HECM reverse mortgage, retirement funds crisis, retirement spreadsheet, nestegg, line of credit

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Senior Homeowners Can Reduce the Risk of Outliving Their Money - But They Need to Unlearn a Shopping Rule

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Seniors who accumulate a nest-egg during their working years which they then use to maintain their lifestyle during retirement, risk running out of money if they live too long. With life spans growing at an increasing rate, that quandary is increasingly being labelled a "retirement funds crisis". Seniors who own homes, however, have a valuable option. They can use a reverse mortgage to reduce the risk of outliving their money. The proviso is that they need to unlearn what they thought they knew about shopping for a mortgage.

The Arithmetic of Living on Wealth

John retires at 65 with $2 million of financial assets that, along with social security, must support him for the rest of his life. Whether it does or not depends mainly on the rate of return earned on his assets, on the rate at which John withdraws money from the fund, and on how long he lives. If the fund earns a constant 6% a year and John withdraws a monthly stipend equal to 4% of the $2 million divided by 12, rising by 2% each year as an inflation offset, he will succeed. He will draw $6667 a month to start, and because this is less than the growth rate of his wealth, his wealth will gradually rise, reaching $4 million when he celebrates his 108th birthday.

These numbers come from a spreadsheet developed with my colleague Allan Redstone, which will shortly be freely available on my web site. The spreadsheet makes it easy to model many different combinations of the factors affecting how long a retiree's wealth will last.

For example, considering how highly priced common stocks are today, and how low interest rates are, a 6% rate of return on John's wealth appears unduly optimistic. If we reduce the assumed rate of return to 4.5% while retaining the withdrawal rate as it was, John's wealth will gradually decline, hitting zero when John reaches 103. A further reduction in rate of return to 3.5%, which is probably more realistic, results in John running out of wealth when he hits age 96. For most retirees, that risk would be unacceptable.

The standard remedy is to reduce the withdrawal rate by an amount that pushes the asset depletion point far enough out that John is comfortable with the risk. If the withdrawal rate is reduced from 4% to 3.15%, John's wealth will last until he reaches age 107. John may be comfortable with this risk, but it involves a reduction in the initial monthly stipend from

$6667 to $5250, which may require a significant scale-down in living style. If John is a homeowner, however, there is another option.

Adding a HECM Reverse Mortgage to the Retirement Plan

The option is for John to take a reverse mortgage line of credit, and let it sit unused until it is needed. While his financial assets are gradually being depleted, his credit line is getting larger. He draws on the line only if he is still alive when his assets are fully depleted, otherwise the equity in his house will pass to his estate.

If John's house is worth $400,000, he can command a credit line of $210,519, which will grow at a rate equal to the interest rate on the adjustable rate reverse mortgage that John selects. Assuming a rate of 6%, the line will reach $1,351,000 when John runs out of money at age 96, extending the monthly draws until he reaches 108. If the rate is only 3.5%, the line grows to $624,000, and it extends the draw period only until John reaches 100.

If John dies before his wealth is fully depleted, the reverse mortgage credit line may never be used. The cost in that case is the initial settlement costs of $6282 if paid in cash at the outset. If John finances the settlement costs, as most seniors do, the cost is the future value when the reverse mortgage is paid off, which will be considerably higher -- yet tiny compared to the available draw amounts. The HECM credit line is cheap insurance against running out of money.

The Right HECM Reverse Mortgage For Implementing This Strategy

Retirees who select a credit line to hold unused as their sole reverse mortgage option should view themselves as investors rather than borrowers. When market interest rates rise, investors benefit while borrowers lose. The distinction is critical to the retiree's decision process.

For example, using the same adjustable-rate HECM, John takes a $100,000 unused credit line while Jane draws $100,000 in cash. In year 2, both John's line and Jane's debt grow at the prevailing interest rate. A higher rate that makes Jane worse off makes John better off.

This should affect John's shopping strategy in two ways. First, in selecting between alternative combinations of interest rate and origination fee, John should select the highest rate/lowest fee combination. Second, in selecting between ARMs with a 5% rate increase cap and those with a 10% cap, they should choose the second. Note that these selections are the opposite of those that should be made by Jane.

That seniors with different objectives should select reverse mortgages with different features points up the need for lenders to offer the different options, and also to provide the expert advice that many seniors need. Not all lenders offer both the options and the expertise -- if yours doesn't, let me know and I'll send you the names of some that do.