The Case for Reverse Mortgages in Australia - Applying the USA Experience

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In the USA, reverse mortgages have been promoted as a means of accessing equity locked up in a residence, especially after the owner/s has retired. Although there have been some teething problems, the concept of mortgaging the family home after achieving freehold ownership has many merits. Often an asset-rich household must survive on relatively small regular income, and is unable to access the increasing wealth of the family home. A reverse mortgage overcomes this hurdle.

The largest asset for many ageing households is their primary place of residence, the traditional house and suburban land parcel. Recently, the Australian housing market has witnessed substantial growth in the value of its capital city housing, especially on the east coast of Australia. This can be attributed to factors such as owner-occupiers trading up to a better class of dwelling, and the continuing gentrification process for owners choosing not to relocate. At the same time, demographic changes 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 visits the reverse mortgage scenario in the USA and considers potential implications for the Australian market. Strengths and weaknesses of this product are contemplated, and the viability of reverse mortgages is discussed. Although there are obvious benefits for certain segments of society, reverse mortgages are a unique product and caution should be exercised to ensure the public is fully knowledgeable from the outset.

Introduction

Even though the current Australian property boom has caused many people's wealth to soar, numerous older homeowners now find themselves with greater assets but little cash income (Whittaker, 2002). Daily household expenses have also increased while many of these households have little or no flexibility built into their regular cash flow streams. A similar scenario also confronted many elderly households in the USA, although the market responded with a number of organizations offering reverse mortgages as a solution to this dilemma and the concept is gradually gaining acceptance (Peterson, 2002).

Simply explained, reverse mortgages are designed for elderly homeowners to access their home equity while continuing to live in their homes. The benefits can be substantial and include continuing to reside in a cherished home and paying for long term care insurance or other health-related costs (Kistner, 1999). Variations of reverse mortgages have surfaced in other countries, such as New Zealand, although with somewhat mixed success. For example, in New Zealand the most that can be withdrawn is 20 per cent of the home's value, although this can be increased if the property increases in value (Whittaker, 2002).

The concept of a reverse mortgage is not new to the Australian financial sector. In the 1990's, the St. George Bank offered reverse mortgage products, although they were withdrawn due to a lack of consumer demand (Thosar, 2002). However, the timing was inappropriate in the 1990s, although the recent housing price boom and continually spiralling medical costs support an argument for a re-launch of reverse mortgages in this country. As many parallels can be drawn between the housing markets of the USA and Australia, this paper proposes that the some of the lessons learnt from the implementation of reverse mortgages to American households may be applicable to the Australian market.

The Concept of a Reverse Mortgage

Reverse mortgages were designed to allow "house rich, cash poor" elderly homeowners access to their home equity to pay living expenses or emergency bills without having to sell their homes.
Before the creation of reverse mortgages in the USA, the only options elderly homeowners had to access their equity was either to take out a traditional forward mortgage or sell their home. A traditional mortgage would require repayment in the form of monthly payments from what is often a

limited income. In addition, most older Americans lived through the Depression and tend to avoid debt, especially debt that would require a lien against their home with the possibility of foreclosure and sale if they were to default on repayment. Selling the home and moving into a cheaper home or rental housing is not a preferred option for most elderly homeowners. Most older Americans want to "age in place" in familiar surroundings and never move during retirement. One solution to this problem was the creation of reverse mortgages, which would allow homeowners to spend the equity they have built up in their homes.

The effect of a reverse mortgage on the changing level of home equity over time is shown in Figure 1. In stage 1, a conventional housing loan is commenced that requires the security of a lien over the house via a mortgage. Over time, the household equity increases (stage 2) through the increasing value of the property and the repayment of the loan. Complete home ownership is often achieved in the middle to later years of the working life (stage 3), when the mortgage is fully paid out. After retirement has commenced and a regular cash inflow has ceased (stage 4), a reverse mortgage can commence. Over time, this will decrease the level of equity in the house (stage 5), although the loan is structured so not all the equity is removed.

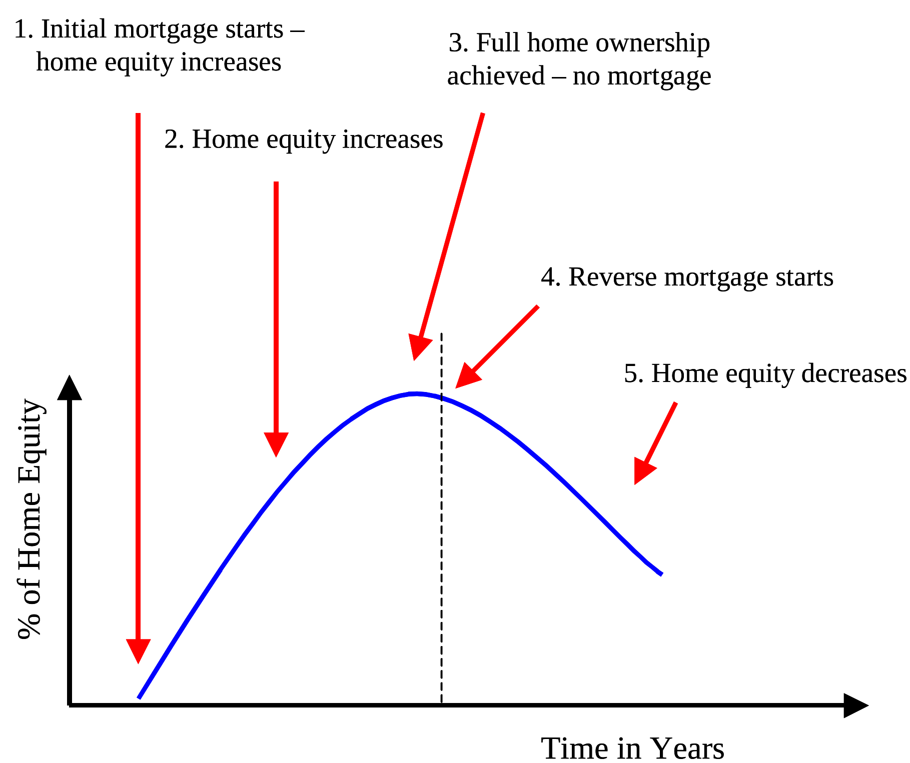

Figure 1 – The relationship between mortgages and home equity over time.

Most reverse mortgage lenders in the USA will require the primary lien position. The security for the loan is the property itself; the loan is nonrecourse. Assuming the borrower meets all the conditions of the loan contract, when the owner moves or dies, the owner or heir is responsible for repaying the loan obligation either through the sale of the property or other assets. If the loan obligation is less than the sales price, the owner or estate keeps whatever amount is left over. If the home is worth less than the amount due, the owner and heirs are not obligated for any shortfall.

Reverse mortgage lenders can accelerate repayment at any time if the borrower defaults through failure to pay property taxes, failure to maintain the property, failure to maintain a valid hazard insurance policy, abandonment of the home, renting the home to someone else, or adding a new owner to the title. Lenders may choose to pay these expenses and reduce the borrower's loan proceeds rather than foreclose.

Three types of reverse mortgages are generally available in the USA today: annuity, term, or lump sum/line of credit. The original programs primarily offered reverse annuity mortgages (RAM). With a tenure reverse annuity mortgage, the owner receives monthly payments for life so long as the home is the primary residence. When the last co-borrower permanently moves or dies, the debt becomes due and the house sold or the heirs use other assets to repay the debt.

The term reverse mortgage, in contrast, provides monthly payments for a fixed number of years, usually up to ten. Under the original programs, the loan became due at the end of the term and the owner was expected to move and sell the house to repay the loan. With current programs, the payments stop at the end of the term and interest continues to accrue, but repayment is not expected until the owner moves or dies.

The third type of reverse mortgage, the lump sum/line of credit, approves the borrower to make draws anytime up to a set amount. Interest accrues and repayment is due when the owner moves or dies. Some programs allow borrowers to receive a combination of the types of payments. The most popular programs in the USA have been the line of credit or a combination of line of credit with either term or tenure.

No matter what the payment plan, the amount of the loan principal is based on the amount of equity in the house, expected appreciation in the property's value, market interest rates, and the youngest borrower's age and life expectancy. The larger the equity and greater the appreciation expected, the lower the risk that the loan principal and accrued interest will exceed the market value of the property when the loan becomes due. Higher interest rates mean more interest will accrue, increasing the risk that the loan obligation will exceed collateral value. The longer the owner lives, the greater the loan obligation whether the borrower chooses the annuity or lump sum with accrued interest option.

History of Reverse Mortgages – The USA Scenario

Reverse mortgages were first offered in the USA in the 1980s to allow seniors access to their home equity while avoiding the problems a traditional mortgage or sale of the home would entail. It has been estimated that some 20 million senior homeowners have more than US$2 trillion locked into home equity (Panko, 2002). After agreeing to the terms of a reverse mortgage, the lender would issue funds based on the equity the owner has built up in the home and would receive repayment of the loan plus interest when the last co-owner permanently moved from the home, sold the home, or died. The reverse mortgage payments would not be taxable as income to the homeowner and would not affect eligibility for most social services.

Supply of Reverse Mortgages in the USA

However, lenders did not rush to offer reverse mortgage products for several reasons. First, legal impediments to creating such loan arrangements existed in some states. Required accounting techniques made the loans financially unfavourable. The innovative product did not have an established consumer base and someone would have to pay the cost of developing the market for reverse mortgages, educating consumers and loan officers alike about the products. In addition, when the product was first developed, lenders either had to offer uninsured or self-insured mortgages. If borrowers defaulted, lenders faced the public relations nightmare of evicting elderly homeowners. Title companies were not interested in insuring title on properties with reverse mortgages. The lender faced additional risks associated with the borrower and property that affect pricing for which no history existed on which to estimate costs. With no secondary market, they also had to hold the mortgages in their portfolios. In summary, the costs were high and the rewards uncertain.

In the ensuring years, some changes have been made, but some obstacles still exist. When the reverse mortgage concept was introduced, several states laws required a mortgage to include a specific maturity date, maximum mortgage amount, or both, making lines of credit and payment upon uncertain death unavailable. Other states restricted compounding interest, negative amortization, and adjustable rate mortgages. The Texas constitution included a homestead provision, which prohibited lenders from making home mortgages for any reason except to purchase a home, to pay taxes on a home, or to finance repairs. Legislative action and a referendum in 1999 removed some of these barriers, but a line of credit is still not allowed in Texas (U.S. HUD, 2000).

Reverse mortgages must comply with federal regulations as well. The loans fall under the disclosure requirements of the Truth-in-Lending Act as amended by the Home Equity Loan Consumer Protection Act. As these laws were written for forward mortgages, the wording of some of the disclosures can be confusing concerning reverse mortgages. Some lenders perceive reverse mortgage programs as an opportunity for positive public relations and an opportunity to demonstrate service to low-income persons and communities, which may improve their Community Reinvestment Act (CRA) ratings.

For purposes of financial reporting, the lender records the outstanding balance of the reverse mortgage as an asset. However, future payments to which the lender is committed are not shown on its financial statements, resulting in off-balance-sheet liabilities. Both the interest and any shared appreciation component added to the loan balance are taxable as current income, even though the lender has not received any payments from the borrower (Boehm and Ehrhardt, 1994).

Lenders still face the risks of longevity, interest rate changes, and future property values (Szymanoski, 1994). The uncertainty of borrower longevity and tenure makes it difficult to estimate the timing of repayment and, therefore, the return the loan will yield. To avoid crossover risk, the loan amount must be set low enough to ensure the collateral will retain sufficient value to cover the lien as the property ages over this uncertain period (Rasmussen, Megbolugbe and Morgan, 1997). A moral hazard problem exists as the homeowner has little financial incentive to make expenditures for improvements or maintenance that would help maintain the value of the property (Schillerand Weiss, 2000) and may be physically unable to do so. Though empirical research is yet to be undertaken in this area, as the equity level is diluted there may be a gradual decrease in the overall maintenance conducted by the homeowner. Over the long term this may have adversely affect the gentrification in a neighbourhood in a similar manner to a high proportion of rental properties, resulting in lower overall house values (Reed and Greenhalgh, 2002).

Longevity risk is a diversifiable risk that can be effectively managed through the pooling of a large number of loans. Then the lender or insurer can rely on mortality tables to estimate future loan terminations. Although one might expect an adverse selection problem, with borrowers expecting to live a long life opting for an annuity program, experience has shown that many borrowers are attracted to reverse mortgage programs specifically because they are ill (Szymanoski, 1994).

To reduce interest rate risk, most reverse mortgages now contain an adjustable interest rate tied to a one-year U.S. Treasury bond yield with a monthly adjustment period as well as periodic and lifetime caps. Lenders can diversify against some property value uncertainty be accumulating a portfolio of loans distributed across many real estate markets. As a protection against crossover risk in individual properties, lenders limit the initial principal on the loan to approximately 50 percent of the home value with the exact percentage dependent upon the borrower's age and current interest rates (Szymanoski, 1994; U.S. HUD, 2000).

Because of these risks, the only lender-insured product currently available is a jumbo loan (up to US$700,000) offered by Financial Freedom in 12 states. However, the advent of securitisation of reverse mortgages may help provide greater access to capital for private sector products. In 1999, Financial Freedom securitised a portfolio of loans they acquired from TransAmerica. This transaction represented the first U.S. securitisation of a reverse mortgage loan portfolio. Standard & Poors has also now issued guidelines for the rating of these transactions. The ability to securitise reverse mortgages is an important factor in Financial Freedom's plans to expand their lending operations to 35 states (U.S. HUD, 2000).

To help promote reverse mortgages, Congress authorized an FHA-insurance program for reverse mortgages. FHA-approved banks, mortgage companies, and other private sector lenders could originate loans under the Home Equity Conversion (HECM) program and receive FHA insurance to protect them against the risk that the loan balance would exceed the home value at the time of repayment. FHA also guarantees the continued annuity payments to the borrower in case of lender defaults. In addition, to ensure borrowers understand reverse mortgages, FHA requires all applicants to receive counselling from an approved agency before taking out a reverse mortgage. FHA-insured mortgages now account for as much as 90% of the reverse mortgage market. The HECM is available in 46 states plus the District of Columbia and Puerto Rico (U.S. HUD, 2000).

The Federal National Mortgage Association (Fannie Mae) has been purchasing FHA-insured reverse mortgages on the secondary mortgage market. Fannie Mae then provides the ongoing funds as required, keeping the loans in its portfolio. If the cumulative charges against the mortgage exceed 98% of the principal limit, Fannie Mae assigns the loan to HUD, which continues to make the payments. Fannie Mae also offers its own product, the HomeKeeper, for homes that are more expensive and for homeowners to use to buy a new home. Freddie Mac continues to monitor the secondary market for possible entry, but the small number of reverse mortgages has discouraged their entry so far (U.S. HUD, 2000).

With FHA insurance and the Fannie Mae secondary market, the number of active HECM originators grew steadily through 1996 and then increased sharply in 1997, reaching 195 lenders, then declined to about 175. Active lenders are not necessarily originating many loans. Four out of five of all HECM lenders were originating at most two loans a month on average in 1999. Three lenders originated more than 500 loans during 1999, accounting for 41 percent of all originations. The 15,000 loans sold in 2001 were twice as many as sold in 2000 (Peterson, 2002; U.S. HUD, 2000). The continued reluctance of banks to enter this market may be due to an inability to generate sufficient loan volumes from their local area to merit offering this product given the time and cost of loan originator training, borrower counselling, and application processing. Most borrowers do not want to pay any cash at closing. Because FHA limits the amount of the origination fee that could be paid out of loan proceeds (US$2,000), this effectively limited the fee that lenders could charge. Closing costs (appraisal, origination, title search, closing, mortgage insurance, and servicing) have been declining to a median US$3,400 over all loans outstanding in July 1999 (U.S. HUD, 2000).

In the USA most reverse mortgage programs have been restricted to a single-family dwelling that serves as the principal residence of homeowners age 62 or older, but recently some programs have started accepting 2 to 4-unit owner occupied dwellings, along with some condominiums, planned unit developments, and manufactured homes. Government-backed insurance programs require that the property meet minimum standards; however, the homeowner may use the borrowed funds to pay for needed repairs.

Demand for Reverse Mortgages in the USA

The initial response toward reverse mortgages was lukewarm at best. Despite reports from the AARP in the early 1990s that they received more inquiries on reverse mortgages than on any other subject and more than 28,000 telephone inquiries to HUD in one year (Merrill, Finkel and Kutty, 1994), only a few hundred mortgages were originated each year during the 1980s and early 1990s. However, as of October 1999, more than 38,000 elderly homeowners had taken reverse mortgages. Since the mid 1990s, growth has been steady with as many as 8,000 new loans originated each year (U.S. HUD, 2000). Possible reasons for lack of consumer interest include the positive relationship between home equity wealth and income, the slow speed at which the elderly adopt innovative products, an aversion to placing a lien on one's home, the perception of home equity as savings for unexpected expenditures, and high origination costs.

The programs were initially envisioned to assist older homeowners with substantial home equity but low retirement income. However, income and assets tend to be positively correlated, even in retirement. Thus, many of the lowest income Americans who are dependent of Social Security as their major source of income also have low net wealth. Their home equity may not be sufficient to generate a substantial amount of support. Those with the greatest home equity also tend to have higher retirement incomes from private pension sources, creating less need to liquidate assets such as home equity. Demand for HECM loans tends to be lower in areas with low house values because the amount that can be borrowed is so small relative to the fixed origination costs. The loan amount limitation may come from the individual's low home value or the limit FHA places on loan amounts relative to the average home values in the area (U.S. HUD, 2000).

The acceptance of any innovative product can take a long time, especially among older consumers. No one reaching eligibility age would have personal experience with a reverse mortgage. Few know anyone who can relate their experiences with such products. Thus, the elderly must rely on information provided by lenders, the government, and organizations such as AARP to learn about reverse mortgages. Misconceptions abound. Fear about losing the home is paramount in potential borrowers' minds and they do not trust that the lender will wait until they move or die to collect repayment.

Many elderly perceive their home equity as a safety net, savings they could tap if needed for unexpected, large medical bills. Researchers such as Palumbo (1999) find that precautionary saving for uncertain medical expenses helps explain the slow rate of dissaving among elderly families. If they take out a reverse mortgage and use the equity to pay for current living expenses, then the savings would not be there when needed. This may explain why research has revealed that homeowners tend to use reverse mortgages only as a last resort (Leviton, 1999). The opportunities for using reverse mortgages to pay for long-term care insurance, home modifications, and in-home care have not been fully explored or promoted to the aging population (Rasmussen, Megbolugbe and Morgan, 1997).

Researchers have argued that because a house is the principal asset passed on to heirs in the USA, a bequest motive prevents many older homeowners from considering a reverse mortgage (Mayer and Simons, 1994). However, this is difficult to determine by examining the saving and borrowing behaviour of the elderly as the uncertainty of life expectancy results in most people dying with positive net worth whether they intended to or not.

Today the typical reverse mortgage borrower in the USA is a white female living alone with a median property value at application of US$107,000. The median initial principal limit in 1999 was US$54,890, with 90% of loans having a limit between US$25,875 and US$104,602. The typical borrower owns a 40-year-old home in a central city or suburb. She is older than the average elderly homeowner, receives lower income, is more likely to live alone, and own a smaller, but more expensive home. Over time, in real terms, more and more owners of less expensive houses in central cities and minorities are taking out reverse mortgages (U.S. HUD, 2000). Thus, the programs are eventually reaching those lower income elderly for whom they were originally envisioned.

Benefits of Reverse Mortgages for Australians

It has been demonstrated that reverse mortgages can potentially be a great benefit to an aging population, but it is important that the products are structured to meet the needs of this group (Fratantoni, 1999) and the lenders who will provide the loans. The aging population in Australia has been presented with many of the issues that have also confronted their American counterparts, and accordingly many of the advantages associated with reverse mortgages can be readily appreciated. Unfortunately, many elderly Australians were not able to foresee today's spiralling costs that have to be paid on a regular basis, and in many instances were inadequately prepared with low income streams. Substantial advances in the medical field have been fortunate to extend the retirement of many Australians, although this has been accompanied by substantially increased medical costs. When their working lives were conducted in a relatively simple and low cost era, it is unlikely that many retirees in Australia enjoy the benefit of a regular and adequate cash flow.

It is envisaged that not all elderly Australians would seriously consider undertaking a reverse mortgage, with many perceiving that there would be too many negative aspects. For example, in the older population group the status of homeownership was not as easily achieved as it is today. Even though a large proportion of Australian households are now dual income with fewer children, and can often afford multiple investment properties, elderly Australians usually viewed their primary place of residence as their entire investment portfolio. The proposal that this investment portfolio may now be diluted, especially with no possibility of replacing this equity, would appear to be inconceivable to many.

However, due to the exact same reasons it can be argued that a reverse mortgage would appeal to a different section of older households. The earning capacity of their children has been substantially increased, with decreasing importance placed on the value of the inheritance being passed down. The value of a single dwelling through an inheritance, especially when divided amongst multiple children and grandchildren following the deducting of expenses, would not be as substantial as it used to be. Often many elderly parents are encouraged to enjoy their savings whilst alive, and a reverse mortgage can expand this concept and reduce reliance on relatives to help meet on-going expenses.

From a broader perspective, allowing elderly households to access to illiquid housing funds would increase the level of spending and have widespread implications for the economy. This money could be spent on holiday and cars for example, and help to keep the economy from falling into a recession (National Association of Realtors, 2002). There may be many other indirect benefits for society from the acceptance of reverse mortgages, although these are often difficult to predict and even harder to measure.

Conclusions

This paper has reintroduced the concept of reverse mortgages to the Australian market, where the concept has considerable merit considering the recent housing boom and increased cost of living expenses. An overview of this product has been presented, including the advantages of accessing previously inaccessible home equity to elderly households. Most importantly, consideration has been given to the success of reverse mortgages to the American market with many similarities drawn with the Australian scenario, including the ageing population and demands on daily income streams.

It appears that although reverse mortgages were introduced and subsequently withdrawn from the Australian market in the 1990s, the timing is appropriate for re-introduction of this product. However, substantial consideration should be given to the framework surrounding reverse mortgages, including the provision of a governing body to regulate the implication by financiers, to ensure equity and a high level of ethics are maintained. In an ever increasing ‘risk society’, many elderly are choosing to travel less and often view their house as their best form of security. It would be an unfortunate situation if they lost their last form of security, namely their home, if they didn’t fully understand the loss of equity that accompanies a reverse mortgage agreement.

In summary, reverse mortgages appear to have a lot to offer a limited number of elderly households. It offers a means of accessing hard earned equity and raising the quality of lifestyle in later years. The Australian reverse mortgage industry can benefit from the experience of overseas housing markets, especially in the USA, and tailor a product that will suit both the elderly household, the financier, and society at large. With rapidly growing superannuation and insurance funds, this appears to be an ideal opportunity to tap into the security of a residential mortgage whilst increasing the overall standard of living for our elderly Australians.

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