Issue Briefs
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UW Extension Cooperative Extension

Reverse Mortgages: Home Equity Conversion Mortgages

Background

People over 65 often own their home, many without a mortgage. Yet as retirement accounts dwindle and expenses increase, these 'house-rich' homeowners may find themselves in a position where they need to sell the home to generate current income. But selling a home can be a major challenge emotionally and logistically. Many seniors want to remain in their home and selling is not a desirable option.

Reverse mortgages offer another alternative. These allow homeowners to convert a portion of home value into cash while allowing them to continue living in their homes.

While these loans do fill a niche for some, there a number of disadvantages and they should be considered carefully. Reverse mortgages will reduce the amount of wealth a senior can leave to their family or heirs. The home will no longer be owned "free and clear". These loans can have big fees and can be complicated to understand, especially for lower financially experienced populations. Most lenders have little experience with reverse mortgages. A relatively small number of lenders have invested in expertise on these loans.

Home Equity Conversion Mortgage (HECM)

The most common type of reverse mortgage is the Home Equity Conversion Mortgage (HECM), insured by the Federal Housing Administration (FHA) and constituting over 90% of the U.S. reverse mortgage market. Although millions of seniors could be eligible to use these loans, fewer than half a million have used the these loans since they were created.

Eligibility & Borrowing Limits

To be eligible for a HECM loan, borrowers have to be 62 years of age or older and occupy the property as their principal residence. Borrowers must either own their homes outright or have a small mortgage balance.

The amount that the borrower can receive from a HECM loan is calculated in three steps.

1. The first step is to determine the Maximum Claim Amount (MCA) - the lesser of the appraised value of the property or the county-specific FHA mortgage limits.
2. The second step is to determine the Initial Principal Limit (IPL) by multiplying the MCA by a factor between zero and one.
3. The third step is to calculate the Net Principal Limit (NPL), which is the amount the borrower can take as a lump sum in cash at closing, by subtracting from the initial principal limit the upfront costs associated with HECM loans and a set-aside for a monthly servicing fee.

A HECM loan is a "non-recourse" loan, meaning that the borrower and her estate will never be required to pay more than the value of the property and that no other assets can be seized to repay the loan. Reverse mortgage loans are not due until the borrower dies or permanently moves out. People who know they are likely to stay in their homes for a long time will find reverse mortgages more attractive than others.

Under this program, FHA insures the borrower against the risk that the lender can no longer make the contracted payments. It also insures the lender against the risk that the loan balance exceeds the property value. For example, lenders can assign loans to HUD when the loan balance reaches 98% of the MCA. In the event that the proceeds from the sale of the property are not sufficient to pay the outstanding loan balance, lenders who have not assigned the mortgage to HUD can submit a claim for insurance benefits up to the MCA. To pay for this insurance program, HUD charges a Mortgage Insurance Premium (MIP). The initial MIP is set at 2% of the MCA. The monthly MIP is set at an annual rate of 0.5% and is charged on the outstanding balance of a HECM loan.

If a borrower dies shortly after his or her HECM loan is originated, the borrower pays back only the loan balance.

Costs

The upfront costs include the initial Mortgage Insurance Premium (MIP), origination fee, and closing costs. The initial MIP is set at 2% of the MCA. The origination fee is set at $2,000 or 2% of the MCA, whichever is greater. Closing costs include origination fees and other third-party fees such as appraisal fees, credit report fees, and title insurance fees.

Overall, the upfront costs on a HECM loan range between $7,000 and $20,000. A servicing fee set-aside is the present value of the monthly servicing fee charged by the lender. The typical monthly servicing fee is $30 or $35. Both the upfront costs and servicing fees are financed rather than paid by the borrower out of pocket.

Payment Options

There are various ways borrowers can receive money from a HECM loan.

Under a *Term* plan, the borrower will receive equal monthly payments from the lender for a fixed period of months selected by the borrower. Note that even though payments stop at the end of the selected term, the loan is not due until the borrower dies or moves out of his or her home.

Under a *Tenure* plan, the borrower will receive equal monthly payments from the lender for as long as the borrower lives and continues to occupy the property as her principal residence. This payment plan is also called a "reverse annuity mortgage" in the literature due to its resemblance to an annuity product. Only 10% of HECM borrowers choose the tenure payment plan or the modified tenure payment plan

Under a *Line of Credit* plan, the borrower will receive the mortgage proceeds in unscheduled payments or in installments, at times and in amounts of the borrower's choosing, until the line of credit is exhausted. This payment plan is the most popular among HECM borrowers.

Under a *Modified Tenure* plan allows the borrower to combine a line of credit with a tenure plan. A *Modified Term* plan allows the borrower to combine a line of credit with a term plan.

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