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REVERSE MORTGAGES

A Lifeline of Last Resort

In the mid- to late 2000s, with home values soaring, no credit checks needed, and retirees stretching every dollar, reverse mortgages surged in popularity. However, when the tide went out in the real estate market in 2008 and 2009, the reverse mortgage market dried up quickly. The number of loans peaked in 2009 with 114,692 and has fallen almost every year since – to only 48,903 originations in 2016.[1] Most of this waning popularity is due to dramatic decreases in home equity as the result of falling home prices, but we believe reverse mortgages will become a topic of conversation again at some point.

A reverse mortgage is an agreement with a lending institution in which an individual, aged 62 or older, exchanges equity in his or her home for cash, a line of credit, or some combination of the two. The key attributes of reverse mortgages are as follows:[2]

1. No repayment is due until the last surviving homeowner/loan holder dies, the home is sold, the owners move, or the owners fail to maintain the property, taxes, or insurance.
2. Homeowners can only access a certain percentage of the home equity. This percentage is determined by borrower age, interest rates, mortgage insurance rates, home value limit, and home equity percentage.
3. The home value limit is set by the Federal Housing Authority's Home Equity Conversion Mortgage (HECM) program and is subject to change at its discretion.
4. Reverse mortgages are nonrecourse loans, which means that even if the loan value exceeds the home's value, the borrower, his or her estate, or the borrower's family will never be liable for the excess debt. (A loan might exceed a home's value due to falling real estate prices or a borrower outliving the actuarial projection.)
5. The borrower pays all costs associated with closing—mortgage insurance premiums, lender's fees, loan points, and closing costs.
6. The loan balance on a reverse mortgage accrues interest, which is not deductible until paid.
7. The existing mortgage is required to be paid off using the reverse mortgage proceeds.
8. Credit score has no impact on reverse mortgages.
9. All loan distributions, in cash or line, are tax-free.
10. All borrowers have a three-day right of rescission from the point of entering into the contract.
11. Borrowers must complete a loan counseling course to obtain a reverse mortgage.

Ultimately, a reverse mortgage is a method by which older homeowners can keep their home and easily access its equity. The advantages are easy access to credit or cash, no home sale, and no required credit check. The disadvantages are that it's expensive, the interest rate grows exponentially, and it limits future flexibility. In order to gain a better understanding of the advantages and disadvantages of a reverse mortgage, let's examine a hypothetical situation.

Both 68 years old, John and Jane Smith have spent the past 20 years in their current home, which is currently valued at $600,000, with a $150,000 mortgage. They

EXHIBIT 1 COMPARISON OF REVERSE MORTGAGE AND HOME SALE: IMMEDIATE TERM

	Reverse Mortgage	Sale of Home for FMV
Interest Rate Index	0.15%	N/A
+ Lender's Margin	2.50%	N/A
INITIAL LOAN INTEREST RATE	**2.65%**	**N/A**
+ Mortgage Insurance	1.25%	N/A
TOTAL LOAN RATE	**3.90%**	**N/A**
VALUE OF THE HOME	**$600,000**	**$600,000**
Home Value Limit	$625,500	N/A
Lesser Of Limit Or Home Value	$600,000	$600,000
AVAILABLE PRINCIPAL LIMIT*	**$314,400**	**N/A**
- Total Fees & Costs**	($12,381)	($30,000)
NET PRINCIPAL LIMIT	**$302,019**	**$570,000**
- Less Mortgage Payoff	($150,000)	($150,000)
- Less Lump-Sum Cash	($10,000)	($420,000)
Available Credit Line	$142,019	$0
IMPROVED MONTHLY CASH FLOW	**$2,684**	**$884*****

An actuarial calculation using borrower age, current interest rates, mortgage insurance rates, and home equity percentage. **Total fees and costs include loan origination fees, mortgage insurance, and other closing costs. * Includes rent cost of $1,800/month to replace sold home.*

Source: National Reverse Mortgage Lenders Association, Reverse Mortgage Calculator

recently had a large financial setback that has upset their monthly cash flow to the point where they need to generate an additional $3,000 per month for the foreseeable future. John and Jane have, unfortunately, spent down all of their investment accounts, and their only additional source of income is the $450,000 of equity in their home. They have two long-term solutions available: (1) sell their home and use the equity proceeds to invest/fund cash needs, or (2) enter into a reverse mortgage. Using today's interest rates, Exhibit 1 details the costs/benefit they would get from the reverse mortgage versus selling the home and investing/spending the proceeds.

Using a reverse mortgage, the Smiths improve their cash flow by $2,684 per month, or the amount of their former mortgage payment, receive a lump sum payment of $10,000 today, and create access to a $142,019 line of credit. To create this cash flow, which is currently accruing interest at a variable annual rate of 3.902%, they paid $12,381 in fees. When you compare this to downsizing their home, the upfront fees and costs of $30,000 are more than double, but they also net $420,000 in cash with no strings. These summaries alone aren't sufficient to determine the best decision; therefore, it's important to look to the possible effect on their long-term financial health.

If the Smiths live five years longer, what will their financial picture look like in each scenario? What about ten, fifteen, or twenty years from now? Let's assume the Smiths earn 6% annually on their investments, their spending needs remain constant at $3,000 per month in both scenarios, and their reverse mortgage loan rate remains constant at 3.9%. Exhibit 2 demonstrates the true cost of using a reverse mortgage in order to stay in your home. By year 10, the Smiths have exhausted their reverse mortgage funds, and their outstanding loan balance has grown to $308,317. At this point, they have no ability to access additional funds unless they sell their home. Assuming the value of their home remains $600,000, the net proceeds from a sale in year 10 are $261,683, or $600,000 less the outstanding loan balance of $308,317 and $30,000 in seller's fees. Compare this to the $406,094 available in year 10 had they downsized from the start. The bottom line is that they have painted themselves into a corner, and the reverse mortgage has cost them $144,411! The situation would be even direr if interest rates had increased, which would have forced their loan balance to grow even faster.

EXHIBIT 2 COMPARISON OF REVERSE MORTGAGE AND HOME SALE: LONG-TERM

Year	Reverse Mortgage		Home Sale	
	Loan Balance	Remaining Credit Line	Loan Balance	Invested Home Sale Proceeds
5	(231,679)	60,340	-	413,712
10	(308,317)	(16,298)	-	406,094
15	(406,971)	-	-	398,476
20	(533,518)	-	-	390,859

Source: RMB Capital

Reverse mortgages were created to allow older homeowners the means to stay in their home in times of financial hardship or crisis. While reverse mortgages accomplish this goal, they do so at a hefty cost; often the price the borrower pays is not worth the value gained. The decision to sell a family home is sometimes steeped in emotion, but it is your financial advisor's responsibility to help provide concrete evidence to guide you in making a sound financial decision. RMB Capital strongly encourages all of our clients to work with their advisor to explore *every other* potential method before considering a reverse mortgage. ■

1 *National Reverse Mortgage Lenders Association, Annual HECM Production Chart, October 24, 2016.*
2 *AARP.*