DAY HAGAN PRIVATE WEALTH

FINANCIAL PLANNING TIDBITS

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August 18, 2023

WHAT'S A REVERSE MORTGAGE?

SUMMARY

Reverse mortgages, like any financial product, have their place, but it's important to understand exactly how they work before committing to one.

BUILDING EQUITY

According to real estate website Redfin, the median sale price of a home in Sarasota County has increased over 60% in the last three years (June 2020-June 2023). Those who have owned their homes for some time or purchased before values started to peak may be sitting on a sizable amount of equity. While that's good news for your net worth, your home equity isn't contributing to your cash flow. In some very particular situations, a reverse mortgage can let you use the net value of your home without having to move.

WHAT IS A REVERSE MORTGAGE?

A reverse mortgage is a loan that enables homeowners to convert part of the equity in their homes into cash without having to sell the property or make any monthly mortgage payments.

This can be an attractive option for older homeowners who need to supplement their retirement income or cover unexpected expenses. Reverse mortgages are only available to homeowners who are at least 62 years old and who have significant equity in their homes. The homeowner works with a lender, which calculates how much money can be borrowed based on the value of the house, the owner's age, and current interest rates. Once a loan amount is agreed on, it can be paid out as a lump-sum, as a line of credit, or in monthly payments.

One of the key advantages of a reverse mortgage is that the borrower does not have to make any payments on the loan while they continue to live in the home. Instead, the loan is repaid when the borrower moves out of the home or passes away. At that point, the home is typically sold, and the proceeds of the sale are used to pay off the loan. If the home is sold for less than the value of the loan, neither the homeowner nor his or her heirs are responsible for covering the shortfall.

CAREFUL CONSIDERATION

Getting liquidity out of an asset that would not otherwise contribute to cash flow sounds like a great option, especially if you listen to the gurus and celebrities espousing these products in commercials. But taking out a reverse mortgage is not a decision to be made lightly. There are several potential downsides to consider when evaluating a reverse mortgage.

One concern is that the interest on the loan can compound over time, which means that the amount owed can grow significantly if the borrower lives in the home for an extended period of time. Additionally, if the borrower does not maintain the property or pay their property taxes, he or she could be at risk of defaulting on the loan and losing the home.

Another thing to keep in mind is that a reverse mortgage can have an impact on the borrower's eligibility for certain government programs, such as Medicaid. Because the loan is considered a form of income, it can affect the borrower's eligibility for these programs, which could be problematic if he or she requires long-term care in a nursing home or assisted living facility.

Reverse mortgages aren't free, either, and there are several costs associated with them. While you won't make monthly payments on the loan, it will require an upfront mortgage insurance premium (MIP), which is typically 2% of the home's value. There is also an origination fee, which is usually 2% of the first $200,000 of the home's value, plus another 1% of the amount over $200,000. A monthly servicing fee of $30-35 is also normal, as are closing costs and appraisal fees. And, of course, there is the interest to be paid on the loan. You should closely and carefully compare these costs with the potential benefits of a reverse mortgage.

AN ESTATE ISSUE

When I was in college, one of my older coworkers shared about the reverse mortgage she had taken out to increase her cash flow. While she understood the process and accepted the terms, she didn't mention it to her daughter. Meanwhile, her daughter lived—and spent—with the assumption that she would inherit the house. When her mother told her years later that the loan, including all attendant interest and fees, would have to be repaid in full upon my coworker's death, she was dismayed. The only way my coworker's daughter would be able to pay off the loan when that time came would be to sell the property, which snarled her family's plans to move in after her mother's death.

This isn't a warning to always avoid reverse mortgages. In the right situations, they can be an appropriate solution to very specific problems. Sometimes, lenders will even negotiate a settlement with heirs for a reduced amount to satisfy the loan. But this story is a good reminder to make sure you understand—and help your family understand, if necessary—the consequences of taking out a reverse mortgage before you sign any paperwork.

CONSULT BEFORE COMMITTING

While we at Day Hagan rarely consider a reverse mortgage as a prudent financial solution, it can be a useful tool for older homeowners who need to supplement their retirement income and have few, if no other, options. To ensure that this is the right choice for you, it's important to carefully consider all of the factors involved and to consult with a financial advisor, who can help you make an informed decision.

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—Written 8.16.2023.

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