PLANNING FOR RETIREMENT: THE IMPLICATIONS OF CARRYING HIGHER HOUSING DEBT INTO RETIREMENT

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Introduction

The financial profile of the typical American household entering its retirement years today is quite different than in generations past. In earlier generations, retiring employees were often eligible for employer-sponsored financial benefits, such as the guaranteed lifetime income provided by traditional pensions and retiree healthcare coverage. Households also typically drew two Social Security benefits in retirement—often a worker benefit and a spousal benefit based on the breadwinner's work record.[1] Most Americans sought to have their mortgage paid off by the time they retired, and households did not have easy access to refinancing options, home equity loans, lines of credit, or reverse mortgages.

Today, Americans bear a much greater financial burden. While some retiring workers still benefit from the income provided by a defined benefit pension plan, most employees are largely responsible for saving for their own retirement through defined contribution plans (e.g., 401(k)s) and other retirement savings vehicles. Retiree healthcare benefits are increasingly rare in the private sector, requiring households to fund their own healthcare costs in retirement beyond what is covered by Medicare. As households increasingly rely on dual incomes, Social Security benefits stand to replace less of the households' earnings in retirement. Due to a greater access to credit, individuals are borrowing more over a lifetime, rather than just in early adulthood, in the form of student loans, credit cards, mortgages, home equity loans, home equity lines of credit, and reverse mortgages. As a result, American households are now carrying greater amounts of debt into retirement.[2] This phenomenon is especially true for housing debt.

The latest National Retirement Risk Index (NRRI) research, which is produced by The Center for Retirement Research (CRR) at Boston College, examines the impact on retirement readiness of households' increasing propensity to carry housing debt into retirement.

Increasing Debt Levels at Older Ages

Housing debt (i.e., mortgage debt, home equity loans, and home equity lines of credit) has increased substantially over the last couple of decades. The celebration of burning a mortgage when a home is paid off has become much less prevalent in recent years. While part of the increase in debt may be attributable to the extraction of more home equity during the housing bubble, this trend began even earlier, and has continued through the housing recovery that has occurred in much of the country.

Interestingly, the increase in housing debt is not limited to young adults. In fact, over the last 25 years, Americans nearing, or in, retirement experienced an increase in housing debt that far outpaced the increase in housing values over the same period. For those ages 65 to 74, the median value of primary residences increased 76 percent in constant dollars from 1989 to 2013, while the increase in the median level of housing debt was five times as great, at 393 percent. For those ages 75 and older, it increased sevenfold. See Figure 1.

Chart View   Table View

Figure 1

Increase in Housing Values and Housing Debt 1989–2013

Age 65 to 74	Age 75 and older
The median value of primary residences increased 76 percent in constant dollars from 1989 to 2013, while the increase in the median level of housing debt was five times as great, at 393 percent	The median value of primary residences increased 46 percent in constant dollars from 1989 to 2013, while the increase in the median level of housing debt was seven times as great, at 329 percent

Source: 2013 Survey of Consumer Finance. Values are in 2013 dollars.

Easier access to credit, low interest rates, and increased refinancing activity have each contributed to the rise in housing debt. Notably, cash-out refinancing, in which borrowers extract equity from their home by increasing their mortgage loan in exchange for cash as part of the refinancing, has become very popular, with close to half of all borrowers who refinanced between 1985 and 2010 increasing their loan balance by at least five percent.[3] In addition, higher college education costs may have also contributed to the growth in housing debt, as parents became able to leverage their home equity to fund these costs. In addition to economic factors, a more significant hypothesis is that Americans have simply developed an increased comfort level with holding debt.

The Risks of Holding Higher Debt Levels

Borrowing can be a helpful financial strategy for families at many stages of their lives, as it can provide upfront funding of a big purchase such as a house, a car, or an education. However, as Americans approach and enter their retirement years, the negative consequences associated with holding debt may begin to outweigh the benefits. Higher debt levels often result in higher monthly payments and/or payments being made for longer periods of time. As a result, households will need to save more to provide for these debt payments in retirement. This, in turn, may also make it more challenging to save an adequate amount in a 401(k) plan or other retirement savings vehicle.

These consequences become even more dire when one spouse passes away, leaving a higher housing debt burden for the surviving spouse. Although the surviving spouse could be male or female, this is often a women's issue, as women not only have a longer life expectancy than men, but typically marry someone older. Women have a life expectancy that is 4.6 years longer than men,[4] and in nearly half of American heterosexual marriages, the husband is two or more years older than the wife.[5]

When a spouse dies, the mortgage payment on housing debt does not decrease, but household income does. As will be discussed in the next section, this loss of income at the death of the first spouse is often substantial, and even more significant today than it was for prior generations.

Utilizing Life Insurance to Erase Debt

In the past many financial experts have recommended that the need for a family to carry life insurance usually goes away once a couple retires, since lost earnings from work no longer need to be replaced if a spouse dies. In reality, however, other sources of income may still need to be replaced if there is outstanding debt that needs to be repaid.

During an individual's working years, debt repayments are typically generated from wage earnings. In retirement, however, income is generated from Social Security retirement benefits, and, if applicable, a pension, and savings. When this retirement income ceases, or is reduced as a result of the death of a spouse, there is less income available to retire outstanding debt. The debt lives on, but income drops.

Household income from Social Security and pensions, in particular, is likely to drop significantly—perhaps by as much as 50 percent or more—when a spouse dies. Let's first consider Social Security. For those currently approaching retirement age, and those who will retire in the future, it is much more likely that both spouses worked and earned comparable salaries than in previous generations. Therefore, it is more likely that both spouses have a Social Security worker benefit based on their own earnings. When one spouse dies, the lower of the two benefits drops off, resulting in a more considerable drop in Social Security income than would have occurred for generations with only one working spouse.

In terms of traditional defined benefit pensions, most households will see a substantial drop in retirement income from these plans when the spouse who participated in the plan dies. This drop is due to the plan providing either a reduced survivor benefit, or no survivor benefit at all, depending on the prior election of the retired worker.

In contrast, an important benefit of a 401(k) plan is that the accumulated wealth is passed on to a surviving spouse. However, the typical household approaching retirement with a 401(k) has only $111,000 in combined 401(k) and IRA assets,[6] and higher housing costs can cause a household to draw down these assets at a faster rate. As a result, the financial security these assets can provide to a widow or widower may be limited.

While it may have been true that earlier generations of retirees did not have a widespread need to carry life insurance protection in retirement, the coming generations of retirees will have this need due to the amount of debt they are choosing to carry into their retirement years and the loss of income resulting from the death of a spouse.

Death benefit proceeds from life insurance can provide a family with choices about how to live going forward. Having these choices is especially meaningful for those who are widowed in retirement. For instance, being able to utilize life insurance proceeds to pay off a mortgage might allow a widow or widower to remain in her/his home for the remainder of life, as opposed to being forced to move away from friends, neighbors, and community. This, in turn, can also provide comfort to adult children who will not have to worry about whether an aging mother or father will be forced to move out of her/his home due to financial hardship.

Conclusion

Prior generations of retirees had little need to carry life insurance in retirement, as they did not carry much housing debt into retirement, and their drop in household income when the first spouse died wasn't as great as it often is today. Going forward, however, retired Americans are carrying more housing debt and will often see a significant drop in retirement income at the death of a spouse. These factors create a much greater need for older Americans to consider life insurance coverage to help ensure the financial security of their loved ones.

[1] Butrica, Barbara, and Karen E. Smith, "The Impact of Changes in Couples' Earnings on Married Women's Social Security Benefits," *Social Security Bulletin*, Vol. 72, No. 1, 2012, p. 6.

[2] Brown, Meta, and Donghoon Lee, Joelle Scally, Katherine Strair, and Wilbert van der Klaauw, "The Graying of American Debt," Federal Reserve Bank of New York, February 2016, http://libertystreeteconomics.newyorkfed.org/2016/02/the-graying-of-american-debt.html#.V7MsH8sUXcs

[3] Freddie Mac, http://freddiemac.mwnewsroom.com/manual-releases/2011/82-Percent-of-Refinancing-Homeowners-Maintain-or-R

[4] Institute for Health Metrics and Evaluation, http://www.healthdata.org/research-article/left-behind-widening-disparities-males-and-females-us-county-life-expectancy-1985

[5] United States Census Bureau, "America's Families and Living Arrangements: 2012," p. 22, August 2013.

[6] Balances are as of 2013. The Center for Retirement Research, "Falling Short: The Coming Retirement Crisis and What to Do About It," Issue Brief 15-7, p. 4, April 2015.

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0296322-00001-00 W2308