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Wade Pfau: Retirees Should Consider Reverse Mortgages

Reverse mortgages have acquired an undeserved bad rap, according to Pfau

Using home equity conversion mortgages — commonly known as reverse mortgages — strategically can help improve clients' retirement sustainability and build a larger legacy to leave their heirs, according to Wade Pfau, professor of retirement income at The American College and director of retirement research at McLean Asset Management and in Stream Solutions.

Conventional wisdom on reverse mortgages or HECMs is that they are irresponsible, expensive or a last resort, and has made them unattractive to many retirees and their advisors.

"I was in the same situation as many advisors of knowing about the conventional wisdom, which is that reverse mortgages are generally a bad idea," Pfau said on a webinar for the Financial

Planning Association on Wednesday. After joining a study group on the products, he changed his mind, finding reverse mortgages are a “viable retirement income tool” and can be useful in managing sequence risk.

“I think it’s really important for advisors who may have done their due diligence about reverse mortgages 10 or 15 years ago to look at what all has changed starting in 2012 and to do their due diligence over,” he said.

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There are four ways to manage sequence risk in retirement, according to Pfau. One is spending conservatively by employing the familiar 4% rule, for example.

Flexibility in spending is also important to managing sequence risk. “If you’re able to cut your expenses when the market declines, you don’t have to sell off as much of your portfolio at that point,” he said.

Advisors can also reduce volatility for their retiree clients by building a retirement income bond ladder, incorporating income annuities or using a funded ratio to manage asset allocation.

Creating “buffer assets” to avoid selling at losses is the final way to address sequence risk, and that’s where reverse mortgages come into play.

Understanding Reverse Mortgages

Reverse mortgages can be complicated, Pfau said. “I think one of the most difficult things to understand is the line of credit on a reverse mortgage and why it’s able to grow over time.”

The HECM program is administered by the Housing and Urban Development Department and Federal Housing Authority.

Policywise, there have a been a number of changes to HECMs, Pfau said, that make reverse mortgages more attractive. To qualify for a reverse mortgage, borrowers now have to undergo a more complete financial assessment. In the past, some investors used reverse mortgages inappropriately or irresponsibly. “It’s not really meant to be the case for someone who’s desperate,” Pfau noted.

Family misunderstandings between children who expected to inherit a family home when their parents passed away also led to a “negative image that wasn’t really justified,” Pfau said.

New regulations have eliminated the risk that a non-borrower spouse could be pushed out of the home on the death of the borrower spouse. Pfau also noted that the perception that the borrower loses the title to the home when he or she takes a reverse mortgage is a myth.

High costs can still be an issue, he acknowledged, but he said it's still worthwhile for potential borrowers to shop around. "Unfortunately, there's no central clearinghouse type of service for comparing different options from different lenders, but the initial costs on a reverse mortgage can range from anywhere between $100 up to more than $10,000," he said.

Stigma over taking on more debt, especially if they've finally paid off their mortgage, is another obstacle to using reverse mortgages for eligible clients, but Pfau said there's "probably a better way to frame reverse mortgages." When clients spend money from their retirement portfolio, they don't think of it as debt; Pfau said spending from home equity can be viewed the same way. "You have to compensate for that through paying back the loan balance, but the home is the collateral on that loan, so you're really just spending down your home in the same way you might spend down your investment portfolio."

To qualify for a reverse mortgage, borrowers must be 62 or older, and have equity in their home. They must also prove that they're able to pay property taxes, homeowners' insurance and continued maintenance on the home.

Borrowers must also undergo a counseling session with an approved counselor, and an appraisal by the FHA on their home, which must be their primary residence. Assuming they meet those qualifications, borrowers can be approved for up to $625,500.

A reverse mortgage loan must be repaid when borrowers no longer meet these eligibility requirements, either due to their death or a move to a nursing home or assisted living facility.

While interest rates are low, retirement is expensive because investments are generating lower returns. Still, Pfau identified two strategies that can use low interest rates to their advantage. One is delaying Social Security because it has a "built-in implicit rate of return of 2.9% after inflation. That's better than you're going to get on any sort of bond investment in today's environment."

The other is to open a reverse mortgage line of credit. "The amount you can borrow is essentially based on a present value calculation," Pfau said. "The lower the discount rate, the lower the interest rate, the higher the present value."

A lower expected rate means a larger initial principal limit that grows at a lower rate than if interest rates were higher. "To the extent that interest rates are low today, you get a bigger initial amount and then if we see any sort of mean reversion where eventually interest rates go up again, then the principal limit's going to grow faster as well."

Borrowers who take out an HECM can choose to take the payment as a lump sum; a tenure payment, which acts as an income annuity and provides a payment as long as they're in the home and remain eligible; a term payment, which provides guaranteed payments over a set term; a line of credit; or a modified tenure or term payment, which carves off part of the line of credit for regular payments.

When borrowers choose how to take their payments, they aren't locked in to that decision for the duration of their loan, Pfau said. If they take a term payment and their financial situation changes, they can decide to open a line of credit instead.

Uses for Reverse Mortgages

Pfau identified four categories where reverse mortgages could be used depending on whether the client is trying to spend down credit or preserve it.

Clients can use the reverse mortgage in combination with their retirement portfolios to pay off an existing mortgage, fund home renovations to age in place or to use the HECM to buy a new home.

Clients can use the HECM to fund their retirement while their portfolios grow, but Pfau noted one risk with that strategy is that in low markets, their portfolios may not grow that much.

Clients can also use the HECM to improve retirement efficiency by taking tenure payments as an alternative to annuities, to support them while they delay Social Security benefits, or to cover taxes for Roth conversions or long-term care insurance premiums. However, "it's important to not use it to fund a new [LTC] policy, but to keep paying premiums on a current policy," Pfau warned.

Finally, an HECM can help preserve credit if borrowers open the reverse mortgage early but don't access the line of credit until they deplete their retirement portfolio.

A reverse mortgage is a non-recourse loan, meaning when the loan comes due, borrowers only have to pay 95% of the appraised value at that time. "If the home had a big drop in value," Pfau said, "the line of credit can grow to be worth more than the value of the home."

In coordinating reverse mortgages with portfolio spending, Pfau said the "Sacks and Sacks" strategy, so named for its authors, brothers Barry and Stephen Sacks, is easier to implement. Under this strategy, clients spend from their reverse mortgage line of credit in years following a bad year for their retirement portfolio. Following years when the portfolio had positive returns, retirees draw from it for retirement income.

The "Texas Tech" strategy follows a similar principle but requires that advisors determine what return their clients would need to make their portfolio last 40 years in retirement and base a wealth glide path on that. When clients' remaining wealth drops below 80% of the glide path number, they turn to their line of credit for income. If their wealth improves, they spend from the portfolio and try to pay down any loan balance on the reverse mortgage, Pfau said.

“With Sacks and Sacks, you don’t pay back the reverse mortgage loan balance until the loan comes due at the end of retirement or until you’re no longer eligible. With the Texas Tech strategy, you do pay back the loan balance earlier if markets start doing better,” he said.

Or, clients can simply spend from their retirement portfolio first, then turn to their line of credit when their portfolio is depleted, or set up a tenure payment to guarantee payment for as long as they’re in the home.

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