

# The potential for use and misuse of reverse mortgages in Australia

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## **Abstract:**

Reverse mortgages have continued to increase in popularity in Australia, with many seniors agreeing to mortgage their home. However, since the largest asset for many ageing households is their primary place of residence, consideration should be given to the level of risk that seniors may be exposed to. At the same time, there have been demographic changes that have placed pressure on the regular income of retirees, many of whom have no superannuation fund. For example, life expectancy rates continue to rise and there are an increasing proportion of single person households in society. This has placed additional pressure on financial resources of retirees, especially those with a substantial investment in their family home and a relatively small pension.

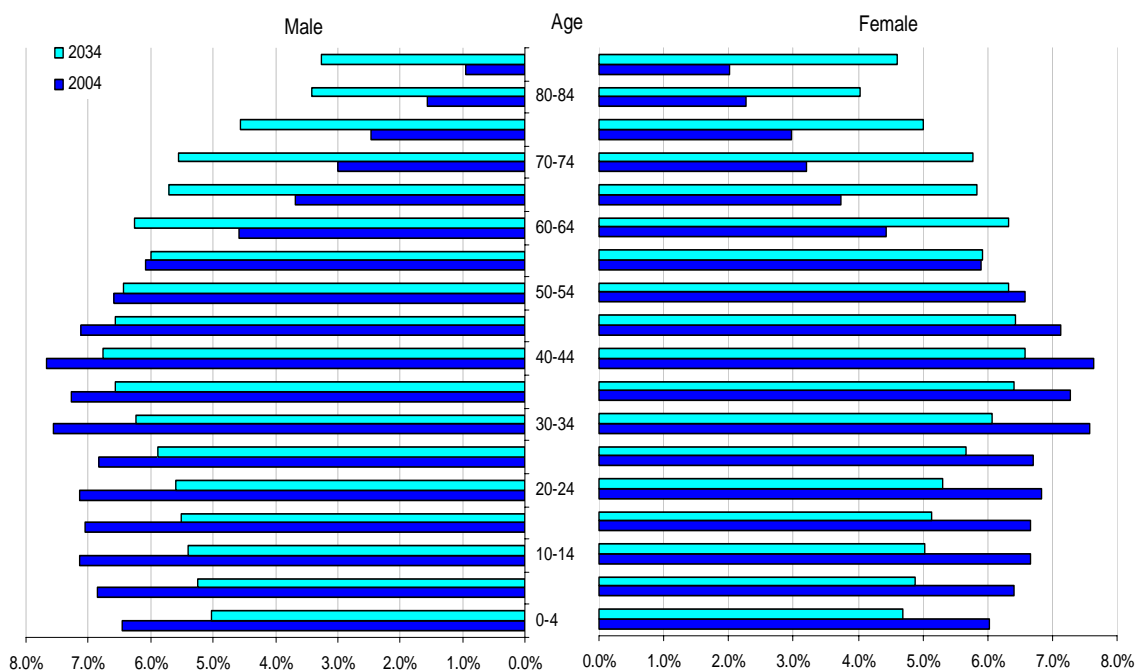
This paper focuses on the potential for reverse mortgages to be both successfully used and also misunderstood by Australian seniors. It considers the recent growth in reverse mortgages in Australia and discusses some preliminary findings. The paper introduces the framework for the larger project which involves interviews of prospective and current reverse mortgage customers. Like any financial, careful planning should be undertaken and importantly not every financial product is suitable for every person.

## Introduction

The largest single asset for many older Australian households is their primary place of residence, usually in the form of a detached house or a medium to high density unit. This cohort consists primarily of retirees aged 55 years and over who have permanently left the full-time workforce with limited means of earning additional household income, but who also have a lack of prior financial planning assistance and often no access to superannuation funds. As shown in figure 1 there is a rapidly aging profile predicted for the Australian population between 2004 and 2034 (ABS, 2004). At the same time there has been an increase in essential living expenses such as medical, food, transport and the introduction of a Goods and Services Tax (GST). These changes were generally unforeseen and have severely challenged the ability of Australians or seniors to retain a reasonable level of housing in retirement, as the combination of restricted household income and increased living costs has placed substantial pressure on the household budget (Weiner, 2003).

To reduce financial stress for seniors directly related to financial issues, a product in the form of reverse mortgages evolved allowing seniors to tap into the equity in their home (Korn, 1997; Kane, 2003). In the US the number of reverse mortgages continues to double each year as older households find themselves in the predicament of being ‘asset rich-cash poor’ (Hendricks, 2003; Max, 2004).

**Figure 1. Changing Age Profile in Australia 2004 - 2034**



(Source: ABS, 2004)

Prior to their relatively recent introduction in Australia, many countries had already embraced the concept of reverse mortgages including New Zealand, USA, UK, Canada, Hungary and Singapore. Reverse mortgages are now being actively promoted in Australia by major banks (e.g. Commonwealth Bank of Australia) and other financiers as a means of accessing equity in a retiree's home, even though there is no requirement to make repayments during the course of the loan (Peterson, 2002). Simply explained, the borrowed principal component and other associated costs accrue interest for the term of the loan. For many households the timing of reverse mortgages is ideal, with residential property in most urban areas experiencing rapid price increases during recent years and this is a means of accessing this increased equity without relocating (Williams, 2003). The equity in the home is used to repay the loan, usually on the death of the last inhabitant where the outstanding amount plus accrued interest is then fully repaid.

### **Concerns relating to the use of reverse mortgages**

Although the market for reverse mortgages in Australia is still relatively immature, there are rapidly emerging issues that need to be addressed prior to the widespread adoption of reverse mortgages. Lessons can be learnt from overseas, such as in the UK where reverse mortgages have been available for some time and a number of equity release mortgages and hybrid products have evolved and have become increasingly complex for seniors to understand (Huan et al., 2002). These areas of concern that this research seeks to address are listed below.

#### *Residents outlive the term of the loan*

The loan for a reverse mortgage is calculated on (a) the financial worth of equity in the family home and (b) the expected longevity of the youngest resident. Thus, the loan is structured so the youngest resident will die before the value of the loan exceeds the value of the house. On the other hand, if the value of the loan exceeds the value of the house, the borrower has no means of repaying the loan by re-entering the full-time workforce. Following the initial introduction of reverse mortgages in the US and partly due to a poor understanding by the public, some reverse mortgage applicants lived considerably longer than anticipated. In certain instances, the amount of money owed to the lender exceeded the total value of the property, mainly due to the compounding effect of money over time as well as the large proportion of the original house value advanced. To ensure that this gap would not become a problem, reverse mortgages in the US can now be insured privately or through the Federal Housing Authority (FHA). Underwriting the reverse mortgage with insurance appears to be one of the distinguishing characteristics and is available with about half of the US reverse mortgage suppliers. In many cases the insurance component is underwritten by the US Department of Housing and Urban

Development (HUD), which adds a 2 percent mortgage premium to the reverse mortgage (Taylor, 2003). After considering the healthy lifestyle and increasing longevity of residents in Australia, it is possible that a resident may exceed their longevity calculation and the value of the loan. This issue is yet to be resolved and could have widespread implications, especially as there is no equivalent insurer in the Australian market.

#### *Aggressive marketing tactics*

The market for conventional forward mortgages in Australia has become increasingly competitive with banks and financiers offering incentives, and although this trend has not yet been observed with reverse mortgages it appears inevitable. For example, the market for reverse mortgages in the UK and US is mature and the product is aggressively promoted as a means of overcoming financial difficulties (Kutty, 1998) or converting the house into a ‘credit card’ (Giegerich, 2004). How banks and financiers are using incentives and discounts to lure elderly homeowners into home equity loans has raised concerns as to the ethical nature of this approach (Simon, 2005). It is not possible to accurately estimate the amount of equity that will be remaining at the end of the reverse mortgage, which will be available to the homeowner or for distribution on their final discretion. This final amount is adversely affected by the increase in house value, the length of time before selling the house, the interest rate and the original amount advanced.

#### *The concept is poorly understood*

In Australia reverse mortgages have received limited exposure in the media and only one text has been written explaining the mechanics of this product (Reed, 2004). Other countries have varying regulations that affect the use of reverse mortgages and this has created confusion in the Australian marketplace. The vast majority of Australians have never heard of a ‘reverse mortgage’ and hence are unable to offer advice to their parents and grandparents. Furthermore, those considering a reverse mortgage usually are completely unfamiliar with the advantages and disadvantages, with the exception of direct advice from the financial institution although often receiving remuneration on a commission basis.

#### *Costs associated with reverse mortgages*

Each reverse mortgage is structured differently according to the requirements of the banker or provider and accordingly has varying fees and charges. For example, some reverse mortgage products have floating interest rates whilst others are fixed, and there may be substantial set-up fees and on-costs

involved. Such costs are levied against the loan and will accumulate interest over the term, therefore requiring a large repayment at the end of the loan that was not originally planned for.

#### *Effect on inheritance*

Traditionally most Australians anticipate receiving some form of inheritance from their parents, usually when the family home is eventually sold. However, a reverse mortgage must be repaid prior to the distribution of inheritance monies, if any. This may create concern amongst descendants who consider that inheritance is a right and in turn may have long term social implications (Higgins, 2003). On the other hand, research undertaken by a social and market research firm 'Heartbeat' has shown that people in Australia aged 65 and over were open to the reverse mortgage concept for their parents - although they may receive a smaller inheritance, they parents stand to enjoy a better quality of life (Commonwealth Bank of Australia, 2004).

#### *Maintenance and upkeep of the residence*

In a similar manner to a conventional forward mortgage, the responsibility for maintaining the house rests with the homeowner and not the lending body, with the homeowner retaining ownership at all times. Regardless of how much the level of equity has been reduced this aspect is open to misinterpretation and further complicated by the lack of funds accessible by an older person for maintenance and upkeep of the residence.

#### **Significance and innovation of the overall research**

The larger research project, of which this paper discusses the framework, addresses a rapidly expanding area that affects a growing section of society and examines factors influencing reverse mortgages, both in supply and demand. To-date this area has been overlooked in terms of understanding the needs of older Australians, and importantly to what extent reverse mortgages adequately addresses their needs. Furthermore, it examines the potential for reverse mortgages to be misunderstood. Rather than adopting the individual perspective of (a) a bank or financier, (b) an older household or (c) the government, in part 2 of this research (the next stage) all three stakeholders will be collectively examined for their roles in the reverse mortgage process. This paper at hand overviews the growth in reverse mortgages in Australia and outlines the direction of the overall project.

The larger project will use a cross-disciplinary approach that links property, in the form of residential housing, with demography, being retirees over 55 years of age. It will be conducted in three stages and follows the three aims of this project.

### Stage 1.

To investigate the role of existing reverse mortgages in the Australian market.

### Stage 2.

To assess the financial needs of older Australians and their willingness to undertake a reverse mortgage or home equity loan.

### Stage 3.

To examine the potential for reverse mortgages to be misused or misunderstood

## **Background to the research**

There are widespread social and economic implications to be gained from the completion of this project. The provision of safe and affordable housing for citizens remaining a priority for all governments (Troy 2000). In addition, governments have had a vested interest in the housing market, and closely monitor the status of the market at any given time (Yates, 2000). Nevertheless, a large proportion of the emphasis is placed on the lower end of the market at the ‘first home owner’ entry level - seemingly little attention is paid to existing older homeowners who are perceived to already be in the market place and have already overcome housing-related financial problems (Reed et al., 2002). However this is not correct in all circumstances with certain sectors of the older homeowner bracket in need of priority assistance. Furthermore, it is the older homeowners who, although may have a large proportion of equity in their property, struggle with important tenure issues (Reed, 2006). It is unclear to what extent reverse mortgages will affect government entitlements in Australia and these complications have been highlighted in overseas markets. For example, in the UK one of the major problems lies with the loss of state income support entitlement and other benefits that can be withheld from a UK citizen who takes out a reverse mortgage (Huan et al., 2002).

While there have been links identified between housing and health, such studies have only focussed on homeownership as a means improving the location of housing from slum areas and therefore quality of life (Easterlow et al., 2000). There are clear intangible benefits attached to independent homeownership for older citizens as most would prefer to ‘age in place’ in their own home (Howden-Chapman et al., 1999). Even older residents who are not 100% active are often encouraged to remain at home where possible, rather than relocate into a nursing home or a medical facility for partial care (Weinberg et al., 2001). Alternatively, it is common to have live-in nursing care at home or a limited form of care on a regular basis for meal preparation and associated duties. This is accompanied by

additional expenses that were not anticipated when calculating financial needs in retirement, although a reverse mortgage can meet these expenses and is often promoted in this manner (Reed, 2006).

It has been argued that in western civilisations home ownership has a direct bearing on health and life expectancy in comparison to those living in rented properties (Macintyre et al., 1998). But if growing old in the family home is the preferred option, steps must be taken to address the growing gap between income and expenses without re-entering the workforce. A reverse mortgage has the ability to provide a viable solution, such as where a reverse mortgage enabled one applicant who required money to fund a new prosthetic leg and another required a wheelchair ramp to be installed (Boreham, 2003).

Nevertheless, there remains the potential for the improper application of reverse mortgages with long-term consequences.

The proportion of residents in Australia aged over 50 years is expected to rise from 29% to 46-50% by 2051 (Australian Bureau of Statistics, 2005). Originally the number of years available to enjoy and active retirement were substantially less due to (a) a shorter life expectancy especially for males and (b) often a longer period of employment for many workers who used to work for many more years before seriously contemplating retirement. It is now accepted in society that older households, after ceasing full-time work, should be able to enjoy an increasingly active lifestyle after entering retirement without financial stress (Shiller, 2000). This older group of retirees is predominantly without compulsory superannuation with a heavy reliance on the pension and/or a reverse mortgage. The importance of superannuation is clearly acknowledged in society today, as it is compulsory for all Australian workers to contribute to a superannuation fund for their retirement. As additional workers in the 'baby boom' generation retire and there is less tax paid to the government, it appears that there will be increasing pressure placed on the pension and there are serious doubts if the pension will exist in its current form. Those Australians who were fortunate to have a superannuation scheme should be adequately prepared for retirement. However, the remainder of the population may struggle to enjoy a fulfilling retirement and are rapidly drawn towards a reverse mortgage.

Pressures on society would be substantial if older Australians were unable to maintain a respectable quality of life and there remains a moral obligation on governments and society not to price seniors out of the marketplace. Due to changes in the level of house prices and perceptions towards lifestyle in society, the ability of older households to obtain and retain homeownership has been placed under substantial pressure. Clearly homeownership underpins the traditional Australian society, where a diminished ability to retain homeownership has the potential to directly and indirectly affect many sectors of society (Waxman, 2005). For example, older Australians who don't retire at home may be

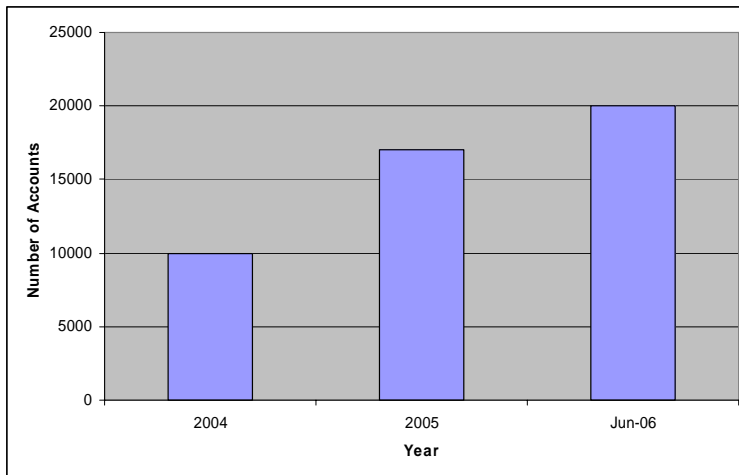
forced into a nursing home earlier than anticipated, placing additional pressure on this resource. This cross-disciplinary project will ascertain the extent of the problem and the catalysts behind its development, as well as provide a direction to address this dilemma.

### Recent growth in reverse mortgages in Australia

Due to the reluctance for a reverse mortgage provider to release information about the growth of sales, it is relatively difficult to gain information about the recent growth in reverse mortgage. Nevertheless, this section seeks to present an overview of the take-up rate in recent years. The majority of this information is provided by ‘SEQUAL’ members, which stands for Senior Australians Equity Release Association of Lenders. This leading group of reverse mortgage providers has been proactive and leads the reverse mortgage market in terms of a high profile and acceptance in the marketplace.

As at June 2006 there were over 20,000 reverse mortgages in Australian issued by SEQUAL members, representing a total loan aggregate of \$1.1 billion with an average loan size of \$53,300 (Hickey et al., 2006). As shown in figure 2, the size of the market has doubled between 2004 and June 2006.

**Figure 2. Growth in Reverse Mortgages in Australia 2004 - 2006**



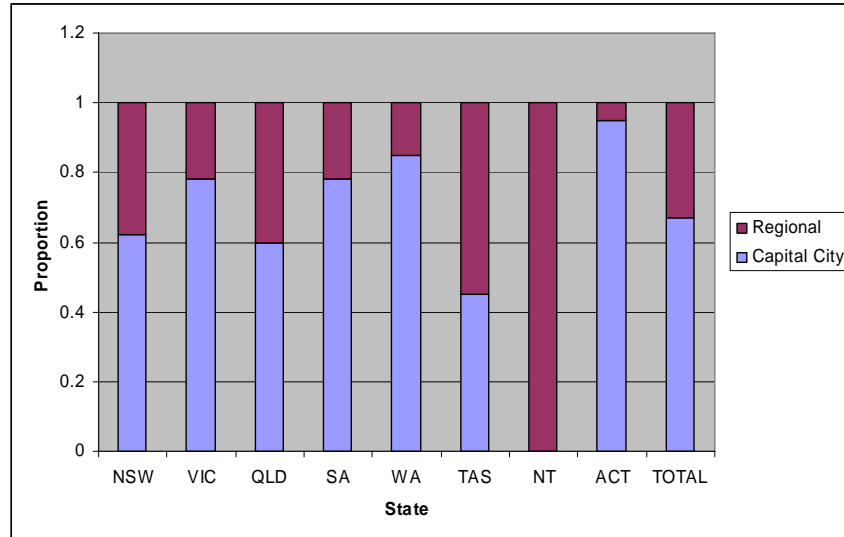
(Source: Hickey et al., 2006)

Due to the geographical diversification between Australian states and territories, there are varying degrees of urbanisation. For example the Northern Territory has a low degree of urbanisation compared to the Victoria and the Australian Capital Territory which both have generally higher degrees of urbanisation. This is reflected in the results displayed in figure 3, where reverse mortgages



undertaken in states and territories with a higher degree of urbanisation are usually in the cities and towns. This result is as would be expected.

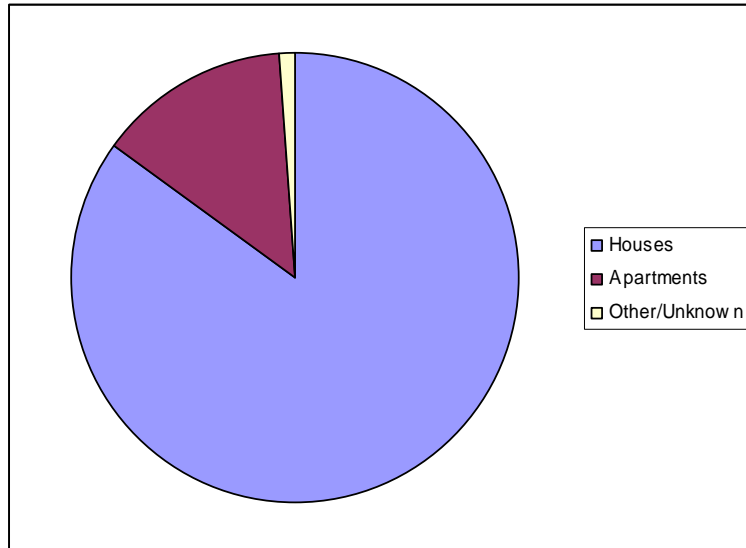
**Figure 3. State by State Comparison (2006)**



(Source: Hickey et al., 2006)

Reverse mortgages are available for different types of housing including detached houses, medium and/or high density units, as well as for alternative forms of accommodation (as long as a mortgage can be taken over the freehold land value). In Australia the predominant housing type that reverse mortgages are being taken over are detached houses, as would be expected due to the high proportion of value in the land component (especially for older homes). Only a small percentage of reverse mortgages were undertaken against apartments or units, with ‘other/unknown’ representing an extremely small proportion.

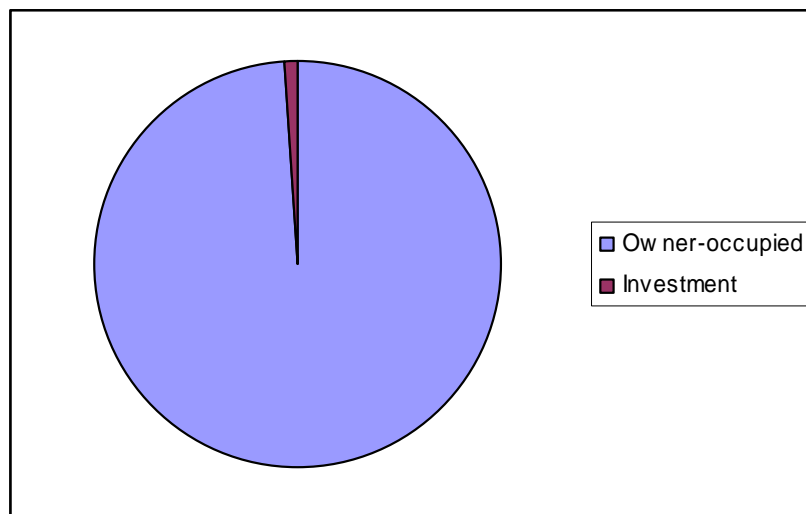
**Figure 4. Reverse Mortgages in Australia by Housing Type (2006)**



(Source: Hickey et al., 2006)

In line with reverse mortgages in the US and the UK, the majority are taken out by owner-occupiers who usually are ‘asset rich – cash poor’ and wish to remain in their current dwelling and not move as shown in figure 5. A relatively small proportion of reverse mortgages are taken out against investment properties.

**Figure 5. Reverse Mortgage in Australia by Ownership Type (2006)**



(Source: Hickey et al., 2006)

## **Further research**

The information presented in this paper confirmed that reverse mortgages are being accepted in the Australian market and there has been a rapid take-up rate. Nevertheless questions remain about the future of reverse mortgages and the depth of the market. Also, the perception of reverse mortgages has changed rapidly and although concerns have been raised about the possibility of eviction, some providers have included an ‘equity guarantee’ in their product so the borrower will never lose 100% of the value of their home.

The next stage of this research is to interview current and prospective reverse mortgage borrowers about their perception about this product. This in turn should identify any problems with the product and provide invaluable feedback to reverse mortgage providers, industry bodies and the relevant government authorities. The data for the analysis will be taken from two main areas:

- (a) primary data collected from focus groups conducted in Brisbane, Melbourne and Sydney;
- (b) secondary data sourced from organisations e.g. Australian Bureau of Statistics (ABS), The Real Estate Institute of Australia (REIA) and government records on a time series basis.

The data will then be assembled and analysed to address the research aims. Preliminary results from this data analysis will highlight difficulties associated with reverse mortgages, prior to conducting the focus groups in the three capital cities. Furthermore, the preliminary results will ensure that the focus groups questionnaires are robust and address areas of concern for older households in respect of reverse mortgages.

For many, reverse mortgages provide a realistic solution for ‘asset rich – cash poor’ Australians who prefer to age in place. This product allows the homeowner to access the equity tied up in their principal place of residence, without incurring costs associated with relocation. However, like many financial products reverse mortgages are suitable only for a specific sector of the market. Part of this process of establishing a successful profile for reverse mortgages is to objectively evaluate the perception of the public. The next stage of this research will undertake this task.

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