Reverse Mortgages:

Information to Consider on Benefits and Risks

Some experts note that workers in America may not have sufficient savings to live comfortably during their retirement. Many homeowners, however, do have sufficient equity in their homes that can supplement their retirement income. This group of homeowners includes the elderly; in fact, according to a 2006 survey by the Pew Research Center, 72 percent of people aged 65 and older have no home mortgage; this figure contrasts with the percentage — 32 percent — of all homeowners who do not have a mortgage on their home. The same study showed that 79 percent of seniors had experienced home value appreciation, which was particularly strong over the past several years.

There is a financing option that is becoming increasingly popular: seniors now have the opportunity to tap into their home equity through reverse mortgage loans.

This article explores who qualifies for reverse mortgages, how payments may be structured, and the advantages, as well as potential risks, of the product.

What are Reverse Mortgages?

The "baby boom" generation has started entering retirement age, and many analysts suggest that the so-called boomers hold most of their savings in the form of home equity. As of July 1, 2005, the U.S. Census Bureau estimated the baby boom generation — people born between 1946 and 1964 — to be 78.2 million people. The Census Bureau also estimated that 7,918 boomers turn 60 each day, which translates to 330 persons every hour.

According to Social Security Administration statistics, in 1935, life expectancy for people who were 65 years old was 12.5 years. Today, it is approximately 18 years. Thus, as the aging population lives longer, retirees will also have to depend much longer on traditional sources of income, such as social security and pension funds, and may well find themselves turning to other funding sources, such as reverse mortgages.

Reverse mortgages are loans that allow homeowners to convert equity in their homes into cash, and at their option, provide them with periodic payments for as long as they live in their homes. Reverse mortgages may not be appropriate for some homeowners, such as those retirees who have pensions and other investments that provide adequate income for their lifestyles. Other retirees, however, such as those with limited income, may benefit. As this population continues to age and retire from the workforce, many will depend on their accumulated home equity savings as a source of income.

Potential Benefits

Many financial institutions have started to market reverse mortgages to seniors. The U.S. Department of Housing and Urban Development (HUD)'s Federal Housing Administration (FHA) reverse mortgage program is the most widely used product in the country.[1] Known as the Home Equity Conversion Mortgage (HECM), the mortgages are provided by FHA-approved private lenders and receive the benefit of FHA-insurance. However, only a small number of OTS-supervised institutions offer the program.[2]

Fannie Mae has a similar reverse mortgage program called the Home Keeper® Mortgage. There are also variations of the Home Keeper® Mortgage that have slightly different features.

Both FHA's and Fannie Mae's program guidelines require that qualified homeowners be at least 62 years old and have little or no mortgage balances on their properties.[3] Additionally, applicants for HECMs and Fannie Mae reverse mortgages are required to undergo an educational mortgage counseling session prior to the processing of the loan application. (Fannie Mae is not a direct lender; it purchases the reverse mortgage loans from its approved lenders for sale to the secondary market.)

Homeowners with reverse mortgages can receive their payments in one of the following forms (items #2 through #6 represent the payment plan options for reverse mortgage proceeds; lump sum proceeds are not characterized as a payment plan):

- Lump sum cash payment at closing of the transaction;
- Monthly or periodic cash advances for as long as the borrower uses the property as the primary residence ("tenure" payments);
- Monthly or periodic cash advances for a specific period of time ("term" payments):
- A line of credit having a specific dollar amount, from which the borrower determines when to withdraw, and the amount of the withdrawal;

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[1] According to May 2006 testimony by Peter H. Bell, President, National Reverse Mortgage Lenders Association, before the U.S. Senate Subcommittee on Housing and Transportation, the market share for FHA-insured HECMs is approximately 90 percent.

[2] Per listing of FHA-approved HECM lenders.

[3] The first and second lien position is required for the HECM; therefore, the program requires existing mortgages to be repaid in full, using the reverse mortgage proceeds, or subordinated.

- A combination of a line of credit and regular monthly payments for as long as the borrower lives in the primary residence ("modified tenure"); and

- A combination of a line of credit and a fixed term of monthly payments ("modified term").

Homeowners have the option of adjusting these payment structures at any time. The amount of the cash proceeds received depends on the age of the borrower(s), prevailing interest rates, and the value of the property. Simply stated, the older the borrower, and the higher the property value, the more cash is available.

Moreover, reverse mortgages are non-recourse, which means that borrowers are not personally liable in the event of default, and cannot be required to pay off the loan even if the amount of cash received exceeds the value of the primary property. When the property is no longer the primary residence of an HECM borrower, for reasons such as the home is sold, the borrower dies, or the homeowner vacates the property for a period of 12 months or longer, the mortgage becomes due and payable in full. The amount due would include the outstanding mortgage balance, accrued interest, and other finance charges or fees.

It is critical that prospective borrowers receive independent financial counseling on the financial implications of, and alternatives to, HECMs.[4] Calculating the costs of the loan and determining the most advantageous way to structure the payout of the funds to the borrower present significant issues, particularly when comparing product features and payment options offered by different lenders. Typically, questions will arise about the impact of the reverse mortgage payment stream on certain public benefits, such as Supplemental Social Security Income (SSI) and Medicaid.

The disclosures that lenders provide to potential borrowers must note that HECMs may have tax consequences, affect eligibility for assistance under federal and state programs, and have an impact on the estate and heirs of the homeowners. The lender can provide a listing of housing counseling agencies, or the borrower may consult the HUD Web site. Seniors can also contact the American Association of Retired Persons (AARP) for the names of qualified reverse mortgage counselors.

Counseling will also help inform the borrowers' decision-making process and prevent them from falling victim to abuse and scams. Seniors have lost their homes as a result of unscrupulous lending practices and have even had family members take financial advantage of them.

HUD emphasizes that the flexibility of HECMs is a major benefit for seniors. Holders of reverse mortgages may also refinance their loans; financial counseling is required for product refinancings, unless certain conditions are met.

Although HUD does not have current statistics for homeowners in distress who have applied for reverse mortgages, troubled homeowners who meet eligibility requirements may use reverse mortgage payments to address financial hardships.

Not for Everyone: Risks Associated With Reverse Mortgages

Reverse mortgages are not suitable for all homeowners. While there are significant benefits to using the product, there also are disadvantages for some borrowers.

The complexity of reverse mortgage transactions, particularly for uninformed borrowers, is one drawback to product use. Prospective borrowers should carefully review the payment structure and method for receipt of the funds with the financial counselor to ensure it suits their particular situation.

The costs of reverse mortgage products are generally high compared to those associated with traditional mortgages. Costs include origination fees, closing costs, servicing fees and mortgage insurance premiums.[5] A 2 percent mortgage insurance premium fee is charged upfront at closing, and a small percentage is added to the interest rate that is charged on the rising loan balance.

Reverse mortgage loan origination fees are based on the home's value, which typically is greater than the loan amount. Thus, the origination fees are greater than those associated with other mortgage loans. Interest rates are also generally higher than the average 30-year mortgage loan.[6] Closing costs can range between $7,000 and $15,000, depending on the amount of reverse mortgage proceeds.[7]

A homeowner who may sell or move out of the property within a few years of taking out a reverse mortgage loan may not find the product appropriate because of the high associated costs. Borrowers in those situations would owe substantial amounts of fees and interest but may not have received a sufficient amount of cash advances to offset these costs, which is an important factor in the decision-making process. As with any loan scenario, however, lender fees and third-party costs will vary, so HUD and AARP advise prospective borrowers to shop around and negotiate for the most favorable deal.

In sum, borrowers should be prepared to work closely with certified financial counselors and approved lenders to perform the necessary cost/benefit analysis of different reverse mortgage products, and, based on their financial circumstances, determine the most advantageous ways to structure their payment plan options ■

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[4] It is advisable for prospective borrowers to consult with an attorney or financial adviser about tax implications specific to their circumstances.

[5] The FHA insurance protects the lender if the loan balance exceeds the value of the property, provides a higher loan principal amount, and ensures payment to the borrower in the event the lender defaults.

[6] Lenders now have the option of using different indices, including LIBOR and the rate on one-year Treasury securities. The margin may vary depending on the lender and investor(s).

[7] Estimates provided by HUD.