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Reverse Mortgages for Seniors

For seniors being squeezed by low incomes and rising costs for health care, property taxes, and more, reverse mortgages can provide needed financial relief. But before taking out a loan one should understand the potential consequences and consider other alternatives.

The record low interest rates of the past few years have been especially hard for seniors who depend on the interest income generated by their savings. At the same time, the housing boom has sharply increased the value of many seniors' homes. As a result, growing numbers of retirees are "house rich and cash poor." Not surprisingly, some have been turning to reverse mortgages to help supplement their incomes.

A reverse mortgage is a loan that allows you to convert the equity in your house into spendable cash. You can take a lump sum, a line of credit, or a series of annuity-like monthly payments, or any combination of these. The payments from a reverse mortgage are tax-free, there are no minimum income requirements, and they can usually be used for any purpose.

No mortgage payments are due as long as you live in the house. The loan (principal plus accrued interest) must be repaid when you sell the house, move out permanently, or die. It also may become due if you fail to pay property taxes or do not adequately maintain the house. In addition, the interest on a reverse mortgage is not deductible on income tax returns until the loan is paid. The loans are generally available only to people 62 or older.

There are two "reverse" aspects to these loans. One is the nature of the monthly payment. With a conventional loan, you (the borrower) make a monthly payment to the bank (the lender). With a reverse mortgage, however, the lender makes a monthly payment to you. Second, with a conventional mortgage you pay off the debt over the life of the loan; as your debt shrinks, your equity in the house increases. With a reverse mortgage, the opposite occurs; your debt increases over the life of the loan and your equity in the house shrinks.

The most popular reverse mortgage program is the Department of Housing and Urban Development's (HUD) Home Equity Conversion Mortgage (HECM), which is insured by the Federal Housing Administration. The HECM program sets regional loan limits that currently range from $160,000 in rural regions to $290,000 in major metropolitan areas (in 2004).

Within limits, the amount you may borrow depends on three factors: your age, the value of your house, and the level of interest rates. The older you are, the more you can borrow.

The HECM program currently allows a 65-year old who owns a home worth, say, $200,000 to borrow a maximum of $115,000. A 75-year old may borrow up to $133,000 on such a home, and an 85-year old may borrow $152,000. If a couple owns a home jointly, the amount they can borrow is based on the age of the younger co-owner. (Thus if your spouse is under the age of 62, you probably would not be eligible for a reverse mortgage.)

If you choose to receive a monthly check, the amount you receive is based on your age, much like an annuity. You can choose a "term" benefit, which provides a fixed monthly amount for a specified number of years. For example, you would get payments for 10 years and nothing after that. Alternatively, you can select a "tenure" benefit that provides a monthly payment for as long you live in your house. This payment continues even if the debt increases to more than the value of the house. Currently, a 75-year old with a $200,000 house would get a maximum of $862 per month under the tenure plan.

The Effect of Interest Rates

The lower the level of interest rates, the more cash you can get. This is one reason that reverse mortgage loans have become more popular. With rates currently near record lows, you can borrow more through these loans than ever before. The $115,000 that a 65-year old could borrow against a $200,000 house, as noted above, would be much less if interest rates were higher. For example, when the HECM reverse mortgage rates were almost nine percent, a 65-year old could have borrowed only $52,000.

The table below shows how much you could borrow at various interest rates, if the value of your home were $200,000.

All HECM reverse mortgages have adjustable rates. With a conventional mortgage loan, a variable rate means that your mortgage payments may vary from one month to the next. With a reverse mortgage, the variable rate determines how fast your debt increases over the life of the loan and how much you will owe when you (or your heirs) sell the house. If the interest rate is adjusted upward, the amount you owe will increase at a faster rate. However, the amount of money you receive monthly (should you choose that option) will not change regardless of what happens to rates.

The rate charged on HECM reverse loans is pegged to that for one-year Treasury securities. Depending on the type of loan you choose, it is adjusted monthly or annually. In recent years, the rate on annually-adjustable loans has been set at 2.1 percentage points above the Treasury rate. It cannot change by more than two points up or down in a given year, or by more

HECM Lump Sum or Line of Credit

Maximum lump sum or line of credit when home value is $200,000 and initial mortgage rate is:

Age	*6%*	*7%*	*8%*
65	$103,207	$83,323	$66,955
75	$123,332	$107,715	$93,648
85	$144,937	$134,344	$124,132

Source: AARP.

Reverse Mortgage vs. Home Equity Loan

A more straightforward way to convert the equity in your house into cash is to take out a home equity loan or line of credit. The closing costs on reverse mortgages are much higher than for home equity loans—some home equity loans have no closing costs at all. You do have to make monthly interest payments on a home equity loan, but these can be added to the loan. You do not have to repay the principal until the end of the loan's term, typically 10 years. For seniors interested in getting a lump sum or a line of credit, a home equity loan usually is preferable to a reverse mortgage.

than five points either way over the life of the loan. The rate on monthly-adjustable loans is lower—1.5 points above the Treasury rate—but it can change by as much as 10 percentage points over the life of the loan. You can also get a larger loan by choosing the monthly-adjustable loan.

The rates on HECM loans recently have been extraordinarily low. If rates increase, the debt on such loans will build up at a faster pace. However, there is a limit to this increase. *Although your loan will grow each month (even after your death) until the reverse mortgage is paid, your debt can never exceed the value of your home, even if the cash you received is more than the value of your home.*

What happens to the equity in your home as the debt on a reverse mortgage rises? The answer depends on the future change in the value of your house. If the value of your house stays the same or falls over the life of the loan, clearly the rising debt will erode your equity. If house prices rise, your equity will not fall as fast, and if your home's value appreciates rapidly your equity may even increase.

Closing Costs and Fees

Interest rates on HECM loans do not vary from lender to lender, but other charges might. These include the usual closing costs for a loan, such as the lender's origination fee (which can range from about $1,800 all the way up to two percent of your home's value) and fees for appraisal, inspection, survey, a credit report, title insurance, pest inspection, and legal services. There also is a loan servicing fee that usually ranges between $30 and $35 per month.

In addition, HECM loans require you to pay two mortgage insurance premiums, which cover the lender's risk that the outstanding balance on the loan may someday exceed the resale value of your house. There is an up-front premium of two percent of the lesser of the home's value or the HECM loan limit in your area. (Thus, if you borrow $50,000 against a $200,000 house, you pay two percent of $200,000). There also is a monthly premium equal to 0.5 percent per year of the (rising) mortgage balance. The cost of this premium is added to the balance of the loan rather than paid out of pocket.

A recent rule change gives seniors credit for the insurance premiums they paid in their original loan, in the event they refinance the loan. Therefore, if they refinance an additional amount they pay a premium only for the increased value of their home.

Total upfront closing costs typically run about $10,000 or more. Most of these can be paid for by adding them to the loan. For example, if a senior were entitled to take out a $115,000 loan, he might finance $10,000 of fees through the loan itself, leaving him with $105,000 in a lump sum.

The Federal HECM loan program is by far the most popular type of reverse mortgage. Any lender authorized to make HUD (Housing and Urban Development)-insured loans, such as banks, mortgage companies, and savings and loan associations, can participate in the HECM program, although only a small number actually offer them. To be eligible for a loan, the house must be your principal residence, be at least one year old, and meet minimum property standards. (You can usually use the proceeds from the reverse mortgage loan to pay for any repairs that may be required).

In addition, before getting an HECM loan you are required to speak with a counselor from an approved counseling agency, either in person or by phone. The counselor will talk about the financial implications of reverse mortgages and discuss other options that might be available to you. However, few counselors have much experience because, despite recent growth, the reverse mortgage market is still tiny. Fewer than 20,000 loans were made last year nationwide. Thus, informed counselors may be hard to find.

There are other kinds of reverse mortgages besides the FHA's HECM loan. "Single-purpose" loans are offered by some state and local government agencies for a specific purpose, such as to pay property taxes. Fannie Mae offers the HomeKeeper loan, and some banks and other lenders offer their own proprietary plans. The interest rates, loan limits, service fees, and other provisions vary. Since HECM loans are usually the least expensive, the primary attraction of the other reverse mortgage loans is their higher loan limits.

Pause Before Hitting Reverse

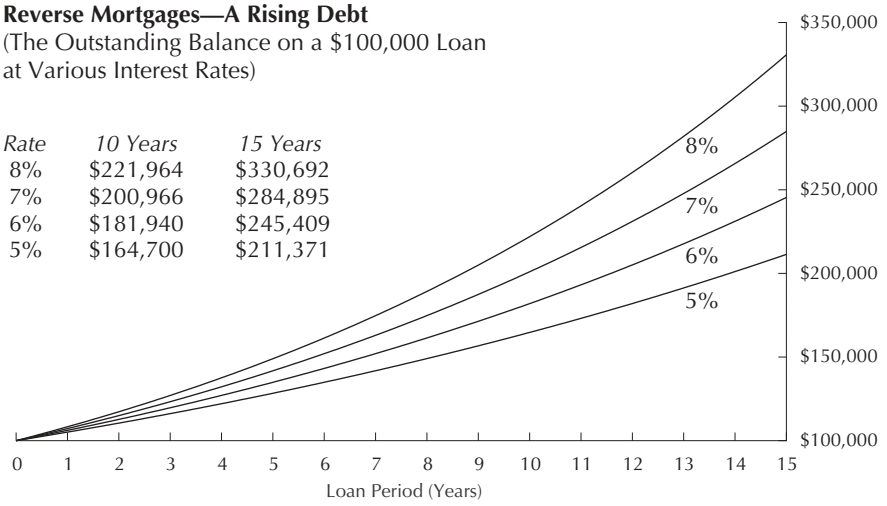
Under the right circumstances, when a senior is fully informed and understands the financial costs and consequences of a reverse mortgage, this type of loan can provide needed financial relief. However, these expensive and complicated loans are not for everyone.

The closing costs on reverse mortgages are high. This is especially significant if the term of the loan turns out to be short. In effect, you (or your estate) may end up paying a lot of money for a short-term loan. This is not an insignificant consideration, given that more than 25 percent of applicants are 80 or older, according to one study.

More important, the rising debt on these loans can quickly eat away your equity in your home. The rate at which your equity decreases depends on what hap-

Reverse Mortgages—A Rising Debt
(The Outstanding Balance on a $100,000 Loan at Various Interest Rates)

Rate	*10 Years*	*15 Years*
8%	$221,964	$330,692
7%	$200,966	$284,895
6%	$181,940	$245,409
5%	$164,700	$211,371



pens to interest rates and the value of your house. Falling rates and rising home values work to your advantage. Conversely, the "perfect storm" would be rising rates and a decrease in your home's value, a combination that could rapidly deplete your equity.

The chart on the previous page illustrates the increasing amount of debt that would be owed over time if a borrower took a lump sum reverse mortgage loan of $100,000 and the interest rate averaged five, six, seven or eight percent over the life of the loan.

In addition, some loans include a "shared equity" provision, whereby the lender shares a percentage of any increase in the house's value when the house is sold. This is a good proposition for the lender but a bad one for the borrower.

As noted earlier, your debt can never exceed the value of your house, and you do not have to repay it as long as the house is your primary residence. Even if you spend all your proceeds from the loan, it will not be due until you move out. Thus, high costs, rising debt, and depleted equity might not matter to you—*if* you are willing and able to stay in your current home for the rest of your life, and if leaving the house to heirs is not a concern.

Will You Stay in Your Home?

However, one's preferences and circumstances can change. In this regard, health is a primary consideration in whether you stay in your house. According to one study by the National Center on Health Statistics, about 35 percent of those aged 80 or older need assistance as a result of a disability. Yet many older homeowners live in houses that were not built to accommodate the needs of seniors who use assistive devices, such as wheelchairs and walkers. At the same time, since the home typically accounts for a large portion of a senior's net worth, many older individuals should weigh carefully all possible options, such as downsizing to a condominium or some type of assisted housing, versus taking a reverse mortgage. Alternative living arrangements for seniors are more widely available now than in years past. They are not for everyone, but some seniors eventually require their services while others may someday prefer their amenities and companionship to living alone.

Other reasons besides health can affect where you want to live. You might decide to downsize or to move to a warmer climate. You might want to be closer to your children. Or the "old neighborhood" might change so much that leaving it no longer seems unthinkable.

In short, the vicissitudes of life and age suggest you should try to keep your options open. But a reverse mortgage can limit your options. If your house is your biggest asset and you use up the equity in a reverse mortgage, you might not be able to afford to move.

A reverse mortgage should be regarded as a loan of last resort. It is an expensive loan that can tie you to your house. Depending on how fast the debt eats into your equity and what your other financial resources are, it may limit your financial flexibility to move. It is important to consider alternatives, which include selling your house, taking out a home equity loan, tapping further into the principal of your financial assets, cutting expenses, and asking your children for assistance. You also should look into any state or local programs designed to offer seniors (or veterans) relief from property taxes, prescription-drug costs, and other expenses. A reverse mortgage is the best option usually when it is the *only* option available to help a senior maintain independence for the foreseeable future. ❑

THE FLEXDOLLAR WELFARE STATE*

Some conservatives think the way to shrink government is to provide more "choices" in government programs (e.g., Medicare, Social Security, education). However, these experiments may be too timid and flawed to succeed.

> Freddie Mac provides its employees FlexDollars to help pay for the benefits our employees select. These funds offset the cost of employee's medical, dental, vision, life insurance and vacation purchased.
>
> — Freddie Mac web site

As pundits geared up for the 2004 Presidential campaign, a number of President Bush's defenders have argued that he is redefining conservatism. Rather than shrinking government, the President is, like Freddie Mac, giving people more choices within their menu of benefits. One might say that, according to these pundits, the new conservative ideal is the FlexDollar Welfare State.

For example, George Will writes:

> Today "strong government conservatism"—"strong" is not synonymous with "big"—is the only conservatism palatable to a public that expects government to assuage three of life's largest fears: illness, old age and educational deficits that prevent social mobility.

And in *Commentary* magazine, Daniel Casse writes:

> …such conservative causes as school vouchers, modernized weapons systems, and privatized Social Security all require expanding the role of government...What it comes down to is that, for Bush, there are conservative goals that take precedence over limiting the reach of government.

Casse cites an essay late last year from Michael Barone, which Casse says "suggested that Bush has successfully replaced the conservative touchstones of small government and spending cuts with the bolder, more inspirational ideas of choice and accountability."

The Bush-friendly conservative pundits cite Administration initiatives on school testing, health care spending accounts, and private accounts for Social Security as evidence of the new focus on choice. The argument is that once these initiatives are in place, they can be expanded to make choice available to more Americans, giving us the sort of flexibility provided by Freddie Mac and other companies that offer "cafeteria-style" benefits.

My own view is that it is very risky for Republicans and conservatives to embrace the FlexDollar welfare state. The reforms involved may be too timid and peripheral to have any lasting meaning. I fear that, like the drip castles that my daughters and I like to build when we go to the seashore, whatever minuscule reforms are enacted during this era of Republican ascendancy will be washed away the next time that the tide sweeps the Democrats into power.

Oxymoronic Benefits

The term "company benefits" is an oxymoron. When the company gives you "benefits," it takes away more than that in salary. Why, then, do so many people like to work for companies with "good benefits?" For example, if you could buy health insurance for $4,000, then why would you want to have $5,000 less in

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* This article is by Arnold Kling, who holds a Ph.D. in economics from the Massachusetts Institute of Technology and was an economist with the Federal Reserve Board. It first appeared in Tech Central Station (www.techcentralstation.com), a website for which Mr. Kling is a contributing editor. We are grateful for permission to reprint it. Related articles cited by Mr. Kling may be viewed at this website.

salary in order to have health insurance paid for?

Many economists, including Milton Friedman, speculate that tax arbitrage is the main reason that companies offer health insurance and other benefits. Salary is subject to tax, but benefits are not, so that on an after-tax basis a worker might be better off with non-cash benefits.

I am not sure that I find this explanation convincing. Contrary to my training as an economist, I believe that at least some of the preference that workers have for in-kind benefits reflects flat-out irrationality. Even without tax arbitrage (and, after all, something like half the population pays no income tax and therefore does not even participate in tax arbitrage), many workers would choose to receive $4,000 in health insurance rather than take $5,000 in salary, even though the latter would allow them to buy health insurance and have $1,000 left over. (See my earlier essay, "America is Crazy.")

In a world with rational workers, and certainly in such a world without tax distortions, companies with "good benefits" would be shunned in favor of companies that paid better salaries. Company benefits would disappear. As it is, the oxymoron of company benefits seems to fool most people.

What is interesting is that workers are not naturally suspicious of companies that pay "good benefits." Apparently, most people believe that "good benefits" reflect generosity and sharing by the company, rather than a shrewd, calculated effort to save on compensation costs. My guess is that the people who see through the scam of "good benefits" tend to gravitate toward self-employment, which allows them to take their payments in cash and buy benefits themselves.

The Oxymoron of Welfare State Benefits

Like company benefits, the concept of middle-class benefits in the form of government programs in education, health care, and Social Security is an oxymoron. On average, the value of what we receive is less than the value of the taxes that we pay to support these programs. That is because tax collection is not a costless process. Taxes create considerable friction in the economy by distorting choices. Payroll taxes penalize work. Personal and corporate income taxes penalize thrift. The lost output and reduced capital stock that result represents what economists call "deadweight loss," and it amounts to trillions of dollars. In the case of Social Security, for example, see "Privatizing Social Security: The $10 Trillion Opportunity," by Martin Feldstein (at www.cato.org).

As with corporate benefits, I am not sure why the public does not see through the scam of government benefits for the middle class. However, one possible reason that people underestimate the cost of the welfare state is that much of that cost has been shifted into the future. The taxes that will be required tomorrow to meet the promises that we make with Medicare and Social Security today are staggering to contemplate.

If Social Security and Medicare were defined-contribution plans, in which the money you spend in old age comes from principal and interest on the money you pay into the plans while you work, then they might be perceived differently. People would see a stronger connection between taxes and benefits.

If taxpayers were carefully comparing the benefits of government programs with the costs of funding those programs, then government provision of education, health care, and pensions would disappear. We would be better off taking care of these needs as individual families, while using a progressive consumption tax to provide for the poor. (See my essay, "Bleeding-Heart Libertarianism.")

As that essay pointed out, public education, Medicare, and Social Security are the drivers of big government. Public works projects (i.e., pork), agricultural subsidies, and other programs that pundits like to rail against, are a drop in the bucket by comparison. No conceivable cuts in domestic discretionary spending could offset the tax revenue increases needed to fund Medicare in the middle of this century. As satisfying as it might be to conservatives to see President Bush veto some spending bills, such moves would be symbolic rather than substantive.

Experiments with Autonomy

Large segments of the population are afraid of privatized Social Security, school vouchers, and paying for medical care as individuals rather than collectively. That is the political reality that is leading the Bush Administration toward the FlexDollar Welfare State.

Because most of the public does not recognize that middle-class benefits are an oxymoron, the Bush Administration is offering alternatives only in small, experimental stages. Instead of fully privatizing Social Security, the President proposes a partial privatization plan — and even that probably will be badly compromised in Congressional negotiations. Instead of school vouchers, the President has offered limited choice to parents of children in "failing schools." Rather than scale back promised Medicare benefits for future recipients, the Administration has set up experiments with medical savings accounts and incentives to purchase catastrophic rather than first-dollar medical coverage.

If the experiments develop enough success and traction, then a constituency may develop to extend—or at least to maintain—such efforts. In theory, over time the success of alternatives could open the way to shrink the public benefits programs.

The perils of such a timid approach are illustrated by the "No Child Left Behind" act. Our local elementary school qualified, based on low test scores, as a school that parents could opt out from. However, the only choice is another public school that itself is of marginal quality as measured by test scores (about which I am skeptical to begin with). The bottom line is that parents feel no sense of empowerment whatsoever, and instead of creating a constituency that supports choice and reforms, the No Child Left Behind concept is getting a bad name, which it probably deserves.

My own view is that at some point we should confront and overcome the public's desire for middle-class government benefits, because they require heavy taxes and impose large economic costs. Perhaps the FlexDollar Welfare State is a necessary step in that direction, because people who do not trust economic theory will nonetheless believe experiments that they can see with their own eyes. But if all of the experiments turn out to be as weak and ineffectual as the No Child Left Behind Act, then the political capital that the Administration is spending on limited reforms will go to waste. Given the likelihood of such an outcome, the enthusiasm of George Will and others for conservatism redefined as the FlexDollar Welfare State is difficult for me to share. ❑

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