Reverse Mortgage

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Introduction:

Reverse Mortgage is a product that will allow senior citizens to avail themselves of funds by mortgaging their residential property. The scheme is similar to a housing loan except that in a home loan the borrower pays a fixed EMI to the lending institution, while in a reverse mortgage the lender pays the borrower a fixed sum of money on a monthly (or quarterly) basis, the total payment being equal to the value of the property and the interest on the loaned amount. After the death of the borrower and the borrower's spouse, the housing company sells the property to recover the amount paid out along with interest at a rate similar to interest on housing loans.

Features:

The contract converts the capital value of a home into an annuity over the homeowner's lifetime. The loan is not an income so is tax free. The amount loaned would depend on the estimated value of the property (minus the interest cost), its condition and life. The borrower is given upto 3 business days to exercise his "right of recession" i.e. the right to cancel his transaction. If the loan amount has been disbursed, the entire loan amount will need to be repaid by the Senior Citizen borrower within this three day period. However, interest for the period may be waived at the discretion of the lender. The legal heirs have the option to re-possess the property after the demise of both the borrower and the spouse on clearance of all debts. The borrower or the heir can even prepay the loan amount, but they would have to bear an additional cost. If the borrower outlives the tenure of the loan (normally 15 years), he will not be asked to move out of the house. Although payments made to him will stop after 15 years, the interest will keep accumulating till the accounts are finally settled. It has been suggested that a certain portion from the payments be parked in bank fixed deposits to fund the years that one may outlive the loan.

The loan amount is sanctioned based on the:

- Age of the borrower: On an average the age of the borrower and the spouse should be 60. There is no upper age limit to avail the loan; but the higher the age the easier the loan. The table given hereunder may serve as an indicative guide for determining loan eligibility :

Age	Loan as proportion of Assessed Value of Property
60 – 65	40%
66 – 70	50%
71 – 75	55%
Above 75	60%

- Average value of the property: The aggregate value depends on the capital value of the home. The property is revalued by an in-house property consultant every 5 years, adjusting the payments accordingly (thus it is inflation adjusted). The annuity may be designed to rise, fall or stay steady over the lifetime. However, currently on the basis of present actuarial analysis, the loan to value ratio is fixed at 40-60 per cent of the value of the property based

on the age. Some banks are however designing reverse mortgage products with a higher loan to value ratio -- as much as 90% in some cases.

- Rate of interest on the loan: The interest rate at which the loan will be given will typically be marginally higher than the prevailing interest rates as the lending company will receive its money when the borrower dies. . The banks have so far not indicated which interest rates they will use to determine the EMI -- however, we can safely assume that it will not exceed the interest rates used for loan against property -- which is currently in the region of 10-12%

Terms and Conditions to Borrower:

- Should be living in a self-owned property, which is free of any other encumbrances, and is an approved construction
- Can pledge their house only if they are using it as their permanent primary residence for a minimum of 1 year
- It may not be possible to provide reverse mortgage for houses on power of attorney
- Need to pay property tax and insurance and maintain the house
- The loan amount cannot be used for any speculative or trading purposes
- The loan does not apply to ancestral property
- The residual life of the property should be at least 20 years
- The borrower will be provided the option to accept the revised terms and conditions to continue the loan. However, if he refuses to accept the revised terms and conditions, no further payments shall be made by the bank/HFC. Interest at the rate agreed before the review will continue to accrue on the outstanding loan amount.
- Commercial property will not be eligible for the loan
- Bankruptcy can lead to foreclosure
- The residential property cannot be donated or abandoned by the borrower(s).
- The borrower(s) cannot effect changes in the residential property that may affect the security of the loan for the lender. For example: renting out part or all of the house; adding a new owner to the house's title; changing the house's zoning classification; or creating further encumbrance on the property either by way taking out new debt against the residential property or alienating the interest by way of a gift or will.
- Lump sum withdrawal of loan shall be permitted for restricted uses such as for upgradation, renovation and extension of residential property
- It may lead to foreclosure if the government under statutory provisions, seeks to acquire the residential property for public use; or
- If the government condemns the residential property, for example, for health or safety reasons
- The lender may consider taking an undertaking from the prospective borrower that the "Registered Will" given to the lender is the last "Will", as per which the property will vest in his/her spouse name after his/her demise.

Terms and Conditions to Lender:

- The lender will have the discretion to determine the eligible quantum of loan reckoning the 'no negative equity guarantee' i.e. the costs of the borrower should not exceed the amount of the loan payment.
- The lender may consider ensuring that the equity of the borrower in the residential property (Equity to Value Ratio - EVR) does not at any time during the tenor of the loan fall below 10%.
- The methodology adopted for determining the quantum of loan including the detailed tables of calculations, the rate of interest and assumptions (if any), should be clearly disclosed to the borrower.
- Lenders are advised not to reckon expected future increase in property value in determining the amount of the loan.
- The lenders will observe and maintain high standards of conduct in dealing with the Senior Citizens and their families and treat them with special care.
- The lenders may suggest to the Senior Citizens to nominate their 'personal representatives' usually a close relative who the lender can contact in the event of any potentialities.
- The lenders shall in no way assert or imply to the borrower(s) that the borrower(s) is/are obligated to purchase any other product or service offered by the lender or any other associated institution in order to obtain a reverse mortgage loan.
- Take reasonable steps to check out the background and procedures of third parties before accepting referrals of business from them, and refuse to accept referrals from those that are found unacceptable.
- Lenders shall disclose to clients any third party with a financial interest in the reverse mortgage transaction.
- After the death of the borrower the lender will give 6 months time to the heir to repossess the loan or else it will bequeath the property.

Advantages to the Borrower:

- Higher standards of living and better access to health care
- Homeowners in reverse mortgages will be protected against inflation
- Retains the principal flavour of a defined benefit scheme by providing a guaranteed base income
- Reverse mortgage can supplement retirement income
- Also with the burgeoning real estate market in India there is a good possibility of the value of the house appreciating more rapidly than the mortgage loan increasing. In such a scenario, there could be some equity left over for heirs.
- There is no upper age limit for getting the benefit of the reverse mortgage facility.
- It is a non-recourse loan, which means the bank/financial institution can never come after any person or estate for repayment of the loan. The lender can only receive payment of the loan from the value of the home.
- Tax free payments from the lender

- The payment method can be setup as a line of credit to be drawn at the time of need (monthly, yearly or quarterly). In case you want a line of credit, then you will be required to pay a commitment fee.
- The spouse can use the property after the borrower's death.
- In case the residential property is already mortgaged to any other institution, the lender may, at its discretion, consider permitting use of part proceeds of loan to prepay/repay the existing housing loan. The loan amount will be paid directly to that institution to the extent of the loan outstanding with that institution with a view to release the mortgage

Disadvantage to the Borrower:

- The biggest challenge would be balancing the need for supplementing retirement income and the desire and wish to bequeath homes to children.
- Compounded with the natural reluctance of many seniors, who have worked a lifetime to pay off a housing loan to go back into debt, irrespective of the merits of the scheme, the psychological acceptance of this concept in itself would, no doubt, be difficult.
- One clause that is likely to draw a lot of criticism is the one that fixes the maximum loan tenure at 15 years
- Very high transaction costs, possibly amounting to as much as 14% make it very unattractive to potential borrowers, especially when there is a desire/ plan to move out.
- If the loan is prepaid then the borrower will have to pay an additional cost
- Homeowners may fear that they may have to vacate their house in case they become too ill in future to afford maintaining the house as per the loan requirements and the lender insists upon foreclosure.
- Excessive procrastination when decisions involve current costs and future benefits
- If the loan proceeds are used to buy an annuity, the interest part of the annuity may attract income tax.
- If the house is sold so as to result in a capital gain, the sale proceeds will attract capital gains tax.

Advantage to lender:

- It would not be unrealistic to presume that property values will double in 15 years
- It is definitely more profitable to offer mortgages to people at older ages, say above age 75, due to reduced life expectancy
- Higher rate of interest than market rate on housing loans so higher return
- Low probability of default

Disadvantage to lender:

- There is the risk that a borrower lives longer than anticipated. The lender might get hit both ways: he has to make annuity payments for a longer period; and the eventual value realised might decline. However, this risk is usually 'diversifiable', if the lender has a large pool of such borrowers. Possibility of adverse selection (of predominance of relatively healthier borrowers) is counterbalanced by the possibility that even borrowers with poor health may be attracted by the credit line or lump sum options.

- If the value of the property does drop below the amount owed on the reverse mortgage, the lender must absorb the loss
- There are other issues such as pricing which can be extremely complex as it involves a number of uncertainties, such as future value of houses, life expectancy, and interest rate risks.
- The principal and unique problem facing the lender is that of predicting accumulated future loan balances under this loan, at the time of origination.
- Since this is a non-recourse loan, the lender has no access to other properties, if any, of the borrower.
- Most of these loans accumulate interest on a floating rate basis to minimize interest rate risks to the lender, which can only be realized only at the time of disposal of the house, if at all.
- For the lender, both the interest and any shared appreciation component added to the loan balance are taxable as current income even though there is no cash inflow
- Once the loan is taken, the homeowners may have no incentive to maintain the house so as to preserve or enhance market value.
- In these loans where the borrower draws down on his loan through a credit line, there is a risk of sudden withdrawals.

Importance to India:

India is a young country, the average age of its citizens being about 26. Moreover, its population is expected to grow at 1.6 per cent annually. The proportion of the working-age population will rise for a long time and remain at a high plateau for a longer time. India's economy is estimated to continue to grow at over 6.5 per cent, at least until 2040. The demand for housing, as a result, will remain high.
According to the 1991 census reports, India has an estimated 314 million workers, of which a mere 11 per cent are covered by the formal pension system. Hence for the majority of population, personal savings are their only source of retirement income.

According to the Business Intelligence Unit (BIU), housing accounts for more than 75% of incomes. Households are hence expected to create more housing assets in the future. Reverse mortgages will also provide additional incentive to accelerate future investments in housing assets. Realtors do not dread any decline in home values for a long time to come. This also means that those who are 60 now will enjoy rising incomes or very certain incomes for a long time after retirement.

The mortgage market in India is reasonably large. The Indian mortgage market is dominated by institutions such as HDFC and banks such as ICICI Bank. In the past few years, higher affordability, low interest rates and easy availability of credit have helped the mortgage market to grow at more than 20% pa. The real estate prices have also moved up by 100-300% in the past few years

The case for reverse mortgage has been made at the right time. Its relevance to India has been enhanced significantly by three proposals included in the recent Budget:

- Proposals pertaining to the tax treatment of savings up to Rs 1,00,000,
- Continued deductibility of interest expenses on home loans; and
- Legal framework for the issuance of mortgage-backed securities.

The role of an actuary:

An actuary looks into the pricing and modeling of the policy according to the age of the borrower, the life expectancy, the average value of the property (condition, location, age of the property, etc.) and the market conditions. The reserves should be sufficient to meet the expenses of the lender as well as any unpredictable need of the borrower (eg. Setting up a line of credit or the borrower requiring a lump sum payment).

An actuary plays a key role in this area. The valuation of a reverse mortgage would be quite similar to a pensions annuity. The lender might take an insurance against any default that is depreciation of property value or some catastrophic calamities effecting the property and hence the lender's return.

Companies in India:

National Housing Bank (NHB): The National Housing Bank, a subsidiary of the Reserve Bank of India (RBI), is preparing the guidelines on reverse mortgage. This rule applies to both stand-alone houses as well as flats. In case of inherited property, all claimants to it will need to give their consent in writing. Sridhar says that if the property is inherited, the lender will be guided by legal advice on the borrower's clear rights or title. Reverse mortgage loans are to be extended by Primary Lending Institutions viz. Scheduled Banks and Housing Finance Companies (HFC's) registered with NHB. They reserve their discretion to offer Reverse Mortgage Loans.

NHB seeks to refinance banks/HFC's to extend reverse mortgage loan to senior citizens. According to the NHB guidelines, senior citizens aged 60-65 can obtain loan up to 40 per cent of the value of the property; between 66-70 up to 50 per cent; between 71-75 up to 55 per cent; and above 75 up to 60 per cent. Equity to Value Ratio - EVR) does not at any time during the tenor of the loan fall below 10%. A reasonable amount of time, say up to 2 months may be provided when the repayment is triggered, for house to be sold.

Under the existing regulatory regime, banks come under the RBI and HFC's under the NHB. NHB plans to provide guarantee to borrowers against default by lenders by starting a loan mortgage company. The company would also safeguard the interest of lenders in case borrowers bungle on the terms of the agreement. NHB is also trying to build in a mechanism where the loan amount could flow beyond 15 years. NHB has suggested a loan to valuation ratio that varies with the age of the house owner.

State Bank of India (SBI): The loan is being offered by all branches of SBI from the 12th of October, 2007. The loan is offered at an interest rate of 10.75% pa and is subject to change at the end of every five years along with revaluation of security. Joint loans will be given if the spouse is alive and is over 58 years of age.

Dewan Housing Finance Limited (DHFL): DHFL was the first to launch the Saksham scheme on reverse mortgage in September 2006. The loan to value for DHFL is 90% and is offered to citizens above the age of 60. The rate of interest on reverse mortgage offered by DHFL is 12 per cent while that for a classical home loan it is 11.75 per cent. The company assesses the value of the property and lends about 30 per cent of the value o to a customer in the age group of 60 years and about 60 per cent to those of 80 years and above. DHFL asks for documentation and other upfront charges to the extent of 1.5% of the credit limit. If the interest charged is 12% per annum and the time of tenure of the reverse mortgage is 10 years, then the monthly payment for a 61-year old living in a property worth Rs. 60 lakh would work out to around Rs 10,000 (this is an indicative figure,

calculated on the basis of actuarial tables). DHFL has adopted the method of counseling their clients through the senior citizens' association and other such forums.

Punjab National Bank (PNB): PNB is charging an interest rate of 10% per annum. The tenure of the loan is about 15 to 20 years for the 60-70 age group and 10 to 15 years for individuals aged above 70 years. In case of joint account, the minimum age of the spouse for availing the loan under these two categories shall be 58 and 68 respectively. After the death of the borrower, bank will give six months time to the legal heirs for repayment of loan. But if this option is not exercised, bank will sell the property and liquidate the loan. The qualifying amount of loan will depend on the realisable value of residential property, after maintaining margin of 20% and upfront charges equivalent to half + month's loan installment subject to a maximum of Rs 15,000. The senior citizen shall be given upto 10 days time to relook into his requirements if he so wishes to cancel the transaction for any reason whatsoever.

Depending on the age of the beneficiary a chart containing the amount of monthly installments (calculated on 'Reverse Annuity Mortgage" basis) to be paid to the senior citizen borrower for different tenors of loan per lakh of rupees is as under :-

Tenor (yrs.)	10	11	12	13	14	15	16	17	18	19	20
Monthly Instal-ment(Rs.)	490	420	360	315	275	240	215	190	170	150	135

Other institutions: GIC Housing Finance Ltd plans to enter this segment in the next few months. LIC Housing Finance also plans to offer a reverse mortgage product where senior citizens will be given between 40% to 60% of the value of their homes as loan with tenure of 15 years. According to news reports, other institutions like Allahabad Bank, ICICI Bank and Bank of Baroda amongst others are also evaluating the reverse mortgage segment. Grah Finance is one institution that is waiting for clarity over taxation aspects before launching a reverse mortgage product.

What are the documents required?
Before seeking loan against property, the senior citizen would have to provide a proof of residence, age and the bank statement for the last six months. The property owner would also have to provide copies of last three months' electricity, water and phone bills. Maintenance receipts of the past six months from the housing society, if available, need to be submitted. The certificate of home insurance for the property is to be given as well. A copy of the ration card, too, may be asked for. The borrower may be charged pro-rata origination, appraisal and inspection fees by the lender/appraiser. Other charges involved are:

- Verification Charges of external firms
- Title Examination Fees
- Legal Charges/ Fees
- Stamp Duty and Registration Charges
- Property Survey and Valuation charges

Reverse mortgage to fund long term care insurance:

No older person should have to sacrifice his or her home or opportunity for independence to secure necessary health care and supportive services:

Today, an increasing number of married couples are setting up nuclear families, with parents and grandparents living independently and having to manage their own resources. To protect older-aged homeowners from potentially catastrophic costs of long-term care, additional resources are required; an important option to consider being long-term care insurance. Reverse mortgage could significantly increase the affordability of long-term care insurance. By mortgaging their own home, homeowners can purchase a policy without having to sacrifice their current lifestyle. One option could be to use the proceeds from a reverse mortgage to pay for the insurance premiums. Another could be to limit the amount of insurance purchased by the elderly by increasing the amount of long-term care self funding through the reverse mortgage.

It is difficult to determine how much long-term-care coverage a person should purchase as some people with no disability may need it for only a few years but those with ADL's may need it for a much longer time. One way to asses the value of the reverse mortgage is determine the amount of money that would be available to the impaired elders. Building up a substantial home equity is not very easy for a physically or mentally impaired person. For severely impaired elders who take out a reverse mortgage, there is a risk that they will not be able to maintain the home for a long time or remain in it for many years. Because reverse mortgages have relatively high termination costs, it would be preferred by people who expect to stay at home for a longer time. However, they can be an expensive option for borrowers who opt for a monthly contract and then may have to move out, sell the home or die within a few years of taking out the loan.

Using a reverse mortgage for payment of long-term care insurance premiums would reduce up-front expenses for this coverage. But this strategy can also be very costly for borrowers who would have to pay both insurance premiums and interest on the loan for many years. In order for reverse mortgages to be a viable option, the financing strategy must meet three key criteria:

- Sufficient funds to purchase appropriate long-term care coverage
- Reverse mortgage income should cover a substantial proportion of the insurance premiums, and any future premium increases
- Reverse mortgage proceeds must last long enough to pay premiums until a policyholder needs long-term care

The income received under the reverse mortgage contract should be able to fund a significant amount of paid home care (and/or nursing if required) to help impaired seniors avoid or delay the need for institutionalization. For example, elders who require only three days of paid home care per week would be able to use their loan to pay for assistance for a number of years. Many older people find that the need for long-term care arises slowly, as they gradually require more help with everyday activities at home. For these elders, it may be more appropriate to receive payments from a reverse mortgage through a credit line or payment made for a fixed term (which pays for as long as the borrower lives in the home). By having money of their own to pay for long-term care, elders can maintain their dignity, as well as retain some independence and control over their lives. For the family of the borrower, these supports can help reduce the financial, emotional and physical strain associated with caring for an impaired elder.

On the other hand, using most of the proceeds from a reverse mortgage to pay for premium coverage might be risky for many. After paying for insurance premiums, they would have little left from their monthly cash withdrawal to pay for expenses or for any premium increases. A good approach may be to use the loan proceeds to increase the amount of long-term care that homeowners fund out of their savings making private insurance more affordable because elders could then buy less long-term care coverage. Some options that maybe offered to homeowners could be:

- Homeowners could select a policy with a lengthy waiting period (such as one year) and use loan proceeds to cover expenses until the insurance starts paying benefits.
- Homeowners could purchase a limited amount of long-term care coverage (such as a two-year policy) and pay for any care they needed beyond this time period.

Duration of the loan is a critical factor in assessing the value of the reverse mortgage required to cover any private insurance. The risk of needing long-term care increases significantly after age 85. For the typical reverse mortgage borrower, who takes out a loan in his 70s, this could mean holding onto the loan for five to 15 years or longer.

Any future premium increases may be more manageable for elders who opt for costly long-term care policies later on in their lives as the higher the age the easier and the better the value that a borrower will get on a reverse mortgage. As people grow older, they are at greater risk for being uninsurable due to a pre-existing chronic health condition, a drawback that can be countered by drawing out a reverse mortgage contract. Also elders can pay for their long-term care needs as and when they arise with the help of a reverse mortgage loan to buy additional coverage for oneself or by setting a line of credit on the loan.

Due to the widespread availability of home equity (since more and more people are buying houses at younger ages as explained before), using reverse mortgages is a strategy that strengthens the long-term care safety net for all elders. Currently, there is still little awareness of this product among seniors, the market still being at a very early stage. Government incentives to reduce the upfront cost of these loans may be able to play an important role in promoting such an approach to financing long-term care. The appropriate uses of these funds—whether to purchase personal care services or private insurance—also needs to be examined to ensure that seniors make wise decisions with their limited housing resources, probably with the help of counselling.

Conclusion:

Reverse mortgage in simple terms is a rather unconventional retirement tool. Even in countries where it has been around for quite a while, acceptance has been very cautious. It is a boon for the asset rich and the income poor population.

However, a point to note is that some time during the tenure of the loan, an elderly borrower may simply be physically incapable of maintaining the home as per loan requirements. Though the loan contract provides for foreclosure under such conditions, this seems to be impractical and sure to result in litigation and bad publicity for the lender.

Experience to date may not be a reliable guide to the future as most of the experimental schemes are in their infancy. Losses due to moral hazard may take many years to develop. Competitive pressures for achieving volumes in future may increase this risk.

At the macro level, implementation of reverse mortgage schemes could reduce the burden on the Government and employers who are paying pensions, whether in the public or in the private sector, and would thus be an indirect measure to bring in pension reforms. It spurs economic activity, provides security and retains the principal flavour of a defined-benefit scheme. It can bring about a great degree of regulation and transparency in the Indian market, which as of now is missing.