Retirement Villages: Comparison Rent and other Metrics by T J Kyng

Background: I got interested in RVs when my mother was looking for one. I went to visit about 6 of them with her. I was struck by how difficult it is to get information about them, and how difficult it is to compare one RV contract with another.

The contracts have a complex structure: with entry fees, recurrent fees, exit fees, sharing of capital gain etc.

For the average consumer it is very difficult to make an informed decision about the financial benefits, costs, and risks. The average retirement village customer has lower than average financial literacy.

Following my experience with my mother I began a research project on RV resident's financial literacy relating to their RV contracts and the factors that influenced them about RV residency. I visited a lot of RVs and met with a lot of RV residents and managers. Heard many stories about the potential traps for the unwary.

Many of the residents feel that they own their apartment even though legally they don't

Retirement Villages: The good, the bad and the ugly

- Some very nice comfortable high quality accommodation and facilities
- May contribute to happier and healthier life for residents.
- Does offer security of tenure compared to other rental arrangements
- Low financial literacy for the customers of RVs: Many traps for the unwary in the contract
- Difficult to get information about RVs compared with other types of real estate – more time and effort required to shop around relative to other types of real estate
- Complex contracts – difficult to compare them or assess the costs, benefits and risks
- Need for fuller and more useful disclosure of information relevant to decision making
- The “information sheet” provided by RV operators is **inadequate for consumers to make proper and well informed decisions and comparisons**

National Credit Code and Comparison Rate

The National Consumer Credit Protection Act 2009 (Cth) (NCCP) includes the National Credit Code (NCC) as Schedule 1 to the Act. Part 10 of the NCC requires that credit providers include a **comparison rate** when they advertise fixed term credit which is for, or mainly for, personal domestic or household purposes. The comparison rate includes the interest rate and most fees and charges.

The comparison rate regime

- **aims to inform consumers of the true cost of credit** that applies to a specific credit product and
- **make it easier for consumers to compare the different credit products available on the market**.

I believe we need similar / analagous metrics appropriate to retirement village contracts to

- Allow consumers to know the true cost of retirement village residency
- Make it easier for consumers to **compare** the different retirement village deals on offer
- Provide information about the costs, benefits and risks of RV contracts

My research uses actuarial science and financial mathematics to develop metrics suitable for the purpose of measuring the cost, making comparisons and quantifying the costs benefits and risks.

We can define and calculate a **comparison rent** for RVs.

The insurance nature of the RV contract features

- The customer buys **the right to reside** but, usually **does not own the apartment**. This component of the contract is similar to a "**life interest**" in a property, typically valued as an annuity of the rental the property would get in the market (nb - done this way for stamp duty calculations)

- The monthly CPI indexed recurrent fees payable over the term of the contract is like a "life annuity"

.

- On exit from the village, the resident receives a **repayment of the entry fee** less the deferred management fee (DMF). This is payable at the time of exit, typically due to death or disablement. This benefit is a form of death and disability insurance contract.

- The resident may get a **share of the capital gain** on resale of the apartment. The capital gain is the payoff on a financial contract known as a call option. This component of the contract's benefits is a hybrid of a death and disablement insurance contract and an option contract.

- The resident **pays** the up front entry fee and the maintenance fees and **receives** the benefit of the right to reside in the apartment (instead of having to pay rent), the benefit of the exit fee (insurance policy) and the capital gain benefit (if applicable).

The insurance nature of the RV contract features

- Using actuarial / financial mathematics we can estimate the economic value of the components of the costs and the benefits inherent in the RV contract. These methods were originally developed for defined benefit pension and retirement funds.

- The customer is buying a package of a life interest in an apartment, a death and disability insurance product and a hybrid option / insurance contract. The customer is paying via a combination of a lump sum “single premium” and an ongoing monthly “recurrent fee”.

- The economic value of these components of the costs and benefits depend on the age and gender of the consumer.

- The life interest component of the benefit can be converted to an equivalent monthly inflation indexed rent payable over the term of the customer’s residency. This is the equivalent rent metric and it allows comparison between different RV contracts in much the same way as the comparison rate does for credit contracts. This is the **COMPARISON RENT**

A (not so hypothetical) sample RV contract:

- Entry fee = $1,000,000
- Ongoing recurrent fee: = $560 per month ($6720 per year)
- Deferred Management Fee: 6% of the entry fee, per year of residence, paid at exit subject to max 5 years, so the DMF is capped at 30% of the entry fee
- Sharing of capital gain on exit : nil
- Timing of exit: may be forced on the resident by death or ill health, ill health resulting in expulsion.
- Timing of payout to the resident on exit: The contract allows the RV operator 3 years to pay the departing resident the amount owed to them. During this time the RV operator can continue to charge the RV resident the recurrent fee despite the fact they don’t live there.

Q: What do you get for your money?

- The right to live in the RV in a two bedroom apartment, until you exit from the village as above
- You do not own the apartment. You don’t have the right to sell the apartment or to lease it out.
- The right to receive the exit payment (entry fee less the DMF) when you exit the village

Is it a good deal for the residents? This is the central question.

To answer this we can compare it to
- cost of renting an equivalent apartment and
- to cost of buying and maintaining an equivalent apartment
- cost of some other retirement village deal

What things to include / exclude when making the comparison?
- The cost of renting a 2 BR residence in the area is up to $800 pw in this suburb (this was the most expensive one on domain.com.au)
- Cost of buying a 2BR apartment (most expensive on domain.com.au) is $950K
- If you rented an apartment the landlord is responsible for maintenance and insurance of the building, council rates. The resident pays for contents insurance, water rates, electricity, heating
- What facilities / features does the RV have relative to other accommodation options?

<u>COMPARISON RENT METRIC 1</u>

Assume a term deposit interest rate of 3% p.a. (current rates as at nov 2016)

Making an interest free loan of $1m costs the consumer $30K in interest foregone p.a.

Over years 1 to 5 of of the contract total paid to RV each year is

$$\underbrace{\left(12\times\$560\right)}_{\text{recurrent fee}}+\underbrace{\left(3.00\%\times\$1,000,000\right)}_{\text{interest income forgone}}+\underbrace{\left(6.00\%\times\$1,000,000\right)}_{\text{Deferred Management Fee}}=\$96,720 \text{ per year}$$

This is $483,600 over the 5 years, or $1,860 per week.

By comparison using domain.com.au the **most expensive** 2 BR apartment in that suburb of Sydney had a rent of $800 per week

COMPARISON RENT METRIC 1

Assume the customer is 82 years old and a female. Based on actuarial calculations using the latest Australian Life Tables published by the ABS and the ABS data on disability prevalence rates, we estimate that

- the customer's life expectancy is 9.0 years but
- her expected term of residency is lower at 7.1 years
- the difference is due to the possibility of becoming disabled before death and having to leave the RV to move into an aged care facility

over the average term of residency of 7.1 years, the cost is **$79,764.18 p.a.** or **$1,533.93 per week**, still substantially more than the most expensive 2BR apartment in the area at $800 per week

COMPARISON RENT METRIC 2 (ACTUARIAL METHOD)

The above comparison rent calculation ignores the time value of money but has the merit of being easily understood by many people.

We can compute a comparison rent in a more actuarially correct way but the method is more complex and requires assumptions about interest rates, inflation, real estate price Volatility, demographic features of the residents etc.

We can compute the actuarial value of

- the insurance component, (refund of entry fee less dmf paid at death / disablement)
- the capital gain component (entitlement to share of the capital gain at time of exit)
- the recurrent fees (payable monthly during residency)
- the life interest

Then convert the value of the life interest to an inflation indexed monthly income stream payable during the term of residency. This gives a different comparison rent to the simpler method but it is a more valid method for doing it.

ACTUARIAL COMPARISON RENT

The method is more complex and requires assumptions about interest rates, inflation, real estate price volatility etc as we may for a DB pension fund. We assume 3%, 2% and 10% respectively for these parameters, entry fee and other details as above. Below we show the comparison rent and the economic value of the contract's components. The results vary with the age / gender of the consumer.

Age / gender	Comparison rent p.m.	Insurance component	Capital gain component	Life interest component	Value of Recurrent fees
65 male	$3,564	$453,717	$0	$648,115	$101,831
75 male	$4,410	$558,015	$0	$506,277	$64,295
85 male	$5,736	$682,887	$0	$351,420	$34,307
65 female	$3,483	$440,457	$0	$666,733	$107,190
75 female	$4,279	$543,929	$0	$524,753	$68,681
85 female	$5,586	$666,353	$0	$370,824	$37,178

ACTUARIAL COMPARISON RENT

Here we vary the terms of the RV contract and examine the impact on the comparison rent.

- Increasing the DMF increases the comparison rent, increasing the CG share reduces it
- Scenarios 1 and 3 have the same comparison rent but different entry fees and DMF.
- The disclosure document obscures consumer understanding that these 2 contracts (1 & 3) are equivalent in terms of comparison rent

Scenario	Age / gender	Entry Fee	DMF %	DMF TERM	CAPITAL GAIN SHARE	Comparison rent p.m.
1	75 female	$1,000,000	6%	5	0%	$4,279
2	75 female	$1,000,000	10%	5	0%	$5,321
3	75 female	$781,175	10%	5	0%	$4,279
4	75 female	$1,000,000	6%	5	50%	$3,105

ACTUARIAL COMPARISON RENT

The comparison rent

- increases with the age of the new customer
- is lower for females than males. This reflects the fact that females have higher life expectancy at each age than males.

The insurance component of the contract's value is a substantial part of the entry fee ($1m here). As the age of the consumer increases the value of the life interest component decreases and the value of the insurance component increases

Though they don't know it, the consumers are in effect buying an insurance policy from the RV operator. If they paid only for the right to reside in the village the entry fee could be much lower

The RV operator is not licensed to sell insurance nor regulated as an insurer would be particularly regarding capital adequacy and solvency. Consumers are exposed to the risk the RV operator can't pay the benefits promised.

RISKS INHERENT IN RV CONTRACTS FOR THE RESIDENT / CONSUMER

Paying rent up front puts you in a weak bargaining position relative to the landlord

Maintenance Fees / long term maintenance contracts with related companies
Maintenance fees may be uncompetitive so consumers pay too much. They probably have no say in choosing who does the maintenance

renovations / repairs to your RV unit if you want to leave
The resident may have to spend a lot of money on renovations to make their unit more saleable. Not all of this may be recovered, particularly if share of capital gain is less than 100%

waiting a long time to get the exit payment when you leave
Long delays in receiving the exit payment are common
This may happen at a time when the customer is ill / under a lot of stress
Many RV contracts require the departing resident to continue paying recurrent fees even after they've moved

Capital gains: what is being resold?
The RV operator may change the structure of the contract (e.g. increase the DMF) which could reduce the resale value. The amount of any capital gain is highly uncertain.

solvency and capital adequacy of the RV operator

As mentioned above, some aspects of the RV contract are akin to insurance. Insurance companies are heavily regulated and required to meet solvency and capital adequacy standards so that they can fund any valid insurance claims made on them. RVs are very lightly regulated and are not subject to any controls over their solvency or capital adequacy. I am advised that departing RV residents often have to wait till their unit is resold before they can get their exit payment. What if the RV experiences an epidemic of flu or some other illness that leads to a lot of exits in a short timeframe? In such circumstances the RV may not be able to make the exit payments in a timely manner

disclosure of financial condition of RV operator, disclosure of relationships with other entities

As far as I am aware, RVs aren't required to disclose much information about their financial health to enable residents or potential customers to assess their solvency and financial capacity.

Recommendations about the disclosure document / product disclosure statement

In my opinion the RV disclosure document should include a plain English explanation of the contract and the fee structure and any obligations on the resident to pay for renovations to the unit on exit. In addition any features of the contract that may lead to a delay of more than 1 month for the departing resident receiving their exit payment should be highlighted.

A calculation of the comparison rent metric should be computed for terms of 1 year, 5 years and 10 years. This could be done via comparison metric 1 assuming a term deposit interest rate equal to the average of the 3 best available in the market at the time, and taking into account the maintenance fees.

A calculation of the comparison rent metric for the actuarial method should be computed for the consumer taking account of their age and gender, using reasonable assumptions for the interest rate, inflation rate, mortality and disability rates and real estate growth and volatility.