

Understanding Reverse Mortgages: Do They Make Sense For You?

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Overview

Your home can be a significant financial asset, particularly if you have owned it for some time. In the years leading up to the recent economic recession, you may have heard it said that people were “using their homes like ATMs” and wondered how that could be possible.

Home equity is a dollar amount calculated as the difference between the current market value of your home and the remaining balance on any mortgage loan. There are three ways to access this home equity for cash. You can sell it and move to a different home. You can borrow against it, using a home equity loan that would need to be repaid. You can borrow against it using a reverse mortgage.

Many people are familiar with traditional home mortgages. They are formally known as “forward” mortgages. The primary purpose of a forward mortgage is to purchase a home. Through the use of a mortgage, a new borrower typically owes a lot and has a little equity in their home. Until the loan is paid off, the borrower makes regular payments to the lender. Over time, the loan balance decreases and the amount of equity increases. When a traditional, or forward mortgage, is paid in full, the borrower owes nothing and has substantial equity. If the home is sold before the mortgage is paid off, the proceeds from the sale of the home are used to pay off the mortgage before the seller receives any proceeds from the sale.

A home equity loan is an installment loan secured by your home. The borrower makes regular payments until the loan is paid back. In the event of missed payments or lack of repayment, you could be forced



to sell your home to repay the loan. Similarly, a home equity line of credit provides an open-ended loan that allows borrowers to pull money out as needed. Regular payments must be made on the amount of money that



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has been withdrawn. For example, home equity loans and lines of credit are often used for home remodeling expenses, starting businesses, or paying for weddings.

Another type of mortgage, one that may be less familiar, is the “reverse mortgage.” The primary purpose of a reverse mortgage is to provide access to home equity without requiring regular loan payments from the homeowner. Before using a reverse mortgage, a borrower typically has a lot of equity in the home. For example, 80 percent or more of the home’s value. As a homeowner receives payments over time, the mortgage loan balance rises and the amount of equity decreases. Although the loan balance grows over time, the borrower does not have to repay the loan while continuing to live in the home. When the homeowner moves out of the home, sells it, or dies, the loan must be paid off. At the end of the life of the loan, the borrower owes a substantial amount and her or his equity has decreased, possibly substantially.

A reverse mortgage loan isn’t for everyone. This special type of loan is only available to homeowners aged 62 and older who are living in their homes. While the idea of using your home for cash may be appealing, it is an important decision that cannot be made hastily or before you understand the benefits and pitfalls of this financial product.

In 2012, the Consumer Financial Protection Bureau (CFPB) published the results of a study it conducted on reverse mortgages. They reported that in fiscal year 2011, 46 percent of new reverse mortgage borrowers were younger than age 70.

Reverse mortgages are a complex financial product and difficult for consumers to understand. Misleading or deceptive advertising confuses consumers, further complicating the reverse mortgage process. The CFPB reported that 1 in 10 reverse mortgages were in default in FY 2011. Most of these defaults occurred because homeowners did not maintain home insurance or pay property taxes.

When considering if a reverse mortgage is appropriate, first assess whether or not your current home will allow you to age in place. Consider balancing health and safety issues with a desire for independence and a familiar setting.

For example, ask yourself:

- Is my home safe and comfortable? Does it fit my

needs? Will it continue to fit my needs as I grow older? Would I feel isolated if I could no longer drive? Can I get adequate help and supportive services if I need them?

- Do I have the resources I might need to help me stay in my home, including support from others, personal finances, and home equity?
- What other housing options do I have? Could I live with family members? Is senior housing available in my community?

If you decide to stay in your home, be clear about why you feel you need the money a reverse mortgage can provide, determine how much cash you can get from your house, and decide whether or not you have the information and appropriate documentation to tap your home equity.

For example, ask yourself:

- Why do I need the money? Is my need immediate to deal with an emergency? Am I trying to be prepared to meet an anticipated need sometime in the future? Am I looking for a longer-term solution in order to be able stay in my home?
- Is my house currently in good repair? How much can I realistically get from my house based on current market conditions in my community and my age?
- Does my durable power of attorney include real estate? Is my title to the property shared with others and would that affect my ability to obtain a reverse mortgage?
- Do I have existing relationships with the professionals I am likely to need, including a banker, real estate agent, lawyer, appraiser, inspector, and contractors?

For immediate, short-term needs, there may be state and local programs that you can access. These may be in the form of single-purpose loans (e.g. home repair and improvement loans) or programs that help you lower heating costs. A home equity line of credit or loan may be appropriate if you are unsure how long you can continue to live in your home and you can make the loan payments from your current income.

The age of the youngest homeowner affects eligibility and the amount of money that can be borrowed

through a reverse mortgage. Older borrowers are able to borrow more than younger borrowers. Younger borrowers may risk having fewer resources later in life to pay for both everyday needs as well as major unexpected expenses. They also risk being unable to finance a future move because the reverse mortgage must be repaid when the house is sold.

If you decide a reverse mortgage meets your needs and you qualify, understand the product features and payout options. The Home Equity Conversion Mortgage (HECM) from the Federal Housing Administration is the most common reverse mortgage product and is discussed below.

Product Features

Types of Loans. As of early 2014, there are three HECM loan options to choose from.

- A traditional HECM loan allows borrowers access to a predetermined amount of equity on their home. The amount is determined based on the borrower's age, the current market interest rates, and the amount of equity in the home. With some exceptions, borrowers are allowed to access 60 percent of the total loan amount in the first year, with the rest made available in following years.
- An HECM "mini" loan is similar to a traditional HECM loan, in that it allows borrowers to access home equity in their existing home. However, borrowers are only eligible to withdraw 60 percent of the total eligible loan amount. For borrowers that want to preserve home equity this may be a better option.
- The last type of loan is an HECM for purchase. It allows an individual to purchase a home with a substantial down payment and the proceeds from an HECM in a transaction similar to a forward mortgage. However, like the other reverse mortgage products, no repayment is due until the owner moves, dies, or sells the home.

Eligibility. To be eligible for a HECM loan a borrower must meet the following criteria:

- Be 62 years of age or older.
- Use their primary home as collateral.
- Complete HECM approved counseling.
- Have no outstanding federal debt (for example,

past due income tax, student loans, or HUD-insured loans).

- Undergo a financial assessment to determine if adequate resources are available to maintain the home. Borrowers may be required to set aside a certain amount of loan money if the financial assessment indicates that the homeowner does not have enough income to cover the expenses associated with maintaining the home.

HECM Counseling. Potential borrowers are required to receive loan counseling from an approved HECM counselor. A nationwide database of approved counselors can be found here:

http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfb/hecm/hecmelist

Counselors will educate borrowers on:

- The financial implications of a reverse mortgage, both during life and when the borrower sells the house or dies.
- Alternatives to a HECM.
- Borrower obligations.
- The costs associated with the loan.
- Situations under which repayment must be made, as well as the various repayment alternatives.

Costs. HECM loans come with a number of costs that must be considered against the total value of the proceeds from the loan. Typically total costs range from 4 to 6 percent of the home's value. They can include:

- A loan origination fee.
- Costs associated with the home appraisal, inspection, and title search.
- Annual loan service fees.
- Interest that accrues monthly on the loan balance.
- Both upfront and annual mortgage insurance premiums.
What is the purpose of the mortgage insurance premiums? A borrower's liability to repay an HECM loan is limited to the home's value. This means that in a case where the loan balance exceeds the home's value upon repayment, the homeowner will not have to pay any additional amount to the

bank. This insurance, which the borrower pays for, covers the lender if any shortfall exists.

Amount and disbursements. The amount of money available to each borrower will vary. It will be based on three factors: the borrower's age, current market interest rates, and the amount of home equity. In general, older borrowers qualify for larger loan amounts. So do borrowers with higher home equity amounts. When interest rates are lower, the loan amount may be larger than when interest rates are higher.

Borrower obligations. It is important to have adequate financial resources to pay property taxes, insurance, maintenance, and upkeep expenses for your home. You could face foreclosure if you can't pay for these items. A financial assessment will be conducted and, depending on the outcome, you may be required to set aside a portion of the loan proceeds to cover these expenses. Even if you are not required to do so, some borrowers elect to set aside this money anyway.

One common misconception is that the house must be sold or surrendered to the bank upon repayment. That is not true. Your heirs can choose to keep the house and repay the loan with other resources. They can keep the house by paying the lesser of the loan balance or 95 percent of the home's current appraised value. Repayment is typically due within 3 to 12 months.

Other Considerations

You can remain in the home until you move out or die. Children and any dependents living within the home must be prepared to purchase the home when you die or move out of the house. It is important that you discuss your plans with your family members.

A reverse mortgage is a complicated financial product and it is important to understand it before making any final decisions. As you consider your options, asking yourself these questions may help you to decide whether or not a reverse mortgage is appropriate for you.

Do I understand that:

- it is important to assess whether my home will allow me to age in place?
- I retain ownership of my home with an HECM?
- I will have to go through a credit check and financial assessment, which will determine the amount of money I am able to borrow?
- while no payments are due, failure to maintain the property and pay property taxes could result in a loan default?
- higher fees will be charged if I withdraw more than 60 percent of the maximum loan amount in the first year?
- interest and fees accumulate each year on the HECM loan balance?
- the HECM must be repaid if I move or at my death?
- my liability for the HECM loan only extends to the value of my home?
- it is possible that my heirs may be forced to sell my home to pay off the loan balance?

Also, do I know how to:

- talk to my family about the financial consequences of an HECM?
- find a HUD-approved HECM housing counselor?

Understanding Reverse Mortgages: How Much Is it Worth to You?

Example and Worksheet

Reverse mortgages are complicated financial products. Before you decide that a reverse mortgage is for you, use the example below to understand how the calculations work.

The example below illustrates the process. In this example, we assume the home is valued at \$200,000 and there is an existing mortgage balance of \$15,000. The youngest borrower is 67 years old and the interest rate is 5 percent. Use the worksheet that follows to estimate how much cash you can get from your house.

Calculate the maximum claim amount. The maximum claim amount (MCA) is either the appraised home value or \$625,000, the HECM FHA mortgage limit, whichever is less. In this example, the home is valued at \$200,000.

Fair-market value or appraised home value	\$ <u>200,000</u>
HECM FHA mortgage limit	\$ <u>625,000</u>
The Maximum Claim Amount (MCA) is the lesser value	\$ <u>200,000</u>

Determine the principal limit. The amount you can borrow is determined by your principal limit. Your principal limit is determined by multiplying your maximum claim amount (MCA) by your principal limit factor (PLF). The principal limit factor is determined by the age of the youngest borrower and the current expected interest rate. In this example, we assume a market interest rate of 5 percent and 67-year-old borrower. Use the table below to find the PLF:

<i>Example Principle Limit Factors Based on Age and Interest Rate</i>					
	Expected Interest Rate				
Borrower Age	<=5%	6%	7%	8%	9%
62	0.526	0.420	0.343	0.281	0.229
67	0.551	0.450	0.379	0.319	0.269
72	0.575	0.483	0.417	0.361	0.313
77	0.597	0.511	0.451	0.400	0.352
82	0.621	0.545	0.489	0.442	0.400
87	0.646	0.581	0.532	0.490	0.453

Note: After 2011, the minimum interest rate that can be used to calculate PLF is 5 percent regardless of prevailing rates.

Maximum Claim Amount (MCA) from above	\$ <u>200,000</u>
Estimated PLF from the table is	<u>0.551</u>
Principal Limit (MCA × PFL)	\$ <u>110,200</u>

Understand how the loan funds are distributed. Typically, the amount of money that can be accessed in the first year is 60 percent of the principal limit. To determine the amount of cash the borrower will receive, subtract the cost of mandatory obligations related to the loan from the principal limit. Common mandatory obligations include any existing mortgage debt, loan origination fee, mortgage closing costs, and initial mortgage insurance premium amounts. In this example, assume an existing mortgage of \$15,000.

Total amount accessible in year 1 is 60 percent × \$110,200 (Principal Limit)	\$ <u>66,120</u>
Subtract	
Any existing mortgage balance	- \$ <u>15,000</u>
Loan origination fee (estimate 2 percent of MCA)	- \$ <u>4,000</u>
Closing costs associated with the loan (estimate 1.5 percent of MCA)	- \$ <u>3,000</u>
Initial Mortgage Insurance premium (estimate 0.5 percent of MCA)	- \$ <u>1,000</u>
Amount available as cash in year 1	= \$ <u>43,120</u>
Amount available after year 1 is 40 percent of \$110,200 (Principal Limit)	\$ <u>44,080</u>

Note: If your existing mortgage balance is greater than 50 percent of the principal limit, you will have to pay an initial insurance premium amount of 2.5 percent of the MCA rather than the 0.5 percent in the example. Additionally, borrowers are restricted to accessing 10 percent of the principal limit as cash in year one. Whatever money remains will be available in year 2. Based on the results of a financial assessment, you may be required to set aside funds for insurance and property tax.

Worksheet

What is your maximum claim amount?

Fair-market value or appraised home value \$ _____

HECM FHA mortgage limit \$ 625,500

The Maximum Claim Amount (MCA) is the lesser value \$ _____

What is your principal limit? Use the table below to find the PLF:

<i>Example Principle Limit Factors Based on Age and Interest Rate</i>					
Borrower Age	Expected Interest Rate				
	<=5%	6%	7%	8%	9%
62	0.526	0.420	0.343	0.281	0.229
67	0.551	0.450	0.379	0.319	0.269
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77	0.597	0.511	0.451	0.400	0.352
82	0.621	0.545	0.489	0.442	0.400
87	0.646	0.581	0.532	0.490	0.453

Note: After 2011, the minimum interest rate that can be used to calculate PLF is 5 percent regardless of prevailing rates.

Maximum Claim Amount (MCA) from above \$ _____

Estimated PLF from the table is _____

Principal Limit (MCA × PFL) \$ _____

How will the loan funds be distributed?

Total amount accessible in year 1 is 60 percent × \$ the principal limit \$ _____

Subtract

Any existing mortgage balance - \$ _____

Loan origination fee (estimate 2 percent of MCA) - \$ _____

Closing costs associated with the loan (estimate 1.5 percent of MCA) - \$ _____

Initial Mortgage Insurance premium (estimate 0.5 percent of MCA) - \$ _____

Amount available as cash in year 1 = \$ _____

Amount available after year 1 is 40 percent of the principal limit \$ _____

Note: If your existing mortgage balance is greater than 50 percent of the principal limit, you will have to pay an initial insurance premium amount of 2.5 percent of the MCA rather than the 0.5 percent in the example. Additionally, borrowers are restricted to accessing 10 percent of the principal limit as cash in year one. Whatever money remains will be available in year 2. Based on the results of a financial assessment, you may be required to set aside funds for insurance and property tax.

Resources

Consumer Financial Protection Bureau. (2013, June). Spotlighting Risk in the Reverse Mortgage Market. Available at http://files.consumerfinance.gov/f/201206_cfpb_Reverse_Mortgage_FactSheet.pdf

National Council on Aging. (2013). Use Your Home to Stay at Home. Available at http://www.ncoa.org/news-ncoa-publications/publications/ncoa_reverse_mortgage_booklet_073109.pdf

U. S. Department of Housing and Urban Development. (n.d.). Home Equity Conversion Mortgages for Seniors. Available at: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/hecmhome

Helpful Links

Information from the United State Department of Housing and Urban Development
http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm

<http://portal.hud.gov/hudportal/documents/huddoc?id=ML13-27.pdf>

A calculator from the National Reverse Mortgage Lenders Association

<http://www.reversemortgage.org/About/ReverseMortgageCalculator.aspx>

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