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The Case for Reverse Mortgages

WADE PFAU: What financial term do you wish those nearing retirement better understood?

Reverse mortgage. Reverse mortgages have received a bad reputation, but recent research has demonstrated how financially responsible individuals can improve their retirement sustainability with a reverse mortgage. The issue is that financial services are still mostly focused on wealth accumulation, and there is still a need for greater recognition about how retirement income requires a whole new host of tools as people seek to transform their pot of assets into an income for life. This is especially true for individuals who hold a disproportionate amount of their overall wealth in the form of home equity. What a reverse mortgage can do is to increase a retiree's flexibility to meet spending objectives by integrating an otherwise illiquid asset into an overall framework for how to best spend down assets in retirement.

The research I mentioned includes a series of articles in the "Journal of Financial Planning" by authors such as Barry Sacks, Harold Evensky, John Salter, and others. The process involves opening a standby line-of-credit through the Federal Housing Administration's Home Equity Conversion Mortgage (HECM) program. The line-of-credit will grow throughout retirement as long as the individual remains in their home and meets other requirements, and it can be accessed to meet spending goals when deemed appropriate. The researchers found that part of the success for this strategy is that it alleviates the sequence of returns risk in retirement, which results from retirees digging a hole for their portfolio by selling assets after a market decline. Proceeds from the line of credit may be repaid when markets recover, but repayment is not required until the individual has left the home.

These reverse mortgages are also non-recourse, which means that one never owes more than the value of their home. This can be useful in the event of declining housing prices, and for someone living sufficiently long, there is real possibility that the line-of-credit will actually grow to be more than the value of the home. Mortgage insurance paid on any outstanding balance is what will be used to make the lender whole in such cases.

For individuals who are planning to downsize their home, or who are otherwise thinking to move in retirement, an alternative now available is the HECM for Purchase. Downsizing combined with the HECM for Purchase can potentially free up a large amount of home equity and create more liquid financial assets to help sustain a retirement spending objective over retirement.