



Reverse Mortgages

August 2002

For homeowners who are age 62 or older and are “house-rich, cash-poor,” a reverse mortgage (RM) may be an option to help increase their income. However, because a person’s home is such a valuable asset, homeowners will want to consult with their family attorney or financial advisor before applying for an RM. Knowing their rights and responsibilities as borrowers may help to minimize the financial risks and avoid any threat of foreclosure or loss of home.

This technical bulletin will explain how RMs work. It describes similarities and differences among the three RM plans available today: FHA-insured; lender-insured; and uninsured. It also discusses the benefits and drawbacks of each plan. Each plan differs slightly, so homeowners will want to exercise care in selecting the plan that best meets their financial needs. Organizations and government agencies that offer additional information about RMs are listed at the end of this technical bulletin.

How Reverse Mortgages Work

A reverse mortgage is a type of home equity loan that allows a homeowner to convert some of the equity in the home into cash while at the same time retaining home ownership. RMs work much like traditional mortgages, only in reverse. Rather than making a payment to a lender each month, the lender pays the homeowner.

Unlike conventional home equity loans, most RMs do not require any repayment of principal, interest, or servicing fees for as long as the homeowner lives in his or her home. Funds obtained from an RM may be used for any purpose, including meeting housing expenses such as taxes, insurance, fuel, and maintenance costs.

Requirements and Responsibilities of the Borrower

To qualify for an RM, a borrower must own his or her own home. The RM funds may be paid to the borrower in a lump sum, in monthly advances, through a line-of-credit, or in a combination of the three, depending on the type of RM and the lender. The amount a borrower is eligible to borrow is generally based on the borrower’s age, the equity in the home, and the interest rate the lender is charging.

Because the homeowner retains title to the home with an RM, the homeowner also remains responsible for taxes, repairs, and maintenance. Depending on the plan selected, the RM becomes due with interest either when the borrower permanently moves, sells the home, dies, or reaches the end of the pre-selected loan term. The lender does not take title to the home when the borrower dies,

but the homeowner’s heirs must pay off the loan. The debt is usually repaid by refinancing the loan into a forward mortgage (if the heirs are eligible) or by using the proceeds from the sale of the home.

Common Features of Reverse Mortgages

- RMs are rising-debt loans. This means that the interest is added to the principal loan balance each month, because it is not paid on a current basis. Therefore, the total amount of interest owed increases significantly with time as the interest compounds.
- All three plans (FHA-insured, lender-insured, and uninsured) charge origination fees and closing costs. Insured plans also charge insurance premiums, and some impose mortgage servicing charges. A lender may permit a borrower to finance these costs so they will not have to be paid for in cash. However, these costs are added to the loan amount.
- RMs use up some or all of the equity in a home, leaving fewer assets for the homeowner and his or her heirs in the future.
- A borrower can generally request a loan advance at closing that is substantially larger than the rest of the payments.
- The borrower’s legal obligation to pay back the loan is limited by the value of the home at the time the loan is repaid. This could include increases in the value (appreciation) of the home after the loan begins.
- RM loan advances are nontaxable. Further, they do not affect Social Security or Medicare benefits. If a homeowner receives Supplemental Security Income, RM advances do not affect benefits as long as they are spent within the month they are received. This is true in most states for Medicaid benefits also. When in doubt, a homeowner should check with a benefits specialist at a local area agency on aging or legal services office.
- Some plans provide for fixed rate interest. Others involve adjustable rates that change over the loan term based upon market conditions.
- Interest on RMs is not deductible for income tax purposes until all or part of the total RM debt is paid off.

How Reverse Mortgages Differ

This section describes how the three types of RMs —FHA-insured, lender-insured, and uninsured—vary according to their costs and terms. Although the FHA and lender-insured plans

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appear similar, important differences exist. This section also discusses advantages and drawbacks of each loan type.

FHA-insured. This plan offers several RM payment options. A borrower may receive monthly loan advances for a fixed term or for as long as he or she lives in the home, a line of credit, or monthly loan advances plus a line of credit. This RM is not due as long as the homeowner lives in the home. With the line of credit option, a borrower may draw amounts as needed over time. Closing costs, a mortgage insurance premium, and sometimes a monthly servicing fee are required. Interest is charged at an adjustable rate on the loan balance; any interest rate changes do not affect the monthly payment, but rather how quickly the loan balance grows over time.

The FHA-insured RM permits changes in payment options at little cost. This plan also protects the homeowner by guaranteeing that loan advances will continue to be made even if a lender defaults. However, FHA-insured RMs may provide smaller loan advances than lender-insured plans. Also, FHA loan costs may be greater than uninsured plans.

Lender-insured. These RMs offer monthly loan advances or monthly loan advances plus a line of credit for as long as a homeowner in his or her home. Interest may be assessed at a fixed rate or an adjustable rate, and additional loan costs can include a mortgage insurance premium (which may be fixed or variable) and other loan fees.

Loan advances from a lender-insured plan may be larger than those provided by FHA-insured plans. Lender-insured RMs also may allow a borrower to mortgage less than the full value of the home, thus preserving home equity for later use by the homeowner or the heirs. However, these loans may involve greater loan costs than FHA-insured or uninsured loans. Higher costs mean that the loan balance grows faster, leaving the homeowner with less equity over time.

Some lender-insured plans include an annuity that continues making monthly payments to a borrower even if the borrower sells his or her home and moves. The security of these payments depends on the financial strength of the company providing them, so borrowers must be careful to check the financial ratings of the company. Annuity payments may be taxable and affect eligibility for Supplemental Security Income and Medicaid. These “reverse annuity mortgages” may also include additional charges based on increases in the value of the home during the term of the loan.

Uninsured. This RM is dramatically different from FHA and lender-insured RMs. An uninsured plan provides monthly loan advances for a fixed term only—a definite number of years that a borrower selects when first taking out the loan. The loan balance becomes due and payable when the loan advances stop. Interest is usually set at a fixed interest rate and no mortgage insurance premium is required.

Borrowers considering an uninsured RM usually think carefully about the amount of money they need monthly; how many years they may need the

money; how they will repay the loan when it comes due; and how much remaining equity they will need after paying off the loan.

If a homeowner has short-term but substantial cash needs, the uninsured RM can provide a greater monthly advance than the other plans. However, because the loan must be paid back by a specific date, borrowers must be sure to have a source of repayment. If a homeowner is unable to repay the loan, he or she may have to sell the home and move.

Reverse Mortgage Safeguards

One of the best protections borrowers have with RMs is the Federal Truth in Lending Act, which requires lenders to inform borrowers about a plan’s terms and costs. Homeowners should understand them clearly before signing. Among other information, lenders must disclose the Annual Percentage Rate (APR) and payment terms. On plans with adjustable rates, lenders must provide specific information about the variable rate feature. On plans with credit lines, lenders also must inform borrowers of any charges to open and use the account, such as an appraisal, a credit report, or attorney’s fees.

For More Information

For a current list of lenders participating in the FHA-insured program, sponsored by the Department of Housing and Urban Development (HUD), or additional information on reverse mortgages and other home equity conversion plans, write to AARP Home Equity Information Center American Association of Retired Persons 601 E Street, N.W. Washington, D.C. 20049

More information is available from the National Center for Home Equity Conversion 7373 – 147 St. West, Suite 115 Apple Valley, MN 55124. This organization requests a self-addressed stamped envelope.

This information was provided by the FTC in cooperation with the American Association of Retired Persons and the National Center or Home Equity Conversion.

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