RISKS AND POLICY ISSUES ASSOCIATED WITH REVERSE MORTGAGE LOANS

Accounting for Reverse Mortgages

The accounting for reverse mortgages, including the recognition of interest and fee income, should be in accordance with instructions provided by the staff of the Securities and Exchange Commission (SEC), in an October 1992 paper, "Accounting for Pools of Uninsured Residential Reverse Mortgage Contracts." In general, the SEC instructions require the grouping of individual reverse mortgages into pools, and then adjusting the carrying value of, and recognizing income on the pools based on the retrospective yield. The retrospective yield is the effective yield from inception of the mortgages, which reflects both actual cash flows to date and expected future cash flows.

The SEC instructions require that estimates of future cash flows incorporate actuarial projections of mortgage terminations, including assumptions about life expectancy, prepayments, and borrower relocation, and projections of collateral values. At each reporting date, the analysis of actual cash flows to date and expected future cash flows is to be updated, and the retrospective yield is to be recomputed. The carrying value of each pool of reverse mortgage loans represents the recorded investment in the loans, adjusted on a cumulative basis for income recognized based on the retrospective yield. Considering the complex accounting issues involved with reverse mortgage lending, savings associations are cautioned against engaging in such programs unless their accounting staffs have the knowledge and experience to deal with such issues.

Classification of Reverse Mortgage Loans

Savings associations should classify reverse mortgage loans in accordance with the OTS Classification of Assets regulation 12 CFR § 560.160 and OTS bulletins and policy statements. The OTS regulation directs federal savings associations to classify assets based on well-defined weaknesses. Assets are classified Substandard, Doubtful, or Loss based on the degree and likelihood that the association would sustain a loss on the assets.

Unlike standard mortgage loans, reverse mortgage loans are repaid from the proceeds of the sale of collateral, not monthly borrower payments. As such, reverse mortgage loans that are not insured by an agency of the federal government should be classified based on the ability of the collateral to support the loan. A loan should be adversely classified if the recorded investment in the loan (including accumulated advances to borrowers, accrued fees, accrued interest, deferred net fees, and any unamortized purchase premium or discount[1]) exceeds the estimated net proceeds from the sale of the security property, based on the most current value of the property (based on an appraisal or evaluation). Disposition costs, such as real estate commissions, attorney's fees, settlement costs, etc., reduce the

[1] The contra account resulting from the application of the retrospective yield approach, if determined on a pool basis, should not be deducted in arriving at the recorded investment. (Specific valuation allowances, however, can be deducted from the loan balance in arriving at the recorded investment.) This is because the classification decision is made on a loan-by-loan basis. Also, because this contra account is not available to absorb losses in the association's entire portfolio, it cannot be included in the association's allowance for loan and lease losses (ALLL) for purposes of the risk-based capital regulation.

amount realized from the sale of the property. Therefore, unless an association can show that its disposition costs will likely be less than 10 percent, it should classify loans with a loan-to-value (LTV) ratio (based on the current appraised value of the property) greater than 90 percent as no less severe than Substandard.[2] It should be noted that loan amounts greater than the expected net disposition value of the property should be netted from the loan by additions to the retrospective yield contra account. Therefore, classifying such amounts Loss is not necessary.

Risk-Based Capital Rule Treatment

Reverse mortgages are treated as follows under the risk-based capital rule:

On-balance-sheet amounts are treated like other mortgage loans. Reverse mortgage loans that meet the requirements for "qualifying mortgage loans" (including LTV ratio and performance requirements) are risk-weighted at 50 percent. Once the loan no longer qualifies as a "qualifying mortgage loan" (such as when the LTV ratio is 90 percent or higher), the loan should be risk-weighted at 100 percent. (The LTV ratio, for the capital rule purposes, is computed using the recorded investment in the loan as the numerator and the original property value as the denominator.)

The off-balance-sheet commitment amount is first converted to an on-balance-sheet credit equivalent amount and then risk-weighted in the same fashion as the on-balance-sheet asset. Savings associations should use the 50 percent credit conversion factor for the off-balance-sheet commitment. (The 50 percent credit conversion factor assumes that the commitment is not cancelable by the association. Unconditionally cancelable commitments do not have to be included in the calculation of risk-weighted assets.) The amount of the off-balance-sheet commitment is determined by multiplying the number of remaining payments[3] by the amount of the advance to be paid each period. The off-balance-sheet commitment amount must be recalculated annually. For line of credit loans, which contain a cap on the dollar amount to be provided to the borrower, the off-balance-sheet commitment is the undisbursed line of credit amount.

Although pool accounting may be used to determine an association's yield on its reverse mortgage investment, the risk-based capital requirement must be calculated separately for each loan.

Mortality/Relocation Estimates

In order to estimate how long a savings association will have to make payments under the tenure reverse mortgage loan contracts, it must assess each borrower's life expectancy. Such estimates are generally made using mortality rates, published by the U.S. Bureau of the Census, or actuarial tables

[2] Because reverse mortgage loans are accounted for using the retrospective yield method, which requires a contra account for uncollectible amounts, it is not necessary that uncollectible amounts be classified Loss. An ALLL is not automatically required on reverse mortgage loans classified Substandard. However, general allowances should be established for reverse mortgage loans if the association is likely to experience losses on the disposition of the security property that are not reflected in the recorded investment. The level of any required ALLL on reverse mortgage loans should be based on the association's historical net loss experience for reverse mortgage loans, adjusted for current conditions and trends.

[3] For tenure loans, the number of remaining payments is usually equal to the estimated number of remaining months of a borrower's life, based on a third-party, independent actuarial table.

available from life insurance companies.[4] It is important that an association use current actuarial tables from a reliable and independent source (preferably from a major life insurance company or some other entity that has proven expertise and reliability). Also, consideration should be given to whether national mortality norms can be expected to hold for the association's particular area and mix of borrowers. There is the risk that a particular population will not behave as predicted by national mortality and relocation norms. Persons who apply for reverse mortgages may not be representative of the general population, so there is the potential for the mortality rates of an association's borrowers to deviate significantly from published tables. Therefore, an association should perform a sensitivity analysis on the effect a range of alternative mortality rates would have on the program's profitability.

Some reverse mortgage lenders use both mortality and relocation rates to estimate when the reverse mortgage contract will terminate. Typically, a reverse mortgage loan is expected to terminate when the borrower either moves or dies. Since senior citizens often relocate before they die, the use of relocation rates allow for contract term estimates to be shorter and allow lenders to justify larger payments to the borrower. Federal savings associations are urged to use caution when adopting relocation rates for the general elderly population, because reverse mortgage borrowers may alter their relocation patterns in light of the fact that they will continue to receive monthly payments from the lender as long as they remain in their homes.

Appraisals and the Requirement for Reappraisals

As with other real estate loans, the provisions of 12 CFR Part 564 establish when an appraisal or evaluation is required for a reverse mortgage loan. There are no specific requirements for reappraisals or reevaluations after a loan is made; however, as with other types of real estate loans, the association should periodically assess the value of the collateral supporting its loans. This is particularly important for reverse mortgage loans because the loan balance increases over time and the collateral is the primary source of repayment.

As stated in Thrift Bulletin 55, Real Estate Appraisal and Evaluation Guidelines, the useful life of an appraisal or evaluation will vary depending on the property and the market place. Management should determine if there have been material changes to the appraisal's or evaluation's underlying assumptions that affect the original estimate of value. Factors that could cause material changes in property values include:

- Passage of time.
- Market volatility.
- Availability of financing.

[4] Insurance companies use actuarial tables (also referred to as annuity tables) to determine the monthly amount they can profitably pay to a purchaser of their annuity products. Actuarial tables differ from mortality tables in that they have built-in assumptions that annuitants will die at a slower rate (generally 65 percent to 85 percent) than indicated by mortality tables. This assumption serves two purposes: (1) it protects the insurance company in the event that annuitants live longer than projected by mortality tables, and (2) it allows the insurance company to build a profit into the annuity product.

- The inventory of unsold homes in the marketplace.
- New improvements to, or lack of maintenance on the security property or surrounding properties.
- Zoning changes.
- Changes in the local economy.

If the useful life of an appraisal or evaluation becomes suspect, management should determine whether there is a need for a reappraisal or reevaluation. Where property values have changed significantly from when the loan was originated, a new appraisal or evaluation may be warranted.

This is particularly important if property values have declined or if the loan balance of an individual loan approaches the anticipated market value of the security property. A significant change in property value will result in a corresponding increase or decrease in the estimated net collateral proceeds at contract termination and, therefore, an adjustment to the association's effective yield on the loan.

Property Appreciation Assumptions

Reverse mortgage loan programs often assume that the security property will appreciate over the life of the loan. Integrating property appreciation assumptions into the loan contract allows lenders to offer higher payments to borrowers because the lender would ostensibly receive more funds from the sale of the property when the borrower dies or relocates. While appreciation assumptions may seem reasonable and supported by historical experience, in some markets the anticipated appreciation may not materialize, and, in other markets, properties that have experienced high appreciation rates over the past decade could experience substantial depreciation in the future.

Savings associations should analyze the characteristics and profitability of their reverse mortgage loans under a variety of appreciation and depreciation scenarios, including a "worst case" scenario of property depreciation such as those experienced in parts of California and Boston in the early 1990s. When estimating cash flows for accounting purposes, associations should adjust any appreciation or depreciation assumptions periodically during the life of the loan.

Finally, association management is encouraged to take a very conservative stance toward property appreciation and depreciation assumptions. It may be useful to structure contracts to withhold the appreciation portion of the payment until appreciation actually occurs. The benefit of this structure is that, if appreciation actually occurs, the association could justify higher payments to borrowers later in the contract, which, in effect, would provide borrowers with a hedge against inflation.

Interest-Rate Risk

Interest-rate risk is potentially high for fixed-rate reverse mortgage loans. Because of their negative amortization feature, fixed-rate reverse mortgage loans could have substantially greater interest-rate sensitivity than standard 30-year fixed-rate mortgage loans. The Thrift Financial Report's Consolidated

Maturity and Rate Schedule (Schedule CMR) does not have a separate category for reverse mortgages, so they must be reported as they are on Schedule SC. For purposes of Schedule CMR, the savings association should report the outstanding balance of reverse mortgages similar to the manner in which it reports other home mortgage loans, that is, the current outstanding balance (not the estimated future disbursements). The weighted average maturity should be based on the expected life of the loan, given mortality calculations.

Because Schedule CMR may not reflect the interest-rate sensitivity of reverse mortgages, savings associations that plan a significant investment in reverse mortgage loans should conduct an interest-rate sensitivity analysis. Such investment may require associations to undertake an internal interest-rate risk analysis required by Thrift Bulletin 13a, Management of Interest Rate Risk, Investment Securities, and Derivatives Activities.

Taxes and Insurance

To protect the collateral value of the security property, savings associations should ensure that real estate taxes are paid and that adequate hazard insurance is maintained. This becomes critically important as the borrower's equity diminishes, because they may have less incentive to pay real estate taxes. Savings associations are advised to monitor the payment of real estate taxes and insurance and to hold blanket hazard insurance policies to cover any lapse in coverage.

Property Maintenance

Adequate maintenance of the security property is critical to a reverse mortgage program. Although most reverse mortgage loan documents oblige borrowers to keep their property in good repair and otherwise maintain the value of the property, the borrowers may have little incentive or ability to do so. While typical reverse mortgage loan documents grant the lender the authority to make needed repairs and add the costs to the loan balance, such additions to the loan balance only increase the risks that there will be insufficient value in the home upon sale to cover the amount due. While the lender could conceivably declare default if the borrower fails to maintain the property, public relations considerations may preclude such action. Also, there are costs associated with property inspections to ensure that the borrower properly maintains the property. Therefore, lenders should consider the effect of deferred maintenance (or lender funded repairs) on the value of their investment.

Legal Requirements and Legal Risks

While reverse mortgage loans have been available for some time, the product is not in widespread use. Therefore, federal savings associations may not be thoroughly familiar with the statutory and regulatory requirements that will apply if they offer a reverse mortgage program. In addition, the contractual rights and obligations of borrowers and lenders in these transactions will differ significantly from those under, for example, purchase-money mortgage loan contracts. For these reasons, a savings association that offers, or intends to offer, a reverse mortgage program should consult its legal counsel to ensure that the program complies with applicable requirements and that any legal risks associated with these loans are adequately addressed. In this regard, the association should, at a minimum, consider the following laws and statutes:

Basic Authority

Federal savings associations have express authority, under the Home Owners' Loan Act (HOLA) and OTS regulations, to originate or purchase reverse mortgages, notwithstanding any contrary state laws. By virtue of the Alternative Mortgage Transaction Parity Act ("Parity Act"), 12 USC §§ 3801 et seq., state savings associations are also authorized to originate and purchase reverse mortgages even when state law purports to prohibit reverse mortgages, unless the state in question expressly "opted out" of the Parity Act within the three year period beginning on October 15, 1982, and ending on October 14, 1985. In "opt out" states, state law governs the permissibility of reverse mortgages for state savings associations. Federal savings associations are not subject to state law even in states that have exercised their "opt out" option.

Notwithstanding the foregoing, a special rule applies in the state of Texas. The HOLA provides deference to the specific provision in the Texas constitution that prohibits most non-purchase money liens against homesteads.

State Usury Laws

Some reverse mortgage loans have an annual premium feature designed to offset the risks that some borrowers may live longer than the mortality tables predict. If the annual loan fee is significant, the earlier the borrower repays the loan, the higher the effective cost of financing. For example, OTS is aware of some private programs that include an annual loan fee based on the value of the home, not the loan balance. A program with a 5 percent annual loan fee and a 10.5 percent interest rate would result in an effective interest rate of greater than 20 percent should the loan repay within the first 6 years.[5] Therefore, savings associations should determine whether state usury laws apply. Although federal law generally pre-empts the application of state usury laws to mortgage loans (including reverse mortgage loans) that are secured by first liens on residences, 12 USC § 1735f-7a, states were permitted to "opt out" of this pre-emption provision within the three year period beginning on April 1, 1980, and ending on March 31, 1983. Maximum interest rates in "opt out" states will either be governed by state law or the federal Most Favored Lender provision. 12 USC § 1463(g).

Disclosure Laws

Disclosures made to borrowers about reverse mortgage loans must comply with the Truth in Lending Act (TILA) and with the implementing regulation – Regulation Z – promulgated by the Federal Reserve Board. Lenders must provide reverse mortgage borrowers with full and accurate disclosures including, where appropriate, the loan's annual percentage rate and total finance charges. Borrowers must also be notified of their right to rescind the transaction. Also, savings associations should consider making annual percentage rate and finance charge disclosures under varying scenarios of property appreciation and borrower mortality.

In addition, the Community Development Banking Act amends the TILA to require that lenders make certain new disclosures regarding the projected total cost of a reverse mortgage loan to the borrower.

[5] The OTS would look unfavorably on such aggressive pricing, which may have a negative effect on the association's CRA rating.

Contractual Provisions

Circumstances unique to reverse mortgage transactions may affect both the borrower's ability to comply with the terms of the reverse mortgage loan contract and the association's ability to recover possession of the security property at the appropriate time. For example, an elderly borrower receiving a modest fixed income may lack the resources to maintain the security property as called for under the reverse mortgage loan contract. A borrower's heirs may be unaware that he or she has taken out a reverse mortgage and may, upon the borrower's death, challenge the association's right to take possession of the property. While no contractual provision can eliminate the possibility that these problems will arise, foresight and careful drafting of the reverse mortgage loan documents may mitigate the legal risk they present for the association. Savings associations may also reduce their legal risk by ensuring that borrowers understand the practical consequences of the rights and obligations that the reverse mortgage loan contract creates. Savings associations should therefore consider encouraging borrowers to seek independent credit counseling as part of their reverse mortgage programs.

Government Guaranteed Reverse Mortgage Programs

The Department of Housing and Urban Development (HUD), through the Federal Housing Association (FHA), offers a reverse mortgage guarantee program that lenders may participate in. The FHA program is similar to reverse mortgage programs discussed above, except that FHA guarantees payment to the borrower (in the event the lender should become unable to meet its payment obligations to the borrower) and guarantees the lender's investment. Under the program, borrowers pay FHA a mortgage insurance premium (MIP), consisting of an up-front fee of two percent of the maximum claim amount, plus an annual premium of one-half of one percent of the outstanding loan balance. Under the FHA program, the maximum claim amount is the maximum dollar amount that the FHA can insure for a particular geographical area. The MIP, which can be financed, provides a fund to absorb losses in the event that the mortgage balance on some loans exceeds the value of the property at the time the loan becomes due and payable.

The FHA guarantee is structured so that once the balance of a guaranteed loan reaches 98 percent of the maximum claim amount, the lender has the option of assigning the mortgage to FHA, thus eliminating the likelihood of loss to the lender. FHA's loan guarantee is limited to a maximum of the lesser of the appraised value of the house or the maximum dollar amount that the FHA can insure for single-family residences in a geographical area (currently $67,500 to $227,550). As mentioned above, the FHA program bases payments on the assumption that a borrower will live to age 100, so monthly payments to a typical FHA program borrower may be lower than payments under programs that use actuarial life expectancies.[6] Also, interest rates on the FHA reverse mortgage program are often lower than the rates charged by private programs.

As with other FHA guaranteed loans, the guaranteed portion of these loans is risk-weighted at 20 percent for the risk-based capital rule.

[6] The fact that an association's reverse mortgage loan program may have specific features that are very conservative does not ensure that the program as a whole is prudent. Similarly, the fact that the association bases expected loan terms on current actuarial tables, rather than the very conservative mortality assumptions used by the FHA, does not mean that, taken as a whole, the lender's reverse mortgage lending program is imprudent.

Another positive aspect of the FHA program is that Fannie Mae will purchase an association's reverse mortgage loans made under the FHA program. Because of the federal guarantee, an association's participation in this or similar government guaranteed reverse mortgage loan programs alleviate many of the safety and soundness concerns discussed above.