Debt Management – Costs and risks of reverse mortgages

The risks associated with a reverse mortgage mean it is unsuitable for some home owners. It is essential to carefully consider these risks and to obtain legal advice and estate planning advice before proceeding with a reverse mortgage strategy.

With access to a large amount of credit, some people may have difficulty budgeting over the long term. The need to budget is greatest when the family home is your biggest financial asset.

The specific risks associated with using a reverse mortgage include:

- **Timing of repayment and sale** – Generally, a reverse mortgage has no fixed repayment date. The amount owing (including interest charged) must be fully repaid when you sell your home, move out, or die. This means that your home may have to be sold urgently at short notice, at an inconvenient time, or at a time when house prices are at a low point.
- **Capitalisation of interest** – A reverse mortgage compounds the interest charged, as generally no ongoing repayments are made to the loan. This means the balance of your loan will continue to increase as interest builds up, even if you do not borrow additional funds. It also means that over time interest will accrue on the interest that you have already been charged.
- **Interest rates are higher** – Interest rates are generally higher than average home loans.
- **Variable interest rate** – A variable interest rate means that your interest rate may rise, increasing your overall interest costs, and potentially reduce the net value of your home.
- **Fixed interest rate** – Fixing the interest rate gives you more certainty of interest costs. However, there is a chance that variable interest rates may fall to a point lower than the rate you have your loan fixed to.
- **Exit penalties and other fees** – Reverse mortgages usually charge an exit penalty if the loan is paid out early, particularly those where the interest rate has been fixed. Reverse mortgages have fees that are comparable with normal mortgages. Fees may be quite high relative to the size of the loan particularly if the loan size is small.
- **Terms and conditions** – There may be terms and conditions in the reverse mortgage contract that are unacceptable to you. For instance particular circumstances triggering the immediate repayment of the loan, the loss of key rights, the loss of a ‘no negative equity guarantee’, and/or possible eviction.
- **Lump sum drawdown** – A lump sum drawdown means you receive a single amount of money by drawing once from a reverse mortgage. If the lump sum is large, high interest costs will apply immediately.
- **Regular drawdowns** – Regular drawdowns involve receiving many ongoing amounts from your reverse mortgage, usually of the same size over a period of time. Some lenders will charge additional fees for regular drawdowns. Regular drawdowns will continue to increase the size of your loan until they cease being made.
- **Reduction in emergency funds** – A reverse mortgage will reduce the amount of capital available to you in an emergency. This means that in the future, you may not be able to access sufficient funds to meet any emergencies for health or other purposes, because of the reduced equity in your home.
- **Lender’s rights** – As a result of a reverse mortgage, the lender (generally a bank) will have an interest in your home. This means that you may need to consult with the lender when making decisions regarding your land or home.
- **Maintaining or renovating your home** – The lender may require you to maintain your home to a higher standard than you think necessary, which will increase the time and cost of maintenance. The lender may also place restrictions on the scale and type of renovations you may wish to complete on your home.

- **Reduction in the value of your estate** – A reverse mortgage will reduce the net value of your home. This means that in the event of your death, the value of your estate will be less than if you did not use a reverse mortgage. You may wish to discuss this aspect with the beneficiaries of your will, or obtain estate planning advice. You should also review your Will and any other estate planning arrangements.
- **Negative equity** – With some reverse mortgage products, it may be possible for the loan to increase to a point where it is worth more than the value of your home and land. This means that there would still be a debt owing after selling your home and using the entire sale proceeds to pay off the reverse mortgage. This carries extra risk. You should ensure that your reverse mortgage product has a 'no negative equity guarantee'.
- **Residents who are non-borrowers** – If you are a sole owner and someone lives with you, that person may not be able to stay when you die.
- **Moving to an aged care facility** – If or when you decide to leave your home and move into an aged care facility, the net value of your home will be less after paying off the reverse mortgage. The reduced amount of funds may limit your financial ability to enter an aged care facility of your choice. Also, if you have to repay the outstanding debt when you move in to care and the home has to be sold, this could have a negative impact on your social security entitlements and aged care fees.
- **Social security** – Depending on how you use the funds from your reverse mortgage, your social security benefit may be reduced. This may be as a result of an increase to your assessable assets (such as funds in a bank account), or an increase to your income (due to the deeming of financial investments or the payments received from a pension you may have purchased).
- **Reduced ability to support other loans** – You may want to assist a family member or friend by providing your home as security for their loan. Your ability to provide this support may be reduced, because the equity in your home will be reduced.
- **Property expenses** – You will still be required to pay for property expenses such as council rates. You will also be required to maintain appropriate insurance cover for your home.

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