T R A N S C R I P T

STANDING COMMITTEE ON LEGAL AND SOCIAL ISSUES

Inquiry into the retirement housing sector

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Dr Timothy Kyng, Macquarie University.

The CHAIR — I would now like to welcome Dr Timothy Kyng of Macquarie University. Dr Kyng, thank you very much for joining us this morning. Before I invite you to make some opening remarks, I will just caution that all evidence taken at this hearing is protected by parliamentary privilege. Therefore you are protected against any action for what you say here today, but if you go outside and repeat the same things, those comments may not be protected by this privilege. We have allowed about half an hour for our time today, so I would invite you make some opening remarks, and thereafter will have questions.

Dr KYNG — Thank you. How long should I talk for?

The CHAIR — If you keep your presentation to 10 to 15 minutes, that will leave us enough time to ask some questions thereafter.

Visual presentation.

Dr KYNG — The background is I was interested in retirement villages when my mother wanted to go into one. I went to visit a large number of retirement villages around Sydney, and I was struck by how difficult it is to compare one retirement village to another and how much variation there is in the way the contracts are structured. So I thought for the average consumer it is really difficult to make an informed decision or to choose between retirement village A and retirement village B.

Following my experience with my mother I got a small grant from the institute of actuaries of Australia to do research into retirement village residents' financial literacy relating to the contracts they are signing. I went to visit a large number of retirement villages and spoke to a lot of different residents and a lot of different retirement village managers. I found that a lot of the residents feel that they own the apartment that they are entering into, even though they do not actually own it.

The cohort of people who are going into retirement villages tend to have low financial literacy relative to the rest of the community, so in some ways they are a vulnerable group. When I went to visit these various retirement villages I found some of them were very nice, very comfortable, luxurious accommodation. There are lots of good points about retirement villages. They contribute to a healthier, happier lifestyle for the people that live in them. They offer security of tenure, whereas other types of tenancy do not. If you rent a flat, you might be thrown out if the landlord wants to sell the building or whatever.

The low financial literacy I believe is a problem, and it is actually very difficult to get information about retirement villages relative to other types of real estate. There is a lot more effort required to go check out the retirement villages. There is much less information available on the web, for example. Contracts are very complicated, and it is in particular very difficult to compare one deal with another. There is no readily available metric to let you to do that. I believe there is a need for fuller and more useful disclosure of information relevant to decision-making by retirees. The information sheet which retirement village operators provide, I think, is inadequate for the purpose of allowing people to make a comparison.

If we compare this to consumer credit arrangements, the National Consumer Credit Protection Act includes the National Credit Code, and part 10 of the NCC requires that credit providers provide a comparison rate when people are searching for funds. In a comparison rate regime the purpose is to inform consumers of the true cost that applies to a credit contract and make it easier for consumers to compare different credit providers available on the market. I believe that we should have a similar comparison metric available for retirement village contracts, which I would call the comparison rent. I think that would make it much easier for consumers to make a decision. It will not be the critical factor necessarily — I think often it is an emotional decision as to which place people buy — but it is additional useful information for them.

They can define and calculate a comparison rent. I recently did some research into this using actuarial and financial mathematics methods to devise a whole lot of metrics to allow people to calculate the comparison rent and the costs and benefits and risks inherent in the retirement village contract.

I have got a slightly different perspective on this than many people might have. I see the retirement village contract as a combination of insurance-like products. The customer buys the right to reside but they do not own the apartment, so the contract is really similar in that respect to a life interest in a property, and there is legislation in all of the states and overseas about how to value a life interest. It is often done for stamp duty purposes, part of divorce settlements, wills, that kind of thing.

The monthly CPI index recurrent fees at this table — you can think of that as a kind of a life annuity. On exit from the village the resident receives a refund of the entry fee minus the deferred management charge, which depends on how many years that they lived there. That is a kind of life insurance product. That is how I see it — it is a life and disability insurance product. Then at the end they may also get a share of the capital gain, but they may not; it varies from village to village. That sharing of the capital gain can be thought of as a kind of option contract, so it is like a call option on real estate. It is what we would call an 'at the money' real estate call option with a random exercise date equal to the date of exit.

It is possible to compute the economic value of all of these things using actuarial methods. The resident pays the up-front entry fee and the maintenance fees and they receive the benefits of the right to live there — the refund of the entry fee minus the DMF and the capital gain. Using actuarial methods we can compute the economic value of each of the different components, and we can then figure out the component of the cost that they paid that pays for the right to reside there as a sort of lump sum amount. We can then convert that to an income stream as a kind of life annuity. There would be an indexed life annuity of the equivalent rent that they have been paying. That is what I have been calling the comparison rent.

Here is a sample of a retirement village contract based on a recent example from Sydney. There is a $1 million entry fee and recurrent fees of $560 per month. The DMF is 6 per cent of the entry fee each year for a maximum of five years. There is no sharing of capital gain on exit. Timing of exit may be forced by either death or ill health, or voluntary exit. One of the nasty features of this particular contract is that under the terms of the contract the operator can take three years to pay the person their exit fee, which I think is unconscionable really.

The CHAIR — Is this a real example?

Dr KYNG — Yes, it is. If they cannot sell the unit to another buyer, then they have got up to three years to actually pay — three years after the person has left, possibly because they are either dead or disabled. It is a nasty situation which I believe is just unconscionable.

What do people get for their money? They get the right to reside, and they get the right to receive the various benefit payments down the track. The question is: is it a good deal for residents? To answer this we could compare it to the cost of renting an equivalent apartment somewhere else or the cost of another retirement village contract or the cost of buying an apartment somewhere. You could argue that there are certain things that should be included or not included in the calculation. I will skip over that point, and we will maybe come back to that later.

So here is my proposal for comparison rent method no. 1. By paying the entry fee, the resident is making an interest-free loan to the operator of $1 million. Current term deposit interest rates are around 3 per cent. So each year that person is foregoing $30 000 of interest income that they could be earning. Over a five-year time frame they also have to pay have to pay a 6 per cent deferred management fee — 6 per cent of 1 million is 60 000. Three per cent of 1 million is 30 000, and if you add on the recurrent fee, that adds up to $96 720 per year in equivalent rent, which is really huge. If you look at that over a five-year term, it is $483 600. By comparison, if you look at the most expensive two-bedroom apartment available in that suburb of Sydney, it is costing $800 per week to rent. So the equivalent rent for the retirement village is more than double the most expensive two-bedroom apartment in that part of Sydney.

The CHAIR — I suppose the retirement village operator would say there are a whole lot of other benefits that come from being in that environment.

Dr KYNG — That may be true, and it is up to the resident to decide if it is worth paying the extra money. It is for them to decide. It may well be true that it has these extra benefits.

Ms SPRINGLE — So is your point around the transparency of that?

Dr KYNG — Yes. I believe that people should know that, know what it is costing them over the first five years. It is just additional information to help them make the decision. This particular example is of a female aged 82. According to my actuarial calculations, she has got a life expectancy of nine years, according to the most recent Australian life tables. If you take into account the possibility of exit from the village due to ill health or disablement, that reduces the term of residency from nine years to about seven years; the difference being accounted for by the fact that if you are unable to live independently, the village operator can force you to leave.

So if we work out the total equivalent rent over the 7.1-year expected term of residency, it comes down a little bit to $79 764 per year, which is still a lot of money, or $1533 per week, which is compared to $800 a week for the most expensive two-bedroom apartment. Need I say more?

There are other methods for computing the equivalent rent metric — more complicated and more actuarial. I will not go into the gory details of how the calculations are done, because that would take another couple of hours to go through. But basically what we do is we look at the contract as a combination of insurance-type products. We value each of the insurance products and we compute the component of the entry fee that goes to pay for the right to reside. We convert that to an income stream — an indexed annuity-type income stream.

Here is an example. For this particular contract for a range of different people of different genders and different ages, it shows what the comparison of the rent is. You can see from the figures that the total comparison rent increases as the age of the resident increases — that is the entry age we are talking about. It is lower for females than it is for males. That is explained by the fact that females live on average for longer than males do.

Another interesting thing about it is if you look at the insurance component — how I have computed the economic value of the insurance they are buying — for the 85-year-old female, two-thirds of the $1 million is going on buying an insurance product. Approximately one-third is going on buying the right to live there. So I would say that they are paying a lot of money, more than they need to, to buy an insurance product from an organisation which is not licensed to sell insurance and which is not regulated in the way an insurance company would be. In particular it is not regulated with regard to capital adequacy or solvency. Hence, it exposes those residents to risk at the end of the life of their contract when they leave. It exposes the risk that they do not get paid out the amount that is coming to them.

Here is another example, and this illustrates why the information sheet that providers give the customer does not necessarily allow them to make a valid comparison. For a 75-year-old female we can vary the terms of the contract. We can vary the entry fee, we can vary the way the deferred management fee works. If we look at scenario no. 1 — a $1 million entry fee, 6 per cent deferred management fee and a five-year term — the comparison rent is $4279. Scenario no. 3 has a much lower entry fee of $781 000, lower by over 200 000, it has a higher deferred management fee but the same comparison rent. That would not be at all apparent to a consumer from looking at what is on the information sheet. So it does not allow consumers to make these sorts of comparisons.

The CHAIR — Just to interrupt, you are saying the National Credit Code, if you applied that model, does provide that capacity to make those cost comparisons, as a potential model.

Dr KYNG — As a potential model, yes. If we used either of these two metrics, that would allow consumers to make a better-informed decision and also maybe to renegotiate the terms of the contract with the operator and have a slightly lower entry fee in return for a higher deferred management charge or whatever.

The CHAIR — I know it is a subjective decision, but how do you price the additional services that are provided by retirement villages, which vary from village to village, which makes that — —

Dr KYNG — I am not looking at it from the perspective of the operator; I am looking at it from the perspective of the consumer. It is up to the consumer and the operator to negotiate about that and for the consumer to decide whether it is worth paying that extra money. It may well be that it is, but I think this is additional information to help them make their decision. I doubt that it would be a critical factor, but I believe they should have that extra information.

Looking at the results, we see the insurance component of the contract's value is a very large proportion of the amount that they are paying. The consumers do not realise that what they are really buying is a package of insurance products. That is how it looks to me as an actuary. As I mentioned, the operator is not licensed to sell insurance. There are cases where people have to wait for an extremely long time to get their money at the time of exit. If they are exiting, say, due to ill health and needing to relocate to an aged-care facility and have to wait for two to three years to get their money, that is really a bad situation. The comparison rent goes up with the age of the consumer and is varied for females and males.

Some of the risks inherent in the retirement village contract arrangement are, number one, paying all of your rent up-front for the rest of your lifetime puts you in a weak bargaining position relative to the operator down the track, particularly over issues like maintenance. Also, it is possible that the maintenance fees are uncompetitive and the residents have really no say in who gets to do the maintenance. It could be the case that the companies engaged to do the maintenance are companies related to the developer that originally developed the retirement village.

Waiting for a very long time to get the exit payment when you leave. That is a nasty feature of a lot of the contracts. Very long delays are very common. It often happens when the resident is either ill or unable to argue the case with the retirement village operator. It is a David versus Goliath type of struggle. It is the individual consumer against a very powerful, wealthy, well-resourced opponent.

Another point about it is that when you look at the capital gain component, you have got to ask yourself, 'What is it that it is being sold? What is it that is being resold?'. I would argue that what you are buying is a package of different insurance products and at the time when it is resold the package might change. The deferred management fee could change, for example, or the sharing of the capital gain could change, so what you bought is not necessarily the same thing as what gets resold later on. That is another risk. Also, the amount of the capital gain is highly uncertain.

As I mentioned before, there are the issues of the solvency and the capital adequacy of the retirement village operator. I note that retirement villages are regulated at the state level whereas insurers are regulated at the federal level, so the regulation of retirement villages relative to those insurance companies is relatively weak.

I believe there should be more disclosure of the retirement village operator's financial condition to consumers. In my opinion the disclosure documents 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. Another possible trap for the unwary is the cost of the renovations. If you spend $50 000 renovating your unit, it may not necessarily increase the resale value by $50 000. If you are only getting, say, a 50 per cent share of the capital gain, then it would be what we in economics call a 'negative net present value transaction' — in other words, a loss-making transaction. I think there should be a calculation of the comparison rent metric, comparing for terms of 1, 5 and 10 years using the simple method and possibly also using the more complicated actuarial method. I believe this would be beneficial to consumers and make for a better industry and better arrangements down the track. That is my spiel.

The CHAIR — Thanks, Dr Kyng. That is a really different perspective and way of looking at these issues. Can just ask, given your analysis of New South Wales, have you done any comparison of jurisdictions, particularly New South Wales and Victoria, about the disclosure regime for consumers?

Dr KYNG — The disclosure regime in New South Wales requires them to produce a product disclosure statement that is very similar to what you do here. There is not a lot of difference there. I am looking at it more from a financial actuarial perspective; I am not a lawyer.

The CHAIR — No, fair enough. Thank you. That was a really fascinating presentation.

Ms SPRINGLE — In your view, what should that product disclosure statement contain?

Dr KYNG — I think it should contain a plain-English explanation of all the fees and charges. Another thing it should explain is the potential for having to make payments at the end to renovate your property. It should contain a calculation of the comparison rent metric. Some form of comparison rent metric I believe should be included in the disclosure statement. I have applied for a grant from Financial Literacy Australia to create an online calculator to do this kind of stuff. I am still waiting to hear from them.

Ms SPRINGLE — That is a good idea.

Dr KYNG — If they say yes, we will be developing that and making it available for free to the regulatory bodies around the country in each of the states, and we will put it on the ASIC website et cetera.

Ms SPRINGLE — How much would something like that cost to develop?

Dr KYNG — We have asked them to give us $128 000.

Ms SPRINGLE — So around about $128 000.

Dr KYNG — I am advised by my friends in the IT industry that the real cost is actually quite a lot more than that. But at university we can hire research assistants at a cheaper rate than might apply elsewhere.

Ms SYMES — Kind of where I was thinking it applies is an online calculator. From your experience of looking at the contracts, and taking note of your recommendation that plain-English explanations should be added, do you think, rather than a standard-type contract, you would be able to just have them all lined up and plug in the information from each one on the deferred management fee, the exit fees and the maintenance fees? Is that how you envisage it?

Dr KYNG — Yes, that is exactly the plan.

Mr MULINO — Can I just preface my two brief questions by saying that I think the way you are framing it makes a lot of sense, but I just have a couple of questions. One is, any kind of model like this might draw some criticism in that you are making a lot of assumptions, for example, around the interest rate, which is going to be something that there is a wide range of views on and which would have to be recalibrated periodically. Also, I suppose other things which might be even more contentious are, for example, around life expectancy, which you can estimate based on age and gender but there is going to be a wide range based upon idiosyncratic features above and beyond that, which, for example, your health insurer might know but which you may not want to disclose to others. I am just wondering what you think about the fact that some might say you are going to come up with a calculation that may skew people's views on certain types of products out there based upon a whole lot of assumptions that are embedded in any model.

Dr KYNG — That is a fair enough question, but you could say the same applies to the comparison rate in the consumer credit code. If we look at the first version of the metric, which takes the deferred management fee, the recurrent charges and the interest rate you could earn on a term deposit, that is a relatively straightforward and simple calculation, particularly compared to the more complicated actuarial metric. But when I came up with this idea I was using what information was available publicly. In insurance the insurance companies pool their data, and they do a mortality study based on the pooled data of all the insurers in Australia. It is conducted by the Institute of Actuaries of Australia.

There are lots and lots of different retirement villages. They are not cooperating with each other to pool their data to come up with a data set that we could use to model the mortality experience of the retirement village population. So I had to make some simplifying assumptions for the purpose of designing a metric. I mean, if we had better information, we could come up with a better way to do it.

Mr MULINO — I suppose a related question is: have you done much analysis on the sensitivity of how much the comparison rent changes? I am thinking here in particular about life expectancy, but I imagine the interest rate would have a big impact too. For example, if somebody's life expectancy was 11 or 7 rather than 9, does that change the number a lot?

Dr KYNG — It changes it quite a lot, yes, and yes, I have done sensitivity analysis of that, looking at different possible mortality assumptions, different possible morbidity assumptions, but I did not put that in the presentation because I thought that would take more than the required 15 minutes.

Mr MULINO — Yes, I am just thinking, though, would one approach be to, I suppose, convey a degree of uncertainty to people.

Dr KYNG — I agree that that would be a good thing to do. I am not sure that the recipients of the information would understand it, but you are quite right. There is no certainty about this. As in many things in economic calculations, there is quite a lot of uncertainty.

The CHAIR — Can I just ask: can you quantify the benefits of the national credit code or such similar disclosure regimes? I mean if that is a model that you are suggesting would increase transparency, have the benefits of those models been quantified?

Dr KYNG — I do not know whether they have been quantified. I cannot answer that. I believe that it is beneficial to consumers to have that extra information, but I do not know of any method of quantifying it all — if anyone has quantified it.

The CHAIR — No, fair enough. Thanks so much for your presentation, Dr Kyng. It is a really different perspective on the way of looking at how consumers can understand the cost or benefit of making their decisions. Thank you.

Dr KYNG — Thank you.

Witness withdrew.