Home sweet home or retirement nest egg?

Retirement preparedness requires one to think ahead and to save for the future. As everyone has his or her own personal financial situation and specific retirement goals, the ideal saving strategy will vary by individual. A good place to start measuring one's saving success is by completing a net worth analysis, one of the many important components of a financial plan.

A net worth analysis is an important financial metric that examines two key factors critical to assessing saving success: savings (or assets accumulated) and debt load. It is a snapshot of one's current financial well-being that shows the amount of equity currently available to sustain one's lifestyle if all assets were liquidated and all debt was paid off. The goal is to create a large, positive net worth and to assess it regularly to ensure it is moving in the right direction to enable funding for future retirement goals.

Traditionally, Canadian baby boomers have built their retirement nest eggs by accumulating savings in non-registered and registered accounts and diversifying investments in stocks, bonds and cash. In the last four decades, Canadians have also included other asset categories, such as real estate, in their retirement portfolios. In fact, boomers' consumption habits have driven up housing demand and prices, often resulting in an enhanced feeling of financial security. As real estate values increase, they represent a larger portion of a boomer's net worth.[1] The old adage, "Don't put all your eggs in one basket," is wise advice; perhaps the diversification of retirement portfolios should encompass all assets, including the home. However, these inflated net worth statements may cause many to rely on the equity in their home to fund their retirement, while failing to address shortcomings in their savings habits, their intentions for their home and their personal debt situation.

The BMO Retirement Institute was established to conduct research and provide thought-provoking insight and financial strategies for those individuals planning for, or currently in, their retirement years.

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Foundations of a sound retirement plan

In a recent BMO Retirement Institute survey, 32% of Canadians agreed that living comfortably in retirement was the most important financial accomplishment to achieve over a lifetime.[2] Though the definition of "living comfortably in retirement" can vary by individual, it generally consists in the desire to fund future retirement lifestyle goals, whether they are basic, modest or extravagant and pay the bills without worrying about running out of money during one's lifetime and that of one's spouse.

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The survey also showed that Canadians believe their government pensions, registered retirement savings plans (RRSPs)/registered retirement income funds (RRIFs) and workplace pensions will be their top three sources for income in retirement. Since government pensions pay at most approximately $18,830 per year, the accumulation of savings in RRSPs and workplace pensions (if available) should clearly be fundamental building blocks of a sound retirement plan, particularly when one-third of Canadians place a priority on living comfortably in retirement. Unfortunately, this goal may not be achieved by many, since 40% of Canadians are not confident in their ability to save for their ideal retirement lifestyle and 29% of Canadians anticipate having to delay their retirement and work part-time during retirement due to a shortfall in savings.

40% of Canadians are not confident in their ability to save for their ideal retirement lifestyle.

This should not be a surprise, given the household personal saving rate reported by Statistics Canada, which has been on a declining trend since the early 1980s, dropping from its highest level of 20.2% in 1982 to its lowest of 2.1% in 2005. If a balanced portfolio generating annual returns of about 8% requires a savings rate of about 6%,[3] the reported savings rate of just 3.6% in 2011 looks woefully inadequate (despite a modest rise since 2005) to finance a comfortable retirement in an environment of more modest returns.[4]

Consequently, due to a lack of savings for retirement, Canadians may have to turn to Plan B – using their home as a source of retirement income. Interestingly, 41% of Canadians consider equity in their home an option to save for retirement. The reliance on home equity to fund retirement is no surprise, given that 47% of Canadians said their home or primary residence is their biggest financial asset, and on average it accounts for 51% of their total net worth.

Home ownership challenges to retirement

Home ownership may also pose risks to the retirement security of many boomers.

Baby boomers have driven up housing demand and prices for four decades since beginning to buy homes in 1970.[5] What will happen when boomers begin to sell off their high-priced homes to relatively smaller, less-advantaged generations? It is very likely that boomers are going to have a considerable impact on the supply and demand for real estate in Canada. However, home ownership may also pose risks to the retirement security of many boomers. Such factors as housing tenure, attitudes and behaviours towards home ownership, prevailing lending standards and carrying a mortgage in retirement can create challenges boomers may face when deciding to stay in their home or to relocate.

Housing tenure

In a global study investigating how aging might affect house prices, analysis suggested that as baby boomer purchases drove up house prices in the past, their sales will drive real house prices down in the future.[6] In the past forty years, the Canadian economy has experienced the positive impact of aging. As baby boomers reached working age and started buying houses, they contributed to the rise in property prices. According to some estimates in the past 40 years, the baby boom generation in Canada has experienced real house price increases of approximately 20% (0.5% per annum). But as boomers age, they may consider selling their homes, which may depress prices. Estimates from the same global study suggested that these demographic factors could reduce housing values in the next 40 years by around 40%, or 1.0% per annum. Though the results do not imply absolute real price declines, they suggest that in the next 40 years, house prices will face a more difficult environment than the past 40 years.[7]

Evidently, the Canadian population is aging (i.e., the number of asset buyers, the young, is diminishing and the number of sellers, the old, is growing) and this could result in a decline in housing prices. In fact, according to Statistics Canada's 2011 Census, for the first time there were more people aged 55 to 64, typically the age group where people leave the labour force, than those aged 15 to 24, typically the age group where people enter it.[8]

Additionally, for every person aged 55 to 64, there were 1.4 people in the 15-to-24 age group in 2001, but by 2011, this ratio had fallen slightly below 1 (0.99). These statistics indicate that the Canadian population is aging rapidly and perhaps there may be some validity to the notion that a demographic tailwind will have an impact on housing prices.[9]

Attitudes and behaviours regarding home ownership

Canadians may be torn between believing "their home is their castle" and relying on it as a retirement asset.

Canadians have a love affair with home ownership. Traditionally the home has been viewed as a shelter, but more and more Canadians may be torn between believing "their home is their castle" and relying on it as a retirement asset.

Keep it

Our survey shows that 45% of homeowners do not intend to sell, and 34% are unsure if they'll sell their home prior or during retirement. Perhaps those who are unsure have simply not thought about it and are waiting until they get closer to retirement to evaluate this decision.

Even those intending to hold onto the family home during retirement may be forced to reconsider, depending on their personal financial situations.

Top reasons to sell home in retirement[10]
1. Need a smaller home
2. Need net proceeds from sale of home to supplement income
3. Not good for retirement

Sell it

Need a smaller home

Many people have come to believe that bigger is not always better and people are focusing on what really matters when it comes to finding a suitable home. In the last fifty years, the average household size has fallen from 3.9 to 2.9 people and in 2011 there were more than three times as many one-person households (27.6%) as those consisting of five or more people (8.4%).[11] Our research suggests that

Being inadequately prepared for retirement has compelled almost one in three Canadians to sell their homes.

boomers may continue to positively influence the demand for smaller homes, when three in five are considering selling or have sold their home because a smaller home would be more appropriate.

Need net proceeds from sale of home to supplement income

The survey showed that being inadequately prepared for retirement (that is, not having enough saved) has compelled almost one in three Canadians to sell their homes and use the proceeds to supplement their income in retirement. Boomers may be purchasing smaller homes because they no longer need multiple bedrooms and large backyards.

Not good for retirement

Boomers are looking for homes that are more appropriate for the retirement lifestyle they envision. In a previous report from the BMO Retirement Institute, the top factors that boomers stated as reasons to relocate upon retirement included weather, financial reasons, proximity to family and friends and better access to health care and support services.[12]

Prevailing lending standards

The increase in the price of homes in the last decade has been influenced by the direction of interest rates and lending standards. Historically, low interest rates over this period meant that boomers could afford to buy more expensive homes, driving home prices higher. This is demonstrated by 86% of boomers experiencing gains in the value of their homes with two in five of them experiencing gains of 50% or more.

Recently, the government introduced several new mortgage rules to tighten lending in Canada in order to cool the housing market. For example, it reduced the cap on the amortization period of insured mortgages from 30 to 25 years. These new lending standards are likely to reduce the number of eligible homebuyers. If lending standards dictate how much first-time homebuyers can borrow, they will seek homes based on what they can afford. They may also purchase less expensive and smaller homes, because they presumably will have not accumulated any equity from the sale of an existing home.

80% of pre-retirees feel uncomfortable carrying debt in retirement.

Rising house prices are influencing the accumulation of debt and may lead to retirement stress.

Carrying a mortgage in retirement

The use of credit to purchase items can be an extremely valuable tool, as long as it is used with caution and responsibility. When used responsibly, it can aid in building net worth. However, the accumulation of debt can also pose risks and challenges that become problematic and stressful and that can even result in negative net worth. "While asset prices can rise or fall, debt endures."[13] More and more Canadian boomers are approaching retirement with some level of debt, even though a growing number of them are uncomfortable about carrying debt in retirement. In the 2005 BMO Retirement Trends Study, we learned that more than one-third (36%) of pre-retirees did not feel comfortable carrying debt in retirement. Today, this number has increased, with 80% of pre-retirees feeling uncomfortable carrying debt in retirement.

Over the years and particularly in the last decade, Canadians have been accumulating debt twice as fast as their incomes have grown.[14] The Bank of Canada has repeatedly warned Canadians to monitor their overall household debts levels and take action to reduce their debts sooner rather than later.

Mortgage debt has increased in tandem with housing prices. The average price of a home rose from $71,800 in 1982 to $303,500 in 2008, while the average mortgage per home increased similarly, from $41,200 to $176,200.[15] Rising house prices are influencing the accumulation of debt and may lead to retirement stress. As boomers consider home ownership to be the third-most cited financial accomplishment, it is not surprising that their explosive demand for housing has also fuelled the over-extension of debt. Much of the rise in overall household debt is driven by mortgages; 43 % of pre-retirees are carrying a mortgage and almost one in five expect to continue carrying a mortgage in retirement.

Top financial accomplishments one can achieve over the course of a lifetime[16]
1. Living comfortably in retirement
2. Living debt-free in retirement
3. Home ownership
4. Becoming debt-free before retirement

Every one percentage point increase in mortgage rates can translate in a 7% increase in monthly mortgage payment.

56% of pre-retired boomers consider their current level of debt an obstacle to achieving their retirement goals.

Boomers' increasing household debt levels due to the surge in demand for housing could make households more vulnerable to rising interest rates. There is a concern amongst 29% of boomers (with a standard mortgage) that they would need to adjust their spending or not be able to handle a higher mortgage payment if rates were to rise. More interestingly is that over half of those with a standard mortgage said that they would be unable to handle an interest rate increase of 3%–10%.

To put it in perspective, every one percentage point increase in mortgage rates results in a 7% increase in the mortgage payment (see Table below). So if rates were to double from 4–8%, mortgage payments would increase by approximately 28%. This means the retiree now has 28% less disposable income in retirement until the mortgage is paid off. The survey also found that one in every ten mortgagors (who carry a standard mortgage) don't know how much of an interest rate increase would be too much for them to handle financially. It would be prudent to calculate or ask a mortgage professional to estimate the impact a rate increase would have on a mortgage payment; interestingly, only 21% have done so, placing the majority of mortgagors at risk.

Interest rate increase effect on mortgage payment[17]

Interest rate	4%	5%	6%	7%	8%
Monthly mortgage payment	$1,257	$1,344	$1,434	$1,528	$1,624
Payment increase	—	7%	14%	21%	28%

The calculations are using the term of a three-year variable (open) mortgage, and assuming that, on average, Canadian home or condo owners have 15 years remaining on their mortgage[18] and that the average mortgage principal outstanding is $170,000.[18]

The risk of rising interest rates is not the only concern. The possibility of unemployment can pose further difficulties. For those intending to delay retirement or work part-time, not being able to work for health reasons or being forced to retire due to a company downsizing could place a boomer's retirement security in severe jeopardy.

Boomers should weigh their unique circumstances and let those circumstances dictate how much debt they can realistically assume.

At a time when it is expected that individuals will have accumulated sufficient assets to carry themselves throughout their retirement years, the increase in the bankruptcy rate of Canada's aging population is of concern.[20] Considering that 56% of pre-retired boomers consider their current level of debt an obstacle to achieving their retirement goals, there is clearly cause for concern. Rising insolvency is indicating stresses in the financial stability of boomer households. A growing number of seniors are finding themselves faced with the prospect of declaring bankruptcy. The top five causes of bankruptcy are over-extension of credit, medical reasons, insufficient income, loss of employment income and money mismanagement.[21]

Boomers should weigh their unique circumstances and let those circumstances dictate how much debt they can realistically assume, as their retirement will bear the consequences of those financial decisions.

Conclusion

While Canadians have enjoyed a stable housing market and increased home values, this should not reduce the role that personal savings play in retirement preparedness. When and if the time comes that a home is going to be sold to fund retirement needs, housing prices may be lower than expected. If home values were to decline over the next twenty years, for either demographic or economic reasons, so would home equity – and the retirement savings of many boomers. Considering the most important financial accomplishments for Canadian boomers are living comfortably in retirement, owning a home and being debt free, Canadians should evaluate financially and emotionally what their home means to their retirement plans. They also need to fully appreciate how carrying debt, or for that matter increasing debt, may affect their retirement security.

[1] Amélie Lafrance and Sébastien LaRochelle-Côtä, "The evolution of wealth over the life cycle", Statistics Canada, June 22, 2012.
[2] BMO RI Q4 2012, Harris Decima survey, "Retirement and Homeownership".
[3] Assuming a 5% initial withdrawal rate and 3.5% annual indexed income growth over 40 years.
[4] BMO Capital Markets, Economic Research, Focus, February 11, 2011, pages 6–7.
[5] "Aging Baby Boomers and the Generational Housing Bubble," Dowell Myers and Sung-Ho Ryu, Journal of the American Planning Association, December 31, 2007.
[6,7] "Ageing and Asset Prices", Elod Takats, Bank for International Settlements, August 2010.
[8,9] "Fifty years of families in Canada: 1961 to 2011", Families, households and marital status, 2011 Census of Population, Statistics Canada.
[10] BMO RI Q4 2012, Harris Decima survey, "Retirement and Homeownership."
[11] "Fifty years of families in Canada: 1961 to 2011" Families, households and marital status, 2011 Census of Population, Statistics Canada.
[12] "Where do Canadians plan to retire and why", BMO Retirement Institute Special Report, October 2011.
[13] "Carney sharpens warning on household debt levels", Jeremy Torobin and Tavia Grant, The Globe and Mail, September 30, 2010.
[14] "All I want for Christmas is a brighter 2012 outlook," Sal Guatieri, Focus, December 9, 2011.
[15] "The distribution of mortgage debt in Canada," Raj K. Chawla, Statistics Canada, Summer 2011.
[16] BMO RI Q4 2012, Harris Decima survey, "Retirement and Homeownership".
[17] BMO Mortgage Payment Calculator, – www.bmo.com/mortgage
[18] BMO Financial Group, Leger Marketing, Home and Condo Owner Report, March 2012.
[19] "Confidence in the Canadian Mortgage Market," Will Dunning, Canadian Association of Accredited Mortgage Professionals, May 2012.
[20] The number of consumer bankruptcies in Canada has grown in the past 30 years from 6,271 in 1973 to 84,638 in 2005. Out of the 7,797 bankrupts over age 55, it was found that 63% of total bankrupts were age 55 to 65, 28% were between 65 and 74 and 8% were 75 and older. In 1993, 6.9% of all individual bankrupts in Canada were over age 55. In 2003, this figure has more than doubled to 15.3%.
[21] "Growing Old Gracefully, An investigation into the growing number of bankrupt Canadians over age 55," Office of the Superintendent of Bankruptcy, March 31, 2006.

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