HECM Reverse Mortgage Update: Outline
Elder Justice Center – Senior Enrichment Series
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Learning Outcomes:

1. Distinguish the mechanics of a "forward" for-purchase mortgage loan from those of a "reverse" mortgage loan.
2. Review the requirements of the Home Equity Conversion Mortgage (HECM) reverse mortgage loan program as modified by the Department of Housing and Development (HUD)
3. Examine the factors that determine how much a homeowner can borrow
4. Explore some advantages and disadvantages of a reverse mortgage loan and alternatives

1. Comparison of the mechanics of a traditional for-purchase mortgage with those of a reverse mortgage loan.

<u>1a. Traditional for-purchase loan.</u>

- The traditional for-purchase mortgage loan can be described as a "forward mortgage" in that it is usually used to purchase a home and is paid off over time.
- The loan consists of a promissory note secured by a mortgage on the property
- <u>Before</u> closing, borrower has no equity in the property
- <u>At</u> closing, borrower's equity may include a down payment, if any was made
- <u>During</u> the loan period, borrower makes payments to the lender
    - o Loan balance decreases
    - o Equity increases (in normal market conditions)
- <u>At the end</u> of the loan:
    - o Borrower owes nothing, and
    - o Owns 100% of equity (market value) of the home
- Loan can be described as a "falling debt, rising equity" transaction.
- Loan amount (principal and interest) is **known** at the beginning of the loan and is repaid over a determined period, typically 30 years. The Truth in Lending Act (TILA) requires a precise determination of total loan costs and Annual Percentage Rate of the amount financed.
- Loan payment consists of four components (PITI):
    - o Principal
    - o Interest
    - o Taxes: annual property taxes
    - o Insurance: hazard insurance on the property

- Taxes and hazard insurance usually are paid from an "escrow" account that lender creates and manages to protects lender's interest in their collateral (property) from:
    - Tax liens
    - Fire, Wind damage
- Lender may also require mortgage insurance policy if borrower's equity is less than 20%.
- Borrower must show financial capacity to repay the loan

<u>1b. Reverse mortgage loan</u>

- Literally a "mortgage in reverse" - a special type of home equity loan that permits an eligible homeowner to convert a **portion** of their home equity into cash
    - allows a homeowner to have some of the equity that has built up over years of home ownership be paid to the homeowner without having to sell the home
    - often used to pay off existing forward mortgage or to generate a regular cash flow
- As with a traditional mortgage loan, reverse mortgage loan consists of a promissory note secured by a mortgage on the property
- Homeowner retains title to the property
- Repayment is generally not due until youngest borrower no longer lives in the home as his or her primary residence
- Loan proceeds can be disbursed as lump sum, periodic payments, line of credit, or a combinations of these
- <u>Before</u> closing, borrower has substantial (as much as 100% of equity (market value) of home
- <u>During</u> the loan period, lender makes payment(s) to borrower
    - Loan balance increases (accrues)
    - Equity in home decreases
- <u>At end of loan</u>, borrower – or borrower's estate - has less (if any) equity in home and owes a debt
- Loan can be described as a "falling equity, rising debt" transaction.
- Two key differences between a traditional "forward" mortgage loan and a "reverse" mortgage loan: at the beginning of a reverse mortgage loan:
    - The duration of the loan period is **not known**, because neither the lender nor the borrower knows how long the borrower will live in the home
    - The total loan amount (principal, interest) that will be due at the end of the loan is also **not known** for the same reason.
- These factors complicate the calculation of how much the borrower may receive in loan disbursements

<u>1c. Recourse vs. Non-Recourse Loans</u>

- A traditional, "forward" mortgage loan is usually a **recourse** loan.
    - In the event borrower is in default on repayment of loan, lender can foreclosure on the property, evict homeowner, and sell property to settle the debt.
    - Illinois is a judicial foreclosure state and the foreclosure process occurs in court. The foreclosure process is governed by the Illinois Mortgage

Foreclosure Law (IMFL). The IMFL provides the exclusive method for foreclosing on all mortgages.
    - If the sale of the property produces less than the loan balance, borrower can be held responsible for any deficiency.
    - Lender, therefore, has <u>recourse</u> to obtain the shortfall from the borrower.
- A reverse mortgage loan is **a non-recourse** loan.
    - In the event a reverse mortgage borrower is in default on conditions of the loan (detailed below), a lender can foreclosure on the property, evict the homeowner, and sell the property to settle the debt (as with a "forward" mortgage loan).
    - In Illinois the IMFL governs this judicial process as well.
    - However, with a reverse mortgage if sale of the property produces less than loan balance, borrower is **not** responsible for any deficiency.
- Lender, therefore, has no recourse to obtain the shortfall from the borrower. (This is what is covered by the FHA insurance program. (See 2f. below).
- This feature, combined with the uncertainty of the loan duration, also complicates the calculation of the initial loan principal available for disbursement to the borrower.

2. Almost all reverse mortgages in U.S. are federally insured and are referred to as Home Equity Conversion Mortgages (HECM). They are governed by regulations established by the Department of Housing and Urban Development.

<u>2a. HECM qualifications of the borrower:</u>

- Must be at least 62 years old
- Home securing the loan must be borrower's primary residence
- Borrower must be able to extinguish any outstanding federal tax debts with loan proceeds: HECM lender must be in superior lien position
- Since March 2015, borrower must show financial capacity to pay property tax and insurance.
- Borrower(s) required to receive counseling from HUD certified reverse mortgage counselor who issues a certificate of counseling that borrower submits with loan application. (HUD form 92902).

<u>2b. HECM property qualifications</u>

- Single family residence in 1 to 4 unit dwelling, or
- HUD approved planned unit development, or
- Condominium units or townhouses.
- Manufactured homes made after 1976 with a permanent foundation
- Cooperatives, boarding house, B&B's are **not** eligible
- Properties held in a living trust are eligible
- Home must be owned outright or have a low mortgage balance that can be paid at closing with the loan proceeds: HECM lender must be in superior lien position.
- Home must meet minimum HUD property standards. HECM loan proceeds can be used to pay for repairs

- A HECM-For-Purchase reverse mortgage allows for sale of existing home, purchase of new home with a reverse mortgage on the new home in one transaction. (Not covered in detail here).

<u>2c. HECM loan disbursements</u>

- HECM loan disbursements can be made as:
    - Lump sum – single cash payment
    - Tenure – monthly payments for a specified term or for as long as the borrowers live in the property as their primary residence
    - Line of credit – borrower draws funds when desired, up to an approved limit
- Loan amount that can be disbursed in first year is limited due to changes in the program that went into effect in 2013 as a result of the Reverse Mortgage Stabilization Act.
- The overall available loan amounts were further reduced by the provisions of HUD regulation (ML 2017-12) that went into effect October 2, 2017.

<u>2d. HECM loan repayment</u>

- In general, the homeowner does not have an obligation to repay the reverse mortgage loan until the borrower (or surviving, non-borrowing spouse) no longer lives in the home due to:
    - Death,
    - Sale of the home,
    - Borrower leaves home for more than one year for any reason, including entering a rehabilitation facility, assisted living, or nursing home for more than one year.
- The loan may be repaid from:
    - The sale of the property, or
    - From other assets of the borrower's estate
- Any remaining equity from the sale of the home remains in the borrower's estate
- The loan amount due, regardless of loan balance, cannot be more than the market value of the home. (Non-recourse loan)
- There is a provision allowing heirs to pay off loan or extinguish the loan for 95% of the appraised value of the home in accordance with current regulations.

<u>2e. HECM foreclosure provisions</u>

- A HECM loan can be accelerated and foreclosure initiated if:
    - Borrower fails:
        - To pay property taxes
        - To maintain hazard insurance
        - To keep property in good repair
    - Borrower:
        - Rents out the property
        - Adds another owner
        - Takes out additional debt and pledges the property as collateral.
- In all repayment situations, only the note is due – borrower still owns the home.

    - If borrower (or estate) can repay loan without selling property, ownership is maintained,
    - If not, then home is sold.
        - Any surplus from sale is returned to borrower or borrower's estate
        - If sale is insufficient to extinguish the loan, lenders applies for FHA insurance

<u>2f. HECM government insurance</u>

- HECM reverse mortgages insured by Federal Housing Administration (FHA) Mortgage Insurance Policy **(**MIP)
    - Lender makes monthly premium payment and charges the cost to the borrower's accruing loan balance
    - Insurance protects:
        - Lender against non-recourse market risk
        - Borrower against lender default or insolvency
- In addition to a monthly premium, there is an upfront MIP premium.
    - Calculated as a percentage of the maximum loan amount available and based on the amount of loan proceeds disbursed as cash in first year of the loan.
    - Changes made in 2013 made upfront MIP premium more of an incentive for borrowers not to take entire loan proceeds upfront in cash.
    - As of October 2, 2017 the upfront MIP premium for all loans is the same (2%). Previously the upfront MIP premium was based on the first-year loan disbursement amount.

3. Factors that determine how much a borrower can receive from a HECM reverse mortgage loan

<u>3a. MCA: The Maximum Claim Amount</u> is the most a lender can claim for repayment of a reverse mortgage. It is limited to the lesser of:

- Appraised market value of the property, or FHA limit of $679,650 for CY 2018. (Dec 8, 2017).
- There is a private market for "Jumbo" reverse mortgages, but they are not HECMs

<u>3b. MPL: The Maximum Principal Limit is determined by:</u>

- Age of youngest borrower (younger, less; older, more)
- Interest rate charged (higher, less; lower, more)
    - To receive a fixed rate loan, borrower must have full amount of disbursement made at closing
    - Tenure or Line of Credit loans have an adjustable rate adjusted monthly or annually using the London Interbank Offered Rate (LIBOR) index.

<u>3c. MPA: Maximum Principal Available to borrower depends on MPL, reduced by:</u>

- Closing costs – similar to amounts and types for "forward" mortgages, no statutory limit.
- Loan origination fees are based on a sliding scale:
    - For homes valued at less $125,000, max fee is $2,500

- For homes valued at greater than $125,000, fee is:
  - 2% of first $200,000, plus
  - 1% of amount over $200,000 with a $6,000 cap
- Servicing fees:
  - (not all lenders charge these fees)
  - Limited by HUD and FHA to
    - $30 per month for loans with annual adjusted rates
    - $35 per month for loans with monthly adjusted rates
- Total Mortgage Insurance Premiums (MIP) based on percentage of loan balance.
  - Upfront premium of 2% (Since Oct 2, 2017)
  - Annual premium of 0.5% of rising loan balance and added to accrued balance.
    - Reduced from 1.25% Oct 2, 2017.
    - This reduction will slow the growth of borrower debt as well as the growth of unused credit lines.

<u>3d. Life Expectancy Set Aside (LESA).</u> Since March 2015 some borrowers may be required to provide a set-aside for annual taxes and hazard insurance payment.

- Beginning with loans made after March 2, 2015, lenders are required to make sure borrowers have the means to pay their property taxes and hazard insurance.
  - This change was intended to add a financial capability component to HECM reverse mortgages that was not required previously
  - All income sources are analyzed, including Social Security, IRA's, 401k's
  - Borrowers' credit history is also considered
  - Lenders analyze disposable income after typical living expenses and debt payments are factored in.
  - Threshold disposable income levels will be established and considered
- Previously there were no financial qualifications for a reverse mortgage, homeowner only had to have equity
- If not financially qualified, borrower will have to set aside sufficient funds to do so, which will reduce amount available for disbursement.
- A borrower may also be required to make a set aside for needed repairs to the property

4. Advantages, disadvantages, alternatives to a reverse mortgage

<u>4a. Advantages of a reverse mortgage</u>

- The mandatory, independent counseling required before a homeowner can obtain a reverse mortgage is a valuable safeguard.
- Allows "aging in place"- a highly valued consideration for many seniors in good health.
- Seniors with a forward mortgage balance on their home and sufficient equity can convert that loan into a reverse mortgage with only tax and insurance to pay out of pocket, thus providing more disposable income.
- Seniors with equity remaining in their home can draw cash at closing at a fixed rate or a larger amount over a term of years at an adjustable rate to provide:
  - Cash for long-term out of pocket medical expenses not covered by other insurance
  - An alternate means to supplement other income sources in retirement.

- Seniors concerned that they may outlive their savings can set up a HECM Line-of-Credit that will grow until it is drawn upon. This is particularly useful with a property that is appreciating in value.
- A reverse mortgage may be appropriate if children are in better economic situation then parents and the children have little or no expectations of receiving bequest from their parents.
- Non-recourse nature of the loan is an advantage in that the amount owed can never exceed the market value of the home.

4b. However, taking a reverse mortgage disbursement may not a good idea:

- If the borrower doesn't need the money now. Consuming home equity at an early age can have serious negative consequences to the borrower in their later years.
- To use money from a reverse mortgage to buy an investment – seniors don't have as much time to recover. (Illinois Reverse Mortgage Act actually prohibits such use).
- If the borrower has only a short-term need of cash. In such a case, the homeowner should consider using 401k, IRA, or savings first.
- If the property value is low: upfront costs will represent a much higher percentage of a low value loan limit than for a higher value loan.
- If borrower does not have the requisite resources to pay the property taxes and maintain hazard insurance. The LESA requirement may substantially reduce loan amount available.
- If the borrower plans to live in the home less than a few years
- If the borrower expects to have equity to buy another home in later years.
- If the borrower plans to keep the home in the family and will not have other resources in the estate to repay the loan.

4c. Alternatives to a Reverse Mortgage

- Sell home, downsize with proceeds and use surplus as additional cash.
- Tap savings, IRA, 401k for short-term cash needs.
- Take out conventional home improvement loan or Home Equity Line of Credit (HELOC) for repairs – these may involve a second mortgage on the property, but with much lower loan costs.
- Some states, like Illinois, have deferred payment loans, similar to reverse mortgages, to pay property tax.
    - In Cook County: "Senior Citizen Real Estate Tax Deferral Program"
    - Tax payers 65 years or older with household income less than $55,000
    - Owned and occupied qualifying property for at least 3 years
    - Property owner must maintain hazard insurance.

4d. Illinois Reverse Mortgage Reverse Mortgage Act (Jan 2016)

- Key provisions include:
    - Full compliance with HUD regulations regarding borrower counseling by a certified reverse mortgage counselor. Notice must be in at least 12-point type and include a contact list of counselors. Telephone counseling still permitted.
    - A "cooling off" period of three (3) business days before loan becomes binding to borrower.

    - A written attestation that lender is not using loan proceeds to purchase an annuity, investment, life insurance policy, or long-term care insurance policy with the loan proceeds.
    - A prohibition against anyone other than borrower's spouse or partner to receive any portion of the loan proceeds except for bona fide fees for origination of the loan.
- The Act also provides that Illinois Attorney General will enforce violations and consider a violation of Illinois Reverse Mortgage Act to be a violation of the Illinois Fraud and Deceptive Business Practices Act.

In Summary:

- A reverse mortgage is a loan; the money must be repaid.
- A reverse mortgage can be an expensive way to borrow money for some, but can provide substantial financial relief for others.
- A reverse mortgage line of credit can be a valuable asset management tool.
- Reverse mortgage loans are financially complex
- Reverse mortgages involve legally intricate contracts
- One size does NOT fit all consumers.
- A reverse mortgage loan can be foreclosed on and the borrower can lose their home if they default on the loan conditions, particularly with property taxes and hazard insurance.
- Taking out a reverse mortgage is NOT a casual decision and the consumer should educate themselves about all the ramifications, advantages, disadvantages, and alternatives before doing so.

Where to get more information:

- HUD website: www.HUD.gov
- CFPB website: www.consumerfinance.gov
- AARP website: www.aarp.org
- National Reverse Mortgage Lender's Association: www.nrmlaonline.org