Report Warns Retirees about Potential Downsides of Reverse Mortgages

Reverse mortgages have been around for years. But they're getting a new spin: Some senior homeowners are tapping into their home equity to "bridge the gap" until the time they're ready to apply for Social Security benefits.

However, an independent consumer agency — the Consumer Financial Protection Bureau ("CFPB") — is cautioning retirees against using this strategy. A recent CFPB report claims that the costs and risks associated with a reverse mortgage often exceed the cumulative increase in Social Security benefits you would receive by delaying benefits.

"A reverse mortgage loan can help some older homeowners meet financial needs, but can also jeopardize their retirement if not used carefully," said CFPB Director Richard Cordray in a press release. "For consumers whose main asset is their home, taking out a reverse mortgage to delay Social Security claiming may risk their financial security because the cost of the loan will likely be more than the benefit they gain."

How Do Reverse Mortgages Work?

As the name implies, a reverse mortgage is almost the opposite of a regular mortgage. Instead of making regular monthly payments to a financial institution, you typically *receive* a lump sum or monthly payments from the lender. Or the reverse mortgage can be set up as a line of credit that the homeowner may draw on as needed. You can also arrange a combination of payment methods if it better suits your needs. In the meantime, you continue to live in the home while the reverse mortgage remains in effect.

This enables a homeowner to tap into the equity in a home before actually selling it. This strategy is similar to an advance sale of the home, except that the money you receive is generally tax-free. (Normally, a sale of a principal residence results in capital gains income, but you may qualify for a generous home sale tax exclusion on the proceeds.)

To qualify for a reverse mortgage, you must:

- Be at least 62 years old; and
- Own the home outright (or have a low mortgage balance that can be paid off with the reverse mortgage proceeds at closing).

There are no income requirements (or limitations) to qualifying for a reverse mortgage. The amount you can receive depends on several factors, including your age, the value of your home, the area where you live, the length of the loan and the interest rate.

There are three basic types of reverse mortgages:

1. Single purpose reverse mortgages. These are provided by some not-for-profit organizations and state and local government agencies.

2. Proprietary reverse mortgages. These include private loans offered by financial institutions.

3. Home Equity Conversion Mortgages ("HECMs"). HECMs are federally insured reverse mortgages and are the most common variety.

As a general rule, you don't have to pay back a reverse mortgage while you're still living in the home. However, it must be repaid when you sell the home, move out, default on taxes or insurance, or die. In some cases, your estate will have to sell the home to obtain the amount needed for repayment.

When Should You Apply for Social Security Benefits?

Generally, you're entitled to receive 100% of your allowable Social Security retirement benefits, based on your earnings history, when you reach your full retirement age ("FRA"). Your FRA depends on the year of your birth. It ranges from age 65 for those born before 1938 to age 67 for individuals born after 1959. For most Baby Boomers retiring this decade, the FRA is age 66.

You don't have to wait until your FRA to receive benefits, however. You can elect to begin taking benefits as early as age 62 **—** the same age you can qualify for a reverse mortgage **—** although your monthly benefits will be reduced. The closer you are to the FRA when you apply, the lesser the reduction in benefits. But the monthly reduction can be as much as 25% of the full amount you would have received if you'd waited until your FRA to apply.

Conversely, if you choose to delay your application for benefits beyond your FRA, you'll receive a higher monthly amount. Essentially, your benefits are increased by 8% for each year you delay taking benefits until age 70. Thus, the maximum increase for Baby Boomers with an FRA of age 66 is 32%. Once you reach age 70, the monthly benefit amount is maxed out.

What Are the Potential Pitfalls of Using a Reverse Mortgage to Defer Benefits?

Some seniors decide to retire before their FRA (or delay applying for benefits past their FRA) and then rely on a reverse mortgage to supplement their cash flow needs. But it's critical to consider the costs and risks a homeowner assumes when using a reverse mortgage to bridge the shortfall from deferring Social Security benefits.

The CFPB report identifies the following drawbacks of using this strategy:

***The cost of a reverse mortgage often exceeds the lifetime benefit of delaying Social Security*.** The average length of a reverse mortgage at age 62 is seven years. By age 69, borrowers that pursue this strategy will have paid about 60% of the cost of the borrowed amount — including interest, insurance and fees — for the privilege of receiving higher Social Security benefits in the future.

In fact, the CFPB report found that, by age 69, the costs of a reverse mortgage are $2,300 higher than the additional cumulative Social Security benefit you'll receive during your lifetime.

***The decrease in home equity limits your ability to address future financial needs*.** This is especially true for individuals who end up selling their homes after taking out a reverse mortgage, because the loan balance grows faster than the home's value increases. This could limit options for moving or coping with financial difficulties.

For example, the CFPB references a 62-year-old homeowner with a home valued at $175,000 who takes out a reverse mortgage. Assuming 2% appreciation each year, the homeowner will have only 61% of the home's total value available as equity at age 67 if he or she decides to move and sell the home. By age 85, this homeowner will have a mere 16% of the equity in the home if the home is sold.

There are other drawbacks to consider, as well. For instance, you have to pay back a reverse mortgage if you sell or move out, which could create complications if you're forced to go into an assisted living facility or nursing home. Also, if you default on the loan, the lender may demand repayment in full or even foreclose on the home. Furthermore, the reverse mortgage reduces the nest egg you can leave to your heirs and your family won't be able to inherit your home, which they may have emotional ties to, if you take out a reverse mortgage.

Look before You Leap

Consider all the relevant factors before embarking on a reverse mortgage as a method to replace Social Security benefits or simply to tap into home equity when you're retired. The CFPB has published a consumer guide and video in conjunction with its report on reverse mortgages to help prospective borrowers and their families make an informed decision. Or you can contact your tax and financial advisors for more information relating to your personal situation.

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