Older people’s assets: using housing equity to pay for health and aged care

The research agenda on the ageing population should be broadened to include consideration of how people will pay for their health and aged care later in life. With aged care costs difficult to estimate in advance, it is not easy for people to plan ahead. Hopefully, further financial innovation, including alternatives to reverse mortgages, will occur to help people address these issues.

CLOSE TO 200,000 ELDERLY PEOPLE live in residential aged care. In the first six months after entering residential care, most people will sell their homes to pay an accommodation bond. In many instances, the family home is sold reluctantly because there is little alternative. Reverse mortgages are a relatively recent financial innovation in Australia designed, in part, to address this challenge. Financial products that ‘monetise’ housing equity will be increasingly important as the population ages.

The title of this paper draws on an article by University of Queensland researchers who observed that:

Whereas policy changes increasingly promote self-provision of retirement incomes and the use of capital assets to fund care choices, families and older people often retain the view that income and care in older age should primarily be funded by the state.

The researchers argued that the ‘market, state and family’ all have claims against the assets of elderly people and these competing claims create generational tensions that will emerge as an important public policy issue.

While the thrust of this argument may be correct, the ageing population also presents an opportunity for those researching and developing new products. Reverse mortgages, for example, have been specifically designed to address the needs of elderly people.

Finsia–UMR research

While most people are now aware of reverse mortgages, they are less aware of their use for aged care funding. That is not surprising; very few people put much thought into aged care until they have a personal experience, such as putting a family member into residential care. Recently, Finsia commissioned research about people approaching retirement, which has highlighted this issue and revealed that:

- ‘...very few Australians have considered the implications of our ageing population’;
- ‘...worse still they tend to reject all solutions that have been offered up’; and
- ‘...they want quality health and aged care’.

Not only are those approaching retirement myopic about their future health and aged care needs, but very few elderly people or their families seek advice from financial planners on this issue. And, only a small number of financial planners make it their business to advise on aged care or on negotiating accommodation bonds.
Henry Review acknowledges the importance of housing to elderly people
The challenge of paying for entry to aged care, however, has not gone unnoticed. The importance of the family home in financing aged care has been recognised by the Treasury. In its Report on Strategic Issues, as part of the Henry Review, Treasury observes:

Owner occupied housing … is frequently used by retirees as a form of longevity insurance. The capital value of a home can be used as a 'backstop', including as a source of funding for residential aged care, if they outlive their savings.4

Based on this premise, Treasury builds a case for the ongoing exemption of the family home from the assets test. The concessional treatment of the family home should be a consideration when designing new financial products for elderly people. With the family home one of the few exempt assets, new products that allow elderly people to 'monetise' its capital value should emerge. Reverse mortgages are only one way to do this.

While there may be attempts by policy makers to include the family home in the assets test, the political economy of the family home will ensure that any changes will affect only a small number of elderly people. In fact, assessing the net value of the family home could spur the use of housing equity withdrawal products. This has occurred in the United Kingdom where retirees routinely draw equity out of their homes and spend it to avoid inheritance tax.

One of the main reasons why the home will continue to be favourably treated is its special role in paying for entry to residential aged care.

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Residential aged care – an overview
With numerous types of care, and different fees and charges paid depending on the care received, Australia's system of aged care may seem daunting to the uninitiated.

Prior to receiving government-subsidised care, a person is assessed by an aged care assessment team (ACAT), which makes a recommendation on the type of care required. Where it is recommended that a person needs residential care, it is common for a person to pay an accommodation bond on entry (see below for more detail on this).

Government subsidies towards the cost of care are substantial, ranging from an average of $18,000 for low-care residents to $45,000 for high-care residents.5 These subsidies are adjusted in line with a weighted index reflecting both growth in consumer prices and wages. They represent a steady but not growing source of funding to aged care operators.

FIGURE 1: Australia's aged care system
Users are also required to make daily co-payments. These amounts are mechanically calculated by a series of rules closely linked to the age pension. For example, basic daily care fees are set as a percentage of the age pension. These fees, while paid by residents, are often no more than indirect government transfers.

Income-tested fees are an additional fee levied on those with higher incomes. These fees are, in effect, a tax on the incomes of part- and non-pensioners and have been designed to ‘claw back’ some of subsidy paid by the government to aged care operators.

The funding model for aged care has embraced ‘user pays’ more than any other part of the health system. Means testing, drawn from social security policy, applies to most aspects of residential aged care. In other words, people with different levels of wealth and income will pay different fees.

Accommodation bonds are the one user payment where there can be large differences in the amount paid. Some residents will pay a bond equivalent to 30% of their net wealth, while others will pay bonds that are much higher.

What is an accommodation bond?
Accommodation bonds have been the most important source of funding the expansion of aged care facilities over the past decade. A bond is, in effect, an interest-free loan paid by incoming residents to aged care operators. When negotiating the size of a bond, aged care operators collect information about the assets of the prospective resident and use this information in setting the size of the bond.

There is a statutory rule capping the size of bonds, requiring residents to be left with assets of at least two-and-a-half times the age pension after paying the bond (currently $36,000). However, competition between operators to fill their beds means that bonds are typically 30–50% of the median house price in the aged care operator’s catchment area.

It is important to recognise that because bonds are negotiated at the point of entry it is almost impossible to plan for this in advance; preserving housing equity appears to be one of the few strategies available to the prudent.

How do people currently pay for bonds?
Even for those who have planned ahead, most will sell their family homes to pay a bond. It is for this reason that the system of charging accommodation bonds has been controversial.

In 1997, when the Aged Care Act was introduced in its present form, the charging of accommodation bonds for high care (also known as ‘nursing homes’) led to a public outcry and a government backdown. More recently, however, the National Health and Hospitals Reform Commission has reopened this debate by arguing that bonds, or a bond-like equivalent, should be paid by all residents who have the means. Most people entering residential aged care should expect to pay a bond.

The decision to retain the family home or to move to alternative accommodation is influenced by the size of bonds and the social security rules around assessing the family home. Government policy affecting the treatment of these areas has evolved over the past 10 years.

When bonds were introduced in their current form in 1997, the Parliamentary Library researched the policy landscape and asked the question: Will we need to sell our homes? At the time, when bonds were estimated to be $26,000, the Library’s research suggested that single pensioners with limited assets would have little option but to sell their homes to fund a bond on entry to care. Ten years later, the average size of bonds is substantially higher, about $189,000, but not everyone will have to sell his or her house to pay a bond.

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<thead>
<tr>
<th>FIGURE 2: Snapshot of accommodation bond holdings in 2007–08</th>
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<tr>
<td>Average new bond</td>
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<tr>
<td>Median new bond</td>
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<tr>
<td>1/5 bonds less than</td>
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<tr>
<td>1/3 bonds more than</td>
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<tr>
<td>1/5 bonds more than</td>
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<td>Total bonds held</td>
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Ongoing exemption of family home from the assets test in care situations

Government policy currently allows a person in residential aged care to keep their family home exempt permanently from the assets test if the home is rented and some of the rent goes towards the cost of the accommodation payment. Also, the policy exempts the rent from the income test. These concessions have encouraged many aged care residents to retain their former homes, using their homes as a form of retirement savings. However, most people still need to realise a capital sum to pay an accommodation bond on entry.

To assist with this, a suite of equity release products has been released. Where used appropriately, these products can help elderly people pay an accommodation bond without having to sell the family home. In Australia, by far the most common equity release product is the reverse mortgage.

A reverse mortgage is a loan that allows a consumer to borrow money against the equity in his or her home while the principal and interest is not repaid until the house is sold (usually when the last surviving borrower dies).

The most important difference between a reverse mortgage and a standard mortgage is that the interest is capitalised rather than regularly paid out of the borrower's income. Thus, an elderly borrower's ability to service the loan is not the major consideration. Instead, the loan is based on the lender's appraisal of the property secured by the loan. Reverse mortgages by design will consume, in almost all instances, a portion of the borrower's equity in the home resulting in a smaller inheritance for their children. Borrowers need to consider carefully the interest cost (and the interest on interest cost) when making the decision to take out a reverse mortgage.

Much has been written about this feature of reverse mortgages; not surprisingly, not all of it has been positive. Steve Keen has called reverse mortgages the 'most dangerous “innovation” around in finance.' Yet, others have been more positive, describing reverse mortgages as an area of financial innovation that ‘potentially represents a virtuous combination of sound social policy goals and value-added financial products, which would benefit the public as well as stakeholders in the financial services industry’. Reverse mortgage products have also received substantial scrutiny from regulators, including ASIC. New regulations, which specifically deal with reverse mortgages, will be introduced as part of the National Consumer Credit Regulation.

Credit regulation issues

Prior to the Federal Government recently assuming control of consumer credit regulation, the issue of aged care and reverse mortgages was considered by the states. In 2007, when debating changes to the state-based Uniform Consumer Credit Code, the Ministerial Council on Consumer Affairs drafted an exposure Bill that included the following clause:

Matters to be complied with in relation to credit proposals for reverse mortgages.

Brokers to provide the following information in reverse mortgage credit proposals:

... if, following inquiry of the consumer, it appears that the consumer may need to preserve equity in the mortgaged land of a particular value to finance future expenses (such as aged care accommodation), a range of estimates, calculated in accordance with the regulations, as to when the debt under the contract is likely to reach a level beyond which the consumer's equity in the land will be less than that value.

This proposal would have seen a limited form of aged care advice mandated as part of reverse mortgage advice. While this should be encouraged, there are many complex issues for those drafting legislation to consider. Any attempt to estimate the 'future expenses' of aged care accommodation is almost impossible. This is because a bond is negotiated at point-of-entry to care and its size is a reflection of the value of a resident's assets. There is no 'one size fits all' bond.

A further consideration is that most reverse mortgages are also used for purposes unrelated to aged care. The three most common uses of reverse mortgages are debt repayment, home improvement and regular income. The proposed regulations would mandate that a person receive advice about aged care possibly 15 to 20 years before that person actually needs care. Therefore, where a reverse mortgage is being recommended to a younger borrower (say 70 years of age), it would be almost impossible to estimate the future cost of aged care for when that person is 85 or 90.

We are yet to see how the Commonwealth Government, Treasury and ASIC deal with this issue or how lenders and advisers would respond to changes mandating this advice.

FIGURE 3: Features of a typical reverse mortgage

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<tr>
<th>Feature</th>
<th>Description</th>
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<td>A loan secured by a mortgage over an elderly person's residential property.</td>
<td>Maximum loan of up to 40% of property's value (typically dependent on age of youngest borrower).</td>
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<tr>
<td>No requirement for borrower(s) to make regular repayments on loan.</td>
<td>Interest is typically capitalised.</td>
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<td>Loan repaid within 6 to 12 months of death of the last remaining borrower.</td>
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A role for financial innovation

If elderly people wish to retain their family homes, financiers will need to develop further the reverse mortgage market. Today, only a small number of lenders offer the option of using the loan proceeds to fund an accommodation bond.

Other alternatives to reverse mortgages should also be examined. One alternative would be for lenders to develop intergenerational loans, allowing children to assist in servicing the loan of an elderly parent who borrows a capital sum to fund an accommodation bond. These intergenerational loans could assist families who wish to retain assets, such as a property, within the family.

The research agenda on the ageing population should be broadened to include consideration of how people will pay for their health and aged care later in life. As we have seen, aged care costs are hard to estimate in advance and the means by which a bond is calculated – by reference to a person’s assets – make it very difficult to plan ahead. Hopefully, further financial innovation will occur to address this issue.

Notes

3 Financial Services Institute of Australasia (Finsia) 2009, National study of financial attitudes and behaviour in light of the global financial crisis, July.
4 Department of the Treasury (‘Henry review’) 2009, Australia’s future tax system: the retirement income system report on strategic issues, May.
6 Warren Hogan 2007, The organisation of residential aged care for an ageing population, Centre for Independent Studies Policy Monograph no. 76.
7 It is difficult to say anything definitive about this issue because there is wide disparity in the size of bonds paid. A simple estimate of the size of bond paid relative to a person’s assets involves taking the average new bond and comparing it to a published estimate of average house prices.
9 Lee Jones 1997, Accommodation bonds for residential aged care: will we need to sell our homes, Australian Parliamentary Library, Law and Bills Digest Group, 20 June.
10 Department of Health and Ageing, op cit, pp. 42–43.
11 For a recent case examining the exemption of the family home after its owner moves into residential care see: Bignall and Secretary, Department of Families, Housing, Community Services and Indigenous Affairs [2009] AATA 691.
13 There are many other factors to consider as well. On the one hand, selling the home can affect a person’s pension and fees paid in aged care; while on the other hand, the interest cost needs to be weighed up against the expected growth in the value of the home. Also, there are many non-financial considerations. For example, many elderly people have the belief (sometimes incorrectly) that they will return to their family home. The reverse mortgage decision is a very complex one and requires good advice and consultation with the whole family.
14 Steve Keen quoted in Andrew Linden 2007, ‘Reverse mortgages should be banned’, Sydney Morning Herald, 28 November.