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A PRIMER ON REVERSE MORTGAGES

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Introduction

Housing equity is the most important asset for the vast majority of Americans. In principle, this asset might be used to support consumption in retirement. Reverse mortgages were envisioned as a mechanism that would allow older people to consume their housing equity without selling their homes. Yet this market is extremely small — less than one percent of qualified homeowners have a reverse mortgage. This brief provides an overview of reverse mortgages and explores possible reasons for their currently limited appeal.

What Are Reverse Mortgages?

Under a traditional (or "forward") mortgage, an individual borrows money to buy a house and makes periodic loan payments to a lender. Under a reverse mortgage, a homeowner borrows against the equity in her house and receives money from a lender. Unlike a home equity loan, no loan payments or interest are due until the individual dies, moves out, or sells the house. When one of these events occurs, the borrower or her estate is responsible for repaying the loan in full. Contrary to a widely-held belief, the lender does not receive the house as repayment. The loan can be repaid with any available source of funds, which may include proceeds from the sale of the house.

The most important reverse mortgage currently on the market is the Home Equity Conversion Mortgage (HECM). The HECM program emerged from the National Housing Act of 1987 when Congress authorized the Department of Housing and Urban Development (HUD) to institute a pilot program and issue 2,500 reverse mortgages through 1991. Over the next decade, Congress extended and expanded the program, making it permanent in 1998 and increasing allowable outstanding loans to 150,000 (Abt, 2000).

HECM loans are available to all 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 maximum loan amount depends primarily on three factors: the value of the home, the expected average mortgage 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. However, for HECM loans, the value of the home used in computing the loan amount cannot exceed the Federal Housing Administration's (FHA) insurance limits (which currently range from $132,000 to $239,250 based on geographic area). Therefore, homeowners with property values that exceed the FHA limit are constrained in the amount of equity they can tap.

Interest payments are added to the loan principal over the life of the loan and must be repaid as part of the total loan balance. Therefore, in determining the size of the total loan, interest payments are included in the calculation. Accordingly, for any given home value, lower interest rates mean that more money is available to the borrower since interest payments will constitute a smaller share of the total loan balance.

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As for age, older borrowers are expected to receive the loan for a shorter period of time before repayment. Since interest payments accrue over time, a shorter loan period means that interest costs will be lower and the amount an individual can borrow will be larger. The table below illustrates how principal loan amounts can differ based on interest rates and the borrower's age for a home valued at $100,000.

Table: Principal Amounts Available for HECM Loans as a Lump Sum or Line of Credit

	Interest Rate		
Age	*7%*	*8%*	*9%*
65	*$38,423*	*$30,455*	*$23,920*
75	*$50,815*	*$43,948*	*$37,739*
85	*$64,544*	*$59,532*	*$54,704*

Source: AARP 2000.
Note: This example is for a home valued at $100,000. The median appraised home value for HECM borrowers in 1999 was $107,000. This example also assumes a servicing fee of $30, closing costs of $2,000 and an origination fee of $2,000.

Borrowers can take their money in regular payments for a fixed term, regular payments for as long as they stay in their house, a line of credit, or some combination of these choices. They can also choose to receive the entire amount in one lump sum. Among these options, the line-of-credit has been the most popular — it was chosen by about two-thirds of HECM borrowers as of July 1999. The second most popular option (13 percent) was the line of credit combined with payments for a fixed period of time (Abt, 2000). Under the HECM program, the unused balance of a line of credit grows over time at the same interest rate used for the loan. So, borrowers selecting this option see an increase over time in the amount available to them.

An array of provisions protects both the borrower and the lender. First, the borrower cannot be forced to sell the home to pay off the mortgage. Second, regardless of how long the borrower remains in the home, the borrower's liability is limited to the value of the home. Finally, if the lender fails, HUD will make the payments.

The main risk to the lender is that the loan balance can grow to exceed the value of the home, which can happen for three reasons (Abt, 2000). First, if the borrower chooses to receive payments for life, she can live in the home for so long that the loan payments exceed the value of the property. Second, if the loan carries an adjustable interest rate, a rise in rates would increase the size of the loan and, again, the loan could end up greater than the value of the home. Third, when the loan becomes due, the value of the property might be less than anticipated. Under the HECM program, the lender is protected from all three of these risks by FHA mortgage insurance, which is financed by premiums paid by the borrower.

The number of HECM lenders grew rapidly until 1997, but then declined from a peak of 195 to an estimated 174 in 1999 as many financial institutions found reverse mortgages to be unprofitable (Abt, 2000). Although Congress has authorized HUD to issue 150,000 loans, the agency had issued only about 50,000 mortgages under the HECM program as of May 2001 (Hicks, 2001).

In addition to the HECM, two private sector products are available. First, since 1995, Fannie Mae (a government-sponsored company that buys and sells mortgages) has offered a reverse mortgage called the HomeKeeper. One advantage of the HomeKeeper is that the borrowing limit is higher ($275,000 in 2001) than the HECM's FHA loan limits. On the other hand, the HomeKeeper does not offer the option of receiving payments for a specified term and does not raise the loan limit on unused lines of credit. Second, the Financial Freedom Senior Funding Corporation offers a reverse mortgage aimed at wealthier homeowners in that it has a maximum loan amount of $700,000. Adding private sector products to the approximately 50,000 outstanding HECMs suggests that roughly 60,000 reverse mortgages exist in the United States — less than one percent of a potential market of 14.5 million homeowners age 62 and over who own their home free and clear (Federal Reserve Board, 1998).

Why Aren't Reverse Mortgages More Popular?

Reverse mortgages certainly appear to be a useful way for cash-strapped homeowners to have access to their equity without having to move out of their homes. Yet Americans seem remarkably unenthusiastic about this financial innovation. One obvious explanation is that people want to retain ownership of their homes in order to leave them to their children. In fact, researchers find that the elderly tend to hold on to their homes, which is consistent with a desire to leave the homes as bequests (Venti and Wise, 2000). Typically, the house will be the only significant asset in the bequest. Critics, however, question whether housing bequests are intended. For example, it is highly unlikely that the value of a house, often unknowable in advance, would exactly equal the desired amount of a bequest (Caplin, 2000). Indeed, a host of other factors could also explain the small size of the reverse mortgage market.

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Obstacles to the Borrower

Several factors could discourage homeowners from taking out reverse mortgages. These include high up-front costs, low borrowing limits, concerns about future medical expenses, and fear of debt.

The up-front costs are substantial. Borrowers pay an origination fee, mortgage insurance premium, and closing costs. In addition, while servicing fees can be paid over the life of the loan, the expected present value of these fees is subtracted from the amount borrowed. Together, all of these up-front costs could have totaled up to $10,000 for the median HECM borrower in 1999. In comparison, the principal loan amount available to the median borrower ranged from $52,500 to $63,000 (assuming an interest rate range of 7 to 9 percent) (Abt, 2000). In this example, the up-front costs could reach nearly 20 percent of the loan's principal.

The limits on the size of HECM loans may further hamper the demand. In part, the low loan amounts simply reflect the fact that the loan will grow with interest over the life of the borrower, so initial amounts need to be relatively small. But, in some cases, the owners' borrowing capacity is capped not by their property value but by the FHA limits. The FHA limits were set for the forward mortgage market to target FHA subsidies to low- and moderate-income borrowers. These limits may well be too restrictive for reverse mortgages.

Some have argued that retirees may be reluctant to take on reverse mortgages due to concerns about future medical expenses (Caplin, 2000). To the extent that they spend down housing equity early in retirement, they will have less available to cover a serious bout of illness. A period of sickness is also the time that an elderly person might reconsider the optimal living arrangement, and depleting equity early may make moving difficult (Feinstein, 1996). On the other hand, most people with reverse mortgages opt for payment in the form of a line of credit, and it could be argued that this reserve offers them precisely the safety cushion they need in case of illness.

In addition to the specific arguments, elderly persons may simply be unwilling to take on debt of any sort except in the case of dire emergencies. Many of those who own their homes outright have spent their entire adult lives paying off their initial mortgages. Moreover, according to several lenders, the media message about reverse mortgages tends to focus on the potential costs rather than the potential benefits (Abt, 2000). A focus group of borrowers said that they felt reverse mortgages involved a stigma suggesting dire financial circumstances; for example, according to one participant, relatives viewed taking out a reverse mortgage as equivalent to losing a home (Abt, 2000).

Obstacles to the Lender

Despite substantial government subsidies and protections, many lenders have been unable to generate enough reverse mortgages to justify maintaining a trained staff for this specialized product and have exited the market. Low origination fees, the risk that borrowers will not maintain their homes, and regulatory and legal uncertainties are all possible explanations, but many of these obstacles could be overcome if demand for reverse mortgages were strong.

Originators report that one difficulty with HECMs is that they have offered lower compensation for loan officers than forward mortgages (Abt, 2000). HUD effectively limits the fee that lenders can charge because, until recently, it permitted only $1,800 of the origination fee to be financed with the mortgage; elderly homeowners generally cannot afford to pay any additional costs out-of-pocket. (In 2000, HUD increased the fee that could be financed to the higher of $2,000 or 2 percent of the maximum loan amount.) HECM mortgages are also more time consuming in that elderly borrowers require more attention, and the mortgages involve many complex documents.

Another problem from the lender's perspective is the potential for elderly homeowners to let their homes fall into serious disrepair, since many HECM applicants are very old and poor. Although the contracts say that failure to maintain the house constitutes default on the loan, lenders may not want to foreclose on their vulnerable borrowers, particularly if illness is the reason for the lack of maintenance.

When the HECM program began, a variety of regulatory and legal barriers also hampered the origin of reverse mortgages. Although many of these barriers have eased over time, many legal uncertainties remain. For example, in some states, the status of HECM loans in the case of bankruptcy is still unclear.

Conclusion

On balance, the small size of the reverse mortgage market seems mainly due to a lack of interest from homeowners as many of the obstacles facing lenders could be alleviated by higher demand. For example, higher demand would allow lenders to reduce their costs and would create a constituency to eliminate or clarify the remaining regulatory barriers and tax issues. Yet, higher demand may be unlikely to develop, because, in the end, the lack of interest in reverse mortgages may come down to a simple preference to hold onto one's major possession and preserve a legacy for one's heirs.

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