

Home . . . A Loan Reverse Mortgages

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Margaret was 80 years old. She wasn't wealthy, but she was content. Since her late husband's passing, she had lived on a fixed income, but at least she was able to stay in the home they had bought together. It had been paid off for years.

Unfortunately, it was becoming more and more difficult to make ends meet, and she needed funds to pay taxes, insurance, utilities, and other living expenses. She had some wealth, but it was all tied up in her home. She didn't qualify for a cash-out refinance or a home equity loan. Her financial advisor suggested she consider moving and selling her home, but Margaret adamantly refused.

Then her advisor mentioned another idea: a reverse mortgage. Margaret didn't know what to think about that, but when she mentioned it to her friends, they sure did.

Few financial and real estate topics spark debate quite like a reverse mortgage. Depending on who is doing the talking, a reverse mortgage is either a godsend or a scourge. The truth is, it can be both.

Takeaway

Reverse mortgages are a financial tool that can benefit homeowners in certain situations. However, they carry many stipulations. Before taking out a reverse mortgage, homeowners should fully understand how they work and have a lawyer review the contract.

Before taking out a reverse mortgage, homeowners should educate themselves to avoid any unpleasant surprises. Many such problems can be prevented simply by understanding what a reverse mortgage is and how it works. Simply put, it is a loan. As with any loan, there are conditions and costs. For example, a reverse mortgage is secured by the home, and, as with any loan secured by a home, there are ways the home might end up in foreclosure.

Reverse Mortgages Then and Now

Reverse mortgages are a relative newcomer on the lending scene, especially in Texas.

The generally accepted story goes back to the widow of a high school football coach in Portland, Maine. In 1961, following the coach's death, she needed a lending solution that would allow her to stay in her home. Portland banker Nelson Haynes, who also happened to be one of her late husband's former players, came up with an idea, and the reverse mortgage was born.

That idea, in general terms, works like this. A reverse mortgage is a way to borrow against the equity a homeowner has in his home. The homeowner pays off any existing mortgage and there are no longer any mortgage payments. In fact, he receives monthly payments. He continues to own and live in the home. This arrangement lasts for the rest of the homeowner's life or as long as the homeowner lives in the home. Some homeowners receive larger payments for a set term or a lump sum. This way, the owner has an opportunity to get cash from the equity in his home. The loan is paid back when the homeowner sells the house, moves out of the house, or dies.

The reverse mortgage idea caught on and grew, but it was, relatively speaking, unregulated. That is, the strict requirements and protections that exist today were not yet in place. Over the years, additional requirements have been put in place in an attempt to limit unwise and irresponsible use of the reverse mortgage and to prevent fraud against seniors. Congress paved the way for those protections by creating standardized loans, which are insured by the Federal Housing Authority (FHA) and the U.S. Department of Housing and Urban Development (HUD). This created the most common type of reverse mortgage: the Home Equity Conversion Mortgage (HECM).

For many years, Texas law did not allow reverse mortgages or home equity lending of any kind because of the implications of its unique homestead laws. Homestead provisions allow homesteads to be encumbered by liens only for certain purposes and only if certain requirements are strictly met. Because the lien could not attach to the homestead, the only way a homeowner could access the equity in the home was to sell it.

That changed when the Texas Constitution was amended in 1997 and again in 1999. After the constitutional amendment, home equity lending and reverse mortgages were permitted, and Texans were playing with house money, so to speak.

How They Work

With a regular mortgage, the homeowner borrows to buy the home, giving the lender a note, which is simply a promise to pay the loan back in monthly payments, with interest. The homeowner also gives the lender a deed of trust, which gives the lender a security interest. The trustee named in the deed of trust is also given a power of sale in the event the borrower defaults. If the borrower defaults, the lender may foreclose and sell the property.

In a typical reverse mortgage, the homeowner borrows against the equity he has in the home and receives a lump sum or monthly payments. The lender takes a security interest in the property to secure repayment of the principal after the borrower's death. The loan still accrues interest, but principal and interest need not be repaid until the owner's death or another event triggering payback.

There are variations in reverse mortgages. For instance, a homeowner can establish a reverse mortgage line of credit to have a source of cash to draw from as needed. The borrower's equity in the home is the market value, less the amount of any liens on the property.

To take out an HECM, the homeowner must be at least 62 years old, and the home must be his principal residence. The homeowner must own the home outright or have a low mortgage balance. On the closing of the HECM, the balance of the existing mortgage, if any, may be paid off from the proceeds of the reverse mortgage. The homeowner is required to meet with a HUD-approved counselor to discuss eligibility, financial responsibilities, and other alternatives. The homeowner must live in the home for the majority of the year and must stay current on property taxes. This may be required even if the taxes are deferred. The homeowner is responsible for all maintenance and repair on the home, and he must maintain adequate property insurance.

Payback is triggered if the homeowner dies, fails to pay taxes, fails to maintain insurance, fails to make necessary repairs, or no longer maintains the home as his principal residence. Moving to a nursing home continuously for 12 months may be considered a permanent move, triggering payback. If the homeowner is not able to pay back the loan, the lender may foreclose.

It is important to note the difference between a co-borrower and a non-borrower. A co-borrower is a person whose name is on the loan documents along with the applicant and who is equally responsible for the loan. If the applicant dies, the co-borrower and his children,

other relatives, or others may stay in the home. A person who lives in the home but is not a co-borrower is a non-borrower. If the borrower passes away, non-borrowers must move unless they are qualified to stay under HUD guidelines.

And Now Some Caveats

Reverse mortgages are not without their drawbacks. They can be expensive. There are up-front and ongoing costs that are often greater than those of other loans. These costs include mortgage insurance premium, origination fee, servicing fee, and third-party fees. For an HECM, the initial mortgage insurance premium is 2 percent of the home's value plus an annual mortgage premium of 0.5 percent of the outstanding balance. (Note that unlike a conventional mortgage, the outstanding balance will *increase* over time.) The origination fee is \$2,500 or 2 percent of the first \$200,000 of the home value (whichever is greater), plus 1 percent of the amount over \$200,000. The origination fee may not exceed \$6,000. Additionally, many reverse mortgages have variable interest rates that fluctuate over the life of the loan.

Another negative feature is that the loan balance keeps going up while the owner's equity in the home keeps going down. The home may still be passed along to the owner's heirs or devisees, but, because of the loan balance, there is less equity to be passed. An appreciation in home value may cover or offset this, but there is no guarantee. If the home comes to the heirs saddled with a large debt, they may have a difficult time keeping it, if that is the intent. An important protection is that reverse mortgages are non-recourse loans. In other words, the lender can collect only against the home itself. The lender may not make a claim against the borrower's other assets during his lifetime or the borrower's estate after his death. Likewise, the lender may not pursue any other assets of the borrower's heirs or devisees.

Depending on the condition of the property, homeowners may have to make repairs to the home to qualify for a reverse mortgage.

The biggest unwanted surprise that some reverse mortgages might face is foreclosure. This is sometimes due to unscrupulous sales practices, but it also occurs when homeowners fail to recognize their responsibilities in the loan transaction. The owner may have to repay earlier than expected if he moves out, fails to pay property taxes, fails to pay homeowners insurance, or fails to make required repairs. Often, this occurs because owners find

themselves in a poor financial condition, so it's generally not a good idea to use a reverse mortgage to get money for things that are not necessities. It's also not generally a good idea to use a reverse mortgage to get money for another investment.

This loan is secured by the equity in a home. It is not income, and the cash payments are not taxed as income. However, the interest may not be deducted on a tax return until the note is paid off. The proceeds do not affect Medicare or Social Security benefits, but they may affect eligibility for Medicaid benefits or other government programs.

Possible Uses for Reverse Mortgages . . . and Some Alternatives

Who might consider a reverse mortgage? It could be a good solution for an elderly homeowner who owns his home debt-free (or with a low debt-to-equity ratio) but needs funds to pay taxes, insurance, utilities, and other living expenses.

It might be fine for homeowners who need cash and plan to stay in their homes for a while. If they don't intend to stay there for long, the initial costs may make it less attractive. It might be just what the doctor ordered if a homeowner needs money for home improvements, medical expenses, large bills, or for paying off high-interest debt. It could even be used for extra cash in the event of a downturn in other investments, allowing accounts to recover, rather than selling at a loss.

Other alternatives exist that may be more appropriate if the homeowner qualifies. These include a second mortgage, cash-out refinance, home equity loan, home equity line of credit, or property tax abatements. A homeowner might also consider a single-purpose reverse mortgage loan (a one-time loan that helps pay for home repairs, improvements, or property taxes).

Reverse mortgages are another financial tool available for homeowners to use in an appropriate situation. They are not perfect for everyone. If a reverse mortgage is determined to be an appropriate course of action, a homeowner should get a referral to a housing counselor through HUD. For an FHA-insured reverse mortgage, counseling is required and should be completed before applying.

As with any legal document, applicants should read and understand everything and have their lawyer review everything. No one wants unpleasant surprises. In reverse mortgages, surprises can often be avoided by remembering one simple fact: It's a loan.

Nothing in this publication should be construed as legal or tax advice. For specific advice, consult an attorney and/or a tax professional. ➡

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