

In-Focus

MOVING FORWARD IN REVERSE

AN EXCERPT FROM
STRATMOR
INSIGHTS



MOVING FORWARD IN REVERSE

By Jim Cameron

A few weeks ago, I got a Dear John letter from my bank. My home equity line of credit will soon reach the end of its “draw period” and will begin to enter the “repayment period” in which I will have to make monthly payments until the maturity date.

My first reaction was to just ignore the letter — if I need money I will just go to my bank or another financial institution and would have no problem qualifying for a new line of credit. I am in my mid-50s (okay, I just turned 57 but I am rounding down) and I am still in the workforce, make a reasonable amount of income and have some financial assets.

But what if I were one of the millions of seniors who are on a limited fixed income, have no significant financial assets and whose home equity line draw period is about to end? What choices do they have?

Enter one possibility: a reverse mortgage structured as a revolving line of credit.

Reverse mortgages have been around for almost 30 years. And, while the reverse lending market is a fraction of the forward market, how many more

reverse units might be originated if more forward lenders recognized that their customers might really benefit from a reverse? Why aren't more lenders going forward — in reverse?

What is a Reverse Mortgage?

The reverse mortgage product allows homeowners over age 62 to access a portion of their home equity in a lump sum at closing, monthly cash payments or a revolving line of credit with growing availability.

In his best-selling book, *Understanding Reverse*, Dan Hultquist, Director of Learning and Development at ReverseVision (the leading loan origination system for reverse mortgage lenders), defines a reverse mortgage as, “Any loan, secured by a home, where repayment is deferred until a later date, generally when the home sells.”



Most reverse mortgages originated in the U.S. are the FHA-insured Home Equity Conversion Mortgage or “HECM.” Unlike a traditional forward mortgage, reverse loan balances will grow as borrowers take out cash and receive monthly payments, unless the borrower is also making payments on their mortgage.

Who are these senior homeowners who might benefit from a reverse mortgage? Hultquist describes senior homeowners who might benefit as:

- **Those in need.** Seniors who are “house rich and cash poor.” These homeowners may need cash for certain things like medical expenses or in-home care.
- **Those maintaining a lifestyle.** Seniors who need cash for home upgrades, travel, a new vehicle, etc.
- **Those seeking financial planning flexibility.** For example, seniors who may want to monetize a portion of their home equity to supplement retirement income or senior homeowners who have other investments that are not liquid that they may not want to sell (e.g. a building, stock holdings with large potential capital gains, an investment portfolio that experienced recent large declines in value, etc.).

One of the key attributes of a reverse mortgage is that the borrower never has to make a payment unless they want to; however, there may be good reasons for senior borrowers to make payments. What happens if the loan balance grows to a level that exceeds the value of the home and the borrower dies or moves out? This is where the FHA insurance comes into play.

Understanding the FHA Mutual Mortgage Insurance Fund

Reverse mortgage borrowers pay an Initial Mortgage Insurance Premium (IMIP) and ongoing MIPs into the FHA’s Mutual Mortgage Insurance Fund. If there is a loss on the ultimate sale of the property, the loss is covered by the FHA fund with no recourse to the borrower, the borrower’s estate or heirs. This FHA fund experienced major losses during the recession, mortgage meltdown and aftermath as the economy tanked and real estate values declined. As a result, HUD has enacted a series of changes to the HECM program since 2010 to ensure that the program remains viable and is adequately priced for the risk.

The most recent changes to the HECM program were effective October 2, 2017 and included the following:

- Increased the initial MIP to two percent from .5 percent for borrowers who take more than 60 percent of loan proceeds upfront.
- Decreased the annual MIP from 1.25 percent to .5 percent of the outstanding loan balance.

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- Lowered the interest rate floor from five percent to three percent. By lowering this rate, lenders will have to offer lower interest rates, thereby increasing the amount of money that a senior will be able to borrow.
- Reduced the principal limit factor (PLF) tables which govern the maximum amounts available for a given age. This reduces the amounts that can be borrowed, which will reduce the risk that loans will be “upside down” when the borrower dies or moves out, resulting in losses to FHA’s MMI fund.

So Where is the Reverse Mortgage Industry Now?

While many would agree that the recent rule changes will help to ensure the long-term viability of the HECM product, the reverse lending industry is in an uncomfortable place in the first quarter of 2018. Applications and counseling requests are down more than expected for this time of year. Given the reduction in the interest rate floor, it is reasonable to expect that gain on sale margins will decline, but just how far, who knows. The reduction in unit volume and the resultant excess capacity is driving up the cost to originate reverse mortgages in the short run.

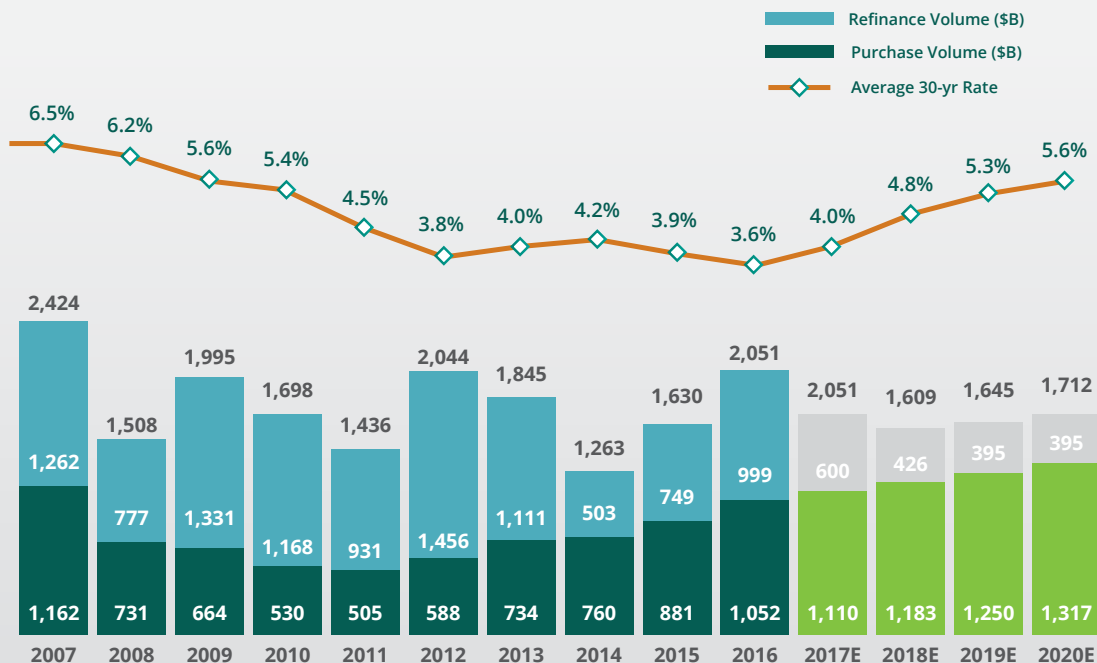
Hmmm ... lower volumes, higher costs and lower margins — sounds a lot like the traditional forward mortgage business right now.

The Forward Mortgage Lending Environment

Chart 1 summarizes actual and forecasted industry volumes and interest rates since 2007.

Chart 1

Originations 2007 to 2020



Source: Mortgage Bankers Association — January 2018



Average 30-year fixed interest rates have declined steadily (in fits and starts) from 6.5 percent in 2007 to 3.6 percent in 2016. Average rates increased to 4.0 percent in 2017 and are trending much higher in the first quarter of 2018 with rates approaching the 4.50 percent range. Could this be the long-predicted inflection point in which rates begin a steady upward climb? It sure seems like it as the MBA is predicting average rates to increase to 5.6 percent by 2020.

With rate-term refinance transactions on the wane and purchase production constrained by a lack of supply, the MBA is predicting overall industry production to decline to \$1.6 trillion in 2018 with only modest volume increases in 2019 and 2020.

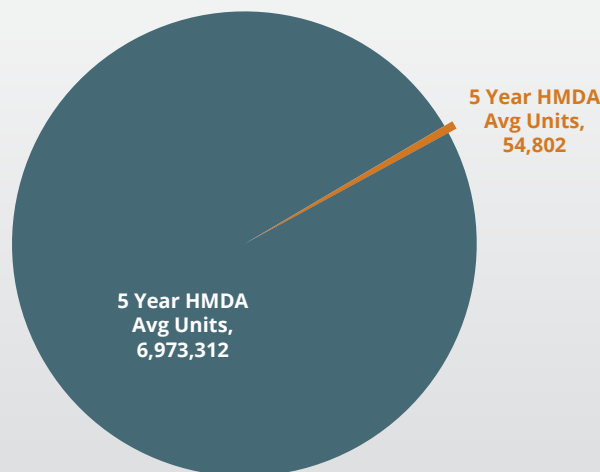
What does this mean for the traditional forward market? As volumes decline, mortgage bankers are facing the age-old challenge of higher origination costs and compressed margins. As is typical in a down market, traditional forward lenders are looking for opportunities to improve profitability and gain market share. This may include expanding into new channels such as Consumer Direct or into new products such as non-QM, construction, renovation and, last but not least, reverse mortgages.

Overview of the Forward vs. Reverse Market

Chart 2 reflects the relative sizes of the traditional forward and reverse mortgage market based on five-year average unit volumes from 2012 to 2016.

Chart 2

Average Production: Reverse vs Forward

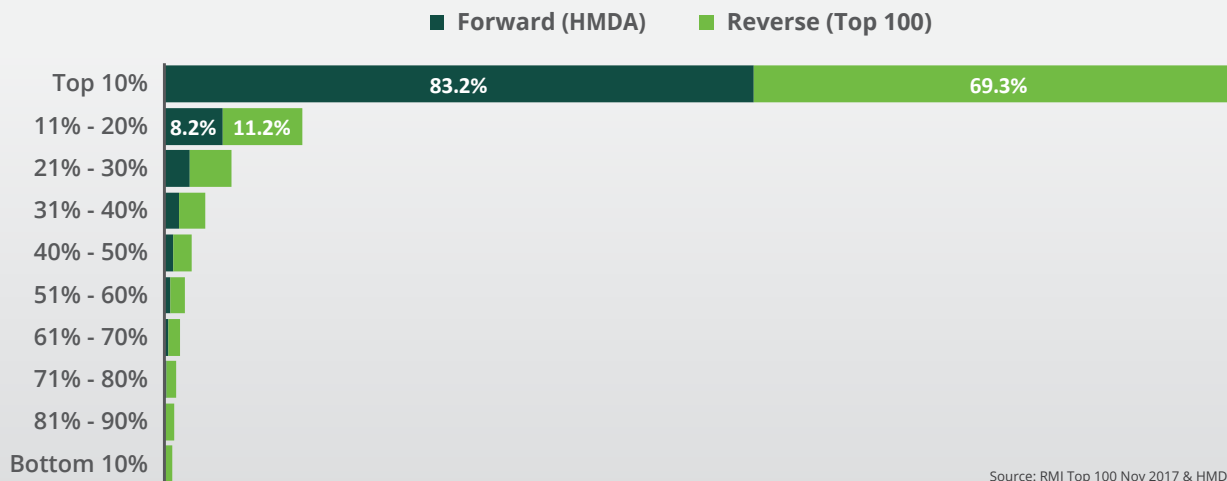


Source: HMDA 2016 & The Department of Housing and Urban Development

While the reverse mortgage lending volume is only a fraction of the traditional forward market, this could be an opportunity. Both the forward and reverse market are heavily concentrated at the top with the top 20 percent of forward lenders originating 91 percent of total volume, while the top 20 percent of reverse lenders originated 81 percent as shown in Chart 3.

Chart 3

Origination Decile Comparison

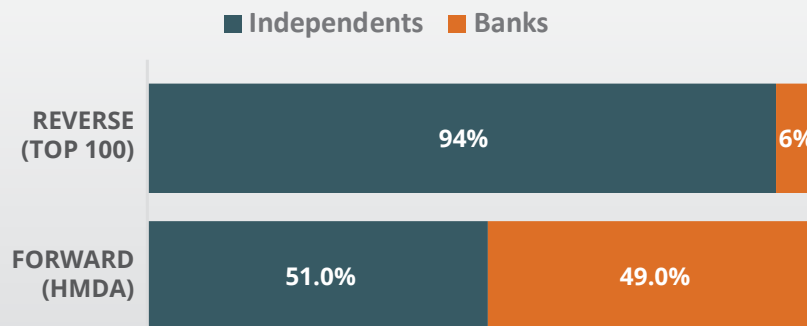


Source: RMI Top 100 Nov 2017 & HMDA 2016

But while the forward market represents an even mix between bank and independent lenders, the reverse market is dominated by Independents as shown in Chart 4.

Chart 4

Market Share Comparison



Source: RMI Top 100 Nov 2017 & HMDA 2016

Why aren't there more banks offering reverse? Not so long ago, large banks like Wells Fargo and Bank of America dominated the sector. But in the aftermath of the recession and mortgage meltdown, large banks exited reverse due to concerns about reputation risk, the need to focus on the larger issues around mortgage foreclosures, and the onslaught of new rules flowing from the Dodd Frank Act. At that time, banks were

generally "playing defense" when it came to mortgage production and servicing and their main goal was to hunker down and stabilize. As banks exited reverse, independent mortgage bankers filled the void. While banks appear to have some natural advantages such as liquidity, capital, and large customer bases (potential for lower marketing costs), they don't appear to be returning to the reverse market any time soon.

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The Opportunity — Borrowers More Than 62-Years-Old

When sizing the industry opportunity for the reverse mortgage market, there are two common approaches. The first approach is to size the market from the “Top down.” The second is to use a “Bottom up” approach.

In the “Top down” approach, the focus is on the number of seniors with a large amount of equity in their home who may need to tap into that equity for reasons of need, lifestyle or financial planning. There is plenty of market data that shows the incredible amount of home equity held by seniors and the fact that there is a large and growing population of seniors who have not saved enough for retirement. For example, according to a study conducted by the Urban Institute, there are 3.3 million seniors over 65 who have \$773 billion in home equity and who would benefit from tapping into it. If just one percent per year of these seniors acquired a reverse mortgage, it would add 33,000 reverse loans per year or 60 percent to the current five-year reverse loan origination average of roughly 55,000 loans.

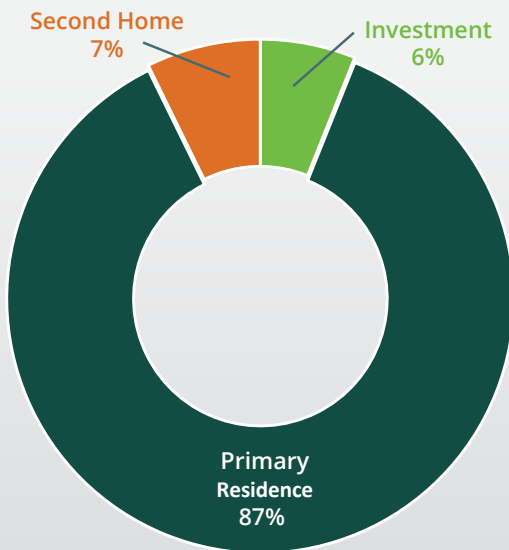
Sizing the reverse mortgage using the “Bottom up” approach attempts to estimate the number of traditional forward loans originated in which a reverse mortgage may have been the better choice or

at least should have been taken into consideration. It is this approach STRATMOR has taken to estimate the reverse mortgage market opportunity using studying data gleaned from our MortgageSAT Borrower Satisfaction program. MortgageSAT is a data-driven survey designed to measure every step of the borrower experience including origination, processing, underwriting and closing. To date, we have received more than 250,000 completed surveys. Of the 250,000 surveys received, approximately 45,000 were from borrowers over 62, which represented approximately 18 percent of respondents.

If we apply the 18 percent factor to an average of seven million forward units originated annually, this would result in an estimated 1,260,000 units originated industrywide for borrowers over 62. A 10 percent capture rate would result in 126,000 reverse mortgage transactions, 70,000 more than the current industry average. This “Bottom up” approach does not consider the opportunity from homeowners over 62 who have significant equity in their home and little or no mortgage debt.

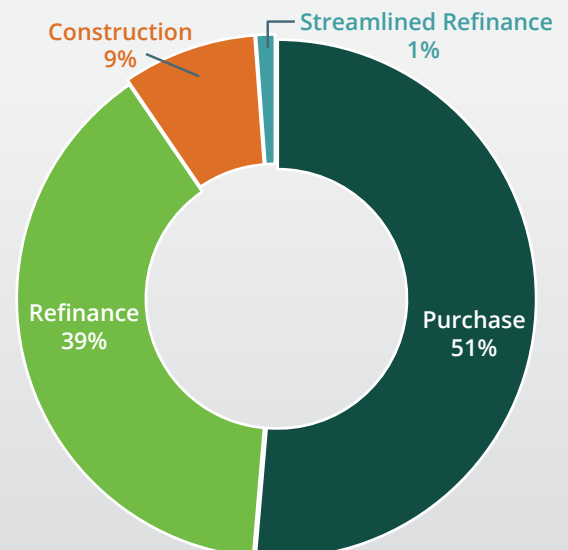
Of these 45,000 loans originated for borrowers over age 62, 87 percent were secured by primary residences and thus eligible for a reverse mortgage.

Chart 5 **Property Use**



Source: MORTGAGESAT © STRATMOR Group, 2018

Chart 6 **Loan Purpose**



Source: MORTGAGESAT © STRATMOR Group, 2018

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Fifty-one percent of the loans were for purchase transactions, which begs the question: How many of these borrowers should have considered a HECM for purchase? Based on our data, cash out refinances typically represent about 15 percent of total refinance transactions. How many of these cash out refinance customers should have considered a HECM? Were they asked?

STRATMOR Group's 2018 Reverse Lending Survey

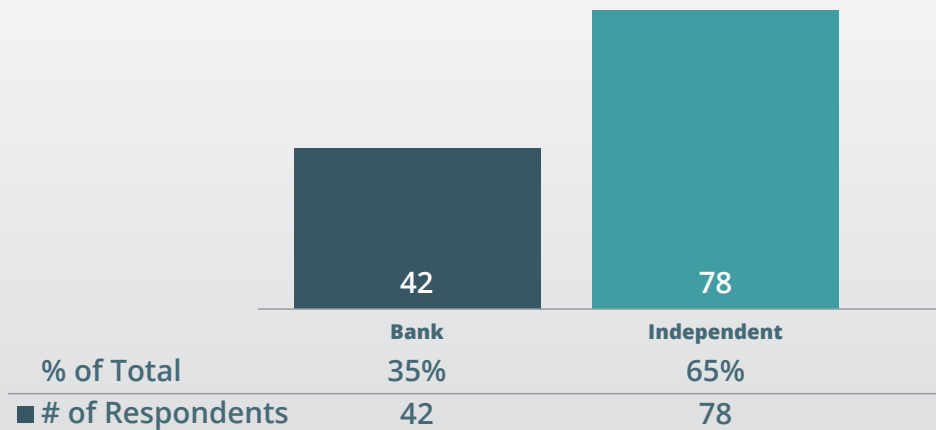
In preparation for a recent conference on reverse mortgages, STRATMOR conducted a survey on the reverse lending business. We asked lenders to classify themselves into one of three categories:

- **Category 1:** Don't originate reverse mortgages — explore the primary reasons for not offering reverse
- **Category 2:** Don't originate reverse but plan to — understand the general timeframe for getting up and running
- **Category 3:** Currently originate reverse — questions about reverse volumes, channel mix, product mix, functional matrix overlap, originator information and capital markets model (e.g. sell, issue HMBS, hold in portfolio).

We received responses from 120 lenders, roughly one-third were banks and two-thirds were independents.

Chart 7

Survey Respondents — Bank vs Independent



Source: STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

The survey respondents had the following key characteristics:

- **C-Level** — The respondents were primarily C-level executives plus reverse and capital markets executives.
- **Retail Focus** — About two-thirds of the traditional forward volume of the respondents was Retail, with the rest of the volume spread across Consumer Direct, Broker/Wholesale and Correspondent.
- **Production Volume Distribution** — The survey respondents were spread fairly-evenly across

production volume segments, as there were just as many with annual volume over \$10 billion as under \$500 million.

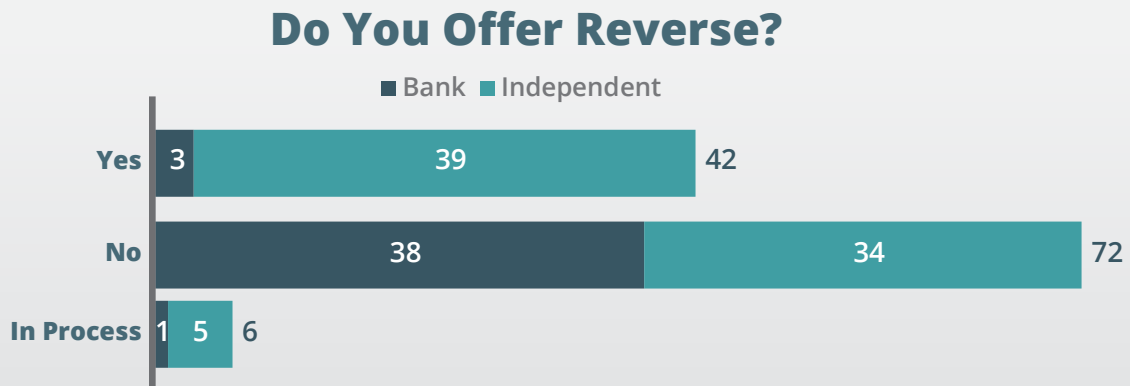
- **Lower Forward Volume** — The 42 survey respondents offering reverse tended to be smaller than the 72 lenders who do not.

Smaller independent lenders may be more inclined to offer reverse as they seek to gain competitive advantage in the marketplace by leveraging their more nimble, entrepreneurial culture, especially when compared to banks.

The respondent breakdown between banks and independents is shown in Chart 8.

Like the market share data shown in Chart 4 on page 7, the overwhelming majority of survey respondents offering reverse were independent mortgage bankers.

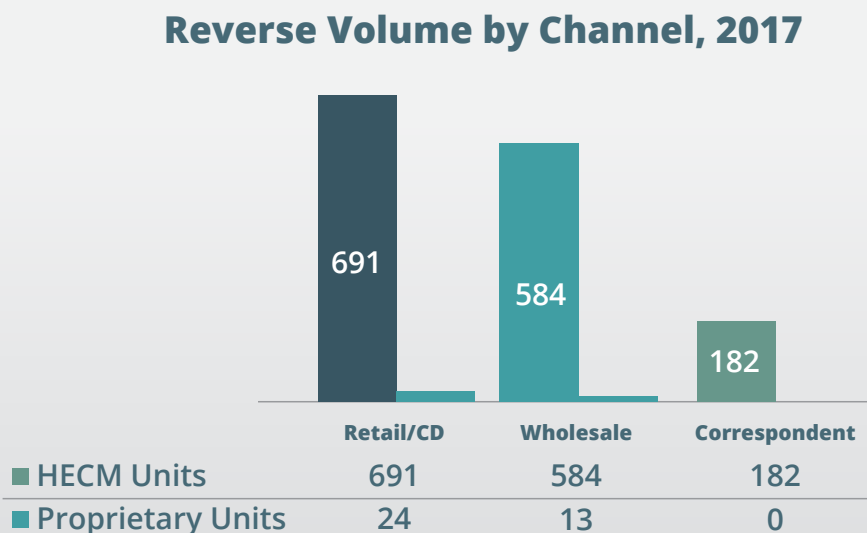
Chart 8



STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

The 2017 reverse unit volume of survey respondents is shown by channel in Chart 9.

Chart 9



Source: STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

The respondents reflect a roughly even split between Retail/Consumer Direct and the Wholesale channels in 2017.

The reverse volume mix by product type and purpose is shown in Chart 10. Table 11 summarizes our views on the key drivers of future volumes by loan category.

Chart 10

Reverse Volume by Mix Type

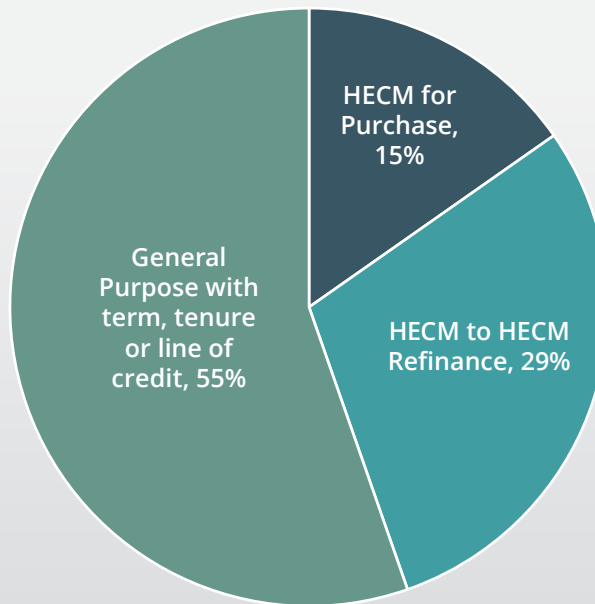


Table 11

Reverse Volume by Channel, 2017

| Category | Overall Trend | Impact | Drivers |
|-------------------------|---------------|--|--|
| HECM for Purchase (H4P) | ↑ | <ul style="list-style-type: none"> ↑ ↑ ↑ ↑ ↓ ↓ | <ul style="list-style-type: none"> ▪ Growth in US purchase market despite supply challenges ▪ Market penetration — more awareness from referral sources ▪ Cost reductions — initial MIP decline from 2.5% to 2.0%: Annual MIP reduced from 1.25% to .50% ▪ Builder business — Certificate of Occupancy not needed for FHA case # ▪ Lower Principal Limit Factors (PLFs) ▪ Financial Assessment requirements — more cash to close |
| HECM to HECM Refi (H2P) | ↓ | <ul style="list-style-type: none"> ↓ ↑ ↓ | <ul style="list-style-type: none"> ▪ Lower PLFs ▪ Home Price Appreciation ▪ Bona fide advantage needed — some apps won't pass the tests; yet a positive for consumer and industry in the long run |
| General | → | <ul style="list-style-type: none"> ↑ ↓ | <ul style="list-style-type: none"> ▪ Market penetration — more awareness from referral sources ▪ Upfront costs have increased for many borrowers; IMIP increase for “low draw” borrowers; |
| Proprietary | ↑ | <ul style="list-style-type: none"> ↑ | <ul style="list-style-type: none"> ▪ Lower HECM PLFs — creates an opportunity for the private market to expand; while proprietary PLFs are still lower, they are typically applied to larger loan balances |

Source: STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

One key area of the survey focused on which functional areas are dedicated for reverse lending only or are shared with the forward lending side. Our findings are summarized in Table 12.

Table 12

Functional Overlap — Forward vs Reverse

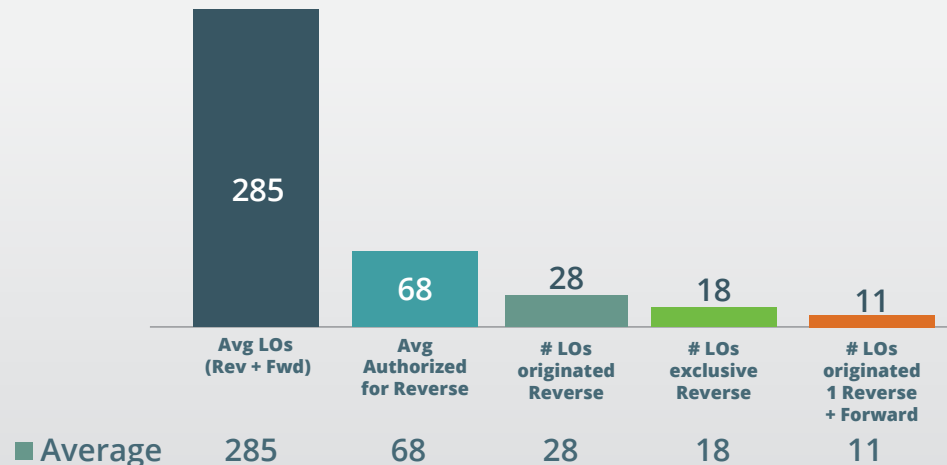
| | Dedicated for Reverse |
|-----------------------------|-----------------------|
| Processing | 79.5% |
| Sales / Application | 71.1% |
| Training / Onboarding | 64.9% |
| Underwriting | 60.9% |
| Servicing | 50.0% |
| Marketing / Lead Generation | 44.1% |
| Insuring | 40.0% |
| Secondary Marketing | 40.0% |
| Closing | 39.3% |
| Post Closing | 34.5% |

STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

Not surprisingly, our survey results indicate that front end processes are more likely to be dedicated for the reverse channel. As we move toward the back end of the mortgage process, reverse functions are more likely to be shared with the forward lending side of the business. Given the cost and margin pressures being experienced on both traditional forward and reverse lending, combining functions where it makes sense will be a key area of focus.

Chart 13

Average LOs by Type



STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

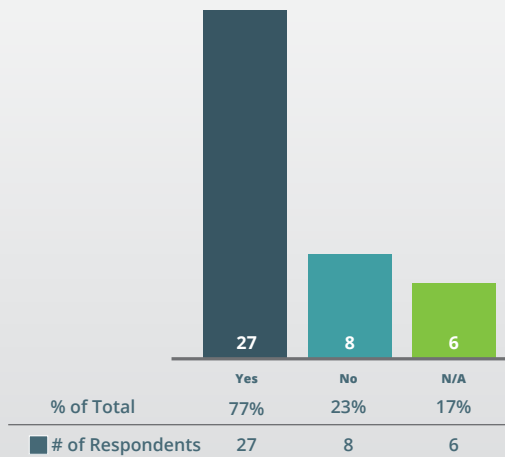
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Chart 13 shows that survey respondents offering reverse had an average of 285 total loan officers, including both forward and reverse. Of that total, only 68 loan officers were authorized to originate reverse. Of the 68 LOs authorized to do reverse, only 28 (41 percent) actually originated a reverse loan. Of the 28 LOs who originated at least one reverse loan, 18 (64 percent) were dedicated to reverse. Of the 28 LOs who originated reverse, 11 (36 percent) originated at least one reverse loan and one forward loan during the year. The key point here is that only a small percentage of originators actually originate reverse, both as a percentage of total LOs and as a percentage of those authorized to originate reverse. Why is that? To what extent is this due to structural issues versus originator personality types or “hard wiring”?

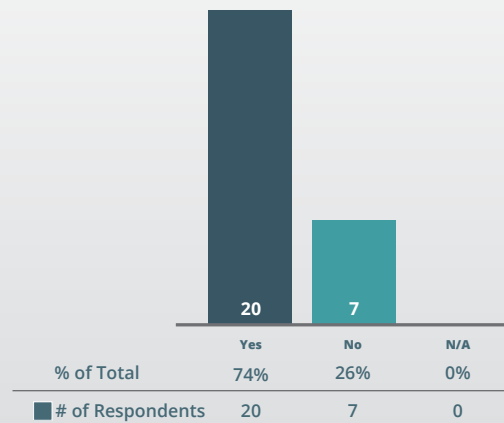
As shown in Chart 14, most forward loan officers refer reverse loans to specialists and receive an incentive for doing so.

Chart 14

Do forward originators refer loans to a Reverse Specialist?



Do forward originators receive financial incentive for the referral?



STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

How productive are Loan Officers by quintile? STRATMOR summarized 2016 volume by quintile for forward loan officers from our annual Originator Census Survey database containing approximately 20,000 retail loan officers. We obtained data on reverse loan officer closings from the ReverseVision origination system for 2016. Table 15 summarizes the results.

Chart 15

Comparison of LO Productivity

| 2016 Monthly Production (Units) per FTE | | |
|---|------------|------------|
| | Forward | Reverse |
| Top 20% | 9.3 | 2.0 |
| 21% to 40% | 4.6 | 0.4 |
| 41% to 60% | 2.9 | 0.2 |
| 61% to 80% | 1.8 | 0.1 |
| Bottom 20% | 0.7 | 0.1 |
| | 3.9 | 0.6 |

STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

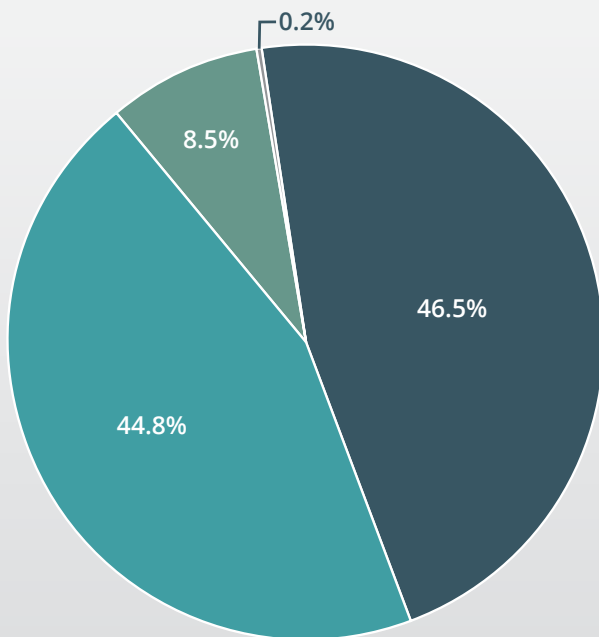
Production is heavily weighted to the top two quintiles for both forward and reverse. As expected, productivity per forward LO far exceeds productivity for reverse LOs. Common hypotheses offered for this include:

- Longer sales cycle required to educate the borrower on the benefits of a reverse mortgage including required counseling.
- Lack of a “forcing function” or sense of urgency on the part of borrowers
- Lower pull through percentage.

We asked survey respondents to indicate their secondary market strategy as summarized in Chart 16.

Chart 16

Secondary Market Outlets



- Brokered out to Wholesale Lender
- Sold to Correspondent Lenders / Investors
- Issued Ginnie Mae HMBS
- Held loan on Balance Sheet - Portfolio

| | Average | Avg Reverse Units |
|---|---------|-------------------|
| Brokered out to Wholesale Lender | 46.6% | 185 |
| Sold to Correspondent Lenders / Investors | 44.9% | 1,083 |
| Issued Ginnie Mae HMBS | 8.5% | 7,112 |
| Total | 100.0% | |

STRATMOR 2018 Reverse Lending Survey © STRATMOR Group, 2018

The 42 survey respondents offering reverse either brokered out the loans, sold them to correspondents or issued HMBS.

- **Brokered Out** — 47 percent of the volume of respondents, they tend to be small originators (only 185 units)
- **Sold to Correspondents** — 45 percent, they tend to be larger lenders with average volume of 1,083 units
- **Issued HMBS** — 8.5 percent, this is the domain of larger lenders with average unit volume over 7000.



Is the Industry Still Listening to Cassette Tapes?

Of the 72 respondents not currently offering reverse, we asked them for their primary reasons for not offering the product. A score of one indicated that the respondent was not concerned about the item and a score of ten indicated that they were highly concerned. The results are summarized in Table 17.

While the scores tended to cluster in the seven to ten range, the results indicated that concerns about reputation risk ranked highest, followed closely by concerns about being a distraction and a lack of expertise in house. A smaller number of lenders were concerned that the reverse product would not be profitable. Not surprisingly, reputation risk was more of a concern for banks than independents.

Chart 17

Why Lenders Do Not Offer Reverse

| | Reasons to not offer Reverse | | | | | | | | | | Overall | | |
|--|------------------------------|---|---|---|---|---|----|----|---|----|---------|------|-------|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | Avg | Bank | Indep |
| Don't have expertise in house | 2 | 0 | 3 | 4 | 5 | 4 | 5 | 16 | 7 | 7 | 7.0 | 7.4 | 6.7 |
| Don't believe it will be profitable | 1 | 1 | 6 | 4 | 7 | 4 | 6 | 3 | 3 | 3 | 5.8 | 5.5 | 6.1 |
| Concerned about reputation risk | 0 | 1 | 1 | 3 | 6 | 6 | 11 | 12 | 5 | 12 | 7.4 | 7.7 | 7.0 |
| Believe it will distract from fwd business | 1 | 2 | 2 | 2 | 6 | 4 | 5 | 10 | 5 | 14 | 7.3 | 6.3 | 8.5 |

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The reasons noted for not offering reverse mortgages appear to be influenced as much by a lack of understanding of the current reverse mortgage environment as they are by actual experience with reverse. It's time to toss that old cassette tape deck and break out a new media player to hear the latest:

- **Reputation Risk** — There have been many changes in the last several years, including caps on origination fees, bona fide advantage rules, financial assessment / LESAs, reduction of interest rate floor, and common-sense regulation, which is good for borrowers and the industry in the long run.
- **Profitability** — While current market is challenging for both forward and reverse, there is a lot of room for improvement in efficiency and cost reduction. We have been through cycles before, and combining functions with forward where it makes sense will be a big help.
- **Too Complex** — While the front end of the sales cycle is different and requires different skills (vs. forward), at some point, a loan is a loan. Reverse is not so much more complex as it is unfamiliar to forward lenders and consumers.
- **Distraction from Forward** — Shrinking forward margins will cause more lenders to move into reverse as expansion into new products is a common reaction to declining margins. What may seem to be a distraction for some may be an opportunity for others.



Think in Reverse

As we move through the first quarter of 2018, there are clearly challenges in both the traditional forward and reverse mortgage markets. Margins are compressed in both sectors, and lenders are looking to crack the code on leveraging both the forward and reverse sales force and to optimizing marketing expenditures. As in all down markets, forward and reverse lenders have a renewed focus on operational efficiency and are carefully examining the need to combine functions where it makes sense.

To lenders who are thinking about going into reverse, here's the good news:

- Reverse is a mortgage product that can benefit senior borrowers.
- Concerns of the past are being mitigated through regulation and improved practices.
- Compelling demographics will continue to create opportunities for lenders that can execute well in the go forward market.

WE WELCOME YOUR FEEDBACK

Interested in discussion the reverse mortgage market? Connect with Jim by emailing him at:
jim.cameron@stratmorgroup.com . ■