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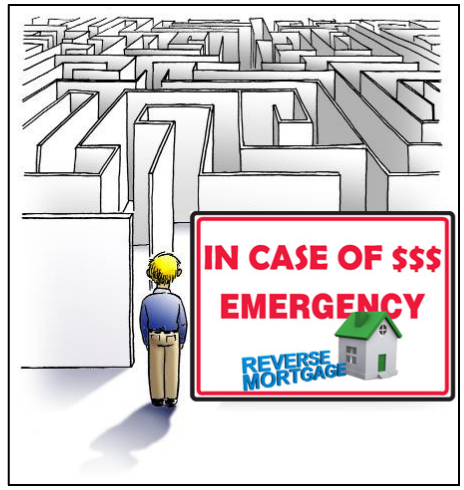
Reverse mortgages: Time to break the glass?

Navigating the Retirement Maze



“ Where we you in ’62?”
- *Tag line of movie “American Graffiti”*

“I need money in 2020.”
- *Many unemployed and retired people*

When I first wrote in 2017 about reverse mortgages, also called home equity conversion mortgages (HECMs), they were known to most people as “those awful mortgages that you should avoid,” even though they were FHA guaranteed and had numerous protections built into them, a vast improvement from the horror stories resulting from HECMs years earlier. Fast forward three years. We’re in the midst of a pandemic that has shut down most of this country and created personal financial crises for many. Add to that a volatile stock market, and you have the makings for a lot of anxiety.

The CARES Act has granted a temporary reprieve for those who are having difficulty making mortgage payments because of reduced income – up to 12 months of forbearance which must eventually be paid back with interest – but it hasn’t done anything for the other living expenses. While people scramble to get HELOCs (home equity lines of credit) on their homes, tap their retirement plans (not a good idea unless a last resort), or plead with creditors for forbearance on their debts, many are overlooking HECMs as an option. Provided that at least one spouse is age 62 or older, reverse mortgages can be a superior way to access cash and reduce debt today.

HECM basics

A reverse mortgage is essentially a lifetime loan that uses your home as collateral, never has to be repaid, and you still own the home. The amount of cash that can be withdrawn is a function of the age of the youngest borrower, current interest rates, and the equity in your home: the value of the home minus any outstanding mortgages and liens on it. Like a typical mortgage, there are closing fees, though the fees can be rolled into the loan. You can never be forced to sell your house as long as keep it maintained, have homeowner’s insurance, and pay your property taxes. It must be your primary residence, meaning that you live there at least six months a year.

HECMs are FHA-backed loans, and the FHA insurance premiums paid at closing and added to the interest on the outstanding balance ensure that you or your heirs will never owe any money on your home when it is finally sold, regardless of the house’s value at the time. The homeowner’s equity in the home grows over time at a predetermined rate built into the HECM agreement, which actually increases the amount of available borrowing power if the equity growth exceeds the interest on the debt balance.

A HECM cannot coexist with other mortgages, so any existing mortgages or loans using the home as collateral must be paid off by rolling those into the HECM. While there are multiple uses for a HECM, the best reasons today for getting one are that it eliminates any existing mortgage payments and thus reduces your outgoing cash flow, and it can be tapped for income and other expenses by writing a check if you have sufficient equity available.

Recent changes to HECMs

In the past several years, there have been several changes to the program. The up-front FHA insurance premium was increased to 2 percent, but the FHA surcharged that is added to the loan rate was decreased from 1.25 percent to 0.5 percent, which represents a savings to those who roll their existing mortgages into the HECM as well as when the line of credit is accessed for cash.

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Maximum HECM mortgage amounts have been increasing each year. In January 2017, the maximum was $625,000. Today it is $765,525. Loan limits were tightened up to ensure solvency in the overall program, and second appraisals are now required on homes that are flagged as having the potential for inflated valuations. For homes in excess of the HECM cap valuation where tapping more of the equity in the house is desired, there are now private reverse mortgages available from many lenders. Also, condos and some multifamily units that are not FHA approved can also access private reverse mortgages from many of the same lenders.

HECMs vs. HELOCs

An important question to ask is whether it makes more sense to get a home equity line of credit (HELOC), rather than a reverse mortgage. If you are able to get a HELOC, you probably should, as it may end up costing less than a HECM. There are usually no closing costs on HELOCs, and the interest rate is typically lower than that of a HECM. However, if you are currently not employed or have reduced income, you may not be able to qualify for a HELOC. HELOCs also need to be repaid, and banks want to make sure that you have sufficient cash flow to do so after paying your primary mortgage and other expenses. Some major banks are curtailing or halting their issuance of HELOCs, as JPMorganChase did last month. Other banks may soon follow suit.

Other issues with HELOCs are that banks can reduce your line of credit, as many did during the financial crisis of 2008-09, or loans can be called back and require immediate repayment. Plus, while a HELOC may provide needed immediate cash, paying it off will add to your outgoing cash flow for many years, which can be daunting if you are in or approaching retirement. HECMs never need to be paid back, and the closing costs can be rolled into the mortgage, eliminating the need to come up with cash at the closing. If you can get a HELOC and can pay it off reasonably quickly, it might make more sense than a HECM. But for those in difficult financial circumstances and nervous about the prospect of increased mortgage payments for years to come, a HECM may be a better choice.

Uses for HECMs

I once described HECMs as the "Swiss Army knives of financial tools," and this is still true today. Among the possible uses for tax-free HECM withdrawals in addition to those cited above, are:

- Postpone claiming Social Security and thus increase your eventual Social Security income.
- Pay the taxes due on Roth conversions to maximize the Roth IRA reinvestment.
- Cover long term care (LTC) expenses if LTC insurance is not affordable or you can't qualify for it.
- Generate "on-demand" tax deductions (withdrawing cash and then paying off accrued interest).
- Finance the sale of your retirement home after you sell your current home, eliminating mortgage payments.
- Reduce the need to tap taxable retirement assets above the required minimum distribution (RMD).

Reverse mortgages are a practical way to tap the equity locked up in your home, and free up cash that might be urgently needed now or later on in your retirement. To ignore them is to possibly put your current and future financial security at risk when the solution is sitting there right under your nose.

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