HECM Reverse Mortgages: Is Market Failure Fixable?

By Jack Guttentag

Introduction

People reaching retirement age are living longer than ever, and retiring with less capacity to maintain their living standards. The Center for Retirement Research at Boston College estimates that more than half of the households entering retirement "may be unable to maintain their standard of living in retirement."

Yet a sizeable segment of retirees have equity in a home that could generate additional funding through the use of a HECM reverse mortgage. The HECM program is well-designed and provides options for meeting a wide variety of retiree needs. Yet very few seniors use it. At current rates only about 60,000 reverse mortgages will be written in 2015, which is a drop in the bucket of need. To put this in perspective, about 3 million homeowners turn 65 every year.

The premise of this article is that the stunted growth of the HECM program mainly reflects market failure, as opposed to a considered preference by senior homeowners not to participate. This article will present the indicators of market failure, the causes of market failure, the "remedies" that have not worked, and a new set of measures that will create a new distribution channel. Stripped of the baggage that has bedeviled the existing program, reverse mortgages originated through this new channel will be termed "kosher HECMs", signifying that there are major differences between them and HECMs originated in what I will call the "mainstream market." The central difference is that the kosher channel is competitive and the mainstream channel is not.

Indicators of Market Failure

Markups Are High: Statistical data on markups by loan originators is viewed as highly proprietary, but I have discussed it with lenders who operate in both the standard and the reverse mortgage markets. They report that on average the markups on HECMs originated in the mainstream channel are 2.5-3 times larger, though the workload is much the same. This is a high price/low volume industry.

Borrowers Do Not Price-Shop: There are no published price data on reverse mortgages originated in the mainstream market, and most lenders do not post prices on their web sites. My colleagues and I looked at the web sites of over 200 members of NRMLA, the trade association, most of them lenders. Only 8 posted prices, and only one of those posted complete prices -- both interest rates and origination fees. That lender is one of the handful of maverick lenders who price HECMs as if they are operating in a competitive market. They provide the most convincing evidence that the mainstream is non-competitive, and they are key players in the alternative kosher channel.

Loan Providers Are Not Trusted: A major reason is the unfavorable press coverage that HECMs receive, which is discussed below. Keeping prices under wraps is a source of distrust, and so is slick TV advertising using celebrity spokespersons, which for many seniors is their only HECM information source. Loan providers who are part of the kosher distribution network do not employ celebrity spokespersons.

Mainstream Prices Are Much Above Competitive Prices: While most HECM lenders keep prices under wraps, they must be responsive to requests for information about draw amounts, which depend in part on the HECM prices. Hence, the special purpose calculators used to show available draw amounts require HECM prices as inputs.

There are two publicly available HECM calculators that reveal the prices used. One is sponsored by NRMLA and appears on its web site. The prices used in the NRMLA calculator are described as "estimates" of the market price, with multiple disclaimers but no explanation of the estimating procedure and no lender names.

The other calculator was developed by me with the help of Darrel Tubbs and Jack Pritchard, and it appears on my web site. I call this the "kosher calculator" because the prices used come from the internal pricing systems of the maverick lenders and mortgage brokers who are participating in the kosher network. A feature they all have in common is a willingness to compete in terms of price. They are identified by name in the kosher calculator. A sample comparison of the prices used by the kosher calculator and those in the NRMLA calculator on a recent date is shown below.

HECM Reverse Mortgage Prices to a Borrower of 70 With a Home Worth $600,000 and Existing Mortgage Balances of Varying Amounts, on May 22, 2015: The NRMLA Calculator Versus the Kosher Calculator

Existing Mortgage Balance	NRMLA Calculator				Kosher Calculator			
	FRM		ARM		FRM		ARM	
	Interest Rate	Origination Fee	Interest Rate	Origination Fee	Interest Rate	Origination Fee	Interest Rate	Origination Fee
Zero	5.060%	$6,000	2.686%	$6,000	3.99%	$2,500	2.529%	$1,000
$100,000	5.060%	$6,000	2.686%	$6,000	3.99%	$2,500	2.029%	$0
$200,000	5.060%	$6,000	2.686%	$6,000	3.99%	$0	2.029%	-$2,033
$300,000	5.060%	$6,000	2.686%	$6,000	4.25%	-$6,066	2.029%	-$6,066

The large price differences between the two calculators are evident. In addition, prices in the kosher calculator decline as the size of the existing mortgage balance rises. The reason is that the existing mortgage balance must be paid off with the proceeds of the HECM, increasing the size of the HECM balance on which the originator is paid a premium when the mortgage is sold. In the competitive segment of the market, larger premiums result in lower interest rates and/or origination fees to the borrower. The negative origination fees shown by the kosher calculator are rebates paid by the lender which are used to cover other settlement costs, resulting in low-cost or no-cost HECMs.

In the mainstream market, the premiums paid on large balances result in larger markups for the originator. There are no no-cost HECMs in the mainstream market.

Causes of Market Failure

HECM Complexities and Borrower Caution: The major cause of market failure is the complexity of HECMs, and their unfamiliarity to seniors -- HECMs are far more complicated and difficult to understand than the mortgages they had used to buy their houses. Two interest rates are involved in the process, one to calculate the draw amounts available to the borrower, the other to calculate both the accrued interest that is added to the loan balance and the increment to the borrower's unused credit line. An appendix note has more detail about HECM interest rates.

A major strength of the HECM program is the multiple options for drawing funds, which a borrower can combine in any number of different ways, but this is also a source of complexity. In addition, borrowers have the right to swing from one option to another in the future as their needs change.

Complexity makes seniors exceptionally easy to hoodwink, and it also makes them wary and suspicious.

Negative Media Coverage: Few of those who write about reverse mortgages understand them, which is much less of a handicap in writing about purported abuses of the program than in writing about how they help people. And of course, abuses are always more newsworthy.

Another reason that the media is negative is that its focus is on the mainstream segment. A standard complaint is that upfront fees are very high. The media doesn't touch the competitive segment, which offers low-cost, and in some cases no-cost options.

In addition, media people do not like to criticize seniors, so the misuse of HECMs <u>by</u> seniors is converted into an abuse <u>of</u> seniors. The best illustration are the cases where seniors with wives too young to qualify for a HECM took one in their own name, telling their wives that their tenure was secure when it wasn't. When they died, the wives were forced to move out, and the media portrayed it as an injustice committed by the program -- rather than as a moral failure by the husbands.

Lack of Accurate Information From Reliable Sources: Millions of seniors don't take out reverse mortgages because they don't know of their existence, or because they have heard nothing but bad things about them from the media, or because their own exposure to HECM marketing campaigns created a negative impression. There is very little positive media coverage serving to neutralize the negative coverage. One of the major proposals of this article is directed to promoting the kosher HECM as an alternative, one that is not burdened with the negative baggage associated with the mainstream market.

“Remedies” That Haven’t Worked

Mandatory Counseling: Under Federal law, a lender cannot accept an application for a HECM reverse mortgage until the applicant delivers a certificate attesting to their having been successfully counseled by a third party who is independent of the lender. While most of the borrowers I have queried about their counseling experience found it useful to some degree, its potential for improving the market has not been realized.

The weakness of the existing approach to counseling is that it is designed to protect seniors against mistakes of commission: taking a reverse mortgage when they would do better without one. The implicit assumption is that the senior may make a mistake, and if so will discover it in the counseling process and drop out. In fact, very few seniors opt out of the process as a result of counseling, suggesting that there are very few mistakes of commission.

The big mistakes, affecting untold millions of seniors, are mistakes of omission, committed by those doing nothing, because they never heard of reverse mortgages, or never heard anything good about them, but would nonetheless benefit from one. The existing counseling system does not touch them. Virtually all the seniors who are counseled have been to a lender first, which means that they had already made at least a tentative decision to proceed.

Counseling directed to mistakes of omission would focus on the best possible use of the reverse mortgage, which means helping the senior make the best choices among the different ways of drawing funds, the type of mortgage (ARM versus FRM), high and low mortgage insurance premiums, and the combination of interest rate and origination fee. The critical question is whether there is a combination of these factors that would make the senior better off? This question is now off-limits to counselors whose goal is preventing mistakes of commission.

Mandatory Disclosures: A large mass of Federal legislation and regulation, with the Truth in Lending law as the centerpiece, is based on the premise that markets don’t work well if one group of participants, such as lenders, knows a lot more than the other group, such as borrowers. And therefore Government can make markets work better by mandating that lenders disclose critical information to borrowers.

There are two kinds of decisions that mortgage borrowers have to make that they frequently get wrong: these are the “which” and the “who” of the borrowing process. Every borrower must decide <u>which</u> of the several types of mortgages available to them best meets their needs; and they must decide <u>who</u> of many available loan providers will give them the best deal on the type of mortgage they prefer.

Government-mandated disclosures can help mortgage borrowers make these decisions more wisely if properly implemented, but proper implementation cannot be taken for granted. The challenge to Government is not only to identify the information that borrowers need, but also to specify how disclosures should be worded so that borrowers can understand them, and at what point the disclosures must be provided if they are to be useable.

The history of mandatory disclosures in the home mortgage market over three decades suggests that the Federal Government has great difficulty in meeting this challenge. My web site has some 25 articles on mandatory disclosures in connection with standard mortgages written over the last 10 years, and most are critical.

The information gap between lenders and borrowers is even larger in the reverse mortgage market than in the standard mortgage market. The potential benefits from useful disclosures are therefore even greater. Furthermore, the reverse mortgage market is newer and regulators had some opportunity to learn from their mistakes in the older market. Unfortunately, that did not seem to help.

The centerpiece of Truth in Lending disclosures about reverse mortgages is the Total Annual Loan Cost, or TALC. The TALC is the reverse mortgage equivalent of the Annual Percentage Rate (APR) disclosure required on standard mortgages.

Both measures are designed to answer the "which" and the "who" questions of borrowers. They do this by consolidating the different costs of a mortgage into a single composite measure. The APR is a single rate calculated over the term of the mortgage. TALC is calculated over three periods for three different property appreciation rates, which results in a 9-rate matrix.

APR came first and is largely a failure. There are a few limited situations where it can be used effectively, but borrowers are hard-pressed to find out what these are. (Note: One source is the APR tutorial on my web site). I regret to say that the there are no situations in which TALC provides useful information to borrowers.

The "which" problem of reverse mortgage borrowers is selecting the combination of options that best meets their needs. Seniors can choose between upfront cash disbursement, credit line, monthly payment for as long as they live in the house, monthly payment for a specified term, or any combination of cash, credit line and monthly payment. This is a critical decision for borrowers but in making it, the TALC loan rates play no role whatever, and shouldn't. What matters to borrowers is how best to meet their cash needs now and in the future.

If TALCs were computed for each major reverse mortgage option, it would be the lowest on transactions in which borrowers draw the maximum amount of cash at the outset, leaving nothing for the future. Transactions on which borrowers take out a credit line which they don't draw on for many years, which is the most prudent use of a reverse mortgage, would have the highest TALC.

I don't think that is the message that the regulators who designed TALC wanted to convey, which is perhaps why they don't require that it be calculated for different options. Borrowers receive only one TALC, on the option they have already selected.

The TALC might nevertheless be justified if it could be used to find the best deal from among the offerings of different lenders. But using a 9-cell matrix of rates to compare lender is totally fruitless, and seniors <u>never</u> use the TALC for that purpose. I have queried numerous originators and supervisors with experience covering multiple thousands of loans, and not one could report a single case of a borrower using TALC to shop.

In sum, the TALC does not help seniors in making either their "which" or their "who" decision. The only ones who benefit from TALC are regulators, who can indulge the illusion that seniors are receiving the information they need, and the firms who license the software that lenders need to calculate it.

<u>Making the Market Work Better</u>

The major target of efforts to make the reverse mortgage market work better is not the small group of seniors who contact loan providers now but the large group of senior homeowners that doesn't. The kosher HECM channel is directed toward meeting the needs of those whose lives would be improved by taking the right HECM. This will involve four initiatives:

1. Develop and maintain a current data base of competitive HECM prices -- from loan providers electing to compete in the kosher segment of the HECM market.
2. Increase general awareness of the HECM program -- through widespread dissemination of market information about kosher reverse mortgages.
3. Offer seniors free and disinterested help in assessing kosher HECM options -- from HECM option experts who are not authorized to originate loans in the state in which a senior resides.
4. Provide competitive transaction information -- to be used by seniors to shop among kosher loan providers, and/or others.

These will be discussed in turn.

1. *Maintain a Current Data Base of Competitive HECM Prices:* Participating loan providers (LPs) provide their current HECM prices to www.mtgprofessor.com whenever their prices are adjusted, using a pricing widget developed by us to assure reporting uniformity. Their intent is to obtain high-quality leads consisting of seniors who know what they want because they have had a session with a HECM option expert. LPs are not charged for HECM leads. This data base is used in developing general market information (item 2 below), and in price shopping by seniors (item 4 below).

2. *Disseminate Kosher HECM Market Information*: I intend to distribute tables showing kosher HECM prices and transaction costs, and the amounts of different draw options available to seniors of varying age with homes of varying value. This information is embedded in a set of 6 tables that are updated weekly or whenever HECM prices are reset. To see the tables, click on Characteristics of Kosher HECM Reverse Mortgages.

The tables will be offered to web sites and media with no charge, along with a commitment to keep it updated. While the tables will be an integral part of each web site that displays it, we have a way to update all the sites through one operation.

3. *Offer Services of of HECM Option Experts:* A major tool for remaking the HECM reverse mortgage market is connecting seniors to experts when the seniors are in an exploration stage, as opposed to the existing arrangement where seniors who have already made up their minds are directed to counselors by lenders. Where the current focus of counseling as prescribed by HUD is to make sure that the senior is not making a mistake by proceeding with a HECM, the focus of our option experts is whether or not a HECM would be useful in meeting the senior's needs. The option experts will deploy the calculator referred to below, which allows users to see how different draw options and combinations of options will affect future debt, equity and credit lines.

The option experts are a selected group of reverse mortgage brokers and loan officers who we certify as proficient, and who are willing to provide their services on a pro bono basis. Seniors will be assigned to an expert who is not licensed to originate loans in the senior's state, eliminating any financial inducement to steer a session in one or another direction. The experts we have signed up are satisfied to participate in a program that will expand the size of the market, which will benefit them indirectly as it will all loan originators.

The press release announcing the availability of HECM option experts will be directed to senior homeowners who may be curious as to whether a HECM would benefit them. It would emphasize that there is no charge, and that the expert is not authorized to originate a HECM for them.

4. *Provide Competitive Transaction Information:* Seniors who want to take the next step will have access to our calculator, which not only shows the HECM draw options and combinations of options that are available to them, but also has competitive prices for different combinations of interest rate and origination fee. Every such combination will identify the loan provider whose quote it is. The senior can select the combination that generates the lowest HECM debt after a period that reflects the senior's best guess as to how long the HECM will last.

The senior can take this step on her own, or can solicit the help of the option expert. She can also use the calculator results as a shopping tool, contacting outside loan providers, but we do not ask the option experts to help seniors do that.

Our plan is to offer the calculator to web sites and media on the same basis as the tables. There will be no charge, and we will commit to keep it updated. As with the tables, the calculator will be an integral part of each web site that displays it.

To access the calculator, click on Competitive Reverse Mortgage Calculator.

Enlisting Government

Among the web sites to which we offer the calculator and tables are those managed by two Federal agencies that have responsibilities related to HECM reverse mortgages: the Department of Housing and Urban Development (HUD), and the Consumer Financial Protection Bureau (CFPB). The HUD web site has a page directed to HECMs with a note asking for suggestions on how to beef it up. We will respond to the note by offering both the tables and the calculator at no charge, along with a commitment to keep them updated.

The HUD site now has a link to the NRMLA calculator. Appendix Note A is a point by point comparison of the NRMLA calculator and mine.

The HECM reverse mortgage market is one of those in which CFPB is charged with responsibility for protecting consumers. Considering that this is perhaps the most dysfunctional of all consumer markets, this is quite a challenge. To date, CFPB has done little to confront the challenge except to criticize the advertisements of HECM loan providers -- for sins of commission and omission that characterize almost all advertising. Our tables and calculator will allow CFPB to exercise their responsibilities in this market in a much more meaningful way. There will be no charge, and we will keep them up to date.

Concluding Comment

We are taking a four-pronged approach toward remedying the dysfunctional HECM reverse mortgage market. Prong one is to create and maintain a current data base of competitive HECM prices posted by those loan providers who are willing to be competitive. Prong two is to make senior homeowners more aware of the HECM program by distributing to mainstream media and web sites highly informative tables on major HECM features. Prong 3 is to offer seniors access to HECM option experts who pro bono will provide them with disinterested help in assessing kosher HECM options. Prong 4 provides seniors who have selected a desired HECM option or set of options competitive prices for different combinations of interest rate and origination fee posted by competing loan providers.

Appendix Note A: Summary Comparison of Reverse Mortgage Calculators: Mortgage Professor Versus NRMLA

	Mortgage Professor	NRMLA
Information on Interest Rates and Origination Fees		
Data Sources	Rates and fees are reported to Mortgage Professor by each participating loan provider.	Interest rates "generally represent rates that may be available in the market today…" Origination fees are the "maximum allowable under HUD rules."
Comparison	Rates and Fees Are Consistently Lower on Mortgage Professor	
Availability of Information on Amounts That Can Be Drawn		
Maximum tenure payment with zero cash draws and zero credit lines	Readily Available	Readily Available
Maximum upfront cash draw with zero monthly payments and zero credit lines	Readily Available	Readily Available On FRMs. On ARMs, Only Available Through Trial and Error
Maximum available upfront credit line with zero monthly payments and zero cash draws.	Readily Available	Only Available Through Trial and Error
Maximum payment available for 5 years, with zero credit line and zero cash draws.	Readily Available	Not Available, no Capacity to Calculate Term Payments
Initial credit line remaining after tenure payment and cash draws of specified amounts.	Readily Available	Not Available, Very Limited Capacity to Model Multiple Ways to Draw Funds
Credit line available after a specified period assuming stable interest rates	Readily Available	Not Available, no Projections of Future Values
Credit line available after a specified period assuming maximum allowable rate increases	Readily Available	Not Available, no Projections of Future Values
High and low mortgage insurance premiums when these are valid choices with different draw amounts	Yes, shows both	No, shows only one
Information on Individual Lenders		
Ability to Select the Best Pre-lock Rates and Fees Posted by Individual Lenders	Yes	No
Protection Against Lock Abuse Through Access to Rate and Fees Posted on Lock Day	Yes	No
Access to No-Cost and Low-Cost Options	Yes	No

Appendix Note B: Pricing of HECM Reverse Mortgages

HECM reverse mortgages are unique in using two interest rates in every transaction. The two rates can be either fixed or adjustable rate.

The Two HECM Rates

One interest rate is used in calculating the borrower's future debt and his future credit line if there is one. This is the "mortgage rate" and it is comparable to the rate on standard mortgages (though there is no credit line option on a standard mortgage). On one adjustable rate version, the rate adjusts monthly subject to a 10% lifetime adjustment cap. On another version, the rate adjusts annually subject to a 5% lifetime adjustment cap. In both cases, lenders may offer different combinations of initial rate and origination fee.

The second interest rate is called the "expected rate" and it is the rate used in determining draw amounts – the higher the expected rate, the less the senior can draw. This relationship between expected rates and draw amounts is set by HUD as the insurer of HECMs.

If the borrower elects a fixed rate, the mortgage rate and the expected rate are the same, but if the borrower selects an adjustable rate, the two will differ. During the years of very low rates, the expected rate was consistently higher than the mortgage rate.

Interest Rates, Origination Fees, and Lender Income

The price of a reverse mortgage to the borrower includes the origination fee as well as the interest rate. Under FHA rules, origination fees are capped, with the cap based on property value up to a maximum of $6,000. There are no caps on the rate.

The income of loan originators consists of the origination fee plus the premium received on the sale of the mortgage, which is expressed as a percent of the loan balance. On high balance transactions, which includes those with significant existing mortgage balances that must be repaid with proceeds from the HECM, premium income can be substantial.

\The competitive lenders reporting their pricing to us will rebate part of their premium to the borrower as a negative origination fee, or rebate. Many if not most other lenders, however, will charge borrowers the maximum origination fee set by regulation, regardless of the size of their premium income.

Locking the Rates

The expected rate is locked as soon as the loan application has been submitted to FHA. The mortgage rate, however, is not locked until all processing has been completed, the property has been appraised, and the borrower has been counseled, which typically takes multiple weeks during which time HECM rates may change – the practice is to reset rates to the market every week.

The upshot is that borrowers draw the amounts they were promised, but the rate they were quoted may be different. Under these circumstances, lenders should lock at the rate they would quote to a new shopper with the identical transaction, but whether they do or not nobody knows. The temptation to pad the closing price must be very strong, especially when market rates have gone down and they can pad the current price while delivering the price they had quoted earlier.

HECM lenders who pad the final closing price are not likely to encounter any resistance from borrowers who focus on the draw amount, which conforms to what was promised, especially if there is no simple way for the borrower to check the price. Borrowers with access to the competitive calculator, however, can check the lock price against the price being quoted to shoppers on the same day.

Competitive Calculator Prices

Whenever HECM prices change, the loan providers (LPs) who have agreed to report prices to www.mtgprofessor.com submit a fresh set of prices using a special widget designed for that purpose. Usually this happens once a week. At this writing there are 8 LPs reporting prices, with 5 more in the pipeline. This is more than enough to assure competitive pricing because each of the LPs has multiple relationships in the secondary market.

Because LPs report multiple combinations of interest rate and origination fee, the calculator is programmed to use the combination that generates the lowest HEXCM loan balance over the period that is the borrower's best guess of how long she will have the HECM. Because this number if usually quite uncertain, the calculator makes it easy to "try out" alternative periods and observe the impact on the loan balance.