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

Jim Parrott, Laurie Goodman, and Ted Tozer

January 2023

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.[1] 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.[2] 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.[3]

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.[4]

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.[5]

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.[6] Thus, on $10 million of buyouts, the total cost to the servicer is $1.4 million, despite the government assuming the credit risk.

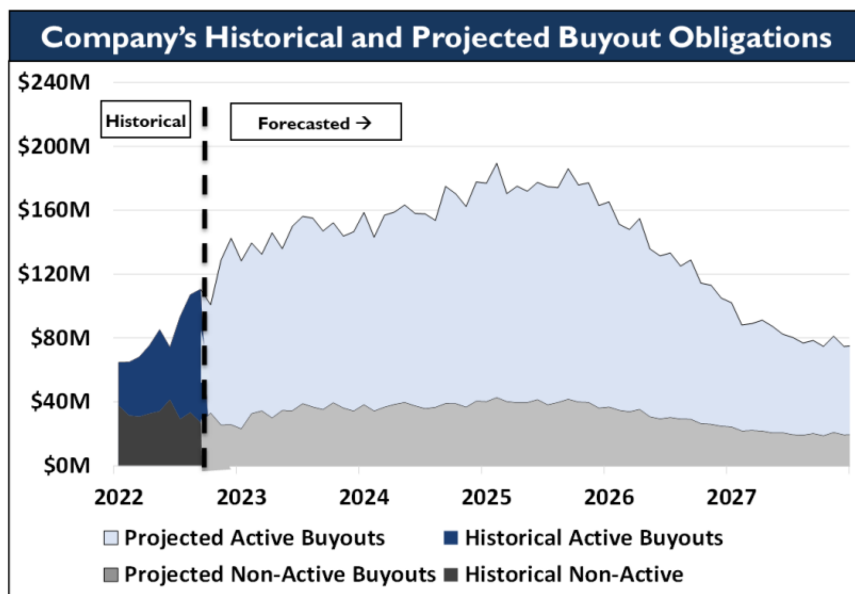
How This Problem Will Ripple through the Industry

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.[7]

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.[8] As we have pointed out previously,[9] loans assigned to the FHA have long been serviced in a way that increases their losses unnecessarily.[10] 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

[1] "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/.

[2] 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/.

[3] 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.

[4] The lender does assess the borrower's financial condition to determine whether they must escrow their taxes and insurance.

[5] There is a small non-agency market for reverse mortgages, but these mortgages are illiquid and are rarely traded after initial issuance.

[6] 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.

[7] 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.

[8] 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.

[9] 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.

[10] 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.

References

Bhutta, Neil, Jesse Bricker, Andrew C. Chang, Lisa J. Dettling, Sarena Goodman, Joanne W. Hsu, Kevin B. Moore, Sarah Reber, Alice Henriques Volz, and Richard A. Windle. 2020. *Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances*. Washington, DC: Board of Governors of the Federal Reserve System.

EBRI and Greenwald (Employee Benefit Research Institute and Greenwald Research). n.d. *2022 Retirement Confidence Survey*. Washington, DC: EBRI and Greenwald.

About the Authors

Jim Parrott is a nonresident fellow at the Urban Institute and owner of Parrott Ryan Advisors, which provides strategic advice on housing finance issues to financial institutions active in the primary and secondary mortgage market. Before joining Urban in 2013, Parrott spent several years in the Obama White House as a senior adviser at the National Economic Council, where he led the team of advisers charged with counseling the cabinet and president on housing issues. He was on point for developing the administration's major housing policy positions; articulating and defending those positions with Congress, the press, and public; and counseling White House leadership on related communications and legislative strategy. Before his time in the White House, Parrott was counsel to Secretary Donovan at the US Department of Housing and Urban Development. Before that, he was a litigator, first in New York with Sullivan and Cromwell, and later in North Carolina with Smith Anderson. Parrott has a BA in philosophy from the University of North Carolina, an MA in philosophy from the University of Washington, and a JD from Columbia Law School. He was a Peace Corps volunteer and served in Sri Lanka. He currently serves on the local advisory board of the Ackland Museum of Art in Chapel Hill, North Carolina.

Laurie Goodman is an Institute fellow and founder of the Housing Finance Policy Center. The center provides policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Before joining Urban, Goodman spent 30 years as an

analyst and research department manager at several Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, a boutique broker-dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked first by Institutional Investor for 11 straight years. Before that, she held research and portfolio management positions at several Wall Street firms. She began her career as a senior economist at the Federal Reserve Bank of New York. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman serves on the board of directors of MFA Financial, Arch Capital Group Ltd., and Home Point Capital Inc. and is a consultant to the Amherst Group. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an AM and PhD in economics from Stanford University.

Ted Tozer is a nonresident fellow in the Housing Finance Policy Center. Immediately before joining Urban, he was a senior fellow at the Milken Institute's Center for Financial Markets. Previously, Tozer was president of Ginnie Mae for seven years, bringing with him to the institution more than 30 years of experience in the mortgage, banking, and securities industries. As president of Ginnie Mae, Tozer managed Ginnie Mae's nearly $1.7 trillion guarantees of mortgage-backed securities and more than $460 billion in annual issuance. He also led the modernization effort of the Ginnie Mae Securitization Platform. Tozer oversaw the transition for a depository-dominated issuer base to an independent mortgage banker–dominated base. He was the Obama administration point person for rewriting the Home Affordable Refinance Program. Tozer also oversaw the transition from the Ginnie Mae I program to the Ginnie Mae II program. Before joining Ginnie Mae, he was senior vice president of capital markets at the National City Mortgage Company (NCM) for more than 25 years, overseeing pipeline hedging, pricing, loan sales, loan delivery, and credit guideline exceptions. He was instrumental in transforming NCM from an originate-and-hold lender to an originate-and-sell lender. Tozer also serves on the board of directors of PennyMac Financial Services, a mortgage originator. He holds a bachelor's degree in accounting and finance from Indiana University.

Acknowledgments

This brief was supported by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at urban.org/fundingprinciples.

500 L'Enfant Plaza SW
Washington, DC 20024
www.urban.org

ABOUT THE URBAN INSTITUTE

The Urban Institute is a nonprofit research organization that provides data and evidence to help advance upward mobility and equity. We are a trusted source for changemakers who seek to strengthen decisionmaking, create inclusive economic growth, and improve the well-being of families and communities. For more than 50 years, Urban has delivered facts that inspire solutions—and this remains our charge today.

Copyright © January 2023. Urban Institute. Permission is granted for reproduction of this file, with attribution to the Urban Institute.