The Cost and Benefit of Reverse Mortgages

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ABSTRACT

There has been a growing popularity of reverse mortgage among senior citizens who need cash. The loan allows homeowners to convert a portion or the entire amount of equity on their house into cash. They do not have to move out or pay back the loan as long as they live. The amount of reverse loan that they can receive depends upon the age of the property owner, interest rate and the appraised value of the home. No income or credit qualifications are required since they do not have to make monthly loan payments. They can receive a single lump sum, periodic payments, a credit line or a combination of these payments methods. However, the reverse mortgage has some drawbacks. The financing costs include an origination fee, a third party closing costs (title insurance, appraisal, recording fees, etc), a mortgage insurance premium (MIP), a servicing fee, and interest. If the borrower dies or moves to another home within a few years after the loan is obtained, the loan can be very expensive in terms of high financing costs.

Keywords: reverse mortgages, closing expenses, senior citizens, home equity, mortgage interest rates

INTRODUCTION

There are many senior citizens in the U.S. who have cash-flow and financial problems due to bad economy and lack of savings. Their capital investments as well as home value declined substantially during recent years. Many of those in this specific group are either retired or planning to retire soon. Many of them do not have much savings in their retirement accounts such as IRAs, 401(k), 403(b) and pension. The social security does not provide them with sufficient funds to maintain their current standard of living, and the future of the U.S. social security system is subject to a great deal of uncertainty, considering high federal deficits and the increased number of aging population. Given the current state of the economy, some senior citizens or retirees are having a trouble with paying their bills, creating a liquidity problem. Therefore, there is a need for such senior citizens to find a financial solution based upon their equity on their house.

There are two ways to get cash from their house: selling or obtaining additional loans. If they sell, they have to move out. If they borrow against their home, they have to make monthly mortgage payments. None of the solutions is acceptable for most senior citizens who need a place to live and have insufficient income for making monthly loan payments. Then, a reverse mortgage can be a reasonable solution that does not require them to leave or make periodic mortgage payments. A reverse mortgage is a loan that allows homeowners to convert a portion or the entire amount of the equity in their house into cash. They do not have to move out or pay back the loan as long as they live. The demand for a such loan has been increasing substantially during recent years due to subprime loan crisis and a resulting collapse of financial asset value. (AARP Foundation Report, 2008)

There are several ways to cash home equity in reverse mortgages: a single lump sum, periodic monthly cash received, a credit line, and a combination of these payment methods. A homeowner does not have to pay back anything to a lender until he or she die, sell their home, or permanently move out of their home. You have be at least 62 years old to be eligible for most reverse mortgages. (www. reversemortgage.org). Unlike other (forward) mortgages you can be qualified for a reverse loan even if you have no income at all since it does not require any monthly mortgage payments. Also, a credit score is not a major issue with a reverse mortgage application. With a forward mortgage, a borrower has to make monthly interest and principal payments to a lender, building up equity in his or her home. However, a reverse mortgage is just an opposite that allows a home owner to cash out equity, increasing your loan balance. As a result, the loan balance is increasing and your equity can be shrinking unless home value appreciates substantially. A borrower maintains a possession of the property, and is responsible for property taxes, homeowner insurance and any home repairs. (AARP Report, 2006)

There are many types of reverse mortgages, but the most popular one is the HECM (Home Equity Conversion Mortgages) that is insured by the FHA (Federal Housing Administration). In 1987, the US Congress approved the FHA insurance for developing reverse mortgage programs. The amount of reverse loan that you can obtain depends upon age of the property owner, interest rate and appraised value of the home. As mentioned earlier, no income or credit qualifications are required and closing costs can be financed also. The reverse mortgage program requires a homeowner to receive a counseling and education by a government approved HECM counselor. The purpose of the requirement is to educate elderly people, so that they can understand the cost and benefit of the reverse mortgage. (www. hecmresources.org)

There were some studies on the subject of reverse mortgage. The study by Edward Szymanoski, Jr. (1994) analyzes the risk associated with reverse mortgage and presents a pricing model for the HECM mortgage insurance. The main risk on the loan for a lender is that the loan amount can be more than the property value at some future. The model developed by Szymanoski presents a good analytical tool for pricing the HECM mortgage insurance. Another study by David Rodda, Ken Lam and Andrew Youn (2004) discusses the low-cost refinancing issue of reverse mortgage. Their study presents a stochastic model in which interest rates and home values are allowed to change over time. The main conclusion of their stochastic modeling is that “low-cost refinancing would reduce the net asset value of the fund by 54% starting from the current low interest rates. Therefore, low-cost refinancing enhances the ability of senior owners to tap the equity in their house without unduly jeopardizing the soundness of the insurance fund.” (p.614, Rodda, Lam and Youn)

ADVANTAGES OF REVERSE MORTGAGES

The most important benefit of the HECM is that it does not require loan repayments until the last surviving borrower dies, or the home is sold, or the borrower permanently moves out of the home. Therefore, a borrower assumes no risk of missing payments, or defaulting on the loan and losing the home. Furthermore, a borrower is not subject to income qualifications and credit approval. There is no need for qualifying a mortgage. Another significant benefit is that the HECM loans are non-recourse. It is possible that the borrower can receive payments in excess of the home value and will never owe more than the home is worth. (Ling & Archer, 2005)

Also, the loan program offers a great deal of flexibility as to how cash payments are made. Every senior citizen is in different need of cash payments, so the flexibility can satisfy the borrower’s specific needs for liquidity. As shown in Table 1, the most popular way of withdrawing cash is a credit line. Approximately 83 percent of HECM borrowers selected the line of credit option in FY 2009. (HECM, 2009) About 5 percent of borrowers chose a line of credit plan combined with a term or tenure payments. A significant benefit of the credit line is that the cash available grows over the life of the loan. It is increased by the interest rate charged on the remaining cash balance. For example, if a borrow qualifies a lump sum of $100,000 with 7 percent interest, and cash only a portion of the amount, $20,000, leaving $80,000 balance. The balance will grow each year at the 7 percent rate so that the cash available to withdraw in future will be $85,600 next year and $112,204 by the end of year 5. (AARP Report, 2008)

DISADVANTAGES OF REVERSE MORTGAGES

A reverse mortgage is a good financing option for some elderly homeowners who do not have a stream of income. However, it has some drawbacks. A homeowner is still responsible for property taxes, insurance, and repairs on the home. Also, reverse mortgage loans must be paid off when the owner dies or no longer live in the home. So, the property owner or his/her heirs completely loses the equity in the home. Home equity simply disappears and the property owner ends up with nothing with the home. The other significant drawback of reverse mortgage is high financing costs that include an origination fee, third party closing costs, a mortgage insurance premium, a servicing fee, and interest. These expenses can be financed, but it can reduce the monthly payment that the homeowner can withdraw. An origination fee is charged for processing loans and a lender can charge the origination fee up to 2% of the home value for the

HECM loans. It can be several thousand dollars although it is negotiable with lenders. (AARP Report, 2006)

Furthermore, closing a mortgage loan requires a lot of paper works and services such as title search, appraisal, insurance, recording fees, credit check, etc. The third-party closing cost on the HECM loan varies with the value of the home, but it can be significant amount. Also, a borrower is required to purchase mortgage insurance and pay mortgage insurance premium (MIP). The HECM insurance guarantees that you will receive your promised loan advances, and not have to repay the loan as long as you live in your home. The premium amount is currently 2% of your home value and 0.5% is added to the interest rate charged on your rising loan balance. Furthermore, a servicing fee can be charged to a borrower. (AARP Report, pp. 14 - 17) The Federal Housing Administration (FHA) limits the servicing fee to $30 to $35 per month, but the amount of the fee can vary from one lender to another lender.

The bottom line is that the total expense for obtaining a reverse loan can range 6 percent to 10 percent of the amount borrowed. (AARP Report, 2006) If the borrower dies or moves to another home within a few years after the loan is obtained, the loan can be very expensive in terms of high financing costs. The HECM loan expenses are based on home value, not the loan amount, so if the borrower needs only a small amount of loan, the closing costs can be excessive relative to the loan amount.

Another problem with the reverse mortgage is that it encourages the elderly to remain in older housing that may be unsafe due to physical deteriorations. Most reverse mortgage borrowers are relatively poor and are likely to live in the house that is run-down, unhealthy and unsafe. Furthermore, reverse mortgage is not in the best economic and political interests of urban growth because the elderly people on the loan have no incentive to repair or remodel their homes for improving home value. More than one half of those reverse mortgage holders live in a house that is at least 40 years old. (www. aarp.org)

RECENT ACTIVITIES

Recent trends show that reverse mortgages are growing in popularity. The table 2 shows the number of reverse mortgages issued since 2000. The number of reverse mortgages steadily increased in early 2000, and then exploded at a higher rate since 2005. One possible reason of the growth is due to the increased number of senior citizens. The number of active lenders offering reverse loans is increasing also, and the Wells Fargo Bank is a leader in terms of volume as shown in table 3. (US HUD Report, 2009) The table also shows the percent change of the loan volume from 2008 to 2009. As you can see, the year 2009 was not a great year because of poor economy and a serious trouble in the housing market sector. Table 4 shows the number of reverse mortgages issued by top ten states. It indicates that California and Florida are leading states in terms of reverse mortgage business. (HUD Report, 1990 – 2009)

CONCLUSIONS

Reverse mortgages have substantially grown in popularity recently in the US. Many elderly citizens have found great benefits associated with converting their home equity into a lump sum cash or periodic income. The loan is pretty easy to obtain since it does not require high underwriting standards such as job, income, other debt, credit history, etc. However, it has some drawbacks. The property owner or his/her heirs completely loses the equity in the home at the end. The other significant drawback of the loan is high financing/transaction costs such as a loan origination fee, closing costs, a mortgage insurance premium, servicing fees, etc. These expenses can be relatively costly if the loan amount is small. The empirical data and graphs shown in this paper prove why reverse mortgages have grown recently although the growth has slowed in recent years.

Table 1: Distribution of FY 2009 HECM Loans by Payment Type

Payment Type	**Number of Loans**	**Percent of Total**
Line of Credit	71,719	82.9%
Tenure	2,788	3.2
Term & Line of Credit	2,136	2.5
Tenure & Line of Credit	1,867	2.2
Term	1,403	1.6
Missing Payment Type	6,616	7.6
Total	**86,529**	**100**

Source: FY 2009 HECM Actuarial Review

Table 2: The Number of Reverse Mortgages Issued by Year

Year	**# of Reverse Mortgages Issued**
2000	6,640
2001	7,781
2002	13,049
2003	18,097
2004	37,829
2005	43,131
2006	76,351
2007	107,558
2008	112,154
2009	114,692

Source: America's Reverse Mortgage Lender

Table 3: Lending Activities by Major Banks

Rank	**Lender**	**YTD 09 Vol.**	**YTD 08 Vol.**	**%Chg.**	**Top State**
1	Wells Fargo Bank NA	3,331	3,906	-15%	CA
2	Bank of America NA Charlotte	1,610	881	83%	CA
3	Financial Freedom Senior Fund	1,051	1,359	-23%	CA

4	Metlife Bank	385	302	27%	FL
5	One Reverse Mortgage Comp	340	-	-	FL
6	Generation Mortgage Comp	318	245	30%	CA
7	World Alliance Financial	275	581	-53%	FL
8	Urban Financial Group	240	241	0%	TX
9	Money House Inc	187	29	545%	FL
10	M and T Bank	146	170	-14%	NY
	Total	**7,883**	**7,714**	**2%**	-

Source: US Department of Housing and Urban Development, 2009

Table 4: Total Number of Reverse Mortgages Issued by Top Ten States (1990 – 2009)

State	# of Reverse Mortgages
California	110,793
Florida	69,957
New York	28,612
Texas	30,933
New Jersey	20,496
Illinois	18,554
Pennsylvania	18,544
Arizona	18,258
Maryland	18,102
Michigan	16,404

Source: HUD 1990 – 2009 Reverse Mortgage Figures

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