Which HECM Options Best Meet Your Needs?

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One of the valuable features of the HECM reverse mortgage is that it offers multiple options for drawing funds, which can be used singly or in combination to meet a wide variety of senior needs. If this were better understood and exploited, the HECM market would be many times larger than it is.

This article matches each of a variety of senior needs with the HECM option that can be used to help meet the need. It can be viewed as a senior's first step in determining whether a HECM might help them. Step 2 is to determine how much they can draw on specific HECM options, or combinations of options. They can do this at HECM Reverse Mortgage Calculator, with expert guidance if they need it, but without being hustled by loan providers.

Summary of Senior Needs Matched to HECM Options

Senior Need or Objective	HECM Option that Meets need			
	Credit Line	Tenure Payment	Term Payment	Cash Draw
Eliminate Payment on Existing Mortgage				X
Eliminate Payments on Short-term Debt				X
Meet Unexpected Expenses, Special Occasions	X			
Offset Loss of Pension From Death of Spouse	X			
Insure Against Depletion of Financial Assets	X			

Stabilize Spending When Income Fluctuates	X			
Increase Monthly Income While Staying Put		X		
Increase Spendable Funds For a Limited Period			X	
1. Purchase a House, Limit Depletion of Assets				X
2. Purchase Financial Assets				X
3. Purchase an Immediate Life Annuity				X

Eliminate the Payment on Your Existing Mortgage

If you have a standard mortgage, the HECM reverse mortgage rules require that you pay it off when you take a HECM. If your capacity to make the payments on your existing mortgage has been impaired by your retirement, sickness or something else, the shift to a HECM may make good sense. It replaces debt that must be repaid in monthly installments with debt that doesn't have to be repaid until you die or move out of the house permanently.

If the balance of your existing mortgage is small relative to the total amount of cash you can draw, you retain all your options. You can use your remaining HECM borrowing power to meet any of the other needs discussed here, using any of the HECM options.

If your existing balance is so large that paying it off uses all or most of your HECM borrowing power, paying it off is the only use you can make of the HECM. You lose the ability to draw spendable cash from the HECM in later years. In that situation, you should consider an alternative strategy of delaying the HECM until the existing mortgage has been paid off out of current income. That may require that you defer retirement, but it will pay off big in the future.

Eliminate the Payments on Your Short-Term Debt

This is not a requirement of the HECM program, but otherwise the pros and cons are very much the same as paying down an existing mortgage. The case is more compelling in the sense that the cost of short-term debt is usually much higher than the cost of a mortgage.

On the other hand, seniors who have excessive amounts of short-term debt may lack budgetary discipline, and paying off the debt with a HECM may be merely the prelude to a new round of short-term debt increases. To avoid this outcome, seniors looking to use a HECM to pay off short-term debt should do it only within the framework of a budgetary plan, if necessary with the help of a financial advisor.

Prepare For Unexpected Expenses and Special Occasions

Many seniors have retirement income that covers their basic recurring expenses, but not much more. When an appliance unexpectedly breaks that costs money to fix, or a special occasion arises that costs money to celebrate, they can't cope. A HECM credit line is an excellent way to meet such contingencies.

A HECM creit line can be drawn on at any time to meet unanticipated expenses, or for special occasions such as a wedding or a trip abroad. Credit lines are available only on adjustable rate HECMs; on fixed-rate HECMs seniors can draw cash only.

Seniors selecting the credit line option should have sufficient discipline to avoid drawing on the line impulsively, which could use it up in a short period. Those who don't trust themselves should select a monthly payment option.

For those who take a credit line, forbearance is rewarded by continual growth in the unused portion of the line at the interest rate on the mortgage plus the FHA's 1.25% annual mortgage insurance premium. Some prudent seniors have adopted the policy of drawing on the growth in the line each year for "luxury" items, leaving the original line intact for emergencies.

In the low-interest-rate-market of 2013, I advised seniors to take a credit line ASAP, which is when they reach 62 and become eligible. Their line will then begin growing at about 5% a year. When interest rates rise, the growth rate will automatically increase.

If the senior waits instead, the initial line they can draw will rise over time because they are getting older and their house value may be rising. However, growing older increases their line by only about 1% a year, which means that their house value has to rise by 4% a year to match the growth in an unused credit line. But few houses today are appreciating at 4% a year. For most seniors, HECM borrowing power will increase more rapidly by taking out a credit line as soon as they can – as opposed to waiting to grow older.

Offset Loss of Pension From Death of Spouse

Millions of married couples are living partially on pensions paid to one of them, which will stop when that person dies. The drop in income of the surviving spouse could have a major impact on that person's standard of living – unless it is offset by another source of funds.

A HECM credit line can be used to offset an income drop resulting from termination of a pension following the death of a co-borrower. The line would be used to purchase a monthly tenure payment that would fill the gap. The earlier the credit line is established, the larger the tenure payment will be when the need arises.

Insure Against Depletion of Financial Assets

Millions of seniors retire with a modest nest egg that they intend to use up during their retirement years, but face the risk that their funds will be fully depleted while they are still alive. They may follow the advice of a financial planner who tells them how much of their fund they can draw each year consistent with a low probability of running out of money. However, a low probability of going broke can be a source of continued anxiety.

A standard remedy for anxiety associated with low-probability hazards to life, limb or pocketbook is insurance. In this case, the insurance is provided by a HECM credit line, which if unused grows month by month at a rate equal to the interest rate on the HECM, which changes every month, plus the 1.25% insurance premium.

While many borrowers fear adjustable rate mortgages because rising rates increase the mortgage payment, that is true only on standard mortgages. On a HECM there is no required payment and the downside of rising rates is an increase in the growth rate of their HECM debt. Borrowers with no concern regarding the size of their estate can be indifferent to how rapidly their debt grows.

Seniors using the HECM to insure against the possibility that their financial assets will run out benefit from rising interest rates. When interest rates begin to rise in the future, the growth in unused lines will accelerate.

A HECM term payment can also be used to prevent depletion of financial assets. This approach is discussed below.

Stabilize Spending in the Face of Fluctuating Income

Seniors with fluctuating income can use a HECM credit line profitably to stabilize their spendable funds. They does this by drawing on the line when income drops, and repaying the line when income is high. The benefit, as contrasted to using a bank account in the same way, is that the investment return earned on repayments is the mortgage rate plus the mortgage insurance premium, which is much higher than any deposit rate they can earn at a bank.

Increase Monthly Income While Staying Put

The tenure payment option offered by the HECM program provides seniors with additional monthly income for as long as they live in their house, It ceases when the borrower dies or moves out permanently.

A valuable feature of the tenure payment is that, relative to cash withdrawal, debt accumulation in the early years is slower because equity is reserved for future payments. For example, after 5 years, the debt of a 72-year old who takes the largest possible tenure payment is only about one-third as large as the senior who withdraws the maximum amount of cash. This means that if the borrower dies early, her estate is substantially larger if she had taken the tenure payment.

Further, seniors who take a tenure payment can modify their transaction at any time by paying $20 to the servicer. For example, the senior who finds that the monthly tenure payment won't be needed for a while can switch the unused equity to a credit line, which will grow in size from that point on. In the opposite case, the senior who needs a larger payment can switch to a line of credit or to a term payment.

Increase Spendable Funds For a Limited Period

Monthly payments for a limited period, called a "term payment", can be substantially larger than payments committed for the life of the senior. One application is to incorporate it into a retirement plan as a supplement to a block of financial assets that a senior entering retirement plans to liquidate gradually.

The challenge faced by seniors adopting this type of retirement plan is to decide how much of their assets they can draw down each year without running out of money while they are still alive. HECM term payments delay the process of asset depletion. If the payment on a 10-year payment is adequate to meet the senior's needs, for example, the senior's assets can be allowed to grow for another 10 years before asset depletion begins. This substantially reduces the danger of running out.

A term payment can also be used by seniors planning to sell their house in a few years who need additional funds in the meantime. In this application, the HECM is an alternative to a home equity line of credit (HELOC). While HELOC borrowers must pay interest on the amounts they draw, over a short period they can increase their draw by enough to cover the interest, so that the net cash withdrawal is comparable to the draw on a HECM term payment.

The advantage of the HELOC is that the upfront costs are lower – in some cases, zero – and the interest rate in most cases will be lower than the HECM rate plus the HECM mortgage insurance premium. This means that, assuming the borrower withdraws the same amount of cash on both, after any given period the HELOC debt will be lower than the HECM debt.

But the HELOC has significant disadvantages that in many cases will shift the balance of advantage to the HECM.

- The HELOC borrower must qualify based mainly on income and credit, as with any forward mortgage. Many seniors won't qualify for a HELOC.
- If the senior changes her mind about selling the house and decides she wants to remain, she is in trouble if she took a HELOC because the HELOC must be paid off. The HECM doesn't.
- The borrower using a HELOC as a source of additional cash is dependent upon being able to draw against the unused portion of the credit line. But the lender can cancel the unused line at any time, and will if a question arises about the borrower's credit, income or property value. This is not a risk with a HECM.

Purchase a House While Limiting Depletion of Assets

A senior who is not now a homeowner, or who wants to sell an existing home and purchase another one, perhaps smaller or located closer to family can partially finance the purchase with a HECM. Taking the largest cash draw possible minimizes the depletion of financial assets.

Purchasing a house with a HECM has significant advantages over buying it with a standard mortgage. The standard mortgage must be repaid in monthly installments while the HECM reverse mortgage doesn't have to be repaid until the senior dies or moves out of the house permanently. In addition, the senior might not meet the income and/or credit requirements for a standard mortgage, but these are not a barrier to a reverse mortgage.

Buying a house with a HECM also beats the alternative of buying with a forward mortgage and paying it off later with a HECM. The advantage is that it requires only one set of settlement costs instead of two.

The down side, and it is a big one, is that the senior who uses all the borrowing power of a HECM to buy a house loses the ability to draw spendable cash from a HECM in later years.

This is a lifestyle decision that may be well-considered and sound, or it may be hasty and ill-conceived. The best way to avoid a bad decision is not to act in haste, and consult those who play a role in the plan. It is a particularly bad idea to move in order to be closer to family without first discussing it with them. They could be planning a move of their own!

Purchase Financial Assets

Drawing cash in order to purchase financial assets is usually a bad idea, because it is seldom possible to earn a return in excess of the cost of the HECM except by taking considerable risk. The cost of funds is the HECM interest rate plus the FHA mortgage insurance premium. In 2013, even junk bonds were yielding less than the cost of a HECM.

There may be circumstances or situations where this use of HECM funds makes business sense, but few seniors are positioned to identify them. One exception could be the senior who has a thriving business with great promise that needs additional funding. If I had such a business and if it came down to using a HECM to keep it afloat or letting it die, I would probably use the HECM. But few seniors have thriving businesses.

Purchase an Immediate Life Annuity

A senior who wants the largest possible monthly income that will last for as long as she lives could draw the maximum amount of cash available on a HECM and use it to purchase an immediate life annuity from a reputable insurance company. Because of abuses connected to the sale of annuities to seniors taking HECMs, it is illegal to combine the two transactions, which is a good thing. But there is nothing to prevent seniors from buying life annuities on their own with funds obtained from HECMs.

An immediate life annuity is one that begins monthly payments immediately, as opposed to a deferred life annuity on which payments are deferred for some specified number of years. The abuses referred to above pertained to deferred life annuities, which are unsuitable for seniors.

The major advantage of the immediate life annuity is that it is larger than the HECM tenure payment. Furthermore, the life annuity continues until the senior dies whereas the tenure payment stops if the senior moves out of the house permanently. On the other hand, if the senior dies after only a few years, under a life annuity plan the estate would receive nothing while with a tenure payment plan the estate would recover the senior's equity in the house.

The upshot is that withdrawing cash to purchase a life annuity might make sense for seniors who a) have no interest in the size of their estate, and b) are looking for the largest possible monthly payment that will continue even if they move to a retirement village or nursing home.