Briefing 2

How would housing wealth perform as a pension?

July 2009

The aim of this briefing is to present findings that contribute to an evaluation of the contribution that housing wealth might make to the incomes of older Europeans: how good a pension would it make?

What is the DEMHOW project?

Commencing in March 2008, DEMHOW (Demographic Change and Housing Wealth) is a 3-year research project undertaken by researchers in 10 member states with financial support from the European Union and participation of AGE – the European Older People's Platform. Its aims include investigation of the actual and potential contribution that wealth held in the form of housing might make to the income needs of older European households.

For further information on DEMHOW, please visit: www.demhow.bham.ac.uk

Although the availability of appropriate statistical information limits the number of member states that can be studied, it is clear that, with respect to housing, savings and pensions, there are important differences across member states.

SEVENTH FRAMEWORK PROGRAMME
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How can the performance of housing wealth as a pension be assessed?

The potential contribution that housing might make to the income needs of older Europeans depends on how individuals exploit its two forms of income. Those households who own their homes outright will benefit from the fact that they can occupy it without having to pay rent, and in that sense their income, including any pensions, received as cash is enhanced by an income in kind from their home.

Home owners also have a financial asset that they may be able to convert into cash. This may be done in a number of ways: by selling the house and buying a cheaper one or even by becoming a renter; or, by using a financial product, such as a reverse mortgage, that allows the household to go on living in the house having "sold" a proportion of its value to a bank and thereby obtaining an income.

Those drawing on both forms of income will have the greatest boost to their income which they receive from other sources, such as a state pension. But, the two sorts of housing income are correlated - those with most income in kind own the most highly priced houses – so an assessment can be made by looking either at them individually, or at both together.

How, then, can this housing-based boost to income be assessed? An important criterion against which pension systems are usually evaluated is the "adequacy" test. This asks two questions: how far does it reduce the risk of a household being below the poverty line; and, how far does it help households to maintain the same standard of living they had before they retired?

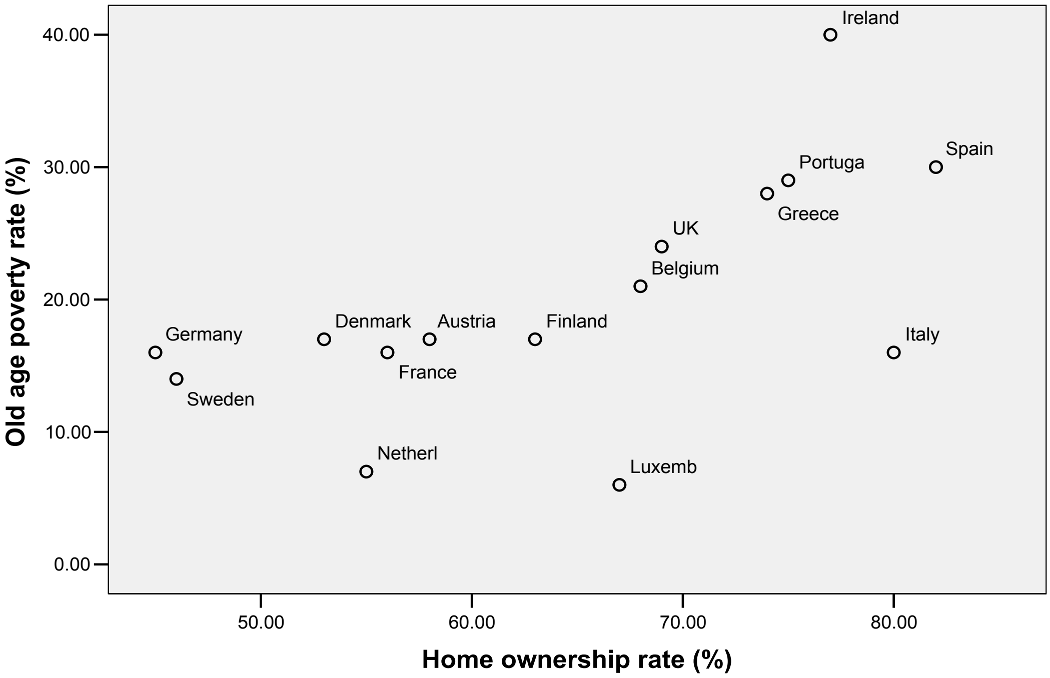
What could housing wealth contribute to reducing the risk of poverty in old age?

Figure 1 could be taken to indicate a broad relationship: that those member states with the highest levels of poverty among older people – of the older member states, Ireland and many of the Mediterranean countries - also have the largest home ownership sectors. This suggests that it is in these countries that there is also the greatest potential for housing wealth to reduce poverty.

But, wider and more detailed examination of the available data suggests this may not be so:

- The risk of poverty is not everywhere highest among older people. In fact in about a third of member states – particularly in the newer member states - it is higher among younger people. In these countries the use of housing wealth to enhance the consumption of older people, rather than pass housing wealth to the younger generation in the form of a bequest, would increase rather than decrease inequality.

Figure 1 Poverty rate among older people by home ownership rate



- There are many examples, particularly but not solely in the newer member states, of older people who have considerable housing wealth but low incomes, the so-called "asset rich, cash poor". For them, releasing housing equity would lift them above the poverty level. However, the more general picture across Europe is that those older people with the highest incomes, both before and after retirement, and the most non-housing wealth, also have the most housing wealth. In short, they are "asset rich, cash rich" For them, since they are not below the poverty level to start with, releasing housing equity would have the effect of even further increasing their consumption possibilities.

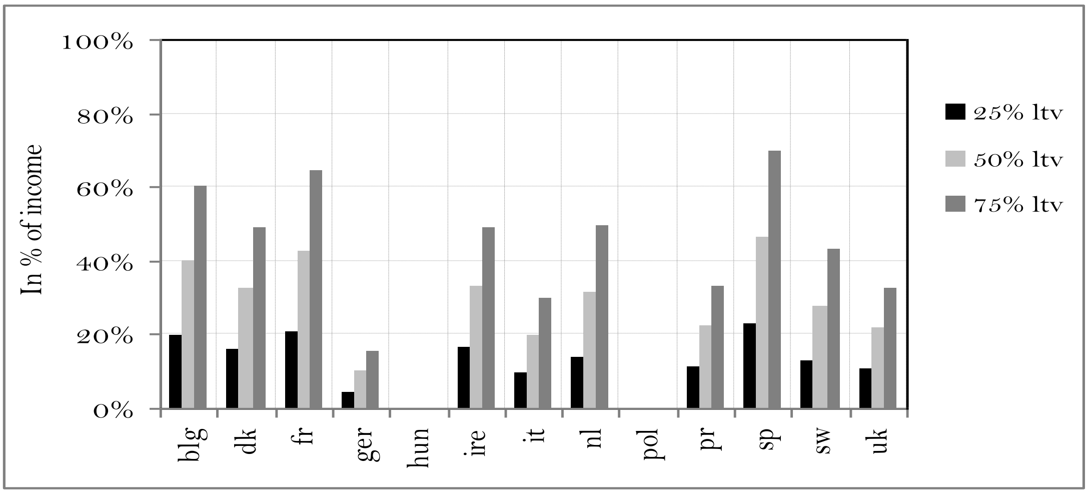
- There are also, in all member states, many older people who can be described as "asset poor, cash poor". These are frequently renters, for whom releasing housing equity is not an option.

In general, therefore, housing wealth could have an effect of lifting some older households out of poverty and its greater use could provide positive benefits. But, a significant effect of the widespread release of housing equity to enhance the incomes of older people, might also be to increase inequality by having little impact on the lower end of national income distributions, while enhancing incomes at the top end.

What could housing wealth contribute to maintaining the pre-retirement standard of living?

Estimates of the amount of the income that older Europeans might derive from their housing must be based on a number of assumptions. In part, this is because accurate data about the distribution of house prices in each member state is not available. It is also because, in order to estimate the amount they might receive from a financial product such as a reverse mortgage, it is necessary to make assumptions about how house prices and interest rates might increase (or decrease) in the future as well as the proportion of the total value of the house that the householder (and the bank) would be willing to “sell” (buy).

Figure 2 % increase in income of retirees derived from a reverse mortgage



Based on such assumptions, Figure 2 shows that in seven of the eleven member states, for which relevant data are available, the contribution, for those taking a reverse mortgage on 75% of the value of their home, would be over 40% of their income. In three member states it would be at least 60%.

While this indicates that housing wealth could significantly enhance other household income and thus increase their standard of living, there is an issue of fundamental importance in assessing the actual effects: would the income from a reverse mortgage be an *addition* or *complement* to existing sources of income, or a *substitute* for that part formerly derived from the state in the form of a pension?

As a *complement*, housing wealth offers the potential to older people to considerably boost their cash income and thereby enhance their living standards. Quite simply, by cashing in some of their assets they can consume more. As a *substitute*, however, governments may use the potential of housing wealth as a rationale for reducing the value of the state pension (or other state spending on older people). The consequences could include people being “forced” to use their housing wealth even if they would prefer to leave a bequest to their children, perhaps leading to some erosion of solidarity both across generations and across society. Furthermore, in this scenario, those who rent their homes might be doubly disadvantaged in having both a reduced state pension and no housing assets to draw upon.

So, of central importance is whether housing wealth presents an opportunity for home owning households or an opportunity for governments and tax payers.

What might be the consequences of the present economic circumstances on the potential of housing wealth as a pension?

The medium and long term responses to the present economic circumstances in Europe may have a number of consequences for the use of housing as a pension, including:

- Across the member states in recent years there has been a general increase in the range and usage of mortgage products. But, given the fragility of many banks, to what extent will financial institutions be eager to maintain or even increase the level of business in products enabling the release of housing equity?

- From a European perspective, the experience of countries such as Japan, Korea, Hong Kong and Singapore that experienced economic difficulties a decade ago in the shape of the Asian financial crisis is perhaps revealing. There, the response has been some dilution of the former centrality of housing to their welfare systems. Broadly, their governments had previously encouraged home ownership as a basis for pensions and other welfare goods – much as some of the recent debate in Europe - but the shock to their housing markets reduced confidence in housing, leading to the development of more European-style, social insurance systems.

- The current widespread – across the member states – fall in house prices along with increases in levels of unemployment are relevant to other criteria against which pension systems are frequently evaluated. Broadly, these can be summarised in the question: to what extent will households and societies be able to afford to finance housing investments at a level that will lead to future, continuing house prices rises?

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DEMHOW Demographic Change and Housing Wealth

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