



Tapping the equity of home sweet home

One of the more intriguing financial ideas introduced in the past decade is the concept of reverse mortgages. We've all seen the ads: an elderly couple singing the praises of their financial decision and the benefits that it has brought to them. But, like everything that seems "too good to be true," there are as many disadvantages to this concept as there are advantages.

Fortunately, there are alternatives to the reverse mortgage that could provide greater flexibility to homeowners at less cost while helping them achieve the same goal.

HOW A REVERSE MORTGAGE WORKS

The reverse mortgage was originally designed for seniors who were house-rich and cash-poor. It was

intended to provide supplementary income during retirement years for people who had no other source of funds but who wanted to retain the home they lived in and enjoy its accumulated equity. In fact, the loan doesn't need to be repaid until the seniors leave the home or the last remaining spouse dies.

This means that the financial institution lending you the money has actuarially calculated your life expectancy and, therefore, when they expect to get their money – plus interest – back. That's why reverse mortgages are only offered to people 62 years of age or older and why the maximum amount is restricted to a certain percentage of the value of their home (originally between 10 per cent and 40 per cent), based on their age. The younger you are, the less they will lend you because the longer you could live or stay. Similarly, if you are female, you're eligible for a smaller loan because, statistically, you're likely to live longer.

For example, a male, aged 70, with a \$200,000 home may be eligible to borrow between \$95,000 and \$102,000. A female homeowner, same home, same age, would be eligible to borrow between \$78,000 and \$85,000.



THE DOWNSIDE

First, unlike a home equity line of credit, where you only pay interest on what you've borrowed when you borrow it, a reverse mortgage requires you to take out the full amount as a lump sum immediately and interest is calculated on the whole amount, even if you don't need it all right away.

Second, the interest rate of a reverse mortgage can be substantially higher than prime. It is guaranteed but is re-set on an annual basis. So, if interest rates go up throughout the year, the reverse mortgage holders have some reprieve before their rate goes up. Conversely, if rates go down, they need to wait for the duration of the year before they can benefit from a lower rate.

Third, some programs cover none of the usual start-up costs. In total, costs for opening a reverse mortgage are approximately \$1,700.

Finally, the requirement of "no repayments" is a mixed blessing. While it's nice to know that you don't need to repay any of your borrowings while you live in the house, the fact still remains that the interest clock is ticking – and it's ticking with interest on interest over the years. The full amount becomes due upon the death of the last surviving spouse, when your house is sold or if you move out. You do, however, have the option of paying it off in full at any time – although, a prepayment penalty will apply if you pay it off within the first five years. In addition, you may also elect to pay all or part of the accrued interest. So, the reverse mortgage may not be entirely irreversible.

But live a little longer than expected or witness a drop in home values, and there may well come a time when the amount of the loan exceeds the value of the home. And, although they won't call the loan, at the very time you may need the cash to relocate to a nursing home or rental property, you may find that the accumulated interest has drained all the equity from your last bastion of security.

A MORE AFFORDABLE OPTION

Unlike a reverse mortgage, with a home equity line of credit you only pay interest on what you've actually borrowed. In other words, you may eventually need \$50,000 but, until you've actually used that much money, you're only paying interest on your current day's outstanding balance. What's more, you can borrow back anything you pay down, any time you want. With a reverse mortgage the balance borrowed is always increasing (unless you are paying the interest once a year) – and it can never be paid down, until it's paid off.

At least one home equity line of credit offers a unique twist that makes it even more affordable as a reverse mortgage alternative. The flexible mortgage account enables clients to combine their mortgage with their chequing and savings accounts. So, every time a deposit is made (pension or government cheque, etc.) it immediately pays off the interest and lowers the principal of the debt. The interest rate is prime – think of it as prime minus your income. So, while the interest rate is competitive, you have the significant advantage of being able to reduce your principal every time you make a deposit to your chequing account.





Apart from any penalties your current financial institution may charge you for moving your mortgage, most banks will cover some or all of your administrative costs (e.g. appraisal, title search, title insurance, registering the mortgage).

CONCLUSION

If you are looking for additional revenue and are thinking about tapping into your home's equity, you would be well advised to work out the numbers. If you want flexibility, full banking functionality, access to up to 75 per cent of the value of your home, at whatever age you decide to borrow, at a rate of prime, applied to only what you owe each day, with the option to pay it down or pay it off whenever and if ever you want to, you'll want to consider a home equity line of credit. And, if you have any intentions of leaving an estate to your kids, they'll be thankful you considered it too.

Borrowing is suitable only for investors with higher risk tolerance. You should be fully aware of the risks and benefits associated with loans since losses as well as gains may be magnified. You must meet your loan and income tax obligations and repay your loan in full.

If you are interested please call me for a referral to a Manulife Bank Banking Consultant.

Manulife Investments is the brand name identifying the personal wealth management lines of business offered by Manulife Financial and its subsidiaries in Canada. As one of Canada's largest integrated financial services providers, Manulife Investments offers a variety of products and services including: segregated funds, mutual funds, principal protected notes, annuities and guaranteed interest contracts.

WealthStyles, Manulife and the block design are registered service marks and trademarks of The Manufacturers Life Insurance Company and are used by it and its affiliates including Manulife Financial Corporation.

www.manulife.ca/investments

 **Manulife Bank**