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Reverse Mortgages and Downsizing: Education for Retirement Success

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Abstract

Downsizing, in combination with a reverse mortgage, can be a partial solution to the widespread problem of insufficient retirement assets. Extension educators should help prepare seniors to make prudent decisions about using home equity. The recently revised U.S. Department of Housing and Urban Development (HUD) reverse mortgage program is described to illustrate the need for updated information to supplement the required counseling. Suggestions for applied research on consumers of reverse mortgages are offered.

Keywords: reverse mortgage, retirement, downsizing, education

Introduction

A substantial portion of the 77 million baby boomers are financially unprepared for lengthy retirements due, in part, to the 2008-2009 global financial crisis and the bursting of the housing bubble. While earlier generations entered retirement mortgage-free and with little or no debt, today's seniors carry a heavier debt burden (Copeland 2013). The concern about retirement adequacy is a major public policy issue as well as a serious concern for families.

Downsizing to aging-friendly housing, in combination with a reverse mortgage (RM), can be a partial solution to this problem (Sass, Munnell, and Eschtruth 2014). Although few seniors currently utilize RMs, with housing equity the second largest asset after Social Security, more seniors may need to tap home equity (Munnell, Orlova, and Webb 2012). Extension educators should take the lead in educating seniors about RMs. As part of this process, educators should integrate information about the benefits of downsizing and senior-friendly universal design. Downsizing plus an RM can be the key to financial security in later life.
Until recently RMs were considered a last resort for the "house rich and cash poor" and ignored by financial planners (AARP n.d.; Salter, Pfeiffer, and Evensky 2012). Due to problems arising when the housing bubble burst and foreclosures on RM clients who could no longer afford

property taxes and insurance, U.S. Department of Housing and Urban Development (HUD) revised the RM program in 2013. The paucity of information in the financial education literature about RMs and the fact that much of what exists is now obsolete demonstrates the need for updated educational materials. Extension educators can play an important role in providing up-to-date information to factor into this critical decision.

Thus, the purposes of this article are to inform financial educators about RMs and the new regulations while encouraging development of RM curricula. This paper suggests that seniors pursue financial education in addition to downsizing to aging-friendly housing when considering a RM. In addition, the authors have provided ideas for research on RMs

Reverse mortgages

A reverse mortgage is a loan based on the value of the property as collateral. The lender pays the homeowner either regular payments or a lump sum, sets up a line of credit, or provides a combination of these options. The loan does not have to be repaid until the mortgagor moves or dies. The homeowner remains responsible for property taxes, insurance, and maintenance. Applicants must be at least 62 years old and live in the home for at least six months of each year. HUD sets the criteria and provides insurance for the Home Equity Conversion Mortgage (HECM) program.

The number of RMs increased steadily as housing values escalated in the early 2000s, peaking in 2009 with 114,692 RMs initiated. Plummeting prices after the housing bubble burst in 2008 resulted in fewer RM initiations; in the past four years originations ranged from a low of 54,822 in FY 2012 to a high of 79,106 in FY 2010 (National Reverse Mortgage Lenders Association 2014).

When the global financial crisis hit, some RM borrowers defaulted because they could not afford the property taxes and insurance after exhausting their available equity. “By 2012, the default rate was 10 percent. Banks were foreclosing on homes worth less than the amounts they had loaned. The government insurance fund had to make up the difference, depleting its reserves” (Buckner 2014).

RM program update

In response to these circumstances HUD redesigned the RM program in 2013 (Munnell and Sass 2014). In the past, some RM borrowers depleted their available credit in the first year, often to pay off their current mortgage plus consumer debts. So the redesigned RM program limits the first-year withdrawal to 60 percent of the loan value. There are exceptions, but the cost is an increase from 0.5 percent to 2.5 percent for the upfront insurance premium (U.S. Department of Housing and Urban Development ML27 2013).

Consequently earlier sources of RM information are now outdated. For example, the HECM Saver RM is no longer available. The redesign is intended to reduce problems with homeowners rapidly depleting their balances and being unable to pay their property taxes and insurance and thus facing foreclosure (Munnell and Sass 2014). By eliminating the Saver RM, HUD created a single loan option (Wagner 2013).

Starting in 2014, HUD requires that lenders conduct a financial and credit evaluation of prospective borrowers to determine whether they can meet financial obligations such as future property taxes and insurance. Until now, no credit check or financial feasibility analysis was required. Under the new rules, if the analysis is negative, HUD requires a tax and insurance pool, called the Lifetime Expectancy Set-Aside, be established from the initial loan proceeds. The amount is based on the age of the youngest borrower and the prevailing interest rate (U.S. Department of Housing and Urban Development ML27 2013).

Review of literature

With few exceptions, academic and financial industry studies concur that Americans are woefully short of achieving financial security in later life. Even prior to the 2008-09 global financial crisis that decimated retirement accounts and housing values, research projected that half or more of baby boomers were inadequately prepared to maintain their current level of living in retirement (Lown 2008). According to Census Bureau figures, the median debt of seniors increased from $12,000 in 2000 to $26,000 in 2011, due mostly to higher mortgage debts; Americans on the cusp of retirement also experienced a 64 percent increase in median debt to $70,000 (Shah 2013). According to the Retirement Confidence Survey (Helman et al. 2013), the 28 percent of respondents "not at all confident" of a comfortable retirement is the highest level in over two decades. Almost half of early boomers are "at risk of not having sufficient retirement income to pay for 'basic' retirement expenditures" (VanDerhei 2011, 5).

According to the National Retirement Risk Index (NRRI) (Center for Retirement Research [CRR] 2010), over half of working-age households risk being unable to sustain their pre-retirement level of living when retired. Those most in jeopardy are persons approaching retirement (Munnell, Webb, and Golob-Sass 2012). If households don't tap their home equity, the NRRI calculates that the share of households "at risk" increases from 51 to 61 percent. Although few seniors currently use RMs, failing to tap home equity "may be a luxury that future retirees can ill afford" (CRR 2010, 2).

According to an analysis of the home equity of Medicare recipients, the "median per capita home equity among beneficiaries with home equity was $97,650 in 2013" (Jacobsen et al. 2014). "The typical U.S. household approaching retirement has nearly $140,000 in home equity, making it the largest asset outside of Social Security. Yet few seniors tap their equity to help support their retirement consumption" (Munnell, Orlova, and Webb 2012, 2).

However, seniors ages 50 to 75 are carrying substantial mortgage debt; from 2007 to 2013 mortgage balances increased by 123 percent (Securian Financial 2013). For seniors 55 and older, the average debt in 2010 was $75,000, with mortgages the primary contributor (Copeland 2013). A study of RM counseling clients reported that most younger clients (ages 62 to 74) were not mortgage-free but were seeking funds to pay off an existing mortgage and consumer debts (Stokes, 2010).

Compounding the increased debt levels is Americans' low levels of financial literacy and the inevitable decline in reasoning and financial decision-making skills that come with age (Agarwal et al. 2009). Taken together, financial illiteracy, high debt levels, and low retirement balances suggest serious implications for retirement security (Copeland 2013; Shah 2013). While RMs were designed to help seniors turn paid-off homes into retirement income, rising debt levels suggest that an RM alone will not provide financial security. Although working longer to pay down debt before retiring is an option, the combination of inadequate retirement funds and high debts places a generation of seniors at financial risk.

Downsizing and universal design

RMs offer a partial solution but downsizing to a smaller, senior-friendly home can further help reduce housing costs (Sass, Munnell, and Eschtruth 2014). Although most Americans prefer to remain in their homes and age in place (Buckner 2014), downsizing offers both economic and safety benefits. The average American house has grown steadily in size since WWII, more than doubling in square feet to 2,225 by 2005 (National Association of Home Builders [NAHB] 2013), resulting in many seniors living in large houses that are costly to insure and maintain. A recent survey revealed that older buyers want smaller homes (NAHB 2013). Downsizing can free up funds for living expenses while reducing ongoing costs (Sass, Munnell, and Eschtruth 2014). However, the main reason to downsize is to move to housing that is built to universal design standards meaning the residence is suited to aging in place; large multi-level houses with stairs can be problematic with advancing age (Lauricella 2014). While most seniors would prefer to remain in their current homes, and there are benefits to staying in a familiar community, advancing age typically results in disabilities that preclude staying in houses that are poorly designed for aging (Scommegna 2013). For cost and safety reasons, downsizing should be part of the conversation when considering an RM. An RM can also provide funds to adapt an existing home to the needs of seniors.

Role of reverse mortgages in retirement security

Until recently, RMs were considered a last resort for financing retirement (Sacks and Sacks 2012; Wagner 2013). Home equity was considered untouchable; tapping equity was to be avoided until all other assets were depleted. However, that attitude is changing as financial planning researchers are expanding their perspectives, recognizing that RMs can serve the needs of seniors in a variety of financial circumstances (McCarthy 2012; Sacks and Sacks 2012; Salter, Pfeiffer, and Evensky 2012; Johnson and Simkins 2014).

Using a RM credit line to supplement retirement income can substantially increase cash flow while delaying asset depletion (Sack and Sacks 2012; Salter, Pfeiffer, and Evensky 2012). Yet "only about 14 percent of advisers have helped their clients create plans for their housing during retirement, such as downsizing, moving to a retirement community, or arranging for long-term housing and care" (Skinner 2014).

RMs have downsides as well as benefits; they are complicated and costly with high upfront administrative costs as explained by AARP (2010), the Consumer Financial Protection Bureau (n.d.), and the National Council on Aging (2013). Although outdated because of the new 2013 HUD regulations, these publications provide consumer-oriented information for prospective RM borrowers. Prior to the 2013 regulation changes, there was no requirement to determine whether the homeowner could afford to pay property taxes, insurance, and maintenance, resulting in some foreclosures. Aggressive RM marketing can encourage poor decisions, especially for seniors with compromised decision-making skills. Under the new regulations potential mortgagors must show that they have the resources to pay property taxes, insurance, maintenance and repairs or they will be required to establish a Lifetime Expectancy Set-Aside which reduces the funds available (U.S. Department of Housing and Urban Development 2013). Mandatory HUD counseling should address some of the previous problems.

RM education needs

Although HUD mandates that seniors receive counseling from a HUD-approved RM counselor prior to initiating a loan, there is a great need for RM education as well. Many seniors interested in an RM are not mortgage-free and may owe a considerable amount on their current mortgage (Stokes 2010; Securian Financial 2013). Contributing to the need for RM education is the fact that financial reasoning ability peaks around age 53 and then declines, often accompanied by dementia in older seniors (Agarwal et al. 2009). Thus, children or a trusted friend or financial advisor should be engaged in the decision process.

Because the RM decision is so important to long-term financial security, one counseling session is not sufficient to make a wise decision and should be supplemented by education. Extension educators are ideally suited to providing unbiased information to balance RM advertising and to prepare seniors for the required counseling. With recent changes in the HUD RM program and the likelihood of future changes, regularly updated web sites are needed. The Consumer Financial Protection Bureau's report to Congress (2012) provides an excellent summary of RM status and issues prior to the 2013 HUD changes. The report confirms that most RM users take their proceeds in a lump sum rather than as an income stream, contributing to problems with early resource depletion.

AARP offers extensive information about RMs but should not be the only consumer resource. Although the AARP resources are among the most comprehensive available, they still focus on the "house rich and cash poor." Another reliable source is the Center for Retirement Research at Boston College's Squared Away blog's "Learn about RMs tutorial" and "Learn about Using Your House in Retirement," and their publication Using your house for income in retirement (Sass, Munnell, and Eschtruth 2014) which discusses the benefits of downsizing as well as RMs. The new perspectives on RMs emanating from the financial planning community are likely reaching only a small segment of clients. That leaves middle income/asset consumers underserved with respect to the critical role housing equity can play in ensuring retirement security.

A review of the literature suggests that few Extension professionals are including home equity as part of retirement planning education. RMs should be part of the solution to the retirement funding puzzle (Munnell, Webb, and Golob-Sass 2012) and Extension professionals are in a position to educate their clientele about this potential resource. The eXtension RM material (O'Neill 2012) is an excellent resource but needs updating.

Most of the existing Extension materials are out of date due to the 2013 changes and because they contain some inaccurate information. For example, one Extension publication states, "You do not have to worry about losing your home to foreclosure" (Hayhoe 2009) yet that was never accurate. Further, "You must attend a free HECM/HUD approved counseling session. This may add time to the process of obtaining a loan" is presented as a disadvantage (Hayhoe 2009). However, the counseling is not free and, furthermore, such counseling could save seniors from making a serious mistake which is not a disadvantage. A study of RM counseling clients found that some clients who initially opposed the counseling mandate were later thankful for the new information and perspective the counseling provided (Stokes 2010). In a "Home Equity Conversion Checklist" (Hayhoe 2009) recommends consulting a lender, yet the lender will not provide unbiased advice. Updated Extension resources are needed to reflect the new regulations. At a minimum Extension should remove outdated materials from its web sites. Following is a proposed outline for content:

- What is an RM?

- How do RMs work and what are the costs?
- RM pros and cons
- Questions potential RM users should ask
- Mandatory counseling from a HUD-approved counselor
- Uses of an RM to supplement retirement income
- Consider downsizing and universal design

Research needs

Data are needed on those clients who obtained an RM and others who decided against an RM (Stokes 2010). Of those who use an RM, how did they take the money and how satisfied were they with their decision? The satisfaction question suggests the need for longitudinal research because satisfaction may change over time. It will be valuable to discover what the RM recipients wish they had known and their advice to others contemplating an RM. Results of such research will help improve education and counseling for RMs which are likely to grow in use.

Summary

RMs are a vital resource for enhancing financial security in retirement, not just for the "house rich and cash poor" but for senior homeowners in a range of financial circumstances. In combination with downsizing, RMs are actually a flexible and potentially important solution to the challenge of funding retirement but consumers must be educated and cautioned about depleting this asset too quickly. Extension educators are ideally suited to provide unbiased information about RMs to counterbalance aggressive RM advertising and to prepare potential users for counseling.

With the decline in financial decision-making skills that accompanies aging and the onset of dementia, seniors need unbiased guidance as they consider an RM. While the mandatory RM counseling is an essential part of this decision-making process, education prior to counseling would be a very valuable supplement to a critical life decision.

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