



OVERVIEW

Reverse mortgage lowdown

A reverse mortgage can be a godsend or the product from Hades. Understand it well before signing the dotted line.

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The ins and outs of reverse mortgages

By [Steve Santiago](#) • Bankrate.com

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For homeowners 62 years and older, a reverse mortgage may seem like an excellent way to tap into home equity, generating much-needed retirement income. After all, the loan typically doesn't have to be repaid as long as the last surviving borrower lives in the home or until the home is sold.

Unlike conventional "forward" mortgages, where you make a monthly payment to the lender, a reverse mortgage lender issues you money that is generally not taxable and does not affect Social Security or Medicare benefits.

"For a person 62 years of age or older who wants to utilize his home to supplement cash flow and doesn't have to worry about budgeting to pay it back, it's a pretty interesting product," says Bob Walters, chief economist at Quicken Loans in Livonia, Mich.

But before rushing out to apply for a reverse mortgage, be aware that this type of loan has several downsides. Closing costs and fees can be steep, and if you are thinking about leaving your home in two to three years, this is not a financially prudent way to extract money from your home. In that case, a home equity loan is likely a cheaper option.

The house edge

Chances are excellent that a reverse mortgage will be a better deal for the lender than for you. Consider these basics about reverse mortgages before you ink the deal.

Reverse mortgages 101

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Reverse mortgage types

Homeowners can choose from three types of reverse mortgages:

- Single-purpose reverse mortgages.
- Proprietary reverse mortgages.
- Home equity conversion mortgages, or HECMs.

Some state and local government entities and nonprofits offer single-purpose reverse mortgages. They are usually low-cost loans, but they are generally available only to people with low or moderate incomes. Also, they can only be used for specific purposes, such as home repairs, improvements or property taxes.

Proprietary mortgages are private loans backed by the companies that market them.

Federally insured home equity conversion mortgages, or HECMs, backed by the U.S. Department of Housing and Urban Development, or HUD, account for 90 percent of all reverse mortgages, according to the National Reverse Mortgage Lenders Association.

HECMs and proprietary mortgages normally have no income requirements and they can be used for any purpose. But they generally have high upfront costs and normally require the borrower to meet with an independent government-approved housing counselor before applying.

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How much can you borrow?

Generally, the more valuable your home, the less you owe on it, and the older you are, the more money you can extract from your home. Remember, the home must be your primary residence.

The amount you can borrow also depends on current interest rates, loan fees and the appraised value of the home or the Federal Housing Administration's mortgage limits for the area, whichever is less.

FHA does not limit the value of homes qualifying for an HECM reverse mortgage. An appraiser determines home values. However, the FHA does set limits on the amounts that can be borrowed. The loan limit is \$417,000 effective Nov. 1, 2008.

The Housing and Economic Recovery Act of 2008, signed into law July 30, 2008, may increase the amount that can be borrowed under the HECM program. At this writing, FHA is still working out the details.

According to the Federal Trade Commission, HECMs generally provide larger loan advances than proprietary loans at a lower overall cost. But owners of homes with high appraised values and small or no mortgages may qualify for larger loan advances through a proprietary reverse mortgage, though the cost will likely be higher.

Interest rates

Borrowers today have a wide range of choices in reverse mortgage products. Some feature fixed interest rates.

But most reverse mortgage products come with variable interest rates pegged to such short-term indexes as the Constant Maturity Treasury index or the London Interbank Offered Rate, or LIBOR, plus a margin, according to David Cesario, executive vice president of sales and marketing at 1st Reverse Financial Services in Westmont, Ill.

"You may have a Treasury with a 150 to 175 basis point margin (a basis point is one one-hundredth of a percentage point). So you'll hear it sometimes as an HECM-175 which means the 175 is the margin over the index," Cesario says.

"There are also loans now like the HECM-100 LIBOR, so you'll have a 100 basis point margin over the LIBOR index."

For example, if the interest rate on the LIBOR were 3.5 percent and you had a

HECM-100 LIBOR loan, the rate on the loan would be 4.5 percent. Keep in mind, though, that rates are low in the current environment, and may very well go up in the future.

Understand, too, that the interest is charged on the outstanding balance and accrues over time, increasing the loan amount. This is the magic of compounding interest at work in reverse -- meaning it favors the lender instead of you.

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Insurance premiums, other fees

FHA-backed reverse mortgages require lenders to collect insurance premiums.

Borrowers will pay 2 percent of the maximum loan amount upfront, plus a 0.5 percent annual premium that is accrued on a monthly basis and added to the outstanding balance.

Borrowers should also expect to pay for an appraisal, credit report, title insurance, legal fees and recording fees -- just as they would for any other mortgage.

Origination fees can also add up quickly and reduce the overall amount of money available to you at closing.

The new housing rescue law limits the fees for HECM reverse mortgages to 2 percent of a loan up to \$200,000, plus 1 percent of any portion greater than \$200,000. Origination fees are capped at \$6,000, but in the future this cap will be indexed to inflation.

Nevertheless, on a \$200,000 loan, that's \$4,000 in origination fees in addition to other loan costs.

"Reverse mortgages traditionally have been very restrictive and pretty costly," says Paula de Vos, a Certified Financial Planner and president of Synergist Wealth Advisors in Carmel, Calif.

Borrowers should fully understand the loan documents before they sign because they are in fact legal documents that could affect your heirs, de Vos says.

"If you don't fully understand what is being proposed, seek the counsel of someone who does."

The service fee set-aside

Another confusing, yet costly, add-on for HECM reverse mortgages is the service fee set-aside, or SFSA.

The service fee set-aside is an estimate of total servicing fees over the life of the loan. Although not considered a closing cost, the SFSA can amount to thousands of dollars that will reduce your available loan proceeds.

The SFSA is not an actual fee but a calculation using complicated algorithms that factor in a borrower's estimated life expectancy among other things. Most lenders assume a life expectancy of 100 years for SFSA calculation purposes. The result is

a fee charged by the loan servicer that ranges from \$20 to \$35 per month.

The SFSA is not tallied until the borrower dies or moves and the loan becomes due.

For example, if a borrower is 65 years old, he potentially has 35 years, or 420 months, of life remaining.

If the SFSA is \$30 per month, that equates to \$12,600 in set-aside fees that will be reduced from your loan total.

However, if you move or sell your home within, say, eight months, you would actually owe only \$240 (\$30 x 8).

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With traditional forward mortgages, the service fees are factored into the monthly payment.

"The reverse mortgage loan has that same servicing requirement but just doesn't have the revenue stream incoming to pay for that, so that's where the whole concept of the SFSA came about," Cesario says.

Mortgage brokers can also affect how much you pay for SFSA if they perceive the margin on the loan to be too low.

"Sometimes he won't allow a \$25 SFSA because he may be able to realize a higher yield spread on \$30 or \$35," says Warren Abelson, manager of reverse mortgages at Advanced Mortgage Solutions of South Florida in Boca Raton, Fla.

In other words, if the loan terms are favorable in one respect, the mortgage broker will look for other ways to make more money on the deal.

Borrowers should shop for the best SFSA and margins, in addition to interest rates, and should compare at least two or three loan offers, Abelson says.

How to extract money

"You get your money one of three ways," says Walters from Quicken Loans.

"You can either get a lump sum, you can get a line of credit that you can draw on, or you can get an annuity-like arrangement that will pay you a certain fixed dollar amount for life and you never have to make a payment."

You can also get a combination of a line of credit plus monthly payments for as long as you live or for a specified term. In any case, income from a reverse mortgage is tax-free.

There are advantages and disadvantages to all these options.

A lump-sum payout may be ideal for borrowers who still owe money on a regular mortgage, but would like to pay it off and get rid of monthly mortgage payments. The downside is you will accrue more interest on the loan over a longer time frame.

Some borrowers opt for the credit line and draw on the money only when they need it.

Interest accrues only on the outstanding balance. If money is conservatively

drawn from the credit line, credit availability should theoretically remain high for emergencies. However, a home equity line of credit works much the same way at a reduced cost.

The annuity-like arrangement is ideal for borrowers who need a steady income stream to either supplement existing income or to pay for ongoing bills and expenses.

The upside is that you can get this payment for life, which can work in your favor if you live longer than actuarial estimates project. If you receive more payments than your home is worth, you (or your heirs) will never owe more than the value of the home.

The downside in that scenario: There won't be anything left for your heirs.

Homeowners considering a reverse mortgage should not enter lightly into the decision. These products can offer a much-needed lifeline to assets or an unnecessary drain on assets to the unsuspecting consumer. In any event, they are generally more costly than other loans.

See Bankrate's work sheet on the [pros and cons](#) of reverse mortgages, which also offers resources to help you research these loans more thoroughly. Bankrate's "[Questions to ask lenders](#)" work sheet can help you compare deals.

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