Shared home equity worth a look for retirees

The Baby Boomers are rushing headlong towards retirement and beyond, but a yawning gap between lifestyle expectations and what their savings pools will provide is increasingly evident. The asset in which most have a disproportionate percentage of their wealth, the family home, commands a high level of underutilised equity when it could help to fund retirement lifestyles.

Innovation to develop more efficient financing solutions for the retirement savings sector has never been more in need, and the market is responding with interesting products.

Gap between desired lifestyle and savings

The damage from the GFC continues to have an impact on retirees. While most investors were well aware that equity markets would not keep rising forever, few expected they would unravel as much as they did. Poorly timed market exits and entries and interest rates falling to record lows have seen many investment portfolios significantly diminish in value and investors struggling to rebuild value. Risk aversion has become the safe option, keeping investors out of the market and missing out on the benefits of the recent recovery.

There is more pressure at the other end of this funding gap. Increased longevity as a result of medical advances means our retirement savings need to last longer. According to the ABS, in 1960 average life expectancy for males at birth was just 69, whilst today, men can expect on average to live to 81, and women can look forward to living even longer, until 86. On current trends, every 10 years that passes delivers two additional years to fund in terms of life expectancy.

Releasing some of the equity tied up in the family home is worth considering as a means of bridging this funding gap, but it is surprising how little this is used. According to RP data, residential housing is the largest single asset class in Australia worth about $5 trillion, over three times the value of all listed Australian equities. Yet in a report commissioned by the Senior Australians Equity Release Association (SEQUAL) in September 2013 entitled, "Australia's equity release market – an opportunity being missed", Deloitte reported the total reverse mortgage market, by far the most common form of equity release, was valued at only $3.5 billion, with an average loan size of $84,000.

A reverse mortgage essentially allows home owners to borrow against the value of a residence, to deliver either a lump sum or an income. Repayment of this loan occurs when the home is eventually sold, vacated (typically on moving into a retirement village) or the last surviving owner passes away. Until then, which can take a long time, the interest capitalises to the loan balance.

Reverse mortgages have their shortcomings. While base interest rates are currently low, lending margins remain high, with reverse mortgage rates generally over 7% compared with normal mortgages around 5%. Retirees also have to overcome their own concerns and those of the next generation that a reverse mortgage is tantamount to selling the family jewels. However, Deloitte argues that a growing number of older Australians are finding the benefits of reverse mortgages in allowing them to travel, renovate homes or enjoy new found freedom.

Downsizing is one obvious alternative option for releasing home value, however such a move is often emotionally unpalatable, disruptive and the transaction costs are high.

Sharing family home equity

Another area of home equity release called ‘shared equity’ is growing, including various products called shared equity mortgages, home reversion and shared appreciation mortgages.

Shared equity enables homeowners to sell a percentage of their residence to receive cash or an income today and on eventual sale or death, the loan settles. The borrower (retiree) forgoes some of the capital appreciation and the lender (investor) earns it instead. There are many permutations of this structure to balance the borrower and lender risk/return dynamics, ranging from a rental stream on the sold portion to a variation of a call option structure to redistribute the risk/return between access and ownership. These products may reduce some of the interest cost compared with reverse mortgages, especially the unexpected consequences of long term compounding. The amount owing on a loan will double in 10 years compounding at 7%.

There are also products where, in exchange for the receipt by the owner of an income stream, the investor is given the option to purchase the home at an agreed price based on certain trigger events. An example may be on a home worth $700,000, an investor pays $1,250 per month for the right to acquire the home at this agreed value when the owner dies or otherwise leaves the property. The investor has to accept that the owner may live for another 25 years or more. The owner receives an income stream and a predetermined price for the rest of their lives, while the investor has the upside in the value of the home. Combinations of shared equity and income are possible.

The shared equity market is not yet deep, but there are compelling reasons for it to develop:

- Life companies, superannuation funds and insurance companies seek increased diversity and long dated assets to offset risk. A portfolio of residential property via shared equity is typically long dated and it offers attractive portfolio diversity.

- Entry to the Australian residential property market has always suffered from affordability challenges. Shared equity could be a partial solution to this vexed problem, delivering an effective 'rent and buy' programme, or a lower entry cost. Apart from this, governments seeking to ease the funding burden of providing social housing could also benefit by attracting investor funds to the sector, albeit with some continuing government support.

- From the retail investor perspective, creating an asset that derives a return linked to Australian residential property has a wide appeal. Authorised deposit taking institutions could offer would-be home buyers a savings product as a means of accumulating deposits. It would give the 'negatively-geared investment property' market some competition that is not constrained by size, and that delivers the same benefits as conventional property investments without the need for a large capital commitment, concentration in a single asset or maintenance costs.

Shared equity offers compelling and complex opportunities. As retirees want to fill the gap between income and expenditure in retirement and the trend towards self-funded retirement continues, the time seems increasingly right to deliver a more efficient solution for retirees and investors around an underutilised asset, residential property.

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