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Protecting Borrowers from the Pitfalls of Reverse Mortgages

By Elliot Wong and Ingrid Evans

A reverse mortgage is a unique financial product that is only available to elderly borrowers. Like a traditional loan, it allows a borrower to access money immediately, using the equity in his or her home. Unlike a traditional mortgage, however, a reverse mortgage defers payment of the loan until after the borrower dies, sells, or moves out of his or her home. This loan structure was specifically designed to fit the needs of a very specific borrower: an elderly homeowner who (1) had few liquid assets, (2) was committed to aging in his or her current home, and (3) did not intend to pass the home to a beneficiary as part of his or her estate. For these borrowers, this type of loan allows them to access the equity in their homes for the purpose of supplementing their income while living there without having to worry about a repayment schedule.

Because of how reverse mortgages defer repayment, the loan balance progressively increases throughout the loan's life, which correspondingly consumes more of the equity in the borrower's home. This is because interest is regularly added to the amount owed and because the borrower does not offset the rising loan balance through periodic repayments. Indeed, the borrower is not required to make mortgage payments (although he or she is still required to pay property taxes, maintenance, and insurance); instead, repayment is made in its entirety when the loan becomes due. If the loan cannot be repaid at that time, the home is sold and the lender recovers the debt from the sale.

Reverse mortgages present a distinct set of pitfalls that may be sorted into two general categories of risk: (1) the long-term risks to the borrower and his or her spouse

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and other household members, and (2) the risks of unsuitable financial decisions. When you are presented with a potential client who has purchased a reverse mortgage, you will want to weigh several issues in connection with these risks.

Protecting against Long-Term Risk

Perhaps the most common complaint about reverse mortgages from potential clients is that they were either not adequately apprised of, or were affirmatively deceived as to, the long-term risks of purchasing a reverse mortgage.

The long-term risks to a borrower are significant. A home is the average consumer's single largest asset. Using a reverse mortgage to borrow against the accumulated value of one's home is costly and may even totally deplete the home's equity. A borrower is more likely to lose all the equity in his or her home in two situations. First, a reverse mortgage will more likely deplete a borrower's home equity when home values decline, as there will be less equity in the home with which to repay the loan. Second, a loan is also likely to deplete a borrower's home equity when the borrower continues to live in the home for a long period of time. The reason for this is that, while the loan is outstanding, the interest grows the loan's balance, and the longer the loan is outstanding, the larger the balance will become. In addition, the fees and costs associated with reverse mortgages have historically been very high—significantly higher than traditional home loans. Spending one's home equity to take out a reverse mortgage precludes the borrower from later using his or her home equity for other things, such as, for example, financing a move or protecting against major expenses in retirement. These are serious long-term risks that may easily go unconsidered during the application process.

There are long-term risks to non-borrowers as well—especially spouses, children, and others who live in a borrower's household. A reverse mortgage must be repaid when the last borrower dies, sells, or moves out of his or her home regardless of whether anyone else still lives there. If those residing there cannot afford to repay the loan at that time, then they will lose their home, as it will be sold to pay off the loan. A borrower may fail to take adequate stock of these risks, especially if goaded by misleading advertising or an unscrupulous or unconcerned lender.

Federal law and the laws of several states provide some protection. As you represent a borrower, first and foremost determine whether the borrower completed a mandatory counseling session. Completion of this session is a precondition that must be met before a lender can accept the borrower's completed loan application. *See* 24 C.F.R. § 206.41; *see also* Cal. Civ. Code § 1923.2(j). Although the efficacy of the counseling process has been under question, *see U.S. Gov't Accountability Office, GAO-09-606, Product Complexity and Consumer Protection Issues Underscore Need for Improved Controls over Counseling for Borrowers* (2009), there must either be an egregious deficiency or a total lack of participation in the counseling process to give rise to a cognizable legal challenge on those grounds. Accordingly, this issue rarely surfaces.

The counseling process is augmented by disclosure requirements. Federal law requires lenders to provide specific information to borrowers, and additional disclosures may be imposed under state law. *See* 24 C.F.R. § 206.43; *see also* Cal. Civ. Code § 1923.5. Keep in mind, however, that violations of these provisions may only yield limited remedies. *See, e.g.*, Cal. Civ. Code § 1923.7.

Another issue to keep in mind (especially when presented with facts that suggest a lender has engaged in skullduggery) is whether the lender is properly licensed. *See* 12 C.F.R. pt. 1008. Lenders are required to be licensed to participate in federally insured loans or to operate in certain states. The Federal Housing Administration maintains a list of federally approved reverse mortgage lenders. *See Lender List*, HUD.gov, http://www.hud.gov/ll/code/llslcrit.cfm (last visited May 14, 2014). States often have their own licensing, registration, and examination requirements as well.

That being said, the most active area of reverse mortgages litigation in the past few years is deceptive advertising. In addition to private claims, many state governments have taken an active stance to combat the practice. Common illicit

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tactics include solicitations that suggest unfounded connections between reverse mortgage lenders and government agencies or programs, falsified or misleading credentials, and Internet-based lenders that skirt state registration requirements. Enforcement actions have targeted a wide variety of entities, including mortgage brokers, originators, agents, and investment advisors, in addition to lenders themselves.

Unsuitability

There are several circumstances in which a reverse mortgage may be a highly unsuitable financial product. Most glaring is a practice known as "cross-selling," which occurs when a borrower is induced to purchase a reverse mortgage and then invest the proceeds into another financial product, such as a deferred annuity contract. This is never a good idea.

A borrower may structure a reverse mortgage loan to receive proceeds in periodic installments or in the form of a line of credit. This way of structuring a reverse mortgage allows the borrower to take out only as much money as he or she needs. The advantage to structuring a reverse mortgage one of these ways is that the borrower is only charged interest on the money he or she actually takes out. Alternatively, a borrower may choose to receive all loan proceeds in one lump sum. A deferred annuity, on the other hand, is a financial product that provides the owner with a stream of payments after a certain number of years. The periodic payments one receives from a deferred annuity are similar to the payment-stream option available to a reverse mortgage borrower (albeit with a delayed payment schedule).

If a borrower purchases a reverse mortgage, receives the loan proceeds in a single lump sum, and then invests in a deferred annuity, he or she will have essentially purchased the same service twice. This is because a deferred annuity provides the same type of periodic payment benefits available under a reverse mortgage. However, by having purchased two separate financial products, the borrower will be charged two sets of fees and will also almost certainly end up with a losing investment, as he or she will be charged more in interest from the reverse mortgage than any possible investment gain from the annuity. In short, a cross-sale is entirely redundant. Accordingly, the practice has been banned by the federal government, as well as by several states. *See* 12 U.S.C. § 1715z-20(n)(1); CAL. CIV. CODE § 1923.2(i). Even so, the practice persists, often in more opaque and indirect methods, which may frustrate laws that go no further than prohibiting the purchase of an annuity as a "condition" for obtaining a reverse mortgage.

A much more complicated issue, but one that warrants attention if a potential client relies on government benefits, is the risk that converting one's home equity into cash by purchasing a reverse mortgage could affect the borrower's eligibility to participate in some government assistance programs. Many programs impose countable property limits. Under these requirements, an individual must possess only a certain—often very small—amount of property in order to remain eligible to participate in the program.

Take, for example, California's Medi-Cal program. Although California's recent Medi-Cal expansion eliminated its "countable property requirement," program recipients could traditionally only possess small amounts (under $2,000 for individuals) of countable property if they wanted to remain eligible. However, Medi-Cal's definition of countable property specifically excluded untapped home equity. In other words, the unused value of one's home would not render someone ineligible for the program—but only if it remained unused. Once traditional Medi-Cal recipients converted their home equity into cash above the countable limit, they would have almost invariably been excised from the program. While recent laws may have changed or eliminated these kinds of restrictions in your jurisdiction, the issue of government program eligibility merits careful review.

Conclusion

Reverse mortgages are a complex and unique financial product. Under-informed borrowers—or those who have been taken advantage of by unscrupulous lenders or deceptive marketing—face considerable risk. The law is grappling with pitfalls presented by reverse mortgages, but additional protections are necessary. ◆

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