Psychology and Economics in the Reverse Mortgages

Henriette Prast*, Mariacristina Rossi**, RiK Dillingh'*, Cesira Urzì Brancati**

***University of Tilburg**

****University of Turin and CeRP CCA**

Extended Abstract

After retirement, pension income is fixed and there is little people can do about it. Resorting to extra labour supply is not an option at old age, and fewer strategies other than using wealth can be adopted. The level of wealth people accumulated by retirement is the most important source to draw on. The ability to reach a higher level of wealth to rely upon, depends on the ability to save efficiently and with high returns. However, the stock of available wealth at retirement is the result of past choices which are no longer reversible. The use of wealth at retirement could be realized through the subscription of annuities, which convert (at least part of) the private wealth into a stream of cash flows until the person dies. Leaving aside the amount of wealth households want to leave to their heirs, Yaari (1965) shows that everything else would be converted into annuities, as the implicit interest rate of an annuity beats the market, given the characteristics of incorporating life survival probabilities.

Home equity release products, such as reverse mortgages or the sale of the bare ownership (home reversal programs in the UK, viager in France) might convert housing equity into cash, by releasing households' needs of liquidity. Drawing down housing asset, albeit only partially, might be the key to increase their liquidity in a stage of the life cycle where income has dramatically dropped after retirement. Nowadays pension systems are based on defined contributions rules, rather than defined benefits rules, so that the system is sustainable for the public budget. Given the contributions people make, the accrual of the contributions over time will determine the pension wealth available once retirement occurs, which is converted into a flow of pension income streams until death. On average in Europe pension income is about 50% of last labour income, given the actuarially fair rule stating the equivalence of contributions given and benefits received. In Europe, the average

housing equity of people aged 50 or more is around 200,000 euro: when housing constitutes a substantial value, it could represent an easy channel to use to guarantee a higher income flow other than pension. Reverse mortgage would enable retirees to cushion pension income shocks. However, surprisingly little attention has been devoted to these products and little effort has been put into the institutional settings ruling them.

Reverse Mortgages could also optimize the time of bequest (Merton, 2007). The average age in which people receive a bequest is 60, when crucial choices, such as how much education to get, have been already made. Having access to liquidity, at least partially, embedded into a house, would ease households in the educational choices for their children, particularly when the credit market is not that easy to access.

In our paper we use a unique module of the Dutch DHS Survey, in which respondents are interviewed about their interest in products such as reverse mortgage.

A similar study for Italy finds that reverse mortgages are not perceived as a financial planning instrument, but as last resort in case of emergency (Fornero, Rossi and Urzì Brancati, 2012). The question regaring the potential interest in reverse mortage was framed in two different ways to capture the inheritance timing appeal that the reverse mortgage could have. Our provisional findings show that the framing of the questions does matter and makes the product better understood and more appreciated by people with high wealth. In this case, taking out a reverse mortgage would not conflict with the desire to leave a bequest, as the borrower could use the loan to help his/her children.