



# Reverse mortgage - chance or risk

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## Introduction

Ageing European societies are standing before a dilemma of having to provide old age pensions to ever increasing group of people. This is also a problem of Poland where the number of people who reached retirement age is now 6 445 000<sup>1</sup>. At the same time a drop in birth rate seriously influenced the relation between those in work and those already retired, which has had a negative impact on the level of paid out. pensions. Due to this adverse demographic background and worsening economic downturn many elderly people are living on the verge of poverty. The currently functioning system of pensions basing on a state fund. does not seem to be doing the job and today's pensioners are not members of pension funds investing on the capital market which were established in the 90s. These problems gave rise to an idea for creation a mechanism that pays out a fixed pension which is a kind of a loan granted by financial brokerage institutions colloquially known by the term of „reverse mortgage”.

## 1. The idea of reverse mortgage

Reverse mortgage is a payment under which the role of a lender and borrower have been reversed. The bank or any other institution undertakes to make a payment which is secured by a mortgage on a property belonging to the beneficiary. In most cases the property is a flat or a house inhabited by the beneficiary. Property owner shall relinquish the right to the property on his death. In return he will receive a monthly payments or a total downpayment. In the case of a downpayment, its level does not exceed 50% of the value of the property. In the agreement with the benefactor the purpose of this loan is not defined so the money can be spent freely. Such resources are extra incomes to the pension and are spent usually on everyday expenses.

This solution, common and popular around the world is recommended by lenders as a secure lifelong mortgage pension whose only condition is ownership right of a flat or a house. The payment which is a kind of a loan thus is not covered by income tax. And because it is a form of pension, it doesn't have to be paid back. In return the lender acquires the rights to the property which acts as a collateral for the agreement.

Such a form of a loan and collateral by a mortgage lead up to associations with traditional mortgage loans taken from a bank. However, between the two solutions there are many differences which make such simplifications impossible. Comparison of a bank mortgage loan and the so called reverse mortgage are illustrated by table 1.

**Table 1. Mortgage loan vs. „reverse mortgage”**

<b>Mortgage loan</b>	<b>Reverse mortgage</b>
Stricte rules for granting	No specific rules for granting
Granted only by banks	Granted mostly by institutions other than banks in form of a loan
For purchase or building a property	Conveyance of rights to property or sale
Repayment in instalments	Monthly instalments
Repayment from current incomes	Repayment from sale of property on death of owner
Credit rating necessary	Credit rating not necessary

source: own source

<sup>1</sup> [http://www.stat.gov.pl/cps/rde/xber/gus/PUBL\\_oz\\_maly\\_rocznik\\_statystyczny\\_2011.pdf](http://www.stat.gov.pl/cps/rde/xber/gus/PUBL_oz_maly_rocznik_statystyczny_2011.pdf) (24.11.2011)



When applying for a traditional loan the potential buyer must prove his ability to pay back the loan within the agreed time together with interest and other charges stipulated by the credit agreement. That, in turn, means collateral for repayment of the future instalments. Most often the value of required collateral is supposed to be twice as big as the amount of loan. In case of default the bank covers its receivables from collateral to the amount of actual indebtedness of the borrower. If revenues from sale of property were higher than the outstanding debt, remaining resources are returned to the borrower. As for reverse mortgage, the value of collateral is also higher than the total of the payments made in favour of the beneficiary. The surplus, however, is not paid back in favour of persons who for example inherit after the beneficiary. Lack of legal regulations and supervision of the state over such transactions (rendered mainly by institutions other than banks) means that such agreements are drawn only under general regulations of The Civil Code, which may raise controversy and prove extremely risky for the beneficiary.

### 1. Reverse mortgage agreement conditions

Reverse mortgage is designed for elderly people. Institutions offering this kind of service clearly limit the age of the beneficiaries to over sixty years of age and some to even over sixty five. It is required that they possess the following:

- Ownership right to property or
- partial ownership right to property or
- perpetual lease on property or
- cooperative ownership right to a flat.

The beneficiary in return for an amount of money stipulated by the agreement is obliged to transfer the right to his property onto the capital provider on the day of his death or after the agreed period of time. The value of the payment calculated by means of a compound interest takes into account changes of money value over time which is affected by factors such as inflation, current interest rate on the market, market risk etc. The amount of the payment depends on how long it will be taken and on the value of property transferred to the benefactor.

Due to these factors, calculation of the payment bases on average data obtained from The Main Statistical Office with regard to:

- property value,<sup>2</sup>
- average life expectancy in Poland,<sup>3</sup>

- sex of the beneficiary.<sup>4</sup>

Value of the property plays a crucial role in the calculation of the payment value.

Most of pensioners applying for reverse mortgage are people with limited means, living in old, low standard houses, very often neglected for years. Their value within next 10-15 years, estimated as the time when the payments will be made, is likely to fall even further. For this reason, such property is not considered as good and sufficient collateral and in consequence, decreases the value of payments considerably.

As property can be taken over only after the beneficiary dies ( in the case of a couple- both die) the length of the period when payments are made is of utmost importance for the benefactor. As a result, the value of payments will depend on the beneficiary's age. For couples the calculation is made for the partner who statistically is likely to live longer. Increasing life expectancy acts against the interest of the payer who will be obliged to pay longer. That is why an older person will receive a higher amount of payment. Differences in life expectancy between men and women also make a difference in the amounts paid. Average life expectancy for men and women in Poland is illustrated by charts 1 and 2.

<sup>2</sup> M.Krasoń: Odwrócona hipoteka: Rozwiązanie przydatne, ale nie pozbawione wad, [http://forsal.pl/artykuly/416631,odwrocona\\_hipoteka\\_rozwiazanie\\_przydatne\\_ale\\_nie\\_pozbawione\\_wad.html](http://forsal.pl/artykuly/416631,odwrocona_hipoteka_rozwiazanie_przydatne_ale_nie_pozbawione_wad.html)

<sup>3</sup> <http://www.funduszhipoteczny.pl/> (24.11.2011)

<sup>4</sup> Odwrócona hipoteka: 2000 zł renty miesięcznie? Nie daj się omamić reklamie, [http://wyborcza.biz/biznes/1,101562,9027667,Odwrocona\\_hipoteka\\_2000\\_zl\\_renty\\_miesiecznie\\_Nie.html](http://wyborcza.biz/biznes/1,101562,9027667,Odwrocona_hipoteka_2000_zl_renty_miesiecznie_Nie.html)



**Chart 1**

**Average life expectancy in Poland from 1950 to 2008**



\* forecast

Source: own source on the basis of: Mały rocznik statystyczny,  
[http://www.stat.gov.pl/cps/rde/xbcr/gus/PUBL\\_oz\\_maly\\_rocznik\\_statystyczny\\_2011.pdf](http://www.stat.gov.pl/cps/rde/xbcr/gus/PUBL_oz_maly_rocznik_statystyczny_2011.pdf)  
(24.11.2011)

**Chart 2**

**Average life expectancy for Poles over 75 years of age**



Source: own source on the basis of: Mały rocznik statystyczny  
[http://www.stat.gov.pl/cps/rde/xbcr/gus/PUBL\\_oz\\_maly\\_rocznik\\_statystyczny\\_2011.pdf](http://www.stat.gov.pl/cps/rde/xbcr/gus/PUBL_oz_maly_rocznik_statystyczny_2011.pdf)  
(24.11.2011)



Statistics show that women live longer than men by approximately 7 years and 4 months, and in the group over 75 years of age women live longer by nearly 2 years. For borrowers it is more profitable to grant loans to men rather than women. To make it attractive for borrowers, payments for men and women are differentiated according to sex, so an average payment for a man is 825 PLN, whereas for a woman only 550 PLN.

The longer a client receives his additional pension, the less the borrower earns. To compensate this, payments according to age, sex and property value can differ even by as much as 1584 PLN. Thus, the highest payment will be for a man over 85 years of age who has a property worth 400 000 PLN, and the lowest amount will be for a woman of 65 whose property value does not exceed 200 000 PLN. Chart 3 shows payments for men and women in different age groups with properties of different value.

Chart 3

### Example of monthly mortgage pension payment with regard to property value

Age                      property value                      monthly payment                      woman/man



Source: [http://www.funduszhipoteczny.pl/?gclid=CNrA-7nE2awCFYJH3god\\_3zRrw](http://www.funduszhipoteczny.pl/?gclid=CNrA-7nE2awCFYJH3god_3zRrw)  
(24.11.2011)

Apart from issues connected with relation between the amount of payment and property value the agreement states also conditions for charges and commissions which as a rule are subtracted from the first payment; and information about who bears the cost of insurance and who pays property tax. Most often it is the borrower who covers such costs. The borrower may additionally commit to valorization of the payment.

#### 1. Settlement of reverse mortgage agreement

The total of monthly payments is correlated with the period when such payments are made in such a way as to bring the borrower's expected

profits. That means that payments are frequently highly underestimated against the property value. For example if reverse mortgage is taken by a man of 65 with a property currently valued at 400 000 PLN, assuming that he will live longer than the average 75 years for men and payments are transferred monthly, according to chart 2 the total amount that he will receive will merely amount to 81 190.81 PLN, which is only 22.3% of his property value. After 15 years the amount will rise to 121 786.2 PLN that is 30.44% of property value and after 20 years 162 381.6 PLN which is 40.6% of property value. Compared to the value of the property one can see that pension payment under



reverse mortgage is incredibly low.

If we assume that value of property will increase within the next 10 years, it becomes clear that the borrower uses unjust practices of property extortion from unaware, elderly people.

Nevertheless, for a single person, without any family, with a low state pension, additional pension in return for property is a way to make ends meet. In the example mentioned above a 65 year old man could receive additional 676.59 PLN (a woman 528.82 PLN). Such extra income in addition to the lowest state pension which in 2010 was in Poland 1624 PLN increases the total monthly income for men by 70.6% and for women by 75,4%.

A closer look at the concept of reverse mortgage one can see that this method provides a big chance of increasing income and life standard improvement, especially that this kind of income is not taken into account when applying for social benefits and is exempt from income tax. Moreover, certain obligations connected with property ownership such as refurbishment may be born by the lender.

Disadvantage of reverse mortgage is the fact that if provided by the agreement, the borrowers are obliged to maintain the property in good condition (they have to pay the rent on time, tax, insurance, maintenance costs). However we must bear in mind that if they die shortly after the agreement is signed, the payments in favour of the borrower only slightly get near the value of the property. Persons who inherit such property as a rule have the obligation to pay back the debt. Otherwise the property becomes the ownership of the borrower who will probably introduce a charge for early repayment of a loan (1-3%).

Adverse conditions of reverse mortgage and lack of legal regulations cause a situation in which banks are not willing to undertake such tasks. Thus, reverse mortgage has only marginal importance for banks. Financial institutions other than banks show more interesting offering reverse mortgage. However, their activities are not supervised by independent bodies and that is why their services are not completely safe.

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