



# Fixing the Home Equity Conversion Mortgage Program, a Fraying Lifeline for Senior Homeowners

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Tens of thousands of seniors would be unable to maintain their standard of living in retirement were it not for the Home Equity Conversion Mortgage Program (HECM), which allows homeowners older than 62 to take out a loan insured by the Federal Housing Administration (FHA) against the value of their home. But the recent bankruptcy of one of the program's largest servicers, Reverse Mortgage Funding (RMF), has exposed a weakness in the program that will undermine it if left unchecked. In this brief, we explain the importance of HECM, discuss the issues that led to RMF's downfall, and offer thoughts on how the program can be improved to keep it viable for those who depend on it.

## Why HECM Is Important

Many seniors enter retirement without enough savings to maintain their standard of living. Less than half of 65-to-74-year-olds have a retirement account, a share that falls to a little over a third for those older than 75. And only one in five seniors can rely on their retirement accounts as a major source of income.<sup>1</sup> This is only marginally offset by other forms of savings, with only 19 percent of retirees holding cash-value life insurance policies and 15 percent holding stocks and bonds (Bhutta et al. 2020).

The gap between what those entering retirement need and what they have is partly caused by many people overestimating how long they will work. Seventy percent of workers expect to work for pay in retirement, but only 22 percent ultimately do, with close to half retiring earlier than expected because of health, disability, or a change in the structure of their organization (EBRI and Greenwald, n.d.). Many find themselves falling out of the workforce before they have built up the savings needed to do without the income.

Yet many of these same seniors have built up considerable wealth in their homes. Seventy-eight percent of 65-to-74-year-olds own their homes, as do 82 percent of those 75 and older, and for most

homeowners, home equity is their largest single source of net worth. As of 2019, 47 percent of homeowners' median net worth was in their home equity, a figure that jumps to 58 percent for Hispanic homeowners and 59 percent for Black homeowners.<sup>2</sup> The numbers today are no doubt higher still, with the increase in home prices from 2020 into early 2022.

Many seniors thus find themselves short of the savings they need to maintain their standard of living in retirement, but the shortfall could be made up with their home equity. For those entering retirement who *cannot* access their home equity, homeownership can be a financial burden rather than a benefit. In 2019, 41 percent of homeowners ages 65 and older had a mortgage on their primary residence, with a median amount of \$72,000. For those already struggling with too little savings entering retirement, this is often too great a burden to bear.

## Options for Tapping Home Equity While Remaining in the Home

Seniors have a few options for tapping their home equity without selling their home. The two most common options are home equity lines of credit (HELOCs) and cash-out refinancing. A HELOC provides a borrower with a line of credit, and in a cash-out refinance, a borrower pays off the balance of an outstanding mortgage with a larger loan, taking the difference in cash. A third option, which has become rare since the 2008 financial crisis, is a second mortgage, an additional loan taken in a single lump sum against the home's value that is subordinate to the borrower's primary mortgage. All three of these loan instruments are collateralized by the home, paid back in monthly increments, and typically allow for total borrowing up to 80 percent of the home's value.

Because borrowers must have income or savings beyond their home equity to cover the monthly payments required in each of these options, many seniors entering retirement cannot qualify for any of them.<sup>3</sup>

This leaves HECMs. As with HELOCs, cash-out refinancing, and second mortgages, the borrower takes out a loan against the value of their home. But unlike in those programs, the borrower need not pay the loan back until the home is sold or the borrower passes away or moves, with the FHA insuring lenders against any loss on qualifying loans. This allows the FHA to require lenders to focus on the home's value in underwriting the loan rather than the borrower's income or savings, opening the program up to those who no longer have much income or savings beyond their home equity.<sup>4</sup>

Lenders are not willing to hold these loans on their balance sheet for several reasons, so the program requires a secondary market into which the loans can be sold or securitized. Fannie Mae initially provided the entire market for these loans, holding them on its balance sheet as an investment. Ginnie Mae then expanded the market to a broader range of investors in 2007 when it created a security backed by the loans. As Ginnie Mae stepped into the market, Fannie Mae gradually retreated, pulling out altogether in 2010. Today, the Ginnie Mae securitization channel provides the only meaningful secondary market for HECMs.<sup>5</sup>

## The Problem with HECM

Although the Ginnie Mae channel has been a blessing for HECM, it is also the source of the problem that brought down RMF. Unlike Fannie Mae and Freddie Mac, Ginnie Mae does not purchase loans from lenders but guarantees the mortgage-backed securities that a lender creates from pools of loans insured by the FHA, the US Department of Veterans Affairs, or the US Department of Agriculture. A HECM thus remains on the lender's books even after it has been pooled and securitized through the Ginnie Mae channel. This distinction does not matter in terms of credit risk, as the FHA and Ginnie Mae have together removed the credit risk for lenders and investors precisely as do Fannie Mae and Freddie Mac, but it matters to the lender's liquidity because of the way the FHA and Ginnie Mae remove the credit risk.

To provide investors some clarity regarding when they will recoup the principal on their HECM mortgage-backed securities investment, Ginnie Mae requires the lender to buy all HECMs out of the Ginnie Mae pool once they hit 98 percent of the initial appraisal value. The lender then assigns qualifying loans to the FHA, which takes over all financial responsibilities for the loans and reimburses the lender for the buyout.

The challenge lies not with the assignable loans but with the one in five loans that is *not* assignable. The FHA will not accept the assignment of any loan with delinquent taxes or insurance payments, forcing the servicer to sort through and resolve any outstanding borrower obligations first. Nor will the FHA accept the assignment of a loan in which the borrower has vacated the home or passed away, forcing the servicer to foreclose on their estate, sell the home, and then file a claim with the FHA for the cost of buying the loan out of the pool. All this takes months or years to resolve, during which time the loan sits on the servicer's balance sheet while the servicer covers the taxes, insurance, and maintenance costs.

For a sense of the costs involved, consider a lender funding \$10 million of buyouts a month. Assume it has maintenance, tax, and insurance payments of 2.5 percent per year over a two-year resolution period, numbers consistent with current market conditions. The best the lender can hope for is to borrow two-thirds of the total at a 6.75 to 7.00 percent rate, funding the rest with equity at a 15 percent rate of return, for a blended cost of funds of 9.5 percent. Assuming the lender is reimbursed at the debenture rate, which has averaged 2.39 percent since 2016, the lender will be spend 7.11 percent per year out of pocket for two years, or about 14 percent of the mortgage's value.<sup>6</sup> Thus, on \$10 million of buyouts, the total cost to the servicer is \$1.4 million, despite the government assuming the credit risk.

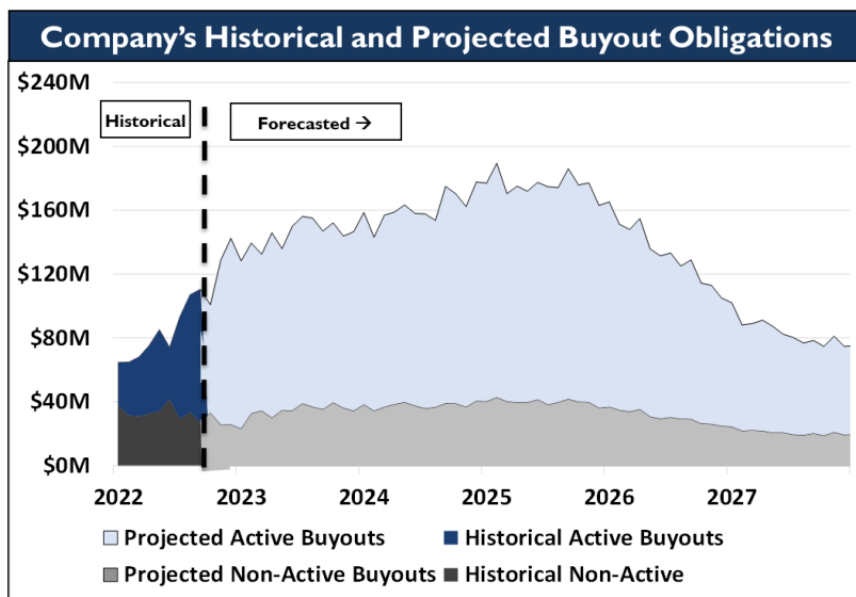
## How This Problem Will Ripple through the Industry

RMF managed a portfolio of HECM loans originated as early as 2006, making it a more seasoned book than the ones other large HECM servicers are managing. The longer a HECM is in place, the higher its loan-to-value ratio tends to be, as borrowers have had longer to borrow against their initial home value. The advanced age of its portfolio thus meant that RMF had a disproportionate number of HECMs

approaching 98 percent loan-to-value ratios, the point at which it would need to buy them out of their Ginnie Mae pool. As we can see in figure 1, which comes from RMF’s bankruptcy filing, this put RMF on a course to incur considerable costs over the coming years, a burden that it would not be able to bear.

FIGURE 1

Reverse Mortgage Funding’s Historical and Projected Buyout Obligations



Source: Reverse Mortgage Funding bankruptcy filing.

The rest of the HECM industry is not far behind RMF. Several other large servicers have portfolios only a year or so less seasoned than RMF’s, putting them on course to face the same prohibitive costs that we see in figure 1 later this year or early next.<sup>7</sup>

## What Should Be Done

The most effective step policymakers could take to address the problem is for the FHA to accept the assignment of all loans automatically upon buyout. This would remove the prohibitive costs of holding nonassignable loans and reduce the costs of holding assignable ones by reducing the time it takes to be reimbursed. Shifting the administrative burden of overseeing servicing on loans in which borrowers are behind on their taxes or insurance, have vacated their property, or have passed away will increase the administrative costs to the FHA, but it could make up those costs and perhaps more by allowing those servicing HECMs to continue once the loans have been assigned.<sup>8</sup> As we have pointed out previously,<sup>9</sup> loans assigned to the FHA have long been serviced in a way that increases their losses unnecessarily.<sup>10</sup> Allowing HECM servicers to retain servicing would prevent the costly and cumbersome transfer process and leave the loan in the hands of those better equipped to service them, reducing costs to the servicer and the FHA alike.

If the US Department of Housing and Urban Development determines that the FHA cannot accept the assignment of a meaningful number of loans, it should extend Ginnie Mae's Pass-Through Assistance Program to HECM servicers to ease the costs of holding the loans that remain. Set up to help forward servicers handle the pandemic's economic fallout, the terms of this Ginnie Mae lending facility are intentionally punitive so that it is used only when there are no other sources of liquidity available to servicers. To help address the challenges HECM servicers face, Ginnie Mae should reduce the rate charged, ideally to a level that is in the money only in times of economic stress so that it avoids supplanting private capital altogether and fits squarely within Ginnie Mae's statutory authority as a lender of last resort.

Limits on Ginnie Mae's authority are likely to make whatever help it can provide here modest. So the key to making HECM sustainable will be reducing the number of loans that cannot be assigned to the FHA upon buyout, not simply improving the economics of loans left with the servicer.

Although there is no silver bullet for the liquidity challenge HECM servicers face, policymakers can reduce the capital burden enough to put the program on more solid footing. But they need to work quickly, because if this burden is not addressed soon, the liquidity challenges that brought down RMF will drive off the rest of the industry, forcing many middle-class seniors to choose between holding on to their home and accessing the one source of wealth they have left: their home equity.

## Notes

- <sup>1</sup> "Before-Tax Family Income by All Families," Board of Governors of the Federal Reserve System, last updated November 4, 2021, <https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/>.
- <sup>2</sup> Fan-Yu Kuo, "Homeownership Remains Primary Driver of Household Wealth," *Eye on Housing* (blog), National Association of Home Builders, February 16, 2021, <https://eyeonhousing.org/2021/02/homeownership-remains-primary-driver-of-household-wealth/>.
- <sup>3</sup> Other features of these products further limit their reach. HELOCs and second mortgages tend to require high credit scores, and cash-out refinances would require borrowers to refinance what is often a lower-cost outstanding mortgage at today's higher interest rates. Most borrowers are not going to pay off a 3 percent mortgage with a new 6.5 percent loan.
- <sup>4</sup> The lender does assess the borrower's financial condition to determine whether they must escrow their taxes and insurance.
- <sup>5</sup> There is a small non-agency market for reverse mortgages, but these mortgages are illiquid and are rarely traded after initial issuance.
- <sup>6</sup> The debenture rate is a regulatorily established interest rate paid from the date the loan is removed from the pool until the date the claim is paid. It is worth noting that the debenture rate is set as of the time the loan is originated, and the rate that a lender pays for capital to cover the buyout is set at the time of the buyout. So in a rising-rate environment, the difference between those two rates can be considerable, creating a large negative carry for the servicer.
- <sup>7</sup> There is another difference worth noting between the loans in RMF's portfolio and those of the other large servicers. The FHA has made several programmatic changes in recent years that have reduced the average risk of loans made through HECM. More of the loans in RMF's portfolio pre-date these changes than those in other servicers' portfolios. So even as the portfolios of the remaining servicers hit buyout levels approximating those

that brought RMF down, their loans will be modestly less distressed as a whole and are thus modestly less costly to service.

- <sup>8</sup> Whether these moves together come at a net cost may ultimately limit what the FHA has the authority to do. Under federal Credit Reform Act guidelines, the FHA would need an appropriation before taking any steps that would increase the costs on loans already insured. So the FHA will need to determine what mix of moves here is cost neutral or better to determine what it can actually do.
- <sup>9</sup> Laurie Goodman and Edward Golding, “The FHA Can Improve Its Reverse Mortgage Program by Changing Servicing Protocol,” *Urban Wire* (blog), Urban Institute, May 31, 2019, <https://www.urban.org/urban-wire/fha-can-improve-its-reverse-mortgage-program-changing-servicing-protocol>.
- <sup>10</sup> In our earlier study, we showed that loans assigned to the US Department of Housing and Urban Development had a 42 percent loss severity, compared with a 12 percent loss severity for those that remained with the initial servicer, despite the latter being a more distressed group (composed of loans in which the borrowers were behind on their taxes or insurance, have vacated their home, or have passed away). Reducing the loss severity of assigned loans from 42 percent to 12 percent should more than compensate for any additional administrative costs to the Department of Housing and Urban Development.

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