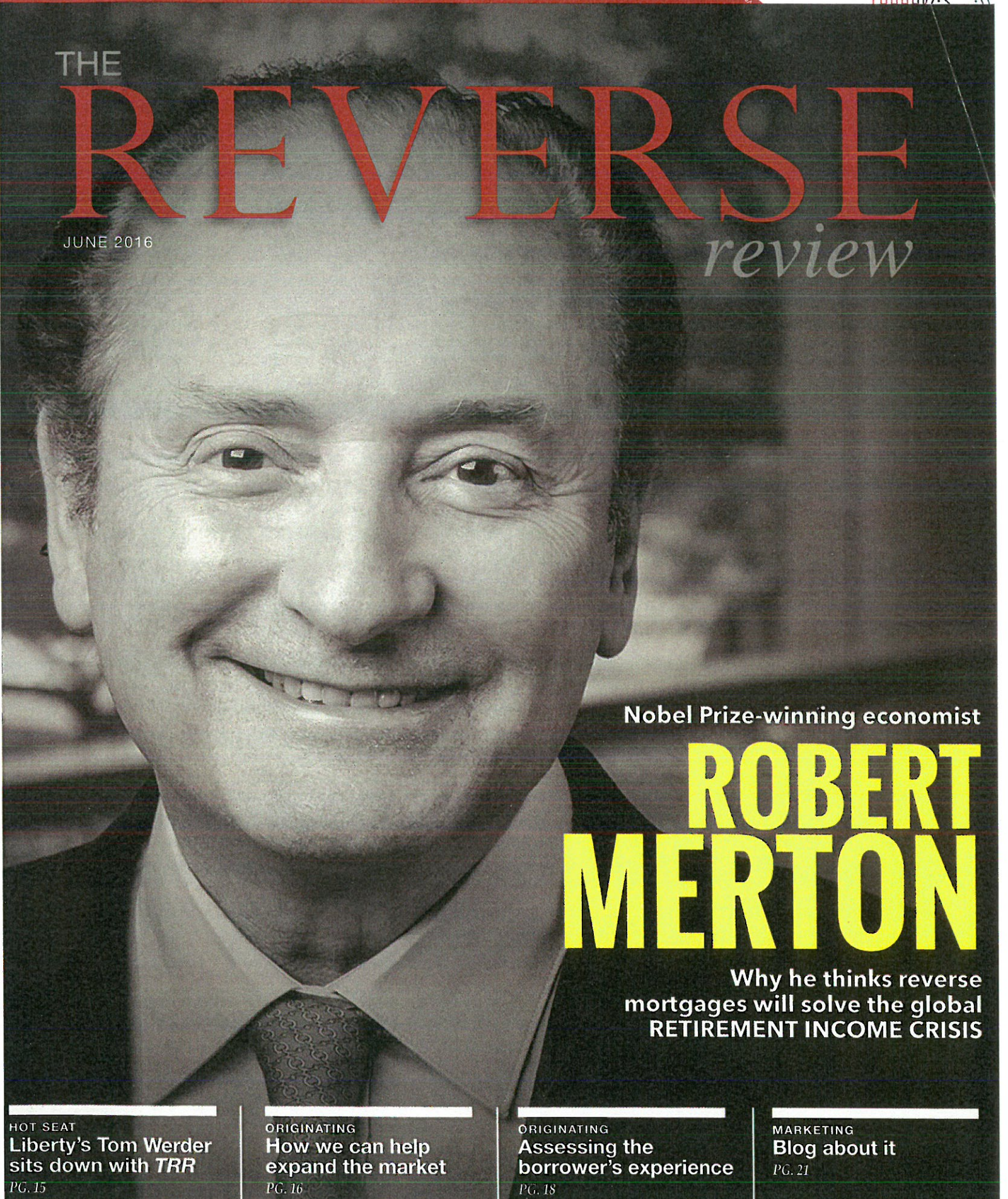


THE REVERSE

JUNE 2016

review



Nobel Prize-winning economist

ROBERT MERTON

Why he thinks reverse
mortgages will solve the global
RETIREMENT INCOME CRISIS

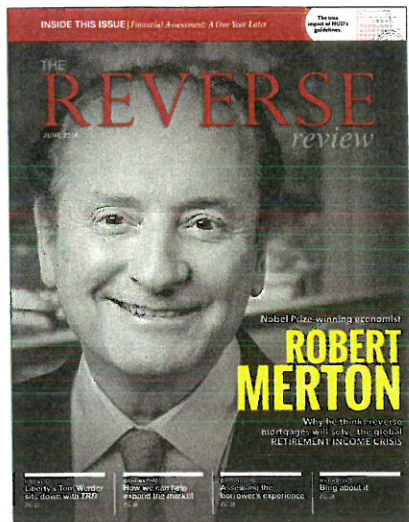
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FROM THE EDITOR



A NOTE FROM JESSICA GUERIN

In this month's feature story, we talk to famed economist and Nobel Prize winner Robert Merton about the importance of reverse mortgages. As part of his ongoing research on retirement funding strategy, Merton has embraced reverse mortgages as key to solving the retirement income crisis.

This crisis, according to Merton, is not confined to the U.S. as the baby boomer generation ages; it is a global phenomenon, happening in countries around the world as life expectancies increase.

Merton predicts that the concept of a reverse mortgage will be adopted on a global scale, pointing to several countries that have already created successful equity release programs. In the future, Merton says, people will inevitably turn to their home equity to support themselves in their advanced age.

Merton travels around the world to speak at financial summits, and his praise of reverse mortgages has garnered considerable attention. With adamant support from someone as prominent and respected as Robert Merton, perhaps the larger financial community will come to see the value of the product.

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The Nobel Prize-winning economist talks about the value of reverse mortgages.

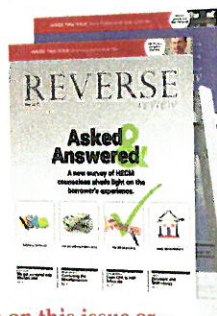
JESSICA GUERIN

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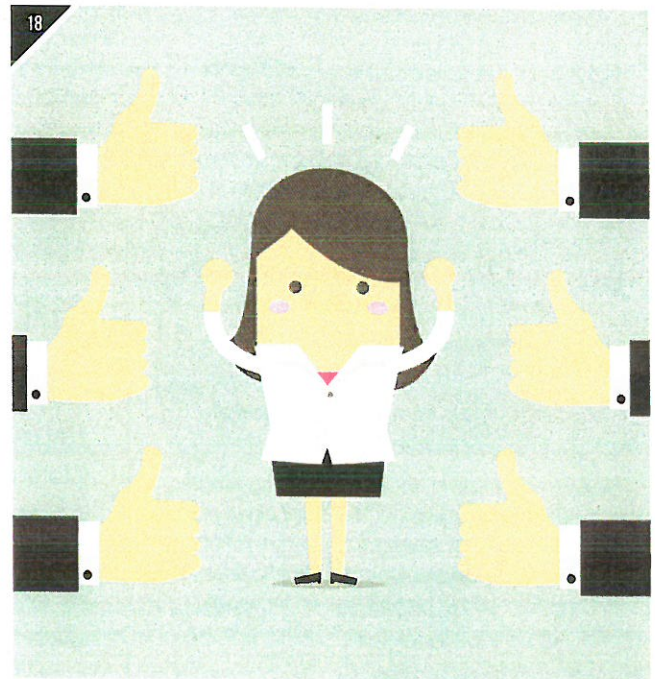
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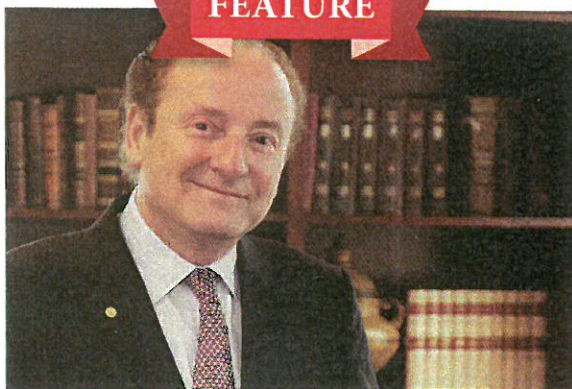
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Robert Merton

The Nobel Prize-winning economist on why he thinks reverse mortgages will solve the global retirement income crisis.

JESSICA GUERIN

"Robert C. Merton has been called a groundbreaking economist, an options guru and one of the finest minds in finance... [His] advocacy of reverse mortgages coincides with support from other leading academics and financial experts. It just might signal the beginnings of a shift in public opinion."



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Nobel Prize-winning economist

ROBERT MERTON

Why he thinks reverse
mortgages will solve the global
RETIREMENT INCOME CRISIS

By Jessica Guerin

ROBERT C. MERTON

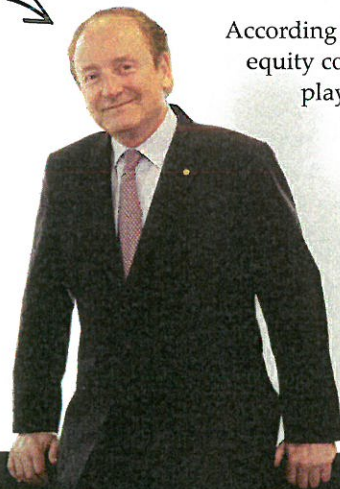
has been called a groundbreaking economist, an options guru and one of the finest minds in finance. For those in tune to the finance world, Merton is as high-profile as it gets.

A sought-after speaker on the investor circuit, Merton caught the attention of the crowd at an asset management conference in St. Louis last fall when he commented on the value of reverse mortgages. "Americans have wrongly steered clear of reverse mortgages," he said. "This is going to become one of the key means of funding retirement in the future."

Merton's advocacy of reverse mortgages coincides with support from other leading academics and financial experts. It just might signal the beginnings of a shift in public opinion. Certainly, support from someone as influential as Robert Merton is a tremendous boost for reverse mortgages, one that might help elevate the product in the financial community, in the press and in the public eye.

WHO IS ROBERT MERTON?

Robert Cox Merton is a longtime student of economics. He holds a B.S. in engineering mathematics from Columbia University, an M.S. in applied mathematics from the California Institute of Technology and a Ph.D. in economics from MIT, in addition to honorary



degrees from 13 universities. (Merton's father, a prominent sociologist, was also a noted academic, known for pioneering the focus group and coining the terms "role model" and "self-fulfilling prophecy.")

In 1997, Merton was awarded the Nobel Prize in Economics for his work in developing a new method to determine the value of derivatives. His options-pricing method, the Black-Scholes model, has been labeled one of the most revolutionary concepts in modern finance.

Nowadays, Merton sits on the faculty at MIT's Sloan School of Management, serves as a professor emeritus at Harvard University, and is a resident scientist at global asset management firm Dimensional Fund Advisors. His current research includes a focus on lifecycle investing and retirement

funding solutions, a topic that has led him to assess the benefits of home equity conversion. His work takes him around the world, where he speaks before groups of riveted followers and sometimes extols the reasons why reverse mortgages have such value.



THE GLOBAL RETIREMENT CRISIS

According to Merton, home equity conversion stands to play a key role in solving the retirement crisis—a problem that plagues countries around the world, not just the U.S.

The global financial crisis that exploded

in 2007/2008 depleted savings for many and volatile markets prevented a significant rebound. Add to this a dramatic increase in the 65-plus population and increasing life expectancies around the world, and it's clear that the world economy is experiencing pressure like never before. Faced with an aging population, government benefits and pension plans in many countries are stifled as resources once earmarked for retirement funds are being funneled toward health care and other services to accommodate aging.

"The world is getting older," Merton says. "With our baby boomers in the U.S., we are an older society. China is aging even faster than the U.S., and Korea faster than China. Increasing demographics is putting pressure on funding."

This means that the traditional three-legged stool of retirement funding—government benefits, employer pensions and personal savings—is getting awfully wobbly. It appears that now, the responsibility to fund retirement has mostly shifted to the individual.

RETHINKING RETIREMENT

But the picture is not entirely bleak, as Merton points out. "There is good news, and I underscore, it is very good news: Future generations are going to live longer. This is great. But, as with many good things, there comes another challenge, which is simply how to fund those extra years."

If you live 10 years longer than your parents, but still want to retire around 65 as they did, you now have to save enough to support 20 years of retirement, Merton points out. "The only way you can do that is to save 33 percent of your income."

If saving more during your working years proves impossible, the alternative is to alter your lifestyle in retirement. »

GOING TO THE SOURCE



"The world is getting older. **With our baby boomers in the U.S., we are an older society.** China is aging even faster than the U.S., and Korea faster than China. Increasing demographics is putting pressure on funding."

"If you want to work the same number of years your parents did, fine, but you'll have to accept a lower standard of living," he says. "If you want to have the same standard of living as your parents, you can have 12 years of retirement—they only had 10—but you have to work 48 years, not 40."

Basically, Merton says it boils down to this: "You either have to work longer or accept a lower standard of living. What you can't do is work the same number of years as your parents, live longer and enjoy the same standard of living. That's not feasible."

FINDING A SOLUTION

For those who can't work longer or save more, Merton draws attention to another solution.

"There is one more thing we can do to try to address the challenge, and that is to take the assets people have and get more benefits from those assets. Now, I don't mean get higher returns; we're already trying to get the highest returns on our investments that we can for the level of risk, we can't just dial up the return... So how do we get more from the assets? Well, we use them differently and we develop tools that are efficient for doing that."

One specific asset that needs to be tapped, says Merton, is the house.

"There's no magic potion here. For working middle-class people, the biggest asset they have is not their retirement pension, it's their house. And it's typically the only major asset they have, but it is big. I'm talking about the house they want to live in in retirement."

Merton says we need to start thinking about the house differently, viewing it as an asset rather than treating it as part of our legacy.

"The house is like an annuity: It provides the housing you need for as many years as you need it," he says, adding that the idea of leaving the house as a bequest is flawed. "In our society, and even in Asian societies that are transforming from agrarian to industrial, the children don't move into the house. No matter how precious the house is, how sacred, in any culture,

"The house is like an annuity: It provides the housing you need for as many years as you need it."

in the end when you don't need it anymore, it's going to get sold, and that makes it a financial asset. So it's an annuity while the retiree needs it, and then it becomes just a financial asset."

OVERCOMING OBSTACLES

While Merton praises the concept of a reverse mortgage, he takes issue with the name itself, which he says has hindered the product's acceptance.

"I hate the name. First of all, it's misleading because saying it's a mortgage makes it sound like it's a loan. But with reverse mortgages, you don't pay anything as long as you stay in the house. So it's a very different animal. It also sounds like you're leveraging your house."

Merton points out that other countries with similar equity conversion programs have much better names. "In England they call it equity release, that's a little more neutral. I like the Korean name; they call it a home pension. It's more descriptive. The house itself provides you a pension, and the home pension allows you to take some of the value from the house to provide you additional pension. It doesn't say anything about a mortgage or imply that you may owe money."

Merton admits that confusion about the product is problematic, and says the HECM program as it currently stands may need some tweaking to help the product reach its full potential.

"We also have to educate people as to the proper use of them and in general make them much more efficient," he says.

"You hear some people say reverse mortgages are bad, but I think what they may mean is the way that they are currently being produced and sold, and the cost associated with them, is not a good example of the product," he says. "I think that's what they mean, but people hear it as, 'Reverse mortgages are not a good idea and we should ban

them.' I say that a reverse mortgage is a good idea, but maybe we need to fix the design a bit. Let's fix it if we need to, but don't get rid of it."

Merton says making product improvements, which have already taken place with recent changes from HUD, is a large but feasible undertaking.

"It's going to require a lot of hard work and innovation, which we know how to do. It's a simple engineering problem," he says, adding that he doesn't believe a government-sponsored program is the right way to go.

"There's going to be a need to find wide-based funding sources, and I don't believe government is the answer. HECMs are about the only reverse mortgages out there, and it's a government plan, but government balance sheets just aren't big enough," he says. "We have to find very efficient ways to provide the funds for the reverse mortgages, but we can do it."

GLOBAL ACCEPTANCE

Merton predicts that home equity conversion—whether it's called a home pension, an equity release or a reverse mortgage—is going to be a crucial part of solving the retirement income problem.

"I believe it is going to be essential for a good retirement around the world. In Asia, they are paying a lot of attention to it, they are working on it. There is a lot of interest in developing it in many countries. Even in Colombia and Latin America, where they don't have a reverse mortgage, they are very interested in finding out about it."

"Sooner or later, to have a decent retirement, a number of people are going to have to tap into this. It's not a matter of choice. This is going to be an essential part of the foundation for funding retirement around the world." ■