

1. The Reverse Mortgage

The Reverse mortgages are aptly named, as they are the reverse of the finance industry's normal expectations in lending money.

They are also the reverse of retirees' borrowing expectations.

They are a specific financial product of relatively recent invention.

They are:-

- 1.1 A response to a business "opportunity" for the financial institutions to lend money into a "new" market.
- 1.2 An "aggressive" product.
- 1.3 In response to the changed financial landscape - including:
 - i) The downsizing of banks,
 - ii) The massive growth in superannuation
 - iii) The role of the financial planning industry and
 - iv) The increasing acceptance of credit, even by "frugals".
- 1.4 Recognition of the tacit acceptance of the SKI club (spend your kids' inheritance).
- 1.5 A function of the impact of family law.
- 1.6 Often a "loan of last resort".
- 1.7 Aimed at retirees who are "asset rich and cash poor", which is an increasing class in our society.

It operates on the reverse of compound interest.

The initial advance is based on:-

1. The amount of equity in the property, as determined by a conservative valuation.
2. The age of the applicant, and their reasonable life expectancy.
3. The continuing "saleability" of the property.

Subject to the satisfactory determination of those matters, and the completion of the documentation, the funds are advanced after the payment of the establishment fees.

No interest is paid, the interest simply capitalises during the term of the loan.

There are only two exit strategies:-

1. The repayment of the loan (almost invariably) from the proceeds of sale during life; or
2. The repayment of the loan from the proceeds of sale after death.

Because the loan is capitalising interest upon interest the loan can easily "eat its head off".

At 7½ % the loan doubles in value in seven years.

This is in contrast to the normal loan criteria, which are:-

- a) Ability to service the loan, as determined by income capacity.
- b) Financial stability.
- c) Ability to repay within the term of the loan.
- d) The financial prudence, or "risk" component.
- e) The Application of the funds to an "approved" purpose.

The ability to pay from the realisation of the asset is the only consideration for reverse mortgages; and that is a function of the "equity" in the property.

There is no concern about:

- i) The ability to service the loan
- ii) The ability to make repayments
- iii) The financial stability or security of the borrower; or the consequence to the borrower
- iv) A plan for repayment, other than sale

The only risk analysis is:

1. the extent of the equity and
2. the saleability of the house should the loan proceed past expectation
3. the continued capital growth in the asset during the term of the loan.

2. Social Changes

2.1 "The Frugals"

There has been a slow acceptance of reverse mortgages because they are pitched at the "frugals"; who have traditionally been credit-averse, and only entered into arrangements which they could comfortably manage.

In many instances they have not had the opportunity to take advantage of the superannuation boom, and/ or have come late into financial planning.

More often than not they have:

1. Helped their kids financially, and
2. Focused on their family duties, to their personal disadvantage. Often they believe they have few other options, are embarrassed about this, and undertake the Reverse mortgage without consultation with the family, because of their embarrassment.

Often their asset pool is extremely heavily weighted in real estate (their home); and they often have little or no share portfolio. Usually they have a lump sum in the bank, which is often treated as a 'sacred' nest egg.

Consequently the only real asset with which to deal is the home. There is usually a significant reluctance to sell or move, until that becomes essential, by virtue of health or aged care requirements; and so the reverse mortgage provides an interim "facility".

2.2 Baby Boomers

The children of the "frugals" are universally "baby boomers".

They do not share the same attitude to credit, financial risk, relationship stability, family responsibility or traditional security of employment.

They are more likely to have had a failed relationship, during which they expected financial assistance from their parents. In many instances they expected assistance from their parents to get them established, either by way of a gift or loan, to acquire the first property; and often providing guarantees for other financial borrowings, before, during or after the first failed relationship and or business!.

3. Financial Industry Changes

Simultaneously with the social changes have been substantial restructuring in the finance industry. Particularly shrinking of the banks after the share market and property crash in the late 80s, evidenced by:-

1. The shrinking of branches numbers, and staff.

2. Dramatic focus on income generation through "fees".
3. Expansion of range of "products".

The emergence of superannuation is an important factor, as it provided growth within the sector, that required to lend that money.

There was a corresponding growth in the financial planning industry, often from ex-bankers.

Initially that was a slow uptake of this changed circumstance. But baby boomers were keen to maximise their opportunities, and in many respects their parents were dragged into the process.

Of recent times the "frugals" have become more enthusiastic and embraced financial planning.

Initially financial planning was a haphazard industry, was poorly regulated and supervised, and lacked a depth of skill.

Over time there has been:

1. a realisation of its importance, and
2. a realization of the huge sums of money involved;
3. that realization of the risk that unscrupulous people would take advantage of it.

Traditional borrowing was seen as too restrictive. So new products emerged, which is where the seeds of reverse mortgages came from.

The decision in the "Allan Bond case" in the High Court caused banks to revisit how lending was undertaken, which led to the emergence of the "necessity" for independent advice by the borrower's chosen advisor.

A "shield" was dramatically developed. The banks mandated the use of the borrower's chosen advisor enabled them to shirk the responsibility to provide products which would previously have been untenable in the marketplace for a range of public policy reasons.

The banks have been able to overcome or sidestep what would have been community expectations to find products to assist long term good clients of the bank at their "time of need". Whereas they have responded by providing a product which is advantageous for the financial institution but disadvantageous for the client.

It is "dressed up" in the guise that they are not pushing "the product" onto the customer, but that the customer is "demanding" this, by virtue of their circumstance.

This is not dissimilar to the old offence of "usury", money was lent at exorbitant rates, which was illegal. The lender used to argue that they were lenders of last resort, and accordingly they had to get a "commercial" return based on risk. This argument now is that they are

simply providing a "product" at a comparable rate of interest; it is not their fault that the consequence of that product can be the rapid erosion of the borrower's equity in their property.

Traditional lending will always dominate the market. But with demand for new ways to assist particular groups, the industry will respond to that perceived (or created) demand, but more importantly to the opportunity for profit.

It is a particularly appealing product for the banks, because it is a "set and forget" structure. Their only ongoing role is to monitor the regular valuations which the borrower pay for, to ensure that the equity in the property is more than adequate. It is important to monitor the continuing capital growth, and therefore the "safety margin".

Because it is a new product, it has not been tried in the Courts (to my knowledge).

The documentation is similar to the traditional lending. A breach by the borrower of any of the key elements of the mortgage entitle the bank to take action . Over the years banks have become smarter about this process. Rather than cause sales, they simply increase the interest rate to the penalty rate, and the customer can quickly see that there is no future in avoiding the inevitable sale.

I can envisage that there will be litigation surrounding these loans. I expect that the most likely course of "attack" will be the Trade Practices Act; based on misleading and deceptive conduct, or a failure to properly disclose.

I would be extremely surprised if any banker would ever recommend a product like a reverse mortgage to their parents; unless it was only as a short-term interim measure (akin to a bridging loan), whilst they downsized or reorganised their funding. That speaks volumes for the "nature" of the product.

Another major concern in relation to reverse mortgages is how the funding is provided, because of its impact on social security payments. I strongly recommend that you have a discussion with the Department of Social Security Financial Advisers as to the consequences of the reverse mortgage payment on any pension payment.

It is important to ensure that it at least works to your advantage!!

4 Case Studies

4.1 Borrowing to produce income, or assets.

If the loan is to facilitate some income production e.g. an extension to the house for the creation of a granny flat to enable the generation of rental income, or a more saleable residence, that has a specific advantage. It will probably be capital gains tax free on sale, and the increase in value by virtue of the works, is realised on sale.

A similar argument could have been advanced in relation to the purchase of shares, prior to the recent share market downturn.

4.2 Necessity - sometimes situations arise where it is vital to obtain additional funding for an urgent project: where it seems there is no other alternative than to turn to the financial institutions for borrowings. Whilst I appreciate the situation, I think it is important that before you commit to a reverse mortgage you explore other alternatives that might otherwise exist, rather than simply "fall" into a reverse mortgage.

"Necessity" borrowing should be seen as a short term or bridging arrangement; with a clear plan to "get out" of the loan.

4.3 Lifestyle choices this is the most common reason for the reverse mortgage. It is potentially the most dangerous; because the expenditure is invariably on either depreciating assets or lifestyle choices (holidays cash flow).

Once the borrowing is undertaken the interest continues to capitalise, and there is no asset other than the real estate.

5. Are there other alternatives?

5.1 Asset sales – not necessarily the house, but other assets which are no longer essential to your future needs, from which you could realise the funds required for the particular purpose involved e.g. do you still need the Rolls Royce when a VW Golf could probably suffice?

5.2 Downsizing – have you reached the stage where the four bedroom, five bathroom house on five acres is really appropriate for the two of you? Whilst the lifestyle "might" be terrific, could you enjoy the lifestyle in a smaller residence which was much more purpose built to your needs? Will you need to consider a move to retirement housing?

5.3 Beneficiary funding –Is it time to reflect upon the loans which you have made to the children; and encourage them to reflect upon the benefit it was to them, and the benefit it would be to you now if they were to:

(i) Repay those loans; or

(ii) Take out a loan and provide you with the funds so that you did not have to borrow and affect the equity in the home?

5.4 Get the kids involved in the "project" for the renovation and subsequent sale of the house – many of the children have made substantial income from renovating and selling houses for profit. This could be their opportunity with the family home. You could "joint venture" with the children; you provide the home, they do the borrowing for the renovations, the works are undertaken and the property sold. The profit is divided in accordance with the "respective" contributions of the parties to the project.

- 5.5 Beneficiary borrowing – why not simply get the children to undertake the borrowing on the basis that you will contribute to the interest-only repayments so that you can enjoy the benefit of the loan without the interest "compounding" against the equity in the property. You could agree on the duration of the loan and how and when it will be repaid.

There are bound to be other alternative arrangements which are workable.

No matter which of these choices you engage, it is important to involve the family members and beneficiaries in the process, so that they are aware of what is proposed. Give them the chance to have an active involvement in the process, and conceivably come up with better alternatives than the reverse mortgage, which is really only to the financial institution's benefit.

6. But what if there are no other alternatives?

What if none of these things work, and you ultimately decide that the reverse mortgage is the way to go?

- 6.1 Set out a "project plan".

What do you need, how much and when?

Is there an "end" to the plan?

What is the actual cost? How can the funds be drawn down so as not to impact on any D.S.S. payments?

Go in with your eyes open. Discuss it with the family anyway, once you have all that material available, so that everyone can see the consequences.

- 6.2 Research alternative products. Not all reverse mortgages are the same. You should hunt around to explore alternatives which might be better suited to you.

Be clear about the set up costs, the interest rates, the charges and the opportunity to pay back part of the interest or make other arrangements, which will limit the impact of the loan during its life.

There are staged borrowing arrangements, and you need to understand the conditions attached to the loan, including the regular valuations, costs and technical breaches which could impact and effect the loan.

- 6.3 Get the lender to do the actual calculations of the cost of the loan, based on current interest rates, and on increased interest rates, so that you can see the effect. Get them to explain the terms – good and bad.

- 6.4 Get copies of the documents, and read them carefully. Ensure that you understand any special conditions or special requirements that could cause technical breaches of the agreement, e.g. other people residing in the property, failure to meet obligation like payment of rates, repairs or insurance, could be a technical breach.

- 6.5 Get independent advice (other than from the person who stands to make a commission in lending the money to you). Your market research will have shown you that there are a number of product suppliers with differing products, and it is worth talking to each of them about their products, to see what the strengths and weaknesses are by comparison.

But get advice outside the finance industry, so that you are clear about exactly what you are signing up

- 6.6 Seek a "no negative equity guarantee" in the documents. This is a guarantee by the lender that they will never allow the loan to reach the point where the amount owed exceeds the value of the property; and prevents the sale of the home during your life. The benefit of the clause is obvious, however its benefit is lost if there are any technical breaches of the mortgage. It is important that you understand what those technical breaches could be, and make sure that they are not brought into play.

- 6.7 Be prepared to negotiate to get the best deal – everybody else does! That may mean other benefits like lower rates on other bank products, like credit cards.

7. What can go wrong?

- 7.1 Changes in the financial landscape; like we are seeing at present, where interest rates increase, which will have a very marked effect on the loan. Obviously we would all prefer to have "locked in" interest rates at the lowest rate, and not be subject to variable rates. That is even more important in reverse mortgages, where any increase in variable rates can have a dramatic impact on the speed with which the capital of the loan grows.

- 7.2 Your needs could change, e.g. health, in which case you are in a situation where you suddenly need much more money than you anticipated. You may have to downsize, or sell the property, in the event that it is going to be impractical to continue to remain in the property, particularly if the borrowing has to dramatically increase.

Alternatively you could continue to suffer "rude" good health for a much longer period, in which case the duration of the loan dramatically increases and therefore the quantum of the loan repayable is really accelerating away.

- 7.3 An emergency – this could be a family crisis involving other members of the family, in which you feel you need to take action by drawing down more funds. The same rules apply. You are dramatically increasing the rate at which your equity is being eroded.

- 7.4 Your family – there could be a dramatic turn of events within your family e.g. a divorce or some other family crisis in which you need to 'intervene'.

- 7.5 Market downturn – the real estate market has been steadily increasing over a substantial period of time, probably 12 years in this cycle. That cycle will change and real estate values will stall or drop. The consequence will be that the equity gap will close more quickly and that would become problematic. In this region that is less likely; but there are places where owning real estate means you have a shrinking asset, which is virtually unsaleable because of the number of other properties on the market.

8. Summary

- 8.1 As "frugals" you are a unique group to whom the sale of financial products like this has been slow to develop, but is increasingly popular because you are "asset-rich and cash-poor".
- 8.2 Your children may not be averse to the project in the first instance (because they are hardly credit-averse), but their attitude may well change when the quantum of the equity is substantially reduced, and they discover the size of the loan has ballooned out. I do not need to tell you how short-sighted children can be in such matters!
- 8.3 There may be a number of reasons why you are reluctant to look at other solutions, and the reverse mortgage seems a simple, quick solution. It is certainly that; but its long term consequences can be unexpected. I would urge you to seriously consider the other alternatives including downsizing, family involvement and other family borrowing, as far better alternatives.
- 8.4 You need to reflect on lifestyle choices versus the cost of funding, if there are no other choices available.
- 8.5 You need to consider your true financial position, your foreseeable needs, the family response, and your longer term needs including aged care accommodation before entering into these arrangements; or at least factoring them into the decision that you make.
- 8.6 You may need to confront the financial "demons" with your children; reminding them of the level of assistance that you have provided to them during their life, and asking whether their borrowing might not be a better way for them to fund your needs - rather than taking a reverse mortgage

Often their "understanding" of the "SKI" club diminishes when the return to them is minimal. You may also have to fight against the "whatever" response, which seems to be a justifiable reaction at the time, but which will lead to tears later when the children berate you for entering into a financial arrangement which will, in their eyes, substantially financially disadvantage them. They having counted on a substantial bequest from their share of your house.

- 8.7 Finally, if there is no other alternative approach this as you would any other borrowing or business venture. Be thoroughly appraised of the alternatives, be thoroughly appraised of the consequences and ensure that you get proper independent advice so that you understand what your duties and obligations are, and the consequences of any breach.