DEMHOW

Demographic Change and Housing Wealth

Briefing 3

Releasing Housing Equity

February 2010

The aim of this briefing is to present findings about the means – especially financial products – whereby European households might release the equity in their own homes in order to contribute to their income in old age.

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 makes 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 equity release, there are important similarities and differences across member states.

SEVENTH FRAMEWORK PROGRAMME

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How can households release housing equity?

Many older European households have built up considerable amounts of equity in their homes. Their options for releasing that equity later in life will depend on a number of circumstances such as whether they own all the equity in the home or part of it is collateral against an existing loan, as well as the costs and possibilities of alternative housing options.

Some older households will be in a position to sell their home and buy a cheaper one, thus releasing some of the equity, while others may be able to rent a home, and while this releases all the equity it will impose a future cost in the form of rent.

There may also be solutions that do not require the household to move. Again, the options will depend on particular circumstances. Thus it may be possible to sub-divide the property to form two separate dwellings one of which can be rented or even sold. In some countries the legal framework allows the sale of a property to a buyer who then rents the property back to the seller for life. In France, the well-known *Viager* system allows the householder to sell the house to as a third party, often a member of the family, obtaining a lump sum or annuity and remaining in the home until their death.

Finally, in some countries there are financial products, made available through the banking system, that allow households to mobilise their housing equity. There are two principal forms of product: equity withdrawal and reverse mortgages, sometimes known as equity release.

How do equity withdrawal and reverse mortgages differ?

While equity withdrawal and reverse mortgages are often confused they are fundamentally different in terms of their technical characteristics as well as the risks they present, on both an individual and macroeconomic level.

Equity withdrawal is generally aimed at households who already have a housing loan: they increase the size of the loan, providing them with a lump sum but requiring some change to the existing repayments in amount and/or in repayment period. In principle, the owner may be able to withdraw further amounts of equity as existing loans are repaid and house prices increase.

In general, reverse mortgages do not require an owner to have an existing loan. In essence, the owner sells the home, or some proportion of it, to a financial institution. They may continue to live in the house, while receiving a monthly payment from the institution, or a lump sum with which they may purchase an annuity. In either case, they receive an income for the rest of their life, while the bank is repaid from the proceeds of selling the home. The financial institution is therefore bearing risk with respect to the number of years that the individual will live and on the whether the value of the house will be sufficient to cover the sums paid out.

The macro-economic effects of the two products are also very different. The effect of reverse mortgages on household consumption depends on the value of the home and anticipated interest rates at the point when the contract is signed. Once the level of payment has been set there is no further relationship with the economic cycle.

The timing of equity withdrawal and the capacity to make further withdrawal, on the other hand, constitutes a dynamic process. If, because the national economy is growing rapidly, house prices rise, this may encourage more equity withdrawal and thus more consumer spending, so prolonging the boom. Conversely, when economies slump and house prices fall, there may be reluctance to withdraw equity with a prolonging of the slump.

In which countries are there financial products enabling equity release?

With respect to the volumes of production, mortgage methods, diversity of products and completeness of the market, the mortgage market is not developed very equally across the member states of the European Union. This is also the case with equity release products.

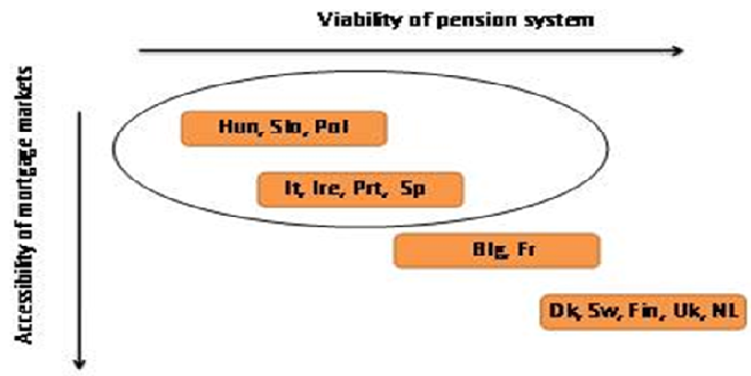
While in the USA and other western countries like Canada and Australia the reverse mortgage market is significant in size, this is generally not so in European countries. The exact picture is not clear because the UK is the only member state in which data about the scale of activity is centrally collected and published. Nevertheless, while overall equity release constitutes a very small proportion of total housing related financial products, it appears that the UK with 33000 contracts in 2007 is by far the largest market, with activity also being significant in scale in the Netherlands, Spain and Sweden.

There is a further set of countries which have established a legal framework that allows the offering of reverse mortgage contracts, but in practice they are taken in very small numbers. In part, this may arise because of an underlying cultural suspicion of systems that appear to favour personal consumption over intergenerational transfer. It may also be the case that suppliers see the products as being necessarily complex, difficult to put into place and requiring a large investment to set up.

Finally, there are some member states – including Belgium, Cyprus, Estonia, Greece, Lithuania, Malta, Portugal, Slovakia and Slovenia – that do not offer reverse mortgage products.

In which countries is there most potential for the growth of equity release products?

In comparing across countries, the growth of reverse mortgage activity appears to have been dependent on two main factors. On the one hand, activity has been higher where the development of mortgage markets has been greatest and thus where households have become most used to using financial products related to housing. On the other hand, it is higher where the need to supplement existing pension arrangements is higher.



Source: DemHow – project, 2009

This relationship, which is illustrated in the diagram, suggests something about the potential future growth of reverse mortgage activity. In very general terms, there are some countries that currently devote quite high proportions of their GDP to pensions and thus the average pensioner in those countries enjoys a relatively high income. This is roughly measured on the horizontal axis, showing the most generous pension provision in the northern and western member states. Since these same countries also have the most developed mortgage markets, those countries that have had least need for reverse mortgages to supplement pensions have the most potential to use them.

The corollary is that households in member states with the least generous pension systems – particularly the newer member states – have generally the least opportunity to take equity release products.

But, the diagram also suggests that countries that may, in the future, face the most severe fiscal pressures as their populations age, precisely because current provision is relatively generous, may be best able to expand the opportunities to take equity release products.

What will be the impact of the current economic crisis

It should not be forgotten that the development of financial products in housing markets played a key role in the economic crisis which continues to impact on economies within and without the European Union. What has been and is likely to continue to be the impact on the further development of reverse mortgages?

For households who already have a reverse mortgage apparently nothing has changed in that their reverse mortgage does not pose a risk for them. It is true that the net value of their home may have been severely reduced but this is essentially an issue for the financial institution.

The situation facing the potential takers of reverse mortgages is more complex. Reductions in house prices may mean that a reverse mortgage is less financially attractive. On the other hand, the losses in equity markets generally may have reduced the value of individual's pension pots, while fiscal pressures on European governments may lead them to reduce their spending on pensions and health and social care. Increasingly, older Europeans – perhaps particularly as the baby boomers reach their mid 70s – may be forced to draw on their own financial resources in order to maintain a reasonable standard of living.

From the point of view of suppliers, there has perhaps been a realisation of the actual level of risks involved, this being crucially dependent on the future trajectory of house prices. The immediate impact in a number of countries, notably the US but within the EU also, Hungary for example, has been a reduction in the sale of reverse mortgage products.

Finally, from the point of view of many governments, it is possible that the association of Anglo-Saxon financial systems with both reverse mortgages and the current economic crisis, may moderate any desire to encourage the developments of such products.

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