THE IN'S AND OUT'S OF THE REVERSE MORTGAGE

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ABSTRACT
An increasing number of elderly Americans owning their own homes are opting for reverse mortgages. The primary motivation for this trend is out of need, rather than choice. Many have lost the better part of their savings as a result of the economic downturn of 2008, impacting their expectations for a desired lifestyle. There are many requirements when applying for a reverse mortgage and the process can be daunting for many. The homeowner should be aware of many issues associated with reverse mortgages. The outcome, including the fees involved, payment options, and restrictions are discussed. We also examine the government's role in the reverse mortgage market and what it means to the applicant. This article examines the advantages and disadvantages, especially the potential surprises that await the homeowner if they do not carefully read the related documentation. Reverse mortgages are not appropriate for all seniors. A careful examination of the costs versus benefits will provide more transparent information for potential applicants.

INTRODUCTION

Reverse mortgages are offered by the Federal Housing Administration (FHA) arm of the Department of Housing and Urban Development and is enabled under the FHA's reverse mortgage program, the Home Equity Conversion Mortgage (HECM). The reverse mortgage is a type of home loan that allows a borrower to convert a portion of the equity in the home into cash. It is unlike a traditional home equity loan or a second mortgage. Borrowers need not repay the loan unless the borrower no longer uses the home as the principal residence or fails to meet the obligations of the mortgage. Basic eligibility requirements are that the borrower be at least 62 years of age, own the home outright, or has a low mortgage balance that can be paid off at closing with the proceeds of the reverse mortgage. The homeowner must also have the financial resources to pay ongoing property taxes and hazard insurance and must live in the home. There is also a requirement to receive consumer information free of charge or at a very low cost from an HECM counselor prior to obtaining the loan. To be eligible, the home must be a single family or a two to four unit home with one unit occupied by the homeowner. HUD-approved condominiums and manufactured homes are also eligible if they meet FHA requirements. The amount that can be borrowed varies based on the age of the youngest borrower, the current interest rate, the initial insurance premium and the lesser of appraised value or the HECM FHA mortgage limit of $625,000 or the sales price.

The transaction is structured so that the loan amount will not exceed the value of the home over the life of the loan. Variables factored into the transaction are the initial mortgage amount, the rate at which interest accrues, the length of the loan and the rate of home appreciation. The lender may require that there be no other liens on the property and any existing liens must be paid off with the proceeds of the reverse mortgage.

Payments can be received in a variety of different ways. *Tenure* refers to equal monthly payments as long as at least one borrower lives and continues to occupy the property as a principal residence. *Term* signifies that there are equal monthly payments for a fixed period of months selected. *Line of credit* offers unscheduled payments or installments at times and in an amount of the borrower's choosing until the line of credit is exhausted. *Modified tenure* is a combination of a line of credit and scheduled monthly payments for as long as the borrower(s) remains in the home. *Modified term* is a combination of line of credit plus monthly payments for a fixed period of months selected by the borrower. A *single lump sum disbursement* at mortgage closing is the final option.

The concept behind this debt vehicle is that the borrower is provided with a source of income in retirement years. There are no income or credit qualifications to obtain the loan. Homeowners are merely expected to pay the annual property taxes, homeowners' insurance and maintenance costs. If property taxes or property insurance is not kept current, the mortgage can be considered in default, in which case the borrower risks foreclosure.

BACKGROUND

Interest in reverse mortgages comes on the heels of elevated need on the part of the elderly, in particular baby boomers. This group has been significantly impacted by high unemployment and an uncertain stock market. The combination of these factors has taken a toll on the retirement accounts of older Americans. Seniors struggling with foreclosure and/or the inability to meet basic needs and living expenses have turned to the reverse mortgage to obtain needed cash.

The reverse mortgage is not a new concept. The first reverse mortgage was made in 1961 and the concept was further developed in the 1970's. Though these mortgages gave seniors money from their home, they did not afford today's protections because they were not FHA-insured. In the early 1980's the U.S. Senate Special Committee on Aging issued a report stating the need for a standardized reverse mortgage program. Late in 1987 Congress passed the FHA insurance bill that would insure reverse mortgages and on February 5, 1988 President Ronald Regan signed the FHA Reverse Mortgage Bill into law.

There are three types of reverse mortgages:

(1) *single-purpose reverse mortgages*, offered by some state and local government agencies and nonprofit organizations
(2) *federally-insured reverse mortgages*, known as Home Equity Conversion Mortgages (HECMs) and backed by the Department of Housing and Urban Development (HUD)
(3) *proprietary reverse mortgages*, private loans that are backed by the companies that develop them

Single-purpose reverse mortgages are the least expensive option. They are not available everywhere and can be used for only one purpose, which is specified by the government or nonprofit lender. For example, the lender might say the loan may be used only to pay for home repairs, improvements, or property taxes. Most homeowners with low or moderate income can qualify for these loans.

HECMs and proprietary reverse mortgages may be more expensive than traditional home loans, and the upfront costs can be high. This is an important consideration, especially if the borrower plans to stay in the home for just a short time or borrow a small amount. HECM loans are widely available, have no income or medical requirements, and can be used for any purpose.
Before applying for a HECM, the applicant must meet with a counselor from an independent government-approved housing counseling agency. Some lenders offering proprietary reverse mortgages also require counseling. The counselor is required to explain the loan's costs and financial implications, and possible alternatives to a HECM, like government and nonprofit programs or a single-purpose or proprietary reverse mortgage. The counselor also should be able to help compare the costs of different types of reverse mortgages and explain how different payment options, fees, and other costs affect the total cost of the loan over time. Most counseling agencies charge approximately $125 for their services. The fee can be paid from the loan proceeds, but the applicant cannot be turned away for inability to pay the fee.

The amount that can be borrowed with a HECM or proprietary reverse mortgage depends on several factors, including the age of the borrower, the type of reverse mortgage selected, the appraised value of the home, and current interest rates. In general, the older the applicant, the more equity the borrower has in the home. This means that the applicant should owe less on the property than a younger borrower. The combination of these factors should allow the applicant to borrow more.

The HECM lets the borrower choose among several payment options:

- term option – provides fixed monthly cash advances for a specific time.
- tenure option – provides fixed monthly cash advances for as long as the borrower lives in the home.
- line of credit that lets the borrower draw down the loan proceeds at any time in amounts chosen by the borrower until the line of credit is used up.
- combination of monthly payments and a line of credit.

The borrower can change the payment option any time for about $20.

HECMs generally provide bigger loan advances at a lower total cost compared with proprietary loans. But if the borrower owns a higher-valued home, he/she may get a bigger loan advance from a proprietary reverse mortgage. If the home has a higher appraised value and the borrower has a small mortgage, he/she may qualify for more funds.

Reverse mortgage loan advances are not taxable, and generally don't affect Social Security or Medicare benefits. The borrower retains the title to the home, and doesn't have to make monthly repayments. The loan must be repaid when the last surviving borrower dies, sells the home, or no

longer lives in the home as a principal residence. Notwithstanding, since the borrower retains title to the home, property taxes, homeowners' insurance, utilities, fuel, maintenance, and other expenses are the responsibility of the borrower. If these charges are not paid, or the home is not maintained, the loan may become due and payable.

In the HECM program, a borrower can live in a nursing home or other medical facility for up to 12 consecutive months before the loan must be repaid. Borrowers should be aware that lenders generally charge an origination fee, a mortgage insurance premium (for federally-insured HECMs), and other closing costs for a reverse mortgage. Lenders also may charge servicing fees during the term of the mortgage. The lender sometimes sets these fees and costs, although origination fees for HECM reverse mortgages currently are dictated by law. Upfront costs can be lowered if a smaller amount is borrowed through a reverse mortgage product called a HECM Saver.

Furthermore, the borrower should be aware that the amount owed on a reverse mortgage grows over time. Interest is charged on the outstanding balance and added to the amount owed each month. Therefore, the total debt increases as the loan funds are advanced to the debtor and interest on the loan accrues. Although some reverse mortgages have fixed rates, most have variable rates that are tied to a financial index and are therefore likely to change with market conditions. Interest on reverse mortgages is not deductible on income tax returns until the loan is paid off in part or whole.

Reverse mortgages can use up all or some of the equity in the home, and leave fewer assets for the borrower and his/her heirs. Most reverse mortgages have a "nonrecourse" clause, which prevents the borrower or borrower's estate from owing more than the value of the home when the loan becomes due and the home is sold. However, if the borrower or the heirs want to retain ownership of the home, the loan must be repaid in full, even if the loan balance is greater than the value of the home.

With most reverse mortgages, the borrower has at least three business days after closing to cancel the deal for any reason, without penalty. To cancel, the borrower must notify the lender in writing. After the cancellation, the lender has 20 days to return any money.

The Great Recession brought about economic pressures on older homeowners. Those struggling with rising household expenses and mounting debt use the reverse mortgage as a crisis management tool. Consensus is growing that a secure retirement for borrowers requires an orderly drawdown of savings and assets.

One advantage of a reverse mortgage is that the borrower's credit is not relevant. The borrower also does not need to make any payments. The home serves as collateral, so it must be sold in order to repay the mortgage when the borrower dies. The heirs may also have the option of repaying the mortgage by selling the home. The lending institution, however, may not pursue heirs for the mortgage nor can they take more than the appraised value of the home.

There are also disadvantages to reverse mortgages. This debt carries with it large origination costs relative to other types of mortgages. Besides the origination fee, which can amount to the higher of $2,000 or 2% of the loan, there are other costs associated with reverse mortgages. Homeowners may be charged an appraisal fee, a reporting and credit report fee, pest inspection fee and flood certification fee, as well as a flat monthly account service fee. To compound the situation, these costs become part of the initial loan balance and accrue interest. Since interest accrues, the amount due increases over time. If borrowers live long enough or if market value declines significantly, the loan balance may potentially exceed the value of the property. The mortgage insurance premium charged by the FHA partially covers the loan in the event the loan balance exceeds the value of the property. It is these premiums that contribute to making a reverse mortgage so much more costly than a traditional mortgage or a home equity loan.

Among the many other disadvantages of a reverse mortgage is the potential that establishing a reverse mortgage may jeopardize the borrower's ability to obtain financing at a later date. Though the elderly may be unlikely to buy another home or make a sizable purchase, this debt can have an adverse impact on applications for car and personal loans. Medicaid payments may also be impacted. Reverse mortgage funds retained may count as an asset and affect Medicaid eligibility.

PROBLEM

As a retirement planning resource, the reverse mortgage has generated much interest in the recent past. However it is important to remember that the reverse mortgage is a loan against the home. That means that it must be repaid. There are many disadvantages associated with reverse mortgages. As with any mortgage, there are typically origination fees. The fees for a reverse mortgage are high because it is a home equity loan that is not made on the basis of income or credit score. The amount that can be borrowed is based on a percentage of the property's value, its location and the age of the youngest borrower (in the case of co-owners). The younger the borrower, the more risk the lender takes on. Consequently, the risks to the lender are unique and those risks are partially offset by charging higher initial fees. Another disadvantage is that the interest rate charged is higher than that for a generic home equity loan. Applicants are attracted to these loans because payments are not expected to be made on the loan. Instead, the loan is paid off when the home is sold. If the applicant dies first, the home must be sold in order to pay off the loan. Otherwise, the heirs would be required to pay off the loan if their intent is to keep the home. Many times this means that the money will come out of the estate. A major consideration with respect to the loan is that the applicant must be living in the home most of the time otherwise loan repayment would be triggered. The applicant is considered to not have lived in the home if the applicant hasn't lived in the home for at least one year. This includes time spent in a long-term care facility. So if the applicant hasn't died but is no longer able to live in the home, loan repayments must start. This can be an unintended, negative event especially at a time when repayment would impose a significant hardship. This hardship is intensified considering that property taxes, homeowners' insurance and regular property maintenance expenditures must continue to be made.

Experienced reverse mortgage borrowers indicate that there is never a good time to enter into a reverse mortgage. This type of loan is one where the interest and principal must be paid off at some point in time, either when the borrower moves, sells the home or passes away. The longer the loan is outstanding, the greater the amount that must be repaid because of compounding

interest. In addition to loan origination fees and closing costs incurred at the origin of the loan, servicing fees are charged throughout the term of the loan. The FHA-insured reverse mortgages are charged a monthly insurance premium. The fees are either paid up front or added to the loan amount. Interest charges are incurred on premiums that are added to the loan amount. A reverse mortgage can potentially consume all the equity remaining in a home. Indeed, it can even exceed the value of the home. An heir could conceivably be left with an asset encumbered by a mortgage greater than the value of the property. But if the applicant chooses to sell the property, the debt will not exceed the value of the home when it is an FHA loan. A non-FHA loan from a private company, a non-profit organization or a state/local government may not have the same guarantees or protections.

The government is scrambling to find ways to protect the elderly suffering reverse mortgage backlash. The housing crash has caused many of these loans to backfire. The younger the borrower, the more risk the lender takes on. In many cases the borrowing couple makes a conscious decision to remove one member of the couple (usually the younger one) from the title in order to qualify for the mortgage or get more money. Should the debtor die (the older member of the couple), the mortgage must be repaid. If the home is worth less than the mortgage amount, the owner would have no remaining equity in the property and would not be able to borrow against it. The property could be foreclosed, depriving the owner of his or her home.

A reverse mortgage can be bad news for the children of borrowers. Though the lending institution does not take title to the home, the mortgagee has an obligation to repay the loan over time with interest. That repayment is made by selling the home.

ALTERNATIVES

In consideration of the fact that the up-front costs associated with a reverse mortgage are relatively high, homeowners in need of liquidity who are considering selling their homes within the next several years may be better served by accessing a line of credit, a home equity loan or a personal loan.

A mechanism for protecting the family of reverse mortgage borrowers is use of a life insurance policy. The policy covers the homeowner. An adult child or the lending institution can be named the beneficiary of the policy. Consequently, the bank can be repaid without selling the property upon the death of the homeowner.

In October 2010, the FHA launched a reverse mortgage called the Home Equity Conversion Mortgage (HECM) Saver. In exchange for borrowing a lower amount, lower up-front fees are charged amounting to 0.01% of the home's value. The tradeoff is that the amount that can be borrowed against equity is from 10% to 18% (depending on age) less than the FHA's standard reverse mortgage. Borrowers are also charged mortgage insurance premiums on an ongoing basis equal to 1.25% annually of the outstanding loan balance.

CONCLUSION

Seniors have less equity, more debt, and less in savings. The confluence of these variables makes a reverse mortgage a dangerous tool being used for the wrong reasons. Originally contemplated

as something to be used to draw money over time to supplement income, the reverse mortgage has now become a "quick fix" for many seniors. About 9.5% of the 775,000 reverse mortgages are outstanding. This is a far higher rate than the rate on regular mortgage loans. As of late 2012 about 58,000 are in foreclosure. The FHA, which insures most of these mortgages, estimates $2.8 billion in losses on reverse mortgages over the next 30 years. A portion of the losses arise from defaults while the rest is attributable to declines in home value less than the mortgage amount.

Fewer reverse mortgages are being made today due to the drop in home values. Lenders continue to market them aggressively and the Consumer Financial Protection Bureau is looking at new rules to protect consumers, including stricter supervision of lenders and more transparency for borrowers.

Policymakers are concerned that retirees receiving lump sum single payments risk outliving these resources. Older homeowners accessing home equity to pay for expenses will need more guidance and support. Part of the solution lies in strengthening consumer education, informing potential borrowers about the risks and benefits of these types of loans. Consumer research shows that many people make poor financial decisions in a crisis. More attention should be paid to what happens after homeowners take out a reverse mortgage. Historically more than half of HECM borrowers terminate their loans within 6 years. This leaves little time for transition planning. Household members can face serious consequences if the loan comes due unexpectedly. Counselors should discuss an exit strategy that includes the ultimate disposition of the home. Another part of the solution will be to better manage how older people use home equity over time. Some research shows that a gradual drawdown of this asset over time can increase financial security over in retirement.

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