Reverse Mortgages: Pros and Cons

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Learn the basics to avoid surprises.

After investing a lot of money in your home, the chance to get some of it back during retirement -- while staying in the home -- sounds like a good deal. That's the idea behind a reverse mortgage. The option may especially appeal to homeowners who have significant equity in the house and want to age in place.

If you or a family member are exploring retirement planning, you'll want to weigh reverse mortgage pros and cons, including the strict eligibility requirements and alternatives.

How Does a Reverse Mortgage Work?

A reverse mortgage is a loan you take against the equity in your home. You don't have to make monthly principal or interest payments as you would with a traditional mortgage or a home equity loan. The lender distributes funds tax-free as a lump sum, a line of credit, or a monthly payment. You won't have to repay the reverse mortgage loan as long as you're living in the home, but it becomes due if you sell, move, or pass away. So, for seniors who plan to spend the rest of their life in their primary residence, the loan may never come due.

What Are the Requirements for a Reverse Mortgage?

Most reverse mortgages are Home Equity Conversion Mortgages, or HECM, loans insured by the Federal Housing Administration. Some private lenders and state or local governments also offer reverse mortgages, but they may not offer the same level of consumer protection.

HECM loans require borrowers to meet strict eligibility requirements, including:

- Being 62 or older (includes both partners in a couple who share ownership)
- Owning the property outright or having paid-down a considerable amount
- Occupying the property as your principal residence
- Being in good standing on any federal debt
- Having enough financial resources to continue making timely payments for ongoing property charges such as property taxes, insurance, and homeowner association fees
- Participating in a consumer information session with a HECM counselor approved by the U.S. Department of Housing and Urban Development

With these strict requirements, many people won't qualify for a reverse mortgage loan. But eligible homeowners will want to know reverse mortgage pros and cons.

What Are the Pros of a Reverse Mortgage?

A reverse mortgage has several benefits, including:

Reverse Mortgages Could Provide Income During Retirement

Retirees can use a reverse mortgage to supplement other retirement income streams, like Social Security or a pension. The reverse mortgage process allows homeowners to turn an illiquid asset (a house) into cash they can use for daily expenses.

Situations in Which the Mortgage Loan Will Be Due Are Clearly Defined

Until you move, sell, or die, you can continue borrowing and using the loan. But you or your heirs may need to sell the residence to cover the loan balance in the future.

The Loan Amount Won't Exceed Your Home's Value

With a changeable real estate market, some homeowners are concerned about what they'll do if their home loses value. The good news is that FHA mortgage insurance fills the void between what you owe and the home's sale price. That means you won't be responsible for more than what your home is worth.

Reverse Mortgages Offer Tax-Free Payouts

The money you receive from a reverse mortgage isn't considered taxable by the IRS. That means you could end up with more money in your pocket than what you'd pay for withdrawals from another retirement account, like a pretax 401(k).

What Are the Cons of a Reverse Mortgage?

Cons of a reverse mortgage include:

Risk of Foreclosure
As with a home equity loan or home equity line of credit, failure to meet loan terms or keep up with costs could cause the lender to repossess the home through foreclosure.

Loan Costs
A reverse mortgage carries insurance costs, closing fees, and origination fees. Discuss these costs with a loan counselor to avoid surprises.

Age Restrictions
Since you must be 62 to be eligible for a reverse mortgage, many homeowners can't access it.

Insufficient Proceeds
The proceeds must be enough to help cover property taxes, homeowner insurance premiums, and home maintenance costs. Failure to stay current in any of these areas may cause lenders to call the reverse mortgage due, which could result in the loss of the home.

Possible Scams
Reverse mortgage scams often target homeowners facing foreclosure. Because of higher closing costs and other fees, taxes, and premiums, a reverse mortgage could be too expensive for a senior with financial problems.

Inability to Borrow the Full Value of the Home
Qualified homeowners may not be able to borrow the entire value of their home even if their mortgage is paid off. The amount a

homeowner can borrow varies based on the age of the youngest borrower or eligible nonborrowing spouse, current interest rates, the HECM mortgage limit, and the home's value. Most reverse mortgages have a "nonrecourse clause," meaning you or your estate can't owe more than the value of your home when the loan becomes due, and the home is sold.

More Owed Over Time
As you get money through your reverse mortgage, interest is added to the balance you owe each month. That means the amount you owe grows as the interest on your loan adds up.

Potential Change in Interest Rates
Most reverse mortgages have variable rates, which are tied to a financial index and change with the market. Variable rate loans may give you more options on how you get your money through the reverse mortgage. Some reverse mortgages -- mostly HECMs -- offer fixed rates, but they may require you to take your loan as a lump sum at closing.

Interest Not Tax Deductible Each Year
Interest on reverse mortgages isn't deductible on income tax returns until the loan is paid, either partially or in full.

What Are Alternatives to Reverse Mortgages?

If you don't qualify for or you decide against a reverse mortgage loan, you still have financing options. A home equity loan, or second mortgage, lets homeowners borrow against the equity in their home. The loan amount is based on the difference between the home's current market value and the mortgage balance the homeowner still owes.

If you don't want to take out a large loan against your home's equity, you may want to consider a home equity line of credit, or HELOC. You can draw funds as you need them and repay them using a variable interest rate. HELOCs can make sense for homeowners who need funds for ongoing home improvement projects or time to pay down existing debt. To qualify for the most attractive rates, you'll need a high credit score, a low debt-to-income ratio, and substantial equity in your home.