Changes in reverse mortgages give advisers new tools in retirement planning

Loans help planners deploy strategies to ensure clients won't outlive their money

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By **Mary Beth Franklin**

Carolyn Dayton: Wondered if she could take money out of her house, rather than her IRA.

Carolyn Dayton had achieved a major goal of many retirees. She owned her home free and clear with no monthly mortgage to erode her retirement income.
But after retiring from her job as a computer business consultant more than a year ago, Ms. Dayton, 67, watched nervously as the investments in her individual retirement account rose and fell amid a volatile market. Meanwhile, the value of her three-bedroom, two-bathroom home in the San Francisco Bay area steadily increased.

“My investments haven't been doing great, but I have a whole pile of money tied up in my house,” said Ms. Dayton, who paid $600,000 for her home 12 years ago. Today it is worth $900,000. “Rather than take money out of my IRA when it is low, I thought I could take money out of my house when it is high. You know, buy low and sell high.”

Without realizing it, Ms. Dayton had stumbled onto one of the most innovative — and controversial — ideas in financial planning today: How to incorporate home equity into a retirement income strategy.

“Having a buffer asset can help manage sequence of returns better and make a retirement income plan more efficient,” said renowned retirement researcher Wade Pfau, a professor of retirement income at The American College of Financial Services and a principal at McLean Asset Management. Translation: A reverse mortgage can reduce the risk of clients outliving their savings by allowing them to use loan proceeds during down markets rather than tap a shrinking nest egg.

GREAT VALUE

Mr. Pfau analyzed several recent studies on how to use a reverse mortgage as part of a comprehensive retirement income strategy. His conclusion: There is great value for clients in opening a reverse mortgage line of credit at the earliest possible age, particularly in a low-interest-rate environment like today.

Once established, the available line of credit continues to grow each year, even if the underlying value of the house does not appreciate. In addition to serving as a hedge against portfolio depletion, a standby reverse mortgage line of credit can serve as **long-term-care insurance or a deferred annuity**, using the home as collateral instead of paying insurance premiums.

Mr. Pfau's advice to financial advisers: If you had dismissed reverse mortgages in the past as inappropriate for your clients, they're worth a second look. Otherwise, you may be missing out on a crucial way to improve clients' retirement security.

> "Prior to 2011, reverse mortgages were expensive and really only made sense in the case of financial hardship. Today, the costs can be on par with a traditional home mortgage."-- John Salter, associate professor of financial planning at Texas Tech University.

Reverse mortgages allow older homeowners to convert the equity in their primary residence into a liquid, usable resource. Borrowers must be 62 or older and must either own their home outright or use the proceeds of the reverse mortgage to pay off the balance of their existing mortgage. They retain ownership of the home and must continue to maintain it and pay their property taxes and homeowner's insurance.

Distributions are tax-free and can be taken as monthly payments for a fixed period of time, as long as the borrower remains in the house, as a line of credit or as a combination of payout options. Interest accrues monthly only on the amount borrowed, not on unused lines of credit. No repayment is required until the last borrower sells the house, moves out permanently or dies. Because it is a nonrecourse loan, the borrower or heirs can never owe more than the home is worth, even if that value is less than the loan balance.

It's undeniable that the reverse mortgage industry has been plagued with a sleazy image thanks to its outdated celebrity pitchmen, aggressive sales tactics and occasional horror stories of widows being forced out of their homes. But the industry landscape has changed dramatically over the past few years. Reform of the federally insured Home Equity Conversion Mortgage program has increased consumer protections, introduced underwriting to weed out unsuitable candidates and significantly lowered costs.

The Reverse Mortgage Stabilization Act of 2013 now prevents reverse mortgage borrowers from using too much equity too soon and protects spouses who are too young to be co-borrowers on the loan by ensuring they can remain in the house after the older spouse dies. However, they are not able to borrow additional money.

Initial setup fees have been dramatically reduced. The upfront mortgage insurance premium has been slashed from 2.5% to 0.5% of the loan amount as long as the borrower taps less than 60% of the available balance in the first year. Mortgage closing costs — for title insurance, appraisal and attorney fees — are about the same as a traditional mortgage or home equity line of credit, and some lenders provide credits to offset upfront expenses, adding it to the cost of the loan. In many cases, the borrower's out-of-pocket cost to establish a reverse mortgage may be as little as $125 — the price of the mandatory consumer counseling fee.

“Prior to 2011, reverse mortgages were expensive and really only made sense in the case of financial hardship,” said John Salter, a financial planner and associate professor of financial planning at Texas Tech University, who has been researching and writing about the HECM program for years. “Today, the costs can be on par with a traditional home mortgage,” he said. But unlike a traditional mortgage or home equity line of credit, borrowers do not need to meet income qualifications, which can be challenging for retirees, and a reverse mortgage line of

credit cannot be frozen, reduced or cancelled as happened to many traditional mortgage borrowers during the housing crisis.

A reverse mortgage can reduce the risk of clients outliving their savings by allowing them to use loan proceeds during down markets rather than tap a shrinking nest egg.

HECM borrowing limits are based on available home equity, the age of the youngest borrower, interest rates and lender margin. Depending on their age, homeowners can tap about half of the home's appraised value up to a maximum home value limit of $625,500. The older the borrower and the lower the interest rate, the higher the available loan amount.

“For anyone 62 or older with no mortgage, it makes sense to establish a reverse mortgage line of credit — especially for $125,” said Mr. Salter, who is a partner at Evensky & Katz/Foldes in Lubbock, Texas. Some of his retired clients who rely on oil and gas royalties used a reverse mortgage to supplement their monthly income when oil prices dropped precipitously.

ADVICE NEEDED

Ms. Dayton, who has been divorced for many years, discussed her idea of taking out a reverse mortgage on her Danville, Calif., home with her adult daughter and Patricia Passon, her financial adviser of more than 30 years.

“I am so happy to have my financial adviser working with me on this,” Ms. Dayton said. “She understands the financial lingo so she could translate all the different offers for me.”

Ms. Passon, principal at Encompass Financial Advisors Inc. in Beaverton, Ore., had little actual experience with reverse mortgages but had read numerous research articles and attended several webinars on the subject. She created a spreadsheet to analyze and compare offers from various reverse mortgage lenders and finally settled on Reverse Mortgage Funding, a finance company that covered all the upfront costs in exchange for a slightly higher lender margin.

SUPPLEMENT TO SOCIAL SECURITY

Based on the maximum allowable home value of $625,500, Ms. Dayton qualified for a $375,000 line of credit. She draws $1,000 a month in tax-free reverse mortgage payments to supplement her Social Security benefits and nonretirement investments, allowing her IRA to grow untouched for a few years.

“Now I can sleep at night, and I have no concerns about running out of money,” Ms. Dayton said. That leaves her plenty of time and energy to devote to her role of doting grandmother to her three grandchildren.

Unfortunately, not all financial advisers are as able — or willing — as Ms. Passon to discuss reverse mortgage options with their clients.

“Advisers have been slow to grasp how reverse mortgage lending has changed,” said Shelley Giordano, chairwoman of the Funding Longevity Task Force, an industry-backed group of leading retirement income specialists, and author of **“What's the Deal with Reverse Mortgages”** (People Tested Media, 2015).

“If the first impulse is to counsel clients to wait until the portfolio is depleted before establishing a HECM line of credit, the adviser is giving outdated advice,” Ms. Giordano said. “And compliance officers who forbid conversations with clients on how a significant asset, the home, can improve retirement outcomes are not meeting an appropriate standard of care,” she added

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Adviser reticence is likely tied to an investor alert, first published in 2010, from the Financial Industry Regulatory Authority Inc. warning Americans about aggressive marketing campaigns that promoted reverse mortgages as a cost-free way to finance retirement lifestyles or risky investments. The agency toned down its criticism slightly in 2014 when it reissued the alert in the wake of the program reforms. Finra noted that reverse mortgages can help seniors manage their finances if used responsibly.

While employing a reverse mortgage to extend the life of a portfolio is a popular research topic, most homeowners actually use the loans to pay off an existing mortgage, reduce other debt or increase their monthly income.

In the past, it was not common to carry a mortgage into retirement. In 1989, only 11% of homeowners ages 65 to 74 had a mortgage, with an average balance of $29,000, according to LIMRA Secure Retirement Research.

But not anymore. By 2013, 43% of these households carried a mortgage, with the average debt totaling $136,000.

EDUCATING CLIENTS

Monthly mortgage payments can severely strain a retirement budget. Just ask Shelly Moss, a rabbi in the Phoenix area. At 66, he would like to retire soon without worrying where the money will come from to pay his wife's extensive medical bills, which have ravaged their savings. But when his financial adviser, Dennis Channer of Cornerstone Investment Advisors in Boulder, Colo., suggested a reverse mortgage, the rabbi was skeptical.

Mr. Channer said he often includes a reverse mortgage calculation in retirement income plan discussions to educate clients about their options. Those include lowering their taxes by combining tax-free reverse mortgage payouts with smaller distributions from fully taxable retirement plans. That strategy also can help higher-income clients avoid surcharges on their monthly Medicare premiums.

Mr. Moss and his wife, Barbara, set up a reverse mortgage earlier this year and used it to pay off their existing mortgage, slashing $2,000 from their monthly spending.

“It gives us breathing room,” he said.

A recent survey by The American College suggests reverse mortgage education could be vital for a new generation of retirees determined to remain in their homes. The survey of more than 1,000 people between the ages of 55 and 75 with at least $100,000 in investible assets and at least $100,000 in home equity found that **83% wanted to remain in their current home as long as possible.** Despite a strong desire to age in place, only 14% of the respondents said they had considered a reverse mortgage, and just 30% earned a passing grade on basic knowledge about the financing tool.

Separately, a new study by **Northwestern Mutual** found that two-thirds of Americans believe there is a chance they will outlive their savings.

“Advisers and consumers need to start thinking about home equity, including reverse mortgages, as part of the retirement income planning process,” said Jamie Hopkins, co-director of The American College's New York Life Center for Retirement Income Planning.

Mary Beth Franklin is a contributing editor to InvestmentNews and a certified financial planner.

9 surprising ways to use a reverse mortgage

By Mary Beth Franklin

Financial advisers who dismissed reverse mortgages in the past may want to take a second look. Consumer protections have increased and set-up fees have been dramatically reduced. Leading researchers believe reverse mortgages could solve some of the income challenges of retirees who saved too little to finance a

retirement that could last decades. Click through to find out the various ways to use a reverse mortgage — some of them may surprise you.

Reverse mortgages allow homeowners age 62 or older who own their home outright or who have a small mortgage balance to convert the equity in their primary residence into a liquid, tax-free asset. Borrowers can take their money in a lump sum or as a monthly payment, or set up a line of credit. Interest accrues on borrowed funds. Unused lines of credit continue to grow at the same compounded interest rate as the cost of money.

Pay off an existing mortgage

Using a lump sum from a reverse mortgage to pay off a traditional mortgage balance instantly increases a retiree's monthly cash flow and reduces portfolio withdrawal needs. "It really improves the odds for retirement success to not carry a mortgage into retirement," said Wade Pfau, professor of retirement income at The American College of Financial Services.

Replace a home equity line of credit

Unlike a HELOC, a reverse mortgage can never be reduced, frozen or cancelled, and there are no monthly loan repayment requirements. A reverse mortgage is not due until the borrowers sell the home, move out permanently or die. The estate or heirs can never owe more than the house is worth, even if it is less than the amount borrowed.

Protect your portfolio

"Should your portfolio decline significantly in value, borrow from the line of credit for your needs, then repay the loan when your portfolio recovers," said John Salter, associate professor of

personal financial planning at Texas Tech University. Interest payments are tax-deductible if retirees itemize their deductions on their income tax returns.

Fund future long-term care or income needs

A 62-year-old couple with no long-term-care insurance may want to set up a reverse mortgage line of credit. With a home worth $625,000, their initial line of credit at current interest rates would be worth $327,375, according to Tom Dickson, founder of the Financial Experts Network. Left untouched, the equity line would be worth $613,365 in 10 years and $1,149,143 in 20 years, said Mr. Dickson, a co-designer of the reverse mortgage modeling now part of MoneyGuidePro. The couple could tap the loan for future long-term care costs, as long as they remained in their home, or to serve as a deferred annuity if they needed additional income in the future.

Create a Social Security bridge

Supplement income with monthly payments from a reverse mortgage either for a set number of years (term) or for as long as you live in your home (tenure). Term payments can provide an income bridge to allow a retiree to delay claiming Social Security until benefits are worth the maximum amount at age 70, said Shelley Giordano, author of “What’s the Deal with Reserve Mortgages?” (People Tested Media, 2015).

Manage taxes

Proceeds from a reverse mortgage are tax-free. Tapping a reverse mortgage can decrease withdrawals from taxable retirement accounts, reducing income taxes and the amount of Social Security benefits subject to income taxes. For higher-income retirees, tax-free reverse mortgage payments can reduce their modified adjusted gross income that can trigger higher monthly Medicare premiums.

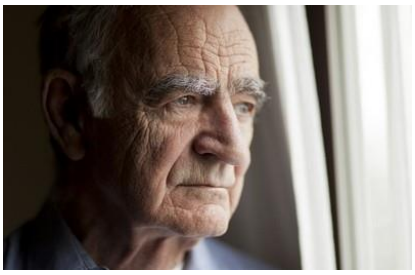
Pay Roth conversion taxes

Sometimes the only thing preventing a retiree from converting a traditional retirement account to a Roth IRA is the amount of income taxes owed on the converted amount. Tax-free proceeds from a reverse mortgage can pay Roth conversion taxes all at once or over several years, reducing future income taxes and possibly reducing future Medicare premiums.

Buy a new home

A reverse mortgage can be used to purchase a new home. Rather than using all of the proceeds from a home sale, downsizers can use some of the sale profits and take out a reverse mortgage to make up the balance, resulting in a new home without monthly payments and additional cash to add to savings for future needs or to supplement current income.

Gray divorce strategy



Older couples can use a reverse mortgage to divide a marital housing asset in a divorce. In one scenario, the spouse remaining in the home can take a lump sum distribution from a reverse mortgage to buy out the other spouse. In a second scenario, the marital home can be sold and each ex-spouse can use some of the proceeds from the home sale and each of them can get a reverse mortgage to buy their respective new homes, according to Shelley Giordano, chair of the reverse mortgage industry's Funding Longevity Task Force.