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About-face on reverse mortgages

Selling, then renting and investing, a better strategy

By Thomas Kostigen, MarketWatch

SANTA MONICA, Calif. (MarketWatch) -- Take the memories and the money and move. That's what the government and financial representatives should be telling senior citizens when it comes to their home sales. Instead, reverse mortgages are the idea being pushed.

These are notoriously bad deals for people in all but the soft sense: they get to live in their homes for the rest of their lives.

Reverse mortgages are exactly what they say they are; you get a loan for the sale of your house, as opposed to traditional mortgages where you get a loan for a purchase. The loan allows you to "cash out" of your home's equity without having to sell or take on any additional debt, such as a second mortgage or home-equity loan.

Reverse loans are available only to people 62 or older. You can take the money as a lump sum, a monthly payment for life (or for however long you own and occupy the home), as a line of credit or in any combination of your choosing.

There is no income verification or any of the other caveats associated with traditional loans. So you can see how they'd be appealing to seniors with little cash but big house value.

What's required with a reverse mortgage, however, is that you stay in your home until you die. Then you - well, any heirs -- would have to pay the loan back. The same payback holds true if you sell your home or move out for good.

If you think that sounds like a good deal, you aren't alone. The number of people taking out reverse mortgages has soared over the last five years to more than 43,000 from 6,600 per year, according to the U.S. Department of Housing and Urban Development.

About 13 million seniors are qualified to take out a reverse mortgage, HUD says. With baby boomers eligible in just two years for the program, that pool promises to grow huge; there are more than 78 million baby boomers, accounting for the largest segment of the population.

The government has also decided to get in on the action through the Federal Housing Administration, insuring most loans and originating many through HUD. These loans are called Home Equity Conversion Mortgages and account for 90% of all reverse loans on the market, according to the National Reverse Mortgage Lenders Association.

The House of Representatives last month lifted the cap on the number of reverse mortgage loans HUD can insure and the Senate is expected to ratify that same provision. Meanwhile, HUD is lifting the limits can effectively "borrow" through these programs to $362,790.

Fannie Mae, a quasi government agency, has a program that will raise its ceiling to $417,000. Private lenders have programs that eclipse these limits, although many aren't federally insured. Federal insurance is important because if a loan servicer goes belly up, people don't get their money.

"These increases in the loan limits for the HECM and [Fannie Mae's] Home Keeper products will enable seniors to access greater amounts of equity in their homes, providing a powerful tool for addressing their financial needs through retirement," says Peter Bell, president of NRMLA.

But the poignancy of people's circumstances is trumping sound financial planning. A quick thumbnail calculation shows you could gain more by selling your home, moving into a rental or less expensive house -- and putting your money in ultra-safe Treasury bills. This would eclipse any reverse mortgage calculation.

Reverse mortgages only tap up to 80% of the equity in a home. So, right off the top you're losing 20% of your capital. The interest rate you're paying on what's effectively your own money -- typically two percent annually above the prime lending rate -- eats away at what you'd get too. Plus, you still have to pay property taxes and any homeowners fees.

Consumer advocate groups as the AARP admit these drawbacks, yet they still say a reverse mortgage is an option to consider. AARP does have its guard up, stating it does not endorse any reverse mortgage lender or product, and that "if you are considering a proprietary reverse mortgage, you must proceed with caution."

Here's where the red flags are: appraisal fees, origination fees, annual insurance premiums and closing costs, which can total $10,000 or more on a loan of just $200,000. Then there's the fact that a lump sum payout could affect any other government subsidies an elderly person receives.

Those are the facts that should be waved in front of seniors first before a reverse mortgage option is considered. But the opposite is happening.