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Reverse mortgages: What homeowners (don't) know and how it matters

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ABSTRACT

Reverse mortgages allow elderly homeowners to unlock and consume home equity without leaving their homes. Relative to the number of elderly homeowners with limited financial resources, the take-up rates of reverse mortgages are low. To understand the low take-up rates we first survey U.S. homeowners aged 58 and older assessing their knowledge (literacy) about the most popular reverse mortgage product, the Home Equity Conversion Mortgage (HECM). Next, we study the relationship between knowledge and the intention to use a HECM. Awareness of reverse mortgages is high, but knowledge of contract terms is limited. More knowledgeable homeowners and those with peers who have a reverse mortgage express greater intention to use such a product. Respondents who would benefit most from reverse mortgages (those with low incomes and limited savings) express greater intention to use reverse mortgages, but lack knowledge of the contract terms. Our findings suggest that take-up rates might be increased through improving knowledge about contract terms or changing the product's design to make it easier to understand in the first place.

1. Introduction

Reverse mortgage demand is low despite the substantial consumption smoothing benefits they can provide to cash-poor elderly homeowners (Davidoff, 2015). Mounting evidence suggests that the elderly may find reverse mortgages difficult to understand and for that reason shy away from using them. In his 2016 Ely Lecture delivered at the annual meeting of the American Economic Association John Y. Campbell specifically highlighted reverse mortgages as one of three examples (the others are retirement asset allocation and consumer credit) of markets that are prone to households making suboptimal financial decisions because of, for example, lack of financial literacy and a poor understanding of product terms (Campbell, 2016). We use a survey to determine and assess elderly homeowners' knowledge about the dominant U.S. reverse mortgage product, the Home Equity Conversion Mortgage (HECM), and how this knowledge relates to homeowners' intention to use the product. We find that general awareness of HECMs among U.S. elderly homeowners is high. However, product knowledge (product-specific literacy) is fairly low and lack of knowledge relates to low intention to use reverse mortgages. Strikingly, homeowners with limited financial resources who would benefit the most from reverse mortgages lack product

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knowledge as well. Knowing others with a reverse mortgage is a strong predictor of the intention to use reverse mortgages. Offering survey participants the opportunity to read a short text explaining product features was not found to be a successful intervention to increase the intention to use the product.

Reverse mortgages enable homeowners to liquidate and consume home equity without relocating. Most retired households own a home and home equity is a large fraction of wealth for those households. According to the 2013 Survey of Consumer Finances, 87% of U.S. households aged 65+ own a home (the 2016 U.S. census figure is 79%), and the value of the primary residence represents 56% of total assets at the median. Housing assets provide a valuable stream of services to their owners, but adjustment of these services and partial liquidation of those assets is difficult and costly. Millions of American retirees may be classified as "house rich and cash poor" and so seem likely to benefit from reverse mortgages (Mayer and Simons, 1994a, 1994b; Rasmussen et al., 1995).[1] With 582,000 HECM reverse mortgages outstanding in 2012 (the most popular reverse mortgages type with 90% market share) (Shan, 2011; CFPB, 2012), actual demand is substantially behind predictions.

According to life-cycle saving and consumption theory, reverse mortgages increase a household's utility if they reduce liquidity constraints (allowing smoothing consumption over the life-cycle) and bequest motives are weak (Artle and Varaiya, 1978; Davidoff, 2009, 2010a, 2010b; Nakajima and Telyukova, 2013; Cocco and Lopes, 2014; Hanewald et al., 2016; Yogo, 2016). Moreover, reverse mortgages allow the household members to continue residing in their own house and to consume homeownership-specific utility, for example, derived from the opportunity to "age in place" (Davidoff, 2010c).

Apart from potentially high costs (e.g., Lucas, 2015), the empirical literature hints at several factors including financial literacy and limited product knowledge as potential explanations for the low demand for reverse mortgages. Dillingh et al. (2013) find evidence that bequest motives are related to low demand in household survey data from the Netherlands. Based on Italian household survey data, Fornero et al. (2016) find that high financial literacy is related to lower interest in reverse mortgages as more literate households might be better prepared for retirement. In both the Dutch and the Italian market, however, reverse mortgages are virtually unavailable and the general public has little awareness of the product. Duca and Kumar (2014) find in U.S. household survey data that more financially literate households use fewer home equity lines of credit (HELOC). Davidoff (2015) and Davidoff and Wetzel (2014) find that HECM borrowers do not recognize the significant value of the put option on the borrowers home embedded in HECMs protecting the borrower from home price risk.[2] Based on 31 qualitative interviews in Massachusetts (U.S.), Leviton (2002) conjectures that a reason for low reverse mortgage demand is homeowners' fear of losing their home, because of the their misconceptions and lack of understanding. Anecdotal evidence from the U.S. (CFPB, 2012, 2015; Stark et al., 2014) and survey evidence from Australia (Reed, 2009) suggest that the product's features may be misunderstood by the elderly with potentially negative implications for demand. In addition, a particular feature of the HECM market in the U.S. is that the product is primarily marketed through television and media advertising. Distribution of the product is primarily accomplished through call-centers or brokers, not through banks and community financial institutions (Lucas, 2015). In that sense, it is a unique market where information about the product may not be well diffused. Even the acquisition and interpretation of information about the product may pose a challenge to the elderly. As reverse mortgages are targeted to the elderly, age-related cognitive decline may impair their ability to make appropriate financial decisions (e.g., Li et al., 2013, 2015). The fact that consumers are required to attend a counselling session before entering into a HECM contract (see Section 2), indicates that the government views targeted consumers as having insufficient knowledge.

In general, it is difficult to identify the role of product knowledge in reverse mortgage demand, as large household surveys like the Survey of Consumer Finances (SCF) or Health and Retirement Study (HRS) do not contain information on reverse mortgage holdings. Reverse mortgage origination data is available from the U.S. Department of Housing and Urban Development (HUD). Shan (2011) matches this data with ZIP code level demographic data and county home price growth, and studies ZIP code characteristics correlated with reverse mortgage originations. Moulton et al. (2014) compare the demographic characteristics of households in the HRS with households attending a reverse mortgage counselling session, and those that took a reverse mortgage after attending counselling. These studies find that reverse mortgage take-up rates are higher among households with low income, high home values, and high payments for conventional mortgage debt. Due to the nature of the data used in both studies, however, the focus is on demographic variables rather than an assessment of knowledge about reverse mortgages in the respective overall target group.

Our research contributes to the literature on retirement finance in two ways. First, we assess the knowledge of U.S. elderly homeowners about reverse mortgages. That is, we provide a snapshot of the current knowledge and perceptions of reverse mortgages based on a survey among eligible homeowners. Second, we study how product knowledge and general financial literacy relate to the intention to use reverse mortgages. In doing so, we disentangle general and product-specific literacy. We build on earlier works that study literacy and knowledge for complex financial decisions and products, like debt literacy

[1] Home equity lines of credit (HELOCs) or conventional mortgages are alternatives to reverse mortgages and allow homeowners to tap into their home equity. However, those homeowners who might especially benefit from reverse mortgages (low savings, low income) often do not pass the required payment to income tests. For reverse mortgages these tests are of lesser importance (see Section 2).

[2] HECMs include a no-negative equity guarantee for the borrower (see Section 2). That is, the borrower is not liable for the part of the loan amount that might exceed the home value when the loan is paid back. Thus, in essence, the borrower owns a put option for selling the home (underlying) to the lender with the loan amount as the strike price.