Reverse Mortgage Book Edited by Vishaal Bhuyan

The History of Reverse Mortgages – an Insider's View©

Note: A chronological point-by-point history of the reverse mortgage industry can be found at http://www.reverse.org/History.HTM

The first reverse mortgage-type loans are thought to have been done in Europe, probably France. In French, the system is called *viager*, after a word for pension. The most famous of these is a lesson in longevity risk. In 1965, Andre-Francois Raffray approached Jeanne Calment and offered her the equivalent of $500 per month for life in exchange for his inheriting her country house when she died. Mr. Raffray was most certainly convinced he had a good deal because at the time, he was 45 years old and Ms. Calment was 90. He died in 1996 at the age of 77 and she outlasted him by two years, dying at 122.

Except for one-off reverse mortgage type loans in the United States, the first organized reverse mortgage program began in 1963 in Oregon as a property tax deferral program to ease the financial burden for seniors and allow them to remain in their homes. In this case, the Oregon Public Employees' Retirement Fund advanced monies to the seniors with the expectation of repayment when the seniors moved from their homes. State and county government in other states followed suit. These were simple loan programs tied to need and promoted by social responsibility.

In 1979, the San Francisco Development Fund contacted Anthony M. (Tony) Frank who was then the CEO of Nationwide Savings and the Chairman of the Federal Home Loan Bank Board about creating a pilot "Reverse Annuity Mortgage" (RAM) program. This program was launched in Northern California and closed the first RAM loan in 1981. Tony was later this author's partner in creating Transamerica HomeFirst, the private reverse mortgage subsidiary of Transamerica Corporation. The RAM program expanded throughout California 1982 under the direction of Bronwyn Belling, later the program director at AARP.

Much of the credit for creating the reverse mortgage industry then and for the next twenty years goes to a handful of dedicated people like Ken Scholen, Bronwyn Belling, Don Ralya, Jeff Taylor and Katrina Smith Sloan at AARP. Although AARP has never endorsed a specific reverse mortgage vendor they have been the principal sponsor of educational programs and a force in channeling legislation and model statutes in favor of reverse mortgages.

By 1984, the Senate was working on proposals to introduce an FHA reverse mortgage program where the loans would be insured by HUD. It was not until 1987 that the pilot program, called a Home Equity Conversion Mortgage or HECM, was approved and the first loans were written in 1989. In 1990, the pilot program was expanded to a limit of 25,000 loans using FHA loan limits and with a program sunset date of September 31, 1995. In January 1996 the program was extended.

The first private reserve mortgage companies and programs began coming to market in 1988. These were typically insurance company-backed operations taking advantage of the insurance carriers' low cost of capital and need for high returns on investment. Amongst these companies were Capital Holdings, Louisville, KY and Transamerica, San Francisco, CA.

One non-insurance carrier reverse mortgage startup, Providential Home Income Plan, also from San Francisco, had a meteoric rise to be one of the most successful IPOs in 1992. The company was founded by Bill Texido, a pioneer from the rail car leasing business. Modeled in much the same way as a rail car lease, the product design was all about leverage and fees. However, before the end of the "lockup period" when insiders could start to sell stock, the Company cratered because of a combination of an interest rate mismatch in sourcing and lending of funds, and speculative product design. The combination lead to the SEC invoking accounting treatment that was very unfavorable to the Company and their speculative product design. Providential was borrowing at high interest rates in the short-term market and lending long-term at significantly lower interest rates.

Providential's product design was loaded with front-end origination and front-loaded equity sharing fees that the SEC believed unjustly accelerated income (in advance of the planned IPO). On September 2, 1992, the SEC issued an opinion letter stating that reverse mortgages should be accounted for in the same way as annuities.[i] This was one of the first implementations of fair value accounting that required Providential and all other companies to capitalize origination costs and spread them over the life of a hypothetical pool of mortgages.

This SEC ruling meant that aggressive product design was punished and more conservative products received income recognition advantages. When this letter ruling was applied to Providential's pool of loans it drove their pool internal rate of return below 10%. By contrast the similar, but conservative, product from Transamerica HomeFirst enjoyed an annualized projected rate of return of over 20%.

The period in the late 1980s and 1990s saw numerous innovative reverse mortgage product designs. As far back as 1985, Bronwyn Belling and the United Seniors Health Cooperative, Washington DC, conceptualized a line of credit product. This product design suffered from the same fault as many later programs in that these were loans with fixed terms – 10 years, 20 years. This meant that at some predetermined future date "the bank" would come in and seize the home in the unfortunate case when the senior was still alive and living in the home.

This product design flaw was corrected in 1991 when this author through Transamerica HomeFirst and Robert Bachman of Home Equity Partners (later called Freedom Financial) introduced the first lifetime reverse mortgages. Although different in design they allowed the senior(s) or the surviving senior to remain in the home until they permanently moved out, typically for medical reasons. Home Equity Partners accomplished this by using the proceeds from a private reverse mortgage to buy an immediate annuity that paid the senior(s) income for life. This product design benefited Home Equity Partners because all of the fee income was immediate and got around the SEC ruling. It also eliminated any need for loan servicing by shifting that responsibility to the annuity provider. As with other private reverse mortgage programs, the continued viability was dependent upon the issuing insurance company's appetite to stay in the business.

Transamerica HomeFirst's design approach was different. Under Transamerica's lifetime reverse mortgage, "HouseMoney", the senior received monthly payments funded by Transamerica. The initial advance to the senior at the close of escrow include additional funding to purchase a deferred annuity that took over making monthly payments at a predefined point in the future. This point was approximately eighteen months before the senior's average life expectancy. By design, this meant that between sixty and seventy percent of seniors purchasing this product would receive the equivalent of their single premium deferred annuity payment back in monthly payments before reaching life expectancy and then, income for life from the annuity. Another unique feature of the deferred annuity is that the annuity providers, Transamerica and MetLife, issued the annuity directly to the senior with no commission or upfront profit to anyone. The survivors would continue to receive annuity payments for the rest of their lives whether or not they remained in their homes. This patented design offered higher monthly payments because principal payments under the loan were truncated when the annuity took over making the month payments.

Despite the elegance of design, this product was criticized because some homeowners died before they began receiving payments from the annuity thus incurring high front-end loan costs. A second new feature introduced in this product, shared appreciation, also drew fire in law suits brought by disgruntled family members. Shared appreciation features were incorporated into FHA and later Fannie Mae reverse mortgages, but these Government and quasi-government organizations were not as easy to bring suits against as a publicly traded corporation.

Future home appreciation was used in two ways in Transamerica HomeFirst's Lifetime Reverse Mortgage. First, the appraised home value at time of origination was increased by 2.5% per year compounded future home appreciation until the estimated the life expectancy of the homeowner. Inclusion of this future home appreciation meant there was more home value available against which to lend. A loan to a senior with a life expectancy of ten years meant they were given credit for an additional 27% home value when the monthly payments were calculated. Because of this risk the Company had a loan provision that allowed it to share 50/50 with the homeowner in future appreciation at sale in excess of the origination appraised value of the home. This shared appreciation feature was in lieu of fixed percentage of home value fees used by others, including early Fannie Mae / HUD HECM reverse mortgage products.

Transamerica HomeFirst wrote these shared appreciation Lifetime Reverse Mortgages through 1998, despite serious home devaluation and a later surge in home values. From 1992 through 1997 housing prices in Los Angeles County declined by over 30%. Between 1997 and mid-1998 when the housing markets rebounded values doubled in Southern California and other markets. By early 2000, home prices doubled again, spawning a rash of lawsuits over the shared appreciation feature. Although the defendants never lost a suit, the Company usually settled out of court. One case went to trial in 2004, with the final decision on behalf of the defendants being up help by the California Court of Appeals in September 2006 – seven years after the first lawsuit.

During this same period private reverse lenders and HUD/HECM introduced line of credit loan programs giving seniors the opportunity to draw down home value in the same way younger homeowners could with conventional home equity loans. Lower front-end fees and the ability to create a "rainy day reserve" made these programs popular. "Popular" however is a relative term. Prognostications that reverse mortgages would become a popular and common financial planning tool by the year 2000, and certainly by 2010, were optimistic. In fact Reverse Mortgage Insights, Inc. (www.rminsight.net) has calculated that in 2009, reverse mortgage had only tapped into 2% of the total possible market. This lack of product acceptance has deep roots seeded in the Great Depression and nurtured by reports of fraud, abuse and the lack of broad education about reverse mortgages.

Ignorance of education about reverse mortgages was not due to lack of effort to educate. As in all markets dealing with seniors, consumer protection was an early consideration. Independently and later sponsored by AARP, Ken Scholen and others wrote books, articles and scholarly papers about the advantages and pitfalls of reverse mortgages. In 1995, AARP distributed 400,000 copies of the 5th edition of Ken Scholen's "Home-Made Money". This was timed to coincide with the Congressional decision to extend the HECM "pilot" program due to expire at the end of 1995.

The 1996 extension of the HUD/HECM program ushered in the large-scale opportunity for mortgage brokers to begin promoting and offering these government-guaranteed reverse mortgages. The brokers offered these loans through a program backed by Fannie Mae with a HUD guarantee. At the same time, county and state programs started offering reverse mortgage counseling to prospective borrowers. This counseling was later mandated by the federal government as much to combat fraud and abuse as to educate.

In 1996 Fannie Mae introduced a proprietary "Home Keeper" reverse mortgage program. Fannie Mae is a Government Sponsored Entity (GSE), a government chartered mortgage broker and clearinghouse. The Home Keeper product had higher loan limits than the HUD HECM. These higher limits were based upon the borrower's county FHA loan limits for single family homes, often significantly higher than the HECM loan limits. These were often twice the loan limits set for HECM reverse mortgages. Although the Home Keeper loans did not enjoy the HUD/taxpayer guarantees of the HECM program, this meant little to the borrower in these non-recourse loans. The Home Keeper loans allowed condominium owners to now take out a reverse mortgage, as wellas allowing homeowners to leverage equity in their first residence in order to purchase a new home.

The modest downside of the Home Keeper program was that the loan advances to couples were less than to single borrowers. In the HECM and most other programs the available loan limits were calculated based upon the mortality table life expectancy of the younger spouse.

Little known, but extremely important to the expansion of the Fannie Mae reverse mortgage program was the 1994 requirement by Congress that by year 2000, 25% of all Fannie Mae loans needed to be in the "low income" category. This author and Barry Abbott of Howard Rice, a San Francisco law firm, successfully lobbied the Federal Reserve to have reverse mortgages re-categorized as low income loans under the reasoning that many seniors lived on low fixed incomes. Our simple goal was to expand the market for all reverse mortgages. Fannie Mae used this opportunity to expand the upper limit of the FHA conforming loan limit from $203,150 in 1994 to $362,790 in 2008. Congress raising this loan limit allowed Fannie Mae to control much of the conventional forward and reverse mortgage markets with their Home Keeper program. The Home Keeper program was discontinued in September of 2008, when Congress doubled the FHA loan limit to $729,750 and included HECM loans in the category available to utilize this limit. Reflecting back, we and others in this lobbying effort never imagined the "low income" category would morph by 2004 into the Fannie Mae securitization of conforming subprime and adjustable ARM loans to truly low income Americans. Few understood that Fannie Mae was to become a mortgage securitization powerhouse.

Fannie Mae had one great advantage over private reverse mortgage lenders – the Federal Government's balance sheet. At that time Transamerica Corp. was a $60 billion company who had been successfully operating in the low cost commercial paper markets since 1948. Transamerica HomeFirst was able to utilize this low cost source of capital. Fannie Mae, an entity created by the Federal Government and backed by the Government's financial strength, had access to capital at 50 basis points (0.5%) less than HomeFirst's cost of capital. This pricing advantage and early design flaws in the HECM program allowed Fannie Mae to create products that offered seniors more money per month than private lenders. Then as today, the reverse mortgage business is all about how much money an individual lender can offer a senior. Today this is accomplished by small product difference lenders use to differentiate their HUD guaranteed products.

Fannie Mae had another distinct advantage that still exists. Borrowers pay a mortgage insurance premium at the time their loan is originated. These premiums, in theory, were thought to be sufficient to offset HUD's guarantee to Fannie Mae to take back, "put", all loans that went under water. When the sum of the principal advances and accumulated compound loan interest exceeds the origination loan amount, each reverse mortgage is surrendered to HUD and the American taxpayers absorb the loss with more national debt resulting. As time has gone on and long-lived Fannie Mae reverse mortgages have reached that tipping point, the volume of losses now exceeds the capacity of the mortgage insurance pool to cover the losses. In 1994 when this author pointed this out to his partner Tony Frank, who had been Postmaster General from March 1988 through July 1992, Tony remarked "that problem will not come home to roost for two Administrations, and that is a long time in Washington".

Then as now, reverse mortgages are a hard social sell. Seniors spend their whole lives working to pay off their forward home mortgage only to be offered "the opportunity" to reverse mortgage that home. This stigma was particularly important in the early days when most reverse mortgage borrowers were children of the Great Depression. These were the savers who educated their children and provided them opportunities never available in their own youth. Most early reverse mortgages were entered into out of need, not as a conscious planning tool. This use of reverse mortgages to avert a crisis opened the door for mortgage brokers and family members to take advantage of senior homeowners. Although government-mandated educational materials were available at no charge, brokers would exact cash payments to distribute materials and require front-end cash payments to take applications. The hangover from these practices is still with the industry today.

In 1997, Jeffery Taylor organized the National Reverse Mortgage Lenders Association (NRMLA). Jeff had spent the preceding years running a large mortgage and reverse mortgage servicing company and knew the need for the reverse mortgage industry to self regulate. Jeff was the founder of Wendover Funding, Inc. who was the first lender to offer wholesale access to the reverse mortgage business for the HECM HUD reverse mortgage product. He retired from Wendover Funding in 1999, and was recruited by Wells Fargo to build their reverse mortgage sales and servicing operation. Wells Fargo is the largest retail reverse mortgage originator in the US. Mr. Taylor retired from Wells Fargo in August 2009 and is now Chairman of RMInsight Inc., a reverse mortgage data performance company.

By this time private reverse mortgage programs were giving way to the HECM and Home Keeper programs. Transamerica HomeFirst discontinued its captive sales force HouseMoney program in 1998. Clearly HECM and Home Keeper loans sold by large and small mortgage broker organizations who could cross-sell would be the trend in the future. In 2000 Financial Freedom merged with Unity Mortgage to become the largest reverse mortgage brokerage. They were quickly overtaken by Wells Fargo Bank and Bank of America. The appeal is that reverse mortgages offer strong fee revenue to brokerages that can leverage their branches and existing marketing programs. There is little incentive for these mortgage powerhouses to create proprietary private reverse mortgage programs when the FHA limit is at $729,750. Even if this limit is reduced back down to $362,790, except for housing on both coasts, these limits cover most of the housing stock in the United States.

Joe Torrence introduced the concept of securitizing reverse mortgage to this author in 1989. Joe had been a Managing Director at Lehman Brothers and later shared management responsibilities at Fannie Mae with James Johnson and Michael Rush. Joe was later recruited to create GMAC Commercial Mortgage. The securitization model was to use a rated zero coupon bond where the loan maturities would fund the ongoing obligation to make loan payments to borrowers. Provided each loan in the pool was properly underwritten to control longevity risk and interest rate risk was controlled, the tail risk was minimal and did not require either private or public mortgage insurance. Because Transamerica Corp. agreed to provide the funding for all loans, securitization was never implemented. It would be fifteen years before the securitization concept would reemerge.

In early 2009 Fannie Mae stopped securitizing reverse mortgages. This meant that Wells Fargo and Bank of America had to step in to perform this function. They are allowed to incorporate Ginnie Mae / FHA guarantees into these securitizations. The Government has increased the capital requirements for firms to participate in underwriting these securities. This will further limit the participants to large financial institutions.

The History of Reverse Mortgages – Chapter Summary

After thirty years reverse mortgages have only managed to penetrate two percent (2%) of the possible market for this novel and useful financial planning tool. Why? The upper loan limits are sufficient to exclude only high priced homes on either coast. Advertising, loan counseling and other out-reach efforts have gotten the word out, but seniors are still resisting. The spending habits of today's seniors were greatly affected by being teenagers during the Great Depression. Not until reverse mortgage products and their pricing fundamentally change will reverse mortgages become the financially helpful tool many in the industry hope for.

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[i] A copy of the original September 2, 1992 letter from SEC Chief Accountant Walter Schutze to Providential can be found at http://www.lifesettlementfinancial.com/articles.html