Reverse Course Ahead Full

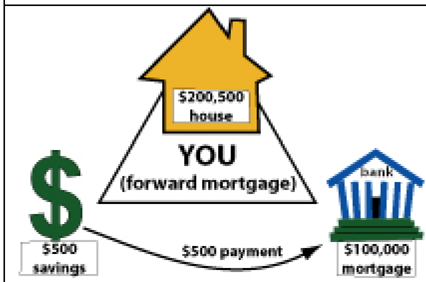
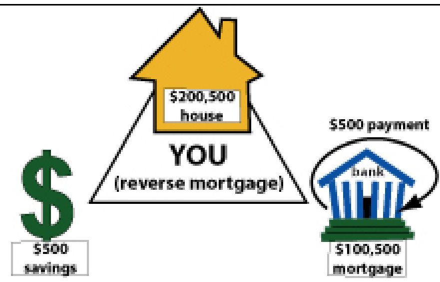
By: Todd K. Ballenger

We've been getting a lot of calls from financial advisors about reverse mortgages, and clearly, we're not the only ones. According to a survey of 111 banking institutions by the Mortgage Bankers Association, there was a 28% increase in requests for reverse mortgages in the first six months of 2005.

Most often, the requests are coming from aging boomers. They have learned from their advisors or from a few minutes with an online calculator that they are in danger of outliving their savings. They may not be clear on what a reverse mortgage is, but they know they need more money to see them through decades of retirement.

This challenge provides an opportunity for advisors who can help clients use a reverse to tap the built-up value of their residence to bridge the gap. For clients who have a firmer retirement foundation, a reverse mortgage can achieve planning and gifting goals.

First, let's go through the basics. A reverse mortgage is just like a forward mortgage: you have a loan balance, an interest rate, and a monthly payment. The homeowner is responsible for property taxes, insurance, and maintenance--it's still his house. With a forward mortgage, the owner pays the lender, who uses the monthly check to cover current interest and applies anything above the interest due to reduce principal. With a reverse mortgage, the payment is the current interest due based on the current balance, and it isn't paid directly by the house owner, it is essentially added to the current balance.

<table>
<tr><td colspan="4">Forward and Reverse Mortgage</td></tr>
<tr><td colspan="4">Cash Flow and Balance Sheet Impact (after 1 month)</td></tr>
<tr><td colspan="2">Forward</td><td colspan="2">Reverse</td></tr>
<tr><td colspan="2">
</td><td colspan="2">
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<tr><td>Cash Flow</td><td>-$500</td><td>Cash Flow</td><td>Unchanged</td></tr>
<tr><td>Mortgage</td><td>Unchanged</td><td>Mortgage</td><td>-$500</td></tr>
<tr><td>Appreciation</td><td>+$500</td><td>Appreciation</td><td>+$500</td></tr>
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For example, if you have a 62-year-old couple with a $200,000 house, and a $100,000 interest-only forward mortgage at 6%, they would have a payment of $500 due each month, or $6,000 annually to maintain their balance of $100,000. Each month, they transfer $500 of their cash flow to the lender to maintain the $100,000 balance.

If this were a $100,000 interest-only reverse mortgage at 6%, the owner would be charged a payment of $500 each month and, after one month, would owe $100,500. The owner would have transferred $500 of his wealth to the lender by increasing the mortgage balance, but he retained use of the home and control of the cash flow of $500 for that month that he didn't pay out of pocket – like he would have with a normal forward mortgage.

Meanwhile, whether the client had a forward or a reverse, the house will have continued to appreciate—perhaps not at the dramatic rates of recent years, but it's safe to assume annual appreciation of 3 percent or so. In a year, the $200,000 house would be worth $6,000 more, or $500 per month. The net worth of the client remains relatively the same, however, the forward puts that money against interest while the reverse allows that cash flow to stay with client by accruing interest on the mortgage.

There are very few hurdles when securing a reverse mortgage. The first hurdle is that it can only be used for your primary residence, and the key secondary rule is that at least one of the owners taking out the loan must be aged 62 or older. None of the normal lending guidelines of income, credit, reserves, etc. apply when considering a reverse mortgage. If the owners have an existing mortgage, it typically must be paid off with the proceeds from the new mortgage, and anything above that can come out in the form of cash, a line of credit, or a stream of payments. The closing costs are more expensive than a forward mortgage; a $100,000 reverse mortgage would cost you about $4,200 more than a traditional forward mortgage. However, there is additional protection against loss; should the house value decline, the owners (or their estate) can never owe more than the value of their house at death.

In the example above, the couple withdrew cash from the house to pay off an existing mortgage. If the couple had no existing mortgage, they could have removed $100,000 cash from their house with no monthly payment and used this to supplement their reserves, or increase their income. This is where the reverse mortgage is most often used and where the financial advisor can add value. The $100,000 comes out of the house, and is annuitized by the financial advisor to provide income for the client —literally through an annuity product or with a portfolio that delivers the desired rate of return. If the annuity would provide $600 a month for life, they receive the full $600 per month.

Why not just borrow against the equity in the home to fund the added cash flow? Unless you can deliver double-digit returns, it doesn't add up. With a forward mortgage, the $500 monthly payment in our example cancels out most of the $600 per month in added cash flow.

When it comes to deciding whether your clients are candidates for reverse mortgages, start by asking whether there is a 'I need' or an "I want' client? Most often, the answer that leads to a reverse mortgage is 'I need'. Clients realize they can't make it on their savings, investments and pensions. This can make broaching the subject difficult, because there is an implicit admission of failure. But you can make up for the discomfort by solving the problem.

Steve Ruckart, a financial advisor in TN shared with us that his clients were 65 and wanted to retire, but still had a $1,600 mortgage payment on their $300,000 house. They said their need to eliminate this $1,600 debt was the only thing that kept them from retiring now. Steve said ‘this is simple; we can refinance the existing forward mortgage with a reverse mortgage, and eliminate the $1,600 per month expense.” They are doing just that, retiring effective with the loan closing. Steve shared that they are buying a life insurance policy to replace the wealth for their children when they die, and a LTC rider to protect their existing assets while they travel in retirement.

In contrast to clients who need a survival mechanism, many older investors may want to use reverse mortgages as a creative planning option. Brent Gilmore, a financial advisor in Ohio, has started asking his older clients if they want to put their grandchildren through college. “Absolutely,” they say, “but can we afford to?” Usually they can by using a reverse mortgage.

Here’s how: Take Jack and Jackie, for example. They’re both 67 and have a $300,000 house with no mortgage. They have over $1 million invested, and with social security and pension, they feel they are in great shape for retirement. They have three grandchildren, the oldest of which starts college in 10 years. Their children are working hard to make ends meet, save for their retirement, and fund college savings. Brent calculates that the $200 per month per child that the parents are saving will not be enough; they’ll need more than twice that just for a state college education. The alternative to $400 per month, per child, for the next 10 years, is a lump sum contribution today of $130,000. That, Steve calculates, should cover the expenses of all three grandchildren’s educations.

Jack and Jackie secure a reverse mortgage for $130,000 and hand it to Steve to set up the college fund. No payment will be due on the mortgage, so there is no reduction in current cash flow to the grandparents. The children receive a gift, free of estate and gift tax, by the transfer of money over several years. The grandparents enjoy the experience of paying for their grandchildren to go to college, and Steve enjoys the opportunity to sit down with the parents to discuss how they can use of the $200 per month per child they were paying for other planning needs.

A reverse mortgage can also be used to fund a life-insurance policy that provides heirs and beneficiaries with far greater flexibility. Would your client prefer to leave a house worth $200,000 that needs to be sold, or $250,000 cash from a life insurance policy that was funded with a reverse mortgage?

Finally, think about a reverse the way you would a forward mortgage: It is simply a device for improving cash flow. In both kinds of mortgages, the client can modify the program as needed--to refinance when rates improve, to take advantage of higher valuation, or to adjust for the increased mortality risk of the aging client.

Help your clients by reversing out-dated thinking about reverse mortgages. Learn to accommodate more of their ‘I needs’ and their ‘I wants’.