HECM Risks: A Balancing Act

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The federally-insured reverse mortgage or Home Equity Conversion Mortgage while holding tremendous value has been challenged with continued losses paid from the FHA's insurance fund. In the wake of the housing bubble and economic crisis the program several changes were enacted. The repeal of the standard fixed-rate HECM, the introduction of the HECM Saver, increases in mortgage insurance premiums, the financial assessment, first year distribution limits, repeated principal limit factor reductions, and most recently, the enactment of the second appraisal rule as part of the Collateral Risk Assessment. The pace of these changes increased with the passage of the Reverse Mortgage Stabilization Act of 2013 which allows HUD to establish new rules via mortgagee letter rather the previous protracted rule-making process. The intention was to allow the agency to act quickly to slow the mounting losses incurred by the program.

When it comes to HECM risks there are basically two types: front end and back end. Front end risks would include the valuation of the home, lending ratios or principal limit factors, and product design. As I've said before, HUD and the FHA are rightly concerned on the valuation of the home which secures the loan. After all, an inflated valuation at the beginning of the loan dramatically increases the likelihood that the loan balance exceeds the home value when the loan terminates. Another risk which has not been addressed to date is the assumption of a four-percent annual appreciation rate for all homes regardless of their local real estate market and historic changes in home value. Consequently, any HECM loans originated in areas which fall below an average four-percent appreciation add to the FHA's potential liability of a future insurance claim.

Additional front-end risks include the ongoing FHA mortgage insurance premiums, and any required Lifetime Expectancy Set Asides, or LESAs. The ongoing insurance premiums were wisely adjusted from 1.25% to .5% which has a significant positive impact slowing the negative amortization and ultimate balance of the loan. However, in cases where the Financial Assessment requires a set-aside the risk of unpaid property charges is mitigated while at the same time significantly increasing the HECM's ending loan balance.

Back-end risks include when loans are assigned to HUD and more importantly, how quickly properties with a terminated HECM are sold to recoup the loan's final balance. In July during a call with reporters FHA Commissioner Brian Montgomery said this of HECM losses. "We are digging deep in the portfolio to find out of the problem is on the front end or the back end. My sense is that it's more on the back end in terms of the losses we are experiencing. Part of 'triaging' is [determining] why that is happening." In the effort to speed up the 'foreclosure' process some have suggested a cash-for-keys program. Steve Irwin, NRMLA executive vice president said in an interview with Reverse Mortgage Daily, "In our ongoing conversations with HUD and the Hill, we continue to emphasize the need to improve property disposition efficiencies, post-assignment. One change that we believe would be within the agency's power to make fairly quickly would be to extend the cash for keys program to the entire book of HECM loans, as opposed to only loans closed after the new HECM rule went into effect."

What is clear are two things. Previous measures have not stemmed continued losses and FHA is committed to diving deep into the HECM portfolio to isolate the root cause of insurance claims. Again, the good news is our FHA commissioner is not only committed to fixing the program, but is a documented supporter of the continued value of the reverse mortgage.

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