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CLOSING THE GAP: EQUITY AS ANOTHER SOURCE OF RETIREMENT FUNDING

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Today, the three traditional sources of retirement income—savings, pensions, and Social Security benefits—aren't always enough to enable older adults to live the retirement they imagined. This leaves many hardworking people financially ill-prepared for retirement.

The numbers tell a very sobering tale: Studies show that 14 percent of U.S. residents age 65 and older have zero retirement savings.[1] The median retirement account balance for near-retirees is just $14,500.[2] And the average baby boomer has less than $50,000 in retirement savings.[3]

As a result, home equity is becoming increasingly important as a component of older adults' retirement plans. In fact, home equity as a percentage of home value rose from 39 percent in 2008 to 54 percent in 2014.[4] The estimated aggregate value of home equity owned by older adults is $5.76 trillion.[5] One way for older adults to access this equity as a retirement asset is through a reverse mortgage.

Recent changes to the Federal Housing Administration's (FHA's) Home Equity Conversion Mortgage (HECM) program have made reverse mortgages a more viable option. The Reverse Mortgage Stabilization Act of 2013 has helped protect consumers and create a more sustainable program. Changes include new limitations on the amount that can be drawn at closing and in the first 12 months; a required financial assessment on each application to help ensure that borrowers can continue to meet their obligations as homeowners; an adjusted Mortgage Insurance Premium (MIP) to more accurately price for risk; and added protection for non-borrowing spouses.

In addition to helping protect consumers, these changes reduce headline risk, ensure the stability of the program, broaden its appeal—and have spawned newly designed products with more options to meet the needs of older adults. For example, Reverse Mortgage Funding LLC (RMF) has an innovative, low-cost HECM option that eliminates nearly all closing costs.

All of this has caused financial advisors to take a fresh look at reverse mortgages, and more are recommending HECM loans for some clients as part of their retirement strategies.

According to the Center for Retirement Research at Boston College, "Accessing home equity will become increasingly important in a world where retirement needs are expanding; people are living longer and facing rapidly rising health care costs; the retirement system is contracting; Social Security replacement rates are declining; and employer-provided pensions have shifted from defined benefit plans to 401(k)s where balances are modest. Reverse mortgages offer a mechanism for tapping home equity for those who want to stay in their home."[6]

It all began in 1989, when the HECM program was created as an FHA-insured loan option for homeowners age 62 and older. It allows borrowers to access a portion of their home equity as income tax-free[7] cash, as long as the home is the borrower's primary residence. Funds may be taken as a line of credit, monthly tenure or term payments, a lump sum, or a combination. There are no monthly mortgage payments required, but the borrower continues to be responsible for property taxes, homeowner's insurance, and property maintenance in order for the loan to remain in good standing. Interest is added to the loan balance, and the balance grows over time.

A HECM is a home-secured debt, payable upon default or a maturity event, and must be repaid when the last borrower (or protected non-borrowing spouse) sells the home, moves out, or passes away. It is a non-recourse loan, so the borrower cannot owe more than the home's value when the loan is repaid.

How can it work for retirement funding? A HECM line-of-credit option can serve as a rainy-day fund, or a standby line of credit to be tapped when invested assets are underperforming, to avoid withdrawing assets and help portfolios last longer. Several academic studies at research universities, including Texas Tech, have supported this approach. In fact, FHA Senior Policy Advisor Karin Hill and Social Security expert Russell Settle, in a recent presentation at a National Reverse Mortgage Lenders Association regional meeting, noted that in fiscal year 2015, 92 percent of HECM borrowers selected the line-of-credit option.

How does it compare to other equity-release alternatives? People can sell their house and move, but that may be disruptive for many older adults. According to a recent study by Philips and Georgetown University, 91 percent of older Americans prefer to continue living in their homes.[8] In addition, the average cost of a move is about 10 percent of the home's value.

A traditional Home Equity Line of Credit (HELOC) also has drawbacks. A November 2014 MarketWatch article[9] noted that, in addition to required monthly payments, rising payments are a risk; retirees' applications may be rejected due to income and cash flow; and draw periods are limited. MarketWatch concluded that older adults in and near retirement should consider reverse mortgages, especially those who need to supplement their incomes.

Reverse mortgages offer borrowers many of the advantages of a traditional HELOC or home equity loan, with additional desirable features such as growth of the unused portion of line-of-credit payment plans. Plus, reverse mortgages allow older Americans to continue living in their homes, without the burden of monthly mortgage payments.

For trusted financial institutions with established customer relationships, these loans provide another option to help meet the needs of the important older-adult segment, and offer a viable alternative to a HELOC or home equity loan.

Candidates for reverse mortgages include long-time customers who may not have the ability to qualify for loans or repay mortgages because of income limitations, such as:

Those who do not qualify for a HELOC

Those who are experiencing a resetting HELOC

Customers who are constrained by cash-flow considerations and prefer not to make monthly mortgage payments

Banks that are exploring HECM loans should consider what level of support they require from a partner. RMF, whose solutions are endorsed by ABA through its Corporation for American Banking subsidiary, works with banks in a variety of ways. Some FHA-approved banks act as correspondents, and others as principal agents. RMF also offers brokerage options, where banks can outsource some or nearly all fulfillment functions, such as processing and underwriting.

A bank's decision as to which service level it requires depends on its specific needs—but those just testing the waters should look closely at options that minimize compliance burdens, and offer marketing and other resources that allow for simple and easy set-up.

Demand is growing for retirement-funding solutions among an older-adult population that's enjoying more longevity, but is in many cases unprepared or under-prepared for retirement. In fact, a third of all older adults aren't confident that they've saved enough for a comfortable retirement.[10] As a result, reverse mortgages are gaining acceptance among financial experts as a way to help people access their home equity to satisfy this demand.

For banks, offering reverse mortgages can help retain existing customers, reduce deposit attrition, and grow wallet share. It's advantageous for banks and customers alike.

FOOTNOTES

[1] Bankrate.com survey, August 18, 2014.

[2]" The Continuing Retirement Savings Crisis," Nari Rhee, Ph.D. and Ilana Boivie, National Institute for Retirement Security, March 2015.

[3] Source: Ric Edelman, author, radio host, and CEO of Edelman Financial Services, as quoted in USA Today, "Some states move to help spur retirement savings" by Rodney Brooks, January 27, 2015.

[4] Independent study, initiated by Reverse Mortgage Funding, fielded by Nielsen, 2015.

[5] National Reverse Mortgage Lenders Association (NRMLA), December 23, 2015.

[6] "The Government's Redesigned Reverse Mortgage Program," Center for Retirement Research at Boston College, January 2014.

[7] Not tax advice. Consult a tax professional.

[8] Philips and Georgetown University, "Creating Connected Communities for Aging Well," June 2014.

[9] "5 tips for getting the best home equity credit line," Richard Eisenberg, Dow Jones "MarketWatch," Nov. 5, 2014.

[10] Nielsen Study, 2015.

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