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Can Equity Release Mechanisms fund long term care costs?

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1 Introduction

1.1 Scope

This paper attempts to explain why equity release products have rarely been used, up to now, to solve the problem of funding long term care for the elderly. A significant influence is elderly people's reluctance to use the equity in their home.

1.2 Equity Release Mechanisms (ERMs)

The majority of people in the UK save over their working lifetime to buy a house and pay off the mortgage. 70% of people live in owner occupied accommodation. Over the years they have made considerable amounts of capital appreciation as house prices have steadily increased with only a few downturns in value. However, though they are asset rich their wealth is tied up in the house. *See Appendix.*

Equity Release Mechanisms (ERMs) are financial schemes, normally mortgage or reversion based which enable a householder to draw down some of the equity in the house. The amount drawn down is repaid when the houseowner dies or moves out of the house. Repayment can be deferred till the death or exit of the plan holder or a surviving spouse. In some schemes interest is paid each year, but in others interest (or equivalent capital appreciation) is rolled up and paid when the capital is repaid. With most ERMs the scheme can be transferred to another house if the owner moves. Up till recently ERMs have been principally designed for retired people.

1.3 Use of ERMs

The planholder of an ERM can either take a capital sum or an income from the plan. The majority use the ERM to provide extra income in retirement or lump sums to fund urgent repairs or maintenance to the house. Alternatively, they can use the

money for leisure or to pay for long term care or the cost of medical treatment. ERMs are of no use to people who do not own a house.

1.4 Customer concerns

The majority of older people are reluctant to use the value of the house to provide capital or income. Consumer confidence in ERMs is low and older people are generally suspicious of the products and of the organisations promoting them. Yet, there are high levels of customer satisfaction from existing planholders. The legislation covering ERM products and the way that they are sold is very patchy - some schemes are totally unregulated. Comprehensive regulation would improve customer confidence. Some potential providers hold back from issuing ERMs until regulation is in place.

2 Government Response to the Royal Commission

2.1 Royal Commission's Recommendations

The announcement in 1997 that the incoming Labour Government was to set up a Royal Commission on funding Long Term Care was widely welcomed. The Royal Commission has reported and made significant recommendations on how the current system could be improved. The main recommendations on funding LTC are:

- Care should be provided under a State Scheme. Everybody would be included. There would be no contribution qualification.

- The cost of care of those who need it should be split between living and housing costs and personal care. Personal care should be free to those who are assessed to need it. Living costs and housing costs should be paid by the individual, subject to a means test.

- The means test for institutional care should be changed, with a person's home being disregarded for the first three months in a residential setting, and then the upper asset limit should be increased from £16,000 to £60,000.

- The extra cost should be met out of general taxation. Since there is no demographic time bomb the costs are affordable.

2.2 Public View

Altogether they made 24 recommendations - free personal care was the most significant in its financial implications. The recommendations were roughly in line with people's views as expressed in opinion polls and surveys.

- The cost should be shared between the State and the individual.

- It was unfair that the home was included in the means test.

- Care standards should be improved.

2.3 Government decisions

The Government rejected the main recommendation of the Royal Commission on free personal care but adopted most of the Royal Commission's other recommendations. Free personal care was rejected because of the uncertainty of future cost, especially if the balance between formal care - currently 30%, and mainly paid by the State, and informal care, perhaps 70% of the total - was disturbed or if the pattern changed over the future.

The Government did, however, agree to cover the cost of all nursing care whether this is delivered at home, hospital or in the nursing home.

In addition the Government introduced the concept of Intermediate Care which covers both prevention and rehabilitation after a stay in hospital.

The means testing limit was raised to £18,500 and a three month disregard before people are obliged to pay for care costs in a nursing home was introduced.

Local authorities are empowered to give loans when a person enters a nursing home to help cover care costs other than nursing care. They already had the power but no money to make the loans. Under Government proposals local authorities will have a delegated budget from central government to operate the loan schemes. How effectively local authorities will operate the scheme is difficult to forecast, and whether budgets will be sufficient (£85 million over a three-year period).

3 Attitudes to Equity Release

3.1 Paying for long term care

At present Long Term Care is paid on a quasi equity release scheme. A single elderly householder without substantial income going into a nursing home would be requested to sell the house and pay care costs out of the proceeds. Alternatively, the cost of care would be charged against the house through loans from the local authority. The run down of the person's assets would continue until the £18,500 limit is reached. Very few people have substantial income to cover nursing home fees and many would pay out of income and using the house value.

3.2 Unfair

This arrangement is considered unfair by the majority of the population and their children/inheritors. To most people outright ownership of the house is a major achievement. It represents the end result of significant saving over a long period of years. Ownership provides a sense of independence and security. People will not lightly compromise this satisfaction and they have an emotional attachment to the home.

3.3 Survey Result

People are very averse to using the house for care costs. In response to the question in a Millennium Debate of the Age survey, 'Older people should be allowed to leave any savings they have including their house to their children rather than using it to pay for care to look after themselves'; roughly 75% of men and 67% of women agree with the question, less than 20%

disagreed, *see Appendix.*

3.4 Attitude to Private Providers

If commercial providers put forward equity release schemes in competition to local authority schemes, people's attitudes to the whole subject of using equity release to pay for care is unlikely to change.

4 Private Schemes

4.1 Enhanced Annuity

So, for people in residential accommodation and nursing homes, or people receiving care at home the local authorities are offering equity release facilities to cover care costs. It is too early to gauge what criteria will be used in practice and the terms and conditions of the loans. Several commercial providers already offer a similar scheme - an ERM is effected and then an 'enhanced annuity' is purchased from an insurance office with the aim of providing an income to pay care costs. The terms of the enhanced annuity take into account that likely reduced longevity of the person in care, and the insurance office takes into account the person's age, gender and state of health.

With enhanced annuity products, (also called immediate needs insurance) the longevity risk is borne by the insurance company. With the loan type arrangement from a local authority or elsewhere the borrower has the risk he/she will survive longer than expected and consequently the cost of care steadily runs down asset values. The use of immediate needs' annuities to cover long term care has been increasing but only a handful of offices issue these contracts. It had the advantage of postponing any decision of funding long-term care until it was clear that care was required. The enhanced annuity can be tax free if it is paid direct to a recognised care provider or nursing home.

4.2 Value for money

These schemes are sold generally via an Independent Financial Adviser (IFA) who not only has to ensure that the

customer is claiming all the relevant State benefits, but also that the client is receiving good value for money.

The good value for money aspect is hard to judge - insurance offices have limited experience on this class of business and have few statistics to guide them. The IFA would generally ask a panel of offices to quote terms for each case and the insurance offices would in turn ask a panel of competing reinsurance offices to quote terms. The customer probably gets the best terms in the market, but in time the terms may be seen to be very conservative or far too liberal.

4.3 Possible change in attitude

It is not clear at this stage what impact the Government proposals will have on equity release or on long-term care insurance. It may have a detrimental effect to the extent people who are houseowners may now think there is no need for ERMs to cover care costs. On the other hand, if Government promotes its own version via local authorities of an ERM scheme it could bring much wanted public confidence to the whole ERM market and to the private sector.

4.4 Prefunded long term care plans

Another type of long term care insurance is a prefunded insurance plan (also known as a Future Care plan). This policy is taken out at relatively young ages - 65 to 75 years old by people in reasonably good health. The profile of people taking this plan is middle class with good pensions sufficient to live on but insufficient to pay for care costs. A high percentage are single women.

The benefits are paid if a person cannot perform a number of defined activities of daily living (ADLs) such as washing, dressing, toileting, eating, mobility. The qualifying conditions vary from office to office; again only a limited number of offices issue this policy. A typical plan would give a low level of benefit if the client cannot undertake 2 ADLs and a higher rate if the client cannot undertake 3 or more of the defined activities.

These policies can be effected on a single premium or on a regular premium basis. The benefit is a defined income not an indemnity of care costs. Market pressures and competition dictate that the insurance company has to guarantee the terms on benefit payment at the outset, especially on single premium contracts. The guarantee of terms adds to the cost of an already expensive product. The benefit levels are fixed to around the cost of nursing home fees (less an allowance for the client's ongoing income or pension). The benefits can also be index linked.

Insurance offices have few statistics on which to base premiums and they tend to be conservative on new classes of insurance.

It is possible to use an ERM to release cash to pay the single premium cost of a prefunded long term care product.

4.5 Value for money - prefunded contracts

The public are wary of prefunded long term care insurance taken at a relatively early age (65 to 75) when the person is reasonably fit since most people believe that the State should pay for all care needs and the popular belief is that there will be only a small chance of a person needing these expensive care services.

Nevertheless, the use of ERMs to pay the single premium cost of a prefunded long term care insurance policy has been promoted by some providers, but has not proved popular with the public - two contracts are involved, a mortgage or reversion and an insurance policy. The combination of two profit and safety margins on interest rates, two sets of expenses and commission and different assumptions on longevity does not lead to an attractive looking overall package to many potential customers, especially if the client has a long life expectation of 20 to 30 years. This type of arrangement was rejected by the Royal Commission as a solution to meeting long term care costs.

It has been evaluated that the cost of the double margins and guarantees take roughly 40% for females and 30% for males of the single premium for people taking a policy at around retirement age. A significantly better product is required with considerably better 'value for money'.

5 Conclusion

5.1 Many of the current private equity release plus insurance do not offer good value for the elderly clients. The value for money tends to be worse for people at or just after retirement. However, more providers are likely to enter the market with different products. This extra competition should improve value for money.

5.2 Private providers have not yet overcome people's poor perception of equity release and of releasing the house value. This is a major challenge for them.

5.3 Local authorities are now required to provide loans and quasi equity release schemes to cover long term care costs. They may have difficulty adapting to the new culture.

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Appendix

A1 Potential Market

The proportion of people who are homeowners, with and without a mortgage, is shown in Table 1.

Table 1 Ownership by age of the head of the household. (Great Britain)

Age	Owned Outright	Owned with a mortgage	Total Percentage
	%	%	%
30 - 44	5	65	70
45 - 59	24	54	78
60 - 64	51	25	76
65 - 69	64	11	75
70 - 79	62	6	68
80+	56	3	59

Source: General Housing Survey

People over age 65 have slightly lower percentage of home ownership than people at younger ages, but home ownership by retired people will grow over succeeding decades. However, outright home ownership, without a mortgage, is highest for people over retirement age and the few who do have a mortgage probably have low amounts outstanding.

Table 2 Property & Equity in houses owned by older people

Age Range	Median Property Value (£)	Median Equity (£)
50 - 64	72,700	64,900
65-79	72,100	71,100
80 plus	72,500	71,900

Source: Family Expenditure Survey 1995-6

Among property owners the mean property value is roughly constant over all the age bands. At ages over 65 practically the whole house value constitutes equity (value of property minus outstanding mortgage) - the equity of the age group 50-64 is lower as not all mortgages are paid off.

In the age range 65-79 there is considerable variation in house value according to income status. For property owners in the highest quartile of income the median was £108,100 compared to £56,600 in the second poorest quartile. Median prices varied according to region: £54,800 in Scotland, £58,500 in the North of England, ranging up to £114,400 around London.

In 1991 The council of Mortgage Lenders (CML) estimated the total equity value owned by people over 65 in the UK was £298 billion. CML reported in 1997 that they estimated a total equity value of £367 billion. At year 2000 values the total must be over £400 billion.

Table 3
'Older people should be allowed to leave any savings they have, including capital assets such as their house, to their children, rather than using it to pay for care to look after themselves' by gender and age group.

Men

	Age Group					
	16-24	25-44	45-54	55-64	65-74	75 & over
	%	%	%	%	%	%
Agree	72	70	77	84	73	75
Disagree	12	17	10	10	19	18
Neither agree nor disagree	16	13	13	6	8	7

Women

	Age Group					
	16-24	25-44	45-54	55-64	65-74	75 & over
	%	%	%	%	%	%
Agree	67	67	66	71	70	62
Disagree	19	17	16	15	17	16
Neither agree nor disagree	14	16	18	14	13	22

Source: Millennium Debate of the Age