

Reverse mortgages: A primer

More and more people, as they enter their retirement years, are going to be hearing about the benefits of obtaining a reverse mortgage.

Here we review a few key features of these loans, as well as some reasons why you may (or may not) want to consider a reverse mortgage. In addition, we highlight a recent study about using them as a way to help pay long-term health care expenses.

The fundamentals

A reverse mortgage, practically speaking, is a way to convert the equity in your home into cash. There are several types of reverse mortgages. Although they may differ somewhat, all of them share certain similarities.

Reverse mortgages are adjustable-rate home loans that need not be repaid until the borrower dies, moves or sells his or her residence. Of course, failure to comply with the terms of the loan agreement—which requires homeowners to continue paying for taxes, insurance and the upkeep of the home, for example—automatically accelerates the repayment of the loan. When the loan term has come to an end, the borrower, or his or her heirs, then must repay all of the cash advances received, plus interest.

Generally, borrowers must be at least age 62 to qualify for a reverse mortgage. A spouse who is a joint owner of the home must meet this condition as well.

Because a reverse mortgage usually is required to be the primary debt against a home (a “first” mortgage), a borrower who still has an existing mortgage at the time that a reverse mortgage is obtained must either pay off the existing mortgage with other financial resources or pay it off with funds received from the reverse mortgage.

Proceeds from a reverse mortgage may be received in a lump sum or as a series of monthly payments for a specified period of time, or for as long as the borrower (and spouse) lives in the home. In addition, the reverse mortgage may be in the form of a credit line, allowing the borrower to draw upon funds when needed.

Fees and taxes

Compared to conventional mortgages, reverse mortgages are likely to carry high up-front costs. As a result, this kind of borrowing should be reserved for situations where the proceeds are intended to be used for a long period of time. Most reverse mortgages will allow borrowers to let the initial costs become part of the loan balance (except, usually, for application fees).

The money received from a reverse mortgage is not taxable as income. In addition, the interest on the loan is tax deductible when it actually is paid—in other words, when the term of the loan comes to an end. But because reverse mortgages are considered to be home equity loans, only the interest on the first \$100,000 of the loan amount is tax deductible.

The chief drawback of a reverse mortgage

In a reverse mortgage the homeowner's debt rises each time that he or she receives money. In addition, interest is added to the outstanding loan balance, and no repayments are made to the lender. Unless the home's value grows very fast, the loan balance will start "catching up" to that value. As a result, reverse mortgages typically are referred to as "rising debt, falling equity" loans.

In simple terms, then, the chief drawback of a reverse mortgage is that it uses up some or all of an owner's equity in his or her home. Thus, reverse mortgages usually should only be considered by individuals and families who have other significant assets.

The long-term health care connection

A new study by the National Council on the Aging (NCOA) shows that reverse mortgages may have potential in addressing the issue of paying the costs of long-term health care at home. According to NCOA, in 2000 the nation spent \$123 billion a year on long-term care for people age 65 and older. Nearly one-half of such expenses are paid out of pocket by individuals, and only 3% are paid for by private insurance. (Government health programs pay the rest.)

In addition, according to the study, of the 13.2 million who are possible candidates for reverse mortgages, about 5.2 million either are receiving Medicaid already or are at financial risk of needing Medicaid if faced with paying the high cost of long-term care at home. "There's been a lot of speculation whether reverse mortgages could be part of the solution to the nation's long-term care financing dilemma," says NCOA President and CEO James Firman. "It's clear that reverse mortgages have significant potential to help many seniors to pay for long-term care services at home."

Proceeds from reverse mortgages could be used to pay for a wide range of direct services to help seniors—including home care, respite care or "retrofitting" of their homes (adding amenities and making structural changes to accommodate special needs). In some instances, NCOA believes, reverse mortgages can mean the difference between staying at home or going to a nursing home.

There are many considerations that should go into the decision of whether to pursue a reverse mortgage. It's always a good idea to seek the opinion of a qualified professional before taking any action.