Chapter 16: Squeezing the Last Drop – Additional Material

In my original manuscript, I had a more extensive discussion on reverse mortgages. Here's the full version.

What about reverse mortgages?

These are creative devices that can be useful for generating *I*, but only under the right circumstances. Here I'll explain how they work, when they might work for us, and point us to additional resources if we want to explore this concept further.

An excellent resource on reverse mortgages is the AARP website, www.aarp.org/revmort/. They provide loan calculators and an excellent summary that we can download, called *Home Made Money*.

Let me start with the basics. Reverse mortgages work best when we don't want to move from our current house, and expect to stay there for many years. We shouldn't consider them if we expect to move in a few years.

I believe that reverse mortgages are like immediate annuities, described in Chapters 10 and 12 of *Live Long & Prosper!*. We should wait to use them when we are no longer able to generate much income through working. Therefore, I won't seriously consider them until I'm in my seventies or eighties, and I'll share my reasons in the next few pages. However, I help my aging parents with their financial situation, like many of you. I'm glad I learned more about reverse mortgages now, for their sakes.

The words 'reverse mortgage' are quite descriptive. Like a regular mortgage, we are taking a loan, using our house as collateral. The word 'reverse' comes into play in two ways.

1. Instead of using the loan proceeds to buy a house, like a regular mortgage, we use the loan proceeds for living expenses or for any other purpose.

2. Instead of paying back the loan with monthly payments, we pay it back when we sell the house and move. We don't make any loan repayments as long as we are living in our house, and meet certain other conditions described next.

There are a few ways to get a reverse mortgage.

- The most common is the Home Equity Conversion Mortgage (HECM), which is the only reverse mortgage that is insured by the federal government. HECM loans are insured by the Federal Housing Administration (FHA), which is part of the U.S. Department of Housing and Urban Development (HUD).

- Many state and local government agencies offer deferred payment loans (DPLs) for repairing or improving homes.

- Some state and local governments offer property tax deferral loans (PTDs). We can use the proceeds of these loans to pay property taxes.

- Banks, mortgage companies, and other private lenders offer reverse mortgages with their own special features.

Here are some features that are common to all reverse mortages.

- We retain ownership of our home.

- Generally the loan must be primary. If there are outstanding loans when we take the reverse mortgage, they must be repaid. We can use the proceeds of a reverse mortgage to repay other outstanding loans.

- The loan balance grows over time with interest. When the loan is done, either we or our heirs must repay the original loan plus interest. If at that time the loan is worth less than the house, then we or our heirs can sell the house, pay off the loan, and keep whatever is left. Fortunately, the loan can never grow larger than the value of the house. The lenders have no other recourse for loan repayment – they can't attach our other assets or income. If the value of the house is equal to or less than the value of the loan, then we or our heirs receive nothing when the house is sold. Naturally the lenders take steps to prevent this from happening, since they lose money in this situation.

- The amount of the loan depends on our age and the value of our home. Generally, the older we are, the more cash we can get. Also, the more our home is worth, the more cash we can get.

- All reverse mortgages must be repaid when the last surviving borrower sells the home, dies, or moves out.

- Some lenders might require repayment if we fail to pay property taxes, fail to keep the home insured, or fail to keep it properly maintained and repaired.

At this point, let me point out the obvious. Reverse mortgages will reduce the amount of inheritance our children might receive when we die, since they eat into the net equity of our homes. We shouldn't consider reverse mortgages if this is important to us.

Another use for a reverse mortgage is to pay for nursing home expenses while keeping our current home. This might be useful if we expect to recover and move back home soon, or if we're married and one of us is ill while the other is healthy. On the other hand, if we don't need or want to keep our current home, we could sell it and use the profit to pay for nursing home expenses. This is one reason to delay using a reverse mortgage for as long as possible, so we keep our options open.

One good way to compare reverse mortgages is through Total Annual Loan Cost (TALC) disclosures. The federal truth-in-lending law requires lenders to provide the TALC for reverse mortgages, and it's useful when comparing and shopping. However, our actual costs may vary, due to the length of the loan and other factors. One thing is clear – most of the time, reverse mortgages area a good idea only if we stay in the house for a long time, at least 10 years. The reason is that most reverse mortgages have high start-up costs, and it doesn't make sense to pay these if we live in the house only for a few more years.

Now, let's look at each type of loan in more detail.

HECM loans. Generally, these provide the best terms for reverse mortgages that can be used for any purpose. The only reverse mortgages that might have better terms are the DPL and PTD loans, which we discuss further below. However, these must be used for specialized purposes.

The FHA dictates the terms of HECM loans. Here are some conditions.

- We must be age 62 or older, and live in our home as a primary residence.
- Our home must be a single family residence in a one-to-four-unit building, or part of a planned unit development or a HUD-approved condominium. Some manufactured housing is eligible, but most cooperatives and mobile homes are not.
- We must discuss the program with a counselor from a HUD-approved counseling agency.

HECM loans provide a variety of loan payout choices. We can use one or more of the following, or any combination.

- Take a single lump sum of cash, to be used for any purpose.
- Take a creditline account of a specific dollar amount. We can control the timing and amounts of our withdrawals.
- We can draw a monthly advance for a specific period of time, or for as long as we live in our home.

The amount of cash we can get depends on our age, current interest rates, and the value of our home.

- The older we are, the more cash we can get. If we're married, it's the younger age that counts.
- The lower the interest rate, the higher the loan amount will be.

  - The greater our home value, the more money we can get. However, there is a maximum which varies by county. In 2003, these limits ranged from $154,896 in more non-metropolitan areas to $280,749 in many urban areas. The limit changes annually.

The publication mentioned previously from AARP, called *Home Made Money,* shows estimates of the amounts of lump sums or creditline accounts, for various ages, home values and interest rates.

Closing costs with reverse mortgages can be high. There can be an origination fee of 2% of the value of the loan, plus another 2% for mortgage insurance. In addition, 0.5% may be added to the interest rate for mortgage insurance. It pays to shop around for terms, as they can vary by lender. These costs are one reason why we should use a reverse mortgage only if we stay in our house for many years. The closing costs can add up to more than 4% of the value of the house, and if we sell the house, we'll pay up to 6% in selling costs. There goes 10% of the value of our house!

So, I think these reverse mortgages work best if we plan to stay in our house for 10 years or more, and preferably for our last years. In this situation, the selling costs will be borne by our heirs, through the net proceeds of the house sale.

Most HECM lenders use variable interest rates, and two types are required by regulations.

- An adjustable rate that is tied to the current one-year U.S. Treasury security rate; the rate can change once each year. Any change must equal the change in the one-year Treasury rate, and is subject to a cap of 2 points per year and 5 total points over the period of the loan.

- An HECM lender may also offer a lower rate that is adjusted every month. Changes in this monthly rate must also be tied to changes in the one-year Treasury rate, but the lifetime cap is 10 points.

DPLs and PTD Loans. To refresh our memory, these Deferred Payment Loans and Property Tax Deferral Loans, offered by certain state and local governments. They aren't available everywhere. DPLs are used for certain home repairs, while PTD loans are used to pay property taxes. They don't have the high closing costs of HECM loans.

These loans must be used only for the specified purpose, and the amount of loan is limited to the cost of repairs or property taxes. Often they are limited to low-income citizens.

DPLs can be hard to find. For more information, we can try our local housing authorities, local development agencies, city or county housing departments, or local offices on aging.

For more information on PTD loans, we can contact the local agency to which we pay our property taxes.

Other private loans. Mortgage companies, banks, and other private lenders may offer reverse mortgages. They may have different terms than described for HECM loans, and we might be able to get more than the limits for HECM loans. It pays to shop around.

The AARP web site has resources for comparing the terms for private loans to HECM loans.

I'm glad I learned so much about reverse mortgages. While I don't intend to use them for myself for many years, if ever, I know I've got a resource I can use if I need it. I'll only use them if I really need the money in my later years, perhaps for nursing home expenses, or to pay property taxes. And I'll investigate them further for my parents, who are facing the costs of nursing homes.

This document is intended to complement and reinforce the themes in *Live Long & Prosper!* I don't intend for it to make complete sense without reading the book.