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Your Home Newsletter

If you own your home, it's likely to be your greatest single asset. Unfortunately, if you agree to a loan that's based on the equity you have in your home, you may be putting your most valuable asset at risk. This issue of Dollars & Sense discusses why it's important to think twice before using your home as collateral to obtain a loan. This issue also provides tips for shopping around for a loan and choosing a lender, lists early warning signs of untrustworthy lenders to be aware of, and also discusses the ins and outs of reverse mortgages. ■

How Reverse Mortgages Work

In a "regular" mortgage, you make monthly payments to the lender. But in a "reverse" mortgage, you receive money from the lender and generally don't have to pay it back for as long as you live in your home. Instead, the loan must be repaid when you die, sell your home, or no longer live there as your principal residence. Reverse mortgage loans can be received in a lump sum, a monthly advance, a line of credit, or a combination of all three—while you continue to live in your home. To qualify for a reverse mortgage, you must own your home. The amount you are eligible to borrow generally is based on your age, the equity in your home, and the interest rate the lender is charging. Funds you receive from a reverse mortgage may be used for any purpose.

With a reverse mortgage, you retain title to your home. You are responsible for maintaining your home and paying all real estate taxes. Depending on the plan you select, your reverse mortgage becomes due with interest when you move, sell your home, reach the end of a pre-selected loan period, or die. When you die, the lender does not take title to your home, but your heirs must pay off the loan. Usually, the debt is repaid by selling the home or refinancing the property.

Three Types of Reverse Mortgages

The three basic types of reverse mortgages are: 1) single-purpose reverse mortgages, which are offered by some state and local government agencies and nonprofit organizations; 2) federally-insured reverse mortgages, which are known as Home Equity Conversion Mortgages (HECMs), and are backed by the U. S. Department of Housing and Urban Development (HUD); and 3) proprietary reverse mortgages, which are private loans that are backed by the companies that develop them.

Single-purpose reverse mortgages generally have very low costs. But they are not available everywhere, and they only can be used for one purpose specified by the government or nonprofit lender, for example, to pay for home repairs, improvements, or property taxes. In most cases, you can qualify for these loans only if your income is low or moderate.

HECMs and proprietary reverse mortgages tend to be more costly than other home loans. The up-front costs can be high, so they are generally most expensive if you stay in your home for just a short time. They are widely available, have no income or medical requirements, and can be used for any purpose.

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Need a Loan? Think Twice About Using Your Home as Collateral

If you need money to pay bills or make home improvements, and wonder whether the answer is in refinancing your home mortgage, taking out a second mortgage, or signing up for a home equity loan, consider your options carefully. As explained by the Federal Trade Commission (FTC) in cooperation with the American Association of Retired Persons (AARP), if you can't make the required payments, you could lose your home as well as the equity you've built up. That's why it's important not to let anyone talk you into using your home to borrow money you may not be able to afford to pay back.

Not All Loans are Created Equal

The fact is, not all loans or lenders are created equal. Some unscrupulous lenders target older or low-income homeowners and those with credit problems. These lenders may offer loans based on the equity in your home, not on your ability to repay the loan. High interest rates and credit costs can make it very expensive to borrow money, even if you use your home as collateral.

Before you make any decisions about borrowing money, talk to an attorney, financial advisor, or someone else you trust. You can take some steps to protect your home and the equity you've built up in it. Here's how.

1. Shop around. Costs can vary greatly.

Contact several lenders—including banks, savings and loans, credit unions, and mortgage companies. Ask each lender about the best loan you would qualify for. It's wise to compare:

- The annual percentage rate (APR). The APR is the single most important thing to compare when you shop for a loan. It takes into account not only the interest rate, but also points (one point equals one percent of the loan amount), mortgage broker fees, and certain other credit charges the lender requires the borrower to pay, expressed as a yearly rate. Generally, the lower the APR, the lower the cost of your loan. Ask if the APR is fixed or adjustable—that is, will it change? If so, how often and how much?
- Points and fees. Ask about points and other fees that you'll be charged. These charges may not be refundable if you refinance or pay off the loan early. And if you refinance, you may pay more points. Points usually are paid in cash at closing, but may be financed. If you finance the points, you'll have to pay additional interest, increasing the total cost of your loan.
- The term of the loan. How many years will you make payments on the loan? If you're getting a home equity loan that consolidates credit card debt and other shorter-term loans, remember that the new loan may require you to make payments for a longer time.
- The monthly payment. What's the amount? Will it stay the same or change? Find out if your monthly payment will include escrows for taxes and insurance.
- Balloon payments. This is a large payment usually at the end of the loan term, often after a series of lower monthly payments. When the balloon payment is due, you must come up with the money. If you can't, you may need another loan, which means new closing costs, as well as points and fees.
- Prepayment penalties. Prepayment penalties are extra fees that may be due if you pay off the loan early by refinancing or selling your home. These fees may force you to keep a high-rate loan by making it too expensive to get out of the loan. If your loan includes a prepayment penalty, understand the penalty you would have to pay. Ask the lender if you can get a loan without a prepayment penalty, and what that loan would cost. Then decide what's right for you.
- Whether the interest rate for the loan will increase if you default. An increased interest rate provision says that if you miss a payment or pay late, you may have to pay a higher interest rate for the rest of the loan term. Try to negotiate this provision out of your loan agreement.
- Whether the loan includes charges for any type of voluntary credit insurance, like credit life, disability, or unemployment insurance. Will the insurance premiums be financed as part of the loan? If so, you'll pay additional interest and points, further increasing the total cost of the loan. How much lower would your monthly loan payment be without the credit insurance? Will the insurance cover the length of your loan and the full loan amount? Before you decide to buy voluntary credit insurance from a lender, think

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about whether you really need the insurance and check with other insurance providers about their rates.

You'll also want to ask each lender to provide, as soon as possible, a written Good Faith Estimate that lists all charges and fees you must pay at closing. Ask for a Truth in Lending Disclosure, too. It states the monthly payment, the APR and other loan terms. Although lenders are not always required to provide these estimates, they're very helpful because they make it easier to compare terms from different lenders.

Early Warning Signs of Untrustworthy Lenders

As mentioned earlier in this newsletter, not all loans or lenders are created equal. Some unscrupulous lenders may offer loans based on the equity in your home, not on your ability to repay the loan. High interest rates and credit costs can make it very expensive to borrow money, even if you use your home as collateral. If you do need to apply for a mortgage loan, make sure you avoid any lender who:

- Pressures you into applying for a loan or applying for more money than you need.
- Pressures you into accepting monthly payments you can't make or could have trouble making.
- Tells you to falsify information on the loan application. For example, stay away from a lender who tells you to say that your income is higher than it is.
- Fails to provide required loan disclosures or tells you not to read them.
- Misrepresents the kind of credit you're getting, like calling a one-time loan a line of credit.
- Promises one set of terms when you apply, and gives you another set of terms to sign—with no legitimate explanation for the change.
- Tells you to sign blank forms—and says they'll fill in the blanks later.
- Says you can't have copies of the documents that you've signed.

2. After Choosing a Lender

- Negotiate. It never hurts to ask if the lender will lower the APR, take out a charge you don't want to pay, or remove a loan term that you don't like.
- Ask the lender for a blank copy of the form(s) you will sign at closing. While they don't have to give you blank forms, most legitimate lenders will. Take the forms home and review them with someone you trust. Ask the lender about items you don't understand.
- Ask the lender to give you copies of the actual documents that you'll be asked to sign as soon as possible. While a lender may not be required to give you all of the actual filled-in documents before closing, it doesn't hurt to ask.
- Be sure you can afford the loan. Figure out whether your monthly income is enough to cover each monthly payment, in addition to your other monthly bills and expenses. If it isn't, you could lose your home—and your equity—through foreclosure or a forced sale.
- If you are refinancing a first mortgage, ask about escrow services. Ask if the loan's monthly payment includes an escrow amount for property taxes and homeowner's insurance. If not, be sure to budget for those amounts, too.

3. At Closing

- Before you sign anything, ask for an explanation of any dollar amount, term or condition that you don't understand.
- Ask if any of the loan terms you were promised before closing have changed. Don't sign a loan agreement if the terms differ from what you understood them to be. For example, a lender should not promise a specific APR and then—without good reason—increase it at closing. If the terms are different, negotiate for what you were promised. If you can't get it, be prepared to walk away and take your business elsewhere.
- Before leaving the lender, make sure you get a copy of the documents you signed. They contain important information about your rights and obligations.
- Don't initial or sign anything saying you're buying voluntary credit insurance unless you really want to buy it.

4. After Closing

Having second thoughts about the loan? The Truth in Lending Act gives most home equity borrowers at least

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Reverse Mortgages (continued)

Before applying for a HECM, you must meet with a counselor from an independent government-approved housing counseling agency. The counselor must explain the loan's costs, financial implications, and alternatives. For example, counselors should tell you about government or nonprofit programs for which you may qualify, and any single-purpose or proprietary reverse mortgages available in your area.

The amount of money you can borrow with a HECM or proprietary reverse mortgage depends on several factors, including your age, the type of reverse mortgage you select, the appraised value of your home, current interest rates, and where you live. In general, the older you are, the more valuable your home, and the less you owe on it, the more money you can get.

The HECM gives you choices in how the loan is paid to you. You can select fixed monthly cash advances for a specific period or for as long as you live in your home. Or you can opt for a line of credit, which allows you to draw on the loan proceeds at any time in amounts that you choose. You also can get a combination of monthly payments plus a line of credit.

HECMs generally provide larger loan advances at a lower total cost compared with proprietary loans. But owners of higher-valued homes may get bigger loan advances from a proprietary reverse mortgage. That is, if you have a higher appraised value without a large mortgage, then you may likely qualify for greater funds. Location (for example, your neighborhood) is only one part of the determination of appraised value.

Reverse Mortgage Safeguards

The federal Truth in Lending Act (TILA) is one of the best protections you have with a reverse mortgage. TILA requires lenders to disclose the costs and terms of reverse mortgages. This includes the Annual Percentage Rate (APR) and payment terms. If you choose a credit line as your loan advance, lenders also must tell you of charges related to opening and using your credit account.

Facts to Consider about Reverse Mortgages

- Reverse mortgages are rising-debt loans. The interest is added to the principal loan balance each month, because it is not paid on a current basis. The amount you owe increases over time as the interest compounds. Some reverse mortgages have fixed-rate interest; others have adjustable rates that can change over the lifetime of the loan.
- Reverse mortgages use up some or all the equity in your home, leaving fewer assets for you and your heirs.
- Reverse mortgages typically charge loan-origination fees and closing costs. Insured plans charge insurance premiums; some plans have mortgage servicing fees. You may be able to finance these costs if you want to avoid paying them in cash. But, if you finance the costs, they will be added to your loan amount and you will pay interest on them.
- Your legal obligation to repay the loan is limited by the value of your home at the time the loan is repaid. This could include any appreciation in the value of your home after your loan begins.
- There are various reverse mortgage plans offered today. Consult your attorney or financial advisor about the tax consequences of the particular plan you are considering. ■

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three business days after closing to cancel the deal. This is known as your right of "rescission." To rescind, you must notify the creditor in writing. Make sure you document your rescission. Send your letter by certified mail, and request a return receipt. That will allow you to document what the creditor received and when. Keep copies of your correspondence and any enclosures. After you rescind, the lender has 20 days to return the money or property you paid to anyone as part of the credit transaction and release any security interest in your home. ■

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