Tapping into home equity in retirement

MATTHEWS CAMPBELL
A Partnership of Incorporated Professionals

TAPPING INTO HOME EQUITY IN RETIREMENT

It's generally acknowledged that, in part because of the market crash of 2008 which decimated so many investments held within retirement savings plans, and in part because of interest rates which, since then, have been and continue to be near historic lows, many Canadians are having difficulty accumulating the savings needed to finance a comfortable retirement. The problem is particularly acute for those who were near retirement, or just retired, when the market downturn hit.

Only a minority (28%) of Canadians who have spent their working lives in the private sector can look forward to receiving an employer pension, and even fewer (less than 17%) have access to

the gold standard of retirement income—a fully indexed defined benefit pension plan. For a great many Canadian homeowners who are nearing retirement age, equity in their home represents their single biggest asset and, potentially, a source of retirement income. For many, being able to tap into that home equity may make the difference between having a comfortable retirement and just getting by.

For such homeowners, the question is how to convert home equity into a source of retirement income, without undermining other aspects of their way of life. In early 2013, the Investor Education Fund (a non-profit financial literacy organization founded by the Ontario Securities Commission) carried out a survey of a group of 1500 Canadians, all of them current or former homeowners over the age of 50. One of the issues covered in that survey was how the equity in their homes figured into their financial plans for retirement. The findings in response to that question seem to indicate that Canadian homeowners are, in many ways, unaware of how home equity can be used to help finance their retirement.

For such homeowners, the available options, as identified in the IEF survey, come down to the following six choices.

- selling and downsizing to eliminate mortgage debt;
- selling, downsizing, and investing the difference;
- selling, investing the proceeds of sale, and renting;
- getting a home equity line of credit;
- taking out a reverse mortgage; or
- renting out part of one's home to create income.

Whether any one (or more) of those choices are appropriate for a particular homeowner comes down to an individual question of the degree of financial need, risk tolerance, the extent to which the homeowner is committed to staying in the existing home, and how flexible the homeowner is prepared to be when it comes to living arrangements. Each choice has its upsides and downsides.

Sell the current home and downsize

Downsizing from the family home at retirement is not done only, of course, for financial reasons. It's often the case that that home, after children have moved out and are on their own, is too big for the couple or individual who remains. As well, a larger home means higher costs for property taxes and utilities, as well as more home maintenance, repairs, and yard work. In addition, the location of a family home is usually chosen for its suitability for working and family life—the availability of good schools, for instance, and proximity to transportation links for the commute to work. After retirement, a different set of considerations comes into play in determining a good location in which to live.

Downsizing from the family home to a smaller, less expensive property can optimize or augment retirement income in two ways, as follows.

For those homeowners who have paid off the mortgage, downsizing to a smaller, less expensive property will free up a lump sum which can be added to existing retirement savings. Most Canadians do not make the maximum allowable contribution to their registered retirement savings plans each year and so most have substantial amounts of carryforward contribution room. Using the lump sum freed up by the sale of the family home to contribute to an RRSP and deduct that contribution (usually, over a number of years) will, in addition to augmenting retirement savings, allow the homeowner to claim a tax deduction for the amount contributed and reduce taxes payable for the year.

Take, for example, a couple who have paid off the mortgage on the family home and sell that home for $350,000. If a smaller property is purchased for $250,000, the $100,000 difference can be contributed (assuming sufficient carryforward contribution room) to an RRSP over a period of five years. Assuming, as well, a 30% marginal tax rate, each $20,000 contributed will reduce taxes payable for that year by $6,000. It's worth noting, in addition, that where the individual making that contribution is aged 65 or older, reducing net income by $20,000 may have a positive effect on the individual's eligibility for federal tax credits, like the age credit or the GST/HST credit, or may allow him or her to avoid or reduce exposure to the Old Age Security clawback tax.

Having the mortgage paid off before retirement was once the norm, but that is no longer the case. The IEF's survey found that almost half of homeowners over the age of 50 had not yet paid off their mortgage and that, of that group, 70 percent expected to still owe money on their principal residence at retirement. Carrying such debt into retirement has two implications. First, a portion of retirement income must be allocated to pay at least the interest on that debt and, second, such homeowners are vulnerable to increases in interest rates which will drive up housing costs as a percentage of their total budget.

Take, for example, homeowners who are carrying a mortgage or other principal residence-related debt of $71,000 (the median mortgage amount at retirement, as reported in the IES survey) into retirement. Even at a relatively low rate of 4%, homeowners who pay only the interest needed to service such debt would still have to come up with almost $250 a month to do so. When interest rates increase, as they inevitably must, each 1 percentage point increase in the rate of interest levied on that debt will require the payment of another $60 a month in interest costs. And, of course, homeowners whose house-related debt is structured as a traditional mortgage have to add payments of principal onto those monthly interest payment amounts.

Where, however, the family home which still carries a mortgage is sold, and a smaller property purchased with the equity held in that family home, retirement income needs go down. Individuals who choose this course of action will not have a lump sum to invest, as the entire amount of equity in the family home will be used to purchase a smaller property. However, without a mortgage payment to make each month, retirement income needs are reduced or, looking at it from another perspective, more retirement income is freed up to spend on non-housing costs.

Sell, invest the proceeds of sale, and rent

Selling the family home and downsizing doesn't always mean purchasing a replacement property. For some, the sale of a home means a transition from homeowner to tenant.

Making the decision to rent rather than own is much more than a financial decision. Home ownership is a cherished dream for many Canadians and, once achieved, hard to give up. Studies have shown that Canadian homeowners who encounter financial difficulties will let just about any other debt go unpaid rather than fall behind on the mortgage. Being a homeowner has an emotional component which, while impossible to quantify, is undeniably present.

Consequently, for homeowners, becoming a tenant can feel like a step backward to a less secure way of life or even an admission of defeat or failure. Not everyone feels that way, of course – for some, becoming a tenant means a welcome end to both the financial and non-financial obligations that are an unavoidable part of home ownership. For others, the need to use accumulated home equity to create a pool of retirement savings (or to augment one which is insufficient) is just an unavoidable financial reality.

Where the decision made is to sell and rent, all of the accumulated equity in the family home will be available to increase the retirement savings pool. The flip side of that benefit, of course, is that the retiree is now committed to the payment of rent each month for the remainder of his or her life.

Consider the example above of the homeowner who sells the mortgage-free family home and receives $350,000 in net proceeds of sale. Since no new property is being purchased, the full proceeds of sale are available to invest. In the simplest fact scenario, that homeowner invests the $350,000 in an investment paying 3% per year. Such an investment would provide income of $10,500 a year, enough to cover the rental cost of an apartment in most Canadian cities. Or, the

homeowner could, as in the example above, use the proceeds to make RRSP contributions (where current or carryforward contribution room allows) and to benefit from the resulting reduction in income taxes payable. To generate tax savings of $10,500 per year, again assuming a 30% marginal tax rate, an individual would need to contribute $35,000 each year to an RRSP.

Getting a home equity line of credit

Not everyone wants to leave the family home at retirement. There are many situations in which moving and downsizing isn't desirable or even possible. Especially for those living in smaller centres, where the types of available housing may be limited, downsizing or choosing to rent could mean having to move to another community. Moving and leaving behind friends and other social supports is difficult at any age, and especially difficult when it coincides with a major life change like retirement. As well, it's increasingly the case that adult children "boomerang" back to the family home after finishing their education. In many cases, such adult children are unable to find long-term employment or remuneration from available employment isn't sufficient, or sufficiently secure, for them to take on the financial obligations of their own home, even as a tenant. For a variety of reasons, then, it may be that retirees need to stay, or choose to stay, in the current family home. Where that is their choice, and the only factor creating pressure for them to sell that home is the need to free up equity, there are other options available.

Most Canadians have probably heard of a financial product known as a "home equity line of credit", or HELOC—many may, in fact, already have one. HELOCs resemble traditional mortgages in that amounts borrowed are secured by the value of the home. However, unlike mortgages, HELOCs are not a loan of a fixed amount; rather, the homeowner can borrow, using a HELOC, up to a certain pre-set limit. That limit is based on the value of the home and the homeowner's general creditworthiness, and generally don't exceed 80% of the equity value owned in the home. Interest is then charged only on the outstanding balance at any given time. The other significant difference between a HELOC and a traditional mortgage is that HELOCs do not have a structured repayment (or amortization) schedule. While monthly repayments must usually be made, such payments can be as little as the amount of interest accumulated in the previous month, with no requirement to make any payments on principal. Finally, where funds are borrowed using a HELOC, there is no restriction on the use to which the funds can be put—such expenditures do not have to be housing-related.

The flexibility afforded by borrowing through a HELOC creates both benefits and potential risks. In recent years, HELOCs have gotten something of a bad reputation, as borrowers who had taken out a HELOC ran up substantial amounts of debt, often to finance a lifestyle which was otherwise out of their financial reach. Clearly, for those who find it difficult to not spend the funds available to them, the flexibility a HELOC brings more risk than benefit. But, for those who have a history of managing credit well, the judicious use of funds from a HELOC can make staying in their current home possible.

Take, for example, a retired couple who wish, for whatever reason, to stay in their current home. Their retirement income is generally sufficient to meet current expenses, but major house-related costs—like a new roof—are beyond their means. Taking out a HELOC and using HELOC funds to meet those infrequent expenses allows them to stay in the home and keep it properly maintained. The amount borrowed will reduce their equity in the home, of course, and at least the interest on that amount will have to be paid monthly, and they will have to factor that monthly interest cost into their budget for current expenses.

Where, however, homeowners are contemplating the use of a HELOC to meet regular rather than irregular expenses, some caution is warranted. It's critical that homeowners understand that every dollar borrowed means that equity in the home is reduced by the same amount. Where the expense to be paid by HELOC funds is a specific, identifiable one (e.g., doing renovations to make living in the home safer and easier for aging homeowners, or even paying the annual property tax bill), using that HELOC is likely not a danger sign. Where, however, funds borrowed from a HELOC are needed on an ongoing, continuous basis to meet day-to-day expenses, like utilities or even food, it's very likely a sign that the homeowners need to take a hard look at those expenses and their budget, and to determine whether the lifestyle they are leading is, in fact, a sustainable one. In such circumstances it is possible, depending on the value of the home and the cost of the homeowner's lifestyle, that the funds available through the HELOC will eventually be exhausted, leaving the homeowner with both significantly less home equity and an ongoing current expense shortfall.

Taking out a reverse mortgage

Reverse mortgages are better known, more widely used and have a much longer history in the U.S. than they do in Canada. However, such financial vehicles are now being advertised and promoted on a regular basis in the Canadian media, and it's likely that by now most Canadians have at least heard of them.

Like a home equity line of credit, a reverse mortgage allows individuals to obtain a sum of money based on the value of their home and equity which they accumulated in that home. It's also possible, using a reverse mortgage, to structure the receipt of funds in different ways. The homeowner can choose to receive a lump sum amount, or can opt to receive a series of payments which will provide a regular income stream. There are however, significant differences between a HELOC and a reverse mortgage, in terms of both the lending and repayment terms, and the costs involved.

With a reverse mortgage, no repayment of the funds advanced is required until the homeowner leaves or sells the home. Interest will, of course, be levied and will accumulate from the time the funds are first advanced, and will have to be paid, generally out of any sale proceeds, when the homeowner leaves his or her home. Consequently, total interest costs, when the debt is eventually repaid, can be very significant, the result of those costs having compounded over the life of the reverse mortgage.

The amount which can be obtained through a reverse mortgage is also generally less than the amount available through a HELOC. As well, where there is already a mortgage or other form of loan secured by the home, any such indebtedness must be paid off with the funds received as part of the reverse mortgage.

The major benefit of a reverse mortgage, by comparison to a home equity line of credit, is that the homeowner is not required to make payments while living in the home, putting much less of a strain on cash flow. Offsetting that benefit, however, is the fact that the interest rate charged on a reverse mortgage is usually higher than that which would be levied under a traditional mortgage or home equity line of credit. As well, under the terms of many such arrangements, a repayment penalty is levied where the homeowner moves or sells the house within three years of obtaining the reverse mortgage.

Whether a home equity line of credit or a reverse mortgage is the better option depends on the circumstances of the homeowner, but in all cases the following factors must be considered.

- With a reverse mortgage, the homeowner's equity is steadily eroded by both the amount of funds advanced and by accumulated interest. With a home equity line of credit, equity is reduced by the amount of funds advanced, but the interest component is paid on a monthly basis and does not erode equity. In other words, the homeowner who opts for a HELOC will have certainty as to the amount by which his or her home equity will be reduced, while someone who takes out a reverse mortgage will not.

- Are the homeowner's financial circumstances such that the monthly interest payments required under a HELOC can be paid without undue financial strain? As well, the interest rate on a HELOC is almost always a variable one, meaning that it will change as interest rates rise or fall. Since current interest rates are near historic lows, it's a virtual certainty that anyone who takes out a HELOC will face an interest rate hike in the near future. The effect of an increased monthly interest payment on the homeowner's finances should be factored into the decision. On the other hand, homeowners whose financial circumstances do not permit them to take on any additional current financial obligations, but who do not want to or cannot move, may find that a reverse mortgage is the preferable option.

- How old is the homeowner, and what is his or her current state of health? While a HELOC can be obtained by a homeowner of any age, reverse mortgages can be provided only to homeowners aged 55 or older. Homeowners who are in their late 50s or their 60s and who are considering a reverse mortgage should recognize that where that reverse mortgage remains outstanding for 20 years or more, accumulated interest costs will be very substantial. At the other end of the age spectrum, a homeowner in his or her 80s whose health is such that independent living will not be possible for much longer is also not a good candidate for a reverse mortgage, because of the repayment penalty which is usually imposed where the homeowner moves or sells within 3 years.

Renting out part of the family home

For many homeowners, this is the least attractive of all the available choices and, as well, it's not always a practical option. Municipal zoning laws may prohibit the conversion of part of one's home into a rental unit. Even where such use of the property is allowed, most residential properties are not configured so as to provide a self-contained apartment within the home, at least not without carrying out significant (and costly) renovations. And finally, many people are just not comfortable with the idea of sharing their home with a tenant.

But, that's not the case for everyone. In some cases, where zoning laws allow, a little-used basement can be converted into a rented room or even a bachelor apartment for (relatively) little cost. In areas where seasonal housing is required (e.g., where a university or college is nearby and students are looking for housing), the homeowner can rent for only part of the year. And, for an older homeowner who lives alone, having someone else on the premises may provide a greater sense of security, in addition to the financial benefits.

Probably more than any of the other available choices, the decision to rent out part of one's home in order to generate additional income is as much a lifestyle choice as a financial decision. Where becoming a landlord will make the difference between staying in one's home and having to move, many homeowners will "bite the bullet" and take on a tenant. For others, it's just not worth it. For everyone, it's a very individual choice.

Conclusion

Even though just about everyone looks forward to the time they can retire, feeling financially unprepared for that retirement is very stressful. However, Canadians who have made the effort and the sacrifices required to buy a home and keep the mortgage paid will have the security of knowing that the equity they have built up over a lifetime can be made available to them, through any of the options outlined above, to help with any unexpected costs or financial shortfalls.