Reverse Mortgages Explained

This article discusses some of the unseen or unmentioned financial aspects of reverse mortgages, relative to other financial instruments. It is not intended to be a substitute for the good information found on the Internet or that provided by a financial counselor. See https://www.consumer.ftc.gov/articles/0192-reverse-mortgages and https://www.financeofamerica.com/ for some good information. An Internet search may also provide helpful information.

Reverse mortgages may be taken as lump sums, monthly payments, or a line of credit. This article simply uses the term “stipend” for how the money is taken.

This article does not discuss how a reverse mortgage my impact your spouse, your heirs, or a transition from your home to a care facility. Your local Agency on Aging would know about programs in your area. Also, it does not discuss the various types of reverse mortgages, such as, a Home Equity Conversion Mortgage (HECM) or proprietary (private) reverse mortgages.

Annuity versus Reverse Mortgage

It would be beneficial to explain the differences between an **annuity** and a **reverse mortgage**, because they may appear similar on the surface. Both provide a steady, fixed stream of income, which I will call a stipend.

> In an annuity, a fluid asset is deposited with a financial institution. Whereas, in a reverse mortgage, a non-fluid asset, such as property, is deposited with a financial institution.
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> In an annuity, the remaining balance is invested by the financial institution, earning interest. Whereas, in a reverse mortgage, there is nothing for the financial institution to invest and, therefore, no interest is earned and applied to the principle.
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> In an annuity, the interest earned on the remaining balance reduces the amount that the balance decreases by less than the monthly stipend. Whereas, in a reverse mortgage, the monthly stipend plus accrued interest is a loan on which you pay interest, causing the outstanding loan to increase faster than the monthly stipend alone. Therefore, your indebtedness increases more rapidly overtime.

Student Loan versus Reverse Mortgage

Student loans and reverse mortgages are mathematically very similar, in that the lender not only lends the money you see, but also continuously lends your more money to pay the interest on money already lent. Both are **interest-deferred loans**. The difference is in the payback. A student loan reverts to a standard mortgage at payback time, with the initial outstanding principle being the total amount lent. A reverse mortgage is paid pack in a **lump sum** from proceeds of the sale of a property.

Student Loan & Reverse Mortgage vs Savings Account

The mathematics here is the same, but the roles are simply reversed. With a savings account, you invest in a financial institution, expecting to withdraw both your investment and accrued interest at a future date. With student loans and reverse mortgages, also a loan, the financial institution invests in you, expecting to be repaid for both its investment and accrued interest at a future date.

When does a reverse mortgage make sense?

The pros and cons, below, are largely taken from https://consumer.ftc.gov/articles/reverse-mortgages, with some additions.

Pros:

- **Own a home outright or nearly mortgage-free.**
- **Want to access its equity for cash flow during retirement.**
- **Wish to remain in their own home** while supplementing retirement income. Down-sizing is not a consideration.
- **Have limited savings or low regular income but significant home equity**, making traditional loans difficult to obtain.
- **Need funds for specific purposes**, such as home renovations, paying off other debts, travel, healthcare, or supporting family.
- **No regular repayments required:** Borrowers do not need to make monthly payments; the loan plus interest is repaid only when the home is sold or the homeowner passes away.
- **No monthly payments on pre-existing mortgage**, as it is paid off by the reverse mortgage.
- **Access to cash without selling the home:** This allows retirees to maintain their lifestyle and independence while unlocking funds tied up in property.
- **Flexible use of funds:** The money can be used for nearly any purpose, from daily expenses to large one-off costs.
- **Protection against owing more than the home's value:** Many lenders, like Heartland Bank, guarantee that borrowers will never owe more than the net sale proceeds of their home.
- **No debt passed on to heirs**, as reverse mortgages are "non-recursive."

Cons:

- **A reverse mortgage increases your debt and can use up your equity**. While the amount is based on your equity, you're still borrowing the money and paying the lender a fee and interest. Your

debt keeps going up (and your equity keeps going down) because interest is added to your balance every month. This can use up much – or even all ─ of your equity.

- **A reverse mortgage can limit your options down the road**. Generally, a reverse mortgage must be paid back when you die or move from the home. You could use up your equity, so you get nothing when you or your estate eventually sells the home. That means you could come up short if you want to move to a smaller home, an assisted living facility, or to another locale to be closer to family.
- **A reverse mortgage can be an expensive way to borrow**. The fees and other costs to borrow money this way can be higher than other alternatives like a home equity loan or home equity line of credit.
- **There will be less or nothing to leave your heirs**.