Reverse Mortgages and Other Uses of Home Equity

Eileen St. Pierre, Ph.D., CFA
Assistant Professor
Personal Finance Specialist

Oklahoma Cooperative Extension Fact Sheets are also available on our website at:
http://osufacts.okstate.edu

We have all been told we need to save as much as we can for retirement. But for those already in retirement, there may be a point where your current retirement income just is not enough to live on. For those who are just making ends meet, you may feel that you are only one major illness or event away from financial hardship. It may be that you have major household repairs needing to be completed soon, or perhaps you are worried about the cost of long-term care, or maybe poor investment returns may reduce your monthly income in the future. These kinds of issues can cause enormous anxiety. Are there any financial strategies that can help alleviate this stress?

Many seniors do not understand the value of their own homes. Your home is a real, tangible asset. The value of the equity in your home is equal to the current market value of your home, minus any outstanding mortgages or liens.

If the market value of your home is $150,000 and you still owe $50,000 towards your mortgage, then your home equity is $100,000. If you have paid off your mortgage, then you own your home free and clear; you have 100 percent equity in your home.

You can use the amount of equity in your home to help finance your retirement. There are three ways you can do this: (1) reverse mortgage, (2) home equity line of credit, and (3) outright sale of your home.

Reverse Mortgage

A reverse mortgage is a special type of home loan that allows a homeowner to convert a portion of his or her home equity into cash. You need to be at least 62 years of age and own your own home, or at least have a very large equity stake. The lender makes payments to you. These payments are generally tax-free and do not affect your Social Security or Medicare benefits. There are no income or asset requirements. This means your credit worthiness is not considered by the lender.

Repayment is required when the borrower(s) no longer uses the home as their primary residence, sells the home, or passes away. If the owner dies, then the heirs/estate may decide to pay off the loan and keep the house, or sell the house and use the proceeds to pay off the loan. Once the loan is paid off, all remaining proceeds from the house sale go to the surviving owner or estate. In any case, the loan will never exceed the home's value at the time the loan comes due; this is referred to as a "non-recourse" loan.

Here is how the non-recourse feature works:

Suppose your house has fallen in value during the past few years to $150,000 at the time of your death and your reverse mortgage balance (initial loan plus interest) is $160,000. The most your heirs or estate will have to pay back is $150,000. The lender absorbs the $10,000 loss.

Most reverse mortgages are Home Equity Conversion Mortgages, or HECMs. These reverse mortgages are available through the U.S. Department of Housing and Urban Development (HUD) and sponsored by the Federal Housing Authority (FHA). For these mortgages, the FHA (i.e., the federal government) will absorb the loss if the loan value exceeds the value of the home. There are also private reverse mortgages, but since the HECMs dominate the market, the rest of this section will focus on HECMs.

Before applying for a HECM, you must meet with a counselor approved by HUD. The counselor must explain the loan's costs, financial implications, and other alternatives available to you. Counselors use tools to assess whether or not homeowners would be able to sustain themselves in their homes and meet their financial obligations after obtaining the HECM.

HUD has approved four agencies to help provide this counseling: Consumer Credit Counseling Service (CCCS), Money Management International (MMI), National Foundation for Credit Counseling (NFCC), and the National Council on Aging (NCOA). If you have trouble locating a counselor in your area, go to the HUD website http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm?filtersvc=hec&filtermultistate=yes and choose Oklahoma. You will then see a list of all the approved counselors in the state. You may also call HUD at 1-800-569-4287.

The most you can borrow is a percentage of your home's appraised value, up to a maximum value of $625,500. The following factors are considered by the lender when determining your loan amount:

- homeowner's age,
- current value of the home and its potential growth rate,
- current interest rates,
- amount of equity in the home.

Generally speaking, the older you are, the more valuable your home is, the lower interest rates are, the more money you can access. The National Reverse Mortgage Lenders Association provides a reverse mortgage calculator to help determine how much money is available to your particular situation http://www.reversemortgage.org/About/ReverseMortgageCalculator.aspx

There are a variety of ways the homeowner can take the proceeds of a HECM. The following methods can be used alone or in some combination:

- lump sum,
- line of credit,
- monthly payment for life,
- monthly payment for a fixed period.

If you owe any debt on your home, you must take at least that amount as a lump sum at closing and use it to pay off this debt. This will reduce the amount of cash available to you in a lump sum, line of credit, or monthly payment. If you do not qualify for enough cash to pay off this debt, you will be turned down for a reverse mortgage.

Reverse mortgage costs can be steep. The Federal Reserve Board requires lenders to provide seniors with a Total Annual Loan Cost disclosure, which shows the total transaction costs over the projected life of the loan. Because the FHA is absorbing the loss if the loan value exceeds the value of your home, it charges two mortgage insurance premiums: an upfront charge and an annual premium (charged monthly) equal to 1.25% of the outstanding balance. The upfront charge depends on the type of HECM.

There are two types of HECMs available to consumers: the HECM Standard and the HECM Saver. The upfront premium on the HECM Standard is 2% of the property's value. With the HECM Saver, the upfront premium is only .01% of the property's value. However, you will not be able to borrow as much with a HECM Saver.

Suppose your home is currently worth $300,000. The upfront mortgage insurance premium for the HECM Saver will be $30 as opposed to $6,000 for the HECM Standard option.

In addition, you are charged interest during the life of the reverse mortgage. Even though you do not have to pay any interest while you remain in the house, the interest is added to the loan balance, and will need to be paid when you or your heirs sell the house. This interest is not tax-deductible until the loan is paid off. Your lender may also charge a loan origination fee and closing costs.

As your loan balance grows, the equity left in your home is used up, leaving fewer assets for you and your heirs. If you need to sell your home later in life, perhaps to move to an assisted living facility, you may not have enough equity left in your house to support this move. It's important to remember you will still be responsible for maintaining the home and paying property taxes throughout the length of the loan.

Under provisions of the Truth-in-Lending Act, you have the "right of rescission." This means you have up to three business days following the loan closing to cancel the transaction for any reason whatsoever. You need to inform your lender in writing during this 3-day window. A phone call is not enough.

There have been problems with seniors becoming victims of reverse mortgage fraud. The intention of the Housing and Economic Recovery Act of 2008 was to help rein in fees and fraud associated with reverse mortgages. To avoid becoming a victim of fraud, consider the following:

1. Compare rates from up to four lenders.
2. You should never have to pay another company or "estate planning service" to help find a reverse mortgage lender or provide information about reverse mortgages. HUD provides this information free of charge.
3. Meet face-to-face with a loan counselor. Avoid lenders who downplay the need for pre-loan counseling or want to do it quickly over the phone.
4. If the lender pressures you to sign documents that have blanks or incorrect information, cancel the deal immediately and contact HUD about this lender.
5. Be suspicious if the lender also wants to sell you other products, such as insurance or annuities. Chances are you are being scammed into a larger loan with higher fees. These other products are also costly and may not be beneficial for you.
6. Beware of lenders who offer home improvement services or repairs through a recommended contractor. Chances are the contractor is "in" on the scam and will charge you very high prices.
7. A HECM will never be marketed directly to a homeowner by a government representative. If a salesman

claims to be a government representative, then he is not legitimate.
8. Other victims report that the lender forged documents or signatures on checks.

How do you know if a reverse mortgage is right for you? If you really want to stay in your house for the rest of your life, are in generally good health, and can maintain your property, then a reverse mortgage may be right for you. It can provide you with a stable income to help supplement your Social Security and other retirement income. Talk to one of the housing counselors mentioned above; bring a family member along with you. Make sure you fully understand the costs involved, as well as the alternatives available to you.

Home Equity Line of Credit

A Home Equity Line of Credit (HELOC) is a loan in which the lender (bank) agrees to lend you a maximum amount within an agreed period. The amount of the loan is usually a certain percentage of your home's appraised value minus the existing mortgage.

For example, suppose the lender sets the percentage at 75 percent. If your home is currently worth $200,000 and your mortgage balance is $100,000, then the maximum amount you can borrow is ($200,000 x 0.75) - $100,000 = $150,000 - $100,000 = $50,000.

As the borrower, you are not given the entire sum up front, but you can use a line of credit to borrow money up to the loan amount. It works similarly to a credit card. At closing, you will be assigned a specific credit limit. You are only charged interest on the amount you borrow (only the credit you have used of your total credit line). The length of time you have to use the funds is called the draw period. This period can last from 5 to 25 years.

At the end of the draw period, you will have to pay back the amount you borrowed. You may either pay the whole amount back at once or set up a payment schedule with the bank. Some lenders may allow you to renew the HELOC. Keep in mind, there are income requirements for this type of loan. This means the lender will consider your ability to repay the loan in its decision process so you need to have good credit and enough of an income to pay back the amount borrowed.

You will most likely pay a variable interest rate on this loan. This means that your interest payments will change whenever interest rates change. Make sure you understand what index your interest rate is tied to, such as the prime rate. You also want to make sure you understand how and when your interest rate adjusts. Many financial professionals suggest you look for a HELOC that adjusts quarterly (rather than monthly) in increments of 0.5 percent or less. Variable-rate plans secured by a dwelling must, by law, have a ceiling (or cap) on how much your interest rate may increase during the life of the plan.

Try to avoid a HELOC that charges you other fees, such as an application fee (or at least get it refunded at closing), account maintenance fees, appraisal fees and closing costs, prepayment fees, and fees on the unused balance. The annual percentage rate (APR) that you are quoted by the lender WILL NOT include these fees, just the interest you pay on the used balance. Some lenders may set a minimum amount per withdrawal, say $500, and/or require you to keep a minimum amount in your credit line at all times (similar to a minimum balance in your checking account). Overall, a HELOC is a much cheaper alternative to a HECM.

The Truth-in-Lending Act gives you three days from the day the account is opened to cancel the credit line. To do this, you need to inform your lender in writing during this 3-day period. The lender must cancel its security interest in your home and return all fees paid to open the account.

Is a HELOC appropriate for you? If you need to make a major expenditure over a period of time, such as home remodeling or major repairs, then this option may be worth exploring, especially if these actions add value to your home. The interest paid is tax-deductible in the year incurred, which can benefit seniors who itemize expenses and are in higher federal income tax brackets. This option is also good for those seniors who plan to move within five years to either a health care facility or to live with their children.

A HELOC is not appropriate for everyone. Remember, the interest rate on this loan will change whenever the overall level of interest rates changes, so if that bothers you, then you will want to avoid this type of loan. You will have to repay this loan at the end of the draw period. If you plan on remaining in your home for life, you need to budget this expense in the future; this may place a strain on dwindling financial resources in the future.

Sale of Your Home

One final option is the outright sale of your home. Selling your home may seem like a drastic step. However, when considering all options, it may be a good alternative. Many seniors realize they do not need as much room as they used to, so downsizing to a smaller home may make sense. A smaller home requires less upkeep. Perhaps your children and grandchildren have moved away, and you may want to sell your home and move closer to them. If you live out in the country, you may want to move closer to medical facilities.

The key to alleviating financial stress is to use your home equity to downsize without taking out a new mortgage. Make sure you understand how your cost of living will change at your new location. If it costs less to live at your new location, then you may have equity left over after purchasing your new home; this money can go into your savings account to help pay bills later. If you are renting at your new location, make sure the amount of your equity (and future accumulated interest) will cover your rent payments during this next phase of your retirement.

This strategy is definitely not for everyone. Selling a house can be very stressful. Your home may hold a lot of memories of family events for you, making the sale very emotional. Consider your housing market, as you may live in an area where it is harder to sell a house, or where property values are not as high as in the past. If you use a realtor, you will need to pay a sales commission to help sell your house. In these cases, the costs may outweigh the benefits. The moving process itself can be physically and emotionally draining, so have a very positive attitude that you are moving on to a new, exciting stage in your life. If you do not view this in a positive way, then this strategy may not be for you.

Summary

We all worry about being able to fund our retirement. The government, the financial planning community, realtors, and lenders all recognize that people are living longer and innovative financial products are needed to help seniors in retirement. Because your home is likely to be one of your greatest sources of wealth, it is a likely place to find financial security. It's important that you be an educated consumer when considering using your home for income. Learn about these new products and understand their advantages and disadvantages. Doing so will help you make the best possible decision regarding the equity in your home and your individual financial concerns.

Helpful Websites

HUD:
Home Equity Conversion Mortgages for Seniors **at: http://www.hud.gov/offices/hsg/sfh/hecm/hecmhome.cfm**

The Federal Reserve Board:
What you should know about Home Equity Lines of Credit **at: http://www.federalreserve.gov/pubs/equity/equity_english.htm**

The Federal Trade Commission:
Reverse Mortgages **at: http://www.consumer.ftc.gov/articles/pdf-0058-reverse-mortgages.pdf**

Other Resources

National Council on Aging (2009). *Use Your Home to Stay at Home: A Guide for Older Homeowners Who Need Help Now.* **Available at http://www.ncoa.org/news-ncoa-publications/publications/ncoa_reverse_mortgage_booklet_073109.pdf.**

Skarr, D. (2008). Financial Planner's Guide to the FHA Insured Home Equity Conversion Mortgage. *Journal of Financial Planning, 21* **(5), 68-75.**

Supper, W, and Cocozza, C. (2006). Reverse Mortgages: A Troubled Past, a Promising Future? *Journal of Financial Planning*, *19* **(1), 36-38.**

Issued in furtherance of Cooperative Extension work, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, the Director of Cooperative Extension Service, Oklahoma State University, Stillwater, Oklahoma. This publication is printed and issued by Oklahoma State University as authorized by the Vice President, Dean, and Director of the Division of Agricultural Sciences and Natural Resources and has been prepared and distributed at a cost of 20 cents per copy. Revised 0814 GH.