National Information Centre on Retirement Investments Inc.

Accessing the equity in your home – some issues to consider

The National Information Centre on Retirement Investments Inc (NICRI) is a government funded, independent consumer agency providing information to the general public on investment products.

Borrowing against a person's home or, in some cases, other real property, with repayments to be made from the owner's estate or on vacating the property is becoming more popular and the number of providers and the options available has increased greatly.

The loan

These loans are known generically as Home Equity Conversion Loans or Reverse Mortgages. Applicants who qualify can borrow specified amounts of money against the security of their primary residence. In some cases these loans may be secured against investment properties or non owner occupied properties. While this type of loan can never be in default due to lack of payments being made, other conditions of the loan can place it in default. These include not maintaining the property to a satisfactory standard and the lender may have the right to have the maintenance done with the cost being added to the balance of the loan.

Interest and other costs

While repayments do not have to be made until the property is vacated or on the death of the homeowner/s, the interest is compounded and the amount of the debt increases over time.

Other charges, such as an application fee and a monthly charge can also apply. These are included with the loan and compound interest is charged. It may be possible to make repayments of the interest and/or charges, if desired, effectively restricting the amount of the debt increasing. In some cases the amount of the loan is provided only as a lump sum and not as regular payments from the institution. This means the interest accrues on the full amount of the loan.

Where a regular monthly payment is received, interest applies only to the outstanding balance of the loan but the amount drawn and interest charged is limited to the original amount approved as the loan. Prior to making an application for a loan it is important to check if an application or establishment fee is payable even if the loan is not proceeded with. Reading a copy of the contract may be sensible before signing an application for the loan.

Income stream vs lump sum

If the loan is from an organisation that only offers the loan as a lump sum and regular payments over time are desired, it is possible to purchase income stream products, such as Immediate Annuities with the proceeds of the loan. Information on these products can be obtained from NICRI.

Eligibility

To qualify the providers require the borrower, or both borrowers in the case of a couple, to be of a minimum age - commonly 60 years. The amount of the loan available can range from $10 000 to a maximum of the lesser of a percentage of the property value or $750 000, depending on the provider and the age of the applicants. Existing debts from other lenders usually have to be repaid so the lender would have the only mortgage over the security property. It is usually necessary to have the property revalued on a periodic basis and the cost of this has to be paid by the consumer or added, at the time of valuation, to the loan.

Increasing the borrowing in the future

NICRI has had enquiries from people who have not needed the total amount they were borrowing at the time but who were contemplating borrowing a larger sum of money to avoid having to apply for a loan increase at a future time. The main benefits in following this course of action are in the event of changes in the policy of the lending institution and also the convenience of not having to apply for the increase at a later time.

In this situation it would be prudent to calculate the costs that could accrue if additional funds were borrowed initially compared with increasing the amount of the loan at a time when the funds were required. Where the loan amount is to be increased in the future a further application fee usually applies. For example, if $30,000 was borrowed and retained for 2 years, assuming a borrowing interest rate of 8.5% the interest accrued on the unused funds would be about $5,538 (including compounding). Assuming the funds were invested at 5% and neither tax nor reduction in government income support applied, the cost over 2 years would be $2,538. This is because of the extra interest accrued on the larger amount borrowed. Providing the application fee remains stable applying for the additional borrowing later may be cheaper.

The effect of compound interest on the loan balance

Where a person borrows $30,000 gross (including 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 – a big assumption as usually a variable interest rate applies.

Other assumptions that need to be made could include the potential value of the property over time, the cost of maintenance etc. These can be particularly important where it is intended to leave a legacy.

Some providers offer a ‘no negative equity guarantee’. This means that if the balance of the loan exceeds the proceeds of sale of the property, no claim for this excess will be made against the estate or other beneficiaries of the borrower. It is important the contract be examined thoroughly as this guarantee may be subject to certain conditions.

Variations of the loan

Products are now available where providers either purchase ‘a percentage of the future value of the security property’ or purchase the property and offer life tenancy. These options are often only available in certain locations.

The amount provided is usually actuarially calculated and a set percentage of the proceeds of sale of the property is paid to the provider in repayment of the advance. Where the property sells for a higher price than estimated the extra is split between the provider and the owner/s or estate.

Effect on Government Income Support payments

For people who receive Government Income Support, such as an age pension, consideration should be given to the possible impact such a loan may have on the payments they receive. The first $40,000 borrowed is not counted as an asset for 90 days even if it remains unspent. Where more than $40,000 is borrowed and not immediately spent, the amount in excess is counted as an asset immediately, with the remaining $40,000 being counted only after 90 days have expired. Where the whole amount is immediately spent, unless spent on assessable assets or other assessable transactions, the above does not apply. The unspent loan proceeds held are a financial investment and subject to deeming under the income test.

Where the loan is drawn on a regular basis, for example $1,000 per month and the funds not accumulated, there is no effect on the income test nor the assets test. Some institutions that offer regular payments do so by holding the proceeds of the loan in an 'offset account' or a secondary account and making 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. Where an offset account is used, the interest charged by the institution is usually reduced.

Before signing a contract for this type of loan it would be worth speaking with a Financial Information Service (FIS) Officer to confirm the assessment of the loan on Government Income Support payments. Appointments to meet with FIS Officers can be made by telephoning 13 10 21.

Pension Loan Scheme

People of Age Pension age (or their partners) who can't get a pension because of their income or assets, but not both, or those who only receive a part pension, can access capital tied up in their real estate assets under the Pension Loan Scheme. Information on this subject can be obtained from Centrelink or by searching on their website, www.centrelink.gov.au.

Getting advice

It is prudent, and sometimes a requirement, that independent legal and financial advice is sought before proceeding with such a loan. In this situation financial advice can be obtained from an accountant, solicitor or other suitably qualified person. These loans are not at this stage regulated under the Financial Services Reform Act and the advice does not have to be provided by a licensed financial advice provider. People who use a financial adviser could seek this advice from them if they and their organisation are willing to provide it. As with anyone else providing advice a fee is likely to apply.

Your decisions could impact on others

Discussing the decision to access this type of loan with family members could also be sensible so they can be aware of the consequences of such a transaction and, if desired, other alternatives may be investigated. All strategies and transactions have risk. Assumptions are made in providing projections and the reality of the situation could be very different. While every contingency cannot be anticipated, considering possible alternatives, should things not eventuate as planned, is sensible particularly as people age.

To assist with understanding the effects of interest on a loan and the equity remaining in a property a Reverse Mortgage calculator is available on our website *http://moneymap.nicri.org.au*.

Prior to acting on information provided in our publications, NICRI strongly recommends details in relation to personal circumstances are confirmed with relevant government departments agencies or other organisations.

NICRI can be contacted toll free on 1800 020 110 or write to PO Box 893, Woden ACT 2606. Our information leaflets are also available on our websites shown below.

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Redundancy & You
Risk Meter
Safety, Risk & Scams

Financial Planning
A Guide to the Financial Planning Process
Income & Expenditure Sheet

Superannuation
Introducing Superannuation
Superannuation Tax Considerations
Self Managed Super Funds
Rolling Over Superannuation
A Super Checklist

Income Streams
Retirement Income Streams - A Comparison
Account Based Income Streams
Introducing Immediate Annuities

Investment Products
Bond Trusts
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