Interview with Alan Kohler
The Constant Investor – transcript

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Josh Funder is the CEO of a start-up called Household Capital. It's a private company, so you can't invest in it, but what it's about is providing a different kind of reverse mortgage for retirees to access their home equity.

What's different about it? Well, it's a lower LVR and it's a wholesale funding line from ME Bank, which means that the interest rate is lower than the normal reverse mortgage, it's 5.9%. It's still obviously a higher interest rate than a normal mortgage but because the money is leant and not repayable until the end and the interest capitalises, these sort of things are always higher interest rates and they have to be.

But it is an interesting way to access home equity, for whatever reason you need it for. They're suggesting you put the money into super so that it earns as much as 5.9% to in effect pay the interest on it. The business has got some substance to it.

It's got some interesting people behind it including the former Minister for Superannuation, Nick Sherry, who's the Chair of the board, and my old friend, Bob Officer, is on the advisory board, and there's a few other interesting people behind it. I think it's worth knowing about. I don't know whether you are a potential customer of a reverse mortgage provider, but I think it might be something you might want to think about.

Here's Josh Funder, the CEO and Founder of Household Capital.

Josh, I take it your product is not a reverse mortgage, but can you tell us what it is? And in particular, what's the security?

Well, Alan, let's be clear, we haven't reinvented the time value of money and our product is a mortgage and you don't need to pay it monthly, you pay it off at the end. To that extent, we're very much regulated within the Australian regulation and very insistent on making sure all the customer protections that people enjoy with the traditional bank reverse mortgages are provided.

So, to that extent it's similar, but we've innovated a lot to make it very different. We've made the wholesale debt behind this product much more efficient and scalable, and with that, even at these early days, we're able to offer the lowest rate in Australia.

Perhaps you could explain what you mean by wholesale debt, because I take it from your website that that means your interest rates are lower than they would be with a reverse mortgage?

That's right. It's a form of reverse mortgage, we don't need to reinvent that, but we've done a lot to innovate and make it a very different product from the traditional bank approach. The wholesale debt is a facility that we have currently with ME Bank and what that enables us to do is to improve where we mitigate risk, when we mitigate risk, and to do that more efficiently. That's very new. In the past, nobody's innovated specific to helping people stay at home and access their home equity in wholesale debt and that's why we get a lower interest rate, lower than the banks ever got to when they were on market and lower than the current market which has popped up since the banks pulled out and withdrew from retirees in this market at the end of last year.

What is your interest rate, Josh?

The interest rate is 5.9%.

And when you talk about mitigating risk and so on, can you explain exactly what you mean by that?

The important thing about a product which you don't pay monthly, is it's more expensive because the provider of the debt needs to wait until the end. That's why it's higher than a normal mortgage. But the important thing there is also the risks for a normal mortgage for a bank would be in the first few years when the loan to value ratios are high and they're sensitive to property volatility.

But our mortgages start at around 20% loan to value ratio, so it's very difficult for a fluctuation in the property markets to affect the customer's security. If property drops 20% and you start at 20% loan to value ratio, you might start to get to a loan to value ratio of 24%-25%, so these are very secure.

At the end, the customer's get a negative equity protection, they can never own more than the value of their home, but that presents a risk to the lender, and so you have to mitigate that risk in decades three and four, not in the first five years. And so the timing of that risk and when it is mitigated has never been done the way we've done it before and we're proud to say we think it's more efficient and scalable, and so it will meet the needs of many Australians who haven't really had their needs addressed by the banks.

That's a key difference, obviously, the 20% loan to value ratio, you're only lending 20% of the value of the property. That, I would suggest, seems to be the key difference.

Well, it does change the risk in the early years, but it incurs risk in the outer years. The key difference is also, you can stay at home as long as you like, so there's no term on these loans, it's not 25 or 30 years and that's a real benefit to people who plan to retire at home and want the protection of guaranteed occupancy. The loan to value ratios are age adjusted, so at 65 years old 20% is your rule of thumb. It goes up 1% a year, so by the time you're 85, it's 40% for many people. So, that enhances the ability of people to fund their retirement over the journey.

I take it, it's the first mortgage and in fact, the only mortgage, so their house has to be, apart from your mortgage, it has to be debt free?

It is a first mortgage, that's important. The mortgage can be used in part to pay off existing mortgages and there's two sorts of mortgages there that are important to think through. There are existing reverse mortgages that a few people in Australia have and that are highly priced. So, it may suit some people to refinance those at a lower rate.

But very importantly, since the Royal Commission, it's clear that there are a lot of retirees paying off their mortgage and paying those monthly out of their retirement income. That's causing hardship, so an important use of these is for many retirees to have a small mortgage. Maybe it's 10-20% mortgage to value ratio, but it's eating into their retirement income, it's reducing their available retirement funding and causing hardship, and so there's a real opportunity for those people to improve their retirement funding, improve their pension and income by having a facility that means they don't have to pay the bank back monthly.

And so when you say it pays back at the end, what do you mean by the end, just at death or is there a specific time on it?

No, a lot of people are very savvy in how they're using their home to help fund their retirement. When we look at the patterns of retirement in Australia there are four main causes of people finishing and discharging these sorts of products. The first one is mobility, they spend an extra 10-15 years in their family home while their kids are finishing off, while their grandchildren are young, and then they downsize anyway. There's a bridge to downsizing, but it gives people are longer term runway to stay in the home that's fit for that time in their life.

Other people have morbidity, they need to move to an aged care facility because they're getting crook, and that's another reason why people leave the family home. Some people inherit something from grandma and grandpa and pay these off and stay living at home and discharge them that way. And a fourth group, and the smallest group of all, actually live at home forever, don't transition to aged care and die at home.

That's another cause of people – and that's a great outcome because they've been able to spend their whole retirement at home. Along the way there are important needs of just the retirement funding, but also to maintain the home, to pay for healthcare and in-home care so people can stay longer at home, to put in stair rails and ramps and shower rails too.

Through the course of retirement there's a range of different funding needs that people often get caught short because for Australian baby boomers the super is usually less than a third of the value of their home equity and so they have a lot of savings, but they can't access them in order to fund their retirement. Fundamentally, that's what we're trying to do.

You're saying that the smallest group of people are those who stay in the home until they die?

That's right, so you need to understand the needs of retirees and their patterns of behaviour, and we can meet the needs of all four of those groups as they use their home to fund their retirement through different lengths of time.

I don't even know this – what's the typical LVR of a reverse mortgage from a bank?

The banks and everybody, as I mentioned at the start, are governed by ASIC 2012 legislation. ASIC say you can lend 25% at the age of 65. We're more conservative than that, in lending 20%. That's to the borrower's benefit, to the customer's benefit, because they end up with more equity in their home and it also reduces our risk as a lender and with that, reduces the cost, we pass that through. ASIC's set out the loan value ratios, above that ASIC presumes that a loan's not appropriate. And those loan to value ratios go up 1% a year with ASIC and also with us, they're age-adjusted availability of home equity to fund the time.

Are you the lender or is ME Bank the lender?

No, no, we're the lender and we're an independent originator and our investment beyond getting the wholesale debt right, you need to change the customer experience of funding your own retirement for using home equity. We've got software that does that, we've got new approaches to responsible lending in this space, and also we partner with super funds, financial advisors, aged care advisors to make sure two really important things are in place – the banks didn't really do this. We want to make sure that people transfer their home equity into an available and appreciating form of asset, whether that's a super fund or an investment account or their own home.

Secondly, we want to make sure they're doing it with a long-term plan, so they don't get caught short in the future. ASIC found that the traditional bank reverse mortgages broke down because they were largely focused on short-term consumption of equity and that's not appropriate for funding retirement, which in Australia to our great pride, is a very long period, it's up to 30 years for most people, they need to plan their retirements.

So, we really work hard to make sure people aren't consuming their equity in the short-term and not having enough in the long-term. It takes a fair bit of work to re-engineer the customer experience, the product and the constraint. So, the banks have withdrawn credit from this market, we've reintroduced a new form of credit, but importantly, it's got some constraints on it that we think work in the customer's interest.

And of course, the 5.9% interest capitalises until the end, right?

That's right. If you take a 65 year-old couple and they had a million dollar home in Sydney or Melbourne, and they might have $200,000 in super – that's a very typical situation – and if they $20,000 a year from their super index, it might last 12 or 13 years in most investors and financial managers' expectations. If you took a 15% loan to value ratio, the $150,000 and topped up that super account to $350,000, they could draw $20,000 dollars a year indexed for 28 or 29 years.

So, it very much extends the available retirement income on top of the aged pension. That couple starting at 15% loan to value ratio might end up still owning in 30 years' time, between 60-70% of their home. The debt does compound and it's important to always be absolutely transparent about that, but it can transform how long your income lasts and the flexibility you've got to fund your own retirement. Most people are very comfortable with consuming part of their home to transform their retirement funding.

What if the combination of the compounding interest and decline in the value of the property takes the loan to value ratio well above 20% over time, do you require a, as it were, a margin call?

No, no, the customer is very much more protected than that and that's really important to make clear. There's an absolute stop where the loan can never get to be more than 100% of the house, no lender can ever go after the estate. You've got guaranteed occupancy, you can never be forced to leave your home simply for staying on. Those are really important customer protections, but we also provide, and ASIC do a good job of this part of the market, in providing scenarios for customers. We say, what happens is the home doesn't grow at all over the course of the loan? What happens if the home only grows at 3% over 15-20-30 years? What happens if interest rates go up?

Those scenarios have been very useful and effective in making sure people are eyes-wide-open, and that they're managing their available savings in super and they're managing their home equity for the long-term and they're able to do that responsibly. That's actually functioning pretty well at the moment in terms of how to step people through what their scenario's going to look like over time.

I guess if the home does increase in value by 5.9% per annum, then the kids won't lose any inheritance really – well, they'll lose the capital gained, but anyway…

Well, look, let's walk that through, because there's some interesting implications in your question, Alan. Firstly, if you put the transfer of your own equity into a largely appreciating asset that's tax equivalent like super or an investment account in pension phase, that might grow at roughly 5.9%. You've got a relatively low cost or zero cost of making a transfer to where it's available. Now of course people need to consume more of their savings to better fund their retirement, so there's no getting around that or the time value of money. But the transfer of your home equity where it's not available to fund your retirement, into an appreciating asset of some form, is a really important difference and something that we make sure our people are able to think through.

You mention the other point about the kids and their inheritance, and that has been a big factor over home equity access over the last four or five decades. But actually, most baby boomers are dying in their 80s and well into their 90s and their children don't get the bequest until they're almost retired or they're in retirement themselves. And so, what's disinherited the kids of baby boomers isn't so much home equity access, that's been a very small part of the Australian landscape in retirement. It's actually longevity. Because they're living so long, the kids don't get it when they really need it, so an important feature of managing retirees home equity is to make sure their income is right in retirement, make sure the housing is in good shape.

But if their income and housing is okay, it's an opportunity for them to help fund kids' first home buyers' deposits for grandchildren's school fees. The percentage of school fees in Australia that are paid in whole or in part by grandparents is staggering, and a lot of those are being paid at the expense of superannuation which is going to run short in their last 10-15 years of the grandparent's retirement. So, we think people need to be able to plan to make sure people can be the bank of mum and dad, but they can do it responsibly, not deplete their super and put the last decades of their retirement at risk.

In fact, are you finding that many of your customers are taking out a reverse mortgage and then handing the money straight over to the kids as an early inheritance?

No. What we're seeing, and we're working with academic researches on this sort of thing, is kids want their parents to have more, parents want their kids to have more. We have a very structured conversation to make sure the parents' income needs in retirement in the long-term are planned. The parent's housing and retirement is planned. If people have enough wealth to plan for their own long-term retirement and then give to the kids, then that's a conversation that you can have afterwards, it's an open conversation about the parents needs now and the kids needs now.

If a couple or a retiree came to us and said the only thing they want to do is give to the kids and we could see that they didn't have a long term plan for their income or housing, then you'd want to be very careful about that and probably not let that person do it because they might be under duress and there's forms of elder abuse.

Also, it's just going to leave them short in the long-term. It's also probably not what the kids want if you have that conversation in a well-structured way. The idea that people are continuing to deplete their long-term wealth for their kids is not something we think this product should encourage, but we do think that when 3 or 4 times as much of the family savings are tied up in the home, then that's a source of responsible bank mum and dad transfers.

Tell us who's behind your company?

We're an innovative start-up. We have a group of high net worth investors who have various forms of experience related to what we're doing and have been helping us actively. We've got an advisory board which is providing strategic guidance. Jack Diamond, who's a serial innovator in financial services; Peter Harris, used to be the Chairman of the Productivity Commission – a range of people on our advisory board and providing really good input.

Our board of directors who govern the company include Nick Sherry, who used to be the Minister for Superannuation, as our Chair, and people like Jim Miller who is ex-Macquarie Bank's infrastructure and debt finance leader. So, we're drawing on real expertise about how to understand the components of innovation we've done and to try and get this right in a new way.

We've got a team of a dozen people and importantly, the $100 million dollars starting facility of ME Bank is a good sign to get started and test this market, but it really is the start of something much bigger. There's almost a trillion dollars of home equity that Australian retirees own and at the moment they can't access it in a sensible way to fund their retirement.

This is a big complement to Australian superannuation for retirees and baby boomers, and their home equity is at least as much again a part of the system that needs to be brought to bear and help fund at that time.

Thanks for talking to us, Josh.

Alan, thank you.

That was Josh Funder, the CEO and Founder of Household Capital.