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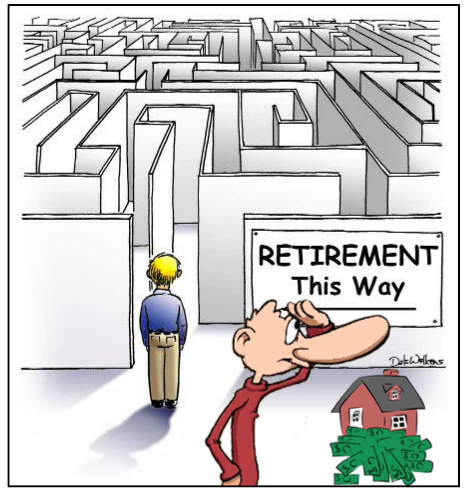
Retirement cash hiding right under your nose

Navigating the Retirement Maze



"Home is the nicest word there is."

– Laura Ingalls Wilder, author, journalist (1867 - 1957)

When doing a financial planning exercise with clients, the key question that they want answered is: "Will I run out of money before I die?" I tell them, half seriously, that if they can tell me exactly when they plan to die and what the stock market will do between now and then, I can predict the result to a fairly high degree of accuracy. Of course, those numbers are unknown, and the best I can do is use estimates to test various scenarios.

Depleting your investments in advance of meeting your maker is probably the major fear of retirees. Increasing longevity combined with tepid forecasted stock market growth only adds to that anxiety. So what if I told you that there is this incredible tax-free source of cash that can be tapped during our retirement that you probably never even considered? Interested? Then read on.

Home is where the cash is

Whenever I utter the phrase "reverse mortgage" to clients or friends, I invariably get the same reaction: a look of disdain as though I was touting a penny stock. Most people think of reverse mortgages as late night infomercial scams and the prospect of being evicted. In other words, consumers have ingrained in their minds that reverse mortgages are a really bad idea.

However, their point of reference is the old reverse mortgages. In recent years, the Federal Housing Administration (FHA) has been adding safeguards that turns them into a new source of retirement income without the fear of winding up homeless once your credit line is exhausted. There are a few added requirements, but these are mostly for the protection of consumers. The resulting "new" reverse mortgage is what I think of as a "Swiss Army knife" of financial planning tools, as it has a multitude of uses in helping retirees make it through retirement with less financial angst.

The new, improved HECM

Reverse mortgages, more correctly referred to as home equity conversion loans (HECMs), are similar to the more commonly used home equity line of credit (HELOC) in that both allow you to borrow against the equity in your home. Interest payments on both loans are tax-deductible. However, it is their differences that highlight the benefits of HECMs:

- HELOCs need to be paid back on a fixed schedule; HECMs never have to be paid back.
- If the value of your house happens to decline, the bank holding your HELOC loan can demand repayment of part or all of the HELOC. HECMs assume an increasing home valuation each year, regardless of market prices.
- HELOCs have a set line of credit amount, and getting an increase requires a new application. A HECMs line of credit increases each year.

The last point is quite important because a HECM can be taken out for an individual or couple in their 60s, remain unused, and twenty years later it can result in a credit line that is more than triple the initial borrowing limit. Consumer protections have been designed into the current generation of HECMs, including income and credit tests, education, and most importantly, allowing owners to live in the house even if the amount borrowed exceeds the house's current market value.

HECMs have a few requirements, though these can be easily met by most retirees:

- The house must be the primary residence of the individual or couple.
- At least one homeowner must be 62 or older.
- Owners must continue to pay property taxes, insurance, and upkeep on the house.
- The HECM will become the only loan against the property. If there are outstanding mortgages or HELOCs, the HECM is used to pay off the existing loan or loans.

HECMs as financial planning tools

What excites me as a financial planner is the multiplicity of uses for a HECM. Other than the most obvious one, which is to cover living expenses in the event of extended longevity, there are other uses that broaden the appeal of HECMs as a source of tax-free cash:

- Lessen the need for taxable IRA withdrawals above the required minimum distribution (RMD), thus reducing taxes and allowing IRA investments to compound longer.
- Keeping taxable income below the Medicare thresholds for higher payments.
- Delay Social Security payments in order to maximize lifetime benefits.
- Pay the taxes on a Roth conversion, reducing the IRA withdrawal and thus the taxes due.
- Cover the costs of long term care (LTC) versus purchasing LTC insurance.
- Provide discretionary tax deductions by selectively paying back a portion of the accrued interest.

HECMs do have associated costs that need to be taken into consideration. In addition to the closing costs, there are interest accruals on the loan balance at a rate slightly higher than equivalent HELOCs because of the included FHA insurance premiums. However, a financial planner can help you compare the cost of a HECM to the benefits, including the value of tax deferral on IRA investments. Another one is the cost of 20+ years of LTC insurance versus the amortized up-front cost of creating this constantly growing line of credit. Most importantly, a HECM never needs to be paid back.

Take one for a test drive

I expect that most people will shy away from considering a HECM because of their preconceptions, mostly coming from anecdotal horror stories of people losing their homes. My suggestion is to buck the conventional wisdom on HECMs and take advantage of them before the government figures out what a great deal they are for homeowners and pulls them off the market.

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