Understanding How Higher Interest Rates Impact Reverse Mortgages

July 14, 2023 - Over the years we've published a number of articles on reverse mortgages. Given the fact that the FED has increased interest rates dramatically since our last publication on this topic, we thought it would be wise to explain how those rate increases actually impact borrowers. And rising interest rates can have a significant impact on reverse mortgages, a financial tool that allows seniors aged 62 or older to borrow against their home equity without making regular payments. Here are the key points to understand about how interest rates affect reverse mortgages:

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Interest Rate Calculation: Reverse mortgage interest rates are determined based on factors such as the borrower's age, home value, loan type, life expectancy, and disbursement option. The initial interest rate it tied to a particular rate index such as the Treasury Rate, or the LIBOR and is rolled into the loan and repaid with the principal balance.

Effect on Principal Limit: In general, a higher interest rate on a reverse mortgage leads to a lower principal limit - meaning that borrowers will have access to less money. This occurs because higher interest rates increase the total loan costs, reducing the available equity for the borrower to receive as a principal amount.

Fixed vs. Variable Interest Rates: Reverse mortgages can have fixed or variable interest rates. With a fixed interest rate, the rate remains the same throughout the loan term, providing protection against rate increases. Variable rates, however, can change over time based on an index rate, which can result in higher costs for borrowers. While the borrowing costs for a variable rate may be higher, as you will see in the next section, this option can offer some advantages.

Distribution Options: Fixed-rate reverse mortgages typically offer only a lump-sum distribution, while variable-rate reverse mortgages provide more options such as term monthly payments, tenure monthly payments, a line of credit, or a combination of monthly payments and a line of credit. Borrowers who keep all, or a portion of their loan in a line of credit without accessing it actually receive interest on that money, meaning that the money that they don't use today will actually increase the amount they can borrow in the future.

Long-Term Interest Charges: Fixed-rate reverse mortgages often result in higher long-term interest charges since interest accrues immediately on the entire loan amount. In contrast, variable-rate loans only accumulate interest on the received funds, resulting in lower overall interest costs.

Protection Against Rate Increases: Fixed interest rates provide protection from future rate increases as they remain unchanged over the loan's life. Variable-rate loans, on the other hand, can fluctuate based on market interest rates, potentially leading to higher repayment amounts.

Access to More Funds: With variable-rate reverse mortgages, the principal limit can increase over time, providing borrowers with access to additional funds. However, the principal limit on fixed-rate loans remains fixed, and the initial lump sum received is the maximum amount available.

Interest Rate Changes: Variable rates on reverse mortgages can change as market interest rates fluctuate with the index the loan is tied to (as previously mentioned, LIBOR, Treasury, etc...). And changes occur based on factors such as the frequency of rate adjustments and caps on rate increases; all of which should be spelled out in the loan documents.

Understanding the impact of rising interest rates is crucial for borrowers considering reverse mortgages. In general and as with other loan products, the lower the interest rate, the better off the borrower is. With that said, and because interest rates today are significantly higher than they were just two years ago, borrowers do need to be aware that you can refinance a reverse mortgage in the future if interest rates fall again. We recommend that potential borrowers consult with their financial advisor for personalized guidance based on individual circumstances and goals prior to taking out any loan; reverse mortgages included.
by Jim Malmberg
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