

# A TURNING POINT IN THE HISTORY OF HUD'S HOME EQUITY CONVERSION MORTGAGE PROGRAM

Despite home sales price declines observed in some markets in 2007, single-family residential real estate values have risen significantly on net over the past decade. The repeat sales house price index produced by the Office of Federal Housing Enterprise Oversight (OFHEO) demonstrates that fact clearly (see Table 10 in the Historical Data section of this issue of *U.S. Housing Market Conditions*). For older Americans, equity in the home has come to represent a major share of their total wealth; however, owner-occupied housing, as an asset, is largely indivisible—a home cannot easily be sold in increments as can a stock portfolio. Thus, liquidating housing wealth to help meet cash needs during retirement is not easily accomplished. Converting home equity to cash generally requires the sale of the entire asset or the ability to issue debt against home equity.

The sale of a home may provide cash, but it will entail moving to alternate housing. Moving may work well for some homeowners; downsizing a home or selling and renting are both viable options, particularly for wealthier seniors. Studies have shown, however, that most older Americans prefer aging in place to selling and moving (for example, Bayer and Harper, 2000), and lower income seniors who have lived a long time in a modestly priced home that they have fully or nearly paid off may be especially reluctant to sell the home and buy or rent new housing.

Traditional debt, such as first- or second-lien home equity loans or lines of credit, can also provide cash, but the requirement for periodic repayment and an income sufficient to service the debt make this alternative approach less than an ideal solution for lower income seniors wishing to age in place. As a result, the question of how future retirees might be best able to use home equity—often their largest asset—to help fund their retirement has been brought to the forefront of financial planning discourse. One solution that has become increasingly popular is the *home equity conversion mortgage*, also called a *reverse mortgage*. A reverse mortgage is debt issued against home equity, which can provide significant sums of cash without the sale of the home and without the need to make periodic repayments. Because no repayment is due until the borrower no longer uses the home as his or her principal residence, no traditional underwriting is necessary to demonstrate the borrower's financial capacity (income) to service the debt. Reverse mortgages are secured only by the equity in the property and not by the borrower's capacity to repay.

This article provides an overview of the design and history of the U.S. Department of Housing and Urban Development's (HUD's) Home Equity Conversion Mortgage (HECM) program, also known as the Federal Housing Administration (FHA) reverse mortgage program. Arguably, 2008 will be viewed as a turning point in the history of the HECM program as first quarter data confirm that annual origination volume exceeded 100,000 loans for the first time. The decade-long rise in home prices and the persistence of relatively low interest rates since 2000 have increased consumer demand for reverse mortgages. In addition, lender interest in supplying reverse mortgages has increased since 2006, the year in which HECM loans were first packaged into mortgage-backed securities. The resulting surge in HECM originations is timely, given that 2008 is the year in which the first members of the large and financially savvy "baby boom" generation (born between the years 1946 and 1964) turn 62, the minimum qualifying age for a HECM loan. Over the next several years, we shall begin to see if baby boomers embrace HECM as a mainstream product to access cash for home improvements, medical bills, or everyday living. We will also soon see if wealthier homeowners will use reverse mortgages for asset management during retirement, enabling the homeowners to consume home equity for living expenses, if desired, before liquidating stock portfolios or other assets.



## Overview of HECM Design and History

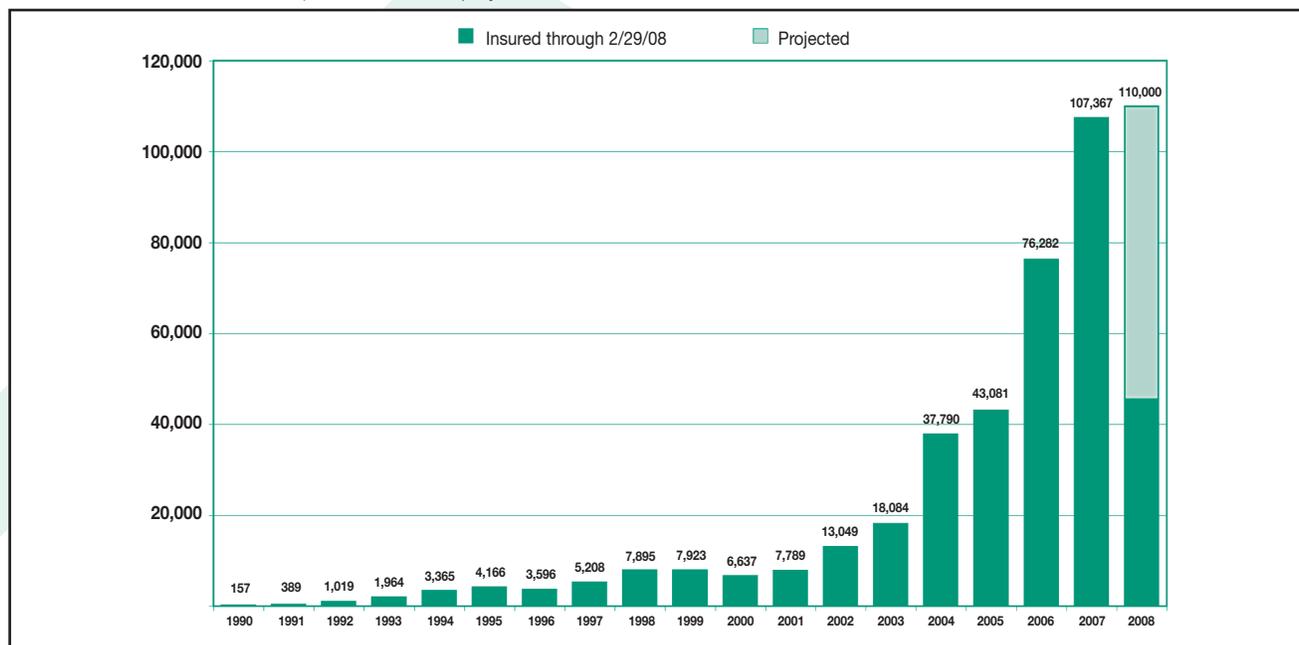
A reverse mortgage is a first-lien-position loan secured by the home equity of an older (usually age 62 and above) borrower. The loans are typically *nonrecourse*—the only asset backing the loan is the mortgaged property. The term *reverse mortgage* derives from the pattern of payments, which is typically the reverse of a traditional mortgage loan used to buy a home. Specifically, with a traditional mortgage, the lender advances funds to the borrower in a lump sum at the outset and the borrower makes periodic repayments to the lender that eventually retire the debt. With a reverse mortgage, the pattern is the opposite: the lender advances funds periodically to the borrower and the borrower makes no repayment to the lender until the end of the loan, when a lump sum repayment is due. Most reverse mortgages have an indefinite term to maturity; that is, the loans are not due and payable as long as the borrower continues to reside in the home. Reverse mortgages are almost always restricted to older borrowers because the longer life expectancies associated with younger borrowers makes the indefinite repayment deferral prohibitively expensive.

HUD's HECM is a major product in the reverse mortgage market, with an estimated share that has ranged between 85 and 95 percent since 2006, according to estimates by Reverse Market Insight, Inc. HUD does not lend money with HECM; rather, it provides *mortgage insurance* to private lenders, protecting them against losses resulting from non-repayment in full of the loans, thereby making private lenders more willing to offer these loans. Nonrepayment losses would typically occur if the amount of the debt exceeds the net proceeds from the sale of the property when the loan becomes due. If a loss occurs due to nonrepayment, the lender files a claim with HUD for insurance benefits.

Conventional (not government-insured) reverse mortgage products have been available in the market for many years, although these products tend to serve the so-called "jumbo" reverse mortgage market—homes valued above FHA's maximum loan amount, which currently ranges from \$200,160 in lower cost markets to \$362,790 in the highest cost markets.

Launched in 1989 as a limited pilot program, HECM volume has now exceeded 390,000 loans; more than 50 percent of these loans occurred in the 24 months preceding March 2008 as growth has been accelerating (see Exhibit 1).<sup>1</sup> The demonstration program for

Exhibit 1. HECM Volume (Cases Insured) by Fiscal Year



HECM = Home Equity Conversion Mortgage.

Notes: Projection is linear: 12 times average monthly volume to date for fiscal year 2008. Fiscal years run from October 1 to September 30.

home equity conversion was first authorized by the Housing and Community Development Act of 1987 and was initially limited to 2,500 total mortgages, although that limit was soon raised. HUD insured the first HECM loan in November 1989 (fiscal year 1990). The Fiscal Year 1998 HUD Appropriations Act made HECM a permanent program.

Although lenders are the direct beneficiaries of the HECM mortgage insurance, older homeowners benefit because, with HECM insurance, lenders are willing to offer reverse mortgages at better loan terms than they would without the guaranty. The many consumer protections that HECM provides borrowers are also beneficial to this market. These protections include a requirement for prospective HECM applicants to receive counseling from a HUD-approved independent source to ensure that applicants understand the HECM product and to determine whether less costly alternatives, such as local deferred payment loan or grant programs, are available before they can proceed with the application for a HECM loan. With HECM, HUD also protects borrowers with a guaranty that cash advances will be received in a timely manner if their lender becomes bankrupt or otherwise unable to make these advances. In the aftermath of Hurricane Katrina, for example, some HECM lenders had their operations disrupted, and, although none failed to advance HECM payments that were due, HUD was prepared to advance the payments to borrowers, if necessary, while the lenders recovered.

The HECM program enables borrowers to choose from many options for structuring cash advances from lenders. Borrowers may access cash in five different ways: (1) as a lump sum received at the time the loan is made; (2) as monthly payments for as long as the borrower resides in the property (called *tenure* payments); (3) as higher monthly payments for a fixed period of time (called *term* payments), after which borrowers may continue to reside in the property and defer repayment; (4) as a line of credit with which borrowers may control the amounts and timing of cash advances up to a maximum credit line; and (5) as some combination of these options. In addition, borrowers may switch any unused credit from one payment option to another at any time for only a small administrative processing fee. HUD believes the high degree of flexibility in setting up and modifying payment options are important to older borrowers, whose life circumstances can change rapidly. By far, the preferred payment option of HECM borrowers is the line of credit (more than

three-fourths of borrowers have chosen this payment option). About 12 percent of borrowers have combined monthly payments with a reduced line of credit.

HUD is able to offer borrowers such flexibility in cash advance options because HUD controls its risk of loss by limiting the net present value of all cash advances to an amount called the *principal limit*, which is uniquely calculated for each loan when it is underwritten. HUD is indifferent to the pattern of cash advances that borrowers take, as long as the net present value of current and future cash advances does not exceed the principal limit. HUD provides lenders a table of principal limit factors, which vary by age of the borrower and interest rate and can be used to calculate the principal limit for any loan. For example, the factor for a 75-year-old borrower and a 7-percent interest rate is 0.609. If a home were worth \$100,000, then the principal limit for that home value, borrower age, and interest rate combination would be \$60,900 ( $\$100,000 \times 0.609$ ). The net present value of all cash advances the borrower receives over the life of the loan, including loan fees paid on behalf of the borrower, must not exceed \$60,900.

HUD places an additional constraint on the HECM principal limit by capping it at an amount equal to the principal limit factor multiplied by the loan's *maximum claim amount*, which is the lesser of home value or the FHA loan limit for the area in which the property is located. Properties valued above the FHA loan limit remain eligible for HECM, but, because the principal limit is capped, homeowners with higher valued homes often choose conventional reverse mortgages, which are not constrained by the FHA limit.

Exhibit 2 illustrates how HECM principal limit factors vary by the combination of the borrower's age and the interest rate. HUD established insurance premium rates for the program, then used an actuarial model to set principal limit factors designed to break even for each age and interest rate combination. In this context, the term *break even* means that the net present value of premium revenues HUD expects to collect minus the insurance claim costs HUD expects to pay over the life of a reverse mortgage with principal limit equal to the factor multiplied by the (uncapped) property value is zero under the HUD pricing assumptions. Pricing assumptions include expectations of future home price growth, loan terminations due to death, move-out, or refinancing, and interest rate fluctuations. The principal limit factors increase with a borrower's age,



**Exhibit 2. HECM Principal Limit Factors (for Selected Ages and Interest Rates)**

Interest Rate* %	Age of Borrower at Loan Origination		
	65	75	85
7.0	0.489	0.609	0.738
8.5	0.369	0.503	0.660
10.0	0.280	0.416	0.589




HECM = Home Equity Conversion Mortgage.

\*Expected Rate (10-year Treasury rate + lender's margin).

as would standard life annuity payments to older people with shorter life expectancies. In addition, principal limit factors decrease with higher interest rates because payment amounts in high-rate environments have to be reduced to offset the higher interest accruals.

Exhibit 3 shows selected characteristics of HECM loans and borrowers by the fiscal year in which the loan was insured. Note that the averages for property value are higher than those for maximum claim amount in each year. For fiscal year 2007, the average value was \$261,900, but the average maximum claim amount was \$229,300. This difference is observed because 30 percent of the cases insured that year had property values above the FHA loan limit for the area; thus, these cases have capped principal limits.

HUD prepared and documented detailed information about the design and historical experience of the HECM program in five reports to the U.S. Congress. The first report, submitted to Congress in 1990, described the HECM product's features and explained why HUD made various design decisions, including the actuarial assumptions of the HUD pricing model. The second HUD report, submitted to Congress in 1992, provided initial findings on characteristics of

borrowers, loans, properties, and lenders and on outstanding legal and programmatic issues. The third report to Congress, submitted in 1995, updated the findings of the 1992 report and conducted an initial actuarial review of the solvency of the program's insurance fund. The fourth report, submitted to Congress in 2000, updated the 1995 actuarial review and presented the latest available findings on the characteristics of borrowers, loans, properties, and lenders. The 2000 report also included borrowers' feedback regarding satisfaction with the program. The fifth and most recent report to Congress, submitted in 2003, was mandated by lawmakers to examine the potential impacts of three policy proposals: (1) a reduced mortgage insurance premium for HECM borrowers who refinance their loans, (2) a national loan limit for HECM to replace the county-by-county FHA loan limits, and (3) a reduced premium for borrowers who use the HECM loan to purchase long-term healthcare insurance. HUD implemented the refinance premium reduction in 2004. The national loan limit is a provision contained in FHA reform bills passed by both houses of Congress during 2007 and is likely to become law when and if FHA reform is enacted. The premium reduction for long-term healthcare insurance is still under review.

**Exhibit 3. Total HECM Cases Insured by Fiscal Year Plus Selected Loan and Borrower Characteristics**  
(Data as of February 29, 2008)

Fiscal Year (October 1 to September 30)	Count of Cases Insured	Average Interest Rate* (%)	Average Property Value (\$)	Average Maximum Claim** (\$)	Average Initial Principal Limit (\$)	Average Borrower's Age	Gender of Borrower(s)		
							Single Female (%)	Single Male (%)	Couples*** (%)
1990	157	9.8	108.7	84.2	39.0	76.7	57.3	16.6	26.1
1991	389	9.3	126.4	97.5	43.5	76.5	56.0	13.9	30.1
1992	1,019	8.9	124.7	97.4	48.6	76.6	57.7	15.0	27.3
1993	1,964	7.6	119.7	97.9	52.6	75.7	55.0	14.3	30.7
1994	3,365	7.6	124.9	103.8	58.0	75.2	54.8	14.5	30.8
1995	4,166	8.6	124.8	105.4	54.3	76.0	56.5	13.5	30.0
1996	3,596	6.8	117.2	103.3	57.3	75.9	56.4	12.5	31.1
1997	5,208	8.1	117.5	105.2	58.0	75.9	56.6	13.2	30.2
1998	7,895	7.4	118.7	107.0	64.3	75.7	56.0	14.1	29.9
1999	7,923	6.5	131.9	117.8	81.6	75.3	54.8	14.5	30.7
2000	6,637	7.3	141.7	124.6	78.6	76.0	56.8	13.0	30.2
2001	7,789	6.7	167.1	140.6	97.4	75.5	54.4	13.6	31.9
2002	13,049	6.4	178.0	151.3	110.0	75.1	51.3	14.0	34.7
2003	18,084	5.4	197.6	165.9	131.3	74.3	48.6	14.2	37.2
2004	37,790	5.8	219.4	182.2	133.9	74.3	48.6	15.2	36.2
2005	43,081	5.7	254.9	206.0	144.4	73.8	46.0	16.1	37.9
2006	76,282	6.0	289.7	235.6	158.9	73.8	44.5	16.7	38.8
2007	107,367	6.0	261.9	229.3	155.7	73.5	44.6	18.2	37.2
2008 (part)	45,538	5.5	243.1	218.8	155.1	73.1	44.8	18.4	36.8
<b>Total</b>	<b>391,299</b>								

HECM = Home Equity Conversion Mortgage.

\*Interest rate shown is the "expected rate," which for adjustable-rate loans is the 10-year constant maturity Treasury rate at closing plus lender margin.

\*\*"Maximum claim" on a HECM loan = lesser of property value or Federal Housing Administration loan limit for locality.

\*\*\*Includes all cases with more than one borrower, irrespective of gender. Age is reported as that of the youngest co-borrower.

Note: Dollar amounts are in thousands.

Source: HUD data

## Financial Soundness of HECM

Between 1989 and 1998, HECM was a demonstration program and was not initially subject to some of the risk management criteria that apply to permanent loan guaranty programs. Rather, during the demonstration phase, the financial performance of HECM was reviewed in the periodic mandatory reports to Congress. These reports showed that the demonstration was operating soundly and premium revenues were likely to be adequate to pay all future claims on a net present value basis.

When by 1998 HECM became a permanent HUD program, previous reporting requirements ended and HECM became subject to all the numerous laws and federal accounting guidance that govern the risk management and reporting for all government loan guaranty programs. One such law is the Federal Credit Reform Act of 1990, which requires HUD to make annual estimates of the *credit subsidy* associated with new HECM insurance guarantees. Credit subsidy represents the projected net present values of all cashflows (premium inflows as well as insurance claim outflows) associated with new loan guaranty commitments over the life of these loans. Under the law, all subsidy amounts for federal loan guaranty programs must be fully budgeted in the year in which



the loan guarantees are committed. If the credit subsidy for a program is positive (meaning program costs exceed revenues), a federal appropriation must be in place to cover the full amount of the subsidy before the loan may be insured. If the credit subsidy is negative (meaning program revenues exceed costs), the program produces *receipts* for the government, which may be used to offset other spending in the budget. A negative subsidy rate, expressed as a percentage of commitment volume, indicates a loan guaranty program is self-supporting from premiums paid by borrowers and does not require federal appropriations to operate. FHA's standard home purchase *forward mortgage* loan product, the Section 203(b) program, is self-supporting and maintains a negative credit subsidy rate.

HECM, too, has always maintained a negative subsidy rate.<sup>2</sup> This observation may seem contrary to the break-even design of the HECM principal limit factors, which suggest the subsidy rate should be zero. With updated economic forecasts and other variations from the original pricing assumptions, such as differences in loan termination rates and the proportion of cases with maximum claim amounts below appraised value (which provide extra equity to mitigate losses), credit subsidy rates can vary.

Given the current downturn in the sales housing market, one may ask if HECM will remain financially sound going forward. Property values are especially important for HECM because the loans are secured only by the mortgaged property and the lender has no other recourse to seek repayment. When assessing HECM's ability to withstand falling house values, however, HUD considers two important points. First, the original pricing model assumed property values would grow at a modest rate on average (4-percent nominal growth per year), but this growth was modeled as a distribution that allowed price changes to vary widely over time and across markets, including allowance for some nominal declines in property values. Unless property values decline for an extended period, the original pricing assumptions may remain robust. Second, because reverse mortgage borrowers do not have to make monthly payments to the bank, they are far more likely to "weather the storm" and keep their loans active until home prices recover. HUD has found that HECM loan terminations are actuarially driven mostly by mortality and age-related factors and are much less driven by economic factors. HUD is still assessing the full impact of the housing downturn on HECM; however, the prospects for continued soundness of the program are good.

## Developments in the Secondary Mortgage Market

Until 2006, nearly all HECM loans were sold by originating lenders to a single investor: Fannie Mae (formally, the Federal National Mortgage Association), a government-sponsored enterprise that provides liquidity to the U.S. housing market. Originating lenders generally prefer not to hold HECM loans on their balance sheets. Regulated depository institutions, for example, may find it difficult to manage portfolio capital requirements if they hold illiquid loan assets such as HECMs. Nondepository originators, such as mortgage banks, are often not structured to hold any loans in portfolio. In addition, interest income on reverse mortgage assets will not actually be received until the loan is paid off, which may discourage other lenders from holding these loans on their balance sheets. Therefore, the liquidity that Fannie Mae brought to the HECM market was vital to the success of the program in its early years.

Other investors have begun to compete with Fannie Mae in the secondary market for HECM loans. Although conventional reverse mortgages had been securitized by investment bankers several years earlier, the first private-label (nonagency-backed) HECM security was issued during 2006. During 2007, the Government National Mortgage Association (Ginnie Mae), an agency within HUD that provides liquidity for government-backed housing loans, launched its HECM mortgage-backed securities program, bringing HECM into the agency market. A HUD policy change in 2007, allowing adjustable-rate HECMs to be indexed to the London Interbank Offered Rate (LIBOR), should support even higher levels of investor interest in HECM-backed securities, whether private label or Ginnie Mae guaranteed, because LIBOR is an interest rate index that many investors prefer.

The advent of a competitive secondary market for HECM will bring many benefits to the primary market. As this market becomes more efficient, reverse mortgage products—both HECM and conventional—will be able to reach their full market potential. Increased liquidity from an efficient secondary market will broaden lender distribution channels for reverse mortgages and expand the investor base. This trend should lead to lower borrowing costs for borrowers and product innovations. HECM product innovations (those permissible under current HECM regulations) that a liquid secondary

market may foster include zero-closing-cost, fixed-rate, and loans with lower interest rates and resultant higher principal limits.

## Prospects for Future Growth

Reverse mortgage lending in the United States is poised for considerable growth. First, demographics show that the number of eligible elder households is much larger than the volumes of reverse mortgages that already have been made. Demand for reverse mortgages would remain high based on this fact alone. The number of eligible elder households is expected to grow rapidly, however, as increasing numbers of the baby boom generation reach the minimum age of 62. Not only will the new generation of senior homeowners be larger than its predecessor generation, it is likely that they will also be less averse to debt and more willing to use reverse mortgages.

To put the numbers in perspective, according to the national sample of the 2005 American Housing Survey, there were 17.8 million owner-occupied units with elderly householders (age 65 or older); of these, 14.8 million represent potential HECM borrowers—12.1 million had no outstanding mortgage, and 2.7 million had outstanding mortgages that totaled less than 40 percent of their home's value.<sup>3</sup> Offsetting refinements to this 14.8 million estimate would add in homeowners with primary householders between the ages of 62 and 65 and subtract those who would be unlikely to apply because they have spouses under the minimum qualifying age of 62 or have homes that would not qualify based on condition. Furthermore, the Joint Center for Housing Studies of Harvard University projects the number of owner households with heads ages 60 to 69 will increase by 53 percent between 2005 and 2015 (Joint Center for Housing Studies, 2007). The Joint Center's projection captures the early wave of baby boomers entering their eligibility years for reverse mortgages.

As the baby boom generation ages, demand for reverse mortgages may also rise with the demand for long-term medical care services, which is also

growing rapidly. Already a major expense for state governments, Medicaid programs are being targeted for cost-control efforts. In this tight fiscal environment, home equity could play an important role in reducing government expenditures for long-term care. The National Council on Aging reports that increased use of reverse mortgages for long-term care could result in substantial savings to Medicaid by 2010, depending on the future takeup rate for these loans (National Council on Aging, 2005). These estimated savings result from the additional cash available to reverse mortgage borrowers that could delay or even prevent their need for Medicaid assistance for nursing home care and, at the same time, afford these older Americans more choices in less costly home-based health care.

Thus, 2008 does indeed appear to be a turning point for HUD's HECM program: the volume of HECM originations has exceeded 100,000 a year, the secondary market for HECM continues to develop, the first baby boomers become eligible, and long-term healthcare demands fuel reverse mortgage demand. The next several years could be very dynamic for reverse mortgage activity in general and for HECM in particular.

## Notes

<sup>1</sup> Note that the rate of HECM growth has slowed during 2008, possibly due to lender liquidity constraints related to conditions in the secondary mortgage market and falling home prices in some markets affecting consumer demand. As the secondary mortgage market for HECM rebounds, and as home prices stabilize, these temporary disruptions in supply and demand are likely to dissipate.

<sup>2</sup> For fiscal year 2008, the HECM subsidy rate is negative 1.9 percent.

<sup>3</sup> Because HECM must be in a first-lien position, homeowners with existing mortgages must pay them off or subordinate them to the HECM. Homeowners with existing mortgages up to 40 percent of home value are more likely to be able to pay off the existing mortgage with the proceeds of a HECM (depending on the available principal limit) than those with existing mortgages more than 40 percent of home value.



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