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Forward on REVERSE

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HECM at 20: Leaders and Pioneers in the U.S. Reverse Mortgage Industry Series (VII)

The Engineers of Reverse Mortgage Securitization

Lehman Brothers lives in U.S. reverse mortgage history. The Federal Housing Administration's (FHA) home equity conversion mortgage (HECM) has had Fannie Mae's deep pockets as a secondary market source of cash for reverse mortgage lenders since its inception in 1989. And since 2007, Ginnie Mae has opened HECM to world investors through its HECM mortgage-backed security (HMBS).

For the proprietary (non-HECM) reverse mortgage market to take off, a strong Wall Street cash machine was needed. Lehman Brothers stepped in and the securitization of non-HECM reverse mortgages in the U.S. was born in 1999.

Among others, the Lehman securitization team included veteran structured finance expert, Joe Kelly, and mergers and acquisitions specialist Michael McCully, co-founders of New View Advisors, a Wall Street boutique specializing in reverse mortgages.

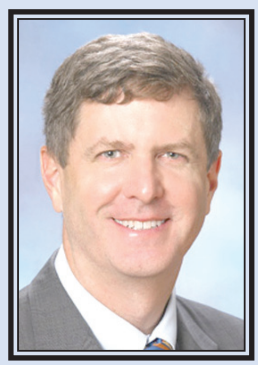
A Wharton MBA and frequent industry speaker, Joe Kelly was the deal manager and chief designer of the 1999-pioneering securitization and four subsequent jumbo reverse mortgage securitizations through 2007 during a 14-year career at Lehman Brothers.

During the 1999 securitization process, it became clear that the deal lacked a solid legal framework, yet Kelly successfully structured the transaction as a FASIT (Financial Asset Securitization Investment Trust), a rarely used and now defunct, structuring tool. He later successfully lobbied Congress to wrap reverse mortgages and other HELOCs (home equity lines of credit) into a real estate mortgage investment conduit (REMIC), a common structuring vehicle. In 2007, Kelly's deal was nominated for the Total Securitization's North American RMBS Deal of the Year.

Michael McCully was responsible for the acquisition, management and sale of Financial Freedom at Lehman Brothers between 1999 and 2004. McCully's extensive portfolio company management experience and strategic advice helped the management team build the company into one of America's largest originators and servicers of reverse mortgages by 2004, when it was sold to IndyMac Bank FSB.

A Cornell University economics graduate, McCully led teams of investment bankers to buy, sell and operate portfolio companies during the last 10 years of his 20-year career at Lehman Brothers.

The following are the reflections of Joe Kelly and Michael McCully on the first securitization of reverse mortgages in the U.S. and their roles in it:



"There existed an opportunity to lend the credibility of a global mortgage franchise in Lehman Brothers to a struggling asset class with unlimited potential."
—Joe Kelly

At Lehman Brothers in 1999, you pioneered the securitization of reverse mortgages in the U.S. secondary market. What attracted you to reverse mortgages as an asset class, and why did you commit to them?

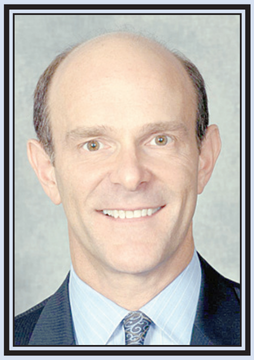
We were attracted to the reverse mortgage industry because it combined our multi-year expertise in mortgage finance, corporate finance and capital markets with a product that had a clear and tangible benefit to society. There existed an opportunity to lend the credibility of a global mortgage franchise in Lehman Brothers to a struggling asset class with unlimited potential. We believed it would become a mainstream product with sufficient education, secondary markets distribution and innovative product development.

Do you still hold that belief in the unlimited potential of reverse mortgages? Why?

We still believe that reverse mortgages are an essential financial product that will grow dramatically in numbers and importance over the next several years. The recent financial crisis took away mortgage alternatives for seniors and has reduced wealth, thus increasingly making reverse mortgages the last, best alternative to supplement income. The demographic wave is too strong and the need is too great, and we also believe that necessity being the mother of invention, the industry can adapt to the changes in the financial markets.

How was the experience of creating the first reverse mortgage securitization for your investors, for Financial Freedom, for Lehman Brothers, and for you?

The SASCO 1999-RM1 securitization required a great deal of work to create the valuation and credit analysis framework required to securitize a new asset class. There were no rating agency criteria and very little historical data regarding prepayments, mortality, mobility, crossover losses and other critical variables. Investors had to analyze actuarial risk, territory unfamiliar for most of them. Financial Freedom had to learn how to service loans in a securitization for the first time, while simultaneously dealing with a major acquisition. Lehman Brothers had to commit a lot of resources to make it all work, including the two of us, Craig Corn, Jim Mahoney, Al Benedetti and many others.



"The recent financial crisis took away mortgage alternatives for seniors and has reduced wealth, thus increasingly making reverse mortgages the last, best alternative to supplement income. The demographic wave is too strong and the need is too great …"
—Michael McCully

Without a model, what were some structural challenges you faced, and how did you overcome them?

The modeling challenges were considerable. The standard structuring model had no "reverse gear." We had to construct a prepayment curve (which turned out to be very accurate), so there was a lot of programming and structuring work involved. We also had to design a reserve fund feature to fund the borrower advances. Finally, we had to use an unusual "FASIT" tax structure, as reverse mortgages were not yet eligible for REMICs.

What is a prepayment curve? What are the factors that go into its design? What is a reserve fund feature? And what is FASIT?

The prepayment curve is a measurement of the rate at which loans pay off over time. For reverse mortgages, the most significant variable is generally borrower age, but the reverse mortgage prepayment curve predicts the rate of payoffs using empirical data regarding mortality, mobility and refinancing.

In a securitization, a reserve fund is an amount of cash or securities that provides cash for the borrower's credit line draws.

"FASIT" stands for Financial Asset Securitization Investment Trust, a tax vehicle designed to accommodate the securitization of revolving asset types, such as home equity lines of credit or HELOCs. With a few exceptions, like the SASCO 1999-RM1 transaction, the FASIT was rarely used. In 2004, FASITs were disallowed by Congress, and reverse mortgages and other HELOCs were allowed, for the first time, to be securitized using the more popular real estate mortgage investment conduit or REMIC tax vehicle.

How informed were investors about reverse mortgages as an asset class when you began, and how educated are they today?

Investors were either uninformed, or worse, disinclined to invest because of the bad publicity surrounding reverse mortgage fees and contingent interest. But a small number of enlightened investors were smart enough to grasp the relative value story of stable prepayments and credit protection. The relatively low LTVs [loan-to-values] of jumbo reverse mortgages and the very conservative rating agency criteria also helped give them comfort. With each successive securitization, the number of investors grew a little larger.

How has the secondary market for reverse mortgages evolved since your pioneering work? Where is it headed?

No securitized reverse mortgage classes have suffered any ratings downgrades because the rating agency criteria are very conservative. For example, AAA-rated reverse mortgage bonds must be able to withstand a drop in home values exceeding 30 percent. Had the rating agencies applied this standard uniformly to all rated mortgage transactions, the mortgage securitization market would not have experienced anything close to the depth of collapse we witnessed in 2008.

Because 98 percent of reverse mortgages were never securitized, but rather portfolioed by Fannie Mae, the secondary markets are still in their infancy, or at best, in their adolescence. The market needs true market-clearing pricing, data and supply for it to become fully accepted. As HECM mortgage-backed securities gain broad acceptance and other new securitization vehicles are introduced, more investors will take interest in the asset class. When that happens, we believe that true secondary markets pricing and execution will become the norm for reverse mortgages.

What are some lessons you have learned about reverse mortgage-backed securities (RMBS) and investors' attitude toward them?

We learned that reverse mortgages are not immune to the vagaries of the market. Like other asset classes, they can get a bit frothy. During the height of the mortgage bubble in 2005-2007, pricing of HECMs became irrational, and the whole loan HECM securitizations sold during the pre-HMBS era did not deliver a lot of value to investors. The market lost sight of HECM's inherent value.

What makes Ginnie Mae's HECM mortgage-backed securities (HMBS) a better value proposition for investors?

HMBS provides: (1) a "full faith and credit" layer of credit guarantee, (2) the superior liquidity and execution of the Ginnie Mae securitization program, and (3) insulation from other risks (borne by the HMBS issuer) of tax and insurance defaults, credit line and other advances.

What prospects and challenges do you see for RMBS after the Great Recession of 2008-2009?

We believe the key to success for reverse mortgages is the establishment of a lower LTV, low-cost product with zero upfront fees in exchange for lesser proceeds. For 20 years, HECM proceeds have been calculated assuming four percent annual home price appreciation—it is time for that to be recalibrated with our current market environment. The main lesson from the "great recession" of 2008-2009 is that we—individuals, corporations and governments—borrowed too much and now must deliver. This is also true for reverse mortgage borrowers. FHA's recent actions are a first step in this direction.

What is your favorite reverse mortgage story?

The first National Reverse Mortgage Lenders Association (NRMLA) Conference we attended in Naples in 1999 was particularly revealing. The following year's conference in Dallas was the first time we witnessed significant audience participation, and it was very good.

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Visit author Atare E. Agbamu's blog at thinkreverse.com for his thoughts and insights on the reverse mortgage marketplace.