ASIAN JOURNAL OF KNOWLEDGE MANAGEMENT

Vol. 8 No. 1: 2021
PP 18417/02/2014 (033797)

In This Issue

- **Knowledge Management of Reverse Mortgages**
  By KP Bose Dasan
  B Econ (hons., UM), MBA (Cranfield, UK), ChFC (USA)

ISSN 2289-6287
9 772289 628008

TST CONSULTING

Asian Institute of Knowledge Management Sdn Bhd

ASIAN JOURNAL OF KNOWLEDGE MANAGEMENT

CONTRIBUTORS

All manuscripts and editorial correspondence pertaining to articles and related matters should be addressed to The Chief Editor, Asian Institute of Knowledge Management Sdn Bhd at the publisher address.

PUBLISHER

Asian Institute of Knowledge Management Sdn Bhd
5, Jalan 3/125D, Desa Petaling, 57100 Kuala Lumpur, Malaysia
Tel: +603-9057 2233 Fax: +603-90571323
Email: info@asianikm.com Website: www.asianikm.com

PRINTED BY

James Aries Printing Sdn Bhd
No. 40 & 42, Jalan TPK 2/5, Taman Perindustrian Kinrara
58200 Puchong, Selangor
Tel: +603-80752502

ASIAN JOURNAL OF KNOWLEDGE MANAGEMENT

CONTENTS

Editor’s Note

Reverse mortgages is a new retirement vehicle for Malaysians. It is a challenging concept and so much reflection is required to confirm if it is an ideal product for clients based on their circumstances. The biggest issue is the cost of such annuity or home equity conversion. The main reason the cost is prohibitive is because when you make no payments, the lenders earn interest on interest thereby compounding the cost. And reversely increasing the banks' profits. Such compounding deflates the amount of equity left in the property. So, heirs to the property are left disappointed. However, by working out the numbers with the option of selling the property today instead of the reverse mortgage. Strikingly the prospect changes. If you sell the property today the value is set and capped at today's price. But with reverse mortgages the owner retains his proprietary interest and the value moves up over the years until date of death. So, after meeting the cost of borrowing there is still a tidy amount to be collected by the next of kin. This is due to the capital base between now and say 20 years’ time. We at KM APPLAUD KP BOSE DASAN for showing this important distinction.

Chief Editor
Asian Institute of Knowledge Management Sdn Bhd

Knowledge Management of Reverse Mortgages

By KP Bose Dasan
B Econ (hons., UM), MBA (Cranfield, UK), ChFC (USA)

Introduction

The latest retirement vehicle to appear in Malaysia is the Reverse Annuity Mortgage (RAM), being offered by Cagamas (M) Bhd with cooperation from the Employees Provident Fund (EPF) and Debt and Counselling Agency (AKPK), an agency under Bank Negara Malaysia. This subject was taught very early in financial planning curriculums but to date until now no financial institution was able to introduce it. The success of this RAM in other countries are not spectacular, to the point of saying that, they are perhaps waning rather than waxing. Let us explore whether Malaysians should take up this new retirement vehicle or best keep away from it. As usual the best decision depends on personal circumstances and whether it is suitable to your circumstances. You can drive a Proton or a BMW. It is up to you in a free market economy. You are only limited by your choice and your circumstances.

How does a reverse annuity mortgage work?

Let's say a retiree lives in a home which is fully paid-up. In other words, he has no more liability attached to the house. But he has other expenses like home insurance, property taxes and in some cases maintenance expenses. Repairs will be a necessary expense. A bank that offers a loan or an annuity, against the equity on the house i.e., against the market value of the house is called a reverse annuity mortgage. Annuity means a regular payment. In an ordinary home mortgage, you take a loan from the bank to purchase a property. The bank would use the property as a collateral and give you a loan. You make regular payments, usually monthly, over a period of say 20 or 25 years. Each payment is amortized, which means you pay interest and some principal of the loan, with each payment. By paying some of the principal you are liquidating the principal sum borrowed over the term of the loan. Interest is being charged or paid on the full principal outstanding each month or day. The amortization is the liquidation of the principal or capital borrowed. It is a nice mathematical formula to liquidate any debt. You pay the interest and some principal with each payment. How is a reverse annuity mortgage different?

Here you are not borrowing to buy the house. The house is fully paid-up. Your house is an asset with a high value but is not generating any income because you are staying in it. Of course, it helps you avoid paying any rent, living in your own house. Usually, you will live in it till you die, and your heirs will inherit the property. The family will either continue to live in it or sell the property and distribute the money among beneficiaries.

In a reverse annuity mortgage, you take a loan from the bank based on the market value of the house and pay back the loan or annuities only upon your demise, either by selling the house or by someone settling the outstanding loan owing to the bank. Usually, it is by sale of the house by the bank. Any amount that is remaining after the sale, is given back to the beneficiaries of the deceased borrower. If the market value of the property is less than the amount owing to the bank, under the RAM agreement, the estate of the deceased is not liable to pay the bank. The bank must absorb the loss. Sounds good. Where is the catch? It's in the details.

In a RAM the bank is lending you either a lump sum money or an annuity to last a lifetime. At the end of your life, the bank will sell the house and recover its loan.

How is interest charged?

In the Malaysian case Cagamas has fixed it at 5% p.a. A very reasonable interest charge you would say. There is an initial processing fee of 1.75%, which most probably is on the value of the house. The catch is you are not required to make any payment to the bank during the RAM period. That is good right? Not really! When you make no payment the interest owing is compounded. The bank makes interest on interest that is owing plus the principal that is borrowed. It is compounding in reverse. This is not an amortization where principal and interest are being paid. In RAM no interest and no principal is being paid. Hence in the end the amount owing will be large as geometrical progression is taking place. We will need to demonstrate with examples.

The rules of RAM

1. You must be 55 and above
2. You will need counselling from AKPK
3. The value of the loan or annuity will be at a steep discount to the value of the house.
4. The house must be fully paid-up with no liability attached
5. You must always occupy the house unless contract is terminated by settlement
6. House must be in good repair and, insurance, property taxes and maintenance fees must be maintained and kept current
7. There will be an initial processing fee of 1.75%.
8. Interest rate is fixed at 5% p.a.

Age of borrower 55	Expected number of payments is calculated to age 80.	Assume borrower dies at age 80.
Current Market Value of house - RM 400,000	Expected market value of house in 25years is RM 1,000,000, although 800,000 would be more appropriate	Value of house at age 80 is say, RM 800,000.
Percentage value of loan or annuity will be based on 35% of the market value of house	Amount of loan value converted to annuity will be: RM 140,000 So converting this amount to an annuity for 25 years will be about RM 815 a month.	Amount owing to the bank in 25 years' time. Annuity received of RM 815 a month over 25 years at 5% p.a. interest compounds to = RM 487,362
Insurance, repairs, taxes, and maintenance expenses borne by the borrower	Amount Depends?	Bank sells house for 800,000. Recovers RM 487,362 and hands over balance of RM 312,637 to next-of-kin.
One time processing fee of 1.75% of 400,000 = RM 7,000		

Observation

Your initial equity in the house was RM 400,000. The bank took a safe figure of using a 35% value to determine the annuity, which amounted to RM 815 per month. For this annuity you must pay back RM 487,362 What is the cost of the loan? In nominal terms it is 487,362 less 244,500 (815*12*25=244,500) = RM 242,862. About 100% over 25 years.

Other modes of Reverse Mortgages

Typically, taking out the home equity you have in your house is a very popular option. If let us say you took the lump sum option of RM 140,000 loan (35% of the market value of the house), what picture do you get about the cost.

Age of borrower 55	Expected mortality age is 80.	Assume borrower dies at age 80.
Current Market Value of house - RM 400,000	Expected market value of house in 25years is RM 1,000,000, although 800,000 would be more appropriate	Value of house at age 80 is say, RM 800,000.
Percentage value of loan or annuity will be based on 35% of the market value of house	Amount of loan value: RM 140,000	Amount owing to the bank in 25 years' time = RM 487,380
Insurance, repairs, taxes and maintenance expenses borne by the borrower	Amount Depends?	Bank sells house for 800,000. Recovers RM 487,380 and hands over balance of RM 312,619 to next-of-kin.
One time processing fee of 1.75% of 400,000 = RM 7,000	Having used 5% cost of borrowing per annum we get the liability of the borrower the same as in the annuity option.	

The big question

Is the Reverse Annuity Mortgage attractive? For spending 244,500 you end up paying 487,380. The family have lost half the value of their inheritance. All the borrower enjoyed was an annuity of RM 815 a month. But for 25 years.

What other options are there?

He could sell his house for RM 400,000 and take on a low rental home and live off the balance of his money. RM 400,000 invested at 5% interest rate can offer an annuity of RM 2,338 a month. If the rental was RM 1,500 a month, he can still have a balance of RM 838 a month to spend on necessities. This is almost identical to living in your house with the bank giving you an annuity of RM 815. And you still have some equity left in the home to be inherited by your next of kin.

Selling your house at RM 400,000 caps your capital appreciation at RM 400,000. But while you live in your own home on a borrowed annuity you get to experience the capital appreciation of around 4% on your house which belongs to you. Yes, there is a cost, but this example says that there is a benefit to Reverse Annuity Mortgages. I am very happily surprised. Cagamas will have to clarify if my assumptions are right or wrong and guide me as to their methodology. But the financial writers have missed a very big point.

DECLARATION FORM

____

Title of Paper

____

____

Organisation or Company's Name (if any):

____

Author's Name: ____

Designation:____

Address:

____

____

Email:____

Tel:__________________________Fax:___________________________

I/We ____

confirms that that my/our submission to AJKM is my/our original work/ manuscript. I/We have read and understood the terms of reference of the **Asian Journal of Knowledge Management**. I/We shall not hold the Asian Institute of Knowledge Management Sdn Bhd liable for the consequences of my/our failure to comply with the terms.

Author's signature: ________________________________

Date: ____________________________________

Call for Paper

Asian Institute of Knowledge Management would like to invite researchers, scholars, academicians, professionals, industry experts and management consultants from all over the world to publish their work in our journal (ISSN: 2289-6287) on any topic relevant to aim & scope of the journal includes:

Knowledge Management Input

- Knowledge management enablers;
- Learning and eLearning;
- Trust and culture;
- Talent;
- Leadership skills and manager skills;
- Information technology support; and
- Business strategy

Knowledge Management Process

Knowledge creation:

- Knowledge creation process; and
- Strategic creation and strategic plan

Knowledge conversion:

- Critical & emotional thinking;
- Business analytical skills;
- Management analysis; and
- Human resource management skills

Knowledge communication and sustainability:

- Marketing communication mix;
- Entrepreneurship skills and communication mix;
- Customer relation & communication mix;
- Economic resource planning;
- Enterprise resource planning; and
- Corporate governance and corporate social responsibility

Knowledge change:

- Change management;
- Risk management;
- Re-inventing & re-engineering; and
- Re-skills and re-engaged

Knowledge Management Outcome

Organization performance:

- Financial measurement;
- Balance scorecard;
- Benchmarking;
- Competitive advantage; and
- Productivity

The use and applications of knowledge management

Knowledge-based economy and development:

- Efficient use of existing & new knowledge;
- Effective creation, dissemination and processing of information;
- Effective system of firms and research centers; and
- Creation, sharing and transferring of knowledge

Knowledge management in the energy Sector:

- New resource revolution;
- Renewable energy development; and
- Energy Innovation

Knowledge management in the public sector:

- Public sector structural change;
- Fiscal Management and issues; and
- Knowledge public services.

Knowledge management in the service sector:

- Knowledge management in accounting practices;
- Knowledge management in management consulting;
- Knowledge management in financial services; and
- Knowledge management in private healthcare services

Knowledge management in human resource management:

- Knowledge talent management;
- Knowledge sharing; and
- Knowledge transfer

Knowledge management in general:

- Knowledge customer management;
- Knowledge financial management;
- Knowledge innovation management;
- Knowledge technology management;
- Knowledge project management; and
- Knowledge wealth management.

Submission of manuscript

All submitted works will be reviewed rigorously and will be accepted after the positive response of reviewers. All the submissions should be original and free from plagiarism; it should not have been published elsewhere. Currently there are no submission, processing or publication fees in this journal.

Our objective is to notify authors of the decision on their manuscript(s) within four weeks of submission. Following approval, a paper will normally be published in the next issue.

AJKM also invite competent scholars and academicians to voluntarily join our review/editorial board. We would appreciate it if you could share this information with your colleagues and associates.

All manuscripts and editorial correspondence pertaining to articles and related matters should be addressed to:

The Chief Editor

Asian Institute of Knowledge Management Sdn Bhd
5, Jalan 3/125D, Desa Petaling, 57100 Kuala Lumpur, Malaysia
Tel: +603-9057 2233 Fax: +603-90571323
Email: info@asianikm.com Website: www.asianikm.com