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The reverse mortgage quandary

By JOHN HEINZL
From Monday's Globe and Mail

They can be a good fit for some senior homeowners, but beware the costs and know the alternatives

On the surface, reverse mortgages seem like the ideal solution for cash-strapped seniors. You can tap the equity in your home, you don't have to make any interest or principal payments, and the mortgage only comes due when you die, sell your house or move out permanently.

As more boomers hit retirement age, reverse mortgages are growing in popularity. HomEquity Bank, Canada's only national provider of reverse mortgages to people aged 60 and over, expects to hit \$1-billion in loans outstanding during the fourth quarter.

"The beauty of this is it gives people the financial flexibility and the freedom to do things that have to be done," said Bob Lauzon of Cornwall, Ont., who recently arranged a \$30,000 reverse mortgage for his 87-year-old mother to pay for a new roof and other home improvements.

But while reverse mortgages may be a good fit for some seniors, the products aren't for everyone. Some financial planners advise clients to avoid reverse mortgages altogether and explore cheaper options. Knowing how reverse mortgages work, how much they cost and the pitfalls to avoid is critical for anyone considering this option.

What's a reverse mortgage?

With a conventional mortgage, you borrow a certain amount and gradually pay it back. Not so with a reverse mortgage. The lender advances you a lump sum (or provides the money in stages) and you make no monthly payments. As a result, the accrued interest is added to the loan balance, and the mortgage steadily grows.

High rates hurt

Interest rates on reverse mortgages are higher than those on traditional mortgages or credit lines. Currently, HomEquity Bank, which operates the CHIP Home Income Plan, charges 5.9 per cent on a fixed, five-year mortgage. That compares with rates as low as 3.5 per cent for conventional five-year mortgages.

Because the interest compounds, the mortgage can quickly balloon. For instance, if you borrow \$150,000 at 5.9 per cent, after 10 years you'll owe \$268,298 (assuming semi-annual compounding). When you die or sell your home, that money will have to be repaid, leaving less cash for your estate or to pay your bills.

"It's all negative amortization. [The loan] goes up and up and up," says Dennis Mitchell, a real estate expert and vice-president with Sentry Investments. Eventually, "you've chewed through a whole bunch of the equity in your home."

A reverse mortgage may make sense for some seniors - those with little income who have medical or other special needs that require a lump sum of cash, for instance - but "I'm not a big fan of them personally," Mr. Mitchell says.

Other costs

Reverse mortgages also require a home appraisal fee of \$175 to \$400, independent legal advice that runs from \$400 to \$600, and legal, closing and administrative costs of \$1,495.

If you decide to pay back your mortgage before the term is over, you could also face stiff penalties, ranging from 11 months of interest in the first year down to four months of interest in the third year (the penalty is waived if the repayment is due to the death of the last surviving homeowner, and reduced if the person is moving into an assisted-living facility). As with conventional mortgages, you may also face an "interest-rate differential" penalty if rates have dropped since you took out your loan.

Also keep in mind that a reverse mortgage must rank first on the home's title. That means any other debts secured by the property must be retired with the reverse mortgage proceeds or moved into second position, which may entail additional costs.

The advantages

The biggest selling point of reverse mortgages is that there are no interest or principal payments, which makes the loans attractive to seniors who are house-rich but cash-poor. Another plus is that the maximum borrowers ever have to repay is the fair market value of their home. So they'll never default or have to dig into other savings to repay the loan.

"They can stay in their home for as long as they want," says Steven Ranson, president and chief executive officer of HomEquity Bank. When they die or move, "they can never owe more than the house is worth."

Isn't HomEquity Bank taking on a lot of risk by capping the borrower's obligation? Not really. It lends a maximum of 40 per cent of the home's current market value, and clients typically stay in their homes for eight to 12 years. That, coupled with rising property prices, means the sale proceeds are usually more than adequate to cover the outstanding loan balance.

Borrowers can choose to pay off their interest annually, which qualifies them for a half-point reduction in the following year's interest rate. Less than 5 per cent of clients use this option, however.

"The product is actually designed for people who can't afford to make the interest payments," Mr. Ranson says. "What I would say is, if you can afford a regular mortgage and you can afford to make the payments, then go get one."

The alternatives

Financial planners recommend looking for cheaper sources of funds before taking out a reverse mortgage.

"I think a secured line of credit would provide a much lower cost of borrowing and greater flexibility," said registered financial planner Derek Moran, president of Smarter Financial Planning in Kelowna, B.C.

Another option is to sell your home and downsize to a less expensive property, freeing up cash to pay for living expenses or to invest in income-producing securities.

For Mr. Lauzon, that wasn't an option. His mother was determined to stay put in the home she shares with her twin sister, so he used the loan proceeds to pay for the new roof, some electrical repairs and safety handrails in the bathroom.

"The whole process took a little bit of time, but in the long run, it relieved a tremendous amount of stress," he says.

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