

OLIVER WYMAN

Financial Services

# Reverse mortgages: Still moving forward



MARSH MERCER KROLL  
GUY CARPENTER OLIVER WYMAN



## Introduction

Entering 2009, the mortgage market continues to face extremely difficult conditions. Reeling from a continuous stream of losses and write downs, traditional lenders have scaled back operations and tightened credit standards. On the demand side, potential customers are struggling with rising unemployment, depleted investment accounts and, for many, negative equity in their existing homes.

One bright spot in the market has been the reverse mortgage industry, which has continued to grow despite the broader turmoil. In 2008, originations of reverse mortgages insured by the Federal Housing Administration (FHA) grew by 6.4% to 115,176 units, setting an annual record. Although still a small portion of the broader mortgage market, reverse mortgage products now generate over \$1 BN in revenue for the industry on an annual basis. Based on data from the Department of Housing and Urban Development (HUD), we estimate that \$500 MM in origination fees, \$120 MM in servicing fees, and \$600 MM in spread income accrued to industry participants in the past year<sup>1</sup>.

Beyond the growth in origination volumes, 2008 was remarkably positive for reverse mortgages, with favorable regulatory changes, two strong market entrants (MetLife and Genworth) and an absence of negative press<sup>2</sup>. We believe that the stability of the industry through the credit crisis bodes very well for the future of the product and significantly reduces the risk for potential entrants into the space. The Federal Government has demonstrated its commitment to reverse mortgages and the demographic imperative is stronger than ever.

Rapid growth and continued stability make the reverse mortgage market an attractive space for those looking to better serve the senior population. While there are significant opportunities for industry participants across manufacturing, servicing and distribution, we believe the greatest opportunity is in distribution. In the near-term, the monoline business model that is dominant today will continue to be successful and provides a blueprint for new entrants. Longer term, we believe integrated models using reverse mortgages as the cornerstone of a more holistic retirement

---

<sup>1</sup> Calculations were based on 2% origination fee, 1.5% interest margin and \$30 per month servicing fee, which are currently standard for the industry. Origination volumes and outstanding principal balance figures provided by HUD

<sup>2</sup> Genworth's acquisition of Liberty Reverse Mortgage, Inc. closed in Q4 2007

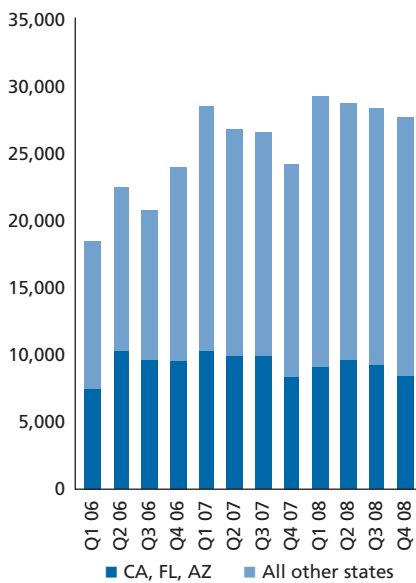
offering will allow institutions to differentiate themselves and create sustainable competitive advantages in serving retirees. Regardless of their ultimate ambition, firms with an interest in serving seniors should ensure that reverse mortgages are a component of their strategic plans.

# Reverse mortgages and the credit crisis

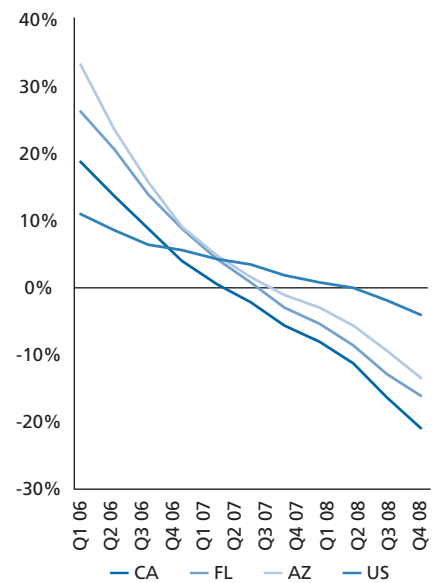
With the unprecedented nationwide fall in housing prices, it would not have been surprising to see a significant decline in demand for reverse mortgages, since the size of the credit line offered to the borrower of a reverse mortgage is directly related to the appraised value of the home. However, to date, most prospective borrowers have not been discouraged by the reduction in available credit line size. Data provided by HUD on originations of reverse mortgages insured by the FHA – known as Home Equity Conversion Mortgages (HECMs) – show that origination volumes have remained stable. This stability is particularly surprising given that the states with some of the most severe price drops are also the states with the highest concentration of seniors.

## Exhibit 1

Quarterly HECM origination counts



Year over year change in HPI by state



Source: OFHEO; HUD; Oliver Wyman analysis

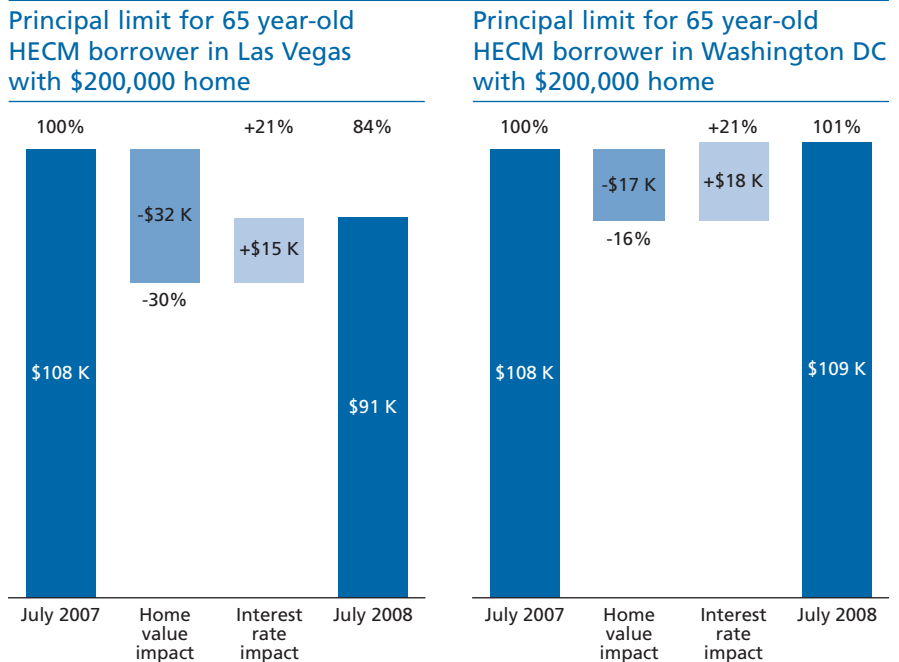
The performance of the origination market is also remarkable given disruptions on the supply side. Proprietary reverse mortgage products have almost completely disappeared from the scene as lenders reduced Loan to Value ratios (LTVs) in response to tighter risk controls and balance sheet constraints. As a result of troubles at parent IndyMac, top lender Financial Freedom shut down originations of its market leading

proprietary jumbo product entirely. In addition, there have been significant reductions in appetite for all types of reverse mortgages in the secondary market, with Fannie Mae and Ginnie Mae left as the only buyers of product.

We believe there are several reasons why the market for reverse mortgages has held up well, despite the unfavorable demand and supply trends:

1. **Declining interest rates have mitigated the impact of falling house prices.** For a given borrower age, HECM LTVs are determined by the 'expected interest rate' – the 10-year Constant Maturity Treasury (CMT) rate plus the lender's interest margin.<sup>3</sup> Exhibit 2 shown below demonstrates the change in available principal limit that a 65 year-old borrower would have experienced between July 2007 and July 2008 in Las Vegas (the worst performing city in the Case-Shiller 20-city composite house price index during this period) and Washington DC (which experienced the same decline as the composite index). During this period the 10-year CMT rate declined from 5% to 4%. Remarkably, the borrower in Washington DC is actually slightly better off in July 2008 despite a 16% decline in home prices.<sup>4</sup>

**Exhibit 2**



Source: EconStats; S&P Case-Shiller; HUD; Oliver Wyman analysis

3 The 10-year CMT rate applies only to treasury-indexed HECM products. LIBOR-indexed HECM products, which became available in 2007, use the 10-year LIBOR swap curve to determine the expected interest rate and corresponding LTV ratio.

4 We have assumed that the lender's margin is set at 1.5% in both time periods.

2. **Reverse mortgages satisfy a key customer need.** Seniors seeking an additional income stream who do not wish to sell their primary residence have few options beyond reverse mortgages. As credit conditions have tightened further, other options for releasing equity, such as cash out refinancing and home equity lines of credit (HELOC), have become more challenging for seniors to get, and particularly difficult for those seniors with an inability to demonstrate other forms of income or those with thin credit files. Credit worthiness and income do not factor in underwriting decisions for reverse mortgages.
3. **Proprietary products have never been a significant factor in the industry.** Even prior to recent events, proprietary products represented a small fraction of the reverse mortgage market (<10%) and HECM was a viable substitute in the vast majority of cases. Proprietary products are not a significant source of originations for most reverse mortgage lenders and their absence will not result in a materially negative impact to distribution channels.

## Demand outlook

Given the stability of the reverse mortgage market during a terrible period for housing and real estate lending, we are optimistic about the future of the industry and expect growth to be robust going forward. Among the many positives for the industry are changes to the HECM regulations mandated by the Housing and Economic Recovery Act of 2008 which have laid the groundwork for a significant expansion in the pool of prospective customers. A further adjustment in the recently passed American Recovery and Reinvestment Act of 2009 has the potential to be even more impactful. Three aspects of the new regulations in particular provide direct support to the growth of the industry.

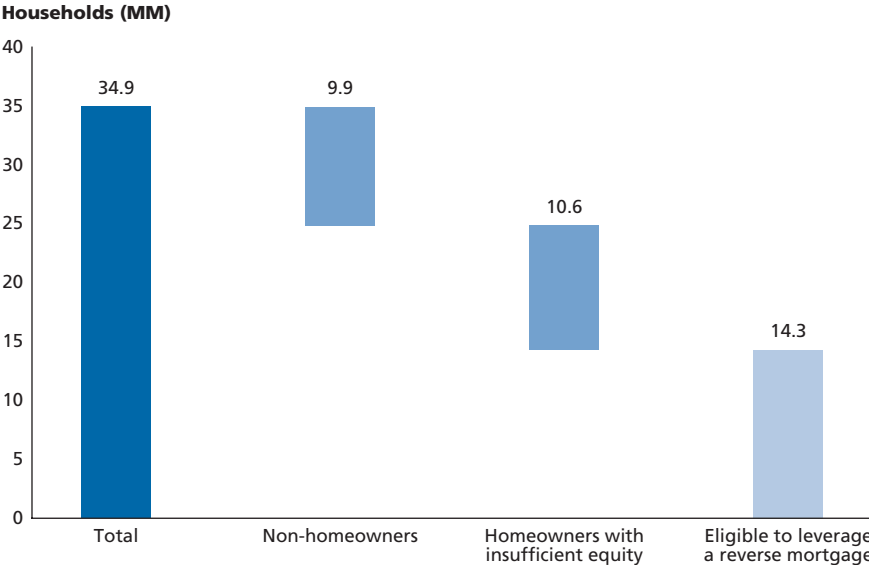
### Exhibit 3

Provision	New rule	Old rule
<b>HECM loan limits (maximum claim amount)</b>	<ul style="list-style-type: none"> <li>■ Permanent nationwide cap of \$417,000</li> <li>■ Temporary nationwide cap of \$625,500 for the remainder of 2009 (mandated by the American Recovery and Reinvestment Act of 2009)</li> </ul>	<ul style="list-style-type: none"> <li>■ Area limits set at the median home value with a floor of \$200,160 and a cap of \$362,790</li> </ul>
<b>Origination fee limits</b>	<ul style="list-style-type: none"> <li>■ 2% of the maximum claim amount up to \$200,000</li> <li>■ 1% thereafter with an overall cap of \$6,000</li> </ul>	<ul style="list-style-type: none"> <li>■ 2% of the maximum claim amount</li> </ul>
<b>HECM for home purchase</b>	<ul style="list-style-type: none"> <li>■ Allowed</li> </ul>	<ul style="list-style-type: none"> <li>■ Not allowed</li> </ul>

The adjustment to the HECM loan limits will have the greatest impact of the three. The changes will significantly increase the opportunity in the market as borrowers with more valuable homes will be able to access larger credit lines. This is especially true of the temporary cap put in place for 2009, which is 72% higher than the original maximum of \$362,790. In areas with low median home values, the new limit is over 200% higher. In addition, by setting a cap of \$6,000 on the origination fee, borrowers will not feel they are being penalized for having a more valuable home. Although the temporary loan limit cap will expire at the close of 2009, we believe it is very possible that Congress will vote to make the change permanent later in the year due to significant support for the HECM program among legislators.

The changes to the HECM regulations could not have come at a better time for seniors. Rising costs of living (health care in particular), declining equity markets and retirement benefit cutbacks by employers have increased the challenge for individuals seeking to maintain their lifestyles during retirement. To compound the problem, both the current and next generation of retirees have significantly under-saved: we estimate that 70% of people between the ages of 40 and 62, representing 35 MM households, will not be able to fully cover their retirement expenses. Fortunately, many of these households have built up significant equity in their homes, allowing over 40% (14.3 MM) of them to take advantage of the additional cash flow provided by a reverse mortgage.

**Exhibit 4: Number of households, aged 40 to 62, which will be unable to cover expected retirement expenses**



Source: Oliver Wyman Retirement Risk Model

# Economic outlook

Recent industry trends suggest the primacy of the HECM product is assured for some time to come. This marks a change from a year or two ago when it appeared as though HECMs would increasingly share the space with proprietary products designed for the “jumbo” (i.e. > FHA limits) space. Despite the increasing commoditization of the product, the economics for lenders remain strong relative to other asset classes, largely due to the product structure and guarantees provided by the FHA. Exhibit 5 shows the key drivers of HECM economics for lenders, along with our expectations for their future direction.

**Exhibit 5**

HECM economic driver	Direction
<b>Origination fees</b>	<ul style="list-style-type: none"> <li>■ Recently lowered as mandated by the Housing and Economic Recovery Act of 2008. Fee regulations are unlikely to change again in the foreseeable future</li> <li>■ Despite the recent regulatory changes, origination fees remain sufficient to cover sales force commissions and other origination costs, while still preserving a sizable margin for the originating lender</li> <li>■ Although lenders generally charge the maximum fee allowed by the HECM regulations, in the absence of product differentiation lenders may choose to begin competing on fees</li> </ul>
<b>Interest margins</b>	<ul style="list-style-type: none"> <li>■ Prior to the contraction of the secondary market, several competitors had been offering margins as low as 65 basis points. Recently, average margins have been above 2%. Lessons learned from the pre-crisis “price war” will likely temper the speed of any future margin compression, as will the near-term lack of balance sheet capacity</li> <li>■ Future competition in both the primary and secondary markets may eventually result in lower margins, although this is unlikely as long as 10-year CMT and LIBOR swap rates remain near historical lows<sup>5</sup></li> <li>■ Lenders may begin trading off rates and fees to create customer choice while preserving all-in economics. Since consumers tend to be more sensitive to fees, this should also help to reduce any downward pressure on interest margins</li> </ul>
<b>Servicing fees</b>	<ul style="list-style-type: none"> <li>■ Lenders generally charge close to the maximum allowable by HUD (\$35 per month)</li> <li>■ Like origination fees, lenders may attempt to differentiate themselves on price in this area. Price differentiation will be particularly attractive for scale players, since servicing margins are currently high</li> </ul>
<b>Secondary market execution</b>	<ul style="list-style-type: none"> <li>■ Currently the Government Sponsored Enterprises (GSEs) are the only buyers in the market, which has depressed gain on sale prices</li> <li>■ Prices will rise as private institutions return to the secondary market. Several hundred basis points above par is not an unreasonable expectation over the long term if interest margins remain healthy</li> </ul>
<b>Risk</b>	<ul style="list-style-type: none"> <li>■ Primary risk burden (interest rate, home price and longevity) for HECM will continue to reside with HUD (though mortgage insurance pricing may change as a result of actuarial studies in progress)</li> <li>■ Credit risk, though minor, is partially borne by the lender – if the borrower is in breach of the contract (e.g. unpaid real estate taxes or insurance), the loan may not be assigned to HUD<sup>6</sup></li> <li>■ Lenders may choose to adopt non-credit risk burden by holding loans on the balance sheet and choosing not to assign loans to HUD</li> </ul>

5 LTVs offered to customers for HECMs are based on the borrower’s age and the expected interest rate (the 10-year CMT or LIBOR swap rate plus the interest margin) at the time the application is processed. For all expected interest rates 5.5% and lower, the LTV is the same for any given age level. As a result, consumers will be largely indifferent to interest margins provided that the total rate is 5.5% or less

6 Loans become eligible for assignment to HUD when the balance on the account exceeds 98% of the principal limit. At this time, the entire financial and servicing burden is placed on HUD and the lender is paid the balance immediately. The lender may opt not to proceed with loan assignment, preferring to continue accruing interest. If this occurs, the lender is responsible for financing and servicing the loan until the account is terminated. At that time, if there is a shortfall between

## Opportunities for market participants

With a nascent and burgeoning market supported by government guaranteed pricing and liquid secondary markets, the question for potential providers should not be whether to compete, but how. Although we believe there are significant opportunities for specialist manufacturers and investors, the largest untapped opportunity remains in distribution.

For new competitors, the first priority should simply be to develop basic distribution capabilities to get a toe hold in the market. In our experience, these initial moves require relatively little investment and can be accomplished quickly. Institutions with idle staff and infrastructure, formerly used for 1st mortgage or home equity originations, can repurpose these resources for reverse mortgage sales and fulfillment. In addition, because the target segment is well defined and generally geographically concentrated, marketing spend can be used very efficiently to generate leads. Our experience suggests that with proper training and marketing support, new sales staff can perform at industry average production levels within 2 to 3 months.

The choice of distribution method for new entrants should be guided by the existing capabilities and business model of the organization. Today, market participants leverage two distribution models – direct remote call center and distributed specialist retail sales.<sup>7</sup> Two of the most recent entrants into the market, Genworth and MetLife have pursued primarily remote models by buying and scaling existing platforms (Liberty and EverBank respectively). At the same time, both Bank of America and Wells Fargo have built large distributed sales forces.<sup>8</sup> As demonstrated by both institutions, success with the retail model requires both effectively leveraging existing sales infrastructure and committing longer term to development of the channel.

Currently, the value chain in the reverse mortgage market is not well parsed, as most companies serve as both manufacturer and distributor, while a single investor holds the vast majority of the risk post-origination. Over time, we expect this value chain to break apart significantly as competitors differentiate their roles within and across

---

<sup>7</sup> With the HECM Advisor program eliminated in the Housing and Economic Recovery Act of 2008, there is no longer a wholesale channel in reverse mortgage

<sup>8</sup> Bank of America supplemented the business built in house with the Seattle Financial and Countrywide reverse mortgage businesses it subsequently acquired

different functions – likely by bifurcating into efficient monolines on the one hand, and integrated solutions providers on the other. Today, the monoline model dominates as lenders shy away from integrating their reverse mortgage product suite and sales force with other products and services targeted towards seniors<sup>9</sup>. It is only a matter of time, however, before both regulators and business leaders start viewing reverse mortgages not only as a one-off transactional sale, but as a potential cornerstone relationship product of a retirement solutions suite. This view will require a new approach to distribution: a dedicated sales force focused on serving the full range of unique financial needs of the elderly (e.g. retirement planning, asset drawdown, tapping home equity, etc.). This new approach will also include a significant management issue around compliance and incentives to avoid undue reputational risk.

While both monoline and integrated solutions models will profitably persist in the long-run, we believe that successful execution of the integrated strategy provides three unique benefits: enhanced stability through the economic cycle, decreased reliance on the ability to attract and retain commissioned sellers and a platform for serving the growing retired population with a broad range of products and services.

As the end-game winners emerge in distribution, opportunities will be created in other parts of the value chain as well. Although we believe that HECM will continue to dominate in the medium term, the market will eventually grow to support niche opportunities for product design expertise. In particular, we believe that institutions with strategic advantage in risk management (e.g. health, life and mortgage insurers) will play a critical role in developing, supporting, and packaging proprietary products to complement the market leading HECM. Furthermore, with secondary market pricing near historic lows, there is a clear opportunity for investors. Reverse mortgages have highly desirable characteristics as balance sheet assets (long-duration, no credit risk, etc.) and have been successfully securitized in a variety of structures.

---

<sup>9</sup> Some separation is mandatory given anti-bundling regulations, while other separation (e.g. single product sales forces) is done largely to manage reputational risk in a historically scrutinized industry

## Conclusion

The reverse mortgage market has survived the credit crisis intact and the future of the industry looks bright. The demographic and economic imperatives for the product are as strong as they have ever been and Congress's passage of the Housing and Economic Recovery Act of 2008 signals that the Federal Government is committed to the sustainability of the HECM program.

There are significant opportunities in the industry for both new and existing players, particularly with regard to distribution. Over the next five years, we recommend that financial institutions proceed aggressively in the reverse mortgage space. We see the market developing as follows:

### ■ Near term (12 to 24 months)

- **Outlook:** New players enter the market. Limited innovation and differentiation
- **Recommendation:** Institutions without a reverse mortgage business should build or buy a basic platform to originate HECMs. Clever new features and sophisticated platforms need not be developed. Choosing an effective distribution model will be the most crucial decision and will differ by institution. Early entrants should grow aggressively while competition is still limited

### ■ Medium term (2 to 4 years)

- **Outlook:** More differentiation across the value chain. Specialization begins to drive efficiency gains
- **Recommendation:** Institutions should determine long term ambitions for their reverse mortgage businesses. Some may choose to silo the business as an independently profitable unit, while others will integrate it with their broader retirement businesses. These decisions will dictate the direction of distribution strategies and will help institutions optimize their platforms

### ■ Long term (4 to 5 years and beyond)

- **Outlook:** Bifurcation of business models into monoline and integrated solutions. Significant product innovation
- **Recommendation:** Institutions should begin looking for ways to differentiate themselves, both in the eyes of consumers and investors. Key innovations will likely take place in distribution and risk management

We expect that within 5 to 10 years, reverse mortgages will be a standard element, if not the centerpiece, of financial institutions' solution suites for senior citizens. However, entering will become increasingly difficult as today's market leaders continue to invest and solidify their dominant positions. Institutions with an ambition to compete in the retirement space should therefore determine their reverse mortgage strategies before the banking sector recovers. Managers who choose to ignore the industry in the near-term will look back on this period as a missed opportunity.



Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development.

**About the authors:**

**Todd Solash** is a Partner in the North American Insurance practice.

**David Goldberg** is an Engagement Manager in the North American Wealth & Asset Management practice.

**Ben Hoffman** is an Engagement Manager in the North American Retail & Business Banking practice.

For more information please contact the marketing department by email at [marketing.fs@oliverwyman.com](mailto:marketing.fs@oliverwyman.com) or by phone at one of the following locations:

**North America**

+1 212 541 8100

**EMEA**

+44 20 7333 8333

**Asia Pacific**

+65 6510 9700

Copyright © 2009 Oliver Wyman. All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman.

This report is not a substitute for tailored professional advice on how a specific financial institution should execute its strategy. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisers. Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages. This report may not be sold without the written consent of Oliver Wyman.



MARSH MERCER KROLL  
GUY CARPENTER OLIVER WYMAN