Reverse Mortgage Perils - What You Need to Know

July 15, 2013 - As more and more baby boomers get ready for retirement, many of them are taking a look at reverse mortgages. After all, the TV ads make them sound like a panacea for the financial woes of anyone over 62.5 years of age. But one has to remember that for every silver lining, there is also a cloud. In the case of reverse mortgages, that cloud can be very big and extremely dark.

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If celebrity-laden TV ads are your primary source of information on reverse mortgages, then you probably think that this financial tool is a great way to make ends meet when you retire. For some people, it is. But for others, it can lead to financial disaster. Before you or a relative goes down the reverse mortgage path, here are a few things that you need to know.

You can lose your home to foreclosure with a reverse mortgage:

Many people simply don't understand this, but mismanaging a reverse mortgage can easily lead to foreclosure. In fact, 9.85% of reverse mortgages nationwide are facing foreclosure. That's more than three times the national rate of 3.17% (May, 2013 number).

You may ask how that can be. After all, the ads will tell you that once you get a reverse mortgage you can remain in your home as long as you live. But that's not the entire story.

Anyone who takes out a reverse mortgage on their home makes an agreement with the lender to maintain the house and keep it in good repair, pay their property taxes, make mortgage insurance premium payments, and pay any homeowners association fees that are due. Failing to live up to any of these clauses in the loan agreement can lead to foreclosure.

Additionally, borrowers must occupy the home. You can take out a reverse mortgage and then rent out the house. And if you go into a long term care facility for more than six months, the lender can force you to sell the property or foreclose on it.

Reverse mortgages are expensive:

Reverse mortgages have a wide variety of fees associated with them. The origination fee alone can be as high as $6,000. Then there are premiums for mortgage insurance and, of course, interest on the money borrowed.

In all, the fees can amount to thousands of dollars that are normally deducted from payments to the borrower.

Types of reverse mortgages:

In all, there are three primary types of reverse mortgages. Borrowers can elect to receive monthly payments, a lump sum payout or a reverse home equity line of credit. In addition to these three, borrowers can combine the different types of payouts into a hybrid.

Borrowers who agree to monthly payments have two options. They can either select a term over which the payments will be made to them or take a payments for life. The amount they receive on a monthly basis is based largely on the type of payment they select.

Borrowers who elect to take a lump sum payment get all of their money right away and can't borrow against their home again unless they agree to pay off the loan.

Borrowers who select a reverse home equity line of credit can borrow whenever they need money, up to a limit specified by the lender. If they never need the money, they don't have to borrow or pay interest on their line of credit however, if they didn't pay for the initial loan origination costs, they will begin to accrue interest on those charges as soon as the loan is approved.

Married couples should both be named on any reverse mortgage:

The amount of money that you can receive from a reverse mortgage is partially dependent on your age at the time you borrow. If you are older, you can get more money; either in a lump sum or monthly payments.

Because of this, when married couples take out a reverse mortgage on their homes they are often tempted to only list the eldest person on the loan. That can prove to be a huge mistake.

As previously noted, anyone who takes out a reverse mortgage is required by the lender to continue to live in their home. In the case of married couples, only one of them has to continue living in the house. So if your spouse requires long term care in a special facility, you can continue to live in your home regardless of the amount of time that care takes. But if your elder spouse is the only person named on your reverse mortgage, the lender can make you sell the house or foreclose on it.

And if only one spouse is listed on a reverse mortgage, and that person dies, the lender will probably force you out of the house immediately.

Reverse mortgages can drain all of the equity in your home:

Anyone taking out a reverse mortgage needs to know that eventually their home may not be worth anything to them or their heirs. That's because interest on a reverse mortgage accrues from the time you start receiving money. If you live long enough, the amount that you owe the lender could actually exceed the value of your home. While neither you nor your heirs will be required to make up the difference, this could create real financial issues for borrowers.
Conclusions:

As reverse mortgages have become more popular, many people are starting to use them as soon as they are eligible. And a majority of people taking out reverse mortgages are asking for as much money as they can borrow in a lump sum payment. Unfortunately, that's a very bad long term strategy.

Anyone who takes a large lump sum payment at age 62.5 years is very likely to spend all of that money well before they die. And because they agreed to a lump sum payment, interest on that payment will start accruing the day they receive their money.

That may sound great to someone who want's early retirement. But what are you going to do when you are 80 years old, facing a significant illness, and the money is all gone? You can't borrow against your home anymore. In fact, in this scenario you may very well owe more on your home than it is worth.

Due to their expensive nature, and the risks associated with them, reverse mortgages should really be a last line of financial defense for the elderly. There are a wide variety of other options that should be considered first. These include downsizing, relocating to a less expensive neighborhood and cutting other expenses. Additionally, you may want consider some form of equity sharing relationship if your state allows this. This can be a lower risk means for people to tap the equity in their homes without a need to repay it until the home is sold.
byJim Malmberg
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