

## Reverse Mortgages – A Source of Funds for Retirement?

Many people make it a goal of their financial lives to invest in a home. It is a great accomplishment when that last mortgage payment is made. Can a reverse mortgage, taken out after retirement, be a good use of this investment? Much of the material on this subject that is publicly available is offered by organizations who are selling reverse mortgages so it often fails to provide a balanced view. This article will present the details of reverse mortgages so you are able to gain a balanced understanding of the product.

### How it works

A reverse mortgage is a loan, available to people 60 years old or older, taken out on the assessed value of your home. There are currently two companies in Canada which offer reverse mortgages: Canadian Home Income Plan (CHIP) and Senior's Money Canada. The details vary between the two lenders but the basics are the same. Once the value of your home has been assessed, the mortgage lender will calculate a maximum loan amount for which you will be eligible. Eligibility for this type of loan is not based on credit rating or income but mainly on the assessed value and your current age. In essence, they are trying to predict how long you may hold the loan and what may happen to the value of your home in that time. Older homeowners will be eligible for higher loans because they would be expected to repay it sooner. Homes in well populated areas may also be considered for higher loans because the value could increase more over time.

The loan amount, plus accumulated interest, is repaid in full only after the sale of your home, either when you choose to sell your home or when your estate is settled after your death. No payments of any kind are required before that time.

### Variations and Options

*Protecting your spouse:* When a married or common-law couple own the home, the loan period can be extended to the lifetime of both spouses. The age minimum still applies however. One spouse must be at least 60 years old and the other spouse 55 or older at the time that the reverse mortgage is arranged. In this situation, the loan does not need to be repaid until the sale of the house or the death of both spouses.

*Controlling your loan amount:* Since interest on a reverse mortgage is compounded and charged from the time the funds are received, taking out a large loan and holding it for many years can really add up. You can reduce the amount of interest accrued by borrowing funds over time rather than all at once. Mortgage brokers offer various options, usually with an initial lump sum payment of \$15,000-20,000 and minimum \$4,000-5,000 per year thereafter.

*Making early payments:* Occasional payments of interest or principal may also be possible. This will keep down the amount of interest that accumulates however there may be early payment fees involved.

## What you get

*Security:* A reverse mortgage allows you to remain in your home while providing a cash flow that may not have been available otherwise. At all times, you retain title to your property.

*Loan Amount:* In determining the maximum loan amount for a reverse mortgage, a broker will consider your age, gender, the assessed value of your home and potential for change in that value. A person close to 60 years old can expect a loan of 15-25% of their property value while an older person may be allowed up to 45%. In the case of a couple applying for a loan, the age of the younger spouse is taken into account.

*Uses:* The funds from a reverse mortgage can be used in any way you wish. There are no restrictions.

*Guarantee:* At the time of the sale of your home, the loan plus interest must be paid in full. If that amount is less than the sale value, which is typically the case, you, or your heirs, keep the excess. Both reverse mortgage issuers operating in Canada guarantee that you will never be asked to repay more than you can get for the sale of your home. In other words, in the worst case, the entire sale value will go to repay the loan but there will be no debt remaining.

## What it costs

*Fees:* The initial fees for a reverse mortgage are substantial. They can range from \$1,500-\$2,400 and include:

- Set fees charged by the reverse mortgage issuers
- An independent assessment of the home's value
- Legal fees

*Interest:* Interest on a reverse mortgage may be 2-4% higher than a regular, variable-rate mortgage. The interest charged will change over time based on changing prime rates. In addition, because the interest is compounded and no regular payments are necessary, the total amount of the debt can rise considerably. In most cases, the total debt will double every 7-10 years.

*Equity:* By taking out a reverse mortgage, just as with a regular mortgage, you reduce the equity that you own in your home. The amount remaining will depend on how much you borrow, for how long and what happens to your property value in that time.

*Risk:* With a reverse mortgage, you remain the owner of the home, and are still required to pay all taxes, insurance and repair costs. The lender has the option to ask for immediate repayment if any of these obligations are not met.

The following example illustrates the changes in debt and equity based on the following initial data:

- Property Value: \$300,000
- Loan Amount: \$60,000 taken out in full at age 60 (20% of initial property value)
- Interest Rate: 8% compounded (currently the lowest rate available for a CHIP mortgage). In comparison, at the time of writing this article, the average rate at the big 5 Canadian banks was 4.1% on a variable rate mortgage and 5.8% for a 5 year mortgage.
- Growth: the change in property value will vary considerably with the type of property and the location. The chart below compares three potential growth rates which reflect numbers below, at, and above the rate of inflation.

Age	Amount Owed (compounded at 8%)	1.0% growth of property value		2.5% growth of property value		4.0% growth of property value	
		Property Value	Equity Remaining (percent)	Property Value	Equity Remaining (percent)	Property Value	Equity Remaining (percent)
60	\$60,000	\$300,000	\$240,000 (80%)	\$300,000	\$240,000 (80%)	\$300,000	\$240,000 (80%)
65	\$88,160	\$315,303	\$227,143	\$339,422	\$251,263	\$364,996	\$276,836
70	\$129,535	\$331,387	\$201,851	\$384,025	\$254,490	\$444,073	\$314,538
75	\$190,330	\$348,291	\$157,961 (45%)	\$434,489	\$244,159 (56%)	\$540,283	\$349,953 (65%)
80	\$279,657	\$366,057	\$86,400	\$491,585	\$211,928	\$657,337	\$377,680
85	\$410,909	\$384,730	-\$26,179* (0%)	\$556,183	\$145,275 (26%)	\$799,751	\$388,842 (49%)

\*The actual amount owed, cannot exceed the value of the home so the remaining equity in this case will be zero and the full proceeds of the sale will go to the issuer of the reverser mortgage.

As can be seen from the table, the amount of equity in the home (total home value less mortgage owed) starts at 80% after the loan is taken out at age 60. As time passes, the total interest owing accumulates quickly. By age 75, the equity in the home has dropped to 45% - 65%, depending on property prices. By age 85, the equity in the home ranges from as low as 0% to as high as 49%.

In another example, the same \$60,000 loan is taken out but in smaller installments. This can change the results as follows:

- Property Value: \$300,000
- Loan Amount: \$20,000 is received up front at age 60 with additional \$5,000 payments made by the issuer every 2 years until a total of \$60,000 has been given to the client (final payment at age 76)
- Interest Rate: 8% compounded

Taking the payments as installments, the amount owed at age 75 would be \$126,309 (compared to \$190,330 in the earlier example) and the amount owed at age 85 would be \$282,687 (compared to \$410,909 earlier).

These examples show that while a reverse mortgage can be a source of income during retirement, it can greatly reduce your future assets at the time your home is sold. Let's look at some alternative ways of using your home to supplement your retirement income.

### **Weighing your options: alternatives to a reverse mortgage**

*Trade down to a smaller home:* By selling your current home and buying a smaller one, you can lower your payments on utilities as well as property taxes. You can also use the net difference from the sale to invest and provide future income.

*Rent part of your home:* If renting space in your home is a viable option, you can use the proceeds to supplement your retirement income.

*Use your existing savings more quickly:* If you have existing retirement savings that won't last to the end of retirement, you might plan to spend those savings more quickly during the first part of retirement while you remain in your home. Then sometime before those savings are exhausted, sell your home to help finance the second part of your retirement.

*Liquidate assets:* Determine if you own items which you can do without such as an extra vehicle or a vacation home. By selling these assets and investing the proceeds, you can create additional income.

*Apply for a standard mortgage:* The advantage that a standard mortgage has over a reverse mortgage is that interest rates are lower. The main disadvantage of this type of loan is that regular payments must be made. For a senior with a small income, this may not be possible. In fact, a bank will not likely grant a mortgage unless there is a clear means of repayment such as employment or investment income or the future maturing of assets, such as a series of GICs coming due. A senior who qualifies for a regular mortgage may be better off than they would be with a reverse mortgage since, when the home is sold, he will have paid less interest overall.

*Apply for a secured line of credit:* A secured line of credit is a loan which can be drawn on as needed and uses an asset such as a property for collateral. Interest rates on a secured line of credit will be lower than a non-secured loan or reverse mortgage. As we showed in the examples with reverse mortgages, drawing on funds only as needed will minimize the interest that accrues. As with regular mortgages, payments must be made on a regular basis. With a secured line of credit, however, it is only necessary to pay the interest. In this way, it is possible to leave payment of the principal for a later date. While it may sound ideal, here are some drawbacks:

- In the long term, as more is borrowed each year and the loan balance rises, interest payments will increase and may not be sustainable.
- Banks may find a steadily increasing loan balance risky. They do not guarantee not to recall the loan and may force you to sell your home.
- Banks do not guarantee that the final amount due will not be more than the value of your home, potentially leaving you with a liability.

Given these drawbacks, a secured line of credit should only be seen as a short term solution.

## In Summary

A senior who is house-rich and cash-poor may have several options, along with many unknowns to juggle. It is necessary to first determine your priorities regarding your required income, your lifestyle, your feelings about keeping your home and your feelings about leaving something to your heirs. A reverse mortgage is clearly very expensive and quickly eats into the equity of your home. Other loan alternatives (a regular mortgage or a secured line of credit) may be difficult to obtain and/or maintain over a longer period of time. If you conclude that a short term loan is a good option for you, then a secured line of credit could work well. If, on the other hand, you require income over a long period and your priority is to remain in your home as long as possible, a reverse mortgage is the best long-term loan option. Other avenues to increase retirement income should be explored before any long term loan is considered.

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