

Legal Practitioners' Liability Committee

ADVISING ON REVERSE MORTGAGES & OTHER EQUITY RELEASE PRODUCTS

“*Equity release products*” is a generic name given to a range of financial products now being offered by lenders.

As the term “equity release” implies, the property owner trades or releases some of their equity in the property in return for a financial benefit from a third party (a lender).

The financial benefit could be in the form of a lump sum or regular payment or a combination of both.

1. PRODUCT TYPES

There are 3 main types of product currently in the market

Reverse mortgage

Conceptually, this is the simplest type of equity release product.

In a reverse mortgage, the lender receives no repayments of either principal or interest whilst the owner lives in the property, and has no right to sell the property so long as there is no default under the loan terms and conditions. Instead of the loan amount reducing as repayments are made, interest and other costs are capitalised, with no repayments required until the borrower dies or permanently vacates the property.

In essence, the lender is offering a lump sum of money now in exchange for the right to receive a larger sum of money in the future – and is betting on the chance that the value of the property over which it takes a mortgage will be sufficient at the end of the loan (whenever that might be) to protect it from making a loss.

The major variables in this type of arrangement are:

- (a) the life expectancy of the borrower (looking at both age and health)
- (b) the amount of the loan
- (c) the rate of interest applying to the loan
- (d) the value of the mortgaged property over time.

As a rough guide, reverse mortgages are generally available to consumers over 60 years of age (sometimes 55) who own their own home, with the amount of borrowing usually restricted to between 15% - 50% of the total property value depending on the age of the applicant(s), but as a rule of thumb, progressively increasing by 1 extra percentage point for each year of age. At 60, lenders will advance 15-20% of the property's value, rising to about 50% at age 80-85.

The documentation involved is generally an ‘*all monies*’ mortgage in conventional form,

coupled with a loan agreement incorporating terms and conditions that relate to the specific features of the reverse mortgage transaction. The loan terms and conditions and loan schedule need careful review.

One of the biggest risks with a reverse mortgage is the potential for increases in interest rates on compound interest to significantly erode, if not exceed, the retiree's equity in the property.

Home reversion scheme

Sale and lease

In this scenario, the retiree sells all or part of the property to a lender (or reversion company) at a reduced market price in exchange for a sum of money (both a lump sum and an annuity) and a life interest to reside at the property. The important feature of a 'sale and lease' home reversion scheme is that there is an immediate sale of the property and transfer of title to the lender.

Sale and mortgage

In a 'sale and mortgage' scenario, the retiree (the vendor) sells a percentage of the property's future sale price to a purchaser (financier) in return for a lump sum. Title remains in the vendor's name, but the purchaser's interest in the property is secured by a mortgage registered on title so as to prevent the retiree from dealing with the property without the purchaser's permission.

Home reversion scheme products, whether of the sale and lease type or sale and mortgage type are extremely complex products.

Shared appreciation mortgage

The LPLC is not aware of any of this product type currently being offered in Australia. It has been available overseas, and is a type of product not particularly directed at those of retirement age, but those looking to enter the property market for the first time who cannot afford to either buy their own home or raise the necessary funds to do so as a result of having insufficient income to service the necessary loan on their own

The lender reduces or waives the interest payable by the borrower on some of the monies borrowed to acquire the property, in exchange for a share of the capital appreciation on the property.

One susceptibility with shared appreciation mortgages is that consumers may regret some years later having "given away" their equity too cheaply if property values rise, and the increase enures to the benefit of the lender instead of the borrower.

2. MARKETING OF EQUITY RELEASE PRODUCTS

The target market for these products is cash-poor retirees.

Australians, particularly those of the current retirement age, have a strong emotional attachment to the security of owning their own home.

Lenders use evocative images to entice their market. However, the truth is that:

- Equity release products are not free. They are more expensive forms of finance than a conventional mortgage loan, probably much more expensive.
- They put the retiree into debt.
- They give the lender a right to evict the retiree from the home in certain situations.
- Equity release products should be considered only after other (better) options have been exhausted.

The mere availability of this type of finance to retirees also opens up opportunities for the unscrupulous to pressure retirees into taking out an equity release loan for the benefit of others. Much of the marketing material already promotes this possibility – e.g. taking out a loan to make a gift to the children or pay for the grandchildren’s education expenses. It’s not all that far from suggesting that retirees utilise a reverse mortgage to support a family member’s business enterprise. And that leads right back into Amadio territory.

In their marketing documents, lenders emphasise the importance of borrowers seeking independent legal advice. The experience related to the LPLC by many practitioners is that at Bank branch level, customers are often told the trip to the solicitor to witness the documents “should only take 5 minutes”.

It is important to treat any request for advice in this regard in a professional and businesslike manner. Correct any misapprehensions the client might have about the nature of the solicitor’s role, and set the client’s expectations straight.

3. LIABILITY RISKS FOR SOLICITORS

All equity release mortgage products require that the borrower/retiree obtain independent legal advice.

The borrower looks to the solicitor for advice on the nature and effect of the transaction and for particular risks of which he or she should be aware.

The lender also looks to the solicitor to advise the client, so as to perfect the lender’s security in the sense that independent legal advice prevents the client from later challenging the transaction or the security.

Accordingly, the solicitor acting for the borrower/retiree is central to whether or not the transaction proceeds.

Understanding the transaction – recognise what is involved

One of the biggest risks is failing to.

Equity release products have a vast array of names. Regardless of the product name, it is important to identify the type of product at hand:

- Is it a loan, a mortgage, a sale of property or a combination of each:
 - Reverse mortgage – a mortgage and loan agreement
 - Home reversion scheme – depends on the model:
 - Either an immediate sale and lease; or
 - A deferred sale and mortgage
 - Shared appreciation mortgage

Refer to the discussion under “Product Types” above for more details of the salient feature of each.

- If the transaction involves a sale, what protection does the client have to remain in the property, and what happens to the title?
- If the loan involves a mortgage only, in what circumstances can the mortgagee’s power of sale be exercised, and in what circumstances might the debt exceed the value of the property, and can the client go into ‘negative equity’?

It is necessary to read and review the documents presented to the client, as the product terms are continually changing, and there is nothing that could be described as a standard product or of standard form.

Are you offering your client independent advice?

A threshold question is whether your advice to the client is independent.

Be careful not to advise borrowers on the terms of documentation in circumstances where your firm has a relationship with the lender, the promoter, or an intermediary who has an interest in ensuring the sale of the product to the client such that your advice may later be viewed by others as not having been entirely independent, or given without full disclosure of the nature of any relationship having been made.

Another problem can arise when lenders promote their product offerings via public seminars or information evenings. The LPLC has heard stories of solicitors who have been invited to attend such evenings by promoters or financial intermediaries, ostensibly for the purpose of providing advice to clients who might be thinking of taking out a loan. The upside for the solicitor is portrayed as a marketing opportunity. However, this can be a dangerous thing for a solicitor to do, because the perception created by the fact that the solicitor is present on such occasions, whether it be true or not, is that there is an association with the promoter and arguably give rise to a conflict of interest, or at the least, an allegation of a conflict.

The safest rule is to maintain absolute independence.

Another point is that equity release products are a relatively new phenomenon in Australia. The market is experiencing rapid growth, and lenders are out there competing aggressively for market share. Products are continuing to evolve – terms and conditions are changing and new products continue to emerge on the market. In order to expedite transactions, there are lenders who are looking to associate themselves with solicitors who have familiarity with their documents. Beware of lenders who are looking to align themselves with solicitors in this way – it has the capacity to create perceptions of a lack of true independence.

Distinction between legal advice and financial advice

It is often difficult to mark a clear distinction between legal advice and financial advice. Cash-strapped retirees have to weigh up a range of variables – life expectations; their state of health (both present and future) and in particular when they might conceivably not be able to continue residing in their own home and need aged care or nursing accommodation; the extent to which they have financial means other than the home in order to fund their lifestyle; as well as the personal choices they might wish to make to benefit the next generation in a testamentary sense.

None of these questions necessarily bespeak easy answers, and good financial advice and guidance is essential. Lenders strongly recommend that borrowers obtain independent financial advice, but not all insist upon it.

What is the role and obligation of the solicitor presented with documents for execution and charged with the task of advising the client? The answer will depend on the circumstances of each case. However, it is suggested that the solicitor's role would include:

(a) An explanation of the nature and effect of the transaction at hand.

Insofar as a reverse mortgage is involved, the explanation will cover the main terms of the loan, the nature of a mortgage securing the loan, the legal effect of what it means to mortgage one's property, the circumstances in which the loan and the mortgage must be repaid, and the obligations of the borrower to make sure that (s)he does not trigger an event of default.

The solicitor would also explain that because no repayments are required during the life of the loan, interest will accumulate at a compounding rate on the balance outstanding, and that (if the loan is at a variable interest rate) that if interest rates rise, the compounding effect of interest will more quickly erode the borrower's equity in the property. Explain that it is a more expensive form of finance than a traditional mortgage loan.

Insofar as a home reversion scheme is involved, the explanation will likewise cover the nature and effect of the documents which together constitute the

transaction. As such products are inherently more complex than a reverse mortgage, the key for solicitors will be to communicate the mechanics of how the scheme works so that the client can understand the major areas that will impact on the ultimate cost of the loan. With such products, the LPLC's view is that solicitors should strongly advise the client to seek independent financial or accounting advice, since the solicitor will not usually be qualified to express an opinion on whether or not 'the deal' is a good one for the client, nor whether another product might better suit the client's circumstances.

(b) Consideration of whether the client understands the explanation and the risks.

This is making sure the client has thought through what he or she is doing.

The lawyer applies his or her common sense and experience in looking at a transaction from a professional distance, making sure that the client is acting rationally and responsibly, and if not, then taking proper steps to alert the client to the risks which the client is proposing to take by entering into the transaction.

The ultimate decision to proceed or not then rests with the client, properly advised and warned.

(c) Consideration of whether the client is under any external pressure or influence.

Situations that might typically cause a solicitor to be alert to possible influence from others include:

- When the client is borrowing money for the benefit of a third party, or to gift to a third party, and there are objective indications of pressure or influence from others (e.g. family members).
- When the client is physically or mentally infirm.
- When the client is dependent upon family members to look after their financial affairs.
- When someone wants to provide instructions and sign documents on behalf of a client pursuant to a power of attorney.
- When there are communication difficulties because English is not the client's first language.
- When there is family division, typically between the client's adult children.
- When the client is in an inexplicable rush to complete the transaction.

Maintain a paper trail

The LPLC recommends that solicitors maintain a clear paper trail of the instructions received, presumably in the form of a detailed file note, followed by a letter of advice to the client confirming the main aspects of the transaction and the advice given. Written advice is preferable because an elderly client might well need time to absorb complex advice with an opportunity for reflection.

In addition, having a document trail to evidence attention to the following matters could be helpful from a risk management perspective:

- Checking that the client has considered their various options. The options could be downsizing – selling and moving to a new house; making do with limited means; or exploring alternative sources of finance such as government schemes or family members.
- Instructions about the client's particular circumstances – their station in life, state of health, their relationship with family members and broad details of their financial circumstances.
- Instructions as to the purpose for which the client is requiring the funds, and whether the reason withstands objective scrutiny – in particular whether the client is being placed under pressure from family members. Who is getting the benefit of the money?
- Discuss also in general terms that an equity release product, whilst providing cash now, may cut off other options later in life and rob a client of flexibility when it might really be needed. For example, has the client thought about whether he or she estimates whether he or she will have enough money left to buy an aged care accommodation bond?

Fees

A solicitor should render professional fees that fairly represent the value of the solicitor's service and the responsibility undertaken. Rendering no charge, or only a nominal fee, might well found an allegation later that insufficient attention was paid to the client's situation.

4. REVERSE MORTGAGE PRODUCT ISSUES

Date of repayment

Reverse mortgages will generally provide for repayment of the loan within a stipulated time period of either of two key dates:

- (a) Death of the borrower
- (b) The borrower ceasing to permanently reside in the property

The second of these items may vary from one agreement to another. Review each agreement carefully to see the precise time or event on which the loan will be repayable.

'No negative equity' guarantee

A particular risk that reverse mortgages (and other forms of equity release products) bear is that the borrower's equity in the property is not only exhausted, but goes into the red. That is the loan balance exceeds the client's equity.

In Australia, the majority of lenders (but not all) offering reverse mortgages are doing so with a 'no negative equity' guarantee. The importance of this guarantee is that even if the loan goes into negative equity, the borrower will not be evicted, and will never be liable for more than the proceeds of sale of the home.

Solicitors reviewing an agreement which does not contain such a guarantee should advise the client to find a product that does contain a 'no negative equity' guarantee – there are plenty around. Indeed, the major reverse mortgage lenders are members of an industry body, SEQUAL, for whom it is a condition of membership that the lender offers such a guarantee.

A number of lenders are now providing a 'protected equity' option, that is, a loan in which the lender promises that the client's equity in the property will not fall below a specified percentage (e.g. 20%) of the value of the property. It puts an upper limit percentage cap on the percentage of the property value the lender can take. This has attraction for borrowers who want to ensure that they will always have recourse to a residual sum of money, whether to pay for an accommodation bond in the future or simply to ensure that something is left for their estate.

Read the documents to make sure the 'no negative equity' guarantee is REAL

A point to note in this context however is not simply to rely on the lender's marketing brochures, but rather to examine the terms and conditions of the loan agreement closely for the wording of the guarantee. There has been recent experience where one reverse mortgage provider had been making claims in its marketing material that its product did not expose borrower's to any 'negative equity' risk, yet the product itself did NOT actually include a guarantee to that effect.

Events of default

However, 'no negative equity' guarantee clauses will commonly not apply if the borrower is in default under the agreement.

This then necessitates an examination of the circumstances in which the loan agreement or the mortgage is deemed to be in default. The events of default are important because they enable the lender to call up the loan early, and also to apply the default (higher) rate of interest. Given that the underlying premise of a client entering into an equity release product is that they don't have the capacity to service the loan or make repayments before the normal maturity date, a default might well have catastrophic consequences, namely a forced sale of the home at a time not of the client's choosing.

Again, it is necessary for each individual agreement to be examined, however, the following events are routinely provided as giving rise to default by a borrower:

- Failing to maintain the security property in good repair and condition

Indeed, agreements oblige the borrower to undertake repairs required by lenders from time to time, and even to enable the lender to carry out the repairs at the borrower's cost if the borrower fails to do so. Most lenders will carry out periodic inspection of the security.
- Failing to maintain building insurance
- Failing to pay rates, taxes and other charges when they are due for payment
- Conferring on any other person an interest in the property without the lender's consent
- Any misrepresentation by the borrower in any of the information disclosed in the application form, in particular as to the age of the borrower
- If the property is left vacant for a lengthy period (usually between 6 – 12 months) without the lender's consent
- Bankruptcy of the borrower

Some go further and provide for default if:

- There is any material adverse change in the borrower's financial condition (in the lender's opinion)
- There is any change in the borrower's circumstances which the lender reasonably believes might adversely affect the borrower's ability to perform his/her obligations under the agreement
- There is any failure to comply with any term of the loan agreement
- Failure to fill out and return an annual statement confirming that the borrower still lives in the home.

Once a default occurs, all agreements provide for a higher rate of interest to accrue.

Broad default clauses are highly dangerous, and their potential impact should be explained to clients.

Impact on social security

Solicitors advising on equity release products should ensure that a client is advised to consult Centrelink for advice on the client's individual circumstances.

The last thing your client will want, having received a lump sum, is a nasty surprise in the form of a letter from Centrelink advising of a pension reduction or termination because of an increase in their assessable assets or income.

Given the importance of this aspect, prudent practice would be not only to advise the client to seek the necessary advice, but to defer execution of the documentation until the client has advised you of having done so, and of the outcome.

If the client is in receipt of an aged pension payment, then any lump sum over \$40,000 that is borrowed and remains unspent after 90 days will be included in the assets test, and will also be classed as a financial investment and subject to deeming under the income test.

Regular income amounts drawn from an equity release product will not be included in the income test unless the funds are drawn down and held in an offset account or another financial investment. If they are, then income from the investment will be assessed under the deeming rules that apply to all financial investments.

Advise the client to seek tax advice

Recommend that your client seek their own taxation advice unless you have the expertise to provide it.

5. CERTIFICATION

The LPLC has long made a point of emphasising the risks involved with solicitors certifying in relation to mortgage and finance transactions.

There is an approved Law Institute form of solicitor's certificate, which certifies as to having explained the general nature and effect of the mortgage or agreement; the borrower's apparent understanding; and having witnessed execution by the borrower or surety as the case may be.

So long as certification is confined to those types of matters (and of course what is certified is true and can be demonstrated as such) the LPLC considers that risk to solicitors is appropriately managed.

The problem is that there are always lenders/financiers looking to 'push the envelope' and take advantage of unsuspecting or inexperienced solicitors, and look to obtain certification from solicitors of additional matters such as:

- That the solicitor has given financial advice to the client

- That the client has in fact understood the solicitor's explanation – that is, a warranty that the borrower in fact understood, rather than a statement of opinion that the borrower appeared to understand

New equity release products and documents are evolving all the time, and caution is continuously required.

6. THE FAMILY

Lenders routinely encourage borrowers to consult with their family before taking out an equity release product. The reason for this is obvious enough – to make sure that any problems are brought to the surface before money changes hands. This is a far better position for the lender than a suit after the event alleging the lender has preyed on a disadvantaged borrower.

This also raises an interesting risk management issue for solicitors, because the solicitor's duty of care, and obligation of confidentiality, is to the client and not to other family members. No doubt in the vast majority of cases, the client will be willing to accept advice and communicate with family members before entering into a reverse mortgage, knowing that the loan will reduce the value of their estate having regard to the compounding effect of interest over time, and being mindful of wanting to leave an inheritance. However, for some clients, their financial independence from family members is of greater importance, or they may prefer the privacy of keeping their financial affairs to themselves.

If a client is determined not to involve family members, a cautious solicitor might well take a bit more trouble to make sure that he/she has a demonstrable paper trail of having carefully and thoughtfully advised the client on the transaction.

The impact of a reverse mortgage on a borrower's estate could be substantial, which means there is potential for family members and beneficiaries to complain later.

Acknowledgments/Further reading

ASIC Report – “Equity Release Products” November 2005

The National Information Centre on Retirement Investments Inc – “Accessing the equity in your home – some issues to consider” (May 2005)

Department of Family and Community Services – “Home Equity, Retirement Incomes and Family Relationships” (February 2005)

Australian Consumers Association report on Reverse Mortgages (April 2006)

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