

# STUDENTS' ECONOMIC FORUM

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September 2007

Theme 190

REVERSE MORTGAGE

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## SIB STUDENTS' ECONOMIC FORUM

SEPTEMBER 2007

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### Theme No. 190 : REVERSE MORTGAGE

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We are all aware of the mortgage for the housing loan that we avail of when we buy a house. Reverse mortgage, as the name suggests, is just the opposite. National Housing Bank (NHB) has recently taken steps to introduce this product in India, though it is quite common in the US. This scheme would provide greater financial security for the elderly, especially those who either prefer or are forced to live independently in their twilight years. This may prove to be a useful scheme in India, where more than 90% of the population does not enjoy any old-age benefits like pension or social security. In this month's forum, we will discuss this loan product, which has been just introduced in our country.

#### **What is Mortgage?**

Mortgage is a transaction where a mortgagor takes a loan from a mortgagee, against an immovable property as security. Land or land with building / house is the security, that we generally reckon as immovable properties, while considering a mortgage transaction.

#### **What is a Reverse Mortgage?**

It is a novel loan product under which a senior citizen who is the owner of a house can avail of a lump sum amount or a monthly stream of income against the mortgage of his house, while remaining the owner and occupying the house throughout his life time, without repayment or servicing of the loan. The home owner's obligation to repay the loan is deferred until the owner dies, the home is sold, or the owner leaves the house.

#### **Why it is called as "Reverse"?**

In a reverse mortgage, the home owner makes no payments and all interest is added to the lien on the property. If the owner receives monthly payments, then the debt on the property increases each month. Reverse mortgages work much like traditional mortgages, but in reverse. Instead of the borrower making a payment to the lender each month, the RM lender pays the borrower. In a typical mortgage, the equity of the borrower in the mortgaged property increases over a period of time. While in a RM, the equity of the borrower in the mortgaged property normally decreases over a period of time. Reverse Mortgage loans are also called "rising debt, falling equity" loans. As the amount you owe (your debt) grows

larger, your equity (that is, your home's value minus any debt against it) generally gets smaller.

### **What are the advantages of a reverse mortgage?**

There are many. Here are a few of the most significant:

- Remain independent - a reverse mortgage allows you to remain in your home and retain home ownership.
- No monthly mortgage payments - you need not pay back the reverse mortgage loan nor make any monthly mortgage payments until you permanently move out of the home.
- Tax-free money - because the money you receive from a reverse mortgage is not considered income, it is tax free. (Pending clarification)
- Freedom and flexibility - the money you get from a reverse mortgage is yours to use in any way you choose.

### **What is the role of NHB?**

NHB, a wholly owned subsidiary of Reserve Bank of India, was established on July 9, 1988 under an Act of the Parliament. NHB carries out its statutory functions of developing a healthy housing finance sector through refinance of housing loans, supervision of the sector and creation of a vibrant securitization market. NHB provides refinance to various Primary Lending Institutions (PLIs) in respect of the retail housing loans extended by them. NHB has formulated the guidelines to be followed by the PLIs while considering reverse mortgage loans in India. Please refer [www.nhb.org.in](http://www.nhb.org.in) for updates. NHB has also plans to set up a mortgage guarantee company as a Joint Venture with international partners to provide risk cover to lenders against defaults. To maintain the majority stake, NHB will have two to three partners in the new company and one of the partner is the Asian Development Bank with whom NHB is in talks. It may also be noted that Govt. of India is now planning to take over the stake of RBI in NHB.

### **Who is eligible for a RM loan?**

You will have to be a Senior Citizen of India above 60 years of age who have retired from active work life. Married couples will be eligible as joint borrowers for financial assistance. One should be the owner of a self-acquired, self-occupied residential property (house or flat) located in India. Residential property should be an approved construction, free from any encumbrances and the residual life of the property should be at least 20 years.

### **How is the appraised value of property calculated?**

The PLI shall determine the Market Value of the residential property through

their internal or external approved valuers. PLIs are advised not to reckon expected future increase in property value in determining the amount of RML.

### **How is the value of loan amount calculated?**

The amount of loan will depend on market value of residential property, as assessed by the PLI, age of borrower(s) and prevalent interest rate. As per the NHB guidelines it may vary between 40% ( for those at 60 years) to 60% (for those at 75 years) of the Assessed Value of Property. The PLI may consider ensuring that the equity of the borrower in the residential property or Equity to Value Ratio (EVR) does not at any time during the tenor of the loan fall below 10%. The PLIs will need to revalue the property mortgaged to them at intervals that may be fixed by the PLI depending upon the location of the property, its physical state etc. Such revaluation may be done at least once every five years and the quantum of loan may undergo revisions based on such revaluation of property at the discretion of the lender.

### **What are the allowed end uses of RML?**

The loan amount can be used for renovation, extension , maintenance/insurance of residential property, medical/emergency expenditure for maintenance of family, supplementing pension/other income, repayment of an existing loan taken for the residential property to be mortgaged and also for meeting any other genuine need of the borrower. But use of RML for speculative, trading and business purposes is not permitted.

### **What about the settlement of RML?**

The loan shall become due and payable only when the last surviving borrower dies or would like to sell the home, or permanently moves out of the home for care, to an institution or to relatives. Settlement of loan along with accumulated interest is to be met by the proceeds received out of Sale of Residential Property. However, the borrower(s) or his/her/their estate shall be provided with the first right to settle the loan along with accumulated interest, without sale of property. Two months time may be provided when RML repayment is triggered, for house to be sold. The balance surplus (if any) remaining after settlement of the loan with accrued interest, shall be passed on to the borrower or to his estate. The borrower will have the option to prepay the loan at any time during the loan tenor. There will not be any prepayment levy/penalty/charge for such prepayments.

### **What are the other major clauses of the RML covenant?**

The PLIs shall ensure that all reverse mortgage loan products carry a clear and transparent ‘no negative equity’ or ‘non-recourse’ guarantee. That is, the Borrower will never owe more than the net realizable value of their property, provided the

terms and conditions of the loan have been met. In addition, the PLI may also consider obtaining a Registered Will from the borrower stating, inter-alia, that he/she has availed of RML from the PLI on security by way of mortgage of the residential property in favour of the PLI. The PLI will also ensure that the borrower has insured the property against fire, earthquake, and other calamities and pay all taxes, electricity charges, water charges and statutory payments.

### **Can PLIs foreclose the loan?**

The loan shall be liable for foreclosure if the borrower fails to meet the terms and conditions of the RML covenant. Instances such as the borrower declaring himself bankrupt, the borrower effect changes in the residential property that affect the security of the loan and the government seeks to acquire the residential property for public use are sufficient reasons for the PLI to trigger foreclosure.

### **What are the tax implications of RML?**

Bank customers want to know whether the monthly RML payments are taxable. Technically they should not be, as the payments are in the nature of a loan, but banks want the IT department to explicitly clarify this point. Another aspect is, whether the interest accrued on this reverse mortgage loan can be treated at par with that of accrued interest in case of a normal housing loan. At present, such interest accrued up to the tune of Rs. 1.5 lakh per year can be deducted from the taxable income. Bankers themselves want clarification on another point. The interest accrued on the monthly payments is booked as income, but banks want to pay tax on it only when they recover the money by selling the house after the borrower dies!

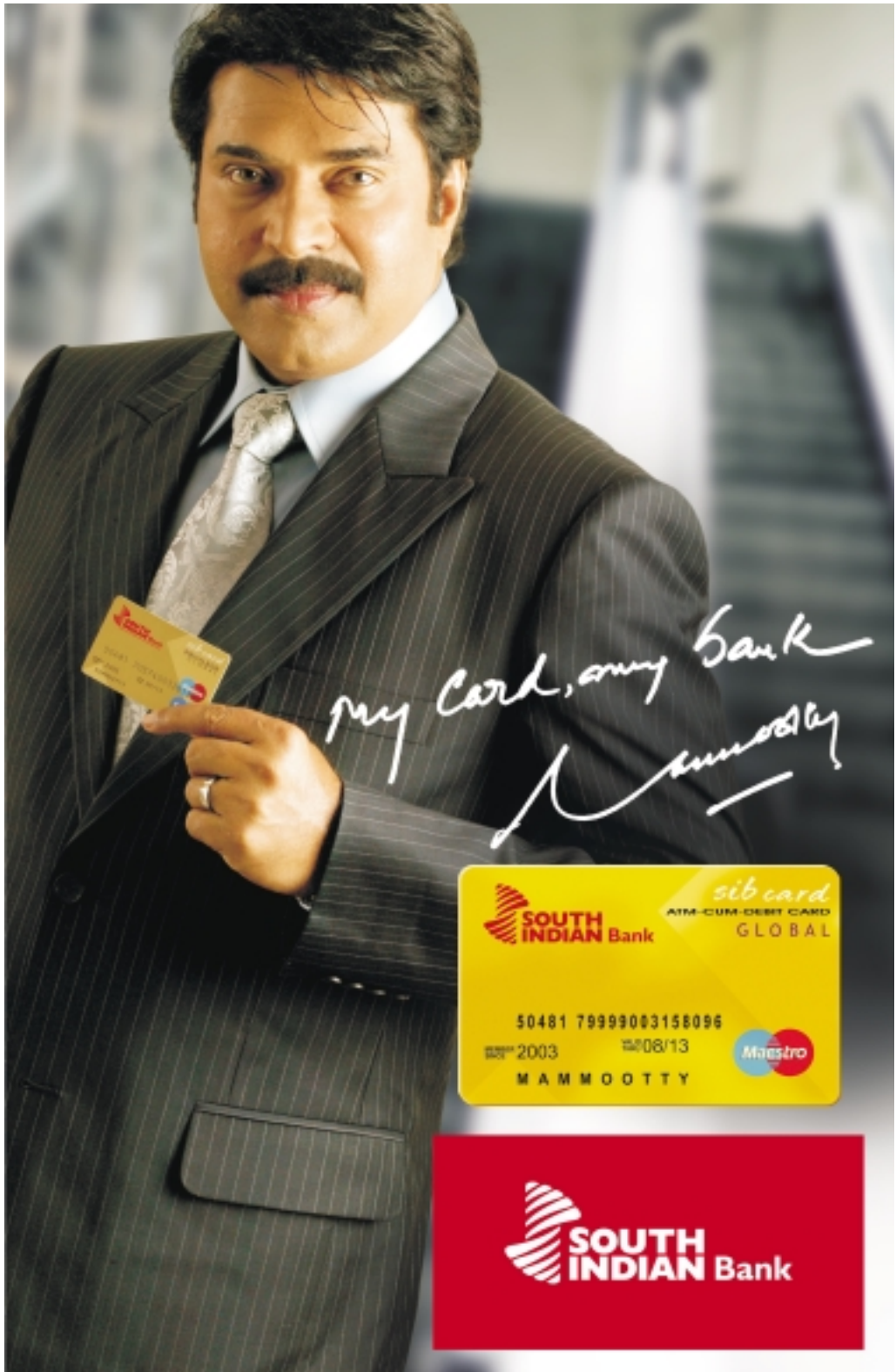
In these circumstances, the National Housing Bank has written to the Income Tax department, conveying concerns of banks and their customers on these issues related to the treatment of loans from reverse mortgage arrangements.

### **Conclusion**

Reverse mortgage is a new product and there are bound to be some teething issues – operational and legal - which need to be sorted out. Notwithstanding all these issues, which seem quite challenging, the reverse mortgage is a product, which offers an option to the old people to continue to live with dignity.

But there are some emotional issues too. Let us heed to a middle class senior citizen - “I consider my house as a very dear asset and I have a very high emotional value attached to it. Therefore, creating a debt on it will require a big change in my present mind set. Also, I want to leave it behind as a legacy for my children, irrespective of the fact whether they take care of me or not. Therefore, to give it away to a bank would be another mind set hurdle for me to overcome”.





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## **SOUTH INDIAN BANK TIES UP WITH BAJAJ ALLIANZ FOR DISTRIBUTION OF GENERAL INSURANCE PRODUCTS**

South Indian Bank has entered into a tie-up with Bajaj Allianz General Insurance for distributing their range of general insurance products. According to Dr. V A Joseph Chairman and CEO of South Indian Bank, "Our aim is to provide a wide range of financial products to our customers. Our tie-up with Bajaj Allianz General Insurance would ensure our customers not only get good service but also a range of need based general insurance products"

Bajaj Allianz has devised a Bank assurance module, which is a customized module solely for bank assurance and meets the needs of its various Bank partners. Bajaj Allianz General Insurance is one of the leading private general insurance companies with presence in over 100 towns through its network of offices and representatives. Bajaj Allianz is the first private insurer to generate over Rs.100 Crores in profit before taxes in 2006-07.

*In Photo : Dr. V A Joseph, Chairman & CEO of South Indian Bank and Mr. Kamesh Goyal, CEO, Bajaj Allianz General Insurance exchange the agreement for marketing of General Insurance products.*