

ATTACHMENT C

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2. THE COMMISSION'S REFORM PROPOSALS

The Productivity Commission's proposals seek to ensure consistent subsidy arrangements exist for care received in a community or residential setting and an increase in the proportion of aged care costs met from private contributions. This would be achieved through the inclusion of the care recipient's principle place of residence in the means test for care services. Due to the nature of elderly peoples' asset holdings, this would result in more people being required to pay for their care costs. Other features of the funding proposals will result in people that have sizeable assets outside the family home paying less than under the current regime.

Such a funding regime is dependant on people being able to access the equity in their home. This has led the Commission to recommend the creation of two financial products, the **Australian Aged Care Home Credit Scheme** and the **Australian Age Pensioners Savings Account**.

The Australian Aged Care Home Credit Scheme would provide people receiving care in their own home with an income stream to pay their care costs. It could also be used by people in residential aged care who don't want to sell or rent their home if, for example, a family member is still residing in the house.

3. AUSTRALIAN AGED CARE HOME CREDIT SCHEME

THE CURRENT EQUITY RELEASE MARKET

Current products

There are three types of equity release products currently available to seniors in Australia—reverse mortgages, accommodation bond loans and home reversion schemes.

Reverse mortgages

A reverse mortgage is a loan product under which a borrower uses their house as security for a loan, which is provided in the form of a lump sum (including lines of credit), regular payments or both. The consumer retains title to their property but grants the lender 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). Interest is often 1 per cent higher than traditional home loan products because of the uncertainty of the loan term and the borrower's longevity. The consumer is usually not required to make any repayments until they die or otherwise voluntarily vacate the property. For a consumer to be eligible for a reverse mortgage they must usually be over 60 years old and own their home, or use some of the proceeds of the reverse mortgage to pay out any existing mortgage.

These products are the most commonly used form of equity release product in Australia.

Accommodation bond loans

An accommodation bond loan is used for the sole purposes of funding an accommodation bond for residential aged care. It operates similar to a reverse mortgage, however the term of the loan is fixed (usually for 3 or 5 years). It is usually expected that the borrower will move into residential care shortly after entering into the contract, but that they wish to defer the sale of the home for a period (for example, there is still a non-title holding partner who will remain in the home).

Home reversion schemes

A home reversion scheme allows a consumer to sell a proportion of the equity in their home (usually between 35 and 50 per cent) to a reversion company for a lump sum payment in exchange for a fixed proportion of the future value of their home. The sum they receive will be less than the market value of the sold portion. This discount reflects the risk the reversion company incurs such as the homeowners' longevity and future property value movements. Depending on the type of reversion, the consumer may or may not retain title over their home.

Market size

Reverse mortgages are a relatively small sector of Australia's mortgage market. Industry statistics currently suggest that only approximately 1.5 per cent of seniors have taken out an

equity release product. However, it is anticipated that there will be growth in this market given Australia's ageing population. The total value of reverse mortgages in 2004 was estimated to be \$459 million. This estimate has risen to \$3 billion as at 30 December 2010, with over 41,000 reverse mortgages currently issued.

In the calendar year 2010¹:

- 5543 borrowers took out new reverse mortgages.
- The average amount agreed to be borrowed was \$54,200.
- Across all loans, borrowers drew down (or immediately used) 72 per cent of the amount agreed to be borrowed.
- Only 5 per cent of loans provided a regular (small amount) income stream.
- Approximately 73 per cent of loans were provided to borrowers living in a capital city.
- Approximately 73 per cent of loans were provided to borrowers who were aged over 70 years with 26 per cent of all loans provided to borrowers who were aged over 80 years.
- Only 2.5 per cent of all loans were for aged care purposes (although the purpose of the only 2.5 per cent of all loans were for aged care purposes (although the purpose of the only identified in 58 per cent of cases).

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Supply and demand constraints on the market

The equity release market suffers from both supply and demand side constraints which have contributed to these products having a lower uptake than industry expectations.

The supply side constraints include:

- the illiquidity of the product means it is more difficult than traditional credit products for lenders to provide, meaning it is more commercially attractive to large lenders who have economies of scale or certain niche providers;
- the unfamiliarity of the underlying asset class (i.e. Australian residential property) to institutional investors; and
- recent disruption to international capital markets has constrained the ability of some lenders to access funding, with the effect that some lenders have exited the market and others scaling back their distribution of the product.

The demand side constraints include:

¹ These statistics are from the *SEQUAL/Deloitte Reverse Mortgage Survey 2010* (provided to Treasury on a confidential basis and are not for public release)

- noting that seniors are conservative in their dealings with the family home, the product is viewed by many as more risky than other financial products, or is viewed as a product of last resort;
- information asymmetries mean that seniors lack the information about how equity release products work and have relatively poor financial literacy with which to make informed decisions and comprehend how the risks of the products may impact them in the future; and
- financial planners are yet to embrace the product as an appropriate strategy in retirement planning.

Low use of equity release products for aged care

As the Productivity Commission has noted in its aged care report, an equity release product provides seniors with a way of unlocking their housing equity to improve their capacity to pay for their aged care, particularly for those who are asset rich but cash poor.

However, the use of equity release products by seniors to meet medical or aged care costs is extremely low with industry statistics indicating less than 5 per cent of reverse mortgages are used for such purposes.

From a lender's perspective, there is less commercial incentive in providing the small loan amounts that may be involved in using a reverse mortgage for small regular expenses arising from community care.

The 2010 statistics report found that there is currently both a very low take up of loans providing regular instalments (only 5 per cent of all loans), and of loans for aged care (2.5 per cent of 58 per cent of loans where the purpose was identified).

Election commitment and Phase Two credit reforms related to equity release products

Through its *Delivering for Seniors* election commitment, the Government is establishing important protections for older Australians accessing the equity in their homes via reverse mortgages and home reversion schemes. This commitment has two elements:

- extending protections for consumers who enter into reverse mortgages and home reversion schemes, including greater disclosure of the features and fees on these products; and
- establishing a statutory protection against negative equity.

The Government has committed to these protections being in place by mid 2012. These changes will be progressed under Part One of Phase Two of the National credit reforms. Legislation will be in place by mid 2011, with implementation to take place in consultation with the equity release industry.

These measures are aimed at enhancing the confidence of seniors when seeking to assess the equity in their homes through an equity release product by eliminating the risk of negative equity and increasing their understanding of the features and risks of the product. This should reduce the information asymmetries which many seniors have experienced.

THE PRODUCTIVITY COMMISSION HOME EQUITY RELEASE PROPOSAL

The PC proposal

The PC suggests that drawing on housing equity could improve the capacity of seniors to contribute to the costs of their own care (especially those with limited superannuation). The PC has proposed 2 methods for achieving this:

1. a government provided equity release scheme (called the Aged Care Home Credit Scheme); or
2. extension of the Pension Loans Scheme (PLS).

Government provided equity release scheme

The proposed Aged Care Home Credit Scheme would have the following features:

- seniors could assess a line of credit up to a specified limit (e.g. 40 or 50 per cent of the equity they have in their primary residence);
- the government would take a charge over the senior's principal place of residence to secure the loan;
- available to seniors in all localities;
- the line of credit should only be drawn upon for the purposes of funding aged care services, including residential aged care accommodation charges;
- relatively low upfront charges;
- interest would be charged at a rate equivalent to CPI, calculated daily and compounded on the outstanding loan balance;
- once the line of credit is completely drawn down (including interest charges) no further equity could be released and no further interest applied (effectively a no negative equity guarantee);
- repayment would only be required from the person's estate after their death. However, if a partner, carer or dependent child still reside in the home, repayment would not be required until such a person vacates or ceases to be a dependent; and
- the Australian Seniors Gateway Agency would arrange the valuation of the principal place of residence and specify the maximum level of equity available for the line of credit.

Fiscal implications

In order to provide the line of credit to seniors the Government would need to raise the funding through additional debt issuance, which would place further stress on the debt limit.

- This scheme would gross up the balance sheet through an increase in both interest bearing assets and interest bearing liabilities.

- The financial risks associated with the nature of the asset, including the provision of a no negative equity guarantee, would be passed on to the Government's balance sheet.
- In addition, the interest rate differential between the Government borrowing rate and the rate charged on the line of credit provided to seniors would increase the Government's PDI and negatively impact on underlying cash balance.
- Should this proposal be treated as a concessional loan there would be an upfront reduction to the fiscal balance and increase in net debt (to the extent of the concession). As repayments are made, this impact is unwound, improving the fiscal balance.

Advantages and disadvantages to the Aged Care Home Credit Scheme

The below table summarises the advantages and disadvantages of the type of government back equity release product recommended by the Commission.

Stakeholder	Advantages	Disadvantages
Seniors	Increases seniors' ability to pay for aged care co-contributions costs.	May be used as a subsidy for seniors to live in larger houses for longer.
	Reduced instances of downsizing allow seniors to stay in their primary residence and remain connected to their existing community.	Has equity implications in that the greatest benefits accrue to those seniors who have the highest house values.
	Promotes seniors capacity to exercise choice in aged care services.	Greater choice may have implications on aged care provider resources.
	Provides access to a potentially safer way for seniors to access the equity in their homes than current commercial products.	Over time, may reduce incentives for seniors to plan for retirement income from other sources.
	Overcomes information asymmetries applicable to reverse mortgages (e.g. uncertainty about longevity, over-depleting equity and house price and interest rate movements).	
Government	As those with a greater capacity to pay contribute more to their own care, government funding of care could be increased for those with less capacity to pay.	Creates a method (and incentive) to convert means tested assets into non-means tested assets, and in turn, increases exposure to aged pension outlays in relation to those seniors who use the scheme in that way.

	Increased co-contributions by seniors would reduce reliance on government expenditure on aged care services.	Depending on the rate of take-up, Government would incur relatively large costs in the establishment and administration of the scheme, and may face risks of losses should the amount of the debt be allowed to exceed the value of the house on sale.
	Government has the benefit of immediate economies of scale not available to commercial equity release providers. This should mean Government could provide the product at a relatively lower price.	
Future generations	Promotes intergenerational equity with seniors who have a greater capacity to pay for their care relieving stress on the tax base, especially in light of Australia's ageing population.	The liquidation of housing equity now reduces intergenerational wealth transfer.
Economy	Supplying a product which private providers have relatively less commercial incentive to provide (in the case of small regular payment loans).	May distort decisions to downsize, delaying the turnover of housing stock.
	Overcomes the market failures which are considered to prevent the equity release market supplying this type of product universally.	
Current equity release product providers	Increased awareness by seniors of a government provided product may increase their awareness of commercial products or of equity release products more generally.	Commercial providers likely to criticise government unless the product is restricted to persons where a commercial product is not available (for example, those in regional areas). However, this would risk creating a dual pricing system, according to the borrower's location, or other attributes.
		May crowd out the development of equity release products used for aged care purposes (especially accommodation bond loans) by commercial providers.

Extending the Pensioner Loans Scheme (PLS)

The PLS allows seniors to use their equity in real estate (not necessarily their primary residence) as security for a loan for any purpose. Eligibility is restricted to persons aged 65 and over who are not eligible to receive the aged pension (due to either the income test or the asset test, but not both), or who receive a part pension. Therefore, seniors who are on the full rate aged pension are ineligible for the scheme.

The PLS provides fortnightly non-taxable payments up to the full amount of the aged pension (i.e. is only available as an income stream and not as a lump sum). This means a part-rate pensioner would receive the difference between what they are entitled to receive and the maximum pension rate and a senior who is ineligible for an aged pension would receive an aged pension up to the maximum rate.

The total amount of equity that a senior can draw down using the PLS is ultimately dependent upon the location of the secured property and its value.

Seniors can elect to protect a certain percentage of their equity from being part of the security for the loan. This percentage can then be available for other purposes such as paying for residential age care. However, the more equity they protect, the less can be borrowed.

Interest on the loan is charged fortnightly and is compounded until repayment is made. Full repayment is not required unless the senior voluntarily sells their property, or from the proceeds of their estate after their death. The PLS also includes a no negative equity guarantee which provides that borrowers will not have to repay more than the value of their home.

The Commission suggest that the PLS could be expanded to allow small regular sums to be drawn down above those currently available to PLS borrowers to cover aged care costs. The proposal is not clear regarding the quantum of these regular drawdowns, however, it implies amounts would be greater than those currently available (i.e. greater than topping up the borrowers pension to the full maximum rate).

An expansion of the PLS to all eligible seniors would pose similar costs and risks to the Government as described above for a Government provided equity release scheme.

Advantages and disadvantages to extending the PLS

- This proposal would have advantages and disadvantages consistent with many of those under the Aged Care Home Credit Scheme proposal detailed above. In addition to these, it would also have the following advantages:
- start-up costs are eliminated and administration costs reduced since it would utilise an existing scheme;
 - the period required to implement changes to the current PLS would be shorter compared to the establishment of an entirely new scheme; and
 - effects on the existing commercial equity release market would be limited since the market is already familiar with the existing PLS scheme and there is therefore unlikely to be criticism from these operators.

Alternative options for a home equity release scheme

Government supported scheme

An alternative to a fully government operated equity release scheme is a scheme provided by Government in conjunction with private providers who also provide the Australian Aged Pensioners Savings Account (AAPSA) also proposed by the Commission. Under this model, Government would provide the capital product and private providers who are contracted to provide the AAPSA would also be contracted to provide the equity release credit facility.

Under the AAPSA proposed by the Commission, a senior can downsize their home and invest the proceeds of the sale into a savings account operated by private providers (discussed further in Section 4). This alternative to a fully government operated equity release scheme would provide seniors with an additional way to invest the equity in their home into a means tested exempt facility with a private provider the AAPSA, but rather than access their equity by downsizing alone, they can release their equity via the government supported equity release scheme and still remain in their home.

This model could operate similar to the government backed scheme but with the following additional features:

- eligibility for the loan would be restricted to seniors who qualify for government subsidised community and residential care services;
- the loan would be provided as a lump sum (including a line of credit allowing for regular draw down). The sum made available would be calculated as a percentage of the borrower's equity in their home (for example, 40 or 50 per cent);
- proceeds from the loan would be used for the sole purpose of funding the borrower's co-contributions toward government subsidised community and residential care services.² Borrowers could use the lump sum to pay for accommodation bonds or progressively draw down the line of credit to pay for community care or residential accommodation charges. This could be achieved by allowing the borrower to organise such payment, or by paying the third party care provider directly from the credit facility AAPSA;
- the credit facility could be operated by private providers who are also contracted to provide the AAPSA, with the Government bearing the financial risks (e.g. no negative equity guarantee);

² The Productivity Commission also recommends this contribution be limited by a lifetime stop-loss limit.

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- borrowers may also elect to protect a certain percentage of their equity, however, this would reduce the loan-to-value ratio available to them and consequently reduce the amount which they could borrow; and
- if a partner, carer or dependent child still reside in the home, repayment would not be required until such a person vacates or ceases to be a dependant.

This alternative option would have the same financial risks to the budget and the Government's balance sheet as those described above. The inclusion of the AAPSA in this proposal would, subject to the guarantee of any deposits beyond the current FCS, constitute a larger contingent liability for the Government.

Extending the Pensioner Loans Scheme

The PC recommended consideration be given to extending the PLS to allow regular draw downs to allow seniors to pay for aged care. This could be further extended by allowing seniors to also draw down payments to fund larger aged care costs such as lump sum accommodation bonds. Also, the current PLS eligibility criteria which is limited to those who are ineligible for the full rate pension, could be extended to all Australian seniors.

Other Comments

This section discusses in more detail some of the matters relevant to the consideration of the alternative options set out above.

Longevity risk of allowing other residents to remain in the property

In the commercial reverse mortgage market, the structure of products takes account of the risk to the lender of the borrower's longevity. Currently, loan -to-value ratios (LVRs) provide that the younger a borrower is, the less LVR is available to them. Initially the longevity risk is borne by the borrower since the total loan amount increases the longer they live. However, with a product that provides a no negative equity guarantee, the longevity risk is borne by the provider once the loan amount exceeds the market value of the home. This longevity risk contributes to the interest rates on reverse mortgages being approximately 100 to 150 basis points higher than traditional home loans.

This circumstance also arises when the loan agreement provides that a non-title holding resident who is not a borrower under the loan has the right to continue to occupy the secured property after the borrower's death. Such a right increases the longevity risk to the lender. Some commercial providers do allow a non-title holding resident (such as a spouse) to have a lifetime tenancy, however, this is limited to residents who are at least the same age as the borrower.

However, a scheme which provides that other residents, such as partners younger than the borrower or a dependant child can continue to occupy the secured property after the borrower's death could increase the longevity risk substantially. In the case of a dependant child, the Government could potentially have to wait for decades before the home could be sold and the loan repaid. This risk would be further exacerbated since the loan would not require repayment above the market value of the property.

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If the scheme were to provide tenancy protections to non-borrowers, especially residents younger than the borrower, either the Government would have to be prepared to assume the additional longevity risk or the LVR available to borrowers would need to be reduced. However, offering reduced LVRs could only be achieved prior to entering the contract. If the scheme allowed non-borrowers to be provided guaranteed tenancy after the loan has already been entered into and the LVR already set, reducing the LVR would not be possible.

Alternatively, the scheme could not allow tenancy protections to non-title holding residents. However, this would mean that these residents would be required to vacate the property (or potentially be evicted) in order for the home to be sold and the loan be repaid.

Potential for crowding out private providers

In delivering this scheme, there is potential scope for demand for current and future privately provided equity release products to be diverted to the Government product. This may be particularly the case if seniors view the Government scheme as being more "safe" than private products (e.g. reputation, superior product features such as better tenancy protections for non-title holding residents).

Careful consideration should be given to ensuring that the Government product be used exclusively for the purpose of funding co-contribution for aged care. This would limit the scope of the Government product to be in direct competition with privately provided products, as reverse mortgages are more commonly used for other purposes. This would also indicate to the Australian equity release industry that the Government scheme would be servicing a customer base which is less attractive to private providers (e.g. seniors seeking a small regular supplement to retirement income).

However, if the Government product could be used to fund aged care accommodation bonds, it would be in direct competition with accommodation bond loans.

Using the scheme to avoid means testing

This proposal would potentially allow seniors to use the AAPSA as a method of avoiding the aged pension means test. For example, a senior could use means tested assets or income to upsize their primary residence; thereby increasing the amount of equity they have. They could later use the government backed equity release scheme to access that increased equity and via the AAPSA, which would allow that investment to be exempt from the aged pension means test.

Types of property offered as security involved - primary residence only or other real estate

A government supported scheme could provide that only the seniors primary residence could be used as security or that any real estate in Australia (e.g. an investment property) could be used. The latter would potentially broaden the take up of the scheme or at least increase the amount of security some seniors could offer and therefore, increase the loan amounts they could potentially access.

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