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Reverse mortgages are set to rise, unfortunately

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The more financially unprepared you are for retirement, the more likely it is that there's a reverse mortgage in your future.

Sadly, we seem to be poised for big growth in reverse mortgages.

"Seniors today are living longer, they're spending more and they've saved less," said Greg Bandler, senior vice-resident of sales and marketing at HomEquity Bank, the country's sole provider of reverse mortgages (under the name Canadian Home Income Plan). "They also have so much of their net worth tied up in their home, a very illiquid asset. We're all about helping them unlock that asset and provide some liquidity so they can have some cash flow and do the kind of things they want to do."

The plight of the senior who didn't save enough for retirement – get ready to hear more about it as people 65 and older become a bigger and bigger segment of the population. Where can cash-poor seniors find some money? Reverse mortgages are an easy option (I'll look at some other possibilities in an upcoming column).

Here's how a reverse mortgage works in three steps:

1. Borrow up to 50 per cent of the appraised value of your home.

2. Spend the money as you see fit.

3. Repay the principal, and interest that has been accumulating, whenever you sell your home.

It's rare to hear financial advisers unreservedly criticize a product, but this does happen with reverse mortgages. "The reverse mortgage, to me, has always been the lender of last resort," said Clay Gillespie, an adviser with Rogers Financial Group in Vancouver, who mainly has seniors as clients. "There are very few cases where I believe it makes sense to take out a reverse mortgage."

The points against reverse mortgages include hefty set-up fees and higher than usual mortgage rates. But the biggest issue is the way interest compounds. You know how you get paid interest on interest when you invest in a term deposit? With a reverse mortgage, many people will end up paying interest on interest. That's because unpaid interest on your loan gets added to the principal and generates a bigger interest bill moving forward.

If you keep a reverse mortgage going for many years, a worst-case result would be that you're left with little or nothing after repaying the accumulated interest and principal and covering the costs associated with selling your home.

HomEquity Bank's Mr. Bandler said reverse mortgage holders have on average retained 50 per cent of the value of their homes when they eventually sold. He also said that a rising real estate market can offset the effects of a reverse mortgage by boosting the value of the remaining equity in your home.

A sales presentation used by HomEquity Bank includes a slide showing that home prices rose at a national average annual rate of 5.91 per cent for the 15 years to Sept. 30. But the chances of prices rising at that rate in the years ahead are slim. More likely, prices will coast or fall in the near term.

Combine falling home prices and a reverse mortgage and you could see your home equity dissolving in a way that doesn't leave much when you sell in the future. Don't worry – you will never owe HomEquity Bank more than the fair market value of your home. If you sell for less than you owe, HomEquity Bank eats the difference.

HomEquity doesn't leave this to chance, though. The younger you are when you apply for a reverse mortgage, the less equity you can take out. If you sign up at the minimum age of 55, Mr. Bandler said you would be capped at 20 to 25 per cent of the equity in your home. "We're very conservative lenders," he said. "That conservative approach is baked into our model."

HomEquity Bank became a full-fledged bank in 2009, enabling it to offer lower interest rates on reverse mortgages. This helps explains why the volume of new reverse mortgages was up 87 per cent last year over 2009. "The CHIP Home Income Plan is being transformed from a niche product to a mainstream solution that will increasingly be included in Canadian seniors' financial plans," the parent company's 2010 annual report says.

In a world where people are living longer, spending more and saving less, the reverse mortgage is probably a necessity. The less you prepare for retirement, the more likely you are to need one.

REVERSE MORTGAGES

Some facts and figures on the Canadian Home Income Plan reverse mortgage:

Setting one up

Set-up costs: As much as $2,500 or so to cover appraisal, legal fees and administration/closing costs.

Interest rates: 4.75 per cent for a variable rate; 5.95 per cent for a five-year fixed term.

Options for receiving money: Take the money in a lump sum, gradually or a combination.

Interest payment options: Pay all, part or none of the interest that accrues ever year.

Profile of users

Average age of applicants: 72

Average amount of home equity borrowed: 36%

Average length of time people stay in their homes after taking out a reverse mortgage: 12

Average amount of home equity left after a home is sold and the reverse mortgage paid off: 50%