Consumer Concerns for Older Americans

NATIONAL CONSUMER LAW CENTER

HOME A LOAN? A Quick Guide on Reverse Mortgages for Senior Advocates

At first glance, it seems there is a lot for a senior citizen to love about a **reverse mortgage**. It's a way to turn home equity into cash -- albeit in the form of a loan. It allows a senior to keep the title to their house. It allows (in fact, requires) the borrower to continue to live in the home. In addition, no payments are due until the borrower sells, moves out, or dies.

That can be an attractive proposition to a financially strapped senior – especially one whose **home equity** constitutes their primary or only financial asset and who lacks the income and savings to pay medical expenses, home repairs, or other necessary costs.

But there are also drawbacks to a reverse mortgage. It is usually quite **expensive** (although the costs may be hard to measure). In some cases, it can affect a borrower's future eligibility for government benefits. It may not solve a borrower's financial problems. Worst of all, a reverse mortgage transaction can be used by an unscrupulous individual to separate a senior from his or her assets.

In fact, the financial and budgetary analysis needed to weigh the costs and benefits of a reverse mortgage is so daunting that federal law requires a borrower to receive approved third-party counseling prior to getting a reverse mortgage insured by the government.

HOW A "REVERSE" MORTGAGE DIFFERS FROM MORE FAMILIAR MORTGAGES

A **mortgage** is a familiar -- if not always welcome – presence in the lives of millions of American homeowners. It is a lender's legal claim to an owner's house. That claim lasts until the owner fully repays the principal and interest on a loan.

While a **reverse mortgage** is also a legal claim against a house, it differs from a conventional, or forward, mortgage in important ways. The borrower and everyone else on the title must be at least 62 years old. While the loan is outstanding, the borrower gets paid by the lender rather than making payments. Often, a borrower gets payouts in the form of a line of credit or a commitment to make a future loan. Other times, a borrower may opt for monthly or lump-sum payments.

Over the life of a reverse mortgage, the **balance of the debt grows**, as principal, interest, fees, and insurance premiums accumulate. However, that balance comes due only when the borrower sells the house, moves out, or dies.

That's different from conventional mortgages or home equity loans, which normally require – at pains of foreclosure and loss of the house -- steady repayment.

A reverse mortgage shares some key characteristics with a conventional purchase or refinance mortgage. The borrower keeps the title to the house. And the borrower pays property taxes and must insure and maintain the property.

OTHER REVERSE MORTGAGE FEATURES

Eligibility

To qualify for a reverse mortgage loan, a homeowner must be at least 62 years old. The loan must be secured by the borrower's primary residence, and the property's previous mortgages must be paid off before or during the transaction.

A senior may qualify for a reverse mortgage even if they lack the income or credit required by other types of loans. That's because the size and availability of a reverse mortgage depends upon other factors, including the borrower's age, the net value of their property, interest rates, fees and limits set by the government and lenders.

Insurance

The most popular reverse mortgages are **insured by the Federal Housing Administration** under its Home Equity Conversion Mortgage ("HECM") program. This insurance requires an upfront premium equal to 2% of the gross value of the house (up to a federal ceiling) and boosts the interest on the outstanding loan balance by 0.5%. Those premiums reduce the equity available to the borrower, although they are not collected until the loan is paid off.

The insurance protects a homeowner against default by the lender. It also ensures that the lender will be repaid. The terms of most reverse mortgages prevent a lender from going after a borrower's other assets in case of a default.

A borrower should look closely at what insurance – if any – backs non-HECM reverse mortgages. An uninsured reverse mortgage could jeopardize a borrower's home equity or raise the cost of a loan to reimburse the lender for the additional risks assumed.

Counseling

Eligibility for an FHA-insured (HECM) reverse mortgage requires counseling from an agency certified by the U.S. Housing and Urban Development Department (HUD). Others considering a reverse mortgage may also seek **counseling, which is free**. California and a few other states require counseling prior to issuance of any reverse mortgage.

A counselor must help a borrower weigh other financial and loan options, the cost and benefits of any reverse mortgage, its impact on eligibility for other federal and state benefits, and how a mortgage might affect the estate left to the borrower's heirs.

To find an approved counseling agency, call HUD at 1-800-569-4287 or visit its website at www.hud.gov/offices/hsg/sfh/hecm/hecmlist.cfm.

Disclosures

The federal Truth in Lending Act (TILA) requires that a lender fully disclose to a potential borrower all terms of a reverse mortgage loan, including the total annual loan cost (TALC). However, most reverse mortgage loans carry variable interest rates, so such a disclosure will be an estimate based on assumptions about future interest rates and not a hard and fast calculation.

Unfortunately, reverse mortgage loans are excluded from the enhanced disclosure requirements and restrictions on terms mandated by the Home Ownership and Equity Protection Act (HOEPA).

Pay-out options

Reverse mortgage lenders usually offer a borrower several ways to convert home equity into cash. Although choices may vary with the lender and program, the usual forms are a line of credit (a commitment to make a loan in the future), monthly payments, or a lump-sum payment.

Line of credit: Many reverse mortgage borrowers use their equity to create a line of credit or loan that will be available to draw in the future. Interest charges do not accumulate on the unused balance of a credit line. FHA-backed HECM loans offer an additional benefit: they *pay* interest on the unused portion of the line of credit. That benefit, which can greatly reduce the cost paid by the reverse mortgage borrower or their heirs, is missing from most other reverse mortgages.

Tenure payouts: A monthly payment that, like an annuity, continues as long as the borrower survives and continues to live in the house.

Term payouts: A monthly payment (generally higher than a tenure payout) that continues for a set term.

Lump sum: Equity cashed out all at once can be used to respond to a financial emergency. It almost never makes sense to cash out all the home's equity as a way to raise money for other investments or to spend on items that aren't necessities.

Many programs and most states allow combinations of the forms of payout. For a fee, lenders sometimes allow the payout method to be changed during the life of a reverse mortgage.

PITFALLS

Cost

Because the costs of a reverse mortgage loan don't come due until the borrower dies or moves out, they may seem distant and small. But, like objects in a side view mirror, those costs may be much larger than they appear. Interest rates on a reverse mortgage loan are usually higher than on comparable home equity loans. And most reverse mortgage interest rates are variable. Meanwhile, the debt on which a senior is paying interest continues to grow. Other substantial costs include an origination fee, mortgage insurance premiums, closing costs, and a monthly servicing fee.

A borrower who ends up staying in their home for a short period gets hit hardest by the cost disadvantages of a reverse mortgage, which typically fall over the life of the loan.

One-shot deal

A reverse mortgage is normally a one-time transaction. Once a senior citizen's home equity has been tapped, it is unlikely to be available for future financial needs. That makes it important to use the money to meet urgent financial needs as part of a realistic plan for the future and not to fund investments or discretionary spending.

Benefits eligibility

While a reverse mortgage loan is not usually considered income, cash-outs held for more than a month may affect eligibility for Supplemental Social Security Income, Medicaid, or food stamps. A senior should check with benefits providers to ensure that a reverse mortgage deal won't exclude them from benefits to which they would otherwise be entitled.

Bad for investments

Because of the high costs of a reverse mortgage loan, it is nearly impossible to come out ahead using the proceeds to buy annuities, other insurance products, or securities. Yet commission-driven sellers may paint a different picture. Be wary of anyone who links a reverse mortgage pitch with a push to sell a senior something else. Make sure that the senior considers not just the potential gains but the loan costs and tax effects of any investment deal.

Paying for freely available advice and other rip-offs

Some predators contact seniors offering to refer them to reverse mortgage lenders in exchange for a "small" percentage of the payouts. That's like paying something for nothing. HUD's websites provides free information at www.hud.gov/offices/hsg/sfh/hecm/rmtopten.cfm. Or call 1-800-569-4287 for referral to a local housing agency.

In addition, advocates should warn seniors to beware of unwanted solicitations for home repairs, investment schemes, or donations.

Effect on estate planning

When considering a reverse mortgage, keep in mind that it could have a big impact on a senior's plans to preserve their estate. That's because the home equity tapped won't be there to be passed on to heirs.

ALTERNATIVES

Be sure that a senior considers other financial solutions to the problem they are trying to address with a reverse mortgage. Property tax deferrals or abatements may be available. Rehabilitation loans or grants, utility assistance, or housemate match programs may also help. Taking out a different form of loan or selling the house may also be a better financial move in some situations.

CONCLUSION

While they can be useful financial tools for wise users, reverse mortgages are expensive, particularly in the short run, and not for everyone.

Senior homeowners should explore alternatives such as property tax credit and abatement, and eligibility for other programs. Those who wish to leave their property to their heirs free and clear should probably not consider a reverse mortgage. Sound, in-depth counseling on these issues is essential and is required by the HUD program as well as some state laws.

For More Information

American Association of Retired Persons (AARP), *Home Made Money: A Consumer Guide to Reverse Mortgages*, call 1-800-424-3410 to order or http://www.aarp.org.

Dept. of Housing and Urban Development (HUD), Home Equity Conversion Mortgage, Demonstration Handbook 4235.1, Publications Service Center, Room B-258, 451 7th St. S.W., Washington, D.C. 20410, (888) 466-3487, *http://www.hud.gov/rvrsmort.html.*

Fannie Mae, 3900 Wisconsin Ave., N.W., Washington, DC 20016-2899, (800) 732-6643 h*ttp://www.fanniemae.com/singlefamily/ products/markets/emg-reverse.html.*

Federal Trade Commission, *Facts for Consumers: Reverse mortgages*, Office of Consumer/Business Education, Washington, D.C. 20580, http://www.ftc.gov.

National Center for Home Equity Conversion, 360 N. Robert Street, Suite 403, Saint Paul, MN 55101, (651) 222-6775, http://www.reverse.org.

California: Victoria Wong and Norma Paz Garcia, *There's No Place Like Home: The Implications of Reverse mortgages on Seniors in California*, Consumers Union, August 1999.

Massachusetts: *Financial Options for Older Homeowners: A Consumer Guide*, Homeowner Options for Mass Elders(H.O.M.E.) 30 Winter Street Boston, MA 02108.

Advocates seeking more information can also call the National Consumer Law Center at (617) 542-8010.

This brochure was supported, in part, by a grant, number 90-AM-2041, from the Administration on Aging, Department of Health and Human Services, Washington, D.C. 20201. Grantees undertaking projects under government sponsorship are encouraged to express freely their findings and conclusions. Points of views or opinions do not, therefore, necessarily represent official Administration on Aging policy.