OPPORTUNITIES IN HOME EQUITY CONVERSION FOR THE ELDERLY

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OPPORTUNITIES IN HOME EQUITY CONVERSION FOR THE ELDERLY

TUESDAY, JULY 20, 1982

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, D.C.

The committee met, pursuant to notice, at 9:40 a.m., in room 3302, Dirksen Senate Office Building, Hon. John Heinz, chairman, presiding.

Present: Senators Heinz and Cohen.

Also present: John C. Rother, staff director and chief counsel; E. Bentley Lipscomb, minority staff director; Mary Parker, professional staff member; Kate Clarke, communications director; Robin L. Kropf, chief clerk; Angela Thimis, staff assistant; and Eugene R. Cummings, printing assistant.

OPENING STATEMENT BY SENATOR JOHN HEINZ, CHAIRMAN

Senator HEINZ. Today, the Senate Special Committee on Aging will explore the relatively new and promising idea of converting home equity to an income source for elderly homeowners. Both the White House Conference on Aging and the President's Commission on Housing have recently recommended that the Federal Government take a more active role in making home equity conversion available on a national basis.

The potential benefit of these arrangements is enormous. Americans over age 65 today own 12½ million homes, 80 percent of which are free and clear of any mortgage debt. The total value of the equity held by older Americans is over $600 billion. Obviously, millions of older Americans could greatly benefit from the ability to draw on home equity to meet monthly income needs, to finance home repair and maintenance, or to pay major medical expenses.

At present, financial mechanisms are not widely available which enable homeowners to turn their homes into income, while continuing to live in the home. However, several ways to accomplish this have been tried; for example:

A loan, called a reverse equity loan, can be made to the homeowner in monthly payments, which is not repaid until the house is sold or until the term of the loan ends.

An investor can purchase the house from the homeowner and lease it back with a lifetime tenancy agreement, a sale/leaseback contract.

Or a third alternative, a public or nonprofit body can purchase an equity interest in the house, giving the older homeowner a guarantee of lifetime income and residence—a split-equity arrangement.

The purpose of today's hearing is to explore the remaining barriers to the national development of this idea in light of our present experience with varied demonstration programs from around the country. The hearing should bring into focus the possible ways in which Federal agencies can assist in making income from home equity more accessible to elderly homeowners.

As with any new idea, there are potential problems with home equity conversion. There is always the risk of fraud in representation of benefit claims, although no problems have yet occurred. Since for most homeowners, older and otherwise, their homes represent their major lifetime investment, an added purpose of this hearing is to identify possible abuses. Thus, as model equity conversion plans are developed, protections can be built in at the outset.

Because of the great potential of this idea, and because of the increased awareness of both the opportunities and risks is important at this time for both lending institutions and homeowners, the committee has prepared an information print on this subject. I am pleased to release it today. Its title is, "Turning Home Equity Into Income for Older Homeowners." I believe it is available to you all.

Today's hearing is the first congressional hearing concerning this issue. I welcome our witnesses and look forward to their testimony. I hope that today we can move toward a definition of the remaining steps necessary to truly unlock the value of home equity for the millions of older Americans who can appropriately benefit from its promise.

Before I call on our witnesses, I would like to turn to Senator Bill Cohen of Maine who has shown such a great interest on the Committee on Aging.

Senator Cohen.

STATEMENT BY SENATOR WILLIAM S. COHEN

Senator COHEN. Thank you very much, Mr. Chairman.

I want to commend you for holding what I consider to be very important hearings on a concept which is new to many people, both to homeowners and people alike.

You were correct in pointing out that equity conversion today holds great promise. I was also pleased to hear you mention that there are some problems associated with this. I think that most older people who have spent their life savings and paid off their mortgage at an early age are reluctant to put a lien on that property in their remaining years.

Also, there is an attitudinal obstacle that has to be overcome in dealing with that.

Second, I think that most people, older people included, want to leave something behind, something for their heirs, for their children. That may include their home.

Third, I point out that in States like Maine, we have some of the oldest, if not the oldest, housing stock in the Nation. Many investors—or lenders—would be reluctant to loan money out on homes that have not appreciated very significantly over the years, that are not terribly energy efficient, and would require substantial investment on their part to make it a wise investment.

Fourth, I think that a person is going to want to know what happens if he or she outlives the mortgage term.

Last night's oldtimers' all-star game is a reminder of that, where a 75-year-old man hit a home run.

If a person takes out a mortgage, for example, at the age of 65, and the mortgage is for 10 years, and at 80 he or she is still going strong, what happens to the nature of the relationship between the bank and that person?

So that is a question that remains to be answered.

Finally, I would suggest we also have to deal with the question of whether or not they would be disqualified from benefits they might now be receiving, such as SSI or other State and local programs, if in fact they will now have income as a result of converting that equity into cash. That is something that would have to be clarified through the course of these hearings.

Those are some of the issues that would be in the minds of the elderly population. Frankly, we have seen some attempts in my own State of Maine to utilize this device and it has not proven particulary useful. Perhaps we can address those this morning.

Senator HEINZ. I thank you for making some excellent points that I am sure our witnesses would like to address.

Before we hear from the witnesses, I am going to insert the statements of four members of our committee into the record. The statements are from Senators Pressler, Grassley, Pryor, and Dodd.

[The statements of Senators Pressler, Grassley, Pryor, and Dodd follow:]

STATEMENT OF SENATOR LARRY PRESSLER

Mr. Chairman, I would like to commend you for holding this hearing on this very important subject. Although home equity conversion has long been hailed as a major opportunity to provide income security to older Americans, little has been done to foster the use of this option.

It is commonly agreed among those working in the field that older Americans' homes are their most common and most valuable asset. Recent statistics indicate that of the three out of every four older persons who own their homes, 80 percent do not have a mortgage. Yet most of these people live on a fixed income and are never able to benefit from the investment they have in their homes. Financial counseling should, of course, be a part of any homeowner's decision to convert home equity. Clearly, the disposition of the property at the end of the term, or when the homeowner dies, must be worked out to the satisfaction of the lender, the homeowner, and the heirs. I believe that these terms can be arranged to satisfy all parties involved, and that home equity conversion can be a great boon to many older persons.

I am proud to note that my home State of South Dakota has taken steps to specifically exempt reverse mortgage loan proceeds, both interest and earnings, from consideration in determining initial or continuing eligibility for, or the amount of, medical or public assistance. South Dakota is, in fact, the only State that has taken this course of action, but I would like to encourage others to do so, in order to allow those who use home equity conversion plans to maintain their eligibility for benefit programs such as medicaid.

It is my hope that this hearing will provide a body of information that can be made available to those who might wish to make use of a home equity conversion plan. I hope that we will see this option achieve widespread use in the years ahead, for I believe it can provide well-deserved security for many of our older citizens.

STATEMENT OF SENATOR CHARLES E. GRASSLEY

Mr. Chairman, I congratulate you on holding this hearing. It is not a subject that is likely to generate a lot of spectacular press but it is a subject that needs the type of exposure this hearing, and the very informative information paper released today, by this committee, will give.

The very discussion of equity conversion can prompt families to deal with the realities of augmenting elderly relatives' income, while allowing them to stay in the familiar surrounding of their home.

Financial institutions must be convinced that through a delicate area of mortgage lending there are social and financial rewards awaiting those who openly and imaginatively approach equity conversion as a source of service to the elderly in their communities.

I know that elderly homeowners are reluctant to discuss incurring the debt of a mortgage on their homestead, but the same homeowner is most often equally reluctant to leave the familiar surroundings of that homestead. This hearing and the discussion and information it will generate will go far to resolve these two strong feelings shared by America's elderly population.

I look forward to reading what is presented here today.

STATEMENT OF SENATOR DAVID PRYOR

Mr. Chairman, I am pleased that the Special Committee on Aging has chosen to explore the concept of home equity conversion. We are all aware that this is one very viable solution for many elderly homeowners who have cash flow difficulties because most of their resources are tied up in home mortgages. A few facts highlight the importance of examining this issue:

Three out of every four elderly persons own their own homes and of these, 80 percent have no mortgage on that property.

Six out of every 10 elderly single homeowners have incomes of $5,000 or less.

Home equity held by older Americans is estimated at more than $600 billion.

Studies show that one-fourth of all low-income elderly homeowners could raise their incomes above the poverty level if they could draw on their equity.

Unfortunately, there are very few options currently available to the elderly homeowner who finds himself in the "house rich" predicament. In most cases his only alternative is to sell the home, often times at a loss, because the home has fallen into disrepair and the owner is unable to repair it for lack of funds, or it is situated in a neighborhood that has deteriorated since the time it was originally purchased. Very often the senior citizen winds up selling his home, and moving into a rental unit which, in the long run, drains much more of his home than if he were able to remain in his own home. Perhaps the most unfortunate aspect of this type of situation is that the individual may suffer psychologically, because he has been uprooted from familiar and comforting surroundings. He has also been forced to liquidate the one possession he has spent his lifetime trying to acquire—his home.

It is encouraging to know that, while still very much in the demonstration phase, home equity conversion plans are proving to be a very creative and positive alternative to sale of homes. Through the use of reverse annuity mortgages and sale/leaseback plans many senior Americans have been able to continue living in their homes. Many other seniors have been provided with the cash liquidity necessary so that they can make many needed repairs on their homes and thereby improve their standard of living. This is a particularly significant opportunity as older dwellers tend to live in older homes, which are generally harder to maintain due to less efficient heating-cooling systems. I am sure we will hear some very excellent examples this morning through the testimony of our first panel of witnesses.

I think it is very important that we begin to pull together the available information on this issue with the goal of identifying exactly what needs to be done in order to provide this innovative option nationwide to our senior citizens. And at the same time, we must remain ever mindful of the limitations of these types of conversion plans.

I want to take this opportunity, Mr. Chairman, to commend you for holding this hearing today, and would like to also commend the staff of the Special Committee on Aging which has put together an extremely thorough and helpful information paper on home equity conversion. I am hopeful that the successful execution of these conversion plans will lead to even more creative and innovative uses of other types of equity currently held by our senior citizens. I look forward to the testimony of today's expert witnesses.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Mr. Chairman, I wish to commend you for holding this hearing this morning to explore ways to help senior homeowners convert their home equity into income without making them leave their homes.

This past February, I held a hearing in my State of Connecticut, sponsored by this committee, focusing on the special housing problems of older citizens. At that time, I learned that 69 percent of all Connecticut's retired citizens own their own homes. I believe that the nationwide figure is even higher, or some 75 percent.

Far too many of these senior homeowners find themselves "house-rich but cash-poor." Such seniors have limited, often fixed incomes, making it impossible for them to repair or pay for the upkeep of the houses they own. Some cannot even afford to pay the rapidly skyrocketing costs of heating and lighting their homes.

Despite the fact that millions of retired homeowners are faced with the prospect of spending more and more of their limited, monthly income on utility and repair bills and less on other essentials such as food, the vast majority do not wish to move. In Connecticut, I discovered that of all 522,000 senior residents, both homeowners and renters included, only 15 percent or some 78,000 expressed any inkling of a desire to move. The percentage of just older homeowners in the State who wish to leave their homes is even lower than that.

We have to do something to help those homeowners who need to convert some of their "house riches" into cash to pay the bills. Provided thorough consumer safeguards are put into place, home equity conversion programs offer us one possible option.

Reverse annuity mortgages allow lenders to pay cash to older homeowners periodically in exchange for a portion of the value of the home in question. Deferred payment loans would help retired homeowners to borrow money to pay repair and maintenance bills. Neither the principal nor the interest from such loans, however, would have to be paid until the homes in question were sold. In addition, split equity or sale/leaseback arrangements would assist seniors to sell their homes to investors who in turn would lease the property to the owner rent-free.

Such programs are complicated, indeed, Mr. Chairman. We must study them carefully and methodically to insure that senior homeowners who wish to take advantage of such programs are provided with all necessary disclosure information.

And, at the same time, we have to be thinking about other new ways to assist all older Americans with housing problems, from home-sharing arrangements where seniors rent out rooms to others, accessory apartments where separate living quarters are built into family homes, and elder cottages built behind family homes, to special projects such as congregate housing. To this end, Mr. Chairman, I will be introducing a bill this week calling for a HUD demonstration project to explore all varieties of ways to meet the unique housing problems of senior citizens, including home equity conversion.

In closing, I would like to mention that a few weeks ago the health coordinating council in my State reported that Connecticut could be spending nearly $1 billion a year on nursing home care by 1990 unless alternative housing for seniors is found. Given the administration's proposed changes in surveying nursing homes, the problems and expense of insuring quality long-term care are very much in our thoughts these days. Your excellent hearing on this subject last week, Mr. Chairman, certainly expressed this committee's concern about all seniors who have to reside in nursing homes.

It would be tragic if we didn't do all we could to prevent certain retired homeowners from being institutionalized simply because they cannot afford to modify their homes to accommodate a wheelchair, guardrail, and other self-help needs.

Home equity conversion programs could help provide some financial assistance for such alterations.

Mr. Chairman, again, I commend you for holding this hearing. I look forward to this committee continuing to hold hearings on ways to solve the acute housing problems so many older Americans face today.

Senator HEINZ. I would like to call our first panel which consists of Kenneth Scholen, Maurice Weinrobe, Jack Guttentag, and James Firman.

Gentlemen, you come from diverse States, somewhat diverse backgrounds. I would like to ask Mr. Scholen to begin, and then Mr. Weinrobe, Mr. Guttentag, and Mr. Firman.

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STATEMENT OF KENNETH SCHOLEN, DIRECTOR, NATIONAL CENTER FOR HOME EQUITY CONVERSION, MADISON, WIS.

Mr. SCHOLEN. Good morning, Senator Heinz and Senator Cohen. Thank you for focusing your attention today on an important new idea for older Americans.

As you know, most older people do own a home free and clear of mortgage debt. This home equity "nest egg" is their single most important financial asset. But until recently, the only way they could cash in on this resource was to sell it—and to move. Now, we are seeing across the country a variety of efforts to develop ways for older persons to unlock their home equity while they remain in their homes. These home equity conversion plans can be placed in one of three general categories—reverse mortgages, sale plans, and special purpose loans.

Reverse mortgages provide monthly loan advances to a homeowner over a given term of years, with all loan repayment deferred until the end of the term. This instrument has developed in three ways: First, a handful of small- to medium-sized lending institutions have independently developed a product and made a limited number of loans, usually on a trial or community relations basis; second, a nonprofit development agency in San Francisco has mounted a major, statewide demonstration effort involving several substantial lending institutions; and third, a New Jersey firm is developing a large-scale, risk-pooling approach that relates the loan term to the borrower's age, and trades off a below market interest rate for a share in future appreciation.

These efforts have pinpointed two major factors in the further development of reverse mortgage lending. One is simply the cost of information and consumer counseling in the early stages of a different and complex idea. The other factor is the need for a secondary market and insurance structure for dispersing the different and complex risks associated with these new instruments.

Another general type of home equity conversion involves the sale of some of the equity in the home with the seller retaining occupancy rights until death. One of these plans—the sale/leaseback—has been developed by a few realtors in California, Florida, Oregon, and the District of Columbia. A serious development issue related to this instrument is the need for detailed guidelines on the Federal income tax consequences of specific plans. A second issue is the complexity of the contract. It combines aspects of real estate finance, landlord-tenant law, and personal financial planning. Since most of the details are open to negotiation, the merits of any particular deal are difficult to evaluate.

A second type of sale plan is now being tested by a nonprofit organization in Buffalo. This plan involves an annuity pool and is strongly targeted to housing conservation goals.

The third general category of home equity conversion includes several types of special purpose loans. None of these loans have to be repaid until the borrower dies or sells the home. But all loan advances must be used for a specified purpose such as home repairs, weatherization, property tax payment, or home health care. The major obstacles to these plans in the public and nonprofit sectors are the availability of loan capital, and further developments in program design.

All of these home equity conversion plans present a fundamentally new idea and different choices for older homeowners. Spending your equity while you live in your home is something that hasn't been done before. The instruments can be complex; they involve cost and risk; and they reduce your estate. Consumer demand, therefore, is likely to be quite small at first, and to grow slowly only as consumers gain positive experience with specific instruments.

The basic goals of home equity conversion are to expand the range of personal asset management choices, to increase the utility of private savings, and to create opportunities for greater economic independence for older Americans.

The sound development of this idea, however, will depend to a substantial degree on the support, vigilance, and public information efforts of organizations serving the elderly. For 2 years, the U.S. Department of Health and Human Services provided significant direct support to the early development process. This committee's involvement and concern add an important new element to that process.

Thank you.

Senator HEINZ. Mr. Scholen, thank you.

Mr. Weinrobe.

STATEMENT OF MAURICE D. WEINROBE, ASSOCIATE PROFESSOR OF ECONOMICS, CLARK UNIVERSITY, WORCESTER, MASS.

Mr. WEINROBE. Thank you, Mr. Chairman.

My name is Maurice Weinrobe. I am an associate professor of economics at Clark University and a special consultant to the reverse annuity program of San Francisco.

I would like to address the role of the private sector in providing instruments that will allow elderly to convert home equity into an income stream in a way that provides a decent income stream, yet maintains consumer safeguards that are consistent with consumer objectives, where the objectives are likely to be individual in their nature, and in a way that is profitable to the provider.

There are some simple rules that must be recognized in a private sector plan for providing for the release of home equity.

First of all, you cannot take more out of a property than is already there in an equity. If the equity in a property is $30,000, with consideration for interest, that is all that is going to come out of it.

Second, property appreciation is worth something. Potential property appreciation is worth something. But the other side of that is that the ability to dispose of property is also worth something.

And third, the laws of compound interest apply as much to home equity conversion as they do to any other financial matter.

Can the private sector on its own provide for home equity conversion?

I think the answer is unequivocably yes. If nothing else, it has been doing it for years. Children have been lending money to their parents, essentially as a loan against equity. Financial institutions provide second mortgages to the elderly and nonelderly, and there are a great number of individual sale/leaseback arrangements between independent parties that are exactly a release of home equity.

But the problem seems to be in going from these individually tailored arrangements to more general programs that involve either financial institutions or large pools of money. There are undoubtedly substantial problems with any program for the conversion of home equity. Reverse mortgages have been unsuccessful to date, as Senator Cohen noted, at least in part because they have been tied to annuities.

But, additionally, they have been unsuccessful because they have been poorly structured. They do not address the specific needs that reverse mortgages can take care of. Sale/leasebacks have seen more individual success than general success. There have been some recent attempts to develop sale/leaseback programs that would apply in a variety of areas of the country in a variety of circumstances, but they also face substantial problems, whether it be tax considerations, rent schedules that would be equitable to both parties, or simply establishing a fair price.

Finally, the latest arrangements for sharing equity or converting equity, the pool arrangements, show a great deal of promise, but they are not in place yet, and potentially there are statutory and regulatory problems as well as problems of acquiring the potential pool of funds for those arrangements to take place.

The development of a successful private sector plan is going to depend on the availability of a counseling process to guide the elderly through a decision that is traumatic and unfamiliar. But at the same time a private sector plan is going to have to be sufficiently well-defined that it appeals to those individuals who are willing to put their money forward to provide for the recapture of home equity.

Thank you very much.

Senator HEINZ. Mr. Weinrobe, thank you very much.

[The prepared statement of Mr. Weinrobe follows:]

PREPARED STATEMENT OF MAURICE D. WEINROBE

I. SOME PRINCIPLES FOR THE CONSIDERATION OF PRIVATE SECTOR HOME EQUITY CONVERSION INSTRUMENTS

I have been asked to address the matter of the role of the private sector in providing financial instruments that will allow elderly homeowners to convert home equity into an income stream. It is important to note at the outset that there are some implicit premises about such a conversion process:

(1) The income stream should be nontrivial, but it need not be the sole support for the person or couple—indeed, its most important function may be as an income supplement.

(2) The financial instrument should incorporate reasonable and sound consumer safeguards.

(3) The home equity conversion process should be sensitive to consumer objectives, and particularly to the fact that consumer objectives are nonhomogeneous—differing from one homeowner to another; and

(4) A reasonable private sector based instrument must be profitable to the provider.

The four premises for private sector instruments establish some ground rules for judging the quality of different instruments. The premises are not completely consistent with one another and may involve trade-offs. For example, the more consumer safeguards an instrument is designed to include, the less profitable the instrument may be to the provider.

Beyond the basic premises for private sector plans, there are also three simple rules or laws that pertain to home equity conversion instruments (HECI's) and that inescapably affect income to the elderly and profitability to the provider. It is unfortunate that these rules are not given more heed since they, more than anything, determine cash flows and rates of return.

Rule 1: One cannot take more out of a property than already is there as equity. Many home equity conversion programs are criticized on the grounds that they do not generate sufficient income. Quite apart from the criticism that "sufficiency" in general is an irrelevant concept (it depends on individual circumstances and objectives), because a property has a limited equity, it can only produce a limited income. It is not a fault of the home equity conversion process that equity is finite. The aim of the process should be to design a way of converting the fixed equity into the income stream that is most desirable, when there are a multitude of possible income streams that are contenders.

Rule 2: The laws of compound interest and theories of the interest rate apply to HECI's as much as to any other financial instruments. The criticism is often heard that a particular conversion plan will not work at high interest rates. There is no question that high interest rates reduce the income flow from most HECI's, but at the same time it must be recognized that the same high interest rates make money today more valuable than money tomorrow, and generally portend a higher level of prices (including property values) tomorrow than today. So while high interest rates reduce cash flow from the same equity, they may also signal that future equity will be higher than would otherwise be the case. A similar point concerns the effect of interest rates on the relationship between funds dispersed and funds repaid under HECI's. There is nothing special about HECI's in this regard. For example, in comparing a reverse mortgage with a standard (forward) mortgage with the same interest rate and term to maturity, the amount (or proportion) of interest paid will be the same.

Rule 3: Property appreciation is worth something, as is the ability to dispose of property at will. Different HECI's will have different income streams associated with them in part because the residual control or ownership of property differs. If a homeowner wants to maintain the residual ownership (at the end of a fixed term or at the end of life) that means the homeowner will have to give something up in the way of income produced from home equity. There is absolutely nothing wrong with an elderly homeowner wanting to maintain residual ownership in full or in part (again, the matter of differing objectives is relevant), but she or he must be prepared to accept a lower income stream as a consequence.

The above premises and rules provide a background that makes it much easier to consider and compare private sector plans for home equity conversion. I will now turn to a brief examination of some basic private sector plans.

II. CAN THE PRIVATE SECTOR PROVIDE FOR HOME EQUITY CONVERSION

There is no uncertainty about whether the private sector can provide for home equity conversion. The reason for this assertive response is simply that the private sector has been providing for HEC for a long time.

The most common form of HEC in the private sector is use of the standard home mortgage to release home equity. This is done via refinancing of existing debt, through the taking out of second mortgages against home equity, or through the increase in debt and recapture of equity at the time a homeowner sells one residence and purchases another. In 1976 and 1977 "* * * household borrowing against equity in existing homes * * * accounted for nearly half of total home mortgage debt formation * * *" [1] Arrangements more closely related to the elderly include individual sale/leasebacks, purchases by unrelated individuals of remainder interests in properties, and casual or formal arrangements between parents and children providing for a flow of income during the parent's life in exchange for a remainder interest.

The types of arrangements that exist for HEC for the elderly are limited in design and extent of coverage. In a sense, they are all individual in nature and nonprogrammatic. They generally require special relationships between parties or very

[1] David F. Seiders, "Mortgage Borrowing Against Equity in Existing Homes: Measurement, Generation, and Implications for Economic Activity." U.S. Board of Governors of the Federal Reserve System, Staff Economic Studies No. 96, 1978.

imaginative and innovative action on the part of an elderly homeowner. Further, they only take limited advantage of life or tenure expectancy. The significant improvements that can be expected to come from private section HEC plans are in the form of more general availability to the elderly and more efficient design with respect to the interests and characteristics of the elderly.

III. WILL THE PRIVATE SECTOR EXPAND HOME EQUITY CONVERSION FOR THE ELDERLY

There currently are three types of private sector HECI's in the design or implementation stage. These nascent instruments hold substantial promise but to date have not made great progress in converting home equity into income. A brief review of the three will highlight some of the problems they face.

Reverse mortgages.—Reverse mortgages or reverse annuity mortgages (RAM's) were initially developed with the idea that an annuity could be purchased with liberated home equity, and the annuity could then serve to generate income sufficient to pay income to the elderly homeowner as well as interest (or interest and principal) to a lender. This arrangement was not successful simply because of the relative interest rates on annuity contracts and mortgages. Fixed term RAM's without purchased annuities have been offered sporadically around the country, but with limited commercial success. Some of the reasons for the limited success include the lack of a secondary market, inadequate instrument design, and an unwarranted fear by lenders of the so-called "term problem."

It is unlikely that a secondary market in RAM's will develop until a substantial volume of loans is generated. This is simply due to the economies of scale of large-scale purchases of RAM's, especially as perceived by pension funds. If a government agency or sponsored agency was to initiate purchases of RAM's, this could well speed the process along, as it would encourage lenders to originate RAM's, which in turn would boost the volume of RAM's. The problem of instrument design is more tractable by the private sector.

A RAM represents a forward commitment of funds. One big problem of the first RAM's offered is that they were designed with fixed interest rates. In an environment of fixed rates there was little choice for that decision, but it also dictates the basic rule that a RAM must be profitable for the lender. It is little wonder that lenders approached fixed rate RAM's with restrained enthusiasm. There are other aspects of instrument design that should make RAM's more attractive to lenders or investors and to senior/homeowners (particularly commitment fees and graduated payment schedules), and in combination with the diminished risk to lenders of variable interest rates these changes in instrument design could markedly enhance RAM popularity.

The final difficulty with fixed term RAM's is the problem of what to do at maturity. Early evidence from pilot projects would seem to indicate that this perceived problem may have been overdramatized. Many term RAM's are taken down for special needs which are themselves of limited term, and the incidence of early payoff with RAM's seems to be rather high. As noted at the beginning, different individuals have different objectives and in a climate of various opportunities for HEC, term RAM's should appeal to those with matched term objectives. If that turns out to be the case, the real question becomes what number of elderly homeowners have objectives with predictable terms.

Sale/leaseback.—Sale/leaseback (S/L) arrangements for elderly homeowners are not uncommon, but to date they have rarely gone beyond the individual investor level. There are a few obstacles to S/L's becoming widespread. First an S/L is a real estate transaction, which in turn means that it may be subject to favorable tax treatment. On the other hand, however, it also means that S/L's must compete with other real estate transactions for investor funds. Many other real estate transactions have unequivocal favorable tax status and thus dominate S/L's, other things equal.

A sale/leaseback must include a lease arrangement that offers the senior a reasonable rent well into the future. Because the senior/renter will be somewhat tied to the residence it is important that the tie not be exploited. It also is important that the former homeowner have the right of tenancy protected under what otherwise might be unusual circumstances, including temporary confinements for medical reasons.

On the investor's side, it must be recognized that something is being given up in various lease provisions. Particularly important in this regard is the long-term nature of the lease, and possible restrictions on sale of the property. It follows that some discount from the ordinary market price of a property will probably be in order, but exactly what discount is equitable may be a difficult determination.

The fact that real estate concerns and securities dealers are becoming interested in S/L's for elderly homeowners is very encouraging. With some experimentation and perhaps with uniform documentation, S/L's on a large scale could begin to take place. This might include institutional investors acting as intermediaries, or limited partnerships, or other similar arrangements.

The third type of HECI in the design stage is a natural outgrowth of the two previously discussed instruments—a loan with a sharing of appreciation or equity. A RAM is a loan. A S/L is an equity transaction. One could combine the loan and equity sharing features in a shared appreciation RAM. Because of the somewhat greater variance of individual returns (i.e., actual returns on individual properties) with an equity or appreciation participation this type of HECI should by nature be pooled.

There are two obstacles to this combination instrument. First, if the loans must be pooled to provide for risk reduction, large scale is important. Second, because of the hybrid nature of the instrument it is possible that statutory/regulatory problems could be greater than with the other two instruments.

The discussion of the three HECI's has been oriented toward individual problems with each instrument. There are also problems that apply to all three instruments and, indeed, to the existence of any private sector plan for HEC. That is the subject of the concluding section.

IV. GENERAL CONSIDERATIONS ON PRIVATE SECTOR PROGRAMS FOR HOME EQUITY CONVERSION FOR THE ELDERLY

The development of individual private sector programs for home equity conversion for the elderly will be tied together. It has often been noted that the elderly are reluctant to take on debt, reluctant to mortgage their homes, and perhaps most of all reluctant to sell their homes. The perception of these three issues are not independent. If the elderly maintain this overall reluctance to tap their home equity then no HEC plan stands a chance of success. But beyond the willingness to consider tapping home equity, other issues will tie HEC plans to one another. I would like to focus on two matters that are of prime importance—counseling and capitalization.

Any program of HEC for the elderly must have a counseling component. This counseling component is to be distinguished from a marketing strategy in that counseling must be aimed at revealing the attitudes and objectives of the elderly homeowner (while marketing may involve attempts to adjust or alter the attitudes and objectives). It is completely in the provider's interest to know the objectives of the senior and to make sure that the senior only becomes involved with an HECI that matches those objectives. A 62-year-old male who wishes to remain in his home for the rest of his life should not take down a 7-year RAM, and an 84-year-old woman with terminal cancer probably should not negotiate a residential sale/leaseback.

Counseling is a necessity for any HECI, but it can also go beyond the individual program. There are externalities to the counseling process. A savings and loan may find through its counseling that an individual is best suited for a S/L and accordingly refer the individual to an appropriate provider. In providing this information and advice, the savings and loan has assisted the person at its own expense (it is unlikely that the S/L could charge the full cost of providing counseling). Because the benefits of counseling are general, it would be appropriate for a general counseling process to be available—general both in the sense that it would provide counseling for a variety of different HECI's and in that it would address the broad issue of the desirability of HEC for the specific person in light of her or his individual objectives. If, as it would seem, there are socially desirable features to HEC that go beyond the benefit to the individual, then it would be appropriate for this broad-based counseling to be publicly provided and publicly funded.

The second matter that ties HEC programs together is capitalization. In a standard loan to an individual the burden is on the individual to pay back the loan. In a purchase of property it is common for the seller to be paid in cash and any burden of repayment is between a third party (perhaps a financial institution) and the purchaser. HECI's by design put a burden of maintaining a continuing flow of income on the provider—either a lender (RAM) or investor (S/L). An elderly homeowner is not typically well-versed in ways to insure that funds will continue to flow nor in what to do if the flow of funds is interrupted. Any HEC program should be required to meet capitalization standards that make reasonably certain that the flow of income to the elderly person will be continued over the life of the contract, and penalties for default should be statutory. As with counseling, the benefits of sufficient capitalization extend beyond the individual program or instrument. The analogy of

Federal insurance of deposit is appropriate. Just as the creation of deposit insurance through the FDIC was sufficient to halt bank runs in 1934, so a Federal program to insure the flow of funds to RAM and S/L recipients would have widespread benefits to the concept of home equity conversion for the elderly.

It is obvious that the progress of various home equity conversion programs will be tied together. If attitudes of the elderly toward tapping home equity remain negative, it is unlikely that any single plan or program will succeed on a large scale. If a single type of program develops a reputation for possible payment interruption, this will have negative spillover consequences for other programs. And, on the positive side, if some programs for HEC do show that income can be provided for older Americans while allowing them to enjoy the continued full use of their homes, the future for other improved programs will be enhanced.

Senator HEINZ. Mr. Guttentag.

STATEMENT OF JACK M. GUTTENTAG, PROFESSOR OF FINANCE, WHARTON SCHOOL OF THE UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

Mr. GUTTENTAG. Thank you, Mr. Chairman.

My name is Jack Guttentag, and I am a professor of finance at the Wharton School of the University of Pennsylvania.

All home equity conversion plans have in common a homeowner who wants to use up some or all of the equity in the home while continuing to live in it, and an investor who is prepared to finance the homeowner.

Beyond that, the plans differ in many, many respects.

The conversion of equity, for example, may be full or it may be partial. The investor may be a public body or it may be a private institution or individual. The transaction between the homeowner and the investor may be a loan transaction, it may be the sale of equity, or it may be some combination.

The program itself may be permanent in the sense of a continuing revolving fund type of program, or it may be temporary.

Home equity conversion programs also can have different objectives. One objective of all such programs is to relieve the financial plight of the elderly. But other objectives may be involved also, such as neighborhood preservation or even some degree of population control. The payment to the homeowner may take the form of an annuity, a lump sum, or payment of expenses on the homeowner's behalf.

And, finally, programs may or may not guarantee lifetime tenure to the homeowner.

I have been asked to summarize briefly two or three programs which are in operation or under development. One of them is the Buffalo help program. In the Buffalo program a newly chartered corporation writes a contract with a homeowner under which the corporation agrees to rehabilitate the homeowner's property, and pay expenses of maintenance, insurance, and taxes for the remainder of her life, plus a small cash annuity.

The Buffalo program, therefore, involves full conversion of equity. A person who signs up for that program relinquishes the entire equity in her house. The investor is a public body, a new, not-for-profit corporation, and the funds used are from HUD block grants provided to the city of Buffalo.

The Buffalo program is permanent in the sense that the funds invested in the program are invested permanently. As all contracts are terminated by deaths, new contracts will be written.

The Buffalo program has multiple objectives. One of them is to relieve the financial plight of homeowners. But in addition, it is designed to help protect and rehabilitate a specific neighborhood in the city of Buffalo. The payment to the homeowner under the Buffalo plan comes in two parts: A cash annuity which is fixed for the life of the homeowner, and the defraying of expenses which are not fixed. Indeed, they will rise over time. In part, therefore, the Buffalo program provides an indexed annuity, that is, an annuity that will rise roughly with the cost of living.

And, finally, the Buffalo program provides guaranteed lifetime tenure.

The second program that I will touch on briefly is the American Homestead plan which is still on the drawing board but which is planned to be made available in the fall. Jim Burke, the architect of this plan, is in the audience. He may want to elaborate on my comments later.

American Homestead will offer a reverse shared appreciation mortgage. A loan to a homeowner, paid out in the form of installments over time, is made at a preferential interest rate in exchange for a portion, perhaps all, of the appreciation in the value of the home.

The American Homestead plan is privately funded. If all goes well, it will be the largest of the home equity plans in operation.

There are no neighborhood or similar objectives in this program. It is designed strictly to generate a cash annuity for the homeowner, and under existing plans the cash annuity will be fixed over the lifetime of the homeowner. The plan, however, will guarantee lifetime tenure for the homeowner.

So both the Buffalo program and the American Homestead plan guarantee lifetime tenure.

Senator HEINZ. Mr. Guttentag, thank you very much.

Mr. Firman.

STATEMENT OF JAMES P. FIRMAN, PROGRAM OFFICER, ROBERT WOOD JOHNSON FOUNDATION, PRINCETON, N.J.

Mr. FIRMAN. My name is James Firman.

I am program officer at the Robert Wood Johnson Foundation, where I am working primarily in the area of long-term health care services.

I am speaking to you as an individual, a professional with a personal interest in helping the frail, elderly, and disabled to maintain independent living.

I should say at the outset that the views I present are my own and not necessarily those of the Robert Wood Johnson Foundation.

A lengthier version of my remarks has been submitted for the record,[1] but I would briefly like to summarize my views on the potential implications of home equity conversion and then suggest

[1] See page 15.

some possible actions by the Federal Government that can make home equity conversion plans more available.

I am convinced that home equity conversion can have a major impact on a serious and large-scale problem, how to offer better long-term care services to our growing elderly population. Let me review a few numbers which I think will make my case.

Currently there are more than 3.7 million older persons living outside of institutions who need the help of at least one other person to live independently. An estimated 2.8 million of the older people are also homeowners.

The estimated net home equity of this at-risk population is between $100 and $110 billion.

Home equity, if available, could have the potential to help address the current imbalance between institutional and community services. In 1981, national expenditures for nursing homes were approximately $24 billion. In stark contrast, national expenditures for home care services were only $3 billion.

In addition, experts estimate the unmet or latent demand for home health care is between $4 and $6 billion annually. The interest or appreciation alone on $100 billion could easily cover most of the latent demand for in-home services.

I believe there is substantial public interest in making home equity conversion plans available to the frail elderly. If such plans were available, many of the estimated 30,000 older Americans who are currently in hock or awaiting nursing home placement may be able to return to the community, using their own resources.

These 30,000 people currently cost society an estimated $7.5 million a day, or $2.8 billion annually.

Senator HEINZ. How much, $2.8 billion?

Mr. FIRMAN. Yes; that is simply multiplying $7.5 million by 365 days.

Some of the older people, as you know, already in nursing homes, probably do not need to be there. Yet, if sufficient community services are available, some of these people might be able to go home. In addition, there are 2.8 million frail at-risk elderly that would be better able to complement current formal and informal services, and more able to deal with the financial consequences of future acute and chronic illnesses, and probably avoid some institutionalization.

Because of the compelling public interest and potential Government saving from making home equity available to the frail elderly, I suggest a consideration be given to the concept of an independent living loan fund. This would be a home equity conversion plan designed specifically to offer a line of credit to elderly homeowners which are at risk of institutionalization.

In my written remarks, I describe some of the benefits of this notion.

The second area I have been asked to address is the potential role for the Federal Government. I think there are five areas in which Government action is warranted: (1) To remove legal restrictions and disincentives to home equity conversion; (2) to reduce the risks to potential investors; (3) to help such programs raise or attract needed capital; (4) to protect consumers against potential fraud or abuse; and (5) to foster some pilot research and demonstration effort.

In my written testimony I discuss each of these options in greater detail and make some further suggestions. If there is sufficient interest, I could follow up on any of this during the question and answer period.

I would like to emphasize, I am not advocating massive new expenditures of Government funds. The only area where I think such expenditures are warranted or might be warranted is in programs specifically aimed at the at-risk elderly and this is because I think these programs could keep many people out of nursing homes, help reduce the hospital backlog problem, and, consequently, save the Government some money.

If I might, I would like to conclude with some personal observations about the values which help shape our national long-term care policies. I believe, as a Nation, we should agree that an overarching policy goal should be to enable as many older people as possible to live outside of institutions. Second, scarce Government funds for services should be targeted on those most in need; the less needy should be encouraged to pay for their own care.

If we accept these premises as reasonable and desirable, the necessity of home equity conversion options for the frail elderly moves from the periphery to center stage. If options, such as the independent living-loan fund were available to the frail elderly, a great deal of inappropriate institutionalization and human anguish might be avoided.

If our society is unable to pay for the home health care that the frail elderly want and need, it is imperative that we develop imaginative ways to help them pay for it themselves.

Thank you for the opportunity to express these views.

[The prepared statement of Mr. Firman follows:]

Prepared Statement of James P. Firman

Mr. Chairman, members of the committee, my name is James P. Firman. I am a program officer of the Robert Wood Johnson Foundation in Princeton, N.J., where I have been working primarily on programs in the area of long-term health care. My prior experiences include developing an intergenerational home care enterprise in New York City and directing a multisite national demonstration program at the National Council on the Aging.

I am speaking to you as an individual with a strong professional and personal interest in the issue of helping the frail elderly and disabled to maintain independent living. In contrast to the other members of this panel, I am a relative newcomer to the field of home equity conversion. These gentlemen, and a handful of others, have pioneered in the conceptual development of home equity conversion. I have learned a great deal from reading their works and talking with them. The views that I will present are my own and not necessarily those of the Robert Wood Johnson Foundation.

I am convinced that home equity conversion can have a major impact on a serious and large-scale problem: How to offer better long-term care services to our growing elderly population.

Allow me to review a few numbers which I think will make my case:

More than 3.7 million older persons living outside of institutions need the help of at least one other person to live independently.

Between 20 to 40 percent of the 1.3 million elderly already in nursing homes would be able to live in community settings if adequate home care services were available.

It is estimated that there are 30,000 older Americans currently in high-cost hospital beds awaiting placement in nursing homes if and when beds become available.

There is a large current imbalance between institutional and community services. National expenditures for nursing homes are approximately $24 billion in 1981. In striking contrast, experts estimate that only $2.8 to $3.1 billion was spent in 1981 for home care services. The primary sources of funding for home care services were Government programs which spent approximately $2 billion (primarily through medicaid, medicare, title XX, and the Older Americans Act). Private sources, including both private insurance and out-of-pocket expenses, paid out between $800 million and $1.1 billion.

There is general agreement that current Government programs provide home health care services to only a fraction of the older persons who need them. What worries policymakers are the projections that it would cost an additional $4 to 6 billion annually to meet the latent demand for home care services of the elderly. I believe that most of this unmet demand could be addressed without significant additional Government expenditures if home equity conversion options were available to the frail elderly. Let me give you the reasoning behind this statement.

While most older people do not have the cash to pay for catastrophic medical expenses and extensive home care costs, most do have the wealth. Nationwide, 75 percent of all people over 65 own their own homes. Eight percent of these have no mortgages. Thus it is estimated that the net home equity of all older Americans is approximately $700 billion. This represents 70 percent of all the assets of older people and 83 percent of the assets of single elderly women who are a particularly vulnerable group. In addition, more than 2.5 million homes are owned by older persons within 150 percent of the poverty line and 40 percent of those homes have a net equity of $45,000 or more.

It is estimated that approximately 2.85 million older people, or 11 percent of all the aged, are both functionally dependent and homeowners. The estimated net home equity of this "at-risk" population is between $100 and $110 billion. The interest or appreciation alone on $100 billion could easily cover most of the latent demand for home care.

If home equity conversion options were broadly available to frail or "at-risk" elderly, both individual older persons and the public-at-large could benefit. Some of those persons currently held in expensive hospitals would be able to return home using their own resources. This would save considerable Government expense.

Some of the elderly now in nursing homes could be cared for at home.

Many other elderly who now reside in the community, but are at high risk of becoming nursing home occupants, would be better able to complement current informal and formal services and more able to deal with the financial consequences of future acute and chronic illnesses.

In addition to potentially adding billions of dollars to the amount available to pay for long-term care, it is likely that accessible home equity conversion plans could spur needed innovation and reform in the home care industry. Because those new dollars would be controlled directly by the consumers of care, providers would have to compete for their business on the basis of responsiveness to individual needs, flexibility in service approaches, and increased concern with the demands of individual consumers for both quality and reasonable prices.

If it is agreed that making home equity options accessible to the "at-risk" elderly is desirable and in the public's interest, the pressing question is how. One approach would be to hope that general home equity conversion plans become widely available and that the frail elderly will take advantage of them. However, I believe that the potential human and public benefits are sufficient to warrant consideration of a more aggressive and direct approach.

I propose that consideration be given to the concept of an independent living loan fund, designed expressly to offer a line of credit to older homeowners who are at risk of institutionalization. This more targeted home equity conversion approach would be aimed at those groups of older persons in greatest need of additional cash to maintain independent living and who are at considerable risk of winding up as wards of the state.

The independent living loan fund could be established as either a profitmaking or a break-even enterprise. It could be either national or local in scope. Given the compelling public interest in and potential Government savings from such a program, I think consideration should be given a tax-exempt financing through State or local bond issues as a way of attracting capital and moderating the interest rates that would be charged to elderly consumers.

It is important to keep in mind that an independent living loan fund would not benefit only the wealthy and middle-class aged. As noted earlier, more than 2.5 million homes are owned by poor or "near-poor" older persons who could benefit directly from such a program. The other important benefits of home equity conversion for the elderly poor is that it might enable the nonpoor elderly to live outside of nursing homes. This could reduce the number of people who are competing for scarce nursing home beds, most of whom will spend down in a short time and then become a medicaid expense. In this way medicaid would be able to better target its resources on those older people truly in need of both institutionalization and financial assistance.

The second area I have been asked to address is what roles might the Federal Government consider to increase the availability of home equity conversion options. I would like to offer two responses, one general and the other more specific.

My general response is that investors need a reasonable return on investment at an acceptable risk, elderly homeowners need cash or other benefits and a fair deal, and the appropriate role of the Federal Government is to encourage and assure that these outcomes are achieved.

Within this general framework, I believe there are five specific types of actions which the Federal Government should seriously consider: (1) Remove legal restrictions and disincentives to home equity conversion. (2) Reduce the risk for potential investors. (3) Help such programs raise or attract needed capital. (4) Protect consumers against potential fraud and/or abuse. (5) Foster some pilot research and demonstration efforts.

Some efforts to remove legal restrictions and disincentives to home equity conversion are already underway. The proposed regulations issued by the Federal Home Loan Bank Board seem to be a step in the right direction. Action will also be needed by the Internal Revenue Service or the writers of tax legislation to clarify how depreciation might be treated in sale/leaseback arrangements. Also of critical importance is some action by the Social Security Administration and by State governments regarding the effect of home equity conversion income on eligibility for SSI and medicaid. As long as eligibility criteria for public assistance excludes home equity but counts income from equity conversion, the poor elderly will have a strong incentive not to participate in such programs. I believe the policy adopted by the State of South Dakota which excludes conversion income from eligibility considerations should be generalized by either Federal or State-by-State action.

A second possible role for the Federal Government is to help reduce the risks to potential investors in home equity conversion plans. Two actions for which there is considerable historical precedence are Federal loan guarantees and a mortgage insurance program. In combination, these two actions might substantially reduce the potential risks to investors. I believe they warrant further study.

A third strategy for governmental action would be to help raise capital for home equity conversion by allowing tax-exempt financing of loan programs. Although there is a significant governmental cost associated with such a strategy, there might be comparable savings if the program were targeted on the frail or at-risk elderly. Regardless of whether an enterprise is profitmaking or not for profit, the program will need to lend money at a rate that is 2 or 3 percent higher than the cost of the money. Through tax-exempt financing, the rate at which money could be lent to elderly homeowners would be substantially less and consequently their equity would last longer.

Consumer protection is another potential area for governmental action. Elderly homeowners may need protection both from potential consumer fraud and the possibility of bankruptcy by lenders. There is considerable precedence for Government action in both of these areas.

The fifth possible area for Federal action is to support needed research and demonstration efforts. For example, the Department of Health and Human Services could study in greater depth the potential implications of home equity conversion for long-term care. A demonstration project could be launched to test the benefits and costs of the proposed independent living loan fund to provide a line of credit to the at-risk elderly. The Small Business Administration could be encouraged to invest in a few innovative home equity conversion projects, perhaps in conjunction with a DHHS demonstration project.

Let me emphasize as strongly as I can that I am not advocating massive new expenditures of Government funds. Much of what I have suggested could be accomplished for little or no additional dollars. The only area where I think consideration of substantial expenditures is warranted is in the area of tax-exempt financing of independent living loan funds. I suggest this because I firmly believe that such programs will help keep a number of frail elderly independent and out of institutions, and that this in turn will save Government money.

I would like to conclude these remarks with some personal observations about the values which help shape our national long-term care policies. I believe, as a Nation, we should agree that an overarching policy goal should be to enable as many older people as possible to live outside of institutions. Second, that scarce Government funds for services should be targeted on those most in need—the less needy should be encouraged to pay for their own care.

If we accept these premises as reasonable and desirable, the necessity of home equity conversion options for the frail elderly moves from the periphery to center stage. If options such as the independent living loan fund were available to the frail elderly, a great deal of inappropriate institutionalization and human anguish might be avoided. If our society is unable to pay for the home health care that the frail elderly want and need, it is imperative that we develop imaginative ways to help them pay for it themselves.

Thank you very much for the opportunity to present these views. I would of course be delighted to respond to any questions you might have.

Senator HEINZ. Mr. Firman, thank you very much.

You are, as a group, an extremely expert panel. You have all identified a number of general problems, starting with the attitudinal problem that probably exists, that Senator Cohen referred to earlier.

It is rather unusual for anybody to seek, as a senior citizen, to take on the additional obligations—debt—which many of these plans require.

What, beyond the psychological block, do you gentlemen see as the major roadblocks to the availability of equity conversion on a national basis?

I suppose you can divide that question into two parts. No. 1, are there sufficient incentives for the privite market to provide equity conversion arrangements on a national basis; and No. 2, is there any way the Federal Government should assist or facilitate this development?

Let me start with Mr. Scholen.

Mr. SCHOLEN. The psychological block you cite is directly related to the incentives for development. Any significant home equity conversion enterprise requires a substantial research and development investment plus a long-term commitment to the growth potential of the idea. Many other financial services are much easier to develop, implement, and explain. In addition, they can capture a larger market at a faster rate than home equity conversion plans can.

Thus far the incentives inherent in home equity conversion have only been sufficient to bring about a modest amount of private market research, development, and demonstration activity. As the results of these efforts become known and evaluated, the incentives for further development and investment will become clearer. The real test will be whether or not they can attract the kind of large-scale operational financing in today's economy that can present consumers with a sufficiently attractive deal.

If the investment incentives are only strong enough to produce a deal to which consumer response will be weak, then the initial market for home equity conversion will be very small and less likely to grow. It is difficult to estimate precisely how robust consumer response must be to produce a viable marketplace. But clearly, the response of consumers most receptive to this idea in general will be strongly related to the financial terms of the specific deal being offered.

Part of the attractiveness of home equity conversion to investors and consumers will be determined by Federal Government action or inaction in three specific areas.

One area is Federal income tax requirements governing depreciability for the investor and excludability of gain for the seller in residential sale/leaseback contracts.

A second area is the manner in which income derived from home equity conversion will be treated by public benefit programs. And a third area is a possible demonstration role for insuring and secondary marketing of reverse mortgages.

Senator HEINZ. Mr. Scholen, could you go into a little bit more detail on all three areas?

What is the problem in each?

Mr. SCHOLEN. The problem in the first area is that both parties in a sale/leaseback need to know the Federal income tax consequences of the transaction before they can evaluate the deal. The IRS Code does not clearly and explicitly state the requirements and the method for depreciating the property as an investor, and for excluding the one-time $125,000 capital gain as a seller. We need that spelled out in the code, or there may be a need for legislation to spell that out.

Senator HEINZ. At this point is the IRS about to rule on that issue?

Mr. SCHOLEN. Not that I am aware of.

In fact, this issue was submitted to the Service by a private company more than 1 year ago. When it become evident that a timely ruling was not forthcoming, the company had little choice but to proceed with a strong opinion letter from its attorney on the matter.

Senator HEINZ. As regards the treatment of the income under SSI, which is your second point.

Mr. SCHOLEN. This is an important area for low-income homeowners. A woman who lives near me in Madison was considering taking out a reverse mortgage. As an SSI recipient, her first question was the effect it would have on her benefits. The only answer she could get was that at the present time, under the present rule, it looks as if it would not affect her SSI. But that is according to the current rules and current interpretations, and these could change.

That wasn't sufficient for her. She didn't feel she really knew what the answer was. A more definitive answer is needed.

Senator HEINZ. At the present time, the situation appears to be that someone on SSI could, in fact, enter into one of these arrangements without jeopardizing their eligibility for their SSI benefits.

Mr. SCHOLEN. Only if it is a loan plan in which direct cash advances to an individual must be repaid according to a specific schedule, and only if the loan advance is expanded within the month it is received. Any funds not expended during the month become countable liquid assets.

Senator HEINZ. Whereas they would be counted out under other reverse equity and sale/leaseback arrangements?

Mr. SCHOLEN. Other types of equity conversion income will reduce SSI benefits, and could make a person ineligible for SSI and medicaid.

Senator HEINZ. Now, on your third point, the availability of the secondary market, would you expand on that, please?

Mr. SCHOLEN. Portfolio lending is fast fading from many parts of the American financial scene. Unless there is a way for originating lenders to sell their reverse mortgages, it will be difficult to develop these loans. Reverse mortgage insurance would enhance the secondary market appeal of those instruments.

Senator COHEN. How would the insurance work? Who would be insured?

Mr. SCHOLEN. The type of insurance depends upon the type of instrument. On a simple term product, you could insure the cash flows for the borrower and the encumbered equity for the lender. On a long-term reverse mortgage, by contrast, you are pooling a number of different risks—mortality, mobility, casualty, appreciation—all in one instrument. That is an uncommon combination of risks, and no one knows how it will play out over a period of time. In this case, insurance would protect the borrower against corporate default, and limit the liability of the lender and investors.

Senator COHEN. Does not the lender take that into account when he makes the conversion? The lender is going to take into account the mortality, the appreciation, potential appreciation, all the factors you mentioned. Why would he need to have insurance in order to sell that if he makes a good equity conversion? I do not understand.

Mr. SCHOLEN. It is very costly and difficult for an individual lender to price the risks, and to generate a sufficiently large pool over which to spread the risks. If the private mortgage insurance industry and secondary market do not explore this territory, there may be a role for the Federal Government in analyzing and possibly insuring this new type of composite risk.

Senator HEINZ. What you are addressing is really the first part of my question, which is whether or not there is a sufficient incentive relative to the risks involved for the investor to make a market for these instruments. What you are saying, in effect, is that the risk associated with a single individual arrangement may be so difficult to figure out that, unless you find a way of pooling the risks into some kind of insurance pool where there is more of an actuarial certainty, that it is difficult or somewhat unlikely that a sufficient number of lenders or investors will come forward.

Is that correct?

Mr. SCHOLEN. Yes. Even if they do come forward, however, they may do so only on terms that consumers will find unacceptable. In that case, a Federal demonstration role could make the critical difference in the development of this idea.

Senator COHEN. Let me come to the other area of concern I have, and that is the need for counseling. That is sort of pervasive throughout the testimony.

One of the reasons it is not more utilized is so much counseling has to go into it, and I assume that it is an impediment to institutional lenders.

Mr. Scholen, I think you indicated that homeowners should be very careful before they go into one of these arrangements. You were quoted in the Boston Globe in an interview. But with all the admonitions and cautionary language, how are you going to overcome that except perhaps by involving State agencies?

It seems to me most elderly, whether frail or healthy, are indeed reluctant or skeptical of dealing with bankers and they may be reluctant to trust them, saying this may be a good deal for the bank, but not for me.

How do I trust them?

They may not be able to afford an attorney, unless that is factored into the equity conversion.

It seems to me that you are going to have to have some State agency that is recognized as dealing with the problems of the aged to serve as an intermediary, if you are going to overcome that reluctance on the part of older people. Is that valid or not?

Mr. Guttentag.

Mr. GUTTENTAG. I think you are raising two issues, Senator Cohen.

There is, first, a question of whether or not any given program is structured in such a way that it is fair to the homeowner. That may raise a regulatory problem. Second, there is an individual counseling problem. A program may be fair in every respect and there may be full disclosure and yet there is still a need for an individual homeowner to decide that this program is for me and, if it is for me, which of the options are best for me, and how does it tie in with my other financial arrangements?

Those are two separate issues. It seems to me that you may need intervention by the State on the first.

I am not sure that the State is the agency to provide the counseling function.

Senator COHEN. What about those areas in the State of Maine, such as I mentioned before, that tend to be rural and low income, and where the homes are of relatively low value.

What sort of incentive is there for investors or lenders to engage in this sort of equity conversion, where there is not much equity appreciation and you have an overstock of homes, and you have high energy costs?

Most of Maine is dependent on the high cost of oil, not much natural gas. Many of them are returning to wood burning.

Senator HEINZ. A lot of political talent, though.

Senator COHEN. That does not pay the heating bills.

Now, 60 percent of the homes in Maine are using wood, either as a primary or secondary source of energy. That creates other problems, mainly hazard of fire.

What do you do with those areas? Do you need a model program structured in those areas? Can it work there?

Mr. FIRMAN. If I may, I am not sure the question is different incentives, but different expectations. I think that the homes in Maine are different, certainly, from Marin County. You certainly cannot expect to get the same deal.

Senator COHEN. Most of the areas I am told where this has been utilized with any degree of effectiveness are homes that are valued at $100,000 or more. You do not find many of those in the rural and poor States.

Mr. FIRMAN. It seems to me that maybe there are other options that can be made available to homeowners which are short of lifetime tenancy plus a guaranteed annuity for the term of their life. It may be that one could offer an actuarially defined line of credit

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plus lifetime tenancy, which would say to an elderly resident that you can borrow money up to 40 percent of the value of the house. That is what you can get for your equity in addition to lifetime tenancy, but we cannot guarantee you $5,000 a year.

Even though the value of the home is less, it should be possible to convert that asset into some income and guaranteed lifetime tenancy, and yet not offer the same major benefits as for the more valuable homes.

Senator COHEN. Mr. Guttentag, you answered one of my questions that I raised during my opening remarks, and that is what happens to the person who lives longer than the mortgage, and that is a guaranteed lifetime tenancy?

What about a variation on that, what if a person does not hit the 75-year-old mark, and yet at the age of 65 or 66 suffers a stroke and has to be institutionalized and no longer is living in a home and the lender sees a potential loss of, or a depreciation of the property and loss of appreciation of it? What kind of arrangements could be worked out there under those circumstances, where the person is going to live in a nursing home for the next 10 years and not living in the house? How is that going to work?

Mr. GUTTENTAG. Well, that is a problem that any program has to handle, and it can be handled in different ways. In the Buffalo program, if a person has to go to a nursing home and vacates the house for more than a specified period, which is stipulated in the contract—I believe it is 2 or perhaps 3 months, the corporation has the right to lease the property on a month-to-month basis. The rent will go to the homeowner except for an agency fee which is retained by the corporation.

Under a reverse mortgage program, the lender has the right to exercise surveillance over the house and possibly even enter it to make sure it is not vandalized.

Senator HEINZ. I think Senator Cohen's question also is directed at what benefits come to the person who has moved out of their home and has been institutionalized? How do they benefit?

Mr. GUTTENTAG. Well, they continue to receive the proceeds of the plan depending on how the contract is written. In the Buffalo plan they continue to get the annuity, and if the corporation rents their house, they will get the rent. Under a reverse mortgage plan——

Senator HEINZ. They would get the rent in addition?

Mr. GUTTENTAG. In addition, that is right.

In reverse mortgage plans, they would continue to get the payments under the contract until the contract expires. They just go on as before.

Senator COHEN. Could you explain the reverse share mortgage? How does that work?

You say the homeowner will get a preferential interest rate and the bank or lender would be sharing in the appreciation of the property. How does that work out in terms of charging the homeowner the interest rate?

Mr. GUTTENTAG. Well, there is a tradeoff between the interest rate the lender charges on the loan and the share of appreciation that the homeowner gives up.

For example, and these are just hypothetical numbers, if fixed rate mortgage loans in today's markets are running at 17 percent, under the plan the rate on a reverse shared appreciation loan might be 14½ or 15 percent. In exchange for that low rate, the homeowner would give up some specified portion of the appreciation in the value of the house during the period between the initial appraisal and the time the contract is terminated on the homeowner's death, or when the homeowner sells the house, whichever comes first. The loan is paid out in installments so that from the standpoint of a homeowner, it is like an annuity, but each payment is a separate loan which is added on to all prior loans and the debt accumulates with interest.

When the homeowner dies, the debt is repaid, along with the accumulated interest, plus the share appreciation which has been pledged to the investor.

Senator COHEN. In an ordinary situation, assuming 17 percent interest rates charged to the homeowner, no matter what the appreciation is, the lender would achieve that upon the death of the homeowner. Is that right?

Mr. GUTTENTAG. On an ordinary loan?

Senator COHEN. They make a loan of 17 percent interest. It goes for——

Mr. GUTTENTAG. They get their loan principal back, plus 17 percent interest. They have no share in the equity of the property. After the loan is repaid, the home belongs to the homeowner.

Senator HEINZ. I would like to return to the rest of the panel on the initial question which I asked, which Mr. Scholen answered, which is: What are the other facilitating mechanisms—private, Federal, or State—that we need to address the problem?

What do you gentlemen suggest that we need?

Mr. GUTTENTAG. Well, one problem, of course, is the existing legal and regulatory roadblocks that face some programs. There has been some success in getting rid of these roadblocks. The problem is that each specific program encounters its own difficulties. When Jim Burke began to design the American homestead program, he encountered difficulties which were more or less unique to that particular program.

So there is no such thing as a wholesale removal of the legal impediments to home conversion programs. There is only a case-by-case, piece-by-piece removal of impediments to specific programs.

Now, if you are operating on a large scale, if you plan to invest a lot of money in a home equity conversion program, and you can hire a high-powered lawyer and people to come down to Washington, and to go to State legislatures, and so forth, you may be able to get these impediments removed yourself.

But most investors that have thought about going into this field do not care to invest that kind of money and they take the existing legal framework as a given, and when they find that there is some barrier, they give it up.

I think it would be nice if there were someplace in the Government where a potential investor could go and say, "I want to set up this type of home equity conversion program, but I am blocked by this barrier. Can you help me? "

I think that would be it, a nice facility to have.

Senator HEINZ. Do you share the suggestion, Mr. Guttentag, that there should be an insurance program that would facilitate the development of a secondary market?

Mr. GUTTENTAG. I am not sure about that.

Private mortgage insurance companies might be willing to insure some types of home equity conversion instruments, depending on the type of instrument, and the risk.

I would hesitate to make a blanket statement that such facilities are inadequate and, therefore, we should have the Government come in. I think, again, we have to consider the issue on a case-by-case basis; what is the specific instrument, is it desirable, is it really hung up by an inability to market it in the secondary market, and do we know that the private companies will refuse to insure it.

Senator HEINZ. Do you believe that there would be a secondary market for some of these instruments?

Mr. GUTTENTAG. If the Government provided insurance?

Senator HEINZ. Without any insurance.

Mr. GUTTENTAG. Well, I think it is possible. The secondary market in conventional and some nonconventional mortgage instruments have developed very substantially over recent years. You have new types of passthrough instruments which are sold in the private market, with private insurance. So we have had a considerable development in that area.

Whether or not, over time, the market will come to include these instruments remains to be seen.

Senator HEINZ. Mr. Weinrobe, what recommendations do you have?

Mr. WEINROBE. Well, first of all, with respect to the insurance issue, there are a number of layers of insurance. The layer that I think has been discussed most is the ordinary insurance of a mortgage against default, at term.

In the California experimental program, the lenders initially indicated that they wanted to be insured. But when it came time to implement the program, that was one thing that was dropped by the lenders. The lenders, I should mention, are the Bank of America, Wells Fargo, Crocker National Bank, and First Nationwide Savings & Loan. The reason they dropped their insistence on insurance, or even their interest in insurance, is they felt it was not the principal risk. The principal risk was something that we have discussed as depletion insurance, not just that at the end of a term of reverse mortgage the house would be inadequate in collateralizing that loan, but that the individual would want to stay. They also cite a problem, what happens if the person outlives the term of the loan, and then what happens to the value of the property relative to a loan that continues to accumulate interest?

That kind of insurance is a lot more difficult to address.

The words "actuarially sound" come up occasionally but there are no actuarial data on that kind of risk. It involves too many kinds of dimensions of risks.

If there is a role for the Government that would assume a risk that private insurers would not take on, it would be that kind of a risk. Indeed, there has been some indication that the Department of Housing and Urban Development is willing to offer the regular insurance, the top 20 percent of the loan or even the full amount of the loan within the term. But, as I say, that does not present much of a problem to lenders. I do not think that is an impediment at all.

The other side of it, the secondary market, when we were discussing expansion of our California program with the same lenders that had been at the first stage, there was a little bit of hesitancy on the part of lenders and we asked them what would it take to get you to dive into this program, and there was not a second delay. The answer was, "If we could sell off the mortgages that we were writing, we would write thousands."

So the secondary marketing of these reverse mortgages—term reverse mortgages—is a critical matter, and one where there would be a role for the Government as a pilot coming into an area where the costs of small-scale programs would be prohibitive to large pension funds.

Indeed, the answer we have gotten from pension funds on buying the reverse mortgages is, it is not worth their while to deal in a couple of million dollar units. They want much bigger units than that.

Perhaps if the Government came in and started to provide the market, that would be a catalyst for the real development of a secondary market.

Senator HEINZ. One alternative that we have mentioned for equity conversion is model sale/leaseback and loan agreements. You have had some experience with that, Mr. Weinrobe.

Do you think there would be a Federal role in developing instruments for such arrangements, and in particular, do you think a national task force should be established to develop documents and contracts?

Mr. WEINROBE. Let me answer that in two stages.

First, in terms of the further development of your question on the governmental role, the one thing that I think that would be most effective in terms of utilizing the resources of the Government would be, to provide for HUD counseling centers or HUD-sponsored counseling centers for programs to enable the elderly to tap home equity similar to counseling centers that were proposed during the 1970's but never funded.

In terms of model instruments for sale/leaseback, I think that is a critical issue. The number of sale/leaseback arrangements that are floating around are just growing exponentially. It seems that everybody has an anecdote about a particular arrangement. Whether it is the American Bar Association or a publicly sponsored task force that goes ahead with the development of model instruments, I think it is critical that that be done. The absence of a model instrument does provide a block for large-scale implementation of that program.

Senator HEINZ. Mr. Firman.

Mr. FIRMAN. It seems to me we have been talking about one-half of the investment equation which is reducing the risk. The other side, I think, is return on investment. It seems to me there are at least two areas to be considered. One has been mentioned, which is the IRS consideration of appreciation and sale/leaseback. If you remember the numbers on sale/leaseback, they are not very good. If you add in that depreciation factor, it would make it a much more attractive investment.

The second option in a limited number of cases would be to limit the cost of money to investors. If the cost of money is 16 percent, in essence it has to be lent out at 19 percent in order to have a viable enterprise. At 19 percent, an individual's equity will be eaten up rapidly. If the Government can identify that at least for very specific groups, such as people at risk of institutionalization, that it would be in the public interest to see that they do get loans. It should consider tax exempt mortgages which might reduce the cost of the money to 11 or 12 percent which could then be lent out at 15 percent.

Senator COHEN. The President just vetoed a measure that provided for some sort of subsidy under the so-called Lugar bill.

Mr. FIRMAN. The only reason I think it should be considered is it would result in direct savings. We know that when somebody enters a nursing home, either immediately or within approximately 9 months, they will wind up on medicaid. The problem is that hospitals are costing $250 per day and the only thing the elderly can afford to pay for is institutional care. I would not advocate an interest subsidy for someone in a $250,000 house who wants to take a trip to Hawaii, but the issue of returning people to the community is critical. The cost of money is too high now, and it is a major barrier.

Senator HEINZ. I have a number of questions which I will not pose to all of you right now. I am particularly interested in any comments you may have on the Federal Home Loan Bank Board's proposed regulations which would permit equity loans to be paid out in lump-sum payments as well as monthly payments.

We have two other panels we want to hear from this morning. Before I call the next panel, I want to yield to Senator Cohen.

Senator COHEN. To what extent are the State usury laws an impediment to those equity conversions?

Anybody?

Silence is construed that they are not an impediment.

Mr. WEINROBE. They are.

Mr. GUTTENTAG. They have to be an impediment on reverse mortgage arrangements, if the rates are below what lenders consider to be a reasonable market rate. They also have to be an impediment to the provision of variable rate reverse mortgage loans which lenders prefer to fixed rate loans, because you cannot write a variable rate loan when you have a usury ceiling that may limit rate increases.

How many States at this point are subject to such impediments, I do not know.

Mr. WEINROBE. The other aspect of that is reverse mortgages are essentially interest on interest or negatively amortizing loans. Negative amortization is restricted by State usury laws.

Senator COHEN. So it is not enough to say we should have one agency that they can come to at the Federal level to say they have a problem. The agency will tell you to go back to your State legislature and get your usury law changed.

Mr. GUTTENTAG. The States are another problem.

Senator HEINZ. Gentlemen, thank you very much.

You have given us the benefit of a great deal of hands-on, real-life experience. Each of you have been involved with demonstration projects, model projects, and have devoted a considerable amount of time, attention, and study to what at the present time are many variations on three different models.

It is a very rich area of inquiry and we are clearly just beginning to scratch the surface. It clearly is posing some problems, in part because of the ambiguity of existing regulations. You mentioned the IRS, among others, that keep us guessing. But also questions about the best way to insure any safeguards we might want to make for the beneficiaries.

Also, there are a number of questions that have been raised and addressed regarding the trade-off between risks and returns for the investors.

As I mentioned, I do have some followup questions which I hope you will be able to respond to which will go into each of those, and a few additional areas, in more depth.

I thank you on behalf of the committee for appearing here. We appreciate your coming so far and wide to be with us.

Thank you very much.

Our next panel is Philip Abrams, General Deputy Assistant Secretary-Deputy Federal Housing Commissioner of the U.S. Department of Housing and Urban Development; and Dorcas Hardy, Assistant Secretary for Human Development Services of the U.S. Department of Health and Human Services.

I would like to welcome Philip Abrams back to the committee.

So Phil, I will ask you to go first, and then Secretary Hardy to succeed you.

Will you please proceed.

STATEMENT OF PHILIP ABRAMS, WASHINGTON, D.C., GENERAL DEPUTY ASSISTANT SECRETARY-DEPUTY FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. Abrams. Yes; we have submitted a statement for the record. I will make some comments on it, if the committee is willing to accept it.

Senator Heinz. Without objection the entire statement will be a part of the record.[1]

Mr. Abrams. HUD has been considering home equity financing for the elderly for the past year and we are in the process, as you know, of developing our 1984 legislative program which will be submitted to you sometime early in 1983.

This is one of the subjects that is being considered.

There are a number of opportunities for FHA and HUD to play roles, as your previous panel pointed out. There are also a number of problems that we are wrestling with and that we would have to come to you for statutory changes in order to implement.

But, basically, we are considering making FHA insurance available for reverse annuity mortgages—RAM's—of the various types that you have been discussing. The principal advantage of FHA in-

[1] See page 29.

surance would be a higher loan-to-value ratio which would in turn allow the participants in the program to receive higher annuities if they chose that method. This would represent a substantial increase in the amount of funds potentially available to the elderly.

A second advantage, as you discussed with the previous panel, would be an enhancement of the RAM's marketability in secondary markets, whether through Ginnie Mae, Fannie Mae, or other securities.

FHA insurance of a substantial percentage of the value of the property, out to loan maturity, would limit the risk to lenders and investors and would bring new funds from the secondary markets into RAM's.

Finally, FHA insurance could be used to insure that the stream of payments would continue to the homeowners. Because in our consideration, the worst scenario, as I am sure you agree, as I heard you allude to, would be the case where the elderly homeowner suddenly had an end to their stream of payments and no longer had their home, we would have the worst of all worlds. So some type of FHA insurance which would insure the stream of annuity payments would continue would be critical to any kind of RAM program.

The Secretary is considering coming to you with the statutory proposal on reverse annuity mortgage. The President's Commission on Housing recommended that HUD, the Federal Home Loan Bank Board, IRS, and others, get together and see if we can establish a private market for equity conversion instruments for elderly homeowners.

There are several issues that we have to look at in considering what our position is going to be. We have looked at the programs that are successful and that you discussed with the previous panel, and many of them involved wealthier people and wealthier elderly families which were converting homes over $200,000 to RAM's. And that is really not a role for FHA.

We would like to continue pursuing an FHA role for low- and moderate-income homeowners, and we think that there is a market of somewhere around 670,000 households or 10 percent of the elderly homeowners that should be eligible and might want to take advantage of an FHA-insured RAM.

There are a number of issues related to Federal involvement which you have gone over, and I am not going to repeat those that do not bear directly on HUD.

One of the questions that we ask ourselves is whether it is appropriate for the Federal Government to support what some people feel is overhousing for the elderly, by supporting a program where you facilitate the elderly staying in larger homes rather than moving into smaller apartments, smaller houses—because there is a considerable amount of speculation that there would be an advantage if the elderly were to give up their larger homes and allow larger families to move into them.

We really do not feel that is a decision to be made by the Federal Government. That is a decision for the elderly homeowner. But it is one that is constantly raised.

Senator COHEN. Can I interrupt you for a moment?

Don't you have to take into account to what extent an elderly homeowner may not be able to come up with those payments and then the Federal Government is involved, because that person that has to go to a nursing home and medicaid payments are involved. So there is a role.

Mr. ABRAMS. There is a role, but I do not see the Federal Government moving out—if someone is overhoused, to move out of it. Even though——

Senator COHEN. I am not saying the Federal Government is forcing them out. Many of them are moving out because they cannot maintain the payments and they go into nursing homes, and we end up paying there.

Mr. ABRAMS. There are advantages to the elderly who are overhoused being able to take advantage of a program like this. My emphasis is that whatever we do should be voluntary and there should not be incentives one way or the other.

Senator COHEN. What you are suggesting is that we should not get involved in any way, because if elderly persons are, in fact, overhoused we should not be encouraging it by a subsidy or insurance program.

Mr. ABRAMS. The point is, it is none of our business.

Senator COHEN. I know, but it may be your business if that family goes into nursing homes and we are paying through the Federal Government, when they could not stay in their homes. The trade-off could be to the advantage of the Federal Treasury.

Mr. ABRAMS. I understand. There was an interesting question raised by the last panel about the role of private insurers. I think that, again, raises the role of FHA which is to be an innovator in areas like this and the reason that the Secretary is interested in pursuing the whole area of home equity conversion loans is because we do not really believe that private market insurers are going to open up a new field unless someone has done a little exploration ahead of them, and since that has been the traditional role of FHA, pursuing the potential and the possibilities.

Thank you.

Senator HEINZ. Secretary Abrams, thank you.

[The prepared statement of Mr. Abrams follows:]

PREPARED STATEMENT OF PHILIP ABRAMS

Mr. Chairman and members of the Senate Special Committee on Aging, I am happy to be here today to talk about home equity conversion financing for the elderly. In my allotted 5 minutes, I should like to begin by describing a possible role for HUD in mortgage financing under this relatively new concept. Following the description, I would like to raise a number of important issues which the Government needs to resolve prior to deciding whether or not to go forward with such a program.

HUD ROLE AND POTENTIAL BENEFITS

Based on a review of the various home equity conversion plans around the country, especially those in Wisconsin and California, perhaps the cost significant role HUD can play would be to make FHA insurance available for reverse annuity mortgages (RAM's) and other similar mortgage instruments. HUD would need statutory authority for this purpose. The potential benefits of FHA insurance availability are several:

First.—RAM's financed by private lenders are usually limited to a loan-to-value ratio of 80 percent or less, where the homes are owned free and clear. An FHA insurance program for RAM's would presumably allow for higher loan-to-value ratios, perhaps as high as 90 percent. For such FHA-insured RAM's, this would mean a substantial increase in the amount of funds potentially available to elderly homeowners, either at loan origination to pay for needed home repairs or to support the purchase of a deferred annuity, and/or to increase monthly payments from the lender or insurance company to augment household income.

Second.—FHA insurance, if provided, would enhance RAM marketability in secondary mortgage markets. RAM's are relatively new mortgage forms and involve a different type of mortgage insurance risk than is present in existing programs, namely the value of the property at loan maturity. If FHA were to insure this risk, many mortgage investors, including insurance companies and pension funds, might be attracted to RAM's.

Third.—A variety of other potential benefits exist. For example, FHA insurance might also be used to insure the homeowner against lender or investor default on annuity payments (the reverse of present FHA practice). This type of protection would be especially helpful to elderly households with modest incomes who must feel financially secure in any financial arrangement.

ISSUES FOR CONSIDERATION

Secretary Pierce is seriously considering the possibility of FHA insurance of RAM's. In addition, the President's Housing Commission has recommended that our Department, the Federal Home Loan Bank Board and the Internal Revenue Service facilitate and encourage the use of such mechanisms. HUD is asked to determine, via an advisory committee, how best to develop an effective private market for an equity conversion instrument for elderly homeowners. I would like to turn my attention to a number of important questions which must be addressed and answered concerning any future HUD involvement as we respond to this charge.

First, of critical importance is whether or not a Federal program, such as the one I've described, is really needed?

Where the RAM appears to be working successfully, elderly participants tend to own homes of substantial worth—for instance, in the Marin County, Calif., RAM program, average property values of participating homeowners exceed $200,000.

At the present time, the maximum mortgage amount insurable under FHA's single-family programs is $67,500 (with certain exceptions for high-cost areas). The question is whether or not there is sufficient demand for a RAM program within the statutory framework of FHA's programs, intended primarily for low- and moderate-income homebuyers? In partial answer to this question, one HUD estimate would place the potential market for RAM's at 10 percent of elderly homeowners, or about 670,000 households.

Home equity conversion on the part of an elderly household with modest income is a major life decision—a decision that far surpasses the home-purchase decision made by young, first-time buyers with a lifetime ahead of them. For the elderly, what is involved is "estate planning"—how best to utilize scarce resources given uncertainties about the future. In the context of estate planning, the RAM is but one of a number of options available to elderly homeowners.

The greatest resistance to home equity conversion is found among those most in need—older individuals, age 75 or older, living alone with annual incomes below $5,000. To meet their specific needs, a RAM must be carefully tailored and contain sufficient consumer protections to offset fully the concerns of these individuals.

A number of issues related to Federal involvement with RAM's are apparent:

First.—Federal and State tax treatment of RAM proceeds, and relatedly, treatment of RAM-generated income by social welfare agencies, in cases where benefits are determined on the basis of a recipient's assets or resources. Would RAM income be treated as a loan, a converted liquid resource, an annuity, or a return on investment?

Second.—Should the Federal Government support "overhousing" of the elderly? Many argue that Federal housing programs targeted to the elderly should encourage moves by "empty-nesters" to smaller, more manageable housing in order to free up larger, existing homes for younger families.

Finally.—In terms of an FHA insurance role, there are a number of issues regarding the nature of risks to be insured by HUD.

Unlike conventional mortgages, where risk is primarily associated with the borrower's ability to repay the loan, risk with regard to RAM's relates principally to the future value of the home—will there be sufficient value in the home for loan repayment?

This risk is associated with a number of factors, including the upkeep and maintenance of the individual property, changes in value by neighborhood and by local market, the condition of the overall economy, as well as incremental changes in Federal and State tax and related laws affecting housing prices.

These risk factors raise the issue of how to price mortgage insurance for RAM financing. Is the potential liability small enough to permit a modest mortgage insurance premium? Current responses to these questions by housing economists and insurance actuaries are mixed.

CONCLUSION

To sum up. We know that home equity conversion for some elderly households is workable—witness the success of the California, Wisconsin, and New York programs.

We also know that there is considerable resistance to home equity conversion, especially among lower income elderly homeowners living on relatively fixed incomes.

The key question is whether or not equity conversion programs can be designed for low- and moderate-income elderly which not only include the kinds of protections needed by these homeowners, but can as well assuage the fears of the older homeowners as they consider their future.

HUD is prepared to help in this effort. As I mentioned earlier in my remarks, Secretary Pierce is deeply interested in a possible role for HUD, and we hope to continue to work closely with the committee, the U.S. Department of Health and Human Services and other public and private organizations representing the elderly in looking for solutions to the problems of our senior citizens.

Thank you. I will be happy to answer any questions you may have.

Senator HEINZ. I have obviously, a number of questions and thoughts I would like to ask you about, Mr. Abrams, but first, we would like to hear from Dorcas Hardy.

Let me say, Madam Secretary, one of the reasons we are interested in your testimony, in part is because there have been demonstration projects which have utilized the revenues from one or another kind of arrangement to pay for home health care, to pay for the expenses of the frail and elderly. It seems to me there is a means of avoiding unnecessary hospitalization or other institutionalization.

Obviously, we are interested in what your views are on what home equity conversion means for better care, treatment, and maintenance of our elderly in the least restrictive setting possible.

If these views are not in your opening statement, we will get to them in the questions.

STATEMENT OF DORCAS R. HARDY, WASHINGTON, D.C., ASSISTANT SECRETARY FOR HUMAN DEVELOPMENT SERVICES, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Ms. HARDY. Thank you.

I have submitted a statement for the record,[1] and I would like to highlight some of the things we have thought about in the Office of Human Development Services, and also in the Administration on Aging, in regard to the topic of home equity conversion.

There are obviously a lot of issues involved in the conversion of home equity by older persons, and we have been reviewing many of the facts and figures, the advantages, and some of the disadvantages. We know that home equity conversion programs have been offered sporadically by local savings and loan institutions over the past two decades. But, obviously, systematic efforts have not been made until recently to really study the economic, legal, and social

[1] See page 33.

ramifications, and the political implications of a very complex process.

We have had direct involvement in the Office of Human Development Services with the issue of home equity conversions, through a grant award by the Administration on Aging to the Wisconsin Department of Health and Social Services. They conducted a 24-month study on home equity conversion. The basic objective of the study was to assess the current as well as the potential supply and demand dimensions of home equity conversion.

The Wisconsin project also embarked on an effort to stimulate the development of the home equity conversion market through a wide range of dissemination activities and the provision of support for six pilot projects, three of which were in Wisconsin; one in Essex County, N.J.; one in Buffalo, N.Y.; and one in San Francisco.

The notable achievements of the Wisconsin project are the creation of an awareness of home equity conversions' potential among economists and financial analysts of this country, the stimulation of a major nationwide private sector effort to offer a lifetime income plan to older homeowners, and the formation of a nonprofit organization which offers counseling and referral services on home equity conversion.

The final report of the Wisconsin project gave us an opportunity to look at the state of the art and determine some of the feasible policy options that are before us. We still need to do quite a bit more work. We have acknowledged that there are some barriers that impede further development in this area.

One is that prevailing mortgage interest rates seem to curb the willingness of lenders as well as some homeowners to conclude home equity conversion transactions. Another barrier is that older homeowners have unresolved concerns, some doubts and some fears about the whole home equity conversion process. There is in some parts a basic reluctance to participate in a conversion program—a reluctance that may be due to its apparent low cash payout. At the other extreme, older homeowners may fear the possibility of fraudulent schemes.

Finally, I think various regulatory and statutory provisions at the State and Federal levels, as we talked about this morning, often impede a nationwide implementation.

I think, on balance, the whole home equity conversion discussion has a great deal of merit in that the older homeowners can derive income benefits from participation in the program.

We have heard from several participants and one of them in New York says, "I haven't signed my house away, I have signed my worries away."

Our overall assessment of home equity conversion is that it has enormous prospects for growth, but I think in the short run it may develop slowly because of some of the barriers and our current economic situation.

In order to facilitate the acceptance of home equity conversion by lenders as well as borrowers, and to promote its further growth, we need to create several preconditions.

One is to encourage a broad spectrum of the private sector, nonprofit, community-based, and local governmental organizations, to really participate as a team in looking at this and addressing at the local level the home equity conversion program.

The second is promoting coordination and cooperation among several Federal agencies.

And the third is providing some technical assistance materials for organizations that can be used in terms of home equity, knowledge about home equity conversion instruments, perhaps a consumer handbook, perhaps some discussion at the local level about some consumer safeguards.

To begin this process, the Office of Human Development Services and the Administration on Aging have already taken steps to look at selective issues with the U.S. Department of Housing and Urban Development. These two agencies will continue to work cooperatively in the areas of research, evaluation, policy analysis, and the kinds of things that the Assistant Secretary from HUD referred to this morning.

All of the officials who participated in these programs and who will continue to participate I think view home equity conversion as one of several alternatives for meeting the needs of older persons for adequate shelter and income.

Some of the alternatives which the Administration on Aging is jointly exploring with the U.S. Department of Housing and Urban Development are shared housing, the concept of group homes, shared equity, the new idea of echo housing and accessory apartments.

I think there is a great amount of potential in all of these options that can lead us to insuring that older Americans can be as independent and self-sufficient as possible. We need to involve and continue to promote the strong involvement of the private sector, in meeting some of these economic and housing needs of our seniors.

But I want to emphasize that we believe we should explore all of these options.

Thank you, Mr. Chairman. I would be glad to answer any questions you or Senator Cohen may have.

Senator HEINZ. Thank you very much, Secretary Hardy.

[The prepared statement of Ms. Hardy follows:]

PREPARED STATEMENT OF DORCAS R. HARDY

Mr. Chairman and members of the Senate Special Committee on Aging, I am pleased to have the opportunity to appear before you to present our analysis of the issues involved in the conversion of home equity by the older Americans. I also intend to outline policy measures which we consider appropriate for facilitating the home equity conversion process. Older homeowners may wish to convert their home equity for accomplishing a variety of objectives—home repair and maintenance, design modifications, weatherization, and meeting tax obligations. A salient aspect of home equity conversion is that it allows older homeowners to unlock some of their assets without having to give up their occupancy rights. This innovative approach to supplement the income needs of older homeowners has been the central theme of numerous articles in newspapers and periodicals across the nation on the subject of home equity conversion.

Another feature of home equity conversion, frequently highlighted in these articles, is its seemingly vast untapped potential. It has been estimated that the average value of a home owned by an older person is $50,000 and that the total amount of home equity held by older Americans in 1980 was $500 billion.

Although older Americans (65 years or older) comprise 11 percent of the general population, they constitute 20 percent of all households and 21 percent of all homeowners. Eighty-four percent of homes owned by older Americans are held mortgage free. Thus, the housing characteristics of older Americans seem to illustrate the essentially untapped nature of the home equity conversion market and point in the direction of growth in this market in the future. An additional factor that might favor the growth of the home equity conversion market in the coming years is the projected increase in the percentage of this country's older Americans which, by the year 2040, will climb to 18 percent of the general population.

While there are clear indications of a potential growth in demand for home equity conversion, we believe that private, as well as public efforts to satisfy this demand, will address several key goals of this administration. Private sector response to the demand for home equity conversion is expected to substantial and broad-based to include such vital operations as marketing and financing this new multibillion dollar industry. Such a development will have positive effects on the employment, income, and the housing needs of this Nation, and will contribute to the creation of a healthy and vigorous economy which is, Mr. Chairman, a principal goal of this administration.

Home equity conversion programs have been offered, sporadically, by local savings and loan associations of this country during the past two decades. However, major and systematic efforts have not been made, until recently, for studying the economic, social, legal, and political implications of the complex process of converting home equity.

The first direct involvement of the Office of Human Development Services with the home equity conversion issue began through a research award ($250,000) made by the Administration on Aging to the Wisconsin State Department of Health and Social Services to conduct a 24-month study on home equity conversion. The basic objective of the study was to assess the current as well as potential supply/demand dimensions of home equity conversion.

The Wisconsin project also embarked on an effort to stimulate the development of the home equity conversion market through a wide range of dissemination activities and the provision of support for six pilot projects in Monona, Madison, and Milwaukee, Wis.; Essex County, N.J.; Buffalo, N.Y.; and San Francisco, Calif.

The notable achievements of the Wisconsin project are: The creation of an awareness of home equity conversion's potential among economists and financial columnists of this country, the stimulation of a major, nationwide private sector effort to offer a lifetime income plan to older homeowners, and the formation of a nonprofit organization which offers counseling and referral services on home equity conversion.

The final report of the Wisconsin project provided us with an opportunity to comprehensively examine the state-of-the-art and determine the feasible policy options on the basis of what we currently know about home equity conversion. Although home equity conversion is seemingly a vast reservoir of unexploited potential, it has to be acknowledged that several barriers impede its further development.

First, the prevailing mortgage interest rates seem to curb the willingness of lenders as well as older homeowning borrowers to conclude home equity conversion transactions. Second, the older homeowners have unresolved concerns, doubts, and fears about the complexity of the equity conversion process. Their basic reluctance to participate in the program is due to its apparent low cash payout and, at the other extreme, the fear of deception through fraudulent schemes. Finally, regulatory and statutory barriers at the Federal and State levels impede a smooth nationwide implementation of home equity conversion.

However, on balance, home equity conversion has merit in that older homeowners can derive income benefits through participation in this program. Despite some of the apparent barriers and disincentives to home equity conversion, the participants seem to be pleased with their decisions. To quote one participant: Miss Julia Schick, Buffalo, N.Y.: "I haven't signed my house away; I have signed my worries away."

Our overall assessment of home equity conversion is that it has enormous prospects for exploitation as well as growth potential. However, in the short run, the conversion idea may develop slowly because of numerous barriers and the current economic conditions.

In order to facilitate the acceptance of home equity conversion by lenders as well as borrowers and promote its further growth, we envisage the need to create the following preconditions:

Promoting coordination and cooperation among several Federal agencies.

Encouraging a broad spectrum of private sector, nonprofit, community-based, and local governmental organizations to participate in home equity conversion programs.

Developing technical assistance materials for organizations that want to spread the use of home equity conversion instruments, a consumer handbook for older homeowners, and effective and enforceable consumer safeguards.

To begin this process, my office has already taken steps to address select issues relating to home equity conversion in consultation with the U.S. Department of Housing and Urban Development. Our meetings explored the possibility of our two agencies working together in the areas of research, evaluation, demonstration, policy analysis, and the production of technical assistance materials. We expect firm policy decisions to emerge at subsequent meetings with the officials of the U.S. Department of Housing and Urban Development.

The officials who participated in these meetings agree that home equity conversion is one of several alternatives for meeting the needs of older persons for adequate shelter and income. Some of the other alternatives, which the Administration on Aging is jointly exploring with the U.S. Department of Housing and Urban Development, are shared housing, group homes, shared equity, echo housing, and accessory apartments.

I believe there is a great amount of potential in all of these options to insure the independence and self-sufficiency of older Americans, and to promote the strong involvement of private industry in meeting the economic and housing needs of our seniors. We will continue to explore all of these options.

Mr. Chairman, this concludes my formal testimony. I will be happy to answer any questions you may have.

Senator HEINZ. Secretary Abrams, I understand you will be making some legislative recommendations next year on mortgage insurance, is that correct, FHA insurance?

Mr. ABRAMS. On this particular subject?

Senator HEINZ. Yes.

Mr. ABRAMS. Well, it is not determined as yet.

We are just beginning the review process. As a matter of fact, my opportunity to meet with the Secretary on the 1984 budget legislative package, is this afternoon.

Senator HEINZ. Maybe I misunderstood you, but you did say some pretty encouraging words, that it is the role of FHA to encourage innovation, facilitate new ideas, to create markets. You said some pretty encouraging things about why this would be helpful. Maybe I misread you.

Mr. ABRAMS. No, I don't think you misread me. But I am trying to relate that to the chronology of events. I meet with the Secretary today. The Secretary makes his recommendations in September and they come to you.

Senator COHEN. Are you going to be as enthusiastic this afternoon as you are now?

Mr. ABRAMS. I think so.

There are other issues thornier than this one. Our biggest problem, to be frank, when we considered this idea a year ago was with the—at current high interest rates, the amount of the annuity is so low that we are concerned about whether the homeowner would be better off if he did not take the annuity.

We knew, for example, that we would have major problems in instances where a homeowner outlived the stream of annuity payments. If he did have an annuity, it would be so small an amount of money we did not think it was worthwhile.

As interest rates come down, the program would be much more attractive. We have given it a great deal of consideration over the last year. We have met with HHS. I think it is a program that will be given some more consideration.

Senator HEINZ. One of the witnesses who testified spelled out some of the aspects of the program in Buffalo. Mr. Guttentag, as I recollect.

That program used CDBG funds in its equity conversion program.

Has HUD given any consideration to making specific authorization for the use of CDBG or perhaps UDAG in equity conversion, perhaps to write down the interest rates on reverse equity and deferred equity loans for neighborhoods targeted for rehabilitation?

Mr. ABRAMS. I honestly do not know the answer to the question. But my understanding of the CDBG program is that it is an eligible activity.

Senator HEINZ. It was rather interesting to hear that one of the reasons Buffalo was encouraging this kind of program is that it was aimed at improving neighborhoods, maintaining the stability of the population, and insuring that upon the death of the homeowner, there is an orderly transition of that property into new hands having been well maintained and an attractive place to live for some other family, some other person.

Mr. ABRAMS. I see. It would stabilize neighborhoods.

Senator HEINZ. Secretary Hardy, do you think when, and if, home equity conversion plans become more widespread there is the potential that some homeowners could be deceived or defrauded by unscrupulous people? Has AoA or HHS given any consideration to the need for national guidelines or consumer protection in equity conversions?

Do you have any reaction to the idea suggested by one or two of our witnesses that there ought to be a HUD counseling program as an alternative?

Ms. HARDY. I think it is always possible that an individual, regardless of age or situation, can be conned by some unscrupulous other party. But in terms of looking at consumer issues, we are going forward in our discretionary funding.

We have received a number of proposals in this area, process on several fronts in terms of housing. One of them, from the department of human services' bureau of elderly in the State of Maine, is to develop a consumer handbook as part of a fairly large demonstration project on home equity and some of these other alternatives.

I think that would show, assuming that it is funded, that that kind of consumer handbook done at the State level, in cooperation with the State units on aging, is the way we should be going rather than development of this kind of material at the Federal level.

I think there are also a lot of local issues involved.

Senator HEINZ. Do you see a role for the local area agencies on aging?

Ms. HARDY. Absolutely. You asked about counseling. I would much prefer to get the area agencies on aging involved. There are a lot of individuals in the community, be they bankers or insurance people, that are knowledgeable about these issues. The University of Maine Law School is involved in the proposed project in Maine.

Senator HEINZ. Let me ask Mr. Abrams if he would agree that this is better done in the area agencies on aging, or if the HUD counseling centers can do it better?

Mr. ABRAMS. I believe that HUD counseling centers have been focused on default counseling and that they have not been as effective as local programs that have been funded out of CDBG funds.

Senator HEINZ. We will ask the members of the expert panel who mentioned that as to whether they have any strong feelings.

Ms. HARDY. I think we should add, if the area agencies on aging are involved in a community, that they should have some knowledge of housing. They should know what is available. They should already be in this business.

Senator HEINZ. Frankly, those would be my sentiments but I would like to hear from our experts who raise it as an issue.

Senator COHEN. Mr. Abrams, before you arrived there was a question about the IRS having to clarify the tax status of any sale or leaseback arrangement, or any of these home equity arrangements in which the seller may very well not be exempt from the one time capital gains tax, and indeed whether the lender would be able to depreciate the property.

Have you had any contact with the IRS, any indication whether they are going to rule or need to rule on this?

Mr. ABRAMS. I have had no contact.

Senator COHEN. Don't you think that would be important?

Mr. ABRAMS. I do. I have a meeting upcoming on some other issues and I will bring this one up.

Senator COHEN. One of the four items you mentioned in deciding whether FHA should be involved, you indicated it should be for low and moderate income. How do you intend to measure that, by assets or income?

Mr. ABRAMS. In the FHA programs, there are no assets or income tests, but the mortgage limit, $67,500, a statutory limit, tends to bring us a market made up of low- and moderate-income families. So that is a self-regulating——

Senator COHEN. What is the cutoff?

Mr. ABRAMS. $67,500, plus there are high-cost areas that go up to $90,000. But, generally, we use these ceilings as a means of limiting us to areas where FHA has an appropriate role.

Senator HEINZ. But you would adjust it for high-cost areas?

Mr. ABRAMS. Yes.

Senator COHEN. There has been some talk that the administration has been contemplating placing liens on the property of medicaid patients before making payments.

The question I have is, would that not impede lenders from going forward with these home equity conversions, if that policy is, in fact, adopted?

I assume under bankruptcy laws you would take a priority.

Ms. HARDY. I am not exactly aware of where that discussion is within the Department. That would certainly impede. At the same time, there may be ways in which that could be worked out, and the collection or the liens could still take place and the individual could still have their mortgage equity program, going along as well.

I am not familiar with where we are on that particular policy.

Senator COHEN. The only other question I have is whether you were familiar with the application from the State of Maine. Apparently you are, and the next question is, when do you expect you will make a determination on the feasibility of such a program?

Ms. HARDY. I believe they have been notified that they need to come in with a full application. That should be in at the beginning of August. They will be funded or not funded by the end of this fiscal year.

Senator HEINZ. Now, I know why Senator Cohen is so interested in this hearing.

Senator COHEN. I did not come for one question only.

Senator HEINZ. Let me just follow up on the next previous question that Senator Cohen asked.

In the committee information print, that we released today, there is a discussion of the effect of equity income on supplemental security income and medicaid. As I am sure you are aware, the Social Security Administration has not developed specific policies to deal with home equity income.

At the present time, my understanding is, only where there is a loan program, and the money is used in the month in which it is received to pay the expenses of someone who is either medicaid eligible or SSI eligible—equity income would not be counted against SSI income or eligibility for medicaid.

Could you comment on that situation, how it would appear to rule out, with the exception of those loan programs, as just described, the participation of poor, elderly homeowners, and the use of the other equity conversion instruments that we have talked about, and also, of course, what you might be considering doing about it.

Ms. HARDY. We have not specifically discussed with the Social Security Administration the comments that you have made here in terms of SSI eligibility. The Department will be looking at this issue.

In terms of that eligibility question, if you make the assumption that an individual has a home that is less than the average value and that the return in terms of the reverse equity mortgage or the monthly income from that is very low, then there are two questions.

One, is that worth taking them off the SSI program; and, two, is it worth that person participating?

Senator HEINZ. There is a policy question that has to be resolved, whether, in fact, you want to reverse existing policy.

Existing policy is that that home belongs to the person. It is not to be counted in the assets test. It does not weigh against them in the eligibility for SSI or medicaid benefits, and that is our policy today.

Now, it seems to me, if you answer that we do not want to—that we do want to count a reverse mortgage arrangement, and the benefits therefrom as income, you are reversing present policy.

Now have you decided you want to reverse present policy?

Are you undecided on whether you want to reverse present policy, or have you decided that the present policy is something you want to stick with, or as Senator Cohen suggested, are you getting close to the decision point where you do want liens placed on the estates of medicaid eligibles?

Ms. HARDY. To my knowledge there has been no decision. There is still a lot of discussion and, obviously, this may have a significant impact on the issue we are discussing today.

I can have further discussion with the Commissioner on Aging and the Secretary and Under Secretary and see where we are. It affects more than our part of the Department.

Mr. ABRAMS. The same sort of issues cut across into some of the other HUD programs. I have talked to the Commissioner on the effects of ICF and gifts. When we allow them under the 202 program, then the SSI benefits are cut off. So there is no contribution of rent. The tenant then only receives $25 a month for expenses.

We have been working out with individual States some accommodation. But we have been instructed to sit down and work out the programs. Then you get further into housing, where if there is a role for congregate housing within the HUD program, to some extent it relates to Senator Cohen's question earlier about relieving demand for nursing homes or institutionalization by using congregate housing.

But if there is no understanding between HUD and HHS that this is a mutual benefit to overall society by both agencies working together, then we have a problem.

Senator COHEN. You have a problem with cross occurrence in terms of encouraging a new program of home health care. One of the things we have been deeply involved with is whether or not we try to encourage people to stay in their homes as long as possible, in order to reduce the demand for institutional care, so that those who really need it can get it.

I think right now 14 to 25 percent of those in nursing homes do not really need to be there. So you have to have some plan if you are going to encourage a program that is contrary to something that you think is desirable. That is why you cannot say it is none of our business, because we have Federal programs which are designed to keep people in homes. If you argue, on the other hand, if they are overhoused, the fact is, if you take a person out of their home, there is no housing for them to go into.

We do not have a housing industry that is terribly viable, and you have a shortage of homes. The chances are, the younger people, the ones in those smaller homes, are there because they cannot afford anything bigger.

Senator HEINZ. Just to add, if by some quirk, and I hope you do not, you end up with a policy that makes it difficult or impossible for medicaid eligibles to purchase home health care or some other kind of assistance that would keep them in their homes, by virtue of their medicaid eligibility, of course—if they get out of their homes, guess who pays for the nursing homes? Fifty-five percent of all expenditures under medicaid right now are for senior citizens. A lot of that goes to nursing home care.

Mr. ABRAMS. I know. I cannot speak for previous administrations, but there has been a great deal of cooperation between HHS and HUD. And a feeling that we have an obligation to present one coherent voice for the Federal Government, and not be uncoordinated in terms of relating where our programs overlap, and we will continue to pursue that and, hopefully, we will be able to come up with some intelligent answers.

Senator HEINZ. We may have a few questions for both of you for response in writing.[1]

Let me thank you both, Secretary Abrams and Secretary Hardy.

We encourage you to have a good meeting with the Secretary today, and come out of that meeting just as cheerful and positive and go-ahead as you are at this moment.

Thank you.

Our next witness is Leo Baldwin.

STATEMENT OF LEO BALDWIN, SENIOR COORDINATOR OF HOUSING PROGRAMS, AMERICAN ASSOCIATION OF RETIRED PERSONS, WASHINGTON, D.C.

Mr. BALDWIN. Mr. Chairman, I am glad to be here to testify in regard to reverse equity or home equity conversion.

I am reading an edited version of the copy of the statement which has been delivered for the record.[2]

I am Leo Baldwin, coordinator of the housing program of the American Association of Retired Persons.

With me today is Ralph Borsodi, an economic consultant with AARP's Federal legislative staff.

The 13.5 million members of the association have a vital interest in reverse equity, as they represent a substantial portion of the homeowners whose property is being considered the subject for reverse equity programs. The interest of the association is to make available to its members and the older population at large legitimate avenues through which assets, such as home equity, which have been acquired by responsible and prudent citizens, may now be used with responsibility and prudence during the remainder of their lives as discretionary cash resources.

Our testimony, therefore, is directed to reflect the interest of the membership in the concepts and programs being developed in the field of reverse equity; the programs which appear to be most advantageous to the older homeowner; the areas in which we believe consumer safeguards need to be provided; and suggestions for the role the Federal Government might assume.

Since AARP has not endorsed any specific reverse equity program, we have been in a position to study the wide variety of proposals that have surfaced since this subject came to public attention. Some of the things that have become apparent over this period are: A large number of older homeowners are frustrated and dismayed that they are unable to use the equity in the home as a means of meeting expenses without giving up their place of residence. To our knowledge, no actual survey has been conducted to determine the market potential, but my office receives hundreds of letters each year requesting information.

Most of the programs have produced new documentation to deal with the contractual obligations, that are established between the lender and the borrower. The older homeowner has been hesitant to be a party to these sophisticated and untested arrangements drawn by attorneys representing interests other than the homeowner, and generally establishing a lien against their property.

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[1] See appendix 1, items 1 and 2, pages 49 and 50.

[2] See page 42.

Most of the programs have had limited market appeal because of being structured to meet specific objectives perceived by the lender, rather than providing a flow of cash for the discretionary use of the homeowner. For example, several States use home equity as security for real estate tax deferral. Once that lien is in place the homeowner may not use remainder equity for any other purpose. The same situation pertains to home maintenance, remodeling, personal obligations, or unusual expenses for which equity has served as security.

Fixed-term reverse mortgages have generally run from 3 to 15 years. In most cases they have been placed with homeowners whose life expectancy exceeds the term. This forces the homeowner to contemplate selling the home in order to settle the debt or renegotiate the transaction under future unknown conditions.

The objective of the homeowners seems quite clear cut. They want a regular, predictable flow of cash for life over which they can exercise discretionary use without the threat of foreclosure, loss of residency, or legal entanglement.

We remain skeptical of the interest or ability of the regulated mortgage industry to respond without governmental incentives, or of private investors to discipline themselves to deal in a fair and evenhanded manner with this vulnerable and unsophisticated population. Recognizing that disparity exists between the State banking laws and regulations, we believe that in the field of reverse equity this is an opportune time for the Federal regulatory bodies and the federally chartered institutions to establish exemplary homeowner safeguards, and encourage the several States to adopt this same code.

Therefore, we recommend for reverse equity programs, whether offered through private, regulated, or governmental agencies, federally mandated safeguards for the homeowner. Specifically, as homeowner safeguards, we recommend the following:

One, a legal and financial "arm's-length" counseling service should be established that would be available to homeowners considering a reverse equity arrangement. The service could be financed up front as a cost of business by organizations offering the programs, and could be charged back against the equity.

Two, an insurance program should be created that protects the homeowner from (*a*) loss of his property—or his rights in the property—through misrepresentation or fraud, including residency rights and income; (*b*) from outliving the value of the property; and (*c*) from the cost of counsel in the event of litigation. This program, as well, might be financed by organizations offering equity conversion, and could likewise be charged back to the equity interest of the homeowner.

Three, notwithstanding the present laws which govern truth in advertising, truth in lending, or mail fraud, our experience with the older population indicates that for many there is increased vulnerability as they age. We, therefore, urge consideration of a strengthening of existing laws and penalties to be imposed on organizations and individuals guilty of high pressure sales tactics, lack of disclosure, fraud or deceit as it relates to reverse equity transactions.

Four, since a reverse equity transaction may be one of the last major contracts to which an older homeowner is a party and will usually terminate with the death of the homeowner, we suggest that a safeguard which could be protective of the interest of both the lender and the estate of the homeowner be considered. Guidelines for federally chartered institutions should include a provision that the parties agree upon a reasonable period following death, within which all accounts related to the reverse equity contract must be satisfied. This would confirm to the lender that such outstanding accounts would be met without undue delay. For the beneficiaries of the estate it would identify any remainder interest subject to probate proceedings.

For the mortgage company, regulated banking institution, or private investment group, there should be established: One, a reverse equity property pool or Federal Housing Administration type insurance program, should organizations offering the program choose to spread the risk inherent in an open-ended commitment without a fixed settlement date. Two, a secondary funding source at Treasury interest rates from which qualified organizations could draw a percentage of their collateralized commitments, say up to 60 percent.

Reverse equity, if it is to be dealt with succinctly and with provision for both consumer protection and underwriting, must have an identity, objectives, and uniform standards of its own. A federally mandated task force might be the best vehicle for setting these standards; its composition should include, at a minimum, representatives of the Federal Home Loan Bank Board, the Securities and Exchange Commission, investors, the mortgage industry, the homeowner/consumer, and representatives of HUD and AoA.

We congratulate the chairman and the committee for their interest and the opportunity to participate in this hearing. We would be pleased to work with you in preparation of any recommendations on legislation which may result from these inquiries.

Senator HEINZ. Thank you very much.

[The prepared statement of Mr. Baldwin follows:]

PREPARED STATEMENT OF LEO E. BALDWIN

Mr. Chairman, I am glad to be here to testify in regard to reverse equity, or home equity conversion. A copy of this statement has been delivered for your record. I am Leo E. Baldwin, coordinator of the housing program of the American Association of Retired Persons. With me today is Ralph Borsodi, an economic consultant with AARP's Federal legislative staff.

The 13.5 million members of the association have a vital interest in reverse equity, as they represent a substantial portion of the homeowners whose property is being considered the subject for reverse equity programs. The interest of the association is to make available to its members, and the older population at large, legitimate avenues through which assets such as home equity, which have been acquired by responsible and prudent citizens, may now be used with responsibility and prudence during the remainder of their lives as discretionary cash resources.

Our testimony, therefore, is directed to reflect the interest of the membership in the concepts and programs being developed in the field of reverse equity; the programs which appear to be most advantageous to the older homeowner; the areas in which we believe consumer safeguards need to be provided; and suggestions for the role the Federal Government might assume.

Since AARP has not endorsed any specific reverse equity program, we have been in a position to study the wide variety of proposals that have surfaced since this subject came to public attention some 15 years ago. Some of the things that have become apparent over this period are:

A large number of older homeowners are frustrated and dismayed that they are unable to use the equity in the home as a means of meeting expenses without giving up their place of residence. To our knowledge, no actual survey has been conducted to determine the market potential, but my office receives hundreds of letters each year requesting information about the possibility, and asking for the name of a bank, savings and loan, or other agency which offers a reverse equity program.

Most of the programs have produced new documentation to deal with the contractual obligations that are established between the lender and the borrower. The older homeowner has been hesitant to be a party to these sophisticated and untested arrangements, drawn by attorneys representing interests other than the homeowner, and generally establishing a lien against their property.

Most of the programs have had limited market appeal because of being structured to meet specific objectives perceived by the lender rather than providing a flow of cash for the discretionary use of the homeowner. For example, several States use home equity as security for real estate tax deferral. Once that lien is in place the homeowner may not use remainder equity for any other purpose. The same situation pertains to home maintenance, remodeling, personal obligations, or unusual expenses for which equity has served as security. Many homeowners have expressed displeasure that the discretionary use of funds is eliminated once they seek relief in one direction.

Fixed-term reverse mortgages have generally run from 3 to 15 years. In most cases they have been placed with homeowners whose life expectancy (either personal or actuarial expectancy) exceeds the term. This forces the homeowner to contemplate selling the home to settle the debt or renegotiate the transaction under future unknown conditions. Homeowners often do not feel it is prudent to put themselves in such a position.

The objectives of the homeowner seems quite clear cut. They want a regular, predictable flow of cash for life over which they exercise discretionary use without the threat of foreclosure, loss of residency, or legal entanglement.

Although this is not the result of specific, researched inquiry, our conclusion is that there are millions of older homeowners for whom there is not now an opportunity to manage their home equity asset in their own best interest. At the same time we remain skeptical of the interest or ability of the regulated mortgage industry to respond without governmental incentives, or of private investors to discipline themselves to deal in a fair and even-handed manner with this vulnerable and often naive population.

Therefore, we believe reverse equity programs, whether offered through private, regulated, or governmental agencies, require federally mandated safeguards for the homeowner.

Recognizing that disparity exists between the State banking laws and regulations, we believe that in the field of reverse equity this is an opportune time for the Federal regulatory bodies and the federally chartered institutions to establish exemplary homeowner safeguards and encourage the several States to adopt this same code.

Therefore, we recommend for reverse equity programs, whether offered through private, regulated, or governmental agencies (federally mandated) safeguards for the homeowner. Specifically, as homeowner safeguards, we recommend the establishment of:

(1) A legal and financial "arm's-length" counseling service to be made available to homeowners considering a reverse equity arrangement. The service could be financed "up front" as a cost of business by organizations offering the programs, and could be charged back against the equity.

(2) An insurance program which protects the homeowner from loss of his property, of his rights in the property through misrepresentation of fraud, including residency rights and income; from outliving the value of the property; from the cost of counsel in the event of litigation. This program, as well, might be financed by organizations offering equity conversion, and could likewise be charged back to the equity interest of the homeowner.

(3) Notwithstanding the present laws which govern truth in advertising, truth in lending, or mail fraud, our experience with the older population indicates that for many there is increased vulnerability as they age. This population tends to be prone to high pressure and deceitful practices. We urge consideration for stiffening existing laws and penalties to be imposed on organizations and individuals guilty of high pressure sales tactics, lack of disclosure, fraud or deceit as it relates to reverse equity transactions.

(4) Since a reverse equity transaction may be one of the last major contracts to which an older homeowner is a party and will usually terminate with the death of the homeowner, we suggest that a safeguard which could be protective of the inter-

est of both the lender and the estate of the homeowner be considered. Guidelines for federally chartered institutions should include a provision that the parties agree upon a reasonable period following death within which all accounts related to the reverse equity contract must be satisfied. This would confirm to the lender that such outstanding accounts would be met without undue delay. For the beneficiaries of the estate it would identify any remainder interest subject to probate proceedings.

For the mortgage company, regulated banking institution, or private investment group, there should be established:

(1) A reverse equity property pool (or Federal Housing Administration type insurance program) should organizations offering the program choose to spread the risk inherent in an open-ended commitment without a fixed settlement date.

(2) A secondary funding source at Treasury interest rates from which qualified organizations could draw a percentage of their collateralized commitments, say up to 60 percent.

AARP has long endorsed the concept of reverse equity, but has constantly expressed concern for homeowner safeguards and underwriting, such as represented by these six recommendations, which we believe are applicable to all types of reverse equity programs in which title to the property resides with the homeowner.

In the matter of sale-leaseback programs, in which title is transferred to an investor and residency rights are established by lease, the same consumer protections should be required. However, the nature of the transaction and existing Federal and State security regulations, as well as current tax statutes, would preclude the property pool or secondary funding suggested above.

Both the 1981 White House Conference on Aging and the President's Commission on Housing recognized and strongly endorsed home equity conversion as a way to legitimatize access to an asset which otherwise remains dormant during the owner's occupancy. Most legal and regulatory barriers have been removed. The program will be handicapped as long as homes can be used as collateral for only one purpose. Discretionary cash resources, available through standardized documentation, insured to prevent deceit, default or fraud, with guaranteed residency rights, appear to us as critical to the widespread application of reverse equity. These are areas in which the Federal Government can establish guidelines and provide underwriting for both risks and funding which neither regulated agencies nor the private sector is willing or able to assume. Until such commitments are made at the Federal level, we believe it will be impossible to correctly assess the interest in or the marketability of home equity conversion programs.

Reverse equity, if it is to be dealt with succinctly and with provision for both consumer protection and underwriting, must have an identity, objectives, and uniform standards of its own. A federally mandated task force might be the best vehicle for setting these standards; its composition should include, at a minimum, representatives of the Federal Home Loan Bank Board, the Securities and Exchange Commission, investors, the mortgage industry, and the homeowner/consumer. It might also be wise to include representatives of HUD and AoA.

One of the most recent areas of inquiry involving equity conversion is in the field of long-term care with home-delivered services. This approach contemplates that services such as housekeeping, food delivery or preparation, even health care, which help maintain the older homeowner in the residence, could be financed at least in part by charges building up as services are rendered, but which are not paid by the homeowner until residency in the home is terminated. In this case the lender is the service agency. The agency will presumably have to pledge their accounts receivable to a finance source willing to wait for settlement until home delivery ceases. I bring this up in part to illustrate the innovations that are surfacing in the use of equity. These innovations point further to the need for the Federal Government, through legislation and regulation, to actively pursue the goals of consumer protection and underwriting.

We congratulate the chairman and the committee for their interest and the opportunity to participate in this hearing. We would be pleased to work with you in preparation of any recommendations on legislation which may result from these inquiries.

Senator HEINZ. You have clearly done a lot of thinking about this. You have a comprehensive and rather specific set of recommendations that reach across the entire gamut.

You address the questions, the financing incentives, both to the lender and the senior citizens. You look at the question of consumer safeguards. You propose a task force to sort those out and get some unanimity among all the organizations, both competing and cooperating.

You gave a very impressive summation of many things that you advocate.

From what you have heard today, particularly from HHS and from HUD, where there were some encouraging comments from HUD that they intend to try and move ahead, depending on a meeting today, in the area of insurance. Do you feel HUD is headed, if we can take Mr. Abrams' comments at present value as future value, that they are headed in the right direction?

Mr. BALDWIN. Mr. Abrams' testimony was a surprise to me. Inquiries were made at HUD, some time ago, and did not indicate there was an interest in pursuing this. I was pleased to learn that this was now on their agenda.

I was also impressed by Secretary Hardy's comments, particularly with regards to the possibility of the establishment of a counseling service which might be operated out of their AAA, area agency on aging programs. I think I have to disagree with her a little bit that the AAA's currently have people who are versed in housing issues.

So this may be a new area of activity for them. But it is one which I think they are not only qualified to undertake, but where the service is very desperately needed.

Senator HEINZ. Mr. Abrams made the point that the existing HUD counseling is limited in expertise to counseling on foreclosure and seemed to imply that HUD would not be a very good agency to rely on for the counseling involved in home equity conversion. Would you agree or disagree?

Mr. BALDWIN. HUD has an entirely different kind of mechanism for its counseling procedures and, to my knowledge, in the past these have been limited primarily to areas which were dealing with community development block grant programs, where there were displacement issues and things of this kind, of existing tenants or residents.

My reaction is that the AAA's which are of course involved in the local communities, have the ability to contract for the services through other existing agencies, rather than provide the services themselves. Thus, they could meet the concept I have outlined of an "arm's-length" counseling group that could be trained and specifically used in the area of reverse equity counseling.

Senator HEINZ. Now, with respect to a few specifics in your statement, one of the things you urge are tougher laws against high pressure sales tactics and fraud or deceit in reverse equity transactions. Maybe my recollection is mistaken, but while truth in advertising, truth in lending, and mail fraud are under Federal laws, principally State and local statutes apply to high pressure sales tactics.

Mr. BALDWIN. Yes, you are correct, of course. The current laws are Federal in nature. The concern I think I am trying to express here relates to some of the testimony you heard earlier, that there is just a plethora of contracts now being developed by a fantastic variety of organizations or groups that are looking upon this as having some market potential, not necessarily from the interest of the homeowner, but from the standpoint of an investment opportunity.

I do not think we want to discourage the development of these instruments because have to find ways for the market to become involved.

On the other hand, I think that it is incumbent upon us to keep in mind the fact that this last asset of the homeowner is the thing that is in jeopardy. If we were to permit a situation to exist where the older population could be hoodwinked in one way or another to put that asset on the line and then be defrauded out of it, without severe penalties, then we would be delinquent in our charges.

So I am concerned that this be looked at as an issue dealing with the reverse equity situation rather than just interstate commerce or truth-in-lending situations, as it stands at the present time.

Senator HEINZ. You see the reverse equity loan arrangement as being the principal means by which senior citizens will benefit?

You do not see as much in the sale and leaseback or in the other kinds of loan kind of arrangements? Is that correct?

Mr. BALDWIN. When I use the term "reverse equity," I am really applying that to the reverse mortgage in its several different forms, and to the sale/leaseback.

Senator HEINZ. You would include sales/leaseback?

Mr. BALDWIN. Yes, sir.

Senator HEINZ. I suppose, if we get to the point where we want Mr. Abrams to get to, then it would be easy enough to insure as a precondition for any Federal insurance, mortgage equivalent insurance, that there would be a set of adequate protections built in—or standards built in—as a protection to people.

Are you suggesting, though, that there should be a set of Federal standards even if we cannot tie them to insurance for federally chartered institutions?

Mr. BALDWIN. Yes.

Senator HEINZ. One other question.

I understand that AARP is exploring the possibility of a national program to assist in equity conversion education and counseling.

Would you care to comment on the role that you think private and not-for-profit and volunteer groups play can in increasing the availability of home equity conversion and how are your plans coming as they relate to home equity conversion?

Mr. BALDWIN. One of the objectives of the housing program for which I work has been the establishment of a housing counseling program through our own resources and through the use of our own membership and trained volunteers.

We have not yet been able to initiate that program. But we have encouraged development of counseling services by other agencies, some Federal and some private.

We would be very happy if we could find a way in which there could be a cooperative arrangement made so that our resources could be used in conjunction with the AAA's, or other counseling programs, so that this could become quite universal across the country.

The biggest problem that I see confronting the counseling program is that if it were initiated, for example, by our own association, we would have to start out on a very limited, parochial basis, and it would take a considerable period of time to grow to any extent.

So anything we could do that would lend our resources to the development of a nationwide program, I am sure we would support.

Senator HEINZ. Very well.

Senator Dodd has a few questions for you, which we will submit to you in a few days.[1]

You have a tremendous amount of expertise. You have made a number of extremely useful suggestions.

We thank you for being a part of our hearings today.

Thank you.

The hearing is adjourned.

[Whereupon the hearing was adjourned at 11:40 a.m.]

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[1] See appendix 1, item 3, page 51.

APPENDIXES

Appendix 1

QUESTIONS SUBMITTED SUBSEQUENT TO HEARING

ITEM 1. QUESTIONS AND RESPONSES FROM PHILIP ABRAMS, GENERAL DEPUTY ASSISTANT SECRETARY-DEPUTY FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Question 1. During your testimony, you mentioned the possibility of legislation on equity conversion being included in the fiscal year 1984 legislative package. Would you please elaborate on the type of legislation which is being considered and what the program will be? Also, during the hearing there was mention of cooperative efforts between HUD and HHS on equity conversion. Would you please indicate what types of cooperation are contemplated and which offices within HUD have been involved.

Response. As I indicated in my testimony, Secretary Pierce and I are both very interested in the development of a role for HUD in assisting elderly homeowners through increasing the market availability of home equity conversion mortgages.

I stated also that HUD participation would most likely take the form of FHA insurance of equity conversion mortgages, and that FHA would insure the lender against the risk that underlying property values would not decline in value over the term of the annuity. This form of protection would permit higher loan-to-value ratios, increase the cash flow to the borrower, and enhance the mortgage instrument's marketability. It is also possible that HUD would insure the borrower against default on annuity payments made by the lender (the reverse of current FHA practice).

In terms of a specific legislative initiative, it is likely that HUD would propose a limited demonstration authority in order to experiment with a number of alternative home equity conversion programs. With such authority, we would have an opportunity to determine whether or not sufficient demand was present in the marketplace to support a national program, and to evaluate alternative approaches in terms of their usefulness and acceptability to elderly homeowners, and their attractiveness to lenders and investors.

Thus far our cooperative efforts with HHS on equity conversion have been limited. We have held two exploratory meetings with the Administration on Aging (AoA) to discuss the "state of the art" in equity conversion. Representatives from the Office of Housing, Office of Policy Development and Research, Office of Community Planning and Development, and the Office of Intergovernmental Relations have attended these meetings.

Both HUD and HHS believe that any Federal role in home equity conversions should be limited, particularly in view of the growing number of privately financed and operated equity conversion programs across the country. Nonetheless, we intend to work closely with AoA in the future in order to obtain their suggestions and comments if any demonstration activities are initiated. We also see a potential cooperative role in providing information to consumers on home equity conversions. In this regard, we have already discussed the possibility of working through AoA's network of some 600 local and area agencies, which provide direct and indirect services to older persons who might potentially benefit from equity conversion.

Question 2. We would like to know if FHA has explored the possibility of insuring rising debt equity loans, as well as fixed debt loans, and if such loans could be written by mortgage bankers, as well as lenders, and sold to GNMA in the same way in which conventional loans have been insured and sold? Also, has FHA considered the possibility of insurance for an indexed reverse equity loan which would insure lenders and borrowers against the risk that the property will not rise in value or may decline in value?

Response. Any future FHA insurance program for home equity conversions would presumably allow for graduated as well as fixed payment annuities. Graduated payment annuities are especially helpful to homeowners seeking relief from increasing operating and utility expenses.

To the extent home equity conversion debt instruments are attractive to secondary investors, then mortgage bankers are likely to become active originators of such mortgages. It is also possible that GNMA would purchase equity conversion mortgages, at least until other secondary market purchase programs were in place.

Initially, amounts insured by FHA would be limited to some percentage of home value at loan origination, similar to current practices in our existing FHA insurance programs. The purpose of such insurance, in the case of home equity conversion, would be to protect the lender or investor from any decline in the value of the property prior to loan maturity.

Such insurance coverage would permit the use of fixed-, graduated-, or indexed-payment annuities, but the maximum amount insured by FHA would be limited at loan origination to some percentage of available equity in the home, and would not take into account future or expected growth in home equity.

In the event the value of the property incresed over time, then it might be possible for homeowners to convert some or all of their additional equity into a supplemental cash flow at that time. This process would involve a recasting of the original loan agreement, or the creation of a second equity conversion mortgage.

Question 3. Has HUD given any consideration to funding a national demonstration program on home equity conversions?

Response. While a national demonstration program is under consideration, it is more likely that HUD will propose a legislative initiative based on a series of local demonstrations designed to experiment with different home equity conversion plans. Crucial to this determination is the need for close coordination between HUD and local participants, including local mortgage lenders and local organizations representing older persons.

Question 4. You state that the greatest resistance to home equity conversion is found among those most in need (i.e., individuals age 75 or older living alone with annual incomes below $5,000). How will HUD target an equity conversion program to the needs of those homeowners? What is the likelihood of getting HUD-sponsored counseling centers for senior homeowners interested in such programs?

Response. In my testimony, I suggested that current statutory maximum mortgage amounts in our FHA programs would serve as one factor in targeting the financing of home equity conversions. The use of maximum mortgage amounts would limit the amount of home equity which could be converted, thereby targeting the program to elderly homeowners with low- and moderate-incomes. Such utilization might eliminate the need for income eligibility limits as a mechanism for program targeting.

Concerning the likelihood of HUD funding for counseling centers for the elderly, it is my view that such counseling is more properly provided through national senior citizens organizations, perhaps in connection with HHS's Administration on Aging. Also, it should be noted that housing counseling is an eligible local activity for community development block grant (CDBG) funding. Finally, once the private sector becomes active in the financing of home equity conversions for the elderly, the lending organizations should become an excellent source of information on estate planning for elderly persons considering the advantages and disadvantage of home equity conversions.

ITEM 2. QUESTIONS AND RESPONSES FROM DORCAS R. HARDY, ASSISTANT SECRETARY FOR HUMAN DEVELOPMENT SERVICES, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Question 1. During the hearing, there was mention of cooperative efforts between HUD and HHS on equity conversion. Would you please indicate what types of cooperation are contemplated and which offices within HHS have been involved?

Response. Within the Department of Health and Human Services, the agency which has been primarily involved in discussions of this subject with HUD is the Administration on Aging (AoA), one of the components of the Office of Human Development Services, which I, as Assistant Secretary, head. AoA officials have recently held two meetings with HUD officials for discussions of issues relating to home equity conversion.

Currently, both AoA and HUD are in the process of comparing their staff analyses of the potential of home equity conversion in order to develop a feasible, cooperative strategy. The two agencies are expected to cooperate on identification of issues, the joint funding of projects, and policy formulation with respect to home equity conversion.

Question 2. James Firman from the Robert Wood Johnson Foundation gave testimony concerning the potential use of equity income to finance home health services for health impaired elderly, enabling them to remain in their homes, rather than enter hospitals or nursing homes. Has the Department of Health and Human Services investigated this possibility?

Response. The Secretary's Task Force on Long-Term Care, particularly its Subcommittee on Private Sector Initiatives, has given careful consideration to home equity conversion as a means of enhancing incomes in old age. Because the added income could be used for any purpose, including the purchase of long-term care services, the task force has made no estimates of the extent to which any additional income which might result would be used to finance home health services.

Question 3. As was indicated during the hearing, the Social Security Administration has not developed any policies to deal specifically with home equity conversion income. Would you please comment on this situation and indicate if the Department of Health and Human Services is considering the development of a specific policy?

Response. The Social Security Administration advises us that no supplementary security income recipient has received funds from a home equity conversion (HEC) plan. Therefore, that agency had not had occasion to determine how income from an HEC plan would be treated under the SSI program.

However, SSA has been examining the matter with the view to arriving at a policy decision. Among the considerations involved in this review is the fact that existing policies, such as those covering the proceeds from loan and annuity and interest payments, were determined before the emergence of HEC plans, and these policies were not formulated with such plans in mind.

The basic question to be answered is how should income from such a plan be treated in the SSI program, which is an income assistance program. Its purpose is to assure a minimum level of income to aged, blind, or disabled people with little or no income and limited resources. What SSA will be looking for is an appropriate way for this income assistance program to treat significant amounts of recurring income resulting from home equity conversions.

ITEM 3. QUESTIONS AND RESPONSES FROM LEO BALDWIN, SENIOR COORDINATOR OF HOUSING PROGRAMS, AMERICAN ASSOCIATION OF RETIRED PERSONS

Question 1. Do you feel there is a danger that home equity conversion projects might be used as a precondition for the receipt of government assistance in the future?

Response. Yes, but this is not out of keeping with the history of qualifying assistance recipients by means tests. Our social policies have always presumed that applicants were prepared to prove their impoverishment and if necessary to divest themselves of assets.

This undesirable situation always results in a conflict of goals, i.e.; we would like to see American aspirations for homeownership, financial independence, and self-sufficiency come true for everyone, but if personal circumstance (such as long-term health needs) prevent this we expect the victims to ante their assets, give up the dream, and accept the largesse of society.

If carefully conceived, home equity like an annuity, pension plan, or any deferred income program could be be actuarially folded into personal assets without requiring the sacrifice of residency rights or the discretionary use of funds should a specific need be alleviated. Because of these factors the conversion of home equity into a life term discretionary cash flow is an important concept in contrast to income, earnings or other resources the government may regard as assignable liquid assets.[1]

Sale/leaseback programs with annuity provisions are responsive to this issue. For reverse mortgages, however, the only vehicles which address this issue are the entitlement programs. While it may not be a favorable time to suggest another entitlement program, some adaptation—perhaps through title commitment of owner-occu-

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[1] This is one of the reasons why a tax ruling, or possibly a tax policy, become critical to reverse equity program development.

pied property for a life term discretionary cash flow—may be an appropriate means of preventing forced impoverishment.[2]

Question 2. What else can the Federal Government do (for consumer protection) besides establishing guidelines and providing underwriting for both risks and funding?

Response. As indicated in previous testimony, an "arm's-length" counseling service is of great priority in the matter of homeowner protection. The establishment of a nationwide creditable service without Federal involvment is difficult to conceive. Since this service could properly be charged against the equity, the Federal Government could provide startup resources, perhaps as a revolving fund. With the current limited application of reverse equity, the program could be initiated as the market expands, but without the opportunity for development in these first program sites, circumstances may force a less adequate crash program at considerably greater public expense in the future.

In regard to the federally mandated task force, I would suggest it be charged with the responsibility of (1) delineating guidelines and uniform standards for reverse equity marketing (homeowner protection), (2) developing actuarial and underwriting standards to address the issues of risks and funding (financial viability), (3) ascertaining impact and remedies regarding reverse equity and means-tested assistance programs (public and taxing policy).

This would then justify three-person teams from each independent agency or organization so that each team would have participation in each facet of the task force charge.

Beyond legislative remedies which might grow out of task force recommendations, Federal involvement should be limited to the function and oversight requirements within existing regulatory bodies and security commissions.

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[2] The article, "Home Equity Conversion and Means-Tested Programs," Marilyn Moon, is an excellent presentation of the morass of consequences of providing liquidity to fixed assets for people requiring means-tested program assistance.

Appendix 2

MATERIAL SUBMITTED FOR THE RECORD

ITEM 1. LETTER FROM JOHN A. SVAHN, COMMISSIONER, SOCIAL SECURITY ADMINISTRATION, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES, TO SENATOR JOHN HEINZ, CHAIRMAN, U.S. SENATE SPECIAL COMMITTEE ON AGING, DATED JULY 26, 1982

DEAR SENATOR HEINZ: I am responding to your inquiry of June 10, 1982, regarding the effects of home equity conversion (HEC) programs on the eligibility of elderly persons under the supplemental security income (SSI) program.

As you know, the overall purpose of the SSI program is to provide a minimum level of income to help needy aged, blind, and disabled people meet their basic needs. Accordingly, it is generally true under SSI that income and resources available to meet basic needs are taken into account in determining eligibility for, and the amount of, SSI benefits.

At this time there is no SSI policy that deals specifically with any form of HEC by name. The proceeds of each type of HEC fit under some broader existing policy. For example, the proceeds of a reverse mortgage loan would fall under the general provision in 20 CFR 416.1103 that money a person borrows is not income. However, based on 20 CFR 416.1201, to the extent that loan proceeds are retained beyond the month of receipt, they become countable resources to be measured against the SSI limit of $1,500 for a single individual or $2,250 for couple. As long as countable resources are within these limits, they have no effect on SSI payment amounts. However, countable resources in excess of the limit make a person ineligible to receive any SSI benefit.

Countable income, on the other hand, results in a dollar-for-dollar reduction of the SSI benefit payable. Thus, based on Federal benefit rates which became effective July 1, 1982, an individual with countable income in excess of $284.30 a month ($426.40 for an eligible couple) is not eligible for a Federal SSI benefit. These income and resources limits, as well as what can be excluded from counting, are established by specific provisions of the Social Security Act (sections 1612(b) and 1613(a)).

If a reverse mortgage is coupled with an annuity, the annuity payments (and any interest accrued) are unearned income under section 1612(a) of the Social Security Act. However, receipts from the sale, exchange, or replacement of a resource (a home is a resource) are not income but are merely resources that have changed form (20 CFR 416.1103). In the case of a sale/leaseback arrangement, the buyer's payments on the house which has been sold remain a resource. However, if the seller's sale/leaseback contract has value and can be sold, it is a countable resource.

Property tax deferral is not considered a loan under the SSI program. Therefore, a governmental payment (deferral) of a homeowner's property tax over a period of time results in the homeowner's receipt of in-kind support and maintenance which is unearned income for SSI purposes (20 CFR 416.1130).

Sincerely,

JOHN A. SVAHN.

ITEM 2. LETTER FROM DORCAS HARDY, ASSISTANT SECRETARY FOR HUMAN DEVELOPMENT SERVICES, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES, TO SENATOR JOHN HEINZ, CHAIRMAN, U.S. SENATE SPECIAL COMMITTEE ON AGING, DATED OCTOBER 18, 1982

DEAR SENATOR HEINZ: The purpose of this letter is to inform you of the various efforts which the Office of Human Development Services has recently made to facilitate the wider use of home equity conversion by older persons. As you may recall, I mentioned during my testimony before your committee on July 20, 1982, that a supportive Federal role was essential for enhancing the potential of home equity conversion.

I was very pleased that, as a result of the review of applications submitted in response to our fiscal year 1982 discretionary program announcement, we were able to fund two projects in the area of home equity conversion. Based on the reviewers' comments and staff analyses, I firmly believe that these studies will lead to a better understanding of the home equity conversion process and will provide us with the knowledge-base for developing options, initiatives, and policies at the Federal level on diverse home equity conversion plans. These two projects, funded by the Administration on Aging, are briefly described below:

Bureau of Maine's Elderly, a model for innovative home equity conversion through linkages between the private and public sectors.—The project's work plan includes a statewide survey, counseling and estate planning services, and two demonstration projects. The highlight of this study is the development of a consumer handbook for older homeowners. This study is expected to make significant contributions through testing and feasibility of home equity conversion: (a) For low- and moderate-income older homeowners residing in a predominantly rural State; and (b) in the broader context of living arrangements such as congregate and shared housing.

National Center for Home Equity Conversion, homemade pension plans: Converting home equity into retirement income.—Ken Scholen, the organization's founder, has played a major role in raising the public awareness of the potential of home equity conversion for older homeowners. The funding of this study represents an effort on the part of the Administration on Aging to consolidate and promote knowledge on the process and issues involved in converting home equity.

Specifically, this research/demonstration study will advance the state-of-the-art on home equity conversion through the development of technical papers on several complex issues. Furthermore, the Administration on Aging's support of this study will enable the applicant organization to assume the major functions of a national clearinghouse and provide counseling and referral services to interested individuals and organizations throughout this country.

The Administration on Aging has established a work group which will provide consultation and technical assistance to the project staff throughout the duration of the study. The work group will be composed of representatives of key Federal agencies and national organizations with a keen interest in home equity conversion. It is our expectation that the highly focused efforts of this project should lead to tangible policy outcomes in the area of home equity conversion.

Subsequent to your committee's hearing, representatives of the Administration on Aging and the Department of Housing and Urban Development have met several times to discuss and outline a coordinated strategy to make diverse housing options, including home equity conversion, available to older homeowners. In addition, the Administration on Aging has shared with the Department of Housing and Urban Development materials relating to the two projects discussed in this letter and sought their technical advice. We are now pursuing ways to further jointly explore home equity conversion issues.

In view of your interest and commitment to making home equity conversion work for the benefit of older Americans, I will keep you informed of the progress we are making on the two studies. I will make available to you copies of interim products and final reports resulting from these studies.

Should you or your staff have any suggestions concerning our work in this vital area, I hope you will feel free to share them with me.

Sincerely,

DORCAS R. HARDY,
Assistant Secretary for Human Development Services.

ITEM 3. LETTER FROM JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), U.S. DEPARTMENT OF THE TREASURY, TO SENATOR JOHN HEINZ, CHAIRMAN, U.S. SENATE SPECIAL COMMITTEE ON AGING, DATED AUGUST 20, 1982

DEAR SENATOR HEINZ: This is in response to your letter of June 9, 1982, on behalf of the Senate Special Committee on Aging. You have asked us to describe the operation of sections 121, 453, and 168 of the Internal Revenue Code ("code") as they relate to home equity conversions by the elderly. By home equity conversions, we understand from your staff that you are interested particularly in transactions in which individuals sell their homes to third parties, while continuing to occupy those homes under lease arrangements with the buyers.

The following outline of the tax consequences of such transactions assumes that the home equity conversion will be undertaken in the form of a traditional sale and lease-back transaction, with a sale of fee simple title to the property to a seller at a fixed price followed by a lease-back to the seller under a normal residential lease for a fixed term. Different and more complicated questions may arise where an equity conversion takes a more complicated form. Issues in such complex cases can only be resolved on a case-by-case basis, depending on the facts of the particular transaction, and may involve issues under sections of the code not mentioned in your letter.

Under section 121 of the code, an individual who has attained age 55 may make a one-time election to exclude up to $125,000 of gain ($62,500 in the case of a married individual filing a separate return) realized on the sale or exchange of a personal residence, provided that during the 5-year period ending on the date of the sale or exchange, the property has been owned and used by the individual as his principal residence for periods aggregating 3 years or more. In the case of jointly held property, only one spouse need satisfy these age, holding period, and use requirements.

In the event gain from a sale or exchange eligible for the section 121 exclusion exceeds the excludable amount, the individual may report this excess gain on the installment method if at least one payment under the sales contract is payable in a year after the year of sale. Similarly, gain on sales not eligible for the section 121 exclusion may also be reported under the installment method if such sales otherwise qualify under section 453. Under the installment method, the seller must report as gain the percentage of each payment received that is equal to the ratio of the seller's gross profit on the transaction to the contract price. The Internal Revenue Service has held, in Rev. Rul. 80-249, 1980-2 C.B. 166, that in calculating the gain reportable ratably under the installment method where section 121 applies to exclude part of the gain from gross income, the section 121 excluded amount is subtracted in determining the gross profit on the transaction. Thus, if an individual aged 55 or older sold a residence under an installment contract for a contract price of $350,000, realized total gain of $150,000, and elected to exclude $125,000 of that gain under section 121, only $25,000/$350,000, or approximately 7.1 percent of each installment payment, would be reported as gain in the year the payment was received.

In general, the full cost of residential rental property (but not the cost of land) placed in service by the taxpayer after 1980 may be recovered using the accelerated cost recovery system ("ACRS"), a new system of cost recovery added to the code as part of the Economic Recovery Tax Act of 1981. ACRS generally permits a recovery of the full cost of the property over a 15-year period using either the straight-line method or prescribed tables which provide for recovery rates equivalent to use of the 175 percent declining balance method of depreciation, switching to the straight-line method at a time to maximize deductions. However, under section 168(e)(4)(B)(ii) of the code, ACRS may not be used if the taxpayer leases the property to a person who owned it at any time during 1980. This "antichurning" limitation was included as part of the ACRS provisions of the code to prevent the generous cost recovery provisions of ACRS from applying to property owned by taxpayers before the effective date of this new system where use and enjoyment of that property has not changed.

Because property qualifying for the section 121 exclusion at the present time will have been owned by the seller during 1980 in virtually all cases, the buyer of the property generally will not be permitted to use ACRS depreciation if the property is leased back to the seller. Of course, over time, more and more sale-leaseback transactions of this type will involve property that was not owned by the seller in 1980. In such cases, the transaction will be able to qualify both for the section 121 exclusion and for use by the buyer of ACRS depreciation.

If the ACRS provisions do not apply, a buyer in such a sale-leaseback transaction could depreciate his cost less the salvage value of the residential real property (but not the cost allocable to land) over the useful life of the property using either the straight-line method or the 125 percent declining balance method.

Please let me know if I can be of further assistance to the committee.

Sincerely,

JOHN E. CHAPOTON,
Assistant Secretary (Tax Policy).

ITEM 4. LETTER FROM DOYLE L. ARNOLD, ACTING COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY, TO SENATOR JOHN HEINZ, CHAIRMAN, U.S. SENATE SPECIAL COMMITTEE ON AGING, DATED SEPTEMBER 1, 1982

DEAR SENATOR HEINZ: I appreciate the opportunity to present the views of the Office of the Comptroller of the Currency on home equity conversion plans for elderly homeowners.

In your letter, you asked us to address three issues: the role of the Federal Government in facilitating the development and use of home equity conversion plans, the legislative and regulatory framework within which national banks wishing to offer such plans operate, and the need for borrower safeguards in such contracts.

To date, home equity conversion plans have not gained wide acceptance. We believe that much of that lack of acceptance reflects market forces. High interest rates substantially reduce the payment stream available from a reverse annuity mortgage (RAM).

Further, it is likely that lenders and investors consider home equity conversion plans risky undertakings. High interest rates and uncertainty about the future path of house prices reduce incentives for investors to participate in sale and leaseback or split equity arrangements. Similarly, if an elderly homeowner's ability to maintain the property is limited, the value of the collateral may be impaired. The lender's response to increased credit risk might be to limit the loan-to-value ratio on a RAM and to incorporate a sizable risk premium in the loan's interest rate. Investors in a sale and leaseback arrangement might reduce the price that they are willing to pay for the real estate. Such reactions to risk—reflections of the market's operation—reduce the payment stream that is available to elderly homeowners and could result in less demand for home equity conversion plans.

Role of the Federal Government

We believe that the design of home equity conversion programs should be determined by market forces—not regulation. Government's primary role should be to assure that financial markets have the flexibility to develop such instruments. Lenders can best test alternative instruments to enable elderly homeowners to realize income from the equity they have in their homes.

Government can facilitate private sector initiatives by making clear the "rules of the game." In this regard, the President's Commission on Housing recommended that action be taken to clarify the tax status of payments received under some home equity conversion plans. We view that as a proper step that government might take.

Government can also provide information about the benefits and risks of alternative home equity conversion plans. The Federal Government can make available information for borrowers and for lenders that impartially decribes plans that are being developed in the marketplace and the kinds of factors that might be considered in evaluating whether such plans meet a borrower's or a lender's needs.

Legislative and regulatory framework

The authority of national banks to make home equity conversion loans is governed by national banking laws generally.

In addition to the factors cited above that may have limited the development of home equity conversion plans, there are several statutory limitations that may restrict national banks' RAM lending: 12 U.S.C. § 371 which governs the real estate lending powers of national banks; and 12 U.S.C. § 29 which limits national banks' ownership of real estate.

12 U.S.C. § 371 requires, with some exceptions, that installment payments on real estate loans be sufficient to amortize the entire loan principal within 30 years when the real estate is improved with a one- to four-family dwelling. There is some uncertainty as to whether most RAM loans would satisfy that amortization requirement because, by design, the debt on a RAM grows over the loan term and is at its highest level at the end of the term.

Absence of amortization does not necessarily exclude national banks from the RAM market. Up to 10 percent of the aggregate amount a national bank is permitted to invest in real estate loans may be in loans that do not comply with the restriction of 12 U.S.C. § 371. We believe, however, that this statutory constraint probably discourages national bank initiatives in this area. Section 403 of the bill favorably reported by the Senate Banking Committee on Banking, Housing and Urban Affairs on August 19, 1982, would amend 12 U.S.C. § 371 to grant additional flexibility to national banks to make real estate loans subject to the regulations of the OCC. We encourage the enactment of that legislation as one way to increase the mortgage lending powers of national banks.

A second legal issue relates to the real estate holdings of national banks. 12 U.S.C. § 29 generally restricts the authority of national banks to acquire real property only as necessary to accommodate bank facilities and in satisfaction of previously contracted debt. Elderly RAM borrowers often do not have current income that will be sufficient to retire the debt at the end of the loan term. A national bank making RAM's might be found in violation of this restriction if the bank clearly has no reasonable expectation that the loan can be repaid and is therefore looking, from the outset, to ownership of the property to retire the debt.

Borrower safeguards

We believe that comprehensive disclosure of contract terms provides the best borrower protection. Home equity conversion plans typically involve complex financial arrangements that homeowners will probably undertake only once in a lifetime. The elderly homeowner's house may represent the bulk of his or her wealth. Thus, potential borrowers must have the opportunity to carefully evaluate a plan's costs and benefits.

Disclosure notices should include a statement of the payment schedule and how that payment schedule might be altered during the loan term, information on the tax status of the payments, an explanation of the disposition of the property and the rights of heirs if the borrower dies before the end of the loan term, and a clear explanation of the borrower's obligations and options at the end of the loan term. If the agreement involves the purchase of an annuity to provide income at the end of the loan term, there should be assurances regarding the quality of the annuity.

I trust that these comments will prove useful to the Senate Special Committee on Aging. We would be happy to assist the committee as it examines this matter in greater detail.

Sincerely,

DOYLE L. ARNOLD,
Acting Comptroller of the Currency.

ITEM 5. LETTER AND ENCLOSURE FROM RICHARD T. PRATT, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD, WASHINGTON, D.C., TO SENATOR JOHN HEINZ, CHAIRMAN, U.S. SENATE SPECIAL COMMITTEE ON AGING, DATED JULY 26, 1982

DEAR SENATOR HEINZ: This is in response to your letter of June 9, 1982, inquiring about Board actions to implement the recommendations of the President's Commission on Housing regarding revision of regulations governing reverse annuity mortgages.

By Resolution No. 82-310 (April 28, 1982) (47 Fed. Reg. 19711; May 7, 1982) (enclosed), the Board proposed amendments to its regulations governing home lending by Federal associations that expressly would provide for lump-sum disbursements on mortgage loans and would provide flexibility to facilitate the development and implementation of new forms of equity conversion mortgage instruments, including reverse annuity mortgages, by Federal associations. These amendments, as well as the Board's current regulations in this area, are discussed in detail in my testimony (enclosed), submitted to you today, concerning home equity conversion. If I, or any of my staff may be of any further assistance to you, please feel free to contact us.

Sincerely,

RICHARD T. PRATT.

Enclosure.

STATEMENT OF RICHARD T. PRATT

Mr. Chairman, members of the committee, I appreciate this opportunity to present the views of the Federal Home Loan Bank Board on home equity conversions for elderly homeowners. My statement will focus on the Bank Board's regulations allowing home equity conversion through reverse-annuity mortgages ("RAM's"). As you requested, I will also discuss the possible utilization of RAM's to provide borrowers with lump-sum payments or line-of-credit financing.

At the outset, I would like to comment briefly on mechanisms, such as RAM's, which enable homeowners to convert their home equity into income. In the Bank Board's view, such mechanisms are extremely desirable in that they afford homeowners the opportunity to maximize the use of a major asset—home equity—to obtain income, without requiring the sale of their homes. Such conversion may be particularly attractive, of course, to elderly homeowners. These homeowners frequently desire a means of generating additional retirement income. Home equity conversion provides elderly homeowners with the flexibility to address their financial needs by utilizing the billions of dollars of home equity that they have accumulated.

In light of the tremendous potential benefits of home equity conversion mechanisms, the Bank Board concurs with the recommendation in the recent report by the President's Housing Commission that the role of the Federal Government in this context should be to continue to facilitate their availability. In this regard, the Board believes that lenders and borrowers should have maximum flexibility to tailor such instruments to their individual needs and desires, subject to certain consumer protections, such as adequate disclosure. It is our view that, given such flexibility, the private market will generate viable and attractive instruments to foster home equity conversion.

CURRENT RAM REGULATIONS

The Bank Board has authorized Federal associations to offer reverse-annuity mortgages since 1980 (12 C.F.R. § 545.6–4(c)). As set forth in the regulations, a RAM is a secured real estate debt instrument under which periodic payments are made to the homeowner/borrower based on the homeowner's accumulated home equity. Such payments are made either monthly, directly by the lender, or through the purchase of an annuity from an insurance company; the regulation does not permit the distribution of the loan in one, or even several, lump sums during the term of the loan, except where a lump-sum disbursement is used to purchase an annuity from an insurance company. The loan becomes due on a specified date, after disbursement of the entire principal amount of the loan, or when a specified event occurs—such as sale of the property or death of the borrower. The interest rate on RAM's may be fixed or, may be adjusted periodically, subject to certain Board regulations governing adjustable mortgage loans generally (12 C.F.R. § 545.6–4a (b)(1), (b)(3)–(4), (c)–(f)). These regulations provide a description of adjustable mortgage loans generally; the test for permissible interest rate indices; costs and fees; notices to the borrower of payment adjustments; and disclosure requirements. Interest rate adjustments may be implemented through charges to the principal loan balance.

Perhaps the two most important consumer protection provisions in the RAM regulations are those relating to disclosure and to prepayment. The regulations do not contain prescribed disclosure language because of the variety of ways in which RAM's may be structured. However, the regulations do require associations to provide each prospective borrower with written materials explaining the type of mortgage being offered and its specific terms. Such materials must include, among other things: (1) A general description of RAM's; (2) if refinancing is not guaranteed, a prominent notice that a large payment will be due at the end of the loan term; (3) a schedule and explanation of payments to the borrower; (4) a schedule of outstanding debt over time; (5) the repayment date or event (e.g., sale of home or mortgagor's death) which causes the loan to become due; (6) the method of repayment and schedule, if any; (7) all contractual contingencies which may result in forced sale of the home; (8) the interest rate, annual percentage rate, and total interest payable on the loan; (9) a description of prepayment features and refinancing features, if any; and (10) an example of the operation of the type of RAM offered to the applicant. The regulations also require that each RAM instrument provides for prepayment in whole or in part without penalty at any time during the loan term.

In our view, these regulations allow sufficient flexibility to enable lenders and borrowers to tailor a RAM instrument that is responsive to their particular financial needs and preferences. At the same time, the regulations, through the disclosure and prepayment provisions, promote consumer protection. We are aware of no consumer complaints concerning RAM's currently offered by associations under our regulation and supervision.

PROPOSED LUMP-SUM PAYMENTS AND LINE-OF-CREDIT AUTHORITY

As indicated above, the RAM regulations do not currently authorize lump-sum payments to the borrower or line-of-credit financing. On April 28, 1982, however, the Bank Board in Resolution No. 82–310 proposed several amendments to its home loan regulations, including an amendment to utilize RAM's to make a lump-sum disbursement of loan proceeds, with payments by the borrower deferred until maturity. Such deferral until maturity, of course contrasts to the common method of repayment wherein the borrower makes monthly repayments of the loan during the loan term.

The proposed lump-sum disbursement authority reflects the Board's general goal of minimizing regulatory constraints which could reduce the attractiveness and marketability of RAM's. In our view, associations should generally have the freedom to make such operating decisions, and they have the means, such as credit review and collateral requirements, to minimize the risk of such loans. Notwithstanding the Board's desire to maximize the flexibility of RAM's, however, the Board is currently examining several consumer protection issues which may arise under such a deferral mechanism. The principal issue in this regard concerns the possibility that lenders would require balloon repayments of such lump-sum disbursements.

In addition, the April 28 Bank Board resolution specifically requested comments on whether line-of-credit loans, with payments deferred until maturity, should be permitted under an association's real estate lending authority. Although line-of-credit financing, with payments by the borrower deferred until maturity, may currently be made available under an association's consumer lending authority (12 C.F.R. 545.7-10), such lending authority is limited by both the requirement that an association rely essentially upon the borrower's creditworthiness as the primary security for the loan (12 C.F.R. 561.38), and the 20 percent of assets limitation on consumer loans. Finally, although associations currently may offer line-of-credit financing under their real estate lending authority, utilization of such authority is limited by the requirement that such a loan contract must provide for at least semiannual payments of interest (12 C.F.R. § 545.6-2(a)(iv)).

The Bank Board has received relatively few letters which address specifically line-of-credit financing through RAM's. However, the letters which the Board has received favored the availability of such financing. The letters focused primarily on the fact that failure to provide RAM line-of-credit authority would make Federal associations noncompetitive with other lending institutions offering such proposals; that underwriting such loans does not differ materially from the underwriting of short or intermediate term balloon loans; that line-of-credit authority would simply be an extension of the current authority under the RAM regulations for monthly advances and of the proposed authority for lump-sum advances; and that line-of-credit fianancing would be particularly attractive to many older homeowners because such financing, by serving as a buffer against unexpected expenses, could provide them with pyschological security.

In sum, the Bank Board supports fully, efforts to promote the availability of home equity conversions. The Board will continue to pursue actions that could enhance the availability of such mechanisms.

NOTE.—In accordance with 12 U.S.C. § 250, this statement has not been reviewed outside the Federal Home Loan Bank Board and does not necessarily reflect the views of the President.

ITEM 6. LETTER FROM HENRY L. JUDY, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, FEDERAL HOME LOAN MORTGAGE CORP., WASHINGTON, D.C., TO SENATOR JOHN HEINZ, CHAIRMAN, U.S. SENATE SPECIAL COMMITTEE ON AGING, DATED AUGUST 16, 1982

DEAR SENATOR HEINZ: At your request, the Mortgage Corp. is submitting the following comments on reverse annuity mortgages (RAM's). The following comments represent the corporation's preliminary views on RAM's, since it does not currently have a secondary market purchase program for these loans. We have not undertaken an extensive evaluation of this mortgage instrument. In the event that the corporation would develop a secondary market purchase program for RAM's, a substantial amount of State law and market research would be required.

The corporation applauds your efforts to explore the need for this type of mortgage instrument. As the Nation's population of retired people grows, and average life expectancy increases, attention is being focused on developing new sources of income for our older citizens. A major potential source of such funds is home equity. The net equity held by the Nation's homeowners is now estimated at approximately half a trillion dollars. Converting this vast store of wealth into spendable income will require the development of financing vehicles attractive to older citizens as well as financial institutions.

In addition to refinancing, a widely used technique for drawing on the equity of a home, another design for equity conversion is the reverse annuity mortgage. With RAM's, homeowners may contract with lenders to receive monthly payments over a period of years, using their homes as security for the RAM loan. When the loan becomes due, payment can be made from the proceeds of the sale of the home, or from the homeowner's other assets. No payment is required from the RAM borrower during the term of the loan, and the borrower is able to remain in his or her home during the loan period while enjoying a steady flow of income.

Federally chartered savings and loan associations were authorized to make reverse annuity mortgages in 1979, when the Federal Home Loan Bank Board issued its alternative mortgage instrument regulations. Since that time, acceptance of these financing vehicles has been hampered by high interest rates, restrictive State lending regulations, and relatively low borrower demand. In an effort to remove some of the roadblocks lenders face in offering RAM's, the Bank Board proposed revised its regulations in 1981 to eliminate the requirement of Bank Board approval of RAM plans, allow RAM's to be structured on an adjustable rate basis, and remove the requirement that lenders offer standard mortgage refinancing when the RAM matures.

While FHLBB regulations preempt any conflicting State laws which affect the lender's ability to make or deal in RAM's, the preemption only applies to federally chartered savings and loans, and State chartered institutions that operate under a tie-in with Federal regulations. State chartered lenders that do not operate under Federal regulations may face a number of obstacles in originating RAM's under local State law.

The Mortgage Corp., which develops and maintains a secondary market for conventional home mortgages in order to increase the amount of funds available for home financing, operates as a financial intermediary drawing funds from the capital markets into the housing market. To attract these funds, the corporation offers investors ownership interests in pools of conventional mortgages it has purchased. The corporation's conventional mortgage pass-through securities called mortgage participation certificates ("PC's") carry no government guarantee. Their attractiveness to investors depends on the characteristics of the underlying loans. The characteristics of the conventional mortgage loan are generally predictable due to the long experience lenders have had in originating these loans and the standardization of loan characteristics the Mortgage Corp. requires in the loans it purchases. Although RAM's have been authorized investments for savings and loans for a number of years, they have not achieved the widespread acceptance of the conventional fixed rate mortgage among either borrowers or mortgage lenders. It seems unlikely that the RAM concept will prove attractive to secondary market investors until an active primary market for the loans is established.

It is apparent, from the lender's point of view, that the uncertainties associated with future property values, borrower life expectancy and possible legal impediments reduce the attractiveness of RAM's. In addition, any structure that requires periodic cash outlays or delays the receipt of investment earnings will inevitably aggrevate the already serious earnings problems of mortgage lenders that are depository institutions. The attractiveness of RAM's in the secondary market is likely to be affected by the same considerations that are important to primary market lenders. From the borrower's perspective, the spendable income available from a RAM loan is dramatically reduced by interest charges, and the RAM structure, viewed in light of available alternatives for liquidating home equity, cannot be recommended on an economic basis in the current high interest rate environment.

Reverse annuity mortgage plans may be structured in a variety of ways. The lender may elect to provide the annuity payment directly to the borrower, disbursing payments on a regular basis over the loan term. Payments are added to the loan balance as they are disbursed. Interest accrues on the outstanding balance at the contract rate and the unpaid interest charges may then be added to the loan balance. Alternatively, the lender may use the full amount of the loan proceeds to purchase a life annuity for the borrower. The borrower receives a regular payment from the insurer or other annuity provider for the remainder of his or her life. From that payment he/she deducts the amount owed to the lender as interest on the loan.

Because interest charges on these reverse loans substantially reduce the amount of money the borrower receives for his or her use, the RAM plan may be structured with a below market interest rate. Normally, the lender is compensated for the below market rate by receiving a share of any appreciation in the value of the property.

Direct payment plans (those where the lender makes monthly payments to the borrower) may offer some lender advantages if fully integrated into the lender's overall cash management strategy and if carefully structured to minimize default risk. However, the plans may expose lenders to uncertainties that are normally not a part of real estate secured transactions. If the borrower lives beyond the maturity date of the loan, the lender may be forced into restructuring of the indebtedness, or may have to foreclose and evict the borrower, who is likely elderly, from the property. The adverse effect of such a situation on the lender's earnings or reputation may discourage their participation in such plans. Other uncertainties, such as the borrower's ability or willingness to maintain the property, the expected value of the property at loan maturity, the effect of intervening liens on the lender's security, and the lender's ability to secure payment of interest on the loan may also decrease the attractiveness of this type of investment. In addition, because this structure involves negative cash flows for the life of the loan lenders which are also depository institutions may find these loans a heavy burden on their available cash resources.

Indirect payment (annuity purchase) plans are less risky from the lender's perspective. The annuity provider (possibly an insurance company) assumes the uncertainty associated with the borrower's remaining life expectancy. The lender disburses the full loan amount when the loan is closed, using the loan proceeds to purchase an annuity for the borrower, and the lender's lien priority as to the full loan amount is clearly established. In addition, the lender receives interest income throughout the life of the loan. The problem with indirect payment plans in a high interest rate environment is that the amount of the annuity payment received by the borrower may be insufficient to cover the interest due the lender as well as providing income to the borrower. This increases the risk of borrower default—both economic default (nonpayment), and noneconomic default (deferred maintenance or other action which decrease the lender's security in the loan)—and at the same time makes these plans unattractive from the borrower's perspective.

Designing RAM plans that make sense to real estate investors as well as to borrowers is difficult in a high interest rate environment. It is conceivable that, given the proper incentives, individuals desiring to shelter a portion of their incomes might find investment in RAM's an attractive option. Alternatively, it may be possible to encourage RAM lending through an interest subsidy mechanism. If State or municipal government agencies, for instance, subsidized the interest payments on RAM loans, through direct or indirect payments to lenders (and/or investors) the amount of the monthly payment to the borrower could be increased, making the loan more attractive to both the borrower and the lender. RAM's made with below market interest rates which offer investors a share in any appreciation in the property value to compensate for the low interest rate may attract speculative investment. In general, however, investment vehicles which carry below market interest rates or which are of a speculative nature are unacceptable to the private institutional investor. Currently, the secondary market for conventional mortgages is almost entirely limited to this type of investor. A technique in current use which allows homebuyers to draw on the equity on their home and avoid some of the marketing problems associated with RAM's is refinancing.

A reduction in interest rate levels alone should make RAM investments more attractive. However, the economic consequences of diverting funds available for mortgage lending to owners of existing homes at the expense of potential new homebuyers deserves careful consideration. Other options, such as sale/leaseback arrangements or sales subject to life estates may prove more viable in meeting the needs of older homeowners, in the current environment.

I hope that this information is useful to you and the members of the committee in your efforts to respond to the housing needs of elderly Americans. If I can be of any further assistance, please feel free to contact me.

Sincerely,

HENRY L. JUDY.

ITEM 7. LETTER FROM JAMES E. MURRAY, PRESIDENT, FEDERAL NATIONAL MORTGAGE ASSOCIATION, WASHINGTON, D.C., TO SENATOR JOHN HEINZ, CHAIRMAN, U.S. SENATE SPECIAL COMMITTEE ON AGING, DATED JULY 23, 1982

DEAR SENATOR HEINZ: Your letter of July 13, 1982 requested our views regarding the role of the Federal Government in facilitating home equity conversion. You also asked for suggestions to facilitate the development of a secondary market for reverse equity loans.

Background

For at least 50 years, financial mechanisms and institutions have been developing to meet the demands of individuals wanting to accumulate equity in a home. Currently, however, there is no practical way an individual can withdraw this accumulated equity. Equity conversion is a missing component of residential finance.

Homeownership equity conversion, including reverse mortgages, has been considered in academic and financial circles. Feasible plans have not developed, however, for several reasons: homeowners are reluctant to treat the equity in their residences as a financial resource to consume; life tenure is a very expensive characteristic and is usually financially unattractive except for relatively old homeowners; and, there are substantial institutional and regulatory obstacles to the development of homeowner equity conversion plans.

Notwithstanding these significant problems, there have been some hopeful developments in the past 2 years. The elderly population is now expending at a rate more than twice that of the total population. During the next 20 years, over one-third of the net increase in the population will be from those 65 years of age or older. This is important because this is the primary population group that will benefit from equity conversion.

In addition, because they usually are on fixed incomes, inflation has affected the elderly more than the younger employed population, with the result that residential equity of the elderly has been more openly considered as a means of income support. Finally, it has been recognized that there may be periods of time, other than when we are elderly, that equity conversion is needed. For example, periods of lengthy unemployment or sickness could be funded through a home equity conversion product rather than conventional means.

Equity conversion plans

As you may know, practically all equity conversion plans are composed of one or more of three basic financial transactions: a reverse (negative amortization) mortgage; a sale and leaseback transaction; and a life insurance annuity.

The simplest form of reverse mortgage transaction can be constructed using a lump sum or single draw mortgage accumulating interest over time and rising to a predetermined loan-to-value limit. With the lump sum payment, the homeowner could purchase a life insurance annuity or invest the funds and use the interest income. The debt would be paid from the proceeds of selling the house at a later date. There are various reverse annuity mortgages (RAM), including a rising debt RAM, a graduated-payment, rising debt RAM and an adjustable rate RAM.

The second major category of equity conversion plans is sale and leaseback. In the basic transaction, the original homeowner sells and simultaneously leases back his or her residence to an investor. A lifetime lease is a usual part of the contract. Theoretically, the sale and leaseback is a very efficient equity conversion mechanism. The homeowner has retained the right to live in the property until his or her death and has reaped the benefit, by sale, of the remaining value including potential appreciation.

An equity conversion project in Buffalo, N.Y., for example, consists of a subsidized corporation engaged in modified sale and leaseback transactions with participants. Another publicly funded group in Essex County, N.Y., is in the planning stage, but appears to be considering sale and leaseback transactions funded through limited partnerships.

The third major financial component used in equity conversion plans is a life insurance based annuity. Life insurance annuities can be used singularly or in conjunction with reverse mortgages or sale and leaseblack transactions.

The insurance annuity is straightforward. An insurance company, most likely in conjunction with its real estate subsidiary, accepts ownership of the residential property in exchange for lifetime tenure in a monetary annuity for the resident. Similar to the sale and leaseback, the theoretical advantage of such an arrangement would appear to be significant. The insurance company purchase is able to use the total value of the property, particularly the remaining portion in the structuring of its annuity. In addition, the insurance company would have the benefit of ownership and consequent tax advantages.

Life annuities can be used in tandem with reverse mortgages. Combined with a rising debt RAM, the homeowner draws an initial net sum and purchases an annuity scheduled to commence when the term of the first mortgage is reached. The objective is for the annuity to be large enough to carry future interest payments on the mortgage as well as provide the resident a continuing income. In real world simulation, however, this option has so far not proven to be financially feasible.

It is difficult to perceive a substantial role for FNMA in home equity mortgages until the primary market for such mortgages develops further although the secondary market can act as a catalyst. As I am sure you and your committee heard on July 20, there still exist various obstacles to the efficient operation of a primary market in reverse annuity mortgages. Many of these obstacles are tax-related.

Potential Secondary Market Role

However, even given these limitations, participation in equity conversion funding by FNMA or other secondary market entities could be structured in two basic forms. The first is through direct secondary market purchase and subsequent funding of rising debt reverse annuity mortgages. The second is through commercial loan funding of corporate portfolios or residential properties held for sale and leaseback or insurance annuity plans.

The first option, purchase of rising debt mortgages, involves a very different cash flow than our traditional mortgage purchases. The actual amount of negative cash flow to the mortgagor, however, is not large. With a 15-year reverse annuity mortgage at 14 percent, cash flow from the lender to the resident amounts to approximately 30 percent of the eventual mortgage payoff amount. Consequently, while reverse mortgages carry the additional interest rate risk of unfunded future cash requirements, they may not be as large an asset/liability management problem as initially believed. Financial modeling of RAM's could identify this additional risk and the increase in yield necessary for investors to incur this risk. Perhaps the FHA is the appropriate vehicle for beginning a large-scale demonstration or experiment with RAM's. If so, we would be pleased to work with them and provide a market for the loans.

The cash flow and other characteristics of rising debt RAM's are very different from conventional mortgages, but they may present some very unique opportunities for originators and investors. For instance:

—The reverse cash flow and lack of reinvestment risk of RAM's may be quite attractive to certain categories of investors like pension funds.

—The issuance of reverse mortgage-backed securities could give the secondary mortgage market originator an opportunity to guarantee both sides, payee and payor, of the transaction.

—The blending of normal amortization mortgages with reverse mortgages could produce a pool with more of a bond-like cash flow pattern.

—The underwriting risk in RAM's should be much lower than with regular amortizing mortgages.

The second way FNMA could participate in equity conversions, sale and leaseback funding and annuity purchase funding, might be handled with a "loan on the security or mortgages" product. This product would be fairly complex and would involve joint ventures and some possible FNMA Charter Act changes.

Summary

In summary, we believe that FNMA can contribute substantially to the development of a market in reverse annuity mortgages and other home equity conversion products. We would be pleased to meet with you and your staff to discuss how this might be accomplished. We would also be happy to discuss this with some primary mortgage lenders to determine their interests in pursuing such a product. This would be necessary because FNMA cannot originate loans directly but must purchase them from mortgage originators. Finally, we would have to spend some time on the investment side with pension funds and life insurance companies, among others, to see whether a demand exists for such a product. We would be pleased to participate in the role of a catalyst.

If we can be of further assistance, please let us know.

Sincerely,

JAMES E. MURRAY.

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