

Going Forward With Reverse Mortgages

The benefits and pitfalls of borrowing against your home.

by Howard Godfrey and Edward Malmgren

EXECUTIVE SUMMARY

■ **Increased life expectancy has caused the elderly** to need more funds after retiring, especially if they elect early retirement. The home is often the most valuable asset an individual owns.

■ **Reverse mortgages allow homeowners to continue to live** in their homes while borrowing against the equity. A reverse mortgage may provide a lump-sum advance, a line of credit and/or periodic advances. Monthly advances may be received as long as the homeowner lives in the home. Best of all, the homeowner never needs to make a mortgage payment.

■ **A lump-sum advance from a reverse mortgage may be used** to pay off the existing first mortgage and eliminate the monthly mortgage payment, reducing monthly cash requirements.

■ **Caution is required because reverse mortgages can be** prohibitively expensive unless the homeowner has a substantial amount of home equity, plans to convert all or most of the equity into retirement funding and lives in the home and benefits from the reverse mortgage for the long term.

■ **A homeowner who allows reverse mortgage payments to** increase checking or savings balances beyond certain limits may lose government benefits.

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Reverse mortgages were created in 1987 by the Department of Housing and Urban Development (HUD) to provide greater financial security to American homeowners age 62 and older. With the aging population in the United States and the rapid appreciation of residential property, the reverse mortgage industry is destined to continue to grow. Reverse mortgages often are thought of as the solution for elderly citizens who need additional funds; however, they can be a costly solution and should be used with caution.

This article will help CPAs recognize situations where reverse mortgages can provide much-needed supplementary retirement income—and equally important, when they should be avoided.

A total of 157 home equity conversion mortgage loans were made in fiscal year 1990. By 2005, the number had skyrocketed to 43,131.

Source: Department of Housing and Urban Development, www.hud.gov.

WHAT ARE REVERSE MORTGAGES

A reverse mortgage is a loan against home equity that requires no repayment as long as the owner continues to live in the home. An HECM (see [box](#) below) must be a first mortgage, which means any existing mortgage debt must be paid off first, possibly with some of the reverse mortgage funds. This reverse mortgage provides a line of credit, one or more lump-sum advances and/or a series of periodic advances that may continue until the last surviving borrower leaves the home permanently. Reverse mortgage debt increases over time as a result of advances to the homeowner that increase the principal, and the accumulation of service fees and accrued interest.

About 90% of all reverse mortgages are Home Equity Conversion Mortgage (HECM) loans, which are discussed in this article. HECM loans were designed by HUD and are insured by the Federal Housing Administration (FHA). Other home-equity loans not covered in this article may have unique advantages, such as the absence of the lending limits that are applicable to federally insured loans, and drawbacks, such as higher costs.

The reverse mortgage debt does not become due until the house is sold or the homeowner(s) move out permanently. At that time the lender likely will receive payment of the loan balance through the sale of the home, though in order to keep the

mortgage with other funds. If the sales proceeds are insufficient to pay off the mortgage, the shortfall is covered by mortgage insurance, which is required with an HECM. Sale proceeds in excess of the debt go to the homeowner(s) or the estate.

EXHIBIT 1 Reverse Mortgage Meets Needs of Elderly

Joe Homeowner is 85 years old and his wife Jan is 84. Their home, valued at \$300,000, is debt-free. They are committed to living in their home as long as possible. Their Social Security benefits and interest on savings have been adequate for their living costs, but they now need in-home nursing care several days a week at a cost of about \$1,000 per month.

Joe and Jan do not want to be a financial burden to their children. They do not qualify for a bank loan to cover these extra costs because they do not have extra income to cover loan payments. They could sell the home, but they would need to find alternative housing. A reverse mortgage may be a good way to get the funds they need to balance their budget.

REVERSE MORTGAGE LIMITS

Since the homeowner is not expected to make payments on a reverse mortgage, no minimum income level is needed to qualify for the loan. The borrower's health and credit rating also are irrelevant. The amount of debt that may be incurred is based on the value of the home, the age of the homeowner and expected interest rates. An older taxpayer can qualify for larger monthly advances and/or a larger lump-sum advance because of the shorter life expectancy over which the loan balance will grow (see [exhibit 2](#)). Lower interest rates also allow greater borrowing because there will be less accrued interest. The impact of age on borrowing capacity is seen in [exhibit 2](#) with a \$250,000 home, where mortgage rates are 6%.

EXHIBIT 2 Know Your Limit

Sample age and credit-line limits for a \$250,000 house at 6% interest.

Age	Credit line
65	\$129,425
75	\$154,538
85	\$181,460
90	\$194,150

Source: AARP, *HomeMade Money*, page 11.

The home value that may be used in calculating an HECM is capped by the FHA. The limit varies from \$200,160 in areas with lower median home values to a maximum of \$362,790 in many major metropolitan areas where home values are higher. So a \$1 million home and a \$400,000 home might be eligible for exactly the same loan amount. Of course the maximum loan would be lower for a home worth less than \$200,160. The lower limit of \$200,160 is applicable in about 80% of the counties in the United States.

HUD cautions homeowners that they should not need to hire a paid consultant to find a reverse mortgage lender, because HUD provides a list of HUD-approved lenders. But all loan applicants must obtain HUD-approved, third-party counseling before proceeding, because reverse mortgages are complex and potentially costly. HUD requires the counseling to include topics such as alternative sources of financial assistance, other home-equity conversion options, the financial implications of the HECM such as rising debt-falling equity, the possible effect of the loan on public programs such as Medicaid and details of loan options and payment plans. This counseling is provided free or at a nominal cost. The HECM, which provides funds for medical costs and other living expenses during retirement, is not intended to be used by seniors as a source of funds for making investments, loans to relatives and so on. [Exhibit 3](#) describes some situations in which a reverse mortgage may be a good option and some in which it is not.

EXHIBIT 3

Likely Candidates

Those who can get the most from a reverse mortgage:

- Homeowners who are much older than the minimum age of 62. For an older homeowner, the life expectancy suggests there will be fewer remaining years for reverse mortgage advances and less accumulated interest and service fees. The homeowner can receive larger advances over a relatively short period without projecting a loan balance that will exceed the value of the home.
- Homeowners with small balances on their mortgages and those who are debt-free can receive larger reverse mortgage advances.
- Homeowners who are having difficulty paying an existing mortgage can use a reverse mortgage to eliminate the monthly mortgage payment.

Those who can get little benefit from a reverse mortgage:

- Homeowners who are just above the minimum age of 62. Because their life expectancy suggests there will be many remaining years for reverse mortgage advances, there will be more accumulated interest and service fees.
- Homeowners with little equity in their homes are limited to smaller advances.
- Homeowners who plan to move to another living situation such as a nursing home within a few years. They may incur high costs and receive relatively small benefits, especially if they select a monthly advance option.

COMPARISON SHOPPING

The monthly adjusted HECM provides the largest loan at the lowest interest rate. However, the annually adjusted HECM, with a higher initial interest rate, has less risk, because the increase on interest rates is capped at 5 percentage points, compared with 10 for the monthly adjusted HECM. If a borrower allocates some (or all) of the net principal amount to an HECM line of credit, the unused portion of that credit will increase over time, at a rate tied to the accruing interest rate.

Both the monthly and the annually adjusted HECM have an initial mortgage insurance premium of 2% of the maximum claim amount (the lesser of the value of the home or the FHA loan limit) as well as an annual mortgage insurance premium of one-half of one percent of the loan balance. The origination fee is limited to the greater of \$2,000 or 2% of the maximum claim amount. The origination fee, upfront mortgage insurance premium and other closing costs may be financed as part of the reverse mortgage.

Example. Joe and Jan Homeowner have a \$300,000 home, but the FHA lending limit for their area is \$200,160, which is their maximum claim amount. They choose the monthly adjustable HECM. ([Exhibit 4](#) shows how to compute the amount of reverse

mortgage funds available, loan costs and so on.) The initial interest rate is 5.87% and the expected future rate is 5.85%, with a cap of 15.87%. There is also a charge of 0.5% of the mortgage balance each month for mortgage insurance.

EXHIBIT 4 FHA/HUD Monthly Adjustment Reverse Mortgage

The loan principal limit is \$156,525.12, which is computed with a formula that takes

expected future interest rates. A set-aside is deducted for future monthly loan processing fees, leaving an available principal limit of \$152,317.47. Joe and Jan choose to finance the initial mortgage insurance premium of 2% of the maximum claim amount (\$4,003.20) and the origination fee, which also is \$4,003.20, as well as other closing costs of \$1,561.32. This means that they have a loan balance of \$9,567.72 before they begin receiving reverse mortgage advances. These financed costs reduce the net principal limit to \$142,749.75.

Their first option is to receive monthly advances of \$1,187.42 for as long as either one of them lives in the home. They also have the option of receiving more, say \$1,500 per month, for only a fixed period.

The Impact of the Deficit Reduction Act of 2005

BY MICHAEL DAVID SCHULMAN

One major unknown factor concerning reverse mortgages is the impact that the Deficit Reduction Act of 2005 will have on them. Because one of the goals of the act is to reduce government spending on Medicaid, it legislates that Medicaid be denied to applicants with more than \$500,000 in home equity. As a result, more and more older adults will be required to pay for their own health care. It is expected that the number of reverse mortgages will increase as a result.

The Deficit Reduction Act also requires the state be named as a remainder beneficiary in annuity contracts, presumably to permit states to recover their Medicaid costs. While the details, on a state-by-state basis, have yet to be worked out, it seems clear that many planning situations that would have been solved through the use of an annuity contract (whether issued by an insurance company or a so-called “private annuity”) will need to find an alternative income source. Despite looking like annuities, reverse mortgages are a form of borrowing, so the “remainder to the state” rule referred to above does not apply. Reverse mortgages likely will be used in many of these cases.

Another “not yet determined” aspect of the Deficit Reduction Act and reverse mortgages is who gets the money when the house is sold. Put differently, the lender is in a primary position on a reverse mortgage. However, Medicaid also can put a lien on an older adult’s residence as benefits are paid. What will happen if Medicaid insists on being first? Or, if a Medicaid lien is in effect when an adult wishes to take a reverse mortgage, will Medicaid take a subordinate position to the mortgage lender?

As with any financial product being marketed to older adults, CPAs must take care to protect the client from financial fraud. In general, it is inappropriate to purchase

a reverse mortgage—or any investment product—from a “door-to-door” vendor.

Many of these products have extremely high fees, closing costs and interest rates that can trap the unwary homeowner.

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TAX IMPLICATIONS

A reverse mortgage may be tax-neutral. Money received from a reverse mortgage payout is not taxable income. The borrower continues to be liable for property taxes, for which he or she still qualifies for a tax deduction. A borrower with no existing mortgage will have no interest deduction to lose, but a borrower who refinances a standard mortgage with a reverse mortgage will lose the annual mortgage interest deduction. Since no interest payments are made, cash-basis taxpayers cannot take a current deduction for mortgage interest and other costs that the lender pays or accrues; that deduction potentially will be available only when the mortgage is paid off.

» Practical Tips

- ▶ Suggest a reverse mortgage only if your client has substantial equity in the home, plans to borrow a large part of that equity and plans to live in the home for the long term.
- ▶ Don't recommend a reverse mortgage for small loans such as minor home repairs.
- ▶ Advise against getting reverse mortgages for investments or loans to friends or relatives.
- ▶ HUD provides information and face-to-face or phone counseling about HECM loans free or at nominal cost.

LOAN ACCELERATION CLAUSES

A homeowner with an HECM is responsible for taking care of the property that likely will be sold in the future to pay the loan balance. Such responsibilities include home repairs, property taxes, and fire and storm insurance. Failure to fulfill such responsibilities may cause the reverse mortgage loan to become due. The homeowner also can cause acceleration of the loan by renting out the home to another party, adding a new owner to the home's title, changing the home's zoning classification or taking out new debt against the home.

The Upside and the Downside of a Reverse Mortgage

UPSIDE

Keep the home and receive cash. Borrowers can stay in their homes and convert their equity to cash without having to make current loan payments.

Larger amounts when older. Older borrowers are able to obtain a larger monthly advance because they have a shorter life expectancy.

DOWNSIDE

Expensive for short-term borrowers. Substantial loan origination fees and mortgage insurance premiums are required, as well as annual interest and service fees. At the end of the first year, the loan balance will include reverse mortgage advances received during the year, accrued service fees, all of the costs of getting the loan that were financed and accrued interest. Part II of [Exhibit 4](#) shows that if the loan with a 5.87% initial interest rate is outstanding for only one year, the accumulated loan costs are 63.7% of the average loan balance; the average loan cost will be 26.5% if the loan is outstanding for two years. If the borrower dies or moves into a nursing home within a few years, the loan will have been a very expensive source of funds.

Expensive for small amounts. HECM loan costs are based on the home value or loan limit, not on the amount the homeowner wants to borrow. If the borrower needs only a relatively small amount (for example, \$10,000 for a new roof), closing costs are very large relative to the amount of benefit received.

Risk of losing government benefits. Reverse mortgage advances will not be considered income and will not affect Medicaid coverage, but any resulting unspent cash balance may be a problem if it exceeds Medicaid asset limits. To avoid this, the homeowner should borrow only enough to meet current needs.

THE BOTTOM LINE

A reverse mortgage makes economic sense for you or your clients only when it will be long-term and there is substantial equity in the home. When considering a reverse mortgage, homeowners should evaluate their commitment to remain in the home and their current state of health. They also should consider whether in-home health care will be available if needed from family members, friends or health care professionals. Then, they should obtain a reverse mortgage only if it does not have the downside features listed in [exhibit 5](#), above. The CPA's advice here may be critical. After all, what's involved is the client's most valuable asset, the home.