Reverse Mortgage Program Reinvigorated

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MarketWatch Blog by Alicia H. Munnell

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Changes to the HUD-backed loans should help both borrowers and lenders

As a great fan of reverse mortgages, I am delighted that the government has made the changes needed to protect the viability of the Home Equity Conversion Mortgage (HECM) program.

Accessing home equity will become increasingly important in a world where retirement needs are increasing – people are living longer and face rapidly rising health care costs – and the retirement system is contracting – Social Security replacement rates are declining under current law and employer-provided pensions have shifted from defined benefit plans to 401(k)s where balances are modest.

Reverse mortgages allow homeowners age 62 and older to borrow against the equity in their house and pay off the loan plus accumulated interest when they die, move out, or sell the house. The most widely used reverse mortgage is the HECM, which provides loans on assessed home values up to the Federal Housing Administration current limit of $625,500. Under this program, the government designs the product and provides insurance (for a fee) for the borrower against the risk that the lender can no longer make the contracted payments and for the lender against the risk that the loan balance exceeds the property value. The product is then sold through private sector lenders. Before the changes, the government provided two HECMs – the "standard" and the "saver." The saver was cheaper than the standard, but provided less access to home equity than the standard and was rarely used.

Since the financial crisis, the government fund that provides the insurance for the reverse mortgages has been under pressure. Financially troubled borrowers were drawing much of their money at closing, leaving them with few resources to sustain homeownership. The advent of fixed rate mortgages with high profit margins gave lenders an additional incentive to encourage borrowers to take out all of the reverse mortgage proceeds up-front. And declining home prices hurt the program's finances, since lenders could not recoup the full amount of the loan when the houses were eventually sold.

The changes, most of which went into effect on September 30, are designed to fix these problems. The new regulations place a limit on the amount that can be withdrawn in the first year. In most cases, borrowers cannot access more than 60 percent of their total loan. Some exceptions are possible if an existing mortgage and other "mandatory obligations" exceed the 60-percent limit. Mandatory obligations do not include credit card debt.

A portion of the mortgage costs will now be based on the amount withdrawn. Borrowers who take out more than 60 percent in the first year will have to pay a higher up-front mortgage insurance premium (2.5 percent of the appraised value of the property) than those who withdraw less than 60 percent (0.5 percent of the appraised value). Previously, the upfront fees were 2.0 percent for standard reverse mortgages and 0.01 percent for savers.

The new regulations also reduce the maximum amount of home equity that borrowers can access. It will still depend largely on the age of the borrower, the value of the home, and the interest rate. But under the new regulations, with a mortgage rate of 5 percent, a 72 year old will be able to withdraw up to 57.5 percent, minus fees. This compares to 67.7 percent of the home's value using the standard and 55.4 percent using the saver.

Starting in January, lenders will also be required to make sure that borrowers will be able to make their required tax and insurance payments over the life of the loan, by examining all sources of income and credit history. To qualify for a full loan, homeowners must have a certain level of monthly income left over after paying all expenses, including taxes and insurance. For a single homeowner, this threshold level ranges from $529 to $589, depending on the region in which he lives. If the borrower falls short of this amount, he will be required to make a cash set aside, which will either be deducted from payments or charged to a line of credit.

All these changes should be viewed as positive. The limit on first-year withdrawals will reduce the likelihood that borrowers spend their money and are left without a buffer to allow for future needs. The financial assessment will ensure that the people taking out a reverse mortgage will not be forced into bankruptcy by failing to pay taxes and insurance. Consolidating the standard and the saver will make the program easier to understand. A better customer experience combined with slightly higher fees and slightly lower loan amounts will also take pressure off the insurance fund.

We need this program to work well, because people are going to need the money.

[Full disclosure: I am an investor in and a member of the Board of Advisors of Longbridge, LLC, a startup company that has been formed to provide reverse mortgages in a socially responsible fashion.]