Maddick Consulting Group Pty Ltd
33/1140 Nepean Highway Mornington

Reverse Mortgage v Equity Release

Author Alan Maddick 19th December 2021

Contact alan@accountantmm.com.au

When clients ask me "how much do I need to retire?" or "what should my goals be" I always say the first thing you need is to own you home with no mortgage. There are a couple of reasons for this;

1. If you own your home then you have no mortgage or rent cost to pay in retirement. Rent or Mortgage would be one of the largest expenses for most households so cutting this out improves retirement.
2. Capital preservation. In Australia most Real Estate goes up in value well above inflation so the money tied up in your home is increasing, this increase and the underlying asset do not form part of the pension asset or income tests and any gain is tax free. This can allow you to make money early in your retirement while giving you options later in life for example if you need aged care or another unexpected event occurs.

Sometimes clients will use a Reverse Mortgage or Equity release early in retirement to "Pay off their Mortgage" This is not what you are doing as you will be just replacing one debt with a different type of debt. Let's have a look at what these products are:

Reverse mortgage

A reverse mortgage allows you to borrow money using the equity in your home as security.

If you're age 60, the most you can borrow is likely to be 15–20% of the value of your home. As a guide, add 1% for each year over 60. So, at 65, the most you can borrow will be about 20–25%. The minimum you can borrow varies, but is typically about $10,000.

Depending on your age and lender policy, you can take the amount you borrow as a:

- regular income stream
- line of credit
- lump sum, or
- combination of these

How a reverse mortgage works

You stay in your home and don't have to make repayments while living there. Interest charged on the loan compounds over time, so it gets bigger and adds to the amount you borrow. The interest rate is likely to be higher than on a standard home loan.

You repay the loan in full, including interest and fees, when you or your deceased estate sell your home.[1]

[1] MoneySmart.gov.au, Reverse mortgage and home equity release, https://moneysmart.gov.au/retirement-income/reverse-mortgage-and-home-equity-release

Alan Maddick and Maddick Consulting Group Pty Ltd are Authorised Representatives of Vivid Financial Planning Pty Ltd AFSL 478937 and send you this communication in this role.

Maddick Consulting Group Pty Ltd
33/1140 Nepean Highway Mornington

Equity release / Sale Proceeds Sharing

Equity Release, Home sale proceeds sharing, or home reversion are all names for more or less the same thing. Terms can vary depending on the provider and agreement but in short they allow you to sell a proportion (a 'share' or 'transfer') of the future value of your home while you live there. You get a lump sum, and keep the remaining proportion of your home equity.

How home sale proceeds sharing works

The provider pays you a reduced ('discounted') amount for the share you sell. How much you get for the share depends on your age. Terms and conditions vary. The provider may offer a 'rebate' feature. This means you (or your estate) get some money back if you sell your home (or die) earlier than expected. The amount you get back depends on when you sell your home and how much you got for your sold share. You may also have the option to buy back the sold share later, if you wish.

For example, suppose your home is currently worth $500,000 and you sell a 20% share of the future value. Depending on your age, the provider may offer you $37,000 to $78,000 to buy that share today. When you sell your home, the provider receives their share of the proceeds. Say in 20 years time you sell your home for $800,000. The provider gets 20% of the sale price ($160,000), minus any rebate (if applicable).[2]

What home sale proceeds sharing costs

It's not a loan, so you don't pay interest, this appeals to many clients. You will typically pay a fee for the transaction but the real cost is the difference between what you get for the share of your home you sell now, and what it's worth in the future (minus any early sale rebate) The more your home goes up in value, the more the provider will receive when you sell it.

So what is the best option?

When Capital growth is low then equity release will often turn out to be quite attractive but the opposite is also true; in periods of rapid capital growth (like now!) clients are often shocked how much they end up paying under an equity release scheme.

Equity release also generally works out well when the time from taking out the loan to the eventual sale of the property is long as interest doe not build up or accrue over time.

[2] MoneySmart.gov.au, Reverse mortgage and home equity release, https://moneysmart.gov.au/retirement-income/reverse-mortgage-and-home-equity-release

Maddick Consulting Group Pty Ltd
33/1140 Nepean Highway Mornington

There are other options

Often equity release and/or reverse mortgages are portrayed as the only or best option if you get caught in a situation where you have a lot of equity in your home but need funds for your lifestyle of even to pay out the last portion of your home loan when you retire. Depending on your situation there are a range of other options that may work for you for example;

- Selling other assets
- Withdrawing a lump sum of pension from Super
- The government pension loan scheme

In my experience in most situations where a Reverse Mortgage or Equity Release is considered clients are better to sell their home; free up the capital they need and then re-buy a new more affordable home. Of this may be smaller and lower maintenance as well which often fits with this stage of life.

When I have modelled these scenarios for clients as well as in real life situations doing this (selling and buying something smaller) preserves the most capital for clients. This allows you to pass this on to family. Some clients tell me that either they don't care about what their kids inherit or perhaps they don't have kids, in these cases it is still wise to preserve capital. You never know what the future holds and as long as you have capital in your home you have options, remembering your home is not counted for the Pension Asset test either.

One thing to consider when looking at the capital you are preserving is if one partner needs aged care down the track you will want to have a RAD (Aged Care deposit) at the moment this is averaging 450k.

This products are complex and I have seen many scenarios where they have caused significant harm to clients, please get professional advice before you act and remember this article is just my opinion and what is right for you will differ depending on your personal situation.

Alan Maddick and Maddick Consulting Group Pty Ltd are Authorised Representatives of Vivid Financial Planning Pty Ltd AFSL 478937 and send you this communication in this role.