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U.S. Reverse Mortgages, Moving Forward

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U.S. Reverse Mortgages, Moving Forward

Standard & Poor's Ratings Services has observed that looming uncertainties about Social Security, Medicare, and Medicaid—and the relative unpopularity of defined benefit pension plans—are spurring many U.S. seniors to seek new sources of retirement income. So it comes as no surprise that many seniors are turning to reverse mortgages for assistance. A reverse mortgage is essentially a home loan that enables borrowers to convert their home equity into a form of income. Reverse mortgages have existed for nearly 20 years, but have evolved and grown as markets, demographics, and borrowers' needs have changed. And, despite an overall slowdown in the origination of traditional mortgages due to the recent problems in the housing market, the origination volume for reverse mortgages continues to grow.

As the reverse mortgage market advances, Standard & Poor's adjusts its rating assumptions to reflect and capture the changing risks in reverse mortgage transactions and securitizations. This article addresses the "payment structure and cash flow mechanics" principle discussed in "Principles-Based Rating Methodology For Global Structured Finance Securities," published May 29, 2007 (see Related Publications).

A Reverse Mortgage Primer

Fundamentally, reverse mortgages enable borrowers to access their home equity without having to make monthly mortgage payments. Reverse mortgages were essentially designed to assist seniors who are "house rich and cash poor." Because the borrower is not required to make any cash payments during the life of the loan, there's generally no credit risk associated with reverse mortgages. When lenders determine whether to issue a reverse mortgage, they look at the property's value and the borrower's age (generally 62 or older) and gender.

Unlike conventional forward mortgages, where borrowers receive a lump sum of money and make monthly payments of principal and interest to retire the debt, reverse mortgages are accrual loans. Borrowers make no periodic interest payments to lenders; instead, the lender adds the accrued interest to the loan balance over time. The total principal balance only decreases when the borrower or someone on the borrower's behalf makes payments to lower or retire the loan balance.

Reverse mortgage borrowers can choose from a variety of payment options. They can elect to receive an initial lump sum payment, fixed monthly payments over a period of time, or payments from a line of credit at times and in amounts of the borrowers' choosing, or a combination of these options. Reverse mortgage loans typically don't need to be repaid until the last surviving borrower dies or has been out of the house for 12 consecutive months, the loan is refinanced, or the property is sold. Additionally, to the best of Standard & Poor's knowledge, of the known reverse mortgage products in the market, the borrower is not liable for any amounts greater than the value of the property when the loan is retired. As a result, when a reverse mortgage loan is paid off, the lender is entitled to the lesser of the loan balance and the proceeds generated from the sale of the home.

Two Product Types Dominate The Market

There are two principal types of reverse mortgages: home equity conversion mortgages (HECMs) and jumbo reverse mortgages.

HECMs

The more common reverse mortgage product available to eligible borrowers is the HECM, which the Federal Housing Administration (FHA) insures through the U.S. Department of Housing and Urban Development (HUD). HECMs make up the lion's share of the reverse mortgage market. According to the AARP, more than 90% of all reverse mortgages that lenders have originated to date are HECMs.*

HECMs are popular because of the insurance benefit that mitigates most of the lenders' risk associated with a reverse mortgage. However, HECM loans limit the amounts the borrower is able to borrow; this makes the program less attractive to borrowers with relatively high home values and creates an obstacle when borrowers want to borrow greater amounts.

The AARP reports that HECM reverse mortgage issuance has grown significantly, from roughly 400 loans in 1990 to approximately 265,000 at the end of 2007.* Despite this significant growth, much of the market remains untapped. According to HUD, the total number of loans outstanding at the end of 2007 represented just 0.9% of the estimated 30.8 million household(s) occupied by people 62 years of age and older.* This suggests that the reverse mortgage market has room to grow at a rapid pace for the foreseeable future. In fact, FHA has projected the total dollar value of HECM loans to grow by more than five times from 2006-2016.*

Jumbo reverse mortgages

Homeowners who wish to borrow amounts that exceed the HECM loan limits are turning to a new product: jumbo reverse mortgages. Also known as proprietary reverse mortgages, these products are similar to traditional jumbo forward mortgages because they provide the option to borrow more than the amount allowable under the government-insured loan programs.

Currently, jumbo reverse mortgages make up roughly the remaining 10% of the reverse mortgage market and are generally for borrowers living in homes with values that exceed the HECM loan limit. The key difference for jumbo reverse mortgages is that, because they're not insured, lenders charge higher interest rates to compensate for the added risk. The added risk is associated with the lack of insurance and inability of the jumbo reverse mortgage lender to assign the loan to HUD when the balance reaches a certain amount in relation to the maximum amount insurable by HUD. As a result, the jumbo lender has more exposure to cross-over risk. Cross-over risk is the risk of diminished returns that occurs when the outstanding principal amount of a loan, together with the accrued interest, exceeds a home's value. Additionally, since reverse mortgages are accrual loans, higher interest rates reduce the amount of funds available to borrowers.

Reverse Mortgage Demographics

As the demographics of the aging population change, reverse mortgage products continue to change as well. The reverse mortgage, once a product designed to provide cash flow to those in need, appears to be making a presence as a "luxury" and financial planning tool. As the first baby boomers are making the transition to retirement, they're seeking new products that cater to their individual needs. The development of the jumbo product, combined with a lowering of the eligibility age to 60 for some jumbo programs, has expanded borrower profiles even more. A decrease in the minimum eligibility age may affect a reverse mortgage's risk profile due to the increase in the loan's life in relation to cross-over risk. As a result, the lender may advance less to the borrower to account for this additional risk. Borrowers may be able to use these loans to help plan their estates, finance luxury expenditures, or perhaps identify ways to decrease tax liabilities. All in all, the product's expansion from an income stream tool for a

retiree with limited cash flow (or to enable the borrower to remain in the home while at the same time financing home health care needs) to a financial engineering tool appears to be paving the way to a change in borrower demographics and evolving loan features.

Another notable feature of reverse mortgages is the change in borrower age. We can see this demographic shift when we compare reverse mortgage borrowers before and after the year 2000. Before 2000, the average borrower age was approximately 76 compared with a post-2000 figure of 74. Additionally, it is Standard & Poor's understanding that unlike the past in which borrowers' children tended to object to their parents' accessing a reverse mortgage loan, today it appears that originators are getting leads from the children of seniors who are struggling to save for retirement.

Reverse Mortgages Can Contain Complex Risks

Even though there is generally no credit risk in reverse mortgages, the risk evaluation process during the loan's origination can be complex. Two of the key underwriting metrics are property value and borrower age (or age of the youngest borrower, in the case of couples). Since the reverse mortgage product has an annuity feature that can provide the borrower with a fixed payment to the end of the borrower's life, property value and borrower age can be key to determining the loan amount. For example, a 75 year-old male borrower generally would be entitled to a loan amount greater than that of a 65 year-old, assuming other variables such as property value, property type, location, interest rate, and payment feature are constant, due to the likelihood that the 65 year-old borrower's loan will exist and accrue interest for a longer period of time.

Inappropriate lending practices can cause additional problems for the reverse mortgage market. With the recent volatility in the residential mortgage market, reverse mortgage lenders have faced increased scrutiny due to the inappropriate solicitation of products such as annuities. While lenders can use their reverse mortgage business to enable borrowers to fund certain financial planning products such as annuities and long-term care insurance, in Standard & Poor's opinion, certain tools may not always be appropriate for the borrower. One example would be providing an annuity to a recipient who would receive a lower overall benefit from the annuity than what the homeowner's equity can provide. As legislation continues to address the mortgage industry overall, there's been additional focus on improper lending practices for reverse mortgage products.

Rating Assumptions Are Keeping Up With The Market

Standard & Poor's refines its rating assumptions and the stresses it uses to analyze securitizations as the reverse mortgage market evolves. Factors such as home price depreciation, the aging population, and the availability of more product options contribute to the need for analytical rigor when assigning a rating to a security backed by reverse mortgages.

The market value of the properties collateralizing the reverse mortgage is the primary source of funds for the repayment of the loan, so it is a main determinant in cross-over risk. The principal balance of a reverse mortgage loan can grow over time, based on the amounts of cash that the borrower draws on the loan each month; we use draw rate assumptions in our analysis to capture this effect. Standard & Poor's assumes that a property's value will decline by a set amount over the first three years of the life of the securitization, but then grow at a constant rate for the rest. Additionally, the decrease in value may differ depending on the property's geographic location. Some of the

most popular areas where borrowers take out reverse mortgages include Miami, Tampa, and Orlando, as well as Los Angeles and Phoenix, which are popular retirement destinations. As we do when we analyze forward mortgages, we determine the market value decline based on the property type, the geographic location, and the rating stress. To capture the differences in rating scenarios, market-value decline assumptions differ by rating category. We further adjust our market value declines to reflect the property's location.

We also incorporate the likelihood of foreclosure when we analyze reverse mortgage transactions. Unlike forward mortgages, in which foreclosures occur due to borrower defaults, provisions for foreclosure in reverse mortgages include "technical defaults," which occur if the borrower fails to pay property taxes and homeowners' insurance, or maintain the property to certain standards. To account for these occurrences, based on different rating scenarios, we assume that a certain percentage of properties will be subject to foreclosure due to technical defaults.

Borrowers aren't required to make any payments on their reverse mortgage loans before permanently vacating their properties. Instead, the lender adds interest, servicing fees, applicable FHA mortgage insurance premiums, and draws that the borrower may have taken to the loan balances every month. When reverse mortgages are securitized, the trust's ability to receive cash flow is contingent on the payoff of underlying reverse mortgages. Therefore, we use our repayment speed assumptions to model the periods when the trust would receive the cash flow necessary to make payments to securityholders. In the analysis, we use fast and slow repayment speeds assumptions for males, females, and couples. We segregate males, females, and couples when implementing repayment speeds for several reasons. For instance, males and females have different life expectancies, and couples have a different mortality expectation due to the association of a joint probability of both borrowers no longer living.

Fast repayment speeds are designed to capture scenarios in which the amount of excess interest (interest generated less interest paid to the securities and any other applicable obligations) is reduced due to a quicker paydown of the underlying loans. This scenario may occur in an environment of significant home price appreciation when borrowers may be more willing to refinance or sell their properties. Conversely, the slower repayment speeds, which generally mimic periods of minimal voluntary repayment, result in longer average loan duration and an increased likelihood of cross-over risk. Historically, the repayment rate on reverse mortgages is much faster than a mortality table would suggest, implying that borrowers are paying off their reverse mortgages for reasons other than death or infirmity.

Overall, as demographic profiles and the needs of property owners change, the reverse mortgage product may change as well. As appropriate, Standard & Poor's continues to evaluate the assumptions we use for rating securitizations backed by reverse mortgages as the product continues to evolve.

For additional information regarding our cash flow analysis of reverse mortgages, see Related Publications below.

Where Is The Reverse Mortgage Market Headed?

Although reverse mortgage originations remain strong, Standard & Poor's believes that the securitization of this product hasn't kept up because of the recent conditions in the credit markets. Specifically, because the duration and performance of reverse mortgages depend on home values and life expectancies, investors in secondary markets may be cautious about these securities right now. Conversely, since reverse mortgages generally aren't associated with credit risk, we believe we may see a secondary market rebound in reverse mortgages sooner than a rebound in the secondary markets for more traditional mortgage products. Additionally, the ability of Ginnie Mae to purchase certain reverse mortgages may also result in strong originations while limiting activity in the nonagency

securitization market.

In response to this growing, changing market, Standard & Poor's continues to observe the key attributes of these mortgages and securitizations based on them, honing our analyses to make more accurate assessments.

Related Publications

The following articles are available on RatingsDirect. The criteria articles are also available on Standard & Poor's Web site at www.standardandpoors.com. In the left navigation bar, select Ratings and then Policies, Criteria & Definitions. The articles are located under the Criteria tab.

- "Principles-Based Rating Methodology For Global Structured Finance Securities," published May 29, 2007;
- "U.S. RMBS HECM Reverse Mortgage Cash Flow Assumptions," published April 16, 2007;
- "U.S. RMBS HECM Reverse Mortgage Analysis Assumptions Revised," published April 11, 2008;
- "U.S. RMBS Nonconforming (Jumbo) Reverse Mortgage Analysis Assumptions Revised," published March 20, 2008;
- "HECM And Proprietary Lenders Are At Home In The U.S. Reverse Mortgage Market," published July 24, 2007; and
- "For Seniors, Equity Begins at Home," published June 6, 2006.

Notes

*Donald L. Redfoot, Ken Scholen, S. Kathi Brown, "Reverse Mortgages: Niche Product or Mainstream Solution," AARP, December 2007, <http://www.aarp.org/research/credit-debt/mortgages/inb999_revmortgage.html>.

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