Developments in the Equity Release Market

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Agenda

- Equity Release products in UK
- Regulation
- Risks
- Funding
- Financial Modelling
- Discussion

Equity Release in the Press in October

North East spiraling house prices…public appetite for equity release…major cause for concern according to BoE.

Equity release home loans move for Standard Life arm

Finance the great escape,,,record number cashing in equity on properties to purchase second home abroad

Fragility in housing market…reinsurers to boycott it…they will no longer underwrite the risk that prices may fall

Providers concentrated too heavily on top end of property market ignoring needs of pensioners with moderate amounts of equity

NU faces problem over equity release early surrender charges

IFAs predict more sales scandals …with profits bonds and perhaps equity release mortgage cases

FSA not protecting people from risks of lifetime mortgages

What IFAs should do to protect themselves and their clients

Mortgage Express move into equity release

Easy money?… equity release market to become more vibrant… so why are advisers reluctant to take advantage

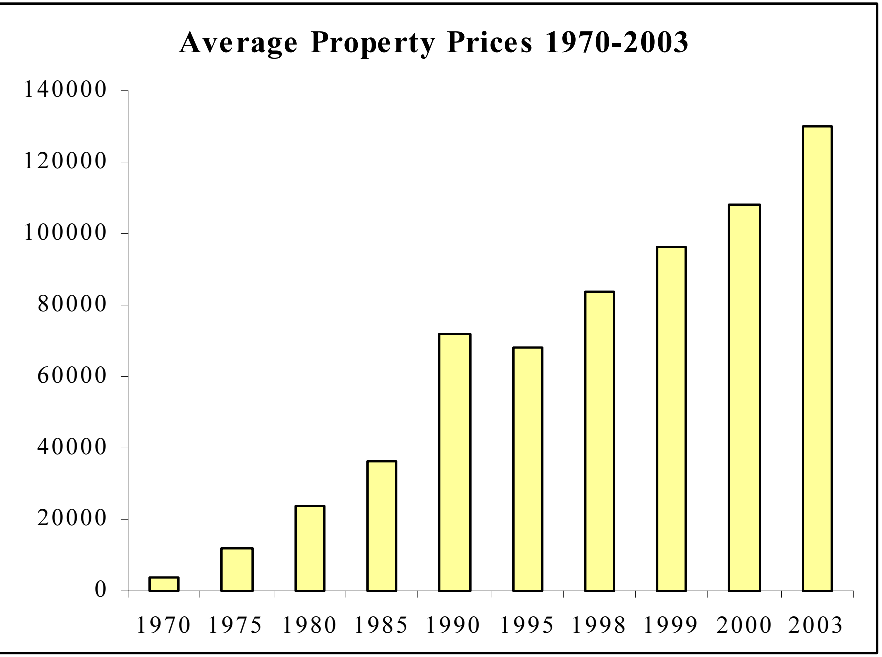
What do we understand by equity release?

- Financial product that allows homeowners to ‘release’ part of value of own property above amount owed on a mortgage:

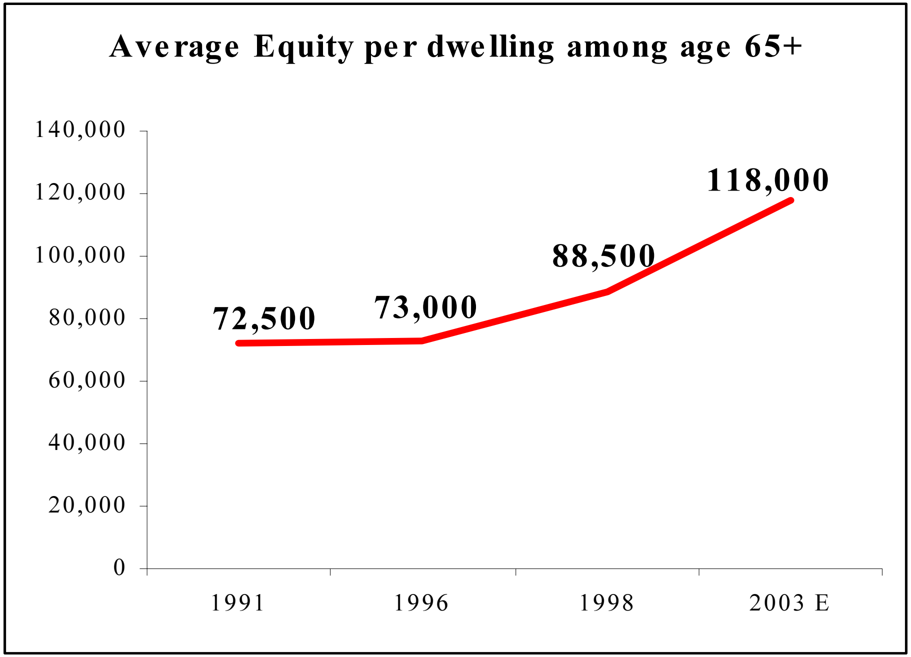
    “The unlocking of some or all of the equity tied up in the property, without the owner having to move house or being able to demonstrate that the finance generated can be repaid out of income”

    [CML definition]

Context: house prices have risen substantially



Source: Norwich Union/CML/Nationwide



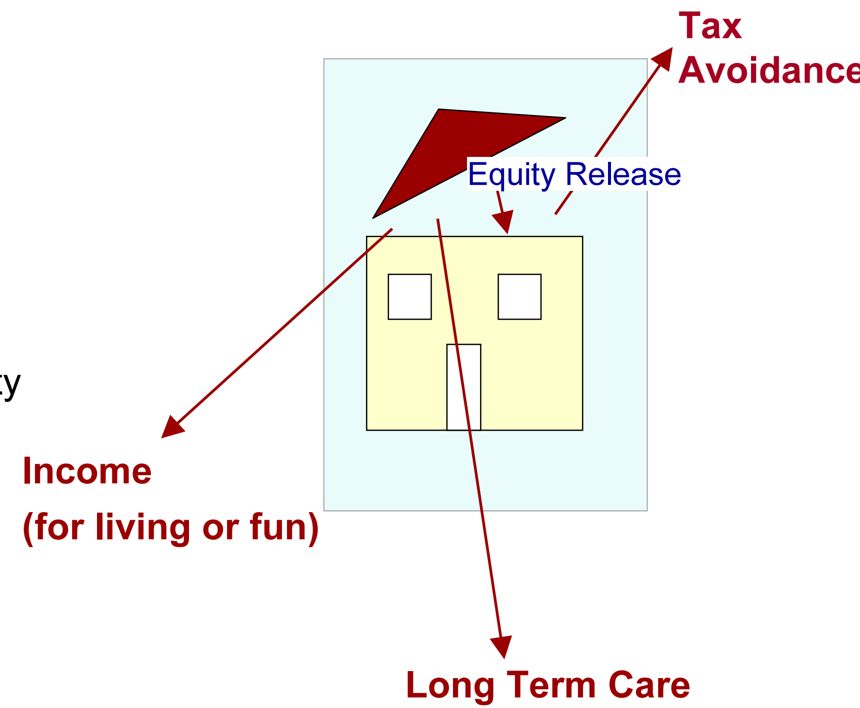
Source: CML/ English House Condition Survey
Estimate beyond 1998 from Datamonitor

- Datamonitor estimates (2001 values):
  - Older home owners (age 65+) hold over £460bn worth of equity in property
  - Less than 1% of equity realised
- Home ownership is the main way many people create their personal wealth, especially in the UK

Market potential for equity release

- Outstanding equity release market worth less than £4bn
- Estimate to grow to at least £50bn by 2008
  - Source: CML The Market For Equity Release Schemes Oct 2001
- Drivers feeding this growth:
  - Property price inflation
  - Increased longevity
  - 67% of pensioners live off state pension only
  - Diminishing pressure to retain 100% equity inheritance
  - Debate on the funding of long-term care
  - Registered Bodies involvement in developing mechanisms for low income clients

Usually sold on three key themes



Awareness of equity release high

- Nearly 70% of house owners aware of equity release products
- 15-20% of homeowners believe they will at some time use them
- June 2001 Mintel survey of adults aged 65+
  - 68% disagreed when asked whether it was a good idea to raise money on own home
  - A further 23% were not sure whether equity release was a good idea or not
- Often viewed as a last resort to a distress sale
- Recognised need for greater positive image creation to overcome previous schemes legacy
- Elderly views on inheritance will impact future potential product take up

Evolution of equity release products in the UK

Relatively few 'different' products on the market

1980s	1990's – 00's

■ Popular method of borrowing in the 1980's
■ Poor packaging of equity release products
  ■ Originally only reversion plans offered
  ■ Unsuitable products offered based on investment bond schemes and roll up plans with variable interest rates
  ■ Home income plan scandal placed many elderly people in financial difficulty
	■ Outlaw by FIMBRA of High Risk HIP
	■ Industry self regulation (SHIP and CML mortgage code)
	■ Shared appreciation mortgages introduced
	■ New entrants few and far between
	■ Equity release gains favour again
	■ Involvement of non commercial entities in low income client base e.g. Help the Aged
	■ Norwich Union Equity release securitisation
	■ £500m new business sold (H1 2003)

Lack of impartial advice available for potential clients

Typical Equity Release product types

Products can be split into two main types

Home Reversion	Lifestyle Mortgage
Cash Reversion Plan Income Reversion Plan	Roll Up Mortgage Cash Plan Roll Up Mortgages Income Plan Traditional Home Income Plan Shared Appreciation Mortgage Plan

Safe Home Income Plans

- 1991, Safe Home Income Plans (SHIPs) set up as a voluntary code of practice to promote safe equity release schemes
- Membership of SHIP requires the following commitments
  - Lenders should provide clear, fair and simple presentations of their plans to consumers
  - Offering a no negative equity guarantee to all customers
  - Providing a SHIP certificate that will clearly state the main cost to the householder's assets and estate
  - The homeowners solicitor will be required to sign a certificate to the effect that the scheme has been explained to the client
- No guidance on:
  - Sales processes employed by the lenders
  - Defining the suitability of the product

Formal Regulatory Environment

- Statutory regulation patchy as scope to fall between defined regulations
- Not all lenders are members of SHIP
  - No formal regulatory power
- Consumer Credit Act
  - Lays down minimum information requirements, including the amount and rate of interest
  - Only applicable on loans of size < £25,000
  - Certain secured loans for home improvement are exempt from the CCA
- FSA Regulation
  - CP 186, with effect from October 2004
  - Applies to Mortgage based equity release ‘Lifestyle Mortgages’
    - (According to the 2000 FSMA) FSA may only regulate financial products
  - Reversion mortgages are not part of this regulation
    - Considered to be only contracts for sale

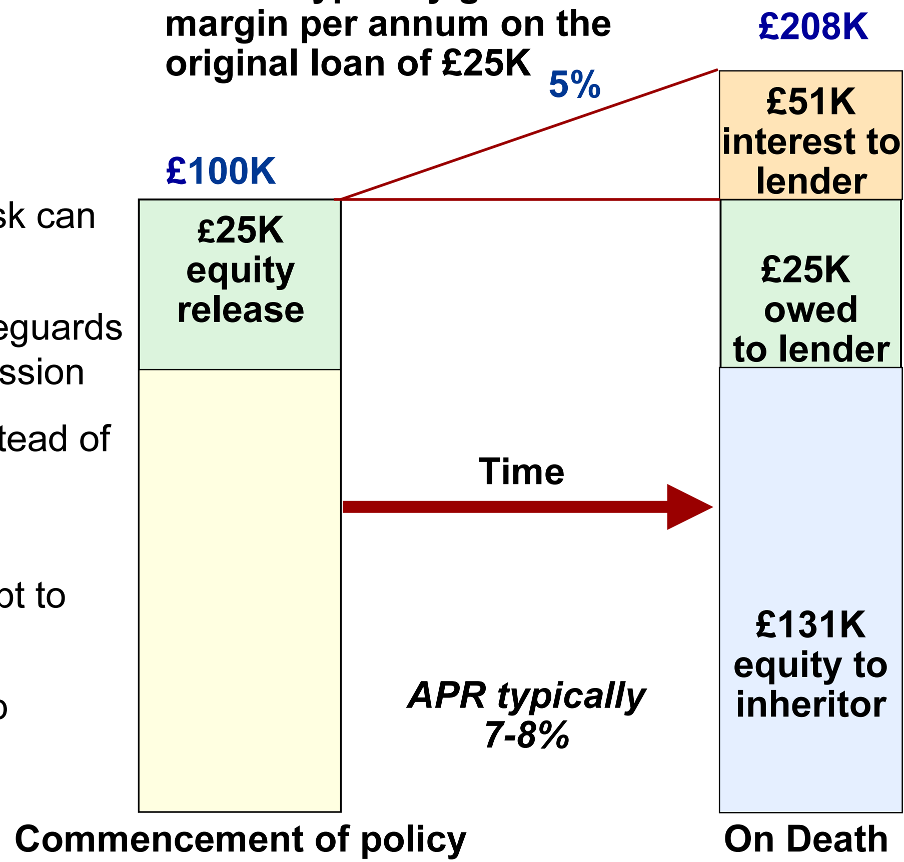
Equity Release in the UK today

- Regarded as niche products, marketed to elderly higher income people by specialist providers
- Approximately 40 players and not all participate in SHIP
- Recent new entrants in 2003 including:
  - Saga, Scottish Widows, Prudential, Newcastle, Zurich, Abbey, Standard Life, London & County
- Mainstream providers expected to provide price competition
- Greater interest from providers in mortgage equity release as a result of:
  - Customer demand
  - Gap in product range (cradle to grave)
  - Higher margins than traditional mortgage products
  - Poor market returns and endowment shortfalls on other investments
  - Inheritance tax planning
  - Distribution opportunities post depolarisation

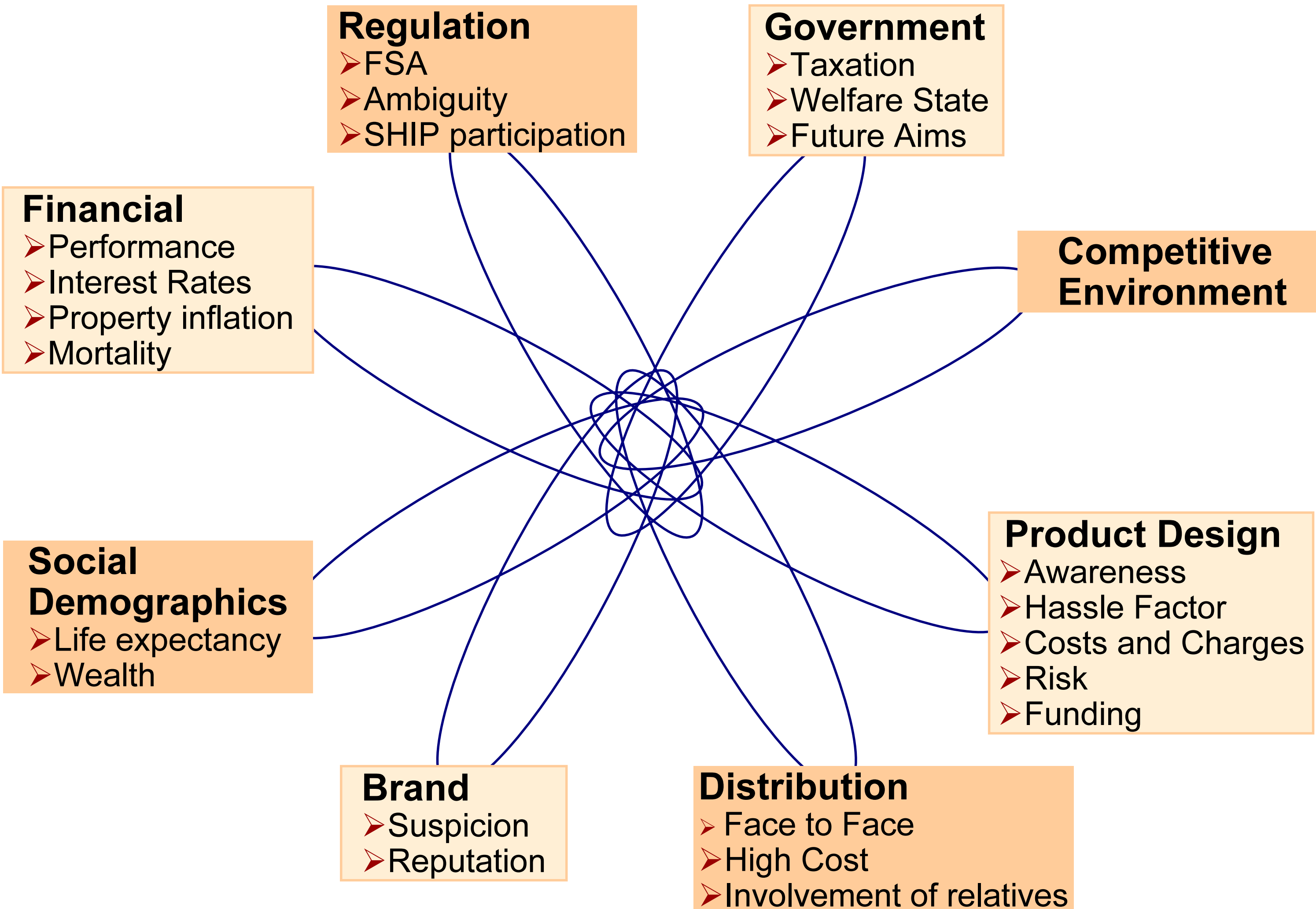
Typical roll up mortgage cash plan

- Illustration of £25K equity release on £100K property over 15 years
- Key Features
  - Age of borrower 70
  - Interest rate on loan 7.59% fixed
  - Property Price Inflation and mortality risk can be removed through SPV
  - SHIP participation provides certain safeguards e.g. no negative equity and no repossession
  - The inheritor on death gains £131K instead of £207K
  - Will required as part of product design transfers ownership of property and debt to inheritor e.g. children
  - The lender is repaid £25K and rolled up interest over 15 years of £51K

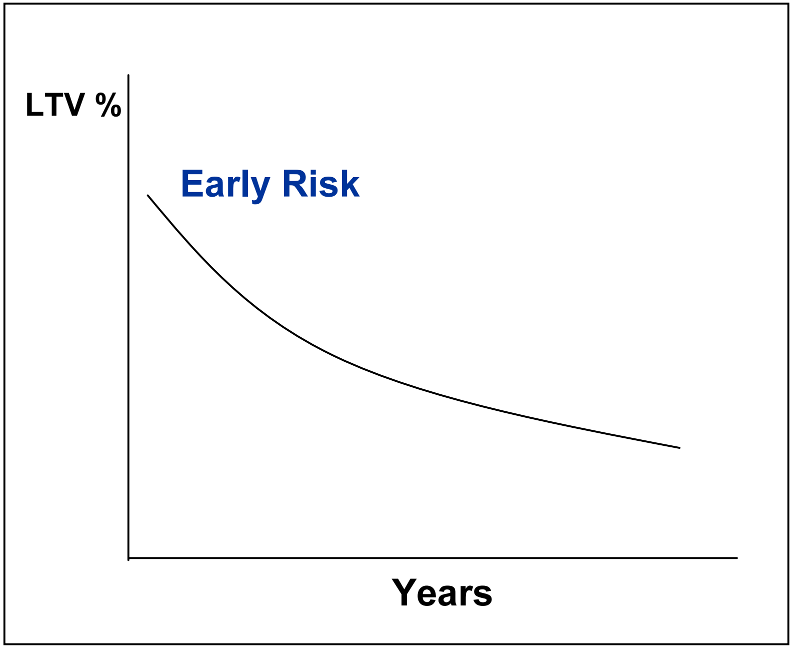
After 15 years the value of property would increase to £207K
Lender typically gain 2-3% margin per annum on the original loan of £25K

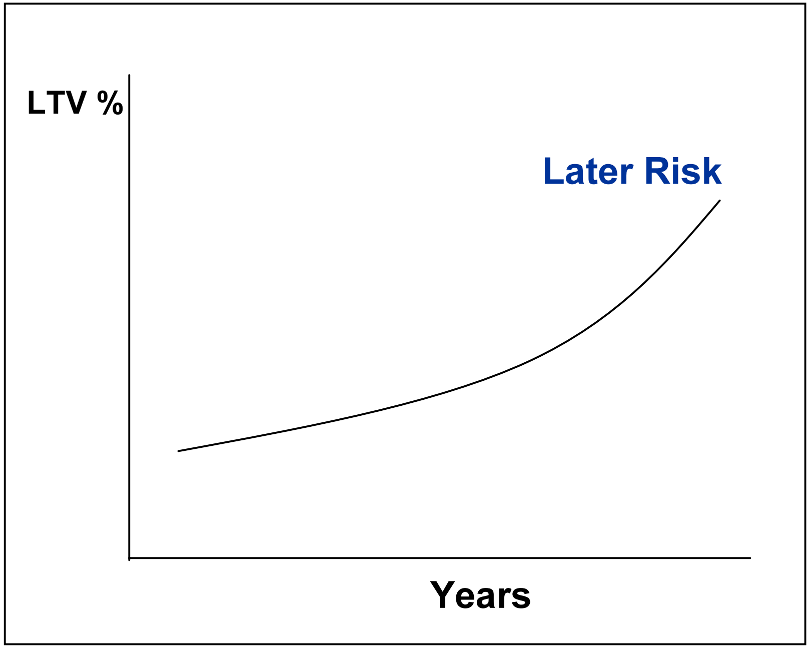


Complex and dynamic marketplace



Equity release products reverse the traditional mortgage risk model



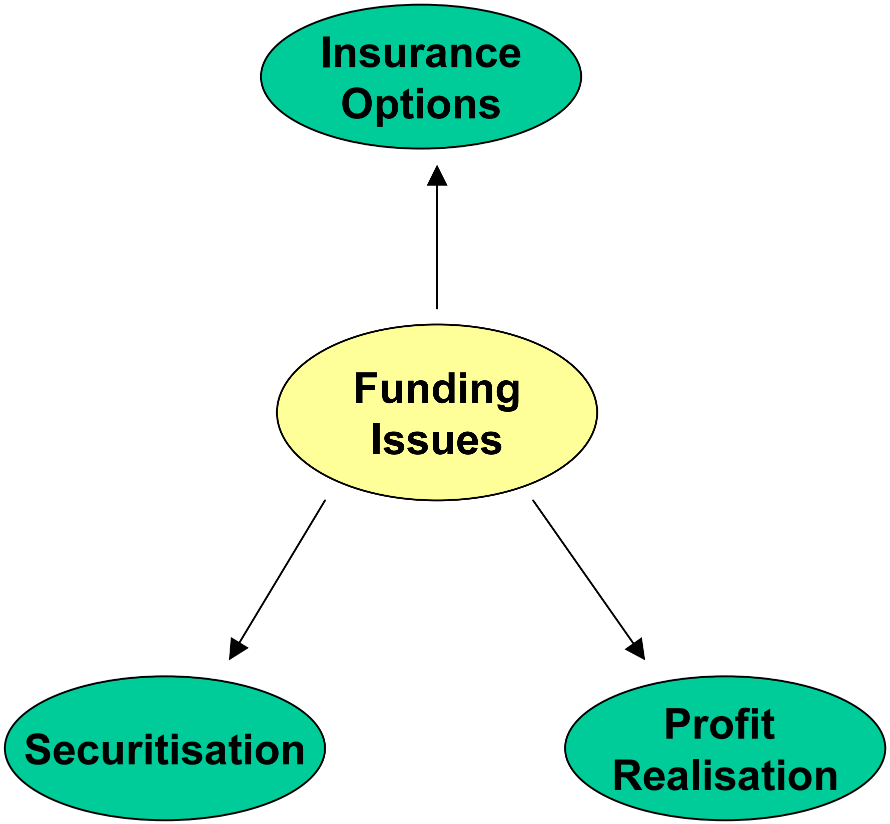


- Substantial losses may occur where:
  - No or modest capital appreciation e.g. less than 1% per annum over the average duration of the loan e.g. 15 years +
  - Level of LTV's where lender not confident in achieving sustained % HPI increase
  - Early prepayment due to long term care requirements
  - The longer the borrower lives the bigger the no negative equity guarantee exposure (NNEG) – open ended nature of loan

Funding

- Cost of loan
- Ongoing funding of loan
- Illiquid asset
- Provisioning
- Potential shortfalls

Balancing the risks and funding issues for equity release pricing provides a real challenge for providers…



Securitisation

- Asset securitisation involves:
  - Pooling of individually illiquid assets with the intent of obtaining third party financing on the strength of the cash flows generated by these assets.
  - Finance obtained by issuing asset backed debt securities that are primarily serviced by the cash flows created by the pooled set of assets.
- Objectives of securitisation can be grouped around the following areas:
  - Obtaining a cheaper form of finance
  - Gaining a beneficial of balance sheet for a specific funding mechanism
    - When internally funded raises greater uncertainties about assets e.g. liquidity risk
    - As a minimum provides a cash injection up front and seeks to un bundle risks
- Sufficient pool of institutional investors e.g. admissibility issues?

Insurance options to mitigate shortfall risk

- Need for highly rated life and property reinsurers to cover unbundled risks
- Insurance to protect against shortfall losses NNEG (and/or longevity)
  - By individual loan or aggregate
  - Willingness of insurer to accept risk?
  - Unbundle
- Self–insure against the risk of NNEG (and longevity)
  - Is it affordable?
- Previously seen as source of financing

Pricing - Financial Modelling

Two approaches

Deterministic

- Prudent allowance for assumptions
  - House Price Inflation – including shocks
  - Demographics - mortality & Long Term Care
  - Funding Costs - fixed/ variable
  - Expenses (including exit costs)
- Stress testing and Scenario analysis
  - Gap between HPI (incl shocks) and Funding Cost
  - Longevity
  - Volumes (hi/lo) and demographics

Option Pricing

- Limited use to date of stochastic modelling
- Development of reliable house price models limited
  - There is lagged relationship with economic indicators – HPI and wage growth
- NNEG viewed as put option in the hands of the customer so can be valued
- Value using option pricing techniques

  e.g. Black Scholes, requires house price volatility assumption
- As for 'Deterministic'

Key Assumptions - House Price Inflation

- Varies based on:
  - Region
  - Type
  - Occupants
  - Age
- Set assumption with regard to:
  - Drop towards 'base level'
  - Shift in areas with highest inflation
  - Influence of 'Speculative Bubbles'
  - Reliability of information
  - Economic effects

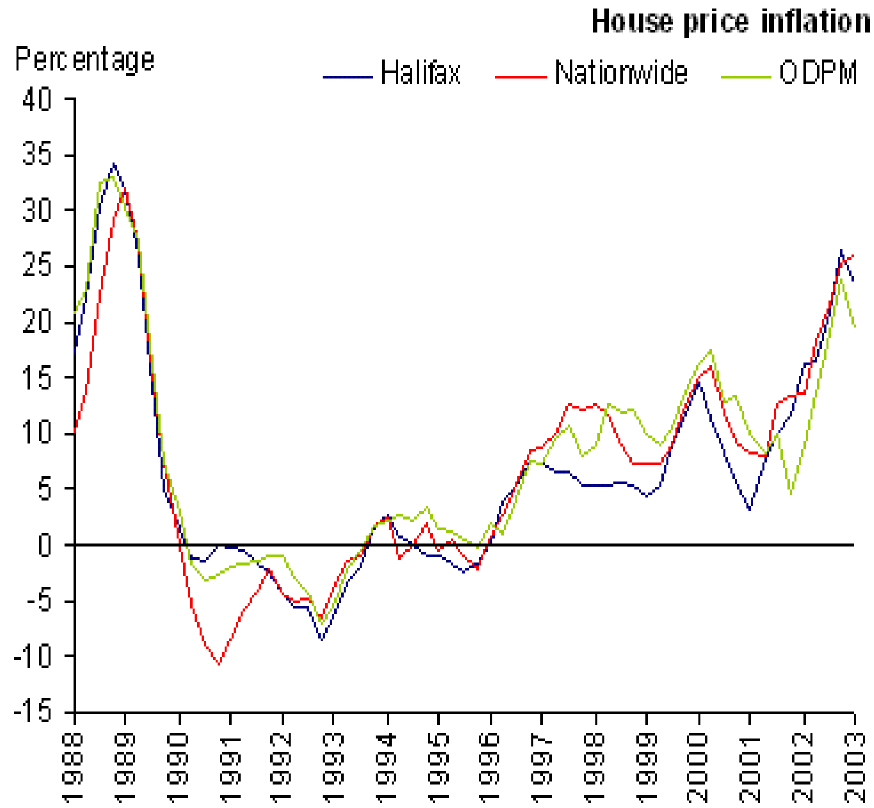


Fig 1: UK house price inflation (updated May 03)
Halifax plc, Nationwide Building Society and Survey of Mortgage Lenders

Key Assumptions – Mortality/ Long Term Care

- Impact varies across different socio-economic groups
- Off-setting effects on risk of breaching the negative equity threshold
  - Improving longevity cause higher proportion of loans to reach threshold
  - Increased evidence of LTC reduces proportion of loans to reach the threshold (depending on ‘sale’ conditions)
- Risks further heightened under income plans
- Limited information on the Mortality and LTC experience of equity release participants
- Impact of self selection?

Discussion

- Appropriate vehicle
- Hedging risks
- Funding
- Modelling
- Distribution

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