Regulation Impact Statement: Delivering for Seniors – Equity Release Product Reforms

Election commitment

This section relates to an election commitment announced on 7 August 2010 to extend protections for older Australians accessing the equity in their homes via reverse mortgages and home reversion schemes (the election commitment). The election commitment announced that the Government has committed to protecting older Australians by:

- introducing specific protections in relation to both reverse mortgages and home reversion schemes, including greater disclosure of the features and fees on these products; and
- establishing a statutory protection against negative equity.

The election commitment will be progressed as part of Phase Two of the National Consumer Credit Protection Reforms and were announced to be in place by mid-2012.

Establishing a statutory protection against negative equity can only be achieved via a legislative requirement for reverse mortgage lenders to not seek more than the sale proceeds of the secured property as repayment for the loan. Extending protections to seniors using either a reverse mortgage or home reversion scheme product may be achieved by several options, including specific reverse mortgage responsible lending conduct obligations, improving pre-contractual disclosure or regulation of certain product features.

Summary

Reverse mortgages carry unique risks and complex financial and legal impacts for borrowers that are significantly different from those associated with other more traditional credit products. This disparity results in the following problems for consumers:

- Fluctuations in interest rates and house prices make it impossible for a borrower to assess how much equity they may have left in their home at any given time during the life of the loan. They may find themselves in a position where they owe the lender more than the value of their home, or their future choices (particularly relating to aged care accommodation) are constrained by the depletion of the equity in their home.
- The characteristics of the class of borrowers who use reverse mortgages (including limited financial literacy, lack of income and reduced capacity due to health problems) can create particular risks in relation to the use of these products. These risks include a limited understanding of how they operate, and an inability to respond promptly or appropriately to defaults under the contract.

It is proposed to address these problems by:

- establishing a statutory protection against negative equity;
- requiring providers of equity release products to comply with specific responsible lending conduct obligations, before the consumer enters into the contract;
- requiring providers of equity release products to provide consumers with improved pre- and post-contractual product information;
- requiring providers who do not offer tenancy protections for non-title holding residents to disclose this to borrowers before they enter the contract. If providers do offer tenancy protections for non-title holding residents, they will be required to offer this in a mandated way;
- excluding certain matters from being able to be a default under the Code, or therefore as triggering enforcement action; and
- requiring providers of equity release products to meet additional procedural requirements before they can take enforcement action in the event of default by the borrower, with these requirements adapted to the characteristics of this class of borrower.

These reforms would make a significant difference for consumers in that:

- Consumers will be assisted to make more informed choices in respect of the balance between current access to credit and the future restrictions on lifestyle choices from reduced equity.
- Consumers will have protections that reduce the risk of them being evicted from their home.

These reforms would have the following impact on the equity release industry:

- The obligations are largely consistent with existing industry practice under a voluntary code of practice for reverse mortgage providers and equity release consultant accreditation for brokers. It is therefore not expected that the equity release industry would incur significant additional compliance costs, although all credit licensees would need to review their practices to ensure they comply with statutory requirement.
- The introduction of standardised requirements in relation to matters such as no negative equity guarantees and default clauses and non-title holding arrangements will reduce the need for third parties to be familiar with a range of products with minor variations in terms. This will simplify the task for those giving advice on these products, reducing their time and cost, and making advice more accessible.

Problem identification

Background

An equity release product allows a consumer to access the equity of a property, whilst still retaining ownership over it. In Australia, the most common forms of equity release products utilised by seniors are reverse mortgages and home reversion schemes. For the purposes of this RIS, the term “equity release product” is used to describe both these types of equity release transactions.

A reverse mortgage is a credit product under which a consumer, who is usually at least 60 years or above, borrows money against the equity in their home, in return for a lump sum, line of credit or regular payment. The debt does not need to be repaid until the home is sold (usually when the borrower dies or voluntarily vacates the home), with interest compounded until this time.

Reverse mortgages are currently subject to regulation under the Credit Act and self-regulation under the Senior Australians Equity Release Association (SEQUAL). SEQUAL’s self-regulation measures include a Code of Conduct and Guideline’s which include a requirement for members to include a no negative equity guarantee (NNEG) in its products. Membership of SEQUAL is voluntary, with nine providers of reverse mortgages currently members. These providers lend the vast majority of reverse mortgage and therefore, the majority of borrowers are offered SEQUAL self-regulation protections. However, at least two small lenders who offer reverse mortgages are not SEQUAL members. Although the nature of their market share in uncertain, it is estimated that at a maximum non-SEQUAL members offer no more than 5 per cent of reverse mortgage loans.

Currently, borrowers take out reverse mortgages for a variety of personal purposes. The most common uses include supplementing retirement income and paying off other debts. Reverse mortgages are also used to fund home renovations, which may allow a borrower to improve the value and use of their home, and allow them to remain in their home longer than they otherwise could.[1]

A home reversion scheme allows a consumer to sell a portion of their home to a reversion company for a fixed lump sum payment (usually less than its market value), with the consumer retaining title over the home. As a home reversion scheme product is a part sale of the consumer’s home, it represents a property transaction regulated by the states and territories. Therefore, it is not a credit product regulated under the Credit Act. Currently, the only provider of a home reversion product in Australia is Homesafe Solutions Pty Ltd, which is a member of SEQUAL.

With the ageing of Australia’s population, the demand for equity release products is expected to increase, resulting in an increased market of potential consumers being exposed to the risks inherent to the products.[2] The unique risks these products pose to seniors seeking to use these products are set out in detail below.

Difficulty in managing the risk of negative equity

Negative equity occurs when the debt repayable under the reverse mortgage exceeds the value of the borrower’s property. In such a situation, without intervention, the entire risk of negative equity is borne by the borrower who could be required to pay more than the

[1] SEQUAL Media Release 28 May 2010. Australia’s reverse mortgage market reaches $2.7bn at 31 December 2009.

[2] The Australian Bureau of Statistics has reported that by 2056 Australia's population is projected to increase to around 23% - 25% being 65 years or older. In 2007 Australia's senor population consisted of 13% being 65 years or older.

proceeds from the sale of their property as repayment for the loan. The potential impact of this is that unexpected increases in interest rates or falls in house price values could result in consumers having to exhaust all their available assets to pay the debt. The risk is that these borrowers could be left severely impoverished and facing eviction from their home, at a stage in their life when they are unable to generate any income. If the debt is repaid due to the death of the borrower, repayment may require the sale of other assets from their estate, impacting their executors and beneficiaries.

There are several factors which mean borrowers face a significant information asymmetry which make it difficult for them to understand and manage the risk of negative equity, including:

- if interest rates rise and/or house prices fall, the effect of compounding interest on the loan can result in the total amount owing increasing exponentially relative to the value of the security; and

- it is difficult for a borrower to assess how much equity they may have left in their home at any given time during the life of the loan, or at the time they enter into the contract, as this will depend partly on future movements in interest rates (unless the loan is for a fixed rate) and property prices, as well as the period of the loan.

Since the risk of negative equity depends on the future movements of interest rates and house prices, it is not possible to determine the proportion of borrowers who may find themselves at risk of incurring negative equity.

Negative equity has been identified as a significant risk to borrowers by the Australian Securities and Investments Commission (ASIC) and State consumer agencies.[3]

Negative equity has also been identified as a risk to consumers in the United Kingdom, United States and New Zealand where measures have been introduced to address the problems created by the absence of a guarantee. For example, in the UK the equity release industry body Safe Home Income Plans (SHIP) requires its members to offer protection against negative equity. This requirement flowed from experiences in the late 1980s during which thousands of retired people took out variable rate reverse mortgages to invest in stock market related investment bonds. The income from these bonds was expected to be sufficient to pay the interest on the mortgage and provide additional regular income. However, due to poor market performance, coupled with increasing interest rates and decreasing property values, many consumers' debts exceeded the value of their properties, with many borrowers being evicted. [4] This demonstrates that, in the absence of a no negative equity guarantee, lenders can be less conservative in their lending practices and more aggressive in enforcement actions, with significant impacts on borrowers who have no means of repaying the debt other than by selling their home.

[3] ASIC Report 59. Equity Release Products. November 2005. See also ASIC Report 109: 'All we have is this house' Consumer experiences with reverse mortgages . November 2007. (ASIC's second report). Also, a statutory protection against negative equity was included in the draft National Finance Brokers Bill 2007 and would have applied across all State and Territory jurisdictions.

[4] ASIC report 59, Equity Release Products report, November 2005. These events occurred before the industry was bought under regulation from the Financial Services Authority or self-regulation by the UK equity release body SHIP.

SEQUAL has responded to concerns about the risk of negative equity by including a requirement in its Code of Conduct that its members must include a No Negative Equity Guarantee (NNEG) as part of their reverse mortgage lending policy. This guarantees that the amount the borrower owes on their loan will be capped so that the maximum amount recoverable cannot exceed the net realisable value of their property, except in a limited range of circumstances.

The majority of reverse mortgages in Australia are provided by SEQUAL members who offer this NNEG. However, since not all reverse mortgage providers are members of SEQUAL, this requirement is not mandated across the whole of the reverse mortgage industry. There is also no requirement for new market entrants who do not elect to become members of SEQUAL to provide borrowers with any form of negative equity protection (although they may choose to offer their own form of negative equity protection).

Inadequate information

Taking out a reverse mortgage can involve major financial implications and create new legal rights and obligations for a borrower. Reverse mortgages are very different from more traditional credit products and their risks are therefore unique. Also, they are a relatively new loan product to the Australian market with borrowers generally taking out only one reverse mortgage in their lifetime, leaving them unfamiliar with its risks and implications.

The financial implications include:

- the risks of insufficient equity being available for future requirements such as inheritances to children or meeting aged care costs;
- the possible application of large break fees on fixed interests loans which cannot be calculated at the time the borrower applies for the loan; and
- potential impacts on pension entitlements.

The legal implications include:

- the application and effect of default clauses and procedures; and
- potential loss of tenancy rights for non-title holding residents.

For these reasons, it is essential that borrowers make fully informed decisions regarding taking out a reverse mortgage. However, there are several sources of evidence which indicate that consumers are particularly vulnerable to the risk of entering into a reverse mortgage without adequate understanding of its risks and implications. The most significant findings are:

- It has been noted that the demographic of reverse mortgage borrowers currently have relatively poorer financial literacy than other demographics. Reverse mortgage lenders usually limit their eligibility requirements to seniors aged 65 years and over, with the average age of new borrowers being 73 years.[5] The latest ANZ survey of adult financial literacy has reported that adults aged between 60 and 69 years have relatively poorer financial literacy than other age groups older than 24 years. People aged over

[5] SEQUAL Delliotte survey June 2009.

70 were reported as having the poorest financial literacy of any adult age group with females 70 years or older having the poorest financial literacy of any demographic subgroup, including those whose education did not go beyond year 10, those who speak a language other than English at home and those who are unemployed.

- There is a lack of borrower awareness of the features of a reverse mortgage, its long-term costs and how they will affect the borrowers long-term financial circumstances. For example, ASIC's second report on reverse mortgages found that:
  - only 2 out of 29 reverse mortgage borrowers interviewed indicated that they had considered the implications of taking out the reverse mortgage in terms of their longer-term future needs of aged-care accommodation, inheritance for their children or possible health care requirements; and
  - almost half of the reverse mortgage borrowers interviewed did not know how much the loan was likely to cost them over time.
- The SEQUAL-RFI reverse mortgage survey of 1000 seniors reported that:
  - 22 per cent of survey respondents were completely unfamiliar with reverse mortgages. Only 40 per cent of all survey respondents had heard of reverse mortgages and recognised the basic features of the product.[6]
  - on average younger borrowers utilise the maximum loan-to-value ratio (LVR) available to them. This leaves them more likely to deplete their equity before the end of their life expectancy, compared to borrowers who use a lower LVR; and
  - 45 per cent of respondents did not know how much they could expect the entry costs of aged care to be.[7] This indicates that many consumers may access the equity in their homes without making any conscious decision about how to meet such costs in the future.

In summary, the class of borrowers who are likely to utilise a reverse mortgage tend to be less financially literate than other borrowers and more susceptible to the risks associated with having inadequate information regarding these loans.

These risks are present irrespective of whether the borrower enters into a reverse mortgage through an intermediary or directly with a provider. Currently, approximately half of new reverse mortgage borrowers source their loan via intermediaries such as finance brokers and financial planners. Such intermediaries may be under certain statutory obligations according to the services they provide. For example, under the Corporations Act, licensed financial planners are required to ensure that the product would be suitable for their client. Also, under the Credit Act, a licensed broker would be required to ensure that the product would not be unsuitable for the borrower. Certain disclosures, such as the cost of the loan, fees, charges and commissions, must also be provided to consumers.

[6] SEQUAL-RFI Reverse mortgage Survey "It's on the house: A consumer study into the attitudes and perceptions of Australians aged over 60 years".

[7] SEQUAL-RFI Reverse mortgage Survey "It's on the house: A consumer study into the attitudes and perceptions of Australians aged over 60 years".

However, the use of intermediaries does not necessarily resolve all issues associated with a borrower's lack of information. For example, within the financial planning and credit intermediary professions, beyond the obligations mentioned above, there is no consistency in standards for the provision of financial advice and information to reverse mortgage borrowers concerning the unique characteristics and impacts of the product. SEQUAL provides training to members of the Financial Planning Association of Australia (FPA), the Mortgage and Finance Association of Australia (MFAA) and CPA Australia, for industry accreditation as an equity release consultant. However, the training is not mandatory for all professionals who provide information and advice to borrowers,[8] which increases the risk that borrowers may receive advice from professionals who are not equipped to identify all the financial issues consumers face which are unique or inherent in taking out a reverse mortgage.

Within the legal profession, there are currently no mandatory standards for legal advice specific to reverse mortgages and no accreditation programs offered by legal representative bodies for reverse mortgage and personal finance specialist lawyers.[9]

Inadequate equity

Borrowers may face a situation where the equity they have in their home is depleted to the extent that it may limit their ability (and options) to fund what can be very significant long term financial needs (including medical care and aged accommodation expenses).

This is because the long term financial implications of the loan largely depend on variables such as future movements in interest rates and property values and how long the borrower will have the loan (i.e. how long they may live or decide to live in the property). It is difficult for a borrower at the time they are considering taking out the loan to assess how these variables will impact the amount of equity remaining in their home at any point in the future. However, the effects of this could be severe. For example, a borrower may not be able to fund other crucial requirements, such as medical and/or aged care. Also, many borrowers who find themselves in this type of situation may have little to no ability or time to reverse, or mitigate it.

Default procedures

The Code contains requirements that lenders must comply with, before they can enforce a contract where the borrower defaults, including that they send the borrower a written notice of default.[10] However, default procedures in the Code are not specifically tailored to reverse mortgage borrowers and may not be appropriate to their age. For example, borrowers have an increased risk of being incapacitated due to illness and have relatively poorer financial literacy than other age cohorts. This increases the risks of borrowers not having the ability to address the default and prevent enforcement action.

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[8] The only professional body which requires its members to have SEQUAL accreditation before providing services to reverse mortgage applicants is the Mortgage and Finance Association of Australia.

[9] However, the Law Council of Australia, SEQUAL and some law societies are progressing plans to implement specific reverse mortgage training, education and guidance materials aimed at improving the quality of legal advice to consumers.

[10] Section 88 of the National Credit Code requires a lender to give the borrower a default notice before commencing enforcement proceedings.

This risk has been identified by SEQUAL which has provided a guideline for its members to follow in relation to default conditions. This contains requirements in addition to those under the Code for members, including that they personally contact (or make a reasonable attempt to contact) the borrower prior to the expiry date of a default notice and ensure the borrower has received the notice and understands the consequences of not rectifying the default. However, these requirements are not mandated across the industry and may not apply to a new lender which enters the market.

Default clauses

Default clauses under a reverse mortgage usually do not relate to non-payment of the loan. This is because a reverse mortgage does not require ongoing repayment. Rather, most default clause relate to other conduct by the borrower, such as non-payment of council rates. However, there is a risk that borrowers could be forced to sell their homes and required to repay the loan, due to default clauses which:

- are too broadly drafted, creating uncertainty for the borrower about their obligations and what circumstances would trigger a default (for example, a default clause may require a borrower to maintain the home in a sound condition, however, what level of maintenance this requires may not be clear);
- may include default triggers involving minor oversights such as failure to inform the lender that another person is living in the home, or failure to pay for a property valuation; and
- may bear no relationship to the risk to the lender from the default, such as being in default under another credit contract with that lender (e.g. a credit card).

SEQUAL has recognised the risk of borrowers being impacted by such default clauses by requiring its members to only include default clauses which are "fair and reasonable". This is however, a high level obligation, not mandated across the industry and may not apply to any new lender which enters the market.

Lack of tenancy protections for non-title holding residents

Reverse mortgage contracts require repayment either when the borrower dies or permanently vacates the property. In the event of a borrowers death any surviving non-title holding resident may not have the right to remain in the property. This can cause detriment to, for example, a surviving spouse.

Some lenders have acknowledged this problem and addressed it by allowing a non-title holding resident to be designated as a nominated resident, affording them protection of residency. However, such protection is not uniform across the industry, nor are lenders required to disclose pre-contractually whether or not they provide protections to non-title holding residents.

Home reversion scheme products

Home reversion schemes are commonly used by consumers of the same demographic and for similar purposes to borrowers of reverse mortgages, with the two products often considered competitive products.

However, being a property transaction which does not involve repayment of a capitalised interest debt, some of the risks associated with reverse mortgages do not apply to home reversion schemes. For example, a reverse mortgage borrower may incur negative equity. However, a home reversion scheme user sells a fixed portion of the equity in their home, and retains ownership of the remaining portion, meaning that they can never incur negative equity. Similarly, a home reversion scheme user does not face the risk of eroding the equity in their home over time like a reverse mortgage borrower does, since the portion of equity they have in their home is fixed for the life of the contract. Also, a home reversion scheme user cannot be in default, unlike a reverse mortgage borrower.

However, home reversion scheme transactions involve complex legal and financial impactions for consumer which may impact a consumer’s ability to meet future needs. Therefore, consumers making fully informed decisions before entering into a home reversion scheme is essential.

Inadequate information

There is a risk that consumers enter into a home reversion product without adequate access to information regarding its legal and financial implications. Currently, as a SEQUAL member, Homesafe does require consumers to obtain legal advice and recommend that they obtain financial advice before entering into the contract. They also provide applicants with a pre-contractual disclosure document which sets out the features of the product. However, this is only a voluntary requirement and would not apply to any new providers of home reversion schemes who do not elect to become SEQUAL members.

The above discussion in relation to the risks arising from inadequate information still apply broadly to consumers as the different structure only addresses one variable, namely the percentage of the equity in the house they will retain but still does not let them determine the dollar figure they will receive at a future point in time.

The issues in relation to a lack of protection for any non-title holding residents are still applicable to home reversion schemes. In the absence of a clear statement or provision of information it is still possible that the indefinite nature of this type of product will mean that proper consideration is not given to the future position of this class of residents.

Objectives of election commitment

The objectives of government action are to:

1. Provide a statutory protection against negative equity.

2. Introduce measures which protect consumers against the specific risks associated with equity release products.

3. Improve decision-making by consumers, to the greatest extent possible, via better access to adequate information regarding the features, costs and implications (both current and future) of equity release products.

4. Facilitate competitive neutrality between reverse mortgages and home reversion schemes.

5. Reduce the risk of regulatory arbitrage and avoidance mechanisms.

6. Ensure that reforms minimise, as far as possible, the regulatory burden on the market and market participants, especially in regard to compliance costs and impacts.

Options

Option 1: Statutory protection against negative equity

As part of the election commitment, the Government has announced it will implement a statutory protection against negative equity. As this commitment is a statutory protection, non-regulatory implementation options are not considered in this RIS.

This option would be implemented under the first part of Phase Two of the consumer credit protection reforms, and in place by mid-2011.

This option would see the introduction of a statutory requirement that lenders be unable to recover amounts from the borrower which exceed the net sale value of the property (except under limited circumstances). If the lender provides for a certain percentage of protected equity under the loan, lenders could not seek to recover amounts from the borrower which exceeds the net sale proceeds of the property minus the amount of the protected equity.

This option would create a universal standard of protection for borrowers across the industry and also clarify for both borrowers and lenders the circumstances in which the protection against negative equity would not apply. This recognises that there are legitimate circumstances under which lenders should be able to protect their security in the mortgaged property. Such conditions would only result in the recoverability of negative equity to the shortfall the breach of such a condition has caused, rather than allowing lenders to recover the full amount of accumulated negative equity.

The conditions which would void the statutory protection include:

- sale of the property in a non arms-length transaction or other transaction not based on commercial terms;

- fraud or misrepresentation by the borrower at the time they enter into the contract or relating to the terms and conditions of the loan; or

- significant wilful damage to the property by the borrower, or a nominated resident.

This option would also provide ASIC with options for enforceability with appropriate penalties and sanctions available. Consumer redress for non-compliance would also be introduced.

Impact on consumers

This option would completely eliminate the risk to borrowers of negative equity, preventing the financial stress and impacts its causes to borrowers, their estate and estate administrators. As this benefit is preventative in nature, it is not possible to quantify its impact.

Consumers will also benefit from enhanced certainty regarding what conditions could void this protection.

Reducing the complexity of the product will also reduce the cost to consumers of obtaining advice on these products.

Since providing negative equity protection constitutes approximately 0.25 to 0.5 percentage points of the interest rate, this cost will be passed onto the borrower. The amount of this cost will vary on a case-by-case basis (depending upon movements in interest rates and house prices and the length of the loan). However, this amount could be in the tens of thousands of dollars.[11]

However, since most lenders already include either the SEQUAL NNEG, or their own negative equity protection as a part of their reverse mortgage products, the cost of this protection is already incorporated into their lending policy and will not be passed on to consumers. New entrants may be affected, but they could address this when establishing their business model, rather than changing an existing model. To this extent, borrowers using such lenders will not have any additional cost passed on them as a result of Option 1.

Impact on industry

Industry will benefit from increased confidence in the integrity of the equity release market as the risk of new entrants marketing aggressive products with risks of negative equity is eliminated.

Since most current reverse mortgage providers already include some form of no negative equity guarantee as part of their lending policy, it is expected that a statutory protection against negative equity will have a limited cost impact.

It may affect new entrants, but they could address this when establishing their business model, rather than changing an existing model. This impact is also further offset, since the recoverability of negative equity is uncertain for any lender and a margin is likely to be factored into the price of the loan product regardless of whether a lender provides a negative equity protection or not.

Option 2: A range of regulatory measures for borrowers of reverse mortgages

Under this option, a range of protections would be provided for reverse mortgage borrowers as described below. No option will ever completely eliminate the risks and information asymmetries borrowers experience with equity release products since there will always be some consumers who enter into a reverse mortgage based solely on meeting the short-term need of obtaining immediate access to credit, regardless of any long term impacts. In these circumstances, the best protections would be those which are most effective for most consumers whilst minimising compliance costs on the equity release industry.

This option would be implemented under the first part of Phase Two of the consumer credit protection reforms, and in place by mid-2011.

[11] For example, if a 65 year old borrower with a property valued at $500,000 takes out a reverse mortgage at an LVR of 15 per cent, at an interest rate of 8 per cent, their total debt at age 85 would be approximately $370,000 (exclusive of ongoing charges). The same borrower, with an interest rate at an additional .5 per cent, would have a total debt at 85 years old of approximately $410,000 (a difference of $40,000).

Applying a range of protections for borrowers using reverse mortgages will create the risk of avoidance and regulatory arbitrage. The circumstances in which the obligations apply will need to be defined in such a way that they cannot be avoided through minor changes to product design or features.

Option 2.1 Reverse mortgage specific responsible lending conduct obligations

Phase One of the credit reforms introduced a requirement on holders of an Australian credit licence to observe responsible lending conduct obligations. These obligations apply to reverse mortgage lenders and persons providing credit assistance such as finance brokers.

These responsible lending conduct obligations prohibit licensees from entering into a credit contract with, or suggesting a credit contract to a consumer, or assisting a consumer to apply for a credit contract that would be unsuitable for the consumer's requirements. A contract will be unsuitable where either it does not meet the consumer's requirements and objectives, or the consumer does not have the capacity to repay the loan, either at all or only with substantial hardship. To determine if a loan meets these requirements, licensees will need to make reasonable inquiries as to the consumer's requirements, objectives and financial situation and take reasonable steps to verify the consumer's financial situation.

Under this option, responsible lending conduct obligations tailored to reverse mortgage products would be introduced. The following matters would be included as part of the licensee establishing the suitability of a reverse mortgage for a consumer's requirements and objectives:

- making the consumer aware that there are alternatives to a reverse mortgage (such as downsizing, Centrelink's pension loans scheme, utilising existing assets, other credit products);
- making the consumer aware that taking out a reverse mortgage may affect their entitlement to government benefits; and
- mandating specific high-level inquiries about the borrowers future objectives (such as aged care, desire to leave equity to their estate, etc).

These additional responsible lending conduct requirements would also introduce two measures which would specifically require credit licensees to canvass with borrowers the long terms costs of the loan and its implication on borrowers. Firstly, licensees would need to provide personalised examples to a borrower of the potential effects of the loan on the equity they have in their property (including changes in house prices and interest rates). This could be achieved by a requirement for licensees to demonstrate specific scenarios to prospective borrowers using a calculation tool through an ASIC reverse mortgage website. Licensees would be required to input certain variables (such as the consumer's age, approximate house price and potential LVR) and the calculation tool would automatically generate a range of scenarios to reflect the specific outcomes in a way that is personalised. The details of the scenarios would be developed through further consultation with stakeholders, but would be intended to demonstrate the impact over time of different choices as to the amount borrowed, and whether it is borrowed as a lump sum or by way of regular instalments.

Currently, the majority of intending borrowers have a face to face meeting with a lender or broker, meaning that the provision of this information would be largely consistent with existing practices.

Secondly, a point would be introduced in the decision-making process of borrowers so that if a borrower wishes to take out a high LVR, they must make a positive election to do so, and specify the reasons for this. This would be done by introducing a presumption that a loan amount above a low risk LVR (calculated using conservative assumptions about changes in house prices or interest rates) would be unsuitable for a borrower's needs and requirements. The presumption could be rebuttable and therefore displaced where some further need was demonstrated before the borrower can agree to a higher LVR. This could be supplemented by further requirements on the lender or the broker in respect of identifying and articulating those needs.

This is intended to address the risk of a borrower taking out a reverse mortgage which carries a greater risk of depleting their home equity without appropriate consideration. It would also require the borrower and the licensee to specifically identify a need for greater funds before applying for the loan.

Impact on consumers

Consumers will benefit from:

- having increased access to information regarding reverse mortgages, and their legal and financial impacts;
- a reduced risk of being offered an unsuitable loan;
- mandated use of an ASIC website demonstrating personalised projections of how different loan options will apply to the borrowers personal circumstances will improve their ability to assess how the loan will impact their current and future requirements; and
- a reduced risk of accessing an LVR which may adversely impact their ability to meet future financial requirements, without adequate consideration.

To the extent that credit licensees will incur costs in meeting these reverse mortgage specific responsible lending conduct obligations, such costs may be passed onto consumers.

Impact on industry

Licensees will benefit from being provided with greater clarity regarding their responsible lending conduct obligations.

The time and cost for credit licensees of providing, or assisting a consumer to apply for a reverse mortgage may increase, as such licensees will be required to meet more robust responsible lending conduct requirements. To the extent that credit licensees already perform these obligations under self-regulation measures, the cost impact of this option will be limited. For example, the MFAA requires its members to have accreditation with SEQUAL as an equity release consultant, meaning such brokers currently perform obligations commensurate with those proposed to be applied under this option. Also, SEQUAL members are required to make available to all borrowers and their advisers a calculation tool illustrating the potential effects of future house values, interest rates and the capitalization of interest on the loan. This requirement is similar in practice to the requirement to use an ASIC reverse mortgage calculator as proposed above.

Option 2.2 Reverse mortgage information statement

Under this option, lenders and intermediaries such as brokers would be required to provide borrowers with a pre-contractual reverse mortgage information statement containing generic information regarding the key features and implications of a reverse mortgage. Such a prescribed information statement would need to be provided to the consumer with sufficient time for them to adequately consider it before gaining further legal and/or financial advice or before entering the contract (for example, upon first meaningful contact with the lender or broker). This information Statement would not be a PDS as defined in the Corporations Act. Nevertheless, the proposed approach is informed by the broader analysis of disclosure undertaken in relation to other products, and the desirability of information being short and high impact. The exact length and content of this Information Statement would be determined after further consultation, but would not need to be more than four A4 pages and could include the following:

- a description of a reverse mortgage and its key features. For example it is a loan which must be repaid, secured by a mortgage over the borrowers property, how repayment may occur.

- the cost of the loan, including entry, ongoing and exit costs and an indicative break fee under a fixed interest loan described in dollars.

- description of compound interest and how it affects the amount repayable under the loan. This could include a statement that it involves being charged interest on the interest and a brief example of the effect of compound interest on a typical loan.

- explicit cautions about potential risks. This could include over-depleting equity, possible implications for pension entitlements, limiting future options, non-title-holding residents' rights and effects on inheritances.

- client examples. This could include examples of situations which would be common to most borrowers and demonstrate which loan may suit which loan purposes (e.g. borrower taking loan as a regular income stream to supplement their income, or as a lump sum to pay for renovations). This could also include a borrower "worst case scenario" where a borrower has insufficient equity to meet their aged care costs to prompt an applicant to consider more carefully the long-term effects the loan may have for their future personal circumstances.

- indicative illustrations of loan options (using graphs). This could include how taking out a reverse mortgage as a lump sum, line of credit or regular payment affects the amount repayable under the loan, and provide different scenarios regarding changes in interest rates and house prices.

- generic information regarding how taking out a reverse mortgage product may effect a borrower's pension entitlements.

- sources of further information: e.g. ASIC, Centrelink (Financial Information Service), National Information Centre on Retirement Investments (NICRI), SEQUAL.

- a checklist for consumers: could include questions about alternatives such as downsizing and possible questions consumers could ask legal and financial advisers.

Impacts on consumers

Under this option, consumers will be in a better position to make informed decisions regarding the appropriateness of a reverse mortgage to their personal circumstances via receiving timely, simple, and standardised information to educate their decisions. In particular, this will facilitate comparison between the borrower's current and future needs and how the loan will affect their ability to meet such needs.

The benefit to consumers will vary on the financial literacy of each consumer. More financially literate consumers will benefit relatively less as they are more likely to already understand the risks and implications which characterise equity release products. However, less sophisticated consumers will be able to improve their understanding and decision-making via the use of the information statement. Previously disengaged consumers of all levels of financial literacy may become more engaged as a result of the availability of the information statement. However, a portion of borrowers may choose not to read the information statement, although industry experience suggests that this is an area where borrowers are more likely to read information provided to them..

Impacts on industry

Currently, SEQUAL members are required to provide potential borrowers with the SEQUAL Key Facts document. SEQUAL has indicated that they expect their members would substitute the use of this SEQUAL document with the document prescribed under this option. To that extent, transitional costs for lenders may be incurred; however, ongoing costs can be absorbed into existing practice.

Option 2.3 Excluding certain default clauses

Under this option, lenders would be prevented from including the below matters in their default terms leading to enforcement action in their reverse mortgage contracts:

- cross default (e.g. being in default with a different credit contract with the same lender);
- failure to inform the lender that another person is a resident in the property;
- failure to pay for any contingent cost under the loan, such as a periodic home valuation; and
- a clause which does not expressly state the borrower's specific obligation.

Impacts on consumers

Consumers will have greater clarity regarding what circumstances can result in a default and have a reduced risk of incurring a default for minor reasons or matters not connected with the loan.

To the extent that lenders incur transitional costs in ensuring their reverse mortgage contracts comply, such costs may be passed onto consumers.

Impacts on industry

Providing advice to consumers on the effect of default clauses for professional advisors such as lawyers will be less onerous, as default clauses will be simplified.

Existing lenders will incur transitional costs in the short term, in ensuring their contracts comply with default clause obligations. New entrants could address this when establishing their reverse mortgage contracts, rather than altering existing contracts.

Option 2.4 Mandatory default procedure

Under this option, a uniform default procedure would be mandated across the reverse mortgage industry requiring lenders to personally contact, or make reasonable attempts to contact, the borrower (or their legal representative) before the expiry date of a default notice and ensure the borrower has received the notice and understands the consequences of not rectifying the default.

Impacts on consumers

Consumers will have a reduced risk of default as borrowers are better informed when they are in default and how to remedy it. This will particularly benefit those borrowers who have fallen into default as a result of being incapacitated due to illness and/or hospitalisation.

Impacts on industry

Lenders will not incur enforcement expenses for defaults which are remedied as a result of the mandatory procedure.

Since SEQUAL members comply with a similar obligation, it is expected this will have a limited cost impact on these current lenders.

Option 2.5 Improving post-contractual information

Under this option, the ongoing disclosure regime under the Code would be tailored for reverse mortgage borrowers. The additional disclosure content would cover issues such as the status of any non-title holding residents under the loan and ongoing obligations of the borrower under the contract such as property maintenance, property valuations, and especially those obligations that trigger default or void any no negative equity protection.

Impacts on consumers

Consumers will be better informed regarding the ongoing obligations of the reverse mortgage during the course of the loan.

Impacts on industry

Existing lenders will incur compliance costs in ensuring their ongoing disclosure documentation complies with this option. New entrants could address this when establishing their business model and practices, rather than altering existing practice.

Option 2.6 Requirements relating to non-title holding resident protections

Under this option, if a lender elects to provide legal recognition to the tenancy of a non-title holding resident, such a resident must be designated as a nominated resident under the loan contract, upon the request of the borrower prior to entering the loan. In order to qualify for this, the non-title holding resident would need to be at or above the minimum age required to be a borrower under the loan.

Those lenders who do not provide non-title holding protections will be required to disclose this to consumers before entering into the loan.

Impacts on consumers

Borrowers will be better informed regarding the protections available under the loan to non-title holding residents.

Impacts on industry

Currently, lenders are not required to disclosure to borrowers pre-contractually the rights of non-title holding protections. Therefore, lenders will incur transitional costs in incorporating this requirement into their pre-contractual processes. Any new lenders could address this when establishing their business model and practices, rather than altering existing practice.

Option 2.7 Mandatory legal advice to borrowers

Under this option, a regulation making power will be inserted into the Credit Act to require consumers to obtain independent legal advice before entering into a reverse mortgage or home reversion scheme product. This would be achieved by consumers being required to seek legal advice from a provider of their choice (for example, their family solicitor or other solicitor of their choice). The commencement of this obligation would be implemented via Regulation, and would depend on further consultations with Law Societies to address factors such as the costs implications or maximising the extent to which specially accredited lawyers are able to provide the advice.

Impacts on consumers

Currently, only SEQUAL members require borrowers to obtain independent legal advice before entering into the loan. This option mandates such a requirement across the whole industry, ensuring that all borrowers obtain such advice regardless of whether or not their lender is a SEQUAL member.

All consumers would therefore, have improved access to legal advice regarding the implications of the loan.

The cost of entering into the loan will increase as borrowers are required to meet the cost of obtaining the legal advice. This cost can range between $300 and $1,500 depending upon the solicitor the borrower uses and the solicitor's familiarity with equity release products.

Impacts on industry

SEQUAL members already require borrowers to obtain legal advice before entering into the loan. Therefore, this option will have no effect beyond current practice for those lenders and will not increase the time and cost of entering a borrower into a loan.

Option 2.8 Mandatory financial advice for borrowers

Under this option, consumers would be required to obtain independent financial advice before entering into a reverse mortgage. This could be achieved by consumers being required to obtain advice from a financial planner of their choice, either as part of an overall financial plan or specifically in relation to the product.

Impacts on consumers

Currently, SEQUAL members recommend borrowers should obtain independent financial advice before entering into the loan. This option would mandate a requirement to obtain such advice across the whole industry, ensuring that all borrowers obtain such advice. This would significantly increase the number of borrowers accessing independent financial advice and increase the information available to borrowers regarding the short and long term financial impacts the loan would involve on the borrowers personal circumstances.

Currently, approximately 5 per cent of borrowers access their reverse mortgage via a financial planner. Therefore, mandating such a requirement will add a new step into the process of entering into a loan for approximately 95 per cent of borrowers.

The cost of entering into the loan will increase as borrowers are required to meet the cost of obtaining the financial advice. The cost of this will depend on whether the borrower obtains this advice in regard to entering into the reverse mortgage only or in regard to a full financial plan. However, it is expected that the cost would be several hundreds of dollars at a minimum. As few borrowers currently use a financial planner, and seek to use a reverse mortgage because they have no ability to service a traditional loan, there is potential that this cost may discourage many borrowers from seeking advice.

Impacts on industry

Currently, financial planners are only advising approximately 5 per cent of reverse mortgage borrowers. Mandating this requirement for every borrower will require the financial planning industry to engage with reverse mortgage products to a much larger extent. If this did not occur, the supply of such advice would not meet the demand, creating a bottleneck of potential borrowers waiting to apply for a reverse mortgage.

Option 3: An information campaign

Under this option, an information campaign directed at seniors would be conducted to raise their understanding of equity release products. This could be achieved by increasing the scope of current sources of information provided to consumers by Government agencies such as ASIC or Centrelink, or by the Government funding information campaigns conducted by independent bodies such as the Council on the Ageing or the National Information Centre on Retirement Investments (NICRI).

Such a campaign could involve:

- seminars in locations across the country, particularly in major cities where most reverse mortgage borrowers are located;
- a public telephone service such as the Equity Release/Reverse Mortgage Information Service currently operated by NICRI (which will cease operation in mid-2011);

- publishing information in existing print media and especially seniors publications; and
- the production and distribution of materials to seniors.

Option 4: Applying regulatory measures to home reversion scheme products

In order to address consumer information asymmetry and facilitate competitive neutrality between reverse mortgages and home reversion scheme products, this option largely applies options 2.1 to 2.7, with adjustments for differences in product structure (for example there is no need to apply a statutory protection against negative equity to a home reversion scheme product).

Under this option, the following requirements would be applied to home reversion scheme providers:

- Requirement to be licensed with ASIC and have membership with an ASIC-approved external dispute resolution scheme.
- Requirement to provide consumers with a home reversion scheme specific information statement prior to the consumer entering into the contract.
- Meet certain responsible conduct requirements prior to offering to enter into a contract with the consumer. Such a requirement would mirror the responsible lending conduct requirement under the Credit Act that a borrower not be offered a credit product that would be unsuitable for their requirements.
- Require applicants to obtain independent legal advice prior to entering into the contract.
- Requiring providers who do not offer tenancy protections for non-title holding residents to disclose this to consumers before they enter the contract. If providers do offer tenancy protections for non-title holding residents, they will be required to offer this in a mandated way.

Impact on consumers

Seniors applying for a home reversion scheme product would benefit in the following ways:

- The requirement to provide a home reversion scheme specific information statement will allow consumers to be better informed about the long term costs and risks the home reversion product creates for their long term situation and will be in a better position to decide whether the contract meets their requirements and objectives.
- The requirement for providers to meet responsible conduct obligations will facilitate consumers not being placed into unsuitable home reversion schemes. If a consumer is placed into an unsuitable home reversion scheme, remedies would be available to them to compensate for any loss or damage they suffer as a result.
- ASIC's ability to licence home reversion scheme providers and, if appropriate ban a provider, will ensure that only reputable and competent operators supply products to this market.

To the extent that providers incur transitional costs, these could be passed onto consumers.

Impact on industry

This option ensures competitive neutrality between reverse mortgage and home reversion scheme products, ensuring that the equity release market is not distorted in either the supply or demand for these products by government action.

Improving protections for consumers will also improve consumer confidence with home reversion schemes and consequently, the creditability and reputation of the home reversion industry.

As providers of home reversion schemes are not currently subject to these obligations, they will incur transitional and ongoing compliance costs. For example, in regard to obtaining membership with an EDR scheme, the application cost of membership to the Financial Ombudsman Service (FOS) for a credit licensee is $220 with a yearly membership fee based upon the size of the business. The only current provider of a home reversion scheme, Homesafe Solutions Pty Ltd is already a member of FOS and will therefore not incur these costs as a result of Option 4. However, new entrants not already FOS members will incur this cost.

Home reversion scheme providers will also incur costs in obtaining and renewing a licence with ASIC. The cost of this will vary for each individual provider and largely depend on the volume of their business.

Implementation Strategy

The Government has committed to have the election commitment in place by mid-2012. This will be achieved via the recommended options being progressed under the first part of Phase Two of the consumer credit protection reforms, and in place by mid-2011. Specific transition and implementation issues will be progressed in consultation with industry via the specialist equity release consultation sub-group discussed below and be in place by mid-2012.

The implementation of options relating to home reversion schemes will involve a referral of power from the states to the Commonwealth. This will be progressed via the Financial Services and Credit Implementation Taskforce (FSCRIT) which comprises representatives of Commonwealth, state and territory departments and agencies.

Consultation

The Government has conducted extensive consultations in the development of enhancements to the regulation of equity release products. The main forum of consultation has been the Equity Release Consultation Working Group (ERCWG) convened by the Department of the Treasury since February 2010. The membership of this group consists of SEQUAL (the main industry body for reverse mortgages and home reversion scheme products), major industry bodies such as the Mortgage and Finance Association of Australia and the Financial Planning Association, as well as seniors, legal and consumer group representatives (a full list of membership is provided at Attachment A).

The members of the ERCWG who submitted responses to the Green Paper were the Royal Bank of Scotland (RBS), Commonwealth Bank (CBA), Westpac Bank, Homesafe Solutions Pty Ltd, SEQUAL, the MFAA, the FPA, Consumer Credit Legal Centre (NSW) (CCLC), Council on the Ageing (COTA), National Legal Aid (NLA), and NICRI. In general, these consultation stakeholders have expressed in-principle agreement with the election commitment, considering such protections as facilitating consumer confidence in the equity release industry and promoting responsible use of these products by seniors. Their main views as detailed in their Green Paper submissions are outlined below.

Industry representatives

The main industry body SEQUAL and its members who made submissions support options such as a statutory protection against negative equity, mandatory default procedure, mandatory legal advice for borrowers, and improving pre-contractual disclosure via an information statement.

In regard to the regulation of home reversion schemes, all these stakeholders (including the only current provider of the product in Australia, Homesafe Solutions) agree that home reversion schemes should be regulated consistently with reverse mortgages, to reduce compliance costs and regulatory arbitrage between these products.

Homesafe Solutions supports home reversion schemes being subject to their own regulatory regime, rather than subject to the same regime as reverse mortgages. It supports the options of an information statement being provided to consumers and an obligation for consumers to receive independent legal advice. However, it also does not support a 'one-stop-shop' delivery of all legal and financial advice to borrowers.

Professional bodies

The FPA and MFAA agree that there is a need for a statutory protection against negative equity, however, the MFAA considers that such a protection is achieved usually by a higher interest rate.

The FPA also considers there is a need for standardised default clauses, mandatory non-title holding protections and specific responsible lending obligations applicable to reverse mortgage providers and intermediaries. The FPA is of the view that any reforms which simplify the structure of reverse mortgages are important, as this will reduce the time and cost of giving advice on these products.

The FPA supports regulatory consistency between home reversion products and reverse mortgages whilst the MFAA does not consider they should be subject to the same regulation.

Consumer, legal and seniors groups

There was in-principle agreement amongst these stakeholders with most reforms canvassed under the above options (although not all these stakeholders commented on each option).

COTA has expressed concern that the cost of obtaining independent legal and/or financial advice could be prohibitive for borrowers and that this needs to be addressed.

CCLC, NLA and NICRI support a requirement for borrowers to obtain legal and financial advice before entering into the loan, with NICRI being government funded to deliver this service.

Regulator

ASIC, as regulator of the consumer credit regime, has been a member of the Equity Release Consultation Working Group and has provided feedback at all stages of the development of these options.

Conclusions and recommended options

The below are recommended options:

- Option 1: Statutory protection against negative equity;
- Option 2.1: Reverse mortgage specific responsible lending conduct obligations;
- Option 2.2: Reverse mortgage information statement;
- Option 2.3: Excluding certain default clauses;
- Option 2.4: Mandatory default procedure;
- Option 2.5: Improving post-contractual information;
- Option 2.6: Requirememts relating to non-title holding resident protections;
- Option 2.7: Mandatory legal advice; and
- Option 4: Applying a range of regulatory measures to home reversion scheme products

Costs and benefits of recommended options

Benefits

The below summarises the benefits of the recommended options

- Option 1: Statutory protection against negative equity. This option directly achieves the Government's objective under the election commitment of establishing a statutory protection against negative equity. It would also eliminate the risk to all borrowers of incurring negative equity.
- Option 2.1: Reverse mortgage specific responsible lending conduct obligations. This option will address borrower information asymmetry and facilitate their improved decision making by requiring credit licensees to discuss with borrowers the specific risks associated with equity release products and how it may affect their situation. Importantly, this option achieves the objective of making borrowers more aware of how the loan may affect their future financial situation, and not just their situation at the time they enter into the loan.
- Option 2.2: Reverse mortgage information statement, Option 2.5: Improving post-contractual information and Option 2.6: Requirements relating to non-title holding resident protections:
  - These options are recommended as they meet the government's election commitment of providing borrowers with greater disclosure of the features and fees on reverse mortgages.

- These options would address the problems of borrower information asymmetry regarding the legal implications of a reverse mortgage, especially via better disclosure regarding the rights of non-title holding residents, and the borrowers' ongoing obligations under the loan.

- It would also address the information asymmetry relating to the financial implications of entering into the loan, both current and future, by proving explicit information to the borrower of the long term affects of the loan and how it may affect their ability to meet future requirements.

• Option 2.3: Excluding certain default clauses and Option 2.4: Mandatory default procedure:

  - These options are recommended as they meet the objective of protecting consumers against a specific risk associated with reverse mortgages, that is the effects of current default clauses and procedures.

• Option 2.7: Mandatory legal advice:

  - This option is recommended as it would meet the Government's objective of improving the decision-making of consumers by facilitating access to information regarding the legal implications of entering into the loan.

• Option 4: Applying a range of regulatory measures to home reversion scheme products:

  - This option is recommended as it meets the Government's election commitment of introducing specific protections to seniors using home reversion schemes.

  - It also meets the objective of facilitating competitive neutrality between home reversion products and reverse mortgages, since it applies comparable requirements on providers of both products.

Costs

The above options are also recommended as they meet the Government's objective of ensuring the reforms minimise the regulatory burden on the market, especially in regard to compliance costs. To a large extend, the current equity release market already meets many of the requirements involved in these options under industry self-regulation measures. Therefore, transitional costs will be incurred; however, the ongoing requirements for the majority of the equity release industry can be substantially adapted to existing practice.

The highest cost to equity release consumers would relate to the cost of obtaining independent legal advice, which (depending on the solicitor providing the advice) could be several hundreds of dollars.

However, since SEQUAL members already require borrowers to obtain legal advice before entering into a reverse mortgage, this is already a cost being meet by the vast majority of current borrowers.