Funding Your Lifestyle in Retirement

An E-Book

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1. Funding one's retirement years

It is a sad truth that a large number of retired people depend almost entirely on the pension for their survival. On the other hand, a high percentage of pensioners have worked hard over the years to finally own their home outright, free of mortgages.

Most analysts and social commentators refer to statistics which show that a large percentage of those in their late sixties and seventies have little additional capital and were severely under funded with superannuation if indeed they had any at all.

Those who grew up just after the depression and during World War II were a frugal bunch who had a dislike for debt. They worked for a lifetime to pay off the family home and clear the title of any borrowings.

Whilst we in Australia are lucky to have a good social security set up, the pension falls far short of providing the lifestyle we enjoyed when we were in the workforce. Many sacrifices must be made by those who depend on the pension alone.

There is a certain inevitability that retirees will have to resort to supplementing their lifestyle by spending some of their capital, whatever form that takes.

After five or ten years of retirement, maintenance issues arise with the family home, motor vehicles and other matters. Many will resort to selling the family home, rationalising that they no longer need the space, nor do they need to be as close to the city. They may also decide to "move out" to be nearer to their children and grandchildren.

By selling, they free up some capital to purchase a new car, perhaps take a holiday, and move to a new maintenance free unit. This should reduce their running costs and building maintenance for the foreseeable future. There is also a significant cost in agents fees, removal expenses, stamp duty, and fit-out for the unit if it is brand new.

This move, for many, will create a "wrench" in leaving the family home. Some will regret the move and declare it a big mistake for a variety of reasons, none less than the family whom they moved to be near, have now shifted due to a job change or other opportunity.

In many cases, the sole purpose of this move is to release capital to enhance their retired lifestyle. If they have moved from an inner to an outer suburb, the appreciation in value of the new home may fall far short of the rise in value of the old, thus denying them of some capital growth otherwise available to them. However, if this move occurred five to ten years ago, they may have been unaware of another option.

The Reverse Mortgage allows seniors who own their home to borrow a lump sum and/or a recurring amount of money, but not be required to repay any of the loan until the home is sold or the borrower dies.

The idea of entering a new mortgage, having spent a lifetime trying to get rid of one, is anathema to many seniors. They are also reluctant to diminish their children's inheritance.

On the other hand there are seniors who boast about skiing, or **S**pending the **K**ids **I**nheritance.

2. Retirement Villages – an alternative lifestyle from the late1970s

The late 1970s and early 1980s saw the emergence of the Resident Funded Retirement Village. Prior to that, most ageing people lived in their family home or unit, a religious based self care unit or a nursing home when they became frail.

The earliest villages generally had modest sized one and two bedroom units, mainly with carports. Community facilities were also modest. Villages were constructed around a "care" model, often employing a fully qualified nurse who would quickly respond to any health related emergency.

As the Industry moved forward, developers realised that there was a market for much larger units, lock-up garages, and even double garages. Community facilities became bigger, and offered bowling greens, heated indoor pools and many other features.

As this was happening, the Industry was moving away from the "medical" model towards a "hospitality" model.

Throughout the 90s and into the new century, seniors were voting with their feet, and moving to this new form of accommodation. They could sell their home, purchase a retirement unit, and have some money left over. The monthly fees were very affordable for what was provided, they felt secure in their new environment, and had a greater sense of companionship.

Many people living in villages could get by on the pension, perhaps with a small amount of other savings. They all realised that the system was in part a "use now pay later" arrangement, in that "deferred management fees" would be deducted at the end of their tenure.

Many retirement villages also offered serviced apartments, which were intended for the more frail elderly, who may not qualify for Aged Care Hostels or Nursing Homes. These were typically occupied by people in their eighties, and the accommodation was augmented with other services such as meals, cleaning and other services.

3. Retirement Village Financials

There are far too many financial variations to mention in this small e-book. Suffice to say that in the majority of instances the retirement village resident will lose a significant amount of capital on their departure.

The capital which is retained by the village operator is generally called “deferred management fees” (DMF), “deferred fees” or “exit fees”.

A typical self care retirement village unit might provide for the resident to pay DMF of 3% per year for each year of occupation, up to a maximum of 10 years or 30%, based on the sale price at the end of the tenure. (the resale or outgoing price)

A village in which one of my relatives resides has the same formula, but in addition the operator shares the capital gain on a 50/50 basis. In that instance, it has been calculated that 60% of the resale price will go to the village owner/manager if it is resold at the end of 10 years.

Retirement village residents pay a monthly maintenance fee, and the summation of all residents’ fees is calculated to cover the day to day running costs of the village including all staff. The maintenance budget is meant to break even, and not provide a profit for the operator.

The resident is of course required to pay all utilities and charges that are a direct charge to the unit. Council, water and sewerage rates may be levied individually or within the monthly maintenance charge.

The other significant burden on the resident is the internal maintenance of the unit, and the requirement to refurbish to its original condition at the end of the tenure. Some schemes also require the outgoing resident to pay selling costs and agents commission.

For many villages, the paperwork that sets out the financial implications lacks clarity and transparency, at the time the village operator is selling the “sizzle”. How many prospective residents would jump at an opportunity which gave them 40% of the resale price after 10 years, and 60% to the operator?

However, regardless of these “sums”, that village will still be the right decision for some people.

4. New services to help the elderly remain at home

Around the late 1990s some other products were emerging, which would encourage people to stay longer in their own home.

Home and Community Care (HACC) services were being developed, delivering services generally through local councils. Many people with mobility problems found that they could get help to install ramps to overcome steps, or grab bars in toilets and bathrooms. Electronic devices became available which allowed an emergency button to be pressed which would summon help in various ways.

Aged Care Packages were also developed to help people to delay their entry into Aged Care Facilities. These packages were "rationed" by the Commonwealth, which distributed the services through Aged Care Providers.

It should be noted however that for many elderly, these services did little to reduce their vulnerability, lack of companionship and isolation. The highlight of their day would often be the visit by a nurse to attend a dressing, or the delivery person with meals on wheels.

In addition to these very helpful products, we have also seen the emergence of the Reverse Mortgage, also referred to as a Seniors Equity Loan. This product, which was virtually unheard of 10 years ago, is now widely offered and accepted.

In simplistic terms, it allows seniors to borrow a lump sum, an income stream or both against their home. The borrower is not required to make any repayments against the loan until the home is sold for any reason or upon the death of the borrower/s. Interest accrues and is capitalised into the loan. Lenders have set very limited proportions of the home value that they will lend, and this depends on the age of the youngest borrower, who must be aged 60 or more. For example a 60 yr old may borrow about 15%, whereas an 85 yr old could borrow 40% of the home's value.
Another form of equity release is the Shared Appreciation Mortgage which will be discussed later in this book.

5. A cost comparison – Retirement Village or Reverse Mortgage

Seniors want to feel financially secure in their retirement and whether it is making a decision to sell the family home, move to a retirement village, or take out a reverse mortgage, these can be complex and stressful decisions. Making meaningful comparisons between these potential options can also be very complex.

Whatever choices many retirees make, their capital base is going to reduce over the balance of their lifetime. Some will sell the family home and purchase a smaller unit, thus releasing some capital to live on. However, the release of this capital has the potential to reduce the amount of their pension.

Others, who choose to move to a Retirement Village, will pay substantial costs for their move, and if they reside there for 10 years or more will lose at least 30% of their capital at the end of their tenure. Not only that, they (or their estate) will bear the cost of refurbishing the unit and the resale expenses.

Let's assume that a 70 yr old couple sells their home at $470,000 and buys into a Retirement Village at an ingoing price of $450,000. At the end of 10 years, if the value increases at 4% per year, it should re-sell at approximately $666,000. In most villages the operator of the village will take 30% of the resale price or $199,800 plus selling and refurbishment costs of say $20,000. If we consider the up-front costs of $20,000, then the total capital loss is about $240,000.

Remember that the unit holder must also pay their proportion of costs for the day to day running of the village, (although in this there is no profit to the operator) through their regular maintenance fees. In some villages, rates and water rates are included, and in others they are rated separately. The unit holder is also obliged to maintain the interior of their unit, generally paying for the replacement, if necessary, of the village owner's chattels such as air conditioners and hot water services.

Let's now consider the 70 yr old who wishes to stay in their family home or unit. Many will have a home with a high asset value, but they are income poor. They may be battling on a full pension plus a little interest on some other accumulated funds. Most will not have large superannuation funds, and those who did will have diminished them.

When a retired homeowner draws regular funds in the form of a reverse mortgage, this added income should not reduce their pension, and be non taxable. However, this must be verified with a FIS officer at Centrelink.

Considering that the current maximum pension for a couple is $882.80 per fortnight, if a couple could add another $620 per fortnight to their income, their lifestyle could improve significantly. That is, just under $15,000 per year. It is the amount if taken over 10 years on a monthly basis would accrue to about $240,000 if the interest rate were at a constant 9% p.a. It is the amount that the person who moves to the village will sacrifice in deferred fees over a 10 year period, when buying a $450,000 unit.

6. What could a retired couple do with an extra $15,000 per year?

- $2,000 per year maintaining their private health cover.
- $1,040 per year on 26 lawn cuts at $40 each.
- $2,000 on help with external or other household maintenance.
- $1,300 at $50 per fortnight for home cleaning.
- $3,000 for an annual holiday.
- $3,000 on goodwill for family and friends.
- $1,000, on Club Membership which might otherwise be dropped.
- $1,660 or about $64 per fortnight on entertainment.

Of course, the above are just a few ideas on how seniors may choose to enhance their lifestyle with the additional funds.

Now let us assume that our couple started with a home valued at $470,000. If it grew in value at 4% p.a. it would be worth $695,700 in 10 yrs time. As their reverse mortgage would have grown to $240,000 their net equity in the home would be $455,700, which is very close to their starting value.

In other words, this couple would have supplemented their income by using the future capital gains from their family home. Their loss of capital would be about the same as if they had chosen to move into a retirement village.

However, there is not one solution that is right for all. Seniors choose to move into a village for a variety of reasons including security, companionship, the loss of some faculty which impinges on their independence, and so on.

On the other hand, 90% of seniors over 65 yrs old do not move to a village or aged care. They can be fiercely independent and determined to stay in the family home. For these people, the reverse mortgage concept deserves close consideration.

Whilst the reverse mortgage product is available to home owners over the age of 60 years, it is more suitable, and carries less risk for those of 70 yrs or older. This is because of the compounding effect can seriously reduce the borrower's equity when operating for periods of 10 – 20 yrs or more. Retirees who use this product should ensure that they deal with SEQUAL Accredited Brokers or Advisers offering loans from lenders that are members of SEQUAL. (Website http://www.sequal.com.au))

7. Shared Appreciation Mortgages (SAMs)

This form of equity release is not a mortgage loan, but an arrangement whereby the Bank or other entity purchases a proportion of the home in consideration of an up-front capital sum. For example, the client may want to receive an amount of $100,000 against their home which is valued at $500,000. (ie. 20% of the value)

Depending on the age of the youngest owner, the Bank will specify a maximum percentage of the resale price that will become the Bank's equity. If the female partner is say 73 yrs old, and the younger partner, the Bank may establish their maximum ownership at say 37% of the resale price. The percentage will depend on the age of the borrower, the current cost of money, and the outlook for the property market over the projected life of the arrangement.

Because the returns to the Bank would be unrealistically high for a short tenure, the rate is discounted for shorter periods of tenure and for various property growth rates.
The financial modelling required to compare the "SAM" product to the reverse mortgage can be done, but is quite complex. However it is fair to say that the resultant return on funds to the Bank is comparable to prevailing interest rates for the reverse mortgage. We could deduce from that that the Reverse Mortgage and the SAM are quite competitive.

From the borrower's viewpoint, they will always know what percentage of the resale price of the home that they will retain as equity. If they reside in the home for more than their life expectancy, and property growth rates are modest, the SAM may be more cost effective than the Reverse Mortgage.

The SAM provides for a lump sum payment to the home owner. If the intention is to invest this sum to produce an income stream, then it may not be the most suitable. It is difficult to see how the borrower could safely place those funds to receive a return equal to the cost of funds. Would it make sense to borrow money at say 9% only to reinvest it safely at 6%?

On the other hand if the monies are required to be spent immediately, and not to support income, then this product could be more suitable.

8. Conclusion

Many of our current seniors are asset rich and income poor, and the aged pension is inadequate to support a desired lifestyle For this reason, most will have to consciously diminish their capital to support their lifestyle.

Various accommodation forms, support services and financial products have been developed over the past 30 years, which help seniors toward a better lifestyle.

Those that are not available either subsidised or free can be quite complex in their financial structuring, be they Retirement Villages, Reverse Mortgages or Shared Appreciation Mortgages.

It is only after gaining a full understanding of a person’s circumstances that potential solutions can be evolved to help them make the right choice for their future lifestyle.

For some, the right outcome will be to sell up and purchase a smaller home or retirement village unit. For others, it will be to retain the family home and use some of their equity to support their lifestyle.

There will be others residing in a home worth $1 million or more, who will prefer to soldier on living on the pension alone.

9. About the Author

Since the mid 1970s I have been dealing with people at various stages of their retirement years. Firstly, there were those in their late fifties or early sixties who relocated from Melbourne to Merimbula on the south coast of New South Wales.
I was the project manager for Tura Beach, developing and selling a new residential resort development which included an 18 hole golf course.

Becoming friends with many of my fellow residents and clients, they shared their thoughts on retirement, and the benefits and shortfalls of their new lifestyle from both the husband and the wife's perspective.

Following five years living in Merimbula, my wife and I moved back to Melbourne with our three children for educational reasons. It was then that my company appointed me to the new retirement village operation, where I was involved in the development and operation of retirement villages. This brought me into contact with a group of retirees at a different stage of their life. They were generally in their late sixties or early seventies, with a significant percentage of buyers being single women, generally widowed.

Again, I became friends with many of those clients and shared their thoughts on retirement, and the benefits and shortfalls of their new lifestyle.

During the latter part of my 20 year association with retirement villages I was an honorary board member for a Non Profit Aged Care Provider, which operated Hostels, Nursing Homes and Self Care units for elderly with limited capital.

My contact with this client group was more limited, but their main aspiration would be that they would like to be back in their own home. This is an accommodation form that most elderly want access to, but abhor the thought of ever having to use it.

During my time with the Aged Care Provider I learned much about the financial aspects of Aged Care, both from the Provider and the Client's perspective.

In 2003, I felt that I needed a change from dealing with the elderly, as I was now considered to be in that category myself, particularly as retirement village minimum age of entry is 55 yrs! I took up a position with Wizard Home Loans as a Mortgage Broker, but later went solo in my own home based business.

In 2003, few people would have been aware of the relatively new product, the Seniors Equity Home Loan or Reverse Mortgage. However, this type of loan is now heavily marketed by more than 20 lenders, and I find myself again dealing with the retired age group, helping them to make financial sense of the various lifestyle options available to them.

It is on the basis of the above mentioned experiences that I share some thoughts in this E-Book.

Michael Flynn provides a free retirement advisory at Greypath and may be contacted there.