Written Testimony of

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

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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.[1] Borrowers must 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[2] 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.[3]

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.[4]

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

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.[7] 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.[8] 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.[9] 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) launched its pilot HECM program in 1989.[10] According to data from

Reverse Mortgage Insight, at their peak in 2007 about 16% of the volume of reverse mortgages were conventional loans.[11] According to an estimate by the Government Accountability Office, approximately 43% of HECM lenders made non-HECM reverse mortgages in early 2008.[12] 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.[13]

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.[14]

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.[15] 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.[16] Another estimate found that the potential size of the reverse mortgage market is $1 trillion,[17] 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.[18]

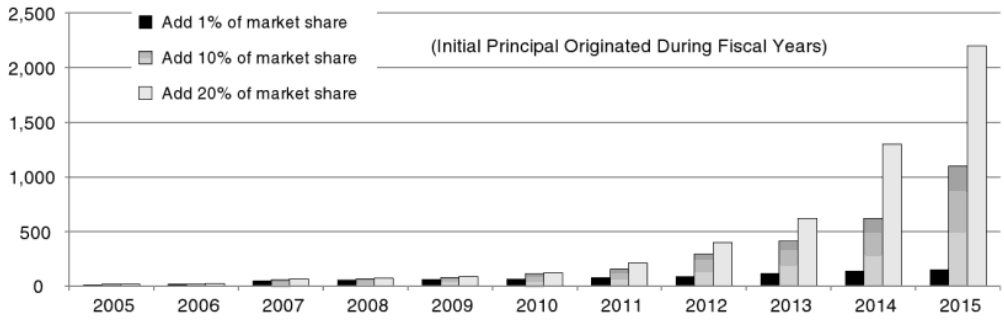

FIGURE 5.1 Reverse Mortgage Issuance Projections
Source: RBS Greenwich Capital, U.S. Census Bureau.

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.[19] 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.[20]

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.[21] 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.[22] 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.[23] 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.[24]

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.[25] 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.[26] In addition, more sophisticated underwriting would allow for larger reverse mortgages to be made and thereby draw more lenders to the market.[27]

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.[28] In terms of overall volume, in 2006 and 2007 $2.7 billion of private reverse MBS were issued.[29] 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.[30] 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.[31] 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.[32]

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,[33] $12.3 billion of securities backed by commercial loans (collateralized loan obligations),[34] and $16.2 billion of securities backed by credit card receivables.[35] Even in 2000, prior to the ramping up of the recent housing and securitization bubble, $57.8 billion of private forward MBS were issued.[36] 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.[37] 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.[38] 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.

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[13] Id. at 18; Heudorfer, supra note 5, at 21.
[14] Elizabeth Ecker, Reverse Mortgage Industry Poised for New Product in 2012?, Reverse Mortgage Daily, Jan. 9, 2012.
[15] Perera, supra note 4, at 43.
[16] Mazonas, supra note 10, at 12.
[17] 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).
[18] Perera, supra note 4, at 44.
[19] Id at 47-48, 51.
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[24] Foote, supra note 1, at 8.

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