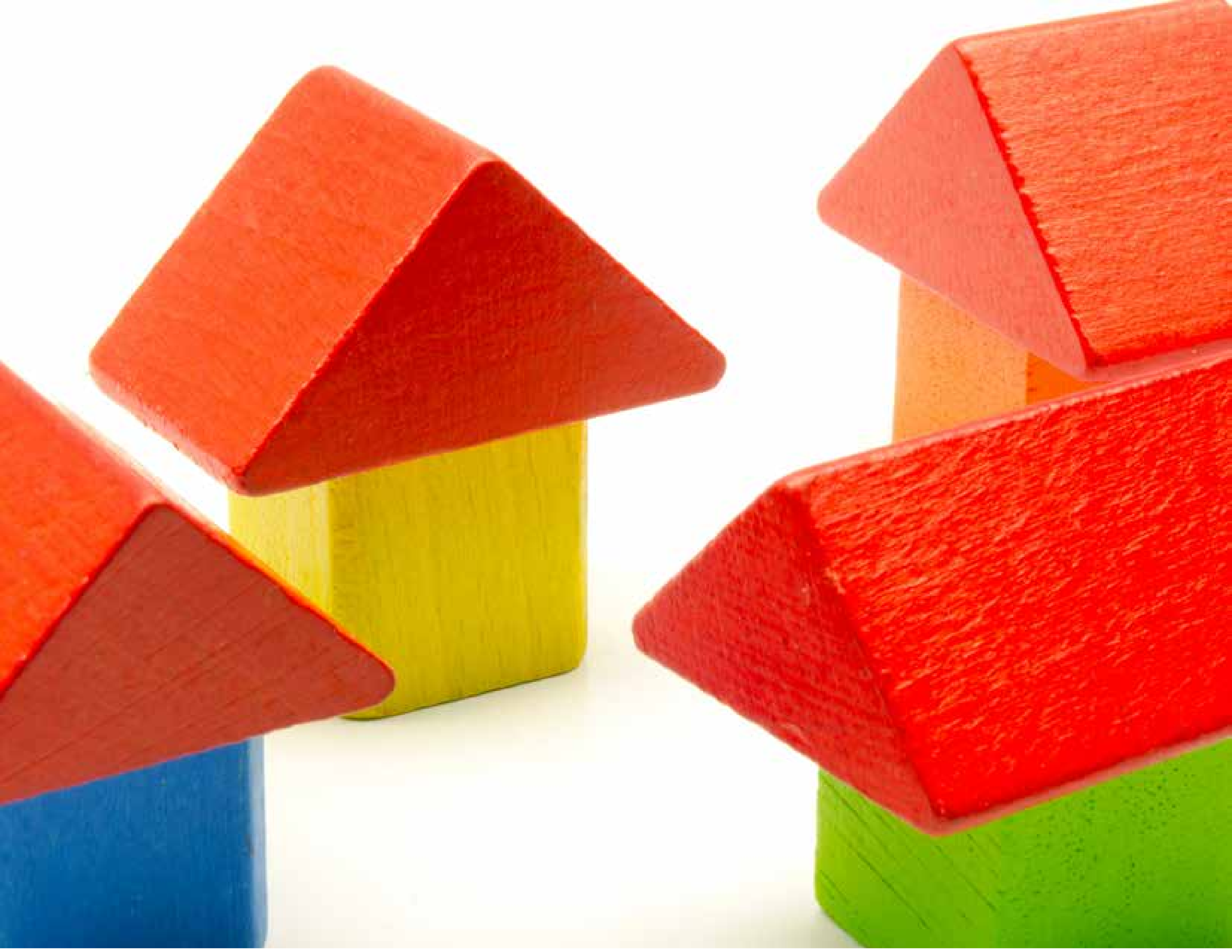


Accessing the equity in your home

Financial Desk
National Seniors Australia

Introduction

The concept of unlocking the equity in personal property is becoming more popular. The method of obtaining the funds, the features, benefits and risks of the various products and schemes can be quite varied and complex. This guide is designed to help consumers understand the various methods, aspects and issues of accessing the equity in their property.

Reverse Mortgages

Reverse Mortgage loans have three defining characteristics:

1. No mandatory payments are required until a ‘Trigger Event’ occurs. Trigger events can include death of the owner/s, sale of the property, the last borrower vacating the property, or breach of certain clauses of the contract.
2. There is generally no set or fixed term. These loans continue until the last surviving borrower dies or a trigger event occurs.
3. Interest is charged and compounded monthly over the life of the loan.

Under the Responsible Lending principles of the National Consumer Credit Protection Act, qualifying applicants can borrow up to specified margins against the security of their primary residence.

In some cases these loans may be secured against non-owner occupied properties. While this type of loan can never be in default due to lack of payments being made, other conditions of the loan can place it in default. These include not maintaining the property to a satisfactory standard, wilful damage or fraud. Lenders may have the right to have the maintenance done with the cost being added to the balance of the loan or arrange the sale of the property.

> “Interest is charged and compounded monthly over the life of the loan”

Eligibility

To qualify, applicants must be of a minimum age – commonly 65 years (though some lenders will consider 60 years and above). Where there is more than one borrower, the age of the youngest person determines their eligibility.

The amount of the loan available varies depending on the provider. The basis for calculating the amount borrowed firstly depends on the age of the applicant. Generally the older the applicant the more they can borrow.

> “Generally the older the applicant the more they can borrow”

Secondly, the value of the property to be offered as security determines the maximum size of the loan. The Loan to Valuation Ratio (LVR) is the amount advanced against the value of the secured property. The maximum LVR can be as a high as 45%.

The minimum loan amount depends on the provider. It can be as little as $10,000.

Applicants must own the property. If there is an existing mortgage on the property to be used as security it must be repaid in full. This allows the reverse mortgage provider to have the only mortgage over the property.

It is usually necessary to have the property revalued periodically. The cost of this may be borne by the consumer or added, at the time of valuation, to the loan.

While eligibility may be satisfied in respect of the age of the intending borrowers, restrictions due to the location of the property that is proposed to be used as security may result in a loan not being offered.

Compound Interest and Other Costs

The interest rate charged is usually just above the market’s standard variable home loan rate. It is generally calculated daily and charged monthly (compounded). Therefore the debt increases over time.

Other costs can include application fees, monthly account fees and valuation fees. These are usually added to the loan balance on which interest accrues and compounds.

For example, a person borrows $30,000 gross (including application fee) at an interest rate of 7% per annum and a monthly charge of $10. At the end of 10 years the debt would have grown to about $62,020. This assumes the interest rate remains constant.

If desired, it is possible to make voluntary repayments which will effectively reduce the amount of debt that accrues. Caution is suggested if considering making repayments on fixed rate loans, as it may create a Break Fee that is greater than the interest cost (see ‘Break Fees’ below).

Other assumptions that need to be made should include the potential value of the property over time and the cost of maintenance. These can be particularly important where it is the borrower’s desire to leave a legacy.

It is sometimes possible to have a protected amount of equity which can be left as a legacy. This usually restricts the amount that can be borrowed. If leaving a legacy is a consideration, applicants should check the terms and conditions of this option with their provider.

Prior to making an application for a loan it is important to check if an application or an establishment fee is payable even if the loan is not proceeded with.

Break Fees

Break fees may apply if the loan is repaid early or a payment is made during a period when the interest rate is fixed. The interest rate may be fixed for a specified term or for life. Where the rate is fixed for life, repayment of the loan prior to the death of the borrower/s could result in the fee being charged.

In general, if rates at the time of repayment are lower than the contracted fixed rate for the loan, the break fee could be a significant amount. They depend on the remaining anticipated term of the loan, the contracted interest rate and the current rate at the time of payment/repayment. Break fees will not apply if repayment occurs due to the death of the last borrower/occupant or moving into assisted aged care. It usually applies if the property is sold early or the loan is being refinanced.

Although amendments were made to the 'National Consumer Credit Protection Act 2009' that prohibits early termination fees for most residential loans, they do not include a credit fee or charge that is a break fee. A break fee should only reflect the actual loss or cost incurred by the lender due to early termination. Fees cannot be charged to discourage or punish the borrower. It is prudent to ensure that the process for calculating a break fee is fully understood and examples are given.

Choices and Options

Lump Sum vs Regular Payments

Commonly there are three ways funds can be received – as a lump sum, a regular payment/drawdown or a combination of these. Structures such as a 'Line Of Credit' (LOC) or a 'loan offset account' may be used to facilitate this. There are pros and cons associated with each approach. Before selecting a particular method it may be prudent to seek professional advice (see section Getting Advice). The amount borrowed, the method in which it is received and how the proceeds are used may affect other issues such as Government Income Support payments (see section Impacts on Your Pension).

> "Before selecting a particular method it may be prudent to seek professional advice"

If the regular payment option is chosen this may be provided in various ways. The loan may be set up as a LOC and funds drawn as desired or an authority taken for regular amounts to be automatically credited to a working account. With this option interest does not accrue until the money is withdrawn. Alternatively, the proceeds of the loan may be held in a separate offset account and authority taken for regular payments to be made from the offset account to a working account. In this case, interest is usually charged on the difference between the loan balance and the offset account balance at the full rate and the offset account balance at a reduced rate - possibly 0.0%.

If taken in full as a lump sum, interest will accrue and be charged on the full balance.

Fixed vs Variable

Fixed interest rate loans mean that the rate charged cannot increase even if interest rates rise. However, if rates fall the reduced rates do not apply to the loan either. Break fees (see page 5) generally apply making it prohibitive to renegotiate the loan. Asking for an example of break fees if rates fell by 3% would be prudent.

A variable interest rate may rise and fall in line with movements announced by the Reserve Bank. The passing on of adjustments in interest rates is at the discretion of the provider.

Equity Protection Option

Another option providers may offer is to quarantine an amount of equity you wish to keep as a legacy. A fee may apply for this option and will probably reduce the maximum amount you can borrow.

No Negative Equity Guarantee

Regulations were introduced in September 2012 which means providers of Reverse Mortgages must offer a No Negative Equity Guarantee (NNEG). Reverse Mortgages offered by some providers prior to September 2012 may have a NNEG.

Increasing the Borrowing in the Future

Some people may contemplate borrowing a larger sum of money than they initially need to use, to avoid having to apply for a loan increase at a future time. The main concern with this course of action is if the borrower does not need the extra money but uses the funds anyway, resulting in a much higher debt at the end of the loan. This of course reduces the remaining equity in the property which, for some, is an important concern.

The benefits in following this course of action is in the event of there being a change in the policy of the lending institution, the loan is already approved. There is also the convenience of not having to apply for the increase at a later time, possibly avoiding extra application fees.

> “There is also the convenience of not having to apply for the increase at a later time”

In this situation it would be prudent to calculate the costs that could accrue if additional funds were borrowed initially compared with increasing the amount of the loan at a time when the funds were required. Where the loan amount is to be increased in the future a further application fee usually applies.

For example if $30,000 was borrowed but remained unspent for 2 years, assuming a borrowing interest rate of 7% and no monthly fee, the interest accrued on the loan would be about $4,500 (including compounding). Assuming the unspent funds were invested at 4% and neither tax nor reduction in government income support applied, the cost over 2 years would be approximately $2000.

This is because of the extra interest accrued on the larger amount borrowed. Provided the application fee remains stable applying for the additional amount later may be cheaper.

Other options include having the approval for the higher amount but not drawing the funds until they are required – a LOC. In practice, some people who have this option do not exercise self-control and spend the additional amounts sooner than they intended.

Equity Release products for Residential Aged Care costs

These credit products may provide a solution for retirees to fund Refundable Accommodation Deposits (RAD) and other costs required by aged care facilities by accessing equity in their home. Although similar in structure to a Reverse Mortgage some key differences apply:

- The proceeds are to be used to cover the cost of Residential Aged Care such as an Accommodation Payment via a RAD and/or other ongoing aged-care related costs.
- They have a maximum loan term (ranging from five to seven years) although the provider may agree to extend the term.

Repayment is required when a ‘trigger event’ occurs. While not a comprehensive list, trigger events include leaving the facility, the sale of the property or death.

Minimum and maximum loan amounts vary depending on the provider, however like a Reverse Mortgage, regulated borrowing limits apply. This is known as the maximum Loan to Value Ratio (LVR). Application and ongoing fees may apply.

Equity Release option for Residents of Retirement / Lifestyle villages

This type of borrowing allows residents to release a part of the investment they have made in a lifestyle community residence.

For those who reside in a retirement village or apartment under a license to occupy or lease arrangement, a scheme is available from a specific lender who will permit the resident to borrow against the value of their Refundable Accommodation Deposit. The amount is calculated against the investment in the retirement village residence and the lender will assist the resident in releasing the equity by providing borrowings in the form of a personal loan or line of credit.

This scheme allows the borrower to draw down a lump sum, either in small or regular amounts as an income supplement or cash reserve for future drawdowns, or in larger lump sum borrowings for any personal asset purchase or lifestyle expenditure. There are no monthly account keeping fees or early termination fees.

This type of borrowing requires consultation with, and the support and agreement of, the Administering Authority of the Retirement Village.

Shared Sale Proceeds Arrangement

Shared Sale Proceeds Arrangements have the following defining characteristics.

1. The homeowner receives an upfront cash amount by selling a share of the future sale proceeds of their home. The provider becomes entitled to its purchased share when the home is eventually sold either by the homeowner or their Estate.
2. The homeowner enters into a Contract which protects their right to remain in their home for as long as they wish.
3. As the homeowner has sold a share of the future sale proceeds and not borrowed against the equity in their home there is no debt attaching to their home.

At present there is only one provider of a Shared Sale Proceeds Arrangement and the following sections generally relate to the product offered by this provider.

> "...certain criteria which must be met, including that homeowners must be aged at least 60 years..."

Eligibility

To be eligible, there are certain criteria which must be met, including that homeowners must be aged at least 60 years. The home being used must be the homeowner's principal place of residence and must be located in certain cities/postcodes. If there is an existing mortgage on the home then it must be repaid in full using the funds from the Shared Sale Proceeds Arrangement or from other funds.

The provider may also impose conditions to protect the rights of a partner who is not on title to continue to reside in the home after the death of the partner on title.

Purchase Price

The provider calculates the purchase price paid for a share of the sale proceeds using the ages of the homeowners and the current value of the home. The purchase price is less than the face value of the share being sold because the homeowners retain the right to live in their home, remain the legal owners and can rent out their home and keep the rental income.

Rebates

The provider when calculating the purchase price for a share of the sale proceeds of the home is effectively making an estimate of when the home will be sold and an estimate of the amount of the sale proceeds. In order to protect the homeowner the arrangement provides that the provider's share may be reduced if the home is sold earlier than expected (early sale rebate) and if the sale proceeds exceed a specified benchmark (excess proceeds rebate). It is important that homeowners receive examples of the rebates for various contract terms and different sale proceeds amounts.

Equity Protection

The risks associated with property values and longevity in relation to the sold share is borne by the provider and not by the homeowner.

As the homeowner has only sold a share of the sale proceeds, they have the certainty of retaining the share they have not sold. For example, if they have sold 30% of the sale proceeds they will know that they will retain at least 70% whenever they sell their home.

> "...it is very important that illustrations be obtained for a number of possible outcomes..."

Illustrative Outcomes

As with all equity release products, homeowners should obtain examples of the financial outcome for different contract durations and various property values. For example, Jill who is aged 75 years with a home valued at $500,000 may need $100,000. The provider may agree to purchase 35% of the future sale proceeds of the home. Therefore, Jill will retain at least 65% of the sale proceeds of her home. If for example Jill decides to sell her home in 5 years for $580,000 (ie. the value of her home has increased by 3% per annum) then the early sale rebate will increase Jill's share to approximately 74% (compared with the minimum 65%).

As stated above it is very important that illustrations be obtained for a number of possible outcomes.

Additional transactions

Homeowners can continue to sell additional shares of the sale proceeds of their home until they reach the maximum permitted by the provider. Each additional sale will be based on the age of the homeowner at the time of the additional sale and the value of the home at that time.

In many cases where a homeowner may only need a limited amount of funds then utilising this option may be beneficial.

Other features

- The contractual basis of the arrangement is an uncompleted property contract which can only be completed after the death of the homeowner thereby protecting their right to live in their home for the remainder of their lives. The provider takes security to protect its right to its share of the sale proceeds.
- The homeowner retains all its legal ownership rights and remains the legal owner and has the right to sell their home whenever they choose. The homeowner also has the right to rent out their home and retain the rent.
- The provider does not have any maintenance requirements or any regular revaluations.

Pension Loans Scheme

People of Age Pension age (or their partners) who are not eligible to receive a pension because of either their income or their assets or those who only receive a part pension, can access capital tied up in their real estate assets under the Pension Loans Scheme.

For example Frank was on a part pension due to his high level of assets but found that he needed more income to get by. Under the Pension Loans Scheme he was able to increase his payment to the amount of the full pension with this difference being the loan. Interest is charged on the loan and a statutory charge is held over the property.

Further information on this facility can be obtained from the Department of Human Services (DHS) or Department of Veterans' Affairs (DVA) by searching on their websites www.humanservices.gov.au or www.dva.gov.au.

How Else Can You Access Your Equity?

Downsizing

Downsizing can free up equity while maintaining full home ownership. This is simply selling the existing home and purchasing a property of lesser value. Any surplus funds are then available for use. It would be advisable to check the costs involved such as stamp duty, agent's fees, marketing fees and relocation costs.

Impacts on Your Pension

Effect on Government Income Support Payments

For people who receive Government Income Support (GIS), such as an age pension, consideration should be given to the possible impact equity release products may have on the payments they receive.

The first $40,000 is not counted as an asset for 90 days even if it remains unspent. Where more than $40,000 is accessed and not immediately spent, the amount in excess is counted as an asset immediately, with the remaining $40,000 being counted only after 90 days have expired. Where the whole amount is immediately spent, unless spent on assessable assets or other assessable transactions, the above does not apply. Any unspent amounts held are a financial investment and subject to deeming under the Income Test.

“Before signing a contract for equity release it would be worth speaking with a Financial Information Service (FIS) Officer...”

Where the loan is set up like a 'line of credit' and drawn on a regular basis directly from the loan, there is no effect on the Income Test nor the Assets Test unless the funds accumulate in another financial investment.

Some institutions that offer regular payments do so by holding the proceeds of the loan in an 'offset account' or a secondary account and make the payments from that source. For GIS the balance of the offset account is classed as an asset and is subject to deeming for the Income Test although the interest rate for an offset account usually matches the loan interest rate. The benefit of an offset account is that the interest cost to the borrower is reduced because it is only charged on the amount of the loan that is greater than the balance of the offset account.

Before signing a contract for equity release it would be worth speaking with a Financial Information Service (FIS) Officer from the Department of Human Services (DHS) to confirm the assessment of the product on Government Income Support payments. Appointments to meet with DHS FIS Officers can be made by telephoning 13 23 00.

Your Decisions Could Impact on Others

Discussing the decision to use an equity release product with family members could also be sensible so they can be aware of the consequences of such a transaction and, if desired, other alternatives may be investigated. As other people could be impacted by using an equity release product, all concerned should be aware and understand the consequences of this course of action.

> "...because an end date is unknown it is hard to predict the balance of the loan..."

A Shared Sale Proceeds Arrangement gives certainty that a percentage of the final sale price remains available, although the final sale price may be hard to predict.

With a reverse mortgage, because an end date is unknown it is hard to predict the balance of the loan and therefore any equity remaining. It is possible the final proceeds of sale may be used to reduce the debt and the provider carries a loss under the 'No Negative Equity Guarantee'. Interest rate movements and property prices are difficult to forecast.

It is a requirement that providers or credit assistance providers such as brokers, show and provide to applicants printed copies of projections using the reverse mortgage calculator on the Australian Securities and Investments Commission's (ASIC) Moneysmart website www.moneysmart.gov.au. These projections are an estimate only and are not a guarantee of how much the loan will be or how much equity will be left upon the termination of the loan.

The Big Picture

As the interest on the loan accrues, the amount of equity in the property falls. If the priority is to leave an estate for heirs, this could be quite concerning. Quarantining a portion of the equity ensures not too much is borrowed. It may also be worthwhile to prepare a workable budget.

Getting Advice

Reverse Mortgages are regulated and providers may make it mandatory that legal advice is sought. As mentioned previously it is mandatory that all borrowers must receive projection information using ASIC's reverse mortgage calculator.

It is also mandatory that a pre-assessment is conducted to determine the suitability of the credit application. This involves a 'needs analysis' taking into account future needs and objectives including possible aged care costs.

Anyone providing a regulated loan such as a reverse mortgage must hold an Australian Credit Licence or be a Credit Representative. ASIC has information on Reverse Mortgages and on Consumer Credit Regulation in the National Consumer Credit Protection Act.

Financial advice is not mandatory but it is prudent that the potential financial implications be considered before proceeding. These include such things as any impact to Government Income Support (GIS), effects on cash flow, in depth projections based on a broader range of scenarios, implications to future needs and objectives including assisted aged care, other options which may be considered and potential impacts to estate beneficiaries. As with anyone else providing advice, fees are likely to apply.

“As with anyone else providing advice, fees are likely to apply...”

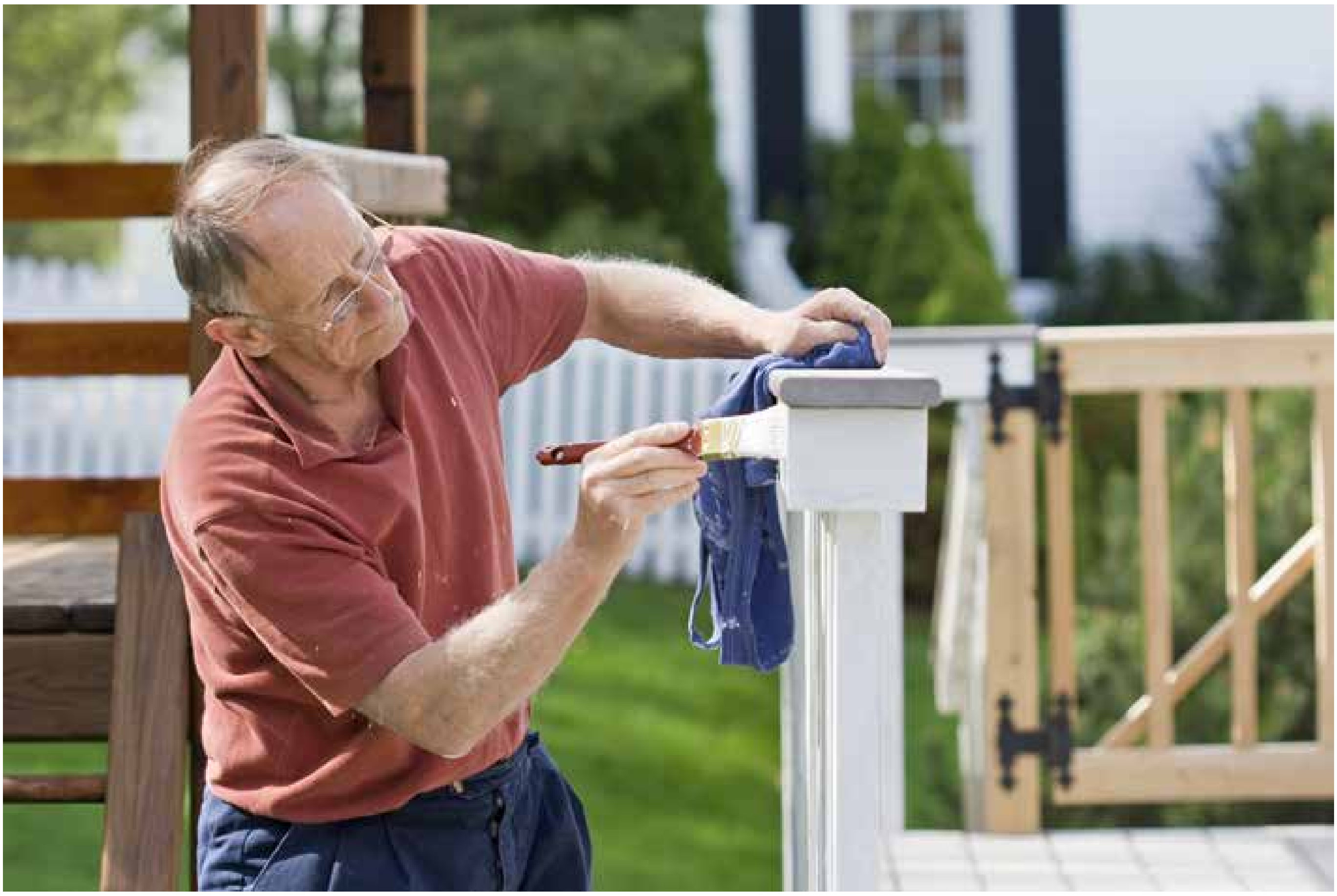
Mortgage & Finance Association of Australia

The Mortgage and Finance Association of Australia (MFAA) is the national peak body of professional credit advisers including mortgage and finance brokers, mortgage managers and aggregators. They have developed a Code of Practice, Disciplinary Rules and other governance guidelines seeking to reassure consumer confidence when dealing with an MFAA member. For more information visit www.mfaa.com.au or phone 1300 554 817.

> "Check if you face any penalties or fees should you choose to exit the scheme..."

Tips

- Check if the provider is prudentially regulated and holds an Australian Credit Licence if required.
- Check with the Department of Human Services (DHS) to see if it will affect your Government Income Support entitlements.
- Check if the equity release transaction is portable in case you wish to move house and retain your equity release facility in the future.
- Check if you face any penalties or fees should you choose to exit the scheme whether retaining or selling the property at a time of your choosing. Mortgage
- Ask the provider what your obligations are as far as maintenance on the property is concerned.
- Ensure that where applicable regulated consumer protections are being met according to the 'National Consumer Credit Act 2009' such as offering a 'No Negative Equity Guarantee', providing you with a thorough pre assessment for suitability of the product and providing the appropriate documentation and projections.
- Ensure that your insurance cover is adequate.
- Find out what your rights are and what dispute resolution process the product provider and/or adviser/broker have in place if you have a problem or a dispute arises.
- Find out what restrictions an equity release product will have on you in the future - for example if you wish to renovate or need to move into aged care.
- Ask the provider questions about themselves such as how long have they been in business, can they give you any customer feedback and how can you deal with them in the future.



Where to Next?

Checklist

Complete the checklist when deciding on an equity release product. If you have any questions or require further information, please call us on 1300 020 110.

- ☐ Do I really need the money?
- ☐ Do I want a lump sum or a regular payment?
- ☐ Have I accurately established the amount of funds I require?

Options

- ☐ Have I considered other options available such as private loans, downsizing and the Pension Loans Scheme?
- ☐ Have I investigated all the equity release product options such as Reverse Mortgages, Shared Sale Proceeds Arrangements, Property Options and if any new products are available?

Providers

- ☐ Did I compare terms and conditions?
- ☐ Did I read the product information?
- ☐ Did I compare rates and costs?
- ☐ Did I compare product features?
- ☐ Are the providers prudentially regulated and financially sound?

Impacts

- ☐ Do I need to check the impact on Government Income Support entitlements?
- ☐ Have I considered the potential total costs of accessing equity now compared to the potential future value of the property?
- ☐ Will it impact on my desire to leave a legacy to my beneficiaries?
- ☐ Do I want to protect any equity?

Advice and Information

- ☐ Have I sought legal advice?
- ☐ Do I understand the product information?
- ☐ Have I received and read all the documentation and illustrations thoroughly?
- ☐ Do I understand the terms and conditions of my contract?
- ☐ Will the loan restrict my future lifestyle choices such as renovations and aged care etc?
- ☐ Do I know what constitutes a breach of contract?
- ☐ Do I understand the disputes resolution procedure?

Rights and Obligations

- ☐ Will the loan restrict my future lifestyle choices such as renovations and aged care etc?
- ☐ Do I know what constitutes a breach of contract?
- ☐ Do I understand the disputes resolution procedure?

Still confused? Call Financial Information Desk (FID) on 1300 020 110

Contacts

Financial Information Desk (FID)

1300 020 110
fid.org.au

Department of Human Services (DHS), Financial Information Service (FIS)

13 23 00
humanservices.gov.au

Australian Securities and Investments Commission (ASIC)

1300 300 630
moneysmart.gov.au

Financial Ombudsman Service (FOS)

1800 367 287
fos.org.au

The Credit & Investment Ombudsman (CIO) Service Limited

1800 138 422
cio.org.au

Mortgage and Finance Association of Australia (MFAA)

1300 554 817
mfaa.com.au

National Seniors Australia (National Seniors) is a not-for-profit organisation that gives voice to issues that affect Australians aged 50 years and over. It is the largest membership organisation of its type in Australia with more than 200,000 members and is the fourth largest in the world.

The Financial Information Desk (FID) is an independent, confidential service funded by National Seniors that aims to improve the investment information available to older Australians

Our Objectives

- To provide an accessible, independent and trustworthy source of information for older Australians - particularly those with modest means.
- To promote industry and community awareness of consumer investment issues - particularly amongst older Australians.
- To promote industry understanding of consumer investment issues and to contribute to the raising of industry standards.
- To examine any unfairness in the market between consumers and providers of investment services and to provide information to consumers on dispute resolution processes.
- To represent the views of consumers on investment issues to industry and government organisations.
- To research and publish items on consumer issues relevant to the financial welfare of older Australians.
- To liaise with relevant consumer, community, academic and industry groups, as well as government organisations, to further these objectives.

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