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PUBLIC ISSUES COMMITTEE

REVERSE MORTGAGES

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Public Issues Committee
Auckland District Law Society
Discussion Paper

REVERSE MORTGAGES – PRÉCIS

Overview

The article seeks to briefly describe the nature of a reverse mortgage (or home equity conversion product), to provide illustrations of the practical effect in particular of compounding interest, highlight the alternative, pitfalls and need for borrowers to seek advice independent of the product provider of their agent – reaching a conclusion that unless the borrower is over 70 years of age and intending to borrow only a small proportion of their equity, they should be very circumspect about entering into such a mortgage. An informed public is better able to react appropriately to the current hype about these products.

ARTICLE ON ISSUES RELATING TO REVERSE MORTGAGES FOR 'SENIORS'

Introduction

Following overseas trends and no doubt recognizing that our ageing population's needs, not to mention the much-publicised Kiwi love affair with home ownership – perhaps even our DIY-lovers' affection for being independent – all add up to a great business opportunity, a number of insurance companies, finance companies and banks are now offering reverse mortgages or home equity conversion products to the elderly.

A reverse mortgage, at first glance, seems an ideal way to maintain our independence – providing cash when needed while enabling us to remain living independently in our own homes – but they are, by their very nature, a product which should be approached with great caution and effort at understanding. The conservative would say they should be avoided at all costs as compounding interest makes them extremely costly and could see the 'family silver' disappear. Even the liberal-minded (they might call themselves realists, given the growing acceptance of these products overseas) would suggest they should only be contemplated by those over 70 years of age who have considered the alternatives carefully, taken appropriate advice and have a full understanding of what they are getting into.

What Are Reverse Mortgages and Why Would You Want One?

You work until retirement to pay off your mortgage, saving as best you can, then, after a few years on the pension, start to struggle to maintain the lifestyle you'd planned for your retirement or to pay mounting health-related bills or to visit children living and working overseas or to financially assist your children as you'd wished…. So you borrow against your biggest asset. What could be simpler? You free up some of the equity in your home so you can have all you want or need now and still keep the home you've worked so hard for… and your independence.

The drawback is you haven't the income anymore to repay the loan in the way you did with your bank mortgage while you were working (so the bank won't give you an ordinary mortgage).

A **reverse mortgage**, or **home equity conversion scheme** seems to be the answer.

The sales representative selling this product explains it all – you don't have to pay anything during your lifetime unless you sell the home and you can have the cash in a lump sum (and even arrange further advances for later) or as a pension – payments when you need them. Why worry about the compounding interest (interest on accrued interest)? That's something your children can deal with when they sell the house - when you're no longer with us.

Is it really that simple? Is anything ever?

Our ageing population (and our love of home-ownership) is now the focus of a great deal of attention from everybody from developers (of retirement villages and rest homes), to political interest groups (such as 'Grey Power'), to government agencies such as the Retirement Commissioner and the Office for Senior Citizens in the Ministry of Social Development.

Insurance companies and banks are now developing products specifically to attract the patronage of this segment of the market. But are these products really the answer? They seem an inevitable

development. Certainly evidence of their popularity overseas suggests they are likely to become increasingly popular here. But there are complexities in these schemes that are frequently overlooked and, **most importantly**, the vulnerability of some senior citizens could make them an easy target for the unscrupulous or even those simply failing to explain in detail the ramifications of a reverse mortgage.

The Office for Senior Citizens has recognized this and invited discussion on whether New Zealand should follow some overseas jurisdictions and regulate the provision of these products (as in the USA and the UK) or do as others, notably Australia, has done and let 'the market' self-regulate.

What Other Options Are There?

In the meantime, should you know anyone considering getting into such a scheme, you might like to discuss with them the following options:

- The government already has a residential care loan scheme whereby the government advances to rest home residents, who do not qualify for subsidies on the cost of their care, loans to meet residential care fees and secures those loans by taking caveats over the homes of those rest home residents.

- The owners of some retirement villages can make loans similar to reverse mortgages with new residents. These are usually unsecured and repaid when the borrower's occupation rights terminate.

- Local authorities will allow rates and interest charges to accumulate, deferring liability for payment until the sale of the house or the death of the owner, at interest rates 3-4% lower than the rates charged by reverse mortgage lenders.

These may only give partial relief to those struggling with insufficient income and they are not available to all, but they **are** less expensive options.

It also has to be said that many of the 'children' of our senior citizens now enjoy a far better standard of living than their parents. If pride will allow, seniors can of course seek the assistance of their children with this disparity between income and needs. A family conference may resolve what seems an insurmountable problem to the elderly but a smaller issue to their families. A family discussion may resolve any emotional issues attached to:

- trading in the family home for a smaller and more economical home for ageing parents ie downsizing.

Alternatively it may result in:

- one or more of the 'children' agreeing to provide loans themselves for their parent/s (with or without interest being payable), against any share they may later inherit in the home perhaps.

These family loans **must** be properly documented (by a lawyer independent of the lender) to ensure there are no emotional or financial consequences (or legal costs) when the parents' estates are in a position (hopefully) to repay loans or the parent/s' estates are being distributed. Family loans should of course be repaid before the estates are distributed amongst family members. No one relishes family

feuds developing over whether, or how much, was lent to elders when repayment might result in less in the ‘kitty’ to be distributed than was expected or there being nothing left to share. Worse still should the estate/s end up in the negative.

How Do Most Reverse Mortgages Work?

Here’s a simple explanation:

- The loan will be limited to a certain percentage of the value of the house (the percentage increasing with the age of the borrower).
- Interest is accumulated on the loan at a variable (usually) interest rate (usually predetermined at 1.5% or 2% above the interest rates then being charged by the major banks for ordinary housing loans).
- Home owners are guaranteed their rights to reside in the home as the loan and interest are not repayable until the house is sold or the owner dies. (Consider the role of live-in partners though, especially those relationships which might be entered into after the reverse mortgage is arranged).
- Some of these products also offer an equity protection option where you nominate an amount of equity in your home you wish to protect. This ensures that, when the loan is repaid, you are guaranteed to receive at least the amount protected, whatever the loan amount may have become with that compounded interest added.
- Some also offer a no-negative equity guarantee which ensures that the value of the loan never exceeds the value of the home on sale, even if the loan plus interest exceeds that amount. This protects your family members from liability after your death too.

How This Works In Practice

Example 1: Christina (present age 67) owns a house valued at $280,000.00. She arranges a reverse mortgage for $30,000.00. If we factor in an interest rate of 11.14% (remembering that margin of 1.5% to 2% above prevailing bank rates) and expected inflation rate on houses of 4%:

Year	House Value	Loan	Equity
1	$291,200	$33,484	$257,716
5	$340,663	$51,966	$288,697
10	$414,468	$90,014	$324,454
15	$504,264	$155,921	$348,343
20	$613,514	$270,085	$343,429
25	$746,434	$467,838	$278,596

Example 2: John is presently aged 72 and his house is also valued at $280,000. He borrows $100,000. Applying the same interest rates and house inflation rate:

Year	House Value	Loan	Equity
1	$291,200	$111,614	$179,586
5	$340,663	$173,219	$167,444
10	$414,468	$300,047	$114,421
15	$504,264	$519,738	$0
20	$613,514	$900,283	$0
25	$746,434	$1,559,459	$0

What Do These Illustrations Tell Us? What Are The Pitfalls?

The first example suggests that these loans should be avoided by the 'younger senior', as time has a very significant impact when interest is compounding.

The second example shows that a significant loan amount, even when borrowed by an 'older' senior, can quickly erode the equity in the home.

The recommendation, should a reverse mortgage seem the only or best alternative to sale of the home, would seem to be – borrow this way as late in life as possible (say over 70 years of age) and borrow as little as possible.

So, apart from the cost of compounding interest and consequent loss of equity, what other pitfalls are there in arranging a reverse mortgage? Well the lender's ability to fund further advances, should these be part of the reverse mortgage arranged, will of course be critical. The possibility that the lender may not be in a position to make the further advances doesn't seem as far-fetched as it might once have seemed with the recent demise of several finance companies.

A prudent borrower would check out the lender's ability to fund further advances and ensure a tight funding market will not unduly affect their lender, even if there is no pre-arranged further advance provision in the initial loan arranged. Any further borrowing which might become necessary would ordinarily be from the same lender as they clearly have the superior security position.

Unlike the position under an ordinary mortgage, the borrower should not have to be concerned about the possibility of having the mortgage 'called up' should the lender get into financial difficulties, as the usual lender's ability to demand repayment (except for default) should have been removed. In this regard reverse mortgages are 'superior' to ordinary mortgages as ordinary 'bank' mortgages can be called up should the bank become insolvent. The likelihood that this might happen, in the case of banks, should not be overstated of course. You should, however, seek advice as to what constitutes a 'default under any reverse mortgage you are considering. If it includes, for example, non-payment of the rates on the property, you should reconsider your chosen lender as only 'major' defaults which reduce the value of the home are appropriate to trigger a right to demand repayment.

Beware also the obligation to maintain the home as the lender's expectations and those of the borrower can differ or the age of the home and need for major capital expenditure, which could be beyond the

means of the borrower or their capacity to borrow more monies while maintaining some equity, may become an issue. The lender's requirements in this area should be carefully examined as part of the borrower's consideration of the product before a commitment is made.

If the lender is unable to fund a further advance, the borrower may wish to refinance with another lender in a better position to do so. This refinancing would, however, require considerable expense in further establishment costs (repeating costs already incurred when the original loan was arranged), these generally being higher than ordinary loan establishment costs, and further legal costs in repaying the existing reverse mortgage and establishing the new one. The refinancing of these loans is not akin to refinancing ordinary mortgages and is more costly. It may also cost to break any fixed interest rate on the reverse mortgage you are repaying.

Beware the loan received in instalments or as an annuity. These payments **may** interfere with any entitlements under the Social Security Act 1964, if they are deemed to be income. This could affect your eligibility for state benefits such as disability assistance or a Community Services Card. It would be wise to check this out with Work and Income before committing to a reverse mortgage of this type as it does not presently have an easy answer. The Office for Senior Citizens is considering this aspect in the report it is compiling for government in this area (see below).

Transferability of the security for the loan, should the borrowers seek to sell and purchase an alternative property at some future time, should also be checked out, although policies of lenders can change over time and specific alternative security properties always need to be evaluated by lenders.

Which Organisations Are Currently Offering Reverse Mortgages?

- Sentinel
- Lifestyle Loans (formerly Propertyfinance Securities Limited – now in receivership) – now administered by Standby Servicers Ltd and The New Zealand Guardian Trust Company Limited
- Westpac
- Southland Building Society (SBS)
- Bluestone
- Dorchester Life

Some of these providers have formed or joined an umbrella organization called SHERPA.

Where Can You Get Independent Advice?

The government's Office for Senior Citizens has sought and received submissions from industry members, the Law Society, the Society of Actuaries and individuals and continues to seek submission and comment before making its recommendations to government on the need or manner in which these products should be regulated.

The Office has published its findings after the first round of submissions and has stated that all respondents strongly supported the view that lawyers are the best placed and trained to advise elderly clients and to ensure that family members receive independent advice. The need for independent legal

advice seems likely to become a fundamental part of eventual regulation in this area as the majority of respondents (submitters) suggested the Office recommended to government the imposition of mandatory legal advice before drawdown of these loans, recognizing the hugely vulnerable position of these elders.

Lawyers are used to giving advice and generating options. They do not have a vested interest in persuading a client to enter into a reverse mortgage or similar arrangement (apart from the fees that transaction might generate – small by comparison with the charges incurred with the product provider or lender and not generally the 'driver' for professionals). They can understand the complexities of the arrangements. And the Law Society has developed guidelines to assist lawyers to advise their clients on the nature of the obligations they are entering into when taking out a reverse mortgage, recognizing the vulnerability of the client is even greater than that of a borrower still in the workforce. Lawyers are encouraged to ensure their clients are not being unduly influenced by sales people, family members (well-meaning or otherwise) and that they are legally competent to enter into these arrangements (ie still have their faculties).

The Office for Senior Citizens also sought comment as to whether separate financial advice should be mandatory but there was less support for this suggestion amongst submitters. Some were mindful of the additional cost. Generally it seemed to be agreed that illustrations and examples and a standardized disclosure statement, summarizing the financial commitment, could suffice.

Regulations would also likely control the manner in which these products are advertised, it having been suggested by submitters that the current advertisements not only induced feelings of comfort with the products, but could also produce feelings of guilt, presumably for anyone suggesting the elderly should not take up a reverse mortgage – thereby depriving their elder of the opportunity for the peace of mind and tranquil, happy retirement portrayed in the television advertisements. The advertisements, predictably perhaps, overlook the dire consequences which could unfold for the unwary who might arrange to 'release' too much of their equity in their home, perhaps without ensuring that the loan and compounding interest could not ever exceed the value of the home or without taking into account the needs of family members residing in the home with the elderly person (partners or younger generations) or those who simply live to a very great age, outlasting expectations and their equity. The possibility of the loss of the home, of substantial debt and of family upset should not be underestimated.

The Office for Senior Citizens has now prepared a Draft Code of Practice for these products/ providers, which may be the forerunner to regulation. A cooling off period of 15 working days from signing of the loan agreement is included in that draft code.

Conclusion

It seems inevitable with an ageing population that these products are around to stay. They are undoubtedly a commercial response to a situation brought about by the combination of that ageing population and the Kiwi love of owning our own homes, above all else. Reverse mortgages should be entertained only by those who have carefully explored and eliminated their other options, investigated the specific product under consideration and taken independent legal advice – and, perhaps, who are over 70 and not looking to borrow more than a small proportion of the value of their home.