Reverse Mortgages
Beyond The TV Ads

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Reverse mortgage loans are facially neutral financial instruments; however, consumers need to know that these loans:

- Can be an expensive way to borrow money
- Involve legally intricate contracts
- Are financially complex
- Have some inherent risks, including:
  - Risk of foreclosure and loss of the borrower's home
  - Reduction of financial options in later years

Traditional mortgage loan

- The loan is a "forward mortgage" in that it is usually used to purchase a home over time
- Note is secured by a mortgage on the property
- Before closing, borrower has no equity in home
- At closing, borrower's equity = down payment, if any
- During the loan period, borrower makes payments to lender
  - Loan balance decreases
  - Equity increases (in normal market conditions)
- At end of loan:
  - Borrower owes nothing, and
  - Owns 100% of equity (market value) of the home
- Loan amount (principal and interest) is known at the beginning of the loan and is repaid over a determined period, typically 30 years

Traditional mortgage loan

- Loan payment consists of four components (PITI):
  - Principal
  - Interest
  - Taxes: annual property taxes
  - Insurance: hazard insurance on the property
- Taxes and hazard insurance paid from an "escrow" account that lender creates and manages to protects lender's interest in their collateral from:
  - Tax liens
  - Fire, Wind damage
- Lender may also require mortgage insurance policy if borrower's equity is less than 20%.
- Borrower must show financial capability to repay the loan

Reverse mortgage loan

- "Mortgage in reverse" - a special type of home equity loan that permits homeowners to convert a **portion** of their home equity into cash
  - allows a homeowner to have **some** of the equity that has built up over years of home ownership be paid to the homeowner without having to sell the home
  - usually used to pay off existing forward mortgage or to generate a regular cash flow
- Loan is a note secured by mortgage on the property
- Homeowner retains title to the property
- Loan is not repaid until borrower no longer lives in the home
- Loan proceeds disbursed as lump sum, periodic payments, line of credit, combinations of these

Reverse mortgage loan

- Before closing, borrower has substantial equity in the home's value, often as much as 100%.
- During the loan period, lender makes payments to borrower:
  - Loan balance increases as interest and fees are added
  - Homeowner equity decreases
- At end of loan, borrower has much less (if any) equity in home and owes a large debt
- Key difference from traditional "forward" mortgage loan: at the beginning of the loan
  - The *duration* of the loan period is **not** known, and
  - The *total loan amount* (principal, interest, fees) that will be due at the end of the loan is also **not** known

Debt to Equity Relationship

"Forward" Mortgage Loan	Reverse Mortgage Loan
Loan amount and duration **known**	Loan amount and duration **not known**

Recourse vs. Non-recourse

- Traditional, "forward" mortgage loan is usually a ***recourse*** loan.
  - In event borrower is in default on repayment of loan, lender can foreclosure on the property, evict homeowner, and sell property to settle the debt.
  - In Illinois this requires lengthy judicial proceedings
  - If sale of the property produces less than loan balance, borrower may be held responsible for any deficiency.
- Lender, therefore, has **recourse** to obtain the shortfall from the borrower.

Recourse vs. **Non-recourse**

- A reverse mortgage loan is a ***non-recourse*** loan.
  - In event borrower is in default on conditions of loan, lender can foreclosure on the property, evict homeowner, and sell property to settle the debt.
  - In Illinois this requires lengthy judicial proceedings
  - If sale of the property produces less than loan balance, borrower cannot be held responsible for any deficiency.
- Lender, therefore, has **no recourse** to obtain the shortfall from the borrower.
- This feature, combined with the uncertainty of the loan duration, complicates the calculation of the initial loan principal

HECM reverse mortgage

- Almost all reverse mortgages in U.S. are federally insured Home Equity Conversion Mortgages (HECM)
- Qualifications – Borrower:
  - Must be at least 62 years old
  - Home securing the loan must be borrower's primary residence
  - Borrower must not be delinquent on any federal debt
  - Beginning March 2, 2015, borrower must show financial capacity to pay property tax and insurance.
- Qualifications – Property
  - Single family residence in 1 to 4 unit dwelling, or
  - HUD approved planned unit development, or
  - HUD approved condominium.
  - Some manufactured homes qualify, but no mobile homes
  - Cooperatives not yet been made eligible
- Home must be owned outright or have a low mortgage balance that can be paid at closing with the loan proceeds
- Home must meet minimum HUD property standards – HECM loan proceeds can be used to pay for repairs
- HECM For Purchase – not covered in this presentation

HECM reverse mortgage

Loan Disbursements

- HECM loan disbursements can be made in five ways:
  - Lump sum – single cash payment
  - Tenure – monthly payments for a specified term or for life of the borrower
  - Line of credit – borrower draws funds when desired, up to an approved limit
  - Combination of lump sum and line of credit
  - Combination of tenure and line of credit
- Loan amount that can be disbursed without penalty in first year reduced by changes in the HECM program that went into effect in 2013

HECM reverse mortgage

Loan repayment

- In general, the homeowner does not have an obligation to repay the reverse mortgage loan until the borrower (or surviving, non-borrowing spouse) no longer lives in the home due to:
  - Death
  - Sale of the home
  - Home no longer primary residence for more than one year – can be triggered by going into assisted living or nursing home for more than one year.
- The loan may be repaid from:
  - The sale of the home, or
  - From other assets of the borrower's estate
- Any remaining equity from the sale of the home remains in the borrower's estate
- Surviving spouse or heir may keep home by paying:
  - Full loan balance, or
  - 95% of appraised value of property

HECM reverse mortgage

Foreclosure

- HECM loan can be accelerated and foreclosure initiated if:
  - Borrower declares bankruptcy
  - Borrower fails:
    - To pay property taxes
    - To provide hazard insurance
    - To keep property in good repair
    - (Each of these may be remedied from additional loan proceeds, if available).
  - Borrower:
    - Rents out the property
    - Adds another owner
    - Takes out additional debt, pledging the property as collateral
- In all repayment situations, only the note balance is due – borrower still owns the home.
  - If borrower (or estate) can repay loan without selling property, ownership is maintained,
  - If not, then home is sold

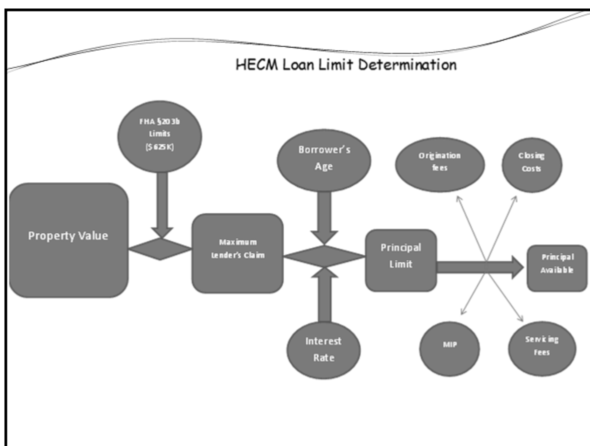
HECM reverse mortgage

- Lender protected from non-recourse risk if HECM loan balance exceeds market value of the property by
  - Federally guaranteed FHA Mortgage Insurance Policy.
  - Insurance premium paid by **borrower**, primarily to protect **lender** against market risk, however
  - Insurance also protects borrower from lender default
  - Premium cost added to monthly loan balance
- Initial MIP premium, as a percentage of the maximum loan amount available, is based on the amount of loan proceeds disbursed as cash in first year of the loan.

HECM reverse mortgage

Factors that determine how much can be borrowed

- Maximum lender can claim is limited by lesser of:
  - Appraised market value of the property, or
  - FHA § 203b limit of $625,000
- Maximum principal limit determined by:
  - Age of youngest borrower
  - Interest rate charged
- Maximum principal available to borrower depends on total reduction by:
  - Closing costs
  - Loan origination fees
  - Servicing fees
  - Initial Mortgage Insurance Premium
- Beginning March 1, 2015 some borrowers required to provide a “set-aside” for annual taxes and insurance payments



HECM reverse mortgage

Claims made in TV advertisements:

- Never make another mortgage payment
  - True, but statement can be confusing for those using loan proceeds to pay off forward mortgage.
    - Forward mortgage: PITI
    - Reverse mortgage: no escrow for TI (property taxes and hazard insurance)
- Loan is "government insured"
  - True.
  - Borrower pays premiums for the mortgage insurance that protects lender from market risk and borrower from lender going out of business
- Still own your home
  - True, with all responsibilities of home ownership to maintain property in good repair
- Will not affect Social Security benefits
  - True, for Social Security retirement benefits and Medicare
  - Means-tested benefits may be affected as well as Medicaid if monthly disbursements result in too much on-hand cash.
- Receive "tax free cash"
  - True, but somewhat misleading: virtually all consumer loans are not considered income and are not taxed.

More reason for consumer caution

- June 2015 report from CFPB titled "A closer look at reverse mortgage advertisements and consumer risks" noted that:
  - Many reverse mortgage advertisements contained confusing, incomplete, inaccurate statements regarding:
    - Borrower requirements
    - Government insurance
    - Borrower risks
  - Consumers often misinterpreted role of federal government and assumed protections that are not actually offered

2012 CFPB Report to Congress

- Reverse mortgages are complex products and are difficult for consumers to understand.
- Reverse mortgage borrowers using loans in ways that increased risks to consumers.
- Almost 10% of reverse mortgage borrowers were at risk of foreclosure due to **nonpayment of taxes and insurance**.
- Misleading advertising contributed to consumer misperceptions about reverse mortgages and poor consumer decision making.
- Non-borrowing surviving spouses of reverse mortgage borrowers were unaware that they were at risk of losing their homes.
- Reverse mortgage market had become dominated by a small group of originators, most of which are NOT depository institutions and not subject to the same regulations as banks.
- Even excellent counseling was often insufficient to counter the effects and perceptions of misleading advertising and aggressive sales tactics.

What consumers need to keep in mind about the reverse mortgage TV ads:

1. A reverse mortgage is a **loan;** the money must be repaid.
2. A reverse mortgages can be an expensive way to borrow money
3. Reverse mortgage loans are financially complex
4. Reverse mortgages involve legally intricate contracts
5. A reverse mortgage loan can be foreclosed on and borrowers can (and do) lose their homes.
6. Taking out a reverse mortgage is NOT a casual decision
7. Appreciation of property value is difficult to accurately predict
8. Reverse mortgage may preclude future living options

New rules for HECMs

- In past several years of economic crisis, more homeowners withdrew entire cash available in lump sum:
  - HECM program's reserve funds were strained
  - However, this practice was encouraged by lenders, because,
  - Lenders were paid more when borrowers took out large lump sums
- Declining home values hurt HECM program's finances because lenders could not recoup full loan amount when houses were sold and **turned to FHA insurance for the balance.**
- FHA insurance program became insolvent and needed a $1.7 billion bailout (from taxpayers) in 2013.
- In order to strengthen the HECM program, HUD made three major changes in 2013, 2014, 2015

1a. Loan Amounts Reduced

- For loans initiated after Sept 30, 2013
  - Less equity available - about 15% for most borrowers
  - Cash withdrawal in first year reduced
- The HECM standard and what was called the HECM Saver programs were combined, eliminating minor differences between them
  - Before, a 62-year-old could tap up to 62% of home value using a 5% interest standard HECM or 52% using a lower interest rate HECM Saver
  - After, same borrower limited to 52% of equity
- The goals for the change were to:
  - Return the reverse mortgage loan to what it was originally intended to be – a long-term financial planning tool
  - Strengthen HECM program by encouraging borrowers to tap home equity slowly and steadily, rather than in up-front cash-out.
  - Assist homeowners to stay in homes as they age
- Borrowers looking to reverse mortgages as a means out of heavy **consumer** debt may find this type of loan no longer a viable option

First Year Disbursement Limit

- Only 60% of loan principal limit allowed to be disbursed in first year. (Example: $200,000 total principal = $120,000 max disbursement in first year of the loan).
- Exception:
  - If h/o's mortgage balance and delinquent federal debts exceed limit, additional disbursement allowed since these debts ("mandatory obligations") must be paid before any cash disbursement to h/o can be made.
  - A h/o can withdraw enough to pay mandatory obligation plus 10% cash disbursement. (Example: $200,000 total principal permits "mandatory obligation" plus 10%: $20,000 cash disbursement.
- Credit card debt NOT considered a mandatory obligation and h/o may not be able to w/draw enough in first year to pay off all such debt.
  - This provision should discourage reverse mortgage borrowers seeking to pay-off such debt
  - Rule appears to be designed to return HECM to intended purpose – long-term financial planning and retirement planning tool
- Borrowers typically take loan proceeds as either lump sum or line of credit
  - Lump sum – fixed rate loan
  - Line of credit – variable rate loan
- In order to obtain fixed rate, borrowers will be required to take one lump sum payment , but that will be limited to 60% of total available equity or amount to cover mandatory obligation plus 10%.
- In order to access more equity, borrowers will have to take a line of credit or term option at a variable rate

1b. Pricing changes

- For loans initiated after Sept 30, 2013, part of reverse mortgage loan cost based on the amount withdrawn in the first year.
- A borrower taking **less** than 60% of the available amount in first year will pay an upfront MIP of 0.5% of appraised value (maximum claim amount – MCA)
- If borrower takes out **more** than 60% of total amount available in first year, the upfront mortgage insurance premium (MIP) will be 2.5% of appraised value of property. This five-fold difference is intended to act as a deterrent to large, up-front cash disbursements.
- Two examples:

Total 1st-year Disbursement **LESS** than 60% of Principal Limit

- Maximum Claim Amount (MCA): $200,000
- Principal Limit (age, interest rate): $100,000
- 60% of Principal Limit: $60,000
- Mandatory obligations: $20,000
- Available disbursement to borrower for first year: $40,000 ($60k - $20k)
- Borrower takes cash disbursement at closing of $15,000.
- Initial Mortgage Insurance Premium: $1,000 (.5% of MCA of $200,000) because total initial disbursement of $35,000 was less than 60% of principal limit.
- Note: the sum of all additional draws during first 12 months may not exceed $25,000 because HUD charged initial MIP of 0.5%

Total 1st-year Disbursement MORE than 60% of Principal Limit

- Maximum Claim Amount (MCA): $200,000
- Principal Limit (age, interest rate): $100,000
- 60% of Principal Limit: $60,000
- Mandatory obligations: $70,000
- 10% of principal limit: $10,000
- Borrower takes maximum cash disbursement at closing of $10,000
- Initial MIP: $5,000 (2.5% of MCA) because total initial disbursement of $80,000 was greater than 60% of principal limit.

2a. Provisions for Surviving Spouse – after Aug 2014

- Surviving spouse issue – Bennett case
  - FHA insurance provisions required repayment of a reverse mortgage when last surviving mortgagor (borrower) died. If surviving spouse was not a borrower and could not repay or refinance the loan, he/she would be evicted in sale of home.
  - Judge ordered HUD to write a rule to address this issue
- Rule that went into effect August 4, 2014 provides that for loans made after this date:
  - FHA's insurance eligibility "safeguard" requirement will be extended to both the eligible borrower and the non-borrowing spouse
  - Surviving non-borrowing spouses will have the repayment deferred until they no longer live in the home and will not have to refinance the loan to do so.
  - Surviving spouse must pay property taxes, maintain homeowner insurance, and keep the property in good repair.
- Loan amount will be based on the age of the younger, non-borrowing spouse. Thus, loan prinicpal available is reduced.

2b. Provisions for Surviving Spouse – before Aug 2014

- Surviving spouses for loans originated before Aug 2014 NOT covered by the rule change
- In the Plunkett case, the court offered two paths HUD could take to deal with surviving spouses of loans made prior to this date:
  - Hold Election (allow mortgagees to simply apply same terms to non-borrowing spouse as borrowing spouse had)
  - Mortgagee Optional Election Assignment (allow lenders to modify their FHA mortgage insurance contracts to assign a HECM loan to HUD even though the loan is eligible to be called due as a result of the death of the last borrower).
- FHA determined that while both options would have a significant impact on the FHA insurance fund.
- Not wanting a repeat of the 2013 insurance fund bailout, FHA determined that the Hold option was not viable.
- HUD has taken position that the only available option to foreclosure will be the MOE Assignment.
- Key: Mortgagee NOT required to seek a MOE. May still foreclose.

Surviving Spouse Case cites:

- *Bennett v. Donovan* (Secretary of Housing and Urban Development)
  - 797 F.Supp. 2d 69 (D.D.C. 2011).
  - 703 F.3d 582 (D.C.Cir. 2013).
  - 4 F.Supp. 3d 5 (D.D.C. 2013).
- *Plunkett v. Castro 67 F.Supp. 3d 1* (D.D.C. 2014).
- Implementing HUD Mortgagee Letters:
  - 2014-07 – new system to protect non-borrowing spouses in reverse mortgages after August 2014
  - 2015-02 – created “Ineligible Non-Borrowing Spouse”
  - 2015-03 - options for covering non-borrowing spouses in reverse mortgages issued before August 2014 (rescinded, replaced with 2015-15)

3a. Financial Assessment

- Beginning with loans made after April 27, 2015 (ML 2015-06), lenders will be required to make sure borrowers have the means to pay their property taxes, hazard insurance.
  - This change was intended to add a financial capability component to HECM reverse mortgages that was not required previously
  - All income sources will be analyzed, including Social Security, IRA’s, 401k’s
  - Borrowers’ credit history will also be considered
  - Lenders will analyze disposable income after typical living expenses and debt payments are factored in.
  - Threshold disposable income levels will be established and considered
- Previously there were no financial qualifications for a reverse mortgage, homeowner only had to have equity
- If not financially qualified, h/o will have to set aside sufficient funds to do so, which will reduce amount available for disbursement.

3b. Life Expectancy Set Aside (LESA)

- Under the new financial assessment rule, as amended by ML 2015-09, if lender determines borrower may not be able to pay property taxes and required hazard insurance premiums, borrower will be required to set aside sufficient funds to do so, further reducing loan disbursement.
- While this requirement could disqualify some borrowers, the change addresses a key problem with the current HECM program: reverse mortgage borrowers falling into default due to non-payment of property taxes and/or hazard insurance premiums.
- The new rule may disproportionately affect borrowers in areas where property taxes and insurance premiums represent a higher percentage of total property value.
- A borrower may also be required to make a set aside for needed repairs to the property

Advantages of a reverse mortgage

- Counseling required before a homeowner can obtain a reverse mortgage
- Allows "aging in place"-a highly valued consideration for many seniors in good health.
- Provides cash for long term out of pocket medical expenses not covered by other insurance.
- Alternate means to supplement other income sources in retirement.
- Can be used to pay off an existing mortgage, thus providing more disposable income
- May be appropriate if children are in better economic situation then parents and the children have little or no expectations of receiving bequest from parents.
- Non-recourse loan – amount owed can never exceed value of the house

However, a reverse mortgage is generally not a good idea:

- If the borrower doesn't need the money.
- To use money from a reverse mortgage to buy an investment – seniors don' t have as much time to recover
- If the borrower has only a short term of cash needed - consider using 401k, IRA, or savings.
- If the property value is low: upfront costs will represent a much higher percentage of a low value loan limit than for a higher value loan.
- If borrower does not have the requisite resources to pay property taxes and maintain hazard insurance: Set-aside requirement may substantially reduce loan amount available.
- If the borrower plans to live in the home less than a few years
- If the borrower plans to keep the home in the family and does not have other resources in the estate to repay the loan

Alternatives to a Reverse Mortgage

- Sell home, downsize with proceeds and use surplus as additional cash.
- Tap savings, IRA, 401k
- Take out conventional home improvement loan or Home Equity Line of Credit (HELOC) for repairs – these may involve a second mortgage on the property, but with much lower loan costs.
- Some states, like Illinois, have deferred payment loans, similar to reverse mortgages, to pay property tax.
  - In Cook County: "Senior Citizen Real Estate Tax Deferral Program"
  - Tax payers 65 years or older with household income less then $55,000
  - Owned and occupied qualifying property for at least 3 years
  - Property owner must maintain hazard insurance.
  - Other specific requirements

Future trends

- 2010 Federal Reserve reported that median retirement account balance of Americans aged 55-64 was only $103,200
- 2015 report by Employee Benefit Research Institute:
  - Nearly half of baby boomers will enter retirement years with inadequate retirement savings for basic expenses and uninsured medical costs
- 2015 National Reverse Mortgage Lenders Association research study showed that homeowners aged 62 and older held a combined total of $3.84 **TRILLION** in home equity.
- It is reasonable to expect seniors will increasingly look to reverse mortgages for fill these financial gaps

Additional sources of information

- HUD website: www.HUD.gov
- CFPB website: www.consumerfinance.gov
- AARP website: www.aarp.org
- National Reverse Mortgage Lender's Association: www.nrmlaonline.org