



## Are Reverse Mortgages Really Expensive?

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June 10, 2008

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A common criticism of reverse mortgages is that they are expensive, resulting in the view that they should only be used as a last resort, when a senior has nothing left but their home equity.

But, most people don't understand the structure of these costs, which are reasonable compared to the alternatives.

A reverse mortgage allows the borrower to convert home equity into cash, receiving a stream of tax free payments. The loan is secured by the home and is repaid when the homeowner dies or ceases to live in the home permanently.

About 90% of all reverse mortgages are Home Equity Conversion Mortgages (HECM), insured by the Federal Housing Administration (FHA). The FHA requires a Mortgage Insurance Premium (MIP) of 2% of the "maximum claim amount" and also allows an originator fee of the same amount. There is an additional annual insurance fee of 50 basis points on the loan balance and a monthly servicing fee of \$30-35. The "maximum claim amount" is the home's assessed value capped at the county lending limit, which, for many urban and suburban neighborhoods, is \$362,790. These upfront fees (plus normal closing costs like appraisal, title search, etc.), typically amount to about \$17,000, which is accrued to the loan at closing. No out-of-pocket payments are generally required.

Once a reverse mortgage is initiated, interest accrues monthly over the life of the loan. Rates are usually low; as this is written, a monthly adjustable HECM (the most popular option) has an APR of 3.66%. The Total Annual Cost of Ownership (TALC), which must be disclosed to borrowers at closing, is a calculation that combines all cash flows over the mortgage's life into one net present value cost. The TALC starts out high in the loan's initial years, drops steadily, and reaches quite reasonable levels as the loan gets older. In other words, the closing costs are amortized over the life of the loan, so the longer it runs, the lower the TALC gets.

The whole point of the HECM is to keep people in their home until they die or leave the home, whichever comes first. The life expectancy of a 62 year old female is 21.89 years, which is ample time for amortization. Thus, the most



obvious way to get a “low-cost” HECM is to get it early in life and let it run for a long time.



Consider two examples:

1. A 75-year old with an appraised property value of \$365,000 gets a line of credit HECM and never uses it. That's a worst case, since the borrower never gets any value from the loan. Yet, even in this worst case scenario, the TALC is only 6.73% after 6 years and 5.54% after 12 years.
2. The same 75-year old takes all the money they can get as an initial draw - \$246,266.57. In two years time, the TALC is 7.9% and in 6 years it is 5.48%, which is a pretty reasonable rate – not expensive at all. At longer periods in this example, the home appreciation rate kicks in. At 0% appreciation, after 12 years, the TALC is only 2.71%, a positive steal. After 17 years, it's only 1.91%. This is because the balance has caught up and exceeded the home value. HECMs are non-recourse and the homeowner essentially never pays back the “underwater” portion.

The average reverse mortgage borrower is about 75, an age when female life expectancy is 12.3 years. If all seniors utilized reverse mortgages at this stage in life, the TALCs would always be low. But, some keep waiting. The older the borrower, the more money they can get, but the higher the TALC on average.

Thus, the HECM benefits a sub-set of the elderly, namely those with a desire and the ability to stay in their home for life. Every senior is eligible, but those in poor health, for example, should recognize their risk of paying a higher TALC if they are forced out of their home prematurely. (Of course, couples have an extra advantage in that the mortgage doesn't end when the first dies.)

The examples above also point out a basic fact: the real cost (TALC) cannot be determined in advance, only estimated. Not only are the cash flows and ending date undetermined, most HECMs have variable interest rates. Uncertainty may breed fear that it *could* be expensive.

A reverse mortgage is asset-based lending to consumers, which is unique. Loan collection is based 100% on the home, not on the borrower's ability to repay. No other type of consumer loan works this way, including forward mortgages, lines of credit, auto loans, and student loans. The reverse mortgage lender shares the home appreciation risk with the borrower and may end up assuming all of it.

Over long periods of time, investment in real estate has proven to have lower returns than investment in equities. Yet, people continue to invest in homes in amounts far higher than their returns would justify. They do this because a home is not just an investment asset; it is also where the heart is. Particularly with seniors, their own home may have deep emotional value, despite not being an ideal environment. Seniors all too often live in homes that are older, need



maintenance, aren't accessible, and have far more space than they need. The ideal place for an 85 year old widow, based strictly on physical capability, is probably not the house she and her husband bought 40 years ago and where they raised their kids.

The ability to stay in a home until death is really a luxury. To have someone else assume some or all of the appreciation risk ought to be expensive.

The lender has no control over the length of the loan and, in extreme cases, it could run to 40 years. How much could a home's value decrease, relative to inflation, during that time? How much deferred maintenance will go on? Lenders actually have no right to enter homes for inspection although they do have the right to "call" the loan if they know it is not being maintained to FHA standards.

Another issue is home improvements., Seniors are increasingly unlikely to undertake renovations as they age, but these play a role in setting market values on homes. There is no requirement that a borrower update the kitchen or bathroom after twenty years and yet that is exactly what the market will demand once the loan does end and the home goes on the open market. With a reverse mortgage, home owners are under little pressure to upgrade their homes in order to maintain their market value.

To a large extent, the depreciation risk has yet to appear and be measured. There were very few HECMs issued in the 1990's and most of the 350,000 outstanding HECMs were originated after 2000. Not enough time has passed for us to know how much depreciation risk lenders are really taking.

In 1998, Shiller and Weiss wrote an article (1) on this topic, arguing that reverse mortgages introduced a moral hazard risk. Borrowers would lose their home maintenance incentive and in the long run lenders would pay the price. But, if true, this is good news for reverse mortgage borrowers, who would be the ones benefiting from the hazard, as our 1.91% TALC example above shows.

A regular forward mortgage and a home equity line of credit (HELOC) may look cheaper on the surface. A senior who knows for sure they will be moving in a few years may well do better with a HELOC. In fact, about 70% of reverse mortgage borrowers already have a forward mortgage and one of their main benefits from the reverse mortgage is to stop making the forward mortgage payments. Intra-family reverse mortgages may be very cheap but relatively few families have the wherewithal to do so. Thus, inevitably, the main alternative to a reverse mortgage comes down to selling the home and going elsewhere. Home sale costs can be high (6-7% of the selling price) but the analysis doesn't stop there. Where does the senior go? What are the purchase costs, moving costs, disruption costs, and so forth? Will the senior suffer depression or require medical intervention due to



a forced move? How much would that cost? Millions of seniors don't mind moving into retirement communities and/or downsizing, but that still leaves millions more for whom such a move would be more than unpleasant.

In short, tossing off reverse mortgages as just "too expensive" is a shallow observation that fails to incorporate the product's benefits and the lender's risk. The borrower who dies unexpectedly the week after taking out a reverse mortgage is paying a very high price, admittedly. But, so what? Buying a new car, furniture, or flat screen TV all have the same risk profile but that doesn't stop people from buying them.

Pre-judgment is self-defeating. Those who might benefit should run their own numbers for TALC and then decide if the benefits outweigh the costs.

(1) Robert Shiller and Allan Weiss, MORAL HAZARD IN HOME EQUITY CONVERSION, NBER Working Paper 6552, May 1998.

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