REPORT 59

Equity release products

November 2005

Contents

Executive summary

In the last year Australia has seen the rapid development of a range of ‘equity release’ products, where consumers can obtain current financial benefit by trading equity in their homes.

The three types of products currently or soon to be available in Australia are:

- *Reverse mortgages*—the consumer borrows money against the equity in his or her home and the principal and interest is not repaid until the home is sold (usually when the consumer dies or voluntarily vacates the home).
- *Home reversion schemes*—the consumer sells part or all of his or her home to a reversion company. The home is sold for less than its market price (typically between 35% and 60%), but the consumer can remain in the property until they die or voluntarily vacates the home. There are at least two types of home reversion schemes – a sale and lease model and a sale and mortgage model.
- *Shared appreciation mortgages (SAMs)*—the consumer gives up the right to some of the capital gain on the property in return for paying reduced or no interest on that part of his or her borrowings.

> Note: Internationally, the three products described above have been grouped together under the title ‘equity release’ products. This term could technically be understood to encompass a broader class of products including lines of credit secured over a home. However, in this paper it will be limited to reverse mortgages, home reversion schemes and shared appreciation mortgages.

Increase in equity release products

These products have previously had limited acceptance in Australia. However, this position has changed dramatically in the last 12 months, during which time the first two home reversion scheme products have been introduced and two commercial shared appreciation schemes have been announced, although not yet launched (with at least another one currently in development).

There has also been an increase from three to at least 15 reverse mortgage products—currently the most popular equity release products in Australia. Whilst remaining only a tiny fraction of total consumer lending, the reverse mortgage sector has grown significantly in the 12 months to March 2005, going from $468 million to $770 million, with 8,899 new loans provided. A recent industry report estimates that the potential opportunity market for reverse mortgages could increase to $12 to $15 billion by 2010[1].

Reverse mortgages and home reversion schemes are increasingly used by elderly people who are asset rich but cash poor to, for example, supplement their incomes or pay for renovations or medical needs. And shared appreciation mortgages, when launched, will be able to be used by younger Australians who do not have enough savings to be able to enter the housing market.

What are the issues for consumers?

In the United Kingdom and the United States, where the market is more established, there have been negative consumer experiences with each type of product having been missold to vulnerable consumers at some stage. For instance, in the UK there was heavy promotion of reverse mortgages to retirees in the 1980s. However, when prices moved against consumers and their debt exceeded the value of their properties, many were evicted. As a result, in both the UK and the USA, there has been some specific regulation of equity release products.

More recently, in Australia, the Australian Securities and Investments Commission (ASIC) has commenced proceedings in relation to Money for Living—a sale and lease home reversion scheme that has gone into administration and ceased making ongoing payments to consumers—on the basis that its advertising was misleading and deceptive. We have also obtained court orders requiring the promoters of Money for Living to surrender their passports and our investigation is ongoing.

As Money for Living was the only scheme of its type, no other products currently available in Australia raise the same specific risks for consumer. However, all equity release products are complex and, if used inappropriately or with poor advice, there are significant risks for consumers. This is because:

- Both target customer groups—the underfunded aged and aspiring first homeowners—will include many who are vulnerable to making poor decisions, whether from financial inexperience, emotional attachment to the idea of owning their own home, or constrained financial circumstances.
- Each of the three types of equity release products has a complex legal structure in which the ownership and management of the property is shared between the provider and consumer over an extended period of time.

[1] Trowbridge Deloitte, 'The Equity Release Opportunity for Financial Planners' July 2005 (Trowbridge report), 3-6; Sweeney Research, 'Research Report Prepared for Australians Seniors Finance', February 2005.

- Used at the end of consumers' working lives, the products have significant implications for consumers' overall financial positions because consumers must appropriately manage their existing equity and income to fund their housing, care and other needs for the rest of their lives.

There are also complex issues surrounding equity release products that consumers should consider including:

- projected movements in interest rates and property prices,
- variations in consumers' life expectancies and old age caring and housing needs, and
- intergenerational tensions and conflict between the desire to leave an inheritance and the need for money to live on in older age.

Finally, there are obligations and consequences specific to some products which consumers should be aware of including:

- negative equity, if the debt exceeds the value of the property (this was the problem in the United Kingdom in the late 1980s),
- terms and conditions that can trigger the immediate repayment of the loan and loss of key rights,
- differences between products as to which party is obliged to undertake necessary repairs to the property and who obtains the financial benefit from any renovations completed,
- the impact of capitalising of interest with reverse mortgages, particularly if interest rates increase significantly, and
- potentially disadvantageous pension and taxation implications.

Key messages for consumers

The key message for consumers is that it is important that they fully understand the product and their obligations. We recommend that consumers obtain independent legal and financial advice and that they consider the following issues before entering into equity release arrangements.

Question	What to look for
Are there protections against excessive costs?	Reverse mortgages may include: • 'no negative equity guarantees' which guarantee that the provider will bear any difference if the debt exceeds the value of the property, and/or

Question	What to look for
	• Fixed interest rates or caps on variable interest rates which may limit the risk of negative equity. SAMs may include: • caps on the amount that providers will be entitled to if value of the consumer's home increases beyond an agreed amount. • a mechanism to measure the price of the SAM, other than the value of the property. Home reversions may include: • rebates if the consumer sells the property earlier than expected.
Who is obliged to maintain the property?	In some home reversion schemes the provider is responsible for maintaining the property but in most equity release products, the consumer is responsible for maintaining the property to a standard that is set by the provider.
What are the terms and conditions?	If the consumer breaches the terms and conditions in the contract (including for example an obligation to maintain the property), they may lose key rights under the contract and the provider may have the right to evict them.
Who gets the benefits from renovations?	Some contracts deliver the financial benefit from renovations to the provider, some to the consumer, and some provide a portion of the benefit to each.
How will it effect consumers' pension and tax?	Payments from reverse mortgages and home reversion schemes can have significant impacts on older Australians' pension entitlements.

Question	What to look for
Does someone else live in the home?	Residents in the consumer's home who do not sign up to the equity release contract may not have any rights in relation to the property. This can arise as an issue if the homeowner dies or moves to aged care accommodation.
Is the provider financially sound and/or prudentially regulated?	If not, there may be an increased risk that the provider may not be able to meet any long term promise to make payments.
What rights does the consumer have if something goes wrong?	If the product provider and issuer are members of an external dispute resolution scheme, the consumer will have better access to resolution of disputes at low cost.
Is this the best option for the consumer?	Other equity release products or non-equity release options may better suit the consumer's needs.

Regulation

Products

The existing regulatory system was not designed to address the issues raised by equity release products, which take the form of a credit arrangement but nevertheless have some of the attributes of an investment product.

At the product level, the principal vehicle for regulation of credit, the Uniform Consumer Credit Code (UCCC), does not provide for disclosure of risk, nor provide a mechanism for disclosing elements of the cost of the product, such as the forgoing of equity, that are not translatable into an interest rate. Finally it will not apply at all where the funds obtained are to be used for investment purposes.

The principal vehicle for the regulation of investment products, the *Corporations Act 2001* (Corporations Act), has limited application to some home reversion and shared appreciation products, depending on their terms, but generally does not apply to reverse mortgage products.

Advice

International research shows that advice on equity release products is often inadequate. For instance, recent research by the Financial Services Authority (FSA) in the United Kingdom shows that more than 70% of product providers, independent financial advisers and mortgage brokers do not gather enough relevant information about their customers to assess their suitability for the product, and more than 60% of advisers do not advise consumers about the downsides of equity release.[2]

Industry statistics indicate that most equity release products are being distributed by mortgage brokers who are, at present, far less regulated than advisers in other sectors of the financial services industry, although there are proposals for further regulation at the state level.

Although shared with the states, ASIC does have clear jurisdiction under the *Australian Securities and Investment Commission Act 2001* (ASIC Act) in relation to any misleading, deceptive and/or unconscionable conduct in the promotion, distribution and sale of equity release products and it will exercise this jurisdiction fully.

Conclusions and recommendations

Although it has been growing, the equity release market remains relatively new in Australia.

Overseas experience suggests that there is a risk of misselling and that consumers may receive poor advice. Whilst the products have clearly been designed to meet consumer needs, the products are complex and, if used inappropriately or with poor advice, there are significant risks for consumers.

The industry has commenced some self-regulatory initiatives and some product issuers are incorporating provisions that mitigate the worst risks for consumers. Nevertheless, some consumer risks remain. The growth of this product sector will depend on establishing and maintaining consumer confidence. That in turn will depend on ensuring widespread negative experiences are avoided, whether through industry promotion of best practice and self-regulatory initiatives, clever product design or regulatory intervention.

ASIC will continue to actively monitor developments in the marketplace and, principally relying on the broad consumer protection provisions of the ASIC Act, will take legal action whenever appropriate.

This report recommends:

- Consumers obtain independent legal and financial advice before entering into equity release arrangements.

[2] FSA Media Release 24 May 2005, 'FSA warns advisers that unsuitable equity release advice has got to stop'.

- Federal, state and territory regulators monitor closely the development of the market, consumer complaints and any problems they point to and keep under review the adequacy of the regulatory structure to address them.
- Equity release products be considered in any review of the Uniform Consumer Credit Code and in the ongoing development of enhanced regulation of mortgage brokers.
- ASIC work with industry to promote best practice and identify and appropriately deal with risks for consumers.

Further work

We will continue to work in this area by:

- Monitoring advertising and complaints.
- Initiating consumer education.
- Creating consumer tools including illustrations and/or calculators.
- Working with industry and state and territory governments to enforce existing legislation and further develop industry best practice.
- Undertaking legal action (usually under the ASIC Act) where appropriate.
- Undertaking future research into the industry as it develops.

Section 1: Overview of the equity release market

In the last year Australia has seen the rapid development of a range of products where consumers can obtain current financial benefit by trading equity in their homes. During this period, a broad range of new products has been launched, the promotion of these products has increased and there has been a significant rise in consumer[3] and media[4] interest.

Against this background of current and projected growth in the market, this report:

- investigates the structure and terms of the different products on offer in the Australian market,
- examines how existing state, territory and federal regulations apply to the products,
- identifies issues of concern for consumers, and
- identifies areas in which ASIC will undertake future work.

What products are available?

The three types of products currently or soon to be available in Australia are:

- *Reverse mortgages*—the consumer borrows money against the equity in his or her home and the principal and interest is not repaid until the home is sold (usually when the consumer dies or voluntarily vacates the home).
- *Home reversion schemes*—the consumer sells part or all of his or her home to a reversion company. The home is sold for less than its market price (typically between 35% and 60%), but the consumer can remain in the property until they die or voluntarily vacates the home. There are at least two types of home reversion schemes – a sale and lease model and a sale and mortgage model.
- *Shared appreciation mortgages*—the consumer gives up the right to some of the capital gain on the property in return for paying reduced or no interest on that part of his or her borrowings.

[3] ASIC has received a significant growth in the number of calls to its Infoline service and our contact with Centrelink indicates that Centrelink has received an increased number of queries relating to the impact of equity release products on pension entitlements.

[4] There has been broad coverage of equity release products in mainstream radio programmes, newspapers and industry magazines.

Most products that release equity allow consumers to receive lump sums, regular payments or a combination of both.

Equity release products have been introduced in Australia in the past, but there were only a few active providers and the products were not taken up by consumers in significant volume. As the Department of Family and Community Services has reported:

> *'We have been trying home equity and sale and lease-back and many schemes for many years, there still seems to be an attitude with the current generation in particular, that they have saved all their lives for a house and finally paid it off and they are reluctant to remortgage it or re-encumber it. Also, there is a design issue in that we have found very few financial institutions prepared to pay for, or bear the risk of, longevity.'*[5]

This position has changed dramatically in the last 12 months, during which time there has been an increase from three to at least 15 reverse mortgage products, the first two home reversion schemes products have been introduced and two commercial shared appreciation schemes have been announced, although not yet launched (with at least another one reportedly in development).

Whilst it is still too soon to build a picture of the current and potential market share of home reversion and shared appreciation schemes, a picture is starting to emerge of an increasing take-up rate of reverse mortgages.

In relative terms, this sector's share of the lending to persons market is still very modest. For instance, the total value of reverse mortgage loans as at March 2005 was equivalent to 2.3% of the total fixed loans to persons in the same month and fixed loans represent only 6% of the overall value of personal loans. However, in actual terms, the sector has grown significantly in the 12 months to March 2005, going from $468 million to $770 million, with at least 12 new providers entering the market and 8,899 new loans provided.

> Note: A 'fixed loan' generally involves a fixed amount for a fixed period for a specific purpose, with repayments over that fixed period which reduce the loan. However, with this type of loan, further finance is not made available. It excludes credit cards and home loans.

[5] House of Representatives Standing Committee on Health and Ageing, 'Future Ageing'. Report on a draft report of the 40th Parliament: Inquiry into longer-term strategies to address the ageing of the Australian population over the next 40 years. Canberra, March 2005, 108.

Although some consider that reverse mortgages will always be a niche product[6], a recent industry report estimates that the potential opportunity market for the product could increase to $12 to $15 billion by 2010.[7]

Social and economic drivers

Reverse mortgages and home reversion schemes

This rapid increase in the range and number of equity release products is industry's response to two key social and economic drivers in the Australian market place: an ageing population that is concerned about being underfunded and rising housing prices.

In relation to the first of these phenomena, the Australian Bureau of Statistics estimates that by 2031 approximately 21% of Australia's population will be aged 65 years or older (a dramatic increase from 8.5% in 1961)[8] and a number of commentators have expressed concerns that these older Australians will not have enough funds to meet their needs in retirement.[9]

The National Strategy for an Ageing Australia has identified three sources of retirement income for Australians: pensions, superannuation and voluntary savings. In particular, it recognises that 'people have a responsibility to make provision for themselves if they are able to and if they expect to have a higher level of income than if they relied on the aged pension alone'.[10]

And the Productivity Commission[11] has reported that only 17% of retirees currently have private incomes that match or exceed the pension and that by the time they reach the stage where they need age care many people may have substantially run down their superannuation balances.

At the same time, according to the Australian Bureau of Statistics, approximately 89% of Australian couples and 72% of singles over the

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[6] A. Dolan, P.McLean & D. Roland, 'Home Equity, Retirement Income and Family Relationships', Paper prepared for the 9th Australian Institute of Family Studies Conference, Melbourne, February 2005 ('Home equity, retirement income and family relatioships'; Nigel Appleton, 'Ready, steady…but not quite go – Older home owners and equity release: a review', Joseph Rowntree Foundation, 2003 ('Ready, steady…but not quite go).

[7] Trowbridge report.

[8] Australian Bureau of Statistics, 'Australian Social Trends 1999 – Population Projections: Our ageing population.'

[9] Trowbridge report.

[10] Office for an Ageing Australia, 'The National Strategy for an Ageing Australia – Independence and Self Provision Discussion Paper', 1999, 3, 55.

[11] Gary Banks, Productivity Commission, 'Policy Implications of an ageing Australia: an illustrated guide', Presentation at Financial Review Ageing Population Summit, Sydney, 27 September 2005 ("Productivity Commission Presentation").

age of 65 own their homes outright.[12] And housing values in most of Australia have increased over both the long term—the prices for (detached) houses have more than trebled since 1970, representing a trend increase of 2.3% per year—and shorter term—the Australia wide average price for a (detached) house more than doubled in nominal terms and rose by nearly 80% in real terms from 1996 to 2003.[13]

These factors have resulted in a situation where a large number of older Australians are asset rich but income poor[14]. In these circumstances reverse mortgages and home reversion schemes have been designed to provide a solution for consumers who do not wish to move house but may require:

- regular income to help meet day to day living expenses,
- lump sum payments to pay for holidays, cars or other one off purchases,
- emergency funds or funds to pay off other debts,
- home improvement loans, and/or
- funds to pay for nursing or aged home care.[15]

In contrast to the usual requirements with other types of lending, consumers do not require an income to qualify and do not need to make monthly repayments.

Some shared appreciation mortgages could also be used by consumers in this ageing market to release funds through forgoing equity in a home they already own, although no product providers appear to be marketing shared appreciation mortgages for this purpose at this stage.

Shared appreciation mortgages

The other phenomenon driving the development of shared appreciation schemes is the increasing number of barriers that are preventing people buying homes. On this issue, the Prime Ministerial Task Force on Home Ownership identifies two main barriers faced by first home buyers: escalating property prices and inflexibilities in housing finance.[16] The Task Force studied approaches to reducing the costs of home ownership and the delivery of affordable housing assistance and it presented a series

[12] Australian Bureau of Statistics, 'Australian Social Trends 1996 – Housing – Housing Arrangements: Housing for older people.'

[13] Productivity Commission 'First Home Ownership' Report No. 28 Melbourne. 2004.

[14] Productivity Commission Presentation.

[15] Rachel Terry and Philip Leather, 'The Market for Equity Release Schemes -Council of Mortgage Providers', October 2001, v-vi.

[16] The Menzies Research Centre Ltd, 'The Prime Ministerial Task Force on Home Ownership', June 2003. The reports issued by the Task Force are available at http://www.mrcltd.org.au/content.cfm?PageID=Hot6&HOTFflag=1

of innovative options, key amongst them being products that allow consumers to use equity as well as debt finance to purchase homes.

These shared appreciation mortgages—in which the provider gives up the right to receive some or all of the interest on the loan and instead takes a share in any increase in the value of the property on sale—allow consumers to enter the housing market despite the fact that they do not have enough savings for a deposit and associated costs and/or sufficient income to meet the regular repayments on a traditional principal and interest loan.

Section 2: Review of Australian products

This section provides a broad overview of the products currently available in Australia and the networks through which they are distributed.

Reverse mortgages

In a reverse mortgage, the consumer's house is used as security for a loan, which is provided to the consumer in the form of a lump sum, a regular stream of payments or both. The consumer retains title to the property but grants the provider a mortgage to secure repayment of principal and interest under the loan. The outstanding balance of the loan grows over time, as the interest is capitalised (rather than repaid), but the consumer is usually not compelled to make any repayments until they die or otherwise voluntarily vacates the property.

The products are generally available to consumers aged 55 and over who own their own homes or only have a small mortgage outstanding.[17] The amount available to be borrowed is usually restricted to between 20% and 40% of the total property value. Most products offer the capacity to borrow additional amounts as the consumer ages. All products permit the consumer to make voluntary repayments over the term of the loan. Some products can be transferred to other properties but this is always at the providers' discretion and will obviously depend on the value of the new property.

Although the specific terms and conditions vary across products, most contracts oblige the consumer to:

- maintain insurance for the property,
- pay all outgoings,
- maintain the property to the standard required by the provider,
- not leave the property vacant for more than six to 12 months (depending on the contract),
- not allow new non-approved residents to reside in the property, and
- not sell, lease or renovate the property without the provider's prior approval.

Whilst most reverse mortgages are currently distributed by mortgage brokers, there is an increasing debate within the industry itself as to

[17] If the consumer has an existing mortgage, it may be able to be paid out using the equity released under a reverse mortgage.

whether planners and/or brokers will have the primary role in distributing the products.

To date, mortgage brokers have been quick to enter the market, but some financial planners have been more reluctant. For instance, Paul Resnick, principal of the Paul Resnick Consulting Group, has said that financial planners have not previously focused on the emotionally charged issues involved in residential or direct property.[18] However, he believes that the potential benefits for financial planners' clients warrant financial planners developing sufficient knowledge to be able to discuss and implement equity release strategies with their clients.

Resnick also believes that as well as being used by lower income clients for living and other expenses the products may be appropriate for wealthy retirees who may wish to pass on their inheritance while they are still alive by borrowing funds against equity and giving it to intended beneficiaries.[19] More recently some large financial adviser groups are beginning to develop preferred lists for reverse mortgages.[20]

Nevertheless, despite the increasing interest starting to be shown by the financial planning industry in providing advice about equity release products, industry sources indicate that mortgage brokers will continue to take a dominant role in distributing the products in the foreseeable future.

Australian Government schemes

In addition to the commercial products provided by banks, credit unions and other specialist providers, the Australian Government offers the Pension Loans Scheme to pensioners and some self-funded retirees who own real estate. Under the scheme, people of Age Pension age (or their partners) who are not entitled to the full pension because of their income or assets can access capital tied up in their assets to obtain a loan that will provide a fortnightly pension payment up to the maximum pension rate. The take-up rate for this loan is relatively low with only 239 pensioners participating in the scheme at the end of 2004.[21]

Home reversion schemes

In general terms, a home reversion scheme involves a reversion company purchasing, or arranging for someone else to purchase, part or all of the

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[18] Resnick, 'Your client's home: a new asset class', *Money Management* June 16 2005, 16.

[19] Keeping in mind that the total value of estate would be decreased.

[20] Lonsdale Financial Group has now created a preferred list for reverse mortgages. According to Chief Executive, Mario Modic, half of Lonsdale's 170 financial advisers are now accredited with at least one reverse mortgage provider, and he expects all the company's financial planners to gain such accreditation in the future. See Zoe Fielding, 'Lonsdale embraces reverse mortgages', *Money Management* October 24, 2005.

[21] 'Home Equity, Retirement Income and Family Relationships'.

consumer's home at a price which is usually between 35% and 60% of the full market price.

Part of the reason for the discounted purchase price is that the consumer retains the right to live in the house for life or until voluntarily moving on to alternative accommodation such as a nursing home. In particular, the level of the discount will depend upon the age and life expectancy of the consumer and the risk borne by the provider that there will be a considerable period before any profit is realisable.

In Australia until recently, there were two home reversion schemes available on the market—one with a sale and lease structure and the other, a sale and mortgage. The sale and lease product provider has recently gone into administration.

Sale and lease model

In the sale and lease model, the title to the property actually passes to the provider at the time the parties enter into the contract and the property is leased back to the consumer for the remainder of his or her life at a nominal rent. The provider pays the purchase price to the consumer in the form of a lump sum payment, in monthly payments over a period of between five and 30 years, or through a combination of the two. It is possible for the consumer to protect their interest in the property by lodging a caveat.

The provider assumes responsibility for rates, maintenance and other outgoings upon title passing to it. The provider may then on-sell the property to investors who acquire the title subject to the lease to the consumer, which is acknowledged by deed. The investor then assumes responsibility for payments to the consumer as well as for paying rates and other outgoings, and maintaining the property.

As previously mentioned, the particular scheme that was marketed in Australia, called Money for Living, has gone into administration. ASIC has issued legal proceedings in the Federal Court of Australia alleging that the providers of the product advertised it in a misleading and deceptive manner. One hundred and seventeen consumers sold their properties to Money for Living and most of these consumers were to receive a combination of an upfront payment and ongoing monthly payments. Money for Living has ceased making ongoing payments to consumers. Some properties were onsold to other investors and, whilst these investors are currently maintaining payments to consumers, it is alleged that at least two are unlikely to be able to meet their monthly obligations to consumers. ASIC also alleges that consumers were told that their tenancies in the property were secure, although none of the leases were registered and no caveats were lodged to protect the consumers' interests. We have also obtained court orders requiring the promoters of Money for Living to surrender their passports and our investigation is ongoing. [22] Money for Living was largely distributed through mortgage brokers.

A particular issue for consumers raised by the product structure is the fact that they no longer have title to the property that they are living in with the security both actual and perceived that having title involves. However, as Money for Living was the only sale and lease home reversion scheme available in Australia, this issue is not one that consumers will need to consider at this stage.

Sale and mortgage model

The sale and mortgage product is structured by two documents, a sale of land contract and a mortgage.

Under the contract of sale the consumer sells a percentage of the property to the provider. The provider pays the consumer an agreed amount on the date the contract is signed. The title to the property remains in the consumer’s name. To protect the provider’s interest in the property, the consumer is required to give the provider a mortgage over the property, the terms of which prohibit the consumer from dealing with the property without the provider’s consent.

The contract may oblige the consumer to:

- pay all outgoings
- keep the property insured
- maintain the property in a ‘reasonable state of repair’, and
- obtain the purchaser’s consent before selling, leasing or renovating the property.

The sale and mortgage product that is currently available in Australia is solely distributed by employees of the one provider with whom the home reversion company has an agreement.

Shared appreciation mortgages

The final type of equity release scheme to be considered are shared appreciation mortgages (SAMs)—in which the provider gives up the right to receive some or all of the interest on the loan and instead takes a share in any increase in the value of the property on sale.

[22] See ASIC media and information releases 05-332 ‘ASIC goes to court over Money for Living’, 21 October 2005 and 05-347 'Money for Living promoters ordered to surrender their passports to ASIC', 3 November 2005.

Commercial products

At this stage two commercial product have been announced, but not yet launched in the market, and at least another one is reportedly in development. In addition, a number of state and territory government facilitated products are available.

In summary, a SAM is a loan of part of the purchase price of a new home or a release of part of the equity of an existing home. If a person wishes to buy a property a SAM is obtained for part of the purchase price and a traditional principal and interest loan secured by a mortgage is obtained to pay for the balance. When the property is sold, the provider obtains a share of the capital gain and repayment of the loan. The percentage of the capital gain to which the provider is entitled depends upon a number of factors including the amount of the loan, whether or not the consumer pays any interest or ‘rent’ during the course of the loan, and the size and direction of movement in the value of the property. As previously noted a SAM is generally combined with a traditional loan and the two can be packaged through the same provider.

Some terms and conditions that may be attached to SAMs include that the consumer must:

- occupy the house as their primary residence,
- if the consumer obtains a traditional mortgage, obtain that mortgage with a provider approved by the SAM provider,
- obtain the SAM provider’s consent prior to refinancing the traditional mortgage,
- notify the SAM provider prior to making any improvement to the house,
- maintain the property in as good or better condition as when the SAM was provided,
- notify the SAM provider prior to any sale, receive a valuation at that time and comply with the SAM provider’s sale procedures, and
- obtain the SAM provider’s consent before granting a lease, granting an easement or ceasing to reside in the house as a permanent residence.

Whilst no products are yet available in the market, current indications are that the primary distribution channel is likely to be through mortgage brokers, particularly if the product providers have no branch or distribution networks of their own.

State and territory government facilitated products

There are also several SAMs offered by Australian state and territory housing authorities.

For instance, the Western Australian Government enables Aboriginal tenants to purchase between 70 and 100% in their rental properties under the Keystart programme's Aboriginal Home Ownership Scheme.[23] The Department of Housing and Works purchases up to 30% of the property (to a maximum value of $50,000) and sells this portion to the resident at market value when they can afford it. The consumer pays all maintenance costs and insurance.

When and if the consumer wishes to buy out the Department's share in the property, a licensed, independent valuer calculates the value of the Department's share and assesses the effect of improvements made by the consumer on the value of the property (which benefit is solely the consumer's).

A similar scheme is also available in the Northern Territory to consumers who earn less than $1100 per week, have a minimum deposit of 2% of their proposed share in the property and whose home loan repayments will be less than 30% of their gross income.

As at December 2004, the Northern Territory government had funded 135 shared equity loans for $18,427,375.00.[24]

[23] Aboriginal Home Ownership Scheme brochure, April 2004.

[24] Media release of Paul Henderson MLA, Acting Minister for Housing NT Government 16 December 2004, '220+ Territorians Celebrate Christmas with Home North'.

Section 3: International experience

Whilst equity release products are relatively new to Australia, they have been available in the United Kingdom and the United States for several decades. This section describes a number of relevant experiences and the regulatory frameworks in each jurisdiction.

United Kingdom

Product review

Reverse mortgages, home reversion schemes and SAMs have been available in the United Kingdom for between 10 and 30 years. It is currently estimated that about 75% of equity release products available in the United Kingdom are reverse mortgages and most of the rest of the products available are home reversion schemes.[25] There are few if any SAMs currently available in the United Kingdom. Commentators have variously attributed the limited size of the current SAM market to the failure of secondary market[26] investors to buy the bonds used to fund SAMs and reluctance by consumers to enter such schemes.[27]

Both reverse mortgages and SAMs have been criticised in the United Kingdom because of their unexpected impact on some consumers.

In the late 1980s thousands of retired people took out variable rate reverse mortgages and put the money thereby obtained into stock market-related investment bonds. The income from these bonds was expected to be sufficient to pay the interest on the mortgage and provide additional regular income. However, the market produced poor returns on the bonds, and at the same time interest rates rose and property values fell. Many consumers’ debts exceeded the value of their properties, so that providers evicted them and a significant number are still involved in court actions with providers.[28]

When SAMs were offered more widely in 1997 and 1998 there was initially a very high take-up rate by consumers.[29] These products were targeted mainly at elderly people and were structured to provide

[25] Sally McCrone, ‘Release or just a trap’ Guardian Unlimited, 25 April 2004.

[26] A secondary market for a loan is a market in which providers can sell loans they have already made to consumer. The secondary loan purchaser pays the original provider for the loan. This reduces the risk the provider would otherwise face and frees up capital that can be used to make more loans.

[27] Anthony Sanders and Carlos Slawson, ‘Shared Appreciation Mortgages: Lessons from the UK’ 2005 *Journal of Housing Economics*, forthcoming.

[28] Sally McCrone, ‘Release or just a trap’ *Guardian Unlimited*, 25 April 2004.

[29] Caplin, A ‘Inertia in the U.S. Housing Finance Market: Cases and Causes’ 2005 *Journal of Housing Economics*, 2000 paper prepared for joint AEA/AREUA session ('Inertia in the U.S, Housing Finance Market').

consumers with an upfront payment, in return for which the provider would be entitled to a share of appreciation in the property, usually upon the consumer's death or vacation of the property. The terms of the SAM loans required borrowers to give up to 75% of any increase in the properties value to the provider on sale. After housing prices increased dramatically from 1998 to 2002, many consumers considered, in retrospect, that they had made a bad bargain and that the capital gain they were required to give up was excessive relative to the size of the original advance. Approximately 15,000 people remain in these arrangements.[30]

Regulation

The regulatory landscape has changed significantly since these two incidents and neither of the schemes described above would be permissible now (in the particular forms in which they existed).

In 1991 Safe Home Income Plans (SHIP) was established as a self-regulatory body for equity release products with a code of conduct that required:

- all plans to carry a 'no negative equity guarantee' (a guarantee provided by some providers that they will bear the difference if the debt exceeds the value of the property),
- all contracts to require customers to obtain legal advice, and
- disclosure of the benefits, obligations, variables, limitations and costs of equity release products.

From October 2004, the United Kingdom's Financial Services Authority (FSA) has regulated mortgages, including reverse mortgages. In particular, in the new regime reverse mortgages are considered to be higher risk and, accordingly, the FSA provides extensive guidance relating to the sale of these products to protect vulnerable older consumers.[31] At this stage, the regulations do not cover home reversion schemes. However, the government has indicated that home reversion schemes will be subject to regulation, although no timetable for the introduction of legislation has yet been set.[32]

The regulations apply to organisations that provide, administer, advise on or arrange mortgages but exclude (in some circumstances) solicitors, conveyancers and financial counsellors (as well as businesses which provide information as opposed to advice).

The legislation now includes:

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[30] House of Commons Hansard Debates for 23 February 2005, pt 9, column 329.

[31] The Regulatory Reform Order and the Financial Services Authority Regulations, *Foundations Bulletin*, 7 April 2004, 3.

[32] Regulating Home Reversion Plans – Summary of Consultation Responses, HM Treasury, 10 May 2003.

- *Product regulation*

  This requires disclosure throughout the life of the mortgage including illustrations of costs and risks and warnings encouraging consumers to seek advice if they are at all unsure.

- *Regulation of advice and intermediaries*

  This includes requirements[33] to ensure that the product is suitable for the consumer (for example, the adviser is required to initially consider whether *any* equity release product is appropriate in the financial circumstances of the consumer and then also consider a number of other issues including the effect of the product on means-tested benefits).

  There are also training and competency requirements that include examination requirements in trading down, tax and pension implications and home reversion schemes.

Despite these regulatory reforms, problems of misselling of equity release products appear to persist. A recent mystery shopping exercise undertaken by the FSA revealed that more than 70% of product providers, independent financial advisers and mortgage brokers in the United Kingdom did not gather enough relevant information about their customers to assess their suitability for the product, and more than 60% of the mystery shoppers reported that their advisers had not explained the downsides of equity release.[34]

United States

Product review

Although various forms of reverse mortgages have been offered in the United States since the 1960s, it was not until 1989 when the United States Department of Housing and Urban Development (HUD) entered into the market with its Home Equity Conversion Mortgage (HECM) that the industry underwent substantial growth.[35] The US Government insures all reverse mortgages loans which are made under the terms of the HECM programme rules. This insurance ensures that the consumers' debts can never exceed the value of their properties and that consumers

[33] Which are wider than the requirements for advice relating to traditional mortgages.

[34] FSA Media Release 24 May 2005, 'FSA warns advisers that unsuitable equity release advice has got to stop'. A 'Banking Practices (Protection of the Elderly) Bill' that would have required banks to adopt and maintain specific practices in dealing with vulnerable elderly clients also had a first reading in the House of Commons in February 2005[34], although it never reached a second reading.

[35] Victor Wong and Norma Paz-Garcia, 'There's no place like home: The implications of reverse mortgages on seniors in California' 1999, Consumers Union of US ('There's no place like home').

continue to receive any regular payments from the loan as long as they live in the property, regardless of:

- how long they live in the property,
- what happens to the property's value, and
- what happens to the provider who provided the loan.[36]

The cost for this government guarantee is borne collectively by consumers who pay an insurance premium to HUD.

The HECM programme rules mandate that providers:

- can only change variable interest rates once a year (in line with the one-year Treasury rate change) and subject to a limit of two percentage points per year and five points over the life of the loan,[37]
- require consumers to obtain independent advice before signing a contract, and
- do not impose prepayment or loan cancellation penalties.

There are also reverse mortgages and other equity release products available in the United States that are not government insured. For instance, Fannie Mae[38] facilitates both a traditional reverse mortgage and an 'equity share' option in which the consumer may obtain an additional loan in return for assigning 10% of the property value of the home at the time the loan matures, when the homeowner sells the property or dies. These loans are offered by Fannie Mae approved providers and purchased from the provider by Fannie Mae in the secondary market. Applicants for the loans provided by Fannie Mae providers must complete approved counselling prior to a loan being granted.

Finally, SAMs are also available, pursuant to which for example, if the consumer chooses to borrow against 60% of the home's equity, the consumer will owe 60% of the home's value when it is sold.

To date, SAMs have been less popular than reverse mortgages, reportedly for reasons similar to those described in relation to the United Kingdom; that is, there is a lower consumer acceptance of this type of

[36] AARP, 'Home Made Money: A consumer's guide to reverse mortgages' 2005.

[37] A HECM provider may also offer a lower rate that is adjusted every month. This rate must also be tied to the one-year Treasury rate change but the only limit is a 1-percentage point cap over the life of the loan.

[38] Fannie Mae is a private company which is chartered by the United States Congress to fulfil a public mission of providing low-cost mortgage funds to Americans with low, moderate or middle incomes. It does not lend money to consumers, but buys mortgages from a national network of approved providers who do originate mortgage loans. It is

product and institutional investors' appetite for residential real estate instruments is still unknown.[39]

There have been a number of problems associated with misleading and deceptive conduct in relation to equity release products in the United States. In the last decade there have been a series of legal proceedings brought by consumers who accuse mortgage providers of defrauding them out of equity in their houses.[40]

For instance, a group proceeding was issued on behalf of approximately 1500 consumers against one provider alleging that reverse mortgages required payment of excessive and hidden fees that concealed the true cost of the loan, and that resulted in consumers being charged tens of thousands of dollars in artificially inflated loan fees. This proceeding was settled out of court.[41] Another proceeding concerned shared appreciation agreements in which the provider allegedly obtained an unconscionably high share of the homes' appreciated value and charged the cost of an annuity against the loan balance from the beginning of the loan, despite the fact that the consumers would not be entitled to a payout from the annuity for at least the first six years.

There have also been a number of scams associated with the industry. For instance, one financial service firm has been subject to legal proceedings by both providers and consumers because it allegedly defrauded consumers by telling them they would receive reverse mortgages, but instead took out conventional loans which consumers could not repay.[42] Another scam involved 'estate planning' firms charging consumers high fees (between 6% and 10% of the mortgage proceeds) for referring a consumer to a provider. In relation to this last scam, the government regulator took legal action against six estate planning firms and also directed providers to cease dealing with companies that charged these fees.[43]

Regulation

Equity release products are subject to a range of federal, state and self-regulatory regimes in the United States. As previously stated, the US federal Government regulates compliance with the HECM rules for reverse mortgages made under HECM scheme. However, while this

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[39] 'Inertia in the U.S. Housing Finance Market'.

[40] See Jean Reilly, 'Reverse Mortgages: Backing into the Future', Spring 1997, 5 Elder Law Journal, 17.

[41], 'There's no place like home' at 26.

[42] 'There's no place like home' at 29.

[43] 'HUD Orders Halt to Charging Senior Citizens Thousands of Dollars Each for Reverse Mortgage Information' HUD Press Release No. 97-31, March 17, 1997; Victor Wong and Norma Paz-Garcia, 'There's no place like home: The implications of reverse mortgages on seniors in California' 1999, Consumers Union of US at 22.

regulation covers reverse mortgages that are government insured, it does not cover other types of equity release products or reverse mortgages that are not insured by the US Government. State legislative regimes also regulate the products to varying degrees (but it is beyond the scope of this paper to provide details of these regimes).[44] Further, Fannie Mae has issued revised policies regarding origination fees, quality control and other issues which must be followed by Fannie Mae approved providers.

In addition, federal Truth-in-Lending law requires providers to disclose a 'Total Annual Loan Cost', combining all of a reverse mortgage's costs into a single annual average rate.[45] Banking regulators oversee bank provider disclosure of information under the Truth-in-Lending legislation, while the Federal Trade Commission (FTC) monitors non-bank providers' compliance.

New Zealand

Product review

Of the products reviewed in this report, the only one currently available in New Zealand is the reverse mortgage[46]. As in Australia, the reverse mortgage sector has rapidly grown in the last 12 months, although it is still only 0.1% of total home lending[47].

There is another equity release product available in New Zealand called a buy-back scheme. Although ASIC is not aware of any buy-back schemes in Australia, they do share some characteristics with sale and lease home reversion schemes. In a buy-back scheme the consumer agrees to sell their home to a scheme promoter in exchange for debts being repaid and to then buy it back later (usually a year) at a higher price. Buy-back schemes are attractive to people who are in financial difficulty and who want to access, in cash, some of the equity in their homes.

In New Zealand, where these products have been, and are still, available many consumers were unaware that they no longer owned their homes, and being unable to obtain a loan one year later to buy back the homes, were evicted. The consumers also lost their original equity in the property[48].

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[44] See 'There's no place like home'.

[45] AARP has identified a number of shortcomings to this disclosure requirements including that they do not address the total amount of funds the consumer will obtain from the loan or the amount of equity heirs may keep at the end of the loan.

[46] See www.sorted.org.nz/60plus-types-of-equity-not-yet-available-in-nz.html This website is resourced by New Zealand's Retirement Commission.

[47] David Kidd, Public Trust, 'Home equity release – A new product for New Zealand's future' Presentation at Annual Conference for HealthCare Providers New Zealand, 8-10 August 2005.

[48] Serious Fraud Office, 'Housing Fraud', undated.

Regulation

Buy-back schemes are now subject to legislation which requires the provider to disclose key information about the scheme, ensures that the consumer receives independent legal advice before entering into a scheme, and provides the consumer with the right to lodge a caveat over the property to protect their interest. The legislation also allows the transaction to be reopened if the court considers it to be oppressive.

More generally, the New Zealand government is developing a code of practice with industry to cover equity release schemes. The code will cover issues such as disclosure of terms and conditions, risk management practices and recoveries[49].

[49] Office of Prime Minister press release, 'Budget 05: Home equity protection for older NZers' 13 May 2005.

Section 4: Some complex issues for consumers

This section outlines the complex set of issues that equity release products raise for consumers. In light of these complexities, ASIC recommends that all consumers obtain independent legal and financial advice before entering into any equity release arrangements.

Some of the structural complexities within and surrounding equity release products include:

- The equity in people's homes is shared between consumers and providers over an extended period of time.
- The cost cannot always be easily assessed at the time of entering into the contract because it can involve a number of elements in varying proportions including initial and ongoing fees, interest charges, rental or license costs, and capital gain or equity foregone.
- Different options can have different social security and/or tax implications.
- Consumers are required to consider both investment and borrowing issues at the same time with respect to a single product.
- Consumers may be vulnerable because they may be financially marginal and/or have an emotional commitment to staying in or purchasing their homes.

Issues for older Australians

In particular, the decision for older Australians to take out equity release products significantly impacts on their overall financial position because they must appropriately manage their existing equity and income to fund their housing, care and other needs for the rest of their lives.

In deciding whether, and when, to acquire an equity release product retirees must consider a complex range of issues including:

- how long they may live (given the wide variations in life expectancies),
- how much care they may require both at home, and perhaps, in aged care facilities, and the cost of such needs,
- how much superannuation they have and how much, if any, government benefit they may be entitled to,
- whether they wish to leave any inheritance to beneficiaries (and, if so, how much),

- if they receive regular payments from the provider, whether there will be sufficient funds available to sustain these payments for the rest of their lives, and
- how much, if any, equity may be left, after repayment of the loan or sale of the property, and in particular, whether there will be sufficient funds to meet the retirees' needs in terms of inheritance and aged care housing needs.

In this context, it is important for retirees in need of short or long term funds to consider all available options including:

- selling and moving to a new home,
- continuing to live in the current home with the current assets and income for the rest of their lives, or at least for a period of time to preserve the 'nest egg' of equity for as long as possible,
- obtaining alternative finance (for example, from family or government), or
- entering into a reverse mortgage or home reversion scheme.

The decision is made more difficult by the number of variables that involve projecting into any uncertain future. For instance, if a consumer enters into a home reversion scheme and dies soon after, they may, in effect, have sold the house for much less than market value, without having obtained the benefit of being able to continue to live in it for the expected amount of time.[50]

In contrast, if a consumer acquires a reverse mortgage and lives longer than projected and/or if housing prices have not increased as projected, then the continued capitalisation of interest over the life of the loan may mean that there is no equity left to fund any future need for aged care accommodation or to provide for beneficiaries. As discussed below, some products now include provisions which, at least in part, mitigate against these problems.

One view that has been expressed by industry is that sophisticated consumers are likely to become increasingly interested in entering into equity release arrangement because they have a broader range of retirement interests (including such things as travel that require cash), a less fixed idea of leaving the entire home as part of their estate, and are less risk averse.[51]

[50] At least one product tempers this gamble by offering an early sale rebate if the sale occurs earlier than expected and an excess proceeds rebate if the sale price exceeds a benchmark specified in the contract.

[51] Trowbridge report.

However, the Council on the Ageing supports research in the United Kingdom that indicates that few older people would consider the option of reverse mortgages except as a 'choice of last resort' for essential items including home modifications and repairs, refinancing mortgages or other debts, supplementing income for daily living and providing money to adult children.[52]

This is also supported by a recent study undertaken in New Zealand which found that 'those who use equity release schemes do so out of necessity, and … interest in the concept [is] very closely correlated with income—the higher the income the less the need to consider equity release.'[53] It is likely that this class of consumers may be less financially sophisticated and find it particularly difficult to understand the complexities involved in making decisions about equity release products, more so because the products are relatively new and some older consumers may be less mentally alert than others and made more vulnerable by financial disadvantage.

Pension, superannuation and tax implications

Two other critical issues that must be considered are:

- whether it will be in the retiree's best interests to obtain the funds as a lump sum or regular payments, and
- when (if ever) the best time is to acquire an equity release product.

It is important for consumers to consider these issues in the context of their superannuation and potential pension entitlements.

In the first instance, funds drawn from equity in consumers' homes are tax free and exempt from the assets and income tests. However, as soon as funds are released in 'home equity conversion loans'[54] they become susceptible to tax and to being assessed for pension-eligibility purposes.

Where more than $40,000 is borrowed and not immediately spent, the amount in excess is counted as an asset, classed as a financial investment and subject to deeming under the social security income test. This can affect a consumer's entitlement to a pension or part pension and associated benefits and concessions. It can also affect the amount of daily care fees that will be levied if the retiree has to enter an aged-care facility.

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[52] Sue Hendy, 'Council on the Ageing Victoria Submission to Consumer Affairs Victoria Consumer Credit Review' July 2005, 5-6; Nigel Appleton above.

[53] A 'Home Equity, Retirement Income and Family Relationships'.

[54] As defined in the Social Security Law.

There are also considerations arising from how the consumer spends a lump sum. As Derkley[55] identifies, if the money is spent on renovations or a holiday there will be no consequences in terms of the asset test. A car on the other hand is an assessable asset. Another significant risk is created by using the money to buy an investment product. As Benedict Davies, technical services manager at OFM Investment Group[56] says,

> *'In effect, you are converting what is a completely exempt asset, in the form of a family home, into an asset that is at least 50% counted towards the assets test if it is a complying annuity or into one that is fully counted towards both the assets and the income test, in the case of any other non-complying income stream product.'*

Finally, if more than $10,000 is used to assist a family member in any one financial year, the additional amount may be assessed as a 'deprived asset' and will go towards the consumer's income test.

Accordingly, unless a large sum of money is urgently required, it may be more appropriate for some consumers to obtain regular payments instead of a lump sum.

However, there may also be implications for pension entitlements associated with receiving regular payments. For instance, some institutions that offer regular payments do so by holding the proceeds of the loan in an offset account and make the payments from that source. Where this occurs, the balance of the account is classed as an asset for the assets test and is subject to deeming for the income test.

Timing Issues

Consumers also need to think carefully about when the most appropriate time is to release equity in their homes. For instance, some consumers who have enough superannuation to provide for an adequate income for the immediate future may elect not to release the equity in their homes until they have used all their superannuation because:

- They are reluctant to take out loans unless absolutely necessary.
- They may be entitled to larger loans as they age.
- Their homes' values may increase in the meantime.
- They will have minimised the equity foregone in their homes.

On the other hand, a report commissioned by an equity release provider[57] has suggested that consumers may choose to release equity earlier to

[55] Karin Derkley, 'On the House', *Personal Investor*, August 2005, ('On the house') 44.

[56] On the house.

[57] Trowbridge report.

provide a supplementary income so that they only need to draw down on their superannuation at a minimum rate and it lasts longer. This may also entitle some consumers to an amount of aged pension.

Conclusion

This section has focused on the complexities facing older Australians because the products targeted at them are currently available in Australia and international experience suggests that they will continue to be the dominant products in the market. However, it is expected that the decision about whether or not to acquire a SAM will also be difficult for younger consumers because of the complexities in the product structure.

One of the key messages to be drawn from this complex analysis is that, as an industry report cautions, 'the risk of using [an equity release product] inappropriately for a particular purpose without qualified advice … is the largest single risk for the product.'[58]

[58] Trowbridge report.

Section 5: Product features and conditions

In addition to the complexity of the issues surrounding equity release products, it is also important for consumers to fully understand the details of the products themselves. This section of the report identifies a range of product features, terms and conditions that consumers should be aware of to avoid unexpected consequences. A list of issues that consumers should consider before entering into equity release schemes is included as Appendix B.

Pricing

One of the most important questions for consumers is how much they will pay in equity release arrangements. However this can be one of the most difficult questions for consumers to answer, given the complexities in the product structures and their dependency on variability in, for instance, housing prices and life expectancies. A range of product features have been designed to help mediate the risks of unexpected pricing variations which consumers should consider when researching the products.

Reverse mortgages—the risk of negative equity

In reverse mortgages interest is charged on the amounts borrowed by consumers and this interest is capitalised over the term of the loan. At this early stage in the development of the market, most reverse mortgage providers offer only variable interest rates which are generally higher (between 0.5% to 1%) than the rate for standard home loans and, where a fixed interest rate option is available, it will generally be higher than the variable rate.

As one measure of the effect of compound interest on the loan balance, the National Information Centre on Retirement Investments estimates that:

> *'Where a person borrows $30,000 gross (including an application fee), assuming a fee of $10.00 is charged monthly and the loan interest rate is 8.5%, at the end of 10 years the debt would have grown to approximately $71,860. This assumes the interest rate remains constant'.*[59]

This compounding interest also leads to one of the most significant risks that has been associated with reverse mortgages, that the debt will exceed

[59] See NICRI, 'Accessing the equity in your home – some issues to consider'. Canberra May 2005; See also http://www.choice.com.au/printFriendly.aspx?ID=104312.

the value of the property. As noted in Section 3, this risk was borne out for many consumers of reverse mortgages in the United Kingdom.

Two of the key initiatives that were introduced by industry in the United Kingdom in the wake of the negative equity problems were to offer fixed (rather than variable) interest rate loans (to avoid the risk that interest rates may dramatically increase) and to include a no negative equity guarantee.

At this stage, some Australian providers are following the United Kingdom's lead by offering these contractual terms in the consumers' favour. However, there are limitations to the effectiveness of both of these mechanisms.

For fixed interest rate loans, only one Australian provider offers a fixed interest rate for the full term of the loan, although several others offer fixed interest rates for between five and 10 years, before reverting to variable interest rates. All remaining providers offer only variable interest rates.

The protection afforded by the no negative equity guarantee[60] is also limited in the following ways:

- Some providers only include the guarantee in promotional statements and not in the contract itself. This type of guarantee may still be enforceable in practice where the consumer has relied on the promotional statement. However, a guarantee which is contained in the contract would be clearer and provide more solid protection for consumers.
- The guarantee does not apply in the case of 'default', which is often broadly defined and includes inadequate maintenance and repair of the property by the consumer. Providers have legitimate interests in the maintenance of the properties which are providing their security and even more so if they are taking a share in the capital gain. However, the impact of the loss of, for instance, a no negative equity guarantee may be disproportionate on the consumer.
- There is no legal impediment to framing a contract to permit eviction of a consumer or discontinuation of regular payments due to the consumer in some circumstances even where there is a no negative equity guarantee.

[60] Several products also allow the consumer to protect a percentage of the future value of the property (up to 20%). The maximum loan amount is then calculated on the remaining 80%.

Shared appreciation mortgages (SAMs)

Because part of the cost of a SAM is the capital gain foregone, the ultimate price depends on the value of the consumer's property at the point of sale. Thus, when entering into the arrangement it is impossible for the consumer to accurately estimate the cost of a SAM relative to the cost of purchasing the same property with a traditional principal and interest loan. The experience in the United Kingdom indicates that if there is a dramatic increase in housing prices the sum that must be repaid by the consumer on the sale of the property may be significantly higher than what a principal and interest loan would have required.

Some SAM providers have developed methods that mediate this risk to varying degrees by:

- taking a smaller percentage of the capital gain than they otherwise would and charging interest payable during the term of the loan,
- limiting the percentage of capital gain payable if the house value increases beyond an agreed amount, and/or
- measuring the price of the SAM against something other than the value of the particular property (for example, a more general index of property values) which would allow the consumer to track how much the SAM was costing from year to year.

There is insufficient publicly available detail about the proposed SAMs in Australia to undertake an analysis of the effectiveness of these measures at this stage.

The position with SAMs in a falling property market is different again. The consumer may effectively not be paying for the cost of funds. However, products may vary as to whether the capital loss realised on the property is shared in proportion to the contributions of the consumer and provider, or otherwise.

Home reversion schemes

Home reversion schemes differ from reverse mortgages and SAMs in that the price is set at the time the arrangement is entered into. As previously discussed, this price takes into account the facts that:

- The consumer retains the right to live in the house for life or until voluntarily vacating the property.
- There will be a considerable period before any profit is realisable for the provider.

The question of how much less than market price the property should be sold for (to take into account these considerations) is a difficult one. However, consumers should ensure that the property is independently valued and that the provider is not asking for a disproportionately low sale price before entering into the arrangement.

In addition, if the consumer vacates the property earlier than expected, they may consider the ‘discount’ on the price to be too great. Some providers mediate this risk by entitling the consumer to a rebate if the property is sold earlier than expected.

Obligations and rights in relation to the property

The class of product and the particular product’s design will make a significant difference to which party bears the obligations generally associated with home ownership including:

- paying rates and other outgoings,
- paying insurance, and
- maintaining and repairing the property.

Generally speaking, these obligations will lie with the party who retains the title to the property: that is, in all products other than the sale and lease home reversion scheme it will be up to the consumer to meet these obligations.

In addition to these obligations associated with home ownership, other conditions that may exist for consumers include, for example:

- not allowing people other than those nominated in the contract to live in the property, and
- not leaving the property vacant for periods in excess of either six or 12 months.

If a consumer breaches any of these obligations, the consequences can potentially be very serious and include:

- the provider taking possession of the house and selling it, and/or
- the consumer losing any consumer protections included in the contract such as the benefit of a no negative equity guarantee.

Difficulties may arise where consumers (who may be older and/or financially vulnerable) may be particularly vulnerable to neglecting their financial and legal responsibilities. For instance, one reverse mortgage provider provides that the consumer will be in default of the contract if they fail to provide an annual declaration of occupancy of the property. It is easily foreseeable that an older consumer may neglect to provide this declaration.

As the terms and conditions in each contract (and in particular the events which may trigger default under the contract) will vary, it is very important for consumers to obtain legal advice about their obligations and to make plans into the future to minimise the risk that they may breach their obligations.

Property repairs

The obligation to properly maintain and repair the property and the opportunity to renovate it can be particularly significant for consumers of equity release products.

For instance, where the obligation to maintain the property rests with the product provider (as with sale and lease home reversion schemes), the consumer may consider that the property requires repair in circumstances in which the provider does not agree and refuses to undertake such repairs. If the consumer completes any repairs and/or renovations, they would not obtain any financial benefit as a result because the title has already passed to the provider[61].

In contrast, in situations in which the consumer is obliged to maintain the property to the standard required by the product provider, the consumer may not believe it to be necessary or be in a position to promptly undertake repairs to the property in situations (e.g. cracks in paint or timber buckling) which the provider may view as a breach of the consumer's maintenance obligation[62].

While this term is important to protect the provider's interest in the property, the prospects of default may be disproportionately significant for older consumers. A typical reverse mortgage consumer is 72 years old, and 50% of applicants are single women, most on a pension[63]. A consumer in such circumstances may have a different perception from the provider on what maintenance is required and may face difficulties, either physical or financial, in doing and paying for maintenance that is required.

In the United States, instead of including these matters as default triggers in the contracts, most providers offer the option to pay for expenses—including tax, house repairs and maintenance and insurance—by reducing loan advances[64]. Some reverse mortgage providers in Australia

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[61] The resident would, however, benefit from the improvement in the state of the property.

[62] Diana Beal, 'Home Equity Conversion in Australia – Issues for providers/investors' in Centre for Australian Financial Institutions, *Newsletter*, volume 5, April 2001, http://www.usq.edu.au/cafi/Newsletter/vol5.pdf.

[63] Megan Fraser, 'Reverse Engineering' Asset, June 2005, 27; Nigel Appleton, 'Ready, steady…but not quite go – Older home owners and equity release: a review' Joseph Rowntree Foundation, 2003.

[64] AARP, 'Home Made Money: A consumer's guide to reverse mortgages' 2005. Please note that this is only an option where there are sufficient funds remaining in the loan to cover the cost of repairs.

also offer alternative conditions to protect their own interests without defaulting consumers.

For example, in a number of cases, if the provider considers that a property requires repair and a consumer fails to organise such repair, the provider will repair the property and add the cost to the loan. It should be noted that failure to maintain the property remains a default event under these contracts.

Renovations

Consumers who wish to renovate after entering into an equity release product should consider whether the contract requires them to obtain the provider’s approval and/or addresses the issue of which party obtains the benefit from such renovations.

Retirees who enter into equity release products may subsequently require home modifications to accommodate some level of infirmity. However, most contracts require consumers to obtain providers’ approval before renovating. Modifications such as ramps and wheelchair elevators may in fact have a negative impact on the property value, leading some providers to limit or reject approvals for these types of renovations.

Whilst the extent to which this may occur in practice has not been investigated as part of this report, consumers are advised to discuss the requirements with product providers.

If consumers wish to otherwise renovate their properties (with improvements likely to increase the properties’ value), they should consider which party will obtain the benefit from such repairs. Different products deal with this issue differently including by delivering the full benefit to the provider or the consumer or providing part of the benefit to each, either in proportion to their respective contributions or otherwise[65].

Consumer rights on provider’s default

Another issue for consumers to consider when looking at equity release contracts is what rights they have if the provider defaults. For instance, consumers should consider whether a dispute resolution scheme has been built into the equity release arrangement in case disputes arise where, for example:

- The provider refuses to approve a consumer’s request to renovate the property.
- The provider is obliged to pay rates and/or repair the property but fails to do so.

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[65] This issue does not arise in relation to products which do not entitle the provider to a share of the capital gain on sale of the property.

- The provider alleges that the consumer has failed to meet his or her obligations under the contract.

In particular, consumers should consider whether there is a prudential risk that the provider may not be sufficiently secure to guarantee ongoing payments[66].

It remains unclear in some situations how a provider default will impact on the consumer. Even if the consumer has adequate legal rights, the issue remains whether they can be enforced in a practical sense (for instance, whether the consumer will have enough money to pay legal fees and can wait up to several years until the court process is complete). In addition, the prudential risk remains as to whether or not the product provider will have the resources to meet any judgement obtained.

Residents who are not parties

Finally, it is important to note that residents in properties that are subject to equity release arrangements will generally only have rights in relation to those properties if they are parties to the contract. For example, if not all residents of the home are borrowers on the loan in a reverse mortgage (if a mortgagor has remarried and the new spouse is not a joint tenant or tenant-in-common in the property) then the resident non-borrower would generally have no rights upon the death of the borrower and may face eviction.

[66] As appears to have occurred in the sale and lease home reversion scheme described in Section 2.

Section 6: Existing regulation

This section describes the current regulatory framework for equity release products in Australia. As industry opinion appears to be that most equity release products are currently, and in the future will continue to be, distributed through mortgage brokers, the section also describes the specific risks and regulations relevant to the distribution of equity release products by mortgage brokers.

Uniform Consumer Credit Code (UCCC)

The primary source of regulation of consumer credit is the Uniform Consumer Credit Code (the Code/UCCC), administered by state and territory governments. This legislation regulates advertising and precontractual conduct as well as requiring the credit contract to disclose:

- details about the credit being provided,
- how interest is calculated and when it is charged,
- credit fees and charges to be paid,
- any default rate of interest and how this is calculated, and
- details of any relevant commission charges.

The Code also includes:

- the capacity for a transaction to be reopened on the basis that it is unjust,
- hardship provisions which enable consumers to renegotiate repayments when they face financial hardship, and
- a requirement that providers give notice before they commence repossession.

However, the Code was drafted in the mid 1990s to apply to traditional credit products with regular repayments and, accordingly, it is not specifically adapted to the issues raised by equity release products. In particular:

- There is no obligation to disclose risks that arise as a result of new complex product designs and purposes (for instance how variations in housing prices and/or interest rates may expose consumers to negative equity or that products may affect pension entitlements).
- The key tools for disclosing the cost of credit under the UCCC, the interest rate and the comparison rate, cannot incorporate costs associated with equity foregone as the value of that equity is unknown at the time disclosure takes place.

- There is no requirement to disclose the total annual loan costs or the amount of equity that consumers will retain at the end of the contract.
- The Code does not apply if the loan is used for investment or business purposes.

Misleading, deceptive and unconscionable conduct

State and federal governments also have jurisdiction to take action in relation to any misleading, deceptive and/or unconscionable conduct on the part of product providers and intermediaries in their advertising and sale of equity release products under the *Australian Securities and Investments Commission Act 2001* (ASIC Act) and state Fair Trading Acts. Whilst this does not address the need for detailed disclosure about the products or the appropriateness of advice, these powers do enable ASIC to take action where the broad consumer protection provisions of the ASIC Act have been breached.

As described in the following section, ASIC will implement a number of programmes (including advertising and complaints monitoring and undertaking legal action where appropriate) to ensure that it makes appropriate use of this jurisdiction for equity release products.

Financial Services Regulation

The *Corporations Act 2001* (Corporations Act), provides a detailed licensing, disclosure and conduct regime in relation to 'financial products'[67]. It extends to cover both the issuing of the products themselves as well as intermediaries selling or advising on them.

The Financial Services Regulation (FSR) regime established under the Corporations Act requires providers to:

- be licensed and continue to meet licensing requirements,
- do all things necessary to ensure that relevant services are provided efficiently, honestly and fairly,
- manage conflicts of interest,
- at no cost, provide retail customers with access to internal and ASIC approved external dispute resolution processes,
- be suitably skilled and qualified,
- ensure representatives are adequately trained and are competent to provide services, and

[67] As defined in the Corporations Act.

- ensure quality of advice, including by considering the individual consumer's circumstances and needs, and ensuring that recommended products are appropriate.
- Although the FSR regime generally does not apply to credit products, there are some circumstances in which the regime may apply to some conduct done in relation to equity release products. That limited application may be relevant to some SAMs and home reversion products, depending on the detail of individual product structures and terms.

For those products the operation of *Corporations Regulation* 7.1.06A means that issuing and advising on the products will not be regulated under the FSR regime, leaving only dealing in the products by intermediaries subject to any coverage. Generally reverse mortgages and conduct done in relation to them, will not be subject to the FSR regime.

Regulation of mortgage brokers

Whilst financial planners who give advice on equity release products may be covered by Financial Services Regulation for other reasons, most brokers will not be.

In 2003, ASIC published a report on mortgage brokers which found that there were few barriers to entry in the mortgage broker industry and that standards needed to improve in the sector in order to reduce the risks to consumers[68]. In particular, brokers are currently not obliged in all states to provide upfront disclosure on their role or to meet any minimum standard in providing advice. And unlike financial advisers, mortgage brokers are not required to meet minimum training and competency standards.

ASIC's report found that consumers who use the mortgage broking industry can face problems that include:

- poor advice, with the increased costs of the inappropriate loans that might result,
- inconsistent documentation from brokers,
- uncertainty about the nature and price of the services, and / or
- in a small number of cases, fraudulent activity such as manipulating loan applications.

More recently, according to the JP Morgan review of the Australian Mortgage Industry[69] over half of the 540 mortgage customers surveyed

[68] Consumer Credit Legal Centre (NSW) Inc. 'A report to ASIC on the finance and mortgage broker industry' March 2003.

[69] Fujitsu, JP Morgan 'Australian Mortgage Industry – Volume 2', *Asia Pacific Equity Research*, 11 October 2005.

believe that they will receive ‘objective and independent advice’ from brokers and only a small proportion believe that commission structures influence a broker’s recommendation. However, a survey of 290 mortgage brokers indicated that the level of commission is the single most important factor that brokers consider when deciding which products to recommend.

The states and territories have committed to developing enhanced national uniform regulation of brokers, and to this end, the New South Wales Office of Fair Trading has recently published a regulatory impact statement regarding this proposed national scheme[70]. Whilst the National Finance Broking Regulation discussion paper has detailed proposals to address some of the identified problems and public submissions have been made, final agreement has not yet been reached on the shape and contents of the proposed legislation.

Because of the complexity of equity release products and the emotional and/or financial vulnerability of many consumers who wish to acquire them, it is particularly important that consumers have access to qualified and independent advice about the products themselves and potentially how they fit within consumers’ broader financial plans.

In this context, the risks facing consumers who receive inappropriate advice about equity release products brings the previously identified need for regulation in the broking industry into sharp focus and should be considered in any regulatory reforms that take place.

At this stage, many, although not all, equity release providers attempt to limit the risk of misselling by requiring consumers to seek independent legal and/or financial advice before acquiring the equity release product.

Self-regulation

In addition to legislative regulatory schemes, some reverse mortgage providers have established an industry association, Senior Australians Equity Release Association of Providers (SEQUAL) which has a Code of Conduct and compels its members to belong to an ASIC approved External Dispute Resolution (EDR) scheme.

SEQUAL’s Code of Conduct requires all SEQUAL members to:

- ensure that all products include a clear and transparent no negative equity guarantee,
- clearly and accurately identify to consumer/s all costs associated with the transaction,

[70] New South Wales Office of Fair Trading ‘National Finance Broking Regulation – Regulatory Impact Statement – Discussion Paper’, February 2005.

- ensure full and clear disclosure of the costs of the product, including a tool illustrating the potential effect of future house values, interest rates and the capitalisation of interest on the loan,
- ensure that all consumers obtain independent legal advice, and
- ensure that all loans are written under the UCCC, irrespective of the use of the proceeds from the loan.

ASIC supports this association's efforts to maintain high standards in this area. However, at this stage SEQUAL does not cover the market as only six reverse mortgage providers and no home reversion or SAM providers are members.

We will continue to work with SEQUAL in the future to further develop its Code of Conduct and encourage further initiatives of industry self-regulation to encourage industry best practice.

At an individual product design level and in some of the self-regulatory and regulatory initiatives overseas, there are already a number of product design features and terms designed to mitigate the risks for consumers: see Appendix A. As the market develops, individual providers, the industry collectively and other regulators may look to incorporate some or all of these requirements to address the specific consumer issues raised by equity release products.

External dispute resolution

The availability of independent EDR schemes provides significant benefits to consumer of many financial services such as general insurance, banking services and financial advice. These schemes—including the Banking Financial Services Ombudsman and the Financial Industries Complaints Service—provide a free service for consumers to conciliate and, if necessary, arbitrate disputes.

In choosing a product, consumers should consider whether or not both the issuer of the product, and any intermediary or adviser they deal with in relation to the product, provides access to EDR. This is not yet the case across the marketplace.

There is no legislative requirement that those issuing and selling equity release products be members of an EDR scheme. However, some providers such as banks will be members already and so provide access to an EDR scheme for consumers who have disputes with them in relation to equity release products. In addition all SEQUAL members must be members of an ASIC approved EDR scheme.

Section 7: Conclusions and recommendations

In the last year, a number of innovative and useful equity release products (with much creativity in product design) have been developed. However, internationally each of the three types of products discussed in this paper have, at times, been criticised because they have been missold to consumers, who have suffered considerable detriment as a result.

We consider that equity release products are complex and that most consumers will need advice to determine whether any of the range of products are suitable to their needs and, if so, which one. The products will often need to be considered within broader financial plans, particularly given the tax and social security issues and the potential to use equity as source of funds for investment. And consumers will also need advice on the detail of product features, terms and conditions, and their rights and responsibilities in the particular product they are considering.

We recommend, therefore, that consumers obtain independent legal and financial advice to ensure that they fully understand the terms and consequences of any arrangements they enter into. We have also formulated a list of issues consumers should consider before entering into equity release schemes. These issues are listed in Appendix B.

The existing regulatory system was not designed to address the issues raised by equity release products, which take the form of a credit arrangement but nevertheless have some of the attributes of an investment product.

At the product level, the principal vehicle for regulation of credit, the Uniform Consumer Credit Code, does not provide for disclosure of risk, nor provide a mechanism for disclosing elements of the cost of the product, such as the forgoing of equity, that are not translatable into an interest rate. Finally it will not apply at all where the funds obtained are to be used for investment purposes.

The principal vehicle for the regulation of investment products, the Corporations Act, has limited application to some home reversion and shared appreciation products, depending on their terms, but generally does not apply to reverse mortgage products.

The products will be distributed through both mortgage brokers and financial planners with mortgage brokers expected to predominate in the foreseeable future. However, there are disparities between the regulation of mortgage brokers and that of financial planners. In particular, there are currently no mandatory training and competency requirements for, or regulation relating to the quality of advice provided by, mortgage brokers.

Given this current regulatory structure and the current and expected growth of the market, state, territory and federal regulators should continue to actively monitor developments and complaints to identify and address any problems that arise and, as the market develops, consider whether there is a need for more detailed regulation of intermediaries, advice and/or product disclosure.

ASIC's principal source of jurisdiction in relation to these products is under the ASIC Act which contains broad consumer protection provisions such as the prohibitions on misleading or deceptive conduct, and unconscionable conduct. ASIC will monitor the marketplace and will take action under these provisions whenever appropriate.

Whilst equity release products appear to meet identified needs in the marketplace, consumers' lack of familiarity with them means that the growth of the industry will depend on establishing and maintaining consumer confidence. Any negative consumer experience has the potential to discourage consumer participation. Thus it is very strongly in industry's interest to adopt best practice solutions and ensure their products and practices appropriately address the risks that do exist for consumers.

Recommendations

This report recommends:

- Consumers obtain independent legal and financial advice before entering into equity release arrangements.
- Federal, state and territory regulators monitor closely the development of the market, consumer complaints and any problems they point to and keep under review the adequacy of the regulatory structure to address them.
- Equity release products be considered in any review of the Uniform Consumer Credit Code and in the ongoing development of enhanced regulation of mortgage brokers.
- ASIC work with industry to promote best practice and identify and appropriately deal with risks for consumers.

Future work

ASIC will continue its work in this area by:

- Monitoring advertising and complaints.
- Initiating consumer education.

- Creating consumer tools including illustrations and/or product calculators.
- Working with industry and State and Territory governments to enforce existing legislation and further develop industry best practice.
- Undertaking legal action where appropriate.
- Undertaking future research into the industry as it develops.

Appendix A: Reverse mortgage consumer protections

A review of current contracts, self-regulatory initiatives and government regulations in Australia, the United Kingdom and the United States indicates that there a number of product features and disclosure requirements that may provide useful protections for consumers who acquire reverse mortgages.

This review is limited to reverse mortgages at this stage because they are currently the dominant products in the Australian market. As the market continues to develop, ASIC may undertake similar reviews of home reversion schemes and SAMs. Table A.1 presents some features and disclosure requirements relevant to reverse mortgages (and the source of such terms), which may afford useful protections for consumers.

Table A.1: Protections for consumers

Type of protection	Source
Full and clear disclosure of the costs of the product, including a tool illustrating the potential effect of future house values, interest rates and the capitalisation of interest on the loan	SEQUAL Code of Conduct
Disclosure of the effect of the contract on occupancy rights and legal ownership	HECM rules—United States
A requirement that consumers obtain independent legal and financial advice	HECM and Fannie Mae—United States
A prominent warning that the product may affect consumers' pension entitlements and taxation obligations	Financial Services Law—United Kingdom
A recommendation that consumers consult family members before signing the contract	SEQUAL Code of Conduct
The option of a fixed interest rate (some provider contracts) or a cap on variable interest rates	HECM rules—United States
No penalty for early repayment or cancellation of the loan	HECM rules—United States
A no negative equity guarantee	SEQUAL and SHIP Codes of Conduct
No default triggers (that would result in the loss of the no negative equity guarantee and/or eviction of the consumer) other than fraud, misrepresentation, non-provider approved sale of property or some interest in property, or vacating the property for more than 12 months without provider approval	HECM rules—United States
A guarantee that the provider will approve consumers' reasonable requests for housing modifications to meet aged care needs	Proposed
A term to address the risks of eviction faced by resident non-consumers	Some provider contracts in Australia and the United States

Appendix B: Checklist of issues for consumers

Table B.1 lists a number of questions that consumers should ask when considering equity release products and the issues and features they should be aware of when asking these questions. ASIC will also develop more detailed information for consumers.

Table B.1: Issues checklist

Question	What to look for
Are there protections against excessive costs?	Reverse mortgages may include: • 'no negative equity guarantees' which guarantee that the provider will bear any difference if the debt exceeds the value of the property, and/or • Fixed interest rates or caps on variable interest rates which may limit the risk of negative equity. SAMs may include: • caps on the amount that providers will be entitled to if value of the consumer's home increases beyond an agreed amount. • a mechanism to measure the price of the SAM other than the value of the property. Home reversions may include: • rebates if the consumer sells the property earlier than expected.
Who is obliged to maintain the property?	In some home reversion schemes the provider is responsible for maintaining the property, but in most equity release products, the consumer is responsible for maintaining the property to a standard that is set by the provider.
What are the terms and conditions?	If the consumer breaches the terms and conditions in the contract (including for example an obligation to maintain the property), they may lose key rights under the contract and the provider may have the right to evict the,.
Who gets the benefits from renovations?	Some contracts deliver the financial benefit from renovations to the provider, some to the consumer, and some provide a portion of the benefit to each.
How will it effect consumers' pension and tax?	Payments from reverse mortgages and home reversion schemes can have significant impacts on older Australians' pension entitlements.
Does someone else live in the home?	Residents in the consumer's home who do not sign up to the equity release contract may not have any rights in relation to the property. This can be an issue if the homeowner dies or moves into retirement accommodation.

Is the provider financially sound / prudentially regulated?	If not, there may be an increased risk that the provider may not be able to meet any long term promise to make payments.
What rights does the consumer have if something goes wrong?	If the product provider and issuer are members of an external dispute resolution scheme, the consumer will have better access to possible resolution of disputes at low cost.
Is this the best option for the consumer?	Other equity release products or non-equity release options may suit the consumer's needs better.