U.S. Department of Housing and Urban Development
Office of Policy Development and Research

Preliminary Evaluation of the Home Equity Conversion Mortgage Insurance Demonstration

Report to Congress

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PRELIMINARY EVALUATION OF THE HOME EQUITY CONVERSION MORTGAGE INSURANCE DEMONSTRATION

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EXECUTIVE SUMMARY

With this report, the Department of Housing and Urban Development begins a series of regular biennial reports to the Congress evaluating the Home Equity Conversion Mortgage (HECM) Insurance Demonstration in accordance with Section 255(k) of the National Housing Act, as amended by Section 417 of the Housing and Community Development Act of 1987 (P.L. 100-242). This preliminary evaluation also updates an Interim Report on the HECM Demonstration that the Department submitted to the Congress in October 1990.

In accordance with the statute, the HECM Demonstration, also known as the Federal Housing Administration (FHA) reverse mortgage program, was designed by the Department in consultation with other Federal agencies and various organizations and individuals having appropriate expertise. The Department's design efforts continue a longstanding tradition of innovation at HUD and FHA going back to FHA's pioneering efforts in developing the first government-backed home mortgage insurance program and the self-amortizing, low-downpayment, long-term mortgage loan in the 1930's.

The HECM Demonstration aims (1) to permit the conversion of home equity into liquid assets to meet the special needs of elderly homeowners, (2) to encourage and increase participation by the mortgage markets in converting home equity into liquid assets, and (3) to determine the extent of demand for home equity conversion and the types of home equity conversion mortgages that best serve the needs of elderly homeowners. At this preliminary evaluation stage, the Department finds that the Demonstration has made significant progress toward meeting these goals, although it will require more time to completely fulfill the stated purpose.

Since the Interim Report was submitted to Congress, the volume of reverse mortgage loans originated under the HECM Demonstration has increased rapidly. Several factors contributed to this increase: the volume cap was raised to 25,000 loans, participants in the mortgage market have become more familiar with the instrument, many legal impediments have been resolved, and the number of qualified lenders and counselors has increased. As a result the number of loans originated more than doubled during 1991, and nearly doubled again during the first six months of 1992. As of mid-August 1992 a total of 2,155 loans had been closed, and there were firm commitments issued to another 367 borrowers.

Although the complexity of the HECM Demonstration may have slowed its initial growth, reverse mortgage borrowers appear to value the flexibility designed into the program. For example, the HECM Demonstration allows for five payment options: (1) monthly payments over a specified term; (2) monthly payments throughout the borrower's tenure in that residence; (3) a line of credit with no regular payments; (4) a line of credit with term payments; and (5) a line of credit with tenure payments. Each of these payment options has been chosen by a substantial share of borrowers to date. Similarly, the program allows borrowers to change payment options at any time during the life of the loan, and about 10 percent of borrowers to date have already taken advantage of this flexibility to change their payment options.

The HECM actuarial design — particularly the monthly insurance premium and the maximum line of credit or monthly payments available to borrowers — is based on specific assumptions regarding borrower mortality, move-out rates, and other parameters that determine the expected value of claims for mortgage insurance under the program. Because the program is relatively new, no mortgage insurance claims have been paid to date and it is still too early to assess the adequacy of the actuarial assumptions.

The HECM Demonstration appears to be a useful mechanism for certain elderly homeowners to convert their home equity into cash. The early evidence shows that the program appeals particularly to older borrowers with substantial equity in their residences but with little current income and few children. HECM borrowers tend to have more valuable houses than other elderly homeowners: the median property value for HECM borrowers to date is about $103,000 compared to about $65,950 for all elderly homeowners. Perhaps more important, the median income of HECM borrowers to date is substantially less than the income of other elderly homeowners: less than $7,600 per year, or less than half the median income of all elderly homeowners. Most HECM borrowers derive more than 92 percent of their total income from social security payments. In contrast, among the elderly population as a whole only about 38 percent of total income is derived from social security. HECM borrowers have an average of 0.59 children, and more than three-quarters have no children at all. This is consistent with the conventional wisdom that reverse mortgages may have less appeal for elderly homeowners who have children to supplement their incomes or to whom they may wish to bequeath their homes.

The HECM Demonstration has prompted the financial community of lenders, loan servicers, and secondary mortgage market investors to develop the capabilities to originate, service, and finance reverse mortgages under the program. Although a scarcity of lenders prepared to originate HECM loans slowed the early growth of the program, the number of qualified lenders is increasing. As of mid-August 1992 there were 52 lenders, including two state housing finance agencies, actively originating HECM loans in 38 states and the District of Columbia. Many lenders have been willing to originate reverse mortgages under the HECM Demonstration because of the willingness of the Federal National Mortgage Association (Fannie Mae) to purchase HECM loans.

In order to facilitate the secondary mortgage market in HECM loans, one company has developed a "correspondent" program through which lenders that have not themselves been qualified by Fannie Mae may originate mortgages and sell them to Fannie Mae through the correspondent. This company has also developed a substantial loan servicing practice specializing in HECM loans, performing subservicing of loans originated by correspondent lenders as well as servicing their own loans.

The statute authorizing the HECM Demonstration requires that prospective borrowers receive mandatory counseling from approved housing counselors before obtaining a HECM loan. Although counseling is viewed as a very important aspect of the design, this mandatory provision appears to have slowed the growth of the Demonstration, particularly since approved counselors are unavailable in some parts of the country, especially rural areas. Some concerns have been expressed as to the quality of counseling provided, but it appears that this concern will dissipate as larger numbers of counselors become more familiar with the program. The scarcity of qualified counselors, however, remains a problem as the program expands.

Existing laws and regulations at both the Federal and the State level have presented problems in implementing the HECM Demonstration. Many such laws and regulations were written for forward mortgages, for other types of loans, or for consumer protection, and contain provisions that conflict with the HECM Demonstration. Generally, preemption of the state law has not been a successful avenue for overcoming state law conflicts with the HECM Demonstration. In some cases, states have adopted enabling legislation to permit FHA reverse mortgage lending. Finally, some conflicts remain unresolved, although unresolved legal issues do not necessarily preclude HECM loans.

One major issue, recently resolved in part at the Federal level, involves the Truth-in-Lending Act (TILA), as amended by the Home Equity Loan Consumer Protection Act (HELCPA). Under HELCPA, mortgages insured under the HECM Demonstration are considered open-ended credit, making them subject to disclosure requirements regarding the risk of foreclosure that are designed for ordinary home equity loans but inappropriate for reverse mortgages. In addition, HELCPA created confusion about when a HECM loan can be declared due and payable. Conflicts with TILA did not preclude originations under the HECM Demonstration, but they held back the volume by generating confusion among borrowers about inappropriate disclosures and among mortgage lenders about unfamiliar requirements of open-ended credit. To eliminate these difficulties, the Department has sought both administrative and legislative remedies. The Department has urged the Federal Reserve Board to provide disclosure guidance specifically for reverse mortgages. Meanwhile, HUD has encouraged lenders to make use of existing administrative authority to modify disclosure language. Some lenders have been successful in making appropriate modifications, although the process does involve some expense for lenders. With regard to the ambiguity raised by TILA on the HECM due-and-payable provision, the Department included a recommendation in its legislative program for Fiscal Year 1993 that Congress clarify the application of TILA on this issue. In response, Congress included language in the Housing and Community Development Act of 1992 that exempts the HECM Demonstration from the HELCPA due-and-payable provision. It is likely that these administrative and legislative remedies will further increase activity under the HECM Demonstration.

CHAPTER 1

HOME EQUITY CONVERSION MORTGAGES: BACKGROUND AND PROGRAM BASICS

The Home Equity Conversion Mortgage (HECM) Insurance Demonstration (also known as the FHA reverse mortgage program) was created by Congress in 1987 to accomplish three objectives: (1) to permit the conversion of home equity into liquid assets to meet the special needs of elderly homeowners; (2) to encourage and increase participation by the mortgage markets in converting home equity into liquid assets; and (3) to determine the extent of demand for home equity conversion and the types of home equity conversion mortgages that best serve the needs of elderly homeowners. The principal objective of the Demonstration is to enable homeowners ages 62 and older to convert home equity into cash while they continue to live in their homes -- cash that can help elderly Americans to meet housing, health care, and basic living expenses.

The HECM Demonstration was designed by the Department in consultation with other Federal Agencies as well as with several other organizations and individuals with appropriate expertise. This design effort has been recognized as innovative by the financial community,[1] and continues a long tradition of innovation at HUD and FHA, extending back to the 1930s with FHA's pioneering development of the first government-backed home mortgage insurance program and the self-amortizing, low-downpayment, long-term mortgage loan.

The HECM Demonstration provides mortgage insurance for reverse mortgage loans originated by FHA-approved lenders. In general, reverse mortgages allow homeowners to borrow

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[1] "The Roles of FHA and HUD in the 1990's," Secondary Mortgage Markets, Spring 1990.

against the value of the equity they have built up in their homes. Unlike a traditional or "forward" mortgage, reverse mortgages provide for payments *from* the lender *to* the borrower. This means that the amount of debt secured by a reverse mortgage rises over time as payments are received and interest is accrued. The loan is repayable with interest in a lump sum when the owners sell the house, move permanently, or die. Lenders are repaid out of proceeds from the sale of the property, with any proceeds in excess of the amount needed to pay off the mortgage going to the borrowers or their estate. FHA insurance compensates lenders in the event that sales proceeds are not sufficient to meet the outstanding mortgage balance, and guarantees borrowers that loan payments will continue should the lender default.

Congress originally authorized HUD to insure 2,500 reverse mortgages through September 1991. The Department selected 50 FHA-approved lenders by lottery and gave them each a reservation of insurance authority to originate 50 reverse mortgages. However, in 1990 Congress amended the program in order to extend the Demonstration through 1995 and to expand insurance authority to cover 25,000 reverse mortgages. At the same time, the Department decided to permit the participation of any FHA-approved lender.

As of mid-August 1992 more than 2,500 home equity conversion mortgages had closed or received firm commitments through the Demonstration. Loans have been made in 38 states plus the District of Columbia with most borrowers ranging in age from 71 to 82 and having properties valued between $75,000 and $146,000.

While the initial startup was relatively slow, program activity has accelerated in recent months. The total number of HECM loans originated more than doubled during 1991. In the first half of 1992 the volume nearly doubled again. This rapid growth most likely reflects a growing familiarity and acceptance of FHA reverse mortgages among lenders and borrowers alike.

This report presents a preliminary evaluation of the HECM Demonstration, based on analysis of available data from a sample of 911 HECM loans originated to date as well as on interviews with individuals involved with the design or implementation of the Demonstration. The statute authorizing the HECM Demonstration explicitly identified several issues that should be addressed in the preliminary evaluation. These specific issues are summarized below, along with a brief description of the parts of this report in which each issue is addressed.

- Design and implementation of the Demonstration. Section 1.2 presents an overview of the design and implementation of the HECM Demonstration. Specific issues concerning program design and implementation are discussed in the following chapters, as described below.

- Number and types of reverse mortgages written to date. As mentioned, 2,522 reverse mortgages had closed or received firm commitment under the HECM Demonstration as of mid-August 1992. Exhibit 2-5 summarizes the types of loans originated, and Section 2.3.1 discusses the types of reverse mortgage loans.

- Profile of participant homeowner-borrowers, including incomes, home equity, and regional distribution. Chapter 2 presents a detailed discussion of the characteristics of borrowers participating in the HECM Demonstration. Section 2.1.2 focuses on incomes, Section 2.2.1 focuses on property values, and Section 2.2.2 focuses on initial equity as a percent of property value. The geographic distribution of reverse mortgages originated to date is presented in Exhibit 5-1.

- Problems encountered in implementation, including impediments associated with State or Federal laws or regulations governing taxes, insurance, securities, public benefits, banking, and any other problems in implementation. Chapter 5 presents a detailed discussion of legal barriers to the expansion of the HECM Demonstration, including State and Federal laws and regulations. Other problems encountered in implementation are described in Section 3.3 (focusing on lenders) and Chapter 4 (focusing on mandatory housing counseling).

- Types of mortgages appropriate for inclusion in the Demonstration. As Section 2.3.1 explains, all five of the payment options currently offered under the HECM Demonstration have been selected by significant numbers of borrowers to date. It is not possible to conduct a more detailed analysis of the types of mortgages appropriate for inclusion in the program until further data has been gathered directly from participating borrowers as well as from non-participating but eligible elderly homeowners.

- Changes in the Demonstration, or in other Federal regulatory provisions, determined to be appropriate. No significant design changes have yet been identified. Chapter 5 discusses several important changes in Federal statutes and regulations that would contribute to the improved availability of the Demonstration by removing legal uncertainty and other obstacles.

- Risk created under HECM loans to mortgagors and mortgagees or to the Demonstration itself, and whether the risk is adequately covered by the premiums. Section 1.3 discusses the risk to borrowers, lenders, and the Federal government under the HECM Demonstration. It is impossible to evaluate the adequacy of mortgage insurance premiums until a significant number of loans become due and payable, but Section 1.3.3 notes that the Demonstration is not likely to suffer significant losses from any short-term recession in house prices.

- Whether the Demonstration has improved the financial situation or otherwise met the special needs of participating elderly homeowners. This issue cannot be addressed until further data is collected directly from participating borrowers.

- Whether the Demonstration has included appropriate safeguards for mortgagors to offset the special risks of reverse mortgages. Section 1.3 discusses the risk protection provisions of the HECM Demonstration. Although this issue should be evaluated further, lenders appear to believe that the Demonstration includes appropriate risk protection provisions.

- Whether home equity conversion mortgages have a potential for acceptance in the mortgage markets. Section 3.4 describes the importance of the secondary market for reverse mortgages. As noted, loan origination activity under the HECM Demonstration has accelerated significantly in the past year, and this growth can be attributed in part to the willingness of the Federal National Mortgage Association (FNMA) to purchase adjustable-rate reverse mortgages on the secondary market. The Federal Home Loan Mortgage Corporation has also expressed a willingness to purchase reverse mortgages, but has not yet done so.

The statute also specified that the Department should include in this preliminary evaluation comments and recommendations solicited from the following individuals and organizations:

- Board of Governors of the Federal Reserve System
- Secretary of Health and Human Services
- Federal Council on Aging
- Federal Home Loan Bank Board
- Comptroller of the Currency
- National Credit Union Administration Board

Each of these individuals and organizations was contacted concerning the issues identified above, and their comments and recommendations have been incorporated into this report. The report is also informed by discussions with participating lenders and HUD-approved housing counselors, as well as representatives of FNMA, the American Association of Retired Persons (AARP), the National Center for Home Equity Conversion, and others involved with the Demonstration. The observations and perceptions of these participants are valuable contributions to a thorough assessment of the Demonstration and its progress.

The balance of this chapter reviews the origins of the FHA reverse mortgage program and explains the chief features of HECM loans. Chapter 2 summarizes HECM activity to date, including a profile of borrowers, properties, and loan terms. Chapter 3 reports on the participation of the financial community in the Demonstration. Mandatory counseling requirements and efforts to increase the availability of counseling are discussed in Chapter 4. The report concludes in Chapter 5 with an examination of legal and regulatory impediments to HECM acceptance.

1.1 Program Origins

The HECM Demonstration represents "the first federal endorsement of home equity conversion as a serious housing option for the elderly."[2] The HECM Demonstration is designed to meet the needs of elderly homeowners who are house-rich but cash-poor. According to the 1989 American Housing Survey, this description fits more than 3.5 million elderly homeowners whose incomes are below $15,000 and whose homes are valued at more than $50,000. In the past, such homeowners typically had to sell their homes in order to realize accumulated home equity. Although home equity loans are widely available, these loans are essentially second mortgages that require monthly repayment. Low-income elderly households seldom have the income required to qualify for such a loan and the risks of foreclosure often make these loans unattractive to them.

In contrast, most reverse mortgages (including both private- and public-sector reverse mortgages not insured by FHA) and other home equity conversion plans are secured only against the value of the home. Reverse mortgages to tap home equity have been evolving for several decades, mostly through loan plans offered by state and local agencies and a few pioneering private lenders. With a reverse mortgage, borrowers can draw down their home equity either in a lump sum or regular installments. The amount that can be paid out varies according to the value of the home, the interest rate, and the particular loan terms. Most reverse mortgages do not require the loan to be repaid until the borrower moves permanently, sells the home, or dies. The balance is due with interest. Interest is charged to the loan balance each month, so that the total

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[2] Fairbanks, Joan E. "Home Equity Conversion Programs: A Housing Option for the 'House-Rich, Cash-Poor' Elderly," Clearinghouse Review 23 (Special Issue 1989), National Clearinghouse for Legal Services, Inc.

amount of interest owed by the borrower increases as interest compounds. This presents the possibility that the amount of the debt can increase beyond the value of the home.

In the absence of mortgage insurance, the private lending community overall has been reluctant to take on this and other risks associated with reverse mortgages. Those lenders who have offered plans have usually tried to reduce their risks by offering a fixed-term product that requires the homeowner to repay the loan at a prescribed date. FHA reverse mortgage insurance is designed both to protect lenders against this risk and to permit elderly homeowners to remain in their homes for as long as they desire and are able to do so. By making reverse mortgage insurance available to lenders nationwide, the Demonstration attempts to encourage the origination and servicing of reverse mortgages.

The Office of Economic Affairs in the Department's Office of Policy Development & Research (PD&R) assumed lead responsibility for developing the HECM Demonstration. Starting in early 1988, staff from this office worked closely with staff from the Office of Housing and the Office of General Counsel to identify key design issues and to determine the type of reverse mortgages to be insured through the Demonstration. HUD staff also consulted with other Federal agencies, private lenders and mortgage market participants, home equity conversion experts, and representatives of the elderly. These efforts resulted in a draft proposed rule by October 1988 and the selection of the pilot lenders by February 1989. The first HECM loan closed in October 1989.

1.2 Program Design

Reverse mortgages available under the HECM Demonstration offer borrowers the broadest array of choices currently available in a home equity conversion plan. The FHA reverse mortgage permits borrowers to choose from several payment plans and to change payment plans at any time. Borrowers can elect

- a term plan that provides for regular payments over a specified period of time (at the end of which payments stop but the borrower can remain in the home indefinitely);
- a tenure plan that provides level monthly payments for as long as the borrower occupies the property as a principal residence; or
- a line of credit plan that allows borrowers to make draws at the times and in the amount of the borrower's choosing.

In addition, borrowers may choose to preserve a portion of their equity as a line of credit while they receive term or tenure payments. The Demonstration permits maximum flexibility. A borrower may receive a lump sum draw at closing to pay off an existing mortgage, to pay off a contractor's lien for repairs, or for other purposes. In addition, a borrower may combine a tenure or term mortgage with a line of credit or restructure payments to accommodate changes in his or her circumstances.[3]

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[3] The flexibility afforded by a HECM loan is possible because the expected value of payments under each option has the same present value at closing; this means that the options differ from each other only in the timing of payments.

Although the HECM Demonstration provides borrowers with the flexibility to adapt the payment stream to their changing financial circumstances, this innovation also presents some difficulties. Experience to date with the Demonstration suggests that while a single reverse mortgage with multiple payment options (as with HECM) may be conceptually simple, implementation has not been easy because the flexibility of the program tends to complicate origination and servicing.[4] For example, because borrowers are allowed to prepay the mortgage balance in part and then to re-borrow the amount prepaid, lenders are required to comply with open-end credit disclosure requirements imposed by the Federal Reserve Board, which are new and unfamiliar to the majority of lenders. Furthermore, because borrowers may establish lines of credit instead of or in addition to scheduled monthly payments, mortgage servicers must also respond to borrowers' unscheduled requests for payment as well as regular disbursements. These features, along with borrowers' ability to change payment plans at any time, has complicated the servicing of these mortgages.

1.2.1 Eligible Borrowers

Any homeowner 62 years of age or older may qualify for a HECM loan provided that he or she owns a home free and clear (or can subordinate existing liens at closing) and occupies the property as a principal residence. A qualified homeowner whose spouse temporarily or permanently resides in an institution continues to be eligible for a reverse mortgage so long as the

[4] Mortgage servicers -- which may be the lender or a separate company operating under a servicing agreement -- perform several functions, including making scheduled or unscheduled payments to borrowers; processing changes in payment options or requests for line-of-credit advances; making payments for mortgage insurance, taxes, hazard insurance, or other items necessary to maintain the security interest of the lender; accepting prepayments from the borrower; and preparing financial reports for the borrower and for the owner of the mortgage.

homeowner continues to use the house as his or her principal residence. Lenders issuing FHA reverse mortgages are required to certify annually that the home is the principal residence of at least one borrower.

Because reverse mortgages are secured only by the property and not by the borrower's credit worthiness, borrower underwriting is minimal. It is presumed that many borrowers are interested in obtaining a HECM loan to pay off other debts. However, the Department requires a credit check to assure that borrowers do not have any delinquent Federal debt that cannot be cleared from mortgage proceeds. Unlike a forward FHA mortgage, the Department has no income requirements under the HECM Demonstration. Since payments are made from the lender to the borrower, the borrower's ability to support the mortgage is not an issue.

1.2.2 Mandatory Counseling

The law establishing the HECM Demonstration requires potential borrowers to receive counseling from an approved third party independent of the lender. The focus of the counseling is to provide borrowers with an explanation of reverse mortgages and their alternatives, and to assure that borrowers understand fully the impact of this financial decision upon their current living situation and estate. Counseling is provided through a network of comprehensive counseling agencies and area agencies on aging that have been approved by the Department for HECM counseling.

1.2.3 Eligible Properties

The property occupied by the borrower must be a one-family dwelling that meets HUD's minimum property standards. Repairs needed to bring a home up to this standard may be financed from mortgage proceeds before or after closing in accordance with program rules.

Repairs that are expected to cost less than 15 percent of the adjusted property value[5] may be made after closing and are subject to inspection. Repairs that are estimated to exceed 15 percent may be performed under a contractor's lien, which is then paid off at closing. Whether repairs are made before or after loan closing, the reverse mortgage program can function as a deferred payment rehabilitation loan program.

Cooperative housing is currently ineligible under the Demonstration. The exclusion of cooperative housing reflects the Department's belief that the newness of reverse mortgages, together with HUD Field Offices' limited experience in dealing with cooperatives, would result in significant processing delays. A condominium unit may be an eligible property under the Demonstration provided that the unit is located in a HUD-approved condominium project. HUD approval depends upon factors such as the project's legal structure, management, and percentage of owner-occupancy. Failure to comply with Fair Housing laws and HUD regulations, which allow age-restrictive covenants only in certain cases, means that properties located in some retirement communities cannot be mortgaged through the HECM Demonstration.

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[5] Adjusted property value, also called "maximum claim amount," is defined as the lesser of the appraisal property value or the FHA Section 203(b) limit for the local area.

1.2.4 Calculation of Payments to Borrowers

Payments to borrowers are based upon the age of the youngest borrower, the mortgage interest rate, and the adjusted property value. The *adjusted property value* is the lesser of the appraised value of the property or the maximum mortgage on a one-unit residence as established for the FHA Section 203(b) program. For the period covered in this report, this amount ranged between $67,500 and $124,875, depending on geographic location.[6] The adjusted property value limits the loan proceeds that can be received by a HECM borrower whose property value exceeds this amount.

Payments are calculated using a *principal limit factor*, which may be regarded as a limit on the initial loan-to-value ratio.[7] There is a unique principal limit factor for each combination of the borrower's age and an interest rate. For example, the principal limit factor corresponding to a 75-year-old borrower with a 10 percent interest rate is 0.416. The principal limit factor measures the percentage of the adjusted property value that is available to the borrower on the first day that a mortgage is in effect (41.6 percent in this case). Principal limit factors are generated by a payments model that contains assumptions about the longevity of the borrower and the

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[6] Under the HUD Appropriations Act for Fiscal Year 1993, the maximum mortgage limit for a one-unit residence under the FHA Section 203(b) program was increased to $151,725. While the mortgage limit for each area is currently being computed, and most areas will have mortgage limits of less than this figure, it is likely the mortgage limits will be as high as $151,725 in a few high-cost areas.

[7] The principal limit factor is calculated to be the highest initial loan-to-value ratio for which the premium collected will cover all the Department's expected costs resulting from mortgage insurance claims. For a technical discussion of principal limit factors, see the Department's Interim Report to Congress, October 1990; also Edward J. Szymanoski, Jr., "The FHA Home Equity Conversion Mortgage Insurance Demonstration: A Model to Calculate Borrower Payments and Insurance Risk," U.S. Department of Housing and Urban Development, October 1990.

appreciation of the property. The principal limit factors are used to calculate payment streams under the tenure, term, and line-of-credit options.

1.2.5 Interest Rates

A HECM loan may bear interest at either a fixed or an adjustable rate. To date, however, very few fixed-rate HECM loans have been issued.[8] Adjustable rate mortgages require the use of a fixed interest proxy, called the *expected average mortgage interest rate*, to determine both the initial principal limit and the compounding rate used to project future values of the principal limit. The expected average rate is fixed at the time of loan origination. It is generally higher than the initial adjustable rate, just as long-term rates are usually higher than short-term rates. The use of this rate results in a lower initial principal limit and, consequently, lower payments than if the initial adjustable rate were used. This adjustment maintains the actuarial soundness of an adjustable rate mortgage.

1.3 Risk Protection

Reverse mortgages carry certain risks. Uninsured public and private sector programs pursued a number of risk-reduction strategies but most failed to provide sufficient comfort for lenders and borrowers alike. While the design of certain program elements contributes to risk

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[8] As noted in Chapter 3 of this report, FNMA will not purchase fixed-rate loans originated under the HECM Demonstration. As a practical consideration, this policy has almost eliminated the fixed-rate option because FNMA is the most active purchaser of HECM loans. Sunwest Bank of Albuquerque, New Mexico is the only lender to have originated fixed-rate reverse mortgages under the HECM Demonstration, and has held all of these loans in portfolio.

reduction, mortgage insurance offers the primary means for reducing risks under the HECM Demonstration.

1.3.1 Borrower Protection

Regardless of the HECM payment option they select, elderly homeowners cannot be forced to sell their homes to pay off their mortgage, even if the mortgage principal balance grows to exceed the value of the property. When the borrower does move or die and the property is sold, the borrower's liability will be limited to the value of the home. In addition, the borrower is protected if the lender fails to make the required payments under the mortgage. The Department will step in to make the payments to the borrower, and the defaulting lender must either resume making payments or assign the mortgage to HUD within 30 days.[9]

Under HECM, the borrower must pay an FHA mortgage insurance premium (MIP) to insure lenders against loss in the event that sales proceeds are not sufficient to pay off the mortgage. The insurance premium consists of two parts, both of which may be financed: (1) an up-front premium of two percent of the adjusted property value,[10] and (2) a monthly premium of one-twelfth of the annual rate of one-half percent of the outstanding principal balance, which accrues to the outstanding balance.

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[9] If the lender resumes payments, the lender must reimburse HUD, with interest, for all payments that HUD made to or on behalf of the borrower. If the lender does not resume payments and fails to assign the mortgage to HUD within 30 days, then the insurance contract is terminated. In this case the lender forfeits any interest that has accrued, as well as future interest, and the lender will be reimbursed only for payments made to or on behalf of the borrower, and only after the mortgage becomes due and payable.

[10] The "adjusted property value" is also called the "maximum claim amount."

In addition, the HECM Demonstration offers a shared appreciation option, although no shared appreciation HECM loans have been originated as of mid-August, 1992, and none are expected to be originated in the immediate future. Under this option, the lender may claim up to 25 percent of the increase in the house value, upon sale, relative to its value at origination.[11] In return for sharing appreciation with the lender, the borrower would be given a lower interest rate on the note at origination, which would provide higher payments and preserve equity. The lack of interest in this option is due in part to recent market conditions which make shared appreciation less attractive -- specifically, relatively low interest rates and low property appreciation rates. It is also due in part to FNMA's decision not to purchase HECM loans with shared appreciation. Unless market conditions change, the added complexity of the shared appreciation option is not likely to be viewed favorably by borrowers or lenders.

1.3.2 Lenders' Insurance Options

The mortgage insurance premium was estimated by the Department to cover all losses, whether these losses are borne by FHA or private lenders. At the time that a mortgage is closed, a lender can choose one of two insurance options: the *assignment option* or the *shared premium option*.[12] Under the assignment option, FHA collects all of the MIP. The lender has the option of assigning a mortgage to FHA at the time that the mortgage balance, including accrued

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[11] The lender's share of house value appreciation is subject to the restriction that the lender realize an effective interest rate of no more than 20 percent, where the effective interest rate is computed as the average interest rate of the HECM loan during the 12 months preceding sale of the house, plus the lender's share in the appreciation of the property value over the life of the loan.

[12] As explained in Chapter 3, FNMA will not purchase HECM loans unless lenders have selected the assignment option. As a practical consideration, this requirement almost eliminates the shared premium option because FNMA has purchased most HECM loans originated to date.

interest and MIP, equals 98 percent of the maximum claim amount. Following assignment of the mortgage, the lender files an insurance claim for an amount equal to the mortgage balance and has no further obligations under the mortgage. The Department will continue to make any payments that are owed the borrower and will accept full responsibility in the event of loss.

Under the shared premium option, the lender forgoes assignment of a mortgage to FHA and retains a portion of the periodic MIP to compensate for the assumption of additional risk. At the time that the mortgage is due and payable, FHA will pay the lender the difference between the mortgage balance and the sales proceeds up to the maximum claim amount. The lender is liable for losses that exceed the maximum claim amount, and the lender's share of the periodic MIP has been calculated to equal the expected value of these losses. However, as discussed more fully in Chapter 3, the shared premium option has not been used to date, in large part because such loans cannot be sold to the secondary market.

1.3.3 Special Considerations for the Federal Government

As the insurer of home equity conversion loans, the Department faces two basic kinds of risk. *Diversifiable risks* are those that are independent and related to characteristics of a particular loan. *Fundamental risks* are interdependent, such as the risk of a national economic recession. As implied in the name, diversifiable risk can be reduced through insurance pooling. By pooling a large number of reverse mortgages from many different regions of the country, the Department can reduce risk of loss because an individual house does not maintain its value, or because an individual borrower lives to be 102, or even because a region experiences an economic downturn.

Although fundamental risk cannot be reduced through diversification, the HECM Demonstration is not likely to suffer significant losses from a short-term recession in house prices. Loan-to-value ratios in the HECM Demonstration remain low for many years, compared to conventional forward mortgages, and loan balances -- including interest charges, monthly disbursements, and other charges -- rise only gradually over time. Fundamental risk in the HECM Demonstration therefore depends on long-term rather than short-term house price appreciation rates. The long-run expected annual appreciation rate of four percent that is assumed in the program also assumes a 10 percent annual standard deviation.[13] This allows the program to withstand considerable regional variation from the long-run average as well.

Overall, the HECM Demonstration has been designed to break even. It is not intended to be a subsidy program. The data generated by the Demonstration will be used to refine program policies and the assumptions used in the payments model, so that the program will pay for itself in the long run.

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[13] Price Waterhouse recently conducted two actuarial studies of the FHA forward mortgage programs, each entitled "An Actuarial Review of the Federal Housing Administration's Mutual Mortgage Insurance Fund" (June 6, 1990; updated March 16, 1992). Although the design of the HECM Demonstration predates these two actuarial studies, the price appreciation assumptions designed into the HECM Demonstration are generally consistent with the baseline economic assumptions specified in these studies.

CHAPTER 2

HECM ACTIVITY TO DATE

Although reverse mortgages are available to all single-family homeowners over age 62, preliminary analysis of borrowers participating in the HECM Demonstration to date suggests that these mortgages appeal primarily to certain well-defined groups of potential borrowers. This chapter reviews HECM activity to date, focusing upon the characteristics of HECM participants and the program design elements that appear to be most attractive to potential borrowers. An understanding of the factors that influence a prospective borrower's decision whether or not to participate in the HECM Demonstration can be a valuable tool in amending the program design elements to meet the needs of eligible elderly homeowners.

Most of this preliminary analysis is based on a sample of 911 HECM loans drawn from two data sources. The first source is the Computerized Housing Underwriting Management System (CHUMS) maintained by the Department, which includes relevant information on 909 reverse mortgage loans that had been endorsed as of the end of March 1992. The second source is a database compiled by Q-Soft, Inc. (under contract to HUD) of similar information on 350 loans originated by lenders who then submitted completed case binders to HUD. This second source is largely a subset of the CHUMS database, and generally includes loans originated earlier in the HECM Demonstration. Some parts of the analysis are based on a separate data base of all individual transactions (including disbursements, charges, repayments, and plan changes), maintained by Computer Data Systems, Inc. (CDSI) under contract to HUD. The CDSI data base includes all loans that had obtained firm commitment as of mid-August 1992, including several that had not yet closed or been endorsed.[1]

2.1 Borrower Characteristics

The HECM Demonstration is expected to appeal primarily to elderly homeowners who are house-rich but cash-poor -- that is, who have a substantial amount of equity in their home but who have relatively low current incomes. It can be expected, then, that HECM borrowers will have lower incomes and higher house values than the general population of elderly homeowners. Beyond this general rule, the specific design elements of any self-selecting program suggest that there may be significant differences between the characteristics of participants and the characteristics of those who choose not to participate. The differences observed in the HECM Demonstration to date are shown in Exhibit 2-1, which compares several characteristics of HECM borrowers to similar data for all elderly homeowners. This section summarizes the differences between HECM borrowers and non-participating elderly homeowners, and identifies the program design elements that may be related to their decision whether or not to participate in the program.

[1] Disbursements and other transactions can occur before a loan has been endorsed, but not before the loan has closed. The CDSI data base, then, has transactions data for all loans that have closed, plus non-transactions data for loans that have obtained firm commitment but have not yet closed.

EXHIBIT 2-1: Characteristics of HECM Borrowers and All Elderly Homeowners

	HECM Borrowers[1]	Elderly Homeowners[2]
Median Age	76.7 years	73 years
Median Income:		
Total Annual Income	$7,572	$16,545
Social Security Income	$7,005	$ 6,287[3]
Average Number of Children	0.59	na
Sex:		
Female Living Alone	56.5%	28.7%
Male Living Alone	14.3%	7.2%
Living With Others	29.2%	64.1%
Race:		
White	95.6%[4]	91.6%
Non-White	3.4%	8.4%

[1] Data from HECM application materials as of date of application.
[2] Data from 1989 American Housing Survey.
[3] Estimated using figures from Susan Grad, "Income of the Population 65 or Over, 1988," Pub. No. 13-11871, U.S. Social Security Administration (June 1990).
[4] Race was not recorded for one percent of HECM borrowers.

2.1.1 Age

Borrowers must be at least 62 years old to qualify for a reverse mortgage under the HECM Demonstration. While there have been a few borrowers in their early 60s, Exhibit 2-1 shows that the median age of HECM borrowers to date has been 76.7 years. In fact, most of the HECM borrowers to date have been between 71 and 82 years old, and 10 have been more than 95 years old. In comparison, according to the American Housing Survey the median age of all elderly homeowners is 73 years, suggesting that participants in the HECM Demonstration tend to be somewhat older than non-participants.[2]

The prevalence of older borrowers is not surprising because the amount of money available to older borrowers can be substantially greater than the amount available to borrowers only slightly older than the minimum age. Specifically, for a given interest rate the principal limit factor, which represents the share of property value available to borrowers for either monthly payments or line-of-credit disbursements, depends on two factors: the adjusted property value (also called the "maximum claim amount," defined as the lesser of the property value or the local FHA 203(b) loan limit) and the age of the borrower. Because older borrowers have shorter remaining life expectancies than younger borrowers, the principal limit increases with the age of the borrower to equalize expected payments over the life of the loan. Thus the Demonstration can be expected to appeal most strongly to older prospective borrowers because maximum monthly payments and credit limits are generally larger.

As an illustration, the maximum monthly payment and maximum line of credit (principal limit) available to a typical borrower at different ages are shown in Exhibit 2-2. This exhibit presents figures computed for a borrower with the median property value ($103,000) and the median expected interest rate (9.63%) at four different ages:

- the lower quartile of the age distribution of HECM borrowers (71.6 years), which means that one-fourth of all HECM borrowers to date were younger than that age at the time of their application, and three-fourths were older;

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[2] In fact, the American Housing Survey identifies "elderly homeowners" as those at least 65 years old. If there were no relationship between borrower age and HECM participation, then, the median age of HECM participants would be expected to be less than the median age of all elderly homeowners, since HECM participants include some who are less than 65 years old.

EXHIBIT 2-2: Maximum Monthly Payment or Line of Credit Available to Typical HECM Borrowers at Different Ages

	Lower Quartile 71.6 years	Median 76.7 years	Upper Quartile 81.6 years	Elderly Homeowners 73 years
Maximum Monthly Payment	$307	$401	$510	$322
Maximum Line of Credit (Principal Limit)	$34,509	$43,182	$50,972	$35,923

- the median age of HECM borrowers (76.7 years);
- the upper quartile of the age distribution of HECM borrowers (81.6 years), which means that one-fourth of all borrowers were older, and three-fourths were younger; and
- the median age of all elderly homeowners (73 years).

As shown in the chart, the monthly payment or line of credit available to younger participants in the HECM Demonstration can be substantially less than the amounts available to older participants. For example, a borrower aged 71.6 years with a typical property value and expected interest rate can receive monthly payments of $307 or a line of credit of $34,509 at the start of their loan. In comparison, an otherwise identical borrower aged 81.6 years can receive monthly payments of $510 (about 66 percent higher) or a line of credit of $50,972 (about 48 percent higher). It is not surprising, then, that HECM borrowers tend to be older than non-participating elderly homeowners.

There are other factors, as well, that explain the tendency for HECM borrowers to be older than the general population of elderly homeowners. For example, older eligible homeowners (that is, those in their late 70s, 80s or 90s) are likely to have less current income than younger eligible homeowners (those in their 60s or early 70s). Older eligible homeowners are also likely to have greater medical expenses, and are more likely to require costly home services or remodeling to remain in their homes.

2.1.2 Income

While there are no income criteria determining eligibility for the HECM Demonstration, the program is expected to appeal primarily to elderly homeowners with limited current income. As Exhibit 2-1 shows, most of the participants in the HECM Demonstration have quite low incomes: the median total annual income reported by HECM borrowers to date was just $7,572. In fact, more than a quarter of all HECM borrowers had annual incomes of less than $3,200, while fewer than ten percent of all HECM borrowers reported incomes greater than $15,000. In contrast, according to the American Housing Survey, in 1989 the median income for households headed by a householder at least 65 years old was $16,545.

As expected, most of the borrowers under the HECM Demonstration reported that social security payments accounted for most of their total annual income. As Exhibit 2-1 shows, the median HECM borrower reported social security income of $7,005. Half of the borrowers to date derived more than 92 percent of their total income from social security, and three-quarters depended on social security for more than 66 percent of their total income. In contrast, among the general population aged 65 years or older, only about 38 percent of total income is derived from social security. Even among the elderly with annual incomes below the poverty line, social security accounted for only about 79 percent of total income on average.[3]

2.1.3 Number of Children

Reverse mortgages are expected to appeal most strongly to older homeowners without children, for two reasons. First, homeowners with children may be able to rely on assistance from their children to supplement their current income, while those without children may have no other resources to meet their living expenses. Second, homeowners with children may want to protect their equity in order to leave a more valuable bequest to their children at their death, while homeowners without children may have no desire to protect their legacy. This expectation seems to be confirmed by the HECM loans to date. As shown in Exhibit 2-1, the average number of children reported by HECM borrowers is only 0.59. More than three-quarters of the borrowers did not have any children. (Comparable data for all elderly homeowners are not available.)

2.1.4 Sex

The perception of lenders, counselors, and others involved in the implementation of the HECM Demonstration has been that borrowers are most commonly elderly women living alone. This perception is confirmed by the data. In fact, as Exhibit 2-1 shows, almost three-fifths of all HECM borrowers to date are single women. About 29 percent of borrowers are pairs (mostly

[3] U.S. Bureau of the Census, unpublished data from March 1990 Current Population Survey, cited in U.S. Senate Special Committee on Aging et al., "Aging America: Trends and Projections, 1991 Edition."

male/female couples), while only about 14 percent are single men. In contrast, among the general population aged 65 years or older, about 64 percent of all elderly live with their spouse or another person. Only about 29 percent of elderly households are women living alone and only about 7 percent are men living alone.

It is interesting to note that the actual distribution of HECM borrowers by sex is very close to the distribution predicted in the design of the program. Specifically, as explained in the interim report to Congress, the HECM payments model uses the female general population mortality table for all borrowers, including co-borrowers, because single females are expected to comprise the majority of borrowers. Couples should be the next largest group, followed by single males. The interim report cited a study of existing reverse mortgage programs[4] estimating the average distribution to be "63 percent single females, 12 percent single males, and 25 percent married couples."

The ratio of women living alone to men living alone among HECM borrowers to date (about 4 to 1) is almost identical to the equivalent ratio among the elderly population as a whole, according to the American Housing Survey in 1989. Both patterns reflect the fact that elderly women are much more likely than elderly men to live alone. These patterns arise partly as a result of differences in life expectancy -- women tend to live about seven years longer than men, so married men often die before their wives do -- and partly because elderly men are more likely to remarry than are elderly women after they have been widowed or divorced.

[4] Maurice Weinrobe, "Marketing Home Equity Conversion — Who Are the Users?" Faculty Briefing Paper presented at AARP Conference: Innovation in Home Equity Conversion: Toward the 1990's, Washington, 1988.

2.1.5 Race

As Exhibit 2-1 shows, more than 95 percent of HECM borrowers to date have been white, with fewer than 4 percent black. In comparison, in 1989 only about 92 percent of all elderly homeowners were white, with about eight percent black and other non-white. There are a number of potential reasons for the relatively small number of non-white[5] borrowers participating in the HECM Demonstration. First, blacks in general have a shorter life expectancy than whites, while for the purposes of determining monthly payments or line-of-credit limits the HECM Demonstration assumes a constant life expectancy regardless of race. To the extent that potential borrowers make participation decisions on the basis of the expected gain, there may be a greater incentive for whites to participate in the HECM Demonstration. It seems doubtful, however, that racial differences in life expectancy would play such a large role in determining participation in the HECM Demonstration.

Another potential reason for the small number of non-white borrowers in the HECM Demonstration is that the program may be marketed less effectively, or differently in some other way, among non-white elderly homeowners than among white elderly homeowners. It is possible, for example, that the share of eligible non-white potential borrowers who are aware of the program is smaller than the share of eligible white potential borrowers who are aware of the program. Alternatively, it is possible that white and non-white potential borrowers receive different housing counseling prior to their participation in the program, or that they respond

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[5] The data used in this analysis included only one loan made to a Hispanic borrower. For the purpose of this analysis, this loan was included with loans made to black borrowers under the category "non-white."

differently to the counseling that they receive. Moreover, lenders may be less active in providing loans and other services in minority communities.

Finally, according to the American Housing Survey, the median value of properties owned by elderly black homeowners in 1989 was just $42,205, substantially less than the median value for elderly homeowners of all races ($65,944). This lower property value is reflected in a lower principal limit under the HECM Demonstration, which means that most black reverse mortgage borrowers would have lower monthly payments and a lower initial line of credit than most white borrowers would have. Most elderly black homeowners also had less owner's equity in their properties -- less than 90 percent in 1989, compared to a median of more than 95 percent for all elderly homeowners, according to the American Housing Survey -- which means that elderly black homeowners generally would have less available under the HECM Demonstration, in the form of monthly payments or a line of credit, after their existing liens had been cleared.

2.2 Property Characteristics

As noted, the HECM Demonstration is expected to appeal to elderly homeowners who have substantial equity in their property but who have relatively low current incomes available to meet ordinary or extraordinary living expenses. On the other hand, the constraint on HECM proceeds represented by the FHA 203(b) loan limits imply that the HECM Demonstration will not appeal as strongly to homeowners with properties valued at substantially more than the loan limit for their area (particularly to the extent that private reverse mortgages are available as an alternative to the HECM Demonstration). Exhibit 2-3 presents a comparison of property characteristics for HECM borrowers and for all elderly homeowners. This section discusses the differences between the property characteristics of participants and non-participants.

EXHIBIT 2-3: Characteristics of Properties Owned by HECM Borrowers and All Elderly Homeowners

	HECM Borrowers[1]	Elderly Homeowners[2]
Median Property Value	$103,000	$65,944
Median Owner's Equity	95%	95.9%
Median Housing Expenses	$278	$231
Median Property Size:		
Lot Size	8,184 sq. ft	14,375 sq. ft
Living Area	1,217 sq. ft	1,576 sq. ft
Number of Rooms	6.0	5.6
Number of Bedrooms	3.0	2.6
Number of Bathrooms	1.5	1.5
Property Condition:		
Average Cost of Repairs	$682	na
Median Age of Structure	36.5 years	34 years
Location:		
Urban	39.0%	26.4%
Suburban	57.3%	44.4%
Rural	3.7%	29.2%

[1] Data from HECM application materials as of date of application.
[2] Data from 1989 American Housing Survey.

2.2.1 Property Value

While it was noted that HECM borrowers have substantially lower annual incomes than elderly homeowners not participating in the program, Exhibit 2-3 shows that HECM participants own substantially more valuable properties than other elderly homeowners. The median property value of all elderly homeowners was just $65,944 in 1989, according to the American Housing

Survey. In contrast, the median property value of HECM participants to date was $103,000 at the time of application, and three-fourths of all participants had properties valued at more than $75,000.[6] Clearly the participants in the program can accurately be called house-rich as well as cash-poor.

Exhibit 2-4 shows the effect of property value on the maximum monthly payment or line of credit available to typical HECM borrowers with different property values. This exhibit presents figures computed for a borrower of the median age (76.7 years) and with the median expected interest rate (9.63%) at four different property values:

EXHIBIT 2-4: Maximum Monthly Payment or Line of Credit Available to Typical HECM Borrowers at Different Property Values

	Lower Quartile $75,000	Median $103,000	Upper Quartile $146,000[1]	Elderly Homeowners $65,944
Maximum Monthly Payment	$284	$401	$492	$247
Maximum Line of Credit (Principal Limit)	$30,638	$43,182	$52,982	$26,581

[1] Financial calculations are based on the maximum claim amount, which is equal to the lesser of the property value or the FHA Section 203(b) loan limit for each area. The FHA loan limit was no higher than $124,875 when these loans were originated.

[6] Exhibit 2-3 shows that the properties owned by HECM borrowers tend to be significantly more valuable than properties owned by elderly homeowners in general even though they are also much smaller in terms of lot size and lining area. This apparent contradiction is attributable to the fact that HECM borrowers tend to live in urban and suburban areas rathern than in rural areas. According to the 1989 American Housing Survey, median property values among elderly homeowners are much higher in central cities ($68,423) and suburbs ($80,448) than in rural areas ($46,769), even though they tend to be on much smaller lots (0.20 and 0.34 acres, respectively, versus 0.68 acres in rural areas).

- the lower quartile property value of HECM borrowers ($75,000);
- the median property value of HECM borrowers ($103,000);
- the upper quartile property value of HECM borrowers ($146,000), assuming the highest adjusted property value of $124,875; and
- the median property value of all elderly homeowners ($65,944).

As Exhibit 2-4 shows, the typical HECM borrower with a property value of just $75,000 can receive maximum payments of about $284 per month, or a maximum line of credit of about $30,638. In contrast, an otherwise identical borrower with a relatively high property value of $146,000 can receive monthly payments of about $492 or a line of credit of about $52,982.[7] An identical borrower with a property valued at $65,944, the median for all elderly homeowners, would receive only about $247 per month or a line of credit of only about $26,581.

The relatively high property values of HECM participants is particularly striking considering that the maximum adjusted property value permitted under the HECM Demonstration is set at the FHA 203(b) loan limit for each area. Thus owners of properties valued at more than the FHA loan limit, no higher than $124,875,[8] cannot take advantage of the full equity in their house under the HECM Demonstration. Notwithstanding this restriction, more than ten percent of all participants to date have properties valued at more than $200,000, and some properties are worth more than $600,000. This may reflect a lack of financial alternatives for owners of high-value properties, or elements of the HECM Demonstration that make it attractive in spite of the restriction represented by the FHA loan limit.

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[7] Assuming the FHA 203(b) limit for the area is $124,875.

[8] As noted, the HUD Appropriation Act for Fiscal Year 1993 raised the ceiling on FHA loan limits to $151,725, and the limits in some high-cost areas will soon be raised above the prior ceiling of $124,875.

It is important to note that the participation of HECM borrowers with property values significantly above the FHA 203(b) loan limit generates an important cross-subsidy from these borrowers to borrowers with properties valued less than the FHA loan limit. Specifically, it is relatively unlikely that payments to borrowers who have such high actual property values will exceed the value of the property at repayment. For this reason, the mortgage insurance premium computed for these borrowers under the HECM Demonstration may be higher than necessary to cover expected losses on their reverse mortgages. The existence of this cross-subsidy was recognized in the design of the HECM Demonstration, and was discussed in the Interim Report to Congress.[9]

2.2.2 Initial Equity

The HECM Demonstration requires that prospective borrowers own their property in whole, or be able to pay off outstanding mortgage balances or other liens at closing from the proceeds of the HECM loan. As Exhibit 2-3 shows, owner's equity for most HECM borrowers to date represented at least 95 percent of total property value, meaning that outstanding mortgage balances were 5 percent or less for most participants. In fact, more than 95 percent of HECM borrowers to date had mortgage balances of 25 percent or less of total property value. In comparison, among all elderly homeowners, owner's equity amounted to about 96 percent of property value for the median homeowner -- not significantly different from the average observed among HECM participants.

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[9] U.S. Department of Housing and Urban Development (Office of Policy Development and Research), "Interim Report to Congress on the Home Equity Conversion Mortgage Insurance Demonstration," October 1990.

2.2.3 Housing Expenses

Exhibit 2-3 shows that median housing expenses (including mortgage payments, insurance, taxes, maintenance, and other costs) totalled about $278 per month for borrowers participating in the HECM Demonstration. In comparison, the American Housing Survey reported that median monthly housing expenses for all elderly homeowners totalled about $231 in 1989. The somewhat higher figure for HECM Demonstration participants, coupled with their significantly lower incomes, suggest that borrowers may need to use their reverse mortgage proceeds to meet ordinary living expenses.

2.2.4 Property Size

Despite the higher market values of their properties, most of the HECM borrowers to date appear to own houses that are significantly smaller than the average for the population at large. For example, as shown in Exhibit 2-3, the median lot size for HECM borrowers was about 8,184 square feet, and half of all HECM borrowers had lots of between 5,940 and 12,400 square feet. In comparison, according to the American Housing Survey, the median lot size among all elderly homeowners was about 14,375 square feet in 1989. Similarly, the median amount of living area among HECM borrowers was about 1,217 square feet, and half of all borrowers lived in houses of between 1,004 and 1,504 square feet. In contrast, the median living area among all elderly homeowners was about 1,576 in 1989. Properties of HECM participants are quite similar to those of non-participants in terms of the median numbers of bedrooms (3.0 versus 2.6) and bathrooms (1.5 for both groups).

2.2.5 Location

The substantially higher values of HECM properties, combined with their smaller size, most likely reflects striking differences in the geographic location of HECM borrowers compared to the elderly population at large as Exhibit 2-3 shows. HECM borrowers are highly concentrated in metropolitan areas. About 57 percent live in suburbs; another 39 percent live in central cities, and only 4 percent live in rural areas. In contrast, according to the 1989 American Housing Survey, in 1989 about 44 percent of all elderly homeowners lived in suburbs; only about 26 percent lived in central cities, and 29 percent lived in rural areas. It is possible that this marked difference in the locations of participants and non-participants reflects systematic differences in the availability of HECM lenders or counselors (or both) in rural and urban areas.

2.2.6 Condition of Property

In general, the condition of properties owned by HECM borrowers seems to be fairly good, at least as measured by the cost of repairs required to bring the property into compliance with loan guidelines. More than half of all HECM borrowers had no repairs required to bring their units into compliance, and the mean estimated cost of required repairs was just $692. (Comparable figures for all elderly homeowners are not available.) Where direct measures of property condition are not available, the age of a house is often used as a useful proxy for the condition of the property. As Exhibit 2-3 shows, properties owned by HECM borrowers appear to be quite comparable to those owned by the general population of elderly homeowners. The median age of properties owned by HECM borrowers was about 36.5 years as of loan application date. This is only slightly older than the median age of houses belonging to all elderly homeowners, about 34 years according to the American Housing Survey.

2.3 HECM Loan Terms

With the exception of the choice of payment option, most of the significant terms of reverse mortgages under the HECM Demonstration depend only on the borrower's age, the adjusted property value, and the prevailing interest rates at loan origination. It is likely, however, that the terms that prospective borrowers face affect the likelihood that they will participate in the program. Specifically, the loan terms -- adjusted property value, interest rates, and principal limit, in addition to the payment option chosen -- determine the maximum line of credit and the maximum monthly payments available to borrowers. The median loan terms under which HECM loans have been originated to date are shown in Exhibit 2-5. This section discusses the loan terms and the importance of each in determining the maximum funds to which borrowers have access.

2.3.1 Payment Options

The HECM Demonstration permits borrowers to design a payment stream that meets their individual financial requirements. Borrowers can select one of five payment options at loan origination and may change payment plans at any time throughout the life of the loan. As mentioned earlier, the available payment plans are:

(1) the <u>tenure</u> payment option, which provides for monthly payments to borrowers for as long as they occupy the property as their principal residence;

EXHIBIT 2-5: Median Loan Terms for HECM Loans to Date

	HECM Borrowers[1]
Choice of Payment Plan:	
Tenure Payments	10.4%
Term Payments	15.7%
Line of Credit	51.2%
Tenure w/ Credit	7.2%
Term w/ Credit	15.5%
Median Initial Interest Rate	8.11%
Median Expected Interest Rate	9.63%
Median Adjusted Property Value	$101,000
Median Principal Limit	$41,958
Median Closing Costs	$2,962

[1] Choice of payment plan data from CDSI data base as of mid-August 1992. All other data from HECM application materials as of date of application.

(2) the term payment option, which provides for monthly payments over a specified period of time (most commonly ten years);

(3) a line of credit with no payment plan, which allows borrowers to draw down payments as needed;

(4) a combination of tenure payments with a line of credit; and

(5) a combination of term payments with a line of credit.

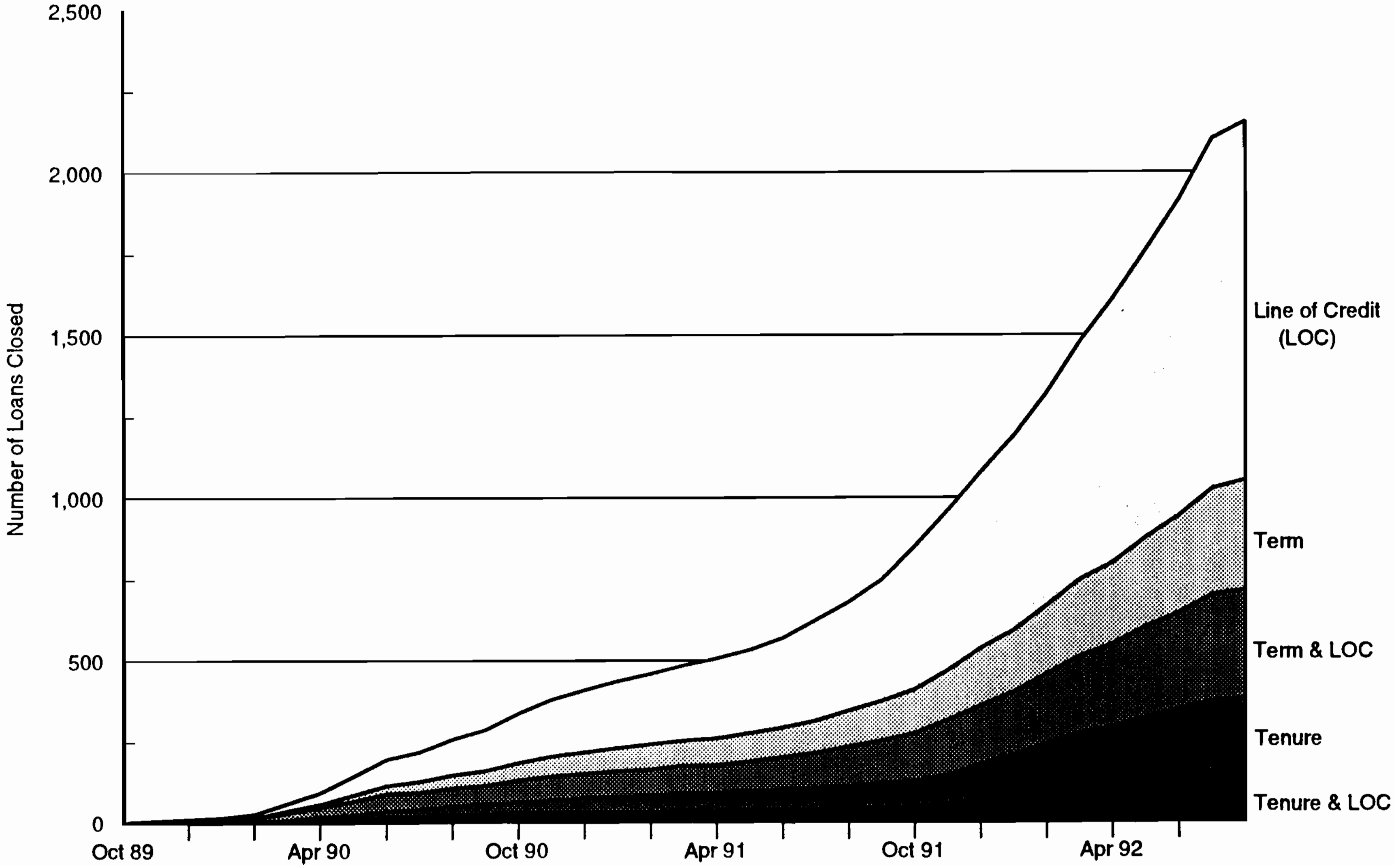
As Exhibit 2-5 shows, about 10 percent of HECM borrowers to date have elected to receive regular monthly payments as long as they occupy their home (the tenure payment option). Another 16 percent have selected the term payment option, while more than half -- 51 percent -- have set up a line of credit with no monthly payments. Finally, 7 percent have combined tenure payments with a line of credit and 16 percent have opted to combine term payments with a line of credit. Exhibit 2-6 shows the growth in the number of borrowers opting for each payment option over the period since the first HECM loan was originated in October 1989.

Although the distributions of loans by payment plan as shown in Exhibits 2-5 and 2-6 are based on the CDSI database of individual loan transactions for all 2,155 HECM loans that had closed as of mid-August 1992, the sample of 911 HECM loans included in the CHUMS and Q-Soft databases show a markedly different distribution of payment options: 28 percent tenure, 24 percent term, 11 percent line of credit, 18 percent tenure with credit, and 18 percent term with credit. The reasons for the considerable differences are (1) the CHUMS sample is non-random, containing an overrepresentation of loans closed in the first year of the Demonstration, and (2) the reported payment option in CHUMS represents the payment option selected by the borrower at the time of closing whereas the payment option reported by CDSI is the option in effect as of August 1992.[10] Despite the likely sampling bias of the CHUMS data, it is more suitable than the CDSI data for much of the analysis to follow because it contains much more information on characteristics of borrowers and of properties.

The line of credit option appears to be extremely popular with borrowers under the HECM Demonstration. According to CDSI data on individual loan transactions, about 94 percent of borrowers with lines of credit have made at least one credit draw. Moreover, borrowers are likely to have drawn on their line of credit whether or not they also receive regular monthly payments. On average, the borrowers who have used their lines of credit have made an average of 1.9 draws at an average of $5,964 per draw. In fact, more than half of the total

[10] CDSI estimates that about 10 percent of HECM borrowers have changed their original payment option.

EXHIBIT 2-6: Growth in HECM Loans by Payment Option, 1989-1992



amount available under HECM lines of credit has already been drawn: the total amount drawn as of March 1992 was approximately $10.65 million, or $15,348 per line-of-credit loan, out of a total of $21.26, or $30,637 per line-of-credit loan, available under established lines of credit.

One of the most important features of the HECM Demonstration is that borrowers can change their payment option at any time, subject to a small fee. However, CDSI data suggest that only about 10 percent of HECM borrowers to date have made any change in their payment option. Since most HECM loans were originated very recently, it is possible that a much higher percentage of borrowers will change their payment options at some time during the life of their HECM loan, but it is impossible to estimate this percentage at this early stage of the HECM Demonstration. Most of the borrowers who have changed their payment options to date have established lines of credit instead of, or in addition to, their initial choice of payment option. According to CDSI data, of the 213 borrowers who have changed their payment option, 90 of them, or about 42 percent, have established a line of credit.[11] Sixty-eight others established a line of credit with term payments, while 19 selected a line of credit with tenure payments. Only 19 borrowers changed their choice of payment option to term payments, and only 17 changed to tenure payments.

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[11] This analysis focuses on the most recent payment option chosen; initial payment options were unavailable.

2.3.2 Interest Rates

While both fixed-rate and adjustable-rate loans can be insured under the HECM Demonstration, fixed-rate loans account for only about 2.3 percent of all HECM loans originated as of mid-August 1992, and only one lender has actively originated fixed-rate HECM loans. A lender assumes considerable interest rate risk with a fixed-rate HECM loan, as would a secondary market investor. FNMA will not purchase any fixed-rate HECM loans because of this risk, and FNMA's policy makes it unlikely that any HECM lenders will resume origination of fixed-rate loans in the foreseeable future.

The *initial interest rate* for an adjustable rate HECM loan is established at some margin above the one-year Treasury rate.[12] Since the Demonstration began, Treasury rates have experienced generally consistent declines that are reflected in the initial interest rates obtained by borrowers. Initial interest rates have been as high as 10.5 percent for some early loans and as low as 4.14 percent for recently originated loans. As Exhibit 2-5 shows, the median initial interest rate has been about 8.11 percent, and most loans originated at initial interest rates between 7.18 and 9.5 percent.

[12] The one-year Treasury rate is defined as the most recent weekly average yield for U.S. Treasury bonds and notes adjusted to a constant maturity of one year, as published by the Board of Governors of the Federal Reserve. Most HECM loans were originated at a margin of 1.6 percentage points above the one-year Treasury rate, although the margin is fixed by agreement between the borrower and the lender.

The HECM Demonstration uses *expected interest rates*[13] for the purpose of computing the principal limit amount, which determines the maximum monthly payment or line of credit available to each borrower. Expected interest rates, therefore, can have a substantial impact on the maximum monthly payment or line of credit that is available to a borrower under the HECM Demonstration. This effect is illustrated in Exhibit 2-7, which presents the maximum monthly payment and line of credit available to a typical HECM borrower of the median age (76.7 years) and with the median property value ($103,000) at three different expected interest rates:

EXHIBIT 2-7: Maximum Monthly Payment or Line of Credit Available to Typical HECM Borrowers at Different Expected Interest Rates

	Lower Quartile 9.125%	Median 9.63%	Upper Quartile 10.0%
Maximum Monthly Payment	$413	$401	$392
Maximum Line of Credit (Principal Limit)	$46,169	$43,182	$41,122

- the lower quartile expected interest rate (9.125%);
- the median expected interest rate (9.63%); and
- the upper quartile expected interest rate (10.0%).

As shown in the chart, the maximum monthly payment or line of credit available to borrowers under the HECM Demonstration is inversely related to the expected interest rate. This relationship reflects the fact that the principal limit is computed to make the expected mortgage insurance losses over the life of the loan no greater than the expected premium collected. Specifically, higher expected interest rates mean higher future loan balances, which in turn would

[13] The expected interest rate is defined the same way as the initial interest rate, except that the most recent weekly average yield for U.S. Treasury bonds and notes is adjusted to a constant maturity of ten years rather than one year.

result in larger insurance losses unless the amount of principal advanced is reduced. For example, a typical HECM borrower initiating a loan at a relatively low expected interest rate of 9.125% can receive maximum payments of about $413 per month, or a maximum line of credit of about $46,169. An otherwise identical borrower initiating a loan at a higher expected interest rate of 10.0% can receive maximum monthly payments of only about $392, or a maximum line of credit of only about $41,122. These amounts are computed so that the present value of the principal amounts disbursed over the life of the loan (whether monthly or line-of-credit), including premium charges and servicing fees, will not exceed the principal limit.

2.3.3 Adjusted Property Values

As noted, adjusted property values are defined as the lesser of the property value or the FHA 203(b) loan limit in each area.[14] For this reason, the program is not expected to appeal strongly to homeowners with property values substantially higher than the adjusted property value (although, as noted earlier, there have been several borrowers with property values substantially above the FHA loan limit). The median adjusted property value under the program to date was approximately $101,000, which is lower than the median property value of borrowers participating in the program ($103,000) because of the constraint of the FHA loan limits.

[14] As noted, the ceiling on FHA loan limits was recently raised by Congress to $151,725, and limits in some high-cost areas will soon be raised above the prior ceiling of $124,875.

2.3.4 Principal Limits

The principal limit under the HECM Demonstration is computed by multiplying the adjusted property value by a principal limit factor computed on the basis of the expected interest rate and the age of the (youngest) borrower. As noted, this limit represents the amount that can be made available to each borrower as the present value of the expected stream of future payments. For the sample of HECM loans originated to date the median principal limit was about $41,958, with limits for most loans between $31,100 and $55,300.

2.3.5 Closing Costs

Closing costs are most closely related to the value of the property, although they are subject to the requirements of specific statutes in each state. In the sample of HECM loans originated to date, the median closing cost (excluding the 2 percent MIP) is $2,962, and closing costs in most cases have ranged between $2,000 and $4,400. The average closing cost to date is approximately $3,560.

2.4 Factors Affecting Choice of Payment Option

The summary statistics presented above have identified certain key factors -- for example, income, age, and property values -- that appear to affect prospective borrowers' decisions concerning whether or not to participate in the HECM Demonstration. For those elderly homeowners who do decide to participate, these same factors may affect the choice of a payment option. This section examines the impact of selected borrower and property characteristics on the probability that HECM Demonstration participants will elect each of the five payment options.[15]

The purpose of the analysis is to identify design elements of the HECM Demonstration that might be modified to meet more fully the financial requirements of elderly homeowners. Any recommendations for program modifications must, however, be based on a more complete analysis of HECM data, as well as on information collected directly from borrowers, lenders, and housing counselors participating in the HECM Demonstration.

2.4.1 Age

Exhibit 2-8 presents the estimated probability that a typical HECM borrower at three different ages will choose each of the five payment options.[16] In this and subsequent charts, boldface type is used to indicate differences in estimated probabilities that are considered statistically significant at an 80% level of confidence. This means that there is less than a 20%

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[15] The analysis is based on the results of a series of logistic regression equations estimated using the sample of 911 endorsed HECM loans from CHUMS and Q-Soft, Inc. data sources. This sample is not necessarily random, and may not be fully representative of all HECM loans. In particular, as noted previously the sample of 911 loans was much more evenly distributed across payment options — tenure, term, line of credit, tenure/credit, and term/credit — than is shown in the CDSI data base of loans that have closed. The analysis is based on the CHUMS and Q-Soft data base because they include extensive information on borrower and property characteristics, whereas the CDSI data base include very few borrower or property characteristics. Appendix A presents additional results of this analysis.

[16] It should be pointed out that, while the sum of these percentages does not equal unity, they are based on artificial model borrowers for whom one variable at a time (such as borrower age) varies while all other borrower characteristics, property characteristics, and loan terms are fixed at the median. Because no such model borrowers actually exist, readers should use these figures for illustrative purposes only.

chance that the estimated probabilities would seem to be so different if in fact the actual probabilities were the same.

EXHIBIT 2-8: Effect of Borrower Age on Selection of Payment Plan[1]

	Age of Borrower		
	71.6 years	76.7 years	81.6 years
Probability of Tenure Option	**30.9%**	**28.2%**	**25.7%**
Probability of Term Option	22.4%	22.8%	23.3%
Probability of Line of Credit Option	12.3%	11.4%	10.5%
Probability of Tenure plus Line of Credit Option	12.5%	12.8%	13.1%
Probability of Term plus Line of Credit Option	**15.9%**	**17.5%**	**19.3%**

[1] Bold typeface indicates that the differences are statistically significant at an 80 percent confidence level.

According to the estimates derived from the analysis, a typical borrower aged 76.7 years (the median for HECM borrowers to date) is about 28 percent likely to elect the tenure payment option (that is, to receive monthly payments until the property ceases to be their primary residence), and about 18 percent likely to choose a combination of regular term payments with a line of credit. An otherwise identical but younger borrower is more likely to elect tenure payments, but less likely to combine term payments with a line of credit, while the reverse pattern holds for an older borrower. Thus a borrower's age is negatively related to the probability that the borrower will elect tenure payments, and positively related to the probability that the borrower will combine term payments with a line of credit.

2.4.2 Income

Interestingly, there appears to be no relationship at all between the income of a borrower and the probability that the borrower will elect each of the five payment options. This result is somewhat surprising. It might be expected, for example, that higher-income borrowers would elect to establish a line of credit to cover extraordinary unforeseen expenses; lower-income borrowers, in contrast, might be expected to elect payment options to cover ordinary living expenses. It is possible that there is some relationship between income and the choice of payment option, but that this effect is confounded with other effects.

2.4.3 Sex

Exhibit 2-9 shows the relationship between the sex and household composition of borrowers and the probability that they will choose each payment. As this exhibit shows, it appears that elderly homeowners living alone, especially single men, are significantly less likely to establish a line of credit than are borrowers living together (including married couples), and more likely to combine a line of credit with monthly term payments.

EXHIBIT 2-9: Effect of Sex on Choice of Payment Option[1]

	Living with Others	Female Living Alone	Male Living Alone
Probability of Tenure Option	29.9%	28.6%	23.5%
Probability of Term Option	22.6%	22.2%	26.0%
Probability of Line of Credit Option	**14.8%**	**10.9%**	**7.5%**
Probability of Tenure plus Line of Credit Option	13.0%	12.0%	15.8%
Probability of Term plus Line of Credit Option	**13.2%**	**19.3%**	**21.0%**

[1] Bold typeface indicates that the differences are statistically significant at an 80 percent confidence level.

2.4.4 Property Value

Exhibit 2-10 shows the estimated relationship between property value and the choice of payment option.[17] As this exhibit shows, there is a strong negative relationship between property value and the probability that a borrower would elect to establish a line of credit. The exhibit also shows that borrowers with relatively high property values are slightly more likely to choose the monthly tenure payments option.

[17] Because of the fairly strong correlations between property value, adjusted property value (maximum claim amount), and principal limit, the latter were not included in the analysis of factors affecting the choice of payment options. Adjusted property value and principal limit do not appear to have any significant effect on payment choices aside from the effects attributable to property value.

EXHIBIT 2-10: Effect of Property Value on Choice of Payment Option[1]

	Property Value		
	$75,000	$103,000	$146,000
Probability of Tenure Option	**26.7%**	**28.2%**	**30.6%**
Probability of Term Option	22.5%	22.8%	23.4%
Probability of Line of Credit Option	**15.2%**	**11.4%**	**7.1%**
Probability of Tenure plus Line of Credit Option	12.9%	12.8%	12.6%
Probability of Term plus Line of Credit Option	17.6%	17.5%	17.4%

[1] Bold typeface indicates that the differences are statistically significant at an 80 percent confidence level.

2.4.5 Location

Exhibit 2-11 presents the estimated probability that a typical borrower living in urban, suburban, and rural areas will elect each of the five payment options. As this exhibit shows, there appear to be dramatic differences in the HECM payment option choices made by otherwise identical borrowers living in the three locations. Rural borrowers are much more likely than urban or suburban borrowers to choose the line of credit option, and much less likely to choose the term option or the tenure option with a line of credit.

There are several possible reasons for these dramatic estimated differences between otherwise identical borrowers in central city, suburban, and rural areas. First, it is possible that borrowers in the three areas may receive different housing counseling and may choose payment options on the basis of this different information. Second, borrowers in the three areas may use HECM loan proceeds for substantially different purposes, and choose payment options to meet their disparate requirements. Third, borrowers in rural areas may be significantly more

EXHIBIT 2-11: Effect of Property Location on Choice of Payment Option[1]

	Location of Property		
	Urban	Suburban	Rural
Probability of Tenure Option	28.9%	27.3%	35.9%
Probability of Term Option	**24.2%**	**24.5%**	**3.1%**
Probability of Line of Credit Option	**10.1%**	**11.3%**	**34.3%**
Probability of Tenure plus Line of Credit Option	**10.9%**	**14.8%**	**7.1%**
Probability of Term plus Line of Credit Option	20.9%	15.2%	23.8%

[1] Bold typeface indicates that the differences are statistically significant at an 80 percent confidence level.

comfortable with a line of credit than otherwise similar urban and suburban borrowers, if they or their acquaintances have made use of large lines of credit in the past to finance purchases of agricultural equipment, leasing of farm lands, or other expenses.

A fourth possible explanation is that the three locations may reflect other differences that are not, or only imperfectly, captured in the available data. For example, according to the American Housing Survey, monthly housing costs for homeowners in 1989 were substantially higher in central cities ($245) and suburban areas ($261) than in rural areas ($194). Since it is quite likely that HECM borrowers make payment option decisions in large part on the basis of their monthly housing expenses, the differences observed between the three areas may reflect differences in housing costs.

CHAPTER 3

PARTICIPATION BY THE FINANCIAL COMMUNITY IN THE HECM DEMONSTRATION

Homeowners' access to HECM loans depends upon the willingness of lenders to make such loans. The HECM Demonstration is designed to encourage and increase reverse mortgage lending by private lending institutions through the provision of mortgage insurance. This chapter discusses the involvement in the Demonstration of the nation's financial community -- the lenders, institutional investors, and loan servicers whose participation is essential for home equity conversion mortgages to become an accepted and available option for elderly homeowners.

3.1 Lender Participation

Since the origination of the first HECM in October 1989, there has been slow but growing acceptance of the HECM loan among conventional lenders. As of August 1992, the Demonstration involved 52 lenders in 38 states plus the District of Columbia.[1]

The Department initially restricted participation to 50 lenders selected by lottery. The lottery approach assured the selection of interested lenders from each of the ten HUD regions in

[1] As of August 19, 1992 no HECM loans had been closed or had reached firm commitment in 12 states: Alaska, Arkansas, Kentucky, Louisiana, Mississippi, North Dakota, Oklahoma, South Dakota, Texas, Wisconsin, West Virginia, and Wyoming.

proportion to the share of elderly homeowners within that region.[2] Each selected lender received authorization to originate a maximum of 50 loans, for a nationwide total of 2,500 insured loans.

Despite timely selection of the first 50 lenders, a number of obstacles delayed origination of HECM loans. Some lenders could not readily locate title companies who understood and were interested in insuring reverse mortgages, a problem that has lessened as awareness of reverse mortgage products has increased. The lack of qualified counselors in some areas, a situation discussed in detail in Chapter 4, also limited lenders' ability to qualify borrowers. Further, lenders in certain states could not reconcile reverse mortgages with state law provisions, a problem discussed in Chapter 5. Faced with these problems, as well as the concern that the maximum 50-loan volume would not justify their costs of participation, 27 pilot lenders withdrew from the program during the first 16 months. These lenders were replaced by others from the same region, although not necessarily within the same lending area. The withdrawal of original lenders disappointed some potential borrowers who could not be served by the replacement lender.

Several changes to the HECM Demonstration are having a positive impact on lender participation. These changes are the result of a 1991 Congressional amendment that modified the Demonstration in major respects. The Demonstration has been extended through 1995 and insurance authority has been increased tenfold to 25,000 loans. As a result, HUD opened

[2] The lottery permitted all FHA lenders to apply to participate. A total of 276 lenders submitted applications. Each HUD region then held a random drawing to determine which lenders would receive reservations of insurance authority. The number of lenders drawn per region was based upon the proportion of elderly homeowners within the region. The number of lenders ranged from two each in Regions VIII and X (the Mountain States and Pacific Northwest, respectively) to 10 each in Regions IV and V (the Southeast and Midwest).

participation in the program to all FHA-approved lenders, not just those selected by lottery, and lenders are no longer limited to 50 loans each.

Exhibit 3-1 presents a profile of participating lenders by type of institution and the number of loans originated. As this exhibit shows, mortgage bankers and mortgage banking subsidiaries of HUD-supervised lenders represent about 69 percent of lenders currently active in the program and account for 84 percent of loans made to date. Included in this tally are loans originated by three mortgage firms created especially to make reverse mortgages.[3] In contrast, bank and thrift institutions account for only 27 percent of the lenders currently active in the program and only 10 percent of loans to date. Two state housing finance agencies -- in Maine and Rhode Island -- are also active HECM lenders, although only the Rhode Island agency has originated an appreciable number of HECM loans.[4]

3.2 Reasons for Participation

According to several lenders and reverse mortgage experts contacted for this report, many participating lenders are banking on the future profitability of HECM loans. Lenders express excitement about the market potential of this new product, and also choose to participate in the program because they perceive HECM loans to be a relatively risk-free way to serve community needs.

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[3] Senior Income Reverse Mortgage (Illinois), Investors West (Idaho), and Home Equity (Maryland) have been set up to serve the market for home equity conversion mortgages.

[4] Loans originated by banks, thrift institutions, or State housing finance agencies, but currently serviced through the Wendover Funding correspondent program, are included in Exhibit 3-1 under "Mortgage Bankers and Subsidiaries." For this reason, Exhibit 3-1 underrepresents the actual activity to date by banks, thrift institutions, and State housing finance agencies.

EXHIBIT 3-1: HECM Activity by Type of Lender

Type of Lender	Number of Lenders Originally Authorized	Number of Lenders Currently Active[1]	Current Number of Loans[2]	Current Aggregate Loan Balance[3]
Mortgage Bankers and Subsidiaries[4]	33	36	2,120	$41,175,395
Banks and Thrift Institutions	14	14	250	$4,338,650
State Housing Finance Agencies	3	2	152	$3,963,615

[1] As of August 19, 1992. Includes several lenders that are currently authorized but were not among the 50 lenders originally authorized. Excludes several lenders that originated loans but that currently participate only through Wendover Funding correspondent program.

[2] Includes 2,155 loans closed plus 367 that had received firm commitments but that had not yet closed as of August 19, 1992.

[3] Including disbursements, interest, mortgage insurance premiums, and other charges. Loan balance is zero for loans that had not yet closed.

[4] Includes lenders participating through Wendover Funding correspondent program.

According to the 1989 American Housing Survey, 15.3 million American homeowners are 65 or older. The widespread desire among the elderly to age in place (that is, to remain in their own homes rather than to move in with family members or to institutions)[5] may give HECM loans special appeal over other home equity conversion options that do not protect the borrower's right to stay in his or her home. In addition, the same demographic changes that foretell declining demand for forward mortgages suggest increasing demand for reverse mortgage products. Faced with an aging population and shrinking first-time homebuyers market, mortgage lenders are starting to look for innovative products to serve less traditional markets.

[5] AARP estimates that 84% of elderly Americans wish to remain in their own homes. See Understanding Senior Housing for the 1990s (AARP,1990).

Lenders indicate that they enjoy the satisfaction of helping elderly homeowners remain in their homes, and identify public service as the most attractive feature of participation. For lenders subject to Community Reinvestment Act (CRA) requirements, home equity conversion mortgages offer an opportunity to demonstrate service to low-income persons and communities and to improve CRA ratings. Lenders also note that they benefit from the positive public relations associated with reverse mortgage lending.

Important safeguards built into the HECM Demonstration increase lenders' willingness to participate by reducing their risks. The slow development of private reverse mortgage models indicates that few private lenders were willing to put their own capital at risk issuing uninsured reverse mortgages. Active HECM lenders say that FHA insurance is critical to their participation. In fact, some lenders and others knowledgeable about the Demonstration believe that FHA insurance effectively eliminates lender risk.

In principle, FHA insurance offers lenders two basic forms of protection, as noted earlier. Lenders participating in the Demonstration have the choice between a shared premium and an assignment option. While both options reduce the collateral risk that the mortgage balance on a HECM loan may grow to exceed the value of the property, the assignment option effectively shields participating lenders from any collateral risk. Furthermore, for this and other reasons (discussed below), secondary market investors will only purchase reverse mortgage loans on which the lender has selected the assignment option. As a result, in practice all lenders participating in the program have chosen the assignment option.

3.3 Implementation Issues

Complex and unconventional aspects of the HECM loan have presented challenges for lenders participating in the first years of the Demonstration. With little reverse mortgage experience to draw upon, the business of making and servicing HECM loans has been costly and time-consuming for lenders. Gradually, however, lenders are starting to realize some economies of scale and to benefit from the experience of pilot participants. On-going origination and servicing costs should diminish as activities become more routine.

3.3.1 Reverse Mortgage Origination

Loan origination refers to the set of activities that bring a loan to closing. For lenders participating in the Demonstration, it has taken as long as 18 months to close their first reverse mortgage. In order to start originating HECM loans, lenders first needed to develop staff capabilities, documents, and loan processing procedures specific to the HECM Demonstration requirements.

Staff Capabilities. Reverse mortgages are new territory for private lenders. Prior to the late 1980s, reverse mortgages were largely the domain of public agencies. The National Center for Home Equity Conversion estimates that at the outset of the HECM Demonstration only 2,500 private loans had been originated nationwide. For lenders accustomed to forward mortgages, reverse mortgage activities required fundamental changes in their thinking and procedures. HUD has not provided for any specific lender training in conjunction with the Demonstration, although lenders have been encouraged to attend the same HUD-sponsored HECM training sessions offered to counseling agencies. This training has been useful for giving lenders an introduction to home equity conversion and features of the HECM loan; attendance has also promoted links between lenders and counselors, a relationship that is crucial to keeping borrowers in the pipeline. However, some specific needs of lenders cannot be met through this training. Consequently, many lenders have been training staff at their own effort and expense, as would be the case with most new loan products.

Lenders are finding that the complexity of HECM processing warrants assigning specialized staff to perform HECM activities. The small volume of HECM loans originated by most lenders does not make it cost-effective to train all loan officers in reverse mortgage origination. One of the larger-volume lenders participating in the program has decided to centralize all HECM operations in one office, despite the fact the company operates in a seven state region. Branch office staff are responsible only for loan intake and settlement; all application review, counseling referrals, and other processing steps are performed by HECM specialists.

Documents. Like any new program, the HECM Demonstration requires lenders to prepare new documents. FHA provides model security instruments and notes to lenders for all of its single-family programs, including the HECM Demonstration, but lenders must ensure that the model documents conform to any applicable state requirements. Unlike other programs, however, the uniqueness of the HECM loan limits the applicability of existing models for questions of state law. Pilot lenders claim to have incurred considerable expense to have the model legal documents reviewed by counsel and revised for conformity with state law. Loan documents can now be purchased from Wasatch, a company that specializes in standard forms. Lenders that use such documents, however, must still assure their compliance with relevant regulations since Wasatch does not provide warranties for its documents.

Preparing documents to satisfy Truth-in-Lending Act requirements has also been difficult for some lenders. The Federal Reserve Board classifies reverse mortgages as open-end credit when they permit re-borrowing of any amounts pre-paid. As such, HECM loans are subject to Regulation Z, which requires the same disclosure information as provided for revolving charge accounts and ordinary home equity lines of credit. Mortgage lenders, accustomed to the truth-in-lending requirements for closed-end credit (i.e., forward mortgages), are not as familiar as commercial lenders with open-end requirements. Regulatory barriers, and efforts to mitigate them, are the focus of Chapter 5.

Loan Processing. Reverse mortgage processing is often labor-intensive. Even though HECM underwriting is reduced because loans are based upon the value of the property rather than the borrower's income, lenders complain that origination is burdensome. One lender reported spending three full days to complete 21 separate documents required to close a HECM loan. HECM origination appears to take between six and eight weeks from application to settlement, about two weeks longer than for a forward FHA mortgage.

To the extent possible, the Department designed HECM procedures to mirror FHA forward processing. One major difference, however, is that all HECM loans are HUD-processed whereas nearly all FHA forward mortgages are direct-endorsed by the lender. HUD processing requires lenders to refamiliarize themselves with an activity that they perform less and less frequently. Further, the approval of the HUD field office staff must be obtained at each stage in the process between application and settlement. Since field offices do not have equal experience processing HECM loans, processing has taken longer in some offices than in others at this stage of the Demonstration.

3.3.2 Origination Costs

As with forward mortgages, lenders participating in the HECM Demonstration may recover a portion of their transaction costs from fees charged to borrowers. For the HECM Demonstration, HUD has determined that general FHA rules pertaining to allowable costs and fees apply. HUD has also established several specific requirements for reverse mortgages.

The Department did not limit the origination fee charged by HECM lenders. This differs from FHA forward mortgages where origination fees are restricted to one percent of the loan. The Department does, however, limit the amount of HECM origination fee that can be financed from loan proceeds to one percent of adjusted property value. Any amount above one percent must be paid for from the borrower's own funds.

In effect, this one percent financing cap has served to establish a base price for origination fees. The concern that borrowers often cannot pay greater amounts out of pocket keeps a few lenders from charging more than one percent, particularly since the program is targeted to low-income borrowers with little wealth other than their home equity. However, most HECM lenders typically charge either 1½ percent of property value or a flat $1,500 fee for origination. For FHA reverse mortgages made on lower value homes, lenders claim that the actual costs of origination are likely to exceed one percent of value. This can be a problem for those borrowers who are the least able to pay the difference out of pocket.

Closing costs on a HECM loan also include an upfront mortgage insurance premium. HUD requires lenders to collect at closing a mortgage insurance premium equal to two percent of adjusted property value, defined as the lesser of the property value or FHA 203(b) mortgage limits. Other fees passed on to borrowers at closing include appraisal costs, title search and recordation, a credit check (to make sure that the borrower does not have any delinquent Federal debts that cannot be cleared), and reasonable and customary local fees.

3.3.3 Reverse Mortgage Servicing

Reverse mortgage servicing runs counter to forward mortgage servicing practices. Servicing encompasses all activities performed after the loan has closed. Lenders may service home equity conversion mortgages themselves or arrange for others to perform servicing. Although certain basic responsibilities are the same for both forward and reverse mortgages -- for instance, loan balances must be calculated and account statements sent -- there are important differences.

Instead of collecting payments from borrowers, reverse mortgage servicers disburse payments to borrowers. With a HECM loan, disbursements include any regularly scheduled payments (for term and tenure plans) and/or line of credit advances. HUD requires that late charges, payable to borrowers, be assessed if the servicer fails to distribute monthly payments by the first of each month, or if line of credit advances are not issued within five business days. The flexible payment plan available with FHA reverse mortgages creates unpredictable payment streams. In turn, this unpredictability makes servicing functions difficult to standardize. Borrowers may change payment options at any time, which means that each loan is serviced in effect as a line of credit, even when it is not. New financial calculations must be performed each time the borrower elects to change to a different payment option.

Under the HECM Demonstration, servicers must ensure that property repairs required as a condition of loan approval be completed before funds are disbursed. They must also verify that taxes and hazard insurance are paid. Although most HECM borrowers elect to continue paying these expenses directly, servicers are still responsible for verification and for paying any delinquencies that result from borrowers' failure. An additional servicing responsibility of the HECM Demonstration is the payment to HUD of the borrower's monthly insurance premium.

Together these requirements mean that reverse mortgages require more individualized attention than forward mortgages. Commercial computer software packages for reverse mortgage servicing are not yet available. The premium collection system operated by Computer Data Systems, Inc. (CDSI) gives lenders on-line access to detailed information on scheduled and unscheduled payments to borrowers, current loan balances, and other data for each loan.[6] Even with the assistance of this premium collection system, however, few lenders have the technical

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[6] The CDSI premium collection system begins with basic information on each loan, obtained from the CHUMS system. Lenders then access the system on-line to update loan information at closing, after which CDSI computes the initial mortgage insurance payment and debits the lender's account. After loan closing, CDSI enters data on scheduled monthly payments to each borrower in accordance with the payment option chosen; lenders enter data on unscheduled payments and changes in payment options. CDSI then updates the outstanding loan balance each month. computes the monthly MIP, and debits the lender's account.

capacity or inclination to service reverse mortgages themselves. Instead, most lenders look to a professional servicer to fulfill these functions.

Most HECM servicing activity to date is performed by Wendover Funding, a North Carolina firm that manages servicing for 860 of the HECM loans originated as of March 1992. Wendover has a relationship with nearly every lender participating in the HECM Demonstration.[7] For example, the firm has been contracting to subservice loans since the inception of the program. Under a subservicing arrangement, the originating lender remains the servicer-of-record (that is, the lender retains full legal responsibility to the owner of the loan -- commonly FNMA -- to ensure that servicing is performed) but contracts with Wendover to perform all functions. Currently, Wendover subservices approximately 400 HECM loans for 17 different lenders. Wendover acts as the servicer-of-record for the balance of its portfolio, having acquired servicing rights from the originating lenders through a correspondent program. This program, launched in June 1991, enables Wendover to purchase loans from originating lenders, and then sell the loans on the secondary market while retaining servicing rights and responsibilities.

Wendover's correspondent program offers lenders several advantages that can speed and facilitate their participation in the HECM Demonstration. For a fee of $2,500, Wendover provides lenders with all of the loan documents required to originate HECM loans in their state along with a one-day training workshop, training manual, and on-going support. This considerably

[7] Wendover currently services or sub-services HECM loans for 45 of the 57 lenders participating in the program to date. All other lenders perform their own servicing, with the exception of the James B. Nutter Company which services loans for itself and one other lender.

reduces lender's time and expense preparing their own documents and systems; lenders must, however, still develop their own Regulation Z compliance materials.

The Department permits, but does not require, lenders to charge borrowers a flat monthly fee for servicing. The fee amount must be established at closing and the principal limit on the loan reduced by a sufficient amount to fund the fee for the duration of the mortgage. The fee is charged only as it is earned. Because HECM servicing is not yet a competitive industry, Wendover Funding's fee structure has become the standard, with fees that range between $25 and $35 a month. In addition, the Department permits lenders to impose a flat fee of up to $20 for every modification to the borrower's payment plan.

3.4 Emergence and Influence of a Secondary Market for Reverse Mortgages

The establishment of a secondary market for reverse mortgages has been essential to the success of the HECM Demonstration. Lenders, particularly mortgage bankers, are accustomed to dealing with mortgage products that can be sold to secondary market investors in exchange for capital to make additional loans. Prior to the HECM Demonstration, reverse mortgage loans had to be maintained in the lender's own portfolio, thus putting the lender's own funds at risk and limiting the volume of loans that could be made.

At the outset of the Demonstration, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) agreed to purchase HECM loans originated by their network of approved lenders. Lender acceptance of the HECM instrument depends on the willingness of one or both of these institutions to purchase HECM loans. Most

HECM loans issued to date have been sold to FNMA. In fact, as of mid-August 1992 FNMA's portfolio included 2,017 HECM loans, almost 94 percent of the total volume to date.[8] FHLMC has not yet purchased any HECM loans, although it has expressed a commitment to the Demonstration.

In order to sell reverse mortgage loans to FNMA, the originating lender must negotiate a commitment equal to the estimated balance of all mortgages to be sold. Lenders who are not approved by FNMA may still sell their reverse mortgages through Wendover's correspondent program. As noted, Wendover acts as an intermediary between the primary lender and secondary market. This concept has considerable potential to expand the pool of lenders participating in the HECM Demonstration by offering secondary market access to small volume lenders or firms that are otherwise precluded from selling to FNMA.

As a condition of purchasing loans made under the HECM Demonstration, FNMA imposes on lenders additional requirements that affect the types of loans they originate. FNMA will not purchase shared appreciation mortgages. Lenders who sell HECM loans to FNMA must also elect the assignment option. FNMA also refuses to purchase fixed rate loans, primarily due to the greater risk that in a high interest rate environment the costs to the lender of obtaining capital might exceed the rate at which borrowers can draw against their HECM loans. These policies reveal the considerable influence the secondary market has upon primary lenders: as

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[8] HECM loans not currently held by FNMA fall generally into three categories. First, several loans will eventually be sold to FNMA but have not yet either because they were originated only recently or because lenders made mistakes in originating the loans and must correct these mistakes before the loans are eligible to be purchased by FNMA. Second, some loans cannot be sold to FNMA because of similar mistakes in origination that cannot be corrected; lenders must therefore retain these loans in portfolio. Third, Sunwest Bank of Albuquerque is holding a few fixed-rate HECM loans that it has originated but that FNMA refuses to purchase.

discussed above, no participating lenders have selected a shared premium option, none presently offers a shared appreciation loan, and only one has issued any fixed-rate mortgages. Similarly, FNMA insists that sellers charge borrowers a flat monthly servicing fee, which the Department allows but does not mandate. There is no limit on servicing fees, although FNMA requests written justification for fees above $50 per month.

Presently, FNMA retains all reverse mortgages in portfolio. The convertibility of the HECM payment plan, which exists for the benefit of borrowers, does present a challenge to securitization of reverse mortgages. According to FNMA, an investor product would need to be more restrictive. Due to the annuity-like structure of reverse mortgages, insurance companies are perceived to be the only investors likely to be comfortable with the variable payment stream potential of reverse mortgages.

CHAPTER 4

COUNSELING FOR HECM BORROWERS

Converting home equity into cash represents a major life decision affecting homeowners and their heirs. To make certain that prospective borrowers understand the full impact of tapping into home equity, the HECM Demonstration requires homeowners to receive counseling about reverse mortgages and their alternatives before they commit to participation in the HECM Demonstration. It has been claimed that this requirement -- intended to protect consumers -- may inadvertently limit consumer access to HECM loans.

The statute mandates that borrowers be counseled by an approved third party before entering into a HECM loan. Counseling serves to inform borrowers about other housing, social services, and financial resources that may be available to them; to review home equity options other than HECM loans; to explain the financial implications associated with the HECM loan; and to make them aware of potential impacts the mortgage may have on their tax status, eligibility for public benefits, and estate.

Although a few participants and others familiar with the HECM Demonstration have suggested that mandatory counseling may alienate some potential borrowers who consider it paternalistic, advocates for the elderly, lenders, and others involved in the HECM Demonstration generally agree that the newness and complexity of HECM loans warrant counseling. The vulnerability of many elderly households is also believed to justify counseling. Most borrowers can benefit from the information, explanation, and support that counseling provides. Rather, criticism and concern about HECM counseling arise primarily from the difficulties encountered in bringing the required services to these consumers.

From the outset, limited availability of counseling services has posed a dilemma for the Demonstration. While HUD's network of certified comprehensive housing counseling agencies is extensive, it is not evenly distributed. In some communities and even some states, there are no certified agencies. Moreover, the Department estimates that only about 75 agencies actively provide counseling to HECM borrowers, including about a dozen Area Agencies on Aging that have been approved to provide counseling exclusively on reverse mortgages. The nonprofit and public agencies certified by HUD to perform housing counseling have been reluctant to take on additional counseling activities without additional compensation.[1]

New training opportunities designed specifically around reverse mortgages are helping to prepare qualified counselors. The Department has provided reverse mortgage training for counseling staff from new and existing HUD-certified agencies, member of the nation's aging network, lenders, and attorneys specializing in elder law issues. The Department funded the initial training at $250,000 in the first year of the Demonstration, and has provided $150,000 for training in each of the past two years. The training funds have allowed the American Association of Retired Persons and its subcontractor, the National Center on Home Equity Conversion, to develop and deliver training workshops in each of the HUD regions. Initial training sessions conducted in 1989 targeted providers located in the vicinity of the first 50 lenders participating in the HECM Demonstration. As of February 1992, AARP has delivered training in 40 locations

[1] Annually, a total of approximately $6 million is awarded competitively to agencies to carry out a full range of counseling activities.

around the country and has trained 463 counselors from 298 HUD-approved agencies. No counselors have yet been trained from agencies in Alaska, Hawaii, Nebraska, South Dakota, or Vermont, but HUD field office staff have provided counseling to prospective borrowers in Hawaii and in some other areas.

Attendance at the two-day AARP training is not a formal prerequisite for providing HECM counseling, but participants report that the training greatly enhances their understanding and skill. Training serves to broaden counselors' perspectives. Most agencies are oriented either towards elderly issues, or housing services, or budget counseling. HECM counseling requirements compel providers to be familiar with each of these areas of expertise. The first day of the workshop focuses upon features of reverse mortgages in general and the HECM loan specifically, and helps to counter misinformation about reverse mortgages. The second day emphasizes alternatives to reverse mortgages, including an overview of services especially for the elderly. Throughout the training, participants have an opportunity to build their knowledge and apply it through case studies, exercises, and practice using the HECM computer software.

In addition to HUD-sponsored training of counselors, the AARP, through its Home Equity Information Center, has formed a network of counseling coordinators in 32 states plus the District of Columbia. These coordinators will maintain lists of trained counselors, make client referrals, and provide liaison between counselors, HECM lenders, and HUD field offices.

Despite these efforts to expand and enhance counseling services, with the recent expansion of the HECM Demonstration to all FHA-approved lenders, many supporters and critics alike have expressed concern that HECM counseling requirements may create a bottleneck in the system.

The Department recognizes that the lack of a uniform nationwide HECM counseling network has made it more difficult for the Demonstration to commence in some areas. This may be particularly true in less populated rural areas. However, the Department is not aware of any communities that have been denied access to the HECM Demonstration solely on the basis of the lack of counseling. Furthermore, it is not evident that the volume of HECM loans would rise commensurate with the expense of building and maintaining such a network. For example, in some areas such as Denver and Chicago HECM counseling has been readily available since early in the Demonstration, yet volume in these areas is not markedly higher than in comparable areas where counseling availability has been a problem.

Briefly, the difficulties encountered with HECM counseling are as follows. In several states, a single counseling agency is responsible for HECM counseling and there are several places where providers serve large geographic territories. This makes it difficult for borrowers to come to counselors or for counselors to travel to borrowers. The Department requires counseling on a one-to-one basis in person or by telephone. However, the need to compute financial comparisons using the HECM software generally makes at-home sessions infeasible, although HUD encourages home visits to screen properties for eligibility. Most counselors use telephone contact extensively for initial and follow-up conversations but favor personal meetings to fully discuss reverse mortgage decisions with borrowers, unless clients are unable to travel. An heir or a trusted advisor is encouraged to attend the counseling session.

Other inefficiencies also beset the current counseling system. There is limited funding available at the Federal, State, and local levels for counseling agencies. Agencies are prohibited from charging clients for counseling, nor can participating lenders pay for counseling. The Department reimburses agencies at a rate of $35 per unit of counseling. Due to broad interpretation as to what constitutes a unit of service, this may not fully compensate agencies for their actual costs in the HECM Demonstration. Although accurate per-client cost measures are not available, some counselors report that costs in the $200 to $250 range are not uncommon for HECM counseling.

HECM counseling interventions are very client-specific and time intensive. The relative emphasis placed upon each of the four mandated topics varies according to the borrower's needs, interest, and understanding. There is also some regional and even local variation in what topics are discussed as a result of the availability or absence of particular options and services. Although counselors do not follow standard procedures, a common approach to providing counseling appears to be emerging. Client intake usually takes place by telephone, when prospective borrowers first contact the counseling agency. This initial phone contact allows the counselor to gather basic data regarding personal and property data to make a preliminary eligibility determination. Borrowers are then typically sent a package of written materials to study and review in advance of their counseling session. This meeting allows the counselor and client to spend time discussing needs in greater detail, clarifying information, working up (or presenting if enough information has been obtained by phone) projections showing the impact of various HECM payment options, and talking through other issues. Subsequent questions and concerns are usually handled by telephone after the session. Counselors generally find that required HECM topics are too complicated to be addressed through one limited intervention. In the words of one counselor, "You can't expect borrowers to absorb complicated material all at once. Information can only be simplified to a point. If it's reduced too much then I'm not doing my job."

Counseling agencies are guided by the HUD Housing Counseling Handbook (7610.1 rev. 2) and by the HUD Program Participants' Handbook (4235.1). These agencies frequently use materials provided to them in training to assist borrowers. Popular sources include AARP publications and question-and-answer guides developed by FNMA. A consumer workbook produced by FNMA in 1992 has added to this body of reverse mortgage literature.

Because of tight funding, agencies seldom perform thorough client tracking. Estimates of the number of initial inquiries that result in reverse mortgage counseling tend to be based on perception rather than recordkeeping. Similarly, agencies lack the capacity to follow-up with counseled clients to determine how many actually choose to take out a HECM loan and why. The screening function of counseling agencies is highly valued by lenders, who are spared the time and expense of having to explain the program features to prospective borrowers who may prove ineligible or may choose not to pursue a HECM loan after learning about it. Counselors suspect that, among those counseled who decide not to move forward, there are some for whom a reverse mortgage may make sense in the future. If circumstances change, or in the case of younger borrowers when larger payments can be realized, the homeowner may decide to pursue a reverse mortgage either through the HECM Demonstration or through a non-insured program that may be available in the local market.

From a program evaluation standpoint, this absence of client tracking is unfortunate because counseling agencies have the potential to be outstanding sources of information. Counselors have a great deal of knowledge about the characteristics of HECM borrowers, intended uses of loan proceeds, and the attractiveness of various features of the HECM Demonstration. At present, however, counselors' insights remain necessarily anecdotal.

CHAPTER 5

LEGAL AND REGULATORY ISSUES

There are a number of regulatory and legal issues that affect the implementation, and potentially the continued success, of the HECM Demonstration. The full impact of these issues probably cannot be evaluated adequately until data are collected directly from borrowers and eligible non-participants. A preliminary evaluation of these issues, however, can form the essential basis for later data collection intended to evaluate their impact on the success of the program.

This chapter is organized in three sections. The first section discusses the loan acceleration provisions of the Truth-in-Lending Act (TILA) and the Home Equity Loan Consumer Protection Act (HELCPA). The second section addresses disclosure requirements under TILA, HELCPA, and the Real Estate Settlement Procedures Act (RESPA). Finally, the third section presents an overview of state statutory or other law that affect the implementation of the program in particular states.

5.1 Loan Repayment Provision

The Truth-in-Lending Act (TILA), as amended by the Home Equity Loan Consumer Protection Act (HELCPA), contains several important provisions that affect reverse mortgage lending under the HECM Demonstration and other programs. In the absence of statutory language to the contrary, some reverse mortgages (including those originated under the HECM Demonstration) qualify as "open end consumer credit plans under which extensions of credit are secured by a consumer's principal dwelling." Specifically, a line-of-credit HECM can be defined as an open end credit plan because there is no fixed repayment date or schedule, and because borrowers can have subsequent access throughout the life of the loan to any funds that they repay after having received them. Furthermore, HECM loans with fixed monthly payments (tenure or term plans) can also be considered open end credit plans because borrowers are permitted to establish a line of credit at any time during the life of the loan.

One of the more significant provisions that has affected HECM loans to date is Section 137(b) of TILA,[1] which restricts the situations in which lenders can accelerate repayment of loans secured by the borrower's home. This section specifies that:

> A creditor may not unilaterally terminate any account under an open end consumer credit plan under which extensions of credit are secured by a consumer's principal dwelling and require the immediate repayment of any outstanding balance at such time, except in the case of:
>
> (1) fraud or material misrepresentation on the part of the consumer in connection with the account;
> (2) failure by the consumer to meet the repayment terms of the agreement for any outstanding balance; or
> (3) any other action or failure to act by the consumer which adversely affects the creditor's security for the account or any right of the creditor in such security.

The Federal Reserve Board's "Official Staff Commentary on Regulation Z: Truth in Lending" asserts that the mere fact that a borrower moves from his or her dwelling does not in itself adversely affect the creditor's security. Thus, under TILA a lender could not require repayment of the loan simply because the borrower moves. In contrast, the HECM

[1] HELCPA amends TILA and adds several new sections. Section 137 of TILA, for example, was enacted as Section 3 of HELCPA.

Demonstration specifically entails repayment of the loan balance in full immediately after the property ceases to constitute the borrowers' principal residence -- that is, after the borrowers sell the property, move into another principal residence (such as a retirement home or long-term care facility), or die. Potentially, a lender who sought repayment of the HECM loan at such a time could be prevented from doing so under TILA by the borrower, or the borrower's estate, unless the lender demonstrates one of the three grounds for acceleration: fraud, failure to meet repayment terms, or actions endangering the creditor's security.

This potentially serious difficulty did not prevent lenders from participating in the HECM Demonstration. It is not clear why this was true, but several possible explanations can be offered. A few lenders, for example, may not have recognized the implications of the original provision; others may have believed it unlikely that any borrowers or their estates would challenge repayment on the basis of TILA. Lenders may also have been anticipating that they would not have to address the issue if the loans were assigned to HUD before they become due and payable.

The Department informed the Federal Reserve Board that Section 255 of the National Housing Act, which authorized the HECM Demonstration, required the HECM borrower to occupy the mortgaged property. Furthermore, the statute authorized HUD to determine the grounds for repayment of a HECM loan. Based on Supreme Court statutory construction rulings, the Department took the position that Section 255 was a specific statute addressing a narrow class of mortgages, and as such was not controlled by the general provisions of Section 137(b) of TILA. Although Section 137(b) was enacted after Section 255, it contained no expression of Congressional intent to amend the HECM Demonstration through TILA.

Since HUD did not receive a ruling from the Federal Reserve Board on this issue, the Department recommended a clarification in its legislative program for Fiscal Year 1993. HUD proposed that reverse mortgages originated under the HECM Demonstration be exempt from Section 137(b) of TILA to protect the Department's rights and the rights of HECM lenders to collect the outstanding balance of a HECM loan when the borrower ceases to use the property as his or her principal residence. In response, Congress included language in Section 520 of the Housing and Community Development Act of 1992 amending Section 255(j) of the National Housing Act to specifically exempt HECM loans from the provisions of Section 137(b) of TILA. It is likely that this legislative clarification will increase activity under the HECM Demonstration by allaying the concerns of some lenders regarding repayment of HECM loans.

5.2 Disclosure Provisions

TILA and HELCPA also contain specific disclosure requirements for open-end credit plans, along with additional requirements for plans secured by the borrower's dwelling. Conventional mortgages are recognized as closed-end lines of credit. As such, their disclosure requirements are substantially different from those that apply to open-end credit, such as revolving credit card accounts and home equity lines of credit. Because of this difference, mortgage lenders must generally learn and comply with an entirely different set of disclosure requirements in order to participate in the HECM Demonstration or in any other reverse mortgage lending. For example, open-end credit rules require home equity line disclosures that are not required under closed-end credit plans.

Because the disclosure requirements applicable to reverse mortgages were developed for ordinary home equity lines of credit, they include a number of specific statements that make little sense in the context of reverse mortgages. For example, Section 127A(5)(B) of TILA[2] requires that lenders provide potential borrowers a statement that "in the event of any default, the consumer risks the loss of the dwelling." This statutory provision is implemented in Section 226.5b(d)(3) of Regulation Z, which requires a "statement that ... loss of the dwelling may occur in the event of a default." However, HECM borrowers are much less likely to lose their property as the result of a loan default. Defaults on reverse mortgages generally are situations in which lenders fail to make regular monthly disbursements, or advances under an existing line of credit. In general, borrowers would risk losing their property only if they failed to pay taxes, failed to keep the property in good repair, or otherwise endangered the lender's security interest in the property. On the other hand, funds adequate to make currently required repairs are set aside at loan closing, and lenders can withhold funds for payment of taxes or other required charges from monthly payments or from the amount available under the line of credit. Thus HECM borrowers are significantly less likely than borrowers under an ordinary line of credit to lose their property because of default.

The disclosure requirements also include the dissemination of a consumer brochure designed to explain home equity lines of credit. No consumer brochure has been prepared specifically for the HECM Demonstration. The consumer brochure provided by the Federal Reserve Board is designed for ordinary home equity lines of credit rather than for reverse mortgages. For example, the brochure is entitled "When Your Home Is On the Line: What You Should Know About Home Equity Lines of Credit," and on the first page the brochure contains

[2] Enacted as Section 2(a) of HELCPA.

the warning: "And, remember, failure to repay the line (of credit) could mean the loss of your home." This warning is, of course, completely inapplicable to HECM loans.

In its "Official Staff Commentary on Regulation Z: Truth in Lending," the Federal Reserve Board acknowledges, to some extent, the potential confusion arising from requirements developed for ordinary home equity lines of credit but not applicable to reverse mortgages.[3] For example, Section 5b(d)1. of the commentary notes that "disclosures required under this section need be made only as applicable." The absence of separate disclosure requirements, regulations, and consumer brochures specifically applicable to reverse mortgages, however, presents a substantial difficulty that may make some lenders unwilling to undertake reverse mortgage lending under the HECM Demonstration or another program. HUD has encouraged lenders to make use of existing administrative authority to modify disclosure language, and some lenders have been successful in making appropriate modifications although the process does involve some expense to lenders. Other lenders have been reluctant to modify disclosures because compliance of the changes with Regulation Z is not assured. A more effective means of addressing this problem, and one that would provide a greater level of comfort for lenders, would be for the Federal Reserve Board to provide disclosures and a consumer brochure specifically for reverse mortgage lending, as the Department recommended in its comments to the Federal Reserve Board on Regulation Z.

The HECM Demonstration handbook requires lenders to provide borrowers with a good-faith estimate of settlement costs within three days after having provided an application, and to

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[3] HUD provided extensive comments to the Federal Reserve Board when Regulation Z and the Official Staff Commentary were published for public comment, but these comments were not incorporated into the Regulation or the Official Staff Commentary.

provide a HUD-1 Settlement Statement at loan closing. Although the Real Estate Settlement Procedures Act (RESPA) does not govern the origination of reverse mortgages under the HECM Demonstration, it does contain similar requirements for other mortgages. The slight differences in these requirements has caused confusion for some lenders. The Department has addressed this issue in a rule (57 FR 49600, November 2, 1992) that now requires reverse mortgage lenders to comply with all of the RESPA disclosure requirements.

5.3 Legal Issues at the State Level

The HECM Demonstration was designed to make the program available to prospective borrowers in as many states as possible. Unfortunately, while most of the potential barriers described above could be resolved with federal statutory or regulatory action, several states have specific statutory or other legal impediments that may inhibit the successful expansion of the HECM Demonstration. The impact of legal impediments in each state can be evaluated in the context of loan volume to date in each state, as shown in Exhibit 5-1.[4]

HUD's Office of General Counsel and the AARP Home Equity Conversion Task Force have been identifying and tracking state legal obstacles to HECM loans. Many states do not have reverse mortgage laws. Where reverse mortgage laws have been enacted, there is often confusion as to the interaction of those laws with other mortgage lending laws. Additionally, state lending laws often conflict with the design of the HECM Demonstration or of reverse mortgages in general. For example, several states require that a mortgage include a specific maturity date,

[4] In interpreting these figures it is important to keep in mind that loan volume in each state depends on several factors other than state legal barriers, including the numbers of interested lenders, qualified counselors, and eligible borrowers.

EXHIBIT 5-1: HECM Activity by State[1]

States with HECM Activity

STATE	NUMBER OF LOANS	STATE	NUMBER OF LOANS
Alabama	6	Montana	3
Arizona	61	Nebraska	12
California	354	Nevada	8
Colorado	159	New Hampshire	13
Connecticut	42	New Jersey	201
Delaware	6	New Mexico	69
District of Columbia	9	New York	284
Florida	84	North Carolina	64
Georgia	93	Ohio	22
Hawaii	22	Oregon	22
Idaho	18	Pennsylvania	172
Illinois	58	Rhode Island	151
Indiana	26	South Carolina	24
Iowa	5	Tennessee	12
Kansas	36	Utah	23
Maine	35	Vermont	26
Maryland	60	Virginia	89
Massachusetts	1	Washington	88
Michigan	13		
Minnesota	97		
Missouri	54		

States with No HECM Activity to Date

Alaska	Arkansas	Kentucky	Louisiana
Mississippi	North Dakota	Oklahoma	South Dakota
Texas	West Virginia	Wisconsin	Wyoming

[1] Data reflect originations as of March 1992.

maximum mortgage amount, or both. Other state statutory or regulatory provisions that affect reverse mortgages include usury laws; restrictions on the use of compound interest, on negative amortization, or on adjustable-rate mortgages; and limitations on lien priority.

Many states have not designated an office responsible for interpreting state laws that affect HECM loans. Where a state agency has authority to interpret a particular statute or regulation, the staff usually must be educated as to the terms of a reverse mortgage. In some states, the difficulty of obtaining legal interpretation of laws affecting the implementation of the HECM Demonstration appears to have discouraged or precluded HECM lending. In other states, lenders have been able to obtain legal interpretations authorizing HECM lending from private counsel, state Attorneys General, or state regulatory agencies. HUD has assisted HECM lenders in understanding and overcoming state legal obstacles, and has in some cases permitted minor changes to the legal documents and program requirements to promote HECM loans.

The state of New Jersey provides an interesting example of the problem of legal uncertainty and of the response of lenders. The state statute that has been identified as authorizing reverse mortgage lending contains provisions that require fixed monthly payments, limit loan terms to ten years,[5] and prohibits loan-to-value ratios greater than 70 percent. Each of these provisions presents a problem when applied to the HECM Demonstration. For example, the fixed monthly payments requirement precludes HECM borrowers from the line of credit option. The ten-year term limitation conflicts with the tenure payment option in which a borrower receives payments as long as the property remains his or her principal residence. Finally, the 70 percent loan-to-value ratio may be exceeded over the life of the loan as the outstanding balance grows.

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[5] Several states appear to have term limitations that apply to reverse mortgages. Tennessee, for example, has a 20-year maximum term for open-ended credit.

Lenders who identify such state legal obstacles generally first investigate the extent to which Federal preemption excuses compliance with the state law. Unfortunately, no Federal preemption is provided for the HECM Demonstration in Section 255 of the National Housing Act. Title VIII of the Garn-St. Germain Act provides for Federal preemption of certain state lending laws (most commonly those prohibiting due-on-sale clauses or adjustable rate mortgages). Title VIII is implemented by regulations issued by three different Federal regulatory agencies: the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration (NCUA) and the Office of Thrift Supervision (OTS). Each agency has issued regulations listing the types of state lending laws that are preempted, but none specifically addresses reverse mortgages.

Under this complex regulatory scheme, a state-licensed lending institution in New Jersey has interpreted the regulations issued by the OCC as preempting the New Jersey law and permitting HECM lending, while a New Jersey mortgage banking company governed by OTS regulations has determined that it is precluded from making HECM loans. Thus, the state law authorizing reverse mortgages actually operates to prohibit the HECM Demonstration, except to the extent that it is preempted. HECM loans are available from state-chartered lenders in New Jersey, but not from others such as mortgage bankers. Interestingly, with 152 loans closed to date, New Jersey is one of the most active markets for the HECM Demonstration.

In considering the expansion of the HECM Demonstration, the Senate Committee on Banking, Housing, and Urban Affairs became aware of state law barriers to the program. The Senate Report reaffirmed the Garn-St. Germain preemption and ordered the Federal regulatory agencies to issue opinions and regulations concerning the Federal preemption applicable to reverse mortgages within six months of the passage of the National Affordable Housing Act (Senate Report 101-316, June 8, 1990, to accompany S.566). No agency has yet issued the mandated regulations or opinions.

Finally, some states limit the use of mortgage proceeds. Perhaps the most significant state-level barrier to the HECM Demonstration, for example, is a homestead provision in the Texas constitution that prohibits lenders from making home mortgages for any reasons except to purchase a home, to pay taxes on a home, or to finance repairs to a home. Because of this, no second mortgages or home equity lines of credit can be advanced in Texas except for these stated purposes. The homestead provision is viewed as a protection against foreclosure, but it denies elderly homeowners in Texas the opportunity to obtain reverse mortgages (including HECM loans), despite the fact that foreclosure would be quite rare under the HECM Demonstration. HUD and its Texas field offices have received numerous inquiries from elderly homeowners in Texas seeking reverse mortgages, but an opinion by the Attorney General of Texas indicates that no reverse mortgages will be viable in Texas for the foreseeable future because of the protections afforded by the homestead provision and its deep historical roots.

In many states the only, or primary, barriers to the expansion of the HECM Demonstration are conflicting statutory or regulatory provisions that were developed to address financial instruments other than HECM or other reverse mortgage programs. In order to encourage the implementation of appropriate enabling legislation and regulations in these states, the AARP has developed a Model State Law designed to provide the necessary legal framework for successful reverse mortgage lending while taking into account public policy differences between the states. This model state law may provide the key to the success of the HECM

Demonstration, because in the absence of concerted assistance it appears unlikely that most of the state-level barriers to the expansion of reverse mortgage lending would be resolved before the number of loans expands considerably in each state. The combination of an existing and growing federally-insured reverse mortgage lending program, an already-drafted model state law, prospective borrowers, lenders, and other interested parties may provide the impetus to remove many of the State barriers to the expansion of the HECM Demonstration.

APPENDIX A

ANALYSIS OF FACTORS AFFECTING CHOICE OF PAYMENT OPTION

This appendix presents additional results of the analysis described in Chapter 2 of the factors affecting the decisions that HECM borrowers make regarding each of the five payment options: (1) tenure payments; (2) term payments; (3) line of credit; (4) combination of tenure payments with line of credit; and (5) combination of term payments with line of credit.

Number of Children. Exhibit A-1 shows the estimated probability that a typical borrower with different numbers of children will choose each payment option. As this exhibit shows, the number of children appears to be negatively related to the probability that a borrower will select tenure payments or a line of credit, but positively related to the probability that a borrower will select term payments or a combination of tenure payments with a line of credit. Specifically, a borrower with no children (the most typical case to date) has about a 28 percent chance of electing the tenure payment option, while an identical borrower with two children is only about 23 percent likely to choose this option. Similarly, a borrower with no children is about 11 percent likely to establish a line of credit, while one with two children is only about 5 percent likely to do so. In contrast, the probability that a borrower will elect the term payment option increases from about 23 percent for a borrower with no children to about 27 percent for one with two children, and the probability that a borrower will choose a combination of tenure payments with a line of credit increases from about 13 percent with no children to about 16 percent with two children. It is not clear why the number of children should have this type of effect.

EXHIBIT A-1: Effect of Number of Children on Selection of Payment Plan[1]

	Number of Children		
	0	1	2
Probability of Tenure Option	**28.2%**	**25.4%**	**22.8%**
Probability of Term Option	**22.8%**	**24.9%**	**27.2%**
Probability of Line of Credit Option	**11.4%**	**7.4%**	**4.7%**
Probability of Tenure plus Line of Credit Option	**12.8%**	**14.2%**	**15.7%**
Probability of Term plus Line of Credit Option	17.5%	18.3%	19.0%

[1] Bold type face indicates that the differences are statistically significant at an 80 percent confidence level.

__Race__. The race of the borrower appears to have no significant effect on the choices that borrowers make regarding payment options. Although there is no strong reason to expect that borrowers of different racial groups would decide differently, it is possible that borrowers of each race would respond to different circumstances. For example, borrowers might make decisions regarding the choice between tenure and term payment options partly on the basis of their expected tenure in that property (that is, on the basis of expected mobility and/or life expectancy), which could be systematically different between white and black borrowers. Alternatively, there could be systematic differences in the housing counseling received by white and black borrowers, particularly if counseling is provided by organizations active primarily among members of one ethnic group. None of these possible differences, however, appears to have affected the choice of payment option by borrowers of each race.

__Property Size__. Exhibit A-2 shows the estimated relationships between two different measures of property size -- living area and total number of rooms -- on the choice of payment options. For example, the first part of Exhibit A-2 shows that borrowers with more living area are more likely to elect to receive term payments or to establish a line of credit, but less likely to combine a line of credit with either tenure payments or term payments. The second part of Exhibit A-2 shows that borrowers with more rooms are less likely to elect the tenure payment option, but more likely to combine a line of credit with either tenure or term payments. The reasons for these relationships are not clear.

EXHIBIT A-2: Effect of Property Size on Choice of Payment Option

PROPERTY SIZE: Living Area	1,004 ft^2	1,217 ft^2	1,504 ft^2
Probability (Tenure)	27.3%	28.2%	29.5%
Probability (Term)	**21.4%**	**22.8%**	**24.9%**
Probability (Credit)	**10.5%**	**11.4%**	**12.5%**
Probability (Tenure/Credit)	**14.5%**	**12.8%**	**10.8%**
Probability (Term/Credit)	**20.5%**	**17.5%**	**14.1%**
PROPERTY SIZE: Number of Rooms	5	6	8
Probability (Tenure)	**32.6%**	**28.2%**	**20.6%**
Probability (Term)	24.1%	22.8%	20.5%
Probability (Credit)	11.5%	11.4%	11.1%
Probability (Tenure/Credit)	**11.5%**	**12.8%**	**15.8%**
Probability (Term/Credit)	**14.0%**	**17.5%**	**26.6%**

Condition of Property. Exhibit A-3 shows the estimated relationship between the cost of repairs required as a condition of HECM loan approval and the probability that the typical borrower will choose each of the five payment options.[1] For example, there is about a 23 percent likelihood that the typical borrower with no required repairs (the most common situation to date) will elect to receive term payments; the likelihood is only about 19 percent, however, that an otherwise identical borrower with required repairs costing $692 will choose the same option. Similarly, a borrower with no required repairs is slightly more likely (28 percent) to elect the tenure payment option than is a borrower with required repairs costing $692 (27 percent). In contrast, a borrower with no required repairs is slightly less likely than an identical borrower with $692 in required repairs to combine a line of credit with tenure payments or with term payments.

EXHIBIT A-3: Effect of Required Repairs on Choice of Payment Option

	Cost of Required Repairs		
	$0	$100	$692
Probability (Tenure)	**28.2%**	**28.1%**	**27.0%**
Probability (Term)	**22.8%**	**22.3%**	**18.9%**
Probability (Credit)	11.4%	11.3%	11.1%
Probability (Tenure/Credit)	**12.8%**	**13.0%**	**14.2%**
Probability (Term/Credit)	**17.5%**	**17.6%**	**18.0%**

While these patterns are fairly weak, it is possible that they reflect the likelihood of extraordinary or unforeseen expenses associated with maintenance or repair of the borrower's property. While the estimated cost of required repairs must be set aside from HECM loan proceeds at origination, borrowers with required repairs who elect to receive regular monthly payments may also establish a line of credit at loan closing to cover larger-than-expected costs

[1] As noted, property age is often used as an indirect measure of the condition of the property. Property age, however, does not appear to have had any effect on decisions regarding payment options.

associated with the required repairs. Alternatively, the existence or magnitude of required repairs may reflect a more general deterioration in the condition of the property, and borrowers receiving regular monthly payments may establish a line of credit to finance maintenance or repairs even though they are not required under the loan agreement.

Interest Rates. Exhibit A-4 shows the estimated relationship between expected interest rates and the choice of HECM payment option. As this exhibit shows, there is a significant negative relationship between expected interest rates and the probability that a borrower will choose to establish a line of credit, but a significant positive relationship between expected interest rates and the probability that the borrower will elect to combine a line of credit with regular tenure payments. Specifically, there is about a 16 percent probability that a typical elderly homeowner taking a HECM loan with a relatively low expected interest rate of 9.125% will establish a line of credit. In contrast, the probability that an otherwise identical borrower with a relatively high expected interest rate of 10.0% will choose a line of credit is only about 9 percent. On the other hand, a typical borrower with an expected interest rate of 9.125% is about 10 percent likely to choose a combination of tenure payments with a line of credit, while the same borrower with an expected interest rate of 10.0% is about 15 percent likely to elect the same combination.

Closing Costs. Exhibit A-5 shows the estimated relationship between the magnitude of loan closing costs and the choice of payment option. As this exhibit shows, closing costs appear to be negatively related to the probability that borrowers will elect the tenure payment option or combine tenure payments with a line of credit, but positively related to the probability that borrowers will elect the term payment option. Specifically, a typical borrower with relatively low

EXHIBIT A-4: Effect of Expected Interest Rates on Choice of Payment Option

	Expected Interest Rates		
	9.125%	9.63%	10.0%
Probability (Tenure)	28.7%	28.2%	27.9%
Probability (Term)	21.4%	22.8%	24.0%
Probability (Credit)	**16.4%**	**11.4%**	**8.6%**
Probability (Tenure/Credit)	**10.2%**	**12.8%**	**15.1%**
Probability (Term/Credit)	17.8%	17.5%	17.4%

loan closing costs of $2,072 is about 31 percent likely to choose to receive tenure payments and about 14 percent likely to combine tenure payments with a line of credit, while an otherwise identical borrower with relatively high closing costs of $4,352 is only about 25 percent likely to elect tenure payments and about 11 percent likely to choose the combination option. In contrast, a typical borrower with low closing costs is about 20 percent likely to receive monthly term payments, while an identical borrower with high closing costs is about 28 percent likely to make the same choice.

Real Estate and Other Debt. Exhibit A-6 shows the estimated relationship between the choice of payment option and the amount of real estate or other debt that HECM borrowers had at the time of loan application. As this exhibit shows, there is a slight negative relationship between the amount of debt and the probability that borrowers would elect to receive monthly term payments or to establish a line of credit: borrowers with no debt were about 23 percent likely to choose the term payment option and about 15 percent likely to set up a line of credit, while identical borrowers with relatively high debt of $6,685 (consisting of $2,957 in real estate

EXHIBIT A-5: Effect of Closing Costs on Choice of Payment Option

	Closing Costs		
	$2,072	$2,962	$4,352
Probability (Tenure)	**30.6%**	**28.2%**	**24.8%**
Probability (Term)	**20.0%**	**22.8%**	**27.8%**
Probability (Credit)	11.5%	11.4%	11.1%
Probability (Tenure/Credit)	**13.8%**	**12.8%**	**11.3%**
Probability (Term/Credit)	17.7%	17.5%	17.2%

debt and $3,728 in other debt) were only about 21 percent likely to choose term payments and only about 11 percent likely to set up a line of credit. In contrast, there was a slight positive relationship between debt and the probability that borrowers would choose to combine a line of credit with monthly tenure payments.

EXHIBIT A-6: Effect of Debt on Choice of Payment Option[1]

	Real Estate and Other Debt		
	$0	$347	$6,685
Probability of Tenure Option	28.2%	28.2%	28.9%
Probability of Term Option	**22.8%**	**22.8%**	**21.1%**
Probability of Line of Credit Option	**11.5%**	**11.4%**	**10.9%**
Probability of Tenure plus Line of Credit Option	**12.8%**	**12.8%**	**13.4%**
Probability of Term plus Line of Credit Option	17.6%	17.5%	15.0%

[1] Bold typeface indicates that the differences are statistically significant at an 80 percent confidence level.

Application Date. The last factor investigated for its effect on the choice of payment option was the date on which HECM applications were filed. This factor was investigated to determine whether borrowers applying later appeared to be making different payment option choices than those applying earlier. There are several reasons why this might occur. First, later borrowers may have heard about the program from earlier borrowers, and may choose a different payment option based on the experiences of earlier borrowers. Alternatively, housing counseling regarding the choice of payment options may have changed over the course of the HECM Demonstration. Finally, it is possible that the borrowers who applied for HECM loans early in the Demonstration are different in some significant way from the borrowers who have applied for HECM loans more recently, and that this difference affects their choice of payment option.[2]

The estimated relationship between application date and choice of payment option is shown in Exhibit A-7. As this exhibit shows, it appears that borrowers who applied for HECM loans earlier were significantly less likely to choose the tenure payments option than more recent loan applicants. For example, a typical borrower applying for a HECM loan in March, 1990 was about 24 percent likely to receive tenure payments, while an identical borrower applying in June, 1991 was about 33 percent likely to do so. Conversely, earlier borrowers were much more likely than later borrowers to choose a combination of tenure payments with a line of credit: a typical borrower applying in March, 1990 was about 17 percent likely to elect this combination, while an identical borrower applying in June, 1991 was only about 10 percent likely to make the same choice.

[2] Interest rates have declined consistently since the HECM Demonstration began, so there is a very strong (negative) correlation between application date and initial interest rate. For this reason, it is difficult to distinguish between the effect of initial interest rate and the effect of application date on the choices that borrowers make regarding payment options. Thus it should be kept in mind that the relationship observed between application data and choice of payment option may actually reflect in part the relationship between initial interest rate and choice of payment option.

EXHIBIT A-7: Effect of Application Date on Choice of Payment Option[1]

	Application Date		
	March 90	November 90	June 91
Probability of Tenure Option	**23.7%**	**28.2%**	**32.6%**
Probability of Term Option	22.8%	22.8%	22.9%
Probability of Line of Credit Option	12.6%	11.4%	10.4%
Probability of Tenure plus Line of Credit Option	**17.0%**	**12.8%**	**9.9%**
Probability of Term plus Line of Credit Option	16.4%	17.5%	18.6%

[1] Bold typeface indicates that the differences are statistically significant at an 80 percent confidence level.