The Rennie Quarterly Return

Rennie & Associates Financial Planning

June 30, 2017

Home Equity Conversion (Reverse) Mortgages

Tom Selleck certainly has come a long way from his freeloading days on the Hawaiian estate of Robin Masters in Magnum PI. His two current roles, however, seem a bit conflicted – a venerable police commissioner on Blue Bloods and a dubitable pitchman for a reverse mortgage provider. How much faith should we grant Tom in either role?

My general philosophy is that if a celebrity is pitching a financial product, caveat emptor. In this rare case however, the product may indeed be useful when used judiciously.

My California clients likely all know someone who is "house rich & cash poor." The majority of their wealth is tied up in home equity with only a modest proportion in liquid assets.

While employed, earned income typically provides all the liquidity needed to meet routine living expenses. Often, particularly in high cost-of-living areas, little is left to dedicate to savings along the way.

Upon retirement, the liquidity provided by W2 income must be replaced. In the case of a house rich & cash poor retiree, a reverse mortgage may be the solution to a comfortable future.

The very first reverse mortgage was written in 1961, but the first FHA-insured home equity conversion mortgage (HECM) didn't arrive until 1989. In the early years HECM's were plagued by high fees, high interest rates, abuse and skepticism.

Occasionally, Government regulation begets consumer benefit and in recent years the FHA has introduced policies that have reduced costs and made the product safer, stronger and less risky for the borrower.

Qualification

To qualify for a HECM, you

- Must live in the home
- Must be age 62 or older
- Own the home outright or have a low mortgage balance that can be paid off with proceeds from the reverse
- Must pay taxes & insurance.

How HECM's work

A reverse mortgage may pay the borrower a lump-sum and/or annuity payments for life, or acts as a "stand-by" credit line to be tapped if needed. If a traditional mortgage exists, the HECM proceeds must first be used to pay it off. The most that can be borrowed is generally 50% – 70% of the home value, depending on the borrower's age and interest rates, up to a maximum of $636,150.

What makes HECM's attractive is that the borrower makes no periodic payments on the loan. The mortgage balance, principal plus accrued interest, is paid with proceeds from the sale of the house, when the borrower leaves either vertically or horizontally. However, the loan repayment can never exceed the home's sale proceeds, regardless of the loan balance. If the home is worth less than the HECM balance, the loan company eats the difference. In rare cases equity could be totally exhausted, when a borrower lives far longer than expected and home prices stagnate, but borrowers or their heirs are never left "upside down."

Uses for a HECM

In the case of a house rich & cash poor retiree, the benefits of a reverse mortgage are apparent; it provides much-needed additional liquidity to meet living expenses. To avoid spendthrift temptations, an annuity stream works best in such cases.

But even for those with home equity and sufficiently funded liquid retirement accounts, there are opportunities worth pondering.

HECM annuity payments are tax-free. Distributions from Traditional IRAs and 401ks are taxed as income. A HECM annuity stream could reduce the annual withdrawals necessary from tax-encumbered accounts, reducing a retiree's annual tax burden. Incidentally, HECM interest is tax-deductible, but only when the loan is repaid.

A standby HECM line of credit may provide emergency, tax-free liquidity for unplanned medical expenses, mobility-associated home remodels, or a "bucket-list" trip.

There are those that simply do not want to enter retirement with a traditional mortgage balance. Rather than draining assets that provide liquidity in retirement to pay it off, a reverse mortgage can be used to eliminate future mortgage payments entirely.

In addition, there have been industry studies showing that tapping a HECM line of credit to cover a portion of living expenses in years of poor market returns, and repaying the loan when the market recovers, improves portfolio longevity.

A HECM can also be used in estate planning. For example, HECM income can be used to cover premium payments on a life insurance policy.

I have helped analyze HECM's for several clients and found them to be a useful planning tool when used appropriately.

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My Two 

"Housing wealth – the net equity held by households, consisting of the value of their homes minus their mortgage debt – is the most important source of wealth for all but those at the very top. "

Janet Yellen

Quarterly Trivia:

What does a red door on a home signify in Scotland?

Scottish tradition is to paint a door red when the mortgage is paid off.