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THE USE OF HOME EQUITY TO FUND THE CONSUMPTION NEEDS OF RETIREES: A SELECTIVE REVIEW OF LITERATURE ON ISSUES AND POTENTIAL RISKS

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Abstract

This paper identifies the broad issues associated with the use of home equity to fund the consumption needs of retirees by reviewing the relevant international literature. The specific literature that examines the role of home equity in the retirement income system deals with attempts by government to shift a greater share of late-life costs onto households. An important part of this literature examines the broad economic consequences of shifting away from a public retirement income system, which features, for example, a partially funded age pension. Other relevant literature considers the decisions older households make about the use of their home equity and other financial assets to fund their consumption needs in retirement. This paper's review highlights important issues that must be considered in a policy change directed toward increasing the use of housing assets to fund consumption needs in retirement. These include the need to obtain a clear picture of the capacity of households to achieve meaningful improvements in their retirement income by accessing their housing, acknowledging the preference of elderly households to hold onto their home equity rather than draw down on it, and accounting for the risks and costs of encouraging households to access their home equity to fund their general consumption needs in retirement.

Introduction

A policy response to the fiscal costs associated with population ageing that is increasingly being mooted is to increase householders' reliance on their personal assets, including their home equity, to finance consumption needs in retirement (see for example Brownfield 2014, Cowan and Taylor 2015). In Australia, a

recommendation for policy that would encourage households to draw down on home equity to fund consumption needs in retirement has been put forward by various government bodies. The Productivity Commission (2011, 2013) has made recommendations for a government-backed equity release scheme that could be used to fund age-related expenditures such as aged care, a proposal subsequently supported by the National Commission of Audit (2014). In early 2015, the then Minister for Social Services further increased the visibility of equity release on the policy agenda by expressing his support for a discussion on releasing home equity to help meets the costs of population ageing in Australia (see O'Keeffe 2015). Peak bodies representing seniors, such as COTA have also publicly expressed support for progressing discussions on a government backed equity release scheme (see Yates and Root 2011).

However, it is also widely acknowledged that a range of important issues need to debated before Australia proceeds down this path towards "asset-based retirement income". The policy direction represents a further diminution of the role played by the age pension and, thus, will have potential negative effects on economic efficiency (see, for example, Orszag and Stiglitz, 1999). It will also create costs and risks for many older households, as well as conflicts with intergenerational transfer motives (see for example Ong et al. 2013; Ong 2014). Equity issues are also involved, including possible negative effects on gender equity as single older women are much more reliant their primary home assets than men.

More broadly, the latest OECD report on pension systems emphasized that there is currently a lack of a "clear, up-to-date picture of how sources of income other than pension benefits help sustain adequate standards of living in retirement" (OECD 2013, p6). It highlighted the need for analyses of patterns of elderly homeownership and wealth holdings to inform the debate on the adequacy of retirement incomes.

This paper identifies the broad issues associated with the use of home equity to fund the consumption needs of retirees by examining the relevant international literature. The policy challenges created by population ageing are the subject of a large and complex literature. However, the specific literature that is relevant to the role of home equity in the retirement income system is much smaller. It deals with attempts by government to respond to the financial pressures on programs associated with supporting the needs of older individuals by shifting a greater share of late-life risks on households. An important part of this literature examines the broad economic consequences of shifting away from a public retirement income system, which features, for example, a partially funded age pension. A further important branch of literature considers the decisions older households make about the use of their financial assets to fund their consumption needs in retirement. A smaller but more directly relevant literature examines the role of home equity as a source of finance for these needs.

Public vs Private Retirement Income Systems

Key writings on the design of retirement income systems compare the broad efficiency and equity consequences of public pension schemes with models of private or individual provisioning of consumption needs. The focus is primarily on the risks and costs associated with increased reliance on private superannuation accounts. However, the discussion also has relevance for the assessment of policy aimed at increasing the reliance on any private assets, including home equity, to fund the consumption needs of older individuals.

The merits of private versus public approach to funding retirement income are hotly contested. However, it is worth noting that Nobel Laureates Joseph Stiglitz and Peter Diamond both challenge what Stiglitz describes as the 'prevailing myth' that private approaches to retirement provision are superior. In a co-authored paper with Peter Orszag, for example, Stiglitz argued that "…the arguments most frequently used to promote individual retirement accounts are often not substantiated in either theory or practice," and recommended that policy-makers "… adopt a much more nuanced approach to pension reform than that offered by the common interpretation of *Averting the Old Age Crisis* (Orszag and Stiglitz 1999, p2).

Diamond (2005) appears to concur, noting several advantages of a partially funded public system, including a superior ability to respond to demographic change. He notes, for example, that a partially funded public pension system can adjust benefits for many cohorts to deal with increased longevity. As such, it can spread the cost of demographic change over many cohorts. The political process can also allow changing contribution rates in response to increased longevity, facilitating an increase in savings. In contrast, in private retirement systems, longevity risk falls on workers, with projected increases in longevity and reductions in interest rates resulting in lower monthly benefits, and unanticipated increases resulting, potentially, in shortfalls in retirement income toward the end-of-life.

Diamond notes that workers may respond to projected increases in longevity by increasing their work hours or by saving more. This is relevant to the claim that private systems encourage higher labour supply and rates of savings. However, Diamond and Stiglitz both rebut these arguments. Diamond (2005) argues that neither an increase in work hours nor increased savings are necessarily optimal responses to increased longevity. For example, additional work hours will not be an optimal response if "the ability to obtain suitable jobs and the interest in holding them [does not] increase in proportion to life expectancy" (p1). Increased savings is judged to be a better option, but Diamond notes that this only makes sense if the current level of savings is too low.

Orszag and Stiglitz (2005) couch their argument in broader terms by emphasizing that the ultimate policy concern must be with *welfare*, not savings or growth. They note that increased reliance on private provision of retirement income may increase savings and labour supply. However, if this comes about because households are

exposed to greater risk it may not represent an increase in welfare.

Orszag and Stiglitz (2005) outline a number of substantial risks and other negative consequences associated with a shift toward greater reliance on private or individual provisioning of consumption needs in retirement. In addition to the shifting of longevity risk onto individuals, private approaches:

1. Shift accrual risk onto individuals. This also represents a loss of efficiency (increased cost) as individuals have a relatively limited ability to diversify their assets or insure against this risk. In contrast, public pension systems can spread risk across generations[1] and thus attain a profile of risk (and diversification) that private programs cannot.
2. Shift risks associated with fluctuations in lifetime earnings onto individuals. A public pension scheme, on the other hand, at least partially cushions the impact on retirement income of lower-than- expected earnings brought about, for example, by unemployment, illness or extended care responsibilities.
3. Expose individuals and households to risks associated with poor financial literacy and imperfect information[2]. This also creates a large regulatory burden in dealing with, for example, unconscionable financial practices.

The Use of Financial Assets by Older Households

A further important and related literature examines the decisions older households make about the use of their financial assets. It provides additional, and perhaps more specific insights to the possible risks and costs associated with a policy shift toward an asset-based retirement income provision.

A key issue addressed in this literature is the limited use of annuities by older US households. In complete markets, and in the absence of bequest motives, annuities are superior to bonds as they deliver a higher level of consumption. The logic is straightforward: Annuities deliver a payout to the individual if she survives (and, thus, they provide longevity insurance) but none if she dies, whilst bonds deliver a payout if the person lives or dies. As the probability of dying is positive, an annuity can be purchased at a lower cost than a bond. Thus, a higher level of consumption in retirement can be achieved from an annuity than from an equivalent bond. In the absence of a bequest motive, and ceteris paribus, the expectation therefore is that retirees would purchase annuities. However, as Davidoff, Brown and Diamond

[1] An interesting idea is that partial funding of a pension scheme provides access to an asset -- the human capital of the young -- that is not normally tradable on the financial markets, thereby providing further diversification relative to the set of assets available on financial markets. Furthermore, this creates an additional reason to invest in both human and physical capital, which can be a spur to economic growth (Orszag and Stiglitz 1999, p52).

[2] Data from the US Securities and Exchange Commission emphasise these risks. They show, for example, that "… more than half of all Americans do not know the difference between a stock and a bond; … only 16 percent say they have a clear understanding of what the Individual Retirement Account is; and only 8 percent say they completely understand the expenses that their mutual funds charge" (Orszag and Stiglitz 1999, p33).

(2005) explain, the evidence shows that people don’t purchase annuities, at least not in large numbers.

Whilst the low take up of annuities could constitute evidence of strong bequest motives, many contributors to this literature reject this explanation[3]. They point instead to the limited financial capacity of many households to purchase annuities, the incomplete nature of annuities markets, and the important role that financial and other assets play in helping insure householders against the risks of health and care ‘shocks’. These analyses are relevant to the evaluation of asset-based retirement income because they identify limitations to and potentially negative consequences from measures that require households to convert their accumulated assets into a flow of retirement income.

Poterba, Venti and Wise (2013) emphasise the limited capacity of most US households to purchase annuities from their non-annuitised wealth. Using data collected by the US Health and Retirement Study they calculated the "potential additional annuity income" (p2) that households could purchase, given their holdings of non-annuitized *financial* assets at the start of retirement. Less than half of all households between the ages of 65 and 69 in 2008 were found to have the capacity to increase their life-contingent income by more than $5,000 per year. These findings, thus, caution against over-optimistic assessments of the potential to use retirees’ wealth as a source of finance for their general consumption needs.

The limited uptake of annuities by households with the financial wherewithal to purchase them appears to be related, in part, to the incompleteness of annuities markets. Davidoff, Brown and Davidson (2005, p1584) observe, for example, a “…severe mismatch between the desired consumption trajectory and the income path provided by a limited set of annuities in an incomplete markets setting.” Annuities are relatively illiquid and may prove to be unattractive for this reason, especially if affordable insurance options for medical and care expenses, or unexpected inflation are not available. This is a critical observation as it highlights a significant potential risk of policies that ‘encourage’ or require households to draw down on their assets to fund general consumption needs. That is, such policies could erode households’ capacity to meet unanticipated or uninsurable health and care expenses in later life. The observations also indicate the importance of efficient annuities and insurance markets to the success of any attempt to increase the reliance on private assets as a source of retirement income.

An important but small part of the literature on the ‘annuities puzzle’ highlights the potential implications of the issue for gender equity. As Diamond (2000) observes, men and women in couple households typically must negotiate the allocation of their retirement income. However, their expected longevities typically diverge, with women having longer life expectancies on average than men. This creates important differences in the interests within the household. If household income is used to

[3] For example, Davidoff, Brown and Diamond (2005) find that whilst a bequest motive reduces the demand for annuities, it does not eliminate it in general.

create an annuity based on the man's expected longevity, the woman faces a 'risk of widowhood', whereby her access to economic resources will fall upon the death of her spouse. However, if household income is used to purchase an annuity based on the woman's longevity the payout rate from the annuity will be lower (see Poterba, Venti and Wise 2013). Because women are more likely to be non- or secondary-earners in couple relationships, in many cases they are less likely to own the financial assets that might be used to purchase annuities. Thus, the risk of widowhood is most relevant to them. These risks can be substantial; with US longitudinal data revealing that on average widows experience a drop in income relative to needs of roughly 30 percent (Holden and Zick, 1998) [4].

The Role of Home Equity in Retirement

A significant and relatively recent sub-set of the literature on the assets of older households focuses on the role of home equity. It is motivated, in part, by an observation of the importance of housing assets in the wealth portfolios of older households. In the US (as in Australia and many other countries) home equity is the primary assets of a large proportion of elderly homeowners (Venti and Wise 2004, Poterba, Venti and Wise 2010). This is especially the case for older women. It is an asset that in principle could be used to support consumption after retirement. It is also an asset that plays a key role in determining the financial security of older homeowners.

However, despite the significance of home equity in the wealth portfolios of older households, its role in supporting the consumption needs of retirees has, to date, received only limited consideration in academic and other literature. Steven Venti (2010, p378) explains that, in part, this reflects the "peculiar" nature of housing assets:

> Housing is a peculiar asset because it has both consumption and investment aspects. This dual role makes it difficult, as a matter of theory, to pin down what motivates households to accumulate, hold, and—at some point in the life cycle—to decumulate housing assets.

Venti also notes that the treatment of housing assets in the literature on savings has been inconsistent, with some studies ignoring housing wealth, some including it, and some assuming an "arbitrary fraction of housing wealth should be considered among the assets that will be used to finance consumption in retirement" (Venti 2010, p379).

An important set of papers by James Poterba, Steven Venti and David Wise, and Johnathan Skinner address this key research gap. Their theoretical and empirical analyses emphasise the role of home equity as a form of precautionary savings,

[4] In the German pension system, for example, for single earner couples, the pension benefit (which is based on earnings) falls to 60% when the earner dies, but stays at 100% if the non-earner dies.

which are only drawn down in response to shocks such as the death of a spouse or a period of substantial medical or aged care outlays. They also note that home equity provides a form of longevity insurance, and thus acts as an alternative to annuities[5]:

> While a household owns a home, it earns returns in the form of imputed rent plus any capital gains or losses associated with changes in the home's value. The implicit rental value of the specific home that the household has lived in for many years may be especially high for the retired household, as it provides continuing contact with a familiar neighborhood and long- standing friends. *But owner-occupied homes can, if necessary, be sold and converted to financial assets. Thus home equity may provide a pool of resources that can be used in the event of unanticipated expenses, such as medical care needs, or in the event that the household outlives its other resources*. (Poterba, Venti and Wise 2013, emphasis added, p14)

The theoretical analysis presented in these papers references the life-cycle model, Skinner (2002), for example, uses a two-period life-cycle model in which households have an altruistic bequest motive and face uncertainty about future earnings, lifespan, and medical expenses. In period one the 'young' household (aged 30-60) accumulates housing wealth, and in period two the 'old' household (aged 60-90) can draw down on this wealth. Households maximize expected lifetime utility. Three possible states of the world are described: a 'good' state where there are no debilitating health or financial downturns for the elderly household members; a 'bad' state, where adverse health or economic circumstances results in the depletion of non-housing assets; and a 'really bad' state of the world, where poor health or adverse financial outcomes results leads to selling the house and moving to a rental or an institutional setting. Home equity in this model is accumulated and held against future contingencies later in life (i.e. the possible eventuality of a 'really bad' state of the world). Importantly, it also simultaneously caters for a bequest motive:

> Wealth is something like traveler's checks: you take them along on vacation "just in case," but odds are they will remain uncashed and available for sundry goods after the journey is complete. (Skinner 2002, p274)

The theoretical predictions of the models developed by Skinner appear consistent with the empirical evidence on the use of home equity by elderly US households. This evidence is derived both from surveys of householder intentions (or preferences) for the use of their home equity in retirement, and from panel data on the correlation between health and other 'shocks' and changes in home equity in older households. Data on household intentions indicates a strong aversion to the idea of using home equity to fund general consumption needs in retirement. Venti (2010), for example, assembled data from the 2004 US Health and Retirement Survey to show that the large majority of retired homeowners do not anticipate selling their house to finance consumption in retirement (see also Venti and Wise 2004). The data on savings intentions is also broadly supportive of the importance of precautionary savings motives. For example, data from the US Survey of Consumer Finances reported by Skinner (1996) indicated that more than 40 percent of retirees

[5] Skinner (1996) also highlights the role of home equity as a hedge against changing house prices, and insurance against the risk associated with renting.

nominated that their savings were against a ‘rainy day’ or emergencies, with only about one-tenth percent responding that they are saving for their children.

Data on actual changes in home equity in retired households is, perhaps, more convincing. The majority of this has been assembled from analyses of the US Health and Retirement Survey[6] data. Poterba, Venti and Wise (2013) use this data to examine the extent to which households ‘tap’ their housing equity and their financial assets at various ages to finance consumption needs and other late-life spending. Their findings are supportive of previous studies (see, for example, Venti and Wise 2004) showing that US households typically *do not* use housing equity to finance year-to-year non-housing consumption. There is little reduction in housing equity (either through reverse mortgages[7], downsizing or selling up) as US households age[8]. However, changes in housing equity *are* correlated with key ‘shocks’, such as changes in family status due to the death of a spouse (for married couples), periods of substantial medical outlays, or entry to a nursing home (Poterba Venti and Wise 2013). Thus, it appears that older households may draw down on their home equity to pay for medical expenses, or to support more general consumption of a surviving spouse. However, older households do not systematically convert their home equity into liquid assets to support non-housing consumption.

A question posed by Venti (2010) helps to bring the threads of this discussion together. He asks how the evidence of reductions in home equity associated with various life shocks might be reconciled with the survey data showing that households do not plan to tap this equity. His proffered explanation highlights the important role of home equity as a form of precautionary savings, and a form of insurance against a range of risks in later life, and as a buffer against the “catastrophic shocks” that may occur later in life. He observes:

> Housing may best be viewed as an asset of last resort, not to be counted among the assets funding the 80 percent replacement rate promoted by financial advisors, but still available if hit by a shock in late life. (Venti 2010, p382)

Conclusion

These findings, and the results of the broader literature that has been reviewed here, have important implications for how we might assess policy change directed toward increasing the use of housing assets to fund consumption needs in retirement. A number of key points can be made. First, it is important to get a clear picture of the capacity of households to achieve meaningful improvements in their retirement income by accessing their housing and other assets. This would avoid the risk of over-stating the potentials of asset-based retirement income and help identify

[6] Venti and Wise (2004) also use data from the Asset and Health Dynamics Among the Oldest Old (AHEAD) survey, as well as the Survey of Income and Program Participation (SIPP).
[7] Venti (2010) discusses the evidence on downsizing; Venti and Wise (2004) discuss the use of reverse mortgages and selling up.
[8] Poterba, Venti and Wise (2013) cite a range of US studies that all show an absence of change in home equity as households age.

the particular types of households that might be the target of such a policy shift.

Second, the preference of households to hold onto their home equity must be acknowledged. The available evidence indicates that these preferences reflect the important role played by home equity in insuring against key risks in later life. Policy change that causes this equity to be eroded may, thus, have unintended (and severe) negative consequences for older households by reducing their capacity to respond to unexpected longevity, late-life medical expenses, the loss of spouse, and/or aged care needs. The nature of gender differences in longevity makes these concerns particularly pertinent to women. Yet very few papers have examined these issues through a gender lens.

The risks and costs of 'encouraging' households to fund their general consumption needs in retirement must also be taken into account. The policy direction increases households' exposure to a range of risks, including accrual risk, earnings risk, and the risks associated with poor information, unconscionable behavior and poor financial literacy. Some women, especially those who are secondary earners in their household, would become more exposed to the risk of unfavourable allocations of household retirement income if such a policy change eventuated. As Venti and Wise (2004, p170) express, "housing equity should not, in general, be counted on to support non-housing consumption in retirement."

However, against this we have key political actors who continue to advocate 'private' approaches to retirement income. It can also be acknowledged that a segment of the population appears to be 'income-poor and house-rich' and might be reasonably able to draw down on some of their housing wealth to support their retirement needs. Thus, a pragmatic policy response might be to ensure the asset thresholds for means-test are set at a relatively high level, and to direct effort toward the development of institutions that will minimize the downside risks for households who need to draw down on their assets to fund their late life needs. This could involve efforts to improve the availability, knowledge and regulation of, for example, reverse mortgage and other annuity products. Mechanisms to resolve potential intra-household could include rules for annuity products akin to the US rule that requires a notarized signature by a spouse if there is no survivor benefit in private defined benefit (or annuitized defined contribution) pensions (Diamond 2000).

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