How Do HECM Reverse Mortgages Work?

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The Home Equity Conversion Mortgage (HECM) is an ingeniously constructed financial instrument that can meet a wide variety of needs of homeowners 62 or older. In addition to its versatility, HECMs are also extremely flexible, permitting changes in the ways in which seniors receive funds as their needs change over the years.

Inevitably, however, the HECM is also very complicated, which prompts the need for this article. It is organized around the 21 questions that I receive most often from seniors.

1. What Is a HECM Reverse Mortgage?

It is a loan to a senior secured by a mortgage lien on the senior's house, with most of the loan proceeds usually paid out over time rather than upfront, and with no repayment obligation so long as the senior lives in the house.

2. What Are the Requirements For Obtaining a HECM Reverse Mortgage?

You must be 62 years of age or older, and have significant equity in either a home that is your permanent residence, or one you plan to purchase using the reverse mortgage. The house must be single family, in a 2-to4 family structure, in an FHA-approved condominium, or an approved manufactured home

Any existing mortgage on the home must be paid off when you obtain the HECM. Hence, it cannot be larger than the maximum cash draw available on the reverse mortgage unless the senior wants to tap other funds to make up the difference. Some seniors might find it advantageous to do this in order to eliminate the payment on the existing mortgage.

3. How Do HECM Reverse Mortgages Differ From Standard Mortgages?

This is the core question. Most seniors have some understanding of how standard mortgages work, because they probably had one for some years, so understanding how HECMs are different may be the best way to understand HECMs.
Purpose: The major purpose of a standard mortgage is to facilitate the purchase of a house, or to refinance a mortgage that had been taken out earlier for that purpose.

A reverse mortgage is designed to provide an elderly homeowner with spendable funds that can be used for a variety of purposes, including home purchase. More

commonly, the funds are borrowed against a home the senior already owns and occupies as a permanent residence, and used in many different ways.
Eligibility Requirements: To obtain a standard mortgage, borrowers usually must demonstrate that they have sufficient income to make the required payments, that their credit rating is good enough to meet lender requirements, and that they have enough financial assets to cover the down payment and settlement costs.

On a reverse mortgage, borrowers must be 62 or older, and have significant equity in either a home that is their permanent residence, or one they plan to purchase using the reverse mortgage. The house must be single family, in a 2-to4 family structure, in an FHA-approved condominium, or an approved manufactured home. If they have an existing mortgage, it must be paid off with proceeds from the HECM.

There are no income or credit requirements, although that could change early in 2014 when HUD introduces some new rules.
Lender Protection: On a standard mortgage, lenders look to the borrower to repay the loan, and view the property collateral as their last resort in the event the borrower defaults.

On a reverse mortgage, lenders depend wholly on proceeds from eventual sale of the property to be repaid. If the debt balance grows to exceed the property value, the lender will suffer loss, though on HECM reverse mortgages the FHA will assume all or most of it. HECM borrowers pay a mortgage insurance premium to cover such losses.
Factors Affecting the Loan Amount: On a standard mortgage, the amount that a home purchaser can borrow depends on the value of the property, and on the borrower's income and available assets.

On a reverse mortgage, the amount a borrower can draw depends on his age and his equity in the home. In both cases, there may be legal and/or regulatory limits imposed on loan amounts.
Payout of Funds: On a standard mortgage, the entire loan amount is disbursed at the outset, as part of a sales transaction or a refinance.

On a reverse mortgage, the homeowner may receive funds in a variety of ways: as a lump sum at the outset; as a monthly tenure payment, which continues until the borrower dies or moves out of the house permanently; as a monthly term payment over a period specified by the borrower; or as a credit line on which the homeowner can draw at her own discretion.
Repayment Requirements: Standard mortgages usually require periodic payments that reduce the balance, or at least cover the interest. Most are fully amortizing, meaning that the payments reduce the balance to zero over the term of the loan. Those

that are not fully amortizing require that the balance be repaid in full at the end of the term, called a “balloon”, or after a specified period.

Reverse mortgages, in contrast, have no required payments, but borrowers are free to make voluntary payments to reduce their balance.
Debt Changes Over Time: On standard mortgages that require amortization, the debt outstanding gradually declines over time. On those that require only interest payments, the balance is constant until the date when fully amortizing payments begin, at which point the balance begins to decline. Standard mortgages on which the balance rises, referred to as “negative amortization loans”, disappeared after the financial crisis.

On reverse mortgages, in contrast, debt tends to rise over time as interest accrues, since there are no required payments.

The table below summarizes the major differences between HECM reverse mortgages and standard mortgages:

Characteristic	HECM Reverse Mortgage	Standard Mortgage
Purpose	Provide spendable funds to existing homeowner of advanced age	Facilitate purchase of a house
Eligibility Requirements	1. Minimum age 2. Equity in owner-occupied home	1. Capacity to make required payment 2. Capacity to make required down payment 3. Acceptable credit record
Lender Protection	Property collateral only	Borrower’s ability/willingness to repay Property collateral as backup
Loan Amount Determinants	Amount of equity in the property Borrower’s age	Property value Borrower’s income Borrower’s credit Borrower’s financial assets
Payout of Funds	1. Cash withdrawal at outset, and/or 2. Monthly payment, and/or 3. Future draws under credit line	Withdrawal at outset used for home purchase

Repayment Requirements	No periodic payments required Balance due on death of borrower or permanent move-out	Monthly periodic payments usually required Payments of balance outstanding ("balloon") may be required
Debt Changes Over Time	Rises over time as interest accrues	Declines over time from principal payments

4. How Do HECM Reverse Mortgages Differ From Other Reverse Mortgage Programs?

This is a difficult question to answer because there have been many such programs both in the US and abroad, and they differ in many ways. In general, the HECM reverse mortgage is unusual in having the Government assume the risk of loss, in requiring that all HECM borrowers be counseled by an independent party before signing a contract, and in offering multiple ways in which funds can be drawn to meet a variety of different purposes.

5. How Are a Borrower's Rights of Ownership Affected by a HECM Reverse Mortgage?

They are affected only in that a lien is placed on the property to assure that the borrower meets the obligations specified in the loan contract. This is the same as with a standard mortgage, except that with a standard mortgage borrowers have a monthly payment obligation and on a HECM reverse mortgage they don't.

6. What Are the Borrower's Obligations on a HECM Reverse Mortgage?

While there is no loan repayment obligation on a HECM, the borrower is obliged to pay the property taxes, to keep adequate homeowners insurance in place, and to maintain the property. A borrower who has someone living with them who is not a party to the HECM contract, such as a spouse not yet 62, also has a moral obligation to that person. The obligation is to inform that person that they will have to vacate the house if the borrower dies or moves out of the house permanently.

7. How Does a Reverse Mortgage Affect the Size of the Borrower's Estate?

The borrower's estate receives the equity in the property at the time the borrower dies or moves out permanently. The equity equals the property value net of transaction costs realized through sale, less the balance on the reverse mortgage.

Some HECM options deplete the estate more than others. Cash withdrawals at the beginning will reduce it the most, credit lines that are rarely used will reduce it the least, and monthly payment plans are somewhere in-between. In general, the longer the borrower remains in the house, the larger the depletion of equity.

8. Can the Borrower's Estate Obtain Title to the House After the Borrower Passes?

Yes, by paying off the HECM debt. If the value of the house exceeds the debt balance, no problem arises. But if the debt balance is more than the house is worth, the estate has to decide whether or not they want to incur the deficiency.

9. Are Seniors Who Take Out a HECM Reverse Mortgage at Risk of Losing Their Homes?

HECM borrowers retain legal ownership of their homes, in the same way as those who take a standard mortgage. In both cases, the only risks are those associated with borrower failure to meet their obligations under the mortgage contract, which means that the risk is entirely under their control.

While borrowers under a reverse mortgage contract have no obligation to make mortgage payments, they are obliged to pay their property taxes, keep their homeowners insurance current, and maintain their property. Failure to comply with these requirements puts them in default, and the lender (with FHA's permission) can institute foreclosure proceedings that would lead eventually to their eviction.

To date, the danger of eviction appears hypothetical. No one inspects HECM properties after the contract is finalized. While some HECM borrowers are in default on their property taxes, as far as we have been able to determine, there has been only one eviction ordered, and that was quickly rescinded. While there is always a first time, there is zero risk for borrowers who meet their obligations.

There is a risk to persons living with a HECM borrower but not covered by the HECM contract, who can be and in some cases have been evicted following the borrower's death. These have been mainly younger spouses and boarders. Such cases have been much publicized, in some cases sensationalized, by media that paint a picture of Government putting innocent people out on the street.

HECM borrowers who have others living with them who are not covered by the HECM contract have a moral obligation to inform those persons of the risk they bear. But this is not a risk to the HECM borrowers themselves.

10. Are HECM Reverse Mortgages Fixed-Rate or Adjustable Rate?

They can be either, but fixed-rate mortgages are available only when the borrower elects to draw all of the proceeds at the outset, with none of it reserved for possible future use. This may be appropriate in some circumstances, including where the HECM is used to purchase a house, or to pay off a sizeable amount of existing debt. Borrowers electing to receive monthly payments, and/or to reserve a credit line for possible future use, must take adjustable rate HECMs.

11. What Are the Upfront Costs of a HECM Reverse Mortgage?

The upfront cost of a HECM is the sum of the origination fee charged by the lender, third party fees including those for an appraisal and title insurance, and the upfront mortgage insurance premium charged by FHA. All of these fees can be (and almost always are) included in the mortgage – there is no cash outlay required of the borrower.

The origination fee HECM borrowers pay lenders is capped by law at $2500 on house values of $125,000 or less, at $4,000 on house values of $200,000 or less, and at $6,000 on values of $400,000 or more. Some HECM lenders charge less than these maximums.

While third party fees vary from one part of the country to another, there are no significant differences between HECMs and standard mortgages.

The upfront mortgage insurance premium is .5% of property value when the borrower draws no more than 60% of his total HECM borrowing power at closing or anytime within the first year. If the draws exceed 60%, the insurance premium is 2.5%. Since the maximum allowable draw is only 70%, borrowers should avoid exceeding the 60% limit if at all possible.

The 60-70% rule was introduced in September 2013 as part of a package of reforms designed to reduce losses to FHA, which were exceptionally high in cases where borrowers withdrew the maximum cash allowed at closing.

Some upfront draws are mandated by HUD, including draws used to pay off an existing mortgage loan balance, and to make important repairs to the house. If mandated draws exceed the 60% level, the borrower cannot avoid the 2.5% insurance premium.

12. What Are the Mortgage Insurance Premiums on a HECM?

Borrowers pay FHA an upfront premium equal to either .5% of property value or 2.5%, depending on the size of cash draws upfront and in the first year. See Question 11 above. The upfront premium is financed. Borrowers also pay a monthly premium on all HECMs equal to 1.25%/12, which is an add-on to the interest due. The premiums compensate FHA for the HECM risks it assumes.

13. Isn't a HELOC a Less Costly Source of Funds Than a HECM?

Yes, upfront costs on HELOCs are substantially lower than on HECMs, and the interest rat e is also lower. The two instruments are not comparable, however. On HELOCs, the borrower must pay interest out of pocket immediately, and at some point must begin paying principal. On HECMs, interest charges are financed and principal payment s are not required so long as the borrower lives in the house.

14. What Happens to the Borrower if the Debt Comes to Exceed the Value of the Property?

Nothing happens to the borrower, who retains the right to live there. The loss that occurs after the borrower dies or moves out permanently is absorbed by FHA's HECM reserve fund, which is financed by the mortgage insurance premiums paid by borrowers.

15. Can a HECM Be Refinanced?

Yes, but whether it is advantageous to do so is another question. It depends on the refinance cost relative to the increase in credit line that is available on the current HECM. If it costs $8,000 to refinance and your credit line rises by $40,000, you probably want to do it. If it costs $8,000 but your credit line rises only by $4,000, you probably don't. But you might, if you have zero interest in the size of your estate.

The required upfront mortgage insurance premium on a refinance is the premium on a new HECM less the upfront premium the borrower paid on the HECM originally.

The additional amount you can draw if you refinance depends on how much of your equity in the house you have already used, the extent to which your property value has changed since you took the original, interest rates now relative to then, and whether or not your original property value was higher than the FHA loan limit then. If that was the case, subsequent increases in the loan limits will increase the amounts you can draw under a refinance.

Under the law, the reverse mortgage loan provider must provide you with the total cost of the refinancing, and the increase in the amount you can draw. The counseling requirement is waived if the increase in the amount you can draw is at least 5 times as large as the refinancing cost, and less than 5 years have expired since the original transaction.

16. What Are the Options a Borrower Has For Drawing Funds on a HECM?

They can draw cash at closing, they can receive a monthly payment for a specified period or for as long as they reside in the house, and they can take a credit line upon which they can draw at their discretion at any future time. In addition, they can combine options, such as a cash withdrawal plus a monthly payment. They can also switch from one option to another, converting a monthly payment plan into a credit line, for example, or the reverse.
This flexibility allows HECMs to be used to meet a large variety of senior needs, as discussed in Matching Senior Needs to the Available HECM Options.

17. What Determines How Much a Borrower Can Receive on Any of the Various Options?

Under a HECM reverse mortgage program, the sole source of loan repayment is the eventual sale of the property. For the investor and/or insurer to avoid loss, the property value when the HECM terminates must be at least equal to the debt balance at that time plus the cost of selling the property, If the value is higher, the excess goes to the borrower if she has moved out of the house permanently, or to the borrower's estate if she has died. If the property value is less than the debt plus marketing cost, the loss is a charge against an FHA reserve account which is funded by mortgage insurance payments.

To minimize losses, draw amounts are calculated so that in the vast majority of cases, the loan balance is less than the recoverable property value at termination. This means that:

- The higher the current property value, the larger the allowable draws.
- The higher the interest rate used to calculate future loan balances, the smaller the allowable draws
- The higher the assumed rate of property appreciation, the larger the allowable draws.
- The higher the initial settlement costs on the HECM, the smaller the allowable draws.

In addition, it matters when draws are made: the maximum allowable monthly draw can sum to a total considerable larger than the maximum cash draw at closing.

18. Must I Pay Income Taxes on Funds Received from a HECM?

No, because the funds received are loans to you and loans are not taxable.

19. Are Interest Payments on a HECM Reverse Mortgage Deductible ?

Mortgage interest cannot be deducted until it is paid. It becomes deductible when the balance is repaid in full after your death or after you move out of the house permanently. If you remain in the house and make a partial prepayment, the payment is allocated first to the portion of the loan balance that represents mortgage insurance, then to the portion that represents servicing fees, and only then to the portion that represents interest. As a practical matter, therefore, partial prepayments would have to be quite sizeable before any part of them become deductible.

20. Will a HECM Reverse Mortgage Cause Me to Lose Public Assistance?

Not unless you manage your affairs carelessly. While eligibility for Medicaid and Supplemental Security Income (SSI) limits liquid assets to $2,000 for an individual and $3,000 for a married couple, it should be relatively easy to draw HECM funds as they are needed, avoiding sizeable asset accumulations. A HECM credit line is not counted as a liquid asset.

21. Why Is There So Much Bad Press About Reverse Mortgages?

There have been abuses of the HECM program by some seniors but nobody wants to depict seniors as abusers, so the press has converted them into abuses of seniors. SeeScare-Mongering the HECM Reverse Mortgage.