On the Design of Reverse Mortgages

Core Issues of Structure, Marketing, Funding and Valuation

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Abstract

There is a serious global challenge in funding retirement. The sources of potential non-sustainability of the current retirement systems are several: Shifting demographic distribution in the USA, Europe, Asia and parts of Latin America have populations aging rapidly; increasing longevity in which people of all ages are expected to live longer; as economies shift from rural agriculture to industrial city; legacy of large unfunded liabilities from defined –benefit and pay-as-you-go pension plans caused by long-time overly optimistic return-earning assumption and inadequate contributions; contribution and balance sheet and contribution risks that are simply too big for plan sponsors to accept.

There are only four ways to improve the chances for achieving a good retirement:
- Save more for retirement and lower lifetime consumption level
- Work longer before retiring
- Take more risk and be prepared for the consequences if the risk is realized
- Improve the income benefits from the assets that are already available from saving for retirement

My talk explores one such approach that has the potential to significantly improve the income benefits from existing assets in many countries, both developed and developing: the reverse mortgage. Although the reverse mortgage has an essential role for funding retirement, it has not yet become a systematic component of everyone’s retirement planning. There are of course a variety of explanations for this. However, the focus here is on the design structure and what it will take to be effective on a scale to become a systematic part of retirement financing. The elements explored are the marketing of the product; providing large and reliable funding sources for it; regulatory coordination needed and its valuation and risk assessments.

The analysis provides an illustrative case for applying the tools of modern finance to help solve a major financial economic challenge