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Reverse Mortgages

For some seniors, borrowing against the value of their homes provides much-needed cash flow. But there are costs--and pitfalls for the unwary.

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Reverse Mortgages By Lisa Hooker | **0 comments**

Senior citizens living on fixed incomes easily can find themselves "house rich, but cash poor." For some, a reverse mortgage may supplement their Social Security check by converting a portion of their home's equity into ready cash.

Unlike a traditional mortgage, whose principal balance gradually declines as the borrower makes monthly loan payments, the principal owed on a reverse mortgage rises as the lender sends the borrower checks.

"The typical customer is looking for better cash flow. They need more money each month to make ends meet, and their home's equity is the only place to get it," says Bill Cavanaugh, area sales manager for Ohio, Kentucky and Indiana for MetLife Bank.

"The beauty of a reverse mortgage is that there are no monthly payments," says Jeff Flees, president of Flagship Mortgage Corp. in Worthington. The reverse mortgage is repaid when the house is sold, often because the borrower has moved into a nursing home or died.

By far the most common reverse mortgages are home equity conversion mortgages (HECMs) insured through the Federal Housing Administration (FHA), an agency of the U.S. Department of Housing and Urban Development (HUD).

AARP, the senior citizen advocacy group, says HECMs comprise more than 90 percent of all reverse mortgages. Since the product debuted in 1989, HUD statistics show more than 660,000 such loans have been made--three-fourths of those in the most recent five years. About 500,000 reverse mortgages remain active loans. In Ohio, HUD reports 8,887 active reverse mortgages, including 1,124 made in the 2010 fiscal year.

Buyer Be Aware

While the nonrepayment feature makes reverse mortgages initially attractive, they are not without costs and potential pitfalls.

It's startling to some seniors to learn their loan balance actually increases over time. "It uses up the home's equity, because the borrower doesn't make payments and the interest is added to the loan. In the end that leaves little, if any, equity for the homeowners or their heirs," cautions elder law attorney Tim Jarvis of Jarvis Law Office.

Reverse mortgages also carry expensive upfront costs. "They shouldn't be a first alternative, especially for those with other sources of income. It should be a last resort," says David Certner, AARP's legislative policy director.

Additionally, AARP cites concerns about the impact reverse mortgages may have on the long-term retirement security of younger borrowers. Consumers Union, the nonprofit publisher of *Consumer Reports*, says it has "deep concerns" about the suitability of reverse mortgages for some borrowers, as well as about aggressive marketing, misleading advertising and inadequacy of consumer protections.

Homeowners considering reverse mortgages need to do their homework and review alternatives. A little research may go a long way toward understanding the pros and cons--and securing the most appropriate deal if a reverse mortgage is the right solution.

Mandatory Counseling

HECM loans are made through FHA-approved conventional lenders. But before an application can be taken, homeowners must meet with a counselor from an FHA-approved independent agency.

"The purpose [of the mandatory meeting] isn't to talk them into or out of the loan," says Richard Korn, certified HECM counselor with Apprisen Financial Advocates, doing business in Central Ohio as Columbus Consumer Credit Counseling Service (CCCS). "It's only educational. We go over the costs and financial implications. People in financial distress must be aware of their options. We explain that it's not right for everybody."

Prospective borrowers are encouraged to bring a family member to the counseling session--often an adult child. "Children are often surprised to learn how this can impact their inheritance, so it helps them, too," says Richard Call, CCCS contract grant administrator.

During the 90-minute session, the FHA requires a counselor to ask the homeowner 10 specific questions. "It's not a test. We incorporate them into the discussion. They have to answer five of them correctly. We're looking for increased knowledge, so a lot depends on their comprehension ability," Korn says.

If the client doesn't answer five questions correctly, a second session can be scheduled. Once the session is completed successfully, CCCS issues a certificate that authorizes lenders to offer a reverse mortgage to the homeowner. "It's good for 180 days, so there's no pressure to make a decision," Korn says.

Even if the homeowner answers the requisite number of questions, counselors can flag comprehension issues on the certificate--or decline to issue it at all.

Currently CCCS has a HUD grant that enables the agency to offer the counseling for free. Earlier, when it was necessary to charge clients, the fee was $125.

HECM Basics

Individuals or married couples may apply for home equity conversion mortgages. Borrowers must pay their property taxes and insurance and maintain the property. A surviving spouse may continue to live in the home as long as all loan obligations are met.

Income or employment qualifications aren't required for HECMs, because the equity in the property stands behind the loan, not the wealth or earning power of the homeowners. "We, as the lender, take the risk without looking at the borrower's credit," says Flagship Mortgage's Flees.

Borrowers retain title to the home. "We place a lien against it, just as any other mortgage holder would. We'd be in first lien position," Cavanaugh says.

Reverse mortgage loan advances aren't taxable income to the borrowers, and generally don't affect Social Security or Medicare benefits. They can impact eligibility for Medicaid and Social Security's Supplemental Security Income disability payments, which are based in part on the net worth of recipients.

HECM borrowers pay substantial origination fees, closing costs, a mortgage insurance premium (MIP), a monthly servicing fee and interest. "There's no doubt the biggest drawback is the closing costs," Flees says. "For a $120,000 reverse mortgage, closing costs could easily total $8,000. That's why it's a niche product."

"The upfront closing costs and monthly servicing fee really add up over time," says elder law attorney Richard Taps of the Law Office of Richard T. Taps. "The effective interest rate can be well into the double digits if you're borrowing for a short time or if you happen to die soon after you get the HECM. The closing costs financed into the loan don't amortize."

Usually borrowers "finance the fees" by including them in the initial HECM draw. "You can prepay the fees, but if it makes sense to do a reverse mortgage, you probably can't pay them upfront," Jarvis says.

Borrowers were limited to FHA's HECM Standard loan until the HECM Saver loan debuted in October 2010. "HECM Saver has taken a lot of the price objections off the table," Cavanaugh says.

The Saver loan's lower upfront MIP cost is 0.01 percent of the property's value, compared to HECM Standard's MIP of 2 percent. That means a borrower with a $200,000 home would pay just $20 upfront on a Saver loan versus $4,000 for the Standard loan. In addition to that one-time charge, there's also a monthly MIP premium for both products that's assessed at an annual rate of 1.25 percent of the outstanding loan balance.

Borrowers make two tradeoffs in exchange for the Saver's lower upfront MIP. First, loan limits for homeowners who take Savers are 10 percent to 18 percent less than the maximum HECM for those who take the Standard loan. Second, as noted by AARP, HECM Saver interest rates have been running 0.25 percent to 0.5 percent higher than HECM Standard loans. In both cases, the tradeoffs reflect the modestly higher risk in making Saver loans.

The HECM front-end fees often send homeowners looking for other options. "Do they have other money they can tap? Do they have cash-value life insurance? Can they refinance? Could they rent to a boarder? Is family able to help? Is it best to move to a less expensive home?" Certner asks.

"I'm not a big advocate of reverse mortgages," Taps says. "I've found a home equity credit line can accomplish the same thing at a much lower cost. If you don't need a lot of extra money each month, I think a home equity credit line is superior."

Getting a bank to approve a home equity line could be troublesome, though. "Being on a fixed income, they may or may not qualify for a home equity loan. Even if they did qualify, the point of a HECM is to improve cash flow, not add another monthly payment," Cavanaugh says.

Accessing the Equity

The FHA determines how much a homeowner can borrow based on age, current interest rates and the home's appraised value. Borrowers can choose a fixed or variable interest rate. The appraised value has no upper limit, but FHA's borrowing limit is $625,000.

In 2010, the average HECM borrower was 72.9 years old with a property valued at $279,880, according to HUD. The loan's average initial principal amount was $175,492 with an average interest rate of 5.7 percent.

"The younger you are, the less you can borrow because your life expectancy is longer," Taps says.

"At age 62 you can get about 50 percent of the equity, assuming the house is paid off. At age 82, it's closer to 70 percent," Cavanaugh says.

AARP notes, though, that the average age of an HECM borrower has dropped steadily from 76.7 years in 1990. "Borrowing with a reverse mortgage at a younger age raises concerns about their impact on retirement security in the long run," Certner says.

Loan proceeds can be paid out in a lump sum, or in equal monthly payments for life or over a fixed time period. "I'm not a big fan of lump sums," says Jarvis. "If the borrower is already in a precarious financial position, I'd hate to see them spend the money unwisely."

Borrowers may use the proceeds of an HECM loan for any purpose. Some use it only for monthly bills. Others pay off a first mortgage. Sometimes, though, the circumstances are more desperate. "More than once we've done a reverse mortgage to save their house or keep them out of foreclosure," Flees says.

Repayment

A reverse mortgage is repaid when the borrower dies or is unable to live in the home for 12 consecutive months. Lenders recover their principal, plus interest, when the home is sold. Home equity in excess of the loan balance is paid to the homeowner or the heirs.

With home values falling, the FHA's mortgage insurance fund for HECM lenders assumes some risk that sale proceeds may not cover the balance due. "It's a nonrecourse loan, so there's no personal liability of the homeowner to repay it from income, or [of] heirs to repay it from any inheritance," Taps says.

When the principal on an HECM loan exceeds the home's sale price, "The shortfall is [covered] by the mortgage insurance premium," Cavanaugh says. "It gives the [homeowners'] grown kids peace of mind. If they wanted to purchase the house, though, the kids could pay off the loan."

Ultimately the FHA's insurance fund itself may be at risk if too many HECM loans exceed the sale prices of homes. Consumers Union reported in December that taxpayer-funded bailouts are rising because of lender claims against FHA's insurance fund. As of March 2010, the report found 20,631 HECM loans, with balances totaling nearly $3.7 billion, were in default and subject to foreclosure.

Feeling the Heat

Seniors often are vulnerable to scams and high-pressure sales tactics, so HECM counselors address the importance of understanding who's pushing a reverse mortgage, and why. When someone wants you to use the proceeds of an HECM loan to purchase big-ticket financial products such as long-term care insurance or annuities, be very cautious. Seniors "shouldn't feel pressured by a lender, financial planner or anyone to invest in anything with the HECM proceeds," Call says.

"In the past, sellers oversimplified the product and encouraged homeowners to invest [loan proceeds] with them to pad their commission," says Jarvis. "That's not as prevalent today, but it's a good idea to get a second opinion from someone who's not directly involved in the transaction."

Sometimes the pressure is closer to home. "Grown children often suggest reverse mortgages to their parents. Some elderly folks put their own financial future in jeopardy to help their kids. At this point in life, it's time for Mom and Dad to put their interests first," Jarvis says.

Because reverse mortgages have potential for exploitation, consumer protections have been strengthened. The 2008 Housing and Economic Recovery Act states homeowners can't be forced to buy any other financial product with HECM proceeds. Lenders are barred from having a financial interest in selling a borrower other products.

The newly created Consumer Financial Protection Bureau is to conduct a study to identify unfair, deceptive or abusive practices in HECM lending and develop standard disclosures. (Former Ohio Attorney General Richard Cordray was named chief of enforcement for the bureau in January.) The Federal Reserve Board also is exploring new disclosure requirements that would force lenders to show clearly how reverse mortgage balances grow over time.

Consumers Union has proposed a requirement that lenders ensure the reverse mortgage is suitable for the borrower and accept fiduciary responsibility, just like a financial planner or an estate planning attorney. CU also proposes legislation or regulation that would outlaw deceptive marketing, adopt stronger prohibitions on cross promotions and strengthen consumer counseling.

"In the future we'll have more people who are living longer with less savings, less pensions and greater health-care costs," says Certner. "Those factors cry out for the need for additional money month-to-month. They'll likely turn to their home, and reverse mortgages will become even more commonplace. It makes sense to talk about these things now."

http://www.columbusceo.com/industry_news/estate_planning_and_retirement/article_06a4a586-6c58-11e0-adea-0019bb30f31a.html