Retirement Income
JOURNAL

Three Advisor-Friendly Reverse Mortgage Strategies

By Kerry Pechter *Thu, May 12, 2016*

In this installment of our HECM series, we review three strategies that should entice advisors: the HECM-for-purchase, the HECM-LOC for liquidity in down markets, and the HECM-LOC created at age 62 but tapped only if all other sources of cash are exhausted.

Financial fads run hot and cold among advisors and planners, but interest in home equity conversion mortgages (HECMs, or reverse mortgages), which allow people over age 62 to tap their home equity without leaving their homes, continues to be lukewarm.

That's not for lack of promotion by thought-leaders in the planning world, like Harold Evensky, Barry Sacks and Wade Pfau. All have published persuasive articles in the *Journal of Financial Planning* that portray HECM lines of credit as a no-brainer income-generating tool for retirees—even for those in the "green zone," with plenty of savings.

Pfau, a professor at The American College, wrote recently that those articles "could very well lead to the strategic use of home equity in a retirement income plan to become the next hot topic for client and adviser education, similar to how Social Security claiming strategies have been ubiquitous in recent years."

If a tipping point in favor of HECMs is ever going to arrive, the time is now. The low interest-rate environment, which reduces annuity payouts, raises HECM loan amounts. Collectively, Boomers have trillions of dollars in home equity. And, as Pfau has suggested, a "loophole" in the HECM rules that currently favors HECM lines of credit (HECM-LOCs) may not stay open forever.

RIJ is agnostic on the advisability of using reverse mortgages. But it seems clear that fiduciary-minded advisors or planners who practice "life-cycle" planning, and even those who don't, should consider every asset on "household balance sheet" when looking for sources of retirement income. And that includes home equity.

In this fifth installment of our series on HECMs, we review three HECM strategies that are tailor-made to entice advisors: the HECM-for-purchase, the "standby" HECM-LOC to supply cash after a year of negative returns, and the HECM-LOC created at age 62 but tapped only if all other sources of cash are exhausted.

A new home, financed with a HECM

We're used to thinking about reverse mortgages as tools to help older Americans "age in place," but since 2009 the Department of Housing and Urban Development has allowed people to finance the purchase of new FHA-approved home or condo—not a vacation home or assisted-living unit, however—with the help of a reverse mortgage.

Michael Banner, a Florida-based HECM broker, has been on a campaign to popularize HECMs-for-purchase. Via online courses sponsored by his company, **AmericanCEInstitute**, he said he has educated 14,000 financial advisors, real estate agents and others in the past five years about the benefits of this strategy.

Consider this hypothetical: A 65-year-old couple wants to sell a paid-off $500,000 home in the Northeast and move to a $500,000 home in the Southwest. According to Banner, they can put down about $250,000 on the new home and borrow the rest in a reverse mortgage.

The result: The couple moves into a new home with equity in the form of a $250,000 down payment (net of closing costs and real estate commissions) from the sale of the departure home. This component is excluded from capital gains tax. The other half of the purchase price is financed with a reverse mortgage, on which the couple has the option but not the requirement to make any payments.

Banner told *RIJ* that when he tells advisors that their clients can move into a new home without having to make mortgage payments and with half of the equity of the previous home available for any purpose they wish, advisors get excited. "When certified financial planners hear this, they say, 'Whoa. What did you just say?'" he told *RIJ* recently. When the heirs sell the house and settle the HECM, he added, any remaining equity passes to the estate and any accrued interest is deductible, under current law.

In his view, a synergy between HECM brokers, real estate agents and financial advisors is waiting to be tapped. "The reverse mortgage world hasn't gotten out and knocked on the doors of the realtors," Banner said. "The industry has been too lazy to build rapport with them. Last year five million homes were sold in the U.S. and 14%, or 700,000, involved sellers over age 62. Of those, there were only about 2,500 HECMs for purchase."

HECM-LOC vs. longevity risk

In an article in the *Journal of Financial Planning*, Wade Pfau of the American College, whose work in recent years has served as a touchstone for retirement planners, demonstrated the benefits of opening a reverse mortgage line of credit as early as age 62 and then leaving it untapped unless or until it is absolutely necessary.

This strategy, as Pfau explains, takes advantage of what may or may not be an intended aspect of the HECM law. Under the regulations, a borrower's HECM-LOC, even if not tapped, starts with the same upper limit as a HECM loan. What's more, the HECM-LOC's limit grows at the same rate as a comparable loan balance would grow—currently, at about 4% a year fixed or 2.75% adjustable.

Because the upper limit is HECM-LOC is growing over time, whether the retiree dips into or not, this strategy was likely to provide the retiree with more borrowing power later in life than if he or she postponed opening the HECM-LOC until a later age. As Pfau wrote:

"The strategy that used home equity as a last resort, but which opened a line of credit at the start of retirement in order to let the line of credit grow before being tapped, provided the highest increase in success rates. Especially when interest rates were low, the line of credit would almost always be larger by the time it was needed when it was opened early and allowed to grow, than when it was opened later."

Pfau hypothesized a 62-year-old investor with a $1 million in a tax-deferred retirement account, a $500,000 home with no mortgage, a 25% tax rate, a 50/50 investment portfolio, and after-tax income needs of $40,000 a year. He then compared the success rates (in terms of never having less than $40,000 a year from investments) and legacy outcomes (the amounts left in the client's portfolio at death) for these strategies:

- Ignoring home equity and withdrawing $40,000 (inflation adjusted) each year from investments
- Waiting until portfolio depletion to open a HECM-LOC
- Opening a HECM-LOC at beginning of retirement and exhausting it before tapping personal savings
- Receiving a HECM in the form of a $17,972 annual "tenure payment" until death or departure from the home
- Opening a HECM-LOC living expenses only to avoid distressed selling in down markets and either paying it back down or not paying it back down
- Opening a HECM-LOC at the beginning of retirement, paying the closing costs out of pocket, and ignoring it unless or until other sources of income failed to provide at least $40,000 in real purchasing power.

On the basis of Monte Carlo simulations, all of these strategies provided a better-than-50% chance that the client would not run out of money if he didn't live past age 85. But the last option—opening a HECM-LOC early but tapping it last—was the only one that offered a chance of portfolio success greater than 70%, even if the client's retirement lasted 40 years.

The best strategies for maximizing legacy value, however, were those that employed the $17,972-a-year tenure payment or the use of the HECM-LOC before tapping personal savings.

Escape from tyranny of 4%

Retirees can also use reverse mortgages as a hedge against sequence of returns risk. "Sequence" risk refers to the rapid depletion of savings that can occur if the retiree has to generate income by selling depressed assets. The risk is considered greatest during the five years directly before and after the retirement date.

Some advisors handle this risk through a bucketing strategy. They tell retiree to hold a bucket of cash or near-cash large enough so that, during a bear market, they can dip into cash rather than lock in losses by selling stocks. In 2012, Barry Sacks, Harold Evensky and others suggested in articles in the *Journal of Financial Planning* that a HECM-LOC could be used as a substitute for the cash bucket.

The payoff was that the retirees, immunized from sequence risk, could then afford to spend from savings at, for instance, a rate of six percent per year for 30 years, rather than at the proverbially safe rate of 4%, without increasing their risk of running uncomfortably short of money before they died.

In their 2012 article, Barry H. Sacks and Stephen R. Sacks published "Reversing the Conventional Wisdom: Using Home Equity to Supplement Retirement Income." Searching for an answer for retirees who resisted living within an annual budget of 4% of savings but who didn't want to increase their longevity risk, they suggested that the clients use a reverse mortgage.

But instead of using the reverse mortgage as a last resort (if and when the clients ran out of money), or as a first resort (before spending a cent from savings), they suggested that retirees only tap their lines of credit during the years that followed a year of negative returns.

Evensky and his co-authors John Salter and Shaun Pfeiffer, also writing in 2012, took a slightly different approach. Unlike the Sackses, they suggested that the retirees apply some of their returns during the profitable years to the HECM-LOC, thereby protecting the equity in their home for their heirs.

David Peskin, president of **Reverse Mortgage Funding LLC** of Bloomfield, NJ, told RIJ that, as it stands today, hundreds of thousands of retirees are opening conventional home equity lines of credit today to supplement their incomes. If they used HECM-LOCs instead, which he claims to be able to set up for about $1,000, they'd have the option of not making any payments on it.

"Advisors should find this more and more appealing because it puts their clients in complete control of their finances," Peskin told *RIJ*. "The reverse mortgage used to be marketed as a no-payment product but it's really a flexible payment product. The unused portion continues to grow, and it's guaranteed. It can't be taken away from you in a financial crisis."

What's not to like?

Despite the logic behind these three uses of HECMs, only a small minority of advisors seems to be pursuing them. Peskin said that if he conducts a HECM seminar with 500 advisors, only about 10% request further information. Similarly, Pfau said his columns about HECMs on the Forbes magazine website attract only about a tenth as many views as his other columns do.

Regarding Pfau's untapped HECM-LOC strategy, he believes that the Department of Housing and Urban Development may eventually change the HECM-LOC rules to preclude a scenario where interest rates have risen, housing prices have fallen, and the upper limit of an untapped HECM-LOC has been allowed to grow for 20 or 30 years. A borrower could use HECM-LOCs to bet against the housing market, and engineer his or her own miniature "big short."

"I think this was unintended. It sounds too good to be true. I expect the government will put an end to it at some point, especially if the line of credit strategies become more popular," Pfau told *RIJ*. "I don't think these strategies were anticipated. Also, I don't think it was anticipated how these strategies become *that* much more attractive in a low interest rate environment."

At the same time, HECM lenders have little to gain from creating empty HECM-LOCs. Most of them make their money reselling the loans, and an empty HECM-LOC gives them nothing to sell. "If it turns out that planners and consumers are putting them in place and never using them, we'd have to rethink that strategy," Peskin said. "So far that hasn't been the case. People are using it to supplement living expenses."

Regarding the problem that advisors often don't see a clear path to compensation for recommending a HECM, Peskin hopes advisors don't look at it that way. "If it was my financial planner," he said, "I'd like them to look at every available option, even if they don't make money on it."