Briefing Paper on Equity Release

What is equity release?

1. Equity is the difference between any mortgage you may have and the value of your home. Equity release is a way of unlocking the value of your property, without having to move home. It is used mostly by older home-owners who either have paid off their mortgage altogether or have only a small amount left to pay.

2. You can release the value of your home to give yourself a lump sum or a regular income (or both). If you live in the property until you die, the money from its sale is used to pay the lender before anything left over is paid to your beneficiaries. If you sell the property before you die, you repay the money you borrowed from the lender. With some types of loan you might also have to make regular interest payments.

How can equity be released?

3. There are two main ways you can do this.

- **Taking out a mortgage**

  There are special types of loans, usually designed to run for the rest of your life. These are called **lifetime mortgages** under the FSA regime from October 2004. You borrow money secured against the value of your home to give you a lump sum or a regular income. The loan is repaid to the lender when your property is sold. You continue to own your home. Interest only and roll-up loans are included in this category.

- **Selling your home (or part of it)**

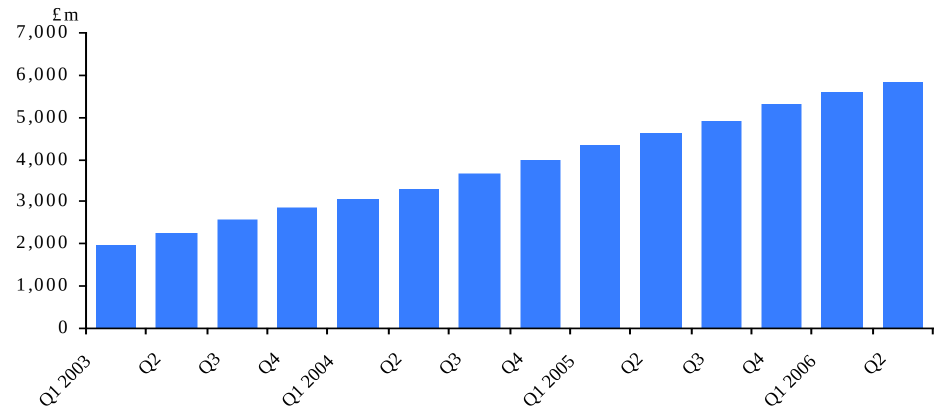
  This is normally called a **reversion** or **part reversion plan**. You sell your home, or a part of it, to a reversion company that allows you and your partner to continue to live there for the rest of your lives. After you both die, the proportion of your home that you sold becomes the property of the reversion company.

4. A description of the most common equity release product types is given in Annex A.

What is the market for equity release?

5. The lifetime mortgage market continues to grow, albeit slowly compared to the mainstream mortgage market. Total outstanding lifetime mortgage lending reached £5.8bn by the end of the first half of 2006, as shown in Chart 1.

Chart 1: Lifetime mortgages outstanding by value

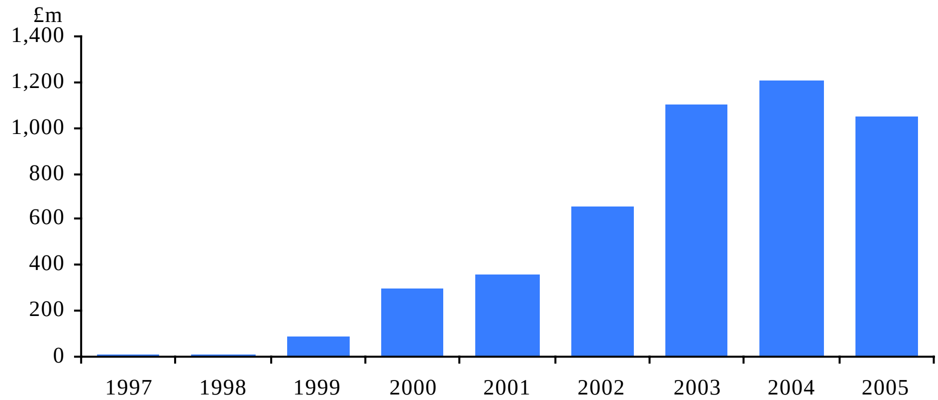


Source: CML

6. The market remains small and highly concentrated with 23 providers offering about 52 equity release products. By the end of the first half of 2006, the volume of new advances increased by 2.3% but the value dropped by about 7%. This downturn is likely to be primarily a response to anticipated lower levels of house price growth, making consumers more cautious about releasing the accumulated equity in their home without the reassurance that the overall values of their property will rise significantly further. However, the impact of regulation and adverse publicity about sales standards following the FSA's mystery shopping may also be factors.

7. This is borne out by attitudinal research which suggests some wariness towards borrowing against equity. Survey research by a number of organisations has highlighted concerns about the complexity, riskiness and value for money of schemes. For example, research by Hannover Housing in 2004 found that while awareness of equity release schemes was very high, interest in taking them up seems quite low. The main reasons home-owners gave for not wanting to use an equity release scheme vary greatly but overall trust of the schemes figure prominently (30-35% of respondents identified this as a reason), as does attitudes towards inheritance (25-30%) and not needing the money (20-35%).

Chart 2: Lifetime mortgage sales newly advanced by value



Source: CML

8. The £5.3bn outstanding represents only 0.36% of the entire mortgage market by value. Although the market has grown, this relatively small size suggests that the substantial scope for growth is not being tapped. An Institute of Actuaries report (2004) estimated that

unmortgaged equity for the over-65s is in the order of at least £1.1 trillion. It predicted that annual equity release sales volumes would double to £2 billion by 2010, and then to nearly £4 billion a year by 2031 (see Table 1).

Table 1: Projected Equity Release Market Growth

	Current (e.g. 2005)	Short Term (e.g. 2010)	Med. Term (e.g. 2015)	Long Term (e.g. 2031)
Population ('000)	12,776	14,076	15,067	19,429
Proportion homeowners	70%	72%	73%	78%
Average number in household	1.45	1.45	1.5	1.55
Number of qualifying households ('000)	6,168	6,989	7,332	9,777
Proportion of population buying equity release at some time	6%	10%	13%	15%
Stable market size (in force cases)	370,063	698,946	953,239	1,466,576
Sustainable annual sales (number)	20,000	40,000	50,000	80,000
Sustainable annual sales (aggregate loans, £m)	1,000	2,000	2,500	4,000

Source: Actuarial Profession 2004, 16.

9. Considering the current growth in the market, their predictions look reasonable. The Pensions Commission's initial report (2004) identified that the state pensions system, insufficient personal savings, and dwindling occupational pensions schemes, were contributing to a retirement savings gap. Its final report (Pensions Commission 2005) concluded that, taken together with poor annuity performance, this gap could lead to old age poverty for many people unless the government takes decisive action. Taken together with greater expectations for lifestyle in retirement this suggests that the Institute of Actuaries' predictions could be considered modest if the market takes off.

Why is equity release important?

10. As the population ages, the number of older households will increase even more rapidly as more older people choose to live alone. At the same time, the proportion of older people who own their homes rather than renting from a social or private landlord, will grow as currently middle-aged groups of households with very high home ownership rates reach retirement. Residential housing wealth has risen steadily from about 150% of GDP in 1996 to 275% in 2004.[i] In 2003, 75% of people aged 60-64 enjoyed home ownership, up from 50% in 1981.[ii] This is also true for younger groups that will retire in ten years: home ownership amongst people aged 45-59 has risen from 58% in 1981 to nearly 80% in 2004. So the drivers for equity release growth are certainly there: consumers want a way in which they can use their unprecedented housing wealth to support their changing retirement patterns.

11. Many of those already in retirement have heard of equity release products but do not see them as attractive except perhaps in the last resort. However, this attitude is changing, as older people realise the potential value of their properties. Middle-aged people, especially those on higher incomes, are more likely to consider equity release in the future as one of a number of financial and investment options, possibly to fund school/university fees and as a vehicle to facilitate further pension contributions or pay for health treatment. The fact that their own children may already be home owners diminishes the pressures for retaining 100% of the value of their home to be passed on as an inheritance. A number of people are using equity release to avoid inheritance tax (particularly in London and the South east where

property values above the £285,000 IHT limit are common). People are also using equity release to supplement under performing pensions.

12. Government policy may have a significant impact on the size of the equity release market. There have been changes in regard to long- term funding for higher education with the withdrawal of tuition fees for students. There has also been a growing perception that state provision for older people will decline in the future, impacting upon both long-term care and pension provision. The Department of Health issued instructions to local authorities at the end of 2001 saying that long term care costs could be charged against an individual's home instead of the property being sold. More recently there have been fundamental changes to the home improvement grant regime operated by local authorities with an emphasis on home owners taking out loans against their homes to fund repairs on owner-occupied property.

Current issues

13. If the equity release market is to expand in the future there are a number of key issues which will need to be addressed -

(a) Improved products and sales process rules

14. Market confidence and trust can only be established through a combination of safe, accessible and flexible products; and information and advice given in a fully compliant sales process regardless of whether the consumer goes to an intermediary or direct to a lender. The FSA does not regulate products, only the way they are sold. Regarding products, in addition to the safety features provided by the SHIP code, the market has also seen new innovations offering greater flexibility, the most important of which is the draw-down product.

15. Draw-down facilities allow smaller amounts of equity to be drawn out only when required, either occasionally or as a regular income. Interest is only charged on the amount drawn down meaning that the total amount owed grows at a slower rate than with a traditional lifetime mortgage. Some products combine both lump-sum and draw-down features for even greater flexibility. According to the latest SHIP statistics, draw-down facilities still make up only 3% of all outstanding lifetime mortgages written by volume. This is likely to grow as a proportion given the obvious benefits of these products of drip feeding funds to borrowers as they are needed and the fact that interest is not charged until the money is drawn down.

16. Advice constitutes the second key pillar of a confident equity release market. Equity release does have specific risks, such as removing a possible inheritance for family members, and a potential loss of benefit entitlement, all of which needs to be actively discussed in any advised sales process. These risks are covered in the Financial Services Authority (FSA) mortgage conduct of business (MCOB) rules, and so the challenge is to make sure that lenders' sales staff and intermediaries in the market routinely follow these rules. The FSA rules on the lifetime mortgage sales process introduced new safeguards including:

- clear, fair and not misleading financial promotions;
- new pre-contractual product information in key facts illustrations;
- access to a free redress scheme if a complaint arises; and
- principles of business such as treating customers fairly that actually require firms to go beyond the basic sales process rules.

(b) FSA thematic research and industry response

17. An FSA thematic review of the lifetime market involving a mystery shop was conducted over two years from early 2005 to late 2006. The first phase released in mid-2005 revealed a number of instances in which advisers were not gathering enough information from consumers or explaining the products fully. It was also concerned that advisers were recommending consumers to borrow to invest without properly explaining the implications of this since the rate of investment is nearly always lower than the rate of borrowing through equity release. The prospect of a second mystery shop exercise this spring has challenged the industry to improve standards, and we believe the message is clear: this is not a market in which advisers can "dabble" – if in doubt, advisers should refer cases on to others.

18. By the time of the second phase of thematic research which was published in summer 2006, notable progress has been made towards creating a robust infrastructure to support compliance and good practice in this market. Its key high-level messages were as follows:

- The market has improved since the first mystery shop in 2005 but problems remain, especially amongst smaller intermediaries that "dabble".
- Product providers, namely CML members, however, "now generally have in place overall systems and controls to enable sales forces to give an acceptable quality of advice to their customers." This clearly recognises the hard work firms have taken over the past eighteen months to improve this market.
- Intermediaries are split into two categories: more established firms which have put into place appropriate controls, and these set an excellent example of how the products should be sold.
- However, the FSA were concerned about other "intermediaries that write occasional business in this area without developing necessary systems and controls, knowledge and skills to give the quality of advice FSA standards require." We have long expressed a concern about such "dabblers" and have done everything to discourage such activity.
- Advisers were not paying sufficient attention to clients' means-tested benefits. As described above, the CML has helped to create Fintal and encouraged its use, but smaller intermediaries have failed to use this.
- The review found several examples of good practice, these included specialist training programmes for advisers, the checking of cases before recommendation; the use of client-specific suitability letters; and the use of "specialist software to assess clients eligibility" to means-tested benefits. Many of these measures are a direct result of various CML initiatives over the last year such as Fintal and the good practice notes.
- The FSA said it will continue intervening directly in this market, and may consider formal enforcement action.

19. The regulator said that "there is no place in this market for firms that do not develop the necessary skills and do not implement appropriate systems to ensure they give advice." We have been concerned about this for some time, and have tried to promote corrective steps for some time.

(c) The tax and state benefit position

20. Equity release products may have substantial implications for a consumer's savings or income related benefits entitlements (such as pension credit and council tax credit) and age-related tax allowances. In addition to the advice and suitability principles, the MCOB rules also specifically require advisers to take tax and benefits implications into account.

21. Recent research conducted by one lifetime mortgage lender found that as many as 45% of lifetime mortgage sales cases were in some way affected by state benefits. In some cases consumers may be better off not taking out equity release but claiming the full benefits that they are entitled to. A recent report by the Department of Work and Pensions and the Office of National Statistics (2006) found that only 34-50% of elder homeowners are claiming the benefits to which they are entitled.

22. The CML has developed *Fintal*, an affordable software system to enable advisers to check that consumers are claiming the benefits they are entitled to and model and compare the effects of different products on a customer's potential tax and benefits.

23. A 1998 report for the Treasury *'Equity Release: report for the Chief Secretary'* concluded that there may be a case for DWP to introduce a disregard for equity release products, particularly if this would support wider policy initiatives. The CML believes this would help to open up the market.

(d) Regulation of Reversion Schemes

24. The FSA, after lobbying by the CML and others will soon also be regulating home reversion plans. Following the passing of the Financial Services (Land Transactions) Act in December 2005, and the FSA and Treasury consulting on the draft rules and enabling secondary legislation through the summer of 2006, the regulation is expected to come into force in March 2007. Firms are expected to begin applying for authorisation to conduct reversion business in by late 2006.

Further information

25. Further information including links to documents can be found on our website at www.cml.org.uk/cml/policy/issues/104.

Council of Mortgage Lenders

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ANNEX A

Types of Equity Release Loan

1. Lifetime Mortgages

There are three main types of lifetime mortgage.

- **Interest-only mortgages**

You borrow a lump sum secured against the value of your home. You pay interest on the loan each month, and the lump sum you originally borrowed is repaid when your home is eventually sold. You need to be able to afford the interest payments out of your pension or other income.

The interest rate may be fixed or variable. But if it is variable, and your pension or other source of income is fixed, you will find it more difficult to meet your repayments if interest rates rise.

One option may be to invest the lump sum you borrow, perhaps in an annuity that gives you a regular income. You use the income to pay the interest on the loan, and what is left over is yours to spend. But because annuity rates are low and depend on your age, this type of loan is really only suitable for very elderly home-owners.

Here is an example.

Your home is worth £100,000. You borrow £30,000 at a fixed rate of interest of 6.5%. Your interest payments would be £162.50 a month. After 15 years, you will have paid £29,250. You still owe the original £30,000, which would be repaid from the proceeds of selling your house. Any increase in the value of your home would belong to you or your surviving family.

- **Rolled-up interest loans**

The lender gives you a lump sum or a monthly income (or both), based on the value of your home. Nothing is repaid until you die or the property is sold, but interest is added to the amount you have borrowed each year. This is 'rolled up' over the life of the loan.

How much you can borrow depends on how much your home is worth and on your age. The older you are, the greater percentage of your home's value that you can borrow. You need to check whether the rate of interest you will pay is fixed. It could also be capped, which means it cannot go above a certain level. That will allow you to be sure about the maximum amount of interest added each year and the amount you owe at any time.

Most lenders offer a 'no negative equity' guarantee. This means that the amount you owe can never be more than the value of your home. Even if the amount you borrow (plus the rolled-up interest) is more than your property's selling price, you will not have to repay any more than the amount your home is sold for.

Here is an example.

Your home is worth £100,000. You borrow £30,000 at a fixed rate of interest of 6.5%. There are no monthly payments. Instead, interest is added on and rolled up over the lifetime of the loan. Because you do not pay off any interest as you go along, the amount you owe mounts up more quickly so that after 15 years you owe the lender £77,155. This includes the £30,000 you originally borrowed. Any increase in the value of your home, after paying off the loan and interest, belongs to you or your family.

- **Shared and protected appreciation mortgages**

These loans are not currently available but have been offered in the past and may be offered again in the future. You borrow a lump sum based on the value of your home and nothing is repaid until you die or the property is sold. At that stage, the amount you originally borrowed is paid back, together with an agreed percentage of the amount by which your home has increased in value.

This means that the amount of 'interest' you pay depends on what has happened to the value of your home since you took out the loan. If its price has gone up sharply, the 'interest' you pay is higher. The slower the rise in house prices, the lower the amount of 'interest' you pay. Either way, you will not know the full cost of the loan until it is finally paid back.

It may be possible to take out a protected appreciation mortgage so you can pay a specific amount of interest. The interest is worked out at the beginning so you can work out how much you will owe at any stage.

Here are some examples.

Your home is worth £100,000. You borrow £30,000 and agree that the lender will also get 50% of any increase in your property's value. When you or your family sell your home, the £30,000 you originally borrowed is repaid, plus half of any amount by which your property has grown in value.

If you sell your home for £150,000, you owe the lender £55,000. This is made up of the £30,000 you originally borrowed, plus half of the £50,000 increase in the property's value. If you sell your home for £120,000, you owe the lender £40,000 (the £30,000 you originally borrowed, plus £10,000). If it sells for £90,000, you will only have to repay the £30,000 you borrowed in the first place.

2. Reversion schemes

With a reversion scheme, you agree to sell a percentage of your property for an agreed amount. You can receive this as a lump sum, an income or both. If you choose to sell all of your property to the reversion company, you may receive between 20% and 50% of its current market value, depending on your age (and your partner's).

When you die, the percentage of your home that you sold belongs to the reversion company. If you sell your entire home, the company owns your home outright, including any increase in its value since you agreed to sell it. Some schemes offer a rebate for your family if you die within the first few years of signing up to a home reversion scheme.

Here is an example.

Your home is worth £100,000. You agree to sell your property to the reversion company for half its current value. You receive £50,000 now. When you die, the house is owned by the reversion company, whatever it is worth.

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[i] Pensions Commission (2005) p.81.

[ii] Ibid, p.82.