Reverse Mortgages Part 1 â€“ What you need to know - An ACCESS Special Project

Part 1 of a 4 part series

When we started this project on reverse mortgages, we didnâ€™t really know what to expect. Frankly, most of the people that I work with arenâ€™t ready to retire just yet and none of us had spent a lot of time researching reverse mortgages or other forms of financing for those who have already entered retirement. Once we delved into the subject, what we found was somewhat surprising and led to some disagreements among us. One group wound up very much in favor of using reverse mortgages. Another group was very much against them. In the process of settling the dispute, we came to realize that oneâ€™s point of view was really dependent upon how borrowers used the proceeds from these loans. When used as intended, reverse mortgages can be very useful. But when used in other ways, a 2012 Forbes article may have said it best. â€œConsider a reverse mortgage an option of last resort.â€• As you will see when you read through this, most reverse mortgages issued today are not being used as legislators envisioned, but there is no reason that they canâ€™t be. First, a little history.

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A brief history of reverse mortgages

The first reverse mortgage was issued by Deering Savings & Loan in 1961 to Nellie Young in Portland, Maine. The loan officer, Nelson Haynes, had designed this very unique type of loan to help the widowed wife of his high school football coach remain in her home after her husbandâ€™s death.

For the next 27 years, our government was un-involved with the fledgling industry. While not heavily promoted, it remained a viable option for some retirees under the right circumstances. In 1988 (signed into law in 1987) under President Reagan, HUD gained the authority to insure reverse mortgages through the FHA. That change was supposed to make reverse mortgages more accessible to the average retiree but it also created a conflict of interest in our opinion. On the one hand FHA was promoting homeownership and on the other, they were promoting a loan product that actually insured the borrower would continue to accrue debt. To make these loans attractive to lenders â€“ FHA wanted lenders to include reverse mortgages in their service portfolio - FHA also promoted a fee structure that was quite expensive to the borrower. That structure has now become even more lucrative to lenders and a number of large lenders now actively push reverse mortgages in national advertising campaigns.

The reverse mortgage that was issued to Nellie Young wasnâ€™t intended to turn her home into a piggy bank; drawing out all of her equity at the loanâ€™s inception and giving her no additional options once the money was spent. Rather, it was intended to give her access to enough money to be able to pay her bills and live comfortably in the house that she and her husband had called home for the rest of her life. She would only take money as she needed it. Law makers and HUD appeared to recognize these loans as having a very limited use by placing a cap on the number of loans that could be issued in their 1987 legislation. These caps made reverse mortgages a lucrative but niche product for the lenders that offered them throughout most of the 1990â€™s.

It wasnâ€™t until 1998 that reverse mortgages became a permanent loan product. At that time, HUD lifted the cap on the number of reverse mortgages that banks could issue to 150,000 annually and began the process of restructuring the fees that banks could charge for these loans to make them even more attractive to lenders; a process that was completed in 2000. The new fee structure worked â€“ perhaps a little too well â€“ leading to unintended consequences as lenders realized that the fee structure associated with the loans made them very profitable and the federal guarantees associated with the loans meant that issuing banks had virtually no risk of loss.

But it wasnâ€™t really until 2008 that the current reverse mortgage products that you see marketed on TV actually came into being. Prior to this, all reverse mortgages were issued as adjustable rate loans. Borrowers only had two options for the way that they could receive the proceeds from these loans. They could either elect to take a monthly payment, or they could elect to have the loan issued as a line of credit which they could use as needed. In 2008, FHA changed the rules to allow a reverse mortgage product that was issued at a fixed rate of interest and which allowed borrowers to take a single lump sum payment at the inception of the loan. This changed the way that the loans were marketed to consumers; encouraging borrowers to take significantly larger loans at a much earlier age.

The proof is in the numbers. In 2000 there were fewer than 10,000 reverse mortgages issued. By 2009, well over 110,000 were issued. In 2007, the last year that no fixed rate product was available, nearly 90% of borrowers gained access to their loans through a line of credit. By 2011, nearly 70% of borrowers were electing to take a lump-sum payment at the loanâ€™s inception. It should also be noted that in the early 1990â€™s, borrowers taking out reverse mortgages were only taking out loans that on average accessed 36% of the amount they were eligible to borrow. By 2008 the average borrower was accessing 80% of the available amount of money they could borrow. The combination of lump sum payments and change in the behavior of borrowers increase both the risk and the cost of these loans, as you will soon see.

The fixed rate reverse mortgage is now a thing of the past (although borrowers can still take a lump-sum payment with some restrictions). FHA eliminated it in 2013 because the technical default rate on it â€“ meaning that borrowers were unable to pay their taxes and insurance â€“ had skyrocketed to almost 14% on loans that were 30 months old. Default rates on adjustable rate reverse mortgages of the same age were less than half that number. And earlier this year, a new qualification process was implemented for borrowers. Borrowers must now go through a financial assessment that includes looking at their credit history. This change was made to reduce the risk of default on these loans.

It is now clear that FHA is attempting to change the mindset of reverse mortgage borrowers; getting them to think of these loans more like legislators intended rather than the way that lenders have been marketing them.

Reverse mortgages today

An April, 2012 report to congress by the Consumer Financial Protection Bureau provides a concise explanation on the intent of legislators and regulators for the use of reverse mortgages. â€œThe original purpose envisioned for reverse mortgages was to enable older borrowers to convert home equity into cash they could use to help meet expenses in retirement. Borrowers could choose between an income stream for everyday expenses, a line of credit for major expenses (such as home repairs and medical expenses), or a combination of the two. It was anticipated that most, though not all, borrowers would use their loans to age in place, living in their current homes for the rest of their lives or at least until they needed skilled care. Upon the borrowerâ€™s death, or upon leaving the home, the borrower or the estate would sell the home to repay the loan and would receive any remaining home equity.â€•

You would never know this by watching the current advertising for reverse mortgages. These ads typically make it sound like anyone close to retirement age can solve all of their financial issues with a reverse mortgage. The fact is that reverse mortgages are really a type of home equity loan which will eventually have to be repaid. And the costs associated with reverse mortgages can be considerably higher than with other types of home equity loans.

In the same Forbes article we mentioned earlier, the author went on to say that, â€œIf you or your aging parent gets charmed by the TV ads, get advice from a competent financial planner and elder law attorney before doing anything. Recognize that your aging loved one might not be in perfect health to the end of her days and that care at home might cost more than a reverse mortgage could cover, especially over a period of years. There just might be less costly, smarter ways to deal with the need for money when funds run low.â€•

The author was correct in her analysis for many borrowers. Thatâ€™s because a lot of borrowers are using reverse mortgages in ways that they were never intended. One of the primary uses for recent borrowers had been to refinance their existing home mortgage; eliminating it and their monthly payment by taking out a reverse mortgage. The CFPB report addresses this issue saying, â€œborrowers today are increasingly using reverse mortgages as a way to refinance existing mortgage debt â€“ while eliminating their monthly mortgage payments â€“ early in their retirement or even before reaching retirement.â€• Noting that â€œThis pattern of use is very different from what was originally intended when the product was first developed, and poses several significant risks to the consumer,â€• it covers some of these risks in detail, arriving at the conclusion that borrowers could easily use up all of their home equity and have nothing to fall back on in an emergency.

Our conclusion here is that reverse mortgages may be a viable financial option when used properly but could pose significant financial risk to those who use them improperly. All of these things need to be kept in mind by anyone considering this type of loan. In our next article in this series, weâ€™ll cover the qualification process for obtaining a reverse mortgage.

Links to other articles in this series:

Part 2 - Click here

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