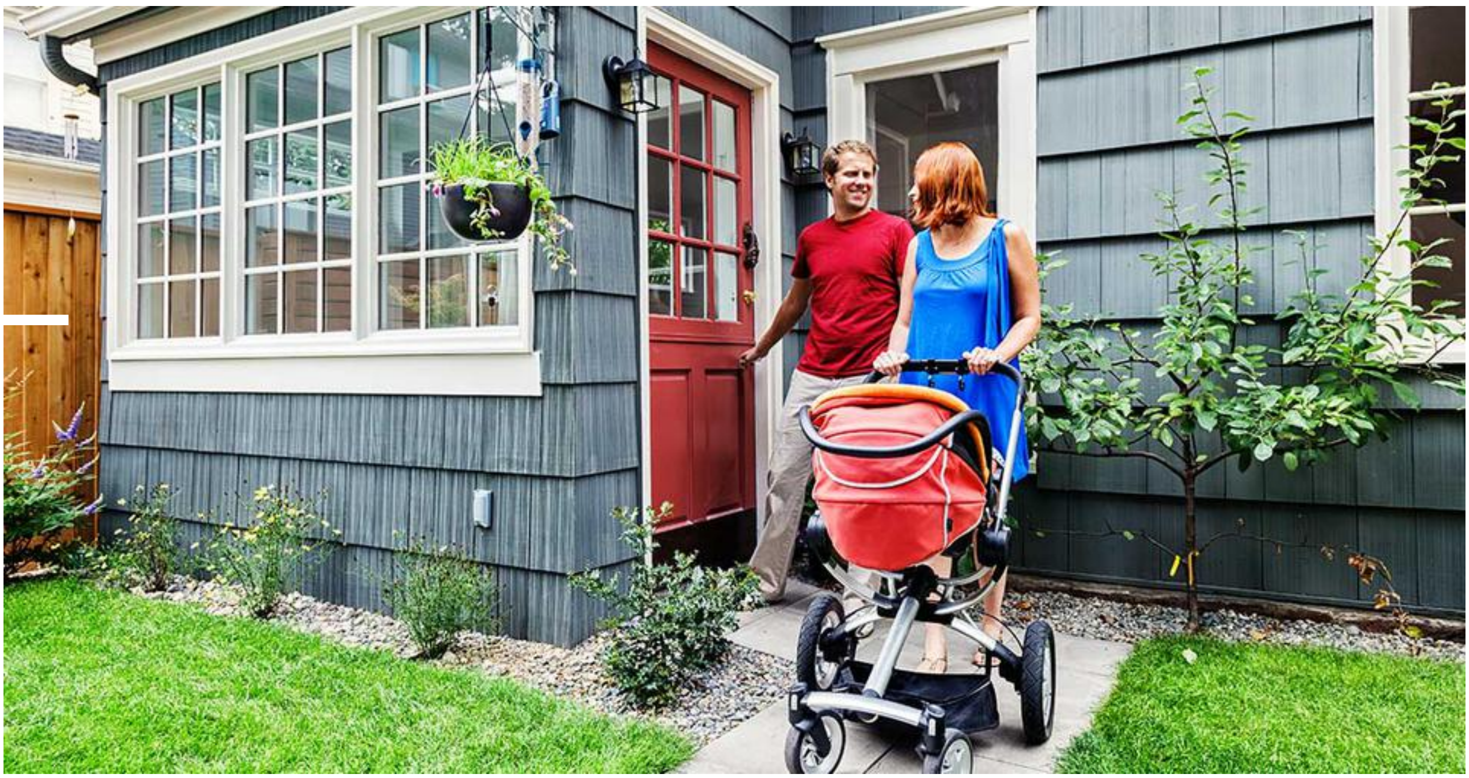
GETTING OUT OF DEBT

What Is a Reverse Mortgage?



11 MINUTE READ

Chances are, you've seen those enticing commercials touting the benefits of a reverse mortgage. *"Let your home pay you a monthly dream retirement income!"* Sounds fantastic, right? These claims make this product sound almost too good to be true for senior homeowners. Let's take a closer look.

What is a reverse mortgage?

A reverse mortgage is exactly what it sounds like: a mortgage in reverse. When you **get a** regular mortgage, you *make* payments on your home's principal. Each payment means you're building up equity in your home.

But when you get a reverse mortgage, you don't *make* payments—you *take* payments from the equity you've built. Put simply, the bank is lending you back the money you've already paid on your home but charging you interest at the same time.

How does a reverse mortgage work?

The "appealing" part of a reverse mortgage is that you don't pay the mortgage or the interest until you sell your home. Seems easy enough, right? But here comes the hard reality. If you die before you've sold your home, your heirs are stuck with two options. They'll need to pay off the full reverse mortgage and all the interest that's piled up over the years, or they can give the bank your house.

Reverse mortgages are often targeted at senior citizens who have tight budgets, fixed incomes, and a majority of their house paid off. Reverse mortgages may seem like they could be a helpful cash-flow option for people in their retirement, but really, these mortgages put seniors and their heirs at financial risk.

Types of Reverse Mortgages

While all reverse mortgages basically work the same way, there are three main types:

FHA's HECM reverse mortgage

The most common reverse mortgage is the Home Equity Conversion Mortgage (HECM)

The most common reverse mortgage is the Home Equity Conversion Mortgage (HECM). HECMs were created in 1988 to help older Americans make financial ends meet by allowing them to tap into the equity of their homes without having to move out.

Homeowners aged 62 and older can qualify for HECM loans and use the proceeds for any purpose. These mortgages are typically the ones you see advertised late at night in celebrity-endorsed commercials. Borrowers are free to use the money they receive however they wish, from paying their electric bills to taking vacations. But the consequences can be huge.

HECM loan requirements are tightly controlled by the Federal Housing Administration (FHA), an arm of the Department of Housing and Urban Development (HUD), whose primary focus is to insure mortgages against borrower default. For example, homes worth more than $679,650 don't qualify for a reverse mortgage.[1] Also, borrowers are required to pay hefty mortgage insurance premiums that protect the lender (i.e. not you) against losses.

Proprietary reverse mortgage

What in the world does *proprietary* even mean and what does it have to do with mortgages? Proprietary in this case means "private" or "privately owned or operated." Many states allow lenders to privately offer proprietary reverse mortgages outside the federally governed FHA/HECM system. In other words, they aren't federally regulated.

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Because of that, homeowners avoid paying mortgage insurance premiums—which sounds like a better deal. But interest rates on these loans can be much higher than federally insured reverse mortgages.

Without the federal government being involved, lenders are free to create their own requirements and restrictions for proprietary loans. So, some lenders may offer reverse mortgages that allow homeowners to borrow more of their equity or include homes that exceed the federal maximum amount.

Single-use reverse mortgage

A single-use reverse mortgage puts restrictions on how the homeowner can use funds from the loan. Typically, these loans can only be used to make property tax payments or pay for home repairs. How the funds can be used is ultimately up to the lender, not the homeowner.

Single-use reverse mortgages are often offered by government agencies at the state and local level, and by numerous non-profit groups. The purpose of these loans is to help keep homeowners in their homes if they fall behind on mandatory costs like homeowners association (HOA) fees or if they need money for major home repairs. The key to a single-use reverse mortgage is that the lender OKs how the money will be used before the loan is approved.

These loans also aren't federally insured, so lenders aren't required to charge expensive mortgage insurance premiums. But since the money from single-use reverse mortgages is restricted to particular uses, they typically are for much smaller amounts than HECM loans or proprietary reverse mortgages.

Who can qualify for a reverse mortgage?

To qualify for a reverse mortgage, you must be at least 62 years old and own a paid-for (or at least significantly paid-down) home. It also has to be your primary residence, and you can't owe any federal debts. Plus, you have to have the cash-flow to continue paying property taxes, HOA fees, insurance, maintenance, and other home expenses.

Your home also has to meet certain requirements. You can get a reverse mortgage on single-family dwellings and multi-family units up to fourplexes, so long as you live in one of the units. The HECM program also allows reverse mortgages on condominiums of the units. The HECM program also allows reverse mortgages on condominiums approved by the HUD.

The ugly truth about reverse mortgages

Before you go and sign the papers on a reverse mortgage, just hear us out. Reverse mortgages will only make your financial hardships worse with high interest rates and low payouts. What we're about to say may well save your bacon in both the short and long run.

You're giving away your net worth.

According to the U.S. Census Bureau, the median net worth of individuals aged 65 and over is almost $203,000.[(2)] That number includes the value of their homes, though. The median senior net worth without home equity is just under $58,000. That means too many people lack the money they need for retirement, and the vast majority of their net worth is in their houses.

Let's break it down like this: Imagine having $100 in the bank, but when you go to withdraw that $100 in cash, the bank only gives you $40—oh, and they charge you interest on that $40 from the $60 they keep. If you wouldn't take that "deal" from the bank, why on earth would you want to do it with your house?

That's exactly what a reverse mortgage does. Homeowners who get a reverse mortgage are only allowed to tap into a small portion of their home's value—about 40% according to federal government rules. So, if you own a home that's worth $200,000, you can borrow about $80,000. But that doesn't mean you're going to receive all $80,000. You still have to pay fees on that amount.

You'll owe fees. Lots of fees.

Reverse mortgages are loaded with extra costs. Lenders can charge up to 2% of a home's value in an origination fee. That's as much as $4,000 for our $200,000 example home mentioned above. You'll also have to fork over the typical mortgage insurance premium of about 0.5% of the home's value up front—or another $1,000. Before you know it, you've spent $5,000 of your reverse mortgage before you've ever seen the first dime.

Then there are closing costs on top of those fees, usually between $2,000–3,000. By the end of it all, you'd be able to cash out roughly $73,000 or so in equity.[3] And that's just the beginning. Once you hit that amount, the money stops. You can't tap into any more of your home's value (which is money that's yours, by the way). Worse still, the interest starts ticking immediately when you sign the papers. So the amount of money you owe goes up every year, every month, and every day until the loan is paid off.

You'll likely owe more than your home is worth.

Reverse mortgage marketing is filled with half-truths, lies, and potential fraud. Think about that commercial you saw during those late-night reruns of *Golden Girls*. You're probably already familiar with the biggest lie: "You will *never* owe more than your home is worth!"

But that's simply not true. Here's the math to prove it:

Home Value: $200,000
Reverse Mortgage: $80,000 (lump sum)
Interest Rate: 5.7%
Age at Time of Loan: 62
Term: 25 years
Total Interest Accumulated: $119,000
Total Owed at Death: $319,863[4]

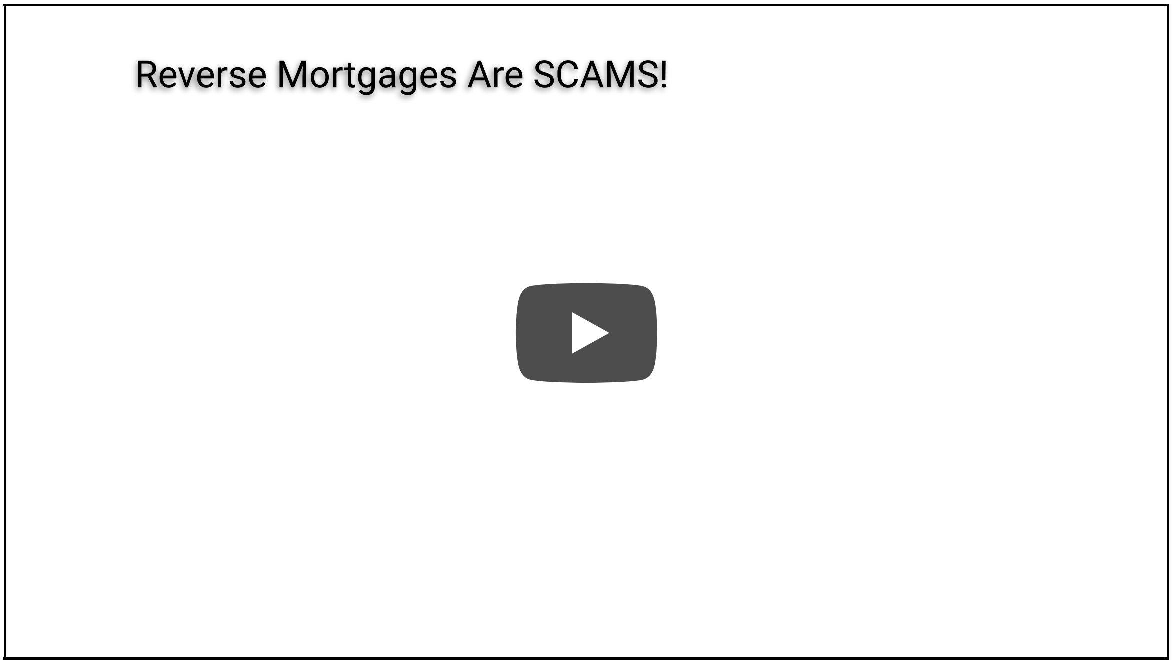
In this example, you receive $80,000 from your reverse mortgage on your $200,000 home. Let's say you live until you're 87. When you die, your estate owes $319,863 on your $200,000 home. To put it another way: your estate is bankrupt! Unless your heirs can afford to fork over $119,000, they will have little choice but to give the home to the bank to settle the loan's balance.

You could lose your home.

Of all the lies reverse mortgage lenders tell, "You won't lose your home" is one of the most offensive ones. Why? Because you absolutely *can* lose your house if you have a reverse mortgage.

Think about the reasons you were considering getting a reverse mortgage in the first place: Your budget is too tight, you can't afford your bills, and you don't have anywhere else to turn for some extra cash. All of a sudden, you've drawn that last reverse mortgage payment, and then the next tax bill comes around. A few days later, the HOA dues start piling up.

If you don't pay your taxes or your HOA dues, how long will it be before someone comes knocking with a property seizure notice? Not very long at all. And that's perhaps the single biggest reason you should avoid these predatory financial products.



The good news is: you don't have to take out a reverse mortgage! We'll show you how.

Avoid the reverse mortgage trap

The first step in avoiding the mistake of a reverse mortgage is pretty simple—*don't get one*. But we know that doesn't help you fix the financial mess you've gotten into.

So, stop and take a look at your budget. Are you going on $1,000 vacations you actually can't afford and neglecting your property taxes? Does a store sale leave your wardrobe overflowing with new clothes that weren't in the budget? Has your income stayed the same but your expenses continued to grow? If so, you may need to do some trimming and get on a **zero-based budget**.

But maybe it goes a little deeper than that. Maybe something unexpected happened, and now you're staring down a pile of medical bills. That can be pretty scary. If you're thinking of tapping into the home equity of your *paid-for house* to make ends meet, it might be best to first answer this question: *Am I house poor?*

How do I know if I’m house poor?

Remember way back when you first bought your home? Maybe you followed Dave’s 7 Baby Steps to get out of debt and save. Which means you know that a good rule of thumb is for your house payment to not consume more than 25% of your budget. That’s a pretty good guide for retirees on a fixed income, too. **But if you’re spending more than 25% of your income on taxes, HOA fees, and household bills, that means you’re house poor.** And downsizing may be a great option for you.

Look around your house and think about the rooms you haven’t set foot in this week, this month, or even this year. That’s wasted space that’s costing you money! Sell the house, take 100% of your home’s worth, and buy something more affordable for your budget.

A smaller house means lower electric and heating bills and less maintenance costs each month. Those savings add up quickly. Another added benefit of downsizing is getting rid of a lot of stuff you don’t need anymore in a garage sale—and that can mean a little extra money in the bank. And as an added plus, you won’t have to vacuum, dust or mop spaces you haven’t used in ages! If you’re considering selling your home, contact one of our Endorsed Local Providers who can help you navigate your options.

You’re Not Alone. There Is Help.

Before you make any decision that will impact your future, seek out the qualified assistance of someone who know the ins and outs of mortgages. Whether you’re still on the fence about getting a reverse mortgage or downsizing your current home, our friends at Churchill Mortgage will equip you with the information you need to make the right decision.

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