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WILL REVERSE MORTGAGES RESCUE THE BABY BOOMERS?

By Andrew D. Eschtruth, Wei Sun, and Anthony Webb*

Introduction

Many of today's workers are at risk of having insufficient resources in retirement. The reason for this gloomy picture is a rapidly changing retirement landscape defined by a rising Social Security retirement age, a sharp decline in traditional pensions coupled with modest 401(k) balances, low saving rates, and longer lifespans. However, one potential bright spot is housing equity, which has grown rapidly in recent years and is the largest non-pension asset for most households. The home value for the typical household approaching retirement was $200,000 in 2004 — up from $139,000 in 2001.[1]

This *brief* examines the extent to which homeowners can count on housing wealth to support their consumption in retirement. The first section introduces reverse mortgages as an option for accessing housing wealth in retirement. The second section describes trends in the reverse mortgage market. The third section explains what factors determine how much a homeowner can borrow through a reverse mortgage. The fourth section highlights the impact of changes in interest rates on reverse mortgages. Given the sensitivity to interest rates, households planning for retirement should be careful not to overestimate the potential of home equity.

Accessing Housing Wealth in Retirement

Houses are not only a store of wealth, they are also a place to live, and part of the return a homeowner receives is in the value of being able to live in the house for free.[2] Therefore, in assessing how much individuals have available to support their (non-housing) consumption in retirement, only a portion of the home value can be included. For example, if an individual sells his house, he cannot simply pocket the full amount as he will need to use part of the proceeds to either rent or buy another place to live.

While homeowners can access a portion of their equity by selling, most prefer to remain in their current home when they retire.[3] One way for such households to access their housing wealth without selling is to take a home equity loan, but these require regular payments of interest (and sometimes principal). In contrast, a reverse mortgage enables households to consume some of their housing equity without the obligation to make periodic loan payments. With reverse mortgages, households borrow against the equity in the home, and the loan plus accumulated interest is repaid when the individual dies, moves out, or sells the house. Depending on how

* The authors are all with the Center for Retirement Research at Boston College. Andrew Eschtruth is Associate Director for External Relations. Wei Sun is a graduate research assistant. Anthony Webb is a research economist.

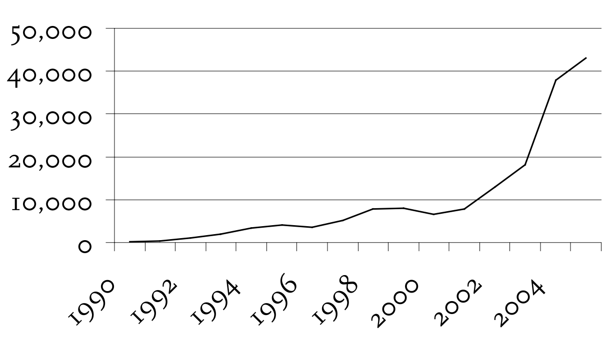
long the borrower stays in the house, the interest can compound over many years. As the amount repayable is capped at the sale proceeds, the maximum loan is always going to be less than the current value of the property.

Trends in the Reverse Mortgage Market

The most widely used reverse mortgage currently on the market is the Home Equity Conversion Mortgage (HECM). The HECM program emerged from the National Housing Act of 1987. HECM loans, which are federally insured, are available to most homeowners age 62 and older who own their primary residence free and clear or who can pay off their mortgage easily with the proceeds of the loan. The loan can be taken as a lump sum, line of credit, lifetime income, or as a payment for a specified period. To date, the line of credit has been the most popular option.

During the 1990s, the demand for reverse mortgages was extremely small — with less than one percent of eligible homeowners opting for one.[4] In recent years, though, the market has begun to expand with the number of reverse mortgages rising from 6,640 in 2000 to 43,131 in 2005 (see Figure 1). Given that many baby boomers will reach retirement with insufficient wealth from other sources, reverse mortgages are likely to become more popular. One indication of anticipated growth is the emergence of a secondary market for reverse mortgages that will allow lenders to package and resell the loans to investors.[5]

Figure 1. Number of HECM Reverse Mortgages Approved, Fiscal Year 1990-2005



Source: National Reverse Mortgage Lenders Association (2006).

How Much Can a Homeowner Borrow?

The amount available to a homeowner through a reverse mortgage depends on three factors — the value of the home, the interest rate, and the age of the borrower. Home values affect the maximum loan amount in a straightforward way — the more valuable the home, the larger the loan. The one limitation is that the home value used in computing the loan amount for HECM reverse mortgages cannot exceed the Federal Housing Administration's insurance limits (which currently range from $200,160 to $362,790 based on geographic area).[6] However, more affluent homeowners can obtain a non-HECM reverse mortgage that is not subject to these limits.[7]

Interest payments are added to the loan principal over the life of the loan. The higher the interest rate, the more rapidly the outstanding balance will increase. Accordingly at higher interest rates, lenders will offer a smaller proportion of the value of the house.

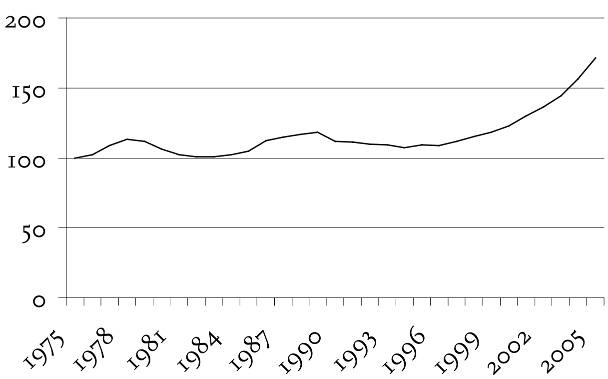
As for age, loans to older borrowers are expected to remain outstanding and accrue interest for a shorter period of time before repayment. With less interest per dollar of loan, the lender can grant a larger loan.[8]

As an example, consider a 65-year-old homeowner with an income of $50,000 and a home worth $200,000.[9] At today's interest rates, this homeowner could borrow approximately 49 percent of the home's value — about $98,000 — a figure that is net of closing and loan servicing costs of $14,907. If this household took its reverse mortgage in the form of a lifetime income, the monthly payment would be about $600 (or $7,200 annually).[10] This amount could significantly improve a household's standard of living by supplementing Social Security, pension income, and other financial assets. But, by itself, a reverse mortgage does not guarantee retirement security.

Furthermore, the ability of the household in this example to borrow about $100,000 may represent a high water mark as economic conditions — both home prices and interest rates — have been particularly favorable in recent years. For example, Figure 2 shows that many homeowners have recently enjoyed an extended run-up in real house prices, but there is no guarantee that this trend will continue.

And while many homeowners pay close attention to their property values as a potentially important indicator of their retirement wealth, interest rates are another story. Interest rates tend to be more volatile and unpredictable than housing price changes, and homeowners may be less knowledgeable about their effects on reverse mortgages.[11]

Figure 2. House Price Index for Single Family Homes, Deflated by Consumer Price Index, 1975-2005 (1975 = 100)

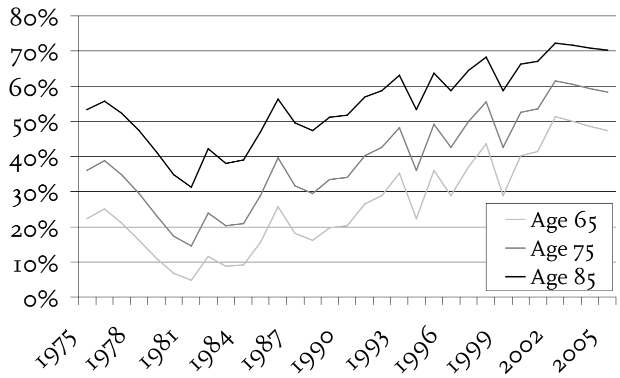


Sources: Authors' calculations based on U.S. Department of Housing and Urban Development (2006b) and U.S. Bureau of Labor Statistics (2006).

The Impact of Changing Interest Rates

As noted above, interest rates directly affect the percentage of the value of the property that can be borrowed. If interest rates increase, the percentage decreases. Figure 3 shows the volatility caused by this relationship from 1975-2005, assuming that reverse mortgages were available during the full period. The variation in the percentage that can be borrowed has been quite dramatic — ranging from 5 percent in 1981 to 51 percent in 2002 for a household aged 65. Interest rates today are close to historic lows, and even increases that are modest by historical standards could substantially reduce the amount that a household can borrow.[12]

Figure 3. Percentage of House Value That Could Be Borrowed at Ages 65, 75, and 85, 1975-2005



Notes: 1) This figure assumes a $200,000 house, a 1.5 percent lender's margin and the closing cost estimates used in AARP's online reverse mortgage loan calculator. 2) HECM loans have only been available since 1990, so amounts for 1975 to 1989 represent the percentages that could have been borrowed had they been available.
Sources: Authors' calculations based on Federal Reserve Bank of St. Louis (2006), U.S. Department of Housing and Urban Development (2006c), and AARP (2006b).

Conclusion

In recent years, house prices have increased dramatically in many parts of the United States. And the average wealth of households aged 55 to 64 has increased substantially, with much of the increase in the form of house price appreciation. But households cannot simply convert all of their housing wealth into non-housing consumption. At current interest rates, which are still relatively low, a household could receive about half of the value of its home through a reverse mortgage. While this amount can be significant for many retirees, it does not guarantee retirement security. And, given fluctuations in interest rates, this amount is subject to considerable uncertainty.

Endnotes

1 The "typical household approaching retirement" is the median household aged 55-64. The home value is from the *2004 Survey of Consumer Finances* (Bucks, Kennickell, and Moore, 2006).

2 Economists refer to this benefit as "imputed rent" — the amount that the homeowner would have to pay to rent an equivalent dwelling (excluding the landlord's maintenance, insurance, and depreciation).

3 For an extensive analysis of homeownership behavior at older ages, see Venti and Wise (2001).

4 Researchers have suggested various reasons why reverse mortgages are not more widespread, including a desire to leave one's home as a bequest, financial costs and limitations of reverse mortgages, concerns about future medical expenses, and fear of debt. For more details, see Eschtruth and Tran (2001).

5 Asset Securitization Report (2006).

6 U.S. Department of Housing and Urban Development (2006a).

7 Homeowners with home values that exceed the HECM limits may be able to get more cash from a loan outside of the HECM program. But a non-HECM loan will not necessarily provide more, and the options available to an individual homeowner vary by region (AARP 2006a).

8 The lender can grant a larger loan while facing the same probability that the loan plus accumulated interest grows to exceed the sale proceeds of the house.

9 $50,000 is an approximate amount for the median household in this age group in 2006 based on data from the *2004 Survey of Consumer Finances* (U.S. Board of Governors of the Federal Reserve System, 2006).

10 These estimates were obtained through AARP's reverse mortgage calculator (AARP, 2006b). Closing costs include an origination fee and a mortgage insurance premium each equal to 2 percent of the home's appraised value, miscellaneous closing costs of $2,074, and a servicing fee of $30 per month. Further details on closing costs were obtained from NETirement.com, Inc. (2006).

11 Age — the third key factor in determining the reverse mortgage amount — has had a stable relationship with the percentage of the house that can be borrowed at specified interest rates, despite improvements in average life expectancy. This relationship is determined by the U.S. Department of Housing and Urban Development.

12 For those borrowers who choose to receive their loan as a lifetime income rather than as a lump sum or a line of credit, the impact of higher interest rates is moderated somewhat. The reason is that the borrower taking a lifetime income only accrues interest on the portion of the loan received at a given time rather than on the total amount of the loan.

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The Center for Retirement Research at Boston College was established in 1998 through a grant from the Social Security Administration. The Center's mission is to produce first-class research and forge a strong link between the academic community and decision makers in the public and private sectors around an issue of critical importance to the nation's future. To achieve this mission, the Center sponsors a wide variety of research projects, transmits new findings to a broad audience, trains new scholars, and broadens access to valuable data sources. Since its inception, the Center has established a reputation as an authoritative source of information on all major aspects of the retirement income debate.

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Contact Information

Center for Retirement Research
Boston College
258 Hammond Street
Chestnut Hill, MA 02467-3808
Phone: (617) 552-1762
Fax: (617) 552-0191
E-mail: crr@bc.edu
Website: http://www.bc.edu/crr

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