

Chapter 15: Reverse Mortgages

- Reverse mortgages are one way to “spend” the equity in your home.
- You maintain ownership and can repay anytime, but must repay when you sell your home
- Costs are fairly high, but generally less than the practice of routinely refinancing a conventional mortgage.

If you own a home for a long time, you’ll build up equity through principal payments and appreciation. This equity is an asset you can use as needed. You can spend the equity in your house in a variety of ways. The oldest and most common approach is to downsize by selling your home and buying something less expensive. Or you can sell without buying a new home, using the proceeds for rent and whatever else you want.

A newer, less common, approach is to borrow against that equity with a home equity loan called a HELOC, or home equity line of credit. If you use this approach, you’ll repay the loan each month, just like a regular mortgage. Many financial experts favor the next approach over this HELOC choice.

A reverse mortgage is a third approach called a HECM -- home equity conversion mortgage – where the lender pays you and you agree to pay the lender back when you sell the house or move. According to the National Reverse Mortgage Lenders Association, homeowners aged 62 and older held \$7.14 trillion in home equity in the first quarter of 2019.

This chapter is about the third option -- reverse mortgages.

Eligibility

Homeowners aged 62 or older who have a substantial amount of equity (at least 50%) are eligible to receive funds as a lump sum, fixed monthly payment or line of credit. Unlike a forward mortgage—the type used to buy a home—a reverse mortgage doesn’t require the homeowner to make any loan payments.

A reverse mortgage allows you to keep living in your home as long as you keep up with property taxes, maintenance, and insurance and don't need to move into a nursing home or assisted living facility for more than a year. Importantly, you continue to own your home. Some mistakenly believe that the lending bank owns the home.

Types of Reverse Mortgages

There are three types of reverse mortgages:

Home Equity Conversion Mortgages (HECMs) are federally-insured reverse mortgages backed by the U.S. Department of Housing and Urban Development. An HECM is likely to be more expensive than a traditional home loan because of mortgage insurance that protects all involved parties. It is the most widely used reverse mortgage because it carries no income limitations or medical requirements, and the loan can be used for any reason.

A Single-Purpose Reverse Mortgage is offered by state, local, and nonprofit agencies. It is the least expensive process option for a reverse mortgage loan. The state or local government, or nonprofit agency, specifies the reason for the reverse mortgage. Homeowners can use single-purpose reverse mortgage proceeds only to pay for a specific lender-approved item, such as necessary repairs to the home or property taxes.

A Proprietary Reverse Mortgage A proprietary reverse mortgage is used for a larger advance for a home appraised at a high value. For example, if your property is worth more than \$822,375, the 2021 lending limit for federally backed HECMs, you may be eligible for a higher loan if you go the proprietary route.

In the following we discuss the most common reverse mortgage – the HECM

How much can you borrow

The amount you can borrow will be based on the youngest borrower's age, the loan's interest rate, and the lesser of your home's appraised value or the FHA's maximum claim amount, which is \$822,375 as of Jan. 1, 2021.

You can't borrow 100% of what your home is worth, or anywhere close to it, however. Part of your home equity must be used to pay the loan's expenses, including mortgage insurance premiums and interest.

The amount you can actually borrow is based on what's called the initial principal limit. In January 2018, the average initial principal limit was \$211,468 and the average maximum claim amount was \$412,038. The average borrower's initial principal limit is about 58% of the maximum claim amount. This limit is increased by credited interest through time.

Reverse mortgage proceeds are not taxable. While they might feel like income to the homeowner, the IRS considers the money to be a loan advance.

What does it cost

Up-front costs include: Origination fees (which cannot exceed \$6,000 and are paid to the lender) Real estate closing costs (paid to third-parties) that can include an appraisal, title search, surveys, inspections, recording fees, mortgage taxes, credit checks and other fees. Origination fees compensate the lender for processing the loan. We estimate that total up-front costs range between \$15,000 and \$25,000.

You'll also pay ongoing interest on borrowed amounts and mortgage insurance. Since lenders can't ask homeowners or their heirs to pay up if the loan balance grows larger than the home's value, the insurance premiums provide a pool of funds that lenders can draw on, so they don't lose money when this does happen. All borrowers pay 2% upfront mortgage insurance premium on the maximum claim amount or appraised value up to a maximum of 2% of \$822, 375 and on-going mortgage insurance premium equal to .5% of the borrowed amount annually.

Only the lump-sum reverse mortgage, which gives you all the proceeds at once when your loan closes, has a fixed interest rate. The other payment options have adjustable interest rates, which makes sense, since you're borrowing money over many years, not all at once, and interest rates are always changing monthly or annually depending on the contract. Variable-rate reverse mortgages are tied to the Constant Maturity Treasury rate (CMT) (older contracts used the London Interbank Offered Rate (LIBOR)).

In addition to one of the base rates, the lender adds a margin of one to three percentage points. So, if CMT is 2.5% and the lender's margin is 2%, your reverse mortgage interest rate will be 4.5%. As of April 2021, lenders' margins ranged from 1.75% to 3.215%. Interest compounds over the life of the reverse mortgage, and your credit score does not affect your reverse mortgage rate or your ability to qualify. Most contracts specify a limit (cap) on the amount of interest that may be charged.

Buyer protection

In order to protect consumers, HUD requires the following:

- Prospective borrowers must receive counseling before applying for a reverse mortgage.
- Counseling is conducted by independent, third-party advocacy organizations and housing counseling agencies.
- Counselors are HUD-approved, exam-qualified professional housing counselors.
- Borrowers receive documentation to prepare for the session

Conclusion

Reverse mortgages are just one way to use the equity in your home. They may or may not be right for you, but they are worth considering.

Please Watch This Video

We end each chapter with a link to a video on the topic. The video for this Chapter can be viewed here: <https://www.youtube.com/watch?v=SywshvixHp0>