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Defining the Decade of Healthy Aging

Unlocking housing wealth to foster the silver economy

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Many elderly households could improve their living standards markedly by releasing part of their housing equity. However, that would also equity require competitively priced insurance policies such as annuities and long-term care insurance. Governments should make it easier to complement social insurance with private insurance.

In many countries, most middle-class households have most of their wealth tied up in their home. For many retired households, the value of net housing wealth is substantial relative to pension income. Those households could potentially increase their standard of living markedly by releasing part of their housing equity and using it to complement their pension income and social services.

The simplest way to release housing equity is to sell the current house and buy a smaller or otherwise cheaper house or move to a rental house. Alternatively, one may take a reverse mortgage against the current house. Releasing housing equity in old age would benefit also the rest of the society by increasing consumption tax revenues, by allowing elderly people to buy services that help them living in their own homes, and by freeing family homes to young households.

Using housing equity to finance consumption in old age appears to be relatively rare, however. At least in the European context, people seldom move to smaller houses after children have left home and reverse mortgages are not very common.

To some extent, this is likely to reflect households' own preferences regarding housing and bequests. In what follows I argue, however, that it probably also reflects lack of competitively priced insurance products that elderly people would benefit from, as well as suboptimal government policies related to taxation and social insurance. As a result, the potential to increase old-age welfare by releasing housing equity remains underused. I also briefly discuss measures to improve the situation.

Lifetime uncertainty and health risks may hold back releasing housing equity

Elderly households may be reluctant to release housing equity because of risks they face. For one thing, an elderly person who has released part of her housing equity and has extra money on her bank account needs to consider uncertainty about her lifespan. There is almost always a chance that she will live exceptionally long. To make sure she will not run out of savings by, say, the age of 100, she can run down her savings only very slowly. Because of this, releasing housing equity may not seem that appealing after all.

Another major risk that elderly people face is that they may need long-term care. While most individuals don't need it at all, some need it for several years. The out of pocket cost for private institutional long-term care can be very high. An individual that needs or wants to make sure that she can always finance institutional long-term care if need be, may rationally consider her housing wealth as a buffer that will be drawn down only to finance institutional long-term care.

In principle at least, financial markets should be able to help people to cope with these risks. Instead of slowly running down their savings, individuals could purchase a life annuity that provides a steady income flow until death. If the price of the annuity is not too high, the annuity allows for increased consumption by guaranteeing that individuals who happen to live very long do not run out of savings. Similarly, competitively priced long-term care insurance should be a good option to cover the relatively small risk of needing long-term care for an extended period.

In other words, availability of insurance products, at competitive prices, could greatly increase the scope for improving old-age welfare by releasing housing equity.

Markets for annuities and long-term care insurance underdeveloped

Unfortunately, in many countries, the market for this type of insurance policies is poorly developed. While private pension schemes are often available, they tend to be designed for long-term saving. A household that considers releasing housing equity would rather need a single-premium annuity that can be bought with a single payment.

In some countries, the situation could be improved by reforming the taxation and regulation of life annuities. For instance, banning gender-based pricing in the EU is problematic as it can make annuities expensive for men who tend to have a shorter lifespan than women. Moreover, while long-term pension saving often enjoys a tax-favoured status relative to many other forms of saving, the taxation of single-premium annuities may be much less favourable.

Private insurance should complement, rather than substitute social insurance

Also, converting housing wealth into an income flow via an annuity may not be appealing if the annuity pay-outs (but not housing wealth) are effectively taxed via higher user fees for e.g. publicly provided old-age care or reduced transfers.

As for private long-term care insurance, one problem is that it may be difficult to complement tax-financed institutional long-term care with private insurance. Long-term care insurance may become very costly if it is supposed to fully substitute for tax-financed care. More generally, it should be possible to complement, or "top up", social insurance with private insurance. The conditions for receiving publicly provided long-term care may also not be well-defined.

Complementing tax-financed care with private insurance requires that the public welfare promise is made as clear as possible and that citizens eligible for publicly provided long-term care may choose to have a voucher instead. They could then use the voucher together with the insurance to purchase privately provided long-term care.

A different type of deterrent for releasing housing equity is real estate transfer taxes. These taxes, which in some OECD countries are close to 10 % of the transaction price, can take up a non-trivial part of the savings from moving to smaller home. Moving away from transaction taxes toward property taxes would make downsizing more appealing.

It is also about financial literacy

Finally, one reason why people do not want to release housing equity may be that they feel unable to assess and compare available private annuities or long-term care insurance products. A government might be able to improve the situation also by investing in financial literacy, by requiring insurers to provide standardised information, and by providing comparison tools for consumers.

This note is part of an ongoing research project by the Research Institute of the Finnish Economy (ETLA) on old-age welfare and private insurance in Finland

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