Releasing home equity a financial health hazard

Noel Whittaker

Rising life expectancies and increasing living expenses mean many Australians find themselves becoming asset rich but cash poor as they get older.

One solution is to downsize to a smaller property but you need to own a high-priced home to make that work, as the cost of changing homes is high.

Over the past 20 years, there have been numerous attempts to create products to enable retirees to unlock some of the equity in their home while still living in it. One is a reverse mortgage in which the homeowner borrows a fixed sum and makes no repayments of principal or interest. The downside is that when compounding kicks in, the debt grows at a faster and faster rate.

However, there is another flaw with reverse mortgages. They are offered at variable interest rates, which leaves borrowers open to serious problems if rates move up.

In an attempt to overcome this problem, some lenders in 2006 started offering reverse mortgages with an interest rate fixed for life.

However, after the global financial crisis hit rates started tumbling. That's frightening news if your loan was fixed for life – the lower rates went, the more expensive it became to quit such loans.

"Exit fees" are subject to a wide interpretation. They depend on a range of factors, including the life expectancy of the borrower and the date at which they might be expected to enter aged care.

Shirley (not her real name) went with her husband to an evening at a seniors' club in 2006 to hear about money that could be obtained by releasing home equity. They signed up to borrow $100,000 from Bluestone Group with an interest rate of 8.59 per cent a year fixed for life.

Fast forward 13 years and the $100,000 debt has grown to $242,000. And the break costs to get out of the loan are now a further $126,500. That's a total of $368,500 for a loan of $100,000.

In their letters to Shirley, Bluestone argues that their money for the loan was funded from external sources and, by charging a break fee, they would be simply passing on what it would cost them if the loan was paid out early.

Pam also took out a reverse mortgage with Bluestone for $37,500 at a rate of 8.39 per cent fixed for life. Her debt has grown to $110,700 and her break fee is more than $100,000.

What are the options for borrowers like Shirley and Pam? The bottom line is they are stuck with an increasing reverse mortgage debt and an expensive break fee.

Reverse mortgages are required to have a "no negative equity" clause, which means that the debt may not exceed the value of the property if it is sold. Therefore, the worst that could happen is that on the borrower's death, the house would be taken in full satisfaction of the loan.

There is also a clause stating that exit fees will be waived if the borrower goes into aged care.

Bluestone's documentation on these loans is immaculate: the borrowers were required to sign a statutory declaration that they had sought legal advice, and were aware there would be "significant" fees if the loan was paid out early.

Reverse mortgages have numerous problems.
Photo-illustration: Dorothy Woodgate

And where is Bluestone while all this is going on? It has repeatedly refused all requests to comment.

More than 13 years after customers entered into lifetime reverse fixed-rate mortgages, Bluestone is legally able to charge them rates of 8.59 per cent and 8.39 per cent.

Even though the company has no legal responsibility, the fair thing to do would be to reassess the situation in the light of record low rates and offer its customers a reasonable break fee.