Experts cautiously optimistic about reverse mortgages

Ilana Polyak
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There's a saying that's popular among financial planners: "You can't take a loan to pay for retirement." Well, perhaps you can, after all.

Reverse mortgages allow older homeowners to draw down the equity in their homes without having to make a payment. In fact, it works the opposite way: Homeowners get a check from the bank either monthly, in a lump sum or as a line of credit.

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The vast majority of reverse mortgages are home-equity conversion mortgages insured by the Federal Housing Administration. To qualify for a HECM, you must be at least age 62, have significant equity in your home and use it as your primary residence.

The amount you receive depends on the age of the youngest borrower (the older you are, the more you can get), interest rates and the home's appraised value. There's a cap of $625,000 on any reverse mortgage. The loan is paid back when the homeowner sells the house or dies.

Even with these benefits, many financial advisors caution against the products, believing they prey on cash-strapped seniors who don't understand the ins and outs of the product.

For starters, closing costs are steep, running between $8,000 and $10,000. It's especially pricey when compared to the closing costs of a standard 30-year, fixed-rate mortgage, which run $2,000 to $3,000.

Much of those costs go toward insurance for the mortgage company to compensate for the risk of having to pay out more than a home is worth (the insurance also covers borrowers against a mortgage company default). "It has to be expensive," said Alicia Munnell, director of the Center for Retirement Research at Boston College. "You've got a bank giving you money for 20 to 30 years and expecting you to maintain their investment."

Also, reverse mortgages are complicated.

"There are so many rules that just add to the complexity," said certified financial planner and accountant Howard Hook of EKS Associates. For example, mortgage interest is not currently tax-deductible but becomes deductible after the property is sold.

Finally, a reverse mortgage reduces the equity that retirees can keep in their home. "It's sucking out the equity that would otherwise go to the heirs," Hook noted.

However, some financial advisors say for the right person, a reverse mortgage can be worthwhile. Even the product's detractors acknowledge that many of the questionable practices of the past have been cleaned up and there are more safeguards today.

For example, reverse mortgages don't allow borrowers to take more than 60 percent of a lump sum in the first year, to prevent them from burning through the money all at once. Also, there is stricter underwriting to make sure that borrowers have enough assets for upkeep, taxes and insurance, all of which must be kept current to avoid foreclosure.

Closing costs, too, have come down.

"Where I see these things as really valuable is for the client who has a lot of equity in their home but not enough income for their lifestyle and wants to stay in the home," said certified financial planner Michael Chadwick, owner of Chadwick Financial Advisors. "It even makes sense for clients who have other assets but not a lot of income."

Chadwick advises clients who take out a reverse mortgage to use the annuity option, especially if they expect to live into their 90s and beyond. Even so, he has only recommended reverse mortgages to a handful of clients.

For some clients, reverse mortgages are a better option than the alternatives. Hook of EKS Associates tells of a client who needed an additional $20,000 of income for living expenses. She considered pulling it out of her individual retirement account, but that would mean that she would need to draw down $30,000 a year to net what she needed, the difference going to taxes.

Hook advised a reverse mortgage. His client would be able to receive $1,800 a month in tax-free income. "From a tax point of view, the reverse mortgage made a lot of sense," even after considering the hefty closing costs, he said.

Munnell of Boston College wishes more retirees would consider a reverse mortgage or some other means of tapping the equity in their homes. "Until now, people have not tapped [home] equity, leaving it to their kids," she said. "But we're in a new world."

There are two options for using the equity: downsizing or a reverse mortgage. Seniors can sell their larger, more expensive home and buy a smaller, cheaper one, adding the proceeds to their retirement savings. In addition, monthly expenses should fall, also improving cash flow.

Retirees might then consider a reverse mortgage, she said. A self-described "reverse mortgage enthusiast," Munnell said that reverse mortgages are most appropriate for people who are living in the house they want to stay in for the rest of their lives. (Munnell is a member of the board of directors of Longbridge Financial, a reverse mortgage originator.)

"You don't want to go through the expense of signing up for the mortgage and then deciding you can't get up the stairs," she said.

Another way to use a reverse mortgage to stretch savings was proposed by Shaun Pfeiffer, John Salter and Harold Evensky in an article in the Journal of Financial Planning. The authors believe that retirees should take out a reverse mortgage at the beginning of retirement as a line of credit.

If their long-term portfolio suffers losses at some point, something akin to what many experienced in the 2008 and 2009 period, they can tap the line of credit for living expenses. When the market recovers, they can pay back the loan amount out of investment profits.

"The borrowing costs on a reverse mortgage in 2008 to 2009 compared to the recovery in the portfolio would have made the reverse mortgage a win," Pfeiffer said.

—By Ilana Polyak, special to CNBC.com