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Transitioning From a Standard Mortgage to a Reverse Mortgage: A Bad Idea For Some, A Good Idea For Others

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In my father's generation, very few people still had a mortgage to pay when they reached retirement age. Now it is common. But retired homeowners may now have an option my father did not have: if they have enough equity in their home, they can pay off the balance of their mortgage with the proceeds of a HECM reverse mortgage, which does not have a required payment.

Is converting a standard mortgage into a reverse mortgage a good idea? The letter below started me thinking about this question.

"...will I be better off 10 years down the road if I take out a reverse mortgage in order to pay off the balance on my standard mortgage? I am paying 3% on that mortgage, and have been told that reverse mortgages are available at 2.5% or less. If I did this, I would invest the $2107 I am now paying monthly for principal and interest. I am 76, the house I live in is worth $626,000, and my current mortgage balance is $380,000."

I decided that whether or not this shift made sense depended heavily on the objectives of the senior borrower. Broadly, they fall into two groups.

Wealth Maximizers

The author of the letter asks whether transitioning to a reverse mortgage would make him wealthier after 10 years than staying with his current mortgage. He is a "wealth maximizer", probably because he is looking ahead to sell his home at some point, or wants to leave as large an estate as possible. However, paying off his mortgage with the proceeds of a reverse mortgage would reduce his wealth.

If he stays with his current mortgage, his $380,000 balance would be paid down to $218,253 in 10 years. If instead he pays off the balance now with the proceeds from an adjustable rate HECM, currently available at 2.154%, in 10 years he will owe $704,343. Investing the monthly payment of $2107.48 at 1%, which is about the highest super-safe return that is available today, would generate $218,253 over 10 years. But that still leaves him with $267,837 less wealth than if he had stayed with the standard mortgage.

Of course, he might earn more than 1% on the monthly payment, but he would have to earn 6.55% to equalize the two strategies.

The transition to a reverse mortgage would reduce his wealth primarily because HECM reverse mortgages require mortgage insurance. An annual premium of 1.25% raises the interest cost to 3.404%, bringing the total cost above the 3% he is now paying. In addition, his HECM loan balance would include financed settlement costs.

The loss from transitioning would be even higher if this borrower itemizes his tax deductions, because he would lose the right to deduct his interest charges. Interest charges are deductible not when they accrue but when they are paid. On a HECM, interest ordinarily is not paid until the borrower dies or moves out of the house.

Consumption Maximizers

Another senior of the same age with the identical standard mortgage, offered the identical HECM reverse mortgage, would find it advantageous if her objective was to maximize consumption rather than wealth. By converting to the HECM, the senior would have an additional $2107 every month to spend, consisting of the payment on her standard mortgage which goes away.

Consumption maximizers don't anticipate selling their home, and the size of their estate is not important. The potential for increased consumption outweighs the decline in wealth resulting from growth of the reverse mortgage balance.

Sorting Out Who You Are

Many seniors are conflicted about whether they are wealth maximizers or consumption maximizers, which may invite intrusion by other interested parties. In most cases, their children will want them to be wealth maximizers who shun the HECM. Loan officers, in contrast, will want them to be consumption maximizers because they are selling HECMs. Seniors should ignore both and decide for themselves who they are.