



Farm Creek Securities, LLC  
Farmcreeksecurities.com  
fc@farmcreeksecurities.com  
89 Roton Avenue, Rowayton, CT 06853  
(203) 838-1025

## The Sound Investor Series #74

### Reverse Mortgages Get More Respect

Ed Hynes, CFA

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Reverse mortgages are getting new attention in the press these days so let's discuss them in more detail. Initially I viewed these products with enormous suspicion, mostly because of their huge fees and that they are marketed mostly to elderly women. But, I learned that even with high fees, reverse mortgages are useful for some homeowners, although not suitable for everyone.

A reverse mortgage is just the opposite of a regular mortgage. In a regular mortgage, homeowners borrow a lump sum of money and pay it back on a monthly basis over a period of years. In most reverse mortgages the bank sends the homeowner money on a monthly basis and at the end of the loan, the homeowner pays the bank back, generally with the proceeds from selling the house. Unlike a regular mortgage, where the payment schedule is set for let's say 30 years, reverse mortgage payments continue until the home owner dies or moves and importantly, homeowners are never on the hook for more than what the house is worth.

In both types of mortgages the house is the collateral for the loan. With a regular mortgage, if the borrower stops making payments the bank repossesses the house and takes the risk that the property will cover the outstanding balance. If it is worth less, the bank loses money; if it is worth more, it gets to pocket the difference.

The collateral setup for regular mortgages does not work in reverse because no one knows how long the payments will continue. On the one hand, if the owner passes away shortly after taking out the loan, they certainly don't want the bank to get the house when it is worth much more than the outstanding loan. On the other hand, if the borrower lives for many years, no one wants the bank pushing them out of their home as the loan value approaches or exceeds the property's value.

To solve this dilemma and help the growing number of seniors who are "house rich and income poor" the government got involved in the 1980s. The Federal Housing Administration (FHA) dealt with the uncertainty by acting as an insurance company to pay lenders if borrowers lived "too long" a time and their final loan value exceeded the property value. The catch is that the FHA charges borrowers a premium of 2 percent up front on the lending limit and 0.5 percent every year on the outstanding balance for this service and these charges are one reason reverse mortgages are so expensive.

The expense of reverse mortgages has kept these products from becoming more popular, although they are starting to catch on. There are now about 300,000 reverse mortgages outstanding and half have been issued in the last two years.

For a typical FHA insured reverse mortgage in Fairfield County, the current “loan limit” is \$362,790 and closing costs come to about \$17,500 or 4.8 percent. Ongoing annual charges which are automatically added to the loan’s balance depend on which payment options are chosen and in the first year could be as low as \$450 or as high as \$1,400. The total cost over of the loan will depend on how long it lasts, but a good ballpark is probably around 8-10 percent.

When considering a reverse mortgage, the most important thing to take into account is if you plan to stay in your house for the rest of your life? If not, these loans make no sense. First, the origination costs are substantial and not recoverable. Secondly, these loans charge an adjustable interest rate and if rates increase dramatically, the loan will grow and could cut sharply into or even exceed your home equity. This would leave you with no money for your next home.

If you do plan to stay in your home, as many people do, the major risks for these products are if you are unexpectedly forced to move, or change your mind. One reason people could be forced to move is their inability to care for themselves. Another reason I fear is unexpected expenses such as escalating property taxes.

For the most part reverse mortgages terminate when people pass away or move. (Theoretically a borrower could stay in their home and pay down the loan, but that probably doesn’t happen very often). In setting up the program the FHA assumed that for every 100 people that passed away, another 30 would terminate their loan for other reasons.

The FHA is now finding terminations vary greatly by age. If someone takes out a reverse mortgage at 65, for every 100 loans that are terminated at death, 500 to 600 additional loans are terminated for other reasons. That means that only around 15-20 percent are keeping their reverse mortgage loans until they die. Considering 75 year-olds, for every 100 loans terminated at death an additional 100 loans are terminated for other reasons; for borrows age 85, for every 100 deaths only 10 or 20 loans are terminated for other reasons.

What does all this mean? 65 year-olds, for the most part, are wasting a huge amount of money on these loans. For 75 and 85 year-olds, the answer is less clear. If the reverse mortgage gives them an additional few years in their home before they move in with their children or to assisted care, I’m not going to say that’s a waste of money. But if those seniors were unexpectedly forced to move and were left without any money from their home to move elsewhere, that’s not pretty.

No one knows what will happen in the future and home owners should be cautious since these products can be expensive and risky. However, it does not necessarily make sense for an older person to scrape by when they have significant equity in their home. There is no sense being too “Puritan” and avoiding debt at all costs. The bottom line comes down to deciding if you are “living within your means.” If the answer is yes, consider reverse mortgages as a serious option. But, if you consider this a strategy for living above your means and beating the system on the way out, it is probably a mistake.

*Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025, ed@farmcreeksecurities.com. Farm Creek is a registered broker/dealer and investment adviser. This series of articles is available at farmcreeksecurities.com.*