Should You Use a ñReverse Mortgageò to Raise Cash from the Value of Your Home?

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Summary

A ñreverse mortgageò is one of several ways of getting equity (cash!) out of your home.

It is called a ñreverseò mortgage, because instead of you making payments to the bank every month, the bank makes payments to you ï whether monthly, or in a lump sum, or as a line of credit, or some combination, depending on what you need.

There is no magic here. A reverse mortgage is a loan, with your house as collateral. The difference from a regular mortgage is that instead of getting a big lump of money up front that goes into the purchase of a home, the reverse mortgage instead pays you out in smaller doses over an extended period of time, and the loan doesnôt come due until you leave the house for good (no matter how long that takes). At that point, if the loan cannot be paid off by other means, the house is sold, the lender gets repaid, and anything left over goes to you or your heirs.

There are important pros and cons to reverse mortgages ï and many possible variations in how they work ï so this is definitely an area where you should look before you leap. A reverse mortgage may be just the thing for you, or just the thing to avoid.

When a Reverse Mortgage Can Be Beneficial

A reverse mortgage may make sense for you if <u>all</u> the following are true:

- You are age 62 or older (if you are married and own the home jointly, both of you must be at least 62).
- You have substantial equity in your home (that is, the market value of the home, minus any existing mortgages or home equity lines of credit, is significant).
- You are short of cash, and have no other assets you can and want to dispose of in order to raise money.
- You expect to stay in your home for at least a few years, preferably more.
- You do not have children or other heirs who are counting on inheriting your home.
- Your home is not going to need extensive repairs in order to qualify for a mortgage.
- You do not have any better option available for extracting the equity from your home (see below).
- You do not have an existing mortgage that features especially favorable terms.

For many people, regardless of age, their homes are the biggest assets they own. This can be a problem in retirement, because even though your home may be appreciating in value, it doesnôt generate cash for you. On the contrary, as home values rise, so do the costs of taxes, insurance, and maintenance. So your biggest asset is actually draining cash from you, rather than contributing to your cash flow.

This is not a problem if you have other assets or sources of income that produce enough cash for you to make ends meet. But when this is not the case, your best move may be to tap into the equity in your home.

There are various ways of doing this, including:

1. You could sell your home, moving into a smaller home or apartment. But that is a relatively extreme solution, which you may not be ready for, and may not need.
2. You could take out a conventional mortgage or home equity line of credit, or refinance an existing mortgage. But these are loans that you are expected to repay, which may be a problem for you. Furthermore, in order to qualify, you usually need to demonstrate that you have some outside source of income that will enable you to make payments on the money you borrow ï and if you had such income, you might not need the loan in the first place.
3. If you have children or others close to you who can provide cash in return for a limited ownership of your home, you might be able to work out a ñprivate annuityò or some other special arrangement[*] ï but such options are often not available, and even when they are, they can create strains in the family.

So if none of those options is workable for you, a reverse mortgage may be the best choice. You do have to be at least 62 years old to qualify. And there are some fairly high closing costs, so it doesnôt make sense unless you expect to be in your home for at least a few more years, and preferably many years.

Furthermore, if you have an existing mortgage with favorable rates, a reverse mortgage might still do you more harm than good. The reverse mortgage lender will require that all other mortgages or home equity lines of credit be paid off, and the funds required to do so will be part of the new (reverse) mortgage. But this means you are refinancing your old mortgage as part of this process. If the rates on the old mortgage are better than those on the new one, you could be paying too high a price for the new arrangement.

How a Reverse Mortgage Works

Reverse mortgages are available in many flavors, but here is how they work in general:

- You apply, as you would for a regular mortgage, with a lender (more on this a bit

[*] A ñprivate annuityò is an arrangement in which an individual, or group of individuals ï rather than a financial institution ï agrees to pay you some amount for the rest of your life. You obtain this right by turning over partial or complete ownership of some asset of yours, such as a house (or it could be a fine painting, a collection of antiques, or anything else of value). Normally, a private annuity would be arranged with one or more family members, who would allow you to remain in the house as long as you live plus pay you a certain amount of cash every month, in exchange for their receiving ownership in the property. Since this is a private arrangement, the terms can be quite flexible. But as with reverse mortgages, there are possible pitfalls.

later). The terms of the mortgage will depend on your age, the amount of equity you own in your home, the level of current interest rates, and your ability to make all the necessary tax and insurance payments over the projected life of the loan. In general, the older you are at the time the reverse mortgage begins, the higher amount you qualify for.

- If you obtain a government-backed Home Equity Conversion Mortgage (more on them later), you will have to go through a counseling process first, to make sure you understand the arrangement and to help assure that it is really right for you.
- There will be closing costs, as there are with any mortgage. These include an application fee, the cost of a home appraisal, mortgage insurance, and others. If you enlist a broker to set up the reverse mortgage for you, there will be additional fees for that service. You should expect the fees to total 2% or less of the total loan amount (unless you borrow more than 60 percent of the total amount available in the first year, in which case fees will be closer to 4%), and these generally can just be added onto the amount of the loan. Some lenders will waive most closing costs, but expect their interest rates to be higher.
- You may receive a lump sum, monthly payments, or a line of credit that you can write checks against ï or a combination of these, depending on your needs (there are tighter limits on lump sums, though). If your needs change, you can usually modify the terms of the reverse mortgage, though there may be a modest fee for doing so.
- You still own the home. This means that you, not the lender, will be responsible for upkeep and taxes. If your home is in need of repair at the time you take out the reverse mortgage, the lender may require that the problems be taken care of. The cost of such improvements would generally be included as part of the loan, so you donôt pay out of pocket.
- The money you receive is a loan, and therefore it is not taxable. It does not affect eligibility for, or taxation of, Social Security or Medicare benefits. However, it may affect eligibility for Medicaid or SSI benefits.
- You do not make any loan repayments while you still live in the house.
- Your ability to continue receiving money under a reverse mortgage depends on your loan limit (which will gradually increase over time) and the amount you have already borrowed. It also depends on the interest that accrues on your borrowings (and therefore on the interest rate being charged, which in most cases will go up and down over time). The total borrowed, plus interest, may not exceed your credit limit. Therefore, even though you do not have to repay the loan for as long as you live there, it is possible that your access to continued new payments from the bank could become severely restricted.

  Note, though, that you may be able to get more from your home if you have an ñequity shareò arrangement instead of a ñstandardò arrangement. An ñequity shareò deal allows the lender to share in the future growth in your homeôs value ï which means less for you or your heirs when the house is eventually sold, but which might give you access to more cash in the meantime. This option is worth investigating if you need more than you can get under a standard agreement.

- When you (and your spouse, if you have one) no longer live in the house as your main residence ï whether because of death, or for any other reason ï the loan becomes due. Typically, the house would be sold at that point, and the lender would be repaid from the proceeds. Any leftover proceeds would go to you or your heirs. However, if the heirs want to keep the house in the family, they may repay the loan in cash and the lenderôs claim on the house is released.

How to Get a Reverse Mortgage

If you determine that a reverse mortgage might make sense for you, the next step is to shop around for a suitable deal.

- ***Home Equity Conversion Mortgages*** (HECMs) are federally-insured reverse mortgages. They are the most popular kind because they tend to be the least costly and are often the most generous and flexible arrangements you can get ï including a line of credit that increases over time. Availability is limited, however, and depending on current levels of demand and Congressional authorization, and your ability to meet somewhat stricter financial qualifications effective starting 2014, you may or may not be able to get into the HECM program. HECM will also require you to see an authorized counselor to make sure that a reverse mortgage is right for you, and if you go through with the mortgage, you will have to have pay for mortgage insurance (which other lenders may not require). The National Center for Home Equity Conversion Mortgages can provide you with current information about HECM loans (see the end of this paper, for website references).

- ***State and local governments*** sometimes sponsor reverse mortgage programs as well. These programs typically offer exceptionally good terms ï even better than HECMs, oftentimes ï but they are usually available only in restricted situations. Check with your state department of housing to see what programs are offered at the state and local levels.

- ***Private lenders*** also offer reverse mortgages, though the number and quality of such programs varies considerably from one part of the country to another. Since these plans are not backed by the U.S. or state governments, they are somewhat more costly. For the same reason, however, they can also be more flexible in some ways. In particular, if you have several hundred thousand dollars in home equity that you want to tap, only private reverse mortgage lenders can meet your need.

The U.S. Department of Housing and Urban Development can help you locate HECM lenders. The National Reverse Mortgage Lenders Association can help you identify lenders in your area for both HECM and private loans (see the end of this paper, for website references).

Choosing among different plans can be difficult. You need to consider limitations that might affect you, overall costs, and the quality and servicing record of the lender. Costs are defined by the Total Annual Loan Cost (TALC), which compares all the costs against all the money you will receive. See the end of this paper for sources you can use to help determine TALC, and other elements of your decision.

Cautions:

Before making your final decision, take these points into consideration:

- A reverse mortgage is likely to reduce what you can leave to others. However, if you have children, it often happens that they care less about inheriting your house than they do about your maintaining your independence. Talk it over with them, to find out what their concerns and preferences might be.
- You may be forced to sell your home before you die, if you need long-term nursing care outside the home. Once you (or both of you, if you are married and co-own the home) have been out of the house for a year, typically, the contract will provide for the loan coming due at that time. Perhaps this would no longer matter to you, but perhaps it would.
- If the house has to be sold, capital gains taxes may be due. If you have borrowed near the full value of the house, so that virtually the entire proceeds are used to pay off the reverse mortgage, you will need other resources to pay any taxes that are due. This is a particular problem if, as noted just above, you are forced to sell the house during your lifetime.
- If you need money now for long-term care at home, a reverse mortgage can often provide such funds. But if you anticipate that you may need to move into residential care sometime in the next few years, the closing costs of the reverse mortgage may prove to have been a very high price to pay for a temporary solution. In this situation, look for a lender offering minimal closing costs, or find other means of raising cash, if possible. In particular, you may want to look into whether or not you qualify for public or private assistance of some kind.
- Brokers for reverse mortgages can make good money ï off of you! Beware of anyone who approaches you first. They may be in it for themselves, not you.

For More Information

- ***Papers available from this same source:***
  - ñOptions for Obtaining Cash from Your Homeôs Equityò
- ***Outside sources:***
  - The National Reverse Mortgage Lenders Association: http://www.reversemortgage.org/
  - Home Equity Conversion Loan providers: http://www.hud.gov/ll/code/llplcrit.html

- ***Evaluating reverse mortgage options:***
    - For a simple, free on-line calculator to help determine how big a HECM loan you could get, with associated costs, try the Ibis Reverse Mortgage calculator at: http://rmc.ibisreverse.com/default_nrmla.aspx
    - For instructions on how you can calculate the Total Annual Loan Cost (TALC), see the eHow write-up at: http://www.ehow.com/how_6809051_calculate-talc-rates-reverse-mortgages.html
    - For general information on reverse mortgage interest rates, Google: reverse mortgage interest rates.
    - To find a counselor in your area approved by the U.S. Dept. of Housing and Urban Development, call 1-800-569-4287 or go to: http://www.hud.gov/offices/hsg/sfh/hecm/hecmlist.cfm