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Reverse Mortgages

Overview: Reverse mortgages are growing in popularity with homeowners who want to take some of the equity out of their home. Are such loans appropriate for everyone? The following explains how reverse mortgages work and discusses things to keep in mind when considering such a loan.

A common problem for retirees is that they are house-rich, but cash-poor, meaning their home is their largest asset. There used to be just two significant ways to receive the equity from a home:

- ▲ Sell or rent it
- ▲ Borrow against it using either a cash-out refinance or a home-equity loan

Reverse mortgages present a third option by allowing homeowners to receive some of the home's equity without moving or making regular loan repayments. Thus, reverse mortgages provide an alternative financing method (though an expensive one) that can help homeowners maintain their independence as well as an adequate standard of living.

Some characteristics of people who take out reverse mortgages are that they:

- ▲ Have a regular need for additional funds
- ▲ Live on a fixed income with their home equity as their most significant asset
- ▲ Do not plan to leave their home to their heirs

Reverse Mortgage Features

Reverse mortgages are similar to conventional mortgages in that lenders pay homeowners based on the equity in the home. The biggest difference is that the homeowners do not immediately begin paying back the loan with a reverse mortgage. Generally, the loans are not due until the home is no longer the homeowners' principal residence. Money received from reverse mortgages is not taxable and typically does not affect homeowners' other assets or their Medicare or Social Security benefits.[1]

Borrowers can repay reverse mortgages with other assets, but typically repay them by selling the home. Any equity that remains after selling the home belongs to the homeowners or their heirs. Also, most reverse mortgages have a nonrecourse clause, meaning the debt cannot be passed along to the estate or heirs.[2]

The amount borrowers receive depends on several factors:[3]

- ▲ Age
- ▲ The current interest rate
- ▲ Loan fees

- ▲ The home's appraised value or the Federal Housing Administration's (FHA's) mortgage limits for the area, whichever is less

Because the maximum amount available is partly dependent on age, the longer borrowers wait before taking out a reverse mortgage, the greater the amount available. Note that many reverse mortgages have no income restrictions. Generally, the borrowing limits increase when there is more equity in the home, the borrowers are older and interest rates are at low levels. In addition, the proceeds of a reverse mortgage are tax free.[4]

Loan Considerations

- ▲ Reverse mortgages involve several costs: origination fees and other closing costs up-front, and service fees during the term of the mortgage. Private mortgage insurance may also be required.
- ▲ The amount owed on reverse mortgages generally grows over time. Interest is charged on the outstanding balance and added each month. However, it is important to note that the FHA or the lender would take the losses on reverse mortgages due to the nonrecourse nature of most of these loans if the debt ends up exceeding the value of the property.[5]
- ▲ Interest rates on reverse mortgages can be either fixed or variable.[6]
- ▲ Because borrowers retain the titles to their homes, they remain responsible for property taxes and all other homeowner expenses. Failing to pay property taxes or maintain homeowners insurance puts borrowers at risk of the loan becoming due.[7]

Eligible Property Types

The home must be a one-to-four unit property, which includes townhouses, detached or manufactured homes and units in condominiums, though condominiums must be FHA-approved.[8]

How Are Payments Received?

In addition to taking a lump-sum payment, borrowers have five options:[9]

- ▲ Tenure — Indefinite equal monthly payments
- ▲ Term — Equal monthly payments over a certain time period
- ▲ Line of credit — A set amount that borrowers can draw from whenever necessary
- ▲ Modified tenure — Combination of line of credit and tenure
- ▲ Modified term — Combination of line of credit and term

Three Types of Reverse Mortgages

According to the Federal Trade Commission, the three basic types of reverse mortgages are:[10]

- ▲ Single-purpose reverse mortgages — Offered for a single purpose, such as home repairs
- ▲ Home-equity conversion mortgages (HECMs) — Backed by the U.S. Department of Housing and Urban Development (HUD)
- ▲ Proprietary reverse mortgages — Loans developed and backed by private companies. Due to the complex nature of these loans, they will not be covered in this paper.

Single-Purpose Reverse Mortgages

Single-purpose reverse mortgages typically have the lowest costs of the different types of reverse mortgages. However, usually only borrowers with low or moderate income qualify for these loans.[11]

HECMs

HECMs are the most popular type of reverse mortgage. The size of HECMs depends on the maximum loan limit, which varies by county and ranges from $200,160 to $362,790.[12]

Before applying for HECMs, borrowers must meet with a counselor from an independent government-approved housing counseling agency. The counselor must explain costs, financial implications and alternatives.

However, HECMs tend to cost more compared to other home loans. For example, an HECM might involve not only a 2 percent origination fee, but also a 2 percent fee for mortgage insurance and a monthly service fee of 0.5 percent. By having insurance on reverse mortgages, homeowners can turn to the government for their loan funds should the company managing the account go under. Furthermore, the mortgage insurance guarantees that borrowers will never owe more than the value of the home when HECMs must be repaid.

Beware of High Up-Front Costs

Reverse mortgages carry high up-front costs compared to conventional home loans, though it is important to note that these costs (with the possible exception of an application fee) become part of the loan balance. Still, "the high initial costs make reverse mortgages prohibitively expensive for the short-term user."[13]

The National Center for Home Equity Conversion provides this example.[14] A 75-year-old single woman gets a $150,000 HECM on her home and finances $6,500 in up-front costs as part of the loan. She receives monthly advances of $562 indefinitely, and her home appreciates at 4 percent per year. If this reverse mortgage is paid off two years later, the loan's effective interest cost is almost 50 percent! She would receive only $13,488 for the life of the loan, compared with the $6,500 incurred as up-front costs (not counting accrued interest). She would receive $80,928 over the life of the loan if she stayed in the home for 12 years, driving the cost of the loan down to 10.8 percent.

Such an example demonstrates why reverse mortgages may be more risky for people needing in-home care. If their health condition requires moving into an assisted living or nursing home, the reverse mortgage stops making advances and the loan must be repaid, though some loans have a grace period before repayment starts.

Other Points

▲ HUD provides names of its approved lenders, and the lenders will help with the application and approval process at no cost.[15]

▲ Although the proceeds are tax free, reverse mortgages may impact eligibility for certain need-based public benefits such as Medicaid or Supplemental Security Income.[16]

▲ During periods of low interest rates, comfortably sustaining withdrawal rates of 3–4 percent from conservatively structured portfolios becomes harder to achieve. On the other hand, periods of low interest rates favor reverse mortgages because low initial rates result in larger payouts or monthly payments. Thus, reverse mortgages can supplement portfolio returns when interest rates are low or falling, and may also help individuals (and their advisors) resist the temptation to stretch for yield by extending maturities or lowering credit quality standards.

Summary

While reverse mortgages can be a relatively expensive means of borrowing, they may be appropriate for some individuals, enabling them to maintain their homes, their independence and adequate standards of living. A significant advantage of reverse mortgages is that there are no income requirements, which is not the case with many other forms of financing.

Individuals should consider all aspects of the various alternatives for tapping into the equity in their home (such as cash-out refinancing, home-equity loans and reverse mortgages).

[1] **Reverse Mortgages: Get the Facts Before Cashing in on Your Home's Equity.** *FTC Facts for Consumers*, June 2005.
[2] **Top Ten Things to Know if You're Interested in a Reverse Mortgage.** Available at http://www.hud.gov/offices/hsg/sfh/hecm/rmtopten.cfm. Accessed Februrary 28, 2008.
[3] Ibid.
[4] **Money From Home: A Guide to Understanding Reverse Mortgages.** (Fannie Mae, 2002).
[5] **Reverse Mortgages: Get the Facts Before Cashing in on Your Home's Equity.**
[6] Ibid.
[7] Ibid.
[8] **Top Ten Things to Know if You're Interested in a Reverse Mortgage.**
[9] Ibid.
[10] **Reverse Mortgages: Get the Facts Before Cashing in on Your Home's Equity.**
[11] Ibid.
[12] **About Reverse Mortgages for Seniors — Section 255 — Home Equity Conversion Mortgages.** Available at http://www.hud.gov/offices/hsg/sfh/hecm/hecmabou.cfm. Accessed February 28, 2008.
[13] **Reverse Mortgages Demystified.** Available at http://www.help4srs.org/finance/reverse_mortgages.htm. Accessed February 29, 2008.
[14] Ibid.
[15] Ibid.
[16] **Money From Home: A Guide to Understanding Reverse Mortgages.**