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Life Choices... a newsletter from Latimer Financial Services

Retirement and Tax Planning   Education Funding   Portfolio Review
Long Term Care   Life Insurance   Critical Illness   and Disability Insurance

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A reverse mortgage you say?

Hmm?

We have been reading lately that reverse mortgages are being used by an increasing number of retirees in order to supplement investment incomes. This is not necessarily surprising as interest rates have fallen and real incomes have shrunk in recent years.

While it may not be surprising it certainly is concerning.

We believe that while reverse mortgages are undoubtedly a legitimate vehicle that can be used to advantage by many who need an additional boost to their income they should only be entered into after a great deal of thought and consideration, making absolutely sure the implications are fully understood.

Let me repeat: If you are thinking about a reverse mortgage and believe it to be a solution to your income problem – do not get involved until you fully understand what it will mean to your present and future financial well being.

What is a reverse mortgage?

A reverse mortgage is offered to Canadian homeowners who are over the age of 55 and have no income, credit or health qualifications. In other words, so long as you own your own home – or a significant portion of it, you can take on a reverse mortgage in spite of any credit difficulties you might have had or have, and regardless of your health.

It is a loan. The collateral is your home equity.

But, unlike traditional loans, you do not have to pay interest or repay the loan as long as you continue to own the home and live in it.

Of course, not having to actually pay interest does not mean that the loan is free. The loan is made at interest and the interest, because you are not actually paying it, will accumulate and be added to the loan amount every month and every year that the reverse mortgage is in place.

If you sell the house, the reverse mortgage – the principal and accumulated interest, must be repaid to the lender.

If you die, the house must be sold and the principal and all of the accumulated interest must be repaid to the lender. If at the time of your death, the reverse mortgage amount is greater than the value of the house, the lender will absorb the resulting loss. If the opposite were true, your estate would receive the difference.

If you elect to move to another home or apartment and even then, wish to retain the home, the principal and all of the accumulated interest must be repaid to the lender. You have to be living in it to keep the reverse mortgage.

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The interest will be charged at a rate said to be competitive with other loan interest rates. Note that we say: "…a rate said to be…" because in our experience, the rate is often higher than what you would pay for a traditional mortgage where you are making interest and principal payments.

Reverse mortgages may appeal to those whose home is their principal asset and who, for one reason or another, have been unable to save enough to finance their retirement without tapping into the equity value of their home.

But keep in mind: It's not magic. It's math!

The marketing

The marketing of reverse mortgages – because lenders like them often better than the borrowers – is interesting.

They are advertised as being a means of your staying in the house you have grown to love – you've raised children in it, good things have happened to you in the house, it is full of memories you cherish – when you might otherwise feel compelled to sell it in an effort to downsize and realize some of the equity you have in the property. So, a reverse mortgage is supposed to allow you to remain in the house but use some of the equity in the house to obtain a flow of income without actually selling it.

On occasion we have seen advertisements showing a distinguished looking retired couple, seemingly healthy and smiling at each other saying things like: "This will give us a chance to help the kids during our lifetime rather than after."

And if you are the type that can be swayed by that type of advertising and believe, as a result, that a reverse mortgage might be a good thing for you and the kids: please watch out! It may not be.

In fact, we suggest that it is not a good thing. Reverse mortgages should only be used if there is no other recourse!…your income will not stretch and other viable alternatives that you explore don't seem to work.

It should not be the means of giving yourself an income increase that will finance an annual cruise or two; or pay for that new car you've so much wanted; or to make a quite possibly unnecessary gift to your children – and we want to be fair to them, so it means a gift for each of them of equal size – and not all kids need financial assistance from their parents! We have seen instances where that unwanted gift resulted in merely increasing the tax burden for the quite well off children!

But the other alternative is that you use the funds not to pay for a cruise, or a new car or even to subsidize children but rather, to invest the amount you borrow and then, use that interest to supplement your income – which needs the boost.

And that's probably the only reason a reverse mortgage should be considered.

Yeah, but what's the real problem?

And that is a good question. The answer is interest rates.

As you are no doubt aware – whether you are an investor or a borrower – interest rates are at what appear to be all-time lows. Perhaps they are. We think they are lower than we have seen in a good many years – they have been steadily coming down and we believe that what we are seeing is a "new normal." Indeed, from an investment standpoint we do believe that they are at that new normal level – with no significant changes in the near future.

If you are one of the borrowers who need the equity to invest to get the income increase, these low interest rates are not going to work in your favor, obviously. A lot of money will be tied up at low interest unless you draw the interest and a part of the invested capital. Some use a prescribed annuity – but that's essentially doing the same thing, isn't it – you're taking capital and interest at a fixed rate.

If you are an investor who is also retired and have no employment income to fall back on, we believe that the solution is dividends. We don't believe that many income levels are sustainable if you are relying on interest earnings unless you are very rich indeed. By the same token, in the current investment and economic climate, we also do not believe that we can rely on capital gains to sustain income. Thus, dividends are the solution to the problem but at levels that we formerly expected from interest rates. We cannot rely on double-digit yields from dividends, or from capital gains and certainly not from interest earnings.

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If you are a borrower – and remember, people who have reverse mortgages are borrowers – then these low interest rates we are experiencing today will also be reflected in loan rates. And that makes loan interest rates appear attractive.

A significant element of the economic problems we are facing today is those very low interest rates on borrowed money.

People lost their homes because of those low rates when they were combined with declining home values. When the home values declined at alarming speed, even with low interest rates people found that they were saddled with very large mortgages. And what made it worse were scheduled increases of very low mortgage rates. They were so "mortgaged" that any rise in rates had a devastating effect on their budgets.

Leave us not forget: reverse mortgages are…mortgages.

So…what will happen should interest rates rise in the future?

What will happen is that the reverse mortgage will increase at a faster than expected rate.

And while you are not required to service the reverse mortgage by paying down the principal OR by paying interest so long as you live in the house, the reverse mortgage holder will find it is essential to stay in the house in spite of changing circumstances.

For those who have invested the proceeds of the mortgage at interest a further increase in income will occur – but at the same time as the mortgage amount is being accelerated by the same rise in interest rates.

Like…?

For many retirees, the next financial crisis will arise when the unexpected comes up. And the unexpected for many will be a health crisis.

What will that reverse mortgage holder do the day that he or she can physically no longer remain in the house because round the clock nursing or health care is required?

What recourse will they have when they find out how little of their home equity remains theirs after years of a reverse mortgage – after years of not paying down the loan or paying any of the interest that steadily accumulates, month after month, year after year.

What then?

Not a pretty picture.

And that is why a reverse mortgage, rather than being a great benefit provided by the banks, is actually something that can prove very dangerous.

You worked hard for that house – and for the capital it represents to you. Think hard before you enter into a reverse mortgage agreement.

Indeed, we recommend that you meet with your financial advisor to explore all possible avenues before settling on a reverse mortgage, which, admittedly, could prove the only recourse you have – but at least, you'll approach the issue with your eyes wide open and not necessarily be entranced by the attractive TV commercials and websites.

Before you act – call us!

TFSAs

Tax Free Savings Accounts ought to have been called Tax Free Investment Accounts. You are not obliged to open an ordinary bank savings account at very low interest rates!

Simply, you can invest in anything you would normally use when investing in an RRSP. The difference is that you will not pay tax – ever – on the investment earnings of a TFSA.

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At this time of year, when you might be considering an investment in RRSPs be sure to talk to your financial advisor about opening or adding to a TFSA. You might do both. Or you might do one or the other. Either way, some dialogue with your financial advisor could prove to be highly profitable to you.

Before you act – call us!

2012

We approach 2012 with cautious optimism. We think there are signs of improvement. Most of our clients are “ahead of the markets” – their assets grew in a year when the markets did not. We want to thank you for being our clients and we wish you and your family good health and every success at home, at work, at play throughout 2012.

We are looking forward to another year with you. We think it may well be exciting and profitable.

And remember – before you act - call us! We can help you make it a great year – just call us!

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