



KNOWLEDGE BASE

Reverse Mortgages

We've been getting a lot of calls from financial advisors about reverse mortgages lately.

Most often, the requests are coming from aging boomers. They have learned from their advisors — or from a few minutes with an online calculator — that they are in danger of outliving their savings. They may not be clear on what a reverse mortgage is, but they know they need more money to see them through decades of retirement.

This challenge provides an opportunity to use a reverse mortgage to tap the built-up value of their residence to bridge the gap. For clients who have a firmer retirement foundation, a reverse mortgage can achieve planning and gifting goals.

First, let's go through the basics. A reverse mortgage is just like a forward mortgage: You have a loan balance, an interest rate and a monthly payment. The homeowner is responsible for property taxes, insurance and maintenance — it's still his house. With a **forward** mortgage, the owner pays the lender, who uses the monthly check to cover current interest and applies anything above the interest due to reduce principal. With a **reverse** mortgage, the payment is the current interest due based on the current balance, and it isn't paid directly by the house owner, it is essentially added to the current balance.


For example, if you have a 62-year-old couple with a \$200,000 house and a \$100,000 interest-only forward mortgage at 6 percent, they would owe \$500 each month, or \$6,000 annually, to maintain their balance of \$100,000. Each month, they transfer \$500 of their cash flow to the lender to maintain the \$100,000 balance.

If this were a \$100,000 interest-only reverse mortgage at 6 percent, the owner would be charged a payment of \$500 each month and, after one month, would owe \$100,500. The owner would have transferred \$500 of his wealth to the lender by increasing the mortgage balance, but he retained use of the home **and control of the cash flow of \$500** for that month that he didn't pay out of pocket.

Meanwhile, whether the client had a forward or a reverse, the house will have continued to appreciate — perhaps not at the dramatic rates of recent years, but it's safe to assume annual appreciation of 3 percent or so. In a year, the \$200,000 house would be worth \$6,000 more, or \$500 per month. The net worth of the client remains about the same, however, the **forward puts that money against interest** while the **reverse allows that cash flow to stay with the client**.

THE HURDLES

There are very few hurdles when securing a reverse mortgage. The first hurdle is that it can only be used for your primary residence, and the key secondary rule is that at least one of the owners taking out the loan must be aged 62 or older. **None of the normal lending guidelines apply** (for example, income, credit or reserves) when considering a



reverse mortgage. If the owners have an existing mortgage, it typically must be paid off with the proceeds from the new mortgage, and anything above that can come out in the form of cash, a line of credit or a stream of payments. **The closing costs are more expensive than a forward mortgage;** a \$100,000 reverse mortgage would cost you about \$4,200 more than a traditional forward mortgage. However, there is additional protection against loss: Should the house value decline, the owners (or their estate) **can never owe more than the value of their house at death.**

In the example above, the couple withdrew cash from the house to pay off an existing mortgage. If the couple had no existing mortgage, they could have removed \$100,000 cash from their house with no monthly payment and used this to supplement their reserves, or increase their income. This is where the reverse mortgage is most often used and where I can add value. The \$100,000 comes out of the house, and is annuitized by a financial advisor to provide income for the client — literally through an annuity product or with a portfolio that delivers the desired rate of return. Realistically, that's probably \$600 a month.

When it comes to deciding whether you are a candidate for a reverse mortgage, start by ascertaining if it's from an "I need" or an "I want" basis. **Most often, the answer that leads to a reverse mortgage is "I need."** Clients who can't make it on their savings, investments and pensions should use it. (But, there are reasons to accommodate the "I wants" too.) For those who need it, it may be difficult to broach the subject, because there is an implicit admission of failure. But you can make up for the discomfort by solving a problem.

A good typical example would be a couple, who are both 65 and want to retire, but still have a \$1,600 mortgage payment on their \$300,000 house. They say the need to eliminate this \$1,600 monthly payment is the only thing that keeps them from retiring now. In this example, we would refinance the existing forward mortgage with a reverse mortgage and eliminate the \$1,600 per month expense." So the clients retirement becomes effective with their loan closing! In addition, I would also advise them to buy a life insurance policy to replace the wealth being sucked from the house for their children when they die, and a long-term care rider to protect their existing assets in retirement.

FOR SURVIVAL OR CREATIVE PLANNING? YES.

In contrast to clients who need a survival mechanism, many older investors may want to use reverse mortgages as a creative planning option. Consider this case study, where an older client is thinking of a creative way to help put their grandchildren through college. Usually this can be done by using a reverse mortgage.

Here's how: Take Jack and Jackie, for example. They're both 67 and have a \$300,000 house with no mortgage. They have over \$1 million invested, and with Social Security and a pension, they feel they are in great shape for retirement. They have three grandchildren, the oldest of which starts college in 10 years. Their children are working hard to make ends meet, save for their retirement and fund college savings. Brent calculates that the \$200 per month, per child that the parents are saving will not be enough; they'll need more than twice that just for a state college education. The alternative to \$400 per month, per child for the next 10 years is a lump sum contribution

today of \$130,000. That should cover the expenses of all three grandchildren's educations.

Jack and Jackie secure a reverse mortgage for \$130,000 and hand it to Gilmore to set up the college fund. No payment will be due on the mortgage, so there is no reduction in current cash flow to the grandparents. The children receive a gift, free of estate and gift tax, by the transfer of money over several years. The grandparents enjoy the experience of paying for their grandchildren to go to college, and the parents can now plan how they can use the \$200 per month, per child they were paying for other planning needs.

A reverse mortgage can also be used to **fund a life insurance policy** that provides heirs and beneficiaries with far greater flexibility. Would your client prefer to leave a house worth \$200,000 that needs to be sold, or \$250,000 cash from a life insurance policy that was funded with a reverse mortgage?

Regard a reverse the way you would a forward mortgage: It is simply a device for improving cash flow. In both kinds of mortgages, the client can modify the program as needed — to refinance when rates improve, to take advantage of higher valuation or to adjust for the increased mortality risk of the aging client.

Call me to help you reverse outdated thinking about reverse mortgages. Learn to accommodate more of your “I needs” and their “I wants.”

FOLLOW THE MONEY:

Cash flows for forward and reverse mortgages.

Cash Flow and Balance-Sheet Impact (after 1 month)			
	Forward		Reverse
Cash Flow	-\$500	Cash Flow	Unchanged
Mortgage	Unchanged	Mortgage	-\$500
Appreciation	+\$500	Appreciation	+\$500