

Home equity conversion and the financing of long-term care

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Home equity conversion for the elderly is a means for elderly homeowners to draw down a portion of their accumulated wealth without having to sell their homes and/or move. The instruments to convert equity have substantial promise for matching the expenditure needs associated with long-term care

services. There have been no formal attempts to pair these potential revenues and expenditures, but the revenue instruments are evolving to a point where such combinations are realistic and reasonable. This article describes why and how such a match might work.

Home equity conversion

Home equity conversion (HEC) for the elderly has been actively practiced in the United States during the 1980's. HEC allows a homeowner to draw funds from a lender based on the home equity. Thus older homeowners with cash-flow difficulties can access the accumulated equity in their homes to meet current expenses. Any "home equity loan plan" is a form of HEC, as is a property tax deferral program, or even a sewer lien. What is special about the HEC programs for the elderly is that they have been set up with a recognition of the demographic characteristics of that group (i.e., their life expectancy) and with the desire to provide to the homeowner a flow of funds that does not require immediate amortization or repayment. Instead, repayment is due either at a scheduled point in time or when a specific event occurs (such as termination of occupancy).

The potential beneficiaries of HEC are the group facing a potential need for long-term care (LTC) services (Jacobs and Weissert, 1987). The elderly as a group have a need for LTC services as well as a desire for insurance to cover the contingency of need for such services. Further, LTC services have two very interesting and related features: they may be delivered in the home of the recipient or, if not home based, the need for services may result in a move from the home to a skilled or custodial facility. The residence plays an important role in either case. Accordingly, it is no surprise that attention recently has been focused on the possibility of combining HEC with LTC services and/or LTC insurance.

The HEC programs that have been established in the United States have enjoyed public and private sponsorship and have taken a variety of forms. For purposes of this article, we deal primarily with four types of HEC instruments: reverse mortgages (RM's), split-term RM's, occupancy-income RM's, and sale agreements. These are described briefly, then the relationship between the plans and the financing of LTC services is explored.

In the early 1980's, general sentiment was that HEC would expand either through sale agreements or loan

agreements (Scholen and Chen, 1980). As events transpired, however, formal sale plans were rather unpopular, with fewer than 150 transactions actually consummated.¹ In a sale plan, the homeowner relinquishes title to the property in exchange for a life estate and either a lump sum payment or the promise of a life income flow. One public program involving a transfer of ownership that has gained attention is the Buffalo H.E.L.P. program (Guttentag and Garnet, 1982; Weinrobe, 1985).

The most prominent HEC loan plans are RM's. An RM is a loan secured by a mortgage against a residential property. The loan can be due at a specific point in time and/or at the occurrence of specific events. No repayments are due before the term of the loan. A principal feature of the loan agreement is the disbursement schedule. The RM can incorporate a schedule of disbursements (level or nonlevel), or it can be an open arrangement in which the disbursements are made at the initiative of the borrower. The characteristics of maturity and disbursements distinguish several categories of RM's.

An RM with scheduled disbursements for a fixed period and an identical term for repayment is a term RM. (For example, disbursements might be scheduled for 12 years, at the end of which the loan is due for repayment.) The best known program offering term RM's is the California-based Reverse Annuity Mortgage Program. Under its aegis, over 400 term RM's have been originated.

An RM with scheduled disbursements for a fixed term (for example, 12 years), but with a different term for repayment (including a guaranteed term of as long as the homeowner is able to and chooses to remain in the residence) is a split-term RM. The best known split-term RM instrument is that offered by the Connecticut Housing Finance Agency (CHFA) through its Pilot Reverse Mortgage Program. An important distinction of this program is that it permits repayment to be deferred until the death of the resident or until the house is sold, while interest

¹The nature of a HEC sale arrangement does allow such a transaction to be negotiated between two parties without the benefit of a formal plan or program. It is much easier for two parties to enter into a transfer of equity than to enter into a loan arrangement. There is good reason to believe that many sale arrangements with a guarantee of life tenancy to the elderly seller have been negotiated.

continues to accrue. Approximately 225 loans have been written since the program began in 1985.

An occupancy income RM is an instrument that guarantees income for as long as the borrower can and does remain in the home. The Century Plan of American Homestead Mortgage Corporation is a loan of this type (Leban, 1984). It has been offered in selected northeastern States since 1984. The Century Plan instrument is unusual in that the loan balance is determined in part by property appreciation. Although there have been some shared-appreciation purchase money mortgages written against residential properties, this is the only extant shared-appreciation reverse mortgage. Approximately 1,200 of these loans have been originated.

It should be noted that as part of the Housing and Community Development Act of 1987, a pilot program for FHA (Federal Housing Administration) insurance of RM's was created (the Home Equity Conversion Mortgage Insurance Demonstration). RM's insured under the pilot program will be required to guarantee occupancy until death or until the resident moves out. This program is currently under development at the Department of Housing and Urban Development (HUD). Lenders making loans under this program are insured against borrower default. The demonstration is to be limited to 2,500 insured loans, but it has the potential to change dramatically the types of RM's available in the marketplace, as well as the public's reaction to the concept.

Equity conversion and health services

The concept of combining HEC with the financing of LTC services is attractive because of two basic principles. The most conspicuous risk associated with HEC is that a homeowner will remain a resident in her/his home for a lengthy period of time, resulting in a long stream of disbursements and, consequently, a larger ultimate loan balance. The most conspicuous risk associated with LTC insurance is that an individual will leave the home for an institution and will remain there for a long period of time. Thus, combining HEC with a purchase of LTC insurance allows one to use one risk to offset the other. This is called the principle of offsetting risks.

The second principle relates to the provision of services. Institutional care generally is considered to be more expensive than home care. Because HEC allows and encourages people to remain in their homes when financial circumstances might otherwise force them to move (including a move to obtain more expensive medical care, reimbursable by the State), it also allows them to obtain custodial or support services at a lower social cost. This is the principle of coordinated risk. (If, however, HEC-generated funds were used to purchase goods and services unrelated to LTC, the principles of offsetting and coordinated risks would be irrelevant.)

These principles are useful in the consideration of different types of HEC and LTC plans.

Indirect linkages

HEC-generated funds can be directly linked or tied to the purchase of specific services, or their usage can be discretionary. To date, most uses of HEC funds for LTC services have been discretionary, and the linkages between income and expenditure indirect.

The indirect purchase of LTC services can be accomplished by either the prepayment of services (including insurance premiums) or the purchase of services on an "as-needed" basis. Oddly enough, although the most common use of HEC for LTC to date is on an as-needed basis, the types of HEC instruments used are often poorly suited to the particular needs. For example, the income from a term RM may be used to purchase medical services. This is inefficient, because the term RM produces an income flow, whether or not there is an ongoing expenditure requirement. However, a term RM would be well suited to a situation involving a hospice patient, where expenses are incurred regularly, and the anticipated timeframe for these expenditures is limited.

For situations in which the indirect combination of HEC with LTC is appropriate, two specific changes can improve this arrangement. One is the availability of either a split term or an occupancy guarantee. These options permit the purchase of services for as long as the homeowner resides at home. (The pending Federal insurance of RM's will be important in this regard.) The second improvement is the discretionary withdrawals of funds, as with a line of credit. This would allow a true matching of expenses with receipt of funds.

Direct linkages

It is in the area of direct linkages of HEC and LTC that the most interesting and innovative possibilities lie for combining the two concepts. It is also in this realm that opportunities exist for substantial cost savings through administrative cost reductions and more efficient resource allocation.

The simplest example of a direct linkage is allowing disbursement of funds only for the use of LTC-related expenses. This arrangement can take the form of a designated line of credit requiring a signoff by a medical official. The only difference between this and the indirect linkage is that the homeowner may not use instrument proceeds for nonmedical purposes.²

A slightly more unusual HEC/LTC combination would have the HEC instrument set up for the direct purchase of LTC insurance. One could easily envision such a combined instrument offered by an insurance

²The CHFA Pilot Reverse Mortgage Program has recently begun allowing its RM's to be used to finance the acquisition of LTC services in a linked form. If there is a certified LTC need, the ordinary eligibility limits of the program and the parameters of the instrument are modified.

carrier. The insurance company would simply keep an account of the debt incurred through the purchase of insurance, and the obligation would be due when the home is sold or the resident moves out. Ideally, premiums would be level for life, or could be decreased but not increased. This would permit an accurate forecast of the potential magnitude of the debt over time.³

More intriguing combinations of HEC and LTC could bring service providers into the arrangement. Two interesting possibilities are life care community fees and life care at home.

Life care communities typically have initiation fees plus monthly fees. These elements correspond to disbursements from RM's with guaranteed occupancy—up front and monthly disbursements. However, the question arises as to how one can have a reverse mortgage when one has already moved out of the home. The answer lies in the nature of homeownership. If an individual owns a condominium unit in a life care community, that person has home equity. An RM written against that unit could generate a flow of income to pay monthly fees or some portion thereof. Such an arrangement might enable the resident/owner to retain equity that could be passed on to heirs, while at the same time assuring the availability of LTC services. This estate effect results because the loan balance rises gradually over time. From the perspective of the manager or owner of the community, it establishes a guaranteed source of funds, either from the community itself or from a lender working in cooperation with it.

It is a small analytical step from using HEC for a condominium in a life care community to using HEC to purchase the same bundle of services without the actual residency. This arrangement is referred to as "life care at home" (Tell, Cohen, and Wallack, 1987). Here again, it is straightforward to have an RM produce the income necessary to finance membership. In an uncomplicated version of such an arrangement, the sponsoring organization writes the loan or works with a specific lender to write a pool of loans.

Lastly, there is no reason to limit the linkage between HEC and LTC services to RM's or to the exclusive purchase of LTC services. Sale-based instruments have been used to finance the purchase of nonmedical services, as in the H.E.L.P. program, where there is an implicit purchase of property management services (Guttentag and Garnett, 1982). The linkage to LTC services simply makes good sense, whether or not other services (home maintenance, social services, memberships, etc.) are part of a package.

³Of course, the purchase of LTC insurance could begin earlier in life, thus potentially reducing the premium payments in later years. For many, it would be optimal to switch from using current income to HEC financing in the later retirement years.

Public policy

It is currently the Federal policy to permit recapture of some or all home equity of elderly Medicaid recipients.⁴ As currently practiced, this recapture varies widely in terms of State effort, and where utilized it is neither effective nor efficient. The principal effect of the policy is to encourage homeowners and their agents to develop innovative means to evade the effort to force home equity conversion.

At the same time, elderly homeowners with substantial net worth in the form of home equity often have little access to quality medical care, even when they are willing to reduce that net worth. If governmental units will assist the elderly in their efforts to remain in their homes or to purchase insurance to protect against the possibility of institutionalization, they will enhance private opportunity while reducing the public's share of the medical bill.

Public policy can encourage opportunities for HEC (e.g., by assisting in the development of counseling programs) and the linkage of HEC with LTC services. It is in this latter direction that the most interesting and exciting possibilities lie.

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⁴This is done either through Medicaid eligibility rules or estate recovery. Rules differ from State to State. See, for example, Scholen et al., pp. 65-66.