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After March 2, Reverse Mortgage Borrowers Will Have to Prove They Are Not Deadbeats

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One of the attractive features of the HECM reverse mortgage has been that there are no income or credit requirements. All homeowners 62 and older who live in their homes without a mortgage have been eligible, and those with mortgages may also be eligible if the balance is not too large. But all that will change effective March 2, 2015 when a series of drastic new FHA rules come into play.

The precipitating factor underlying the new rules is the marked rise that has occurred in recent years in property tax defaults by HECM borrowers. While such borrowers are violating their obligations under the reverse mortgage contract, and are thereby subject to foreclosure and eviction, FHA has been understandably reluctant to allow elderly homeowners to be thrown into the street. Because of the potential political and public relations fall-out, those critical provisions of the HECM contract are essentially unenforceable.

Instead, FHA has elected to impose income and credit requirements on future applicants. The purpose is to assure that henceforth borrowers will have both the capacity and the willingness to pay their property taxes and homeowners insurance. While this won't affect existing loans that are now in default, it should sharply reduce the default rate on new loans. The downside is that future borrowers will have to pay the higher costs of originating and servicing HECMs, and wait longer for deals to be completed.

The new underwriting requirements that lenders will apply to all applicants are very detailed, and in some respects tougher than those used with standard mortgages. I went through the new rules with an underwriter, who pointed out a series of provisions that went beyond anything in the rules pertaining to standard mortgages. This is strange, considering that applicants for reverse mortgages pay only taxes and insurance whereas applicants for standard mortgages also pay principal and interest, which is usually much larger.

On the other hand, the applicant for a standard mortgage who fails to meet the underwriting criteria is rejected whereas the applicant for a reverse mortgage who fails the test has another option, called a Fully-Funded Life Expectancy Set-Aside. The Set-Aside is an amount drawn under the HECM that is reserved for payment of property taxes and insurance by the lender. The amount, calculated using a formula provided by FHA, is viewed as sufficient to assure the required payments can be met though the entire life span of the borrower.

I calculated the required Set-Aside for a borrower of 75 with life expectancy of 144 months, taxes and insurance charges of $5000 a year, and interest rate plus mortgage insurance premium of 5%. It was $54,000, not a trivial sum. If this borrower had equity in his home of only $100,000, the Set-Aside would use virtually all of it, and no additional funds could be drawn. If his equity was less, the required Set-Aside would not be possible and he would be rejected.

There is another possible option, however, termed a Partially-Funded Life Expectancy Set-Aside. This is available to applicants who meet the credit requirements and are therefore viewed as willing to meet their obligations, but don't have enough income. This Set-Aside, which can be much smaller, is used to draw funds from the HECM twice a year, which are sent to the borrower who makes the payments.

In addition to their complexity, the new rules have two remediable weaknesses. One is that the new underwriting requirements must be applied to every applicant. But applicants with plenty of equity in their homes might find that the fully-funded Set-Aside imposes no burden on them at all, in which case the underwriting costs could be avoided. There is no reason why lenders and borrowers should not have that option.

The second weakness is mandating that the lender make the required payments under the fully-funded Set-Aside. Why not give borrowers the option of making the required payments with their own funds, with the inducement that an equivalent amount will be transferred from the Set-Aside account to the borrower's credit line? The purpose is to encourage borrowers to become responsible. This would involve no risk to FHA, since the lender will make the payments if the borrower doesn't.

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