2 shows the probability of cash flow survival for the three withdrawal strategies, with a 5.0 percent initial withdrawal rate, for periods from 15 years to 30 years. It is clear from Figure 2 that, with a 5 percent initial withdrawal rate, the coordinated strategy and the reverse-mortgage-first strategy both result in cash flow survival probabilities significantly greater than the result of using the reverse-mortgage-last strategy. This is true with both the current expected rate and the mean expected rate. Specifically, the 30-year cash flow survival probability for both of the active strategies is approximately 95 percent with the current expected rate and approximately 90 percent with the mean expected rate. The cash flow survival probability for the reverse-mortgage-last strategy is less than 80 percent with both expected rates. Thus, the active and passive strategies result in a difference in the cash flow survival probabilities of 10 to 15 percentage points.

**Figure 2: Probability of Cash Flow Survival (5% Initial Withdrawal Rate) for Three Reverse Mortgage Credit Line Strategies, Current and Mean Expected Rates**

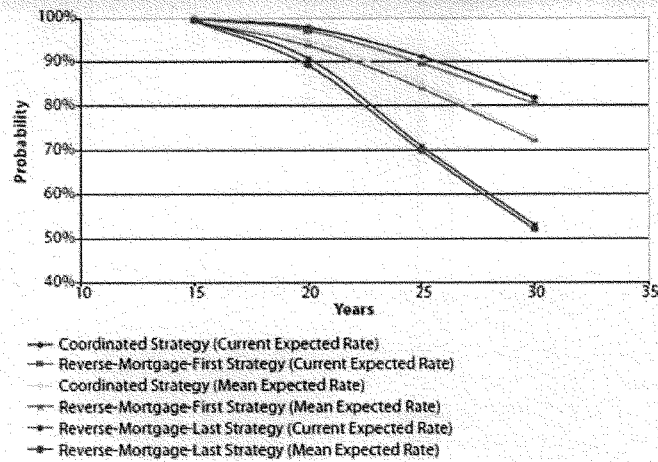


**Results with a 6 Percent Initial Withdrawal Rate.** We next take a larger jump in initial withdrawal rate in our comparison of the three withdrawal strategies by examining the results of a 6.0 percent rate.

This is almost 50 percent more than the safemax rate. In dollar terms, with an \$800,000 initial account value, it reflects an increase of almost \$16,000 in initial annual withdrawal over the safemax amount. This rate is such that, absent the reverse mortgage component, it results in a 60 percent probability of cash flow survival for 25 years and less than a 50 percent probability of cash flow survival for 30 years.

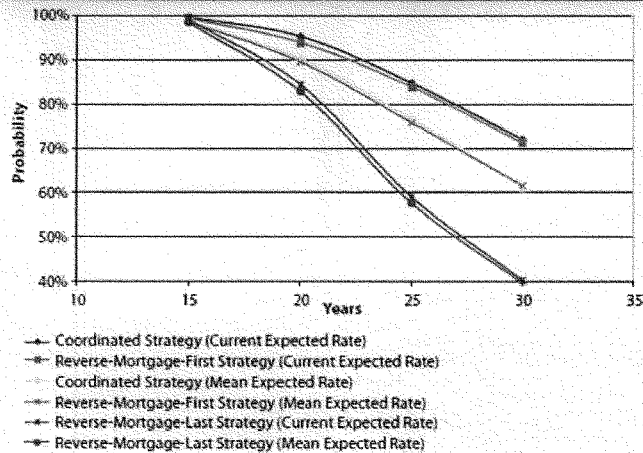
The results are shown in Figure 3. With the two active strategies, the 25-year cash flow survival probability is close to 90 percent with the current expected rate and 85 percent with the mean expected rate. The 30-year cash flow survival probability is over 80 percent with the current expected rate and over 70 percent with the mean expected rate. By contrast, the conventional (reverse-mortgage-last) strategy results in a 25-year cash flow survival probability of about 70 percent and a 30-year cash flow survival probability under 55 percent with both expected rates.

**Figure 3: Probability of Cash Flow Survival (6.0% Initial Withdrawal Rate) for Three Reverse Mortgage Credit Line Strategies, Current and Mean Expected Rates**



**Results with a 6.5 Percent Initial Withdrawal Rate.** The next initial withdrawal rate we examine is 6.5 percent. The results are shown in Figure 4. It is clear from Figure 4 that, with a 6.5 percent initial withdrawal rate, the 25-year cash flow survival probability, with either of the active strategies and the current expected rate, is below 90 percent. And the 30-year cash flow survival probability with either of the active strategies is barely above 70 percent. The reverse-mortgage-last strategy results in a 30-year cash flow survival probability of only 40 percent.

**Figure 4: Probability of Cash Flow Survival (6.5% Initial Withdrawal Rate) for Three Reverse Mortgage Credit Line Strategies, Current and Mean Expected Rates**



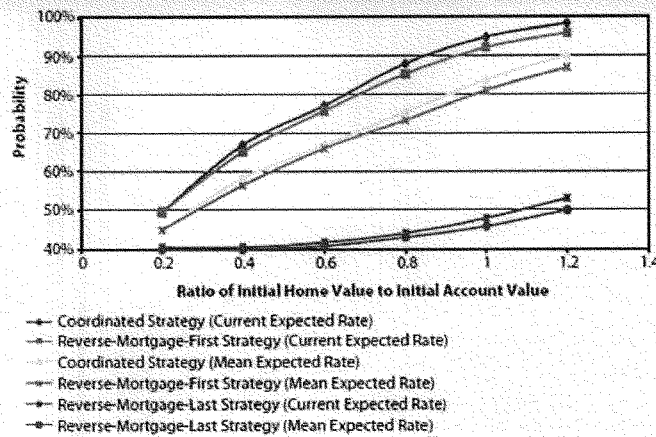
However, before hope is lost for initial withdrawal rates as high as 6.0 percent or 6.5 percent to have 90 percent or greater cash flow survival probability, we point out that there are at least three situations in which these initial withdrawal rates, and initial withdrawal rates even higher, can still result in cash flow survival probabilities of 90 percent or greater:

1. The first situation is where the ratio of home value to account value is higher than the ratio in our example. Holding the home value in our example constant, this situation would occur only where the account value is lower than in our example; in that case, the dollar amounts of the withdrawals would also be lower. This situation is illustrated in the next section.
2. The second situation is the obvious one, where there are higher investment returns on the portfolio than those used in our example. This situation is illustrated later in the paper.
3. The third situation is the one in which certain safeguards are used. The safeguards are described and illustrated later as well.

#### The Impact of the Ratio of Home Value to Account Value

Obviously, the greater the home value, the greater the increase it can provide to the cash flow survival probability. In the example we considered above, the ratio of initial home value to initial account value was approximately 52 percent.<sup>19</sup> We now show how varying this ratio, as we hold the other parameters constant, alters the effect the different strategies have on cash flow survival probability. Specifically, we show in Figure 5, using an initial withdrawal rate of 6.5 percent, the 30-year cash flow survival probability as a function of the ratio of initial home value to initial account value.

**Figure 5: Probability of 30-Year Cash Flow Survival as a Function of Ratio of Home Value to Account Value (6.5% Initial Withdrawal Rate)**



This figure shows a very high probability of cash flow survival when the ratio of home value to account value equals or exceeds 100 percent *and* one of the active strategies is used. For example, when the ratio is 100 percent, the conventional (reverse-mortgage-last) strategy still results in less than a 50 percent cash flow survival probability for 30 years, and the active strategies (at the current expected rate) result in a greater than 90 percent cash flow survival probability.

The active strategies show a sharp increase in the cash flow survival rate as the ratio of home value to account value increases, much more than does the conventional strategy. Thus, the higher the ratio, the greater the impact that comes from the active strategies as compared with the conventional strategy.

Because we hold the home value in our example constant at \$417,000, ratios of home value to account value that exceed 52 percent require lower account values than the \$800,000 value used above. Thus, for the calculations based on the 60 percent, 80 percent, 100 percent, and 120 percent ratios, we used account values of \$695,000, \$521,250, \$417,000, and \$347,500, respectively. Consequently, the initial withdrawal *dollar* amounts for the 6.5 percent initial withdrawal rate were \$45,175, \$33,881, \$27,105, and \$22,588 for those four account values, respectively.

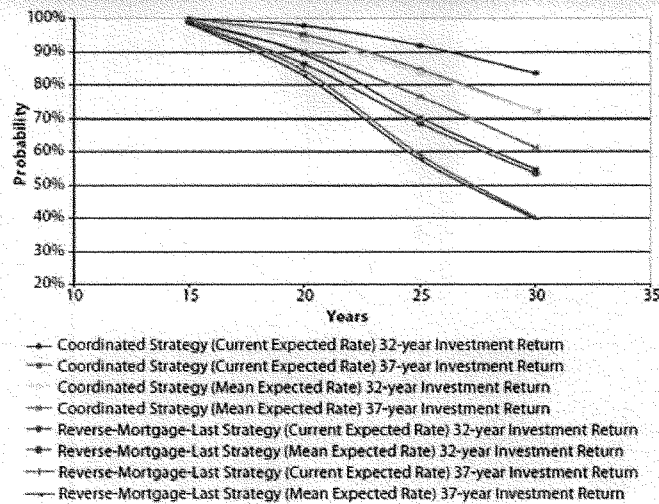
#### The Impact of Higher Investment Returns

The cash flow survival probabilities determined with the use of the 32-year investment return data were noticeably higher than those determined with the use of the 37-year data. But the qualitative results were essentially the same—with each investment return data set, the active strategies yield substantially higher cash flow survival probabilities than the conventional (reverse-mortgage-last) strategy.

Figure 6 is indicative: the cash flow survival probabilities are shown for a 6.5 percent initial withdrawal rate for eight different situations. The upper four lines show the results of the coordinated strategy using the 32-year investment return data and the 37-year investment return data, each with the current expected rate and the applicable mean expected rate. It is obvious that the 32-year data yield greater cash flow survival probabilities. In fact, the 32-year data reflect investment returns sufficiently higher than the 37-year returns in that they bring the 30-year cash flow survival probability almost to 90 percent (and exceed 90 percent when the current home value limit of \$625,500 is used instead of the pre-2009 limit of \$417,000).



**Figure 6: Probability of Cash Flow Survival (6.5% Initial Withdrawal Rate) Comparing Results of Different Investment Returns and Different Expected Rates**



The lower four lines show the results of the conventional strategy, also using the 32-year data and the 37-year data, each with the current expected rate and the applicable mean expected rate. The reverse-mortgage-first lines have been omitted, simply for clarity. (As in the previous figures, the reverse-mortgage-first lines would be very close to the coordinated lines.) And again, the 32-year data yield greater cash flow survival probabilities.

It is noteworthy that the disparity between the results of the active strategies and the conventional strategy is somewhat greater in the case of the 37-year data than in the case of the 32-year data. This is evident in Figure 6, where, for example, the spread between the second and seventh lines is a bit greater than the spread between the first and fifth lines. This disparity also holds true with the other initial withdrawal rates. It suggests that the active strategies for using the reverse mortgage credit line are of somewhat greater value (relative to the conventional strategy) when investment returns are weak than when they are strong.

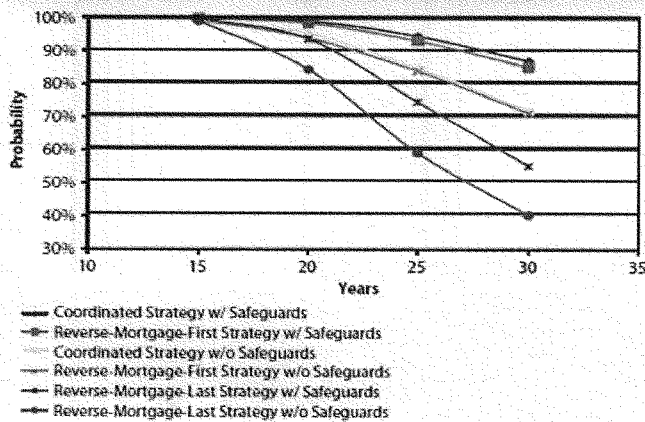
#### Effect of Certain Safeguards

The authors are aware of the innovative work of Guyton (2004) and Guyton and Klinger (2006) in the area of enhancing retirement income survival probabilities. Therefore, we thought it would be interesting to see how techniques similar to theirs could be used in conjunction with the reverse mortgage strategies we have studied. We focused on "withdrawal rule 2" plus the inflation decision rule, both of which are used by Guyton in the 2004 paper.

Under withdrawal rule 2, "there is no increase in withdrawals following a year in which the portfolio's total investment return is negative, and there is no make-up for a missed increase in any subsequent year."<sup>17</sup> Under the inflation decision rule, "the maximum inflationary increase in any given year is 6 percent, and there is no make-up for a capped inflation adjustment in any subsequent year." For simplicity, we call the

combination of these two rules the "safeguards." Incorporating the safeguards into our model significantly increases the cash flow survival probability with both the conventional strategy and the active strategies. Figure 7 shows that, with a 6.5 percent initial withdrawal rate, the safeguards increase the 30-year cash flow survival probability when the active strategies are used from just above 70 percent to nearly 90 percent. (When the current home value limit of \$625,500 is used instead of the pre-2009 limit of \$417,000, the safeguards increase that probability from 80 percent to more than 90 percent.) The safeguards also increase the 30-year cash flow survival probability when the conventional strategy is used from about 40 percent to about 55 percent. Thus, the safeguards give approximately the same boost to the conventional strategy as to the active strategies. The results of incorporating the safeguards into the model at other initial withdrawal rates, and other expected rates, are similar.

**Figure 7: Probability of Cash Flow Survival (6.5% Initial Withdrawal Rate, Current Expected Rate) with and Without Safeguards**



### Residual Net Worth

After reviewing the results of the calculations and analyses set out so far, the reader may ask whether the greater cash flow survival probabilities that result from the use of the active strategies come at the cost of lower residual net worth. We define the term "residual net worth" as the value of the retiree's portfolio plus the equity in the retiree's home at the end of the period in question. The equity in the home is the value of the home minus the cumulative reverse mortgage debt, including accrued interest.

This issue is important to the many retirees who, in addition to their primary concern for continuing cash flow throughout their retirement years, have a bequest motive or concern about late-in-life needs.

Our model includes a provision for calculating the residual net worth for each of the three strategies; it also calculates the differences of those quantities between each pair of strategies. When only the differences of the residual net worth are used, the value of the home subtracts out, leaving only the differences of the account values and the differences in the accrued reverse mortgage debt. We define this as a positive difference if, at the end of any trial, the residual net worth of the coordinated strategy exceeds the residual net worth of the reverse-mortgage-last strategy.<sup>18</sup>

When the percentage of trials with positive differences is greater than 50 percent, it indicates that the residual net worth is more likely than not to be higher with the coordinated strategy than with the reverse-mortgage-last strategy.

Without setting out a detailed display of these results, we note that, for initial withdrawal rates from 4.5 percent through 7.0 percent, we find positive differences in 67 percent to 75 percent of the trials. Thus, in this range of initial withdrawal rates, the choice of an active strategy rather than the conventional strategy is between two and three times more likely to result in a positive difference in residual net worth than in a negative difference.

### Conclusions

We have considered retirement income in the classic mode of constant purchasing power (except where the safeguards are invoked) over periods of up to 30 years. The income sources we have considered consist of a securities portfolio plus withdrawals from home equity by means of a reverse mortgage credit line.

We have focused on cases in which the initial withdrawal rate exceeds the so-called safemax rate of approximately 4 percent of the initial portfolio value. In those cases, particularly in the range of initial withdrawal rates between 5 percent and 6.5 percent, we have found substantially greater cash flow survival probabilities when the reverse mortgage credit line is used in either of two active strategies rather than in the conventional, passive, strategy as a last resort. We have also found that use of these active strategies is likely to result in a higher residual net worth after 30 years than the use of the conventional strategy.

### Endnotes

1. Brandon, Emily. 2011. "How to Retire on Social Security Alone." *U.S. News & World Report* (May 16).
2. Because the retirement accounts are generally invested in portfolios of securities, and because our analysis is based on the behavior of securities portfolios, the terms "account" and "portfolio" can be considered interchangeable in this context. In the case of a retiree taking withdrawals from a pre-tax account, such as an IRA or a 401(k) plan, the retiree's expenses will include his or her income taxes.
3. See, for example: Bengen, William. 2006. "Sustainable Withdrawals." In *Retirement Income Redesigned*, edited by Harold Evensky and Deena B. Katz. New York: Bloomberg Press.
4. There exist a small number of financial products similar but not identical to reverse mortgages. These include, among others, "NestWorth" and "FirstREX." The analysis and computations set out in this article are based explicitly on reverse mortgages. However, the results, at least qualitatively, also apply in situations in which other such financial products are used to supplement withdrawals from the account.
5. See, for example: Lieber, Ron. 2011. "Reverse Mortgages Here to Stay." *New York Times* (June 25): "[Reverse mortgages] will almost certainly become a necessary last resort for a nation full of increasingly strapped people." See, also: Quinn, Jane Bryant. 2011. "Picking the Right Options." *AARP Bulletin* (May): "And don't take a reverse mortgage in your 60s. Save these loans as a last resort, for money in your older age." As another example, see: Osterland, Andrew. 2011. "The Retirement Tool Advisers Love to Hate." *Investment News* (April 11-15): "'Your home should be the absolutely last asset you tap,' said Joseph Duran, chief executive of United Capital Financial Partners Inc." See also: Pond, Jonathan. 2010. "Retired and Loving It!" *AARP Magazine* (May/June): "You know your money will last when...you won't need a reverse mortgage until age 80 or later. These costly deals are best viewed as a late-in-life trump card to keep you in your home."
6. There is a minor modification in certain cases when the investment performance was positive: if the dollar amount of the account's positive return was less than the withdrawal amount scheduled for the next year, only the amount of the positive performance is taken from the account, and the remaining portion of the scheduled withdrawal amount is taken from the credit line. Also, of course, if the investment performance was negative but the reverse mortgage credit line has already been exhausted, the entire withdrawal will come from the account.
7. The algorithm described here, with its embodiment in a computer-based system for advising retirees on withdrawal amounts and sources, is the subject of a patent issued to the authors November 8, 2011.
8. We recognize that inflation figures for any year tend to relate to those of the preceding years, rather than vary stochastically. We plan to further refine our model and our analysis to reflect that fact.
9. It is worth noting that in some of the repetitions the portfolio survives with very substantial value at the end of the 30-year period, and in others the portfolio survives with very little value at the end of the period.
10. Bengen, *ibid.*
11. There are many sources of information on reverse mortgages. See, for example, [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/sfh/hecm/hec](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/hec), which includes, among other information, a link to the AARP website.

12. FHA Mortgagee Letter 2011-39, December 2, 2011.
13. These factors can be found at:  
[http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/sfh/hecm/hecmhomelenders](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/hecmhomelenders).
14. Because the expected rate appears only once in each 30-year trial, our model does not Monte Carlo simulate the expected rate. By means of a set of tests, we have determined that there is no significant difference between the cash flow survival probability results of using a single expected rate throughout a series of trials and the results of Monte Carlo simulating the expected rate throughout the same series with a normal distribution around the same expected rate.  
 Another parameter relevant to the reverse mortgage, but less directly relevant to cash flow, is the so-called "current rate." The current rate is determined each year and is the short-term interest rate (typically the one-year Treasury rate or the one-year Libor rate). It is used every year for two purposes: (1) it determines the rate at which amounts *already drawn* from the credit line accrue interest that year, and (2) it determines the *increase* in the amount still available from the portion of the credit line *not yet drawn*. The second purpose does affect cash flow to the retiree. This parameter is Monte Carlo simulated in our model.
15. This value, although just part of an illustrative example, is chosen because it is very close to the average value of the "investable and disposable assets" held by the members of "Group 3" (those who have a "paid planner and a comprehensive written plan"), age 65 and over, as described in the 2008 FPA and Ameriprise *Value of Financial Planning Study: Consumer Attitudes and Behaviors in a Changing Economy*, conducted by Harris Interactive. (The average is computed without the one outlier who reported investable and disposable assets of \$20 million or more.)
16. At least through December 31, 2012, \$625,500 is the maximum home value that can be taken into account in any reverse mortgage that can be drawn upon in the form of a credit line. Therefore, home values larger than that limit, although theoretically increasing the ratio of home value to account value, in practice do not increase the ratio.
17. We could not use the modified form of the withdrawal rule described in the 2006 work, because that rule involves the withdrawal rate at the time of each year's withdrawal. That rate is equal to the amount of the withdrawal divided by the value of the account. Our three-spreadsheet model has the withdrawal in any given year coming from different sources on the different spreadsheets, and hence the value of the account in any given year (except the first year) generally differs among the three spreadsheets. Therefore, if we were to use the modified withdrawal rule, the amounts of the withdrawals (in some years, and hence cumulatively) could be different among the three strategies; this would be inconsistent with our approach to the comparison of the three strategies, under which the withdrawal amount is the same for each strategy.
18. It is important to note also that the *range* of likely outcomes of the difference of residual net worth, at the end of 30 years, is extremely wide.

### References

- Guyton, Jonathan. 2004. "Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?" *Journal of Financial Planning* (October): 54-62.
- Guyton, Jonathan and William Klinger. 2006. "Decision Rules and Maximum Initial Withdrawal Rates." *Journal of Financial Planning* (March): 48-58.

### Appendix A: 37-year Investment Return Data, 1973–2009

Asset Class	Geometric Mean Return	Standard Deviation
S&P 500	9.67%	18.78%
CRSP 6–10	13.88%	24.12%
MSCIEAFE	9.62%	23.17%
Bar Cap Long-Term		
Gov't. Credit Bond Index	8.71%	11.14%
Bar Cap Int.-Term		
Gov't. Credit Bond Index	7.88%	5.40%
US 1 Year Const. Maturity	6.41%	3.32%

### Appendix B: 32-year Investment Return Data, 1973–2004

Asset Class	Geometric Mean Return	Standard Deviation
S&P 500	11.19%	17.94%
CRSP 6–10	15.56%	23.35%
MSCIEAFE	10.52%	22.46%
Bar Cap Long-Term		
Gov't. Bond Index	9.31%	11.83%
Bar Cap Int.-Term		
Gov't. Bond Index	8.39%	5.58%
US 1 Year Const. Maturity	7.11%	3.37%

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