Advisors Need a Fresh Look at Reverse Mortgages

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by Wade D. Pfau

Through inertia and stubbornness, old ideas die slowly. Financial advisors maintain a dismal view about reverse mortgages. However, much has changed in just the past few years. Revisit your outdated thinking with an open mind about a tool that is on the cusp of more widespread use.

To the extent that there ever was a conversation about reverse mortgages as a retirement income tool, it focused on either real or perceived negatives of the traditionally high costs and potentially inappropriate uses for these funds. Those conversations often suffered from misguided ideas about the homeowner losing the title to their home and hyperbole about the American Dream becoming the American Nightmare. If there was an accepted use in financial and retirement planning for reverse mortgages, it was only as an absolute last resort once all other resources and possibilities of liquidity had failed. Bad press still plagues reverse mortgages.

But much has changed in the past several years.

Since 2013, the federal government, through the Department of Housing and Urban Development, has continued to refine regulations for its Home Equity Conversion Mortgage (HECM) program to improve the sustainability of the underlying mortgage insurance fund, to better protect eligible non-borrowing spouses and to ensure that borrowers have sufficient financial resources to continue paying their property taxes, homeowner's insurance and home maintenance expenses. The thrust of these changes has been to better ensure that reverse mortgages are used responsibly as part of an overall retirement-income strategy rather than simply as a way to fritter away assets in an unsustainable and irresponsible way.

Meanwhile, on the academic side, a series of research articles published since 2012 have demonstrated how responsible use of a reverse mortgage can indeed enhance an overall retirement-income plan. Recently, I reviewed and replicated past findings and extended the analysis further in my own research article. Importantly, these research articles have all incorporated realistic costs for reverse mortgages, both in relation to the upfront costs and the ongoing growth of any outstanding loan balance. The benefits found are net of the costs.

The reverse mortgage should be viewed as a method for responsible retirees to create liquidity for an otherwise illiquid asset, which in turn creates new options to support a more efficient retirement-income strategy (more spending and/or a larger legacy). This liquidity is created by borrowing against the value of the home with the flexibility to defer any repayments until after the borrower has permanently left the home.

It is odd that more advisors are not embracing reverse mortgages for clients wishing to stay in their home as reverse mortgages improve the odds for clients to enjoy a greater overall net worth while also supporting a greater financial portfolio for the advisor to manage.

Retirement-income planning

Because there are so many biases against reverse mortgages, it can be hard to view the matter objectively without a clear understanding of how the benefits can exceed the costs. To understand their role, let's step back and clarify the overall retirement-income planning problem we seek to solve. The key is to understand that retirement income is not an assets-only investment problem; those assets are funding the retiree's liabilities.

Retirees have a series of expenses they must be able to support in order to enjoy a successful retirement. These expenses consist of overall lifestyle spending goals, unexpected contingencies and legacy goals. While keeping matters relatively simple without losing the key message, suppose retirees have two assets beyond Social Security and any pensions that they can use to meet their spending obligations: an investment portfolio and home equity. The challenge is how to link these assets to the spending obligations in an efficient way that mitigates retirement risks related to not knowing how long one will live, to market volatility and to spending surprises that can impact the plan.

Fitting reverse mortgages into a retirement-income plan

The fundamental question is how a responsible household can most efficiently use these two assets to best meet spending goals while also best preserving remaining assets to cover contingencies and to support a legacy.

Spending from either asset today has implications for future spending and legacy. Spending a portion of financial assets today means those assets will not participate in future market movements and will not be available for future spending or legacy. Spending home equity today means that future spending potential or legacy will be reduced by the growth in the loan balance generated by the spending.

Any spending reduces legacy. The goal is to determine which assets to draw spending from in order to have the smallest impact on legacy.

When a household has an investment portfolio and home equity, the strategy that tends to serve as the "default" is to spend down investment assets first and preserve home equity for as long as possible. A debt-free home that can be used to support a legacy for one's heirs is implicitly the goal for this arrangement. A reverse mortgage should only be initiated and used as an absolute last-resort option once the investment portfolio has been depleted. Vital spending needs will otherwise go unfulfilled.

But research over the past several years shows that this conventional-wisdom strategy is constraining and counterproductive. Initiating the reverse mortgage earlier and then coordinating spending from home equity throughout retirement offers a way to meet spending goals and provide a larger legacy. That is the ultimate goal of retirement-income planning: using assets to allow for more income and/or a larger legacy.

For heirs who do actually wish to keep the home, the implication of a larger legacy is that there will be an extra bonus of additional financial assets available after the loan balance has been repaid. The home is *not* lost. Legacy wealth is the combined value of any remaining financial assets plus any remaining home equity after repaying the reverse mortgage. Money is fungible and the specific ratio of financial assets and remaining home equity is not important. In the final analysis, only the sum of these two components matters. Wanting to specifically preserve the home equity is a psychological constraint that leads to a less efficient retirement.

The underlying reasons why reverse mortgages help

There are two reasons why opening a reverse mortgage earlier in retirement has the potential to improve retirement efficiencies in spite of its costs. First, coordinating draws from a reverse mortgage reduces the strain on portfolio withdrawals, which helps to manage the sequence-of-returns risk facing retirees. Retirees are more exposed to investment volatility because volatility has a bigger impact on financial outcomes when taking distributions from the portfolio as compared to adding new funds to the portfolio. This is a key reason why retirement income planning is truly distinct from traditional wealth accumulation: Investment volatility for retirees gets amplified by sequence-of-returns risk. Reverse mortgages provide a buffer asset to sidestep this sequence risk by providing an alternative source of spending after market declines.

The second benefit of opening the reverse mortgage early, especially when interest rates are low, is that the principal limit that can be borrowed will continue to grow throughout retirement. Reverse mortgages are non-recourse loans, and for sufficiently long retirements there is a reasonable possibility that the line of credit may grow to be greater than the value of the home. I wrote about this last year. In those cases, the mortgage insurance premiums paid to the government on the loan balance are used to make sure the lender does not experience a loss, but also the borrower and/or estate will not be on the hook for repaying more than 95% of the appraised value of the home when the loan becomes due.

Potential uses for a HECM reverse mortgage

There are a variety of potential ways for a HECM reverse mortgage to be used within a retirement-income plan. Options include using the HECM as a backup source for liquidity and spending, as an annuity alternative or as a hedge to protect the value of one's home. The following table provides an organizational framework for thinking about these potential uses. The ordering represents uses that spend the available credit more quickly to uses in which the line of credit may never be tapped. Costs for reverse mortgages are negotiable, and the table highlights the combinations of loan costs to negotiate with lenders, depending on how the mortgage will be used. Essentially, the sooner the reverse mortgage is tapped for spending, the more preferable it is to pay higher upfront costs to keep the margin rate as low as possible. This will slow the growth of the loan balance. The four general categories of uses include debt coordination for housing, portfolio coordination for retirement spending, as a resource to fund retirement income strategy enhancements and as insurance for various retirement contingencies.

The Spectrum of Potential Reverse Mortgage Uses

Spend Down Credit (Favors Low Margin Rate / High Upfront Costs)

Portfolio/Debt Coordination for Housing	Pay off an Existing Mortgage Transition from Traditional Mortgage to Reverse Mortgage HECM for Purchase for New Home
Portfolio Coordination for Retirement Spending	Spend Home Equity First to Leverage Portfolio Upside Potential Coordinate HECM Spending to Mitigate Sequence Risk Use Tenure Payments to Reduce Portfolio Withdrawals
Funding Source for Retirement Efficiency Improvements	Social Security Delay Bridge Taxes for Roth Conversions Tenure Payments as Annuity Alternative Long-Term Care Insurance Premiums
Preserve Credit as Insurance Policy	Support Retirement Spending After Portfolio Depletion Protective Hedge for Home Value Provides Contingency Fund for Spending Shocks (In home care, health expenses, divorce settlement)

Preserve Credit (Favors High Margin Rate / Low Upfront Costs)

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The bottom line

As the government continues to strengthen the rules and regulations for reverse mortgages, and as new research continues to pave the way to objectively approach their role, we are reaching a tipping point at which reverse mortgages will become much more predominant. Journalists have been coming around, and the popular press now includes more positive descriptions based on the recent research. Clients will be asking about them, and advisors need to be ready to provide an opinion about their use after updating the due diligence for how the reverse mortgage tool has changed in recent years.

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