

Overseas' Experience in Developing Reverse Mortgage for Retirement Protection

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Executive Summary

Purpose

The major objectives of this study are to: (a) study the general international trend and current development in reverse mortgage in five selected overseas countries with considerable experience in this respect; (b) identify useful and relevant features which Hong Kong may learn from the reviewed countries in formulating appropriate measures to develop reverse mortgage; and (c) recommend strategies to overcome possible obstacles for introducing reverse mortgage in Hong Kong based on the experience of the reviewed countries.

Reverse Mortgage Mechanisms

Reverse mortgage schemes are financial schemes, which enable a homeowner to draw down some of the equity in the property. The amount drawn down is repaid when the homeowner dies or moves out of the property. Repayment can be deferred till the death or exit of the planholder or a surviving spouse. In some schemes interest is paid each year, but in others interest is also deferred and paid when the capital is repaid. Most reverse mortgages can be transferred to another property if the homeowner moves. Up till recently, reverse mortgage schemes have been principally designed for retired homeowners.

Overseas' Experience

(a) United States of America

The government plays an important role in the US reverse mortgage market. Home Equity Conversion Mortgage (HECM), a government-backed organisation, promotes a federal insured reverse mortgage product with a restrictive loan limit. The Federal National Mortgage Association (Fannie Mae), a government-sponsored entity, offers a reverse mortgage programme with more liberalised loan amount. In addition to the

government-related institutions, there is also one private lender offering reverse mortgages to high-value homeowners.

Congress has been supporting to the development of reverse mortgage programmes in the US. It approves funding for reverse mortgage pre-application counselling, consumer education, and outreach for potential borrowers. Special regulations designed for reverse mortgage products have been enacted to protect borrowers.

Two major obstacles to the further development of reverse mortgage in the US are: (1) declining demand and (2) a lack of private sector competition.

A strategy to overcome the demand obstacle is to widen the usages of reverse mortgage loans. Reverse mortgages are now only seen as a vehicle for increasing the income of poor, elderly households. In fact amount from the reverse mortgage loan can be used for many other meaningful purposes such as personal investment, funding long-term care insurance, and sustaining consumption.

One significant development in the last few years has been the advent of securitisation of reverse mortgages in the US. With the advent of securitisation, private loan originators may now have more sources of capital for developing innovative reverse mortgage products. Therefore, the number of reverse mortgages closed each year in the US is expected to grow, not only because there will be an increased number of lenders, but also because there will be an increased variety of lenders.

(b) Canada

Canadian Home Income Plan (CHIP) was founded in 1986 to provide Canadian seniors with a programme which would allow them to unlock the equity in their homes. As Canada's first and only reverse mortgage programme, its introduction followed two years of research into similar successful programs available in the United Kingdom and the United

States, and was tailored to the specific needs of retired Canadians.

In Canada, reverse mortgages are gaining popularity because they offer a tax-free stream of money usually paid in the form of a monthly annuity. Since CHIP has been following the American model for designing reverse mortgage products, Canada is also facing similar barriers and growth of the reverse mortgage market.

(c) United Kingdom

Thousands of elderly people were left struggling under mountainous debts after being mis-sold investment-based home income plans in the late eighties. Even though that sort of poorly designed plans have now been banned, many older people in the UK are still suspicious of any scheme which involves using his or her property to raise cash.

Currently, there are only a few reverse mortgage products on the UK market and the take-up is low. Recently, in a response to the Royal Commission on Long Term Care, the UK government stressed that British citizens are all going to have to take more responsibility for providing for retirement and paying for long-term care and further education.

In April 2001, the UK government took a lead to implement a reverse mortgage scheme that local authorities can make loans on the value of the house with the loan being repaid on death or eventual sale of the property. Furthermore, the government is intended to introduce new regulations on reverse mortgage lending by January 2002 to protect borrowers. With support from the government, the reverse mortgage schemes in the UK are expected to take off dramatically in the next few years.

(d) France

Closely related to the concept of reverse mortgages is the French system of *viager*, a Middle Ages practice that has experienced renewed popularity in Europe. It is a private contractual arrangement between the buyer and the seller of a property. The buyer pays the seller a down payment and the remaining amount is payable in form of monthly payments *en viager* (i.e., for life). Upon the seller's demise, the buyer gets title to the property. The French government promotes the system as an effective way to reduce dependence on social security programmes.

(e) Singapore

An insurance cooperative, NTUC INCOME, is the first financial institution to go into the reverse mortgage business in Singapore. At first, the response far exceeded the cooperative's expectation and NTUC INCOME issued 22 reverse mortgages in the first two months only. However, the market cooled down rapidly. To date there is still no other player in the market.

NTUC INCOME has wrongly over-estimated the demand of reverse mortgage in Singapore. Furthermore, there is no guarantee clause in their reverse mortgages. Homeowners fear they will be forced to sell their homes if they outlive the reverse mortgage. It is suggested that reverse mortgage insurance should be introduced in Singapore. It will provide the non-recourse guarantee to borrowers. Also, it is expected that NTUC INCOME will expand their reverse mortgage loan offers to public flat owners. With 81% of Singapore households owning public flats, the reverse mortgage market in Singapore could still have a bright future.

The Hong Kong Situation

Many people in Hong Kong save over their working lifetime to buy a property and pay off the mortgage. Over the years they have made considerable amounts of capital appreciation as property prices have steadily increased with only a few downturns in value. Even with the Asian financial crisis of late 1997, the average annual appreciation rate for residential property prices in Hong Kong has been more than 13% for the period 1984-98.

Despite possible risks and obstacles, there is a clear potential for a reverse mortgage market in Hong Kong which would help older people of moderate means and with low/medium priced homes to supplement their income, to raise money for capital needs and generally improve the quality of their lives. It is recommended that further feasibility research should be done to explore, in more details, the demand and supply of reverse mortgages in Hong Kong.

1. Introduction

- 1.1 As with many other countries in the world, Hong Kong's population is ageing rapidly. The population aged 60 or over had reached a million at the turn of the century and it is projected that by the year 2016, 20% (around 1.6 million) of the total population, that is, one in five persons, will be an older person. Furthermore, the proportion of those aged 60+ would continue to grow to 26% in 2029.
- 1.2 It has been recognised that most elders have little retirement income and it is indeed a challenge to ensure financial security for the growing number of older population. While reiterating the importance of individual and family responsibility in preparing for old age, the government has at the same time implemented the Mandatory Provident Fund (MPF) Scheme in December 2000 for a better retirement income protection for future generations of old population.
- 1.3 Although the present generation of elders often has little retirement income, some 24% of them have self-occupied properties. We expect the proportion of older property owners to increase in the future since 37% of the soon-to-be-old population (aged 45 to 59) are now owners of self-occupied properties. A consideration number of these owners have only their self-occupied property but little cash on hand because their life savings are vested in their homes. This situation will remain for the next generation since the MPF takes some 30 to 40 years to mature.
- 1.4 This research project explores the feasibility of introducing reverse mortgage in Hong Kong. A reverse mortgage is a non-recourse loan against home equity. It allows older homeowners to convert built-up equity in the property into cash without having to move out or 'downsizing' their accommodation, so that with increased

disposable income, they can afford a more decent standard of living. This will also enable more elders to be self-reliant in the face of dwindling family support.

- 1.5 In the next section, we shall briefly review types and features of different reverse mortgage products. Section 3 studies the history, general trend and current development in reverse mortgage in five selected overseas countries. They are the United States of America, Canada, the United Kingdom, France and Singapore. In Section 4, we examine possible obstacles of introducing reverse mortgage in Hong Kong based on the experience of the five reviewed countries. Possible strategies to overcome these obstacles are recommended. Conclusion and issues for further studies follow in the final section.

2. Features of Reverse Mortgage

- 2.1 Reverse mortgages are a unique option for elderly homeowners who wish to stay in their homes but lack the additional income needed for home expenses and upkeep, health and long-term care expenditures, and daily expenses. A reverse mortgage is a loan against the borrower's home that he does not have to pay back for as long as he lives there. The loan, including accrued interest and other charges, will be eventually repaid in full upon the death of the borrower (or voluntary redemption of the loan by the borrower).
- 2.2 There are numerous types of reverse mortgages and related products around the world (for examples, Equity Release Mechanisms (ERMs) in the UK; Shared Appreciation Mortgages (SAMs) in Scotland; *viager* in France; and basic reverse mortgage loans in Singapore). Up till recently reverse mortgage products have been principally designed for retired people.
- 2.3 Although there are different types of reverse mortgages, all of them are similar in certain ways. In this section, we shall describe some of their common features.

Homeownership

- 2.4 Homeowners with reverse mortgages retain title to their property and can pass that title to their heirs. The heirs, however, would have to pay off the outstanding loan balance if they want to keep the property. The borrower may “opt out” of the reverse mortgage by prepaying the outstanding loan balance at any time (usually without penalty).

Occupancy

- 2.5 All reverse mortgage loans allow the borrower to stay in the property until the borrower (or the last borrower --- in the case of joint-life, say, husband-and-wife arrangement) dies, sells the home, or permanently moves away.

Loan Costs

- 2.6 Analogous to ordinary (i.e., forward) mortgages, there are many costs for obtaining a reverse mortgage loan. These costs commonly include an application fee, an origination fee, third-party closing costs, a servicing fee, and interest.
- 2.7 An application fee covers the costs of a property appraisal and a minimal credit check. The appraisal determines the fair market value of the property value. The credit check determines whether or not the applicant has failed to pay back any loans from banks or credit card companies.
- 2.8 An origination fee pays a lender for preparing the paperwork and processing the loan, also known as “originating” a loan.
- 2.9 A “closing” is a meeting at which legal documents are signed to “close the deal” on setting up the mortgage. Closing a reverse mortgage loan requires a variety of services by parties other than the originating lender. These services typically include a title search and insurance, a survey, home inspections, recording fees, stamp duties, and any other items required by law. Costs of the “closing” are borne by the borrower.
- 2.10 “Serving” a loan means everything lenders or their agents do after closing: making loan advances, sending account statements, paying property taxes and insurance from the loan at the homeowner’s request, and monitoring the obligations and compliance under the

loan agreement. Usually, a flat monthly servicing fee for the reverse mortgage will be charged to the homeowner.

- 2.11 Virtually all lenders charge floating (adjustable) interest rate on reverse mortgage loans. In the US, the reverse mortgage interest rate often ties to the one-year US Treasury Security rates (usually subject to a “cap”, i.e., an upper limit).
- 2.12 In the US, Federal law requires that lenders disclose the total annual loan cost (TALC) of every reverse mortgage. The TALC combines all of the loan’s costs into a single annualised rate, and it is most useful for comparing one type of reverse mortgage to another.

Loan Amounts

- 2.13 The amount of money one can get from a reverse mortgage depends most on the specific reverse mortgage programme and payment arrangements. Typically, the loan limit is set at 20 to 50 per cent of the value of the property. Within each loan programme, the cash amount one can get generally depends on the homeowner’s age and the property’s value. The general rule is:
- the older you are, the more cash you can get;
 - the more your home is worth, the more cash you can get.

Loan Disbursement Methods

- 2.14 Within the approved loan limit, the homeowner can choose one (or a combination) of disbursement methods offered by the lender. Commonly available disbursement options include: lump sum, line-of- credit account, monthly cash advances, and life annuity.

- 2.15 The borrower can choose to receive the whole loan in a lump sum at the beginning of the reverse mortgage. He then has the full flexibility to use or invest the amount. Pure lump sum option is not popular among reverse mortgagees (mostly retirees). The relative advantages of income in preference to cash lump sums at retirement are well known to many senior citizens in developed countries. The main reason is that most ordinary aged individuals are relatively inexperienced in financial matters, and are consequently not well placed to make the most efficient application of the fund proceeds. Furthermore, other things being equal, interest cost of the pure lump sum option is usually the highest among other disbursement methods.
- 2.16 A line-of-credit account permits the borrower to control the timing and amount of the loan disbursement. It is also known as “creditline” account for reverse mortgages in the US. Subject to the loan limit, the retired homeowner can decide when to make a cash withdrawal from his account, and how much cash to withdraw. Only the withdrawn portion of the loan will be charged with interest. Many retired reverse mortgage borrowers treat the unused line-of-credit balance as standby cash for the “rainy” days.
- 2.17 A borrower may opt for a monthly cash advance. Given the loan limit, interest rate, service charges, and the age of the borrower, it can be calculated the amount of monthly cash advance actuarially. There are two commonly used plans of cash advance:
- a monthly cash advance for a specific number of years that the borrower select (a “term” plan); or
 - a monthly cash advance for as long as the borrower lives in the property (a “tenure” plan).

A term plan gives the homeowner larger monthly advances than a tenure plan does. The shorter the term, the greater the amount of cash advance can be. However, under a term plan, the borrower will not receive any cash advance after the “term”.

Finally, it should be noted that the monthly cash advance option is not “inflation protected”. It means that the month loan advance is set at a constant amount and it does not increase or decrease in dollar amount over time. So it will buy less in future as prices normally increase with inflation.

2.18 A tenure plan of monthly cash advance from a reverse mortgage can continue as long as the retired homeowner lives in the present property. If he sells the property or moves, the payments stop. Another disbursement option offered by reverse mortgage lenders is a defined benefit, fixed annuity. This type of annuity is a contract usually with an insurance company. The homeowner pays the annuity premium from the lump sum withdrawal of the reverse mortgage loan. In return, the homeowner gets a cash annuity payment of a fixed dollar amount monthly for the rest of his life (independent of the status of the original reverse mortgage loan).

2.19 In practice, most reverse mortgagees choose a combination of disbursement options, for examples, “Monthly Advance Plus Lump Sums”; “Lump Sum Plus Annuity”; “Monthly Advance Plus Creditline”, and many other combinations.

Priority of Claims

2.20 Reverse mortgages generally must be “first” mortgages. It means that the reverse mortgage lender has the first claim priority over other debtors (if any) against the property. Practically, if the homeowner now owes any money on the property, he must clear the debt by doing one of the following two things:

- payoff the debt before he gets a reverse mortgage; or
- payoff the debt with the money obtaining from a reverse mortgage.

2.21 Most reverse mortgage borrowers pay off any other debt on the property with an initial lump sum advance from their reverse mortgage loans.

Non-recourse Protection

2.22 The outstanding balance one owes on a reverse mortgage loan equals all the loan advances (including all the loan costs charged) paid to the homeowner, plus all the interest added to the loan balance. If the debt amount is less than the property is worth when the loan is terminated (upon death or voluntary redemption), then the homeowner (or his heirs) can keep whatever amount is left over. But if the rising loan balance ever grows to exceed the value of the property, the total reverse mortgage debt amount is limited by the value of the property. In other words, the homeowner can never owe more than what the property is worth at the time the loan is repaid. This is called non-recourse protection. The lender is not allowed to retrieve the deficits from the borrowers or their heirs.

Terms of the Loan

2.23 Most reverse mortgages become due and payable when the borrower (or the last surviving borrower) dies, sells the property, or permanently moves out of the home.

2.24 There is a small portion of fixed-term reverse mortgages in the market. In a fixed-term reverse mortgage, the effective period of the loan is fixed, say 10 years. At the end of the term, the

homeowner must repay the loan. This form of reverse mortgage, however, is fading in most reverse mortgage markets. The homeowners are concerned that they may have to move out of their homes at the end of the term if they cannot repay the debt

2.25 A reverse mortgage programme might include some exceptional default and acceleration clauses that make the loan due and payable immediately (before the term of the loan). For examples:

- the owner fails to pay property taxes;
- the owner fails to maintain and repair the home properly;
- the owner fails to obtain fire and other insurance for the property;
- the owner declares of bankruptcy;
- the owner donates or abandons the property;
- renting out all or part of the home to some unauthorised persons;
- adding a new owner to the property's title;
- changing the use of the property from residential to commercial;
- taking out new debt against the property.

3. Overseas' Experience

3.1 United States of America

History, Trend and Current Development

- 3.1.1 The first reverse mortgage loan in the United States is probably the arrangement made by Nelson Haynes of Deering Savings and Loan (Portland) in 1961 to Nellie Young, the widow of his high school football coach.
- 3.1.2 During 1970s, many research and studies concerning the possibility of introducing reverse mortgage to American senior citizens were published. Examples include the survey research on “A Housing Annuity Plan” conducted in Los Angeles by Professor Yung-Ping Chen, and the “Reverse Mortgage Study Project” directed by Professor Ken Scholen and funded by the Wisconsin Bureau on Ageing in 1978.
- 3.1.3 In 1981, the National Centre for Home Equity Conversion (NCHEC) was incorporated as an independent and non-profit organisation. Its primary mission is to educate consumers about reverse mortgages.
- 3.1.4 In 1984, Prudential-Bache, a private insurance company, announced marketing agreement with American Homestead, the Prudential-Bache was the first private reverse mortgage lender in New Jersey.
- 3.1.5 Under the National Housing Act, the Home Equity Conversion Mortgage (HECM) insurance demonstration programme was created by Congress in 1987. It is a public reverse mortgage insurance programme offered by the Federal Housing Administration (FHA). FHA insures HECM loans originated by

FHA-approved lenders to protect the lenders against loss if amounts withdrawn exceed equity when the property is sold. The programme effectively eliminates most of the downside risk facing by reverse mortgage lenders.

3.1.6 Today, more than 125 lenders are offering reverse mortgage loans across the United States. Many government agencies and non-profit organisations, such as American Association of Retired Persons (AARP) and US Department of Housing and Urban Development (HUD), are providing free counselling services to American retired homeowners.

Reverse Mortgage Programmes in the US

(a) The HECM Programme

3.1.7 Created in 1987 under the National Housing Act, the Home Equity Conversion Mortgage (HECM) insurance programme is designed to provide elderly homeowners a financial vehicle to tap the equity in their homes without selling or moving from their homes. The loan became known as “reverse mortgage” because the lender makes payments to the homeowner, which is the reverse of the payment pattern of traditional “forward” mortgages.

3.1.8 Reverse mortgages under the HECM programme are federally insured, which means the US government guarantees that HECM borrowers will get all the cash advances promised to them. These loans can be used for any purpose, and are available throughout the United States to homeowners aged 62 or over, regardless of income.

3.1.9 Initially, US Congress authorised the HECM trial programme to insure up to 2,500 reverse mortgages in 1990. The next year, Congress extended the trial programme through 1995 and expanded the limit to insure up to 25,000 reverse mortgage loans.

In October 1998, Congress made the programme permanent and increased the number of allowable outstanding loans to 150,000. Currently, the HECM programme generates the largest number of reverse mortgage loans in the US market.

3.1.10 The HECM insurance programme is backed by the Federal Housing Administration (FHA) of the US Department of Housing and Urban Development (HUD). HUD is responsible for the design and modification of the insurance programme. On the other hand, FHA approves the lenders, collects mortgage insurance premiums and manages the insurance fund.

3.1.11 As of October 1999, more than 38,000 elderly homeowners have chosen HECM loans to help them with their financial needs and the programme continues to grow steadily. Of the total 38,000 HECM loans, around 9,000 loans have matured, 28,500 loans are still in force and only 400 loans ended in claims on the insurance fund. The terminations generally follow expectations and the claims have been low so far, allowing the fund to build substantial reserves for future claims.

3.1.12 It should be emphasized that neither HUD nor FHA directly provides the reverse mortgage loan to the borrower. Instead, HECM loans are issued by banks, mortgage companies or other private lenders. However, these companies sell virtually all HECM loans to Fannie Mae subsequently. Fannie Mae is a government-sponsored entity that operates under the general oversight of the federal government.

3.1.13 Fannie Mae has also played an important role in refining the HECM programme over time. Fannie Mae has taken the lead in establishing guidelines dealing with such issues as forbidding the use of bridge loans to finance origination costs beyond that allowed by the programme, the need to set aside funds for property taxes

and insurance in cases where borrowers have demonstrated consistent delinquency in making these payments, and the development of a telephone counselling system to provide better access to quality counselling.

(b) *The HomeKeeper Programme*

3.1.14 Beginning in 1995, Fannie Mae introduced its own reverse mortgage product, the HomeKeeper. The loan options available under the HomeKeeper programme are similar to those of the HECMs, although there are fewer payment options under the HomeKeeper. Borrowers can only choose monthly cash advances, or a line of credit or a combination of both, but not lump sums or term payments. HomeKeepers are monthly floating interest rate loans, which is also the same as most HECM reverse mortgages.

3.1.15 The major advantage of Fannie Mae's programme is that owners with high-value homes may be able to borrow more because limits on the size of loans are not restricted by the FHA as in the HECM programme. Fannie Mae also has a shared appreciation option that borrowers are allowed to gradually increase the loan amount along with their appreciating home values.

3.1.16 The loan costs of the HomeKeeper are similar to those associated with the HECM, although the initial insurance premium is lower (1 per cent under the HomeKeeper rather than 2 per cent under the HECM).

3.1.17 Because of generally using more favourable assumptions for borrowers, HECM loans often provide more funds for qualified borrowers and so are preferred by owners who are eligible for both programmes. On the other hand, the HomeKeeper programme is more popular with high-value homeowners. As a result, the number of HomeKeeper loans originated has been much smaller than the

number of HECMs. For example, in 1999, less than 1,000 HomeKeeper loans were issued compared to nearly 8,000 newly originated loans under the HECM programme.

(c) Private Sector Products

3.1.18 Three private sector reverse mortgage products were available from TransAmerica HomeFirst, Financial Freedom Senior Funding Corporation, and Household Senior Services before 1996. However, Household Senior Services discontinued its programme in 1997. Then in 1999, TransAmerica also discontinued its programme and sold all its loan portfolio to Financial Freedom. At present, Financial Freedom is the only private firm offering a reverse product other than the HECM and HomeKeeper programmes.

3.1.19 While the defunct TransAmerica loan programme had been widely available, up till 1999 Financial Freedom loans had only been available in several Western states in the US. However, Financial Freedom is in the process of beginning lending operations in an additional eight states, and has announced its intention of expanding its operations to encompass all 35 states where TransAmerica had previous originated loans.

3.1.20 The Financial Freedom loan is essentially position as a “jumbo loan” as it offers a maximum loan amount of \$700,000. Loans from Financial Freedom have a much different structure compared to those from the HECM and HomeKeeper programmes. Under the Financial Freedom programme, borrowers receive a lump sum payment at loan closing. They may use this lump payment to purchase an annuity from Hartford Life to convert this equity into monthly payments. One advantage of this approach is that the monthly payments can continue even after the home is sold.

3.1.21 The Finance Freedom plan has an estate equity-sharing arrangement (up to 80 per cent of the home value), which guarantees that borrowers will retain some share of their property value for their heirs.

3.1.22 The Financial Freedom plan does not list explicit interest payments or servicing fees, but these costs are imbedded in the assumptions used to determine the amount that can be borrowed.

(d) *Summary*

3.1.23 Thus, the reverse mortgage market in the US now has three segments. FHA offers a product with a restrictive loan limit, Fannie Mae offers a product with more liberalised loan amount, and Financial Freedom offers a product that can serve high-value homeowners.

3.1.24 The US government plays an important role in the first two reverse mortgage market segments. HUD and FHA are responsible for the federal insurance programme, which is the core component of the HECM loans. Fannie Mae, a government-sponsored entity, issues HomeKeeper reverse mortgages. Furthermore, US Congress has been monitoring the reverse mortgage market closely since 1987. The Department of Housing and Urban Development is required to periodically report to Congress on the HECM programme.

Government Policy and Regulatory Environment

3.1.25 Section 255 under Title II of the National Housing Act (1987) sheds some lights on the US government policy on reverse mortgage. That section states three objectives of the HECM programme: (1) to permit the conversion of home equity into liquid assets to meet special needs of elderly homeowners; (2) to encourage and increase participation by the mortgage markets in

converting home equity into liquid assets; and (3) to determine the extent of demand for home equity conversion and the types of home conversion mortgages that best serve the needs of elderly homeowners.

3.1.26 US Congress also provides funding for reverse mortgage pre-application counselling, consumer education, and outreach for potential borrowers, and requires HUD to find alternative ways of educating potential borrowers about reverse mortgages.

3.1.27 Reverse mortgage loans have been regulated by the general Banking and Lending Act in the US. There were no special regulations designed for reverse mortgage products before 1994. On September 23, 1994, President Clinton signed into the law the Riegle Community Development Act of 1994. The Act made significant changes to the Truth in Lending Act because US legislators were concerned that consumers were not receiving adequate information regarding reverse mortgage transactions. In order to ensure that borrowers are fully aware of the costs and risks associated with reverse mortgages, this legislation created a special disclosure requirement for these transactions. Reverse mortgage lenders are required to disclose a good faith projection of the total amount of loan cost (TALC) to the borrower. All costs and charges connected with the reverse mortgage must be included in the calculation, regardless of whether or not the charge is deemed to be a finance charge. The TALC should be expressed as an average annualised rate, and it is most useful for comparing reverse mortgages offered by different lenders.

3.1.28 Since its inception, the HECM programme has required mandatory pre-loan counselling for all borrowers. The objective of counselling is to ensure that borrowers fully understand the advantages and disadvantages of reverse mortgages, what alternatives to reverse mortgages are, and how the reverse mortgage will affect their

living situation and finances. Counselling is provided by HUD-approved organisations – generally counselling agencies and agencies on ageing – that are independent of the lender to ensure that potential borrowers receive unbiased information. The counselling may take place in person or by telephone.

3.1.29 As a result of legislation passed in 1998 to protect programme from unnecessary charges to borrowers, HECM programme counsellors must discuss with the homeowners whether they have signed a contract or an agreement with an estate planning service firm that requires a senior homeowner to pay a fee on or after closing. Because such firms often take advantage of borrowers by charging a fee for unnecessary service or advice.

3.1.30 Section 203 (b) of the National Housing Act defines the dollar limit of a home's value used for reverse mortgage loans under the HECM programme. The limit varies with counties and states in the US and they are subject to change at least annually. This regulation prevents possible over-lending by aggressive reverse mortgage originators.

Barriers to Growth of the US Reverse Mortgage Market

3.1.31 One of the main obstacles to greater participation by lenders in the US reverse mortgage market is a lack of demand for these loans. Without greater demand, lenders are unable to generate sufficient loan volumes to profitably originate the loans.

3.1.32 In addition to simply making more elderly homeowners aware the availability of reverse mortgages, lenders try to promote a more positive image of these loans, rather than as a last resort for financially strapped elderly households trying to stay their properties.

3.1.33 Another strategy to overcome the demand obstacle is to widen the usages of reverse mortgage loans. Reverse mortgages are now only seen as a vehicle for increasing the income of poor, elderly households. In fact amount from the reverse mortgage loan can be used for many other meaningful purposes. They include turning housing equity into personal investment accounts, enabling children to provide care for their disabled parents, funding elderly households' long-term care insurance, and sustaining consumption.

3.1.34 The other main obstacle to the development of reverse mortgage in the US is a lack of private sector competition. An important challenge for private sector reverse mortgage products is to develop a consistent source of funding for these loans. Insurance companies have long been the financial backers of private reverse mortgage products, including TransAmerica, Financial Freedom, and Capital Holdings. They are early entrants in the field. However, in many cases, the insurance companies financing these reverse mortgage loans have grown concerned about the risks of this kind of portfolios and have stopped offering the products. As a result, most private section reverse mortgage programmes have been short lived.

3.1.35 One significant development in the last few years has been the advent of securitisation of reverse mortgages in the US. In 1999, Financial Freedom securitised the portfolio of reverse mortgages acquired from TransAmerica through Lehman Brothers. This transaction represented the first US securitisation for a reverse mortgage loan portfolio. Standard & Poors, a US rating company, has now formally issued guidelines for the rating of these transactions. With the advent of securitisation, private loan originators may now have more sources of capital for developing innovative reverse mortgage products. Originators of these loans will still have to be well capitalised, as it will take time to develop a portfolio of loans large enough to back the issuance of a security.

But securitisation will provide firms with a ready avenue to replenish their capital so that they continue to offer new loans.

3.2 CANADA

History and Recent Development

3.2.1 Canadian Home Income Plan (CHIP) was founded in 1986 to provide Canadian seniors with a programme which would allow them to unlock the equity in their homes. As Canada's first and only reverse mortgage programme, its introduction followed two years of research into similar successful programs available in the United Kingdom and the United States, and was tailored to the specific needs of retired Canadians.

3.2.2 Canadian Home Income Plan is a privately held corporation which has arranged more than C\$275 million in reverse mortgages. The portfolio has an AAA credit rating, and CHIP is recognized as the Canadian authority in its field and a leader in the industry. The program is distributed through a network of in-house Consultants as well as through leading financial institutions.

3.2.3 Today, a stunning 80 per cent of Canadian homeowners over the age of 65 own mortgage-free properties. A large number of these people are living below the poverty line with inadequate incomes. Under the current low interest rate environment, others are only getting 3 per cent to 4 per cent on their guarantee investment contracts (GICs), while sitting on C\$100,000 or C\$200,000 in their homes giving them nothing.

3.2.4 In Canada, reverse mortgages are gaining popularity because they offer a tax-free stream of money usually paid in the form of a

monthly annuity.

Products Currently Available in Canada

- 3.2.5 The most common reverse mortgage currently available in Canada is the *Reverse Annuity Mortgage*. There are two parts to this plan. First the homeowner borrows a lump sum using a reverse mortgage. Compound interest is charged on the lump sum over the course of the Reverse Annuity Mortgage. That lump sum is then used to purchase an annuity. In most cases, the annuity provides the borrower with monthly payments for the rest of the borrower's life. So even when the home is sold and the reverse mortgage is paid off, the homeowner still owns the annuity and the payments will continue.
- 3.2.6 Reverse Annuity Mortgages are best for people who want the security of a monthly income for the rest of their lives (i.e., an annuity). Borrowers should make themselves aware of the various types of annuities on the market (for examples, deferred annuity, immediate annuity, increasing annuity and inflation linked annuity). These plans can be relatively expensive, as the lump sum that is initially withdrawn is large, and interest compounds on that amount quickly.
- 3.2.7 Another type of Reverse Mortgage is the *Line of Credit* reverse mortgage. This plan allows the borrower to take out only the amount of money he or she requires at any given time, often to a maximum annual amount. Interest is calculated on the total amount withdrawn.
- 3.2.8 Line of Credit reverse mortgages are ideal for people who only want to withdraw money when they need it. This keeps interest charges to a minimum.

3.2.9 *Fixed Term* reverse mortgages provide money for a specific amount of time, often from five to ten years. After the term is over, the entire loan plus interest must be repaid, even if it means selling the house to do so.

3.2.10 Fixed Term reverse mortgages are appropriate for people who only need money for a short time. They can provide income to people waiting for an investment to mature or for a pension to begin. They can help fund a sabbatical, a vacation or educational up-grading. Keep in mind, however, that most cases the entire loan must be paid all at once at the end of the fixed term. If you do not have enough money to pay back the loan, you may have to take out a standard mortgage and make payments, or sell your house to raise the funds.

Regulation

3.2.11 There are no specific regulations designed for reverse mortgage lending in Canada. Financial institutions offering reverse mortgage loans are regulated and supervised by the Office of the Superintendent of Financial Institutions (OSFI) in Canada.

3.2.12 Canadian Home Income Plan consultants are Certified Mortgage Brokers and Licensed Insurance Agents. As such, they are governed by and adhere rigorously to the standards set by the various regulatory bodies in each province of operation:

- British Columbia – Financial Institution Commission
- Alberta - Real Estate Council of Alberta
- Ontario - Financial Services Commission of Ontario - Mortgage Brokers Section
- Saskatchewan - Saskatchewan Justice Consumer Protection Branch
- Nova Scotia - Business & Consumer Services

Pitfalls and Difficulties of Developing Reverse Mortgage in Canada

3.2.13 Since CHIP has been following the American model for designing reverse mortgage products, Canada is also facing similar barriers to improve the growth of reverse mortgage market.

3.3 United Kingdom

History, Trend and Current Development

3.3.1 Reverse mortgage products are commonly called as Equity Release Mechanisms (ERMs) in the United Kingdom.

3.3.2 The majority of people in the UK save over their working lifetime to buy a house and pay off the mortgage. Around 70 per cent of people live in owner occupied accommodation. Over the years, they have made considerable amounts of capital appreciation as house prices have steadily increased (approximately 10% per annum over the period 1964-99) with only a few downturns in value. However, though they are asset rich their wealth is often tied up in the property.

3.3.3 Equity Release Mechanisms have existed in the UK since the mid-1960s, but the market for them has remained small until the early eighties. Thousands of people were mis-sold home income plans (non-guaranteed ERM products) which the homeowner took a variable interest mortgage against his property, in return for an investment bond mainly invested in equities. Ideally, income generated from the investment bond should be able to cover the mortgage payments with a decent amount of leftover cash available to the planholder. Unfortunately, in the subsequent recession in the UK and the global share market crash, interest rates rose and the

value of the equity bonds fell. In many cases the bonds failed to produce an income for the planholder, or even to cover the interest payments on the mortgage. Many elder people were left struggling under mountainous debts. These non-guaranteed products were outlawed in 1990 and compensation was paid under the Investors' Compensation Scheme. However, there are still a few cases that have not been resolved.

3.3.4 This scandal, mainly due to poor plan design, has tarnished the image of ERMs generally. Over the years, consumer confidence has slowly recovered to some extent, but is still not high. Most older people are suspicious of this kind of products and the organisations promoting them.

3.3.5 Recently, in a response to the Royal Commission on Long Term Care, the UK government stressed that British citizens are all going to have to take more responsibility for providing for retirement and paying for long-term care and further education. In April 2001, the government implemented a scheme that local authorities can make loans on the value of the house with the loan being repaid on death or eventual sale of the property. It is a kind of ERM scheme. The government has provided a budget of £85 million spread over a 3-year period.

3.3.6 Currently, there are only a few ERM products on the market and the take-up is low. However, with support from the government, the ERM schemes in the UK are expected to take off dramatically in the next few years. It is estimated that there are more than £360 billion unmortgaged equity locked in people's homes, it seems inevitable that banks and lenders (as well as the government) will be keen to find ways of accessing this huge hidden cash mountain and putting it to work.

Product Types of ERMs in the UK

(a) Home Income Plans

3.3.7 Under a home income plan, the whole or part of the capital released from the property is invested in an immediate annuity paid over the lifetime of the planholder or until death of the last survivor in joint-life cases.

3.3.8 In early versions of the plans that triggered the scandal in the late eighties the mortgage was at variable rates of interest that fluctuated according to the short-term money market. The mortgage was generally arranged on an interest only basis with the loan being repaid out of the sale proceeds of the house at the planholder's death. However, it is possible to employ a loan with capital and interest repayments, though the arrangement drastically reduces the net income to the planholder.

3.3.9 New plans after the scandal now are usually on a fixed rate of interest, which is guaranteed over the whole term of the contract. The annuity also provides a fixed level of income until death. Furthermore, the planholder might not be required to invest the capital released by the plan in an annuity and uses it as he or she pleases. This new breed of plans is often called "safe" home income plans (SHIPs). However, SHIPs have been dropping out of the market since tax relief on the interest paid on the mortgage was abolished in the UK several years ago.

(b) Roll Up Mortgages

3.3.10 Under Roll Up schemes there is no requirement to pay interest, the interest is rolled up and added to the outstanding value of the loan. No payments are made on the mortgage until the property is

eventually sold at the planholder's death.

3.3.11 Some schemes are offered on a fixed rate of interest on the mortgage, but others are on variable rate (often with a cap on the highest interest rate) as lenders consider the investment risk to them to be too severe.

3.3.12 The planholder has the choice of taking a capital sum or an income. He or she can choose an income fixed in amount or a lower income that increases each year.

3.3.13 Modern Roll Up plans provide a "no negative equity" clause that guarantees the planholder can stay in the house even though rolled up loans exceeds the house value.

(c) *Shared Appreciation*

3.3.14 In the recent past, it has been possible to purchase a shared appreciation mortgage (SAM) issued at one time by the Bank of Scotland and later by Barclays Bank in the UK.

3.3.15 The original product had two versions. In the first variant the planholder paid interest at a low rate relative to market interest rates, but the lender took a proportionate share of the capital appreciation on the house over the period of the mortgage.

3.3.16 The second variant required no interest payments, but the loan repayment was the original loan amount plus three times the capital appreciation in property value on the percentage advanced on the loan. The maximum initial advance for this version was 25% of the value of the property. Take, for example, a homeowner with a property worth £100,000 who borrows 25 per cent of the value – £25,000. If the property increases to £150,000 over the period of the loan, the lender would get £62,500 – made up of 75% of the

£50,000 increase (£37,500) plus the original £25,000.

3.3.17 A major drawback to the original SAM was that it could not be transferred to a new property. This restricts the planholder's freedom to move house if his or her circumstances change.

3.3.18 Both schemes (by Bank of Scotland and Barclays Bank) have been withdrawn due to the providers being unable to attract funds from long term institutional investors like pension funds to finance the scheme. SAM was a very successful product and appealed to a wide range of customers. If the funding difficulties can be resolved then variations of shared appreciation mortgage are expected to reappear in the UK market very soon.

(d) Reversion Based ERMs

3.3.19 In lieu of taking a mortgage an elderly person could sell their house to a reversion company, or an individual, in return for a lump sum. The lump sum could then be used to purchase, in whole or in part, an immediate annuity. Some reversion providers give the planholder the option to take the lump sum in instalments over a period of years.

3.3.20 Reversion schemes are often structured as a sale and leaseback. The planholder stays in the house rent free or for a token annual payment on a lifetime tenancy. When the property is sold, usually after the death of the planholder, the proceeds belong to the reversion company.

3.3.21 The lump sum released from these schemes is fixed at the beginning of the plan. It means that the lender has to bear the long-term interest rate and property inflation risks.

3.3.22 A reversion plan is efficient at providing capital or an income stream. However, it means that the planholder is giving up ownership of the house, which is psychologically unacceptable to some old people in the UK.

Regulation

3.3.23 At the current moment, there is no specific regulation that applies to ERMs in the UK. But there are a number of different sets of regulation, which may apply parts or some ERMs. An ERM based on a loan under £25,000 falls under the Consumer Credit Act of 1974. An ERM with an investment element or an annuity is regulated under the Financial Services Act. However, an ERM based on a reversion which just provides cash is not regulated at all.

3.3.24 The Consumer Credit Act 1974 lays down minimum information requirements, including the amount and rate of interest. The withdrawal and cancellation rights, provision of cooling off periods, debt enforcement and early termination are covered. Credit business is licensed and monitored for compliance by the Office of Fair Trading.

3.3.25 Unfortunately, the Act was never designed for ERMs and it adds the cost and complexity of granting an ERM loan. The regulations are very rigid and prescriptive and the documentation is cumbersome. For these reasons many providers do not issue ERMs below £25,000 to avoid the restrictions from the Act. However, there is a significant demand in the UK for ERMs for below the £25,000 threshold, principally for home repairs and maintenance.

3.3.26 The Council of Mortgage Loans has introduced a voluntary Mortgage Code of Practice to which the overwhelming number of mortgage providers, but not all, subscribe. The Code applies to all loans secured on a person's principal residence and covers all

mortgage type ERMs over £25,000. The voluntary code is still the basis of regulation.

3.3.27 Recently, the UK Government has decided that the Financial Services Authority (FSA) will take responsibility for all regulation on mortgage lending and ERMs. It is intended to introduce the new legislation by January 2002. The consultation process began in 2000. The classes of mortgage/loans to be covered by regulation and the form of regulations are being defined. After the consultation, the FSA has decided that ERMs will be included in the new legislation.

Pitfalls and Difficulties in Developing ERMs

(a) Traditional Attitude to the Use of ERMs

3.3.28 Up to now the majority of older people in the UK who are homeowners are reluctant to use the value of the house as a means to increase income. Using the house is generally seen as a last resort only to be used if income becomes really inadequate.

3.3.29 The reluctance to use an ERM to provide income was recorded by Don Preddy in a research report 1994 for National Provident Institute. This attitude is confirmed by several other similar surveys subsequently.

3.3.30 However, existing planholders generally express a high level of customer satisfaction of using ERMs.

3.3.31 The ERM line of business is expanding in the UK, at around £500 million in total up to the end of 1999, resulting from strong marketing messages put out by providers – especially the extra comfort provided by extra income, the ability to indulge in leisure activities, quality time with grandchildren, the sense of security of

having some money in the bank, etc, etc. It is expected that positive images projected by the marketing campaign will change the traditional attitude of older people in the UK later.

(b) Inheritance

3.3.32 There is a strong desire for some people to leave the house as an inheritance for their children/grandchildren. It is argued that people's attitude to leaving an inheritance is changing. It may now be that most people would like to leave the house to children but are not prepared to suffer to do so. ERMs which only use part of the value of the house and leave a remainder for an inheritance may help overcome the reluctance to release house equity.

(c) Funding Issues

3.3.33 The development of ERMs has been held back by difficulties in obtaining finance from long term investors such as pension funds and life insurance companies. The existing vehicles for investing in residential properties or mortgages are not completely satisfactory for long-term investors – tax anomalies and difference in interpretation of the European legislation have to be overcome before vehicles can be developed.

(d) Regulation

3.3.34 The legislation covering ERM products and the way that they are sold is very patchy – some schemes are totally unregulated. Comprehensive regulation would improve customer confidence and enhance the growth of the ERM market. Some potential providers hold back from issuing ERMs until regulation is in place.

Fortunately, the Government will soon introduce a set of new regulation that is specifically designed for ERM products.

3.4 FRANCE

- 3.4.1 Closely related to the concept of reverse mortgages is the French system of *viager*, a Middle Ages practice that has experienced renewed popularity in Europe. Viager has been termed “speculation on death” and likened to high stakes gambling on a person’s life by both buyer and seller.
- 3.4.2 Here is how a viager works. First, the fair market value (FMV) of the seller’s house or apartment is calculated on the basis of a survey of recent sales of similar properties in the same neighbourhood. Then, a viager price is established according to the age of the seller. The property of a sixty-year-old seller is priced at 50% of its FMV, a seventy-year-old seller at 60%, an eighty-year-old seller at 70%, and a ninety-year-old seller at 80%. The buyer then gives the seller a “bouquet” or down payment of 0-30% of the viager price. The remaining 70-100% of the viager price is divided into monthly payments based on the estimated life expectancy of the seller. Because the monthly payments are indexed to the cost of living rate, the seller is guaranteed an income that keeps pace with inflation.
- 3.4.3 Upon the seller’s demise, the buyer gets title to the property. If the seller experiences an untimely death, the buyer gets a *bonanza*. Thus, for example, if a sixty-year-old Parisian were to sell his property through viager and die a month later, the buyer would have effectively bought the entire property for 30% of 50% of its FMV - in other words, 15% of its value. Conversely, if the seller lives on for twenty or thirty or more years, the buyer will have made payments totalling many times the property’s value. If the buyer predeceases the seller, the buyer’s family is obligated to keep sending the monthly check. If the buyer misses a payment, the

property reverts to the seller, who can then sell it again. The defaulting buyer loses the down payment and all of the monthly payments made to date.

3.4.4 The majority of sellers who employ the viager system are elderly people with no living heirs. However, because of France's forced inheritance system, a number of elderly sellers use viager as a means to thwart otherwise automatic inheritance by children who may have neglected them. Either way, sellers are ensured of a steady income for life and are able to continue living in their property, among friends and in a familiar neighbourhood, as long as they like.

3.4.5 The viager arrangement is usually done on a personal level and it is only regulated by the law of contract between two parties. However, some in-between brokers exist in the market bringing potential buyers and sellers together.

3.4.6 The French government promotes the system as an effective way to reduce dependence on social security programmes. Most of the buyers are not would-be felons, but are professional people who have large disposable incomes, but limited capital. Viager scheme is getting popular in France. About 500 viagers was closed in Paris alone in 1999.

3.5 SINGAPORE

3.5.1 Singapore's population will age rapidly over the next 30 years. The population aged 60 or over was about 235,000 (or 7% of the total population) in 1999, and it is expected to increase to 796,000 (or 19% of the population) by the year 2030.

- 3.5.2 The rapid increase in the population of elderly in Singapore is mainly due to the declining birth rates after the baby boom years between 1945 and 1966. One of the financial implications of this ageing trend is that the government must plan to provide sufficient monetary resources for the retirement needs of the aged.
- 3.5.3 Currently, most Singaporeans rely on their Central Provident Fund (CPF) savings for their retirement needs. The CPF Minimum Sum Scheme was introduced in 1987 to ensure that the retirees would have some savings set aside for their old age. The minimum sum amount was set at S\$30,000 when it was first implemented in 1987, and will increase gradually over the years to S\$80,000 by July 2003.
- 3.5.4 However, according to the 1993 CPF annual report, about 427,900 Singaporeans have CPF balances of S\$30,000 or below. Most of these workers are unlikely to satisfy the minimum sum requirement of S\$80,000 by the time they retire.
- 3.5.5 The government-appointed Cost Review Committee suggested in 1994 that reverse mortgages could be one way to help older Singaporeans enjoy capital gains on their property and cover their expenses during retirement.
- 3.5.6 An insurance cooperative, NTUC INCOME, is the first financial institution to go into the reverse mortgage business in 1997. At first, the response has far exceeded the cooperative's expectation and NTUC INCOME has issued 22 reverse mortgages in the first two months only. However, the market cooled down rapidly. To date there is still no other player in the market.
- 3.5.7 The NTUC reverse mortgage loan is open to Singaporean or Permanent Resident retirees who are 60 years or above. The mortgaged home must be a private residential property located in

Singapore. NTUC INCOME charges floating interest rate on the loans.

3.5.8 There is no guarantee clause in the NTUC INCOME reverse mortgage. It means that if the principal outstanding and accumulated interest is larger than the property value upon the termination of the loan, the planholder (or his heirs) is liable for the deficit.

3.5.9 Reverse mortgage is currently unattractive in Singapore because homeowners fear they will be forced to sell their homes if they outlive the reverse mortgage. On the other hand, lenders face downside risks in future property price fluctuations. The recent property market crash in Singapore has also discouraged many potential players in the reverse mortgage market.

3.5.10 In 2000, a government inter-ministerial working group suggested that reverse mortgage insurance should be introduced in Singapore. It will provide the non-recourse guarantee to borrowers.

3.5.11 The working group noted that reverse mortgages are now only offered to aged private property owners. There are about 9,000 owners, aged 60 or above, of private homes in Singapore. The working group suggested that insured reverse mortgages should also be allowed for 3-room public Housing Development Board (HDB) flats, whilst allowing uninsured reverse mortgages for bigger HDB flats. With 81% of Singapore households owning public HDB flats, the reverse mortgage market in Singapore could still have a bright future.

4. The Hong Kong Situation

Inadequacy of Retirement Provision in Hong Kong

- 4.1 The financial income of a future retired homeowner in Hong Kong would mainly come from the following resources:
- Family support,
 - Own wages,
 - Retirement savings (MPF),
 - Social welfare.
- 4.2 For most elderly people in Hong Kong, their main source of income has been their children and grandchildren. As Hong Kong society has become more industrialised, however, relationships between people have also come to be affected by a different set of social values. The traditional pattern of children supporting their parents in retirement is fading away in Hong Kong. There are increasing numbers of people who no longer see care of their parents in retirement as their responsibility.
- 4.3 The demand for elderly labour in Hong Kong has been declining. The 1991 Population Census showed that only 14.1% of the 65+ elderly were gainfully employed; the figure was 23.3% in 1981. Furthermore, the median salary for these elderly workers was HK\$3,557 per month, which is around 30% less than the population median salary of HK\$5,170. Therefore, the future elderly people might not be able to rely on employment to earn a living for themselves.
- 4.4 Since the change of sovereignty from Britain to China in 1997, the new Hong Kong SAR government has been actively reforming its retirement security policy. The newly established Mandatory

Provident Fund (MPF) scheme has just been implemented in December 2000.

4.5 A simple actuarial analysis was conducted to study the levels of income that could be generated from the MPF scheme. The resulting net replacement ratios are reported in following Table. As a rough guide, taking into account standard expenses and income tax deductions, most individuals believe they need approximately 60-70% of pre-retirement income for higher earners, and 70-80% for middle- to low-earners, in order to live comfortably in retirement. From our simple analysis, we have shown that the MPF scheme will provide only a *minimum* floor income to retirees.

Table 1. Estimated net replacement ratios provided by the MPF Scheme

AGE (x)	MALE		FEMALE	
	Low-Mid Earners	Higher Earners	Low-Mid Earners	Higher Earners
20	61.5%	37.9%	54.1%	28.1%
30	40.6%	21.1%	35.7%	18.5%
40	24.8%	12.9%	21.8%	11.3%
50	12.8%	6.6%	11.2%	5.8%
60	3.7%	1.9%	3.2%	1.7%

Key Assumptions:

- Entry age is (x), retirement age is 65;
- Salary growth averages 7%;
- Investment return averages 11%;
- Monthly wage for low-mid earners averages HK\$11,400;
- Monthly salary for higher earners averages HK\$38,525;
- Lump sum MPF benefit is used to purchase a single life (level pay) annuity at retirement.

- 4.6 Hong Kong has a system for provision of welfare subsidies to the elderly through Comprehensive Social Security Allowance (CSSA) and Social Security Allowance (SSA) payments. However, most homeowners in Hong Kong might not be qualified for CSSA under the current means-tested requirement.
- 4.7 In conclusion, Hong Kong residents should not rely totally on family support, own employment or the MPF scheme after their retirement. They are expected to supplement the retirement income with their own personal savings, investments, and other plans (such as reverse mortgages and insurance plans).

Potential Usage of Reverse Mortgage in Hong Kong

- 4.8 Residential property prices in Hong Kong have been rocketing, upstaging London, Tokyo, and New York. Even with the Asian financial crisis of late 1997, the average annual appreciation rate for residential property prices in Hong Kong has been more than 13% for the period 1984-98. In his first Policy Address on 8 October 1997, the Chief Executive of Hong Kong asserted that the Government aims to achieve a home ownership rate of 70% in Hong Kong by 2007. Therefore, it is likely that many middle-class Hong Kong residents will find upon retirement that a major part of their life savings has been channelled into the financing of their homes, and that relatively little is available to provide supplementary retirement income. This pattern is often called “asset-rich but income-poor”: retirees are by no means indigent, but their wealth is tied up in their homes.
- 4.9 “Asset-rich, income-poor” retirees are not a problem unique to Hong Kong. As seen from the above reviewed countries, the problem of generating retirement income from private houses has been occupying policymakers and specialists for a number of years. With average values of properties in Hong Kong ranging from

HK\$2,000,000 to HK\$6,000,000 depending on districts, reverse mortgage could be an important financial product to retired homeowners in future.

- 4.10 Non-recourse-type reverse mortgage loans with various combinations of disbursement options (say, lump sums, life or term annuities or line-of-credit accounts) are most suitable to the Hong Kong situation.
- 4.11 Future public policy changes in medical and long-term care financing for the elderly in Hong Kong might also influence the potential development of reverse mortgages. For many elderly households, housing equity could be the last financial buffer held as a form of insurance against substantial medical care expenses or long-term disability. If coverage for health and long-term care were not complete and universal in future, reverse mortgage can be used to finance part of these expenses.

Risks and Obstacles of Introducing Reverse Mortgage in Hong Kong and the Strategies to Overcome Them

(a) Longevity Risk

- 4.12 If the borrower's life expectancy is greater than the assumed, he or she will stay in the property longer than expected. On the other hand, the lender has to continue making payments to the borrower. The loan could eventually exceed the proceeds from the sale of the house and the lender is not allowed to recover the difference under the non-recourse clause. This is called longevity risk.
- 4.13 When constructing a plan the provider will decide whether to retain the longevity risk within the provider's own funds. The reverse may need to be increased progressively if it appears that the

portfolio of lives is living longer than expected.

4.14 The longevity risk can be reduced through a reinsurance programme, or a derivative can be purchased. The reverse mortgage provider will first estimate the pattern at which loans will be repaid in future years. If the planholders die earlier than expected the provider makes a profit; if they die later then a loss is made. Through a reinsuring programme, or by a derivative, the provider can swap the actual repayment pattern with an agreed, expected pattern with a reinsurer. Hong Kong is a financial centre and it should not be difficult to develop financial management tools for reverse mortgage longevity risk.

(b) Interest Rate Risk

4.15 Lenders also face an interest rate risk with reverse mortgages. In a rising rate environment, a fixed rate investor normally has the benefit of reinvesting cash flows into higher yielding bonds. This benefit is not available to the fixed rate reverse mortgage lender, because reverse mortgages do not result in any immediate cash flows to the lenders. A fixed rate reverse mortgage lender is helplessly locked into a rising rate environment.

4.16 Although a floating-rate reverse mortgage is certainly more attractive to the lender with regards to interest rate, it is not risk-free. In a rising rate environment, an adjustable-rate reverse mortgage accrues increasing amounts of interest. Thus, the lender faces risk from negative amortisation; that is to say, the possibility increases that the accrued interest and principal will exceed the resale value of the home.

4.17 The interest rate risk of reverse mortgages could be diversified with the traditional “forward” mortgages. The interest rate risk and cash flows of these types of mortgages move in opposite directions.

It helps to diversify the associated risks.

(c) General and Specific Home Appreciation Risks

- 4.18 For the reverse mortgage calculation, it is generally assumed a property appreciation rate. The rate depends on the overall trend of the economy. However, the actual overall appreciation rate might be turned out differently from the assumed. This is called general home appreciation risk.
- 4.19 Furthermore, houses in different districts and of different types will appreciate at different rates. In addition, houses that are well taken care of will also sell at higher prices. For example, properties at the Peak in Hong Kong might appreciate higher than the general rate in Hong Kong, but a bad condition apartment in a good district could sell at a price far below the expectation. This is called specific home appreciation risk.
- 4.20 The way to manage the home appreciation risks is by diversification. That is, the lender underwrites reverse mortgages in different areas and different housing structures in Hong Kong.

(d) Reputation Risk

- 4.21 With reputation risk, lenders are worried about how their image may be affected in the event of disputes. If they are brought before the court of law for judgement, the adverse public relation risk cannot be avoided. Regardless of the eventual outcome of the case, the image of the lender may be damaged.
- 4.22 Before introducing reverse mortgage products in Hong Kong, the government should review the regulations related to these financial instruments. Clear and fair regulations should be issued to the public to avoid any misunderstanding between lenders and

borrowers. Like MPF scheme underwriters, a certification examination should be designed for individuals selling reverse mortgage products.

(e) Demand Risk

4.23 The demand for reverse mortgages in an economy is difficult to be estimated and it depends on many factors. In Singapore, NTUC INCOME predicted the demand for reverse mortgage loans is around 200 for two years when their product was first launched in early 1997. The initial response was much better than expected, but it quickly died down. Currently, there are fewer than 10 reverse mortgage loans per quarter issued by NTUC INCOME.

4.24 Lack of demand for reverse mortgage loans will make it unprofitable to keep staff trained in the process of originating these loans. Even if lenders achieve a fairly significant loan volume, they may not be able to generate sufficient profits to sustain their commitment to the product. The basic principle backing the reverse mortgage design is “law of large numbers”. Larger the loan volumes, the designated level of profit is more likely to be achieved.

4.25 Potential reverse mortgage lenders in Hong Kong should perform careful studies on the demand for this kind of loans before launching the product.

(f) Inheritance

4.26 The reluctance (demand risk) to use the house to provide income is compounded by people’s attitude to inheritance. Most Chinese old people wish to leave an inheritance to their children/grandchildren.

- 4.27 Very few families in Hong Kong discuss rationally the subjects of poor health, or death of parents and the issues surrounding inheritance. The subject is a taboo in most Chinese families. As a result parents exist on a depressed standard of living and are unaware of the wide range of choices for inheritance, money to live on and even the possibility of capital release.
- 4.28 However, people's attitude would be changing with time. Recently retired people may feel less pressure to provide an inheritance to their children than the current generation of older people. The new generation are likely to be much more familiar with financial products such as MPF schemes, investment-link insurance policies, holding shares, endowment mortgages, etc. They might have very different attitudes to the reverse mortgage than the older generation.
- 4.29 Perhaps the government and potential lenders join together to mount a campaign to make older people aware of the issues and choices. Campaigns could change people's attitudes rapidly. For example, Funeral Planning was also a taboo issue about 5 years ago in the UK and yet now Prepaid Funeral Plans are very fast expanding line of business after large-scale campaigns launched by providers.

(g) *Annuity Market in Hong Kong*

- 4.30 Overseas' reverse mortgage products often allow borrowers choosing payment options: lump sums, life annuity payments, or a combination of both. Unfortunately, the annuity market in Hong Kong is extremely minimal. As the end of 1998, there were only 247 annuity policies in force and the office premiums for that year were less than HK\$300,000. They only accounted for 0.0008% of the total long-term business in Hong Kong.
- 4.31 Homeowners in Hong Kong might not be able to convert the lump sum released from the reverse mortgage loan to annuity incomes.

One simple option to deal with the lump sum benefit is to deposit it in a bank account. The retiree then withdraws a fixed amount every month. However, the individual runs the risk of the income stream terminating when the balance is exhausted. This is often called “longevity risk”. On the other hand, the purchasing power of the fixed monthly withdrawals will be diminishing with inflation. This is often called “inflation risk”.

- 4.32 It would arguably be better to provide retirees with an option for receiving steady real income for life. This can be achieved by purchasing an inflation indexed life annuity from a life insurance company. Longevity and inflation risks are then fully insured. Life insurance companies should be persuaded to develop annuity market in Hong Kong, and in particular, to introduce index linked life annuity products onto the Hong Kong market.

The Role of The Hong Kong SAR Government

- 4.33 The government should encourage the participation of the Hong Kong financial community in originating, servicing and investing in reverse mortgages by providing insurance that would protect these firms from the risks of substantial losses. Quite clearly, the availability of reverse mortgage insurance has been instrumental in the development of the reverse mortgage market in the US. The Hong Kong Mortgage Corporation Limited (HKMC), which has already been operating forward mortgage insurance programme in Hong Kong, might be a suitable agency to provide reverse mortgage insurance to lenders.
- 4.34 Significant level of participation of the financial community in Hong Kong is essential to the development of reverse mortgage programme. It would make loans more widely available for borrowers and to provide adequate competition among firms so that consumers are offered the most favourable loan costs and

terms.

- 4.35 Effecting a reverse mortgage product is not necessarily a complicated business, but understanding the financial consequence is complex. It would be a major financial transaction for most retired people. The government should ensure that potential consumers are given understandable explanations from advisers who are trained in the subject.
- 4.36 To protect the public and to encourage the development of the reverse mortgage market in Hong Kong, an effective regulatory framework is required. The regulation should apply to the sales process as well as the product design. Legislators and related government authorities should design a special set of regulation for reverse mortgage schemes.
- 4.37 The government could first consider a pilot reverse mortgage programme similar to the HECM demonstration scheme in the US. It might cover properties under the Flat-For-Sale Scheme by the Hong Kong Housing Society or home ownership estates under the Housing Authority and Housing Department.
- 4.38 Financing a reverse mortgage product requires a large amount of capital and it is a long-term business. In addition to the government, other potential participants in the Hong Kong's reverse mortgage market include:
- *Banks* – Forward mortgage loan portfolio is often the largest investment for most commercial banks in Hong Kong. By investing in reverse mortgages, banks can effectively hedge part of their investment risks.
 - *Insurance Companies* – Insurance companies specialise in managing risks (such as longevity and interest rate risks).

Reverse mortgage products are very suitable for them.

- *Pension Funds* – Pension funds collect contributions monthly from individuals and reverse mortgage schemes pay monthly advances to borrowers. Therefore, reverse mortgage products match very well with the cash flows of pension plans.
- *Private Property Developers* – Reverse mortgage schemes may help developers to acquire properties for re-development in Hong Kong's older areas.

5. Conclusion

- 5.1 There is a clear potential for a reverse mortgage market in Hong Kong which would help older people of moderate means and with low/medium priced homes to supplement their income, to raise money for capital needs and generally improve the quality of their lives.
- 5.2 However, overseas' experience showed that there might be many risks and obstacles in the process of developing reverse mortgage market in Hong Kong. Moreover, property prices in Hong Kong have been sliding for the past few years. Currently, it might not be a good time for any institutions to start reverse mortgage programme in Hong Kong.
- 5.3 In future, when the Hong Kong economy is on the road of recovery, it is recommended that further feasibility research can be performed to explore, in more details, the demand and supply of reverse mortgages in Hong Kong.