Evaluating Reverse Mortgage Strategies

Executive Summary

- A reverse mortgage is a loan secured by a primary residence that does not have to be repaid until the borrower dies, fails to take care of the property, or ceases to use it as a primary residence. The reverse mortgage has no ongoing repayment requirements, and unpaid interest simply accrues on the outstanding balance. In fact, the only "payments" from a reverse mortgage are the payments that come *out* from the lender, to the borrower, in the form of loans.

- The classic interpretation of reverse mortgages in financial planning have been as the "income source of last resort" - an option to be used only when no other is available and the client has been stuck in a "house rich, cash poor" situation.

- Unwillingness to utilize reverse mortgages earlier in the process appears to stem largely from their upfront costs, which can be significant. However, the emergence of the HECM Saver option in late 2010 has shifted this landscape, as the virtual elimination of the upfront mortgage insurance premium has reduced the cost of establishing a reverse mortgage by more than half in many scenarios.

- Notwithstanding the recent reduction in upfront reverse mortgage costs - so-called "access costs" that must be borne by the borrower to establish the loan - the reality is that the ongoing "use costs" in the form of loan interest and ongoing mortgage insurance premiums of 1.25% actually represent the primary long-term cost to a reverse mortgage.

About the Author

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- Although the upfront and ongoing costs of a reverse mortgage can be significant, a reverse mortgage is not always a losing financial proposition. In scenarios where a client utilizes the reverse mortgage for cash flow so that an existing portfolio can remain invested, the client can actually increase net worth and long-term retirement sustainability, as long as the return of the portfolio exceeds the reverse mortgage borrowing cost.

- While reverse mortgages are often criticized for accruing loan interest (potentially resulting in huge compounding loan balances that erode net worth), the reality is that for clients who wish to keep leverage on their balance sheet to achieve their goals, the reverse mortgage is actually more effective than the traditional mortgage! The ongoing principal + interest payments of the latter can result in a deleveraging of the client's balance sheet, which is actually counterproductive if the portfolio truly is outperforming the borrowing costs!

- In scenarios where there are little other assets available, the reverse mortgage choice is not so much about the benefits of leverage, but simply represents a lifestyle decision to erode the equity in the residence in exchange for being able to live out one's life in the manner - and in the location - of his/her choosing. Nonetheless, it may still be preferable to utilize a reverse mortgage before reaching the point where no other assets are available, as the borrowing cost limitations of the reverse mortgage may provide insufficient income from the strategy at a late juncture.

- Typical reverse mortgage strategies include using the reverse mortgage to refinance an existing mortgage (to relieve the retiree of the need to make ongoing mortgage repayments from other income sources), or to finance a new (albeit downsized) residence purchase. Many clients will prefer to use the reverse mortgage to receive ongoing monthly payments that can be guaranteed for life (as long as the client stays in the home), which can reduce cash flow demands from a portfolio and result in a balanced retirement income strategy that is more viable than sequentially spending down one asset and then the other (e.g., the portfolio and only then the equity in the home). Some clients may simply wish to establish a reverse mortgage to have access to a guaranteed line of credit to be used as needed on an ad hoc basis.

Introduction

While reverse mortgages actually pre-date the financial planning movement itself, they have gained little popularity amongst financial planners in the five decades since they were first established. Often thought of as the retirement income source of last resort, reverse mortgages are typically used only in such situations - as a last resort, after all other assets have been depleted, and often only after the client's net worth has been so depleted that he/she may have long since ceased to even *be* a client. The significant fees associated with reverse mortgages have also been a significant barrier in considering them as viable tools in the financial planning toolbox.

In last month's newsletter, we looked at the current marketplace for reverse mortgages, including the new HECM Saver option that has cut the cost of establishing a reverse mortgage by more than half, the technical rules of how reverse mortgages work, and the decisions a client must evaluate when considering a reverse mortgage. In this month's newsletter, we continue with an analysis of the true economic realities of using reverse mortgages to help finance retirement, some of the feasible options and strategies for using reverse mortgages, and where they may be appropriate - including situations that are not strictly of the "income of last resort" variety.

Hopefully, this information will be helpful in understanding situations where a reverse mortgage may fit within the client's financial plan, and become a more regularly used arrow in the financial planning quiver.

Where Do Reverse Mortgages Fit?

While last month's newsletter provided an in-depth discussion of the technical information about how reverse mortgages work, the question remains: where exactly do they fit into the financial planning puzzle?

The classic interpretation of reverse mortgages views them as the "last resort" option for a client who lacks any other resources to manage ongoing retirement spending needs. For instance, if the IRAs, 401(k)s, investment accounts, and other resources have been depleted, and all that remains is a fully-paid-off primary residence (and perhaps some Social Security or pension payments) - the classic "house rich, cash poor" scenario - the client can establish a reverse mortgage against the property to extract the value of the equity and generate retirement cash flows, without being forced to give up the home.

Accordingly, the focus of the HUD-mandated counseling sessions for reverse mortgage prospective borrowers is on the alternatives to using a reverse mortgage, such as selling the current home to downsize and free up cash, or even just sell the home and rent a less expensive place to live. Depending on the residence property, taking on a renter or even a family member to share household costs may be an option. The counseling guidelines also suggest that sessions focus on possible availability of other assets before relying upon the reverse mortgage as a last resort, such as any old life insurance policies that might be cashed in, or a potential inheritance that may be coming. In some cases, simply refinancing a current mortgage at today's rates may free up some needed cash flow without incurring reverse mortgage costs and obligations.

Notwithstanding all of this, it still seems that the primary reason that reverse mortgages have been viewed as an income-source-of-last-resort option is because of their cost, especially the upfront setup costs to implement and establish a reverse mortgage in the first place.

Revisiting Costs

As noted in last month's newsletter, the upfront costs for a reverse mortgage include an origination fee, and upfront mortgage insurance premium (MIP) payment, and a slew of smaller miscellaneous fees from appraisals to at-signing closing costs to a potential fee for the mandatory counseling requirement. The latter group of fees together may add up to no more than $1,000 - $1,500 in many

Out and About

- Michael will be speaking on "Cutting Edge Tax Planning Developments & Opportunities" for FPA Albany on December 15th

- Michael will be presenting "Understanding Tactical Asset Allocation" and "Reviewing Existing Life Insurance Policies" at the AICPA Personal Financial Planning Conference in Las Vegas on January 16th -18th

- Michael will be also be speaking about career development for the Young Professionals event for the Society of Financial Services Professionals at the Arizona Institute on January 22nd

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cases; however, the original fee and upfront MIP can be significant.

For the origination fee, the lender is entitled to charge up to 2% of the first $200,000 of Maximum Claim Amount, and 1% of the balance, with a maximum origination fee of $6,000 (which would apply for homes worth more than $400,000). The Maximum Claim Amount - or MCA - used to calculate the origination fee is the lesser of the appraised value of the residence, or the specified maximum mortgage limit put forth by the FHA (currently $625,500).

In addition to the origination fee, the MIP of 2% is also charged on the MCA - notably, *not* on the actual amount of the initial loan - and accordingly can add thousands of additional dollars to the cost of the reverse mortgage, even if no actual funds have been received yet.

> *Example 1*. An age-65 reverse mortgage borrower with a $500,000 appraised value on a house (and therefore a $500,000 MCA, since the value is below the FHA maximum) might pay $6,000 of origination fees plus $10,000 of MIP, plus over $1,000 of additional closing costs, for a total of $17,000 - just to established a reverse mortgage that provides monthly payments of approximately $1,500/month (by comparison, most traditional mortgages are no more than $2,000 - $3,000 in total closing costs, sometimes less)! Although virtually all of the $17,000 of closing costs can be financed into the reverse mortgage loan itself (except perhaps the counseling fee and cost of an appraisal), eliminating out-of-pocket stress, it is arguably still quite a lot of money to pay, just for the privilege of receiving ongoing monthly reverse mortgage loan payments.

As the preceding example illustrates, the reverse mortgage has been viewed as a last resort, where such costs would only be borne if no other choices were available. In theory, though, this is where the new HECM Saver option is intended to improve the situation. By dropping the upfront MIP from 2% of the MCA down to only 0.01%, the most substantive portion of the upfront cost is virtually eliminated. While borrowers may still face a non-trivial origination fee (originators still need to be paid for the work they do!), in the aforementioned example, the upfront closing costs drop from $17,000 down to only about $7,000, a far more reasonable price. And of course, smaller homes that appraise for less than $400,000 will face an even lower origination fee.

The caveat of the HECM Saver, of course, is that the principal limit factors are lower, resulting in a slightly smaller maximum lump sum or line of credit reverse mortgage, or moderately lower monthly reverse mortgage payments. However, if the upfront loan costs are less severe, clients might even consider establishing a reverse mortgage at an earlier point in the process, before the situation is so dire that the absolute maximum amount from a traditional HECM (with the associated 2% upfront MIP) is necessary.

At What Point Should Clients Consider A Reverse Mortgage?

Ultimately, the question arises - when IS it appropriate to think about a reverse mortgage as an income source for a client? Or more specifically - at what point in the client's spend-down process is a reverse mortgage worth considering?

Certainly, from the overall financial planning perspective, it's probably not simply the point at which there are no other resources available. First and foremost, that may present a challenge simply because the available lump sum or income alone is insufficient to meet the client's goals at that point. If an 80-year-old can "only" get about $1,500/month from a $300,000 residence as a reverse mortgage income stream - that may be helpful, but it may or may not be enough to manage all of the needs at that point. Depending on the geographic location, almost 1/4th of that amount may be necessary just to pay property taxes and homeowner's insurance to maintain the property in the first place! If the situation is that far gone, selling the residence and using the proceeds as a lump sum pool of money that is aggressively liquidated to pay monthly rent costs may be the only option available.

On the one hand, that speaks to the fact that a reverse mortgage may not be sufficient to maintain a client's standard of living in a house he/she otherwise just cannot afford - although notably, the later the advanced age at which process begins, the greater the monthly income (if the preceding 80-year-old began payments at age 65, they would only be $1,000/month). On the other hand, it simply emphasizes that if a client is in financial trouble, waiting until the primary residence is the only asset left on the balance sheet probably isn't a great idea, especially if there are substantive other assets available to consider at an earlier stage as part of an integrated plan.

Thus, for instance, when might a 65-year-old client who has a $500,000 investment account and a $500,000 primary residence consider a reverse mortgage, if the ultimate goal was to sustain $3,500/month from the client's assets, above and beyond the income that Social Security provides? Such cash flows would represent a draw of $42,000/year from a *total* asset base of $1,000,000 (a withdrawal rate of 4.2%), which may seem somewhat reasonable, although it would clearly be highly risky to try to extract $42,000/year from "just" a $500,000 investment account (a withdrawal rate of 8.4%!). However, if the client began a reverse mortgage immediately - even while a $500,000 investment account was still available - to receive approximately $1,500/month in cash flows, the portfolio would now be required to support only $2,000/month, which is a withdrawal rate of less than 5% from the investment portfolio and much more sustainable.

Of course, there are some caveats to this scenario. First of all, the ongoing monthly payments of $1,500/month from the reverse mortgage continue for life - like an annuity, they cannot be outlived (as long as the borrower continues to use the property as a primary residence) - but the payments do not increase, either. Thus, over an extended period of time - such as a multi-decade retirement for a 65-year-old - the payments will lose some significant purchasing power. This suggests that it may be preferable to delay the onset of reverse mortgage payments until the client is at least a bit older, perhaps in his/her 70s. At that time, the client might start a higher $2,000/month payment from the reverse mortgage (or more, if the residence has appreciated further and interest rates have not moved too unfavorably), and then support the remaining cash flow needs from a portfolio that would be partially diminished, but also with a shorter time horizon for the corrosive impact of inflation.

Notwithstanding some of the inflation caveats, though, for the client who does not have legacy goals (i.e., does not wish to leave significant assets to the next generation), a comprehensive retirement income plan based on the entire $1,000,000 of assets on the balance sheet may be far more appealing than the alternatives of either: a) spending down $42,000/year from a $500,000 portfolio and then later relying solely on the residence for all remaining income in a house-rich-cash-poor scenario; or b) cutting spending by approximately 50%, to a withdrawal rate that could be sustained by the $500,000 portfolio alone, even though it may result in a significant legacy asset (the unencumbered primary residence) at death.

However, while it is a positive that the reverse mortgage can be integrated into the retirement income plan, and support cash flow needs (while not creating a cash flow obligation in the form of ongoing mortgage repayments), the reverse mortgage still represents a significant economic cost.

The Economic Impact of a Reverse Mortgage

Although there is justifiably a lot of concern about the upfront costs of establishing a reverse mortgage - albeit somewhat relieved with the availability of the HECM Saver option and its reduced upfront mortgage insurance premium - the majority of the economic impact of a reverse mortgage comes over time, in the form of an ongoing accrual of mortgage interest (and ongoing mortgage insurance premiums).

After all, while a reverse mortgage might have an upfront cost of $10,000 - $15,000 (or perhaps half that for a HECM Saver), a loan balance of $300,000 results in interest charges $12,750 per year, each year, compounding, at a hypothetical 4.25% interest rate (calculated as 3.0% {LIBOR + lender's margin} + 1.25% {MIP}). While the cost of this interest does not have to be paid from current cash flow, it *does* have to ultimately be paid - via the proceeds of the primary residence when sold.

> *Example 2a*. A 74-year-old client who takes out a $300,000 lump sum reverse mortgage against a $600,000 residence (borrowing half the equity) might incur approximately $7,000 of closing costs on a HECM Saver loan, but if that client lives until age 90, that loan balance will have increased to approximately $571,298, even if financed with a 4.25% variable interest rate that never actually increases (obviously, if rates rise, the loan balance will just rise more quickly). At a 2% growth rate on the primary residence, the value of the property itself would rise just under 35% over this time period, to $807,521, resulting in remaining equity of $236,223. While it is true that this means the beneficiaries will still receive an inheritance, and that not all of the equity has been consumed, the fact remains that the client reduces the future *net* value of the residence to heirs by a $571,298 of loan balance to be repaid, even though only $300,000 of funds were freed up from the residence via the reverse mortgage.
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> *Example 2b*. Instead, assume the client had decided to extract half the equity by simply downsizing to a

$300,000 primary residence (and pocketing the other $300,000 for spending), and then allowed the new residence to appreciate by 2%/year for the next 15 years, the home (with no debt) would be worth $403,761, while again the other $300,000 of equity extracted would be spent along the way.

The difference in the two examples - between a net equity value of $403,761 by downsizing with no debt, and $236,223 by staying in the home and taking a reverse mortgage - highlights the true economic impact of the reverse mortgage for this client over 15 years, for a net difference of $167,538! It may not be a cash flow cost to the current homeowner, but it nonetheless represents a potentially significant diminishment in net worth, reducing the assets that will be remaining for the surviving spouse or next generation, and to a far greater extent than "just" the $7,000 of closing costs!

Of course, if the client's stated primary concern and goal is "to provide for myself as long as I'm alive while staying in my home; the children can have whatever is left over, if there is anything" then the diminishment of net equity for the next generation due to accruing reverse mortgage interest may not necessarily be a problem. Nonetheless, the above example highlights that in practice, the real cost to be cognizant of is not the thousands of dollars of upfront closing costs (although those do take a bite, not to mention adding to the balance on which loan interest will accrue), it's the *tens* (or *hundreds*) of thousands of dollars of ongoing accruing mortgage interest that may compound for years or even decades. Although the structure of the reverse mortgage and its associated mortgage insurance ensures that the client can never end out with a liability for a negative equity situation - even if the entire value of the house is consumed by the reverse mortgage balance, and then some, the lender has no recourse to the borrower beyond receiving 100% of the proceeds from the sale of the house - the fact remains that a significant portion of the equity value, which might otherwise have been spent directly by the current or future generation, will instead accrue to the lender as loan interest.

On the other hand, it's important to bear in mind that a reverse mortgage only accrues interest on the outstanding loan balance, whatever that may be. Thus, while the aforementioned example highlights the accrued impact of a $300,000 lump sum cash-out reverse mortgage, the results would be different for a client who chose instead to open a $300,000 line of credit under the reverse mortgage, but didn't actually begin using it for a period of months or years. In such a scenario, the client's outstanding balance may only be a few thousand dollars - the financed portion of the closing costs - and no further loan interest will accrue until the client actually begins to draw on the line of credit and incurs an additional balance.

Example 2c. The 74-year-old client looking to extract $300,000 of equity instead decides to simply take a $1,500/month ($18,000/year) lifetime monthly payment from the reverse mortgage. Again, since interest only accrues on the actual proceeds received that contribute to the loan balance, the future loan balance will only be $385,495 (still assuming $6,000 in closing costs), rather than the $571,298 loan balance where the whole $300,000 was extracted at once (example 2a). Nonetheless, that's a loan balance of $385,495 when the total payments actually received would only have been $270,000 (at $1,500/month for 15 years); the remaining $115,495 of loan balance represents the economic cost of the strategy in the form of interest (including ongoing mortgage insurance premiums).

Reframing The Two Costs Of A Reverse Mortgage

Another way to look at the situation is that the costs of a reverse mortgage can be broken down into two categories: Access costs, and Use costs.

Access costs represent the costs the client will incur just to initially establish having a reverse mortgage in the first place. They are generally the upfront closing costs to set up a reverse mortgage in the first place. Notably, these costs typically apply regardless of whether/when/how the reverse mortgage funds are actually accessed. Whether a line of credit tapped in the future, a lump sum received now, or ongoing monthly payments, access costs represent the economic impact of establishing a reverse mortgage arrangement.

Use costs represent the costs the client will incur for actually utilizing funds via the reverse mortgage and maintaining a balance on the account. Use costs are the ongoing interest payments (along with mortgage insurance premiums) that accrue and compound on the outstanding mortgage balance - typically starting with interest on the access costs themselves that are financed, but then accruing further if/when/as funds are extracted via the loan.

As the examples in the prior section showed, the distinction between access and use costs are important because while access costs represent the most apparent and immediate costs, they are often radically smaller than the use costs incurred with an ongoing compounding mortgage balance over a period of years or even decades. And while these use costs may not need to be paid out of pocket on an ongoing basis, they still represent an ongoing diminishment of the client's net worth on his/her personal balance sheet as the liability grows. On the other hand, it's notable that use costs do in fact vary with use; thus, line of credit or monthly income strategies accrue interest more slowly than simply extracting a reverse mortgage lump sum all at once, and any use costs may vary (up or down) with interest rates in the case of the typical variable rate reverse mortgage.

Unfortunately, though, the distinction between access and use costs also highlights the fact that the recent change to reverse mortgages in October of 2010 - including the introduction of the HECM Saver with a reduced upfront mortgage insurance premium, but also the increase in the ongoing mortgage insurance premiums for *all* types of reverse mortgages - arguably represents more of an increased cost than a decreased one. While it is true that the access cost is lower with the HECM Saver - clients may see thousands of dollars in initial savings compared to a traditional HECM, thanks to the reduction of the upfront mortgage insurance premium from 2.0% to 0.01% - the ongoing use cost for *all* types of HECM loans is now 1.25% (up from just 0.5% in the past), which potentially represents a very significant increase in the lifetime cost of such loans as the balance compounds over time. On the plus side, the higher cost helps to support the financial viability of the FHA insurance that backs the loan, ensuring that the guarantees will likely really *be* there if ever needed. But on the other hand, it still means that over the long run, reverse mortgage costs have increased in recent years, in light of the elevated risks in the real estate market.

What About Just Not Borrowing?

Given all these costs, the primary alternative to a reverse mortgage is just not to borrow in the first place, and instead to simply sell the property, and either free up some capital by buying a smaller, "downsized" residence, or to outright rent, using the principal and growth of the proceeds from the sale to generate the cash flows needed to maintain ongoing shelter costs in the future.

In the extreme, a couple could even conceivably sell their residence and lease it back, using the sales proceeds as an asset base to grow and maintain financial security while paying rent/lease (and other) expenses. With such an approach, the client may still whittle down the proceeds of the sale with a monthly payment - not unlike whittling down the equity in the home with monthly reverse mortgage payments - but critically, would not incur an upfront access cost, and would not be incurring ongoing use costs in the form of interest. In other words, selling the property and renting may ultimately still spend down the asset base, but without the multi-year impact of compounding interest, the funds could potentially last much longer.

In point of fact, though, the primary determinant of whether freeing up equity in the home (via downsizing or selling-and-renting) turns out better than extracting it via a reverse mortgage is what the client actually *does* with the equity that has been extracted, or with the funds that don't have to be spent because equity was extracted.

Is The Reverse Mortgage Always A Losing Financial Proposition?

Notwithstanding the preceding discussion about the long-term impact of compounding reverse mortgage interest, it is notable that there are situations where the reverse mortgage can actually still come out as the financially more successful (albeit more risky) strategy, relative to the alternatives available.

The first situation - which could potentially be quite common - is where the use of the reverse mortgage allows the client's portfolio to stay invested, and that portfolio outearns the accruing interest rate on the reverse mortgage balance (including the compounding of mortgage insurance premiums). After all, if a portfolio is earning an average return of 8%, and the reverse mortgage is only compounding at 4.25%, it would be better to incur the loan and compound it at the lower rate, than take a withdrawal from the portfolio and fail to earn the higher rate.

Given low current borrowing costs (especially on a variable-rate basis), the hurdle rate of the reverse mortgage's accruing interest may not be difficult to beat (at least as long as interest rates stay low); accordingly, it may be more beneficial to begin taking payments via the reverse mortgage, *even or especially if* there is a viable portfolio, to allow the portfolio to remain invested for growth. If rates rise in the future, the client can always take a future withdrawal from the portfolio -

hopefully with extra money earned by growing in excess of the borrowing rate - to pay off the reverse mortgage and avoid the higher future interest costs if they are deemed undesirable. Of course, the risk is that the portfolio may not be in a good position to take a withdrawal to pay down the loan at the time that interest rates rise; using leverage is not without its dangers.

Nonetheless, at a fundamental level, this strategy is actually similar to simply having clients keep a current long-term mortgage (and a separate portfolio), rather than pre-paying or paying off, to earn leveraged returns (for further discussion, see the recent Nerd's Eye View blog post on buying stocks "on mortgage"). In a similar manner, the goal is for the portfolio to generate a higher after-tax rate of return than the after-tax cost of borrowing. The only difference is that now, with a reverse mortgage, the leverage can actually be applied even *more* effectively, because the traditional mortgage is effectively "self-liquidating" leverage due to the ongoing required principal and interest payments, whereas the reverse mortgage allows the client to maximize the amount that remains invested and reduces withdrawal stresses on the portfolio while allowing it to grow!

For instance, Figure 1 (below) shows the results when a client portfolio earns 8% while financed by a mortgage at a 4.25% interest rate, comparing a reverse mortgage (left side) with an amortizing mortgage (right side). As the results reveal, as long as the portfolio does in fact continue to exceed the cost of borrowing, the client's net worth rises the most when there is a reverse mortgage, because the leverage remains in place, as the mortgage balance increases by the portfolio increases at a faster rate (regardless of the value of the residence itself). On the other hand, there is no difference between the scenarios after year 1 (both have net worth of $227,250), because the initial impact of mortgage interest is the same, regardless of whether it is paid in cash or accrued. However, in subsequent years, the systematic withdrawals of portfolio funds to make amortizing mortgage principal and interest payments deleverages the scenario, reducing the growth of net worth in the favorable equity return scenarios.

In addition, the reverse mortgage scenario also does not require potentially-ill-timed withdrawals from the portfolio to make ongoing mortgage principal and interest payments during market downturns, which could otherwise further hamper the growth of the amortizing mortgage scenario in a volatile market. On the other hand, it's important to note that if the portfolio fails to outearn the cost of borrowing, the reverse mortgage scenario turns out to be the worse of the two; in addition, since the reverse mortgage can end unexpectedly (e.g., due to death), the investment time horizon over which the portfolio must "beat" the cost of borrowing is itself uncertain, which can exacerbate the risk of the leverage situation.

Another situation where the reverse mortgage can come out ahead financially is when the cost to rent in the client's desired living area is high, relative to the cost of ownership. After all, the

Figure 1. Comparison of Reverse to Amortizing Mortgage with Side Portfolio, assuming 4.25% mortgage interest and 8% portfolio growth.

Year	Reverse Mortgage	Portfolio	Net Worth	Amortizing Mortgage	Portfolio	Net Worth
0	$300,000	$500,000	$200,000	$300,000	$500,000	$200,000
1	$312,750	$540,000	$227,250	$294,871	$522,121	$227,250
2	$326,042	$583,200	$257,158	$289,523	$546,011	$256,488
3	$339,899	$629,856	$289,957	$283,948	$571,812	$287,864
4	$354,344	$680,244	$325,900	$278,137	$599,678	$321,541
5	$369,404	$734,664	$365,260	$272,078	$629,772	$357,694
6	$385,104	$793,437	$408,334	$265,762	$662,275	$396,513
8	$418,533	$925,465	$506,932	$252,313	$735,288	$482,975
10	$454,864	$1,079,462	$624,598	$237,696	$820,450	$582,754
12	$494,349	$1,259,085	$764,736	$221,811	$919,784	$697,973
14	$537,262	$1,468,597	$931,335	$204,547	$1,035,647	$831,100
15	$560,096	$1,586,085	$1,025,989	$195,360	$1,100,619	$905,259
20	$689,672	$2,330,479	$1,640,807	$143,230	$1,512,279	$1,369,049
25	$849,225	$3,424,238	$2,575,012	$ 79,040	$2,117,142	$2,038,102
30	$1,045,691	$5,031,328	$3,985,638	$ -	$3,005,885	$3,005,885

decision to own a $600,000 residence in the first place represents a trade-off; the client could instead have $600,000 of equity in a portfolio, and simply take systematic withdrawals to pay rent, rather than "using" the asset-as-a-residence for shelter. This, in part, is why residential real estate typically only generates a long-term appreciation return of 2%-3% (notwithstanding the volatility of the recent decade), while long-term portfolio returns are often 8%-10%. The difference between the two represents implicit shelter costs that do not have to be paid in cash when the residence is used for shelter, but would have to be paid if the residence asset was converted to a portfolio. Thus, in essence, if the cost to rent would absorb most or all of the portfolio's total earnings (e.g., if it "cost" 8%+/year of the value of the portfolio just to pay rent), it may be preferable to simply keep the residence and with its implicit rental value (and extract any further cash flow necessary via a reverse mortgage), because the non-cash-based value of the shelter it provides still exceeds the cash-based cost of shelter alternatives, resulting in financial savings.

Notably, a third related situation where the reverse mortgage can benefit is where the ownership of the primary residence - with its implicit non-cash-based shelter - also provides a highly effective hedge against inflation impacting the cost to rent (especially unexpected, high inflation). After all, regardless of how inflation jumps upwards, shelter costs cannot outpace the appreciation of the residence (since the shelter continues to provide a living space regardless of the changes in its value!), while there is a risk that rental inflation could outpace growth in the portfolio (at least in the short-to-intermediate term).

Thus, in the end, while the reverse mortgage does represent a cost, as the investor does literally have to pay interest simply for the privilege of generating liquidity to access equity - it does not have to be a financially negative proposition. Keeping the primary residence still allows for an effective inflation hedge against rental/shelter inflation increases (and especially spikes), can be financially strong in areas where the cost to purchase is inexpensive to own relative to the cost to rent, and can ultimately allow for an *increase* in financial wealth if the money not-spent from the portfolio grows faster than the compounding interest on the money borrowed via the reverse mortgage (albeit with the inherent risks of leverage, as the portfolio may underperform)!

The Lifestyle Decision

While the preceding section highlighted situations where the client could actually come out ahead via a reverse mortgage (where it allows a portfolio to stay invested for higher rates of return), in some situations the goal of the client is not to use the strategy for wealth enhancement, but simply as a lifestyle decision.

The framing of a reverse mortgage as a lifestyle decision is especially true when the client truly has reached the scenario where virtually all other assets are depleted, and the equity in the residence *is* the last resort. At such a point, trying to downsize and free up equity to invest may be of very limited value, as the client may need to spend down the assets quickly enough that the time horizon is too short to invest for growth anyway. In such a scenario, the reverse mortgage truly represents a lifestyle cost decision, where the access and use costs of the reverse mortgage upfront and over time may even spend down the equity in the home at an accelerated rate, but doing so will nonetheless allow the client to make the lifestyle choice to stay in the home while spending down assets (and even if the client outlives the equity, can *still* remain in the home).

Notably, in such late stage spend-down scenarios, this potentially means not only that the client is choosing to deplete the value of a legacy asset, but in the event of a long life could result in the depletion of assets entirely. Accordingly, for clients who truly anticipate the possibility of a full depletion of assets and/or completely consuming the equity in the home, a monthly payment option on the reverse mortgage may by far be the most desirable, as payments are guaranteed to continue for life (as long as the client remains in the house and maintains it properly), even if there is negative equity in the home (as opposed to an upfront lump sum, which could be depleted and outlived by the client).

Whether the cost such a lifestyle decision - to stay in the home, despite the fact that compounding reverse mortgage interest will grind down the value of the client's balance sheet for future use or for heirs - is worth it or not, will depend on the client. There is no single "right" answer, inasmuch as an approach that includes borrowing against one's own assets for liquidity will always be more expensive than not doing so; but in the real world, where clients may have a personal preference to

stay in the home, notwithstanding the cost, and there really are little or no other assets available, the reverse mortgage provides a way to accomplish the goal, in a manner that does not place further stress on cash flows that may be unavailable in the first place (the way a traditional cash-out mortgage would).

Common Strategies for Reverse Mortgage Use

There are several common reverse mortgage strategies to consider for clients who are trying to accomplish retirement goals while still living in their primary residence. The list here is by no means exhaustive, but simply intended to illustrate situations where a reverse mortgage may be an appropriate tool to help accomplish a lifestyle goal, particularly in situations where the client may not necessarily be down to the point where the residence is the only remaining asset of last resort.

Refinancing An Existing Mortgage

Although there is a requirement that the reverse mortgage be the only lien on the property - thereby forcing the borrower to refinance any other existing mortgages into the reverse mortgage - using a reverse mortgage to finance an existing traditional mortgage can actually be a proactive strategy.

> *Example 3a*. A 70-year-old homeowner with a $175,000 traditional mortgage on a $450,000 property paying $1,000/month could refinance into a $175,000 reverse mortgage, eliminating the requirement for an ongoing $1,000/month cash flow obligation. In addition, if the net principal limit for the borrower was $250,000 on the property, then the borrower could further extract an additional $75,000 of equity (or create a $75,000 line of credit, or establish lifetime monthly payments based on a $75,000 available loan amount).

Notably, in the scenario above, the client actually improved cash flow by $1,000/month, not by extracting $1,000/month from the equity in the home, but simply by refinancing an existing amortizing mortgage into a reverse mortgage, eliminating the need to make ongoing payments.

> *Example 3b*. Continuing the prior example, if it turns out that the client's overall need was to spend $5,000/month (including the original mortgage), with $1,500/month in Social Security payments coming in and a $600,000 portfolio, the client's ongoing withdrawal demands from the portfolio drop from $3,500/month ($42,000/year), which was a 7% withdrawal rate, down to only $2,500/month ($30,000/year), a much more reasonable and sustainable 5% withdrawal rate for a 70-year-old client. In addition, the demands on the portfolio could even be further reduced if the client started a small lifetime monthly payment from the reverse mortgage with the available excess $75,000 of available borrowing.

Financing a Downsizing/New Home

While most reverse mortgages are used to extract equity from a current residence, it is nonetheless possible to use a reverse mortgage to acquire a new primary residence, as well. The application of the principal limit factors would require the client to still invest a significant downpayment into the property (as the implicit LTV limit is certainly not 100%, and in fact is lower than traditional mortgage financing); nonetheless, if the client is in the midst of downsizing or otherwise buying a new primary residence, equity freed up from a prior residence may be sufficient to cover a downpayment, and the remainder can be financed with a reverse mortgage requiring. The advantage to the strategy is simple: no ongoing payments creating cash flow demands.

> *Example 4*. A client might sell a $600,000 property with a $250,000 mortgage (and a $1,600/month principal + interest mortgage payment), and downsize into a $400,000 home. This initially frees up $350,000 of net proceeds from the original home; $200,000 is used as a downpayment on the new residence, with the remaining $200,000 financed via a reverse mortgage. As a result, the client frees up $150,000 to put into a portfolio, and furthermore is relieved of the cash flow demands of a $1,600/month mortgage payment (as there are no ongoing principal and interest payments on the new home financed with the reverse mortgage).

Monthly Cash Flow Supplement

Another popular strategy for a reverse mortgage is to begin to use it as a monthly cash flow supplement to manage ongoing expenses. While the reverse mortgage is often framed as the "cash flow source of last resort" it may nonetheless be appealing to consider a reverse mortgage at some point well in advance of when all other assets are depleted. By utilizing a reverse

mortgage, the client may be able to maintain some of the existing investment funds available for emergency. Alternatively, using a reverse mortgage and reducing the current cash flow demands from a portfolio may allow it to be invested for further growth.

Example 5a. A 72-year-old couple spends $6,000/month, receiving $3,500/month from Social Security for each of them, and generating the other $2,500/month from a $400,000 portfolio (a withdrawal rate of 7.5% at $30,000/year!). They also have a $400,000 house with no current mortgage. The couple could receive lifetime (as long as they stay in the home) monthly payments of $1,300/month via a HECM Saver reverse mortgage, which would reduce their portfolio withdrawal needs down to $1,200/month (a mere 3.6% withdrawal rate on their portfolio). Notably, the above scenario should be sustainable for the rest of the couple's life, as Social Security payments and the reverse mortgage will continue (as long as they stay in the home), and the now-modest withdrawal rate should be sustainable.

Example 5b. By contrast, if the aforementioned couple waited 12 years, until their portfolio was nearly depleted, then (assuming 3% inflation) their withdrawal need would be up to $3,500/month, and even if the house had appreciated at 3%, a future reverse mortgage would only allow monthly payments of about $2,750 (even at age 84), resulting in a material shortfall because of the maximum borrowing constraints of the reverse mortgage. Thus, by starting the payments earlier - as shown in example 5a - the strategy was actually more sustainable than waiting!

Example 6. A 78-year-old couple spends $5,000/month, receiving $2,500/month from Social Security and trying to sustain the remainder from a $150,000 portfolio. The couple's $5,000/month expenses include a 6% 15-year mortgage with a $95,000 remaining balance against a $400,000 residence, and the mortgage repayments require a principal + interest of approximately $1,250/month. In this case, the couple's retirement plan is in serious jeopardy, as withdrawals of $2,500/month ($30,000/year) in excess of Social Security will rapidly decimate a $150,000 portfolio. However, the couple could use a reverse mortgage to refinance the existing loan, and still receive approximately $750/month in lifetime payments from the remaining borrowing limit. As a result, the couple's cash flow needs would drop to only $3,750/month (after relieving the mortgage repayments), which would drop further to only $3,000/month with the reverse mortgage monthly payments. Given Social Security income of $2,500/month, the couple would only need a mere $500/month of portfolio withdrawals, which can easily be sustained from a $150,000 portfolio (even making up for future inflation adjustments on the reverse mortgage payments). Notably, waiting in this scenario would likely be catastrophic, as a reverse mortgage alone from the property after the portfolio is depleted - even if the couple is a few years older - will be incapable of supporting their spending needs.

On the other hand, borrowers should be cautious not to begin reverse mortgage payments "too" soon, given that the guaranteed payments do not increase with inflation and if relied upon exclusively could present substantial hardships in the future due to inflationary erosion of purchasing power. Thus, while reverse mortgages become available at age 62, clients may often wait until their 70s or beyond to implement (while balancing with other assets and cash flow needs, of course). Waiting until a later age also has the virtue of saving on use costs in the meantime (no outstanding balance accruing interest), and allowing a higher borrowing amount due to the shorter time horizon implied in older age.

Guaranteed Line of Credit

Another popular use of a reverse mortgage is as a (guaranteed) line of credit. The reverse mortgage is established with the maximum line of credit (which in turn increases over time, as discussed in last month's newsletter), and the borrower then draws on the line of credit as needed. The line of credit might be tapped on an ongoing basis for regular cash flows, or simply used in emergencies or for bigger projects. In some cases, the line of credit might be established to deal with a particular need (e.g., a major house repair such as a roof replacement), but rather than "just" borrow the amount for the repair, the full maximum line of credit is established, and then tapped as needed (since interest only accrues on the amounts outstanding).

Use of a line of credit for ongoing needs also allows for the flexibility of tapping the line of credit further if needed for an emergency on top of monthly payments (as long as the maximum line of credit limits are not breached), and/or can be used to plan for an increasing series of payments over time (to help keep pace with inflation, but again only up to the specified line of credit limits).

And notably, because the line of credit is guaranteed (and insurance-backed), it cannot be revoked by the lender - unlike a traditional home equity line of credit, which can potentially be closed down on short notice by the bank.

Caveats And Concerns of Reverse Mortgages

Notwithstanding all the discussion about reverse mortgages up to this point, there are two other important issues to consider when implementing reverse mortgages: interest rates, and time horizons.

Reverse Mortgages And Interest Rate Risk

As with most forms of borrowing, a crucial factor in the equation is the interest rate tied to the loan. In the case of traditional mortgages, the interest rate can be a key driver - if rates are too high, monthly payments become unaffordable for a given level of debt principal, and conversely if interest rates drop a refinancing may be desirable to take advantage and "lock in" the lower rate. However, many of these factors are a moot point in the case of a reverse mortgage, because the overwhelming majority of such loans are financed on a variable rate basis.

In a variable rate environment, timing the financing decision to when rates have troughed is less of an issue. If the reverse mortgage is established while rates are high, the rates will still trend down with interest rates as they later fall. Conversely, even hitting the timing of the bottom of an interest rate cycle may be of limited benefit, if rates rise later and the reverse mortgage interest rate rises along with it.

For those who plan to use the reverse mortgage as a lump sum cash withdrawal, to refinance an existing mortgage, or to finance a new residence purchase - where the fixed rate reverse mortgage is actually an option - the transaction is more sensitive to the timing of the reverse mortgage and the interest rate environment. However, for those who plan to receive ongoing monthly payments or utilize the line of credit option - where a fixed rate reverse mortgage isn't even an option - the only advantage to "timing" a low in interest rates is to set the floor against which the lifetime cap is calculated for an annually adjusting variable rate. For instance, if the loan lifetime cap is 5% above the starting level, timing a reverse mortgage when the rate is 4% provides a more appealing cap than when the rate is 7%, all else being equal.

In addition, for clients who ultimately do plan/expect for a reverse mortgage to consume most or all of the remaining equity - especially where the trade-off represents a lifestyle decision to stay in the home, even if not "financially optimal" - there may be even less sensitivity to interest rates. In point of fact, for borrowers who plan to extract the maximum amount of equity possible over life, and "rely" upon the non-recourse nature of the reverse mortgage to avoid the ramifications of negative equity, the greatest impact of interest rates is not their effect on the compounding loan balance, but instead on locking in what the maximum loan amount can be in the first place. This is true because all else being equal, a lower interest rate allows for a higher maximum reverse mortgage lump sum, higher maximum line of credit, or larger lifetime monthly payments. A lower interest rate may also allow a client to extract the funds needed "just" using a HECM Saver loan instead of a traditional HECM loan and its higher upfront mortgage insurance premium.

On the other hand, for clients who intend to maintain a reverse mortgage on top of an existing portfolio - inherently creating leverage that in the end is only successful if the portfolio return exceeds the cost of borrowing - the variability of interest rates can affect the desirability of the entire strategy. In such scenarios, if rates rise too high, it may be difficult or impossible to outearn the borrowing cost, which in turn may make it more desirable to take a (big) portfolio withdrawal and pay off the reverse mortgage, if rates ever rise "too" far. In turn, though, this introduces further risk into the reverse mortgage leverage scenario - the risk that stocks may not turn out to have delivered a favorable return over the artificially shortened time horizon caused by rising rates.

Reverse Mortgages and Time Horizon

In addition to the aforementioned potential time horizon challenge - that rising interest rates may make it more desirable to pay off a reverse mortgage and deleverage the client's balance sheet (if available), there is a further challenge to reverse mortgage time horizons: the fact that the reverse mortgage must be paid off in certain triggering circumstances based on the terms of the reverse mortgage itself.

Certainly, the reverse mortgage trigger of failing to pay homeowner's insurance, property taxes, and basic

upkeep, is one that can be avoided. However, the trigger that a reverse mortgage must be liquidated at death, or when moving, presents a more substantive challenge.

In the case of the former - death of the (last) homeowner triggering a liquidation of the reverse mortgage - there is a risk that at the time, the portfolio will not have outperformed the borrowing cost of the mortgage, forcing a liquidation while the loan is underwater. While it is true that technically the only recourse against the mortgage is the value of the property, in practice the value of the residence would have been the same either way, and if the mortgage was maintained at the same time that a liquid portfolio was invested and it underperformed, the client's net worth will have been adversely impacted.

On the other hand, if the client anticipates that the time horizon could be shortened due to a planned move - e.g., the client expects to sell the residence in a limited number of years, whether to downsize, relocate to be near family, or for some other reason - more caution is merited when considering a reverse mortgage at all. In the case where a portfolio is remaining invested while the reverse mortgage balance accrues, there is a risk that the portfolio will underperform the borrowing cost over a more limited time horizon. Furthermore, the upfront costs of the reverse mortgage itself become more material when they are paid to have access to the money for just a few years (versus a scenario where a few thousand dollars of access costs allow access to monthly income for decades).

Although a HECM Saver reduces the bite of the upfront cost and may make a reverse mortgage more appealing over somewhat more limited time horizons (e.g., 5-10 years), in general reverse mortgages will still be more appealing when the homeowner anticipates a longer time horizon that allows for more time to both amortize reverse mortgage access costs and for the portfolio to outperform borrowing/use costs.

Bringing It All Together

Most clients will likely wait until at least their 70s to seriously consider a reverse mortgage in coordination with other assets, as starting "too early" can accrue excessive loan interest, limit the amount that can be borrowed against equity, and in the case of monthly payments may far too behind inflation. On the other hand, as the discussion has shown, starting "too late" can also be problematic, as retirees who wait until all other assets are spent down and then begin distributions in their 80s may simply be unable to generate large enough cash flows from a reverse mortgage alone to accomplish their goals.

Because of the costs involved, the client should still have a reasonable time horizon to keep the reverse mortgage. A 5-10 year period seems a reasonable minimum (at least for a HECM Saver loan) to amortize the impact of access costs, but longer is certainly better. This may be especially true in situations where the reverse mortgage will be held while a current portfolio is maintained, implicitly creating a leverage situation where the portfolio needs a sufficient time horizon to outearn the borrowing cost of the mortgage.

On the other hand, for clients who wish to employ leverage (and the associated risks) to try to improve their financial situation, a reverse mortgage arguably works even better than a traditional mortgage, as the "opportunity" to make no interest or principal payments allows the borrower to maximize leverage. In the case of a traditional amortizing mortgage, the ongoing payments slowly deleverage what otherwise may have been a favorable borrowing scenario.

For clients with limited portfolios, where the decision for a reverse mortgage is more of a lifestyle choice to stay in a desired primary residence, the primary cost to consider is not the access cost, but the use costs in the form of ongoing interest (and mortgage insurance premiums), that will slowly and steadily erode net worth. Notwithstanding such costs, though, the reverse mortgage may still be an effective means of achieving a client's goal of living out his/her days in the residence, while still having access to equity to manage other ongoing retirement needs.

In practice, clients may implement several strategies to utilize a reverse mortgage, depending on their situation. Using a reverse mortgage to refinance out of an existing amortizing mortgage can help to reduce cash flow demands, making an existing portfolio more viable. If the reverse mortgage limits are significantly higher than the existing mortgage, additional ongoing monthly income (or an available line of credit) can be established as well. Many clients may simply prefer to focus on the monthly payments option from the reverse mortgage - especially if they truly plan to stay in the residence for life - as such arrangements can dramatically reduce the withdrawal strain on an existing portfolio. Implemented early on, monthly payment approaches can ensure that the client never reaches a "house rich, cash poor"

scenario in the first place - especially helpful since in the extreme, in a reverse mortgage may be insufficient to recover a retirement scenario if it is started too late down the road, due to borrowing limits.

Conclusion

In the end, the reverse mortgage is probably an underutilized tool in the financial planner's quiver, especially given the already common use of keeping traditional mortgages in retirement anyway. Although the costs of reverse mortgages are not trivial, the upfront costs have declined recently, making the strategy somewhat more appealing at the outset, while low interest rates may make the strategy an appealing option on an ongoing basis (even with recently raised ongoing mortgage insurance premiums).

Ultimately, the true appropriateness of a reverse mortgage will depend on specific client circumstances. Nonetheless, reverse mortgages definitely deserve a look for many clients - and far earlier than the traditional "income source of last resort" by which they have been traditionally viewed.

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