Reverse Mortgages: Look Before You Leap

RMs not as sweet as candy
Numerous articles have proclaimed the benefits of reverse mortgages. Typically, RMs enable elderly homeowners to borrow against their home equity while deferring any repayment until the home is sold at some future time. Some articles have noted that RMs may be used to supplement income, make home repairs, and even help children with college tuition and home purchases.

It seems these attractions may blind some homeowners to the fact that RMs are expensive and represent only one alternative among many. Also, RMs tend to devour a homeowner’s equity and remaining options rather quickly. RMs can be most useful for homeowners who want or need to remain in their homes for their remaining years regardless of the steep costs or loss of equity.

Aging changes perspective
However, homeowners should be aware that their abilities and desires could change as they age. Maybe they will want to sell their home and move. Maybe they will be unable to keep up with home maintenance, repair, and taxes. Maybe they will need more money than is anticipated or available through their RM. Maybe a surviving spouse will not have the health or resources to maintain a large home. If moving means the RM becomes due and payable, will there be enough home equity left to purchase a smaller home or invest for rent and needed income?

The concept that an RM is like tapping a homeowner’s equity is true. It would also be true to say that the homeowner is living on a mounting pile of debt that is rapidly devouring home equity. The very feature which allows the homeowner to defer repayment until settlement also means that the entire balance of principal, interest, and any financed loan costs accumulates quickly. Lenders use this knowledge in setting limits on the amount of principal a homeowner can borrow, thereby protecting themselves from the prospect of escalating debt overtake the net value of the home.

Homeowners also need to protect themselves from engaging in arrangements that they might ultimately find too costly, restrictive, or unsuitable. Before deciding an RM is right for them, they need to explore other options—just to be sure.

Other options to consider
• Sell and use the proceeds to invest for rent and income. A typical homeowner might receive $325,000 after paying fees on the sale of a $350,000 home. Invested at 7 percent APR, the $325,000 could generate $3,751 per month in taxable income over 10 years, or $2,904 per month over 15 years. To ensure income for life, the $325,000 could be used to purchase a single-premium immediate annuity, which could provide monthly payments of $2,195 for life.

• Sell and use the proceeds to buy a less expensive home while deriving income from investing the difference. An elderly homeowner could sell a $350,000 home, pay $25,000 in selling costs, and exclude up to $250,000 in tax-free capital gains. Only if the original price plus the cost of any additions and improvements was less than $75,000 would the homeowner have to pay any capital gains tax. If not, he or she could purchase a replacement home for up to $200,000 and still have $125,000 to invest for income and other occasional expenses. At 7 percent APR, this sum could generate monthly income of $1,451 over 10 years or $1,124 over 15 years.

• Sell and lease back your home. This option involves selling your home and leasing it back from the buyer for life. Proceeds from the sale can then be tapped for some larger expenses and doled out monthly for rent.

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