Taking A Fresh Look At Reverse Mortgages

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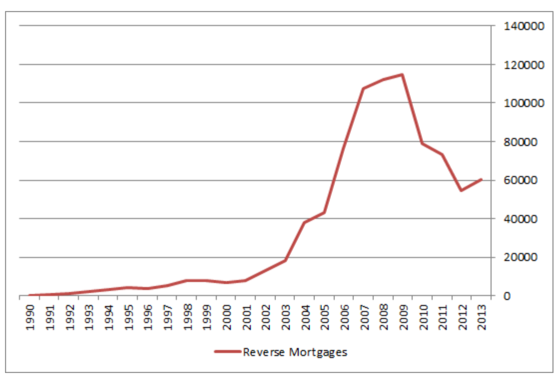
Background On Reverse Mortgages

Background On Reverse Mortgages

- Reverse mortgages originated in 1960s
- Housing and Community Development Act
  - Popularity & support was limited until passed in 1987
  - Established Federal mortgage insurance
  - Created Home Equity Conversion Mortgages (HECM)
  - Originally authorized FHA to insure 2,500 loans

Background On Reverse Mortgages

- Dramatic increase in use, recent decline
  - 8,000 loans originated in 2001
  - 112,000 new loans in 2008
  - ~60,000 new loans in 2013



How Reverse Mortgages Work

How Reverse Mortgages Work: Structuring

- Does not require principal or interest payments
  - Interest accrues against loan balance
  - Loan is repaid from ultimate proceeds of house sale
- Non-recourse loan secured by a residence
  - Risk of being "underwater" covered by mortgage insurance premiums

How Reverse Mortgages Work: Payment Options

- Lump Sum
  - Useful for refinance
- Monthly payments
  - Supplemental income
  - May be payments "for life" (regardless of total debt)
- (Guaranteed) Line of Credit
  - Maximum credit line grows over time
- Combination

How Reverse Mortgages Work: Structuring

- Reverse mortgage remains until triggering event
  - Death (of last owner)
  - Ceasing to use property as primary residence
  - Failing to provide basic maintenance or pay T & I
  - Generally 12 months to repay lender after event

How Reverse Mortgages Work: Requirements

- Youngest borrower must be at least age 62
- All borrowers must be owners of the property
- Must reside in the home as primary residence
- Cannot already be in default on an FHA loan
- Must be first & only loan against property
- Requires HUD-mandated counseling program
- Home must remain in good repair
- Taxes & insurance must be timely paid
- *No income or credit requirements* (for now!)

How Reverse Mortgages Work: HECM Limits

- **Maximum Claim Amount (MCA)**:
  Appraised value up to FHA limit ($625,500)
- **Initial Principal Limit (IPL)**:
  Factor from 0 to 1 based upon borrower age & interest rates
  - ~40% - 70% of MCA depending on exact age(s) & interest rates
  - Potentially impacted by non-borrowing spouse
- **Net Principal Limit**:
  MCA times IPL, less upfront costs to close loan (initial Mortgage Insurance Premium, origination fees, closing costs)
- *New rules effective September 30th 2013* – disbursement limited to 60% of principal limit, or "mandatory obligations" plus 10% if greater

How Reverse Mortgages Work: Upfront Costs

- Upfront Mortgage Insurance Premium (MIP)
  - 0.5% of the MCA *(not the loan value!)*
  - Increased to 2.5% if initial disbursement > 60% of max
  - Old HECM Standard (2%) & Saver (0.01%) no longer apply!

How Reverse Mortgages Work: Upfront Costs

- Origination fee – Generally 2% of first $200,000 of MCA, 1% on remainder; minimum $1k, maximum $6k
- Appraisal fee - $350
- Counseling fee - $125, sometimes waived
- Miscellaneous fees - $1,000(?), including document preparation, title insurance, settlement fees, etc.
- Typically financed (except counseling & appraisal)

How Reverse Mortgages Work: Ongoing Costs

- Service fee – may be ~$30/month, but usually waived
- Loan interest – at stated (or variable) rate
  - Fixed rate usually around 10-year Treasury plus 1%-2%
  - Variable based on short-term rates
    - 1-month LIBOR
    - Usually adjustment caps (2%/year & 5% lifetime, more recently 10% lifetime)
- Ongoing MIP – 1.25% of loan balance (*not* MCA)
  - Increases effective interest rate
- *All costs typically accrued on loan balance*

How Reverse Mortgages Work: Tax Treatment

- Mortgage interest is deductible, but only when paid
  - Deductibility may be "lump sum" when paid off
    - May not be able to fully utilize in single year
    - May be on estate tax return if sold after death!
  - Must still meet normal mortgage interest requirements
    - May be constrained as "home equity indebtedness"
- Loan proceeds not taxable when received
  - Similar to any other loan cash flows

How Reverse Mortgages Work: Tax Treatment

- Mortgage insurance premiums limited deductibility
  - Must meet $100,000 AGI threshold & be acquisition indebtedness, & only for homes purchased 2007-2010!
  - Current provisions expired 12/31/2013
- Underlying property is still appreciating
  - Don't forget capital gains taxes!
  - May be eligible for step-up in basis at death

Reverse Mortgages Decision Points

- What lender/broker will be used?
  - All loans will end out with FHA… but different providers have different closing costs & varying origination fees
- What type of payments?
  - Lump sum, monthly, line of credit? In what amount?
- Fixed or variable rate?
  - If fixed, only available for lump sum payment option
  - If variable, monthly or annual adjustments & what rate index?

Reverse Mortgages Strategies & Uses

- Typically thought of as a resource of last resort
  - Reverse mortgage available once portfolio is depleted
  - Less effective as last resort with new limitations on creditworthiness & disbursements
  - Alternatives with lower cost should be considered first, including downsizing, selling & renting, etc.
  - A resolution to the "house rich, cash poor" scenario
  - Limited in practice for many, due to lending limits relative to value (& FHA limit for larger homes)

Reverse Mortgages Strategies & Uses

- Had rising appeal as "access" costs were declining
  - Virtual elimination of initial MIP on HECM Saver cut typical upfront costs by more than half
  - However, bulk of cost is really ongoing MIP "use cost"
  - New rules brought back higher upfront MIP with elimination of HECM Saver option
- Reverse mortgage appeal declining as 'traditional' lending market improves?

Reverse Mortgages Strategies & Uses

- Supplemental retirement income
  - A(nother) monthly income stream you can't outlive
    - But just spending your own money unless negative equity?
    - If goal is to consume home equity, rising loan ok?
  - Waiting too late leaves insufficient cash flow
    - Supplement income earlier to slow portfolio liquidation?
  - Borrow to spend as needed, but don't wait
    - *Sacks & Sacks (JFP, Feb 2012):*
      Strategies using reverse mortgage first superior to last resort

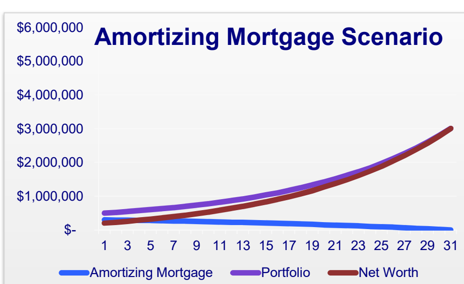
Reverse Mortgages Strategies & Uses

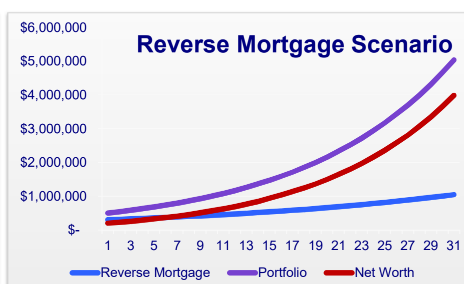
- Flexible access to liquidity
  - Maintain open line of credit – guaranteed
    - But soon must contend with higher costs?
  - Standby reverse mortgage for market downturns
    - Salter, Pfeiffer & Evensky (JFP, August 2012)
    - Borrow during downturn, replace/repay once investments recover
    - Superior alternative to a large cash reserve bucket strategy? (Woerheide & Nanigan, JFP, May 2012)

Reverse Mortgages Strategies & Uses

- Refinancing an existing mortgage
  - Must be able to refinance in full
    - Watch out for cost if more than 60% of Net Principal Limit!
  - Reduces portfolio withdrawals for mortgage payments
    - Minimizes illiquid transition from portfolio to home equity
  - Allows capture of growth/borrowing spread
    - If goal is to capture spread, why use a self-liquidating loan!?

Reverse Mortgages Strategies & Uses





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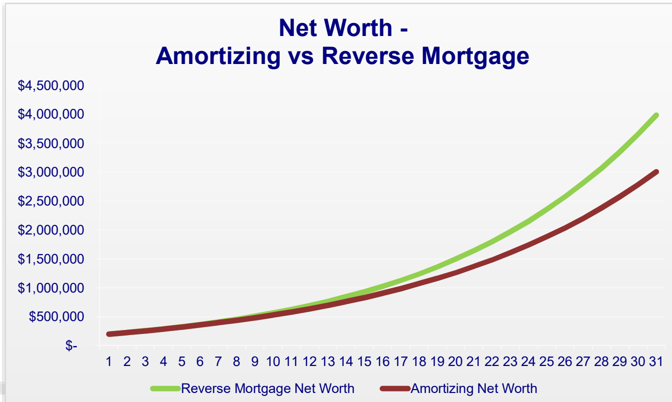
Reverse Mortgages Strategies & Uses



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Reverse Mortgages Strategies & Uses

- Finance a downsized home purchase
  - Can be used for new purchase too!
    - Must become residence within 60 days
  - Very limited LTV financing compared to traditional
    - But no principal or interest payment obligation!
- Lifestyle decisions
  - Home equity as a spenddown asset vs an inheritance

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Caveats/Concerns of Reverse Mortgages

- Interest Rate Risk
  - Many reverse mortgages are variable rate interest
    - Often because it's required (unless lump sum refinance)
  - Can pay off or refinance if it becomes necessary?
  - Interest rate changes (somewhat) limited
  - Does it matter if the plan is to consume equity anyway??
  - Less of an issue if the balance stays low (e.g., contingent/standby reverse mortgage?)

Caveats/Concerns of Reverse Mortgages

- Inflation still a factor
  - Monthly payments for life, but not inflation-adjusted!
- Time Horizon Triggers?
  - Still must be repaid at triggering event
    - May be more or less helpful over "limited" time horizon?
  - "Risky" to invest with (indirect) leverage for short term?
- Costs still not trivial
  - Remember both "access" and "use" costs!

Reverse Mortgage Considerations

- Consider timing carefully
  - "Too early" reduces borrowing limits
    - Also allows loan to compound out all equity… if that matters?
  - "Too late" and home equity alone may not be enough?
    - Limited time horizon also limits value in some scenarios?
    - Rising rates may severely limit future borrowing limits!
- Have a reasonable time horizon
  - Too little time and upfront costs not worthwhile
    - Consider traditional financing or lines of credit instead?

Reverse Mortgage Considerations

- Most popular planning opportunities/scenarios
  - Refinance traditional mortgage into HECM
  - Use reverse mortgage for retirement residence purchase
  - Establish standby line of credit for future contingencies
  - Lifetime income payments to supplement cash flows

Summary

- Monthly lifetime income as a longevity hedge
- If keeping a mortgage in retirement works already…
  - Reverse mortgages should work even better!
- Costs have changed, now more expensive for some
  - If it's a lifestyle decision, still worthwhile?
- Best use may mean *not* waiting until too late
  - Reverse mortgages transitioning away 'last resort' only

Questions?

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www.kitces.com/AICPAWS17

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