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Using Housing Wealth
to
Facilitate Asset Division in "Silver Divorce"[1]

Some Unconventional Uses of Reverse Mortgages

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I. Introduction: The Current Societal Context

In a remarkable contrast to other age cohorts, where the rate of divorce is decreasing, the rate of divorce among older Americans is actually increasing. A study prepared by two academic sociologists and reported in the Washington Post states that, "Since 1990, the divorce rate for Americans over the age of 50 has doubled, and more than doubled for those over age 65 . ." The report goes on to note that, "At a time when divorce rates for other age groups have stabilized or dropped, fully one out of four people experiencing divorce in the United States is 50 or older, and nearly one in 10 is 65 or older, . . . "[2]

II. Two Important Economic Concerns Relevant to "Silver Divorce"

A. Accumulated Wealth. By age 50, and even more so by age 65, many people have accumulated some wealth, primarily a home and some retirement savings (e.g., 401(k) accounts or rollover IRAs). Therefore, in Silver Divorce, the division of these assets often has greater significance than in divorce of younger couples.

B. Considerations of Retirement Income. By age 50, and even more so by age 65, people are approaching, or have reached, retirement. Therefore, in Silver Divorce, financial considerations relating to retirement income are often of greater significance than in divorce of younger couples.

[1] The terms "Silver Divorce" and "Gray Divorce" are both found in the literature, and both have the same meaning. This article will use the term "Silver Divorce," with the added specification that at least one member of the divorcing couple is age 62 or older. (Age 62 is the youngest age at which a person can obtain a reverse mortgage.)
[2] Schulte, Brigid, 2014. "Till Death Do Us Part? No Way. Gray Divorce on the Rise." Washington Post, October 8, 2014, reporting on a study prepared by Susan I. Brown and I-Fen Lin, Sociologists at Bowling Green State University. See, also, Brooks, Rodney. 2016. "Put in the Red by 'Gray Divorce.'" Washington Post, April 10, 2016.

III. The Relevance of Reverse Mortgages

Reverse mortgages[3] can play a very important role in meeting the economic concerns specified in Section II, above, i.e., in facilitating the division of a couple's major assets *and* in optimizing the assets that can be used for retirement income.

Most people, including financial planners and others providing services in divorce matters, have only a limited understanding of reverse mortgages. Therefore, a summary of the salient features of reverse mortgages is provided in the appendix to this article, along with a list of common misconceptions about them and comments about those misconceptions.[4,5] For purposes of this article, however, a reverse mortgage is simply a loan secured by the borrower's principal residence, the most relevant feature of which is that the repayment is not required until the borrower permanently leaves the residence.[6]

This article will illustrate a variety of uses of reverse mortgages in the context of Silver Divorce. The illustrations will be presented by means of a series of examples.

IV. First Illustrative Example: Buyout Scenario with No Existing Mortgage

The series of illustrative examples begins with a rather simple scenario:

A. Joe and Laura, who are both in their late 60s, are divorcing. Their most significant asset is their home, which they own free and clear of debt and is community property. The community also owns a classic automobile, which Joe has restored.

- Home value is $800,000.
- Automobile value is $50,000.
- With the help of their attorneys, they agree that Laura will keep the home, Joe will keep the automobile, and Joe's interest in the community assets will be bought out for $425,000.

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[3] Except as specifically discussed in Section IX, the reverse mortgages referred to in this article are the Home Equity Conversion Mortgages (HECMs), which were created by Congress, are governed by HUD, and are insured by FHA. More than 98% of all reverse mortgages currently outstanding are HECMs. Accordingly, the term "HECM" will be used in this article interchangeably with the term "reverse mortgage."

[4] For more detailed information on reverse mortgages, see, e.g., "What's the Deal with Reverse Mortgages?", by Shelley Giordano, published by People Tested Media, 2015. See, also, "Reverse Mortgages – How to Use Reverse Mortgages to Secure Your Retirement," by Wade Pfau, published by Retirement Researcher Media.

[5] As noted in the text, there are some widely-held misconceptions about reverse mortgages. Some of these misconceptions have contributed to a widely-held (but largely undeserved) negative image of reverse mortgages. For a clearer understanding of this matter, see the article by Wade Pfau, Ph.D., CFA, published in Forbes, at retirementresearcher.com/how-did-reverse-mortgages-get-such-a-bad-reputation/

[6] Although repayment of the loan is *not required* until the borrower permanently leaves the residence, repayment of any or all of the outstanding loan debt *is permitted* at any time during the life of the loan.

B. Initial Steps:

- Laura obtains a HECM in the amount of $375,000.
- This amount of cash, plus the automobile, aggregating $425,000 in value, is transferred to Joe.

C. Subsequent Steps:

- Joe purchases a new home for $700,000.
- He uses the $375,000 he has received in the divorce settlement as a down payment, and obtains a HECM. The HECM allows him to borrow $375,000. Of that amount, he uses $325,000 to complete the payment for the new home, and retains another $50,000 as a line of credit for any future use. (A HECM used for the purchase of a home is called a "HECM for Purchase," abbreviated as an "H4P.")

D. Results for Both Parties:

- Both parties remain homeowners, not renters.
- Neither party incurs any monthly mortgage payment obligations.
- No capital gain tax or sale fees were incurred.

V. Second Illustrative Example: Asset Division Scenario (with Existing Mortgage)

The second illustrative example begins with a slightly more complicated scenario:

A. Bill and Betty, who are both in their late 60s, are divorcing. Their most significant asset is their home, which is community property. Now that their children are grown and on their own, the home is much bigger than Bill and Betty need. Moreover, because they re-financed the home several years ago, there is still a substantial mortgage debt against it. The monthly payments on the mortgage are a heavy burden on Bill and Betty's finances.

- Home Value is $1,650,000, subject to a mortgage of $600,000.
- With the help of their attorneys, they agree to sell the home, using the proceeds to pay off the mortgage debt, the sales fees and the capital gain taxes, and to divide the net proceeds equally.

B. Initial Steps:

• Sell existing home, receive	$1,650,000
• Pay off mortgage	(600.000)
• Pay sales fees	(95,000)

• Pay capital gain tax	(155,000)
Net Proceeds	$800,000

C. Subsequent Steps:

- Equally divide the net proceeds: Each party receives $400,000.
- Each party purchases a new home, using $400,000 as down payment, and using an "H4P" (of up to $375,000) for the remainder of the purchase price.

D. Results for Both Parties:

- Both parties become homeowners again, not renters.
- Neither party incurs any monthly mortgage payment obligations.
- Both parties participate equally in sale fees and capital gain taxes.

VI. Third Illustrative Example: Asset Division Scenario (with Different Existing Mortgage)

The third illustrative is essentially the same as the previous example, except that the existing mortgage is a great deal smaller, and the result sheds light on the other important aspect of Silver Divorce, i.e., money invested to generate retirement income.

A. The example of Bill and Betty is repeated, except instead of their existing mortgage being $600,000, it is assumed to be "only" $300,000. Although less than under the $600,000 assumption, the monthly mortgage payments nonetheless impose a heavy burden on their finances.

B. Initial Steps:

- Proceeding through the same set of initial steps as in the previous example, but with a $300,000 existing mortgage instead of a $600,000 existing mortgage, results in net proceeds that are $300,000 higher, i.e., $1,100,000 instead of $800,000.

C. Subsequent Steps:

- Proceeding through the same set of subsequent steps as in the previous example, the parties each receive $550,000. They each purchase a new home as in the previous example, but, unlike in the previous example, they each also have $150,000 to invest in assets that will provide retirement income for them.

D. Results for Both Parties:

- The parties will have the same results as in the previous example, but, in addition, as noted above, they each will have $150,000 to invest in assets that will provide retirement income.

VII. A Brief Digression into the Realm of Financial Planners' Concepts Relating to Retirement Income

With retirement income having been mentioned, it is appropriate to provide a very brief review of, or introduction to, some concepts relating to retirement income that are well-known to financial planners who deal with retirement, but may not be so well-known to other financial planners or to other professionals providing services in divorce matters. These concepts will be used in the final set of illustrative examples of this article.[7]

A. Special Risk of Silver Divorce. As mentioned in Section II.A, above, as people move into retirement, they become almost entirely dependent upon income, i.e., cash flow, from the assets they have accumulated (plus Social Security). For most retirees, these assets consist primarily of a securities portfolio, such as a 401(k) account or a rollover IRA. As described in Subsection B, below, the securities portfolio does not always provide sufficient cash flow throughout a 30-year retirement. Where there is a risk of cash flow exhaustion, the question that arises is whether the home equity can be used, and what is the most effective way to use it.

B. The "4% Rule". The well-known "4% Rule" is a rule that was originally developed empirically[8] and later demonstrated using the mathematical technique known as Monte Carlo simulation.[9] The rule relates to money distributed on a regular basis (e.g., for retirement income) from a diversified securities portfolio (e.g., a 401(k) account or rollover IRA). The rule states the following:

If, in the first year of retirement, an amount equal to 4% of the portfolio is distributed, and every year thereafter, the *same dollar amount* is distributed, *adjusted only for inflation,* there is a 90% or better likelihood that the portfolio will provide that amount of cash flow to the retiree for 30 years or more. In other words, the rule provides that cash flow will occur with *constant purchasing power*, over a 30-year time period, irrespective of the volatility of the portfolio's investment performance.

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[7] For more complete and detailed discussions of these concepts, see Sacks, Barry H. and Stephen R. Sacks, 2012. *Journal of Financial Planning,* 25 (2): 43-52. See, also, Salter, John R., Shaun A. Pfeiffer and Harold R. Evensky. 2012. "Standby Reverse Mortgages: A Risk Management Tool for Retirement Distributions." *Journal of Financial Planning* 25 (8).

[8] Bengen, William P. 1994. "Determining Withdrawal Rates Using Historical Data." *Journal of Financial Planning7 (4): 171-180.*

[9] Sacks and Sacks, *op.cit.*

This rule is sometimes called the "Safe-Max" rule, because it provides the maximum amount that can be distributed safely, i.e., with minimum risk of portfolio exhaustion, during a 30-year retirement. If a larger amount is distributed, the probability of the cash flow continuing for 30 years is substantially diminished. For example, if the initial distribution rate is 5-1/2%, the probability of the cash flow surviving for 30 years is down from 90% to 60%. Figure 1 shows the probability of cash flow survival for various time periods as a function of various initial distribution rates.

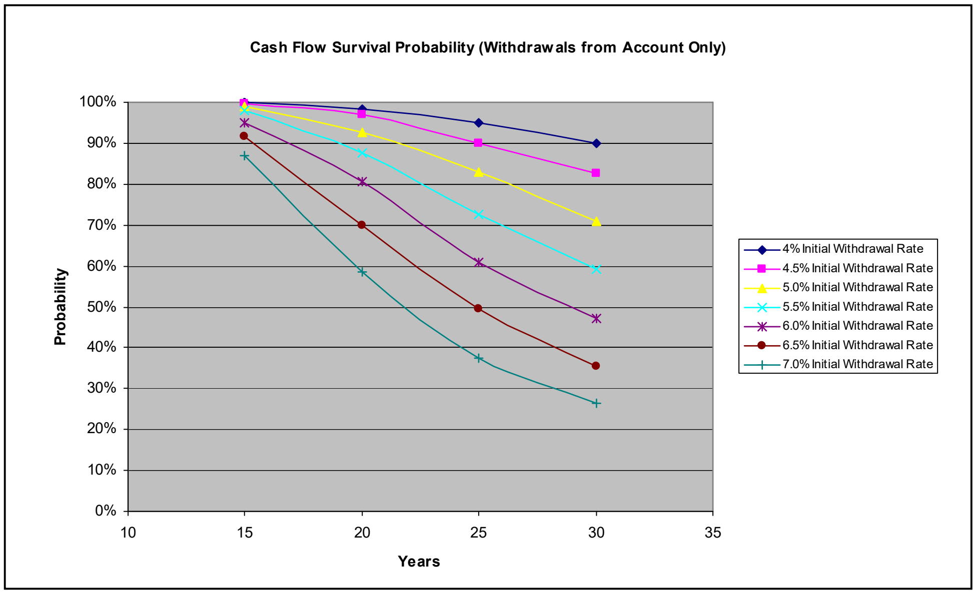

Figure 1. Cash Flow Survival Probability (distributions from securities portfolio only) as a function of initial distribution rate

It is clear from Figure 1 regular annual distributions from the portfolio at a constant purchasing power rate that is even a small amount greater than 4% (initial distribution rate) substantially increases the risk of cash flow exhaustion before the end of a 30-year retirement.

C. <u>Enhancing the Cash Flow Amount and Duration</u>. A detailed discussion of the strategies by which the cash flow amount and duration can be enhanced significantly beyond the 4% amount is outside the scope of this article. However, several such strategies have been developed in the last few years and have been presented in the financial planning literature.[10] These strategies involve home equity accessed by means of reverse mortgages. A few of the results of such strategies are mentioned in the examples set out below.

[10] See, e.g.,Sacks and Sacks, *op. cit.* and Salter, Evensky and Pfeiffer, *op. cit.*; See, also, Wagner, Gerald C. 2013. "The 6.0 Percent Rule." *Journal of Financial Planning* 26 (12) and Neuwirth, Peter, Barry H. Sacks and Stephen R. Sacks. 2016. "Using Home Equity to Increase the Sustainable Withdrawal Rate: Extending the Range." *In Preparation.*

VIII. Final Examples: Buyout Scenarios Involving 401(k) Accounts

These final examples, all based on the same initial scenario, add a dimension of complexity by involving a 401(k) account. These examples are presented as several ways to proceed from that initial scenario.

A. Initial Scenario. John and Jane, who are both in their 70s, are divorcing. Their most significant asset is a 401(k) account, all accumulated during marriage. They also have a home, which is community property and is owned free and clear of mortgage debt.

- 401(k) account has value $1.2 million.
- Home value is $800,000.
- With the help of their attorneys, they agree that Jane will keep the home.
- John wants to travel and later will rent a home.

B. One Way to Proceed:

- Pursuant to agreement, Jane keeps the home.
- To accomplish the equal division of assets, and pursuant to agreement and to a QDRO, John receives an IRA of value $1 million, transferred from the 401(k) account.
- This leaves $200,000 in the 401(k) account for Jane.

Using the 4% Rule described above, John will be able to take distributions of $40,000 per year (inflation- adjusted) from the IRA. Added to a typical Social Security amount of $25,000 per year (also inflation-adjusted), he will have annual income of $65,000. (Because this income will come from an IRA and from Social Security, it will be taxed as ordinary income.)

Again using the 4% Rule, Jane will be able to draw 4% x $200,000 = $8,000 per year from the 401(k) account. Even with Social Security, this is not very much. Is there a better way to proceed? Yes, there are at least three better ways. Below, one such better way is shown, and then two more are briefly mentioned.

C. A Second Way to Proceed:

- Pursuant to agreement, Jane keeps the home.
- Jane obtains a reverse mortgage for $300,000.
- To accomplish the equal division of assets, and pursuant to agreement and to a QDRO, John receives $300,000 cash and an IRA of value $700,000 transferred from the 401(k) account.
- This leaves $500,000 in the 401(k) account for Jane.

Yet again using the 4% Rule, John will be able to take distributions of $28,000 (inflation-adjusted) annually from the IRA plus another $12,000 (also inflation-adjusted) annually from having invested the $300,000 cash he would receive from Jane's reverse mortgage, making an annual total of $40,000 (the same annual amount he would receive under the First Way to Proceed). However, the *taxable portion* of this $40,000 is less than under the First Way to Proceed, because some of it would be a return of capital and some would be taxed as capital gain.

And, from the same rule, under this second way to proceed, Jane will be able to draw 4% x $500,000 = $20,000 per year (inflation adjusted) from the 401(k) account. This amount will be taxable as ordinary income.

D. Results for Both Parties (Buyout – Second Way to Proceed)

- John will have less tax to pay (than under the First Way to Proceed).
- Jane receives more cash flow (than under the First Way to Proceed).
- Jane has more money invested (than under the First Way to Proceed), with greater long-term potential wealth, but also greater risk.

E. Brief Mention of Third and Fourth Ways to Proceed

- <u>Third Way to Proceed</u>: As in the first way, Jane keeps only $200,000 of the 401(k) account. But she also uses a reverse mortgage Life Tenure annual payment of approximately $24,000 (not inflation-adjusted) in addition to her $8,000 (inflation-adjusted) annual payment from the 401(k) account plus her Social Security
- <u>Fourth Way to Proceed</u>: As in the first way, Jane keeps only $200,000 of the 401(k) account. But she also uses a reverse mortgage credit line in "coordination" with the 401(k) account.[11] The "coordinated strategy" (with the quantities in this example) enables the "4% rule" to be replaced by a "9% rule." As a result, Jane can take distributions of about 9% x $200,000 (=$18,000) annually (inflation- adjusted) from the 401(k) account.

[11] See footnotes 9 and 10, and related text.

IX. What About Situations Involving Higher Value Homes?

As noted in the Appendix, the maximum home value that can be taken into account for HECMs is currently $625,500. This does not mean that a higher value home cannot be used to obtain a HECM; it simply means that only the first $625,500 of its value can be considered.

Although more than 98% of all outstanding reverse mortgages are HECMs, there are also available currently so-called "Jumbo" reverse mortgages. The Jumbo reverse mortgages make available much larger amounts, up to $1 million and even more. However, currently the Jumbo reverse mortgages are much less flexible than HECMs, and also much more costly in terms of interest rates. The lack of flexibility means, in particular, that the Jumbo reverse mortgage loans require that the entire loan amount be taken at the outset in a lump sum; the amount of the loan cannot be taken in the other forms available with HECMs, i.e., a credit line or a lifetime annuity (called a "tenure" payment). As a result, only the transactions discussed in the illustrative examples that use the lump sum can be scaled up for home values requiring a larger amount than available with a HECM. This means, therefore, that the coordinated strategy discussed above, which depends upon the use of a credit line, cannot be used with a jumbo reverse mortgage. Moreover, the loan-to-value ratios of Jumbo reverse mortgages are generally much lower than the loan-to-value ratios of HECMs.[12] While loan-to-value ratios of HECMs can equal or exceed 50% (depending upon the age of the borrower when the loan is established), the loan-to-value ratios of Jumbo reverse mortgages generally do not exceed 40%.

Referring back to the illustrative examples, it is clear that the first example cannot be scaled up: Suppose that the home value is $1.8 million instead of $800,000. Then Laura would need a Jumbo reverse mortgage in the amount of $875,000, plus the automobile, in order to buy out Joe's interest in the community assets. That amount represents a loan-to-value ratio of approximately 49% of the home's value, well above the maximum of 40% that might actually be obtained from a Jumbo reverse mortgage.

On the other hand, referring back to the final examples (the ones with John and Jane), suppose that John and Jane have a home worth $2.8 million and a 401(k) account worth $1.8 million, for a total net worth of $4.6 million. An equal division of the assets will give each party $2.3 million.

To obtain the necessary liquidity for the property division (for Jane to stay in the home and for John to have the money to travel, and later rent a home, Jane can obtain a Jumbo reverse mortgage in the amount of $1 million. (This represents a loan-to-value

[12] One reason, perhaps the dominant reason, that HECMs have higher loan-to-value ratios is that the lenders are insured by the FHA against loss.

ratio of approximately 36%, which is close to the limit for Jumbos, as compared with 58% or more for HECMs.)

With this $1 million, plus $1.3 million from the 401(k) account transferred to an IRA for John, the division is accomplished.

It is instructive to note that this result may not be very satisfactory to Jane, because of the disproportionate amount in home value ($2.8 million) compared to the amount in invested assets ($500,000). The income from the invested amount of $500,000, even with the addition of Social Security, may be too little to maintain an expensive home.

If, however, the amount in the 401(k) account were higher than the value of the home, a more satisfactory result would obtain. Suppose that the 401(k) account were to have value $2.8 million and the home were to have value $1.8 million, making the same total net worth of $4.6 million. Then, Jane could obtain a Jumbo reverse mortgage of $600,000 (representing a loan-to-value ratio of approximately 33%), and pay that to John, along with $1.7 million transferred to an IRA for John. The remaining $1.1 million in the 401(k) account for Jane would most likely be adequate to support her in a home worth $1.8 million.

X. Conclusions

The several illustrative examples have shown that there are many situations in which a reverse mortgage can be an extremely useful tool to facilitate asset division in "Silver Divorce." (As noted, "Silver Divorce" refers to the divorce of couples where at least one member is age 62 or older.) The tool is most beneficial to the divorce of people who are in, or are approaching, their retirement years and whose accumulated wealth is primarily in the form of a home and retirement assets such as 401(k) accounts or IRAs.) And, of course, beyond the examples presented in this article, there are many more potential uses, which can be explored, developed, and implemented by the professionals who provide services to divorcing couples.

Financial planners, attorneys and other professionals who provide services to divorcing couples are urged to become more familiar with the academic and scholarly research published about this financial tool and about the many uses described in this article.