

TAKING A FRESH LOOK AT REVERSE MORTGAGES

05.15.2015 | NAPFA NATIONAL

MICHAEL E. KITCES

MSFS, MTAX, CFP®, CLU, ChFC, RHU, REBC, CASL

Partner. Director of Research, Pinnacle Advisory Group

Publisher. The Kitces Report, www.kitces.com

Blogger. Nerd's Eye View, www.kitces.com/blog

Twitterer. @MichaelKitces, www.twitter.com/MichaelKitces



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BACKGROUND ON REVERSE MORTGAGES

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BACKGROUND ON REVERSE MORTGAGES

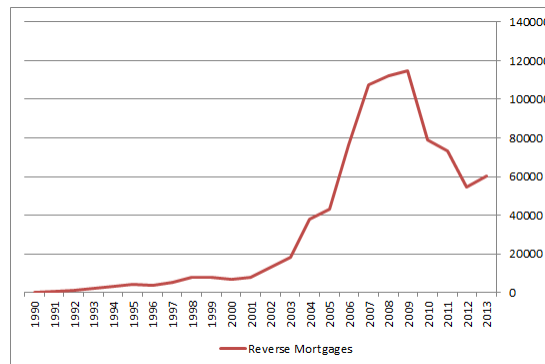
- Reverse mortgages originated in 1960s
- Housing and Community Development Act
 - Popularity & support was limited until passed in 1987
 - Established Federal mortgage insurance
 - Created Home Equity Conversion Mortgages (HECM)
 - Originally authorized FHA to insure 2,500 loans

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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



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HOW REVERSE MORTGAGES WORK

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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

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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

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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

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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!)*

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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

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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!

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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)

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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*

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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

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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

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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?

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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)

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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?

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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

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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)

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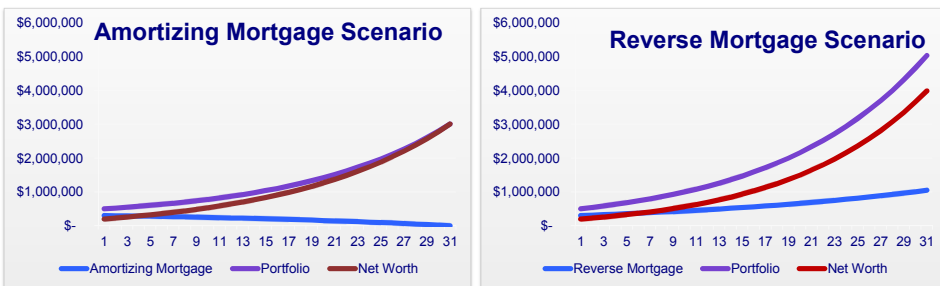
REVERSE MORTGAGES STRATEGIES & USES

- 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!?

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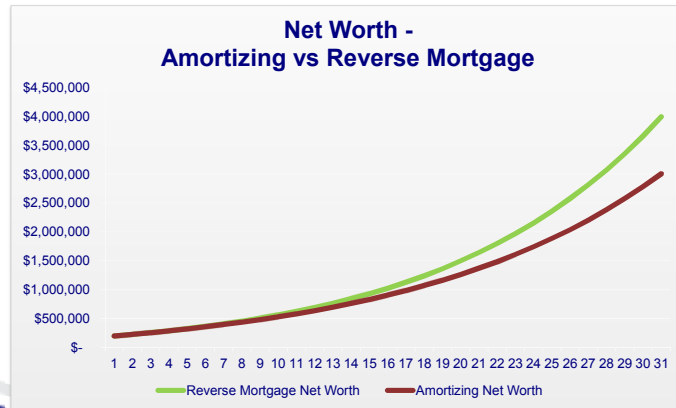
REVERSE MORTGAGES STRATEGIES & USES



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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?)

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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!

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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?

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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

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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

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QUESTIONS?

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Contact: michael@kitces.com

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