The New Case for Reverse Mortgages

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WADE PFAU: Reverse mortgages provide the ability to borrow a portion of your home equity without being required to repay the loan until the owner has permanently left it. The idea for reverse mortgages is that the value of your home is eventually used to repay your loan balance. To the extent that there ever was much of a conversation about reverse mortgages as a retirement income tool, that conversation typically focused on either real or perceived negatives related to the traditionally high costs and potentially inappropriate uses for these funds. The assumption in financial and retirement planning was that reverse mortgages should only be considered as a last resort, once all other resources and possibilities had failed.

Well, a lot has changed in the past several years, and the result is that reverse mortgages have an undeserved bad reputation.

Since 2013, the federal government, through the Department of Housing and Urban Development, has continued to refine regulations for its Home Equity Conversion Mortgage (HECM) program to improve the sustainability of the underlying mortgage insurance fund, to better protect eligible non-borrowing spouses, and to ensure that borrowers have sufficient financial resources to continue paying their property taxes and other home-related obligations. The thrust of these changes has been to help ensure that reverse mortgages are used responsibly, as part of an overall retirement income strategy, rather than simply as a way to fritter away assets in an unsustainable and irresponsible way.

Meanwhile, on the academic side, there have been a series of research articles published since 2012 that have demonstrated how responsible use of a reverse mortgage can actually *enhance* an overall retirement income plan. Recently, I reviewed and replicated past findings and extended the analysis further in my own research article. Importantly, this research incorporates realistic costs for reverse mortgages, both in relation to the upfront origination and closing costs and the continuing growth of any outstanding loan balance. The research shows clear benefits from using reverse mortgages even after incorporating their costs and despite their bad image with the public.

Let me explain why reverse mortgages can help. Retirees have a series of expenses they must be able to support to enjoy a successful retirement. These expenses consist of overall lifestyle spending goals, unexpected contingencies and legacy goals. The task is to manage their assets in a way that efficiently meets goals and mitigates retirement risks related to not knowing how long you will live, to market volatility, and to spending surprises that can impact the plan. The reverse-mortgage option should be viewed as a method for responsible retirees to create liquidity from an otherwise illiquid asset, which in turn can create new options that potentially support a more efficient retirement income strategy, such as more spending and/or more legacy.

Intuitively, there are good reasons why opening a reverse mortgage earlier in retirement has the potential to improve retirement efficiencies despite the reverse-mortgage costs for those wishing to remain in their homes.

One potential benefit for opening the reverse mortgage early, especially when interest rates are low, is that the principal limit that can be borrowed from will continue to grow throughout retirement. Reverse mortgages are non-recourse loans, and for sufficiently long retirements, there is a reasonable possibility that the line of credit may grow to be larger than the value of the home.

In these cases, the mortgage insurance premiums paid to the government on the loan balance are used to make sure the lender doesn't experience a loss, but also the borrower and/or estate won't be on the hook for repaying more than 95% of the appraised value of the home when the loan becomes due.

As the government continues to strengthen the rules and regulations for reverse mortgages, and as new research continues to pave the way with an agnostic approach about their role, we may be at a tipping point in which reverse mortgages become much more predominant in the years ahead.

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