Equity Release Mortgages

by Clarissa Huan and Jim Mahoney

For the aging population in the United States and Europe, equity release products are becoming more prominent in the financial marketplace as alternative methods of financing retirement and aging. The general growth of homeownership has extended to all economic levels and age groups but this growth has not always gone hand in hand with an increase in general wealth or financial security. Thus, many older homeowners find themselves “asset rich, cash poor.”

The dilemma for senior citizens of having too little money for retirement is not a new phenomenon. Records dating back more than 400 years reveal that European investors purchased homes from aging persons and then allowed them to live in the home rent-free for the rest of their lives. In the years surrounding the Crash of 1929 and the Great Depression, a financial vehicle called the home-equity reversion was created in England and became the forerunner to the equity release products of today. Companies specializing in arranging transactions between aged “sellers” and investors added structure to this new industry. The home-equity reversion business continues through the 1990s. Reversions similar to the English purchase model also were completed in France, known as “viageres,” through estate agents. The concept was imported to the United States and became known as home-equity conversion loans or reverse mortgages in the 1970s and 1980s. Since then, the U.S. equity release market has become the global leader in product design and development with widespread distribution channels.

This article will discuss the equity release market in the U.S. including product structure and program types, benefits, risks, funding sources, market and history, and different ways of approaching the product in the U.K. and Europe.

EQUITY RELEASE PRODUCTS IN THE U.S.

In the United States, equity release products, or reverse mortgages as they are also called, have been widely available since 1969 but only gained increasing popularity in the last five years. Nonprofit organizations, financial institutions and government agencies are participating in the product’s development, distribution and marketing, and regulation, as well as taking proactive roles in promoting education and consumer awareness of reverse mortgages. Reverse mortgages have broad appeal and their uses include estate and tax work, long-term care and other medical expenses, insurance and other sophisticated financial planning tools.

Product Description and Benefits

Reverse mortgages are non-recourse loans secured by residential real estate that allow senior homeowners, age 62 and older, to convert home equity into cash:

- Without leaving their homes.
- Without income or credit to qualify.
- Without making monthly payments.
- Without having to repay the loan until they move out permanently, sell the house or die (maturity).

Unlike a conventional mortgage, where the borrower makes periodic payments to the lender, a reverse mortgage provides payments from the lender to the borrower. There is no current obligation by the borrower to make any payment. Loan proceeds available to the borrower are based on a number of factors including the age of the borrower and any co-applicant, the value of the borrower’s home and current interest rates. Interest, fees and costs to the bor-
Program Types

Currently, three types of reverse mortgage lending programs exist with different options and loan terms. The U.S. Department of Housing and Urban Development (HUD) sponsors the Home Equity Conversion Mortgage (HECM) program which is insured by the U.S. Federal Housing Administration (FHA); Fannie Mae, a U.S. government-sponsored enterprise; sponsors and purchases loans under the Home Keeper program; and Financial Freedom Senior Funding Corporation, a subsidiary of Lehman Brothers Bank, FSB, sponsors a private label reverse mortgage program. HECM and Home Keeper loans are subject to a number of origination criteria, the most significant of which is a limit on the home value at the time of origination. The private label reverse mortgage program developed as a response to the underserved "jumbo" market, or homes which exceed HUD and Fannie Mae home value limits (currently $239,250 and $275,000, respectively).

Risks and Funding Sources

Depending on the terms of the reverse mortgage, borrowers face the risk that the lender declares bankruptcy and funding is no longer available. The reverse mortgage is structured such that lenders provide borrowers a lump sum, a credit line or fixed monthly payments. Borrowers who choose to have a line of credit or fixed monthly payments are at most risk from a lender bankruptcy. However, if the reverse mortgage was originated as a HECM, it is federally insured and purchased by Fannie Mae and the government guarantees that the borrower will never have a shortfall in funding. Home Keeper loans are "guaranteed" by the financial standing and rating of Fannie Mae. Private label reverse mortgage programs are not federally insured, but securitization provides a backstop.

The consumer protections and benefits structured into the reverse mortgage product pose as risks to lenders. Lenders run the risk that the homeowner will live in the home for a long enough period that the loan amount will exceed the value of the home. In this case, the sale of the home will not generate sufficient proceeds to pay off the full principal amount of the loan, leading to a loss. Lenders who originate and sell HECM or Home Keeper loans are protected from the risk that the loan balance at maturity exceeds the home value because the federal government (or in the case of Home Keeper loans, Fannie Mae) guarantees the full balance of the loan. Lenders who originate private label loans can avoid the risk of repayment shortfalls by selling loans into securitizations. Investors in reverse mortgages utilize "pooling" effects similar to insurance products to stabilize returns.

Second, the reverse mortgage is a non-recourse loan, meaning that the lender only has recourse to the home for repayment of the loan. A borrower or his estate will never owe more than the value of the home at maturity.
Regulatory and Publicity Issues

Historically, products like reverse mortgages have come under substantial scrutiny. Fears that elderly homeowners will be taken advantage of led to many laws regulating these types of contracts. However, the current growth in reverse mortgages has been accompanied by increasing acceptance of the contract. This acceptance has been aided by standardization and government involvement, both of which make the process more transparent and reduce the potential for fraud and misrepresentation. HUD's decision to make the HECM program permanent in 1998 (after a decade as a demonstration program) and Fannie Mae's entrance into the market in 1996 with the Home Keeper Mortgage program have moved reverse mortgages into the mainstream.

Constituents

In the U.S., a number of nonprofit and government organizations work to shape, direct and regulate the reverse mortgage industry. These organizations work with consumers and lenders to increase acceptance of the reverse mortgage product by standardization and government involvement, both of which make the origination and servicing processes more transparent and reduce the potential for fraud and misrepresentation.


The U.S. Department of Housing and Urban Development (HUD): Since the inception of the Home Equity Conversion Mortgage program in 1988, HUD has supported the reverse mortgage market through its insurance program and its continued funding of American Association of Retired Persons trained counselors. The HECM is now a permanent program administered by the U.S. Federal Housing Administration (FHA) (http://www hud.gov).

Fannie Mae: Fannie Mae, a government-sponsored enterprise, began purchasing HECU eligible HECMs in 1989 and now also purchases all Home Keeper loans. Fannie Mae's proprietary product introduced in 1995, Fannie Mae is currently the largest investor of reverse mortgages, having purchased approximately 95% of all originations, a portfolio in excess of $2 billion (http://www.fanniemae.com).

The American Association of Retired Persons (the AARP): Providing consumer information on the reverse mortgage concept has been endorsed by the AARP for bettering the lives of senior citizens. Over the last 12 years, the AARP has continued to receive HUD funds to promote consumer education and awareness about the benefits of the "right" product (http://www.aarp.org/revmont). Ken Scholten, an AARP employee, also runs the National Center for Home Equity Conversion (http://www.reverse.org), which was founded in 1998.

Congress: Congress has continued to express bipartisan support for the reverse mortgage industry. Most recently, H.R. 5640, the American Homeownership and Economic Opportunity Act, was enacted this past December. H.R. 5640:

- Streamlines and reduces the cost to refinance an existing HECM loan.
- Waives the up-front mortgage insurance premium for borrowers who use a HECM to purchase long-term care insurance.
- Waives counseling requirements for borrowers who want to refinance if they received counseling within the past five years.
- Directs HUD to evaluate the impact of creating a single national loan limit for HECM reverse mortgages.

Players in the Market

In addition, there are a number of originators and servicers in the reverse mortgage market. It is expected that as the industry experiences higher growth rates, the number of competitors will naturally increase. Total originations volume from all lenders is on target to exceed $500 million (approximately 10,000 loans) in 2001.

Financial Freedom Senior Funding Corporation: Largest reverse mortgage originator in the United States with a 65% market share. Also largest servicer of reverse mortgages, with a servicing portfolio of approximately 18,000 loans.

Wells Fargo: Second largest reverse mortgage originator in the U.S. last year with 783 loans closed in 2000. It has operated primarily as a west coast originator since entering the business in the mid-1990s but in January 2001 opened 30 regional offices throughout the country. Volume for 2001 is expected to reach 2,000 loans.

Bank of New York/Alliance Mortgage: Offers HECM and Home Keeper loans through its affiliate BNY Mortgage Company and Alliance Mortgage Company. To date, their geographic reach has been limited to the northeast and southeast.

Wendover Financial Services (subsidiary of ED5): Second largest servicer of reverse mortgages.

Correspondents: These are financial institutions that currently do not own origination platforms but have correspondent agreements with reverse mortgage originators to refer business for a fee. These institutions may decide to create origination platforms of their own in the future.
The U.S. Market

The potential market for reverse mortgages in the United States is growing at a rapid pace. As the baby boomer generation ages, a large demographic trend is underway. According to the U.S. Bureau of Census, the number of homeowners age 65 and older has grown to approximately 20 million and over the next ten years, the number is projected to increase to 25 million. While some of this population will have accumulated enough wealth for retirement, many will need some type of retirement financing. As a result of the growth in the number of senior households over the last decade, the interest in reverse mortgages has doubled since 1997. The American Association of Retired Persons (the AARP) states that reverse mortgages have been the top mail-generator topic since 1997.

The potential demand for reverse mortgages is also supported by the increasing availability of home equity. Over the past 30 years, the housing market has been robust, reflecting the post-war baby boomers’ strong demand for housing. Housing prices have appreciated at a rate of approximately 6.5% annually over this 30-year period and they have created a tremendous amount of home equity, particularly for elderly homeowners. According to Fannie Mae’s Senior Products Group, currently 60% (12 million) of senior homeowners are age 65 to 70. The AARP estimates that 85% of senior citizens want to remain in their current homes. As a result the potential market for reverse mortgage products represents over $2 trillion in home equity. A 1998 Fannie Mae reverse mortgage segmentation analysis states that over 1 million households will be likely candidates for a reverse mortgage over the next five years. This strong demographic force, coupled with the amount of home equity ready to be tapped, forms a powerful base to generate a strong demand for reverse mortgages in the forthcoming decade.

The History of Reverse Mortgages in the U.S.

Reverse mortgages were introduced in the U.S. in the mid-1980s. The earliest reverse mortgage programs in the U.S. were usually sponsored by small lenders and local government agencies and were very specific in their benefits, whereby the loan proceeds were only available for the payment of property taxes and home repairs. The reverse mortgage concept did not gain widespread acceptance until 1988 when the U.S. government began sponsorship of its own reverse mortgage program and authorized HUD to create the Home Equity Conversion Mortgage (HECM) program. To provide a secondary market for reverse mortgages, Fannie Mae began purchasing HUD insurance eligible HECM loans in 1989.

In the early 1990s the reverse mortgage industry garnered the support of major financial institutions including Union Labor Life Insurance Company (ULLICO), Transamerica HomeFirst (a subsidiary of Transamerica), and Household Senior Services. Failure to meet aggressive growth rates and volumes in private programs caused Transamerica and Household to shut down their programs.

Another boost to the public perception of the reverse mortgage industry came in 1995 when Fannie Mae instituted its HomeKeeper program. Fannie Mae’s announcement drew more than 80,000 inquiries following its rollout. The Fannie Mae program is similar in structure to the HECM program but has higher lending limits. Qualified loans originated in both loan programs are federally insured. Fannie Mae continues to be the largest investor of reverse mortgages by purchasing all eligible HECM and HomeKeeper loans.

Throughout the 1990s, major financial institutions continued to influence and shape the industry through product design and consolidation. In September 1996, ULLICO redesigned the private product to help the investor segment and formed a new subsidiary, Financial Freedom Senior Funding Corporation, which began operations in California.

Consolidation in the industry occurred in June 1999 when Financial Freedom acquired Transamerica HomeFirst through financing provided by Lehman Brothers, a global investment bank. In August 1999, Lehman Brothers structured the first domestic reverse mortgage securitization with a loan portfolio purchased from Financial Freedom.

Further consolidation took place in 2000 when Financial Freedom was acquired by an affiliate of Lehman Brothers and purchased the reverse mortgage business of Unity Mortgage Corporation. In 2001 Financial Freedom also purchased the wholesale business of Senior Homeowners Financial Services and became a subsidiary of Lehman Brothers Bank, FSB in August 2001.

EQUITY RELEASE PRODUCTS IN THE U.K.

In the United Kingdom, equity release mortgage products have existed for years but a high volume generating retail product has not yet been introduced. Given the aging of the U.K. population and forecasted changes in pension benefits, equity release products form a major potential market for lenders.

Equity release products can be structured through a form of mortgage or through a sale of part of the home value, with the repayment of the loan or realization of the sale only effective when the homeowner moves or dies.

The current range of products is limited. The fundamental problem lies in a lack of prod-
ucts that can deliver flexible benefits while overcoming the limited capacity for many older people to afford loan interest payments. For some older people, the advantages of equity release in either income or capital terms may be partially eroded by the loss of state income support entitlement and other benefits.

Existing Types of Equity Release Products

Interest-Only Mortgage: This type of loan requires that the borrower make interest payments during the tenure of the loan. The loan is repayable upon death or permanent move out and, if there is a co-borrower, the loan is due upon the second death. If the loan is repaid earlier than maturity the borrower may be charged prepayment penalties. In some cases, interest can be compounded into the loan balance. However, if interest rates rise, there may be a requirement to repay the loan if the outstanding balance increases beyond a set proportion of the value of the house. For this reason, loan amounts are usually limited to a small percentage of the initial value of the home or the interest rate is capped. Interest-only mortgages are suitable for small loan amounts and for those who can afford interest payments.

Mortgage Annuity or Home Income Plans: Home income plans are perhaps the most well-known equity release product and are designed to provide income for life. The most common form involves a secured interest-only loan, which is used to purchase an annuity. Mortgage interest, at a fixed rate, is deducted from the monthly annuity payments before the balance is paid to the homeowner. The principal is repaid on death or when the house is sold. These products benefit older borrowers for whom annuity rates are more attractive.

Home Reversion: In this situation, the homeowner outright sells the house but retains the right to live in the house for life, generally in exchange for minimal rent. The sale price is based mainly on the life expectancy of the homeowner because the lender will earn a return based on the loan amount and the final sale price when the vacant house is obtained. Sale proceeds may be paid as a lump sum or annuity or a combination of both. It is also possible to sell only part of the property's value.

Shared Appreciation Mortgage: The shared appreciation mortgage is a new product introduced by the Bank of Scotland in 1996. This program is a variation on the shared equity approach, providing loans at below-market or no interest rate but the lender takes a pre-agreed share of any increase in the property value, along with repayment of the loan, at death or upon moving or sale. Loan proceeds can be paid in lump sum or used to purchase investment products to provide income. If the property value falls at the time of loan redemption, only the original loan amount is repayable so the lender takes on the risk of the property value. This product is suitable for borrowers who are too young for annuities but who can't afford interest payments.

Interest Roll-up or Reverse Mortgages: Known as reverse mortgages in the U.S., this product was first available in the U.K. Interest on these loans is deferred or added to the original principal amount, the whole of which is due at death or upon moving or sale. This product is similar in design to home income plans.

Publicity and Regulation

Despite the limited number of various types of equity release mortgages that have existed in the U.K. for 15 years, the products have enjoyed consistent demand. However, only the shared appreciation mortgage (SAM) product has produced significant origination volume. During the 1980s, equity release came under scrutiny and suffered a bad reputation due to poorly designed and marketed products that led to several court cases.

In the late 1980s, a number of home income plans were introduced that used alternative investment vehicles to earn a higher return than that offered by annuities. These programs compounded interest and were linked to investment products that, with rising interest rates and poor investment performance, rapidly escalated debt. Due to market conditions, some programs could not guarantee a minimum return or even cover the interest payments. Some homeowners were forced to sell their homes to repay their loans and took lenders to court. These highly publicized court cases tainted home income plans with a bad reputation. Since then, these products have been modified to protect the borrower but the stigma still lingers.

In a similar time period, the expansion of interest roll-up loans in the late 1980s in the U.K. was followed by a period of high interest rates and falling housing values. Problems arose when outstanding debt exceeded home values and the requirement for borrowers to begin interest repayment. As with home income plans, this also led to adverse publicity.

Today, equity release products are regulated by the Financial Services Act or the Consumer Credit Act, or may be self-regulated under the Mortgage Code or Safe Home Income Plan (SHIP). SHIP was created by lenders and guarantees that the homeowner will never lose the right to live in the home, regardless of the housing or investment markets. Although the SHIP has restored consumer confidence, it is an inefficient means to raise equity. With Bank of Scotland's SAM program and the zero pay characteristics, which enjoyed highly positive press, public perceptions changed and demand became and remains strong for equity release products.
The U.K. Market

The Council of Mortgage Lenders estimates that in 1996 there were approximately 4.6 million homeowners over the age of 60 with £360 billion of home equity. By 2011, it is expected that this group will reach 6.1 million homeowners owning £1 trillion in home equity. With the total population of citizens age 65 and older, approximately 65% own their own home. However, about 40% of older homeowners own a home of significant value but do not have the income they need or would like.

Statistics from the Bank of Scotland’s SAM program, which was in place from 1996 to 1998, indicate a potential high degree of demand for equity release products. SAMs generated more than £200 million in origination for the Zero Pay program in just 18 months. The termination of this program was not due to a lack of demand, but rather the structure of the product made it difficult to fund through securitization. Because of the large equity appreciation component of SAMs, asset-backed securities investors were reluctant to bet on the real estate market and the Bank of Scotland could not use securitization as a viable long-term exit strategy.

Funding has been the key to unlocking the equity release market, although the Home Income Plan debacle of the mid-1980s has been a definite drag in the sense of lenders lacking the confidence to attack this market for reputational reasons. Securitization will have the effect of removing risks which do not appeal to the retail banks (e.g., actuarial predictions of longevity, uncertainty around the housing market, potential crossover of outstanding debt exceeding house value, etc.) as well as smoothing returns, particularly in the short term.

The reverse mortgage structure, due to the fixed or Libor linked mortgage-backed securitites nature of its funding, coupled with its zero pay nature, should deliver to the consumer marketplace the certainty of long-term funding and a substantial increase in originations of reverse mortgages. In fact, two smaller originators of mortgage product, Northern Rock and Norwich Union, have been originating reverse mortgages for the last two years. Norwich Union securitized £210.7 million (originated in November 2000) of its reverse mortgage portfolio via £222.5 million notes issued in March 2001 and underwritten by Salomon Smith Barney.

EUROPE

The European economy and demographics also represent a unique opportunity for the equity release market. Many European countries face serious issues in trying to continue to make the generous pension contributions offered in the past. Given zero to negative population growth in certain countries, as the population ages, the number of elderly who collect pensions is growing faster than the number of younger people contributing taxes. The same issues hold true for healthcare funding and other government-sponsored benefits. As a result, governments are likely to focus public sector support on the most needy. The growing senior population in Europe and the realization that governments will not have the necessary funds to provide for the needs of this group suggest that the equity release product could play a pivotal role in providing the necessary income for the elderly and reducing some of the fiscal burdens on the governments.

The Market

In all European countries, the portion of the population that is age 65 and older will increase dramatically over the next decades. The homeownership rate is highest among the elderly. With the influx of the baby-boom generation, the homeownership rate will only increase. In a number of countries, the 1990s with its historical low interest rates has enabled many families to acquire their own property. The statistics show a clear rise in the homeownership rate in this period.

According to country statistics, in 2000 there were approximately an additional 10 million homes owned by individuals age 65 and older in four key European countries (Belgium, the Netherlands, France and Germany) with a total home value of 877 billion euros.

Table 1 details the size of this potentially significant market.

Obstacles to Entering the Market

Culture may be the biggest obstacle to the widespread distribution of equity release products. Many European countries have not really seen any product so the concept has not been tested in these markets. Any potential lender must analyze and understand the retail potential of the market. The success of equity release products depends on legislative support and available viable funding sources. The methodology of implementing equity release products will vary from jurisdiction to jurisdiction since the exact legal structure of house purchase varies from country to country, as does the administration of the process and the servicing of mortgages. The need for legislative support in protecting the consumer and homeownership and ensuring ethical and fair practices is also essential. Securitization may also play an important role in funding this product, but understanding the legal structure and implications in each country will determine if securitization is viable.

CONCLUSION

The history of equity release in the U.K. and Europe is quite lengthy and sets a precedent for the implementation of new products. Certainly the demographics support rapid
Table 1. Total Value of Reverse Mortgage Market in Belgium, France, the Netherlands, Germany & the U.K. (Currency = Euro)

<table>
<thead>
<tr>
<th></th>
<th>Belgium</th>
<th>France</th>
<th>Netherlands</th>
<th>Germany</th>
<th>U.K.</th>
<th>Total</th>
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<td>Total number of</td>
<td>4.00</td>
<td>23.29</td>
<td>6.30</td>
<td>37.05</td>
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<td>residential properties (millions)</td>
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<tr>
<td>Total gross value</td>
<td>288,000</td>
<td>2,300,000</td>
<td>550,000</td>
<td>3,330,000</td>
<td>3,850,000</td>
<td>10,318,000</td>
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<td>residential property market (millions)</td>
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<td>Ownership Rate</td>
<td>74.40%</td>
<td>54.90%</td>
<td>51%</td>
<td>40.90%</td>
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<tr>
<td>• Number of house</td>
<td>1.12</td>
<td>5.97</td>
<td>1.48</td>
<td>9.44</td>
<td>7.40</td>
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<td>holds (65+) (millions)</td>
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<tr>
<td>• Range of ownership</td>
<td>64.7–70.3%</td>
<td>69%</td>
<td>55%</td>
<td>45%</td>
<td>70%</td>
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<td>age and categories</td>
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<tr>
<td>• Number of dwellings</td>
<td>700,000</td>
<td>4.16 million</td>
<td>817,000</td>
<td>4.26 million</td>
<td>5 million</td>
<td>15 million</td>
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<td>group (conservative)</td>
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<td>• Average value of a</td>
<td>70,000</td>
<td>90,000</td>
<td>85,000</td>
<td>90,000*</td>
<td>159,000</td>
<td>494,000</td>
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<td>dwelling (conservative estimates)</td>
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<tr>
<td>Total value target</td>
<td>49</td>
<td>375</td>
<td>70</td>
<td>382.5</td>
<td>796</td>
<td>1,671.5</td>
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<td>market (billions)</td>
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* Considered very conservative

The growth of a lending industry focused on seniors with home equity who wish to age in place. Legal and regulatory issues can be overcome, although growth of the industry would be accelerated through backing by governments for this industry. Standardization of lending regulations and proper disclosure would protect both the borrower and the industry by providing for the necessary consumer education that is requisite when working with the senior population.