Reverse Mortgage –
The Emerging Financial Product – An Evaluation

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Abstract

The current concern for the Indian Government is the management of the growing segment of aged population in the economy. The transformation of the pension concept from the 'defined return' criteria to defined contribution criteria is one more factor contributing to the area of elderly health care. The limitations of the existing financial products in taking care of the senior level population have added scope for designing retirement and annuity based innovative financial products. 'Reverse Mortgage' which is already in vogue in Western welfare oriented economies, if introduced in India will be an appropriate financial product. The paper aims to discuss the pros and cons of the product. The scope of the paper is to provide an overall evaluation of this emerging product from the economic and social standpoint. The possible negative factors and tax implications are also projected in the paper. The mechanisms of the product and the underlying conditions are also discussed in the paper. The international experiences are also quoted. The reasons for the still lukewarm attitudes for the product and possible tax implications are also briefly debated in the paper.

Introduction

It has come to everyone's guessing now as to how Indian economy is going to manage the ever increasing aged group population. A major chunk of this category of population is going to be in the framework of 'unorganized' sector. A new dimension is added to the problem with the phasing out of the 'government' and 'employer' sponsored pension schemes in the employment sector. The limitations of existing financial products in taking care of senior citizens at the most crucial phase of their lives have opened up scope for financial planners to go in for innovative pension based products. The scope of the paper is to evaluate the emerging financial product of 'Reverse Mortgage', which is under design by National Housing Bank of India (NHBI)

Need for better support system for the aged:

A study reveals that by 2020, 20% of Indian population will consist of citizens aged 65 and above[1]. The fast changing lifestyles of people is more leveraged in terms of 'spending' rather than 'savings'. The ever increasing cost areas of parents

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in bringing up their children such as of education, dress codes, communication gadgets, boardings etc. are certainly going to make inroads into parents' savings. The fast vanishing joint family system giving way to nuclear families has added to problems of management of senior citizens at a time when the need for caressing them will be highly felt. Retirees are certainly going to outlive their savings.

Further Contributing factors:

One of the most contributory factors as on current day for this development is the improved health care factors coupled with better nutritional inputs in peoples' food habits. Thanks to the mass media and the services driven economy and better mobility of people, awareness of cross cultural and cross continental food habits has increased. One more aspect is the prime slot offered in the visual and print media on 'health' and 'recipe' oriented programmes, which have added to the health care and dietary awareness of people.

Further, to save for retirement people have to become better at guessing as to how much they need, and how long they will live. Both guesses are very tricky. Normally most people underestimate their longevity and advanced age financial needs. Those who retire at the age of 60 are expected to live today upto 75 years of age and beyond.

The switching over of the economy from the 'defined return' to a 'defined contribution' concept in the pensionary concept is also one more factor. Of the 314 million work forces only a mere 11% are covered by any formal pension sytem[2]. Only 5% of the work force is covered today by any government funded defined pension systems. Pensionary commitments from the Consolidated Fund of India (CFI) which has imposed a heavy burden on Indian exchequer is also forcing the economist to think in terms of alternatives; in pension and annuity related products.

Pension Reforms and entry of FIIs:

The establishment of Pension Regulatory and Development Authority of India (PRDAI) is a development towards pension reforms. With foreign pension funds permitted to entire the Indian capital markets under Foreign Institutional Investment (FIIs) newer pension products are bound to develop. Retirement planners may be thrown open to wider spectrum of pension products. But they will be mostly market risk oriented and the returns on these products will be subject to market volatility. This may not be to the taste of aged retirees whose market risk appetite may be poor. A self propelled product will certainly act to their advantage.

Uniqueness of Reverse Mortgage:

In the traditional socio economic culture of India, retirees were dependent on their children in their old age. Though Indian system still values children supporting elderly parents, nuclear families are becoming order of the day. For majority of the retirees 'personal savings' is the main source of retirement income. A main problems with Indian middle class is that they are 'asset rich' and 'income poor'. With the type of housing boom in the economy most of the middle class earners achieve their life time ambition of constructing house. But on retirement they are compelled to mortgage their houses for meeting their necessity gaps. When they are not able to repay these debts, they end up losing their precious house property, for which they toiled to build. This is where 'Reverse Mortgage' can be thought of a unique financial product.

Current budget proposals:

The need is well realised by the Government and the same has been spelt out in the budget speech by a finance minister. To quote from the speech National Housing Bank (NHB) will shortly introduce a novel product for senior citizens Reverse Mortgage under which a senior citizen can avail of a monthly stream of income against the mortgage of his/her house, while remaining the owner and occupying the house throughout his/her lifetime, without repayment or servicing of the loan[3]

How the concept can work?

Reverse Mortgage is a way to borrow against one's own house to create a regular stream of retirement income while continuing to live in that house. In 'mortgage' the house is pledged for a lum sum. This may bring in a negative psychological feeling for the owner Pledgee may force pledger to evict in case of non payment, leading to the owner's displacement. Further repossession will depend on repayment of mortgage amount with interest on which many retirees will default. 'This may land them in threat of losing their hard earned house. 'Reverse mortgage' can negate this and can enable elderly citizen to continue to live in their own house still earning a stream of income out of that.

International experiences:

The concept of 'Reverse Mortgage' has been very popular in countries such as UK, Ireland, USA, Canada and Sweden. In the UK the concept is in vogue for nearly half a century. The scheme is available in UK to the persons aged 62 years or more. The concept in UK is known as 'Safe Home Income Plan', which aims to fulfill the raising needs of elderly people during a phase when their cost of living are at the maximum.

More that 50 percent of the wealth in real estate used by Britons aged 65 and above is subject to such mortgage. It is estimated that 40,000 people in UK are reported to take up reverse mortgage annually and UK Financial Services Authority is planning to regulate such services[4].

Merits of Reverse Mortgage:

(i) Reverse mortgage derives its awesome power from its ability to motivate people to build or buy their homes and thereby save for their retirement voluntarily.

(ii) The psychological feeling that one borrows against one's own house but still continues to live in that house is an added advantage.

(iii) RM is different from a conventional loan (where the house is offered as a collateral security), in which one would still have to make monthly repayments towards a loan.

(iv) In RM one enjoys a regular stream of income during lifetime against one's house property without any threat of losing the ownership.

(v) All the beneficiary required is to pay property tax and insurance and maintain the house so that the value is retained.

(vi) No repayment is required till the owner continues to live in that house. Full amount becomes due only on the death of the last surviving spouse or when the house is sold, whichever is earlier.

(vii) Reverse mortgage as a concept can serve two significant purposes – it can spur economic activity and can provide economic security to senior citizens.

(viii) Since the spouse is the joint borrower, the spouse will be entitled to continue to live in the house and get monthly payment (of so opted) till he/she continues to live.

(ix) There is provision in the scheme for revision of the value of the house for every five years when its market value rises. This can enable the mortgage to get a higher amount (as loan or installments) if the value gets enhanced.

(x) The mortgage is normally for 15 years. If mortgage or the spouse survives beyond this period he/she will not be evicted but will continue to live in the house, till the last of the spouse survives. In the meantime the interest on the loan amount will continue to be charged. In case the installment system of loan is chosen, the installment will stop after 15 years, which may be renegotiated for extension.

(xi) If the borrower or spouse dies early i.e. before 15 years, the amount to be recovered would be only that which has been given to the borrower or spouse by way of loan or in installments.

(xii) If surplus remains after the sale of the property mortgaged, after adjustment of loan and interest amounts, the balance would be refunded to the heirs of the mortgager.

(xiii) The heirs, if they want to retain the property, can do so by paying the amount of the loan with interest to the lender bank.

(xiv) The recent budget proposals of tax treatment of savings upto Rs. 1.1 lacs, continued deductibility of the interest expenses on home loans and legal framework for the issuances of mortgaged backed securities may add charm to the concept of RM.

(xv) House holds will create more housing assets in the future. The incremental investment could be over Rs. 29000 crore each[5].

(xvi) Aggregate impact on investments in housing assets could be as high as Rs. 105,000 crores each year[6]

(xvii) RM can be truely 'reverse' because instead of paying the monthly housing loan installments the borrower actually receives money from the lender.

Criteria for loan amount:

Amount available is based on factors such as:

(1) Applicant's age

(2) Appraisal value of the house

(3) Projected rate of appreciation

(4) Current interest rates

(5) Other transaction costs with which may go upto 5%

Higher the age of the retiree, the higher will be the value of the house and more the money available. Studies on benchmark scenario indicate the RMs are likely to achieve about 50% income replacement ratios[7]

Few examples:

(A) For a house property of the value Rs. 1 crore the following table shows the possible returns under two options for the elderly:

Table I : Two options for the elderly[8]

(In Rs.)

Age group	Choice – I Loan amount	Choice – 2 Monthly payments
62.70	4500000	31000
71.75	5000000	34000
76.80	5500000	38000
Above 80	6000000	41500

(i) The settlement of loan disbursed along with accumulated interest (interest expected to be @10% pa) will be met from the sale of the house.

(ii) If the heirs of the borrowers so decide, they can keep the property after paying the amount of the loan and interest due

(iii) If the borrower desires to settle the loan before 15 years he/she can also do so.

(B) A retired couple living in their own flat (valued at Rs. 10 lacs) but not receiving many pension income, needs Rs. 10000 per month towards living expenses.

(C) At 9% RoI (the rate guaranteed for senior citizens), the corpus should be around Rs. 13 lacs to meet the living expenses.

A RM taken on the house may fetch a corpus of Rs. 8 lacs (80% of market value). Based on annuity tables the pension will work out as follows:

Age	Monthly Pension	
	For Rs. 100000	For Rs. 800000
50	Rs. 587	Rs. 4696
53	Rs. 638	Rs. 5104
61	Rs. 791	Rs. 5752
65	Rs. 794	Rs. 6352

Underlying Conditions:

Though the pension generated may not cover the entire living expenses it will be a major contributor. The underlying conditions are:

(i) Amount may be paid initially for the 15 years which can be ixtended till life.

(ii) On the death of the last surviving spouse the loan amount (principal & interest) needs to be repaid to lender.

(iii) The bank/FI can sell the house take what is owed, pay the excess if any to the heirs.

(iv) In a rare instance when value of property falls below the amount owed in RM the lender must absorb the loss.

(v) Heirs have the option of entire payment to bank directly and keep the house themselves.

(vi) In the above example for a 15 years RM, the total amount to be repaid would be approximately Rs. 17.38 lacs – Rs. 10.35 lacs towards principal (assuming a transaction cost of Rs. 35000) and Rs. 7.03 lacs towards interest thereon @9% pa.

A simple evaluation:

In today's real estate scenario the property value will double in 15 years, even on a very conservative outlook. Hence it is very likely that even after repaying the mortgage, there would still be something for the heirs. For lenders it would be a profitable proposition since they would be able to get their expected return on capital invested.

Possible tax implications:

The tax liability of the RM concept can be interpreted as follows:

(i) An examination should be made as to whether any income or capital gain arises if a person enters into a RM agreement.

(ii) When installments payments are preferred, the amount received would be receipt of loan amount in installments and cannot constitute income.

(iii) However if we compare in example (A) for an age group of 71-72, RM may work out as follows:

a) Amount under choice I – Rs. 5000000

b) Amount received under choice (2) will be (34000x12x15) Rs. 6120000

c) The difference of Rs. 1120000 (Rs. 6120000 – Rs. 5000000) can be taken to represent interest

d) This can be subjected to tax after deduction of interest at 10%, which the borrower is expected to pay on loan amount.

e) No liability for capital gains would arise whose property is mortgaged, because a mortgage is not considered as 'transfer' within the meaning of the term as given is Section 2(47) of ITA 1961.

f) The question of capital gain or loss would arise at time of sale, which can be computed under provision of Section 48 of ITA.

g) The CG or CL would be computed after taking into account the cost of inflation index for consideration in the hands of the borrowing or the heirs as the case may be.

Lukewarm attitude:

As on now in India there is only a lukewarm altitude towards RM. Even in other countries too, where the tool is in vogue, acceptance has been very cautious.

In India the housing finance is quite booming one and hence FIs are not positive towards the need to launch innovative alternate products. Further it is projected that pricing is a complex one as it depends on a number of uncertainties such as future value of houses, life expectancy and interest rate risk.

Given the Indian psychology a challenge from the borrowers point of view would be balancing the need for supplementary retirement income and the desire and wish to bequeath house to children.

Irrespective of the merits of the scheme, the psychological acceptance among senior citizens may be lacking. Many have worked a lifetime to pay off houses loan. For them to go back into debts may be quite hard to digest.

Further RM may be in the nature of a lifetime commitment and the children of the borrower can create problems, if the property is not self acquired.

Still a high-level appeal possible:

Nevertheless with the possible negatives, RM may appeal on following grounds:

(i) Reverse Mortgage is only a supplementary source of retirement income. For rational retiree, when there is a shortage of monthly income, their equity reduction may be preferable to a reduction in standard of living.

(ii) In the days of booming real estate markets, then is a god possibility of the value of the house appreciating more rapidly than the mortgage loan is increasing. In such a scenario there would be good equity left over for the heirs.

(iii) There is no upper age limit for getting the benefit of the reverse mortgage facility. On the contrary the older to the mortgage, it is easier to get the loan.

(iv) From a retiree perspective, the option may be very handy during the crucial years after retirement.

(v) For the lender it is definitely more profitable to offer mortgage to older persons due to reduced life expectancy.

(vi) RM is a non-recourse loan, which means the bank/FI can never come after any person in the estate for repayment.

(vii) RM concept may ease the burden of state. This may fall well in line with pension reforms too.

(viii) RM products may be helpful at a time of collapse of joint family system. Instead of depending on their children for monetary support, this would provide an option for the elderly to continue with a graceful life style.

Conclusion:

Reverse Mortgage can serve as a boon to retirees, as it does not conflict with the psychology of elderly Indian population. It can serve as a major as well as supplementary source of income for retirees at the crucial phase of their life. But much though is to be bestowed on the designing of this product, for better appeal among senior citizens.

References and Footnotes:

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