# Reverse Mortgage Overview

A reverse mortgage works by allowing homeowners age 62 and older to borrow from their home's equity without having to make monthly mortgage payments. As the borrower, you may choose to take funds in a lump sum, line of credit or via structured monthly payments. The repayment of the loan is required when the last surviving borrower vacates the home permanently.

## How It Works:

- Access a portion of your home's equity
- Percentage is based on age of youngest borrower
- Make no monthly mortgage repayments
- Funds are tax-free, and may be used for virtually anything
- Loan is repaid when you pass away or sell your home
- Any remaining equity belongs to your heirs

## How It's Different

A reverse mortgage is different than a traditional, or "forward," loan in that it operates exactly in reverse. The traditional loan is a falling debt, rising equity loan while the reverse mortgage is a falling equity, rising debt loan.

In other words, as you make payments on a traditional loan, the amount you owe is reduced, and therefore the equity you have in the property increases over time.

With the reverse mortgage, you make no regular payments, so as you draw out funds and as interest accrues on the loan, the balance grows and your equity position in the property becomes smaller.

There is a secret here though that I'm going to let you in on. Two, actually. There is never a payment due on a reverse mortgage, and there is also no prepayment penalty of any kind.

In other words, you can make a payment at any time, up to and including payment in full without penalty. Many borrowers choose to repay some or all the accruing interest, or whatever amount they desire. As the borrower, the choice is yours.

## How Much You May Receive

The amount loaned in a reverse mortgage is determined differently than a standard mortgage, and you don't hear people talking about the "loan-to-value ratio" like you would on a traditional loan.

On a traditional loan, the lender agrees to lend a set amount that is determined as a percentage of the value of the home and can change based on several factors including borrower's credit, the required loan amount and the property type.

With a reverse mortgage, several factors dictate the loan amount, including:

- The age of the youngest borrower, value of the home or the HUD lending limit (whichever is less)
- The interest rates in effect at the time

Also factoring into the loan amount are:

- Any costs to obtain the loan (which are subtracted from the Principal Limit)
- Any existing mortgages and liens (which must be paid in full)
- Any remaining money belongs to you or your heirs.

The current 2021 HUD lending limit is $822,375

Because you are not required to repay the loan at any ongoing interval, the interest accrues on the balance and the entire loan is paid back when you or the last borrower permanently leaves the home. The older you are when you take out a reverse mortgage, the more you will receive under the program based on the HUD calculator. You must be at least 62 years of age for a reverse mortgage.

The Principal Limit of the loan is determined based on the age of the youngest borrower because the program uses actuarial tables to determine how long borrowers are likely to continue to accrue interest. (Link to HUD.Gov HECM Actuarial Review)

If there are multiple borrowers, the age of the youngest borrower will lower the amount available because the terms allow all borrowers to live in the home for the rest of their lives without having to make a payment.

Of course, there will always be exceptions, but the premise is that a 62-year-old borrower will be able to accrue a lot more interest over his or her life than an 82-year-old borrower with the same terms, so the HUD calculator allows the 82-year-old borrower to start with a higher Principal Limit.

## Flexible Payment Options

There are several ways borrowers can opt to take the funds available to them on a reverse mortgage:

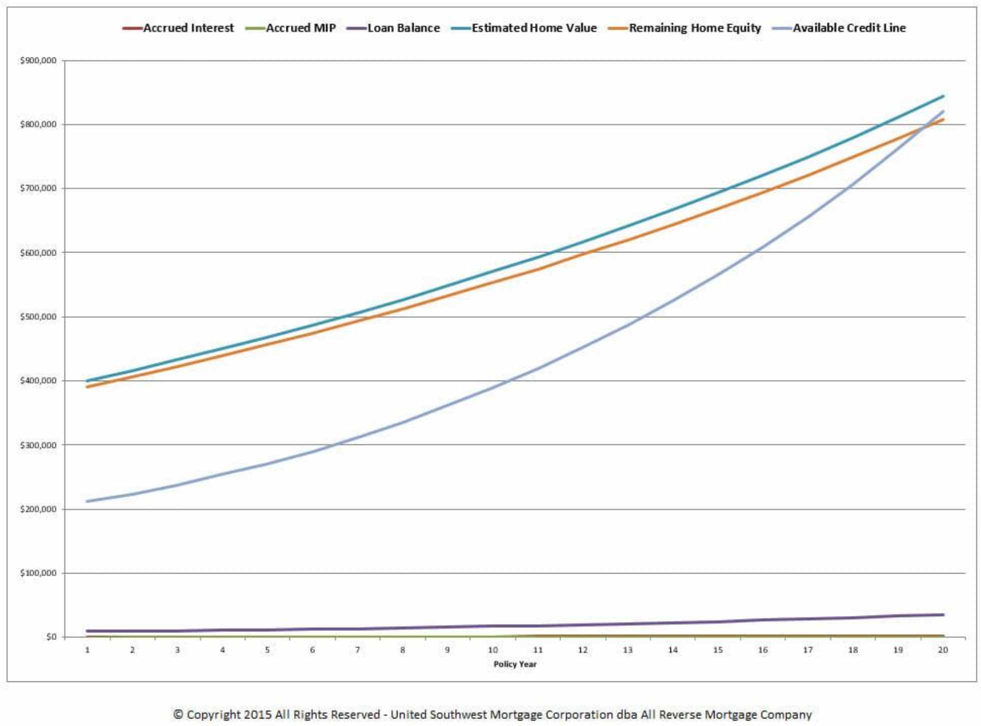
- A lump sum draw of the funds available to them (and we will get into this further shortly)
- A line of credit that they can access as they choose
- A payment for a set amount and period, known as a "term payment"
- A guaranteed payment for life (known as a "tenure payment") which lasts as long as they live in the home.

In addition to these options, they can use a modified version of each and "blend" the programs, if you will.

For example, a borrower in California born in 1951 who owns outright a $385,000 home may decide it is time to get a reverse mortgage. Why? The borrower wants $50,000 at closing to make some changes to the property and to fund a college plan for her grandchild.

She has additional income that she will begin receiving in four years, but until then, she would like to augment her income by $1,000 per month. She can take a modified term loan with a $50,000 draw at closing and set up the monthly payment for four years of $1,000 per month. That would leave her an additional $107,000 in a line of credit that she would have available to use as she pleases. If she does not use the line, she does not accrue interest on any funds she does not use and the line of credit grows on the unused portion.

## Credit Line Growth Feature




This is the credit line growth that is making all the folks, including financial planners, sit up and take notice. Let's look at the $200,000 credit line shown above. As we discussed, many people used to consider the reverse mortgage a loan of last resort. But let's consider another borrower who is a savvy planner and is planning for her future needs.

She has the income for her current needs but is concerned that she may need more money later. So, she obtains her reverse mortgage and — after the costs to obtain the loan — has the same $200,000 line of credit available to her. Her line of credit grows at the same rate on the unused portion of the line as what would have accrued in interest and mortgage insurance premiums had she borrowed the money.

As the years go by, her credit line increases, meaning if she one day needs more funds than she does now, they will be there for her. If rates don't change, here is what her access to credit looks like over time:

- 10 years: $350,000
- 15 years: $500,000
- 20 years: $660,000

Remember, that is just if rates don't change. If interest rates go up 1% in the third year and one more percent in the 7th, after 20 years her available line of credit would be more than $820,000.

Now, of course, this is not income, and if you do borrow the money, you owe it and it will accrue interest. You or your heirs would have to pay it back when the property sells.

But where else can you ensure that you will have between $660,000 and $800,000 available to you in 20 years?

The calculator is shown below, and you can see the very modest rate increases used. If the accrual rates rise more, the growth rate will be higher.

## Lump Sum Restrictions

The fixed rate option requires you to take a lump sum draw, meaning you must take the full draw of all the money available to you at the close of the loan. You cannot leave any funds in the loan for future draws, as there are no future draws allowed with the fixed rate. The reason for this is because of growth of the line.

As you can see, the growth rate can be quite substantial and if there were many borrowers with yet unused funds who borrowed at low fixed rates but wanted to finally access their funds years later after rates had risen, borrowers would have substantially higher funds available to them at rates that were not available and reverse mortgage lenders might not be able to cover the demand of below market requests for funds. Therefore, HUD stopped the fixed rate line of credit when some lenders attempted to offer the product over a year ago.

Since borrowers experienced a much higher default rate on taxes and insurance when 100% of the funds were taken at the initial draw, HUD changed the method by which the funds would be available to borrowers which no longer allows all borrowers access to 100% of the Principal Limit at the close of the loan.

The new parameters coincide with how much of the money you need to pay off existing loans and liens on the property. HUD calls these necessary payoffs "mandatory obligations.  You have access to up to 100% of their Principal Limit if you are using the funds to purchase a home or to pay mandatory obligations in conjunction with the transaction.

You can also include up to 10% of the Principal Limit in cash (up to the maximum Principal Limit) above and beyond the mandatory obligations if needed so that you can still get some money at closing.

Let's illustrate this by using some round numbers as examples. If you have a $100,000 Principal Limit and no loans or liens on your home, you can take up to 60% or $60,000 of your proceeds at closing or any time in the first 12 months of the loan. You can access the remaining $40,000 any time after 12 months.

This is where the fixed rate loan starts to impact borrowers the most. If you do not have existing liens to pay off, you would lose the availability of the remaining funds after the initial draw.

In other words, in our example, as a fixed rate borrower you would receive the $60,000, but because the fixed rate is a single draw, there would be no further access to funds. You would not, therefore, be able to receive the additional $40,000 and would forfeit those funds.

If you were using the entire $100,000 to pay off an existing loan, either program would work equally well because all the money would be required to pay off the mandatory obligation (meaning the existing loan) — which HUD allows.

As for pricing, lenders are more willing now than ever to help pay costs whenever they can on reverse mortgages. Especially if you have a loan that you are paying off, there is often room in the value of the loan for the lender to make back money they spend on your behalf when they sell the loan. Lender credits are allowed by HUD.

Shop around and see what is available. Education is the key, while knowing your goals will help you procure a loan that is best for you.

A very low margin will accrue the least amount of interest once you start using the line, but if you are looking for the greatest amount of line of credit growth, a higher margin grows at a higher rate.

Getting the least amount of fees on your loan won't help you if you plan to be in your home for 20 years, because in that 20 years the interest will cost you tens of thousands of dollars more, thus ruining your goal to preserve equity. Knowing what you want out of your reverse mortgage will help you choose the option that gets you there.

## Weigh the Costs vs. Benefits

I told you that we do not recommend reverse mortgages for everyone. If a reverse mortgage does not meet your needs and you are still going to be scraping to get by, you need to face that fact before you begin to use your equity.

If the costs of the mortgage will approach the amount you will receive from the loan, since you live in an area where closing costs are very high, and your property value is less than $40,000, you need to think hard about whether you want to use your equity on such an endeavor.

If the mortgage doesn't make your life easier and you're thinking that you are just going to have to sell in a few years again anyway, consider making that move now before you begin to erode your equity and the next move becomes harder.

The reverse mortgage is supposed to be the last loan you will ever need. If you know you are not in your forever home, consider using your reverse mortgage to buy the right house instead of using it as a temporary solution — one that is not a true solution at all.

By and large, most borrowers can benefit when they do their research and plan carefully, but you need to know how these loans work, what your plans are, and which options will best to achieve your goals. Education is the key and don't be afraid to compare.

If you didn't before, hopefully you now know how they work and are on your way to determining if a reverse mortgage is right for you.