EBRI ISSUE BRIEF

EMPLOYEE BENEFIT RESEARCH INSTITUTE • 1920 N Street, NW Suite 520 Washington, DC 20036 • (202) 659-0670

September 1982 *#1:*

REVERSE ANNUITY MORTGAGES: A VIABLE SOURCE OF RETIREMENT INCOME?

As America's aged population increases, the problem of providing adequate retirement income is growing. Although many elderly households draw income from more than one source, 7.9 percent of the elderly population have total income and in-kind benefits below the official poverty level.[1/] Nearly three-quarters of all elderly persons, however, own their own homes.[2/] Private homeownership is the major asset of most elderly but it remains a largely untapped income source. Reverse annuity mortgages (RAMs) are developing as a way to generate income from home equity. Academics, mortgage industry professionals, housing specialists and private citizens continue to debate RAMs' potential as a safe and cost-effective retirement income source.

This Issue Brief discusses:

(1) the elderly's income sources and assets;

(2) the concept of reverse annuity mortgages;

(3) recent reverse annuity mortgage programs;

(4) policy considerations and options.

THE ELDERLY'S INCOME SOURCES AND ASSETS

Elderly persons receive income from several sources. Five major income sources provided an average of $12,500 per elderly household in 1979.[3/] Social Security accounted for approximately 34 percent of total income. See Table 1. Close to one-third of elderly households also received some employment earnings. The emergence of employer pensions and public assistance programs over the last three decades has also provided income for many retired persons.

1/ Employee Benefit Research Institute, Retirement Income Opportunities in an Aging America: Income Levels and Adequacy (Washington, DC, 1982), p. 53. This figure does not represent the official poverty level for the elderly. The official poverty level is based on cash income alone.

2/ See Table 3.

3/ This income figure was derived from a weighted average of the data presented in Table 1. This yields the expected average value of income from all sources, but it does not imply that all elderly receive income from all sources.

Another major source of income for many elderly is savings and wealth. Wealth can take several forms. Liquid assets such as savings accounts are the most common form, followed by life insurance and home equity. See Table 2.

TABLE 1

Income Sources for Elderly Households - 1979 1/

	Percent Receiving	Total Income from Each Source 2/ (billions)	Average Income 3/
Social Security	92%	$ 66	$4,300
Employer Pensions	34	23	4,100
Savings/Wealth	71	36	3,000
Employment Earnings	31	49	9,500
Public Assistance/ In-Kind Programs	95	43	2,200
Total	N/A	$217	N/A

Source: Employee Benefit Research Institute, Retirement Income Opportunities in an Aging America: Income Levels and Adequacy (Washington, DC, 1982), p. 3.

1/ Elderly households consist of married couples with a head age sixty-five and over and single persons age sixty-five and over.

2/ Total income provided to all elderly from each source listed. Income from employer pensions may be understated and savings/wealth overstated, since lump-sum pension distributions are not counted as pension income.

3/ Average amount from each source provided to households, which received income from the particular sources noted.

TABLE 2

Percentage of Families with Family Head Age 64 to 69 with Assets - 1975

Type of Asset	Percentage Holding	Median Value of the Asset for Those with the Asset (1979 dollars)
Liquid Assets	81%	$ 7,300
Life Insurance, Annuities	75	5,100 1/
Home Equity	69	27,000
Illiquid Assets	24	13,500
Any of Above Assets	89	33,100

Source: Joseph Friedman and Jane Sjogren, "The Assets of the Elderly As They Retire" (Cambridge, MA: Abt Associates, Inc., 1980), pp. 15, 36, 46, 49 and 66. Median value of assets in 1979 dollars estimated by ICF Incorporated.

1/ This estimate reflects the cash value rather than the face value of these policies.

Home equity, however, constitutes the largest portion of total assets. It represents as much as 70 percent of elderly married couples' total assets and 83 percent of the total assets of elderly nonmarried women.4/

Elderly Homeowners

Among all elderly households, in 1980, almost 74 percent owned the homes they lived in. See Table 3. An estimated 80 percent of these homes had no mortgages.5/ Among households that do hold mortgages, however, long-term homeownership leads to significant equity. In 1977, 80 percent of elderly homeowners had net home equity of more than $15,000, 46 percent had net equity of more than $30,000 and 15 percent had net equity greater than $50,000.6/

Many low-income elderly also have significant home equity. Of elderly homeowners with annual incomes of less than $5,000, 26 percent had net home equity greater than $30,000 in 1977. Among elderly homeowners with an annual income between $5,001 and $10,000, 43 percent had more than $30,000 in home equity. See Table 4.

THE CONCEPT OF REVERSE ANNUITY MORTGAGES

Home equity generally cannot be converted into an income stream unless the homeowner sells the house and moves. A reverse annuity mortgage is a vehicle that allows elderly homeowners to unlock home equity and convert it into an income stream, while permitting owners to continue living in their homes.

A RAM is a loan secured by property. The loan may be used to purchase an annuity or to fund property maintenance or repair. There are a number of RAM arrangements. Two major types are: (1) fixed debt; and (2) rising debt.

Fixed Debt

With a fixed debt RAM, the homeowner/borrower incurs a fixed debt at the inception of the transaction. The amount of the debt is usually a set percentage (often 70 to 80 percent of the home's value). The borrower uses the loan proceeds to buy an annuity. Loan interest is paid from the annuity income with the balance going to the homeowner. For example, a $50,000 loan at 9 percent interest may be converted to a lifetime annuity that yields $7,500 per year. Of this amount, $4,500 in interest would be paid immediately on the loan and the $3,000 balance would go to the borrower.7/ Usually after the homeowner's death, the loan principal is paid off when the home is sold.

4/ Joseph Friedman and Jane Sjogren, "The Assets of the Elderly As They Retire" (Cambridge, MA: Abt Associates, Inc., 1980), p. 43.

5/ Ibid., p. 108.

6/ Bruce Jacobs, "An Overview of the National Potential for Home Equity Conversion into Income for the Elderly" (Madison, WI: National Center for Home Equity Conversion, March 1982), p. 13.

7/ Example from Ken Scholen and Yung-Ping Chen, eds., Unlocking Home Equity for the Elderly (Cambridge, MA: Ballinger Books, 1980), p. 83.

TABLE 3

Owner-Occupied and Renter-Occupied Elderly Households - 1980 1/

	Number (thousands)	Percent
Owner Occupied	13,932	73.8%
Renter Occupied	4,947	26.2
Total Elderly Households 2/	18,879	100.0%

Source: U.S. Department of Commerce, Bureau of the Census, Annual Housing Survey: 1980, Part A - General Housing Characteristics (Washington, DC: Government Printing Office, 1982), p. 18; idem, Part C - Financial Characteristics of the Housing Inventory (Washington, DC: Government Printing Office, 1982), pp. 2, 6.

1/ Households of one or more persons aged sixty-five and over; does not include the institutionalized population (e.g., persons in nursing homes).

2/ Includes mobile homes and trailers.

TABLE 4

Distribution of Elderly Household's Net Equity
by Annual Household Income - 1977

	Household Income			
Net Home Equity	$5,000 or Less	$5,001-$10,000	$10,001-$15,000 1/	$15,001 or More
$30,000 or Less	74%	57%	44%	30%
$30,001-$50,000	20	31	37	37
$50,001 or More	6	12	18	33
Total	100%	100%	100%	100%

Source: Adapted from Bruce Jacobs, "An Overview of the National Potential for Home Equity Conversion into Income for the Elderly" (Madison, WI: National Center for Home Equity Conversion, March 1982), table 6.

1/ Does not equal 100 percent due to rounding.

Rising Debt

With a rising debt RAM, the lender periodically advances funds to the borrower. The debt increases with each advance up to a predetermined ceiling. The debt ceiling is usually specified as a percentage of the home's appraised value. Upon death of the homeowner and sale of the home, the lender recovers the debt amount accumulated. Rising debt RAMs can also be used to purchase supplemental deferred annuities. Above the debt ceiling, the annuity would pay the interest on the loan.

RECENT REVERSE ANNUITY MORTGAGE PROGRAMS

RAMs have aroused interest and have received substantial media attention. Lenders, however, have been reluctant to provide loans. Approximately 150 RAMs have been written by individual banks.[8/]

Five nonprofit organizations have been formed to provide information and advice and to aid in arranging RAM financing: (1) San Francisco (California) Development Funds RAM Program; (2) Essex County (New Jersey) Senior Cooperative; (3) the Buffalo (New York) Home Equity Living Plans; (4) the Madison (Wisconsin) Development Corporation; and (5) the Monona (Wisconsin) Senior Citzens Commission.

The San Francisco Development Funds RAM Program -- the largest program to date -- arranged twenty-two RAM loans through early 1982. On average, the property value was $210,000, the loan amount was $126,740 ($69,922 in principal and $56,818 in interest), the loan term was seven years and the monthly payment to the homeowner was approximately $785. Most homes occupied by the elderly, however, are considerably less valuable.

The primary economic benefit of a RAM is additional income for the borrower. The income generated and the borrower's cost, however, depend on several factors: (1) the age and sex of the borrower; (2) the loan term and amount; (3) the interest rate on the loan and annuity; and (4) the tax policy and income levels.

- Age and sex of the borrower -- The older the borrower is at the loan's inception, the larger the annuity amount will be since the borrower's expected lifespan is shorter. Annuity payments to women are generally smaller than the payments to men because women are expected to live longer.

- Loan term and amount -- For those with low net equity, RAMs will generate proportionately smaller monthly payments. Longer loan terms will also yield smaller payment amounts. Borrowers face an additional risk if they survive the RAM loan term and the loan ceiling is reached. If a large equity amount remains due to property appreciation or a low loan amount relative to property value, then refinancing is possible. If, however, the remaining equity is small, a forced sale of the residence may be necessary, leaving the aged borrower in a poor financial situation without housing.

8/ Sally Merrill and Stephen Mayo, "Housing and the Elderly: Research on Housing Choice and House Equity for a Microsimulation of Retirement Policy" (Paper prepared for a Brookings Institution Conference on Research in Retirement and Aging, Cambridge, MA, January 1981), p. 42.

- Interest rate on the loan and annuity -- High interest rates quickly reduce the income from a RAM. An $80,000 RAM loan, over ten years, at a 14 percent interest rate, will yield the homeowner $37,000 in cash and cost $43,000 in interest. Additionally, the larger the mortgage interest rate relative to the annuity interest rate, the smaller the borrower's net income stream.

- Tax policy and income levels -- Federal, state and local income and property tax policy may be an important factor in evaluating RAMs. The loss of deductible interest payments and the addition of taxable annuity payments may diminish the after-tax value of a RAM to elderly homeowners.

POLICY CONSIDERATIONS AND OPTIONS

RAMs allow the elderly to live at home. This increases the opportunity for self-reliance, decreases the chances of unnecessary or premature institutionalization and may provide a more pleasing lifestyle. Despite the potential benefits of RAMs, however, they do raise critical concerns. They may cause the elderly to overconsume housing relative to other needs such as health care services or normal living expenses. RAMs may also reduce mobility, and the annuity income generated from a RAM may disqualify some elderly from public assistance programs such as Supplemental Security Income. Furthermore, other new kinds of living arrangements for the elderly may free the aged from problems of home maintenance, security and personal safety.

Currently, legislative barriers prevent certain types of RAM loan transactions. The final reports of both the 1981 White House Conference on Aging and the 1982 President's Commission on Housing recommended: (1) encouragement of home equity conversion plans by federal agencies; and (2) investigation of the potential for federal mortgage insurance and secondary-market investment in RAMs. In July 1982, Federal Housing Commissioner Philip Abrams, speaking before the Senate Special Committee on Aging, stated that appropriate statutory authority might allow the Department of Housing and Urban Development to encourage RAM utilization by making Federal Housing Administration (FHA) insurance available for RAM loans.

In addition to raising policy concerns, RAMs may also provoke regulatory problems. Because they affect a particularly vulnerable segment of the population, RAM loans carry heightened potential for consumer fraud. Carefully designed consumer protection standards would be needed.

If RAMs are to be a useful equity conversion vehicle, then the problem of lender risk must also be addressed. Since lenders would often be making loans on older housing that appreciates at a lower rate than new housing (or may even depreciate, depending on the location), they may find RAM loans attractive only at high interest rates or with federal or other loan guarantees. Since high interest rates would diminish the advantage of RAMs to borrowers, government subsidies for these loans have been suggested as a means of encouraging lenders to assume this risk. Mortgage interest subsidies would reduce the spread between mortgage and annuity interest rates (rate of return on the annuity), thereby increasing net income to the borrower. A recent trend toward reducing interest subsidies in other government loan programs, however, makes this development unlikely -- particularly if subsidies are provided to persons with relatively large asset holdings.

Other Home Equity Conversion Programs

Other home equity conversion programs exist that may be more appealing to policymakers. For example, a split equity plan allows the homeowner to sell equity in the house to an investor and purchase an annuity. The seller is permitted to reside in the house until his or her death, at which time the entire property value reverts to the investor. Sale and lease-back plans are another form of home equity conversion that allow lifetime residence at home. Although simple in concept, these plans require complex legal arrangements that result in complicated plan designs. Moreover, the tax treatment of sale and lease-back plans is unclear. For these and other reasons, split equity and sale and lease-back plans are not widely used, but research on their potential continues.

The most basic form of home equity conversion -- sale of the home -- remains the most widely used method of unlocking equity. Federal tax policies encourage this method by allowing a one-time exemption from capital gains tax on the income received from the sale of a house if the seller is age fifty-five or older. Because of this favorable tax treatment, sale of the home provides the greatest amount of income to the elderly homeowner.

CONCLUSION

Although RAMs have aroused interest, they are used infrequently. They present a number of complex problems for borrowers, lenders and regulators. The potential for RAM loans depends upon long-term mortgage interest rate levels, adequate consumer safeguards and government policy. Using RAMs to provide additional income for elderly homeowners may be beneficial for some persons. This determination, however, must be made on an individual basis.

For those interested in further information on reverse annuity mortgages contact: The National Center for Home Equity Conversion, 110 East Main, Room 1010, Madison, WI 53703 (608) 256-2111.

The Employee Benefit Research Institute's Education and Research Fund (EBRI) was established to contribute to the expansion of knowledge in the employee benefit field. The Education and Research Fund is tax exempt under section 501(c) (3) of the Internal Revenue Code and is not a private foundation. Individuals, corporations, companies, associations and foundations are eligible to support EBRI's work through tax-deductible contributions.

EBRI's policy forums, research studies, issue briefs, pamphlets and other publications aid public and private sector decision makers, managers, the press and the general public in formulating and articulating positions on employee benefit issues. As health and retirement issues receive increasing attention, EBRI strives to make effective and responsible contributions to public policy.

RETURN TO: EBRI, 1920 N Street, NW/Suite 520/Washington, DC 20036 (202) 659-0670

EBRI NOTES, a bimonthly newsletter, includes information about: 1) newly released employee benefit statistics, 2) brief summaries of EBRI's ongoing research studies and forum discussions; and 3) reviews of outside research and publications.

ISSUE BRIEFS, published monthly, offer summary information and critical analysis of evolving employee benefit issues and trends.

EBRI's sponsors automatically receive an annual subscription to *EBRI Notes/Issue Briefs*. Others can subscribe to these publications for $100 annually.

I would like information on becoming an EBRI sponsor.

I would like to subscribe to *EBRI Notes/Issue Briefs*. My check for $100 is enclosed.

NAME **TITLE** **TELEPHONE**

STREET ADDRESS **CITY** **STATE** **ZIP CODE**

ORGANIZATION **TYPE OF ORGANIZATION** **AREA OF INTEREST**

EBRI

EMPLOYEE BENEFIT RESEARCH INSTITUTE
EDUCATION AND RESEARCH FUND
1920 N Street NW/Suite 520/Washington, DC 20036

Address Correction Requested
Return Postage Guaranteed

Nonprofit Organization
U.S. Postage
PAID
Washington, DC
Permit No. 3968