# Reverse Mortgages: Backing into the Future

*Jean Reilly*

*Reverse mortgages are a unique option for elderly homeowners who wish to stay in their homes but lack the additional income needed for home expenses and upkeep. This article explores the range of public and private reverse mortgages currently available and identifies the obstacles that have hindered widespread acceptance of these estate planning devices by both borrowers and lenders. The author also examines recent legislative developments and corrective measures concerning reverse mortgages, the myriad tax complexities engendered by such mortgages, and the effect reverse mortgages have on a borrower's eligibility for public benefits. The author suggests that the future growth of the reverse mortgage market depends on increased legislation that protects consumers from fraud, alleviates lenders' concerns, and makes explicit how existing laws relate to reverse mortgage transactions.*

In 1995 there were 2.89 million households headed by persons sixty-five years of age or older.[1] The median income of these seniors was $18,500, while the median value of their homes was $70,000.[2] Thus, many seniors find themselves in the position of being house rich, but cash poor.[3] They find it increasingly difficult to meet home maintenance expenses, energy costs, property taxes, insurance premiums, health care bills, and even subsistence needs. Yet, according to a survey by the American Association of Re-

---

Jean Reilly is the 1997 Tischler Scholar at Rutgers School of Law in Newark, New Jersey. She worked for the New York City law firm of Cravath, Swaine & Moore in 1996 and will rejoin them as an associate in 1998.

---

1. *See* Paul Muolod, *Fannie Is Buying Reverses*, NAT'L MORTGAGE NEWS, Nov. 13, 1995, at 1.

2. *See* INSTITUTIONAL INVESTOR, INC., LAZIO PUSHES FHA-INSURED REVERSE MORTGAGE PROGRAM 5 (1995). The aggregate equity of their homes was between $700 billion and $1 trillion. *See* 1 S. REP. NO. 103-403, at 276 (1994).

3. *See* Marilyn Askin, *Aging in Place with Federally Insured Reverse Mortgages*, 156 N.J. LAW. 755 (1993).

tired Persons, 86% of seniors indicated that they wanted to live in their homes for the rest of their lives.[4] For those older homeowners faced with the dilemma of wanting to stay in their homes and yet not having enough income to meet their expenses, reverse mortgages may be the answer.

Reverse mortgage loans, currently offered by 125 lenders across the United States,[5] permit homeowners age sixty-two and older to turn their heretofore nonliquid house into an income-producing asset. The homeowner can opt for a lump sum payment, a series of monthly cash advances, a line of credit to tap as needed, or any combination of these options. Maximum loan amounts are limited by the value of the home, the borrower's age, the loan's interest rate, and the lender's policies. In general, the older the homeowner and the more valuable the home, the more money will be available. For example, if interest rates were 10%, a sixty-five-year-old homeowner living in a house appraised at $150,000 could qualify for a $30,000 loan, whereas a ninety-year-old in the same circumstances could receive $94,400.[6] Repayment of the loan balance is due only when: (a) the senior dies; (b) the senior ceases to occupy the dwelling as a principle residence or is absent from it for more than twelve consecutive months; (c) the senior sells or transfers any of her interest in the secured property; or (d) the senior defaults on the loan agreement (for example, by failing to maintain the house or to pay property taxes).[7]

Interest, as it accrues monthly, is capitalized or added to the outstanding loan balance and itself becomes subject to the interest rate of the mortgage.[8] The senior, in effect, pays interest on interest. Reverse mortgages, like all mortgages, cost several thousand dollars to obtain. As with home purchase loans, the borrower has to pay for an appraisal, title insurance, monthly service charges, origination fees, and closing costs. These loan costs, however, can be rolled into the reverse

4. *See* Celeste M. Hammond, *Reverse Mortgages: A Financial Planning Device for the Elderly*, 1 ELDER L.J. 75, 78 (1993). The top four reasons for wanting to remain in the home are: (1) comfort, (2) independence, (3) lifestyle, and (4) inertia. Peter Wessel, *Republic Financial Submits Report on Reverse Mortgage Loans*, TAX NOTES TODAY, Oct. 27, 1994, at 211.

5. *See* Lani Luciano, *Reverse Mortgages Are Getting More Generous and Easier to Compare*, MONEY, Oct. 1, 1995, at 48.

6. *See Reverse Mortgages: A Good Idea?*, CONSUMER REP., July 1, 1995, at 490.

7. *See* 5 U.S.C. §§ 1602(bb)(1)-(2) (1994 & West Supp. 1997).

8. *See* Hammond, *supra* note 4, at 86 n.103.

mortgage so that they too become part of the outstanding loan balance.[9]

All reverse mortgages are nonrecourse loans; the borrower can never owe more than the house is worth.[10] The lender cannot pursue the borrower's heirs or family members for any deficiency or look to the borrower's income or other assets for repayment. Moreover, borrowers cannot be forced to vacate their homes even after they have completely exhausted the equity in it.[11] Lenders, for their part, must continue making the contracted for monthly payments to the borrower even after the accrued interest, principal, and loan origination costs have exceeded the value of the house.[12]

Homeowners with reverse mortgages retain title to their property and can pass that title to their heirs. The heirs, however, would have to pay off the outstanding loan balance if they wanted to keep the house. The vast majority of heirs in such cases sell the house.[13] The borrower may "opt out" of the reverse mortgage by prepaying the outstanding loan balance at any time without penalty. It is estimated that 8% of reverse mortgage borrowers choose to pay off the loan and remain in the house debt-free.[14]

Although reverse mortgages have been nationally available since 1988, they have not widely caught on.[15] Indeed, as of March 5, 1996, only 30,000 seniors had taken out a reverse mortgage.[16] This article will highlight some of the obstacles which have impeded widespread acceptance of reverse mortgages by both lenders and borrowers, explore recent developments that may serve as corrective measures, detail the advantages and disadvantages of various types of reverse mortgages, and examine innovative uses of reverse mortgages which may increase their popularity as estate planning tools.

---

9. *See* Joe Blundo, *The Reverse Mortgage: Older Homeowners Can Keep the Roof over Their Heads, and Still Pay Their Bills*, COLUMBUS DISPATCH, Jan. 28, 1996, § I, at 1.

10. *See AARP Official Explains Reverse Mortgages* (CNN television broadcast, Nov. 9, 1995).

11. *See Reverse Mortgages: A Good Idea?*, *supra* note 6, at 490.

12. *See* Joseph Blalock, *Understanding Reverse Mortgages*, SAVINGS & COMMUNITY BANKER, Sept. 1, 1994, at 42.

13. *See* Blundo, *supra* note 9, at 1.

14. *See* H.R. REP. NO. 104-281, at 7 (1995).

15. *See* Pamela Reeves, *Moneywise: Study Reverse Mortgages*, CINCINNATI POST, Mar. 5, 1996, at 3C.

16. *See id.*

# I. Obstacles Impeding Acceptance of Reverse Mortgages by Borrowers and Lenders

Litigation surrounding reverse mortgages and tales of predatory lending have made borrowers wary of this complex financial instrument. The growth of the reverse mortgage market has been further hindered by lenders' aversion to the perceived risks and delays inherent in these mortgages.

## A. Litigation and "Predatory Lending"

Beginning in 1991 there have been a series of lawsuits by disappointed reverse mortgage borrowers who accuse lenders of defrauding them out of the equity in their home. The suits, all against private lenders, have generated bad press and have scared potential borrowers away from even the relatively safe government-backed reverse mortgages. *Barron's*, the well-respected financial publication, trumpeted in an article, "Reverse mortgages can be a nightmare .... Some retirees have seen their home equity completely wiped out in five years or less."[17] The magazine further stated, without differentiating among reverse mortgage lenders, that reverse mortgages "can leave people shell-shocked, with little or no money to pay for extensive stays in nursing homes during their final years of life—or to pass on to their heirs."[18] Similarly, the headline of a *Worth* article discussing charges that some reverse mortgage lenders "bilked millions of dollars from trusting senior citizens" gave potential borrowers the generic warning: "Beware Reverse-Mortgage Mania: Don't Let A Bad Deal Burn Up Your Home Equity."[19] The legal profession also has warned of predatory lending, high interest rates, and unconscionable terms in reverse mortgage transactions.[20] The result has been to make the public wary of reverse mortgages. This public distrust is best exemplified by a woman who wrote into the Newark *Star-Ledger*'s Question and Answer Financial Column asking, "It is my belief that many senior citizens have obtained reverse mortgages without knowing the actual cost of such borrowing, because the mortgage lenders did not

---

17. Andrew Bary, *Reversals of Fortune*, BARRON'S, July 4, 1994, at 23.
18. *Id.*
19. Elizabeth MacDonald, *Beware Reverse-Mortgage Mania: Don't Let a Bad Deal Burn Up Your Home Equity*, WORTH, Oct. 1994, at 122 (quoting complaint filed in class-action suit against Providential Corp.).
20. *See* Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 373 (1994).

reveal those costs. Am I correct?"[21] The answering columnist confirmed her perceptions: "There is little doubt that some unscrupulous lenders did not reveal the true cost of reverse mortgages to gullible seniors."[22]

This latter sentiment is echoed in *McCarthy v. Providential Corp.*,[23] a class action lawsuit brought in U.S. District Court in Northern California. The complaint alleges that Providential, a reverse mortgage lender, "systematically and fraudulently schemed to deny senior citizens the equity in their homes."[24] The complaint contains additional claims of fraud and deceit, negligent misrepresentation, and unlawful, unfair, or fraudulent business practices.[25] The suit charges that the lender, "[b]y misrepresenting the interest rate, finance charges, the borrower's life expectancy, and the terms and conditions of the reverse mortgages, deprived consumers of information necessary to make an informed decision and deceived class members as to the material terms of the reverse mortgage."[26] The suit further alleges that Providential gouged existing customers by inducing them to rewrite their loans by misrepresenting that the additional funds could be obtained on a no points, no fee basis.[27]

Consider the case of eighty-eight-year-old plaintiff Mary McCarthy who took out a reverse mortgage on her $354,000 pink San Francisco row house in 1990.[28] Mrs. McCarthy had been living on her $600 social security check.[29] According to her son, she took out a reverse mortgage with Providential because she did not want to burden her family.[30] Though the literature and documents from Providential said she would be charged 11.5% interest, the suit alleges that she was actually charged 13.5%.[31] As a result, the suit claims, she received 17% less than the amount she was entitled to each month.[32] Further, in

---

21. *Reversing the Mortgage Flow*, STAR LEDGER (Newark, N.J.), Nov. 9, 1995, at 1A.
22. *Id.*
23. No. C94-0627FMS, 1994 WL 387852, at *1 (N.D. Cal. July 19, 1994).
24. *Id.*
25. *See id.*
26. Daniel Levine, *Providential's Last Pummeling*, S.F. BUS. TIMES, Apr. 29, 1994, § 1, at 3.
27. *See* MacDonald, *supra* note 19, at 122; *see also* Liz Harman, *Reverse Mortgages Firm Hit by Class Action Suit*, SAN DIEGO BUS. J., May 2, 1994, § 1, at 5.
28. *See* Bary, *supra* note 17, at 24.
29. *See id.*
30. *See id.*
31. *See* Levine, *supra* note 26, at 3.
32. *See id.*

1993 Providential offered the ailing Mrs. McCarthy a one-time $2,000 payment in exchange for altering certain terms of her original deal.[33] Although her son John had served as her advisor on the first loan, Providential solicited her exclusively on the rewrite of the loan.[34] The suit claims that "Providential knew of [her] advanced age and took advantage of her by pressuring her to rewrite the loan and surrounding the transaction in an atmosphere of haste."[35] The loan amendments not only caused the $2,000 advance to be added to her loan balance, but also an immediate surcharge of $8,796.[36] Throughout 1994 and 1995, the loan changes cost her an extra $68,000.[37] By the middle of 1995, the equity in her house had been completely used up,[38] even though the original 1990 disclosure statement said that after eight years she would have nearly $100,000 equity left to use for nursing home care.[39]

A similar fate befell plaintiff Eda Kavin.[40] Initially she was thrilled about her reverse mortgage because the $1,500 monthly checks lifted her out of a fairly frugal existence and allowed her a few luxuries like opera tickets and a new car.[41] Mrs. Kavin's mistake was agreeing to take an additional $300 per month so that she could be more generous to the San Francisco cultural institutions she loved.[42] Her signature on the revised loan documents resulted in her "home equity being sucked up by Providential at an even faster rate."[43] By the end of 1995, she lost the entire $435,000 equity in her home, having received only $145,000 from Providential.[44] Her equity was depleted so quickly because the rewritten note deleted the provisions in the original mortgage that guaranteed her or her heirs 20% of the proceeds of the sale.[45]

Plaintiffs Perry and Eunice Williams ended up paying a 34% annual interest rate on their reverse mortgage.[46] The couple received

33. *See* Bary, *supra* note 17, at 23.
34. *See* Harman, *supra* note 27, at 5.
35. *Id.*
36. *See* Levine, *supra* note 26, at 3.
37. *See* Bary, *supra* note 17, at 23.
38. *See* MacDonald, *supra* note 19, at 122.
39. *See* Harman, *supra* note 27, at 5.
40. *See* Bary, *supra* note 17, at 23.
41. *See id.*
42. *See id.*
43. *Id.*
44. *See id.*
45. *See id.*
46. *See id.*

$22,800 in monthly payments over three years after using their $85,000 home in the Sierra Nevada mountains to secure a 1989 reverse mortgage.[47] After their health began to fail, they sold their home for $96,500 and moved to a nursing facility.[48] They ended up owing Providential $49,000.[49] This excessive payment is due in part to the fact that their loan agreement gave the company the right to any property appreciation.[50] Appreciation clauses are found in 1% of all reverse mortgages.[51]

After the lawsuit was filed, Providential filed a motion to compel arbitration pursuant to a clause in each loan document that provided that "any controversy or claim arising out of or relating to the loan documents [shall be] settled by binding arbitration under the jurisdiction of the American Arbitration Association in accordance with its Commercial Arbitration Rules."[52] The court granted Providential's motion to compel arbitration of the plaintiffs' claims, but ordered that arbitration proceed on an individual, rather than a class, basis.[53] Providential was pleased with the court's decision even though it may be liable for damages to individual borrowers, because it will likely avoid a comprehensive financial judgment.[54] In reaching its decision, the court rejected the plaintiffs' arguments that Providential had a duty to inform the plaintiffs that they were waiving a valuable right by agreeing to arbitrate; that the agreement to arbitrate was unconscionable; and that Providential fraudulently induced the plaintiffs into accepting the arbitration provision.[55]

In a similar but unrelated case, San Mateo County, California, brought a class action lawsuit against Commonwealth Life Insurance Company, charging it with defrauding senior citizens who bought reverse mortgages.[56] The suit charged the company with consumer fraud, fraudulent misrepresentation, and elder abuse.[57] The latter

47. *See id.*
48. *See id.*
49. *See id.*
50. *See id.*
51. MacDonald, *supra* note 19, at 122.
52. McCarthy v. Providential Corp., No. C94-0627FMS, 1994 WL 387852, at *3 (N.D. Cal. July 19, 1994).
53. *See id.* at *9.
54. *See* Andrew Bary, *Painful Slide: Reverse Mortgage Company Plans to Liquidate Itself*, BARRON'S, Aug. 22, 1994, 13.
55. *See McCarthy*, 1994 WL 387852, at *9.
56. *See* Ken Hoover, *San Mateo County Sues over Reverse Mortgages*, S.F. CHRON., Oct. 11, 1995, at A13.
57. *See id.*

charge stemmed from a 1992 state law that allows elderly victims to collect punitive damages and attorneys' fees for physical or financial abuse.[58] The case arose after Deputy County Counsel Steven Dylina was named the conservator of the estate of Beatrice Mathews, an eighty-three-year-old retired nurse who had entered into a 1993 reverse mortgage with the insurance company.[59] After investigating her finances, Dylina learned that she had been charged an origination fee of $3,000 plus 7% of the value of her home.[60] The fee, which came to $16,685, collected compound interest and allowed the company to receive the equivalent of 62% annual interest.[61] Mathews was paid $52,500 over the two-and-a-half-year life of the loan, but owed $84,000 in fees, principal, and compound interest.[62] Between 1989 and 1993, Commonwealth Life sold 2,000 similar reverse mortgages, mostly in California.[63]

California was the situs of yet a third reverse mortgage suit. In January 1990, Ruby Waldron purchased a reverse mortgage.[64] By June 1991, she was suing the mortgage lender, John Hancock Mutual Life Insurance Company, and Robert Setser, Sofian Susantino, and Net Equity Associates (hereinafter Setser defendants).[65] The suit alleged breach of contract, fraud, negligent infliction of emotional distress, and breach of fiduciary duty.[66] The allegations against John Hancock rested on the claim that the Setser defendants were its agents and used its letterhead to solicit Waldron and encourage her to take out a reverse mortgage with excessive fees and hidden charges.[67] By an order dated November 16, 1993, the trial court granted John Hancock's motion for summary judgment.[68] The court concluded that the Setser defendants were not acting as agents of John Hancock in connection with the reverse mortgage transaction and the Setser defendants had no ostensible authority to sell their reverse mortgage package as John Hancock's. The court also found that John Hancock had no knowl-

58. *See id.*
59. *See id.*
60. *See id.*
61. *See id.*
62. *See id.*
63. *See id.*
64. *See* John Hancock Mutual Life Ins. Co. v. Setser, 50 Cal. Rptr. 2d 413 (Cal. Ct. App. 1996).
65. *See id.* at 413-14.
66. *See id.* at 414.
67. *See id.*
68. *See id.*

edge of either any unlawful purpose on the part of the Setser defendants or of the use of its stationary and business cards to solicit Waldron and that John Hancock had not agreed to participate with the Setser defendants in any scheme to defraud Waldron.[69] The California Supreme Court denied Waldron's petition for review on April 27, 1994, and the judgment became final.[70] The suit against Home Savings and Loan, the mortgage lender, was also dismissed on summary judgment.[71]

On April 1, 1994, Waldron reached a settlement agreement with the Setser defendants whereby they would pay her $200,000 in exchange for which Waldron would drop her suit against them.[72] The parties, however, remain entangled in legal complication. On February 28, 1996, the California Court of Appeals remanded the issue of whether John Hancock could recover attorneys' fees from the Setser defendants because Hancock had been "required to defend against Waldron's claims solely because of the Setser defendants' tortious conduct."[73] On the same day, Waldron filed a new suit against John Hancock and the Setser defendants, alleging breach of a confidentiality agreement reached in connection with the negotiated settlement.[74] All in all, the result was a lot of hassle for an elderly woman who thought she was taking out a loan brokered by a reputable company and wanted only to spend the last years of her life living without worry in her home.

At best, cases such as *Providential*, *Commonwealth*, and *John Hancock* point to how complex a reverse mortgage may seem to those unfamiliar with its intricacies.[75] At worst, the cases provide examples of exploitation of the elderly by private lenders of reverse mortgages.[76]

Although all of the above cases involve private lenders, the government-backed Home Equity Conversion Mortgage program (HECM) has also been threatened with litigation. The Governor of Arizona and the Arizona Aging and Adult Administration filed suit against the HECM program, claiming that its mandatory counseling requirement for potential reverse mortgage borrowers constitutes age

69. *See id.*
70. *See id.* at 414 n.5.
71. *See id.* at 414.
72. *See id.* at 415.
73. *Id.* at 416.
74. *See id.* at 414.
75. *See* Levine, *supra* note 26, at 3.
76. *See id.*

discrimination.[77] On January 15, 1996, the Federal Reserve Board responded by issuing a proposed rule that states using age to determine life expectancy in making reverse mortgages is not a violation of Regulation B of the Equal Credit Opportunity Act.[78] The Act makes it unlawful for banks and mortgage lenders to discriminate on the basis of age, sex, race, or other factors.[79] "Age may be directly taken into account in setting the terms of a reverse mortgage without violating" the Act according to the Federal Reserve Board.[80]

### B. Lenders: "Headaches" and Hesitation

Financial institution managers, despite their constant search for additional sources of loan volume and their long-held interest in the potential benefits of leveraging the equity of elderly homeowners, have nevertheless been hesitant to enter the reverse mortgage market.[81] Peter Spekman, vice president of Richfield Bank and Trust Company in Minnesota, notes that financial institutions are reluctant to offer reverse mortgages because of four perceived risks: value risk, reputation risk, tort risk, and demand risk.[82]

With value risk, the concern is that the mortgage might accrue interest and principal that will eventually exceed the value of the house.[83] Such fate befell Providential, the lender that was the defendant in the fraud and misrepresentation lawsuit discussed above. Providential got in trouble partly because it made loans at the top of the California real estate market, based on expectations that property prices would continue to appreciate at a 5% rate.[84] Instead, California home prices declined at a 5% annual rate from 1988 to 1994.[85] The result was that Providential's reverse mortgage portfolio, which was listed as having a carrying value of $51 million, received a $33 million write-down in 1994.[86] The write-down cut the value of Providential's reverse mortgage holdings by 65% and caused shares of stock in the

77. *See* Hammond, *supra* note 4, at 100.
78. *See Fed Looks at Age Discrimination*, NAT'L MORTGAGE NEWS, Jan. 15, 1996, at 5.
79. *See id.*
80. *Id.*
81. *See* Blalock, *supra* note 12, at 42.
82. *See Finding Riches in Niches*, AM. BANKER'S ASS'N BANKING J., June 1, 1989, at 40.
83. *See* Blalock, *supra* note 12, at 42.
84. *See* Bary, *supra* note 17, at 23.
85. *See id.*
86. *See* Bary, *supra* note 54, at 13.

company to plummet to $5 per share from a high of $16.[87] Providential subsequently sold off all of its loans and liquidated itself.[88] Capital Holding, Providential's closest competitor, also withdrew from the reverse mortgage market in 1993 because it did not believe it could make any money.[89] This sentiment was echoed by New York Senate Staffer Joseph Montalto who noted that New York banks "frequently avoid [reverse mortgage] loans because they perceive the loans are not profitable. Banks are concerned about depreciating property values."[90]

With reputation risk, lenders are worried about how their image may be affected in the event of foreclosure due to default.[91] For example, Spekman, as a bank vice president wonders "how will the bank look on the six o'clock news escorting an elderly couple out of their home?"[92] The likelihood of default is slim, however, according to Fannie Mae's president, Frank Raines, as long as lenders are in constant contact with borrowers and make sure needed inspections and repairs are done properly.[93]

Joseph Blalock, an economist for Savings and Community Bankers of America, worries about a related issue: the moral hazard of reverse mortgages.[94] Moral hazard describes the tendency of borrowers to act against the interests of lenders.[95] For example, when it becomes apparent to an elderly person that she will have to vacate the home by the end of the year because she needs to enter a nursing home, she may cease maintaining the home. This is particularly likely to be true if all the equity in the house has been used up by the reverse mortgage. Substantial deferred maintenance on the home hurts the lender by reducing the home's resale value.[96] To combat against their moral hazard, lenders can insist that the reverse mortgage be structured with an equity set-aside, whereby borrowers are unable to ac-

87. *See id.*

88. *See id.*

89. *See* Bary, *supra* note 17, at 23.

90. Catherine Hubbard, *New York Senate Staffer Says State Faces Controversy over Reverse Mortgage Interest*, TAX NOTES TODAY, Sept. 9, 1991, 187.

91. *See Finding Riches in Niches*, *supra* note 82, at 40.

92. *Id.*

93. *See Servicing 'Home Keeper' May Be Tough*, MORTGAGE MARKETPLACE, Nov. 13, 1995, at 1 [hereinafter *Servicing 'Home Keeper'*].

94. *See* Blalock, *supra* note 12, at 42.

95. *See id.*

96. *See id.*

cess a small amount of their equity and thus will have a continuing stake in their properties.[97]

Tort risk involves the possibility of claims by the borrowers or their heirs and relatives that the borrower was deceived by the bank regarding the material terms of the reverse mortgage.[98] As the cases discussed above indicate, this is a very real possibility. The reverse mortgage is fraught with emotional tension because the house is not only a person's single most important financial resource, but also the physical embodiment of their independence and the repository of years of memories and hopes.[99] The disclosure requirements of the new federal Truth in Lending regulations which became mandatory on October 1, 1995 should not only protect consumers, but also lessen lenders' tort liability fears.

Lenders also face an interest rate risk with reverse mortgages.[100] In a rising rate environment, a fixed rate investor normally has the benefit of reinvesting cash flows into higher yielding investments.[101] This benefit is not available to the reverse mortgage lender, however, because reverse mortgages do not result in any intermediate cash flows to the lender.[102] A fixed rate, reverse mortgage lender is helplessly locked into a rising rate environment. Although an adjustable-rate reverse mortgage is certainly more attractive to the lender with regards to interest rate, it is not risk-free.[103] In a rising rate environment, an adjustable-rate reverse mortgage accrues increasing amounts of interest. Thus, the lender faces risk from negative amortization; that is to say, the possibility increases that the accrued interest and principal will exceed the resale value of the home.[104]

Another reason for banks' reluctance to embrace reverse mortgages is the delay involved. With reverse mortgages, it takes about one year from initial inquiry until closing.[105] The loans can get bogged down in red tape.[106] Banks providing FHA-backed loans must require

97. *See id.*
98. *See Finding Riches in Niches*, *supra* note 82, at 40.
99. *See* Bary, *supra* note 17, at 23.
100. *See* Blalock, *supra* note 12, at 42.
101. *See id.*
102. *See id.*
103. *See id.*
104. *See id.*
105. *See* Bary, *supra* note 17, at 23.
106. *See* Anne Kate Smith, *Turning Equity to Income for Homeowners Who Want to Stay, a Reverse Mortgage Can Pay Off*, U.S. NEWS & WORLD REP., Oct. 19, 1992, at 77.

borrowers to meet with an FHA-certified counselor to discuss options and alternatives.[107] For some borrowers, this requirement may entail some traveling time. Kay White, one such counselor in Phoenix, says that people have to trek 200 miles to come because she is the only counselor in the area.[108] Jeffrey Taylor, president of Wendover Funding, notes that agency budget cutbacks may affect the availability of counseling as well.[109] Currently, the Department of Housing and Urban Development (HUD) pays for counseling provided by HUD-approved nonprofit agencies, but the chances of more funds for counseling are slim to none, according to Taylor.[110] Although a phone session can replace a face-to-face meeting if travel is impossible, borrowers may be reluctant to stay on the phone for the necessary four to five hours and will miss the greater explanatory potential provided by a counselor's ability to point to figures and documents in front of them.

Further, banks complain that completion of counseling is just one step in a process marked by its painstaking pace.[111] The American Bankers Association warns its constituent lenders that "[t]hese loans take a great deal of hand holding, [and] it's not unusual for the borrower's children to become involved in the process somewhere along the line."[112] Also, the American Bankers Association cautions, "[g]roups such as the American Association of Retired Persons . . . forcefully represent the interests of borrowers [and are] likely to be unsympathetic to lenders' concerns."[113] The result is that most lenders who have entered the reverse mortgage market have had to invest considerable amounts of time and money in explanations to family members and education of borrowers.[114] According to David Olson, a veteran industry consultant, "It's a very hard sell, [and] if the sell takes too long, maybe it's not worth it."[115] According to Cathy Lavalette, Assistant Vice President in charge of reverse mortgages at

107. *See id.*

108. *See id.*

109. *See* Scott Kersnar, *How to Service the Reverse Loan*, NAT'L MORTGAGE NEWS, Oct. 23, 1995, 65.

110. *See id.*

111. *See id.*

112. Steve Cocheo, *Are Reverse Mortgages Worth the Effort?*, AM. BANKERS ASS'N BANKING J., Sept. 1993, at 84.

113. Blalock, *supra* note 12, at 42.

114. *See id.*

115. Karen Talley, *A Lender's Lament; Mining the Regulations*, AM. BANKER, Feb. 7, 1996, at 10.

Chittenden Bank in Burlington, Vermont, a considerable number of applicants change their minds after initially expressing interest in reverse mortgages.[116] Because in many lending institutions loan originators are paid by commission, this high back out rate makes employee products-specialists reluctant to get involved with reverse mortgages at all.[117]

Even if the borrower has managed to complete counseling and has decided to go through with the loan, the lending institution still faces inevitable delays in processing the loan.[118] Some of these delays stem from the fact that the FHA must approve government-backed loans and the agency is backed up with refinancing requests on standard mortgages insured by the agency.[119] This slows down the process, with the result that it can take six months to gain FHA approval on a reverse mortgage loan.[120] Other banks, such as Metuchen Savings in New Jersey, have been unable to offer reverse mortgages despite approved applications, because they have been unable to get the needed software to comply with the new federal regulations for disclosure.[121]

Even after the reverse mortgage is closed, lenders still face problems. A reverse mortgage loan can be a very difficult loan to service.[122] Whereas standard mortgages require borrowers to mail in their first check the second month after closing, reverse mortgage payments must be sent to borrowers almost the next day.[123] Moreover, the borrower can change from lump sum payment to line of credit payment to monthly annuity and back again at any time.[124] Lenders must also "have means of monitoring taxes and insurance and the condition of the property. They must supply the borrower [with] a quarterly report on the status of the loan and often must work with the state to dispose of the property after the death of the borrower."[125] Given these complexities of servicing and the relatively small number of reverse mortgages a lender is likely to handle, it is often more effi-

116. *See* Cocheo, *supra* note 112, at 84.
117. *See id.*
118. *See id.*
119. *See id.*
120. *See id.*
121. *See* Telephone Interview with Representative of Metuchen Bank, Mortgage Department (Feb. 21, 1996).
122. *See Servicing 'Home Keeper'*, *supra* note 93, at 1.
123. *See id.*
124. *See id.*
125. Kersnar, *supra* note 109, at 65.

cient for a lender to find a subserver to handle the loans rather than build the software and support necessary to self-service them.[126] One drawback to this approach, however, is that the FHA program's origination fee is set at $1,500 regardless of the loan amount and when a subserver is brought in, a piece of the fee goes to them.[127] The bottom line is that banks simply do not make a lot of money off these loans, according to Teresa Tilley, reverse mortgage coordinator at Centura Bank in Rocky Mount, North Carolina.[128] "We're just meeting people's needs," Tilley concludes.[129]

Some reverse mortgage advocates claim that although reverse mortgages are not themselves profitable, they are strategic products that give banks the opportunity to lure in different types of business.[130] Yet, some bankers remain unconvinced that reverse mortgages can live up to their billing as door-openers to other selling opportunities.[131] Said one banker in a February 7, 1996, interview, "I've heard cross-sell, cross-sell, cross-sell. It's the biggest hoax related to mortgage servicing that ever existed."[132] Banks, put off by the risks, low profit margins, and headaches involved in originating and servicing reverse mortgages, remain hesitant to exploit the market.

## II. Recent Developments and Corrective Measures

Recently enacted federal legislation and proposed rules should help to protect reverse mortgage borrowers and relieve the transactional headaches of lenders.

### A. The Feds: "To Protect and to Serve"

On September 23, 1994, President Clinton signed into the law the Riegle Community Development Act of 1994.[133] The Act made signifi-

126. *See* Cocheo, *supra* note 112, at 84.

127. *See id.*

128. *See id.*

129. *Id.*

130. *See* Karen Talley, *Fannie Preparing Strict Standards for Reverse Mortgage Loans Series*, Am. Banker, Jan. 8, 1996, at 12.

131. *See* Talley, *supra* note 115, at 10.

132. *Id.*

133. Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160 (1997) (amending 15 U.S.C. § 1602(BB)(1) (1994)); *see* Major McGillin, *Truth in Lending Act Modifications: High Cost Mortgages/Reverse Mortgages*, Army Law. 43 (1994).

cant changes to the Truth in Lending Act (TILA)[134] because legislators were concerned that consumers were not currently receiving adequate information regarding reverse mortgage transactions.[135] In order to ensure that borrowers are aware of the costs and risks associated with reverse mortgages, this legislation created a special disclosure requirement for these transactions.[136] To implement changes to TILA, the Federal Reserve Board issued a final rule amending its Regulation Z—Truth in Lending.[137] Although the rule was effective March 22, 1995, compliance was optional until October 1, 1995.[138] The Federal Reserve periodically publishes for comment proposed revisions to its official commentary to Regulation Z.[139] The update applies and interprets the requirements of the Regulation.[140] These updates purport to clarify previous regulations.[141] The most recent revision was made on March 6, 1997.[142]

The amended Regulation Z requires creditors offering reverse mortgages to furnish to consumers at least three days prior to consummation of the loan a "one-time notice disclosing costs of the loan and reminding consumers that signing an application or receiving disclosures does not require the consumer to complete the transaction."[143] The disclosures must be clearly and conspicuously in writing and in a form the consumer may keep.[144] The clear and conspicuous standard does not require any particular type size.[145] Disclosures may be made on more than one page so long as the pages constitute an integrated document.[146]

Lenders are required to disclose a good faith projection of the total annual loan cost to the borrower.[147] All costs and charges connected with the reverse mortgage must be included in the projected

---

134. *See* The Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (1997) (amending 15 U.S.C. § 1635 (1988)).
135. *See* H.R. CONF. REP. NO. 103-652, at 39 (1994).
136. *See id.*
137. Truth in Lending Act, 60 Fed. Reg. 15463 (1997).
138. *See id.*
139. *See* Truth in Lending Act, 12 C.F.R. § 226.33 (1997) (requirements for reverse mortgages).
140. *See id.*
141. *See id.*
142. 62 Fed. Reg. 10193 (1997).
143. 12 C.F.R. §§ 226.31(c)(1), .33(b)(1) (1997).
144. *See id.* § 226.31(b).
145. *See id.* § 226 app. K(d)(2).
146. *See id.*
147. *See id.* § 226.33(b)(2).

costs, regardless of whether or not the charge is deemed to be a finance charge.[148] Thus, for example, some lenders permit consumers to purchase an annuity as part of the transaction that immediately or at some time in the future replaces the lender's payments. The regulation requires that the amount paid by the consumer for the annuity be included as a cost to the consumer.[149] Lenders also must include any shared appreciation they are entitled to receive pursuant to the loan agreement.[150] On the other hand, if the reverse mortgage sets the borrower's maximum liability at the net proceeds available from the sale of the home, the net proceeds must be calculated by subtracting 7% closing costs from the sales price.[151]

When calculating the total annual loan cost, the lender must use three hypothetical house appreciation rates: 0% appreciation, 4% appreciation, and 8% appreciation.[152] The Federal Reserve based the 4% annual appreciation rate on its assessment of long-term averages of historical housing appreciation rates.[153] The 0% and 8% rates are included to "help consumers understand the potential costs and benefits of the loan if their dwelling doesn't appreciate in value at all, or if its value appreciates at a rate double" the historical average.[154]

TILA also requires each total annual loan rate to be based on one of at least three credit transaction periods.[155] The Federal Reserve determined that these periods should be: (1) two years; (2) a period equal to the consumer's life expectancy; and (3) a period equal to approximately 1.4 times the consumer's life expectancy.[156] However, the Federal Reserve, concerned that a significant time interval could exist between the shortest loan period (two years) and the consumer's life expectancy, is permitting lenders to add a fourth hypothetical loan period equal to one half of the consumer's life expectancy.[157] Use of the additional period is optional, but the Federal Reserve believes that the benefits to the consumer will outweigh any additional compliance burden on the lender.[158] Indeed, given the realistic possibility of a

148. *See id.* § 226.33(c)(1).
149. *See id.*
150. *See id.* § 226.33(c)(3).
151. *See id.*
152. *See id.* § 226.33(c)(5).
153. *See id.*
154. 60 Fed. Reg. 15463 (1997).
155. *See* 12 C.F.R. § 226.33(c)(6)(i).
156. *See id.*
157. *See id.* § 226.33(c)(6)(ii).
158. *See* 60 Fed. Reg. 15,469 (1997).

permanent move from the home during the borrower's lifetime, the additional loan period may prove the most valuable to the consumer. Finally, it should be noted that the Federal Reserve mandates that lenders use the U.S. Decennial Life Tables for Women when calculating life expectancy, regardless of whether the borrower is a male or female.[159] This is because women are estimated to comprise the majority of borrowers under existing reverse mortgage programs.[160]

Lenders who permit borrowers to control when cash advances are received (that is, who permit credit lines) must use a special assumption for calculating the total annual loan cost.[161] Lenders must assume that 50% of the amount of the credit line is advanced at the loan closing and that no further advances are made during the remaining term.[162]

Regulation Z also provides that lenders offering adjustable-rate reverse mortgages must base disclosures on the initial interest rate and not assume that the rate will increase.[163] Other loan terms that the lender must disclose are: the age of the youngest borrower it is basing its calculations on; the appraised property value; the amount of money to be advanced monthly; any initial draw or lump sum payment the borrower elects to receive; the line of credit available and any concomitant fees triggered by an initial draw; closing costs; initial mortgage insurance premium and monthly mortgage insurance fees; servicing fees; and any other charges.[164] Specifically exempt from this list are disposition costs or the costs of selling the home.[165]

Finally, the disclosure must contain a warning and explanation: "The cost of any reverse mortgage loan depends on how long you keep the loan and how much your house appreciates in value .... The rates in this table are estimates. Your actual cost may differ if, for example, the amount of your loan advances varies or the interest rate on your mortgage changes."[166]

Ken Scholen, director of the National Center for Home Equity Conversion, believes that these disclosure requirements will enable

---

159. 12 C.F.R. § 226 app. L (1997).
160. *See id.*
161. *See id.* § 226 app. K(b)(9).
162. *See id.*
163. *See id.* § 226 app. K(b)(10).
164. *See* 60 Fed. Reg. 15,476 (1997).
165. *See id.*
166. *Id.*

consumers to compare the real costs of reverse mortgage programs.[167] Armed with estimates from several lenders, borrowers can more easily match programs to their needs and shop for the best mortgage value.[168] Further, these statutory amendments, specifically enacted in response to a number of lawsuits,[169] should stem charges of lender fraud and misrepresentation.

While TILA and Regulation Z were amended to protect consumers, HUD responded to lenders' concerns and on August 16, 1995 issued an interim rule to "greatly reduce the administrative burdens encumbering" government-backed HECMs.[170] The HUD took the unusual step of publishing the rule without first soliciting public comment, because it found the prior procedure to be both contrary to the public interest and unnecessary.[171] The interim rule (hereinafter rule) was made final without substantive changes on December 21, 1995.[172] The requirements of the new rule are specifically directed to making the program more efficient for participating mortgagees.[173]

Of the numerous changes made by the rule, the greatest immediate impact is expected to be the change to Direct Endorsement processing for HECM reverse mortgage loans. Direct Endorsement will expedite the processing of HECMs by delegating loan approval authority to lenders themselves instead of requiring them to first wait for the FHA to approve insurance for the loan.[174] Long used in other mortgage insurance programs, Direct Endorsement "has proven to be an effective method of reducing the time needed for loan approval while permitting reduced HUD field office staffs to deal with other matters."[175] In order for a lender to be approved for Direct Endorsement processing of HECMs, the lender will have to initially submit to the Secretary of HUD five HECM test cases for review.[176] This test case requirement does not apply to any lender that is otherwise approved for Direct Endorsement and that has closed fifty HECMs that were insured by HUD prior to September 15, 1995, the effective date

---

167. *See New TILA Disclosures*, NAT'L MORTGAGE NEWS, May 1, 1995, at 24.
168. *See Reverse Mortgages: A Good Idea?*, *supra* note 6, at 490.
169. *See* 60 Fed. Reg. 15463 (1997).
170. H.R. REP. NO. 103-607, at 305 (1994).
171. *See* 60 Fed. Reg. at 42,757 (citing 24 C.F.R. § 10.1).
172. *See id.* at 66,476.
173. *See id.* at 42,758.
174. *See* H.R. REP. NO. 103-607.
175. 60 Fed. Reg. at 42,757.
176. *See* 24 C.F.R. § 203.3(b)(4) (1997).

of the rule.[177] Although lenders will no longer have a legal commitment for insurance at the time they close the loan, HUD promises to always endorse any loan made under Direct Endorsement as long as the lender has met all other HECM regulations.[178] Lenders that follow all HUD requirements are thus under no greater risk under Direct Endorsement than if they closed a HECM loan in reliance on a HUD commitment.[179] Lenders have vociferously endorsed HECM's conversion to Direct Endorsement processing.[180]

Many of the other changes included in the rule are clarifications that reflect actual program operation during the years the HECM program has been in effect.[181] For example, technical changes were made to the repair set-aside provision to make clear that the lender is not required to recalculate monthly payments when the repairs are completed.[182] Instead, excess funds in the repair set-aside will be automatically transferred to a new or an existing line of credit.[183] If the funds in the repair set-aside are insufficient to complete the repairs, monthly payments will be recalculated only if there are insufficient funds in a line of credit to cover the repair charges.[184] Another clarification of the amended rule was that *any* lien, not just the tax deferral liens specified in the regulation, may be recorded as long as the HECM maintains lien priority.[185]

The rule also adjusts the time frame for a lender's submission of a title insurance policy to HUD.[186] The requirement that a title policy be submitted to HUD before endorsement of the loan has caused delay in endorsing mortgages.[187] As amended, the rule would require the lender to obtain only a title insurance commitment before closing the loan.[188] Further, if HUD determines that title insurance for reverse mortgages is not available for reasonable rates in a state, HUD will allow other forms of title evidence in lieu of title insurance.[189]

---

177. *See id.*
178. *See id.* § 206.15.
179. *See* 60 Fed. Reg. at 42,758.
180. *See id.*
181. *See id.*
182. *See* 24 C.F.R. § 206.26(b).
183. *See id.*
184. *See id.*
185. *See id.* § 206.27(b)(3).
186. *See id.* § 206.15.
187. *See* 60 Fed. Reg. 42,754, 42,756 (1997).
188. *See* 24 C.F.R. § 206.15.
189. *See id.* § 206.45.

Lenders had expressed concern that because they were not able to assign the reverse mortgage to HUD until the debt reached the maximum claim amount, they might be obligated to make a loan advance that was partly lower than and partly in excess of the maximum claim amount.[190] The amended rule will obviate this fear by providing lenders with a window period for assignment.[191] The reverse mortgage can be assigned when the balance is equal to or greater than 98% of the maximum claim amount, or when the borrower has requested a payment that will result in the mortgage balance exceeding the maximum claim amount.[192]

Lenders also wondered how they would meet the requirement of notifying the mortgagor when the mortgage is due and payable if the mortgage became due only by virtue of the mortgagor's death.[193] The rule recognizes that notice to the mortgagor after death will be an impossibility and refuses to extend the due and payable notification requirement to the mortgagor's successors in interest.[194] The rule does add, however, that HUD expects the mortgagee to try to provide adequate notice to an executor before a foreclosure action is commenced.[195]

Instead of permitting the lender to wait until fifteen days before the foreclosure sale to have the property appraised, the rule requires an appraisal within thirty days of the date when the mortgage becomes due and payable.[196] This early availability of an appraisal will enable the mortgagor or the mortgagor's estate to offer the property for sale at realistic terms in an attempt to avoid foreclosure.[197]

After the mortgage has been accelerated, the borrower may not have funds available to pay for the appraisal, or there may be a substantial period of time before the borrower's estate can free up funds to pay for property related costs. The rule therefore provides that the lender can pay for the appraisal and be reimbursed from the proceeds of the sale of the house.[198] If there are insufficient sales proceeds, a

---

190. *See* 60 Fed. Reg. at 42,756.
191. *See* 24 C.F.R. § 206.107(a)(1).
192. *See id.*
193. *See id.* § 206.125(a).
194. *See id.* § 206.125(a)(2).
195. *See id.* § 206.125.
196. *See id.* § 206.125(b).
197. *See* 60 Fed. Reg. 42,754 (1997).
198. *See* 24 C.F.R. § 206.125(b) (1997).

related change will permit the lender to include the cost of the appraisal in its claim for insurance benefits.[199]

In recognition of the time delays inherent in probate proceedings and the time that may be needed for the borrower's estate to sell the property, the rule extends the period within which the lender must initiate foreclosure proceedings.[200] Under the amendment, the time for commencement of foreclosure proceedings is extended to six months from the date of the borrower's death.[201] The lender may extend the period even further with specific approval by HUD.[202]

The rule is further amended to permit a lender to charge a borrower for property preservation expenses incurred by the lender in connection with vacant or abandoned properties.[203] Moreover, while living in the house, the borrower must maintain the applicable property standards of the Secretary of the HUD instead of the lower minimum property standards previously allowed.[204] To encourage them to maintain the property, borrowers are permitted to reserve a portion of the equity in the property for their own benefit or for that of their heirs.[205]

The rule also adds to the list of items for which the lender may submit an insurance claim to HUD: foreclosure costs; payments for repairs necessary to meet HUD or state property standards; expenses in connection with the sale of the property—including a sales commission to a real estate broker; and attorneys' fees incurred in connection with the assignment of the mortgage to HUD.[206]

Further, finding that the initial Mortgage Insurance Premium paid by the borrower is a key factor in the payment model and in determination of risk under the program, HUD codified the existing policy that the Mortgage Insurance Premium is nonrefundable.[207] In a concession to the borrower, however, the rule does require lenders to notify borrowers, at least twenty-five days before changing an adjustable interest rate, of the following three facts: (1) the current index

199. *See id.*
200. *See id.* § 206.125(d)(1).
201. *See id.*
202. *See id.*
203. *See id.* § 206.207(a).
204. *See id.* § 206.47(a).
205. *See* 60 Fed. Reg. 42,754 (1997).
206. *See* 24 C.F.R. § 206.129(d)(2).
207. *See id.* § 206.116.

amount; (2) the date of publication of the index; and (3) the new interest rate.[208]

Finally, HUD correctly anticipated that future statutory authority would permit it to insure HECM loans for two-to-four-family residences.[209] It thus removed in advance any unnecessary regulatory restrictions that would bar lenders from taking immediate advantage of the future liberalization of the size of dwellings eligible for the HECM program.[210]

Thus, federal rules and regulations have been promulgated that not only decrease the likelihood that the terms of reverse mortgage loans are being misrepresented to borrowers, but also address the financial and administrative concerns of reverse mortgage lenders.

### B. HECM Reverse Mortgages

In 1987, Congress authorized the Home Equity Conversion Mortgage Insurance Demonstration.[211] Under this pilot program, HUD was authorized to provide FHA insurance for 2,500 reverse mortgages.[212] This insurance authority was allocated among the ten HUD regions in proportion to each region's share of the nation's elderly.[213] With the program due to expire in 1991, Congress, in late 1990, extended the demonstration to September 30, 1995, and raised to 25,000 the number of loans that could be insured, and on March 28, 1996, the HECM program was extended to the year 2000.[214] The 1990 legislation allowed any lender authorized to originate FHA-insured loans to originate FHA-backed reverse mortgages; under the prior rules, only a few lenders chosen by lottery in each state could originate FHA-insured reverse mortgages.[215] In addition, HECM allows the FHA not only to insure reverse mortgages on one-family homes, but also on two-to-four-family homes in which a HECM-eligible owner resides.[216]

Eligibility for a HECM reverse mortgage depends on age and home ownership, not income, credit history, or assets.[217] Currently, to

208. *See id.* § 206.21(d).
209. *See id.* § 206.45(b).
210. *See* 60 Fed. Reg. 42,754.
211. 12 U.S.C. § 1715z-20 (1994 & West Supp. 1997).
212. *See* S. REP. No. 103-403, at 277 (1994).
213. *See id.*
214. *See* 12 U.S.C. § 1715z-20.
215. *See* S. REP. No. 103-403, at 628.
216. *See* H.R. REP. No. 104-281, at 11 (1995).
217. *See* 12 U.S.C. § 1715z-20.

qualify a homeowner must be at least sixty-two years of age and reside either in a one-to-four-family dwelling or a HUD-approved condominium.[218] Condo owners face a tough time qualifying because condominium buildings must meet strict structural requirements.[219] The home or condo must also be either lien-free or have an outstanding mortgage balance low enough to pay off with HECM proceeds.[220] Under the HECM program, a prospective borrower also must receive advance counseling from a HUD-approved nonprofit or public counseling agency.[221] The counseling should include advice on and explanations of the source of funds; the payout schedule; the services to be received; the monthly service cost; convenience; quality of service; need planning; tax consequences; and housing alternatives such as congregate retirement facilities.[222]

The amount of equity homeowners may borrow against under a HECM reverse mortgage depends on where they live and the prevailing interest rate. Nationwide, the minimum loan amount is $81,548, and the maximum loan amount is $160,950.[223] Homeowners with more expensive homes may participate in the HECM program, but they cannot borrow above the limit.[224] The reason for the limits is that the FHA is statutorily mandated to provide financial assistance to only low- and middle-income Americans.[225] The FHA insures the reverse mortgage in both directions. If the value of the property should fall below the eventual balance of the loan, the agency will make up the difference when the time comes to repay the lender.[226] Similarly, if for some reason the lender is not able to honor its loan commitment, the FHA will stand in the lender's place and pay the homeowner the funds promised.[227]

HECM-borrowers can choose among five different payment plans. Under a tenure plan, the borrower receives monthly payments

218. *See id.*
219. *See* Mary Shanklin, *Would a Reverse Mortgage Be a Step Forward?*, ORANGE COUNTY REG., Nov. 26, 1995, at K4.
220. *See* Charles Nauts, *Reverse Mortgages—Backing into the '90s*, 8 PROB. & PROP. 57 (1994).
221. *See* 12 U.S.C. § 1715z-20.
222. *See* Nauts, *supra* note 220, at 59.
223. Telephone Interview with Representative of Morris County, N.J., Fair Housing Agency (Apr. 9, 1997).
224. *See* Don Finefrock, *U.S. Home Mortgage Agency to Offer Reverse Mortgages to Seniors*, MIAMI HERALD, Nov. 10, 1995, Business Section, at 1.
225. *See* Bary, *supra* note 17, at 23.
226. *See* Cocheo, *supra* note 112, at 84.
227. *See id.*

as long as she lives and remains in the home. In a term plan, the borrower receives monthly payments for a fixed period either prescribed by statute or selected by her. The borrower also can choose a credit plan in which he or she can access a line of credit at times and in amounts of her own choosing. Under a combination of the first and third choices, called a modified tenure plan, the borrower receives a monthly check and can also draw on a line of credit when the monthly amounts are not enough to meet her needs. Under a combination of the second and third choices, called a modified term plan, the borrower has access to a line of credit for a fixed term.[228]

A HECM reverse mortgage is not without costs. Although the program offers fixed or adjustable rate mortgages,[229] an adjustable rate seems to be the market's preferred structure.[230] This is because there is no secondary market for fixed rate HECMs; Fannie Mae will only buy adjustable rate HECMs.[231] Between 1991 and 1995, Fannie Mae purchased $1 billion worth of adjustable rate, FHA-backed, HECM reverse mortgages.[232] The adjustable interest rate floats 1.6 percentage points above the one-year Treasury bill.[233]

On top of interest charges, HECM-borrowers must pay a mortgage insurance fee of 2% of the loan amount, plus a half percent per year over the life of the loan.[234] They must also pay an $1,800 origination fee,[235] a one-time application fee of $100-$300,[236] a monthly service fee of $25-$30,[237] and typical closing costs such as an appraisal fee, title report, and attorney services. Because the statute authorizes the lender to share in the house's appreciation,[238] borrowers who choose this option will face additional costs when the home is eventually sold. The tax consequences of the transaction will be considered below.

Perhaps the best way to assess the overall costs of a HECM reverse mortgage is to look at the table below:

---

228. *See* 12 U.S.C. § 1715z-20(d)(9) (1994 & West Supp. 1997).
229. *See id.* § 1715z-20(d)(5).
230. *See* Blalock, *supra* note 12, at 42.
231. *See id.*
232. *See* Muolod, *supra* note 1, at 1.
233. *See* Bary, *supra* note 17, at 23.
234. *See* Blundo, *supra* note 9, at 1.
235. *See* Bary, *supra* note 17, at 23.
236. *See* HOUSING COALITION OF MIDDLESEX COUNTY, REVERSE MORTGAGE ELIGIBILITY 1 (1996).
237. *See* Muolod, *supra* note 1, at 1.
238. *See* 12 U.S.C. § 1715z-20 (1995 Interim Update).

**TABLE 1**
**Costs of HECM Reverse Mortgages**[239]

Assumptions:
Age of borrower = 75
Initial home value = Maximum claim amount = $151,725
Interest rate = 9%
Closing costs financed = $3,000
Initial Mortgage Insurance Premium = 2% = $3,035
Servicing fee = $25 per month for 15 years = $4,500
Tenure advances = $543.47 per month for 15 years = $97,824.60
HECM repayment triggered after 15 years by moving to nursing home
Basis = $100,000
Home value at maturity based on 3% compound annual appreciation = $236,383
Principal advanced = tenure advances + closing costs = $100,825
Mortgage Insurance Premiums = 2% initial fee + .005% per year for 15 years = $10,585
Interest = $135,907
Loan balance = Principal + servicing fees + MIP + interest = $251,817
Accrued interest prior to Principal and Interest reaching $100,000 = $35,299
Simple interest on the first $100,000 of the loan balance = $60,000
Total deductible "home equity indebtedness" interest = accrued interest + allowable simple interest = $95,299

| Calculations: | |
|---|---|
| Greater of sales price or loan balance = | $251,817 |
| Expenses related to sale = 7% of sales price = | –16,547 |
| Net proceeds = loan balance – sales expenses = | $235,270 |
| Basis = | –100,000 |
| Gain = net proceeds – basis = | $135,270 |
| One time exclusion = | –125,000 |
| Taxable gain = gain – exclusion = | $ 10,270 |
| Deductible "home equity indebtedness" interest = | –95,299 |
| Net Loss = | $ 85,029 |
| Taxes due on net losses = | $0 |
| Residual equity = | $0 |
| Balance to borrower = | $0 |
| Amount of loan repayment to HECM = home value – sales expenses = | $219,836 |

In a March 15, 1995, report to Congress entitled *Evaluation of the Home Equity Conversion Mortgage Insurance Demonstration*, HUD noted that 300-400 HECM reverse mortgages are closed each month and that approximately 13,000 HECM loans have been closed altogether.[240] There have been 550 loans terminated, of which 37% can be specifically identified as being due to the death of the borrower, 34% due to the borrower moving out of the mortgaged property, and 8% due to a payoff in which the borrower remained in the property.[241] The rea-

239. Assumptions and calculations for hypothetical are taken in part from Wessel, *supra* note 4, at 211-12.
240. *See* H.R. Rep. No. 104-281, at 7 (1995).
241. *See id.*

sons for the termination of the remaining 21% are not known, but HUD suspects that some of these are due to unreported deaths.[242] Most borrowers who leave the home go into a nursing home, but some move into a senior community or into a more manageable apartment when their spouse dies.[243] The median age of HECM-borrowers at the time of loan origination is seventy-six, with most borrowers between seventy-one and eighty-one years old, and 5% over ninety years old.[244]

### C. Transamerica HomeFirst

Whereas HECM loans cater to lower- and middle-income homeowners, Transamerica HomeFirst, a private lender, targets people with more expensive homes by allowing them to tap up to $750,000 of their home equity.[245] Transamerica provides three types of reverse mortgages: (1) a lifetime payment plan; (2) a line of credit; and (3) a four-to-ten-year term plan.[246] All three plans require a minimum home value of $75,000 at the time of loan origination and are available in California, Connecticut, the District of Columbia, Florida, Georgia, Illinois, Maryland, New Jersey, New York, Pennsylvania, Virginia, and Washington.[247] Additionally, the lifetime and line of credit plans are available in Michigan.[248] All three loans are nonrecourse and involve no prepayment penalty.[249] Eligible homes include single-family homes, condos, PUDs, and one-to-four-family homes if one is owner-occupied.[250] Loans are not available for co-ops, commercial property, rented-out second homes, or agricultural property.[251]

The HouseMoney Lifetime Plan offered by Transamerica is a new concept in reverse mortgages in that monthly payments to the borrower continue for as long as she lives, *wherever* she lives.[252] The continuing monthly income is provided first by cash advances from the reverse mortgage, then at a specified age, by a single-premium

---

242. *See id.*
243. *See* Wessel, *supra* note 4, at 211.
244. *See id.*
245. *See* TRANSAMERICA HOMEFIRST, HOUSEMONEY HANDBOOK: A REVERSE MORTGAGE GUIDE FOR PROFESSIONALS 10 (1996).
246. *See id.* at 4.
247. *See id.* at 12.
248. *See id.*
249. *See id.*
250. *See id.*
251. *See id.*
252. *See id.* at 4.

deferred annuity purchased at loan inception.[253] If the borrower moves out of the home before the specified age, there are two options. She can take a reduced monthly amount, much like people who begin Social Security at sixty-two rather than sixty-five, or she can purchase additional annuity coverage to maintain the same income.[254] A portion of each annuity payment received is considered taxable income.[255] The remaining portion of each annuity payment is considered a partial return of the original investment in the annuity and is nontaxable.[256] Monthly advances, before the annuity payments begin, are not taxable.[257]

In addition to monthly payments, a HouseMoney Lifetime borrower can receive an initial lump sum payment, money to repay an existing mortgage or to repair the property, and a credit line.[258] The unused portion of this reserve account grows 5% per year, but cannot be tapped once the annuity payments begin.[259] The minimum draw on the reserve account each time it is tapped is $500.[260] Interest on the reserve account is fixed at 12.5%, but does not begin until the first draw.[261]

Just as Transamerica HomeFirst offers higher monthly payments to borrowers than the HECM program, the costs of a Transamerica Lifetime reverse mortgage are concomitantly high. The origination fee is 1.5% of the loan, but can never be less than $2,000 or more than $7,500.[262] The interest rate on the monthly advances is fixed at 9.5%.[263] Accrued interest, all closing costs, the loan origination fee, and the initial annuity premium can all be financed by the lender and rolled into the loan.[264] The lender also assesses a loan maturity fee equal to 2% of the home's appreciated value at the date of its eventual sale.[265] The loan also provides for "50% appreciation-sharing on the full value of the home at sale."[266] That is to say, upon the sale of the home, the

---

253. *See id.* at 7.
254. *See id.*
255. *See* I.R.C. § 72(a) (1994).
256. *See id.* § 72(b).
257. *See* TRANSAMERICA HOMEFIRST, *supra* note 245, at 10.
258. *See id.*
259. *See id.*
260. *See id.*
261. *See id.*
262. *See id.* In New Jersey there is no minimum origination fee. *Id.*
263. *See id.*
264. *See id.*
265. In Illinois there is no maturity fee. *See id.*
266. *Id.* This does not apply to New York 280A loans. *See id.*

lender receives 50% of the difference between the sales price and the appraised value of the home at the time the loan was originated. For tax purposes, the portion of the home appreciation paid to Transamerica is treated as interest paid by the borrower.[267]

The best way to appreciate the costs associated with a Lifetime reverse mortgage is by studying the following table:

267. *See* Rev. Rul. 83-51, 1983-1 C.B. 48.

**TABLE 2**
**Costs of Lifetime Reverse Mortgages**[268]

Assumptions:
Age of borrower = 75
Initial home value = $200,000
Interest rate = 9.5%
Origination fee = $3,000
Repayment triggered after 7 years by move to nursing home
Basis = $100,000
Home value at maturity based on 3.5% compound annual appreciation = $254,456
Principle advanced = monthly advances + annuity cost + origination fee = $83,350
2% maturity fee = $5,089.12
50% share of home appreciation paid to Transamerica = $27,228
Total interest on loan balance = $46,774
Loan balance = principal + maturity fee + 50% shared appreciation + interest = $162,441.12
Annuity cost = $16,892
Portion of interest on loan balance attributed to annuity = $15,868
Percentage of interest attributable to annuity = $15,868/$46,774 = 33.92%
Shared appreciation attributable to annuity = $27,228 × .3392 = $9,237
Origination fee attributable to annuity = $3,000 × .3382 = $1018
Total deductible "home equity indebtedness interest" = total interest on loan balance + shared appreciation + origination fee − portion of interest on loan balance attributable to annuity − portion of shared appreciation attributable to annuity − portion of origination fee attributable to annuity = $46,774 + $27,228 + $3,000 − $15,868 − $9,237 − $1,018 = $50,879

Calculations:

| | |
|---|---|
| Greater of sales price or loan balance = | $254,456 |
| Expenses related to sale = 7% of sales price = | $-17,811 |
| Net proceeds = loan balance − sales expenses = | $236,645 |
| Basis = | -100,000 |
| Gain = net proceeds − basis = | $136,645 |
| One time exclusion = | -125,000 |
| Taxable gain = gain − exclusion = | $ 11,656 |
| Deductible "home interest indebtedness" interest = | -50,879 |
| Net loss = | $ 39,234 |
| Taxes due on net losses = | $0 |
| Residual equity = | $ 92,014.88 |
| Balance to borrower = residual equity − sales expenses = | $ 74,203.88 |
| Amount of loan repayment to Transamerica = | $162,441.12 |
| Approximate annuity payments borrower will continue to receive each month = | $ 750.00 |

Transamerica's line-of-credit reverse mortgage is called "HouseMoney Cash Account."[269] The interest rate is adjustable and is five percentage points above the one-year Treasury Bill index.[270] The rate is reset annually, but can never be more than ten percentage

268. Assumptions and calculations are based in part on figures contained in TRANSAMERICA HOMEFIRST, *supra* note 245, app. B, at 13.
269. *See id.* at 11.
270. *See id.* at 7.

points above the initial interest rate.[271] The loan origination fee is 2%, but can never be more than $7,500 or less than $2,000.[272] There is also an annual fee of $100.[273] All fees, the accrued interest, and closing costs can be rolled into the loan and financed by the lender.[274] The unused portion of the credit line grows by 5% per year, and advances are not taxable.[275]

Whereas the HouseMoney Lifetime Plan and the HouseMoney Cash Account are both designed for homeowners age sixty-five and older, Transamerica's third plan, the HouseMoney Term, is designed for borrowers age ninety and older.[276] The minimum term for ninety to ninety-four year olds is five years, the minimum term for borrowers ninety-five years old and older is four years, and the maximum term for all borrowers is ten years.[277] Monthly advances stop at the end of the loan term, but the borrower can remain in the home for life.[278] Monthly advances are not taxable.[279] A credit line can be established in addition to the monthly advances.[280] While credit-line draws are subject to a fixed 12.5% interest rate, the interest rate for monthly advances is fixed at 9.5%.[281] The loan origination fee is 1.5%, but can never be more than $7,500 or less than $2,000.[282] A premium fee equal to 1/8 of 1% of the original value of the property is added to the loan balance each month that the loan is outstanding.[283] All fees, accrued interest, and closing costs can be lender financed and added to the loan balance.[284] Finally, there is also a maturity fee equal to 2% of the home's value when the loan becomes due.[285]

With all three Transamerica loans, the borrower can rent living space in the home to an individual or a family as long as she herself

---

271. *See id.*
272. In New Jersey there is no minimum. *See id.*
273. *See id.*
274. *See id.* at 10.
275. *See id.*
276. *See id.* at 12.
277. *See id.*
278. *See id.*
279. *See id.*
280. *See id.*
281. *See id.*
282. There is no minimum in New Jersey. *See id.*
283. *See id.*
284. *See id.*
285. In New York this fee is equal to the actual cost of administering the close-out of the loan, but can never exceed 2% of the home value at maturity. In Illinois there is no maturity fee. *See id.*

continues to reside in the home.[286] The loan becomes due whenever the homeowner dies, sells the house, ceases to use the home as a principal residence, or whenever it is medically determined that the borrower cannot return to the home.[287] Under all three plans, the borrower can pledge just a portion of her home equity and retain a percentage of the home's eventual sale price for her own needs or for those of her heirs.[288] The average Transamerica borrower is a seventy-six-year-old woman with a home valued at $200,000.[289] Although for competitive reasons Transamerica will not reveal how many reverse mortgages it has closed,[290] the company is thought to have written between 200 and 300 reverse mortgages.[291]

### D. Ever Yours

Already the nation's most widely available private reverse mortgage program, Household Senior Services' Ever Yours credit line is expanding its geographic reach. Within the last year and a half, Ever Yours became available in Indiana, Missouri, Nevada, Washington, Connecticut, Delaware, Massachusetts, North Carolina, and Oregon. Household had already offered the program in Arizona, California, Colorado, Florida, Georgia, Illinois, Kentucky, Maryland, Michigan, Pennsylvania, New Jersey, New York, Ohio, and Virginia.[292] Ever Yours is available currently in twenty-four states.[293] The program's rapid expansion from a base of seven states when it was launched in 1994 reflects the utility and consumer appeal of Household's simpler approach.[294]

R. Lawrence Johnson, Managing Director of Household Senior Services, stated that before Household designed its program, it researched the cause for its modest activity despite its large potential.[295] The company concluded that those retirees most likely to take out reverse mortgages wanted to control the timing of their borrowing

286. *See id.* at 7.
287. *See id.*
288. *S*[illegible] ry, *supra* note 17, at 23.
289. *See* Telephone Interview with Kimberly North, Transamerica HomeFirst (Feb. 16, 1996).
290. *See id.*
291. *See* Bary, *supra* note 17, at 27.
292. *See 'Ever Yours,' a Mortgage Program for Seniors, Expands*, DES MOINES REG., Dec. 29, 1995, at 18 [hereinafter *'Ever Yours'*].
293. *See* Telephone Interview with Household Senior Services (Apr. 9, 1997).
294. *See* Bary, *supra* note 17, at 25.
295. *See id.* at 27.

and did not need regular monthly payments.[296] Seniors viewed the HECM reverse mortgage "as a way to get a monthly stipend but with someone else taking control of their home," Johnson adds. "One of the goals here [with Household Senior Services] is to overcome the fear that the entire house is being mortgaged away."[297]

Household's solution was to tout the "Ever Yours" credit line as an equity program instead of a reverse mortgage.[298] Indeed, Household's initial marketing materials did not even mention the term reverse mortgage.[299] While people were either fuzzy about what a reverse mortgage is or had a negative view of it, they tended to understand and accept the concept of an equity line, Johnson explains.[300] Household also wanted a program that would be easy to understand.[301] Johnson cited too much complexity as the reason people lose interest.[302]

Household's Ever Yours credit line is a nonrecourse reverse mortgage with an adjustable interest rate that is three percentage points above the prime rate and is reset monthly.[303] After completing the speedy and simple application process,[304] borrowers are given a checkbook. Anytime they want money, they simply write a check for any amount they want above $100.[305] Unlike the HECM and Transamerica HomeFirst credit lines which have growth factors built into their maximum, the Household program's maximum credit limit is set at $250,000 for the life of the loan.[306] This distinction can be crucial for borrowers who live for long periods and need the cash resource.[307] Consider the case of a seventy-five-year-old borrower who has a $250,000 home and who draws down half of her initial maximum credit line at loan closing. After two years, she would have $46,500 of

296. *See id.*

297. Bradley Inman, *Reverse Annuity Mortgages Get Boost*, FRESNO BEE, July 3, 1994, at E1.

298. *See id.*

299. *See id.*

300. *See id.*

301. *See* Bary, *supra* note 17, at 27.

302. *See id.*

303. *See* Nanette Byrnes, *Mortgage the House—No Payments Required*, BUS. WK., July 24, 1995, at 91.

304. *See 'Ever Yours,' supra* note 292, at 18.

305. *See* Videotape: Luminaire/Ever Yours (Household International 1995) (on file with Household International) [hereinafter Videotape].

306. *See* Kenneth Harney, *'Reverse' Mortgages Need Careful Scrutiny*, PATRIOT LEDGER (Quincy, Mass.), Mar. 15, 1996, at 3R.

307. *See id.*

untapped credit left under the HECM program, $35,600 under Household's, and $40,000 under Transamerica's.[308] Seven years after closing, the borrower would still have only $35,600 available under her Household loan, but would have seen her HECM and Transamerica lines grow to $68,800 and $50,500, respectively.[309] By the twelfth year after closing, the Household borrower would still have only $35,600 available, while a similarly situated borrower would have $101,900 available under HECM and $61,400 available under Transamerica's program.[310] The differences become even more accentuated with the passage of time. After twenty-two years the HECM borrower would have her available credit soar to $223,500, 600% more than the Household borrower in the same circumstances.[311]

Although a borrower need only be sixty-two years old to apply for a Household reverse mortgage credit line, the typical borrower is a seventy-five-year-old widow with property valued at $150,000 and a credit limit of $45,000.[312] She accesses 50% of the available credit in the first year and bundles the 2% origination fee and the closing costs into the loan.[313] She uses the money for immediate bill paying, home repairs and remodeling, and intermittent medical expenses.[314] The Household promotional video also suggests that seniors use the money to help take care of their even more elderly parents, go on vacation, or buy themselves luxury items.[315]

The Household Ever Yours reverse mortgage must be repaid immediately if any of the following maturity events occurs: (1) the senior sells or transfers an interest in the home securing the loan; (2) a lien is created against the house that jeopardizes Household's security interest; (3) the senior fails to maintain the home, keep up with home insurance payments, pay property taxes, or live in the home most of the year; (4) the last joint-borrower dies; or (5) there is fraud or misrepresentation by the borrower at the time of loan origination.[316] Unlike the Transamerica plan, the Household program does not have a

308. *See id.*
309. *See id.*
310. *See id.*
311. *See id.*
312. *See* Telephone Interview with Jeff Hauptman, Household International (Feb. 21, 1996).
313. *See id.*
314. *See* Videotape, *supra* note 305; *see also* Michael Brush, *Cash in on Your House Without Leaving Home*, MONEY MAG., Feb. 1, 1996, at 32.
315. *See* Videotape, *supra* note 305.
316. *See id.*

maturity fee or require that the lender get a share of the home's appreciated value at the time of sale.[317]

## E. Fannie Mae

On January 29, 1996, the Federal National Mortgage Association (Fannie Mae) placed its imprimatur on reverse mortgages by launching its own reverse mortgage program, the "Home Keeper" mortgage.[318] The program operates as follows: a lender extends a Home Keeper mortgage to a borrower; the lender then sells the loan to Fannie Mae; Fannie Mae issues checks to the loan's servicer that reflect the payment stream to the borrower; the servicer then issues its own series of checks to the borrower.[319] In an attempt to build volume, Fannie will hold the loans in its own portfolio.[320] However, Fannie's ultimate plan is to pool the loans for sale in the tertiary market in order to encourage lenders.[321] This securitization is likely to occur in five to ten years.[322] To protect itself in the meantime, Fannie is currently working with an unnamed reinsurance company that will cover Fannie's losses when reverse mortgage payments to the borrower are greater than the property's value.[323] Fannie will also be allowed to alter its accounting methods so that it can book income on reverse mortgages immediately even though, technically, it is paying money out and will not take any in until the homes securing the reverse mortgages are sold.[324]

Fannie Mae's purchase of reverse mortgages from lenders is expected to expand greatly the dollars available for such loans and to make them more widely accessible by bringing large banks nationwide into the business. Fannie Mae Vice Chairman Franklin Raines says the company will buy as many reverse mortgages as possible.[325] If initial interest is any indication, business will not be hard to come by. Since January 1996, more than 80,000 consumers have called public information lines at Fannie Mae to inquire about the Home

317. *See* Bary, *supra* note 17, at 23.
318. *See* Neil Downing, *Reverse Mortgage Program Coming*, PROVIDENCE SUNDAY J., Jan. 28, 1996, at F3.
319. *See Servicing 'Home Keeper'*, *supra* note 93, at 1.
320. *See* Talley, *supra* note 130, at 12.
321. *See id.*
322. *See Servicing 'Home Keeper'*, *supra* note 93, at 1.
323. *See id.*
324. *See* Muolod, *supra* note 1, at 1.
325. *See id.*

Keeper.[326] Similarly, about 250 lenders nationwide have already expressed interest in offering Home Keepers, according to Robert Sahadi, Fannie Mae's Vice President for Housing Initiatives.[327] Eventually, many of the nation's 2,000 Fannie Mae-approved lenders can be expected to offer the Home Keeper.[328]

Lenders will have to send their loan officers to classes that Fannie is sponsoring on the mechanics of making and servicing reverse mortgages.[329] Although classes have begun in each of Fannie's regions, the program is oversubscribed, and there is a substantial waiting list.[330] The number of reverse mortgages closed each year is expected to increase not only because there will be an increased number of lenders, but also because there will be an increased variety of lenders. When the familiar bank in town, the savings and loan down the street, and the credit union at work begin offering reverse mortgages, elderly homeowners will be more comfortable with the concept of reverse mortgages and more confident taking one out.[331]

The Home Keeper reverse mortgage has an adjustable rate which is tied to the one-month certificate of deposit index that the Federal Reserve publishes weekly.[332] Fannie Mae resets the loan's interest rate monthly and there is no limit to the amount the rate can change at each monthly adjustment.[333] Over the life of the loan, however, the rate cannot change more than twelve percentage points.[334] Of course, a change in the adjustable interest rate has no effect on the monetary amount or the number of payments the borrower receives.[335] The changes in the interest rate merely cause the loan balance to grow at a faster or slower rate.

Besides principal and interest, other costs associated with the loan include an up-front fee of 1% of the home's appraised value at loan origination, an origination fee of as much as 2% of the home's

---

326. *See* Talley, *supra* note 130, at 12.
327. *See* Downing, *supra* note 318, at F3.
328. *See* Bill Rumbler, *Lenders Prepare for Big Shift to Reverse Mortgages*, CHI. SUN-TIMES, Dec. 3, 1995, at NC.
329. *See* Talley, *supra* note 130, at 12.
330. *See Wendover Gets 1st FNMA Commitment*, NAT'L MORTGAGE NEWS, Jan. 15, 1996, at 3.
331. *See* Pamela Reeves, *Reverse Mortgages to Move Forward in '96*, SAN DIEGO UNION-TRIB., Dec. 10, 1995, at H3.
332. *Home Keeper: It Pays to Keep You in Your Home*, FANNIE MAE, Oct. 1995, *available in* 1995 WL HI047C [hereinafter *Home Keeper*].
333. *See id.*
334. *See id.*
335. *See id.*

appraised value, closing costs, and a servicing fee of $30 per month.[336] Borrowers do not have to pay these expenses out-of-pocket, but rather can finance them through the loan.[337]

The borrower can select from among several payment options. Under the tenure option, the borrower receives equal monthly payments. In a line of credit plan, at times and in amounts of her own choosing, the borrower draws upon the available loan proceeds. Unlike the HECM or the Transamerica credit line, the Home Keeper credit line does not have a built-in growth factor. The credit limit thus remains the same for the life of the loan. The modified tenure plan allows the borrower to set aside a portion of the loan proceeds as a line of credit and receive the rest in the form of equal monthly payments. To increase the amount of loan proceeds available and thus receive higher cash payments through the life of the loan, a borrower can combine any of the above methods with an equity share option. The Equity Share, equal to 10% of the value of the property at the time of loan maturity, is paid in addition to the loan balance when the loan is paid off. The Equity Share will not be charged to the borrower, despite any increased monthly advances or cash draws it may result in, if the loan is paid off in the first twenty-four months after loan origination. The Equity Share may not be available from all lenders.[338]

Financial advisers warn that before agreeing to an Equity Share, borrowers should weigh seriously whether the additional money is really worth the potential cost.[339] Gary Schatsky, a New York financial analyst, notes that a seventy-five-year-old widow who takes out a Home Keeper loan on a $150,000 home would be able to get a total of $72,369 by agreeing to an equity share and $53,635 without the equity sharing.[340] Schatsky cautions that for that extra $18,734, which the borrower might not live long enough to spend, the borrower is locked into paying the lender at a minimum an additional $15,000.[341]

Advisers also suggest that potential borrowers ask how much home equity they will have left under the various payment scenarios.[342] Fannie Mae will have software to assist borrowers, assures

336. *See id.* at 9.
337. *See id.*
338. *See id.* at 8.
339. *See* Deborah Lohse, *Seniors Can Tap Into Equity, But Reverse Mortgages Can End Up Costly*, CINCINNATI ENQUIRER, Dec. 3, 1995, at F5.
340. *See id.*
341. *See id.*
342. *See id.*

Robert Sahadi, Fannie's Vice President for Housing Initiatives.[343] The software will allow consumers to pick any scenario, for example, what happens when they are in the home five or ten years and get monthly payments or a line of credit. Dahadi explains, "We'll go through the loan calculation and [see] how much will be left in the property."[344] Borrowers also will be permitted to change payment plans at any time over the life of the loan, provided they pay a nominal fee.[345]

To be eligible for a Home Keeper reverse mortgage, a borrower must be at least sixty-two years old and either own the home free and clear or have a very low outstanding mortgage balance that can be paid off with initial loan proceeds.[346] The home must be a single-family home; condos and cooperatives are not currently eligible.[347] Applicants must attend a financial counseling session on reverse mortgages.[348] The session must follow Fannie's curriculum[349] and will probably be supplied by the lenders free of charge.[350] Fannie Mae's promotional brochure strongly encourages family members to attend these sessions.[351] Although the lack of independent counseling is potentially worrisome, it must be remembered that lenders offering the Home Keeper must comply with the new federal disclosure requirements. The chance for consumer fraud or improvident decision making is thereby diminished. Moreover, the on-site counselors armed with Fannie-supplied software can help to streamline the ofttimes lengthy reverse mortgage application process.[352]

The maximum amount a Home Keeper borrower can access is based on three factors: the number of borrowers, the ages of those borrowers, and the adjusted property value.[353] The adjusted property value is the lesser of the appraised value of the home or the current Fannie Mae loan limit of $207,000.[354] Lloyd Daniels, President of the Senior Loan Center, a California company that offers the Home Keeper, thinks Fannie Mae might raise the loan ceiling to $250,000 or

---

343. *See id.*
344. *Id.*
345. *See Home Keeper*, *supra* note 332, at 2.
346. *See id.* at 4.
347. *See id.*
348. *See id.*
349. *See Servicing 'Home Keeper'*, *supra* note 93, at 2.
350. *See* Reeves, *supra* note 331, at H3.
351. *See Home Keeper*, *supra* note 332, at 4.
352. *See* Smith, *supra* note 106, at 77.
353. *See Home Keeper*, *supra* note 332, at 5.
354. *See id.*

$275,000 because the Federal Home Mortgage Corporation (Freddie Mac) has announced mortgage programs for values in that range.[355] Moreover, finding some of the life expectancies the HECM program relies on inaccurate, Fannie Mae plans to firm up some of the actuarial assumptions.[356] Doing so could boost the monthly payout to borrowers by 10-20%, according to Robert Sahadi, a vice president at Fannie Mae.[357]

Borrowers are obligated to maintain the property, pay property taxes, and have fire and hazard insurance.[358] Failure to do so could trigger loan repayment. Other maturity events include the borrower's death, and the borrower's sale of the home or transfer of the title.[359] Fannie allows borrowers who need medical or nursing home care to be away from their mortgaged home for one year.[360] After these twelve months, the loan becomes due.[361] The loan is nonrecourse, and even borrowers who opt for the Equity Share never owe more than the sales price of the property.[362] Home Keeper reverse mortgages are available in every state except Texas, where conflicting state legislation is preventing implementation.[363]

### F. Freddie Mac

According to Jay Siegel, a Senior Analyst in the Structured Finance Department of Moody's Investor's Service, Freddie Mac is considering a reverse mortgage of its own.[364] One reason Freddie Mac is hesitating from implementing its program, explains Mike Hyman, Vice President of Wendover Funding, the largest subservicer of reverse mortgages, is that the government-backed corporation cannot hold its own portfolio and thus needs to be able to immediately secure the loans into the tertiary market.[365] When it does enter the field,

---

355. *See* Wanda Coyle, *Reverse Mortgage into Cash*, FRESNO BEE, Dec. 18, 1995, at C1.
356. *See* Smith, *supra* note 106, at 77.
357. *See id.*
358. *See* Jeanne Eck Mahoney, *Reverse Mortgages Can Help Elderly Help Houses*, WASH. TIMES, Dec. 15, 1995, at F1.
359. *See Home Keeper*, *supra* note 332, at 12.
360. *See Servicing 'Home Keeper'*, *supra* note 93, at 3.
361. *See id.*
362. *See Home Keeper*, *supra* note 332, at 11.
363. *See* Letter from Bonnie O'Dell, Director of Consumer Affairs at Fannie Mae, to Jean Reilly (Feb. 21, 1996) (on file with author).
364. *See* Telephone Interview with Jay Siegel, Senior Analyst in the Structured Finance Department of Moody's Investors Service (Mar. 3, 1996).
365. *See* Telephone Interview with Michael Hyman, Vice President of Wendover Funding (Feb. 21, 1996).

Freddie Mac, like Fannie Mae, will be able to treat the reverse mortgage as a loan secured by property and thus will be able to immediately book as income the money it will eventually receive from the sale of the home securing the mortgage.[366] Freddie Mac's reverse mortgage is expected to have an elective, shared-appreciation feature and to be available in the near future.[367]

## III. Reverse Mortgages

When considering a reverse mortgage, the borrower should be fully aware of the complex tax implications of this instrument and its effect on eligibility for benefits. This is especially so if the borrower is considering a charitable or an intrafamily reverse mortgage.

### A. Taxes: Considerations and Complexities

Borrowers considering reverse mortgages must be cognizant of the tax consequences. Initial lump sum payments, credit line draws, and monthly advances are not taxed as income because they are considered loan proceeds.[368] Moreover, even though part of the amount borrowed may reflect appreciation in the home's value, it is not taxable.[369] Because this amount will have to be repaid eventually, the homeowner is treated for tax purposes as not having realized any portion of that gain.[370]

The interest portion of a reverse mortgage presents a complex tax issue. Two basic premises must be borne in mind: the portion of shared appreciation paid to the lender is treated as interest paid,[371] and there is no deduction until the interest is actually paid.[372] Because reverse mortgages provide that interest will be added to the outstanding loan balance monthly as it accrues, the borrower is not actually paying the interest as it is added.[373] Thus, reverse mortgage borrowers have no interest deduction until the entire loan is repaid after sale

366. *See* Telephone Interview with Jay Siegel, *supra* note 364.
367. *See id.*
368. *See* Rev. Rul. 80-248, 1980-2 C.B. 164.
369. *See* Gail Levin Richmond, *Taxes and the Elderly: An Introduction*, 19 NOVA L. REV. 587, 617 n.121 (1995).
370. *See id.*
371. *See* Rev. Rul. 83-51, 1983-1 C.B. 48.
372. *See* Rev. Rul. 80-248, 1980-2 C.B. 165.
373. *See id.*; *see also* Richard Kaplan, *Personal Financial Planning: Tapping the Equity of Older Homeowners with Reverse Mortgages*, J. ACCT. 36 (1993).

of the house.[374] If the house is not sold until after the borrower's death, the interest deduction may not be used.[375]

Conversely, section 1.451(a) of the Income Tax Regulations provides that income is includable in the lender's gross income for the taxable year in which it is actually or constructively received.[376] Because interest on a reverse mortgage is added to the outstanding loan balance as it accrues monthly, it is not available to be drawn upon by the lender, and thus the lender is not in actual or constructive receipt of it.[377] The lender only receives this income when the borrower repays the loan balance or transfers the property to the lender in lieu of repayment.[378] In short, interest is neither includable in the lender's gross income nor deductible by the borrower until the outstanding loan balance is repaid.[379]

Once it is eventually paid, interest is then treated for tax purposes in four ways. First, investment interest is not deductible by the borrower. Investment interest is the amount of interest attributable to the loan proceeds used to acquire an annuity.[380] Second, interest on the first $100,000 of the loan balance qualifies for a home equity indebtedness deduction; interest on equity indebtedness in excess of $100,000 is not deductible.[381] Because many reverse mortgages exceed this statutory threshold, many seniors end up paying nondeductible interest on part of their loan. Third, acquisition indebtedness is interest that may be allocated to the portion of the loan proceeds used to pay off former debt or to substantially improve (as opposed to repair) the home.[382] This interest is deductible until loan proceeds exceed $1 million.[383] Fourth, any remaining interest is personal interest which is not deductible for any purpose, even when paid.[384]

A major income tax issue involves the one-time $125,000 exclusion of gain available to homeowners fifty-five or older who sell their

---

374. *See* Rev. Ruling 80-248, 1980-2 C.B. 164; *see also* Kaplan, *supra* note 373, at 36.

375. *See* Philip Wiesner, *Sale-Leaseback May Offer More Benefits Than Reverse Mortgage*, 6-92 TAX ADVISOR 360 (1992).

376. *See* Rev. Rul. 80-248, 1980-2 C.B. 164.

377. *See id.*

378. *See id.*

379. *See id.*

380. *See* TRANSAMERICA HOMEFIRST, *supra* note 245, at 14.

381. *See* I.R.C. § 163(h)(3)(C) (1996).

382. *See id.* § 163(h)(3)(B).

383. *See* Wessel, *supra* note 4, at 214.

384. *See* I.R.C. § 163(h)(1)-(2).

principal residence.[385] Because a reverse mortgage does not affect a taxpayer's basis in his home, the subsequent sale of the home normally will generate the same recognized gain an unencumbered home would produce.[386] Nevertheless, the duration of a reverse mortgage may negatively affect complete utilization of the $125,000 exclusion.[387] For example, suppose an elderly borrower obtained a fixed-term reverse mortgage on her $100,000 home, and that at the end of the term she owes $80,000.[388] To repay the loan, she sells the home for $120,000, thus triggering gain recognition. Her realized gain is the sales proceeds ($120,000) minus a 6% sales commission ($7,200), minus her basis (let us assume it is $35,000). Thus, she realizes a gain of $77,800. However, she only receives $32,800 in actual cash, because she must repay the loan ($80,000) and pay the sales commission ($7,200). If she has not put aside money to pay the minimum 28% gains tax, she will walk away from the sale of her home with a maximum of $11,016 in cash. Of course, she may be able to shelter this gain via the tax exclusion, but $47,200 of the potential exclusion is lost forever ($125,000 - $77,800). The reverse mortgage, in other words, may compel use of the tax exclusion before she would otherwise have elected it and before it could be maximally utilized.[389]

A tenure reverse mortgage results in similarly unfavorable tax consequences if it becomes medically or pragmatically necessary for the borrower to depart from the home before death.[390] For homeowners with less than $125,000 of potential gain, a forced predeath disposition to repay the loan might waste some of the exclusion otherwise available.[391] For homeowners with more than $125,000 of potential gain or those not eligible for the one-time exclusion (due perhaps to a prior election or that of a spouse), such a disposition triggers recognition of gain that otherwise would be sheltered by the step-up-in-basis rule at death.[392] In either situation, "tax considerations represent a

385. *See id.* § 121(a)-(b).
386. *See* Kaplan, *supra* note 373, at 36. The one exception to this rule is when the loan balance exceeds the sales price. In this situation, it is the loan balance, and not the appreciated sales price, which forms the basis of capital gains measurement. *See* Wessel, *supra* note 4, at 211.
387. *See* Kaplan, *supra* note 373, at 36.
388. The following hypothetical is based in part on Kaplan, *supra* note 373, at 36.
389. *See id.*
390. *See id.*
391. *See id.*
392. *See id.*

major downside risk of reverse mortgages. These mortgages remove from homeowners' control the critical ability to time disposition of their appreciated residences.'"[393]

If the borrower's death precedes sale of the home, the step-up-in-basis rule will shelter the entire gain from income tax.[394] However, for federal estate tax purposes, the home's full value must be included in the decedent's estate.[395] Any principal of the reverse mortgage payable to the lender is deductible for estate tax purposes.[396] The deductible amount can include any shared appreciation that must be paid to the lender.[397] The interest on the reverse mortgage is deductible as expenses in respect of a decedent.[398] Taxwise, the borrower's death in the home is the best of all possible worlds in that the borrower gets liquidity during her lifetime, no taxable gain on disposition after death, and favorable estate tax deductions.[399]

Finally, there are some state tax issues potential reverse mortgage borrowers might want to consider before taking out the loan. Some states have been slow to redefine income for real property tax-exemption purposes to exclude money received from a reverse mortgage. Thus, it was not until April 26, 1995, that New York finally passed such a law.[400] Prior to then, New York seniors with reverse mortgages often found their loan advances offset by loss of a property tax exemption.

Similarly, state mortgage taxes present a muddy issue. States have taken different stances with regard to whether such a tax is applicable to reverse mortgages. Because a mortgage tax usually applies to unrecorded as well as recorded mortgages, and a failure to pay the tax renders the instrument and the debt secured thereby unenforceable,[401] it is imperative for both borrowers and lenders to know how their state treats reverse mortgages for mortgage tax purposes. For example, North Carolina requires the borrower to pay a $500 fee when the reverse mortgage is originated and $100 annually thereafter.[402] Conversely, New York reformed its tax law so that borrowers who

393. *Id.*
394. *See* I.R.C. § 1014(a) (1996).
395. *See id.* § 2031.
396. *See id.* § 2053.
397. *See* Priv. Ltr. Rul. 90-26-041 (June 29, 1990).
398. *See* I.R.C. § 691(b)(1).
399. *See* Kaplan, *supra* note 373, at 36.
400. *See* N.Y. REAL PROP. LAW § 281 (McKinney 1995).
401. *See* Thomas Glatthaar, *Mortgage Tax Rules*, 213 N.Y.L.J. 5, 5 (1995).
402. *See* Hubbard, *supra* note 90, at 187.

record their reverse mortgage may claim an exemption from mortgage tax by submitting an affidavit signed by the lender.[403] The affidavit must certify that the borrower is at least sixty, the reverse mortgage is on a one-to-four-family home or condominium unit that is the borrower's principal residence, and that the reverse mortgage conforms to section 280 of the New York State Real Property Law.[404]

### B. Public Benefits

Lump sum payments, monthly advances, and credit-line draws under a reverse mortgage do not affect Social Security or Medicare benefits because these programs do not have means tests.[405] Similarly, because a Social Security Administration Program Circular has made clear that the proceeds from a reverse mortgage are to be considered a loan and not income,[406] seniors do not have to worry about the income limitations of the Supplemental Security Income (SSI) program. Seniors with reverse mortgages, however, may run afoul of SSI's resource limitations. If proceeds from a reverse mortgage are held beyond the month of receipt, they will be counted as a resource.[407] Therefore, it is advisable for reverse mortgage borrowers to draw on their credit line or receive their monthly advances early in the month.[408] So too, if a borrower opts to receive a lump sum payment for travel or home repair, she should schedule it to arrive in the same month in which it will be spent.[409] Seniors also should be aware that any annuity payments received under a reverse mortgage are considered unearned income for purposes of SSI and Medicaid.[410]

Reverse mortgages may also affect seniors' ability to qualify or to remain eligible for state administered programs such as Medicaid, Aid to Families with Dependent Children (AFDC), food stamps, and state supplements to SSI.[411] Thus, the January 27, 1996, *San Diego Union-Tribune* warns seniors to "weigh whether the additional money [from a reverse mortgage] is worth losing their free medical aid

---

403. N.Y. TAX LAW § 642.5(b)(1) (McKinney 1995).
404. *See id.*
405. *See* JOHN J. REGAN, TAX, ESTATE & FINANCIAL PLANNING FOR THE ELDERLY 12-19 (1995).
406. *Id.* at 12-19 n.1.
407. *See id.* at 12-19.
408. *See id.*
409. *See id.*
410. *See id.*
411. *See Home Keeper*, *supra* note 332, at 13.

through Medi-Cal[ifornia].'"[412] So too, in a 1995 case, the Superior Court of Connecticut affirmed the state's denial of Irenee Bergeron's application for Medical Assistance to the Aged, Blind, and Disabled.[413] The court, in determining that Bergeron was not eligible for benefits because he transferred assets during a thirty-month look-back period, cited as an example the fact that the equity in plaintiff's home was depleted due to a reverse mortgage.[414]

On the other hand, some states specifically exempt reverse mortgage proceeds from the income and resource limitations of public assistance programs. For example, Massachusetts has passed legislation stating that for purposes of AFDC, reverse mortgage proceeds are never to be countable in either the test of financial eligibility or the calculation of the grant amount.[415] In New York, where the law on the subject is particularly expansive, the proceeds of a reverse mortgage are

> not [to] be considered as income or resources of the Mortgagor for any purpose under any law relating to food stamps, public assistance, veteran assistance, home relief, low-income energy assistance, federal supplemental security income benefits and/or additional state payments, medical assistance, any prescription drug plan, or other payments, allowances, benefits, or services available.[416]

Rather more curtly, the Minnesota Administrative Code simply exempts reverse mortgage proceeds from the income limitations of all state assistance payments programs.[417] Finally, Ohio makes explicit the fact that reverse mortgage proceeds spent in the month received are not considered income or resources for purposes of Medicaid eligibility.[418] Because state laws regarding the effect of reverse mortgages on public benefits are so divergent, borrowers considering this type of loan should consult the benefits specialist at their local Area Agency on Aging.

412. Denise Nelesen, *Reverse Mortgage Can Be Valuable Option*, SAN DIEGO UNION-TRIB., Jan. 27, 1996, at E2.

413. *See* Proulx v. Giardi, No. CV 94-04641655, 1995 WL 322423, at *1 (Conn. Super. Ct. May 9, 1995).

414. *See id.* at *3-4.

415. *See* MASS. REGS. CODE tit. 106, § 304.250(mm) (1995).

416. N.Y. SOC. SERV. LAW § 131-X (McKinney 1993).

417. *See* MINN. R. 9500.4080 (1995).

418. *See* OHIO ADMIN. CODE § 5101:1-39-273(5) (1992).

### C. Charity Begins with the Home

A charitable reverse mortgage is an arrangement in which a taxpayer transfers a remainder interest in property to a charitable organization in exchange for the charity's promise to pay an annuity. The property in question need not be the taxpayer's principal residence; it may be a vacation home or similar temporary residence.[419] A cooperative apartment or condominium unit also qualifies.[420]

The amount of the annuity payments is based on actuarial tables and annuity rates established by the Committee on Gift Annuities in Dallas, Texas. The Committee publishes the rates to deter charities from competing with each other and to ensure that at least 50% of the value of the property used to fund the annuity will pass to the charity at the homeowner's death. The annuity payment period may begin immediately or it may be deferred. Because annuity payments are calculated on the basis of the time value of money, deferred annuity payments are larger than annuities which begin immediately.[421]

The homeowner is entitled to take a charitable deduction for the difference between the fair market value (FMV) of the remainder interest and the FMV of the annuity at the time of the transfer.[422] I.R.C. section 7520 rates and IRS tables determine the annuity's FMV.[423] The appropriate rate is the rate in effect for the month in which the transfer occurs or the rate for either of the two preceding months.[424] The homeowner may take the full deduction in the year of the transfer as long as it does not constitute more than 30% of her adjusted gross income.[425] To the extent the deduction exceeds this percentage, she may elect to carry over the excess and claim it in any of the next five years.[426]

The income tax consequences of the annuity payments are governed by the rules for private annuities in I.R.C. section 72 and the accompanying regulations. Under these rules, each annuity payment is treated partially as a tax-free return of basis, partially as a capital gain, and partially as ordinary income. Once the homeowner has re-

419. *See* Treas. Reg. § 1.170A-7(b)(3) (1997).
420. *See id.*
421. *See* Philip Wiesner, *Charitable Gift Annuities as a Planning Technique*, 6-93 TAX ADVISOR 361, 361 (1993).
422. *See id.*
423. *See id.*
424. *See* I.R.C. § 7520 (1996).
425. *See* Jerry J. McCoy, *Charitable Giving Without Trusts*, 19 TAX MGMT. EST., GIFTS & TRUSTS J. 155, 156 n.27 (1994).
426. *See id.*

covered her basis, subsequent annuity payments are treated as ordinary income.[427]

In most cases, the property involved in a charitable reverse mortgage is appreciated property that would generate taxable gain if sold outright. However, under a charitable reverse mortgage, any taxable gain can be deferred over the annuity period.[428] When computing capital gain, the homeowner must allocate her basis between herself and the donee.[429]

Jerry McCoy, a Washington, D.C., estate attorney, advises homeowners contemplating a charitable reverse mortgage to make sure that the agreement specifies what happens if the property is destroyed or the homeowner can no longer maintain it because she must move to a nursing home or hospital.[430] Similarly, it is necessary to specify which party will pay taxes, insurance, and carrying costs and to make sure the agreement does not violate any local laws regulating the issuance of annuities.[431] Finally, because the transferred remainder interest is not immediately available to finance the annuity, the homeowner should make sure that the charity has sufficient general funds to cover the cost of the annuity.[432]

Although the United Jewish Appeal of Greater New York (UJA) has not actually completed any charitable reverse mortgages, it has several in the works.[433] Ed Pitaro, a lawyer with UJA, stresses that homeowners entering into a charitable reverse mortgage must be "driven by charitable intent because this type of transaction isn't going to provide enough income to drive a person to do it."[434] The typical homeowner interested in a charitable reverse mortgage, he adds, has no heirs, a half a million dollar home, and wants $25,000 or so a year just to cover taxes.[435]

---

427. *See id.*

428. *See* Wiesner, *supra* note 421, at 361.

429. *See* McCoy, *supra* note 425, at 159.

430. *See id.* at 161.

431. *See id.*

432. *See id.*

433. *See* Telephone Interview with Ed Pitaro, Attorney with the United Jewish Appeal of Greater New York (Feb. 21, 1996).

434. *Id.*

435. *See id.*

### D. All in the Family

Although it is perfectly legal to enter into a reverse mortgage with a family member,[436] state law produces a number of barriers around which both borrowers and lenders must maneuver. For example, children who want to offer a credit line reverse mortgage to their parents must be wary of conflicting state law regarding the lien priority of these advances. Some states have enacted statutes which specifically address the issue. Thus, in 1993, New York's Real Property Law was amended to provide that previously recorded credit line reverse mortgages have priority over other liens regardless of whether or not the credit line draws are obligatory or discretionary with the borrower or lender.[437] Conversely, the applicable Rhode Island statute provides that any optional or nonobligatory advances which are made by the reverse mortgage lender after receipt of written notice at the address provided for such purpose in the mortgage deed lose their priority to subsequently recorded liens.[438] An obligatory advance is defined as any advance of principal which the mortgagee is obligated to make on or before a specified date or upon application of the borrower.[439] Illinois, taking a slightly different track, grants lien priority to both obligatory and optional credit-line advances, but only up to a maximum principal amount which must be specified in the mortgage.[440] The majority of jurisdictions have not enacted any statutes addressing the matter, but rather follow the common law rule which provides lien priority for obligatory advances of credit, but not for optional ones.[441]

Because a mortgage tax applies even to unrecorded instruments and failure to pay the tax renders the instruments and the debt secured thereby unenforceable,[442] intrafamily reverse mortgage lenders must be sure to wind through the labyrinth of conflicting state laws on the subject. Thus, for example, although New York exempts reverse mortgages from recordation taxes, the lender must claim the exemption by submitting an affidavit signed by the borrower.[443] Minnesota, on the other hand, imposes a tax of twenty-three cents per $100 of

436. *See* Telephone Interview with Ken Scholen, Director of the National Center for Home Equity Conversion (Feb. 5, 1996).
437. *See* N.Y. REAL PROP. LAW § 281(1)(b) (McKinney 1995).
438. *See* R.I. GEN. LAWS § 34-25.1 to .3 (1995).
439. *See id.*
440. *See* 205 ILL. COMP. STAT. ANN. § 105/1-6(b) (West 1994).
441. *See* Hammond, *supra* note 4, at 78.
442. *See* Glatthaar, *supra* note 401, at 5.
443. *See* N.Y. TAX LAW § 642.5(b)(1) (McKinney 1995).

expected total disbursements made under a reverse mortgage.[444] The expected total disbursement is calculated by multiplying the periodic payment amount by the life expectancy in months of the borrower.[445] Interest accruing on the disbursements is not counted.[446] Other states impose a mortgage tax, but make no special provisions for reverse mortgages. Thus, for example, Kansas requires that a registration fee of .26% of the principal debt be paid before any mortgage of real property is recorded.[447] Given the very nature of a reverse mortgage, however, the amount of principal that will ultimately be dispersed is unknown at the time of loan origination. Kansas provides no help regarding how the principal debt is to be calculated for reverse mortgages. Presumably, the family-lender would have to pay tax on all the money that could theoretically be advanced to the parent given the parent's age and the value of the home.[448] In the absence of explicit legislation, the family-lender must gamble that he has paid the appropriate mortgage tax.

Family-lenders must also be aware of the interest rate allowable in their state. Thus, for example, although Indiana permits adjustable rates for forward mortgages, it requires that interest rates for reverse mortgages be fixed at the time the loan is made.[449] Family-lenders in this state may find themselves locked into a bad investment for decades. California permits reverse mortgage interest rates to be adjustable as long as the loan term does not exceed forty years.[450] Family-lenders in California would be wise to enter into a fixed-term mortgage to make sure the loan falls within this statutory requirement. Illinois, quite expansively, permits reverse mortgages to have an interest rate that is fixed, adjustable, or contingent on appreciation in the value of the property.[451] In all cases, family-lenders must ensure that the interest on the reverse mortgage does not exceed the state usury rate.[452] Given the interest-on-interest feature of reverse mortgages, this can be a complicated undertaking. Family-lenders are well

444. *See* MINN. STAT. ANN. § 287.05 (1995).
445. *See id.*
446. *See id.*
447. *See* KAN. STAT. ANN. § 79-3102 (1994).
448. *See* Hammond, *supra* note 4, at 96, 98.
449. *See* IND. CODE ANN. § 28-1-21.5-4(1)(D) (West 1996).
450. *See* CAL. FIN. CODE § 7504(6)(b) (West 1996).
451. *See* 205 ILL. COMP. STAT. ANN. § 5/6.1 (West 1994).
452. *See, e.g.*, N.J. STAT. ANN. § 46:10B-18(c) (West 1989).

advised not to become involved in a reverse mortgage until the usury issue is clearly resolved by their state.

Although Director of the National Center for Home Equity Conversion, Ken Scholen, thought by many to be the foremost authority on reverse mortgages, assures that it is perfectly legal to make intrafamily reverse mortgages,[453] family-lenders inclined to worry may be concerned that there is little statutory authority expressly permitting them to make these loans. Thus, for example, the New Jersey enabling statute provides that "it shall be lawful for any *institution* authorized in the State to make first lien loans secured by a mortgage on real property" to enter into a reverse mortgage transaction.[454] Similarly, the New York statute on reverse mortgages authorizes any bank, trust company, savings and loan, credit union, licensed mortgage broker, or entity exempt from licensing but approved by the Superintendent of Banks to make reverse mortgages.[455] Likewise, in its reverse mortgage statute, Minnesota includes in its list of approved lenders only banks, credit unions, insurance companies, and savings associations.[456] It is unlikely that these and other states, by excluding individuals from the list of authorized lenders, thereby meant to prohibit them from making reverse mortgages. More likely, the statutes neglect to mention individuals in the list of approved lenders because the legislators had not thought of the possibility that family members might want to enter into a reverse mortgage transaction with each other. The validity of this theory is attested to by the fact that of the people contacted at the New Jersey Governor's Office, Attorney General's Office, State Banking Commission, Department of Aging, or Office of Housing and Mortgage Financing, no one had ever heard of an intrafamily reverse mortgage and could not say if it were legally permissible.[457]

Although statutes may not expressly either prohibit or permit family members from entering into reverse mortgages with each other, several leading reverse mortgage specialists think that it may not be financially advisable for family-lenders to get involved. For example, Scholen worries that a family-lender will have to take on the

453. *See* Telephone Interview with Ken Scholen, *supra* note 436.
454. N.J. STAT. ANN. § 46:10B-18 (West 1989) (emphasis added).
455. *See* N.Y REAL PROP. LAW § 280(1)(d) (McKinney Supp. 1997).
456. MINN. STAT. ANN. § 47.58(3)(b) (West Supp. 1997).
457. *See* Telephone Interview with New Jersey Governor's office, Attorney General's Office, State Banking Commission, Department of Aging, and Office of Housing and Mortgage Financing of New Jersey (Feb. 21, 1996).

enormous risk that the borrower will outlive her life expectancy, and the loan balance will exceed the value of the house.[458] Similarly, Julie Overton of the National Resource and Policy Center on Housing and Long-Term Care cautions that although an intrafamily reverse mortgage is feasible, it is not the wisest.[459] So too, Bronwyn Belling, a senior programs specialist for the AARP Consumer Affairs Division, worries about what would happen if the loan goes bad[460] due to home depreciation.

Although these concerns are very real, as FHA insurance for institutionalized lenders and the fate of private-lender Providential make clear,[461] they may be overstated. First of all, many states impose loan-to-value ratios on reverse mortgages. Thus, for example, in New Jersey the reverse mortgage may not be made in an amount to exceed 70% of the value of the mortgaged property.[462] This feature serves to protect lenders from the potentiality of both borrower longevity and falling housing markets. In those states that do not impose such limits, the family-lender and borrower can self-impose them. The lower payments that would result from this imposition are offset by the fact that intrafamily reverse mortgages involve greatly reduced origination costs. As for the risk of home-depreciation, the borrower and lender can regulate the growth of the loan balance by manipulating the interest rate so that it reflects market levels. So too, the lender-heir can simply hold onto the property as an investment until the cyclical housing market rebounds.

The borrower who enters into an intrafamily reverse mortgage also faces some risks. Should the lender run into unexpected financial difficulties two, five, ten, twenty, or even thirty years down the line and be unable to make reverse mortgage payments, the borrower has little recourse and would be forced to move out of the property.[463] Similarly, it is important that the reverse mortgage instrument specify exactly what would constitute borrower default and trigger repayment. The intrafamily sale/leaseback annals are replete with horror

458. *See* Telephone Interview with Ken Scholen, *supra* note 436.

459. *See* Telephone Interview with Julie Overton, mortgage assistant with the Natural Resource and Policy Center on Housing and Long-Term Care, University of California Andrus Gerontology Center (Feb. 21, 1996).

460. *See* Telephone Interview with Bronwyn Belling, programs specialist for the AARP Consumers Affairs Div. (Feb. 28, 1996).

461. *See supra* text accompanying notes 1-129.

462. *See* N.J. STAT. ANN. § 46:10B-18(a) (West 1989).

463. *See* Telephone Interview with Ken Scholen, *supra* note 436.

stories of parents who did not want to insult their children by entering into detailed agreements, only to have the relationship turn sour and be kicked out of the house by the children.[464]

Also disadvantageous to borrowers are the fixed-term limits that some states place upon reverse mortgages. Thus, for example, New Jersey,[465] Kentucky,[466] and Massachusetts[467] all impose a ten-year durational limit on reverse mortgages. For borrowers who want to ensure that they will be able to stay in their home as long as they want, this limitation presents a problem. This obstacle can be overcome, however, by a carefully drafted reverse mortgage instrument. For example, the reverse mortgage can contain a provision which permits the loan to become due and payable only after the borrower's death, a transfer of the property, a cessation of occupancy, or an elapse of a specified term. The reverse mortgage could then contain a further provision that automatically extends the expired term for consecutive periods as long as none of the other triggering events has occurred.[468]

Finally, intrafamily reverse mortgage borrowers should be aware that several states mandate that potential borrowers receive counseling. Although the Minnesota statute specifies that the counseling requirement only applies if the mortgage lender is not related to the mortgagor,[469] the North Carolina statute generically prohibits reverse mortgage lenders from closing a reverse mortgage loan without receiving certification that the borrower has received counseling on the advisability of a reverse mortgage.[470] In New York, borrowers can opt out of counseling, but only by delivering a signed affidavit to the lender stating that the borrower was made aware of the advisability and availability of counseling.[471] To prevent the assessment of penalties against the lender and to thwart potential claims of fraud or loan invalidation, borrowers and lenders should ascertain whether their state has a counseling requirement and whether it exempts reverse mortgages between family members.

464. *See* Keith Jurow, *Lease-backs Advocated for Elderly*, NAT'L L.J., Mar. 7, 1988, at 15.

465. *See* N.J. STAT. ANN. § 46:10B-17 (West 1989).

466. *See* KY. REV. STAT. ANN. § 287.215 (Michie 1988).

467. *See* MASS. ANN. LAWS ch. 167E, § 2(14-A) (Law. Co-op. Supp. 1992).

468. *See* 60 Fed. Reg. 62764, 62771 (1995).

469. *See* MINN. STAT. ANN. § 47.58(8) (West Supp. 1997).

470. *See* N.C. GEN. STAT. § 53-270(1), (6) (Supp. 1992).

471. *See* N.Y. REAL PROP. LAW § 280(2)(g) (McKinney Supp. 1997).

Notwithstanding the fact that, as discussed above, prospective intrafamily reverse mortgage borrowers and lenders may face problems with lien priority, mortgage tax, interest rates, financial risk due to home depreciation or unexpected longevity, lack of express statutory authority to make such loans, default, fixed-term limits, and uncertain counseling requirements, such reverse mortgage transactions have many benefits. First, loan origination costs are greatly reduced, and the borrower does not have to pay points, servicing fees, or mortgage insurance premiums. Second, an intrafamily reverse mortgage allows you "to keep your asset at home where you want it to be—where it should be, instead of in the [institutionalized] lender's pocket."[472] An intrafamily reverse mortgage allows a parent simultaneously to convert the equity in her house into cash and to transfer the equity to her eventual heirs while she is still alive.

Such a transaction not only ensures that children receive their inheritance intact, it also allows parents to encumber their estates below the $600,000 level and thus avoid federal estate taxes.[473] This is because although the full value of the home must be included in the decedent-parent's estate,[474] any principal payable to the lender is deductible for estate tax purposes.[475] Similarly, the interest is deductible as expenses in respect of a decedent.[476] Moreover, the lender-heir receives the home with a stepped-up basis.[477] Finally, the interest which has accrued on the reverse mortgage is not includable in the lender-heir's gross income until the loan balance is ultimately repaid when the home is sold.[478]

## IV. Novel Applications

Closely related to the concept of intrafamily reverse mortgages is the French system of *viager*, a Middle Ages practice that has experienced renewed popularity in Europe.[479] Viager has been termed

472. *Money Tonight* (CNBC television broadcast, Sept. 14, 1994).
473. *See* MacDonald, *supra* note 19, at 122.
474. *See* I.R.C. § 2031 (1996).
475. *See id.* § 2053(a)(4).
476. *See id.* § 691(b)(1).
477. *See id.* § 1014(a).
478. *See* Rev. Rul. 80-248, 1980 C.B. 164.
479. *See* Rone Tempest, *Culture, Life, Death, and Real Estate in France*, L.A. TIMES, Feb. 26, 1991, at 2.

"speculation on death" and likened to high stakes gambling on a person's life by both buyer and seller.[480]

Here is how a viager works. First, the fair market value of the seller's house or apartment is calculated on the basis of a survey of recent sales of similar properties in the same neighborhood.[481] Then, a viager price is established according to the age of the seller. The property of a sixty-year-old seller is priced at 50% of its FMV, a seventy-year-old seller at 60%, an eighty-year-old seller at 70%, and a ninety-year-old seller at 80%.[482] The buyer then gives the seller a "bouquet" or down payment of 0-30% of the viager price.[483] The remaining 70-100% of the viager price is divided into monthly payments based on the estimated life expectancy of the seller.[484] Because the monthly payments are indexed to the cost of living rate, the seller is guaranteed an income that keeps pace with inflation.[485]

Upon the seller's demise, the buyer gets title to the property.[486] If the seller experiences an untimely death, the buyer gets a bonanza. Thus, for example, if a sixty-year-old Parisian were to sell his property en viager and die a month later, the buyer would have effectively bought the entire property for 30% of 50% of its FMV—in other words, 15% of its value. Conversely, if the seller lives on for twenty or thirty or more years, the buyer will have made payments totaling many times the property's value. If the buyer predeceases the seller, the buyer's family is obligated to keep sending the monthly check.[487] If the buyer misses a payment, the property reverts to the seller, who can then sell it again.[488] The defaulting buyer loses the down payment and all of the monthly payments made to date.[489]

Consider the fate of Andre-Francois Raffray who entered into a viager with a ninety-year-old woman thirty-two years ago. On December 29, 1995, Raffray died at the age of seventy-seven, having forked over $184,000 (twice the FMV) for an apartment he never got to

---

480. *See id.*
481. *See id.*
482. *See id.*
483. *See id.*
484. *See id.*
485. *See id.*
486. *See id.*
487. *See Apartment to Die For: French Woman, 120, Outlives Would-Be Buyer*, PHOENIX GAZETTE, Dec. 29, 1995, at A2 [hereinafter *Apartment to Die For*].
488. *See* Tempest, *supra* note 479, at 2.
489. *See id.*

own or live in.[490] The seller, Jeanne Calment is now 122 years old and, according to the *Guiness Book of World Records*, the oldest living person in the world with documented proof of age.[491] Dining on foie gras, duck thighs, cheese, and chocolate cake, Calment said of Raffray, "In life, one sometimes makes bad deals."[492]

Viager is a macabre business that has an inherent potential for shady dealings on both sides. One disgruntled buyer complained, "There are people [sellers] who try to pass themselves off as much older and more frail than they actually are—as though they were nearly dying at the time of the sale. There are others who use make-up to try to fool the buyers."[493] Conversely, in one instance when a man wearing dark glasses and a wig burst into the hospital room of viager-seller Genevieve Martin and fired three shots at the seventy-five-year-old woman, she did not think the perpetrator was a stranger.[494] She told a French newspaper soon after the shooting that she suspected that her attacker was the man who had bought her Cannes apartment en viager two years earlier.[495] The man was arrested and held for six months before being released in the face of inconclusive evidence.[496]

Despite these morbid tales, the system of viager is embraced by all sides. The French government promotes the system as an effective way to reduce dependence on social security programs.[497] Most of the buyers are not would-be felons, but are professional people who have large disposable incomes, but limited capital.[498] "I know bankers, businessmen and politicians who have made their fortunes thanks to viager," states Bruno Legasse, a Parisian viager specialist.[499] The grim reaper is remarkably consistent for investors, and "in fact, most people die when they are statistically supposed to," he adds.[500] About 500 viagers are closed in Paris alone each year.[501]

490. *See Apartment to Die For*, *supra* note 487, at A2.
491. *Id.*
492. *Id.*
493. *See* Tempest, *supra* note 479, at 2.
494. *See* Charles Fleming, *In This Gamble, Apartment Buyer Profits From Seller's Early Demise*, WALL ST. J. EUR., Mar. 26, 1992, at 11.
495. *See id.*
496. *See id.*
497. *See* Tempest, *supra* note 479, at 2.
498. *See id.*
499. *Id.*
500. *Id.*
501. *See id.*

The majority of sellers who employ the viager system are elderly people with no living heirs.[502] However, because of France's forced inheritance system, a number of elderly sellers use viager as a means to thwart otherwise automatic inheritance by children who may have neglected them.[503] Either way, sellers are ensured of a steady income for life and are able to continue living in their property, among friends and in a familiar neighborhood, as long as they like.[504]

Besides viager, there are other novel twists on the reverse mortgage concept. In 1994 an eighty-year-old woman in Washington state was able to use a reverse mortgage to purchase a home in a retirement community.[505] Arcs Mortgage of Calabasas, California, structured the transaction in such a way that the woman was able to use $40,000 of her own savings and $50,000 funded through a reverse mortgage to purchase the home.[506] The motivated seller was willing to accept some risk to allow the transaction to go forward.[507] The seller signed an all-cash-at-closing purchase and sale agreement, subject to the buyer obtaining a reverse mortgage.[508] The seller then quit-claimed the property to the buyer for a twenty-four-hour period in order to meet FHA reverse mortgage title requirements.[509] Final documents were signed and the loan funded after the expiration of the three-day right of rescission.[510]

Scholen, commenting on the above transaction, noted that this is but one example "of reverse mortgages having a use that its creators had not envisioned."[511] Another such novel use involves people who are over sixty-two and have become delinquent in their regular mortgage payments. In these instances, the owners have been able to avoid foreclosure and retain the home by using a reverse mortgage to pay off the primary lender.[512]

---

502. *See id.*
503. *See id.*
504. *See id.*
505. *See* Brad Finkelstein, *Reverse Mortgage Used to Buy Property*, NAT'L MORTGAGE NEWS, June 13, 1994, at 8.
506. *See id.*
507. *See id.*
508. *See id.*
509. *See id.*
510. *See id.*
511. *Id.*
512. *See id.*

## V. Conclusions and Recommendations

With the baby-boomers nearing retirement age and entitlement programs coming under scrutiny, there is room for the reverse mortgage market to grow in coming years. The extent and pace of this expansion, however, will be determined in large part by the activities in four areas.

State legislators need either to enact additional laws concerning reverse mortgages or to make explicit how existing laws relate to reverse mortgage transactions. This need is particularly apparent in the area of intrafamily reverse mortgages. Issues concerning origination authority, lien priority, mortgage tax, rates and type of interest, fixed terms, and counseling will remain impediments to the efficient use of intrafamily reverse mortgages until state legislatures recognize and ameliorate the problems.

The federal government, for its part, needs to increase its efforts at both protecting consumers from fraud and alleviating the lenders' concern about tort liability, interest risk, moral hazard, and the "painstaking pace" of reverse mortgage origination. Although the recently enacted changes to the Truth in Lending Act and the passage of amended rules addressing the administrative burdens encumbering the HECM reverse mortgage are a start, more efforts are needed. For example, lenders unable to obtain the new TILA software have stopped generating reverse mortgages. Counseling requirements and insufficient funding for counselors also remain a problem. The HECM actuarial tables are arguably outdated and, in any case, do not account for the different life expectancies of men and women. Furthermore, lenders still say that the cap on the origination fee is unreasonable in light of the subservicing reverse mortgages require. In short, the federal government can promote the growth of the reverse mortgage market both by providing continuity and being responsive to the operation-in-practice of its regulations and laws.

The entrance of Fannie Mae into the market and the likely participation of Freddie Mac in the near future are likely to increase both the public's awareness of reverse mortgages and their confidence in the transaction. To date, the reverse mortgage market has had a bad public relations campaign. The few seniors who heard of the reverse mortgage at all had vague negative notions of exploitation and predatory lending. That these ideas are changing is evidenced by the rush of phone calls to Fannie Mae after it announced its Home Keeper reverse mortgage, and the widespread favorable newspaper coverage the new reverse mortgage option received. As the Home Keeper program is put into place and reliable private lenders such as Transamerica HomeFirst and Ever Yours expand their geographic reach, consumers will, for the first time, have a range of options to choose from when deciding whether a reverse mortgage is right for them.

In the last analysis, a senior's decision to get a reverse mortgage will be influenced to a great extent by the advice she receives from trusted advisers such as her attorney and her accountant. It is essential, therefore, that these practitioners become familiar with the complex tax and benefits issues involved. Decisions to take a shared appreciation versus a deferred annuity versus a present lump sum payment could have profound financial consequences for the borrower and her heirs. Because a plan advantageous to one borrower could be disadvantageous to another, it is necessary that each borrower receive comprehensive estate planning advice tailored to her particular circumstances. It is not enough for a reverse mortgage to become a standard tool in an estate planner's repertoire; the planner must know how to manipulate its permutations to the best advantage of the client.