

REVERSE MORTGAGE PRODUCTS: AN INDIAN BANKING PERSPECTIVE

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Abstract Reverse Mortgage (RM) provides a range of non-recourse mortgage loans, which helps a borrower, to get liquid funds by mortgaging his/her house property, without moving out or make any repayment options, till he/she dies or sells the house or moves out. This has been an innovative product and has been the idea of the global banking sector for last one and half decades. Hence, RM is a power device to increase the income of the senior citizens. However, Indian banking industry has adapted this innovative product only in 2006, but without much upsurge. It has been observed that the number has, however, increased to 7000 RM Loans of Rs. 1,400 crores as on 31st March, 2010 (www.business-standard.com). The product still has huge untapped market in India. There are however some major issues which is hindering the growth of the product.

This paper endeavors to show that the growth has been sluggish in the past because of lack of awareness among the customers, lack of knowledge, some regulatory factors and confusion relating to tax treatment. The banks felt the need for a complementary insurance product that will cover the borrower if they outlive the tenure of the loan. The paper also would throw light on the fact that the accounting treatment of RM has posed a contradiction towards the concept of revenue recognition and doctrine of conservatism as the assured anticipated incomes became difficult for disclosure. On the other hand the calculation of the indexed cost of acquisition has become difficult due to the controversy relating to the date of acquisition. This has led to the difficulty in computation of the Capital Gains arising out of the transfer.

The study therefore likes to focus on the two-fold aspect of RM as a product: firstly, a study on the future opportunities and challenges that will decide the fate of Reverse Mortgage as an innovative product for the Indian Banking Industry; secondly, the study focuses on the accounting and taxation dilemma arising out of the reporting methodology and disclosure of RM.

Keywords: Reverse Mortgage, Banking, Profitability, and Taxation.

1. INTRODUCTION

Reverse Mortgage (RM)¹ is a new weapon in the armory of Indian Bankers. It was perceived as a star product by most of the banks. But unfortunately they identified procedural bottlenecks within a small period of time after the introduction of this product. This paper endeavors to identify the challenges in introducing the product and tries to throw some light on the opportunities.

RM helps the senior citizens and the retired person(s) to convert the equity in their homes into cash in order to supplement their regular incomes. After observing the success of this product in the developed markets, the National Housing Board of India has decided to introduce this product in the Indian market in order to bring momentum to the

burgeoning housing sector of the country. Unfortunately, this product has not yet received the desired recognition. There may be a multiplicity of reasons behind the non acceptability of this product to the target group of customers like: lack of awareness among the customers, dearth of knowledge, fear of some regulatory factors, and confusion relating to tax treatment. The banks felt the need for a complementary insurance product that will cover the borrower if they outlive the tenure of the loan. The accounting treatment of RM has posed a contradiction towards the concept of revenue recognition and doctrine of conservatism, as the assured incomes that are anticipated became difficult for disclosure. On the other hand, the calculation of the indexed cost of acquisition would become difficult due to the controversy relating to the date of acquisition. This would lead to the difficulty in computation of the Capital Gains arising out of the transfer. Moreover, the sub-prime crisis and the decrease in the value of the properties in the US market has perhaps poised a question to the Indian banks whether to continue this product or form a consortium with the housing development

¹ It is a type of mortgage in which a home-owner can borrow money against the value of his or her home. No repayment of the mortgage (principal or interest) is required until the borrower dies or the home is sold.

authorities and create a safeguard in selling this innovative product to its customers.

The first section of the study explains the RM Loan products for the banking industries. This section focuses on the growth and development of this product worldwide. Some of the studies made worldwide have been discussed in this section. It also takes into consideration the scenario of Indian banking and its current position relating to the growth and development of this product in India.

The second section tries to find out the reasons which are mainly restricting the growth of this product in the Indian market. In this section, special emphasis has been given on the taxation and the accounting treatment of RM Loans and how it is different from the other loans.

Finally, a possible futuristic study has been made as to how this product may land in becoming successful in India, as it happened in the other developed countries.

In the process, it is also intended to study the current status of the Indian banks with response to the global standards and whether the Industry is ready to take up such a product which involves both systematic and unsystematic risk. Specially, in context with the volatility created in the global banking market after the sub-prime meltdown,² and fall in the value of the properties in the US market, it became a matter to be judged whether the Indian banks should continue this product or form a consortium with the housing development authorities and create a safe measure in selling this innovative product to its customers. The study also focuses on the viability of the product in the Indian market, and in case the bank can reduce certain predicament arising out RM, the product might prove its credibility.

2. REVERSE MORTGAGE AS A PRODUCT FOR THE BANKING INDUSTRY

RM provides a range of non-recourse mortgage loans³, which helps a borrower, to get liquid funds by mortgaging his/her house property, without moving out or without

² A financial crisis that arose in the US mortgage market after a sharp increase in mortgage foreclosures, mainly sub-prime, collapsed numerous mortgage lenders and hedge funds.

³ It is a type of loan that is secured by the collateral, which is usually property. If the borrower defaults, the issuer can seize the collateral, but cannot seek out the borrower for any further compensation, even if the collateral does not cover the full value of the defaulted amount. This is one instance where the borrower does not have personal liability for the loan.

making any repayment options, till he/she dies or sells the house or moves out. This has been an innovative idea of the global banking sector for last one and half decades.

This initiative was however taken by the US Department of Housing and Urban Development in 1988 by creating a RM Loan program. Since then, these mortgage products were featured in the US, the UK, Canada, France, Japan, Australia, Singapore, and in various other developed countries. Very recently, RM is trying to gain momentum in the rest of the world, which includes several developing economies. But due to the recent housing crisis in the US market, with the value of the properties going down, the growth of the RM loans has been at a slower pace.

These developed countries, however, promulgated a policy relating to the disclosure of accounting and taxation norms. In case of the US market, the eligibility criteria has been fixed to attaining 62 years of age with a maximum loan amount ranging from 40% to 60% of the value of the property (Business Standard, 2010).

3. SIGNIFICANT RESEARCHES ON REVERSE MORTGAGE LOANS

Research on RM loans has been minimal so far. Some of the major studies made worldwide related to RM products are listed below:

Chandrasekhar et al. (2007) refer to RM as a complex instrument that inculcates the mind of the elderly borrower the fear of the debt burden, eviction, and inability to leave a legacy behind by way of a bequest. They indicated RM as novel and socially preferred alternative to selling or moving out of the house in order to generate an income stream. In the same year, study by Wang et al. (2007) indicates various risks arising out of the provider's perspective which may hinder the further development of these financial products. This paper addresses one method of transferring and financing the risks associated with these products through the form of securitization. The authors demonstrate how to construct a securitization structure for RMs similar to the one applied in traditional insurance products. They investigated the merits of developing survivor bonds and survivor swaps for RM products.

Shan (2009) examines the 1989-2007 loan-level RM data and presents the following findings:

- i. Borrowers who take line-of- credit payment plan, single mail borrowers, and borrowers with higher house values exit their houses sooner than the other RM borrowers.
- ii. The author combined the RM data with country-level house price data to show that elderly homeowners are more likely to purchase RM than housing market

at its peak. His findings suggested that the housing market boom between the years 2000 and 2005 may be partially responsible for the rapid growth of RM Loan in US.

- iii. Finally, he showed that the Federal Housing Corporation (FHA) mortgage limits, which cap the amount of housing wealth that an eligible home-owner can borrow against, have no effect on the demand of the RM.

His findings have important implications to both policy-making and economies of housing and aging.

Nakajima (2011) analysed RM Loans in a rich structural life-cycle model in retirement. The model developed by them indicates that the reverse mortgages are used by the borrowers to pay for medical expenses while remaining in their home. Through a variety of counterfactual experiments, they identified that bequest motives, moving shocks, and house price fluctuations, as well as costs of insurance, contribute to the observed low take-up rate.

4. REVERSE MORTGAGE LOANS IN INDIAN BANKS

The then Union Finance Minister of India, P. Chidambaram introduced the idea of reverse mortgage in his Budget for the financial year 2006-07. National Housing Bank (NHB), an apex bank and a subsidiary of Reserve Bank of India (RBI), India's Central Bank, issued operational guidelines for the issue of RM loans. The Punjab National Bank (PNB), one of the nationalized banks of India has been the first to take the initiative to offer this innovative financial product to the elderly people. This novel scheme is named as "PNB Baagbaan Scheme" and under this scheme senior citizens are allowed to avail themselves of loan along with interest up to Rs. 1 crore against the house for at least 20 years.

However, the most important factor in deciding the loan amount is age. The loan value is directly proportional to the age of the person, i.e., older the person is, greater is the chances of getting high amount of loan. This is because of the fact that the lender is required to pay the amount for lesser number of years [Exhibit I].

Exhibit 1. Proportion of loan with respect to the Value of the Property

Age limit (in years)	Proportion of loan (%)
60-70	45
71-75	50
76-80	55
81 and above	60

Source: "Reverse Mortgage Loan (Rml): Operational Guidelines", http://nhb.org.in/Financial/Reverse_Mortgage_Operations_Guidelines2.html

RM Loans are extended by Primary Lending Institutions (PLIs) which include the Scheduled Indian Banks and Housing Finance Companies (HFCs) registered with NHB or any other class of institutions notified by Government of India. The PLIs assess the value of the house property through an independent valuer in terms of generally accepted property valuation methodology in the industry. In-house professional valuers may also be used to subject to adequate disclosure of the methodology. The loan amount will be decided on the basis of present value of the property. The PLIs have their discretion to offer RM loans. There are however, several eligibility conditions for the Indian borrowers under the scheme [Exhibit 2].

Exhibit 2. Eligibility Criteria for the Borrowers

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|---|
| <ul style="list-style-type: none"> • Should be Senior Citizen of India above 60 years of age. |
| <ul style="list-style-type: none"> • Married couples will be eligible as joint borrowers for financial assistance. In such a case, the age criteria for the couple would be at the discretion of the Prime Lending Institution (PLI), subject to at least one of them being above 60 years of age and the other not below 55 years of age. |
| <ul style="list-style-type: none"> • Should be the owner of a self-acquired, self-occupied residential property (house or flat) located in India, with clear title indicating the prospective borrower's ownership of the property. |
| <ul style="list-style-type: none"> • The residential property should be free from any encumbrances. |
| <ul style="list-style-type: none"> • The residual life of the property should be at least 20 years. |
| <ul style="list-style-type: none"> • The prospective borrowers should use that residential property as permanent primary residence. Permanent primary residence refers to the self-acquired, self-occupied residential property where a person spends majority of his time. Factors that may be relevant in this regard include the address used for general correspondence, utility bills, bank statements, tax return, bank accounts, and banking relations, etc. However, all of the facts and circumstances may be considered for the purpose of determining that the residential property is the permanent primary residence of the borrower. |

Source: "Reverse Mortgage Loan (RML): Operational Guidelines", http://nhb.org.in/Financial/Reverse_Mortgage_Operations_Guidelines2.html

However, though it is a well-entrenched idea in many developed countries, RM has not been quite successful yet

in the Indian sub-continent. In India, till March 2008, out of the nearly 80 million senior citizens, just over 150 senior citizens have availed this facility. The experts and analysts believe that there had been such a minimum response due to the confusion relating to the accounting and tax treatment. Moreover, there may be a feeling that with the global recession and decrease in the value of the house property into play, mortgaging house property against loan might not prove to be a viable option for the banks. The Indian banks are already under the pressure of high non-performing assets (NPAs) due to their aggressive lending policies in the past. Hence, the banks are taking very cautious approach on lending against property.

5. REVERSE MORTGAGE IN INDIA: A FAILURE?

RM loans are not common in the Indian market for long. It was introduced only in 2006-07, while this product was prominent in the developed countries for the last two decades, Indian customers have shown a conservative approach in the past. It took about 25 years for the banking sector to take up the liberalization and globalization challenge after nationalization. The sector has very recently opened itself up to the foreign participants. Hence, history reveals the unwillingness of the Indian customers towards change. Moreover, RM is a product which encompasses the old-age sentiments. Some drawbacks of this product which may have lead to the failure of this product have been identified. This includes the taxation treatment, the accounting disclosure policies, complementary insurance for the banks, existing volatility in the global market, and lack of awareness among the customers.

6. TAXATION TREATMENT

Section 10(43) of the Income Tax Act (IT Act), 1961 (with effect from the Assessment Year 2008-09) deals with any amount received by an individual as loan (either in lump sum or installment basis) in a transaction of RM. This section proves that under a RM scheme, the periodic installment or lump sum paid by the lender to the borrower during his lifetime will be exempt from income tax. This amendment is applicable even for the earlier years.

Income arising out of the “transfer” of house property used for the residential purpose is taxable under the head Capital Gains. According to section 2(47) “transfer” in relation to a capital asset includes sale, exchange, or relinquishment of the asset or banning of any rights therein, or the compulsory acquisition thereof under any law.

The property mortgaged for RM purpose does not fulfill the basic conditions of section 2(47). The ownership of the asset may be transferred to the bank only after the expiry of the

tenure of mortgage if the borrower or the legal heir desires so. If the borrower or the legal beneficiary of the borrower repays the loan with the interest to the bank, the property remains in their hands.

However if the borrower or his legal heir does not repay the loan or in case the borrower having no legal heirs expire before completion of the terms, in such case the ownership of the property is transferred in the hands of the lender. The property is then sold by the bank. The income arising out of such sale proceeds is now subject to income chargeable under the head capital gains.

There are some major issues concerning the tax treatment of RM loans. They are as follows:

- As per Section 48 of the IT Act, the Cost Inflation Index (CII) is considered for calculating the gross capital gains before deductions u/s 54. But in case of indexation of cost, the date that will be applicable—the date of discharge of loan or the date of purchase of house property by the previous owner—is a matter of legal discussion under the IT Act.
- If the house is renovated or repaired with such borrowed money, the interest on loan will be eligible u/s 24(b) of Income Tax Act as deduction at the time of computation of income under the head of income from house property. But the head income from house property has defined house property under the categories self-occupied, let-out, and deemed to be let out⁴. No special provision has been made for RM properties. Again the RM properties cannot be considered in the categories above. So, deduction u/s 24(b) is yet to be justified.
- Section 10(43) has exempted the amount received by the lender from income tax. So, even if the amount received by the lender surpasses the minimum⁵ exempted amount, it remains untaxed. In the long run, with large number of lenders receiving such loans and claiming tax exemption u/s 10(43), it cause loss of revenue for the government. So, it may be charged to tax above the minimum expected amount under the head Income from Other Sources.

In case the lender has more than one house property, RM loan can be utilised as an effective tool for multiplying his income. So, only a person possessing one self-occupied house property may be eligible for such loan.

⁴ In case of a person occupying more than one self occupied House Property, only one property is taken to be self-occupied and the others are taken to be let-out for the purpose of calculation of Income from House Property.

⁵ Income above INR 190000 is taxable in case of citizens below 65 years of age and for citizens above 65 years, income above INR 240000 is taxable for the Assessment Year 2011-12.

The Income Tax Authority suffers from contradiction regarding the tax treatment of the property.

7. ACCOUNTING DISCLOSURE

The accounting disclosure seemed to be one of the major causes of concern for the banks. In financial accounting, two methods are followed—the accrual method and the cash method. In the case of RM loans, the interest is earned by the banks and financial institutions annually, but the entire amount (principal and interest) is recovered only after the term of expiry. Therefore, the question arises on the issue, as to whether the interest income is taxable on the cash basis or on the accrual basis. If it is taxable on accrual basis, then the interest earned by the banks every year should be treated as income and hence taxable. However, in this case, at the time of final disposal of the agreement, the entire amount which is paid by the borrowers is exempted from tax because interest earned during the loan period is already taxed every year and the principal amount is a repayment of loan, and so it is not a taxable income. On the other hand, under the cash basis, the entire interest will be treated as income at the time of final disposal of the RM loan. But, at the time of disposal, this huge interest income creates a tax-burden for the banks.

Another issue which may arise at the final disposal stage is, the receivable amount might be less than the total due (principal and interest). Such cases are controversial: whether the accounting adjustment for the loss may be allowed as bad debts at the time of settlement or may be adjusted through some other accounting procedures. Again, when we are considering the interest earned by the banks, we are anticipating future income. According to the doctrine of conservatism approach, the anticipated loss or expenses are always accounted for, and anticipated incomes and gains are never considered.

Finally, the Accounting Standard Body (Institute of Chartered Accountants of India) or IFRS is yet to come up with specific accounting rules relating to the accounting disclosure of RM.

8. COMPLEMENTARY INSURANCE

The Indian banks have accepted the need for complementary insurance. Though the insurance companies have sensitized the product, none of them have come out with a suitable insurance policy for such products.

9. VOLATILE GLOBAL MARKET

The housing market worldwide has faced a major set back following the sub-prime crisis. The property prices has faced a downturn and the demand for the property has come down,

indicating that the fresh housing mortgage owing to reverse mortgage may seem to be an aggressive lending policy for the banks. Moreover, the fall in the property price worldwide would lead to granting of the loan amount, which is much lower than the actual value of the property.

10. CUSTOMER AWARENESS

Indian customers are not very responsive to the products. Surveys in the branches⁶ reveal that the branches of the major Indian banks are not aware of the product. The banks in its websites have disclosed about the product, but have failed to clear the doubts in the mind of the customers due to unavailability of the detailed information at the branch level. Moreover, there are regular advertisements in the media regarding the housing loan, car loan, personal loans, etc. for the individuals, but the frequent advertisement of the RM has never been projected.

The other cause of the unpopularity of this product has been the sentiment of the elder Indians. When a house is mortgaged, it has a psychological impact in the minds of the mortgagee in the sense that:

- i. If the house is Reverse Mortgaged, the legal heirs may be deprived of the property if it is not recovered at the end, and
- ii. The house they have used might be in the hands of some unknown person of different caste and creed, which is a reality, and it is difficult for them to believe that RM might seem to be a remedy for only the old-age couple having no legal heir.

11. RM LOAN: AN UNEXPLOITED WEAPON IN THE BANKER'S ARMORY

The above complexities have perhaps made RM an idle weapon in the hands of the banks. The following objectives may be set in order to make the product popular among the clients:

- i. The Direct Tax Code which is proposed to come in force from 1st April, 2012 is silent about the tax treatment of the RM loan. A proper taxation policy needs to be framed in order to settle the taxability, both in the hands of the banks and the clients.
- ii. A standard method of accounting needs to be developed. This accounting methodology would set the foundation of the RM accountability. Under the Companies Act, 1956 (Amended till date), disclosing the financial statements through the annual reports have been made

⁶ Surveys have been conducted at few branches like the SBI, Allahabad Bank, Syndicate Bank, Punjab National Bank, and so on.

mandatory for all companies, including the banking sector. But, absence of a proper accounting policy restricts the banks from disclosing the quantum of RM Loans in their Balance Sheet. Surveys made in the annual reports of the banks have no clue about the quantum of the RM Loan sold during the year. Framing up of a proper accounting policy might lead to more popularity of the RM product. Journalized transactions of the RM Loan may be proposed as follows [Exhibit 3].

Exhibit 3. Proposed Journal Entries: Accounting for RM Loans in the Books of The Bank

In The Books of the Banks	
At the time of issuing RM Loan	
# Mortgaged Buildings A/C.....Dr. xxx	
To Suspense for Buildings A/C	xxx
At the time of Payment of Installment	
# Suspense for Buildings A/C.....Dr. xxx	
To Cash A/C	
(To be made monthly/yearly)	xxx
At the time of sale	
# Cash A/C.....Dr. xxx	
Loss on Sale A/C (if Any).....Dr. xxx	
To Mortgage Buildings A/C	xxx
To Profit on Sale A/C (if Any)	xxx

- iii. The need for the complementary insurance arises in case the borrowers outlive the tenure of the loan. In this context, the US market may be taken as a model for implementation. In case of the US market, one has to incur the Mortgage Insurance Premium (MIP), equal to 2% of the maximum claim amount, in addition to which, an annual premium equal to 0.5% of the loan balance is added with. There has been a huge growth in the insurance sector in India after globalization. The complementary insurance policy therefore needs to be implemented as it would benefit the society at large and support the banks heading towards issue of more amounts of RM Loans. However, initially the MIP may have an increased percentage compared to US market, but an introduction of complementary insurance policy might act as a security towards the issue of RM Loans.
- iv. Till now, the efforts of the Indian banks to make the product a success seems to be sluggish effort from the banks since they haven't made the adequate efforts to educate the customers and make them aware of the utility of such loans in the Indian scenario. Regular promotional policies and organization of workshops

for the senior citizens might help in gaining popularity of such products in the market.

12. CONCLUSION

In conclusion we may infer that the product, if accepted by the senior citizens might prove its effectiveness in present-day lifestyle. The RM Loan is the enjoyment of the value of the house within the lifespan of the individual, without giving it on a lease or on rental basis. Finally, the banks have launched this product in India without making proper market research for the product. The product has not been modified and tried in the Indian market. It was launched in the way it was accepted in the developed economies. The banks might prove this product to be beneficial for the customers by re-launching it, and by shaping it up in a way that might be acceptable to Indian customers.

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