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The Reverse Mortgage Trap

by Tim Millar, CFP

Reverse mortgages have been getting a lot of attention as the number of baby boomers reaching retirement rapidly increases and more and more households recognize that their principal source of equity is locked in the equity of their home. Many are finding that their resources are less than they require not only for retirement, but to pay for special needs brought about by rising health care costs, reductions in public benefits, the continuing needs of their children, or other circumstances beyond their control.

However, the appetite for reverse mortgages is not only fed by the needs of retirees, but is fueled by an industry that sees profits buried in home equity as well. A New York Times article published in February 2006 cites a Federal Housing Administration report showing that the number of reverse mortgages originated had increased from approximately 7,700 in the fiscal year ending September 2001 to 43,000 in the same period in 2005. The same article estimated that the number of loan originations was up 56 percent for the 2006 fiscal year.

While a reverse mortgage may be an appropriate tool in some circumstances, the complexity of these financial devices and the rapid growth in the marketing of these products greatly increases the potential for mistakes and abuse. Understanding the differences between a reverse and a traditional mortgage is essential in determining the appropriate tool to use.

Comparing Traditional and Reverse Mortgages

In a traditional mortgage, a borrower or borrowers usually receive a lump sum payment (sometimes a "line of credit" is reserved in lieu of a lump sum) which is secured by the equity in their home. The borrower(s) are obligated to immediately start making payments, usually consisting of interest and principal,

that are calculated to retire the mortgage after a fixed period of time.

The first difference between traditional and reverse mortgages is that in a reverse mortgage, the youngest borrower must be at least age 62. Second, while like a traditional mortgage, a reverse mortgage can provide a lump sum payment or a line of credit, the borrower could also elect to receive a stream of scheduled loan payments, either over a set period of time or over the borrower's entire lifetime. This is the "reverse" part of a reverse mortgage. Instead of the borrower making scheduled payments to the lender, the lender may be obligated to make scheduled payments to the borrower.

Finally, in a reverse mortgage the borrower does not immediately start making payments on the loan. Instead, the amount that is owed will increase as interest accrues and periodic payments (if provided for in the loan) are received, and the borrower will be obligated to repay the full balance at a later date, possibly only after death.

The actual date that the loan must be paid off will vary. While many believe that the loan is only paid off at death, other events will also trigger an immediate obligation to pay off the loan. Some loans have a scheduled expiration date when the loan must be paid. Loans also become immediately due and payable if the home is sold, or if no borrowers remain living in the home. In the case of a temporary absence (e.g. if the need for institutionalized care became necessary), the loan will often accommodate up to a one-year absence before it is called. However, after the year has passed, the loan will be canceled and is immediately due. Other events may also trigger cancellation of the loan, such as renting out part of the home, failure to maintain

insurance, or other stated conditions specified in the individual loan agreement.

The consequences of an early termination of a loan can obviously be traumatic. Not only does it usually force sale of the property, but a borrower depending on the income from a reverse mortgage will see those income payments vanish.

Unexpected Outcomes

Even where a loan is not terminated early, the outcome of a reverse mortgage is quite different from a traditional loan. For those only familiar with traditional mortgages, these outcomes might be quite unexpected.

One of the reasons that so much consumer equity exists in homes today is the working of a traditional mortgage. In a traditional loan the amount that is owed decreases over time as principal payments are made. As the loan balance declines, the borrowers' equity increases. At the same time the borrower receives the full benefit of any appreciation in the value of the property (and suffers a loss if value declines)

In a reverse mortgage the loan amount increases as monthly service, insurance fees and, principal payments are added to the balance. At the same time, interest is charged on the new loan balance and is compounded over the life of the loan. As interest accrues, equity is reduced by the increasing loan balance. In addition, some loans provide that the lender participate in the future gross appreciation of the property, thus further reducing the equity retained by the homeowner.

The rate charged for interest in a traditional loan is usually less than that charged on a reverse mortgage. Further, in a traditional mortgage, interest paid is deductible (within certain limits) for Federal and State income tax purposes. However, since interest is only deductible when paid, there are no income tax deductions over the life of a reverse mortgage making the interest rates higher indeed. Only at termination of the loan, when interest is paid, may a tax deduction be realized.

Interest is only part of the cost of a loan. Both traditional and reverse mortgages charge fees at the time the loan is established. Many of these fees, in fact, are the same.

However some fees are unique to reverse mortgages. Most important are origination, insurance and loan servicing fees. A typical reverse mortgage may charge a 2% origination fee and a 2% insurance fee, which are immediately added to the loan balance. There are also service fees and may be ongoing insurance fees that are also added to the loan balance on a monthly basis. A \$200,000 loan may begin with fees exceeding \$10,000 which are immediately added to the loan. In the case of an equity line or periodic payment loan this means a borrower would owe \$10,000 even though no proceeds had actually been paid at the time the loan was established.

Unlike a traditional mortgage where costs are relatively easy to evaluate, it is impossible to calculate the true cost of the reverse mortgage without making a number of assumptions about future home appreciation, the future living situation of the homeowner, and the borrower's life expectancy. This makes comparing the terms of one loan to another, with differing terms and conditions, particularly challenging and complex.

Types of Reverse Mortgages

The Federal Housing Administration (FHA) offered the first reverse mortgage program. Called HECM, for Home Equity Conversion Mortgage, these are the most common reverse mortgages. Private lenders have developed their own reverse mortgage programs to compete with HECM loans. These proprietary programs include Fannie Mae's "Home Keeper" loans.

The biggest drawback to HECM loans has been the cap on the loan amount. Currently loans are only offered for a value up to \$362,790 (and as low as \$200,160 in rural areas) despite the home's appraised value. Further, while this represents the upper loan limit, the amount actually available is also reduced based on the age of the youngest borrower and the equity value of the home.

Proprietary programs may compete against HECM loans by offering higher loan amounts or other provisions that increase their marketability. While with a traditional mortgage borrowers often shop based solely on the effective interest rate of the loan, a

reverse mortgage borrower must carefully consider the terms of each loan including fees, triggering events, etc. Comparison of loans can be quite complex.

The Department of Housing and Urban Development has an approved counselor program where potential borrowers can receive free counseling about reverse mortgages and different mortgage contracts. Local offices can be found at www.hud.gov/offices/hsg/sfh/hecm/hecmclist.cfm

Note:

Homeowners who enter into a reverse mortgage have a three-day right of rescission of the reverse mortgage contract. This three-day period begins on closing of the loan. **Warning:** For purposes of the three-day right of rescission, “business days” are defined to include Saturdays.

When does a Reverse Mortgage make sense?

While reverse mortgages are complicated and may be costly, they may be the best option in certain situations. They allow a homeowner to realize equity and at the same time to retain use of their home. Alternatives to a reverse mortgage include downsizing into a less expensive home or living situation or governmental programs to help seniors retain use of their home (e.g. California’s Property Tax Postponement Program for Senior Citizens, Blind or Disabled Citizens. See www.sco.ca.gov/col/taxinfo/ptp/)

Individual needs play an important role here. Downsizing may depend on the availability of alternative housing in the community or need for proximity to family or other resources. Traditional mortgages may be less expensive, but unlike reverse mortgages, require immediate servicing.

Avoiding potential abuse

• Referral Agencies

The best source for information on reverse mortgages is through the free counseling program offered through HUD. Clients may also wish to have the terms of a

mortgage reviewed by an advisor who is not engaged in the marketing of these products. However, clients should beware of advisors, including attorneys, accountants, financial advisors and other who receive a referral fee for directing a client to a lender. These fees can be substantial, are often stated as a percentage of the loan amount, and may be added to the amount owed when the loan is established.

• Using Reverse Mortgages to Fund Long Term Care

Reverse mortgages can be a useful tool for allowing an ill or disabled individual to afford to remain in their home. However, as the risk increases that at home care will be inadequate and the potential need for institutionalized care increases, keep in mind that reverse mortgages are called when no borrowers remain in the home. Though current products allow for temporary absence from the home, loans will be called if the home is not occupied by a borrower for more than twelve months.

This makes these loans quite risky if used to fund care for someone who is at an elevated risk for needing institutionalized care. This is true first because the forced sale of the principal residence will result in a countable asset for Medi-Cal eligibility purposes. But even in cases where the individual plans to private pay, the consequences can be very negative.

Since reverse mortgages load fees on the front end of the contract (e.g. Origination, Insurance, etc.), loans are most expensive if held for short periods of time. There have been examples of reverse mortgages held for less than two years and then canceled resulting in effective costs as high as 49%! In cases where institutionalized care is likely to be needed, the homeowner may be better off using more traditional forms of borrowing, even if the loan proceeds might need to service the debt for a short period of time.

Likewise, some have suggested that reverse mortgages be used to reduce the equity value of a principal residence in response to equity caps to be imposed by DRA ’05 for single individuals. However, the termination provisions of these contracts make this use ineffective.

On the other hand, a reverse mortgage may be useful tool for producing additional cash flow for the well spouse of an institutionalized individual. Here the advantage is not in the reduction of the equity value of the home (which does not apply in situations where a community spouse still occupies the principal residence) but in the generation of cash flow, which is not included as income in the calculation of share of cost.

Of course any funds received prior to eligibility will be considered available assets and thus included in the determination of eligibility, so any mortgage providing for a lump sum payout should not be executed prior to eligibility being determined. In addition, even after eligibility, if a mortgage is established it should be taken out only in the name of the well spouse. Finally, any interest generated on distributed funds of a reverse mortgage are countable for Share of Cost purposes.

However, if periodic payments are made to the well spouse, they will first follow the “name on the check” rule and be attributable only to the well spouse and furthermore, payments of loan proceeds are considered assets not income and thus will not jeopardize any income allocation that might exist.

• *Reverse Mortgages to Fund Certain Annuities*

A reverse mortgage providing a stream of income for life does so by providing a payment to the borrower and increasing the loaned amount on a monthly basis.

Early forms of reverse mortgages called Reverse Annuity Mortgages (RAM) provided lifetime income by combining a lump sum reverse mortgage with a life based annuity contract. For example, a borrower may take out a reverse mortgage providing an immediate payment of \$200,000 which would then be used to fund an annuity providing monthly payments for life.

The result was that even though the borrower had yet to receive any net funds from the mortgage, they already owed a mortgage amount of \$200,000 (plus fees). If the annuity provided no guarantee rights (i.e. a life only annuity) a premature death resulted in a huge loss to the estate with little or no benefit to the homeowner.

RAMs have been replaced by today’s reverse mortgages. However, some organizations will advise that a lump sum mortgage be established then used to purchase an immediate annuity. The homeowner pays fees to establish the loan, fees (though usually hidden) to purchase the annuity, and may even pay referral fees to the agent for referring the borrower to the lending firm. In some cases, a reverse mortgage has been used to fund an annuity that is not even scheduled to make payments to the homeowner for a number of years! During this time, of course, interest and other charges continue to accrue against the equity in the home.

In addition, unlike reverse mortgages making periodic payments, the monthly proceeds produced by these products are proceeds from an annuity, and as such would be countable as income for purposes of calculating Share of Cost.

• *SB 1609 (Simitian) - Recent Developments in Reverse Mortgages*

Little legislation exists that controls the abuses of reverse mortgages. In fact, many states have laws excluding reverse mortgages from their predatory lending statutes.

In California concern about these abuses resulted in the recent passage of SB 1609 (Simitian). SB 1609 adds guidelines to protect consumers from certain abusive practices. Most importantly SB 1609:

- Requires that loan documents be presented in the language (Spanish, Chinese, Tagalog, Vietnamese, or Korean) in which the contract was negotiated.
- Mandates that potential borrowers receive financial counseling from a Department of Housing and Urban Development approved counselor.
- Prohibits lenders from requiring a borrower to purchase an annuity as a condition of obtaining a reverse mortgage loan.
- Prohibits lenders from referring the borrower to anyone for the purchase of an annuity prior to the closing of the loan or before the expiration of the borrower’s three-day right to rescind.

Conclusion

As baby boomers mature into retirement and find their security threatened by the deterioration of Social Security, Private Pensions, Public Benefits, and the rising cost of Health Care, the ability to utilize the equity in their homes will become increasingly important. While the use of reverse mortgages will continue to expand, their complexity and costs will require greater diligence on the borrowing public and their advisors.

The chart below demonstrates some the principal difference between a traditional and reverse mortgage:

	Traditional Mortgage	Reverse Mortgage
How Receive Funds	Lump Sum Line of Credit	Lump Sum Line of Credit Periodic Payments for Period Certain Periodic Payments for Life
When Loan is Due	After scheduled period of time during which loan is slowly retired On Sale of Property At last death of borrower	After scheduled expiration date On Sale of Property At last death of borrower If borrower requires long-term (>1 yr) institutionalized care If loan restrictions (e.g. rental of room in home) is violated
How and When Paid Off	Monthly Payments of Interest and Principal or Lump Sum on early termination of loan	Lump Sum - Usually from proceeds of sale of home
Debt Balance	Decreasing	Increasing
Equity Balance	Often Increasing due to property appreciation plus debt reduction	Often Decreasing due to increasing debt and potential lender participation in property appreciation
Interest Charges	Fixed or Variable Usually Lower than reverse mortgage Tax deductible (as permitted by law)	Variable Usually Higher than a traditional mortgage Deductible only on termination of loan (as permitted by law) May include participation in appreciation of the homes value
Other Costs	Application (Appraisal, etc.)	Application (Appraisal, etc) Origination Fee Servicing Fee Insurance