

Pawning Your House

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It's no secret that many seniors have substantially more money tied up in the value of their home than they have invested their 401(k) or any other source of accumulated savings. According to the [U.S. Census data](#), the value of home equity is something that largely goes untapped for many Americans. This shouldn't come as some shocking revelation. After all, by the time retirement starts to crest on the horizon, most homeowners have spent the better part of their adult life diligently making mortgage payments so they can finally own their slice of the American dream free and clear. For better or worse, the culmination of a lifelong dream is something that most of us stubbornly cling to. Maybe to our own detriment.

At a time when interest rates are hovering at unprecedented lows, stock market volatility is considerably elevated, traditional defined benefit pension plans have by and large gone the way of the dinosaur, and life expectancy is stretched longer, the problem for many older homeowners is figuring out when (or if) it's appropriate to tap into stored home equity value. After all, the ability to pay down high cost consumer debt and manage expenses (think home maintenance, prescription drugs, long-term care, or simply creating shared memories with the people you love and care about) doesn't shrink just because your paycheck stopped rolling in.

While tapping into home equity isn't always the first option your planner should consider, it shouldn't be regarded as something akin to the financial planning "no-fly zone" either. This is especially true when a homeowner has thoughtfully rejected more conventional cash-out tactics like downsizing or drawing on a home equity line of credit (HELOC). That probably leaves reverse mortgage financing as the only viable option when cash flow from other sources isn't a feasible solution.

Reverse Mortgage Basics

Stripped down to the basics, reverse mortgages are interest-bearing loans secured by the underlying value of your home. The loan is then permanently bound with an embedded insurance contract that simultaneously protects lenders from the risk of losing money *and* homeowners from being forced out if the combination of payments and accumulated interest exceeds the value of the home. Importantly, reverse mortgages are **non-recourse debt**. This means the proceeds from the eventual sale of the home will always cover the entire repayment amount, even if the loan balance is greater than the home's value.

Where conventional mortgages start with a high principal loan balance that shrinks over time with monthly payments you remit to the lender, reverse mortgages start with a low principal balance that grows with the payments you receive. Using the equity value in your primary residence, the lender provides the borrower (you) with a choice to receive payments as a single lump sum, a line of credit that can be drawn upon for any purpose, or to initiate a stream of income similar to a lifetime annuity.

The most common type of reverse mortgage is technically known as a **Home Equity Conversion Mortgage (HECM)**. These reverse mortgages are FHA guaranteed specialty loans available to homeowners age 62 or older. They also require homeowners to meet with a HUD approved counselor prior to any loan being approved.

Unlike a conventional mortgage or home equity loan, interest on a reverse mortgage is due at the end of the loan term. Loan maturity events occur when:

- The home is sold
- The borrower(s) either move out of the home or pass away, or
- The loan goes into default because the borrower(s) failed to pay property taxes and homeowner's insurance.

Beware of Systemic Bias

While reverse mortgages are frequently labeled as “unconventional” by a significant percentage of financial planners, it's worth noting the vast majority of those practitioners are also employed by organizations that won't offer reverse mortgage products in the first place. Not to put too fine a point on this, but it's often the case of “**no product...no payday.**” Traditional retail lenders like J.P. Morgan Chase, Wells Fargo, Citigroup, and Bank of America have shied away from the market largely because a robust institutional market to repackage and securitize the underlying loans hasn't yet developed.

Many lenders that actually do offer reverse mortgage loans aren't doing themselves any favors either. Tainted by cheesy late-night and daytime TV infomercials featuring celebrity spokesmen like Tom Selleck, reverse mortgages continue to be dogged by a less than sterling reputation. That's too bad. Reflexively turning a blind eye to the options reverse mortgages afford or dismissively labeling them as little more than a “Hail Mary” tool of last resort is a failure of the

financial planning process. Financial planners are tasked with the responsibility to objectively consider the facts and circumstances of each client individually. That means setting aside pre-conceived ideas or preemptively ruling out any available avenue of inquiry.

“Free” Money Isn’t a Thing

If it’s not been made abundantly clear, it bears repeating: *A reverse mortgage is a loan*. Reverse mortgage detractors rightfully point out the front-end financing costs are significant. That assertion is fundamentally correct. The most significant drawback of a reverse mortgage is almost always the relatively high financing cost, which can run anywhere from 5% - 12%. While that sounds like a steep toll, it’s not the 13% - 25% cost of credit card debt either.

To keep things simple, let’s consider the costs associated with a FHA guaranteed HECM. Here’s what you need to know:

- First, the borrower(s) should expect to pay all the normal costs associated with taking out a mortgage. That includes things like home appraisal, credit report, escrow charges, document prep, and title insurance costs. Next, you’ll pay an origination fee. Subject to a \$2,500 minimum and a \$6,000 maximum, origination fees are calculated by taking 2% of the home’s first \$200,000 of value and adding an additional 1% on the remaining value.
- Next, the borrower(s) will be charged a front end insurance premium for FHA guaranteed backing that’s equal to 2% of the home’s appraised value plus an annual premium cost of 0.5%.
- Finally, the borrower(s) will incur annual interest charges based on the underlying fixed or variable rate mortgage interest rate. The higher the rate, the faster home equity is eroded by the cost of the loan. It’s also worth noting mortgage interest expense is tax deductible, but not until it’s actually paid. That means borrowers can’t claim the deduction until they move or the home is sold.

Matching Horizon to Need

Other than cost, if there’s one thing seniors want to keep in the forefront when considering reverse mortgage financing it’s the time horizon they’re likely (or able) to remain in the home. That requires some probabilistic thinking, especially for couples where the ability of one partner to safely remain in the home becomes compromised. Imbalances in age, underlying health conditions, or continued support from family members living in close proximity may signal a stated desire to age in place is only loosely grounded in reality. All too often when **one partner needs to move out** for health or safety reasons, the other does too.

While many seniors are (rightly) concerned about **managing cash flow** and maintaining housing stability, they’re equally leery about entering into any transaction that might become the functional equivalent of walking the deed for the family homestead down to the local pawn shop. Unlike the pawn shop, your property probably won’t ever unexpectedly be sold out from under

you. But if you do wind up needing to move earlier than expected, a reverse mortgage can easily feel like it was engineered to be a permanent solution to a temporary problem...not to mention an unexpected windfall for your local pawnbroker.

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