Tap into Potential Retirement Wealth Utilizing the HECM

(Home Equity Conversion Mortgage)

Introduction followed with an analytical White Paper commissioned by Urban Financial of America, written by John Salter, PhD, CFP® November, 2014.

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INTRODUCTION

Planning for today's retirement can be more challenging than ever before. Are your clients financially prepared to meet retirement head on? Here are factors to consider:

AVERAGE LIFE EXPECTANCY - Today, many of us will live much longer than the "average" retiree; an individual reaching age 65 today can expect to live, on average until age 85.[1]

PENSION PLANS - With fewer employers now offering pension plans and shifting toward offering employees self-directed retirement savings a plan, the retirement landscape is changing.

- 24% of non-retirees say a work-sponsored pension plan will be a major source of retirement income for them,
- 36% of current retirees rely to a large degree on pensions.[2]

INFLATION - Inflation risk and the decline of purchasing power is a serious risk for soon-to-be-retirees, as future inflation rates remain unknown. A major concern for seniors is the cost of medical care: Over the last ten years, it has risen at a significantly faster rate than average inflation.[3]

SOCIAL SECURITY - Although most seniors count on Social Security benefits in their retirement plan, can a retiree count on Social Security keeping up with inflation?

- The Social Security Administration monthly benefits for nearly 64 million Americans will increase 1.7 percent in 2015.
- COLA (Cost of living adjustment) increase in July 1980 was 14.3%.[4]

THE GOOD NEWS - Tap, Tap, Tap

Among those over 60 years of age and not yet retired, 20.5% indicated that they are saving for retirement utilizing real estate or land investments, which, for some, presumably includes tapping the equity of the home they own. Tapping into home equity during retirement as part of one's retirement income plan can help offset some inflation concerns. [5]

MORE EQUITY - Americans 62 years old and older now have more equity in their homes than at any time since early 2008, according to a quarterly measurement by the National Reverse Mortgage Lenders Association (NRMLA). The households of American seniors now have paid 77% of equity in their homes. [6]

HELP STABILIZE CLIENT PORTFOLIOS – FINANCIAL ADVISORS AGREE!

"Mass affluents" and "downsizers" with significant retirement savings are using reverse mortgages. **"The point of how to use it is the most important thing,"** Barry *Sacks* a California tax attorney and author and nationally recognized expert on trends in reverse mortgage says, "Use the reverse mortgage credit line to fill in those troughs when the securities portfolio is down and don't draw upon the securities," *Sacks* says. "If you draw from a reverse mortgage credit line and allow the portfolio to recover, then there's a far better chance there will be money flowing through a 30-year retirement." [7]

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STAYING AHEAD OF THE RETIREMENT CURVE: THINK OUTSIDE THE BOX

"Why you should consider adding a HECM as a part of your financial retirement plan"

Written by John Salter, PhD, CFP®

The HECM

The HECM program is an FHA-insured program for using home equity during retirement years for those aged 62 or older. The program makes it possible to use home equity to obtain (i) a line of credit, (ii) annuity-style payments known as tenure payments, or (iii) cash. The borrower eliminates his monthly mortgage payments. Available exclusively to homeowners and homebuyers age 62 and older, a reverse mortgage allows you to convert a portion of your home equity into tax-free funds—so you can live more comfortably, in your own home, with greater financial flexibility. *(This is not tax advice. Consult a tax professional.)*

Difference between HELOC and HECM

Unlike a traditional home equity line of credit (HELOC) the HECM cannot be called, cancelled, or decreased at any time, borrowing does not commence a payback schedule where foreclosure will occur if not paid back, and HELOC's do not grow over time. Although HELOC may be "free" to set up, there are benefits of the HECM that justify the cost to set up. Also, HECM's do not require monthly principle nor interest payments while HELOC 's frequently do.

POSSIBLE HECM STRATEGIES

RETIREE who owns home free of any mortgage

The simplest of ideas for using a line of credit in retirement income planning arise when a home is mortgage-free.

One strategy using the HECM line of credit is to establish a line of credit today and allowing the line to grow until needed in the future. Future needs might include costs for in-home care, repairs to the property, or market conditions affecting the primary retirement assets. Due to the current interest rate environment, research has suggested the benefit of establishing the HECM line of credit today, rather than waiting.

The benefit of this approach has been tested in the research paper "HECM Reverse Mortgages: Now or Last Resort" published in the Journal of Financial Planning. The important and noteworthy element of this strategy is the line of credit is being established as a risk management tool, a strategy to offer a resource to protect against sequence of return risk during retirement. In an ideal plan the line of credit may never be needed, but it is there if the need arises.

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Taking this idea of sequence of return risk management a step further, the published paper "Standby Reverse Mortgages," also published in Journal of Financial Planning, outlines a strategy of tapping the line of credit during bear markets. The strategy determines:

1. The level of portfolio decline relative to the portfolio needed to meet future goals,
2. A strategy for borrowing from a HECM line of credit to fund goals and,
3. Paying back the borrowed funds when the portfolio recovers.

This program would be more difficult to execute with a traditional HELOC, as drawing on a HELOC during times of portfolio downturn would trigger monthly payments of accrued interest, at a minimum, triggering additional cash flow needs. In addition, traditional HELOCs may be blocked from additional draws at the discretion of the lender.

THE MORTGAGED RETIREE

Retirees with a mortgage are common, particularly at this time with the ability to refinance at historically low rates. So, how can a mortgaged retiree utilize the HECM program?

1. Pay off the home using current assets, then establish a line of credit to be used at a later date if the portfolio depletes.
2. Refinance into a HECM. This is very similar to the ability to simply refinance a traditional mortgage into another traditional mortgage. One caveat to this strategy relates to the up-front cost.

The up-front cost of the HECM program includes those costs and fees associated with a traditional mortgage; including attorney fees, appraisals, title insurance, etc. In addition are any lender closing costs plus an up-front Mortgage Insurance Premium, or MIP, from FHA. The MIP charge is determined based on the amount of the benefit used in the first year. If less than 60% of the initial benefit is used, in this case the line of credit, the MIP charge is currently 0.5% of the home value. If greater than 60% of the initial benefit is used in the first year, the MIP jumps to 2.5% of the home value.

ILLUSTRATIONS BASED ON A MONTE CARLO MODEL

The following illustration compares these two strategies in a Monte Carlo based model. Three scenarios are available to this 68 year old client who has a home currently worth $400,000 and mortgage balance of $130,000, a tax-deferred portfolio worth $500,000, and a spending goal of $20,000 before taxes, following the traditional 4% spending rule, which includes their current mortgage payment.

In the first scenario, no HECM strategy is used. The portfolio produces the spending goal of $20,000, and home equity is never tapped. This strategy may not be the ideal scenario, but has a clear demonstration of the value of the unused home equity in meeting their goals.

The second scenario involves refinancing the existing mortgage into the HECM line of credit. For demonstration and stress-testing purposes, this particular retiree's mortgage balance exceeds the 60% threshold for MIP and therefore incurs an additional 2% up-front MIP charge. The portfolio then is left in-tact to produce the desired income, less the annual mortgage payment amount. Not all of the line of credit

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was needed to refinance the current mortgage, so there was a surplus of the line which will grow until needed, if the portfolio depletes.

The third scenario involves paying off the current mortgage from the tax-deferred portfolio, then establishing the line of credit. By distributing from a tax-deferred account, an additional $24,000 was distributed for the tax liability on the lump-sum distribution, but compared to the second scenario; the additional 2% of MIP was saved. As in the second scenario, the income level needed was the same as Scenario 1 less the current mortgage payment.

THE FOLLOWING TABLE ILLUSTRATES THE RESULTS OF THE MONTE CARLO ANALYSIS.
The probability of success is the percent of simulations that were able to sustain the desired spending goal. Net worth is the median net worth of all scenarios, which includes the total of the home value growing at a 0% real return and the portfolio value, minus any outstanding loan. Available wealth is median aggregate of resources available to fund future goals, which includes any available line of credit plus the portfolio value.

	Age	78	83	88	93	98
	Years from Today	10 year	15 year	20 year	25 year	30 year
Scenario 1	Percent Success	99.9%	91%	70%	52%	41%
No HECM Used	Net Worth	$830,249	$838,407	$827,717	$767,330	$846,140
	Available Wealth	**$387,050**	**$281,213**	**$168,572**	**$20,518**	**$0**
	Portfolio Value	$387,050	$281,213	$168,572	$20,518	$0
Scenario 2	Percent Success	100%	100%	100%	98%	91%
Refinance into HECM LOC	Net Worth	$794,436	$770,173	$704,115	$546,820	$454,699
	Available Wealth	**$640,609**	**$696,228**	**$763,076**	**$815,470**	**$859,660**
	Portfolio Value	$539,182	$553,014	$560,558	$529,093	$454,699
Scenario 3	Percent Success	100%	100%	100%	100%	99.9%
Payoff mortgage,	Net Worth	$764,370	$752,771	$705,530	$602,991	$411,479
Establish HECM LOC	**Available Wealth**	**$610,543**	**$678,826**	**$764,491**	**$871,641**	**$1,001,288**
	Portfolio Value	$271,213	$199,692	$86,955	$0	$0

Noteworthy in the table above is the importance of considering home equity. In Scenario 1, where no HECM strategy was used, we see a decreasingly low probability of meeting the spending goals throughout the year and an increasing net worth through the years. This may be counter-intuitive, but the primary component in Net Worth for this scenario is the untapped home equity.

Although probability of meeting the spending goal substantially decreases over time, there is a resource that could have been used to actually increase the probability. **The following graph illustrates the probability of meeting goals when a HECM strategy is implemented.**

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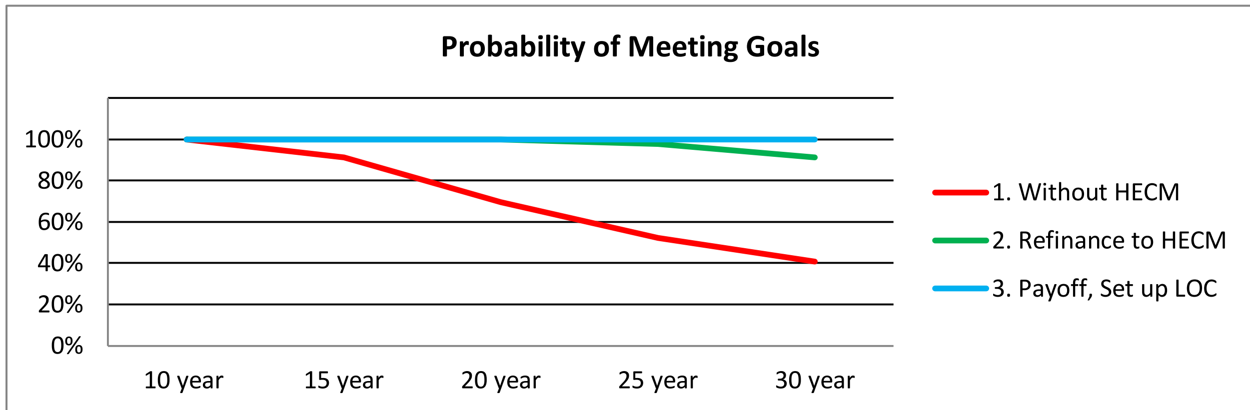
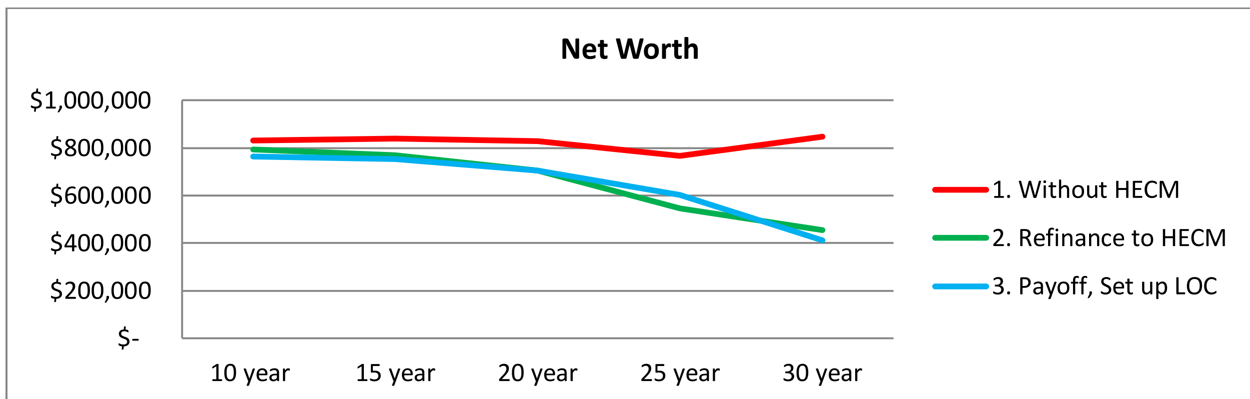
PROBABILITY OF MEETING GOALS



Basing the benefits of the HECM strategy on the probability this client will meet their future goals, **the above graph clearly illustrates the use of a HECM line of credit strategy is superior to disregarding home equity.** In a typical, "average" life expectancy situation, the two HECM strategies produce similar results in terms of probability of success, and through a time period of 30 years, or when the client is 98, each HECM strategy is producing a success rate of over 90%, compared to near 40% when ignoring home equity today.

NET WORTH



Net worth in this illustration is analogous to the value of the client's estate. As noted above, the increasing value of median net worth when no HECM strategy is implemented is somewhat smoke and mirrors, meaning that this increase in net worth is not contributing to producing income for the client; it is wealth that is trapped in the home and not being utilized. Between the two HECM strategies, median net worth follows a similar pattern over time, and although decreasing, is producing income needed to meet the client's spending goal.

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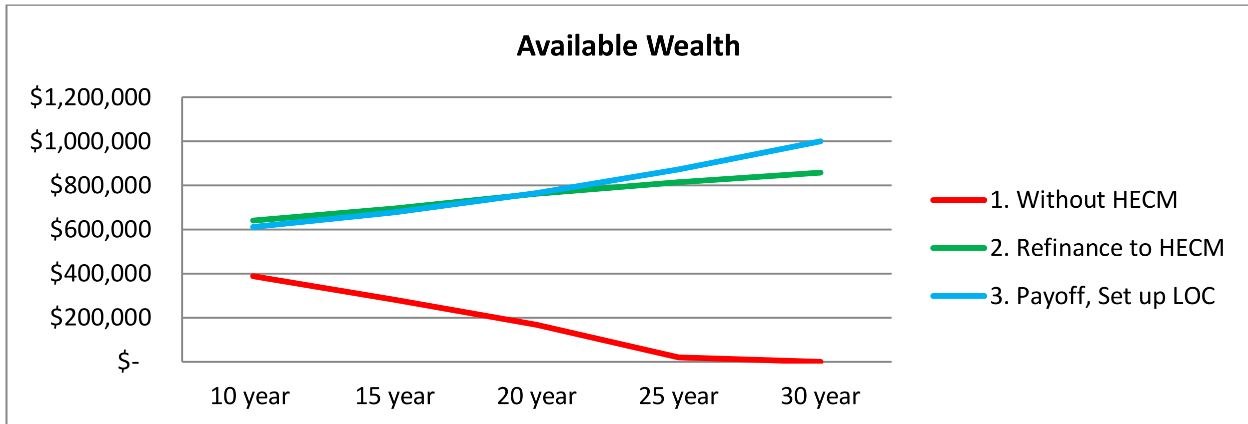
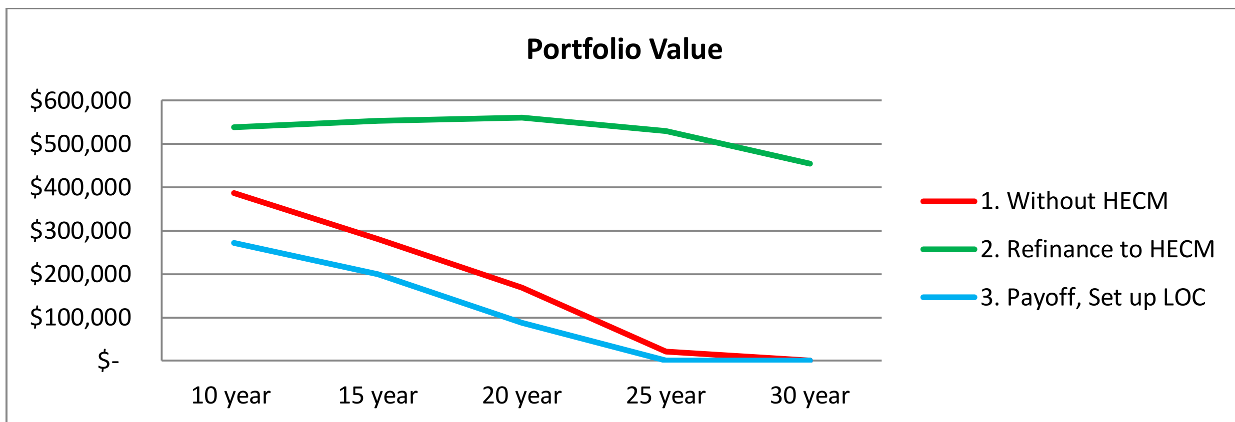
AVAILABLE WEALTH



Available wealth is the main driver of funding goals in this analysis. The trend of available wealth in the figure above for the first scenario, ignoring home equity, is the reality behind net worth's smoke and mirrors. The median net worth declines to near zero after only 25 years, and thinking in the definition of median, after 25 years near half of the future scenarios' portfolios have depleted. Comparing this to the two scenarios using home equity, **available wealth actually increases over time, providing a substantial amount of funding for living well beyond the modeled years**. The reason for this increasing effect is the growth of the unused line of credit in Scenario 3 when paying off the mortgage, and the lessened spending stress on the portfolio in conjunction with a smaller growing line of credit for Scenario 2 when refinancing.

PORTFOLIO VALUE



To this point there has not been a significant difference between the two HECM strategies, however there is an apparent difference in portfolio value. For this client, **there is a significant difference in the future portfolio value,** whereas with net worth there was not. This difference exists due to the portfolio burden of paying off the existing mortgage in the payoff strategy of Scenario 2, where the portfolio remained mostly unused up-front in the refinance Scenario 1. However, an initial loan balance existed in the refinance strategy Scenario 2, taking away from the home value component of net worth, and the home value was

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less likely to be decreased by a loan in Scenario 3. The difference is portfolio net worth versus less liquid housing net worth.

CONCLUSION

Which is the best scenario? First, this is yet another demonstration of the proactive use of home equity though a Home Equity Conversion Mortgage. Which strategy, refinancing versus paying off the mortgage, first depends on the client circumstances. The results in this illustration are for this particular client, and the difference between the two HECM strategies may change as client circumstances change, primarily changes in home value, existing mortgage balance, portfolio value, and spending.

However, in this illustration, the difference is the type of wealth desired (home versus portfolio), and in much later years a decision of meeting goals versus the value of the portfolio as the success rate begins to decline in the refinance scenario, although the portfolio value is higher. This difference may be more pronounced when varying client scenarios.

Additionally, from a public policy perspective, the analysis demonstrates a **higher amount of available wealth to fund additional years of living**. Couple this with the fact that the retiree cannot be kicked out of their home; the HECM program may reduce the risk of many retirees needing public or familial assistance.

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ABOUT JOHN SALTER, PhD, CFP®

John Salter, PhD, CFP® is a financial planning practitioner and an associate professor of personal financial planning. He teaches in the areas of retirement planning and wealth management. John's research focus relates to retirement income planning, and specifically the uses of the HECM program in sustaining retirement income.

IMPORTANT DISCLOSURES

The results demonstrated in this illustration relate directly to the capital market and specific client assumptions listed below.

The projections and other information generated in this Whitepaper regarding the likelihood of various investment outcomes are hypothetical in nature and do not reflect actual investment results and is not a guarantee of future results. The capital market assumptions used in the analysis are projected annual returns, not historic. There is no guarantee the future will follow the assumptions, and historic returns may differ and yield different results.

The following capital market assumptions were used in the Monte Carlo Analysis.

	Cash	**Bonds**	**Stocks**	**Inflation**	**One-Month Libor**	**Home Appreciation**
Mean	3.00%	3.50%	8.10%	2.50%	2.85%	2.50%
Standard Deviation	1.50%	6.50%	21.00%	0.00%	0.80%	0.00%

The following client circumstance was used in the analysis. There is no guarantee the same results would be derived from varying client circumstances; such as home value, spending rates, mortgage balance, client age, portfolio value, and tax characteristics of accounts and tax circumstances of the client.

Client Age: 68
Tax Deferred Portfolio: $500,000
Home Value: $400,000
Mortgage Balance: $132,000
Initial Spending Rate: 4% of portfolio, includes mortgage P&I payment
Annual Principal and Interest (P&I) Payment: $11,600
Additional Taxes on Lump Sum to Pay Mortgage: $26,000
HECM Lender Margin: 2.5%

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Bill Hornbeck

Your Reverse Mortgage Expert

wrh@wrhornbeck.com

38782 Mount Gilead Road

Leesburg VA 20175

703-777-6840

NMLS #1221314

Learn more at www.SeniorLifestyleMortgage.com

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