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Reverse Mortgages: Challenging the Trade-off between Financial and Real Assets

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ABSTRACT

The aim of this paper is to question whether it still makes sense to feel attracted by the trade-off between financial and real assets, based upon the main features of reverse mortgages. Towards this ambitious goal, useful insights can be gained by exploring Italy's recent legislation regarding these loans: on one hand, new opportunities to borrow have been made available, that are secured by home equity and that represent strategic options for financial management purposes, despite some criticism and limited adoption so far; on the other hand, homeowners are encouraged to reconsider their residential property as a way not only to satisfy their housing needs but also to achieve higher standards of living, especially after retirement. Within this framework, the trend towards increasing globalization has made traditional keys of classification obsolete; therefore, total wealth management should be focused on, rather than paying as much attention as in the past to portfolios consisting of securities alone. Conclusions sound like an invitation to devote unprecedented energies to financial counseling and education, in order to increase individual investors' awareness and help them to make more informed decisions about their asset allocation, particularly in the later stages of their life cycle.

Keywords: Consumer financial protection; housing equity; prestito vitalizio ipotecario; reverse mortgages; wealth management.

1. INTRODUCTION

This paper takes inspiration from Italy's legislation on reverse mortgage loans that has been recently amended in order to speed up and widen the recourse to the so-called *prestito vitalizio ipotecario*; it has been forged by defining basic duties and rights, in an attempt at coping with disruptive developments, such as those that refer to the combination of an aging population and low birth rates. While this mix seems detrimental to the sustainability of today's pension schemes in many countries, these loans may be usefully resorted to as lifetime income planning tools.

Focusing on types of reverse mortgages that have been made available by major banks, it comes natural to reconsider the trade-off between financial and real assets: Such a clear-cut distinction has been historically accepted as one of the pillars that portfolio management is built upon; however, doubts may be expressed by acknowledging how many financial products have been successfully structured over time, that are backed by real assets, such as housing equity. They include – but are not limited to – reverse mortgages.

Based on these thoughts, this study draws upon the technicalities of the loans at issue, that have gained momentum in the last few years, not only in Italy: To make its framework appealing, rules have been introduced in 2015 that are likely to encourage homeowners to look at their residential property as a way not only to satisfy their housing needs but also to achieve higher standards of living, particularly after retirement; therefore, it sounds appropriate to start surveying the concepts of both financial and real assets, and to proceed by scrutinizing the features of reverse mortgages, with special emphasis on how they have been designed by Italy's legislator. Finally, the analysis is aimed

at shedding light on policy implications, such as those that deal with consumer protection, total wealth management and financial education.

2. FINANCIAL VERSUS REAL ASSETS

For decades, portfolio management theories have taken the trade-off between financial and real assets for granted, with the latter being considered less liquid and fungible than the former. By tradition, financial assets are identified with intangible investments that range from common and preferred stock to options and warrants, from money market certificates to savings accounts, from Treasury bills to commercial paper, from bonds to financial futures, with cash spearheading the list; by contrast, real assets are essentially physical items, such as real estate, though intangible assets such as intellectual property can be found in the same broad category and its most prominent role is linked to residential mortgage lending by banks.

It was during the subprime global crisis that the fallacies of this trade-off started to surface dramatically: not only the negative performance of real estate markets in the industrial world affected the financial side of the coin, but the economic downturn and the persistent recession that followed severely impacted the wealth of millions of people; financial distress has been particularly felt by 65+ Europeans, who also suffered from falling interest rates and consequently declining yields on bond issues, not to mention the losses borne by stockholders. To make things worse, this crisis added to the negative impact of an aging population in combination with low birth rates, thus inducing to pay unprecedented attention to prudent management of people's retirement savings.

Not surprisingly, some sort of overlapping between real estate and financial markets has been noticeable since when mutual funds started to specialize beyond the boundaries of securities markets: a case in point has to do with real estate funds, that have evolved into specific market segments, such as Real Estate Investment Trusts. Meanwhile, the success that catastrophe bonds experienced after Hurricane Katrina in New Orleans, Louisiana has contributed to unveil how significantly the financial sphere of the economy may support the real one when it comes to redevelop an impacted area in a post-disaster context.

3. FOCUS ON REVERSE MORTGAGES

A closer look at reverse mortgages reveals that these loans look like the opposite of conventional mortgages: borrowers do not access funds to purchase a home but homeowners are allowed to borrow money against the equity in their homes; potential beneficiaries are old people who are willing to keep using their home as their primary residence and these lines of credit are secured by their home equity. As such, these loans may alleviate poverty that affects many homeowners in the later stages of their life cycle and hence can satisfy the widely felt need to improve social – as well as financial – inclusion.

Reverse mortgages have been reportedly introduced by Deering Savings & Loan Association in Portland, Maine in 1961 to help "a recent widow struggling to make ends meet" [1]. As the underlying idea began to take shape, an intensive process of differentiation has involved the market segment under investigation: several options are now available, that feature different payment plans [2], with choices to be carefully made on a case-by-case basis.

If the full range of these loans is taken into account, what seems most attractive is the arrangement whereby no payments should be made to lenders as long as borrowers continue to live in their residential property: it is the property itself that each reverse mortgage is secured by that entitles the homeowner who enters into such an agreement to get money without directly assuming any obligation to pay it back. Therefore, reverse mortgages can be assigned an unquestionable place in the toolkit to be used in financial planning, which makes the trade-off between financial and real assets less persuading.

4. SOME PROS AND CONS

Lessons learned (especially in the US) lead to emphasize the pros – without underestimating the cons – and success stories may justify a more massive adoption of these loans, as long as borrowers are aware of all clauses of the contracts to be signed and have the capability to compare them with other options available. Anyway, attempts have been made at explaining why – right or wrong – many households do not like reverse mortgages: as far as the Italian market, potential beneficiaries have been mainly identified with women, elderly and "house rich-cash poor" individuals who often lack adequate financial literacy to express a genuine interest in this financial product; yet, it is likely to help meet global challenges as a lifetime income planning resource and can be even resorted to within an estate planning framework.

Unfortunately, this type of loans "is perceived not so much as an ordinary instrument to achieve a better standard of living, but rather as a remedy against poor consumption" [3]. However, higher interest can be predicted based upon risk aversion and negative expectations on aging well: for example, fears about not being able to maintain an acceptable standard of living after retiring may act as a stimulus to make recourse to a reverse mortgage, as an alternative to housing wealth decumulation; as a matter of fact, asset depletion in the last part of one's life cycle may turn into "inefficient dissaving" [4].

Along this pathway, full credit must be given to "the need for understanding how to effectively reach and include all financial consumers", which can be considered of "practical relevance not only for policy makers and financial sector supervisors and regulators, but also for the financial industry" [5]. This is especially true for reverse mortgages, due to the importance given by policymakers to help investors make adequate decisions and to propose home equity release products for consumption smoothing: no wonder that their limited set is endorsed as one of the reasons why older Italians (and Europeans, in general terms) have to cope with financial hardship; at the same time, challenging issues have emerged from the overwhelming technicalities of these products and their high implied costs (for the borrowers and/or their heirs), including a non-refundable application fee that some lenders charge (for instance, in the US).

5. THE SO-CALLED *PRESTITO VITALIZIO IPOTECARIO*

In Italy, reverse mortgages may count on a set of rules that spell out basic rights and duties, though they could not be fully understood by most of potential beneficiaries without professional – and hopefully independent – advice. Law n. 44 regulating the above mentioned *prestito vitalizio ipotecario* was enacted on April 2, 2015 in order to amend and better define the legal framework that started to be generated by Law n. 248 of December 2, 2005 and that had been characterized by discouraging foggy areas for about a decade; operating rules were introduced by decree n. 226 of December 22, 2015, which was openly intended to promote a wider recourse to these loans, based on proposals by the Italian Banking Association and consumer associations.

Furthermore, frequently asked questions – together with pertaining answers – have been made available online by the Ministry of Economic Development since October 4, 2016 in order to minimize any information gap. The web too is a source of interesting ideas and a priceless contribution to disseminate them is provided by dedicated websites: needless to say, channeling most relevant information to the target market is a tough – though rewarding – task, which is worth undertaking without underscoring investor protection policies, as well as financial inclusion, literacy and counseling.

It is still too early to predict whether reverse mortgages may become well-established in Italy, though the positive results achieved somewhere else encourage to feel optimistic. They do not only give satisfaction for international interest, in line with the more and more widely accepted *glocal* approach, but also sound like an invitation to replicate them, as shown by the launch of several reverse mortgage products by Italy's major banks: "Prestito Ipotecario Vitalizio", "PatrimonioCasa", "PerTe Prestito Vitalizio", "Prestisenior" and "Valore Casa", offered by Banca Popolare di Sondrio, Deutsche Bank S.p.A., Intesa Sanpaolo S.p.A., Monte dei Paschi di Siena S.p.A. and UniCredit S.p.A. respectively.

6. BASIC RIGHTS AND DUTIES

In a few, simple words, Law 44/2015 describes a reverse mortgage as a home equity release product that allows 60+ homeowners to rely on their housing equity in order to be granted a medium- or long-term loan by banks or other types of financial institutions: these loans are secured by the property itself and cash may be provided to homeowners till when they pass away, so that they are enabled to consume (part of) their housing equity without modifying their housing arrangements. However, interests and expenses are accounted for every year and should be paid to the lender no later than one year after the borrower dies, together with the amount of the loan.

Should this obligation remain unfulfilled, the underlying property can be sold at its market value, after having it professionally assessed, and what eventually remains after satisfying the lender's rights is transferred to the borrower's heirs. Therefore, they are enabled to choose among three options: a) disbursing personal funds in order to pay the full amount due to the lender right after the borrower's death and consequently inheriting the real asset that the reverse mortgage was based on; b) making recourse to a loan which may

be possibly granted by the same lender in order to get the money to do so, if cash is not available either in part or totally; c) leaving the property with the lender, if its rights cannot be satisfied and not even borrowing the money needed is a viable alternative.

Whatever choice is made, heirs cannot be asked for any extra payment, in case the sale price of this property falls below the lender's credit and are conversely entitled to receive what is left after the amount due is paid off. Similar rules apply in case the borrower decides to sell the home that a mortgage loan is secured by or anyhow acts as to significantly reduce the value of this property; different arrangements may be eventually decided upon by the parties at the time of making a reverse mortgage commitment and the borrower may be even allowed to opt for a gradual payment of interest and expenses before – and till – her/his death.

7. POLICY IMPLICATIONS

All in all, a reverse mortgage is not the answer to everybody but an alternative to a home equity loan or to the sale of housing equity. The amount that can be borrowed depends on several factors, such as: a) the age of the homeowner, with the minimum being reduced to 60 from 65 years by Law 44/2015 and resulting in less than requested in other countries; b) the market value of the home to be adopted as the underlying asset, which can be hardly assessed in objective terms and may influence the timing of making a reverse mortgage agreement in line with the trends in the local real estate market; c) the applicable interest rate, that – if not fixed – may be subject to a cap, according to Italy's legislation; and d) customized rules that may be eventually agreed upon concerning a gradual repayment by the borrower.

To better satisfy their needs, homeowners should fully grasp the technicalities of reverse mortgages, that are expected to undergo a more and more sophisticated product design, while financial institutions may be assumed to gradually exploit the potential of these loans even by securitizing them as any other type of loans. Not unexpectedly, it is strongly recommended that independent advice is sought for before entering into a reverse mortgage agreement: this is why counseling agencies have been developed in the US to the benefit of potential users, who can also rely on dedicated services, such as those provided by the National Consumer Law Center [6].

Therefore, policy issues to be addressed beyond borders include the need for improved financial literacy, which stands as a life skill for the 21st century. As far as potential beneficiaries, the targets for reverse mortgages have become wider and even a segment of rich retirees has been reached in the last few years: as a matter of fact, "strategically combining" these products "and investment portfolios can significantly boost sustainable retirement income", which may attract not only under-funded homeowners but also those who enter retirement well-funded [7].

8. CONCLUSION

To conclude, investing in financial education may contribute to increase interest in reverse mortgages. However, skepticism is fueled by the finding that households with greater wealth but relatively little income flows could achieve more consistent welfare gains; these perspective borrowers are supposed to be better financially educated than old and poor homeowners, who represent typical users.
Actually, it is a matter not only of promoting financial literacy centered around reverse mortgages but also of avoiding confusing, incomplete and inaccurate statements regarding these instruments: financially vulnerable homeowners may have misconceptions about relevant terms and conditions, with heightened concern raised because of the age of potential users: at least, they should be advised to proceed with caution. While these loans can help people to meet their financial needs in the later stages of their life, their retirement security might be jeopardized if reverse mortgages are not resorted to carefully.

To this end, qualified reverse mortgage counselors should play a key role: most homeowners need to be assisted in considering these loans within the framework of their overall investment strategy, since the distinction between real and financial assets has been broken down in practice by evolving allocation philosophies and product structures. The limitations of asset class driven portfolio construction that became apparent during the global financial crisis have led to define the concept of wealth management in broader terms, which acts as a reinforcement to challenge the trade-off between financial and real assets.

COMPETING INTERESTS

Author has declared that no competing interests exist.

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She is a full professor in Financial Markets and Institutions at the University of L'Aquila, Department of Industrial and Information Engineering and of Economics, Economy Area, Italy, where she also teaches Bank Management; has served there as the scientific coordinator of the cooperative agreement with S. Seifullin Kazakh Agro-Technical University in Astana (now Nur-Sultan), Kazakhstan (2013-2018), Vice-Dean (2008-2012) and Head of Department (1999-2000); had been previously appointed as an associate professor at the University of Lecce, Italy (1992-1994) and as a research fellow at the University of Cassino (FR), Italy (1988-1992); has published many books and articles focused on financial issues, particularly on innovative topics in banking and evolutionary trends in the global financial system, since 1988, in Italy and abroad; has been involved in academic activities – including exchange programs and international projects – in several countries (Albania, China, Finland, Greece, Kazakhstan, Hungary, India, Macedonia, Morocco, Spain and USA); graduated in 1980 as "Dottore" in Economics and Commerce at the University of Rome, now "La Sapienza", Italy, where she passed the qualifying examination as "Dottore Commercialista" (chartered accountant, 1986); in the meantime, studies had been undertaken in Spain, Denmark and Hungary (1980-1981), as well as in the United States, leading to her 2-yr MBA from Lehigh University (Bethlehem, PA - USA, 1983); operating roles were played by her in the insurance and banking industries at the headquarters of primary institutions in Rome, Italy (1984-1988).

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