adjustable rate, fixed rate, reverse mortgage, retirement plan

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The Fixed-Rate Versus Adjustable-Rate Decision: Standard Versus HECM Reverse Mortgages

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A reader caught me off guard the other day by saying that she had counted 28 articles on adjustable rate mortgages on my web site, but all of them pertained to standard mortgages. Not one applied to reverse mortgages, and she wondered whether that was because the issues were exactly the same? I winced at that, because the issues are not the same – not even close.

Rate adjustment mechanics are the same. For both standard and reverse mortgages, the rate is preset for an initial period. This initial rate is the rate quoted to borrowers. At the end of the initial period and periodically thereafter, the rate is reset to equal the value of a market-based index, such as 1-year Libor, plus a contractually-specified margin, such as 2.25%. In most cases, there is a maximum rate, 5% to 10% above the start rate, and often a minimum.

The consequences of a rate change, however, are very different. On standard mortgages, a rate change is almost always accompanied by a change in the required payment. The new payment is the amount that will pay off the mortgage over the period remaining of the term specified in the contract. If it is a 30-year mortgage with the first rate adjustment after 5 years, for example, the new payment is calculated over 25 years.

On a HECM reverse mortgage, in contrast, there is no required payment. Interest is added to the loan balance, which grows over time. A change in the interest rate, therefore, results in a larger or smaller rate of increase in that balance but no payment is due until the borrower dies or moves out of the house permanently. At that point, the entire balance is due.

The reasons for selecting an adjustable rather than a fixed rate are also different. On a standard mortgage, few borrowers opt for an adjustable-rate because of fears that they will still have their mortgage when the initial rate period ends, and that a rate increase at that time will increase their required payment. Many seniors considering a reverse mortgage bring along a negative mindset from their experience with (or what they have heard about) adjustable rates on standard mortgages. Some begin the process by expressing a strong preference for a fixed-rate reverse mortgage, which may or may not meet their needs.

The rationale for preferring fixed rates on standard mortgages, which is to avoid the risk of a payment increase, has no applicability to reverse mortgages, which have no required payment. The benefit of the fixed rate on a reverse mortgage is only that the borrower knows in advance exactly how fast the debt secured by his home will grow. The downside is that

the fixed-rate HECM offers only one way to draw funds, which is to take a lump sum at closing.

The fixed rate HECM reverse mortgage is primarily for seniors who plan to use all or most of their borrowing power right away. Their intent is to pay off an existing mortgage, buy a house, purchase a single-premium annuity, or transact for some other purpose that requires a large and immediate payment.

The fixed-rate HECM does not allow the borrower to reserve any borrowing power for future use. Once it is closed, no more funds can be drawn. The only way the senior can draw more funds is to refinance the HECM into a new HECM, but for that to work, either the value of the home would have to rise appreciably, or regulations that cap draw amounts would have to be relaxed.

The adjustable rate HECM allows seniors to draw funds at closing, and also to draw funds after the closing. Such borrowers are able to plan for their future in a way that those who take a fixed-rate cannot.

Adjustable rate borrowers can draw a fixed monthly payment for a specified period, or for as a long as they reside in the house; they can draw cash irregularly as needed; and they can let their borrowing power sit as an unused credit line indefinitely. The unused line grows month by month at the same rate as their debt, so that the longer they wait before drawing on the line, the larger is the line.

In addition, seniors can combine these draw options, taking some cash at closing, some as a monthly payment, and some as irregular draws on a credit line. Further, they can adjust their options in the future as their needs change. For example, they can use their unused credit line to purchase a monthly payment at any time, or they can do the opposite, converting their monthly payment into a credit line.

In sum, where the fixed-rate HECM may be helpful in resolving an immediate financial problem, the adjustable rate HECM can be an integral part of a long-range retirement plan.

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