Basics

A "Rising Debt" Loan

The purpose of a reverse mortgage is different from that of a traditional "forward" mortgage. The purpose of a forward mortgage is to purchase a home; the purpose of a reverse mortgage is to get cash from your home.

In a forward mortgage, your loan balance (the amount you owe) gets smaller with each monthly repayments to the lender. Meanwhile the value of your home usually increases. So your home equity grows larger over time as your debt decreases. So forward mortgages are "falling debt, rising equity" loans.

In a reverse mortgage, your loan balance (debt) rises each time you get money from the lender, as interest is added to the outstanding loan balance, and you make no repayments to the lender. Unless the home's value grows very fast, the loan balance starts "catching up" to it. So reverse mortgages are typically "rising debt, falling equity" loans. Table 1 compares a forward mortgage to a reverse mortgage on a step-by-step basis.

Table 1: Comparing "Forward" & Reverse Mortgages

	"Forward" Mortgage	Reverse Mortgage
Purpose of loan	to purchase a home	to get cash from your home
Before closing, borrower has…	no equity in the home	a lot of equity in the home
At closing, borrower…	owes a lot, and	owes very little,
	has little equity	and has a lot of equity
During the loan, borrower…	makes monthly payments to the lender	receives payments from the lender
	loan balance goes down	loan balance rises
	equity grows	equity declines
At end of loan, borrower…	owes nothing	owes substantial amount
	has substantial equity	has much less, little, or no equity
Type of Loan	Falling Debt, Rising Equity	Rising Debt, Falling Equity

A Simplified Reverse Mortgage

Table 2 shows the "rising debt, falling equity" characteristics of reverse mortgages in general. To simplify the example, the table does not include all the closing costs and fees that are generally charged by a mortgage company or bank. It also does not include the costs of selling a home, which typically reduce the amount of equity remaining at the end of the loan.

In this simplified example, you can see that the $1,000 monthly loan advances in column A are added to the monthly interest at 0.5% in column B to equal the loan balance (amount owed) in column C. Over time, the loan balance grows larger. You can also see that the loan balance is subtracted from the home's value (assumed to be growing at 4% per year) in column D to produce the amount of remaining home equity in column D-C.

Table 2: Simplified* Reverse Mortgage Example
Assumptions: Monthly Loan Advance.........$1,000
Monthly Interest Rate...….....0.5%
Original Home Value.....…...$200,000
Appreciation Rate.......……4% per year

	A	B	C	D	(D - C)

End of Year	Principal Advances	Interest @ 0.5%/mo.	Loan Balance	Home Value	Home Equity
1	$12,000	$397	$12,397	$208,000	$195,602
2	24,000	1,559	25,559	216,320	190,760
3	36,000	3,532	39,532	224,872	185,339
4	48,000	6,368	54,368	233,971	179,602
5	60,000	10,118	70,118	243,330	173,211
6	72,000	14,840	86,840	253,063	166,222
7	84,000	20,594	104,594	263,186	158,591
8	96,000	27,442	123,442	273,713	150,270
9	108,000	35,453	143,453	284,662	141,208
10	120,000	44,698	164,698	296,048	131,349

* Illustrative example only; does not include loan closing costs and fees, or home selling costs.

Picturing the Difference

Figure A below shows how the loan balance on a forward mortgage declines over time while the home's value is rising. Since home equity equals home value minus debt (the top line minus the bottom line in the figure), home equity is everything between the two lines, which increases over time.

Figure B shows how the loan balance on a reverse mortgage rises over time (the figure assumes a monthly loan advance). Since home equity equals home value minus debt (the top line minus the bottom line in the figure), home equity is everything between the two lines, which decreases over time.

Figure A-1: Forward Mortgage

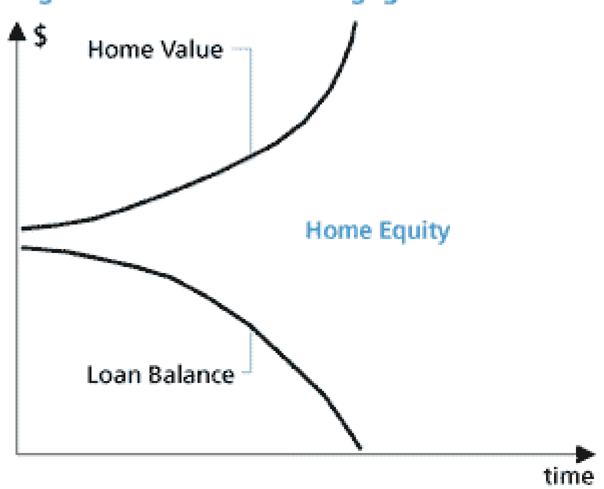
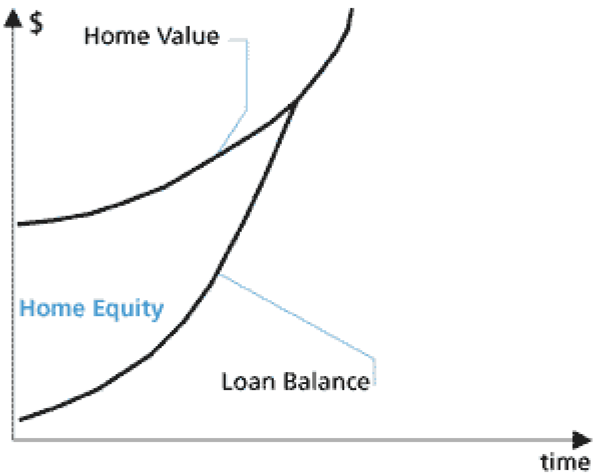


Figure A-2: Reverse Mortgage



The Loan Balance line does not cross over and continue past the Home Value line because of the non-recourse limit, as discussed on pp. 4-5.

For more information, see the Debt Limit section at www.aarp.org/money/revmort/revmort_basics/a2003-03-21-basicloanfeatures.html.

AARP does not endorse any reverse mortgage lender or product.