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How a reverse mortgage can benefit retirement

by Elliot Raphaelson *The Savings Game* October 31, 2016

Many books and articles have been written about reverse mortgages. Very few, however, are written from the perspective of overall retirement-income planning.

Wade Pfau, PhD, CFA, a leading expert in retirement planning, has written a comprehensive book, "Reverse Mortgages: How to use Reverse Mortgages to Secure Your Retirement," that discusses the nuances of reverse mortgages in this context. I recommend it to anyone contemplating a reverse mortgage.

The book includes a history of reverse mortgages, including the changes in Department of Housing and Urban Development (HUD) regulations that corrected some previous disadvantages. These revised regulations ensure that individuals who take out a reverse mortgage have the financial resources to live up to the contract.

The regulations also protect spouses younger than 62 who are not old enough to be a party to the contract. Without these revisions, too many people faced foreclosure because of insufficient financial resources and insufficient understanding of risk.

The principal advantage of a reverse mortgage is that the borrower (minimum age of 62) can have access to some equity of his/her home in the form of either a lump-sum or periodic payments. Although there can be significant upfront costs, the borrower does not have to prepay these costs, nor will he or she have to repay any outstanding loan as long as he or she remains in the home.

He or she must maintain the property and pay all of the real estate taxes and home insurance. The contract will remain in effect as long as he or she does not move out for any period of 12 months or more.

The book contains an excellent discussion of the three upfront costs: the origination fee, the initial mortgage-insurance premium and closing costs. These costs can add up to several thousands of dollars. However, they are often negotiable. For example, some lenders offer lower origination costs if the borrower is willing to accept a higher interest rate.

There is also a fee associated with mandated counseling sessions and some ongoing costs, such as the loan interest and servicing fees (which can be as much as $35 per month).

Most home equity conversion mortgages -- that is, reverse mortgages that are insured by the Federal Housing Administration -- use an adjustable interest rate. This allows four payment options for the borrower: a lump sum, a fixed monthly payment (aka a "tenure" payment), a fixed monthly term payment (i.e., a payment that lasts for a limited timeframe), and a line of credit.

Pfau discusses the advantages of a HECM line of credit vs. the traditional home equity line of credit. The HECM line can't be cancelled, frozen or reduced. With the HELOC, the financial institution does not have to renew the line. Moreover, the principal limit of the HECM will grow through retirement.

The HELOC principal limit is fixed. The HECM requires the borrower to repay the principal and interest. The borrower of the HECM does not need to make any repayment as long as he fulfills the conditions of the contract.

An important feature of the book is a detailed discussion of the potential ways an HECM can be used within a retirement-income plan. These include: as a backup source for liquidity and spending, as an annuity alternative and as a hedge to protect the value of one's home. An HECM can help a couple or individual postpone applying for Social Security, thus increasing benefits by 8 percent for every year of delay after reaching full retirement age up to age 70.

Reverse mortgages are not for everyone. However, thanks to the revised HUD regulations and available lower front-end fees, they can be a reasonable tool in your retirement-income plan. However, don't base your decision on a recommendation from the HUD mandatory counseling representative.

If you don't have the expertise to develop a plan yourself, use a financial adviser or attorney who does.