

The Missing Ingredient in Home Equity Lending



How banks and their customers can benefit from the Home Equity Conversion Mortgage (HECM)

Executive Summary

Home equity is on the rise in a big way, and many retail bankers have responded by building up their home-equity line of credit (HELOC) business. But there's another home equity opportunity bankers may be overlooking. The FHA-insured Home Equity Conversion Mortgage (HECM) offers substantive benefits for borrowers age 62 and older as well as to the banks and credit unions that serve this market. The evolution of HECM since 2011 has been nothing short of extraordinary, and it's happened in lockstep with a nationwide surge in home values.

This paper reviews the consequential evolution of the HECM program since 2011, outlines key consumer benefits and describes the advantages gained by banks that offer this unique home-equity product.

Home equity is on the rise — in a big way.

According to Black Knight Financial Services, homeowners gained a collective \$260 billion in additional home equity in the first quarter of 2016. Daren Blomquist, senior vice president of RealtyTrac, says this growth indicates “borrowers are regaining both home value and the confidence needed to increasingly leverage their home equity.”

It’s a trend retail bankers have been eyeing for some time, and many have responded by building up their home-equity line of credit (HELOC) business — a strategy that’s bearing fruit. RealtyTrac’s U.S. Residential Property Loan Origination Report shows a 10% year-over-year increase in HELOC originations as of Q1 2016, which was also the 16th consecutive quarter of year-over-year HELOC growth.

But there’s another home equity opportunity bankers may be overlooking. Did you know there is a government-insured home-equity product designed exclusively for borrowers over age 62? According to the Census Bureau’s 2013 American Housing Survey, more than 65% of homeowners 65 and older own their homes free and clear.

In fact, according to Freddie Mac Chief Economist Sean Beckett, individuals over age 54 control nearly two-thirds of all equity in single-family homes — and they’re not going anywhere. Says Beckett, “Today’s 65-year-old can expect to live until age 84 on average.”

Many of these equity-holding Baby Boomers are already your customers. According to Gallup, 89% of them have at least one checking, savings or money market account. Of those bank customers, 38% have a mortgage with the same institution, and 21% use their bank’s investment services.

Is HECM part of your home-equity toolkit?

The FHA-insured Home Equity Conversion Mortgage (HECM) offers substantive benefits for older borrowers as well as to the banks and credit unions that serve them.

HECMs enable homeowners age 62 or older to receive a percentage of their home equity as fixed cash payments over time or an available line of credit. Once a HECM is established, the borrower has exclusive control over future draws on the loan. A draw on available HECM funds cannot be denied by the lender. In contrast, additional draws on a traditional HELOC can be denied by the lender should conditions change.

An April 2016 decision from the Department of Labor mandates that if you act as a fiduciary, you must offer advice that serves your clients’ best interests and disclose any conflicts of interest. Industry experts have speculated that the rule will compel financial advisors to present clients with a wider array of financial products, including HECMs, instead of steering them only toward products that generate commissions.

Banks looking to comply with these changes would be well served — and would serve their customers well — by not only offering HECM loans, but also seeking a deeper understanding of the product and how consumers can best leverage a HECM to achieve financial objectives in their senior years.

Once upon a time, a few large banks originated the lion’s share of all HECM loans, but they exited the reverse mortgage business in 2011. The banks cited falling home prices and concerns over the risk profile of the loans as key factors in their decision.

As luck would have it, their timing couldn’t have been worse. In 2011, HECM was already a product with enormous potential to help consumers and, in so doing, benefit banks. But the evolution of the product since 2011 has been nothing short of extraordinary, and it’s happened in lockstep with a nationwide surge in home values.

The all-new HECM is better than ever

A study published in July 2016 found that the latest updates to the HECM program have reduced default risk by 50%. Can you think of any other financial product that has turned itself around so dramatically?

Substantial changes to the HECM program called the “Financial Assessment” rules were announced in 2013 and went into full effect in April 2015. Financial Assessment improves the HECM program in several ways that are meaningful to borrowers and lenders.

For starters, HECM lenders must now review a borrower’s credit history, income, assets, debt and payment history on property taxes, insurance and HOA fees as part of the loan qualification process. If a borrower’s credentials are weak, lenders can either deny the HECM loan or set aside a portion of the loan proceeds to ensure payment of property taxes and insurance in an account called a life-expectancy set-aside (LESA).

Other recent improvements to the HECM program include adjustments to the amount of funds that can be disbursed in the first year of the mortgage and the impact of that disbursement on the cost of the borrower’s mortgage insurance premium (MIP). Unlike the property mortgage insurance (PMI) issued for a traditional mortgage, MIP protects the lender and the borrower. New limits on first-year disbursements encourage borrowers to use HECM proceeds over time, in a sustainable way.

Speaking of insurance, the Federal Housing Administration (FHA) guarantees that borrowers will be able to access their approved reverse mortgage funds even if the loan balance exceeds the home’s current value. On the other hand, neither borrowers nor their heirs or estates are held responsible for loan balances that exceed the value of the home.

Similarly, lenders are guaranteed they will be repaid in full when the home is sold, even if the loan balance is more than can be recovered from the proceeds. While their robust FHA-insured status makes for higher HECM origination costs, the long-tail protection dispels borrower and lender risks.

The reason for the reverse mortgage industry’s commitment to self-improvement is simple: consumers need a product like HECM. That was true when the very first reverse mortgage was invented in 1961 to help a widow stay in her home. It was the driving factor when the Reagan administration formalized the FHA-insured HECM program we know today in 1988. And it’s especially true now, in light of skyrocketing healthcare and housing costs that make even the most well-funded seniors feel a bit jumpy as they face long retirements.

Banks that offer HECM products can help alleviate Baby Boomers’ concerns over long-term Social Security funding, low returns on investments and lackluster senior housing options while solidifying their reputation as a trusted source of financial services advice.

A HECM loan can be structured in one of several ways. Consumers may decide to immediately draw the maximum amount of equity available to them, or they may draw only a portion of it initially and then make additional draws over time. They may take the equity as a lump-sum payment, a monthly cash payment (for a term or for life) or a line of credit. Among the most common ways consumers use a HECM are to:

- **Eliminate any remaining mortgage payment.**

If 65% of retirement-age homeowners own their home free and clear, it follows that another 35% are still plugging away at their mortgage payment. As income dwindles and expenses like healthcare steadily increase, HECM offers a way to eliminate that monthly mortgage payment altogether. And, just because a HECM is usually thought of as a means for the borrower to receive payments does not mean borrowers cannot make payments to reduce existing home debt. With a line-of-credit HECM, the borrower can choose each month whether to make a payment, receive a payment or do nothing. It is the ultimate in mortgage flexibility.

- **Extend resources in retirement.**

"Retirement financial planning traditionally focuses on three asset sources: Social Security, pension and savings," says ReverseVision President and CEO John Button. "But as life expectancy and retirement costs increase and those three traditional retirement assets face greater uncertainty, home equity must be considered as the fundamental fourth asset source in any retirement plan."

Using HECM funds as an alternative source of retirement income enables consumers who are considering taking Social Security early at a reduced rate to wait for full benefit age. For the current generation of people approaching retirement, eligibility begins as early as age 62, but consumers must wait until age 66 to receive their full benefit. The penalty for taking Social Security early is around 7% per year — for life. On the other hand, those who wait 48 months beyond age 66 to draw on Social Security receive 132% of the benefit to which they're otherwise entitled.

HECMs can also help retirees extend their investment savings. Once retirees begin withdrawing money from their investment portfolios, the sequence of returns — the timing of when the financial market has good years and when

it has bad ones — can have a major impact on wealth. Two people who begin retirement with the same amount of savings can have different financial outcomes depending on the sequence of returns they experience — even if they earn the same average return over the course of retirement.

A 2012 study by Salter, Pfeiffer and Evensky of Texas Tech found that homeowners entering retirement with both home equity and a retirement savings nest egg could improve the "survival rate" of their savings over a 30-year horizon by as much as 85% by using a HECM as part of a financial strategy called "sequence of returns."

In the "sequence of returns" strategy, borrowers rely on different sources of retirement income depending on how the stock markets perform. When markets are favorable, borrowers use their normal retirement savings to pay for living expenses, leaving their HECM credit lines untapped. When the stock market performs poorly, retirees switch to drawing on HECM lines of credit to pay for living expenses, leaving investment portfolios alone until the markets recover. Without the HECM option, borrowers must draw on their normal retirement savings regardless of market conditions — and that depletes portfolios at a much faster rate.

"Half of America's home equity is owned by seniors, which makes HECM the ideal financial product for banks to introduce to customers to help them release their available home equity and manage retirement resources in a sustainable way," Button concluded.

- **Buy a home.**

The HECM for Purchase is a special type of reverse mortgage that allows seniors to purchase a new residence and obtain a reverse mortgage within a single transaction, without the need for a second closing. This little-known product can make all the difference for older borrowers looking to downsize or relocate and have no mortgage payment.

So where do banks fit in?

Retail bankers are uniquely equipped to guide consumers through the HECM application process in a way that comes less intuitively to other mortgage lenders.

That's because, despite its moniker as a reverse "mortgage," a HECM is really a home-equity solution. In today's competitive real estate market, the typical mortgage lender is programmed to focus on closing deals as quickly as possible. By contrast, with a HECM, the consumer already occupies their home, so it's not about driving toward a closing date. The key to successful HECM lending is taking the time to educate the borrower on how to use the loan effectively as part of a financial planning strategy. This task is best performed by a trusted advisor — like a community banker. It's a slower process, but a more rewarding one that allows bankers to strengthen their customer loyalty.

If that's not compelling enough, HECMs offers a much-needed avenue of relief for maturing HELOCs. Most HELOCs require low, interest-only minimum payments for the first 10 years. Then the loan converts into a fully amortizing phase, meaning the line of credit is no longer available for additional draws and the consumer must begin repaying the full principal and interest owed, usually over a 15- to 20-year horizon. The typical 11th-year payment on these loans is 30 to 70 percent higher than the payment in years one through 10, according to Experian, putting many consumers in a serious financial bind.

The "payment shock" is expected to significantly increase the number of delinquencies and defaults among HELOC borrowers, which will mean higher incremental costs and significant credit losses for banks.

More than three million HELOCs originated during the peak of the housing bubble will enter the repayment phase between now and 2018, leaving banks and consumers scrambling to find options.

The most common solution is to refinance a maturing HELOC into a traditional mortgage or new HELOC. But a retired homeowner on a reduced, fixed income may not make enough income to qualify for these options.

A HECM could be the ideal solution for HELOC borrowers over 62, especially those who don't have the income to qualify for other HELOC relief options. And by offering HECM as HELOC relief, banks can continue earning interest from customers who might otherwise default or look to another institution for a second home-equity loan.

Banks are under pressure to regain market share lost to non-bank lenders — especially the growing number of "digital lending" platforms. Fortunately, bankers are uniquely positioned as trusted financial advisors to their senior customers, and finding new ways to tap into these long-term relationships could help bankers offset market share losses. Educating senior customers on retirement funding strategies that include HECM loans is a powerful new solution that's great for the customer, good for the bank's performance and fantastic at bringing new solutions to an important customer base.

About ReverseVision

Since 2007, ReverseVision (RV) has been the leading reverse mortgage technology provider, serving 50 of the top reverse mortgage lenders, 100 percent of reverse investors, and more than 10,000 daily users. RV's award-winning technology offers new APIs (Reverse-as-a-Service) that open the total addressable market, creating new technology synergies that allow forward and reverse mortgages to coexist in the lender's core systems, helping break down adoption barriers so that mortgage bankers can serve their borrowers for life. ReverseVision's core platform, ReverseVision Exchange (RVX), is comprehensive and proven to automate the entire reverse lending process from origination through secondary marketing. The company's technology is being successfully leveraged as a springboard that helps lenders get into the reverse space easily and efficiently.

For more information, visit <http://www.reversevision.com>.