Reverse Mortgages: Avoiding a Reversal of Fortune

UPDATE: The Department of Housing and Urban Development (HUD) recently made changes to Home Equity Conversion Mortgages (HECMs), which make up the majority of reverse mortgages in the U.S. We are reissuing this alert to reflect those changes, and to reiterate that while reverse mortgages can help seniors manage their finances if used responsibly, they come with costs and risks.

If you are in your sixties, and own your home, chances are you have heard about reverse mortgages—or will soon. Reverse mortgages can be helpful to homeowners who want to stay in their homes but are having trouble keeping up with their mortgage payments, or who have no other source of funds to pay bills or meet unexpected expenses. But as more Americans near retirement age, some financial institutions are aggressively marketing reverse mortgages as an easy, cost-free way for retirees to finance lifestyles—or to pay for risky investments—that can jeopardize their financial futures.

FINRA is issuing this Alert to urge homeowners thinking about reverse mortgages to make informed decisions and carefully weigh all of their options before proceeding. And, if you do decide a reverse mortgage is right for you, be sure to make prudent use of your loan.

What is a Reverse Mortgage?

Older homeowners who want to tap the equity in their homes typically have three options. They can sell their house and downsize, take out a home equity loan or consider a reverse mortgage. A reverse mortgage is an interest-bearing loan secured by the equity in your home. To be eligible, you and any other co-borrowers, such as your spouse, must own your home and be 62 or older—although some lenders offer reverse mortgages to individuals as young as age 60.

Like a home equity loan, a reverse mortgage allows you to convert your home equity to cash that you can use for any purpose. Unlike other home loans, however, homeowners make no interest or principal payments during the life of loan. The interest is added to the principal, which is why reverse mortgages are often called “rising debt” loans. Unless you opt for a fixed-term loan, the loan only becomes due when you die, sell your home to move or otherwise leave your home for more than 12 months—for instance, if a health issue requires you to enter a nursing home.

If any of those events occur, you or your heirs must repay the loan, including compounded interest, in full. Normally, that means the house must be sold, and the loan will be paid back from the proceeds of the sale. Because interest will have been accruing during the life of the loan, you will likely owe more than you borrowed—
and if home values have fallen or you live longer than expected, you may even owe more than your house is worth. But since reverse mortgages are non-recourse loans, the worst that will happen is that you or your heirs will receive nothing from the sale of your house. The lenders cannot go after any other assets that you or your heirs own.

Recent Changes to FHA Reverse Mortgage Loans

Home Equity Conversion Mortgages, or HECMs, are administered by the Federal Housing Administration (FHA) and make up the majority of reverse mortgages in the U.S. The loans are insured by the federal government against default by a lender (the borrower pays a fee for this protection). The Housing and Economic Recovery Act of 2008 made significant changes to FHA reverse mortgages and how they are sold. For example, the law allows seniors to use a reverse mortgage to purchase a new home (called a “reverse mortgage for purchase”). It also mandates counseling for all FHA reverse mortgages.

Additional changes resulted from the Reverse Mortgage Stabilization Act of 2013, which authorized FHA to change the HECM program. FHA replaced the Standard and Saver HECM options with a single program that is different in a number of ways. For one, it adjusted the maximum loan amount. Based on a formula tied to the borrower’s age and current interest rates, this new maximum is less than the previous HECM Standard, though slightly higher than the HECM Saver option. There are also new limits on the amount homeowners can borrow at closing and during the first 12 months. This new limit is 60 percent of the maximum loan amount, though making repairs or paying off an existing mortgage may constitute “mandatory obligations” that could allow for additional borrowing. And lenders are now required to perform a financial assessment of the borrower before a HECM loan can be approved. Part of the assessment is a detailed credit check.

Beyond HECM Loans

Non-HECM single-purpose reverse mortgages may be offered by some states, local governments and non-profit organizations for specific objectives such as home repairs or the payment of property taxes. There may be income restrictions accompanying these reverse mortgages, and they are not federally insured.

Banks and other lenders may also offer proprietary reverse mortgages, often called jumbo reverse mortgages. These are typically designed for borrowers with high-value homes. Proprietary reverse mortgages are not federally insured, and fees are not regulated as they are with HECM loans. It’s a good idea to work with a HUD-approved mortgage counselor if you are considering either of these non-HECM options (there may be a fee for counseling services).

Three Reasons to Be Cautious

First, reverse mortgages may seem like “free money” but in fact, they can be quite expensive. Like traditional mortgages and home equity loans, you will be charged interest, but interest rates for reverse mortgages are generally higher than these other types of loans. In addition, the fees and costs associated with reverse mortgages are often significantly higher, too—sometimes as high as 4-8 percent of the total loan amount. You can usually have these costs deducted from the loan amount, instead of paying for them out of pocket, but either way, you may end up with less cash than you expected.

Also, be aware that reverse mortgages must be the primary mortgage on your home, so if you have another mortgage already, you will have to borrow enough to pay that off, too. That may also reduce the amount of cash left for you to use.

Second, you are still the owner of your home and therefore responsible for property taxes, insurance and home maintenance costs. If you are not able to meet these obligations, the lender may have the right to foreclose on your home, leaving you in the worst possible situation—no place to live, and no more home equity to draw on.

Third, even if you can keep up these payments, you may get to the point that you want or need to move into a smaller home, or into an assisted living facility, for reasons other than cost. At that point, your loan will come due. With compounded interest due, you may be surprised to find out how much you owe, which may restrict your future housing choices.
Use Your Loan Wisely

Tapping into your home equity in your retirement years through a reverse mortgage is a very serious decision. Whether it is the right decision for you may ultimately depend on a number of factors—your health, your spouse’s health, other sources of income, the reason you’re tapping your home equity, when you do it and how wisely you use your loan proceeds. Unfortunately, some financial professionals who profit from selling reverse mortgages aggressively urge homeowners to obtain them even when they may not be necessary—for example, as a means to fund dream vacations, buy a second home or invest in risky or illiquid investments. In some cases, those who sell the mortgages may also profit from the sale of the touted investment, giving them twice the incentive to talk you into a loan you may not need.

When you obtain a reverse mortgage, you normally have several options for receiving the funds. You can take a lump sum payment, set up a line of credit that you can draw on as needed or set up regular periodic payments. Depending on your lender, you may also be able to set up a combination of these options. For example, you may decide to receive a portion of the loan amount in monthly payments, and leave the remainder as a line of credit that you can use for unexpected expenses.

Whichever you choose, make sure you use your loan wisely. Just because you don’t have to pay it back as long as you live in your home doesn’t mean you should treat it as “mad money.” Reverse mortgages were originally designed as a tool for allowing aging, low-income homeowners to keep their homes by providing a source of additional monthly income to meet expenses. Now, as lenders are realizing that more and more Americans are retiring and sitting on large pools of home equity, they are beginning to aggressively market reverse mortgages to younger retirees as a way to finance a more extravagant retirement lifestyle than they could otherwise afford. The trouble is, those same homeowners may need their home equity some day for something far more pressing than a vacation, only to find that it has already been spent.

If you are approached by a financial professional to do a reverse mortgage in order to fund a particular investment, keep in mind that all investments carry risk and costs—and the higher the promised return, the higher the risk. It’s best to steer clear of investments that are risky or underdiversified—as well as those that make it expensive, if not impossible, for you to access your money if unexpected expenses arise.

Tips When Considering Reverse Mortgages

➤ Weigh All Your Options. Does it make more sense to sell your house—and either downsize or rent while carefully investing the sale proceeds? Take out a home equity loan or line of credit? Can you consolidate credit card debts? Even if you are having trouble paying for your taxes or for home maintenance, there may be local government assistance programs that can help. Whatever your situation, ask your state agency on aging about less risky, or lower cost, ways to address your needs.

➤ Understand the Risks, Costs and Fees. Just because you won’t be making any interest payments as long as you live in your home doesn’t mean the interest rate doesn’t matter. If you do decide to move, for whatever reason, you will have to pay back the loan plus compounded interest. The same is true if you have to leave your home, for whatever reason, for more than 12 months. Be sure to ask about all costs and fees, including any prepayment penalties.

➤ Recognize the Full Impact of Your Decision. While you typically do not have to pay taxes on the proceeds of a reverse mortgage, the income or lump sum you receive could impact your eligibility—or your spouse’s eligibility—for various state and federal benefits, including Medicaid. In addition, depending on the laws of your state, a reverse mortgage may not enjoy the same home-equity protection that would otherwise apply if you have a health emergency and need to enter a nursing home—and your spouse must liquidate assets to pay for that care. Finally, a reverse mortgage is generally not the right choice for those who want to leave their homes to their heirs.

➤ Get Independent Advice. Reverse mortgages are such complicated transactions that the federal government requires borrowers to meet with HUD-approved counselors before obtaining a federally guaranteed loan. (Most loans are federally guaranteed, but some lenders offer proprietary loans that are not.)
The Bottom Line
Home equity is often a homeowner’s most valuable asset, and most precious source of retirement security. Reverse mortgages can be a useful tool for certain older Americans who might otherwise face losing their homes. But homeowners should consider all the risks and explore all of their options before taking out a reverse mortgage, and even then, should use the loan funds wisely.

Additional Resources
➤ FINRA Alert: Seniors Beware: What You Should Know About Life Settlements
➤ FINRA Alert: Betting the Ranch: Risking Your Home to Buy Securities
➤ FINRA Alert: Variable Annuities: Beyond the Hard Sell
➤ FINRA Alert: Equity-Indexed Annuities—A Complex Choice
➤ U.S. Department of Housing and Urban Development: Reverse Mortgages for Seniors
➤ U.S. Department of Housing and Urban Development: Frequently Asked Questions About HUD’s Reverse Mortgages
➤ Consumer Financial Protection Bureau: Considering a Reverse Mortgage?

Make sure that any counselor recommended by your lender is truly independent by asking whether he or she receives any funding from the lender or the mortgage industry. Even if you are applying for a loan that is not federally guaranteed, it is a good idea to get advice from a trusted financial adviser who has no interest in either the mortgage or any investment you plan to make with the proceeds. In any event, before you agree to a reverse mortgage, be sure to consult with legal and tax professionals who know the consequences of reverse mortgages for residents of your state and who are not connected in any other way to the transaction or the lender.

➤ Be Skeptical of Reverse Mortgages as Part of an Investment Strategy. If someone urges you to obtain a reverse mortgage to make an investment or purchase an insurance product or a security, such as a deferred annuity, be very skeptical, particularly if they are promising high returns. In essence, they are encouraging you to speculate with your home equity, which you may need for more critical purposes down the road. Also consider what will happen if the returns turn out to be less than promised, or worse, you lose the principal. If you cannot sustain that kind of low return or loss, you should probably not be making the investment with your home equity.

➤ Ask the Right Questions About the Proposed Investment Strategy. Reverse mortgages can be an extremely costly way to fund an investment. Before you obtain a reverse mortgage for investment purposes, make sure you understand both the terms of the loan AND the terms of the investment. What fees must you pay, directly or indirectly, for the reverse mortgage? What are the costs and fees associated with buying the investment? With selling it? How easy will it be to get your money out if you need it suddenly? Does the investment have a long surrender or lock-up period? What is the potential downside? Is it marketed and sold by the same person or entity that is offering the reverse mortgage? How is the reverse mortgage broker compensated? How is the seller of the investment compensated?

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