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THE REVERSE MORTGAGE: A SOLUTION TO RETIREMENT FUNDING?

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TABLE OF CONTENTS

Page

INTRODUCTION 1

THE REVERSE MORTGAGE 2

A. Theoretical Basis 2

B. General Application 2
1. Eligibility 2
2. Calculating the Maximum Amount of the Loan 4
3. Payment Options 4

C. Advantages and Disadvantages of Reverse Mortgages 5

THE REVERSE MORTGAGE IN CANADA – OFF TO A SLOW START? 6

A. Government Support 6
B. The System's Shortcomings 7

THE REVERSE MORTGAGE IN CANADA – WHAT THE FUTURE HOLDS 9

A. Socio-demographic Factors 9
1. The Senior Boom 9
2. "Freedom 75"? 10

B. The Reverse Mortgage – a Solution? 12

CONCLUSION 13

CANADA

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THE REVERSE MORTGAGE: A SOLUTION TO RETIREMENT FUNDING?

INTRODUCTION

The financial product known as the "reverse mortgage" – or "reverse mortgage loan" – was invented decades ago and has been available for a number of years in Canada and even longer in the United States. It allows homeowners to withdraw part of the net value of their residence and thereby boost their disposable income with the equity tied up in their homes. They can improve their standard of living and cope more easily with unexpected expenses while continuing to own and live in their homes.

The lender or the organization administering the program simply takes a mortgage on the property. Unlike a conventional loan or a line of credit, however, the reverse mortgage requires no repayment of principal or interest during the homeowner's lifetime, as long as he or she continues to live on the property. The homeowner repays the principal and accumulated interest only when he or she decides to sell the property or dies. (In the latter case, the estate pays the balance owing with the proceeds from the sale of the property or other assets.)

For various reasons, the reverse mortgage has never gained wide acceptance in Canada. Yet, in the coming years, it could end up playing a key role in retirement funding. Slumping and stagnant stock markets and low interest rates have forced many seniors to deal with cash flow problems that are seriously eroding their quality of life. They can no longer depend on an adequate interest and dividend income to complement their public or private pension benefits. Meanwhile, real estate prices are in a period of robust growth. Current conditions would appear to be ideal for the development of financial products such as the reverse mortgage.

The first part of this paper describes how the reverse mortgage works: its theoretical basis, its general application and variants, and its advantages and disadvantages. The

second part summarizes the reasons for the reverse mortgage's marginal role in Canada. The final part explores the reverse mortgage's future potential in view of current socio-demographic trends and inadequate retirement planning by many households.

THE REVERSE MORTGAGE

A. Theoretical Basis

The conceptual underpinning of reverse mortgage demand is the consumption and savings lifecycle theory advanced by Modigliani in the 1950s.(1) In simple terms, the theory is that households accumulate a nest egg for retirement and use it to finance their retirement spending, thus cushioning the impact of the income drop that usually occurs at retirement. The theory involves two important assumptions concerning reverse mortgage demand:

- seniors living alone are more likely to participate in a reverse mortgage program (since, if they have no heirs, they will have fewer reasons not to draw down their capital);
- the appeal of a reverse mortgage program increases with age (since the participants will be less reluctant to draw down their capital as their life expectancy and foreseeable needs decline).

B. General Application

1. Eligibility

The reverse mortgage is a financial product designed for elderly homeowners who have paid for their residence or have only a small mortgage. In both Canada and the United States, the minimum age requirement is 62. In the case of couples, both partners must be 62 or over. In contrast to conventional mortgages, eligibility is not based on household income.

In Canada, reverse mortgages first came onto the market in British Columbia in 1986. Today, they are available through the Canadian Home Income Plan (CHIP), a private-sector financial company.(2) The only program of its kind in Canada, CHIP recently became

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(1) Franco Modigliani and Richard Brumberg, "Utility analysis and the consumption function: an interpretation of cross-section data," in *Post Keynesian Economics*, ed. Kenneth K. Kurihara, Rutgers University Press, New Brunswick (N.J.), 1954, pp. 338-436.

(2) Most of the information about this program is taken from the Canadian Home Income Plan's Web site (http://www.chip.ca).

available in all provinces in association with most of Canada's major banks. Eligible dwellings are single-family houses, duplexes, townhouses and condominiums. Leaseholds, co-ops, mobile homes and properties larger than 30 acres do not qualify.(3)

Under the Plan, eligible homeowners can access between 10% and 40% of the net value of their homes. CHIP will lend a minimum of $14,500 and a maximum of $500,000. The interest rate on the loan is revised once a year, and the interest is compounded twice a year.

The Plan offers a number of attractive features:

- the homeowner can use the funds in any way he or she wishes;
- in the case of couples, when one spouse dies, the surviving partner can continue to enjoy the Plan's benefits until he or she sells the property or dies;
- homeowners can rent their property out for short periods or even transfer the reverse mortgage to another residence if they move.

While the Plan is designed to last through the rest of the participants' lives, participants can repay the principal and interest at any time and extinguish the mortgage. On the other hand, pre-payment of the mortgage can result in penalties, often consisting of a number of months' interest or a charge to offset the loss of income incurred by the lender.

The Plan's costs are not limited to interest on the loan. There are fees for the property appraisal and the title search. Participants are responsible for paying the legal fees for review of the mortgage documents. In addition, closing fees are deducted from the amount disbursed by the Plan, along with the costs normally associated with obtaining a mortgage, such as insurance, title registration and other administrative fees.

On 31 October 2002, CHIP had a portfolio of 2,458 reverse mortgages worth a total of $187 million. The ratio of the value of the loans to the market value of the properties was 37%. The average age of the participants was 76.2 years.

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(3) Canadian Home Income Plan Web site (http://www.chip.ca/eng/eligibility.html).

2. Calculating the Maximum Amount of the Loan

The maximum amount that a household can obtain through a reverse mortgage on its principal residence depends on a combination of three main factors:

- *The borrower's age, marital status and, in some cases, gender* are key variables in forecasting life expectancy and determining the maximum amount for which a household is eligible: the older the borrower (i.e., the shorter his or her life expectancy), the larger the loan will be. Similarly, persons living alone can borrow more than couples of a similar age and with property of comparable value, because it has been shown statistically that the life expectancy of persons living alone is shorter.

- *The property's market value* is used as collateral for the loan: the higher the value, the higher the maximum amount of the loan will be.

- *Interest rates* are also a key factor: the higher they are, the faster interest will accrue and the less capital will be paid to the borrower or retained for heirs.

3. Payment Options

Not all reverse mortgage plans offer the same options. In theory, though, where the regulatory framework allows, the borrower can obtain a lump sum, periodic payments or a line of credit. The contract can be for a specified or indeterminate period.

- *Lump-sum payments.* The homeowner receives the full amount of the loan in a single payment. The amount is less than the property's value to allow for interest accumulation. Unless otherwise specified, the borrower can use the funds in any way he or she wishes. In some cases, however, the borrower is required to convert the money into a life annuity[(4)] or an annuity certain.[(5)] In the case of a life annuity, the person continues to receive the annuity even after the property is sold and the reverse mortgage is paid off.

- *Line of credit.* The homeowner is given free access to funds up to a preset amount and can use them as he or she sees fit. Interest accumulates on the line-of-credit balance as funds are withdrawn. The homeowner may periodically repay all or part of the line of credit, but in contrast to a traditional home equity line of credit, he or she is not required to do so. A reverse mortgage line of credit can serve as an emergency fund, but it must be managed carefully.

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(4) A life annuity is a series of payments by a financial institution to an individual – the annuitant – for the duration of the contract or until the individual dies, in exchange for an asset. The annuitant permanently cedes ownership of the asset to the financial institution. The financial institution determines the size of the annuity based on the asset's value and the annuitant's life expectancy.

(5) An annuity certain provides a fixed income guaranteed for a specified term.

- *Periodic payments.* Under this arrangement, the homeowner receives payments for the duration of the reverse mortgage according to a schedule set out in the contract. The amount depends on the interest rate on the loan. If the interest rate remains fixed for the duration of the loan, so will the size of the payments. If the contract calls for interest rate adjustments at regular intervals, the payments will be adjusted as well. The interest rate applies to the total payments received by the homeowner.

In Canada, the only reverse mortgage program on the market has just one option: a lump-sum payment for an indeterminate period. As we shall see later, this affects the diversity of financial products available to Canadians for retirement.

C. Advantages and Disadvantages of Reverse Mortgages

The main advantages of reverse mortgages are as follows:

- homeowners continue to own and live in their residence for the duration of the loan;
- the property's value is likely to rise during the loan period, which reduces the actual cost of the loan;
- from a tax perspective, the payment received by the homeowner is not considered taxable because it is debt rather than income;
- in Canada, the old age pension and Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) benefits are unaffected by the payment;
- the interest paid is tax-deductible if the reverse mortgage is used to earn investment income, such as interest or dividends.

The main disadvantages are as follows:

- interest can accumulate quite quickly depending on the mortgage interest rate and the type of reverse mortgage chosen by the participant;
- with the associated fees, over and above the interest costs, the actual cost of the funds is higher than the cost of funds available from other instruments, such as a conventional line of credit;
- if the value of the property does not increase much, the amount due upon disposition will be a large percentage of the selling price, which will reduce the net proceeds of the transaction;
- heirs may end up with a much smaller inheritance.

THE REVERSE MORTGAGE IN CANADA – OFF TO A SLOW START?

As noted above, for various reasons the reverse mortgage has never gained wide acceptance in Canada. A comparison with the situation in the United States will shed light on what may be nothing more than a slow start. Unlike American households, which have a wide choice of financial products for converting the equity in their principal residence, retired homeowners in Canada who have low incomes ("house rich, cash poor") have no access to a competitive, innovative marketplace offering diverse products to meet their financial needs. Why is that?

A. Government Support

This contrast between the two countries partly reflects the way they view the role of government. In a less socialized economic system, American households have to rely more on their own resources to compensate for the government's absence in a number of areas. Accordingly, America's fiscal and regulatory framework was designed and structured to give residential real estate a key role in funding goods and services consumption throughout people's lives. This public policy approach is based directly on consumption and savings lifecycle theory.

The significant efforts made by American authorities to support home ownership are part of that vision, which involves promoting the formation of a pool of household capital rather than community capital. For the same reason, the American government is a very active player in the reverse mortgage market. Through its Department of Housing and Urban Development(6) and its federally regulated financial institutions (corporations chartered by Congress), the American government directly and indirectly supports the development of reverse mortgages.

One of the key instruments of this support policy is a system of insuring reverse mortgages against market, property and life-expectancy risks, a critical factor for mortgage

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(6) The Department of Housing and Urban Development (HUD) insures reverse mortgage loans so that the risk can be spread among more people and the costs can be reduced. As indicated previously, reverse mortgages – unlike ordinary mortgages – require no repayment of the principal and interest as long as the borrower lives in the house. The mortgage lender recovers the principal and interest when the house is sold. The house's residual value (once the lender has been repaid) goes to the owner or his or her heirs or survivors. If the proceeds of the sale are insufficient to pay the amount owing, HUD will reimburse the lender for the loss. The Federal Housing Administration, which is part of HUD, collects an insurance premium from all borrowers.

lenders. This system encourages them to participate in the supply of reverse mortgages and to offer better-designed, more affordable products in every part of the country. In addition, reverse mortgage loans, like traditional mortgages, can be turned into mortgage-backed securities,(7) which reduces their cost.

In Canada, the federal government plays no role in developing or promoting reverse mortgages. The absence of the public sector is one of the reasons that the Canadian reverse mortgage market remains extremely limited. Although the *National Housing Act* was amended a few years ago to permit reverse mortgage insurance, nothing seems to be happening in that area. Perhaps the demand for such a product is considered too weak to make its development and introduction a priority.

However, a Canadian reverse mortgage insurance program might act as a catalyst and help create a dynamic, competitive environment for this future market. The current wait-and-see attitude is especially surprising since the federal government, through the Canada Mortgage and Housing Corporation (CMHC), has played and continues to play a leading role in developing and promoting home ownership in Canada. Moreover, the CMHC has the basic technological infrastructure and technical expertise to introduce and administer such a program, which could be cost-effective if well managed.

B. The System's Shortcomings

In Canada, many financial institutions offer home equity lines of credit to their customers. However, those lines of credit are not designed specifically for seniors, and they lack the special features that make reverse mortgages so attractive (no repayment before the property is sold or the owner dies, and so on). Canadian financial institutions are generally cool to the idea of reverse mortgages, regarding them as risky and potentially unprofitable in today's conditions.

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(7) The Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) are the two most important financial institutions on the American mortgage market. They buy mortgage loans from American lenders, primarily to create mortgage-backed securities for resale to investors. These transactions establish a secondary mortgage market that plays a significant role in the supply and liquidity of the American mortgage market as a whole. The supply and liquidity of mortgage funds provide American households with access to mortgages at lower interest rates.

To meet the needs of customers for whom a reverse mortgage is a potential solution, Canadian banks simply refer them to the Canadian Home Income Plan, in exchange for a small commission. However, CHIP has some shortcomings that partly account for the present underdevelopment of the Canadian reverse mortgage market:

- *Lack of flexibility.* CHIP offers only the lump-sum payment option, and if the money is not rolled into a life annuity or an annuity certain with a financial institution, it may be a costly option for the participant. Interest accumulates faster and faster as time goes on, and it may not be tax deductible, depending on what the capital is used for.

- *Relatively high cost.* For many people, the reverse mortgage is a last resort – because of its relatively high cost – to deal with financial problems that may arise in retirement. In view of the product currently on the market, most seniors, who do not necessarily want to keep their property, would rather sell it, move to a more modest residence and use the proceeds of the sale to purchase an annuity. The booming demand for condominiums reflects that preference, even though condominium ownership has its own costs. Others will receive financial support from their families, rent out part of their homes or approach their financial institution for a line of credit or refinancing.

- *Limited geographic coverage.* CHIP is not available in all parts of the country; certain areas (mostly rural and one-industry areas) are ineligible. It is obvious why a private firm would not offer such a product in areas where real estate has poor resale potential and the market risk is high. Yet many rural households would probably want to take advantage of a reverse mortgage program. Because of the structure of the rural economy, the rural workforce is less likely to have access to well-paid jobs that allow employees to save for retirement and provide benefits such as generous pension plans. In general, only public servants working in the regions and employees of large natural resources corporations have access to jobs of that type.(8)

- *Lack of familiarity with the product and public reluctance.* There is no doubt that because reverse mortgages are so new, seniors are unfamiliar with the concept. In addition, there is little advertising by institutions that seniors know and trust. Seniors may also be reluctant to remortgage an asset they worked many years to acquire and pay for.

Furthermore, it is evident that the bull markets of the 1990s resulted in large returns for pension plans and individual investment portfolios, which reduced the need for retired people to consider other assets in order to maintain their standard of living. That situation may change in response to the recent poor returns on interest-bearing investments.

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(8) Statistics Canada, *The Assets and Debts of Canadians: Focus on private pension savings*, Ottawa, 2001, Catalogue No. 13-596-XIE, p. 19.

THE REVERSE MORTGAGE IN CANADA – WHAT THE FUTURE HOLDS

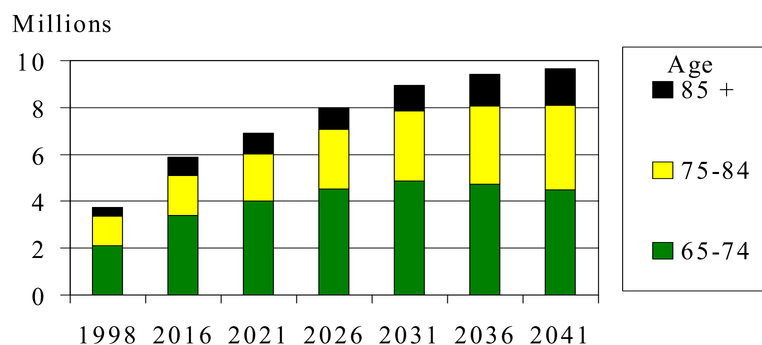
Estimating the potential demand for reverse mortgages is a challenge, since there are no data on the intentions of the target clientele. It would appear that the only way to determine the level of demand with any precision is to actually develop and market products. Nevertheless, a few conclusions about the potential demand can be gleaned from demographic projections and data on Canadians' savings.

A. Socio-demographic Factors

1. The Senior Boom

According to Statistics Canada, about one-eighth of the population was aged 65 or older in 2000. In 2026, one out of every five people will be in that age group. In 2016, Canada will have far more seniors than children under 15 – an unprecedented situation. The population aged 65 and over is expected to double from nearly 4 million in 2000 to almost 8 million by 2026.

Projected Population of Canada



Source: Statistics Canada.

The impact of the growing elderly population will be reflected in the "potential support ratio," which is the number of working-age people per senior. This ratio is already falling and is expected to drop precipitously in the coming decades. Between 2000 and 2026, it will decline from five to only three. The decline will also have an impact on the "dependency

ratio," which is the ratio of the number of children and seniors to the working-age population. At present, there are 46 children and seniors for every 100 working-age people. According to Statistics Canada projections, the ratio will be between 55 and 60 per 100 in 2026.

2. "Freedom 75"?

A survey conducted in November 2002 by Decima Research on behalf of the Investors Group[9] confirms that very few workers are planning for retirement and that many of them will be in a poor financial shape when they retire. For example, only 15% of respondents said that they had scaled back their retirement plans because of the stock market meltdown and lacklustre prospects for investment returns. These "realists" believed that they would have to earn more in retirement (59%) and save more (74%). Of respondents who were already retired, 78% planned to spend less to offset the decline in stock market returns, and 67% were prepared to lower their standard of living.

According to the survey, 72% of non-retired Canadians are strongly considering working in some capacity after they retire, to offset any income loss. This is in sharp contrast to what retirees are doing today, as only 23% of those who responded said they were currently working. However, even though employment opportunities may improve because the generation after the baby boomers is smaller, many retirees will have neither the energy nor the good health to find another well-paid job, especially after the age of 75.

Most retirees (78%) rely on public pension plans (QPP in Quebec or CPP in the rest of Canada) as their primary or secondary source of income. As might be expected, respondents under 50 relied more on their own earnings to meet their needs, while older people depended mostly on government pension plans. Seniors whose only source of income is the CPP or the QPP will have to make do, at best, with a monthly pension of $560.88 if they retire at 60, $801.25 if they wait until they are 65, and $1,041.63 if they hold on until age 70.

Sixty-five per cent of future retirees are also counting on their registered retirement savings plan (RRSP), and 61% believe that their employer pension plan will be a primary or secondary source of income. A survey undertaken by the firm SOM and published in *La Presse* on 12 February 2003 indicates that:

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(9) See *Majority of Canadians plan to work during retirement – But 59% don't know how much money they'll need in retirement*, on the Investors Group Web site (http://www.investorsgroup.com/english/about_us/news_releases/2003/030121cdns_work.htm).

> Half of Canadians have less than $25,000 in savings. Of the 58% of the labour force who have an RRSP, 69% have less than $50,000 in their plan ….
>
> Canadian workers are relying more on employer pension plans, but only 46%[(10)] have access to such plans. [Translation]

The surveys, which provide very useful information about how Canadians intend to fund their retirement, show how little the public knows about reverse mortgages, since they are not even included among the options that Canadians are considering in order to round out their retirement income. Yet 65% of Canadian households own their residence. For households headed by a person aged 65 or over, the proportion was 68% in 1997.[(11)] Six years later, it is undoubtedly higher. And it will continue to rise substantially over the next few years, since 78% of the 55-64 age group and 75% of the 45-54 group owned their homes in 1997. More importantly, the vast majority (9 out of 10) of people aged 65 or over who own their own home have paid off their mortgage.

According to Statistics Canada,[(12)] families (two or more persons) whose primary income recipient was 65 or over had a median net worth[(13)] of $202,000 and a median annual after-tax income of $32,000 in 1999. The same year, for homeowner households aged 65 and over, the principal residence had a median value of $120,000.

Men living alone had a net worth of $111,100 and a median annual after-tax income of only $17,000. Women living alone had a net worth of $76,000 and a median annual after-tax income of only $15,300.

These data show beyond any doubt that the principal residence is still the major asset of a growing number of elderly people and that it represents a pool of savings that could be better used to deal with the fact that life expectancy and age-related financial needs are bound to increase. This is especially relevant in light of the evidence that many households will not have sufficient financial assets to ensure a comfortable standard of living.

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(10) According to Statistics Canada, the figure was 40.6% in 2000.

(11) Statistics Canada, *A portrait of seniors in Canada*, 3rd ed., Ottawa, October 1999, Catalogue No. 89-519-XPE, p. 51.

(12) Statistics Canada, *Survey of Financial Security*, Ottawa, March 2001, Catalogue No. 13-595, p. 7.

(13) Net worth is equal to assets minus debt.

B. The Reverse Mortgage – a Solution?

Once a concern only to demographers, the aging of our population is gradually becoming a tangible reality for the average Canadian. The health system is feeling the pressure, businesses are worried about labour shortages, and workers are seeing an increasing portion of their paycheques eaten up by CPP or QPP contributions.

Although actuaries assure us that public pension plans are well positioned to cope with the mass retirement of baby boomers, governments will be increasingly faced with difficult choices. Pressured by the rising number of elderly voters, they will have to devote a larger share of their budgets to the priorities of the growing senior population. This situation could jeopardize the current pay-as-you-go system for funding public services and weaken intergenerational solidarity. The dominant view is that it is foolish to believe that in the future, three workers will be able to finance, without a heavy tax burden, the same level of public services as five workers do today.

However, a few observers are more optimistic about the aging of the population and its effects on public finances, arguing that the expected decrease in tax revenue will be partly offset by increasing labour force activity among the elderly, rising salaries and, in particular, the decline in net tax expenditure due to RRSPs and other private pension plans:

> Another reason to view population aging with equanimity, at least in Canada, is that governments' revenues will be bolstered by taxable withdrawals from Registered Retirement Savings Plans (RRSPs) and other tax-deferred private pension programs, precisely when upward pressures on public expenditures related to old age – particularly on health care and public pensions – are expected to be most acute. Currently, the net cost of the tax exemption related to these programs constitutes a net "tax expenditure" for governments – but, as demonstrated by new simulations, the net tax expenditure will drop considerably in the years to come, and even turn into a sizeable source of net revenues beyond the year 2030.(14)

Nevertheless, many individuals will find themselves with an inadequate level of pension income to meet their needs during at least part of their retirement. Accordingly, the introduction of a regulatory framework conducive to the development of reverse mortgages

(14) Marcel Mérette, "The bright side: A positive view on the economics of aging," *Choices* (Institute for Research on Public Policy), Vol. 8, No. 1, March 2002, p. 28 (excerpt from the summary).

would help cushion the drop in standard of living for some people, and it would have the advantage of not reducing the incomes of workers through increased taxation to support retirees' standard of living.

Of course, a reverse mortgage is a complex transaction, and much riskier than a conventional mortgage. Its profitability depends on a number of factors. Aside from the property and real estate market risks, there is the risk associated with the participant's life expectancy. In that context, the CMHC could play a key role in developing a financial product that would spread the risks among a large number of participants.

Pending the formulation and implementation of a detailed policy along those lines, nothing stands in the way of arranging private reverse mortgages. Cross-generational financing could be one way of helping children and grandchildren build a nest egg while providing their parents or grandparents with an income.

When it involves people who are not necessarily related, the reverse mortgage can become a very attractive selling point for a buyer who wants to acquire a house but does not want to live in it immediately. The seller will be able to take advantage of the capital himself or herself instead of leaving it to greedy or distant heirs. The buyer will pay less interest than on a conventional mortgage, for a period that will depend on the seller's longevity. Moreover, since reverse mortgages are entirely secured by the property and involve payment of interest compounded twice a year (or more frequently), such financial instruments could be excellent investments.

CONCLUSION

In summary, by enabling a homeowner to keep his or her residence while accessing the capital tied up in it, the reverse mortgage could be a way of compensating for the poor stock market performance and low interest rates that are seriously eroding the retirement savings and probable quality of life of future retirees. All that would be required is for the public sector to provide systematic support for reverse mortgages to mitigate the associated risk and increase the confidence of the lenders and borrowers that form the market.