Consumers Union

There's No Place Like Home:
The Implications of Reverse Mortgages on Seniors in California

by Victoria Wong and Norma Paz García

Consumers Union of U.S., Inc.

West Coast Regional Office

August 1999

This report was prepared by the West Coast Regional Office
of Consumers Union of U.S., Inc.

Consumers Union of U.S., Inc.

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Acknowledgments

The authors wish to thank the Wallace Alexander Gerbode Foundation and the Richard and Rhoda Goldman Fund for their generous support of the Homeowners Project of Consumers Union's West Coast Regional Office. Thank you also to Rebecca Landes, Gail Hillebrand, Betsy Imholz, Robin Kane, Shirley Sanematsu, and Les Chun for their research and editing support. We also recognize those whose contributed to the production of this report: Ven Barrameda, Carol Rivas Pollard and Minerva Novoa.

We also thank those individuals who so graciously consented to being interviewed for this report.

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Executive Summary

Shopping for a mortgage is a complex and often confusing process for many borrowers. The myriad of terms, fees and different products make finding the right mortgage an enormous challenge. Now imagine a mortgage with the following features:

- One that is even more complicated than a traditional mortgage;
- With relatively little public information available to explain the advantages and disadvantages of a given loan package; and
- For which a borrower cannot calculate the true cost without predicting how long she will live and what future interest rates and home appreciation rates will be.

These are the characteristics of a reverse mortgage, a loan that converts home equity into tax-free cash, available to borrowers 62 years of age and older.

A reverse mortgage allows a senior to borrow against the equity in her home in order to access funds. In most cases, the senior must own her home free and clear, or nearly so. A reverse mortgage loan provides a borrower with a lump sum of cash, monthly payments, or a line of credit. The term "reverse" refers to the fact that instead of the borrower making a monthly payment to the lender, the lender makes payments to the borrower. The money need not be repaid until the borrower dies or leaves her home permanently, or in some cases after a fixed number of years passes. Generally the borrower or her estate then sells the home in order to pay the debt.

This report explores the advantages and disadvantages of reverse mortgages for seniors and documents some of the problems borrowers have faced when considering taking out reverse mortgages. The potential market for reverse mortgages in California is huge, since approximately 2,160,000 Californians, 60% of all seniors in the state, are eligible for them.

While this report focuses on the California experience, reverse mortgages are available nationwide, and the problems and recommendations discussed in this report have applicability to other regions as well.

A reverse mortgage can be an attractive option for many seniors who need additional income. The right reverse mortgage can enable a senior homeowner to maintain financial independence and an adequate standard of living by converting a home's equity into tax-free cash. A reverse mortgage borrower retains ownership of the home during the course of the reverse mortgage and does not need to make monthly repayments to the lender. Instead, the reverse mortgage is repaid, usually from the proceeds of the sale of the home, after the borrower sells the home, moves out permanently, or is deceased.

Nonetheless, a reverse mortgage borrower may encounter many financial hazards in taking out a reverse mortgage. First, reverse mortgages are very expensive while promising an uncertain amount of benefits. For example, a typical reverse mortgage may provide to the consumer a $300 per month payment with a monthly compounded interest rate of 1%. Over the course of ten years, the borrower will receive $36,000, but by that time she will owe almost $70,000—almost twice as much as she has received.

In addition, reverse mortgages have complex contract terms that are confusing and can greatly impact the overall cost of a reverse mortgage to the borrower. This report examines the effect of some of these terms on some California reverse mortgage borrowers and looks at the danger to borrowers when lenders or third parties involved in arranging reverse mortgages do not fully disclose a loan's terms and fees. One example involves a lawsuit filed by the San Mateo County Public Guardian which, on behalf of Berta Grey, an 83-year old woman, alleged that Transamerica Corporation unfairly and unconscionably charged her what was in effect a *shared appreciation fee*. This fee gave Transamerica an automatic 50% interest in the difference between the base value of the home when the loan was signed and the appreciated value of the home when the loan terminated, even though the fee bore no relation to the amount she actually borrowed. Additionally, the cost of Berta Grey's reverse mortgage soared when she was required to purchase an *annuity* in conjunction with her reverse mortgage. An annuity is an insurance product financed out of the home's equity to provide monthly payments to the borrower immediately or after a certain number of years. The San Mateo County Public Guardian alleged that Transamerica charged Berta Gray the cost of the annuity immediately and that interest began compounding on that fee even though she was not due to receive any payment on the annuity until six years after the loan began, at age 89. Under this arrangement, if Ms. Gray died before the six-year period ended, her estate would see no benefit from the annuity purchase, although she had paid in full for it.

Numerous other front-end and back-end fees can quickly drive up the cost of a reverse mortgage and are discussed in more detail in this report. These fees include origination fees, points, mortgage insurance premiums, closing costs, servicing fees, shared equity or "maturity" fees, and shared appreciation fees. The case of the *San Mateo County Public Guardian v. Commonwealth Life Insurance* illustrates how some of these fees generated allegations by a class of 1,505 borrowers that they were charged tens of thousands of dollars in artificially inflated loan fees. This suit was settled in 1999.

Reverse mortgage counseling, which is the main consumer safeguard against financial fraud and abuse against seniors, is required for some but not all loans. This means that the current system of reverse mortgage counseling is not enough to protect potential borrowers. Some of the major flaws cited in this report include situations where reverse mortgage counselors are not neutral parties because they are affiliated with the lender. Unfortunately, this practice is encouraged by the fact that Fannie Mae will purchase reverse mortgage loans from loan originators who themselves provide "counseling" to prospective reverse mortgage borrowers.

Additionally, according to HUD estimates, several hundred seniors nationwide have been cheated by unscrupulous lenders and third-party "estate planning" firms who take advantage of consumers' relative lack of knowledge about reverse mortgages to entice them to agree to unfair or illegal contract terms. According to newspaper reports, a woman in Norwalk, California alleged that she paid $5,571 to an America's Trust, Inc. in return for a visit from an agent, who came to her home and referred her to a reverse mortgage lender. She also alleged that America's Trust never informed her that she would be charged 10% of her loan amount for that service. She could have obtained reverse mortgage lender referral information for free from HUD.

These dangers are amplified by the increasing popularity of reverse mortgages and the growth of their target population, senior citizens. Senior home ownership and life expectancy rates are climbing steadily and therefore more seniors are qualifying for reverse mortgages. Accordingly, now is the ideal time to establish consumer protections so that as the reverse mortgage industry grows, current pitfalls and hazards for consumers do not expand as well.

This report sets out recommendations to improve consumer protections in the reverse mortgage industry. These recommendations call for both substantive limitations on the terms of reverse mortgages and stronger consumer education and reverse mortgage counseling services.

Recommended Legislative and Regulatory Actions

- Increase funding for outreach, education and loan counseling for potential reverse mortgage applicants.
- Increase federal and state monitoring and enforcement of existing and new regulations.
- Make counseling for Fannie Mae Home Keeper loans independent of the lender.
- Require all lenders to meet Fannie Mae's Rules for protecting reverse mortgage consumers.
- Mandate independent pre-loan counseling for all reverse mortgage applicants.
- Require all lenders to inform borrowers about reverse mortgage counseling agencies.
- Limit lender fees.
- Eliminate direct lender payments to reverse mortgage counseling agencies.
- Disclose Total Annual Loan Cost (TALC) rates earlier and at additional time points of the loan period.
- Require independent annuity sales agents to disclose the availability of monthly and line-of-credit advances through reverse mortgages.

Recommended Actions to Improve Consumer Education and Advocacy

- Standardize the content and quality of reverse mortgage counseling.
- Increase local outreach, education, and counseling activities.
- Utilize California's Elder Abuse and Dependent Adult Civil Protection Act, existing law providing treble damages for unfair and deceptive practices against seniors, and the California Unfair Practices Act.
- Encourage borrowers to file administrative complaints when they suspect wrongdoing to pressure state regulatory agencies to act.

- Train reverse mortgage counselors to recognize when a borrower's decision-making capacity is in question.

Consumers Union supports these key recommendations to protect consumers who are considering reverse mortgages while preserving and expanding the spectrum of lending options available to them.

This report builds on Consumers Union's research and advocacy work presented in two previous reports—*Dirty Deeds: Abuses and Fraudulent Practices in California's Home Equity Market* (October 1995) and *The Hard Sell: Combating Home Equity Lending Fraud in California* (July 1998). Those reports explored fraudulent and abusive practices in the home equity lending industry more generally, including practices targeted at seniors. This report focuses on reverse mortgages as a unique home equity conversion product marketed specifically to seniors. In the development of this report, Consumers Union consulted published sources of information and conducted interviews with reverse mortgage counselors, representatives of consumer education organizations, a representative of the reverse mortgage industry, consumer advocates and attorneys for consumers. Because the typical reverse mortgage borrower is a single woman in her mid- to late 70s, this report generally refers to a hypothetical borrower as a female, although of course reverse mortgage borrowers are both men and women.

Introduction

One of the most important issues for many seniors today is how to afford to continue living in their homes during retirement. Seniors are living longer and the majority own their own homes. At the same time, many are living on fixed incomes or on the proceeds of investments that do not meet their financial needs. Some require additional sources of income to cover day-to-day expenses, while others need cash to pay for more significant costs, such as home health care services or home repairs. For seniors with these needs, reverse mortgages are an attractive option. At the same time, however, reverse mortgage lending is fertile ground for fraud and financial abuse of seniors. This report:

> *One of the most important issues for many seniors today is how to afford to continue living in their homes during retirement.*

- explores the advantages and disadvantages of reverse mortgages for consumers;
- examines the current and potential dangers for reverse mortgage borrowers; and
- recommends actions that can be taken to protect consumers while preserving their borrowing options.

The report uses both California and nationwide reverse mortgage markets as background.

Reverse mortgages are home equity loans available to borrowers over the age of 62. Most reverse mortgages require that borrowers own their homes free and clear, or nearly so. A reverse mortgage gives a borrower access to a monthly payment, a lump sum, or a line of credit, borrowed against the equity of his or her home. The term "reverse" refers to the fact that instead of the borrower making a monthly payment to the lender, the lender makes payments to the borrower. The loan is not repaid in full until the homeowner permanently moves out of the home or passes away, or at the end of a fixed period.

Consumers Union has chosen to examine reverse mortgages because this type of loan targets senior citizens, a population that is often "house-rich and cash-poor," and that is potentially more vulnerable to fraud and abuse than the general population. Reverse mortgages allow homeowners who need cash to get access to the equity in their homes while allowing them to continue to live there, rather than selling the home. For many seniors, this is an extremely attractive feature. The borrower's home may carry a great deal of family history and personal meaning, and the borrower may be willing to pay a high price to remain there.

At the same time, a lack of regulation and consumer education in this relatively new industry has opened the door to numerous hazards for consumers. Some lenders attempt to take advantage of homeowners by imposing unconscionably high fees or unfair terms, or by convincing the homeowner to borrow more than she needs. The stakes are especially high because a reverse mortgage places the borrower's home on the line. For most borrowers, tapping the equity in their homes is one of the last major financial decisions they will make, and it is a decision that is likely to have significant emotional as well as financial consequences. The danger of incomplete information is exacerbated by the complexity of reverse mortgage products themselves, and by the fact that many homeowners interested in reverse mortgages have less financial sophistication to understand the loan's terms than the average mortgage borrower.[1]

In addition, the senior population is growing and will continue to expand significantly in the coming years. Thus, as the market for reverse mortgages grows, current consumer protection problems in the reverse mortgage industry will be magnified if not addressed. This report comes at a timely juncture, given that the United Nations General Assembly has designated 1999 as the International Year of Older Persons, and recognizes that an older person's home has psychological and social, as well as physical significance. The United Nations' *International Plan of Action on Ageing* recommends that national housing policies assist seniors to "continue to live in their own homes as long as possible."[2] There is a need to closely examine reverse mortgage lending and pre-loan counseling and borrowing practices, and to consider what further consumer protections may be necessary to ensure fair treatment of borrowers.

As the market for reverse mortgages grows, current consumer protection problems in the reverse mortgage industry will be magnified if not addressed.

Growth in the Reverse Mortgage Industry

Nationwide, interest in and use of reverse mortgages has been steadily increasing. In 1989, the Federal Housing Administration (FHA), part of the U.S. Department of Housing and Urban Development (HUD), began offering to insure reverse mortgage loans made under the terms of the Home Equity Conversion Mortgage (HECM) program. Since then, approximately 55,000 reverse mortgages have been made under both government and privately insured programs. About two-thirds of these have been HUD HECM loans.[3] The Federal National Mortgage Association (Fannie Mae) estimates the potential market for reverse mortgages at 3 million households.[4] Interest in and use of reverse mortgages is particularly strong in California[5] due to the state's large senior population and high real estate values. The typical reverse mortgage borrower, both in California and nationwide, is a widow in her mid- to late-70s, living mainly on Social Security income, with few or no children. Although reverse mortgages have received a good deal of publicity, many seniors in California do not know a great deal about them.

Nationwide, interest in and use of reverse mortgages has been steadily increasing. Since 1989, approximately 55,000 reverse mortgages have been made under both government and privately insured programs.

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1 Telephone interview with Dave Brown, Housing Counselor, Eden Council for Hope and Opportunity (Feb. 26, 1999).

2 "International Plan of Action on Ageing", *Areas of Concern to Ageing Individuals - Housing and Environment, Recommendation 19* (last modified: Sept. 5, 1998) <http://www.un.org/esa/socdev/ageipaa3.htm>.

3 National Center for Home Equity Conversion [hereinafter NCHEC], "Estimates" (last modified: May 17, 1999). <http://www.reverse.org/info.data.htm>.

4 Miriam Hill, "Retirees Who Need Money Let Houses Pay Their Way; Reverse Mortgages Are Now Easier to Find, and to Understand," *The Plain Dealer*, Apr. 1, 1996, at 1D.

5 Edmund Sanders, "Reverse Mortgages Become Popular Among Seniors," *Orange County Register*, May 8, 1998, at D12.

Increasing Demand for Reverse Mortgages as Senior Population Demographics Change

California's 65-and-over population currently numbers approximately 3.6 million,[6] and is projected to reach 4.5 million by 2015 and 6.4 million by 2025,[7] as the baby-boom generation reaches retirement age. As of 1993, California had the largest number of persons over age 65 of any state.[8] In addition to the aging of the baby-boom generation, increased life expectancy will contribute to the growth of the senior population. By the middle of the 21st century, over 40% of U.S. residents aged 65 will live to age 90, up from 25% in 1979-81.[9]

Seniors hold an estimated $1 trillion in home equity nationwide.[10] The number of senior homeowners has been increasing steadily, up from 68% in 1970[11] to 79% today.[12] Of all these senior homeowners, 83% have fully paid off their mortgages and own their homes free and clear.[13] In 1990, according to the most recent data available for California, California's home ownership rate for this age group was 72.5%,[14] consistent with national figures.

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The vast majority of seniors live at home: a national survey indicates that only 3% of households with seniors over age 70 live in institutional housing.[15] Fully 85% of senior homeowners would prefer to stay in their homes than move.[16] As seniors live longer, their living expenses often will include significant in-home health care expenses, and the range of health care options is widening to include several levels of care available to those living at home rather than in institutional settings.

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6 "Estimates of the Population of the U.S., Regions, and States by Selected Age Groups and Sex: Annual Time Series, July 1, 1990 to July 1, 1997", U.S Bureau of the Census (last modified: Feb. 4, 1999) <http://www.census.gov/population/estimates/state/97agesex.txt>. Cited figure is from 1997 data.

7 "Projections of the Population by Age and Sex of States: 1995-2025", U.S. Bureau of the Census (last modified; Nov. 4, 1998) <http://www.census.gov/population/projections/state/stpjage.txt>.

8 Frank B. Hobbs with Bonnie L. Damon, "65+ in the United States", *Current Population Reports, Special Studies*, P23-190, at v, U.S. Bureau of the Census.

9 *Id.* at 3-4.

10 William Hathaway, "Reverse Mortgages Allow Elderly to Supplement Their Incomes; Finding Money at Home," *The Hartford Courant*, Dec. 25, 1994, at J1.

11 "Ownership Rates," *Census of Housing*, U.S. Bureau of the Census (last modified: Apr. 22, 1998) <http://www.census.gov/hhes/www/housing/census/historic/ownrate.html>.

12 U.S. Department of Housing and Urban Development, *HUD Proposes Major Expansion of Reverse Mortgage Program to Help More Senior Citizen Homeowners*, July 18, 1996.

13 *Id.*

14 "Ownership Rates", *supra* note 11.

15 "State of the Nation's Housing 1998: Demographic Forces", Joint Center for Housing Studies, Harvard University (last visited: June. 29, 1999) <http://www.gsd.harvard.edu/jcenter/sonh1998/demoforc.htm>.

16 Harry Moss, "The Growing Credibility of Reverse Mortgages," *The Inter-City Express*, Nov. 28, 1995.

Based on the 1990 home ownership rate in California and national trends, 60% of <u>all</u> seniors in California are eligible for a reverse mortgage. Senior demand for funds to pay for expenses will increase in coming years as people stay in their homes longer. Thus, the potential market for reverse mortgages is very substantial and will continue to grow.

These numbers show that based on the 1990 home ownership rate in California and national trends, 60% of all seniors in California are eligible for a reverse mortgage. The data also shows that senior demand for funds to pay for expenses such as home repairs and in-home health care will increase in coming years as people stay in their homes longer. Thus, the potential market for reverse mortgages is very substantial and will continue to grow.

While the advantages and disadvantages of reverse mortgages are not currently issues with a special impact on racial or ethnic minority homeowners, these issues will become more significant in the future as the rate of minority home ownership increases. Currently, home ownership rates among minorities are relatively low: nationwide, the home ownership rate for minority households is 46%, compared to 72% among whites,[17] and while minorities constitute 24% of all households, they make up only 17% of all homeowners.[18] However, the current home buying boom is largely attributable to minority households. While minorities constitute only 17% of the homeowner population, they accounted for 42% of the increase in home ownership between 1994 and 1997, and for 36% of the increase in the period from 1985 to 1993.[19] Much of the growth in home ownership among Hispanics and Asians is due to immigration and the fact that a larger proportion of this population is in the 25 to 34-year-old age group, which has the highest rates of first-time home ownership. Among African-Americans, growth in home ownership is more attributable to wider availability of loans and the relatively low interest rate environment.[20] Increased community lending has also contributed to growth in minority home ownership.[21] Although researchers note that these rapid rates of growth may slow,[22] the fact that home ownership rates among minorities will continue to increase means that reverse mortgage borrowing will have an increasing impact on minority households in the coming years as minority home ownership rates increase.

This is the ideal time to examine the role of reverse mortgages as a borrowing option for seniors, and to ensure that as the reverse mortgage industry expands, proper protection for consumers is in place.

Accordingly, this is the ideal time to examine the role of reverse mortgages as a borrowing option for seniors, and to ensure that as the reverse mortgage industry expands, proper protection for consumers is in place.

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17 "State of the Nation's Housing: Executive Summary", Joint Center for Housing Studies, Harvard University, (last visited: June. 29, 1999) <http://www.gsd.harvard.edu/jcenter/sonh1998>.
18 *Id*., at "The Homeownership Boom".
19 *Id*.
20 "State of the Nation's Housing: Executive Summary", *supra* note 17.
21 "The Homeownership Boom", *supra* note 18.
22 "State of the Nation's Housing: Executive Summary", *supra* note 17.

I. Reverse Mortgages: An Overview

This section describes the basic historical background and features of reverse mortgages, their advantages and disadvantages, and the dangers they present for consumers.

A. What Is a Reverse Mortgage?

A reverse mortgage is a type of home equity loan that allows a homeowner age 62 or over to convert some of the home's equity into cash, while allowing the borrower to retain ownership and not make immediate repayments. The term "reverse" refers to the fact that instead of the borrower making a monthly payment to the lender, the lender makes payments to the borrower. Depending on the program, the borrower will not have to repay the loan or accrued interest as long as she lives in her home, or for a specified number of years. This means that a reverse mortgage is a rising-debt loan: as cash advances are paid out to the borrower, interest accrues and is compounded, so that over time the total amount owed increases significantly. Money obtained through a reverse mortgage can be used for any purpose. Most often, borrowers use the money for everyday living expenses, home repairs or in-home health care.[23]

The term "reverse" refers to the fact that instead of the borrower making a monthly payment to the lender, the lender makes payments to the borrower.

Qualifications. In order to qualify for a reverse mortgage, a borrower must be 62 or over, and in most cases must own her home free and clear, or with only a small remaining amount owed on the mortgage. The home must be the borrower's principal residence. One of the benefits of a reverse mortgage is that borrowers are not required to meet minimum income requirements, so even those on low fixed incomes can qualify, as long as they satisfy the other conditions.

Payment Options. Current reverse mortgage programs allow a borrower to receive payments in a single lump sum, in monthly installments, or through a line of credit. Exact terms vary depending on the program. Generally, the borrower can choose the type of payment that best suits her needs. The lump sum payment allows borrowers to access significant amounts of cash immediately, to cover a large purchase or expense. The monthly payment option ensures that the borrower will have a steady source of income for the life of the loan. The line of credit option provides a borrower with the flexibility to borrow only as the need arises and to accrue interest only on the amount actually borrowed plus interest on any financial set-up fees. At the end of the specified period, when the loan matures, the borrower or her heirs must repay the loan in full, plus interest. Generally, this maturity date is when the borrower dies, ceases to occupy the house, pays off the loan, or sells the house. A reverse mortgage loan may also mature after a fixed period of time and, if the homeowner has no alternative source of funds, she must sell the home in order to repay the loan when the loan matures. One important feature of a reverse mortgage is that it is a "non-recourse" loan, which means that the borrower can never owe more than the value of the home at the time the loan matures. This is important if a property depreciates in value, although this rarely occurs in California over the long term.

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[23] Judy Richter, "Turning House into a Cash Cow; Reverse Mortgages Let Seniors Tap into Their Equity," *San Francisco Examiner*, Mar. 21, 1999, at W6.

Some plans also offer the purchase of an annuity from the loan proceeds. An annuity is an insurance product that guarantees a monthly payment to the borrower for life, regardless of whether she stays in the home. The borrower pays for the annuity out of the loan funds that she would otherwise receive. This means that the borrower gets less money in her pocket and must immediately begin to pay interest on the money used to purchase the annuity. In fact, the borrower may die before ever receiving any benefits from the annuity. Both deferred and non-deferred annuities can be extremely expensive products and borrowers should seek out complete information before deciding to purchase any annuity.

B. Profile of a Typical Reverse Mortgage Borrower

While the characteristics of reverse mortgage borrowers vary, a 1995 study of borrowers in HUD's Home Equity Conversion Mortgage (HECM) program, the most popular form of reverse mortgage, indicated that the median age of a HECM borrower is 76 years. Median income is $10,400, which is 44% less than the median income of all elderly homeowners. Sixty percent of these borrowers were women who lived alone, and 75% of borrowers reported having no children. The median home value of HECM borrowers was $102,000, which is 42% greater than the median value of homes of all elderly homeowners. The five states where HECM loans were most popular were California, New York, Illinois, Colorado and New Jersey. These states accounted for almost one-half of all HECM loans closed at the time of the study.[24]

A 1995 study of borrowers in HUD's Home Equity Conversion Mortgage (HECM) program indicated that the median age of a HECM borrower is 76 years. Median income is $10,400, which is 44% less than the median income of all elderly homeowners.

C. Historical Background

Although various forms of reverse mortgages have been offered since the 1960s, it was not until 1989, when the Federal Housing Administration (FHA) entered the market with its Home Equity Conversion Mortgage (HECM) that the industry underwent substantial growth. Although reverse mortgages had been offered prior to that time, the absence of both insurance coverage for reverse mortgages and a secondary market[25] for the loans prevented them from being widely used. HUD encouraged an expansion in the market with the introduction of the HECM program, under which HUD insures reverse mortgage loans made under the terms of HECM program rules. The growth of the reverse mortgage lending industry was further boosted by Fannie Mae's entry into the secondary loan market time as a purchaser of governmentally insured loans.

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[24] NCHEC, "Info: Data", citing U.S. Department of Housing and Urban Development, *Evaluation of the Home Equity Conversion Mortgage Insurance Demonstration Program*, Washington DC, 1995 (last visited: June 30, 1999) <http://www.reverse.org>.

[25] A secondary market for a loan is a market in which lenders can sell loans they have already made to borrowers. The secondary loan purchaser pays the original lender for the loan. This reduces the risk the lender would otherwise face and frees up capital that can be used to make more loans.

The HECM program was originally a demonstration program, capped at a total of 50,000 loans and allowing only a limited number of selected lenders to participate.[26] In 1995, Fannie Mae introduced its own product, the Home Keeper reverse mortgage. This new product offered a higher lending limit than HUD'S HECM program and less expensive options for potential borrowers than were available through non-governmental programs.[27] In 1998, HUD's HECM program was expanded and given permanent status, with a new cap of 150,000 loans. Today, there are three major reverse mortgage products available: HUD'S HECM, Fannie Mae's Home Keeper, and the Financial Freedom Plan, a proprietary product, i.e., a loan whose particular characteristics are developed and owned by the private lender. Financial Freedom Senior Funding Corporation, which developed the Financial Freedom Plan, is a private, for-profit lender whose loans are not insured by the federal government, and are not sold to Fannie Mae.

The reverse mortgage lending industry has expanded significantly since the introduction of the HECM and Home Keeper programs and the development of a secondary market for the loans. Prior to 1990, only about 3000 reverse mortgages had been closed nationwide. From 1990-92, after the HECM program was put in place, 5000 more reverse mortgages were closed. The most rapid growth has been in the period since 1992: that is 46,750 or 85% of all reverse mortgages were closed from 1993 to 1998.[28] There are other indicators of the large potential market for reverse mortgages. For example, in the first six months after announcing its Home Keeper program, Fannie Mae received 100,000 calls asking for information, demonstrating substantial consumer interest in reverse mortgages.

The most rapid growth in the reverse mortgage market has been in the period since 1992: that is 46,750 or 85% of all reverse mortgages were closed from 1993 to 1998.

D. Reverse Mortgage Products

Consumers Union of U.S., Inc. does not endorse any individual reverse mortgage product or lender.

The term "reverse mortgage" generally refers to general purpose home equity conversion loans made by private lenders. Throughout this report, the term "reverse mortgage" will be used to refer to privately originated general purpose home equity conversion loans.

Currently there are three basic reverse mortgage products available in the private sector: the Federal Housing Administration's Home Equity Conversion Mortgage, the Fannie Mae Home Keeper, and the Financial Freedom Plan. Each product has advantages and disadvantages depending on the consumer's needs. The amount of cash available through a reverse mortgage is calculated based on formulas which consider the borrower's age, current interest rates, and the value

Today, there are three major reverse mortgage products available: HUD'S HECM, Fannie Mae's Home Keeper, and the Financial Freedom Plan.

[26] *See* 12 U.S.C. §1715z-20.

[27] "Fannie Mae Muscles into Reverse Mortgages," *Specialty Lender,* Aug. 1997, at 3.

[28] NCHEC, "Estimates", *supra* note 3.

of the home. Presently, all three of these reverse mortgages use an adjustable interest rate, and Fannie Mae purchases only adjustable rate mortgages. For a comparison of these products, please see Appendix A.

In all of these reverse mortgage programs, the homeowner retains title to the home. This means that the homeowner remains responsible for taxes, repairs, and maintenance on the property, even while she is receiving payments from the reverse mortgage.

Home Equity Conversion Mortgage (HECM).[29] The Home Equity Conversion Mortgage (HECM) is a reverse mortgage designed and insured by the Federal Housing Administration (FHA) of the U.S. Department of Housing and Urban Development (HUD). The Home Equity Conversion Mortgage is available through HUD-approved private lenders. The amount that can be borrowed depends on the value of the property and is limited by a maximum claim[30] amount determined by geographic area, as well as the age of the youngest borrower and the expected interest rate for mortgages. Currently, the maximum amount that can be borrowed with a HECM is $208,800. The HECM is available only for single-family residences, one-to-four unit buildings where at least one unit is owner-occupied, manufactured homes (mobile homes), units in HUD-approved condominiums, and units in planned unit developments. HUD also requires that certain standards for the condition of the property be met.

Under the HECM, a borrower may choose from five payment options: (1) a *tenure* plan, which provides monthly payments to the borrower for as long as she continues to occupy the home as her principal residence—that is, until she dies, moves out of the home permanently, or sells the home; (2) a *term* plan, which provides monthly payments for a fixed time period; (3) a *line of credit*, which allows a homeowner to borrow any amount at any time, up to the maximum loan amount; (4) a *modified tenure* plan, which combines the tenure plan with a line of credit; and (5) a *modified term* plan, which combines the term plan with a line of credit. An important feature of the credit line option is that the amount of credit available grows over time. This feature is unique among currently available reverse mortgage products. Reverse mortgage counselors indicate that the growing line of credit feature makes the HECM the most popular product for reverse mortgage borrowers.[31] HUD requires that all HECM applicants undergo counseling with a HUD-approved agency to ensure that potential borrowers understand the terms and implications of the loan.

The loan becomes immediately due when the borrower dies, sells the home, or does not live in the home for twelve consecutive months. At that time, the borrower must repay the loan either through proceeds from the sale of the home or by using other assets. HUD insures the loan, which means that if the lender defaults, the borrower will still receive payments. Likewise, if the amount of cash advanced by the lender exceeds the value of the home at the time the loan matures, HUD will pay the lender the difference. Fannie Mae purchases HECM loans in the secondary market from loan originators.

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[29] For more details, see "Home Equity Conversion Mortgage Program" (last modified: Jan. 1, 1999) <http://www.hud.gov/progdesc/hecmdf.html>.

[30] The maximum claim amount is the lesser of the appraised value of the borrower's home or the maximum principal amount for a one-family residence that can be insured by the FHA in the borrower's area. The maximum mortgage amount insured by the FHA varies by geographic areas and changes frequently.

[31] Telephone interview with Dave Brown, *supra* note 1; telephone interview with Judy Gaither, Executive Director, Human Investment Project (Feb. 19, 1999).

Fannie Mae Home Keeper.[32] Home Keeper program is a reverse mortgage loan designed and purchased by Fannie Mae. Home Keeper loans are offered by Fannie Mae-approved lenders and purchased from the lender by Fannie Mae in the secondary market. The maximum amount of available cash depends on the age and number of borrowers, the value of the property, and the "adjusted property value." The adjusted property value is the lesser of the appraised value or $240,000, which is the maximum value of a loan on a single-family home that Fannie Mae will purchase. The Home Keeper also offers an "Equity Share" option. The Equity Share option is a fee equal to 10% of the property value of the home at the time the loan matures, due at the maturity date. In return for this fee, the lender provides a higher monthly payment to the borrower. The Equity Share fee is not charged if the borrower repays the loan within two years.

Under Fannie Mae's Home Keeper program, the borrower can receive payments in one of three ways: (1) through a *tenure* plan, which provides monthly payments for as long as the borrower remains in her principal residence; (2) through a *revolving line of credit*, which does not grow over time; or (3) through a *modified tenure* option, which combines the tenure plan with a line of credit.

Applicants for a Home Keeper loan must complete Fannie Mae-approved counseling, either through a HUD-approved agency or through Fannie Mae's telephone counseling service, HomePath. If there is no local counselor available, Fannie Mae also allows the borrower to receive counseling from the reverse mortgage lender. The Home Keeper charges a higher interest rate than the HECM, but the lending limit is also higher, and under some circumstances it can yield higher monthly payments. Like the HECM, the Home Keeper loan becomes immediately due when the borrower passes away, sells the home, or does not live in the home for twelve consecutive months. At that time, the borrower must repay the loan either through proceeds from the sale of the home or by using other assets.

Applicants for a Home Keeper loan must complete Fannie Mae-approved counseling, either through a HUD-approved agency or through Fannie Mae's telephone counseling service, HomePath. If there is no local counselor available, Fannie Mae also allows the borrower to receive counseling from the reverse mortgage lender.

Fannie Mae also purchases loans which are a modified version of this product, called the Home Keeper for Home Purchase. Under this program, a homeowner can use equity in her current home to directly purchase a new home and at the same time establish a line of credit to draw down the equity in the new home. This structure can save the borrower the extra cost of selling the first home and then purchasing the second home in a separate transaction.

Financial Freedom Plan.[33] The Financial Freedom plan, offered by Financial Freedom Senior Funding Corporation, is a proprietary reverse mortgage product, owned and developed by the lender and not insured by the government. The Financial Freedom plan is available in California, Colorado, Washington and Arizona. The main advantage of this plan is that the borrower can borrow up to

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[32] For more details, see Fannie Mae, *Money From Home: A Consumer's Guide to Reverse Mortgage Options*, 1996.

[33] *A Consumer Guide to Reverse Mortgages* (brochure available from Financial Freedom Senior Funding Corporation). Consumers Union of U.S., Inc. does not endorse any individual reverse mortgage product or lender.

$700,000,[34] a higher maximum amount than under either HUD's HECM, or Fannie Mae's Home Keeper. Under the Financial Freedom plan, the homeowner receives the loan in one lump sum and sometimes uses some or all of that money to purchase an annuity, which in turn provides monthly payments for life, regardless of where the borrower lives. The Financial Freedom plan does not require an annuity purchase, but if the borrower wants an annuity, Financial Freedom will arrange for its purchase.

This plan's "equity conservation" feature determines how much a borrower will owe. At the outset of the loan, the borrower "pledges" a certain percentage of the home's equity. That percentage is what the borrower will owe when the loan becomes due, based on the home's value at that time. For example, if a borrower chooses to borrow against 60% of the home's equity, then the borrower will owe 60% of the home's value at the maturity of the loan. Under the Financial Freedom plan, the loan becomes due if the borrower does not live in the home for at least 375 out of 475 days for any reason.

The costs of the Financial Freedom plan tend to be higher than those of government-related programs, particularly the HECM. Thus, this plan is generally appropriate only for borrowers with high home values who seek to borrow more than the HECM and Home Keeper programs allow.

On June 21, 1999, Financial Freedom Senior Funding Corporation announced that it will acquire Transamerica Inc. for $200 million, which will extend Financial Freedom's operations into 35 states. Financial Freedom will acquire 6,000 reverse mortgage loans from Transamerica and intends to repackage the Transamerica loans as securities.[35] "Joseph Hu, director of structured finance ratings at Standard & Poor's Corp., which will rate the issue, said he believes this will be the first securitization of reverse mortgage loans rated by a U.S. credit rating agency."[36]

E. Special Purpose Loans—Alternatives to Reverse Mortgages

> *Special purpose loans allow a homeowner to borrow against home equity without having to make any payments until the loan's maturity date and may eliminate the need for a reverse mortgage.*

Special purpose loans are sometimes also referred to as reverse mortgages, but they are a different type of product. Like private sector reverse mortgages, special purpose loans allow a homeowner to borrow against home equity without having to make any payments until the loan's maturity date. Special purpose loans may eliminate the need for a reverse mortgage. They must be used for a specific purpose, usually to pay for home repairs or property taxes. The two basic types of special purpose loans are described briefly below. Homeowners should be aware of other home equity conversion options available to them before they take out a reverse mortgage. Other options, including special purpose loans, are likely to be less expensive than a reverse mortgage.

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34 *Id*.

35 *See* "Financial Freedom Buys Transamerica Unit", *Los Angeles Times*, June 22, 1999, at C2.; Diana McCabe, "Financial Freedom to Buy Transamerica", *Orange County Register*, June 22, 1999, at C1.

36 "Financial Freedom Buys Transamerica Unit", *Los Angeles Times*, *supra* note 35.

Deferred payment loans for home repair. A deferred payment loan is a no-interest or very low-interest loan for the purpose of making home repairs. This type of loan, like a reverse mortgage, need not be repaid until the borrower passes away, moves out of the home or sells the home. In California, these loans are made by city and county government agencies. Unlike reverse mortgages, deferred payment loans generally carry no loan fees or points. Furthermore, the fact that the loan carries a very low interest rate means that the loan may pay for itself, if the home improvements increase the appreciated value of the borrower's property sufficiently. A deferred payment loan usually carries income eligibility requirements and may not be offered in all areas.

For information on how to apply for a special purpose or a deferred payment home repair loan, borrowers should contact their city or county housing and neighborhood development agency.

Property tax deferrals. California offers a state property tax deferral program, under which a homeowner can borrow money from the government to pay property taxes. This loan accrues interest at a low rate, currently 5%, and, like a reverse mortgage, is payable when the homeowner passes away, moves or sells the home. Unlike a reverse mortgage it does not require the payment of loan fees or points. Property tax deferrals are limited to those age 62 or over, have maximum income requirements, and are not available to borrowers with less than 20% equity in their homes. Consumers seeking a property tax postponement should call the California State Controller, Division of Collections at 1-800-952-5661 to receive an application by mail, or pick up an application from any county tax collector office, usually beginning in mid-May.

Additionally, consumers should determine if they are eligible for the Homeowners Assistance Program which is administered by the California Franchise Tax Board. Homeowners who are 62 years of age or older, blind, or disabled, and meet certain income restrictions may be eligible for a grant of up to $326. This money is a one-time payment that eligible homeowners do not have to repay. Call the Franchise Tax Board, 1-800-852-5711 to receive an application and brochure, or pick up an application in person at a Franchise Tax Board district office.

The point of requiring pre-loan counseling is to ensure that potential borrowers get unbiased, independent information about the benefits and drawbacks of a reverse mortgage, and whether a reverse mortgage fits their needs. Consumers should seek out independent reverse mortgage counseling even if lender-provided counseling fulfills a loan program's requirements.

F. Reverse Mortgage Counseling and Disclosure

The HECM and Home Keeper programs require that all reverse mortgage applicants receive consumer education, which takes the form of pre-loan counseling. The HECM requires borrowers to receive mortgage counseling from a HUD-approved agency. The Home Keeper program requires counseling from a non-profit agency, a Fannie Mae HomePath telephone counselor or the lender. The point of requiring pre-loan counseling is to ensure that potential borrowers get unbiased, independent information about the benefits and drawbacks of a reverse mortgage, and whether a reverse mortgage fits their needs. Given the complexity of determining the true costs of reverse mortgages, independent counseling can play an important role in a consumer's decision-making process. However, the Home Keeper program's allowance for lender-provided counseling raises a conflict of interest issue. For this reason, consumers should seek out independent reverse mortgage counseling even if lender-provided counseling fulfills the loan program's requirements.

Reverse mortgage counseling varies somewhat in content and length, but generally counselors provide basic information about the nature of reverse mortgages as well as the benefits and risks to borrowers. They also help potential borrowers compare the various plans and understand all of their options, including alternatives to reverse mortgages. Face-to-face counseling usually takes about one to two hours per client, while telephone counseling sessions may be shorter.

The National Center for Home Equity Conversion (NCHEC)[37], a non-profit organization that provides information about reverse mortgages, certifies reverse mortgage counselors and lenders who meet its standards. "NCHEC-preferred" counselors pledge to: (1) disclose all of the borrower's options; (2) be unbiased and not accept payments in return for altering counseling standards;[38] (3) be independent, rather than steering a borrower to a specific lender; and (4) protect the borrower's privacy. NCHEC-preferred counselors use NCHEC software to provide a comparative analysis of the terms and costs of various products and programs. This analysis includes calculations of Total Annual Loan Costs (TALCs) for the different options. Lenders who seek "NCHEC-preferred" status must also pledge to: (1) disclose all of the borrower's options; (2) respect the borrower's decisions; and (3) protect the borrower's privacy.[39] NCHEC standards are widely recognized throughout the reverse mortgage industry, although not all lenders have NCHEC-preferred status.

Reverse mortgage counselors and advocates for reverse mortgage borrowers agree that independent counseling (that is, counseling provided by a neutral, unbiased agency, rather than by a lender) is invaluable in helping consumers make better choices about reverse mortgages.

Reverse mortgage counselors and advocates for reverse mortgage borrowers agree that independent counseling (that is, counseling provided by a neutral, unbiased agency, rather than by a lender) is invaluable in helping consumers make better choices about reverse mortgages.[40] In contrast, the National Reverse Mortgage Lenders Association (NRMLA), the reverse mortgage lenders' trade association, takes the position that while counseling can be a very helpful service, consumers should have the option to forego it, for example if they believe they can make an informed decision without it.[41] However, the optional counseling approach defeats the purpose of the NCHEC counseling

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37 *See* "Consumer Information Resources" section of this report for more information about the National Center for Home Equity Conversion.

38 An example of altering counseling standards would be a counselor's decision not to inform a potential borrower of non-reverse mortgage alternatives when he might otherwise do so, in return for continued counseling referrals from a lender.

39 NCHEC, "Help: Standards" (last visited: June 29, 1999) <http://www.reverse.org>.

40 *See* telephone interview with Dave Brown, *supra* note 1; telephone interview with Jonathan Garcia, Housing Coordinator, Consumer Credit Counseling Service of Los Angeles (Mar. 19, 1999); telephone interview with Niall McCarthy, Attorney, Cotchett, Pitre & Simon (Mar. 8, 1999); telephone interview with Steven Dylina, Deputy Counsel, San Mateo County Counsel's Office (Mar. 8, 1999); telephone interview with Carol Sperl, Housing Counselor, Inland Fair Housing and Mediation Board in Riverside, CA (Mar. 2, 1999).

41 Telephone interview with Peter Bell, President, National Reverse Mortgage Lenders Association (June 16, 1999).

requirement itself. A borrower may believe that she has sufficient information to make a sound decision when in fact a reverse mortgage counseling session would have helped her explore additional considerations and options. Also, allowing optional counseling opens the door to lender abuse. Lenders have an incentive to discourage borrowers from seeking out counseling because it might lead a borrower to decide not to take the loan. Even if lenders were required to inform borrowers of counseling options, there is no guarantee that all lenders would comply, and in any case lenders would still be able to advise potential borrowers that counseling is unnecessary.

Specific examples demonstrate the importance of reverse mortgage counseling. One California reverse mortgage counselor reported an experience with a couple where the husband was twenty years older than the wife. The lender suggested that the wife be taken off the title to the home, so that the reverse mortgage would give a higher monthly payout based solely on the husband's age. The lender told the couple that under this arrangement, the wife could continue to live in the home if the husband passed away first. Later, the reverse mortgage counselor explained to the couple that this arrangement could be very disadvantageous for the wife, because if the husband were to die, she would inherit the house, but she would also inherit all of the debt on the reverse mortgage. If she were unable to pay off the reverse mortgage debt with other assets, which in her case was likely, she would have to sell the home. Based on this information, the couple decided to keep her name on the title to the home when taking out the reverse mortgage.

Currently, the American Association of Retired Persons (AARP), HUD, Fannie Mae and reverse mortgage industry representatives are working to increase the availability of independent, high-quality reverse mortgage counseling through a number of initiatives. One proposal under discussion is to develop a national non-profit organization to oversee reverse mortgage counselor training and counseling agency funding. This organization could assist in setting standards for counselor training and would administer a certification exam. It could also audit counseling agencies to monitor the content and quality of counseling. The organization could also serve as a centralized funding coordinator for counseling agencies. Under this type of organizational structure, lenders would pay a fee per applicant counseled, which would go into a central pool. The new organization would then distribute funds to counseling agencies, based on the number of clients counseled. In this way, counseling agencies would receive adequate funding for their services without taking money directly from lenders. This would partially remove a conflict of interest between counseling agencies, whose mission is to provide impartial information, and the lenders, who want to sign up as many borrowers as possible and who, if they pay counseling agencies directly, may have financial influence over these agencies.[42]

Many counselors support this proposal, seeing it as a way of freeing counseling agencies from the financial pressure of relying on lenders for income while attempting to remain unbiased. It is important to note, however, that there are concerns among counselors that the development and monitoring of standardized counseling content and quality may be difficult to achieve, especially given the limited funding HUD has provided for counseling in the past.

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[42] Telephone interview with Ken Scholen, Program Specialist, American Association of Retired Persons (Apr. 9, 1999). The exact structure of counselor training and certification has not been finalized. One possibility is that a national housing counseling organization would administer the reverse mortgage counselor certification exam in conjunction with other counselor certification exams.

G. Advantages of Reverse Mortgages for Borrowers

Tapping Equity Tax-Free Without Losing Ownership

One of the most beneficial features of a reverse mortgage is that it allows a borrower to tap into a home's equity as a tax-free source of income, without having to sell the house and move out. Thus, the borrower retains ownership and control of the property while making use of her equity. In some cases, the borrower may choose to tap only a portion of the equity, an option not available if she were to sell her property. Furthermore, reverse mortgages allow the borrower to benefit from some or all of the potential growth of the value of her property. Allowing senior homeowners to benefit from a home's equity in this way may have psychological as well as financial benefits, as homeowners may have a strong personal preference for staying in their homes as they grow older.[43]

> *One of the most beneficial features of a reverse mortgage is that it allows a borrower to tap into a home's equity as a tax-free source of income, without having to sell the house and move out.*

No Immediate Repayment or Income Requirements

A reverse mortgage offers the unique advantage of not requiring any repayment until the loan matures. As a corollary, reverse mortgages do not have an income requirement. For homeowners on a small fixed income, for example those depending mainly on Social Security benefits, a reverse mortgage offers a way to increase monthly living allowances without the worry of meeting monthly loan payments. Thus, homeowners can benefit from the equity they have built up in their home without worrying about losing the home by defaulting on a repayment schedule.

A Borrower Can Never Owe More than the Value of the Home

A reverse mortgage loan is a non-recourse loan, which means that the lender cannot seek repayment from any source except the real property that secures the loan. There is no danger that the borrower will have to repay more than the value of the home, even if at the loan's maturity date total cash advances to the borrower have exceeded the value of the home. This protects the borrower from debt that would require the liquidation of other assets in addition to the home, which could likely occur in the event that the borrower remains living in the home longer than expected.

Reverse Mortgage Success Stories

Mr. H: Mr. H is an 80-year-old man living in Pleasanton, California. His wife recently passed away after an illness, and he was left alone in his home, with approximately $60,000 in medical bills due to his wife's medical treatment. Although he had never missed any payments, Mr. H was having difficulty meeting his debt obligations. Through reverse mortgage and general financial counseling, Mr. H learned how to negotiate to pay off his various debts and to reduce his total debt outlay. He chose to take out a lump-sum reverse mortgage, which allowed him to pay off creditors and his existing mortgage while remaining in his home. The reverse mortgage provided a needed supply of cash and also provided Mr. H with peace of mind, knowing he would not have to sell his home in order to pay his bills.

[43] Telephone interview with Steven Dylina, *supra* note 39.

Ms. X: Ms. X is a 96-year-old woman living in a high value home in Lafayette, California. Although her mortgage has been paid off, she has spent down her remaining assets and is in poor health, and is in need of additional cash for a variety of expenses. With the assistance of her sister and brother-in-law, she sought the help of a reverse mortgage counselor, who is assisting her in completing a reverse mortgage loan. The loan will allow her to live out her life in her home without having to make any repayments during that time.

H. Advantages of Reverse Mortgages for Lenders

High Up-Front Loan Fees and Potential Lender Windfalls

Reverse mortgage lenders charge substantial fees at the loan's closing. These fees generally are higher than those for traditional mortgages. Many of the fees are charged up front to the loan balance but the cash advances are usually disbursed over time. This means that the lender receives the benefit of fees and costs up front for the full amount of the loan, even if the borrower sells the home or passes away soon after taking the loan. In other words, under certain circumstances the lender can collect a substantial amount of fees while lending a relatively small amount of money.

> *Under certain circumstances the lender can collect a substantial amount of fees while lending a relatively small amount of money.*

Because loan proceeds are used to pay for most of these fees at the time of closing and the debt begins to accrue interest immediately, the lender earns interest on the money borrowed to pay for the fees from the first day of the loan. That interest is compounded over the life of the loan. As a result, fees and interest on those financed fees can quickly use up a substantial portion of a borrower's equity, before the borrower actually receives much cash.[44]

Low Risk of Losing Money Through Declining Property Values

Reverse mortgages in California have relatively low risks to lenders, due to a strong housing market and a long-term trend of home value appreciation. Furthermore, a reverse mortgage is guaranteed by the home, so even if the loan is uninsured, the lender will be prepaid up to the value of the home less sales expenses. Reverse mortgages are structured so that the amount of cash advanced to the borrower is adjusted based on the projected amount of interest charges, which are also financed by the loan, over the borrower's life expectancy. Therefore, the lender would be repaid less than the amount owed only in the event that the home depreciates after the loan is originated. Again, this is an unlikely occurrence, given trends in California's housing market.

I. Disadvantages of Reverse Mortgages for Borrowers

The High Cost of Reverse Mortgages

While not everyone agrees, many borrowers and counselors consider reverse mortgages to be a last resort for the borrower, to be used only when all other borrowing options are unavailable. Reverse mortgages are expensive. Borrowers must pay substantial fees that are added to the loan balance at the outset. For example, the origination fee is usually based on the home's value, which is much

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[44] Telephone interview with Niall McCarthy, *supra* note 39.

greater than the usual loan amount. This means that the origination fee is generally higher than that charged for a traditional mortgage, where the origination fee is based on the actual loan amount. In addition, accrued interest is compounded into the principal of the loan rather than paid off in installments. Interest rates themselves tend to be high and may be 3 to 5% higher than the average rate for a 30-year standard mortgage.[45] Some analysts conclude that reverse mortgages also generally require higher closing costs and higher mortgage insurance payments than traditional mortgages.[46] For example, a reverse mortgage tapping all of the equity in a fully paid-off $100,000 home, with a flat interest rate of 9% and $5,000 in front-end and origination costs may yield only $35,000 in a lump sum payment. After two years, the total amount owed, including the principal, interest and fees on the loan would equal $47,856.[47] For this reason, many borrowers will choose a reverse mortgage only if other options are not feasible.

Because of the high up-front costs, a reverse mortgage is generally unsuitable for a homeowner who plans to sell or move out of her home within a few years of taking out the loan. Likewise, a borrower who has to move out of her home unexpectedly will be hard-hit with the costs of a reverse mortgage. A borrower who moves out of her home, sells it, or dies within a few years after taking out a reverse mortgage will owe a substantial amount in fees and interest, while she may not have received much money through cash advances. Facing these high costs due to an unexpected move is a very real possibility. A 1995 study found that 60% of reverse mortgages are paid off for reasons other than the borrower's death.[48]

> *A borrower who moves out of her home, sells it, or dies within a few years after taking out a reverse mortgage will owe a substantial amount in fees and interest, while she may not have received much money through cash advances.*

Some common front-end fees that drive up loan costs are described below:[49]

- ***Origination fee***: The origination fee covers the lender's costs in preparing and processing the initial paperwork on the loan. HUD's HECM program sets no limit on the amount a lender can charge for loan origination, but limits the amount of origination fee that can be financed through the HECM to $1,800. Fannie Mae's Home Keeper program allows a maximum origination fee charge of 2% of the property's adjusted value.

- ***Points***: Generally, points are an additional charge on the loan based on a percentage of the loan value. Reverse mortgage borrowers may be required to pay points at a loan's closing. In some cases, points are calculated by looking at the adjusted property value instead of the value of the loan. For example, the Home Keeper charges a one-point fee (1%) based on

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[45] Sanders, *Orange County Register, supra* note 5.

[46] Jay Romano, "For Reverse Mortgages, a Fannie Mae Inprimatur," *New York Times*, June 23, 1996, sec. 3, at 9.

[47] Ken Scholen, *Your New Retirement Nest Egg: A Consumer Guide to the New Reverse Mortgages*, 2d ed., 1996, at 46-48.

[48] Sanders, *Orange County Register, supra* note 5, quoting James Mahoney, Senior Vice President, Financial Freedom Senior Funding Corporation.

[49] For more information on these fees, see Fannie Mae, *Money From Home*, 1996; see also Scholen, *Your New Retirement Nest Egg, supra* note 46.

the adjusted property value. Thus, for a home with an adjusted property value of $200,000, the borrower would pay $2,000 in points at the closing of the loan.

- ***Mortgage insurance premiums***: This insurance premium is paid by the borrower and protects the lender against the risk that the borrower's loan balance may exceed the value of the home. For example, a borrower of a HECM, which is insured by HUD, must pay a one-time mortgage insurance fee of 2% of the home's value, as well as an annual premium of 0.5% on the mortgage loan balance.

- ***Closing costs***: In addition to other charges, the borrower must pay closing costs for title search, title insurance, appraisals, surveys, credit checks, taxes and recording fees. Fannie Mae estimates that typical closing costs for a Home Keeper loan in California total approximately $1,600.[50]

Other fees that are not collected at closing, but add to the total cost of the loan, include:

- ***Servicing fee***: A servicing fee covers the on-going costs of processing loan advances and mortgage premiums, record-keeping, and other processing costs. This fee goes to the loan servicer, who may or may not be the loan originator (the lender). This fee cannot exceed $30 per month for a Home Keeper loan. Likewise, the maximum servicing fee for a HECM is $30 per month if the borrower has an annually adjusted interest rate. The Financial Freedom plan has no servicing fees because there are no monthly advances, only the lump sum and annuity purchase.

- ***Shared equity or "maturity" fee***: This is a fee that must be paid at the time the loan matures. It is calculated as a share of the full value of a home at the time the loan matures. The Fannie Mae plan offers an "Equity Share" option under which, in exchange for receiving higher monthly payments, a borrower agrees to pay 10% of the home's full value at the termination of the loan. The now-defunct Transamerica reverse mortgage product charged borrowers 2% of the home's full value at the loan's maturity.

- ***Shared appreciation fee***: In the past, some reverse mortgages have required that at the date of loan maturity the borrower pay a share of the home's appreciation in value since the time of loan origination. Transamerica, for example, required borrowers to pay a 50% shared appreciation fee, which meant that if a home's value increased by $50,000 between the time the loan was originated and the time it matured, the borrower would owe an additional $25,000 at the termination date. A danger of both equity fees and shared appreciation fees is that if the borrower dies or is forced to leave the home soon after taking out the loan, the fee might be larger than the payments received.

Decreased Equity Remaining for Heirs

A significant drawback of a reverse mortgage for some homeowners is that it will drain a large amount of equity out of the home, leaving less for homeowners to bequeath to heirs. If a homeowner wants to leave her home to her children, a reverse mortgage may be a bad idea, unless the homeowner or her heirs will be able to pay off the reverse mortgage with other assets without selling the home.

[50] Fannie Mae, *Money From Home*, 1996, at p.16.

Unfortunately, reverse mortgage lenders often fail to highlight this reality, emphasizing that homeowners can both get cash and keep their homes, without explaining that the house will probably have to be sold on the death of the borrower.

Complexity of Reverse Mortgage Products

Another drawback to entering into a reverse mortgage transaction is its complexity. Even relatively sophisticated consumers have difficulty understanding the consequences of borrowing using a reverse mortgage. The benefits from different reverse mortgage products can vary widely, given the spectrum of fees, choice of loan advancement and repayment options, variable loan amounts based on age and home value, and different interest rates. These variables make it extremely hard to compare among products and borrowers may have difficulty determining the true cost of the loan over time.

> *The benefits from different reverse mortgage products can vary widely making it extremely hard to compare among products. Borrowers may have difficulty determining the true cost of the loan over time.*

Consumer education groups and government agencies have attempted to address this problem by developing the Total Annual Loan Cost rate (TALC), which reflects both the interest rate and the other costs of the loan. The TALC rate provides a standard measure that can be used to compare the costs of different loan packages. The TALC rate indicates the average annual rate that, if charged on the cash advances made up to that point, would generate the total amount owed. In other words, a TALC rate of 16.9% for a two-year loan means that the borrower in effect will pay an average annual interest rate of 16.9% on the principal of the loan (including start-up costs such as origination fees, as well as the cost of any annuity purchase that are financed) and compounded interest for those two years. This means that the TALC rate on a loan is higher in the earlier years and declines as the start-up costs are spread over a longer period of time. For this reason, borrowers are given projected TALC rates at three future time points, to demonstrate the varying costs of the loan depending on how long it is held. TALC rate disclosure is required for the following periods: two years after the loan's origination, the borrower's life expectancy, and 40% beyond the borrower's life expectancy.

> *Although the TALC rates are an important tool for understanding the costs of reverse mortgages, the inherent complexity of reverse mortgages means that they remain confusing for many potential borrowers.*

TALC rates are used by HUD-approved reverse mortgage counselors to help borrowers understand whether and what type of reverse mortgage may be best for them. However, even the use of TALC rates does not make understanding reverse mortgages simple. TALC rate calculations have caused some confusion even among some reverse mortgage counselors. TALC rates must be combined with various projected appreciation rates, the expected length of the loan, and, in the case of a line of credit, when the credit will be used, in order to indicate the future cost of a loan.

Although the TALC rates are an important tool for understanding the costs of reverse mortgages, the inherent complexity of reverse mortgages means that they remain confusing for many potential borrowers.

Adverse Impacts on Government Benefits

Consumers receiving need-based government benefits such as Supplemental Security Income (SSI) or Medicaid must be very careful in structuring the receipt of any reverse mortgage payments and must carefully document when and how those receipts are used. Money from a reverse mortgage may affect a borrower's eligibility for these programs in some cases. For example, monthly loan proceeds are not considered "income" for the purpose of determining SSI eligibility, but proceeds retained by the borrower beyond the month in which they are received are counted as "assets" that may adversely affect eligibility. In addition, annuity advances are considered "income" under the SSI and Medicaid programs. On the other hand, reverse mortgage proceeds used to repair a home do not affect SSI or Medicaid eligibility because the home is not considered a resource.[51] Borrowers who receive or expect to receive SSI or Medicaid in the future should find out exactly how their eligibility would be affected by reverse mortgage payments, which may differ depending on the structure of the payments to avoid adverse affects on public benefits. Reverse mortgage proceeds do not affect eligibility for non-need based programs such as Social Security and Medicare.

Borrowers who receive or expect to receive SSI or Medicaid in the future should find out exactly how their eligibility would be affected by reverse mortgage payments.

J. Pitfalls of Reverse Mortgages for Borrowers

As discussed earlier, although reverse mortgages have substantial benefits for homeowners, they also have significant disadvantages. In some cases, reverse mortgages may contain more than the usual disadvantages. The unwary borrower may encounter any one or more of the pitfalls that may make a particular reverse mortgage even more disadvantageous. This section discusses some of those hazards in greater detail.

Shared Appreciation and Shared Equity Agreements

A shared appreciation or shared equity agreement may be included in a reverse mortgage package. A shared appreciation agreement entitles the lender to a certain share of any appreciation in a home's value between the time the loan is made and the time the loan reaches maturity. A shared equity agreement entitles the lender to a share of the home's entire equity at the time the loan matures. This shared equity agreement guarantees that the lender will receive money from the agreement, even if the home does not appreciate. These agreements enable the lender to provide higher monthly payments by providing an additional fee when the loan is repaid. However, they are also potentially very costly, because of the potentially huge loss of equity for the consumer.

These agreements may be extremely favorable to the lender. For example, the San Mateo County Public Guardian, on behalf of Berta Gray, an 83-year old woman, alleged that Transamerica Corporation charged her a 50% "contingent interest" fee on her reverse mortgage. The contingent interest was defined as 50% of the difference between the base value of the home when the loan was

[51] Charles Nauts, "Legal Counseling for Reverse Mortgages and Sale-Leasebacks", in *Reverse Mortgages: A Lawyer's Guide to Housing and Income Alternatives*, (David A. Bridewell & Charles Nauts eds. 1997), at 35-36, published by the Senior Lawyers Division of the American Bar Association.

signed and the appreciated value of the home when the loan terminated. This contract term was in effect a shared appreciation agreement. The Public Guardian alleged that this fee was unfair and unconscionable because it had nothing to do with the amount of the loan balance. The Public Guardian also alleged that while Ms. Gray's property was originally appraised at $245,000 and her loan amount was capped at $136,363, the "contingent interest" fee alone exceeded the loan advances Ms. Gray would receive under the loan.[52]

Some consumer and industry representatives believe that shared appreciation agreements are less likely to be offered in future reverse mortgage products, because those products that included them were not successful in the market.[53] Nevertheless, consumers should be aware that: 1) both shared appreciation and shared equity agreements have been offered in the past, 2) there is no legal prohibition against them, and 3) they can be extremely disadvantageous for borrowers. While a shared appreciation or shared equity fee is not necessarily unreasonable, borrowers should carefully consider whether agreeing to the term is in their best interest. Given the rapid rate of appreciation in California's housing market, agreeing to such a term may mean giving up an extremely large amount of equity in return for a relatively small amount of cash.

> *The San Mateo County Public Guardian alleged that a "contingent interest" fee was unfair and unconscionable because it had nothing to do with the amount of the loan balance. The Public Guardian also alleged that while Ms. Gray's property was originally appraised at $245,000 and her loan amount was capped at $136,363, the "contingent interest" fee alone exceeded the loan advances Ms. Gray would receive under the loan.*

Annuity Purchases

Annuity purchases are sometimes offered in conjunction with reverse mortgages. Under an annuity purchase arrangement, the borrower takes out at least part of a reverse mortgage loan in a lump sum payment. That sum is used to purchase an annuity, which is an insurance product, that will begin making monthly payments to the borrower. The annuity may begin to provide payments immediately or after a certain number of years. When payment starts later, the annuity is a deferred annuity. The advantage of an annuity is that the borrower will continue to receive payments for the rest of her life, regardless of where she lives. For a borrower who expects to move in the next several years to a nursing home, for example, an annuity might be an attractive product.

However, loan/annuity combinations are generally more costly than reverse mortgages that provide cash advances. The money used to purchase the annuity is charged against the loan balance immediately, which means that the borrower accrues interest debt on that money although she most likely will see no benefits from the annuity for years. Therefore, a forced annuity purchase, while disguised as a way to provide extra financial security, can in fact be a vehicle to squeeze extra money out of a homeowner.

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52 *San Mateo County Public Guardian v. Transamerica Corporation*, Class Action Complaint, Case No. 405495, California State Superior Court, County of San Mateo, filed July 13, 1998.

53 Telephone interview with Ken Scholen, Program Specialist, American Association of Retired Persons, (June 18, 1999); telephone interview with Peter Bell, *supra* note 40.

When considering annuities, consumers may not be aware that regular reverse mortgages are possible alternatives that may better meet their needs. Independent annuity sales agents have no incentive to disclose that reverse mortgages can provide monthly payments and credit lines without any up-front purchase of an insurance product. This means that consumers may be convinced that to obtain cash advances they must purchase an annuity, when in reality a standard reverse mortgage might meet their needs at a lower cost.

> *The money used to purchase the annuity is charged against the loan balance immediately, which means that the borrower accrues interest debt on that money although she most likely will see no benefits from the annuity for years. A forced annuity purchase, while disguised as a way to provide extra financial security, can in fact be a vehicle to squeeze extra money out of a homeowner.*

Annuities are also potentially unwise purchases for elderly borrowers who are unlikely to live long enough to substantially benefit from them. A lender may convince a borrower that an annuity will provide her with financial support for the remainder of her life, when in fact it will merely drain equity from her home while providing little or no additional benefit. In such circumstances, a monthly cash advance through a reverse mortgage may be a less expensive option.[54]

The *Transamerica* case illustrates this problem. In that case, the San Mateo County Public Guardian alleged that Ms. Gray was required to purchase a non-cancelable, non-transferable deferred "Life Annuity" from Metropolitan Life Insurance Company with her Transamerica reverse mortgage. The annuity allegedly would not begin to disburse payments for approximately six years after the initiation of the loan. Yet the Public Guardian alleged that the cost of the annuity was charged to Ms. Gray's loan balance when the loan was closed, and interest was compounded on that charge during the six-year period. According to the complaint, this arrangement protected Transamerica from the possibility that long-term loan advance payments might exceed the value of the home. Furthermore, the Public Guardian alleged that under this arrangement if Ms. Gray died before the six-year period ended, her estate would see no benefit from the annuity purchase, although she had paid in full for it. The Public Guardian claimed that given that Ms. Gray was 83 at the time she purchased the annuity, it was unlikely that she would have benefited much from the annuity, since it would not even begin to disburse payments until she was 89.

None of the currently existing reverse mortgage products requires an annuity purchase, but some reverse mortgage companies encourage annuity purchases. For example, Financial Freedom's reverse mortgage brochure describes its Financial Freedom Plan as including "lifetime payments," although in fact the annuity required to receive those payments is an optional purchase.[55] While some annuities are tailored to work well with reverse mortgages, other "off the shelf" annuities are ill-suited to be combined with a reverse mortgage.[56] Borrowers should carefully consider the consequences of any annuity purchase in conjunction with a reverse mortgage because it may be a very unwise investment. NCHEC advises borrowers to be particularly wary of "tax-deferred, variable annuities,"

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54 NCHEC, "Alerts: Annuities: (last visited: June 30, 1999) <http://www.reverse.org>.

55 "A Consumer Guide to Reverse Mortgages", *supra* note 33.

56 Telephone interview with Ken Scholen, *supra* note 41.

which are targeted toward middle-aged investors saving for retirement. This type of annuity does not guarantee a fixed monthly payment for life.[57]

"Estate Planning" Fee Scams

An unscrupulous practice seen over the past few years is the charging of high fees by "estate planning" firms. HUD estimates that several hundred seniors nationwide have been victimized by estate planning firms that have charged 6 to 10% of mortgage proceeds, translating into a $6,000 to $10,000 fee on a $100,000 reverse mortgage, for referring a borrower to a lender.[58] In 1997, out of an estimated one hundred companies nationwide who were charging these fees, HUD identified six estate planning firms for enforcement actions: America's Trust Inc., Patriot Inc., Senior Information Services, Paramount Trust & Financial Services, America's Financial Inc., and Senior Financial Services. America's Trust, Patriot Inc., and Senior Information Services were all run by one southern California businessman. HUD stated that the firms charged these exorbitant fees despite the fact that lender referrals could be obtained for free from any HUD-approved counseling agency or through a toll-free HUD number. In addition, HUD Secretary Andrew Cuomo stated that these firms attempted to sell annuities and other insurance products to seniors once they had taken out loans.[59] Nicholas P. Retsinas, then the Commissioner of the Federal Housing Administration, stated, "What [these firms] are doing is illegitimate. There is literally no value received" for the fees.[60] According to one newspaper story[61], Maxine Wittig of Norwalk, California alleged that she paid $5,571 to America's Trust, Inc. in return for a visit from an agent, who came to her home and referred her to a reverse mortgage lender. The same story reported that she stated that America's Trust never informed her that she would be charged 10% of her loan amount for that service.[62]

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When these estate planning firms began to sell "distributorships" across the country in 1997, HUD recognized that the problem could quickly grow to nationwide proportions. The agency directed lenders to cease dealing with companies that charged these fees and refused to insure such loans.[63] Patriot and America's Trust challenged this directive in court. They alleged that HUD had exceeded

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[57] NCHEC, "Alerts: Annuities" (last visited June 30, 1999) <http://www.reverse.org>.

[58] "HUD Orders Halt to Charging Senior Citizens Thousands of Dollars Each for Reverse Mortgage Information," HUD Press Release No. 97-31, Mar. 17, 1997.

[59] James S. Granelli, "HUD Warns of 'Illegitimate' Fees for Reverse Mortgages," *Los Angeles Times*, Mar. 18, 1997, at D1.

[60] *Id.*

[61] Don McLeod and Elliot Carlson, "Cuomo's Advice: Stay on Guard," *AARP Bulletin*, June 1997, vol. 38, no. 6, Washington, D.C., at 5.

[62] Granelli, *Los Angeles Times*, *supra* note 58.

[63] E. Scott Packard, "HUD Action Against Reverse Mortgages Halted," *Los Angeles Times*, Mar. 28, 1997, at D3. *See also* "HUD Orders Halt to Charging Senior Citizens Thousands of Dollars Each for Reverse Mortgage Information," HUD Press Release No. 97-31, Mar. 17, 1997.

its authority in acting without producing evidence of illegal activity. Unfortunately, a federal district court granted Patriot and America's Trust's request for a preliminary injunction against the directive, temporarily halting HUD's action. Meanwhile, Congress passed legislation requiring salespeople to disclose to potential borrowers that they were being charged for information that is available for free, and gave HUD the authority to regulate "unnecessary or excessive costs of obtaining" a reverse mortgage.[64] These actions in large part halted the practice of charging illegitimate estate planning fees, because lenders are unwilling to originate loans that the government will not insure.

In January of 1999, HUD issued a final rule on estate planning fees relating to HECMs. Key features of the rule include:

- HECM proceeds cannot be distributed to estate planning firms at the closing of the loan.
- If the borrower takes out at least 25% of a HECM in a lump sum, the lender must inquire and confirm that none of this money will go to pay an estate planning firm.
- HECM borrowers must establish to the lender's satisfaction that they have no outstanding or unpaid obligations against the initial loan payment, except for required repair costs and loan servicing fees.
- An initial payment from a HECM cannot be used to pay an estate planning firm.
- HUD-approved counselors must ask potential HECM borrowers whether the borrower has agreed to pay an estate planning fee. If so, counselors must explain the extent to which third-party services are not needed and the extent to which those services may be available through HUD counseling agencies.[65]

Federal legislation and HUD's final rule appear to have halted estate planning fee abuses for the most part. However, borrowers should continue to be wary of anyone who tries to charge a "financial planning" or "estate planning" fee in return for assistance in arranging a reverse mortgage. A borrower should never have to pay a fee to anyone besides the lender to set up a reverse mortgage.

The Danger of Reverse Mortgage Counseling Agency Ties to Lenders

Some reverse mortgage counseling agencies accept fees from lenders in return for counseling potential borrowers referred to the agency by the lender. For example, at least one California counseling agency requests a $100 voluntary contribution from lenders for each client counseled. This type of arrangement provides agencies with a source of much-needed funding. The agency will not turn away a client whose lender does not make a contribution; however, this funding structure creates a dangerously close relationship between lender and counseling agency. As an agency comes to rely on revenue generated by referral fees, it will have more of an interest in encouraging borrowers to take out reverse mortgages, in order to encourage the lender to refer more borrowers in the future. Such an arrangement could compromise the counselor's neutrality as a third-party provider of information, to the detriment of the consumer.

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[64] PUB. L. NO. 105-276, SEC. 593, 105TH CONG., 2D SESS.

[65] 64 FED. REGISTER 2984, DEPT. OF HOUSING AND URBAN DEVELOPMENT (JAN. 19, 1999).

Some counseling is also provided directly by the lender. Borrowers under Fannie Mae's Home Keeper reverse mortgage should seek counseling from an independent agency, even though Fannie Mae allows the lender's staff to provide the required counseling. Even when the counseling is done in good faith, the lender is not a neutral party. There is an inherent conflict of interest when the lender, who can benefit by completing the loan, acts as the counselor. For example, a lender who offers Fannie Mae Home Keeper loans but not HUD HECM loans has a financial disincentive to fully inform the borrower about the HECM program although it may better suit the borrower's needs.

> *Some reverse mortgage counseling agencies accept fees from lenders in return for counseling potential borrowers referred to the agency by the lender. This funding structure creates a dangerously close relationship between lender and counseling agency.*

Lenders' Unethical and Deceptive Practices

Consumers must be wary of lenders who may fail to disclose all of the fees associated with a reverse mortgage, or who ask borrowers to sign documents without reading or fully understanding the papers. As the *Commonwealth*, *Transamerica* and *Polo Financial Services* litigation described in Part II below show, home owners have sued alleging that such practices have been used to deceive consumers into accepting unconscionably high fees and loans they do not want or need.

> *There is an inherent conflict of interest when the lender, who can benefit by completing the loan, acts as the counselor.*

In addition, counselors have described instances in which lenders have improperly attempted to bias borrowers against lenders. For example, Consumer Credit Counseling Service of Los Angeles reported instances in which a lender accompanied a borrower to a counseling session, pretending to be a friend or family member, in order to pressure the borrower to take out the loan.

Furthermore, while lenders under the HECM program are required to provide potential borrowers with a list of reverse mortgage counseling agencies, in general lenders have an incentive to refer borrowers to counseling agencies with which they feel comfortable. They may prefer a particular agency because they believe counselors there are less likely to dissuade the borrower from borrowing the reverse mortgage or because a particular agency promises a quick turnaround. Reverse mortgage counselors state that some lenders do in fact engage in this practice, despite HECM program rules. This practice of "steering" means that consumers may not always get the counseling services they want or need, because the lender influences the counseling.

Borrower Competency Issues

Some seniors who are potential reverse mortgage borrowers may suffer from a decreased capacity to make sound financial decisions. Some may be legally incompetent to make such decisions, while others do not have the education, sufficient literacy skills, or experience to act as fully informed borrowers. In studying health literacy among Medicare enrollees, the Journal of the American Medical Association cited the most recent National Adult Literacy Survey (NALS). The 1993 NALS reported that 44% of adults aged 65 years or older scored in the lowest reading level (level 1), meaning they could not perform the basic reading tasks necessary to fully function in society.[66] That so many in the reverse mortgage target market may be functionally illiterate underscores the need for consumers to have quality, unbiased financial counseling before entering into a reverse mortgage contract.

> *Consumers must be extremely careful not to agree to any contract terms they do not fully understand, especially because there is currently no mechanism in place to screen for borrowers who may lack the capacity to make sound financial decisions when considering a reverse mortgage.*

While reverse mortgage counseling is designed to educate consumers as to the benefits and drawbacks of reverse mortgages, not all loan programs require such counseling, and the counseling itself may not suffice to ensure that borrowers truly understand the consequences of taking out a reverse mortgage. Consumers must be extremely careful not to agree to any contract terms they do not fully understand, especially because there is currently no mechanism in place to screen for borrowers who may lack the capacity to make sound financial decisions when considering a reverse mortgage.

[66] Julie A. Gazmararian et al., "Health Literacy Among Medicare Enrollees in a Managed Care Organization," 281 Journal of the American Medical Association 545 (1999).

II. Recent and Pending Litigation in California to Stop Abusive Reverse Mortgage Lending Practices

Several lawsuits have been filed in California alleging fraud and financial abuse of seniors in reverse mortgage transactions. These cases, three of which are described below, illustrate some of the dangers consumers face from unfairly high fees and fraudulent and deceptive business practices. The companies named as defendants in these suits have discontinued their reverse mortgage products and no currently available products offer equivalent terms. However, the cases demonstrate some of the dangerous practices that can accompany reverse mortgage lending. No subsequent regulatory or legislative action has been taken to bar these types of practices in the future.

A. San Mateo County Public Guardian v. Commonwealth Life Insurance[67]

One significant lawsuit alleging illegal reverse mortgage lending practices is *San Mateo County Public Guardian v. Commonwealth Life Insurance*, a class action filed in 1995. In *Commonwealth,* the Public Guardian alleged that the defendant seller of reverse mortgages required the payment of excessive and hidden charges that concealed the true costs of the loans, and that resulted in borrowers being charged tens of thousands of dollars in artificially inflated loan fees.

The named plaintiff was the San Mateo County Public Guardian, as conservator for Beatrice Mathews, who was 80 years old when she entered into a reverse mortgage contract. The complaint states that the lending value of Ms. Mathews' home was assessed at $195,500 and, under the reverse mortgage contract, she received $1,143 per month. The complaint also states that Ms. Mathews was charged an origination fee, called a "borrower's fee," of $3,000 plus 7% of the appraised value of her home, which equaled $16,685, as well as a form fee, an appraisal fee, an inspection fee, a survey fee, and a title insurance fee. Overall, the Public Guardian alleged that at the end of the first year of the loan, Ms. Mathews had received $13,716 in loan advances and owed $35,336. Thus, at the end of the first year of the loan, she allegedly owed the lender nearly two and one-half times as much as she had received in monthly payments.[68] The Public Guardian claimed that Commonwealth never disclosed these fees to Ms. Mathews. Ms. Mathews never benefited substantially from the reverse mortgage, since she passed away soon after the suit was filed.

Overall, the Public Guardian alleged that at the end of the first year of the loan, Ms. Mathews had received $13,716 in loan advances and owed $35,336. Thus, at the end of the first year of the loan, she allegedly owed the lender nearly two and one-half times as much as she had received in monthly payments.

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[67] *San Mateo County Public Guardian v. Commonwealth Life Insurance,* Class Action Complaint, [hereinafter *Commonwealth* complaint] Case No. 393961, Superior Court of the State of California, County of San Mateo, filed Oct. 5, 1995. This suit is also sometimes referred to as also referred to as the *Providian* lawsuit because Providian Corporation, the parent company of Commonwealth Life Insurance Company, was one of the defendants.

[68] Hathaway, *supra* note 10.

The *Commonwealth* allegations demonstrate how a lender can take advantage of an elderly borrower through extremely high, front-loaded fees. While Ms. Mathews had seen only a modest benefit from the loan, the lender allegedly already held the rights to nearly two and a half times as much as she had received in the form of equity in her home. The *Commonwealth* suit was eventually settled in 1999 on behalf of 1,505 class action plaintiffs.

One of the most important features of the *Commonwealth* suit was that it relied on the Elder Abuse Protection Act, California Welfare and Institutions Code section 15600 et seq., to seek recovery. Although the case was settled, *Commonwealth* suggests that this statute can be an effective tool to protect seniors from unscrupulous and unfair reverse mortgage lending practices. Under section 15657 of California's Welfare and Institutions Code, a senior can be awarded punitive damages and attorney's fees upon proof of fiduciary abuse of the senior.[69] The argument made in *Commonwealth*, as well as in *San Mateo County Public Guardian v. Transamerica Corporation*, described below, is that the lender should have known that the senior citizens "trusted [the lender] to prepare documents necessary to create a fair and equitable reverse mortgage."[70]

Commonwealth Life Insurance no longer offers reverse mortgage products.

B. San Mateo County Public Guardian v. Transamerica Corporation[71]

San Mateo County Public Guardian v. Transamerica Corporation is a pending class action that alleges alarming practices among some reverse mortgage lenders concerning forced shared appreciation agreements and annuity purchases by the borrower. These terms allow a lender to take an unconscionably high share of a home's appreciated value and forces the purchase of an annuity the borrower may not need or use.

In *San Mateo County Public Guardian v. Transamerica Corporation*, the plaintiff, the San Mateo Public Guardian, alleged that Transamerica, a subsidiary of Transamerica Corporation, issued a reverse mortgage in conjunction with an annuity to Berta Gray in 1994. According to the complaint, the standardized agreement stated that Transamerica was entitled to 50% of the appreciation in value of Ms. Gray's home between the time the loan was issued and the date of maturity. In addition, Transamerica allegedly charged Ms. Gray a 2% "maturity fee," equaling 2% of the total appreciated value of the home at the end of the loan period. The complaint states that Transamerica charged the cost of an annuity against Ms. Gray's loan balance

According to the complaint, Transamerica claimed that it was entitled to 50% of the appreciation in value of Ms. Gray's home between the time the loan was issued and the date of maturity. In addition, Transamerica allegedly charged Ms. Gray a 2% "maturity fee," equaling 2% of the total appreciated value of the home at the end of the loan period.

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[69] CAL. WELF. & INST. CODE §15657. See also CAL. WELF. & INST. CODE §15610.30 for definition of fiduciary abuse.

[70] *Commonwealth* complaint, *supra* note 64, at p. 13.

[71] *San Mateo County Public Guardian v. Transamerica Corporation,* Class Action Complaint, [hereinafter *Transamerica* complaint], Case No. 405495, Superior Court of the State of California, County of San Mateo, filed July 13, 1998.

from the beginning of the loan. This meant that Ms. Gray was required to pay interest on that amount, although she would see no payout from the annuity for approximately six years.[72] The lender was the alleged beneficiary of the annuity, which meant that even if Ms. Gray never saw a penny from the annuity, which she did not because she passed away before it began to pay out, her estate would receive no benefit.[73]

The Public Guardian further alleged that the contract contained an unconscionable requirement that all of the borrower's claims be resolved through arbitration, while lenders' claims are exempt from arbitration.[74] For example, while the arbitration clause attempts to bar both individual and class action suits from judicial resolution, the contract specifically provides that Transamerica can bring a suit for judicial foreclosure or for injunctive relief in the form of appointment of a receiver. It also permits Transamerica to engage in non-judicial foreclosure and to exercise any and all remedies available under the contract, as well as self-help remedies.

In many ways, the allegations in *Transamerica* describe conduct more egregious than that in the *Commonwealth* case. Based on the allegations contained in the complaint, the main danger to borrowers in the *Commonwealth* case was that they were required to pay extremely high fees and purchase an annuity up front. They were required to do this even though they might not live long enough to see any substantial benefit from the reverse mortgage. However, for borrowers who did live for many years, those fees would not be so egregious when spread out over the period of loan advances. In contrast, in *Transamerica*, the alleged 50% shared appreciation fee and 2% maturity fee could never be justified by the possibility of many years of loan advances under the reverse mortgage, since the reverse mortgage term was only for six years. The company still was able to collect a fee that was certain to be substantial, in addition to the interest on the loan. This is because it appeared that there was little risk that Ms. Gray's loan advances might exceed the value of her home or go beyond a projected length of time. Given that Transamerica was allegedly collecting approximately 10% interest on the loan, and that it carried little risk of losing money due to the annuity arrangement, the Public Guardian claims that these fees are extremely unfair, unduly oppressive and unconscionable.

Transamerica Corporation no longer offers reverse mortgage products. However, on June 21, 1999 Financial Freedom Senior Funding Corp. announced its plan to acquire and service Transamerica Corporation's reverse mortgage portfolio consisting of 6,000 loans. This acquisition will enable Financial Freedom Senior Corp. to extend its presence into 35 states.[75]

C. Polo Financial Services/TriStar Suits

One set of cases involving extensive alleged real estate fraud, including the sale of reverse mortgages, is that relating to Polo Financial Services, which did business as TriStar Mortgage (TriStar). Polo Financial Services has been named in at least nine lawsuits by borrowers who claim they were cheated by the firm.[76] The company has also been sued by at least five lenders who allege they were cheated

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72 *Id.* at 7-9.

73 Telephone interview with Steven Dylina, *supra* note 39.

74 *Transamerica* complaint, *supra* note 71, at p. 10.

75 "Financial Freedom Buys Transamerica Unit" and "Financial Freedom to Buy Transamerica", *supra* note 35.

76 Ben Sullivan, "Home Loan Scandal; L.A. Area Customers Cheated, Suits Say", *Daily News*, Los Angeles edition,

through their business dealings with Polo Financial Services. While the total financial impact of Polo Financial Services' alleged illegal activities is difficult to calculate, the Money Store, a lender for many of the loans Polo Financial Services arranged, stated that it held up to $20 million in fraudulent loans set up by Polo Financial Services.[77] Edward Rostami, who ran Polo Financial Services, has denied the various charges in public statements.[78] He has failed to appear in a number of the suits, resulting in default judgments against him. Currently, Mr. Rostami's whereabouts are unknown.

In a number of cases, consumers alleged that Polo Financial Services told them it would give them reverse mortgage loans, but instead it took out conventional loans as collateral. For example, Irene Schuler, a 76-year-old woman living in Santa Clara, California, claimed that under the TriStar name, Edward Rostami and his associates contacted her via telemarketing. She claimed that they convinced her that they could give her a reverse mortgage on more favorable terms than the one she held at the time with a company called Providential.[79] In fact, she alleged, the defendants without her knowledge took out two conventional residential mortgages totaling $340,000, secured by Ms. Schuler's home. Then, she claimed, they forged her signature and embezzled and converted more than $100,000 before Mr. Rostami disappeared. This allegedly left Ms. Schuler with $340,000 in loans that she could not repay. While Ms. Schuler secured a $2.6 million default judgment against TriStar,[80] she has yet to receive any of that money, as Mr. Rostami has disappeared. Fortunately, Ms. Schuler was not evicted from her home, but the loan is still in default. Ms. Schuler has been forced to return to work and rents out part of her home in order to repay the loan, and she will now have to take out another loan to refinance the home.[81]

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The Polo Financial Services/TriStar Mortgage cases demonstrate how sales pitches for reverse mortgages can be used unscrupulously to defraud consumers who do not fully understand what a reverse mortgage is or how it operates. Even a legitimate reverse mortgage is very complex, and without an independent source of information, borrowers can be persuaded to take out what is in fact a conventional home equity loan. Unfortunately, in the Polo Financial Services/TriStar Mortgage cases, plaintiffs say Mr. Rostami used this ruse to put them into loans they did not want or need, and to embezzle their home equity. These cases also demonstrate that seniors' interest in taking out a reverse mortgage is not balanced by an adequate understanding of the product or how to access a legitimate reverse mortgage.

III. Who's Minding the Store?

May 10, 1998 at N1.

77 *Id.*

78 *Id.*

79 *Schuler v. Rostami,* Complaint for Damages, Superior Court of the State of California, County of Santa Clara, No. CV769792, filed Oct. 30, 1997. The Providential Home Income Plan, the program under which Ms. Schuler obtained her original reverse mortgage, no longer originates reverse mortgages.

80 *Schuler v. Rostami,* Judgment Against Defendants Polo Financial Services et al., hearing of Jan. 22, 1999, filed Feb. 9, 1999.

81 Telephone interview with Andrew Fagan, Attorney, Bryant, Clohan, Eller, Maines & Baruh, LLP (Mar. 27, 1999).

Reverse mortgage counselors and attorneys representing borrowers in reverse mortgage litigation characterize the reverse mortgage lending industry as a "wild west" environment, with little if any regulatory enforcement to curb illegal and unethical practices. Other consumer advocates feel that the U.S. Department of Housing and Urban Development is doing the best job it can with current resources, but that regulatory provisions, at both the state and federal levels, need to be revised to better protect consumers.[82] Virtually all of the counselors and attorneys with whom we spoke perceived regulation as inadequate, and most had seen little or no federal and state agency involvement in monitoring reverse mortgage lending and counseling practices. This section of the report outlines the laws and regulations relevant to reverse mortgage lending, and evaluates the effectiveness of current state and federal practices.

Virtually all of the counselors and attorneys with whom we spoke perceived regulation as inadequate, and most had seen little or no federal and state agency involvement in monitoring reverse mortgage lending and counseling practices.

A. Federal Laws, Regulations, and Proposals

For the most part, reverse mortgages are regulated in the same way as traditional mortgages. The main federal statute specifically addressing reverse mortgages is 12 U.S.C. Section 1715z-20, which authorizes the Department of Housing and Urban Development's HECM program, which is discussed in more detail in Part I.D. of this report. A number of agencies have monitoring responsibilities for various aspects of the reverse mortgage industry. HUD regulates compliance with program rules for HECM which are set out in 24 C.F.R. Part 206. Banking regulators oversee bank lender disclosure of information under the Truth in Lending Act (TILA), while the Federal Trade Commission (FTC) monitors non-banks lender compliance with TILA.

Regulation Z of the Truth in Lending Act requires disclosure of Total Annual Loan Cost (TALC) rates for reverse mortgages. The TALC rate is the most comprehensive measure of a reverse mortgage's true cost. The TALC rate indicates the costs of a reverse mortgage loan relative to its benefits at three time points over the lifetime of the loan.[83] The FTC also monitors consumer complaints and provides consumer education publications.[84]

Although existing federal statutes and regulations are important, the regulations do not establish quality control over the provision of consumer education through pre-loan counseling. As a result, lender and counselor practices are far from standardized and vary greatly in quality, and monitoring for compliance with pre-loan counseling requirements is minimal.

Recent National Regulatory Reforms

[82] Telephone interview with Ken Scholen, *supra* note 41.

[83] TRUTH IN LENDING ACT, REGULATION Z, 12 C.F.R. §226.33.

[84] See, for example, "Reverse Mortgages—Fast Facts," available from the FTC or at <http://www.ftc.gov/bcp/conline/pubs/homes/rms.htm>.

On May 7, 1999, Fannie Mae issued revised policies for reverse mortgage loans it purchases affecting origination fees, quality control and other issues.[85] Under the new policies, origination fees for HUD's HECM loans are not to exceed the greater of $2000 or 2% of the maximum claim amount. This restriction is equivalent to the current limitation on origination fees established by Fannie Mae for the Home Keeper loan. Because Fannie Mae is currently the main purchaser of HECM loans in the secondary market, the policy in effect places an absolute limit on HECM origination fees. HECM fees can be of any amount, although only $1,800 can be financed by the loan. However, if another secondary purchaser were to enter the market, HECM lenders would be less constrained by the Fannie Mae origination fee policy.

On May 7, 1999, Fannie Mae issued revised policies for reverse mortgage loans it purchases affecting origination fees, quality control and other issues. Under the new policies, origination fees for HUD's HECM loans are not to exceed the greater of $2000 or 2% of the maximum claim amount.

The new Fannie Mae policies also prohibit "bridge loans." Under HECM regulations, a maximum of $1,800 of the loan origination fee may be financed by the HECM loan. If the origination fee is greater than $1,800, lenders offering the HECM loan may offer borrowers a separate "bridge loan" to finance the rest of the origination fee. Although this practice is technically legal, it is essentially a mechanism to circumvent the HECM financing restriction. The prohibition on bridge loans, in conjunction with the new limits on HECM origination fees, should make reverse mortgages easier to compare and perhaps less costly. This is because the only lender-controlled fees under HUD's HECM and Fannie Mae's Home Keeper programs are origination and servicing fees, the latter of which is capped at $30 per month. The new policy effectively caps HECM origination fees at $4,160 (2% of $208,000, the maximum size of a HECM reverse mortgage). While these revised policies should benefit consumers, HUD and Fannie Mae must continue to monitor lending practices to ensure that other fees are not raised or added in to HECM and Home Keeper loans to compensate for a lower origination fee.

In addition, any lender wanting to sell reverse mortgages to Fannie Mae must establish an internal audit and quality control system to evaluate and monitor the overall quality of mortgage production and compliance with Fannie Mae policies and procedures. This change should provide a structure for monitoring the quality of lending practices for HECM loans, an area that many consumer advocates maintain HUD does not effectively address.

Any lender wanting to sell reverse mortgages to Fannie Mae must establish an internal audit and quality control system to evaluate and monitor the overall quality of mortgage production and compliance with Fannie Mae policies and procedures.

[85] Memorandum from Liz Scholz, Director, Senior Products and Janice Mitchell, Senior Products Manager, Fannie Mae, to Reverse Mortgage Lenders, regarding "Policies for Reverse Mortgage Origination (Reverse Mortgage Letter 1999-6)" (May 7, 1999).

Lenders must satisfy these additional requirements before Fannie Mae will purchase their reverse mortgages in the secondary loan market:

- Lenders must use Fannie Mae Reverse Mortgage Assistant software or similar software to show borrowers the costs and payouts under the HECM and Home Keeper programs, and to offer the borrower a HECM loan if its associated costs are lower than the Home Keeper's.
- Lenders must inform borrowers that obtaining a reverse mortgage does not require the purchase of goods or services from any particular entity, including third-party referral services.
- Lenders must also investigate any referral source that has provided more than five borrower referrals in a twelve-month period to ensure that the source "employs sound business practices," and must perform due diligence reviews of referral sources to ensure that they do not employ "unfair or deceptive business practices."
- Lenders must disclose to borrowers any relationship they have with a referral source, as well as any compensation the lender receives from the referral source.
- Lenders must explain to borrowers who seek to refinance their reverse mortgages the costs of the refinanced loan compared to the current loan.
- If the borrower has lived in and held title to her home for less than a year, the lender must obtain from the borrower a written explanation as to the conditions and motivation for obtaining a reverse mortgage after such a short home ownership period.
- Lenders must not charge unreasonable and/or excessive fees such as cash fees at origination which is "financed" at closing and described as a refund; out-of-pocket costs for the loan that are not clearly described as such; or fees for expedited or preferential service.
- Lenders must provide borrowers with information on paying for home repairs and must "exercise reasonable oversight" over required repair work to ensure that costs are reasonable and work is satisfactorily completed.

Proposal for Earlier Disclosure of TALC Rates

Consumer education and advocacy groups are currently seeking earlier disclosure of Total Annual Loan Cost rates,[86] which presently must be disclosed at least three days before a loan's closing date. TALC rates allow consumers to compare the costs of different reverse mortgage programs, but the current three-day window does not provide consumers with a realistic opportunity to comparison shop, since at that point a borrower has paid application fees and is already preparing to close the loan. Furthermore, the current time points for TALC disclosures are not adequate. TALC rates must be calculated at two years after the loan's closing, at the life expectancy for the borrower, and at 40% beyond life expectancy. However, since the two-year disclosure period was set, Fannie Mae's Home Keeper program, a major reverse mortgage product, was introduced. The Home Keeper program includes an Equity Share option, which raises the cost of the loan significantly but which does not

[86] NCHEC, "Info: Update - Strengthening Cost Disclosures" (last visited: June 30, 1999) <http://www.reverse.org>.

become effective until the first day of the third year of the loan. Thus, while the TALC rate for a Home Keeper loan with an Equity Share option will spike in the third year, current disclosure requirements do not account for this spike. Therefore, current disclosures do not show consumers the full cost implications of an Equity Share term.

TALC rates allow consumers to compare the costs of different reverse mortgage programs, but the current three-day window does not provide consumers with a realistic opportunity to comparison shop, since at that point a borrower has paid application fees and is already preparing to close the loan.

One recent positive change to HUD regulations is that the regulations on calculating the TALC of a reverse mortgage have been clarified to state that the TALC must include annuity costs in its calculation. Previously, it was not clear whether annuities were to be included in this figure. Including them gives a more accurate measure of the true costs of the loan over time. This change is necessary because annuity marketers usually do not disclose that a reverse mortgage can provide monthly payments without an annuity purchase. Since the lenders are obliged to disclose to borrowers the total loan costs, the cost of annuity purchases should be included in that disclosure through the TALC rate. The change will allow consumers to more readily compare the costs of basic reverse mortgages with those of reverse mortgage/annuity combinations.

Proposals to Ensure the Quality of Reverse Mortgage Counseling Services

The National Reverse Mortgage Lenders Association (NRMLA), the American Association of Retired Persons (AARP), HUD and Fannie Mae are currently developing a plan to certify reverse mortgage counselors who demonstrate a defined level of skill and knowledge. Under this proposal, those passing the reverse mortgage counseling exam would receive a special designation based on their qualifications. Lenders would refer borrowers to certified counselors. In this way, consumers would be assured of high quality counseling, while HUD and other potential funders could identify which counselors are the most skilled and direct funds towards those counselors and agencies. The counseling exam has already been developed and participating organizations are awaiting funding from HUD to begin testing its use. A new non-profit agency may be created to administer the certification exam; eventually, the new agency could also develop curriculum materials for counselor training and conduct audits of counseling agencies to ensure the quality of reverse mortgage counseling.[87]

Advocates have also proposed that this new non-profit counseling agency oversee a funding mechanism to minimize potential conflicts of interest. Under the proposal, lenders would pay a fee to a central fund for each client they refer for counseling. The pool of money would then be distributed to agencies on a per-session basis. Fees would not be directly tied to a lender's referral to a specific counseling agency, thereby lessening the risk that counseling agencies might favor lenders to encourage continued referrals and income.[88] While lenders would make payments to the non-profit

[87] Telephone interview with Patti Wallace, Eden Council for Hope and Opportunity (Mar. 8, 1999).

[88] Direct lender contributions to counseling agencies do currently occur. This creates a risk to consumers because a counseling agency may become more dependent on lender contributions in order to support its reverse mortgage counseling program. The agency may feel more pressure to encourage consumers to take out loans, to satisfy the

agency, those fees would be likely to come out of consumers' pockets in the form of an additional loan fee. Ken Scholen, a Program Specialist at AARP who has been a leader in advocating for the development of consumer protections in reverse mortgages, notes that the fee will be worthwhile if as a result the borrower receives high quality counseling that is not lender-influenced.[89]

In addition, AARP has proposed a national toll-free reverse mortgage counseling service. Because of the complex nature of reverse mortgages and the lack of adequate funds for hiring and training counselors, AARP believes that telephone counseling provided by highly qualified staff would help borrowers obtain effective advice and education. The telephone service would also increase access to multilingual counseling, which is currently available on a limited basis, since multilingual counselors could be reached by borrowers throughout the country. This innovative approach could particularly benefit borrowers who live in rural areas where well-qualified reverse mortgage counselors are less likely to be available for face-to-face sessions.

HUD's Rapid Response to the Estate Planning Fees Scam and the Need for Increased Monitoring and Enforcement

In one area HUD has taken effective action to protect reverse mortgage borrowers. In the estate planning fees cases, described above in Part I.J, HUD recognized the dangers posed by current estate planning scams as well as the potential for more widespread harm as these estate planners began to sell "distributorships" across the country. In response, it issued a directive requiring lenders to stop doing business with these companies.[90] While an estate planning firm challenged HUD's initial directive, Congressional action eventually enabled HUD to promulgate a final rule that in effect bars the practice of charging high fees for referral information which is already available to borrowers at no cost. HUD's proactive regulatory action successfully identified a problem and stopped it before it grew to nationwide proportions.

> *Congressional action eventually enabled HUD to promulgate a final rule that in effect bars the practice of charging high fees for referral information which is already available to borrowers at no cost.*

HUD's proactive and effective response to estate planning fees scams is a good example of the type of regulatory agency attention to reverse mortgage scams that is needed. Nevertheless, consumer advocates maintain that HUD regulation of reverse mortgage lending problems is generally weak. HUD should continue to develop an effective monitoring system to identify scams and initiate corrective actions before problems become widespread, as it did in the estate planning fees scams.

B. California Laws and Regulations

California Department of Real Estate and Department of Corporations Licensee Monitoring

Parties involved in reverse mortgage and annuity sales transactions in California are regulated by three state agencies. Mortgage brokers are licensed by the California Department of Real Estate (DRE).

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lender so that the lender continues to refer potential borrowers.

89 Telephone interview with Ken Scholen, *supra* note 41.

90 "HUD Orders Halt to Charging Senior Citizens Thousands of Dollars Each for Reverse Mortgage Information," HUD Press Release No. 97-31, Mar. 17, 1997.

Some residential and commercial mortgage lenders are licensed by the California Department of Corporations, in accordance with the Residential Mortgage Lending Act (under an "RML" license) or the consumer finance lender law (under a "CFL" license). Insurance brokers and agents, who broker and sell annuities in conjunction with reverse mortgages, are licensed by the California Department of Insurance.

The various lending and brokerage licenses are legally distinct, but the functions that brokers and lenders can perform who are licensed by both the DRE and the DOC overlap significantly. For example, a lender can loan and operate under more than one license.[91] Because of this overlap, there is a serious risk of "license shopping," in which a broker or lender who comes under scrutiny or loses a license from one agency obtains a license from another agency and continues to operate using questionable or illegal practices.[92]

Until recently, there was no formal coordination between DOC and DRE to cross-check licensees for disciplinary actions. In October of 1998, the heads of these two agencies signed a Memorandum of Understanding (MOU) that the agencies would share information relating to licensees and applicants.[93] Shared information is to cover both completed disciplinary actions and pending investigations. Currently, licensing information from both DRE and DOC is available on the Internet, so completed disciplinary actions can be checked by consumers. However, the Departments do not make available to the public information on pending complaints, even when there are numerous complaints about a licensee. Furthermore, the agencies are generally slow to respond to complaints, even those that may ultimately result in discipline. Thus, even with some information available on the Internet, consumers may face huge information gaps.

Until recently, there was no formal coordination between DOC and DRE to cross-check licensees for disciplinary actions.

One example of how license shopping can harm consumers is the Polo Financial Services/TriStar Mortgage cases discussed above in II. C. Polo Financial Services and TriStar Mortgage allegedly tricked seniors by offering to make or broker reverse mortgages, when in fact the companies took out conventional mortgages on the borrowers' homes, and subsequently embezzled the loan proceeds. Innocent borrowers who had sought added monthly income were instead left with huge debts that demanded regular repayments, while the defrauding brokers disappeared. Despite numerous complaints, Polo Financial Services and TriStar Mortgage managed to remain in business by operating under licenses issued by different state agencies.

The Memorandum of Understanding between the DRE and the DOC is an important step in protecting consumers, including seniors seeking reverse mortgages, from fraudulent and illegal

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[91] Telephone interview with DiAun Burns, Financial Division, Department of Corporations, (Apr. 2, 1999).

[92] *See* Norma Paz García, *The Hard Sell: Combating Home Equity Lending Fraud in California*, Consumers Union, July 1998.

[93] "Memorandum of Understanding and Agreement Regarding Sharing of Certain Information to Enhance Consumer Protection", Department of Corporations and Department of Real Estate, approved by Jim Antt, Commissioner of Real Estate, Oct. 22, 1998, approved by Dale E. Bonner, Commissioner, Department of Corporations, Oct. 20, 1998.

practices. However, there is still much to be done. Despite numerous publicized cases about consumer abuse in reverse mortgage lending, the head of the enforcement division of DRE stated that she has never seen a reverse mortgage complaint in the agency and that she has never heard of anyone who offers or has taken a reverse mortgage.[94] This may be because consumers and some advocates believe that making an administrative complaint to these agencies is an exercise in futility. Some advocates believe that state enforcement agencies do not have the resources to properly pursue administrative complaints so their clients would not be helped by filing complaints.

The California Departments of Real Estate and Corporations should continue to explore ways to respond to growing threats to seniors seeking reverse mortgages. Consumers Union has recommended in past reports that these regulatory agencies take more proactive approaches to protect consumers. In *Dirty Deeds: Abuses and Fraudulent Practices in California's Home Equity Market* (1995), Consumers Union documented the DRE and DOC's failure to adequately combat home equity lending fraud and abuse because of a decentralized regulatory scheme, inconsistent financial standards and annual reporting requirements, the ability of companies to license-shop, and the ineffectiveness of the DRE in particular at that time. In *The Hard Sell: Combating Home Equity Lending Fraud in California* (1998), Consumers Union found that California's regulatory environment had improved somewhat. The report detailed increased DRE consumer protection activities such as participation in the Los Angeles District Attorney's Real Estate Fraud Task Force and the development of an Internet database to allow consumers to verify license status and completed disciplinary actions. The DRE has also shortened its investigative process from one year to 6 to 9 months. The Department of Corporations has contributed to regulatory improvements as well through enforcement of the California Residential Mortgage Lending Act. While the Department of Real Estate and the Department of Corporations have made progress in improving their regulatory efforts, they must continue to monitor reverse mortgage lending practices in addition to other areas of home equity lending.

The California Departments of Real Estate and Corporations should continue to explore ways to respond to growing threats to seniors seeking reverse mortgages.

California Reverse Mortgage Legislation

California Civil Code Sections 1923 et seq. (AB 456, Ducheny): Sections 1923 through 1923.10 of the California Civil Code, passed in 1997 as Assembly Bill 456 (introduced by Assembly Member Denise Ducheny, D-San Diego), create some basic parameters for consumer protection and apply to reverse mortgage loans originated on or after January 1, 1998. A few of the key terms are summarized below:[95]

- ***Penalty-free pre-payment option***. Section 1923.2 allows pre-payment of the loan, in whole or in part, without penalty at any time during the term of a reverse mortgage loan. However, the prohibition on pre-payment penalties does not bar any fees, payments or

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94 Telephone interview with Betty Ludeman, Chief of Enforcement Division, Department of Real Estate, (Apr. 2, 1999).

95 CAL. CIV. CODE §1923 ET SEQ.

other charges that would otherwise have been owed when the reverse mortgage came due.

- ***Enhanced penalties for defaulting lenders***. Section 1923.2 requires that a lender who fails to make loan advances as specified in the loan documents, and who fails to cure an actual default after notice as specified in the loan documents, forfeit to the borrower treble the amount wrongfully withheld plus interest.
- ***Standard disclosure statement***. Section 1923.5 requires that every reverse mortgage applicant receive a statement that discloses whether an annuity purchase is required and advises the borrower to seek professional advice regarding the transaction. The statement also says that reverse mortgage counselors "may also be available."

California Civil Code Sections 1917.320 et seq.: Shared Appreciation Loans for Seniors:

> *California law does not provide for any substantive regulation on the content or quality of reverse mortgage counseling, or any restrictions on the terms of reverse mortgage loans.*

California law governing shared appreciation loans for seniors provides a few basic protections. This law regulates the use of shared appreciation agreements where seniors seek to borrow against the equity in their homes. First, California law requires extensive written disclosure to all prospective borrowers who must be at least 65 to qualify for protection under California Civil Code Sections 1917.320 et seq. The law also sets out a method for calculating a "monthly annuity," which is a monthly cash advance borrowed against the equity in the home, and limits the shared appreciation to 25% of the net appreciated value of the property securing the loan at the maturity date. The maturity date is when the borrower dies, sells the house, pays off the shared appreciation loan, or ceases to occupy the residence.[96]

California Civil Code sections 1923 et seq. and 1917.320 et seq. cover some basic aspects of reverse mortgages. However, reverse mortgage consumers can still use more protections under the law. For example, California law does not provide for any substantive regulation on the content or quality of reverse mortgage counseling, or any restrictions on the terms of reverse mortgage loans.

C. Assessment of Regulations and Enforcement Efforts

> *Unless major reforms to protect consumers are enacted, unwary seniors will continue to be lured into inappropriate, unfavorable or unnecessary reverse mortgages with little recourse against lenders.*

Overall, the reverse mortgage lending industry must be more effectively regulated at both the federal and state levels. The relative newness of reverse mortgages as a mortgage product and the lack of federal and state law monitoring and enforcement of the reverse mortgage market have led to an atmosphere in which lenders are unrestricted as to the terms of the reverse mortgages they offer and the promises they make to elderly borrowers. This is true particularly for proprietary, privately developed reverse mortgage programs. While the HECM and Home Keeper programs impose substantive requirements for the terms of those loans, compliance monitoring by HUD is still

[96] CAL. CIV. CODE §1917.320(j)

weak. Unless major reforms to protect consumers are enacted, unwary seniors will continue to be lured into inappropriate, unfavorable or unnecessary reverse mortgages with little recourse against lenders.

IV. Recommendations

As this report demonstrates, some of the most serious allegations of reverse mortgage lending abuses have appeared in conjunction with proprietary, i.e., privately developed, reverse mortgage products. More proprietary reverse mortgage products are likely to come on the market as the elderly population continues to grow, senior home ownership rates rise, and life expectancies increase. Thus, in addition to current consumer hazards, many potential dangers of reverse mortgages have yet to be seen. Consumers Union, therefore, recommends the following changes. Some of our recommendations are administrative and could be implemented immediately. Others would require legislation. These proposals seek not only to address current problems, but also to prevent the development and expansion of future hazards to consumers.

A. Legislative and Regulatory Changes

Increase Funding for Outreach, Education and Counseling Activities

Both the state and federal governments, as well as lenders, must increase funding for counseling, outreach and educational activities. Currently, HUD is the main funder of reverse mortgage counseling via its general housing counseling grants. However, this funding is unstable. Counselors report being warned by the agency each year that HUD funding may end and that they should seek other funding sources. Housing counseling agencies state that no other substantial funding sources exist for reverse mortgage counseling. These activities could be funded in greater part by lenders, since lenders will benefit from a consumer's informed decision to take out a reverse mortgage loan. Lender funding of pre-loan counseling, however, has risks unless it is separated from the lender's referral process. The proposal for improving the funding stream for individual counseling activities being developed by AARP, HUD, Fannie Mae and others, which calls for lenders funds to be pooled to support counseling, will also be useful to fund outreach work. A portion of the funds collected and distributed should be designated for general community education efforts.

The state of California should consider funding reverse mortgage counseling and homeowner education. Advocates of counseling maintain that unless a state commits to funding reverse mortgage counseling, mere requirements that counseling be provided will not be useful because funding is difficult to obtain.[97] Advocates point to Minnesota as a positive example of state support for reverse mortgage counseling. Minnesota both requires reverse mortgage counseling for all potential borrowers and provides funding for it.[98]

Increase Federal and State Monitoring and Enforcement of Existing and Any New Regulations

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[97] *Reverse Mortgages: A Lawyers Guide to Housing and Income Alternatives*, *supra* note 50.

[98] Telephone interview with Ken Scholen, *supra* note 41; MINN. STAT. §47.58, SUBD. 8, §462A.28 (1998).

Laws and regulations are of limited benefit to consumers unless lenders actually comply with them. Government agencies must enforce existing and new regulations more effectively. For example, under HUD's HECM program, lenders are required to refer borrowers to a neutral counseling agency before taking out a reverse mortgage but counselors have indicated that this does not always happen. The practice of attempting to bias borrowers and steer them to favored counselors can only be halted through effective monitoring that HUD has thus far failed to provide.

The proposed non-profit training and certification agency that would establish and implement a defined curriculum for all reverse mortgage counselors may take on this monitoring and auditing role. If that does not occur, HUD, perhaps in conjunction with state agencies, must take on this role and ensure that lenders abide by the rules they have agreed to in exchange for HUD's willingness to insure reverse mortgages and Fannie Mae's willingness to purchase them.

The California Departments of Real Estate and Corporations must find ways to win consumer confidence that filing a complaint is a useful step and that complaints will be responded to effectively and efficiently. Until the state agencies do this, consumers will continue to dismiss administrative complaints as a waste of time.

Require all Lenders to Meet Fannie Mae's Rules for Protecting Consumers of Reverse Mortgage Loans

On May 7, 1999, Fannie Mae instituted important protections for consumers whose reverse mortgages it will purchase on the secondary market. The revised policies for reverse mortgage lenders place limits on origination fees, and establish standards for quality control and other important areas of reverse mortgage lending. These rules establish standards that should be required for all reverse mortgage lending, not just for those loans which are to be purchased by Fannie Mae. Specifically, Fannie Mae's rules:

- Limit origination fees for HUD HECM loans to no more than the greater of $2,000 or 2% of the maximum claim amount.
- Prohibit "bridge loans" to finance origination fees which exceed the HECM maximum of $1,800.
- Require lenders to establish internal audit and quality control systems to evaluate and monitor overall quality of mortgage production and compliance with Fannie Mae policies and procedures.
- Require lenders to use Fannie Mae Reverse Mortgage Assistant software or similar software to help borrowers compare the benefits of various reverse mortgage products.
- Require lenders to inform borrowers that it is not necessary to purchase goods or services from a third party in order to obtain a reverse mortgage.
- Require lenders to investigate any source of five or more referrals within a twelve month period to verify that that source employs "sound business practices" free from "unfair or deceptive business practices."
- Require lenders to explain to borrowers seeking to refinance reverse mortgages the costs of the refinanced loan compared to the current loan.

- Require lenders to protect a borrower who has lived in or held title to her home for less than one year from fraud by obtaining a written explanation about the borrower's motivations for obtaining a reverse mortgage.

Mandate Independent Pre-loan Counseling for All Reverse Mortgage Applicants

One of the most consistent recommendations of reverse mortgage counselors, attorneys representing borrowers in reverse mortgage litigation, and others involved in advocacy for reverse mortgage borrowers is to require independent counseling for all potential reverse mortgage borrowers. Currently, independent counseling is required for all HECM borrowers, and the HECM program requires borrowers to receive counseling from a HUD-approved agency. This counseling is generally done face-to-face, but it can also be done by telephone. Fannie Mae's Home Keeper program requires borrowers to receive counseling through either a HUD-approved agency, HomePath (Fannie Mae's telephone counseling hotline), or through the lender. Borrowers of proprietary reverse mortgage products, such as the Financial Freedom Plan reverse mortgage, are not required to receive any counseling. A few states, including Massachusetts, Minnesota, and North Carolina, currently mandate counseling for all reverse mortgage applicants.[99]

Hawaii just passed Act 50 (1999) which requires counseling from a HUD-approved housing counseling agency prior to acceptance of a reverse mortgage loan application, for all reverse mortgage loans not otherwise subject to counseling requirements under state and federal laws. Loans intended for sale to the Federal National Mortgage Association ("Fannie Mae") or to the Federal Home Loan Mortgage Corporation ("Freddie Mac") are excluded from the mandatory counseling requirement. The violation of the counseling requirement is deemed an unfair method of competition or unfair or deceptive act or practice, subjecting the lender to civil penalties of $500 to $10,000 per violation.[100]

With mandatory independent counseling, borrowers of proprietary reverse mortgages would receive unbiased advice and education about whether a reverse mortgage is appropriate for their needs. To date, the most egregious allegations of abusive or illegal reverse mortgage lending reported to Consumers Union's West Coast Regional Office have involved proprietary reverse mortgage programs, such as the Commonwealth/Providian and Transamerica products which have been the subject of litigation described in Part II. Requiring that borrowers receive independent advice and counsel prior to taking out a proprietary reverse mortgage loan would be an important new consumer protection that should help avoid these egregious abuses.

Some reverse mortgage counselors believe that as the reverse mortgage market expands and more private programs become available, mandatory counseling beyond basic, non-lender-specific information may be difficult to provide.[101] However, even if comprehensive comparisons between products become more difficult in the future, providing all potential borrowers, not just those applying for HECM or Home Keeper loans, with access to some form of impartial educational information will assist them in making educated choices. As the elderly population continues to grow in both size and

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[99] MASS. ANN. LAWS CH. 167E, §2 (1999); MINN. STAT. §47.58, SUBD. 8 (1998); N.C. GEN. STAT. §53-269 (1995).

[100] "Relating to Reverse Mortgages", Act 50, 1999 (House Bill 1072), signed by Hawaii Governor Benjamin Cayetano on Apr. 26, 1999. For further information regarding this bill, contact the Legislative Reference Bureau Information Systems Office at (808) 587-0700.

[101] Telephone interview with Rick Harper, Director of Housing, Consumer Credit Counseling Service, San Francisco (Mar. 2, 1999); telephone interview with Jonathan Garcia, *supra* note 40.

proportion, and as rates of senior home ownership and life expectancy rise, mandating pre-loan counseling can reduce or eliminate problems caused by the selection of unsuitable reverse mortgage products before they become more widespread.

Require All Lenders to Inform Borrowers about Reverse Mortgage Counseling Agencies

Reverse mortgages are complex and difficult to understand and borrowers often initially will not know whether a reverse mortgage best suits their needs. Consumers Union recommends that lenders be required to at least inform potential borrowers about the availability of independent counseling, even where counseling is not mandatory. Providing consumers with information about how to seek out counseling will give them the opportunity to speak confidentially with an independent counselor at no charge, even if such a session is not required to complete the loan.

Limit the Terms of Shared Appreciation and Shared Equity Agreements

While the 50% shared appreciation fee in the *Transamerica* case is an example of an extreme reverse mortgage term, lesser shared appreciation and shared equity fees may be unfair as well. This is particularly true in parts of California where real estate market prices have increased steadily with only temporary dips since World War II. Because many lenders in California bear relatively little risk that a home will depreciate below its original value, lenders should not be entitled an unreasonably high shared appreciation or shared equity fee. This type of fee may give the lender the ability to offer higher monthly cash advances or lump-sum amounts. However, reverse mortgages are generally considered an expensive product, and the reverse mortgages are difficult to compare. Thus, a consumer's ability to shop around for more competitive reverse mortgage products is very limited, particularly if the borrower needs higher monthly payments than the HECM and Home Keeper products provide. As the associate director of the American Bankers Association pointed out, many lenders find entering the reverse mortgage lending market attractive because that market is not as competitive as other loan markets.[102]

Therefore, there should be federal or state legislation to limit unconscionable shared appreciation and shared equity fees, such as the 50% shared appreciation fee in the *Transamerica* case. While shared appreciation or shared equity terms may be appropriate in some cases, they must be limited to a reasonable and fair level.

Limit Lender Fees Charged

While Fannie Mae has moved to pressure HECM lenders to limit origination fees to the greater of 2% of the maximum loan amount or $2000, HUD should modify the HECM program rules to incorporate this restriction as well. As the reverse mortgage market expands, additional secondary market purchasers of reverse mortgages are likely to emerge. Thus, the Fannie Mae policy on HECM origination fees will no longer be effective in controlling lender practices, and lenders may again turn to charging origination fees beyond what borrowers can finance through the HECM loan and making "bridge loans," as described above in section III.A. For this reason, state and federal laws should directly cap lender fees for reverse mortgages.

Eliminate Direct Lender Payments to Reverse Mortgage Counseling Agencies

[102] "Fannie Mae Muscles into Reverse Mortgages," *Specialty Lender*, *supra* note 27.

Because a counseling agency's acceptance of funds from lenders in return for counseling clients who are referred to it constitutes a conflict of interest, such direct payments should be eliminated. Consumers Union supports the current proposal, supported by the NCHEC and other groups, to create a centralized funding pool that distributes lender fees to counseling agencies nationwide. This will weaken the connection between the lender, who provides revenue, and the counselor, whose duty is to provide independent counseling.

Eliminate Lender-Provided Counseling for Fannie Mae Home Keeper Loans

Currently, when a local independent counseling agency is not available, Fannie Mae's Home Keeper program allows pre-loan counseling to be conducted by a member of the lender's staff, as long as that person is not a member of the staff processing the loan. Allowing the lender to provide counseling is a clear conflict of interest, especially given the lack of information consumers have about reverse mortgages, the potential for confusion, and the high costs involved in taking out a reverse mortgage. It would be in the lender's interest to "educate" the consumer in a way that encourages her to take out the loan. Even a lender attempting to provide counseling in good faith will encounter this conflict of interest, which is not eliminated by restricting the counseling to someone other than a member of the loan production staff. The staff member still works for the lender and represents the lender's interests. Requiring Home Keeper borrowers to receive counseling from an independent agency or Fannie Mae counselor rather than from a lender would protect consumers against lender bias and ensure that they are fully informed about the available options and the consequences of taking out a reverse mortgage.

Disclose Total Annual Loan Cost (TALC) Rates Early and for Additional Time Points

Regulation Z's current requirement that lenders disclose Total Annual Loan Cost rates three days prior to a loan's closing should be modified to require earlier disclosure. Earlier disclosure would enable borrowers to compare different reverse mortgage programs more fully and give them crucial information before they have virtually completed the loan process.

Regulation Z should also be revised so that TALC disclosures reflect the costs of a Home Keeper loan's Equity Share term that begins in the third year of a loan. Because the TALC rate includes the start-up costs of a loan, such as initial fees and any annuity purchase, the rate generally decreases over time, as the start-up costs are spread over a longer time period. Currently, projected TALC rates are disclosed for three time periods: two years after loan origination, the borrower's life expectancy, and 40% beyond the borrower's life expectancy. However, this disclosure hides the spike in the TALC during the third year that will occur for anyone with a Home Keeper loan that includes an Equity Share option, since that option does not become effective until year three of the loan. Requiring additional time points to the TALC disclosure, at a minimum for loans with the Equity Share option, would alert consumers to the additional costs of the Equity Share option. For example, a three-year TALC rate could be given to Home Keeper borrowers who are considering an Equity Share option, in addition to the current disclosures, in order to reveal the higher cost that is incurred when the Equity Share option becomes effective.

Require Independent Annuity Sales Agents to Disclose the Availability of Monthly and Line-of-Credit Advances Through Reverse Mortgages

Annuities are insurance products that a reverse mortgage borrower can purchase with a lump-sum cash advance from the mortgage. Annuities combined with a reverse mortgage generally are more expensive than a reverse mortgage alone for the amount of cash received. Currently, annuity sales agents have no incentive or obligation to disclose to potential purchasers that a reverse mortgage may meet their cash advance needs without the purchase of an annuity.

In order to protect borrowers from being persuaded to buy costly annuities that they do not need, the California Department of Insurance should require annuity sales agents to disclose to potential purchasers that reverse mortgages can provide monthly advances and lines of credit, as well as lump sum cash advances. This requirement would ensure that consumers are not misled into thinking that the only way to get periodic cash advances from a reverse mortgage is by purchasing a costly annuity.

B. Consumer Education and Advocacy Actions

Standardize the Content and Quality of Reverse Mortgage Counseling

Consumers Union supports the development of a standard curriculum for counselors and a certification program through a national non-profit organization, as described above in Part I.F. Creating a standard training curriculum will allow government and non-profit agencies to provide more complete substantive guidance to potential borrowers, and ensure that those providing consumer education possess the necessary and appropriate information. Furthermore, testing and certifying reverse mortgage counselors who meet minimum competency standards will help government agencies control the quality of counseling provided. The certification examination will allow HUD and other funders to identify the most skilled counselors and direct reverse mortgage counseling funds to those agencies. This targeted funding will benefit consumers in two ways. There will be more high-quality counseling and counselors will have a strong incentive to master the training curriculum and pass the examination.

Increase Local Outreach, Education and Counseling Activities

Many consumer advocates consulted by Consumers Union believe that current levels of education, outreach and individual reverse mortgage counseling are insufficient to meet prospective borrowers' educational needs. Given that the impact of much of the problematic practices of reverse mortgage lenders and brokers could be prevented by better consumer understanding and knowledge about the products, improving these services is crucial for protecting consumers. Currently, reverse mortgage counselors and other consumer groups conduct outreach to potential borrowers through educational seminars at senior centers and special events, as well as through literature and other publications. As discussed in Part I.C., the volume of reverse mortgages is increasing rapidly: through 1992, only about 8,000 reverse mortgages had been made nationwide. From 1993 through 1998, 46,750 reverse mortgages were made --that is, 85% of all reverse mortgages were made between these years.[103] These facts, in conjunction with the growing number of eligible seniors, means that consumer education and counseling programs must expand and develop new channels for educating consumers.

To some extent, marketplace abuses of reverse mortgages and consumers' fear of reverse mortgage scams have hindered outreach efforts. For example, one loan counseling agency reports meeting

[103] NCHEC (last visited: July 8, 1999) <http://www.reverse.org/info.data.htm>.

resistance when attempting to set up educational seminars at senior centers. The centers have heard about reverse mortgage scams and suspect that the counseling agency wants to try to convince seniors to take out reverse mortgage loans. Centers have turned the agency away in its outreach efforts. At the same time, the agency notes that these seniors are being bombarded with television ads, mailings and other marketing materials promoting reverse mortgages, materials which most likely do not discuss the full risks and costs of the loans. This situation creates a danger that consumers will be influenced to make decisions without full information and illustrates that educational efforts have a long way to go. In addition, distrust of some consumer education agencies undermines those agencies' credibility and effectiveness in providing people with needed information. Increased outreach would inform seniors and service providers that unbiased, independent counseling agencies do exist and that they can assist seniors in making wise financial decisions.

Currently, only a small number of non-profit agencies provide these services, some funded by HUD grants. There is no state government involvement. In northern California, for example, as of April 1999, only a few such organizations provide outreach: Human Investment Project (San Mateo County), Consumer Credit Counseling Service (various offices), Eden Council for Hope and Opportunity (Oakland and Oakley) and Consumers Union (San Francisco). In most of these organizations, the staff conducting outreach efforts are also counselors. The bulk of their time is spent with individual clients rather than on outreach activities. In many cases, reverse mortgage work is only one of their numerous responsibilities.

It is troubling that despite the growing evidence of reverse mortgage lending abuse, state agencies have not taken an active role in educating consumers about reverse mortgages. Consumers Union, therefore, recommends the expansion of reverse mortgage outreach, education and counseling. California state agencies such as the Departments of Real Estate, Corporations and Consumer Affairs can participate in these efforts by funding outreach and counseling efforts and developing consumer education initiatives.

Utilize California's Elder Abuse and Dependent Adult Civil Protection Act, and the Unfair Practices Act

Some of the most egregious cases of fraud and abuse through reverse mortgage lending have resulted in litigation. Attorneys representing borrowers in reverse mortgage litigation have found specific causes of action to be particularly useful in protecting elderly victims' rights. The following California statutes have been important in those suits:

- ***The Elder Abuse and Dependent Adult Civil Protection Act***, California Welfare & Institutions Code section 15600 et seq. This statute allows punitive and other damages, as well as attorney's fees, against reverse mortgage lenders and others who breach a fiduciary duty to their elderly clients.

- ***Treble Damages Provision for Unfair and Deceptive Practices Against Seniors***, California Civil Code section 3345. This statute gives the trier of fact the discretion to impose treble damages for unfair or deceptive practices against senior citizens.

- ***Unfair Practices Act***, California Business and Professions Code section 17200 et seq. and section 17500 et seq. These statutes permit both law enforcement officers and consumers to sue to stop unfair, unlawful and/or fraudulent business practices or advertising.

The California Elder Abuse statute has not been widely used thus far in reverse mortgage litigation, but plaintiffs in the *Providian* and *Transamerica* cases have pleaded causes of action under the statute for additional damages. Civil Code section 3345 is also an important tool in reverse mortgage litigation in California, since it provides for discretionary treble damages if fraud against seniors is proven. These statutes, in conjunction with the widely used Business and Professions Code sections 17200 et seq., create disincentives to lenders to cheat seniors who are interested in reverse mortgages. While it is certainly desirable to prevent consumers from being taken advantage of before they enter into these transactions, lawsuits challenging reverse mortgage abuses have become especially important given the absence of sufficient preventive regulation and consumer education at state and federal levels. Therefore, plaintiffs and their attorneys should note the potential these statutes may hold in seeking redress.

Encourage Borrowers to File Administrative Complaints When They Suspect Wrongdoing, and Closely Monitor Agency Response

Currently, many consumers and their advocates believe that the California Departments of Real Estate and Corporations, which have a duty to monitor and investigate their licensees, are unresponsive to consumer complaints. These agencies must monitor and effectively investigate their licensees in a timely fashion. In order to encourage these agencies to increase their monitoring and enforcement activities, consumers who experience illegal behavior by reverse mortgage lenders and brokers should file complaints with the DRE or DOC. This reporting will encourage enforcement and highlight to agency staff the nature and scope of illegal reverse mortgage lending and brokerage activity, making it harder for the agencies to disregard or remain ignorant of these abuses.

Train Reverse Mortgage Counselors to Recognize When a Borrower's Decision-Making Capacity Is in Question

Some borrowers are enticed into illegal or abusive lending scams for home equity and reverse mortgage loans due to a lessened ability to make sound decisions. Training reverse mortgage counselors to recognize signs of legal incapacity could protect seniors from entering into highly disadvantageous agreements that they do not understand. In conjunction with mandatory counseling for all potential reverse mortgage borrowers, this proposal would allow reverse mortgage counselors, at least in a face-to-face setting, to identify cases in which there is a serious possibility that the client cannot understand the nature and the consequences of the financial transaction. While reverse mortgage counselors would not be asked to act as social workers, they would be able to refer clients to the local adult protective services unit for an investigation for conservatorship as necessary, as a person's family members, attorney and others can currently do. While this would require reverse mortgage counselors to take on an additional responsibility, it may be the best way to serve their clients' interests. In explaining the pros and cons of a reverse mortgage to a client, a counselor will most likely be able to determine whether the person is able to understand the information. If the counselor believes that the client is truly unable to make decisions in her own best interest, the client could be referred for a determination of conservatorship.

IV. Conclusion

Reverse mortgages offer seniors the opportunity to stay in their homes while benefiting from the equity they have built up. They are a valuable option for those needing to supplement their incomes. Reverse mortgages are gaining in popularity. The industry will continue to grow as the senior population expands, seniors stay in their homes longer, and more people learn about the products available.

Unfortunately, many seniors have suffered from the pitfalls of reverse mortgages. Nationwide, hundreds have been cheated by "estate planning" firms alone. Some California seniors have instituted class action suits seeking relief from extremely high fees, incomplete disclosure and in some cases fraudulent business practices. This report seeks to document the advantages and disadvantages of reverse mortgages, as well as the dangers for potential borrowers. Consumers Union recommends that, in order to better protect the burgeoning senior population, the federal and state governments focus on reverse mortgage counseling by creating a legislative requirement for pre-loan counseling for all potential borrowers. As a corollary, government must increase funding for education and counseling services. Government efforts should also focus on enforcing compliance with current regulations, prohibiting unreasonably high shared appreciation agreements, and requiring earlier disclosure of the costs of a reverse mortgage. In addition, Consumers Union supports the efforts of consumer advocates to ensure the quality of reverse mortgage counseling by developing a standardized training curriculum and certifying counselors who demonstrate minimum competency levels.

As we move into the next century, California, as well as the federal government, must do a better job of ensuring that seniors can access this important product while not falling victim to unscrupulous and illegal scams. The recommendations presented in this report seek to address many of the current problems faced by reverse mortgage borrowers, as well as to inhibit the expansion of these problems into even greater pitfalls for consumers.

Appendix A

Comparison Chart of Reverse Mortgage Products

Feature	HECM	Home Keeper	Financial Freedom Plan
Payment Options	tenure; term; growing line of credit; modified tenure; modified term	tenure; revolving line of credit; modified tenure	lump sum, with optional annuity purchase for monthly payments
Lending Value That Can Be Borrowed Against	maximum $208,000, depending on are lending limit	maximum $240,000, depending on area lending limit	maximum $700,000
Origination Fee	varies; up to $1800 can be financed through reverse mortgage loan	2% of home value, or 2% of maximum lending value; plus 1% point fee	2% of appraised value of home; maximum $10,000
Interest Rate	variable, tied to 1-year T-bill rate; annually adjusting interest rate has 5% lifetime cap and 2% annual cap; monthly adjusting interest rate has 10% lifetime cap	variable, tied to one-month secondary market CD index, with 12% lifetime cap	none; cost of loan is based on percentage of home value pledged, calculated at loan's maturity.
Residency Requirements	if live out of home for over 12 consecutive months, loan becomes due	if live out of home for over 12 consecutive months, loan becomes due	if live out of home for 375 of 475 days, loan becomes due
Equity Participation	none	option for 10% equity share fee	as determined by borrower
Servicing Fees	maximum $30/month	maximum $30/month	none

Example of Increases in Loan Balances on a Reverse Mortgage over Ten Years[104]

This hypothetical example assumes that the borrowers are a couple, 75 and 79 years old, with an appraised home value of $220,000, appreciating at 4.0% per year. The reverse mortgage in this example would provide the couple with regular monthly income payments of $836.21 with no optional creditline.

HUD Tenure Payment Plan -- Interest Rate Adjusted Monthly
Amortization Scenario with 4.0% Annual Home Appreciation

End of Year	Age	Annual Totals Monthly Advances	Accrued Int.&MIP[105]	Loan Balance[106]	Annual Increase in Loan Balance
		Loan			
	75	10,035		8,246	
1	76	10,035	959	19,600	11,354
2	77	10,035	1,747	31,742	12,142
3	78	10,035	2,590	44,727	12,985
4	79	10,035	3,492	58,613	13,946
5	80	10,035	4,455	73,463	14,850
6	81	10,035	5,486	89,344	15,881
7	82	10,035	6,589	106,327	16,983
8	83	10,035	7,768	124,489	18,162
9	84	10,035	9,028	143,912	19,423
10	85	10,035	10,376	164,683	20,771

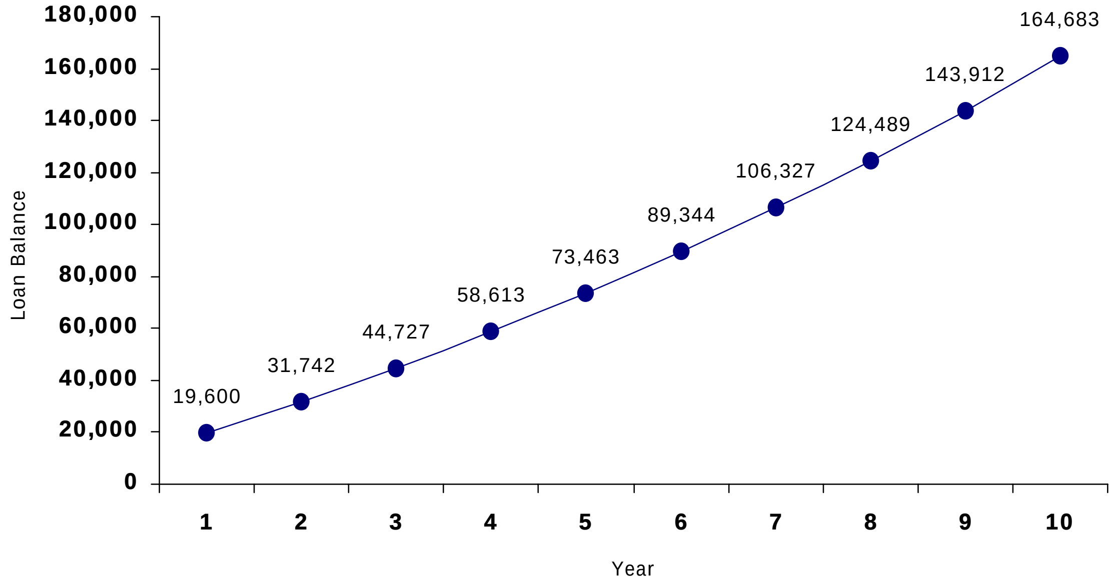
104 Produced by ECHO Housing, 1305 Franklin St., Room 305, Oakland, California, using NCHEC software, June 22, 1999.

105 Interest & Mortgage Insurance Premium.

106 Total amount owed equals "Loan Balance" or "Net Home Value" -- whichever is less.

Appendix C

Graphic Representation of Loan Balance Increases over Time



Reverse Mortgage Consumer Tip Sheet

What is a Reverse Mortgage?

A Reverse Mortgage is a popular but complex home loan just for senior homeowners. If you qualify for a Reverse Mortgage, you will not have to make monthly payments on the loan. Instead, the lender pays you. Typically, the Reverse Mortgage is repaid from your home's equity when you sell the home, move out permanently, or die. You, or those who will inherit from you, can keep any sales proceeds from your home in excess of what you owe the lender.

To qualify for a Reverse Mortgage, you must be a homeowner who is at least 62 years old. The mortgage on your home must be fully or nearly paid off. Generally, the amount you can borrow depends on the value of your home, the amount of equity you have in the home, and your age at the time of loan application.

If you are considering taking out a Reverse Mortgage, you can and should get free and confidential Reverse Mortgage counseling from trained housing counselors certified by the Department of Housing and Urban Development.

How Do I Know If a Reverse Mortgage Is Right For Me?

A Reverse Mortgage may be right for you if:

- ☑ You have a regular need for additional living funds;
- ☑ You live on a fixed income, and your only asset is your home equity;
- ☑ You do not plan to leave your home to your children or others who will inherit from you.

Don't Take a Reverse Mortgage if:

- ☑ You want to leave your home, free and clear, to your children or heirs;
- ☑ You have another, less costly means to reach your financial goal. A Reverse Mortgage can be an expensive way to borrow money.

What Are Some of the Advantages of a Reverse Mortgage?

- ☑ A Reverse Mortgage can help you maintain your financial independence and an adequate standard of living.
- ☑ A Reverse Mortgage allows you to remain in your home and retain ownership.
- ☑ The money you receive from a Reverse Mortgage is tax-free.

What Are Some of the Disadvantages of a Reverse Mortgage?

- ☑ Reverse Mortgage options can be confusing and numerous. Get counseling.
- ☑ Reverse Mortgages are more costly to set up than other types of loans.
- ☑ Although the proceeds are tax-free, a Reverse Mortgage may affect your eligibility for certain "need based" public benefits such as Medicaid, Supplemental Social Security Income (SSI), and Medi-Cal benefits.

What Types of Reverse Mortgages are Available?

There are three types of Reverse Mortgage plans available today: FHA-insured; lender-insured; and uninsured. Each type differs. A Reverse Mortgage counselor can help you decide which type is right for you and which lender offers the program that best meets your needs.

What Questions Should I Ask if I Decide to Shop For a Reverse Mortgage?

Use this list of shopping questions:

- ☑ How much money do I need?
- ☑ Is there a way to meet my needs that does not involve getting a Reverse Mortgage?
- ☑ Will a Reverse Mortgage make my partner or me ineligible for any government benefits, currently or in the future?
- ☑ Do I qualify for this Reverse Mortgage?
- ☑ How much can I borrow through a particular Reverse Mortgage product?
- ☑ How much will it cost me in fees and interest to borrow this money even if I don't have any "out of pocket" expenses?
- ☑ Will I have to sell my house before I die to pay off this Reverse Mortgage?
- ☑ What happens if I die, and my partner is still alive and living in the home; will he or she have to leave or pay the loan off?
- ☑ What happens if I have to go to a nursing home; will the loan become due and payable?
- ☑ What will I or my heirs have left after the loan is paid off?
- ☑ Are there any early-repayment penalties?
- ☑ What are my obligations under the Reverse Mortgage, such as home maintenance, property taxes and insurance?

Reverse Mortgage Essentials

Four important things you should do before getting a Reverse Mortgage:

1. Determine if you really need a Reverse Mortgage or if another type of loan would be better for you. Depending upon your needs and your financial situation, you may be able to meet your goals with another, less costly financial solution than that provided by a Reverse Mortgage.

2. See a HUD approved Reverse Mortgage counselor-free of charge – to help you decide if a Reverse Mortgage is for you, or to help you choose among the different types of Reverse Mortgages.

3. Shop around and compare! Not all Reverse Mortgages are created equal. They vary substantially in how much cash you can get, what they cost, and other features.

4. Consider whether a Reverse Mortgage might make you ineligible for any public benefits you now receive or may be eligible to receive in the future. For example, if you currently receive or expect to be eligible for any "need based" benefits such as Medicaid, Medi-Cal, or Supplemental Social Security Income (SSI), Reverse Mortgage payments will have to be structured so that monthly payments will be spent within the month they are received. If not, such payments will be considered "income," and may make you ineligible for public benefits. You should contact your benefits provider to ask about how a Reverse Mortgage may affect your eligibility.

The ordinary cautions when applying for a loan still apply:

- ☑ Don't sign anything you don't understand.
- ☑ Read everything before you sign.
- ☑ Never sign a loan application with blank spaces.
- ☑ If it sounds too good to be true, it probably is!

Consumer Information Resources

GENERAL INFORMATION ON REVERSE MORTGAGES

American Association of Retired Persons (AARP)
Home Equity Information Center
Consumer Affairs Section
601 E Street, N.W.
Washington, DC 20049
202-434-2277

American Bar Association
Commission on Legal Problems of the Elderly
1800 M Street, N.W.
Washington, DC 20036
202-331-2297

National Center for Home Equity Conversion (NCHEC)
360 N. Robert, #403
Saint Paul, MN 55101
651-222-6775
fax 651-222-6797
www.reverse.org
The NCHEC website has information about the basics of reverse mortgages, history, data, a bibliography, consumer alerts, updates, reverse mortgage lender listings, policy recommendations and other resources.

Consumers Union of U.S., Inc., West Coast Regional Office
1535 Mission St.
San Francisco, CA 94103
415-431-6747
www.consumersunion.org

PUBLICATIONS

Home-Made Money, American Association of Retired Persons (AARP).
To order this free publication, contact AARP (see above).

Retirement Income on the House: Cashing in on Your Home with a "Reverse" Mortgage, Ken Scholen, NCHEC Press (1994)
Contact NCHEC (see above) to order.

Reverse Mortgage Choices, AARP Foundation
Videotape on reverse mortgage information. To order, send $5.00 to AARP Foundation, P.O. Box 51040 GASD, Washington, DC 20091.

Reverse Mortgages for Beginners: A Consumer Guide to Every Homeowner's Retirement Nest Egg, Ken Scholen
A 132-page book containing the information also available on the website of the National Center for Home Equity Conversion. To order, send check payable to NCHEC for $14.95 to NCHEC Web, 7373 147 St., #115, Apple Valley, MN 55124

Your New Retirement Nest Egg: A Consumer Guide to the New Reverse Mortgages, Ken Scholen, NCHEC Press (1996)
A 342-page book containing in-depth analysis of major reverse mortgage programs, comparisons and explanations. Information on ordering is available through NCHEC's website at www.reverse.org/help.guidance/htm.

BROCHURES

"Guarding the Golden Years: Reverse Mortgages," West Coast Regional Office of Consumers Union—basic information and consumer tips. Listings for free, confidential reverse mortgage counseling services in the San Francisco Bay Area. Brochures are available in English and Spanish.

"Reverse Mortgages Fast Facts," U.S. Federal Trade Commission. To order this free brochure, write to Consumer Response Center, FTC, 600 Pennsylvania Ave, N.W., Washington, DC 20580, or call 202-FTC-HELP.

"Reverse Mortgage Locator," National Center for Home Equity Conversion (NCHEC)—a listing of reverse mortgage lenders throughout the country, by state. To order, contact NCHEC (see above).

PRODUCT INFORMATION

Consumers Union of U.S., Inc. does not endorse any individual reverse mortgage product or lender.

U.S. Department of Housing and Urban Development, Federal Housing Administration's Home Equity Conversion Mortgage (HECM)
451 7th St., S.W.
Washington, DC 20410
888-466-3487 (toll-free)

- Money from Home, Fannie Mae. Describes both the HUD's HECM and Fannie Mae Home Keeper programs. To order, call Fannie Mae at 202-752-7000.

- "Home Equity Conversion Mortgage Program," www.hud.gov/progdesc/hecmdf.html

Fannie Mae's Home Keeper Program
Fannie Mae
3900 Wisconsin Avenue, N.W.
Washington, DC 20016-2899
202-752-7000

- Money From Home, Fannie Mae. Describes both the HUD's HECM and Fannie Mae Home Keeper programs. To order, call Fannie Mae at 202-752-7000.
- "Reverse Mortgages for Seniors," www.fanniemae.com/singlefamily/products/markets/ emg_reverse.html

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