

RESEARCH

For Seniors, Equity Begins At Home

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Retirement or planning for it can be scary. Employers are cutting back on pension benefits, the U.S. savings rate is negative, and health care costs are rising as life expectancies continue to increase. Combine that with a volatile investment environment, and the result is added uncertainty. However, there is one bright spot. Housing prices are near historic highs, and through a type of loan known as a reverse mortgage, seniors can use the equity in their homes to balance the instability of other sources of income while remaining in those homes as they age.

Retirees and those baby boomers for whom retirement is on the horizon aren't alone in warming up to reverse mortgages. They're also an attractive product for lenders. Faced with rising interest rates and a slowing housing market, institutions see the reverse mortgage as a vehicle that has wide appeal to a segment of the population poised for huge growth. A recent report commissioned by the National Institute on Aging notes that the U.S. population age 65 and older is expected to double within the next 25 years. The first baby boomers will reach 65 in 2011, bringing a surge of retirees.

For This Vehicle, The Cash Shifts Into Reverse

The reverse mortgage takes its name from the direction of the cash flow: Rather than sending mortgage payments to a bank or other lending facility, the borrower receives money. The amount of money that can be borrowed is primarily based on the borrower's age and equity in the house. To qualify, borrowers in the U.S. must be 62 or older. Borrowers can receive reverse mortgages for different types of homes, including owner-occupied houses, condominiums, and manufactured homes on owned lots. Payments can be distributed to borrowers in several ways: as a lump sum, a series of fixed monthly payments, a line of credit, or any combination of these methods.

The loan matures when:

- The last surviving borrower dies,
- The home is sold,
- All borrowers permanently move to a new residence, or
- The last surviving borrower does not live in the home for the previous 12 months.

The loan may be due sooner if:

- The borrower fails to pay the taxes or maintain the required insurance on the property, or
- The borrower does not keep up the property.

While most borrowers use the payments from reverse mortgages to supplement their incomes, they don't have to. Rather, they can use these loans in any way that they choose; for example, to fund major purchases or take extravagant vacations. Another advantage of reverse mortgages is that the cash

payments that the borrower receives are tax-free (because they're loan proceeds and not income), and generally don't affect Social Security or Medicare benefits, according to the National Reverse Mortgage Lenders Association (NRMLA).

An additional plus for the borrower is that a reverse mortgage is a nonrecourse first-lien mortgage loan, meaning the lender cannot attach the borrower's other assets to satisfy the loan. However, the loan's servicer is able to take certain actions if the borrower fails to maintain the property to certain standards or does not pay property taxes. The servicer can increase the loan amount to cover these costs, or foreclose on the property.

The Rising Potential For Securitization

Reverse mortgage originations are on the rise. A recent survey by the Mortgage Bankers Association (MBA) found that, in the second half of 2005, total reverse mortgage originations increased 45% over the first half of the year. The NRMLA notes that the U.S. Department of Housing and Urban Development (HUD) endorsed a record 6,990 Home Equity Conversion Mortgage (HECM) loans (see box) in March 2006 and 33,141 HECM loans during the first half of fiscal year 2006 (ending March 2006). This represents a 56% increase over the 21,243 HECM loans endorsed during the same period in 2005. Of course, as more reverse mortgages are originated, and as issuers, investors, and the secondary market become more comfortable with them, Standard & Poor's Ratings Services expects to see growth in the securitization of these loans. We have already rated reverse mortgage securitizations in the U.S., Canada, and the U.K. Recently, reverse mortgages were introduced in Israel, and they are being discussed in India as well.

We have rated three U.S.-based reverse mortgage transactions to date. Most recently, in March 2005 we rated Structured Asset Securities Corporation Reverse Mortgage Loan Trust 2005-RM1, the largest reverse mortgage securitization yet. This \$503.5 million issue included 1,218 non-HECM loans originated over the prior two-and-a-half years.

Avoiding The Dreaded "Cross-Over" Point

Despite their many attractions, reverse mortgages do pose risks for borrowers, lenders, and investors. Obtaining one means that after many years of paying down their mortgages, homeowners again begin accumulating debt. Also, as interest accrues, the borrower's equity position continues to decline, which in turn reduces the potential inheritance of the borrower's heirs.

For lenders, the risk is that the principal outstanding, together with accrued interest for the loan, could exceed the value of the home. If this occurs, a loss or point of diminished returns is reached, known as the cross-over point. Any amount that exceeds the cross-over point is a realized loss. To ensure that a loan is profitable, lenders address this risk when establishing loan limits. In determining these limits, lenders consider the homeowner's age and the home's appraised value when the lender originates the reverse mortgage.

In rating reverse mortgage transactions, Standard & Poor's focuses on the interest rate on the reverse mortgage versus the bond interest rate, the market value risk associated with the property, appreciation rates for the property (the expected appreciation over the life of the reverse mortgage), and the expected payment of the loan resulting from either death or relocation of the borrower. This approach differs from the one used to analyze traditional forward mortgages, where our ratings focus on the probability of default by the borrower as well as prepayment risk. However, reverse mortgage borrowers have limited risk of payment default, as the only payment occurs after the property's sale, primarily when the borrower dies or moves out. Still, the borrower can default in other ways, such as failing to pay property taxes or not maintaining the property.

The Need For Accurate Models

The challenge of rating reverse mortgage transactions is to determine at what speeds borrowers will repay their loans. Also, as interest rates continue to rise, reverse mortgage loans are at greater risk of reaching the cross-over point. We must ensure that we address these risks correctly in our cash flow analysis for reverse mortgages.

Our assumptions for analyzing reverse mortgage loans include age-specific repayment assumptions, which represent both mortality and mobility events. When modeling repayment assumptions in our cash flows, we look at the age of the borrower or the youngest borrower (when the mortgage is taken out by a couple).

We combine these considerations with our interest rate stresses and with our market value decline assumptions, which address the possibility that homes will depreciate. We feel that these assumptions accurately address the risks associated with securitizations backed by reverse mortgage loans. As with any of the assets we analyze, we continue to monitor the performance of the loans and the markets for any changes and added risks associated with the assets, and we will modify our criteria accordingly.

As this product continues to evolve, investors will become more comfortable with reverse mortgage securitizations. This in turn will lead to more securitizations backed by these loans. In addition, the secondary markets will continue to add certain efficiencies to the process, reducing the costs associated with originating reverse mortgages. And reverse mortgage originators will use these efficiencies to pass the cost reductions on to borrowers. Although there have only been a handful of U.S.-based reverse mortgage transactions to date, conditions are ripe for the market to explode. And that could be good news for millions of retirees who'll be looking to add some security to their lives.

The Two Flavors Of Reverse Mortgages

Reverse mortgages come in two basic types, each posing advantages and disadvantages. HUD provides the most common type, the home equity conversion mortgage (HECM). These federally insured loans were introduced in 1989. With HECMs, the maximum loan amount is limited, with this limit varying by county. However, recent proposals seek to make HECM loans more accessible to seniors. The NRMLA reports that the U.S. House of Representatives is considering legislation that would create one single national loan limit for the HECM program, as well as do away with the current cap on the number of HECM loans that the Federal Housing Administration can insure.

The second type is the non-HECM. Offered by a variety of lending institutions, these mortgages' primary advantage is that they can exceed the HECM amount limit. However, these loans aren't federally insured, and they can be much more expensive than HECM loans due to higher origination costs.

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