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FHA's HECM is an accidental reverse-mortgage industry monopoly with some festering structural problems. Some analysts believe its payouts are too generous, therefore, increasing its crossover risk. Others say its high upfront costs are driving consumers away and limiting its market-penetration potential.

The recent ten-percent principal-limit cut confirms the rich payout argument, but it is uncertain whether it will be enough to check crossover risk. Anyone who has spent time in the HECM origination trenches knows high closing costs turn-off many senior consumers and their advisors. While many industry professionals agree on the problems, few have thought them through, and even fewer have offered plausible solutions such as the HECM II proposals advanced by the principals at New View Advisors.

Reverse-mortgage securitization pioneers, Joseph J. "Joe" Kelly and Michael McCully, co-founders of New View Advisors, a Wall Street boutique specializing in reverse mortgages, advocated reducing HECM's loan-to-value ratios (LTV) and believe closing costs are still too high.

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 2006 during a 14-years career at Lehman Brothers. In 2007, his deal was nominated for the Total Securitization's North American RMBS Deal of the Year for 2006. A mergers and acquisitions specialist, Mike McCully was the relationship manager for Financial Freedom at Lehman Brothers

between 1999 and 2004, where he deployed his considerable portfolio-company management skills to make Financial Freedom the nation's largest originator and servicer of reverse mortgages until recently. A Cornell University economics graduate, McCully led teams of investment bankers to buy, sell, and operate portfolio companies during 20 years at Lehman Brothers.

Joe Kelly, Mike McCully, and I caught up recently to discuss their radical ideas for re-making HECM reverse mortgages for the twenty-first century.

It appears FHA took your prescription with its FY2010 ten percent cut to HECM's principal limit. Is the cut sufficient to minimize FHA's crossover risk? What are the near-term and long-term implications of this cut for HECM?

Kelly and McCully: The ten percent cut will substantially reduce FHA's crossover risk. In the near term it will mean less loan volume, but if it spurs the industry into more thoughtful changes and new product development, it could be very beneficial to the industry. Politically, it enhances the long-term viability of the program by eliminating the need for subsidies and the accompanying political risk.

HECM is the foundation of the reverse mortgage industry in the U.S., but it has some serious issues. What are these challenges and their implications for the industry's growth?

Kelly and McCully: After building our cash flow model using empirical data regarding mortality, mobility, interest rate, foreclosure costs, home price and other assumptions, our analysis showed that the HECM lent too much money. Unfortunately, the industry got accustomed to this generous Loan-to-Value ("LTV") curve and is now having trouble adjusting to lower lending amounts. Secondly, the HECM's upfront fees are extremely high, limiting broad acceptance of the program. Until a thoughtful, updated HECM is introduced, growth in the industry will be limited.

How should these problems be addressed?

Kelly and McCully: For now Congress and the FHA have addressed the HECM LTV Curve. It was unfortunate the industry did not initiate changes that were more thoughtful. For nearly 10 years we have been advocating the importance of removing upfront costs in this program. If the FHA can introduce a product such as the HECM II we've structured, we believe this will more than offset the borrowers that no longer qualify due to the LTV reductions. One possible outcome would be for Fannie Mae to securitize its \$50 billion portfolio, while simultaneously disclosing the historical data from their years of HECM investment. Investors would feel much more comfortable making investment decisions with that data.

What are some of the "more thoughtful" changes the industry could have initiated before this forced ten percent principal-limit cut?

Kelly and McCully: We mean a product like the HECM II, a Standard HECM with a different MIP structure, eliminating the servicing fee set-aside, and adding a tax and insurance set-aside. Instead, the industry looks like a team that ran out the clock when it was behind, or called for time when it had no timeouts left.

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You have proposed a HECM II as a complimentary offering. What are the elements of your HECM II proposal? And how do we know it will work?

Kelly and McCully: The HECM II we propose has the following elements:

- a. Zero initial MIP;
- b. Three-quarter percent ongoing annual MIP;
- c. Lower Principal Limits, about 8-10% below the now standard HECM;
- d. A tax and insurance set-aside in lieu of a servicing fee set-aside.

With the twin problems of high costs for consumers and high crossover risk for FHA, why do you want FHA to retain the existing product?

Kelly and McCully: We think it's an elegant way to introduce a new product, without going cold turkey on the new standard HECM. The Standard HECM should be available for extenuating circumstances. Compared to a HECM II, a standard HECM costs the borrower up to about \$20 in upfront MIP for every \$100 in incremental Principal Limit. Even taking the lower (0.50%) ongoing MIP into account, it's a very expensive proposition for the homeowner, but it has its place as a needs-based product.

You have proposed resetting the investor put at 88 percent of maximum claim amount instead of the current 98 percent. How did you come by 88 percent?

Kelly and McCully: HECM loans investors assigned to FHA have a higher probability of experiencing crossover loss. The severity of the loss is a lot closer to 12% than 2%. As the party bearing the risk, FHA should take control of the loan (and the servicing) as soon as the loan enters this crossover-loss danger zone.

How could raising eligibility from age 62 to 65 mitigate FHA's crossover risk?

A reverse mortgage to a 62 year old is an awfully long duration loan. Increasing the minimum age to 65 would result in fewer HECMs overall, but from a credit perspective; a reverse mortgage loan made to a 62 year old is not necessarily more risky if the LTV is sufficiently lower.

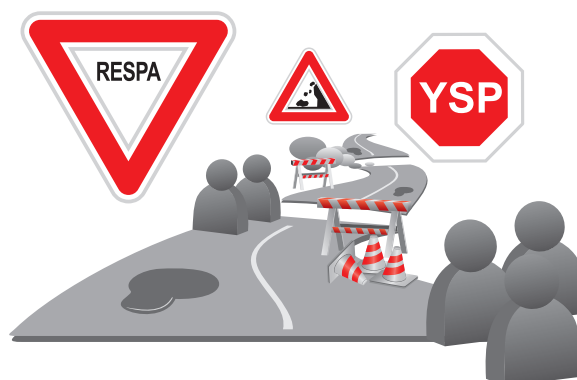
Case-Shiller's recently introduced MacroShares are housing derivatives with the potential to temper crossover risk for government as well as conventional reverse mortgages, how should they be integrated into future reverse mortgage product design?

Kelly and McCully: That remains to be seen. Derivatives have a proper place in managing risk, but should be used with caution.

How will the HECM principal-limit cut affect the development of new private-label reverse mortgage products?

Even with the cut, HECM LTVs are still quite a bit higher than we generally saw with private reverse mortgages. Secondly, lenders would need a revival of the secondary market for non-agency mortgages before they can start originating private reverse mortgages again. That probably can't happen until we see a sustained recovery in home prices.

The RESPA Challenge



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Stricter RESPA rules, lower principal limits, a more complex FM1009 and other changes pose a serious challenge to our industry. Lenders will take on additional responsibilities and need to be meticulous while working with brokers. Brokers will lose all or most of the YSP and any mistake made in the GFE could cut into their origination fee as well.

But there is also good news around the corner...



ReverseVision Inc.

3310 Pollock Place • Raleigh, NC 27607
www.reversevision.com
(919) 834 0070 • info@reversevision.com