Article from

**Pension Section News**

February 2017
Issue 91

# Understanding Reverse Mortgages: An Interview with Shelley Giordano

*SOA research has shown that non-financial assets are the biggest part of retirement assets for many middle American families. The largest part of non-financial assets by far are home values. Housing is the largest item of spending for older Americans, and housing costs vary greatly by geographic area and type of housing. Reverse mortgages offer a way to use some of the value of the home while still living in it. The SOA post-retirement risk research has indicated that few retirees are taking into account home values in their retirement planning. The 2015 focus groups indicated low interest in reverse mortgages. People thinking about planning have been asking the question: how do we take housing values into account in retirement planning? What are the options? How do we evaluate them? This interview with Shelley Giordano provides information about reverse mortgages and how they are being used today.*

**Can you tell us a little bit about yourself and the Funding Longevity Task Force?**

Yes, thank you, I always welcome the chance to brag a little about the task force. After 15 years of experience in various aspects of reverse mortgage lending, and thanks to Torrey Larsen, CEO of Synergy1 Lending, I had the chance to invite a group of distinguished academicians to meet together to see what could done about improving understanding of reverse mortgages. So in 2012, they took the leap, flew to San Diego, and just sat around a table to discuss their emerging interest in the role of housing wealth in retirement. It was becoming clear that in a DC world, where many people are poised to be underfunded in retirement, cash flow was going to be a problem. While just about every retiree has a home, there was a dearth of serious research on how the home could be monetized. This group of respected thinkers catalyzed an accelerating interest in research that measures how the home asset can positively impact a retirement plan. The members and I volunteer our time. Our core group includes Marguerita Cheng, CFP®, Thomas C. B. Davison MA, PhD, CFP, Wade D. Pfau, PhD, CFA, Barry H. Sacks, PhD, JD, John Salter, PhD, CFP®, AIFA®, and Sandra Timmermann, Ed.D.

Recently, the task force aligned with the American College of Financial Services. Associate Professor of Retirement Income and Co-Director of the New York Life Center for Retirement Income Jamie Hopkins, JD, MBA, and I were privileged to hold our first joint meeting at MIT with Dr. Deborah Lucas, Sloan Distinguished Professor at the Golub Center for Finance and Policy.

Our stated mission is to develop and advance, for retirees and their financial advisors, a "rational and objective understanding of the role that housing wealth can play in prudent planning for retirement income." Before 2012, the comments in the financial press, and even the pronouncements of the Financial Industry Regulatory Authority (FINRA), about the use of housing wealth as part of retirement income were not based on any serious quantitative analysis. Instead, these comments were rather "offhand," and consistently propagated a conventional wisdom that the use of housing wealth as part of retirement income planning should only be a "last resort."

In 2012, two significant research papers were published and a well-respected blog was written, all demonstrating *quantitatively* that, for a sizable number of retirees, the conventional wisdom was incorrect. Indeed, for many of those retirees, their financial well-being would potentially be adversely affected by treating housing wealth as a last resort. An objective and rational approach, i.e., the quantitative analysis, used in the research revealed that housing wealth should be considered early in their retirement years and not as a last resort.

The potential to help improve retirements affects a significant number of people. We estimate that those most likely to benefit from this approach, known in the financial planning community as the "mass affluent," total between 10 million and 15 million households, of the approximately 75 million "Baby Boomers."

**How important is home equity as a retirement resource? Why is it often invisible in the retirement planning process?**

Well, first of all, as Dr. Robert C. Merton, Nobel Laureate in Economics and Distinguished Professor at MIT, is fond of saying, the house is an EXISTING asset. Nothing new needs to be created, people have spent their lives building wealth by paying down their mortgages but now have a financial asset that is only realized at their death.

Retirees have built a retirement pie of Social Security, qualified plans, savings, perhaps long term insurance, but when it comes time to retire, 65 percent of their wealth, which is bound up in their homes, is just flat out ignored. For some, it is like trying to retire on 35 percent of their wealth. That may be okay for wealthy people but leaves most retirees dangerously short.

We have to admit that the reluctance to use home equity has some cultural basis, but is probably more influenced by the bad reputation reverse mortgage lending suffers. Although much has been done to improve consumer safeguards, most recently with the Reverse Mortgage Stabilization Act of 2013, there is

Generally, a reverse mortgage is appropriate for those who are fairly certain they will stay in the home for as long as possible.

widespread misinformation that hampers greater uptake. Sadly, financial advisors are often times even less aware of the features of reverse mortgages than their clients who see TV commercials. Financial advisors do not get paid on initiating a reverse mortgage, their compliance officers often forbid a conversation about home equity at all, and financial planning software does not yet include reverse mortgage payments, much less illustrate sophisticated strategies. A homeowner cannot expect an enthusiastic, or even particularly informed, reception from most advisers when seeking advice on how to release equity from the home.

**What are the key features of common reverse mortgages? What are the common differences in products?**

Around 95 percent of all reverse mortgages in the United States are Home Equity Conversion Mortgages, or HECMs, and are insured by FHA. There is a small market for jumbo mortgages for very expensive homes. But what all reverse mortgages share is a nonrecourse feature. This means that regardless of what the loan balances become, the house stands as the sole collateral. Even if the house is underwater, no deficiency judgment may ever be taken against the borrower or his heirs. This is the crucial safeguard for retirees but shockingly, even some financial advisers continue to believe that the "bank gets the house." This is simply not true, and has not been true since President Reagan and the 100th Congress provided for modern reverse mortgage lending with the 1987 Housing and Community Development Act. Clients can choose between fixed or variable rates, trade higher interest rate margins for lender credits on closing costs (resulting in a somewhat lower initial credit capacity), or choose in some cases to limit their first year distribution in order to reduce the FHA mortgage insurance premium from 2.5 percent to .5 percent. Regardless of what structure they choose, these safeguards are inviolate:

**1. The borrower never relinquishes title.** The bank does not "get the house." Just like any mortgaged home, the house will pass to the heirs. The heirs can pay off the mortgage or sell the house and keep the remaining equity.

**2. The borrower never owes more than the house is worth. Every borrower is assessed** FHA mortgage insurance premiums (MIP) that protect the borrower, as well as the lender, if the house value is underwater at loan's end. In fact, no deficiency judgment may be taken against the borrower or his or her heirs.

**3. The borrower never has to move even if he or she no longer has access to more credit.** Even if the HECM loan balance exceeds the home value and/or there is no remaining new credit available, the loan is in effect as long as one member of the couple remains in the home as a principal residence and homeowner obligations such as tax and insurance are met.

**4. The borrower never has to make a payment on the principal or the interest until the last one remaining dies, moves or sells.** Voluntary payments are accepted but never required. Some reverse mortgage strategies include paying down the loan balance when the portfolio regains value. It may be advisable to make voluntary payments on the interest early in retirement, if convenient, in order to restrain the buildup on the load balance from tacked-on interest. Compounding interest accumulation may not have as much impact later in retirement when life expectancy is shorter and home values are likely to be higher, but managing interest in early retirement years may be a prudent strategy. FHA does not impose a prepayment penalty.

Note that all homeowner obligations must be met, such as tax, insurance and maintenance, during the life of the loan, as will any other mortgage.
Source: The 4 Nevers. (2000). Giordano

The initial credit capacity is based on the younger borrower's age, the current interest rate environment, and the housing value. A rough guide is 50 percent (for the minimum age of 62) and reaches as high as 75 percent of home value at today's rates, but only to the current FHA lending limit of $636, 150. Higher home values are accepted but for purposes of calculating credit the lending limit represents the highest initial credit calculation possible. Current mortgages are allowed at time of application as long as the reverse mortgage (plus other funds if needed) extinguishes the lien/s at closing. Borrowers must attend third party independent counseling before a loan may be originated.

Normally, interest accumulates and for the HECM is based on the one year or one month Libor. Upfront insurance (MIP) is either .5 percent for 60 percent or less initial utilization, or 2.5

percent if greater amounts are drawn at closing. The ongoing MIP accrues at the annual rate of 1.25 percent and is assessed on current loan balance monthly. The loan may be prepaid at any time without a prepayment penalty.

**How can reverse mortgages be used? What are the principal strategies? Are reverse mortgages used much to generate more regular monthly income?**

Reverse mortgages can be set up as an annuity on the house, known as a tenure payment option. This provides a monthly paycheck that will continue until the last borrower dies, moves or sells. The advantage to this payment, besides meeting cash flow needs, is that since funds from a reverse mortgage are not taxable, the tax equivalent withdrawal from a qualified account is avoided. In other words, not having to draw from an account that needs to accommodate taxes can significantly reduce early depletion of precious portfolio assets.

The HECM can be used to convert a traditional mortgage with monthly principal and interest payments into a mortgage without mandatory debt service. In addition, very few people are aware that a HECM can be used to actually purchase a new home. This allows retirees to move to a more appropriate housing without the need for monthly payments or dipping into savings in order to avoid a monthly mortgage payments.

Recently we discovered that the HECM product could be used in two different scenarios to restore equivalent housing to both sides in a gray divorce! This is an option divorce lawyers need to learn.

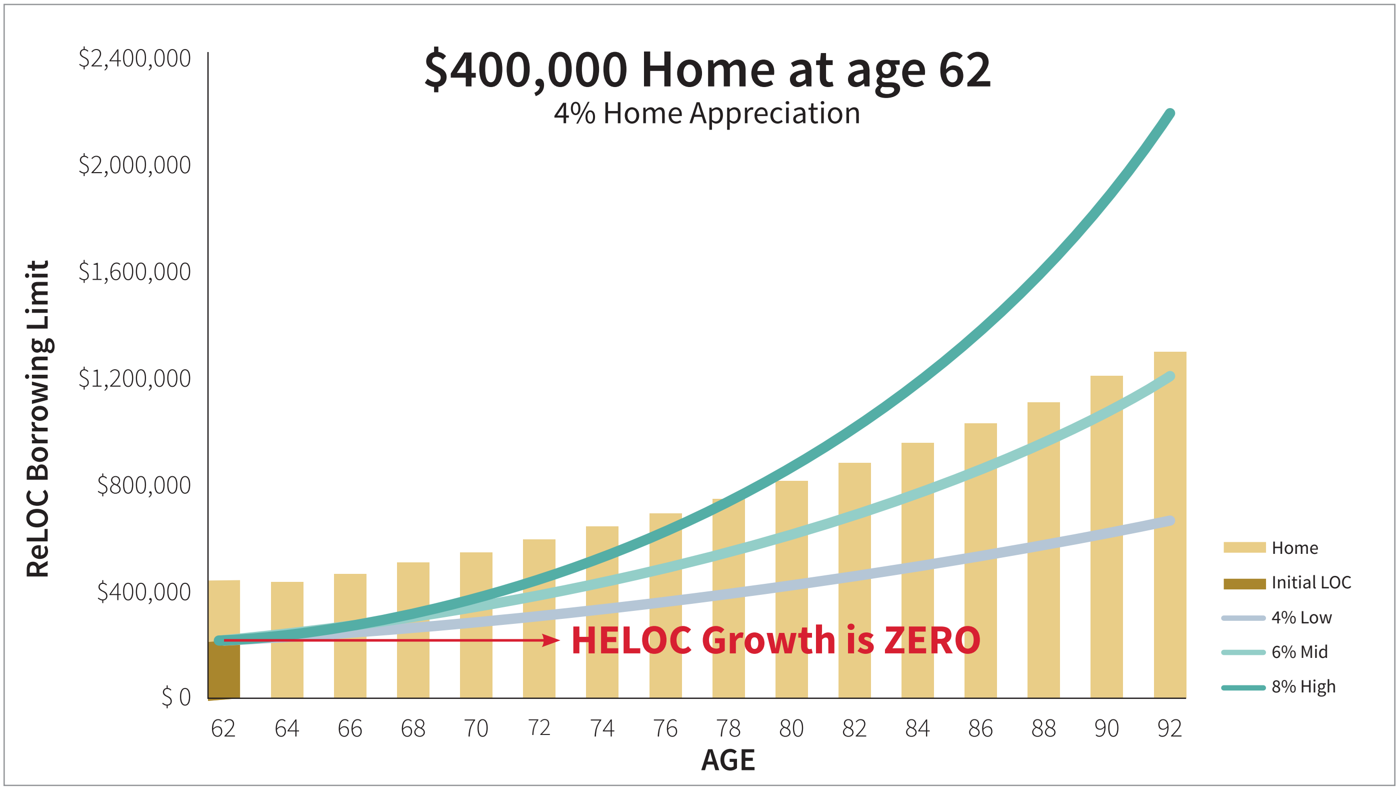
The most conservative and popular use of a reverse mortgage is to set it up as a standby line of credit to meet future unexpected spending shocks. Interest does not accumulate on the unused credit, just like a traditional HELOC. However, unlike a HELOC, the line of credit grows every month at the exact same rate the borrowed funds are compounding. For example, if the monies borrowed are compounding at the annual rate of 4 percent in any given month, the remaining line of credit will compound at the smae 4 percent rate. This increase happens regardless of the value of the underlying asset, the home. Over many years, it is possible the LOC can exceed the home value, which provides valuable diversification for an asset that has idiosyncratic risk.

In addition, a HECM line of credit cannot be frozen, cancelled or reduced. The client is free to make any payments he wishes, or no payments at all.

Traditional HELOC vs. HECM Line of Credit Comparison

| | Traditional HELOC | HECM Line of Credit |
|---|---|---|
| Line of credit (LOC) cannot be frozen, reduced or canceled if the ongoing terms of the loan are met. | | ✔ |
| Line of credit grows each month, regardless of home's value. | | ✔ |
| Allows homeowner to access the equity in their home for funds they can use for purpose while owning their home. | ✔ | ✔ |
| No monthly payments required.* | | ✔ |
| Minimal credit requirements. | | ✔ |
| Minimal income requirements. | | ✔ |
| Age-based loan: Homeowners 62 and older. | | ✔ |
| Government-insured loan. | | ✔ |
| Non-recourse protection insures the borrower can never owe more on the HECM loan than what the house is worth. | | ✔ |
| Draw period remains open during borrower's residency never recasts into a principal and interest payment. | | ✔ |
| No time limit on access to cash. | | ✔ |

*Borrower must maintain home as primary residence and remain current on property taxes and insurance.
Source: Retirement Funding Solutions




Source: www.toolsforretirementplanning.com

Homeowners can compare a HECM line of credit to a traditional HELOC. Although potentially useful in retirement, a HELOC requires monthly payments, can be altered, has no guaranteed credit growth feature, and often specifies time limits. A HECM line of credit, in comparison, is flexible and reliable in a way that is not possible with traditional lending.

The rate variables at which a HECM line of credit grows is determined at closing. Depending on interest rates, the line of credit can actually outstrip the home value over time. As interest in reverse mortgage has grown, several other uses have been unveiled. An excellent place to learn about these strategies is at www.toolsforretirementplanning, an independent blog authored by Task Force Charter Member Thomas C.B. Davison, PhD, CFP.

**Can reverse mortgages be used as part of a withdrawal strategy to avoid or lessen the need to sell in down markets? How does this work?**

If you think about a dip in portfolio value as a potential spending shock, it does not take long for you to see the HECM standby line of credit as a solution. This is exactly what Barry H. Sacks, PhD, JD, did when he constructed the first coordinated strategy to avoid spending from a losing portfolio.[2] His strategy is simple but powerful. In years following a downturn in portfolio value, the spending comes from draws on the house via the HECM line of credit. If the portfolio is in positive territory, draws the following year come from the portfolio, as usual. This coordination of home equity with portfolio throughout retirement results in access to a better bank balance, which the *Wall Street Journal* refers to as the best path to happiness.[3] Later research by John Salter, PhD, CFP, Harold Evensky, and Shaun Pfeiffer of Texas Tech University validated the Sacks findings, although their approach is slightly different.[4]

Just about anybody can appreciate that you don't want to sell your Bank of America stocks for a couple of dollars, when you paid $30 for them. But this is exactly what happened to some retirees during the financial crisis, and what depleted their portfolios prematurely.

Of particular concern for retirees is a bear market early on. Under the stress of systematic withdrawals, an undervalued portfolio in early years, known as sequence of returns risk, can be quite dangerous. If the portfolio is under stress, taking draws will result in spending too large a percentage of that asset. So you can see from the start that the conventional advice to use your house as a "last resort" is wrong. Results are much better for cash flow survival if housing wealth is integrated into a retirement plan, especially if the early years of a retirement would subject your withdrawals to reverse dollar cost averaging, aka "buying high and selling low."

Dr. Sacks points out that reverse mortgage is different than the debt in the usual sense. Obviously the debt management is discretionary. Payments of any combination can be made, or not, totally in the control of the homeowner. And yes, taking draws from the HECM is "spending" equity but wholly unlike spending equities. Once an equity is spent it is gone forever, and cannot participate in a recovery/increase in value. But in spending parts of the "home" the owner still is able to enjoy the entire home, and derive comfort and enjoyment despite borrowing against it.

**Can reverse mortgages be used at time of purchase of a new home? How does this work?**

Sometimes it makes sense to move to another part of the country, or into a different, perhaps more social, neighborhood. It could cost some money to move, and the retiree may be reluctant to do so if it would involve a mortgage payment. Actually mortgages are often tough to get once you are retired and have no income. So much cash is required in those cases, that the move might require a substantial draw on the portfolio. There is a way to finance a new house using a HECM for purchase. Basically the borrower provides a substantial down payment and the remaining financing is met by a reverse mortgage. Just like any reverse mortgage, there is no monthly debt service, and the loan if not due until the borrower dies, moves or sells.

**How can reverse mortgages be used to help pay for long-term care?**

There are no restrictions on how reverse mortgages can be used so it is possible to use proceeds to purchase long-term care insurance. Another way to provide for long-term care is to set up a HECM growing line of credit early in retirement and use a reverse mortgage fund to pay for long term care. This line of credit will increase at a contractually determined rate and can easily grow to be hundreds of thousands of dollars. If the funds are never needed, the cost of maintaining the fund was small especially when you compare it to the cost of premium payments for years of long-term care coverage that you may or may not ever redeem.

**Can people who are trying to maximize their Social Security benefits use reverse mortgages to help? How does this work?**

It is important to calculate the cost of debt in evaluating whether or not to use a reverse mortgage to fund spending needs in the gap years between 62–70, in order to delay Social Security. But there are case studies that have shown that in combination with being able to avoid draws on an undervalued portfolio *and* delay Social Security benefits until 70, that there could be a substantial improvement in cash flow survival for later years. Strategies like this always have the best results when the client can avoid early negative sequence of returns.

**How can someone tell if a reverse mortgage is a good deal?**

As the saying goes, "when banks compete, you win." There just is no substitute for comparison shopping. Do not allow yourself to be rushed. Get at least three quotes and make sure each quote shows a selection of margins on fixed rate options, as well as

How HECM Purchase Money is Calculated

It is difficult to envision how the HECM Purchase transaction unfolds unless you understand that the reverse mortgage financing attaches to the home being purchased, not to the home being left behind.

**Illustration 8.1** Departure House Not Part of Transaction

Legacy Home — The departure home is not used to calculate purchase money funds.

**HECM Reverse Mortgage is placed on new home.**

New Retirement Home — This house is used to determine HECM purchase funds. The reverse mortgage attaches to the new principal residence.

**Illustration 8.2** Formula for Determining Down Payment Needed to Purchase/Examples

(Purchase Price) minus (HECM Lump Sum)* equals Down Payment

| | | | |
|---|---|---|---|
| **A.** | $ 300,000 | $180,000 | $120,000 |
| **B.** | $1,000,000 | $340,000 | $660,000 |
| **C.** | $ 700,000 | $300,000 | $400,000 |

*The HECM Lump Sum draw is calculated using the HECM formula taking into account the age of the youngest borrower or Eligible Non-Borrowing Spouse, the current "Expected "interest rate and the FHA appraised value of the home or $625,500.

Source: What's the Deal with Reverse Mortgages? Shelley Giordano 2015. People-Tested Media.

both monthly adjusting and annually adjusting rates. You will get a sense of the right balance of margin to upfront costs if you do your homework, and through the discussion, learn what structure is right for your particular needs. A good place to start is http://www.mtgprofessor.com/home.aspx. All lenders will be happy to send you colorful, easily digested materials. Never work with a lender who is not patient about discussing the loan, if you wish, with your children, planner, accountant, lawyer, trusted friend, or minister.

**What is the Reverse Mortgage Stabilization Act of 2013 and how did it change things?**

During the housing bubble, some borrowers and lenders abused the reverse mortgage. People who may not have been realistic candidates for home ownership were able to borrow enormous sums of money through a reverse mortgage. Many were unable or unwilling to make their tax and insurance obligations, with homes underwater because of the crisis leaving no cushion, Congress acted to tighten the credit box for HECM going forward, as well as address some other shortcomings:

The Reverse Mortgage Stabilization Act of 2013

| | |
|---|---|
| **1. Brakes** | Cannot use too much too soon |
| **2. Qualifiers** | Demonstrate willingness and capacity to meet tax and insurance obligations |
| **3. Discounts** | Slow early use, reduced FHA mortgage insurance premiums .5% vs. 2.5% |
| **4. Protections** | Non borrowing spouse cannot be displaced |

Source: Benefits Magazine, October 2016. Giordano, "Could Employers Improve Retirement Outcomes with Reverse Mortgage Education?

## CAN A REVERSE MORTGAGE EVER BE FORECLOSED? WHAT IS THE RISK?

Just like any mortgage, the homeowner must meet his tax, insurance and maintenance obligations. Foreclosure is possible if these requirements are not met. The risk of not being able to meet these obligations has been reduced by the Stabilization Act of 2013. Borrowers must now demonstrate their ability to make these payments, and if they cannot, the payments are escrowed or in extreme cases, the loan is denied altogether. The homeowner must treat the house as his primary residence although snowbirds are allowed. Both Congress and HUD continue to refine the program to ensure that the reverse mortgage is a sustainable solution for homeowners.

## WHAT OTHER RISKS ARE THERE?

Generally, a reverse mortgage is appropriate for those who are fairly certain they will stay in the home for as long as possible. It only makes sense to use your home as carefully as you would any other asset. This might mean making interest only payments early on in order to manage the compounding interest. As you age, and those payments become a burden, just stop them. Your life expectancy is shorter, and chances are your home value has increased.

In other words, don't consume your housing wealth recklessly. You may need to move and use that equity later in life for other living options.

**How do we find the academic literature and economic analysis on reverse mortgages? Who are some of the most important authors?**

My little book, *What's the Deal with Reverse Mortgages?* is fairly comprehensive and catalogues dozens of resources for getting started. Tom Davison's www.toolsforretirementplanning.com is the most up to date review of all of the research. Dr. Wade Pfau, PhD, CFA, has just published *Reverse Mortgages: How to use Reverse Mortgages to Secure Your Retirement (The Retirement Researcher's Guide Series)*. All of these publications will point you to the work done by Dr. Sacks, Dr. Davison, Dr. Pfau, Dr. Salter, and Dr. Gerald Wagner, as well as others.

**If I want to find out what products and companies are in the market, is there a comparison service or data base available that is up-to-date? Where do I find it?**

Again, a great place to start is at Jack Guttentag's site www.mtgprofessor.com. The National Reverse Mortgage Lenders Association has a large list of lenders at http://www.reverse-mortgage.org/Find-a-Lender. ■

### ENDNOTES

1 http://www.fool.com/investing/general/2015/05/17/americans-average-net-worth-by-age-how-do-you-comp.aspx

2 Sacks, Barry H., and Stephen R. Sacks. 2012. "Reversing the Conventional Wisdom: Using Home Equity to Supplement Retirement Income." Journal of Financial Planning 25(2): 43-52.

3 WSJ, Andrew Blackman, Money and Happiness: A Surprising Twist, September 12, 2016.

4 Pfeiffer, Shaun, John Salter, and Harold Evensky. 2013. "Increasing the Sustainable Withdrawal Rate Using the Standby Reverse Mortgage." Journal of Financial Planning 26(12): 55-62. And Pfeiffer, Shaun, C. Angus Schaal, and John Salter. 2014. "HECM Reverse Mortgages: Now or Last Resort?" Journal of Financial Planning 27(5): 44-51.

Shelley Giordano founded and chairs the non-profit Funding Longevity Task Force at the America College of Financial Services. She can be reached at *shelley@longevityview.com*.