How do reverse mortgages work?

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada.

Marcelo: Marcelo, how are you today?

Keith: I'm doing great. I'm excited to do the intro for this show. It's a repeat guest, a great guest too by the way, and it's a great subject. Who did you have on this show before on mortgages?

Marcelo: Yeah, we had Morgan Engelbretson for the discussion on mortgage interest rates. That was a really good podcast. We got great feedback from clients, people who listened to it, friends, and it was a good discussion. So, I think today is going to be a great discussion as well.

Keith: Today's discussion is on reverse mortgages. So Marcelo, what's the concept of a reverse mortgage?

Marcelo: A reverse mortgage is when you've paid off your home and now you're in a situation where you need equity or you need money. So, think about the traditional person who finishes paying off their home. Maybe they haven't saved enough for retirement or maybe they need money for something else. They don't want to take a line of credit. They don't want to take a traditional mortgage with monthly payments and they just want to get the money out. So, there's a mechanism for doing that. And it's called a reverse mortgage. You pretty much take the equity out that gets built into a credit product where the interest gets built up. And then once you pass away or you sell the home that gets paid out but there are no monthly payments. It's just a way of getting money out of your home.

Keith: Perfect. And Morgan is going to go through all the ins and outs of the reverse mortgages. In today's episode with Morgan, we're going to talk about who are the ideal candidates in Canada. What are some of the trends that we're seeing in reverse mortgages? We're going to look at who's eligible, what institutions issue reverse mortgages. What are the mechanisms? What are the rules around the reverse mortgages? We'll look at the different costs associated with a reverse mortgage. When you first told me that Morgan does reverse mortgages to me it was a bit of a surprise because I was sitting back saying, "This is an independent mortgage broker. I didn't think they did reverse mortgages but lo and behold they do it and they're experts at it. So, we'll look at everything. Once you've borrowed the money, how do you repay your mortgage? Some of the alternatives to reverse mortgages because a reverse mortgage is a strategy, it's not the only strategy. And then finally, Morgan's going to give us a summary of the pros and cons on

Marcelo: reverse mortgages. It's a great discussion to have especially now we're in a situation where a lot of people maybe didn't save for retirement as much as they should and they have a lot of equity. Their homes have gone up 30, 40 percent in the last 5-6 years. I'm making those numbers up. It's probably more than that, probably less but you get the idea. Houses have appreciated a lot. People are sometimes fully paid them and they may not have the liquidity to fund the retirement and they are in a situation where they need to take money out.

Keith: One of the things that I know I've heard of a lot from some of the individuals we work with is maybe 10 years ago people would say, "By 75, I'm ready to downsize. I'm ready to maybe even sell and go into an apartment or a condo or maybe a little bit older, maybe a retirement home of some sort." Now you're actually hearing people say, "I'm never going to move from my house." And so that creates a financing issue. Today's show I think will be great. Morgan's a great guest. Marcelo, thank you for helping me with the intro and folks, enjoy the show.

Marcelo: Enjoy the episode.

Keith: Welcome to the episode, Morgan.

Morgan: Thank you, Keith, for having me back.

Keith: You were on the show a couple of weeks ago when we did mortgages and mortgage rates and mortgage brokering. And so, amazing to get you back for reverse mortgages.

Morgan: Thank you. I'm looking forward to it.

Keith: When we first talked last week, I was unaware that mortgage brokers did reverse mortgages. So, you want to just spend a few secs just explaining how that works. How does a mortgage broker end up doing both mortgages and reverse mortgages?

Morgan: Great comment on the fact that you didn't know that a mortgage broker did reverse mortgages. I think that there's a big gap in knowledge when it comes to reverse mortgages in Quebec and in Canada. So, a reverse mortgage really is a mortgage. The only difference is how the mortgage gets repaid. And so, when you're dealing with a mortgage broker, the mortgage broker by nature is looking to offer a variety of solutions that are going to be best tailored for the client. So, that falls in as one of our tools in our toolkit to help the clients out with whatever they're trying to accomplish.

Keith: Excellent. So, let's just jump right into it right away. Let's start with what exactly is a reverse mortgage?

Morgan: Very simply put, a reverse mortgage is a mortgage where the interest that you would have been paying the minimum monthly interest, the minimum monthly payment instead of being paid monthly is compounded, is added to the total debt which can then be repaid later. So, you receive the money upfront. But you have no requirement to repay any interest or any capital on a monthly basis.

Keith: Ultimately these vehicles, they're set to provide funds to individuals who wish, if they've got a home that's paid up, they wish to take funds out of the equity side. And they get a reverse mortgage.

Morgan: Yes. It could also be for clients who don't have the home paid off but no longer have the capacity or the desire to make mortgage payments and now have enough equity in the home to say get a reverse mortgage to close out their actual mortgage.

Keith: So, what's the ideal user? Who are the classic reverse mortgage beneficiaries?

Morgan: So, I think that you can probably divide that into two groups. You've got the retirees that are looking for some liquidity to fund their lifestyle. And within that group, you can have those that are really looking for that liquidity to have a certain quality of life, to do certain things with their money. And then another group that may not have saved up enough money. May have accumulated some debts, would like to consolidate those debts, clean up their finances, and have some money left over to live. And then I would say the second group is those who are the strategists, who are using the money for investments that are not necessarily in need of the money but would rather take the money out from a reverse mortgage than say take money out of their corporation and be taxed on that money.

Keith: Let's treat the two groups separately for a sec. We work a lot with the first group. We have lots of clients that are retirees or soon to be retirees. And I will say one thing, what's happened over the pandemic period is we're hearing statements like, "I don't ever wish to leave my home. I think I'm going to stay here forever." We never saw that before. What we would see was clients or individuals say, "If I get to 75, 80, I think I'll sell, downsize." We're not actually hearing that anymore. So, I suspect that going into the future, the reverse mortgage is going to be a really interesting vehicle to help those individuals if they are running out of liquidity.

Morgan: Big time. I think that the pandemic also brought an appreciation for enjoying your home. So, I think as people have done the work and made their backyards and redone their kitchens and looked around and said, "This is really nice. I would like to stay here considering I now have an enormous amount of equity in my property." The reverse mortgage is an ideal product for someone who would like to access some of that liquidity.

Keith: I think if you look at Canadian statistics, what we'd see is the vast majority of Canadians are home equity rich and possibly investment light. So, they haven't necessarily saved the amount of money they need to finance the 20 to 30-year retirement, but they have equity in their home and the reverse mortgage brings that out.

Morgan: And that's probably a whole other conversation about financial education, but I think a lot of people have had the aim that their house was their retirement plan. "We're going to buy the house. We're going to pay it off and it's going to grow in value. And that's going to be our retirement plan." And now, not having to sell the house but having an option to pull some of that equity without taking on a monthly payment because we can, of course, refinance a property or get a home equity line of credit, but then we have minimum monthly payments which affects our cash flow. It's a nice advantage for the Canadian homeowner.

Keith: We've warned individuals never really to consider the home as that retirement fund. What we prefer to suggest is make sure you have the retirement funding in place. At the end of the day, we've got this expression, "You can't eat your gutters." So, the reverse mortgage allows you to do a little bit of that but we like to think of the home as that last asset, the last secure asset that later in retirement years if you need to sell, downsize it provides liquidity for medical costs, for long-term care if it's needed. Suffice it to say, we're really talking about those that need the financing to help them get through retirement.

Morgan: Absolutely.

Keith: Okay. So that's category one. Let's take a few moments and think about category two. I'd never thought about that before. What does that mean exactly? The strategic user?

Morgan: Let's lay out a scenario. You have a client, they have a property that's paid off. That's worth a million dollars, let's say. And they're looking to purchase a condo in Florida, a very common practice for a Quebec client. And they're self-employed. They have a corporation. They pay themselves a small dividend per year to cover their life expenses. They could pay 300,000 in cash for their condo in Florida. They could get a mortgage in Canada on their property, but that would require most likely that they increase their annual dividend or paid from the company. Or they could get a reverse mortgage. They could take the money with no income qualification required. So, they could leave whatever they've been paying themselves for their corporation at that level, take the money out of the property via a reverse mortgage and pay cash for their investment.

Keith: Mostly for business owners possibly across the country?

Morgan: And business owners definitely, there's the advantage of not having to increase your income to then qualify for loans. But let's say you're not a business owner, you're simply just retired and you would like to then purchase a condo in Florida. And you're only receiving your pension which is going to be set. This is also a nice way to be able to borrow not based on your income but based on your asset value.

Keith: Fair enough. That's a great point. So, let's talk about eligibility. Who is eligible for a reverse mortgage? Let's go through all of this sort of the ABCs on eligibility.

Morgan: So, the first requirement, of course, is age. By nature, this is a product for people who are going into or are in their retirement stage, so you need to be 55 and over. The second is going to be the equity. The property is going to need to be worth over 300,000 at the very least.

Keith: Is that a standard 300K?

Morgan: Yeah. Other than that, as long as you have enough income to cover the property expenses, school taxes, and municipal taxes, there are no other qualification requirements for the reverse mortgage applicant. So, of course, the lender wants to know that you can still cover the school municipal taxes because that's the bare minimum. You need to be able to cover those costs reasonably. Because then the municipality could seize the property from you if you stopped paying your taxes. But other than that, there's no requirement. So, someone who's simply receiving the federal and provincial pension but has a million-dollar house or a half-million-dollar house and would like to pull some money. No problem.

Keith: Is there a certain limit in terms of what you can access with the equity levels?

Morgan: So, depending on your age and the location of the property and the value of the property, you're going to be able to borrow up to 55 percent of the value of the property and I'd have to double check but the minimum amount I believe is either 15 or 25 percent.

Keith: I'm assuming the way the math works is the older you are, the more you're allowed to take out. The younger you are, closer to 55, the smaller the amount. If you're in a larger home, 700, 800 million, 2 million, the more you can take out. And if you're in an area in Canada that appreciates quicker, the more they'll lend to.

Morgan: Exactly. It's a risk calculation for the lender because the interest is compounding on the debt which so long as you're not paying it off, there needs to be at least enough gain in value. Now, something to add to that is that the reverse mortgage issuers do have a guarantee that you will never owe more than the value. So, that is a guarantee. So, you cannot, no matter the appreciation level of your property, find yourself in a situation where now the capital plus the interest is higher and the value and the lender is saying you need to give us more money than what you can get selling the property.

Keith: Oh, so they won't come back and ask?

Morgan: No, they will not.

Keith: So, it's a protection for the borrower.

Morgan: Yes.

Keith: Yes. So, that's interesting. Financial institutions usually don't do that.

Morgan: Yeah. Canada is a little bit more conservative. We have rules that protect the consumer.

Keith: So, the rules are then that, and we'll talk about who's allowed to lend, who does these reverse mortgages, but the rules are that they cannot ask for more than the value of the property.

Morgan: Yes.

Keith: Okay. That's good protection.

Morgan: Yes. Very good protection.

Keith: So, if somebody borrows at 55 or 60 and lives to 100, they can't be forced out of their home. And they can't pay more. There's actually a risk on the lender here.

Morgan: Yes, there is. But that's why the amount that they're going to lend is going to be significantly reduced if you're 55 versus if you're 85. Because of course that time that is the risk.

Keith: Of course. And they've done their math and they've done their calculations. So, they're very careful.

Morgan: Yes.

Keith: Let's switch a little bit and move into who's actually doing the reverse mortgages. What are the institutions that provide these financial instruments?

Morgan: The two reverse mortgage lenders in Canada are going to be CHIP as well as Equitable Bank. CHIP, many people have heard of as they spend a lot of money on advertising.

Keith: They're on TV all the time.

Morgan: Exactly. So, we know CHIP and then Equitable, a little bit less known, but also offer a great reverse mortgage product.

Keith: Are you telling me that no big bank offers reverse mortgages? You can't walk into Bank of Montreal, CIBC, Royal and ask for a reverse mortgage. Is there a reason why they're not in the reverse mortgage business?

Morgan: Oh, this would only be speculation, but I would think that it's because at this moment, the market is quite small in comparison to the regular business that they're doing. Now, more speculation, possibly in the future, they may revise that as the reverse mortgage business grows. Because it will be and is a growing space in Canada.

Keith: Fair enough. So, what is the size of the reverse mortgage market in Canada relative to the mortgage market?

Morgan: It's below 1 percent of mortgages issued are going to be reverse mortgages in Canada. So, it's not a large amount of mortgages. And that's for two reasons. One is that when we talk about major city centers, we have enough equity in our property to warrant a reverse mortgage. But if you look at the Canadian market as a whole, there are a lot of areas where a reverse mortgage to pull 30 percent of a 300,000 house is not very much money when compared to 80 percent if you're doing a regular mortgage.

Keith: Fair enough. I suspect this is going to be a growing marketplace in the next five but even really 10, 15 years for sure. There's no question.

Morgan: Yeah I mean CHIP, their 2022 was 30 percent more than their 2021. That is a huge increase in demand. And we're really, because of the pandemic, only at the beginning because property values have gone up so substantially which then makes everybody eligible for more money.

Keith: So, CHIP, Equitable, the two main reverse mortgage providers. What does the application process look like? Walk me through it. Imagine I'm 59-60. I think that in about five years from now I wish to get a reverse mortgage. What I come to Morgan who's an independent mortgage broker. Walk me through the process.

Morgan: So, the process is fairly easy. First, we're going to require some documentation from you, but because income documentation is not as intense as a regular mortgage, I'm going to need pieces of ID, maybe your most recent T4s, and a copy of the property's school and municipal tax bill to make sure that it's not in arrears. From there, based on age, location, and property value, we're going to determine roughly how much you should be able to borrow. From that point on, we're submitting it to one of the lenders. When we do that, there's a couple of things now that become on the onus of the potential client. First, a home appraisal needs to be done to determine the actual value of the property. That will be at the cost of the client. So, that will need to be ordered. Depending on the city you're in, there should be a list of preferred evaluators or recognized evaluators. Once that's done, now we know for sure a property is worth X amount of money. The lender will have some sort of a document, a commitment letter which will say, "Hey, based on this value, we're going to give you this much money at this percent interest." And you can have it 1-year fix, a 2-year fix, or you can go on a variable rate if you want. Once that's done, the lender says, "We've agreed to give you this amount of money." You then have two more steps. First, you're going to have to speak to either a notary or a lawyer because they need to verify your mental capacity. So, they're going to do an interview with you if you will and sign off saying, "Yes, this person is capable of making this financial decision." And then once that's done, like a regular mortgage, you're going to go to the notary, they're going to register it, and they're going to give you the money.

Keith: There are interest rates that apply and they come up for a renewal just like a regular mortgage industry.

Morgan: Yes, absolutely.

Keith: What's the role of an independent mortgage broker? So, what do you do, Morgan, in terms of bringing the client on board, getting them signed up, and actually getting them through the process?

Morgan: To your previous question of what the process is when working with a mortgage broker, I would say that before we get to the process of applying for a reverse mortgage, we want to determine first, is that the best strategy? What other options do we have available based on our current situation and our objective? And then once we've had that discussion, we figured out, okay, maybe we go and we get a regular mortgage and that tides us over for a couple of years. And then we apply for a reverse mortgage. Maybe the product that we need is a line of credit because we need a revolving debt so we can move the money in and out of the product. If we've covered all of those bases and then we find that the reverse mortgage is the best option, then we go ahead with that.

Keith: That makes total sense. So, Equitable and CHIP, I would assume, each have a way to offer the product directly to Canadians?

Morgan: Yes, correct.

Keith: Can you go through the reason why someone uses an independent broker versus going direct to CHIP? And does CHIP like to work with independent brokers? Talk about that whole dynamic.

Morgan: Both of them do work with independent mortgage brokers. The reason is actually fairly similar as to why you would want to work with a mortgage broker versus working with the bank specialist because if you're dealing with a representative of the lender, they are very narrow in their option. They offer the reverse mortgage. They're going to be able to counsel and advise on their specific reverse mortgage where when you're working with the broker, as I've mentioned, we're looking at the whole strategy and also because as an independent broker, you're looking for a long-term relationship with your client. You're not just looking at how do I get the client what they're looking for right now but what is going to be that impact over time and is that the best way to move forward right now or are there other ways to set things up?

Keith: I think the mortgage broker acts more as an advisor on financing.

Morgan: Correct.

Keith: So, we've covered interest rates in terms of there's a renewal process every X amount of years depending on when it comes up. What are the current rates that are used in the reverse mortgage?

Morgan: Obviously, this is time-sensitive but we're somewhere between the mid-sevens to the mid-eights.

Keith: So, we're looking at prime plus one to maybe prime plus two.

Morgan: Yeah.

Keith: Okay, so that's not cheap financing.

Morgan: No, but it's still not relatively expensive when you compare, say, to a home equity line of credit which might be at prime plus 0.5, prime plus one.

Keith: They have to charge that premium. The advantage is that you don't repay the interest.

Morgan: Correct.

Keith: You get your money and then you don't have to, whereas a lot of credit, you have to constantly pay.

Morgan: You have to make a minimum payment. Now, that being said, and a lot of people don't know this, is you can repay your interest on your reverse mortgage. You're not stuck compounding that interest, but the difference is you get to choose if you would like to pay that interest back or not.

Keith: Fair enough.

Morgan: And how much of it you'd like to pay back.

Keith: So, can we talk about repayment and how actually money gets into the mortgagee's hands? So, I'm an individual. I'd like to pull out 200,000. Do I have to take 200,000 in one lump sum or can I access it on a regular basis or even semi-regular basis?

Morgan: Yes. The way that's going to work is the amount of money that you receive, how you receive it will be up to you. So, if you would like to have it in one lump sum because you're, say, buying a condo in Florida and you need all of the money, no problem. If you'd like to receive a monthly payout from that, you could. If you wanted to receive a monthly payout but maybe a year down the line you'd say, "Hey, you know what, let's pull out another 50,000 because we want to do a renovation on the kitchen, but we're receiving 600 a month from the current," you can do that. It's fairly flexible in terms of receiving the money.

Keith: So, that's good to know. How about paying back? If an individual somehow comes up with capital, usually the scenario would be they need capital. On the rare occasion where they maybe have extra capital coming in later, can they repay the loan?

Morgan: Yes, absolutely. And in fact, it's not that uncommon for them to repay that mortgage because if, for example, you're talking about a retiree, at some point they may move into a retirement home and have sold the property and then need to repay that debt. So, you can, of course, make a lump payment, just pay off the entirety of the debt. But annually, you have to first pay off the interest. And then once you've paid off the interest, you can pay up to 10 percent of the capital on an annual basis.

Keith: So, there is a lot of flexibility.

Morgan: There's a fair amount of flexibility, yeah.

Keith: Flexibility as to how you receive money and flexibility as to how you pay back money. So, alternatives, you alluded to it a little bit earlier, alternatives to the reverse mortgage. An individual needs access to capital. Line of credit?

Morgan: Yep.

Keith: A mortgage?

Morgan: Yes.

Keith: Or a reverse mortgage?

Morgan: Correct.

Keith: Are those the three biggies that you work with?

Morgan: Yes. Those would be the primary ways to access capital in your property. Of course, we're talking in general terms here. Everyone's finances are nuanced, but the least expensive way to borrow is going to be through a regular mortgage. And then if we're looking at either a line of credit or a reverse mortgage, my first question would be the intended purpose of that money. Because of course the line of credit is revolving. We can put money in, we can take money out, we can put money in. Whereas the reverse mortgage is not, we can pull money out. When we put money back in, we cannot then take it out later. The question then becomes, what is the strategy? What do we want to do? And then the time is a big factor because if we're 55, we're still working, we qualify for a mortgage, we'd like to get some money to do a renovation or whatever the project may be. Maybe the plan or the best strategy is get the mortgage for the money we need. Carry that mortgage until we no longer can or no longer want to because we've now retired or income is reduced and then discuss adding or replacing that with a reverse mortgage.

Keith: I suspect the statistics show that, and I'm just thinking of perhaps clients of ours or individuals that we might know, I think the vast majority of users might be in their seventies and eighties as opposed to the mid-fifties and early sixties.

Morgan: Really, if you're in your fifties, you really should not be trying to get a reverse mortgage because to compound that interest over such a period of time is expensive.

Keith: And I suspect as we go into the future, we're going to see individuals, you'll stay at 80 years of age, "I'd like to continue to live in my home. I'm running a little bit short on liquid assets. I need to tap into my equity."

Morgan: Correct.

Keith: So, let's start to wrap the show up here, Morgan. It's been a fantastic learning experience around reverse mortgages. Let's go through pros and cons just as a quick list of pros and cons. And I think we've done it throughout the show, but let's wrap up with a summary and then go from there.

Morgan: A nice tight list of pros and cons. I would say that the biggest pro, obviously, are there two biggest pros for the reverse mortgage is the income qualification because a regular mortgage you do have to qualify with your income and not just on the value of the asset. So, if we're retired and we're no longer drawing a pension or we're drawing a small pension or we're taking a small dividend, that becomes much easier to qualify for that money via reverse mortgage. And then the second big pro is the no monthly payment because if you're doing this with the purpose of increasing your monthly cash flow, adding a monthly payment directly decreases your monthly cash flow. So, by accessing the money, you may in fact need to access less money because you now don't have the monthly repayment of a mortgage or a line of credit. The con, obviously, is that if you do not pay any of your interest, you are accumulating that interest on the total debt, taking away some of the equity that you had on the property. Now, that may be offset by the gain in value on your property, but there's no way to calculate that beforehand.

Keith: This has been a great show, Morgan. You've really highlighted all of the different nuances in the reverse mortgage. It is something that's new to a lot of Canadians. I think with our real estate in terms of how things are moving, I think we're going to see tremendous upside and individuals tapping into this.

Morgan: Big time.

Keith: Thank you so much for coming back.

Morgan: Thank you.

Keith: As our resident mortgage expert, we really appreciate your time and your ability to communicate this clearly to our listeners.

Morgan: Thank you. It was a pleasure coming to you.

Keith: Thank you so much.

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