The Actuarial Profession
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# Equity Release
Report 2005


**EQUITY RELEASE WORKING PARTY**
THE ACTUARIAL PROFESSION


Volume I: Main report

## Disclaimer

The views expressed in this report are the collective views of the Working Party, though not necessarily those of individual members. Nor are the views necessarily those of the employers they work for or the bodies they represent.


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The *Equity Release Report 2005* has been written by the Equity Release Working Party (Chairman: Ged Hosty) and is published by the Actuarial Profession.

# Equity Release Report 2005

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# Executive Summary

In this 2005 Report, the Actuarial Profession continues its support for the development of the equity release market. As with the previous (Actuarial Profession, 2001) Report, the membership of the current Working Party has included representatives from charities, academia, product providers and the Consumers' Association as well as actuaries, with a view to producing a report that will be of interest to a wider audience than actuaries alone.

In Section 2 we analyse trends in private, occupational and state provision of pensions to reach the inevitable conclusion that there is a significant gap between current provision and the provision necessary to meet consumer needs. Current government policy is to reverse the 40/60 per cent ratio of private to public pension provision by 2050, the principal measure for which is the linking of state pensions to the Retail Price Index instead of the National Average Earnings Index. This places an increased burden on private and occupational provision. However in recent years employers have reduced their contributions to occupational schemes from an average of 11.1% of salary to 5.1%, and slightly less than half the population of working age have any pensions savings at all in excess of state provision.

The main measure by which the shortfall in retirement provision will be met is by people working to older ages. However, equity release offers an alternative for many people, and with the aggregate housing wealth of the population over the age of 65 now standing at around £1,100 billion, its impact could be significant.

In Section 3 we consider historic and projected future sizes of the equity release market, and describe two approaches to market projections. We reach the conclusion that the market is currently under-supplied, and could grow to several times its current size over the next few years if the large mortgage providers enter the market.

We also describe the main types of scheme available in the market today, and variants on these. The two main categories of scheme are:

- Mortgage Schemes, under which the provider lends the customer cash and takes a mortgage charge over the consumer's property. The Fixed Interest Lifetime Mortgages, or "roll-up" mortgages, are the dominant schemes in the market today, representing over 90% of sales. Under these schemes the customer is advanced a sum of money by the provider, and interest is compounded at a fixed rate with no repayments during the customer's lifetime. Capital and interest are repaid from the property sale proceeds when the customer dies or moves into care, and a "no negative equity" guarantee ensures that there is no further call on the estate in the event that the value of the loan has overtaken the property value.
- Reversion Schemes, where the provider buys a share (or all) of the customer's property, and the customer continues to live in the property for the rest of their life. The provider pays a discounted price for the property (e.g. £30,000 for a 60% share of a £100,000 house), reflecting the fact that it will be some years before the property is sold and they get a return on their investment, and the customer does not pay rent in the meantime.

In Section 3 we also outline recent market developments in terms of products, providers, distribution and regulation. We raise concerns about current mortgage disclosure regulations, and we make recommendations for the Financial Services Authority (FSA) to improve the regulatory framework in the future.

In Section 4 we discuss barriers to the development of the equity release market. These principally relate to concerns for consumers and advisers, but we also consider the lower end of the market, where need is greatest, but which is uneconomic for commercial product providers.

In Section 5 we outline the financial risks inherent in equity release mechanisms (ERMs) for product providers, and outline issues in setting assumptions for product pricing and for assessing appropriate levels of risk capital and reserves. Lack of publicly available information makes the setting of decrement assumptions difficult for both existing product providers and potential market entrants, and we recommend that the Profession should carry out ongoing experience investigations, to the extent that providers are willing to contribute their data.

Providers are exposed to significant financial risks on remortgaging if they don't charge appropriate surrender penalties, but the vast majority of existing providers feel constrained by regulation and the current market dynamics. In this section, and in the Technical Supplement, we also investigate the value of the "no negative equity" guarantee, and conclude that it is a valuable consumer benefit, having an associated cost to providers perhaps in excess of 60 basis points of margin per annum after taking into account the difficulty to hedge this exposure and hence the inherent variability of the outcome.

# Recommendations

## 1. Recommendations for consumers

Taking out an equity release scheme can make immediate and significant improvements to your quality of life. However, it is likely to be the last major financial transaction you enter into, and there are a few sensible steps you should follow before committing yourself.

- Consider, first, other options: have a "benefits check" to see if there are any state benefits you are entitled to but not claiming; consider trading down, use of savings, or the sale of other assets.
- Consider what your attitude towards an inheritance is. Everyone's circumstances are different, and you will know best whether it is appropriate to talk things over with your family. In most cases it is sensible to do this because it will probably be your family that will have to deal with the equity release provider on your death.
- Seek advice from a properly qualified adviser. It is vital that you do this. Make sure that your adviser has considered other alternatives with you, and has explained the impact an equity release scheme can have on any means-tested benefits you are entitled to, and also any tax you may have to pay. Make sure he has considered properly both mortgage schemes and reversion schemes, and that you understand what your potential future repayments are. Mortgage illustrations are only usually provided up to your average life expectancy (when around half the population is still alive). Ask for an illustration of what you will have to repay if you live 10 years beyond your average life expectancy, and consider the impact this will have on any inheritance you would like to leave. You should also ask your adviser for an estimate of the costs of entering the scheme (application fees, valuation fees, solicitors' fees, etc.).
- Make sure you understand the contract you are entering into, and before making a final commitment go to an independent solicitor to have the legal contracts explained. Legal advice does not replace financial advice, but is in addition to it. What happens if you want to make repayments, trade down or move into care? What if you want to remarry, or perhaps have a family member move in with you at some time in the future? Most providers make restrictions on the type of property you can move to and take your scheme with you – make sure you know what these are.

## 2. Recommendations for the government

- Investigate the overall effect of a larger equity release market, and then decide on a clear policy of support or otherwise. This is because the complex macroeconomic impact of a large functioning equity release market makes it unclear how an expanded market would fit with wider government economic and fiscal policy.
- Simplify and make coherent the way the social security benefit system and ERMs fit together in order to remove barriers to the market for consumers and financial advisers.
- Provide access to advice for people on benefits who may otherwise be excluded from the market.

## 3. Recommendations for the Treasury and the FSA

- Introduce regulation for reversion schemes as quickly as possible
- Introduce regulations requiring providers to illustrate potential repayments beyond the average life expectancy at the point of sale, and update the method and basis for the calculation of the average life expectancy so that it reflects current expectations. For in force business, require providers to provide an annual statement including new illustrations to demonstrate the progression of the customer's loan, and restate projections for their revised life expectancy and beyond.
- Ensure that providers are setting aside adequate reserves or have risk management strategies in place to meet potential future liabilities on remortgages and no negative equity guarantee claims.

# Recommendations

## 4. Recommendations for SHIP (Safe Home Income Plans)

- Tighten up definition of 'no negative equity guarantees' (NNEG) to ensure that there is no further call on the customer's estate in the event that the property is sold for less than the mortgage outstanding, after allowing for the costs of sale.
- Ensure all schemes are completely portable, so that customers can move property without the need for payment against their ERM (except where moving to a property that doesn't meet the provider's underwriting criteria, or moving to a property of lower value, when proportionate payment is appropriate).

## 5. Recommendations for providers

- Ensure product pricing has recognised the full cost of customer options and guarantees.
- Ensure adequate risk capital has been set aside or other risk management strategies are in place to protect the provider against potential future liabilities on remortgages, variations in mortality, and NNEG claims.
- Introduce more flexible products, including income drawdown products, that will have appeal for a wider range of customers, and offer efficiencies over most existing arrangements.
- Ensure that your advice channels consider properly whether the customer's need is for income, or for capital, and provides an appropriate financial solution.

## 6. Recommendation for the Actuarial Profession

- Carry out ongoing investigations into decrements on equity release portfolios, assuming that market participants are willing to contribute their data.

# 1. Introduction

The Actuarial Profession is supportive of the development of the equity release market, as it believes that it can help to empower older homeowners.  There is a clear need for a service that helps older people to access their wealth more efficiently, and thereby to utilise their own resources to exercise extra choices and have the means to arrange their affairs and choice of lifestyle more satisfactorily.

In 2001 the Profession produced its first report into equity release mechanisms (Actuarial Profession, 2001), in which the market at that time was investigated, and which produced a number of recommendations that could help to expand the service.  The Profession has reconvened the Equity Release Working Party in order to investigate developments in the market, to report progress on the 2001 Report recommendations, and to produce further recommendations to support the future development of the market.

A detailed review of progress on the 2001 Report recommendations is shown in the Appendix.  It will be seen that the recommendations have largely been met, and that the market today is more developed and flexible than it was in 2000.

This report continues investigation into wider market dynamics, and the majority of the recommendations made relate to market and legislative infrastructure.  However, this Report has also investigated in more depth the actuarial and other financial issues associated with manufacturing equity release mechanisms, and the Technical Supplement contains significant detail on product pricing and capital considerations.

# 2. The Case for Equity Release Developments

## 2.1. Growing requirements for retirement funding

One of the principal reasons that current provision for retirement funding is proving inadequate is the improved health of the population. This results both in increased life expectancy and in increased ability to maintain an active lifestyle into retirement with associated costs.

Historic mortality studies show that, although life expectancy at birth increased significantly during the 19th century, it wasn't until the 20th century that life expectancy at older ages started to improve. By 2000, both the likelihood of reaching age 65 (which we take as being a typical retirement age), and the life expectancy having reached age 65, had both increased significantly. The Government Actuary's Department (2004) has projected further improvements by 2020 and beyond, as shown in Table 2.1.

**Table 2.1**
**Life expectancy 1841 to 2020 (source: GAD, 2004)**

| | Expectation of life at birth | | Expectation of life at age 65 | |
|---|---|---|---|---|
| | Male | Female | Male | Female |
| 1841 | 40 | 42 | 11 | 12 |
| 1900 | 49 | 52 | 11 | 12 |
| 2000 | 76 | 80 | 16 | 19 |
| 2020 | 79 | 83 | 18 | 21 |

Although aspirations for lifestyle in retirement are increasing in higher socio-economic groups, most older people on modest incomes have unambitious plans for their retirement (Gay, 2004). So for most people, it is changes in life and health expectancy, and changes in the economic environment that are driving the increasing gap between retirement provision and retirement need.

## 2.2. Adequacy of current pensions provision

In 2001 research carried out by Oliver, Wyman and Co under sponsorship from the ABI (2001) concluded that as a country we are saving £27 billion less every year than we need to if we are to enjoy a comfortable retirement. The ABI estimates that the move from defined benefit to defined contribution company schemes, or no scheme at all, is adding another £5-6 billion to the problem every year. While these figures have been contested - they were based on achieving a target replacement ratio of 2/3rd salary - it is beyond dispute that there is a significant gap between existing pensions provision and what would be required to meet people's reasonable expectations for retirement. The reasons for this gap are well-documented elsewhere, but we outline below the principal drivers.

### 2.2.1. Erosion of state support

Issues with an increasing dependency ratio have resulted in government policy being formulated to reduce the proportion of pension provision that is provided by the public sector. Current government policy is to reverse the 40/60 per cent ratio of private to public pension provision by 2050 (DSS, 1998). The principal measure supporting this is the linking of state pensions to the Retail Prices Index instead of the National Average Earnings Index; between 2000 and 2050 this measure will reduce the state pension from 15% of National Average Earnings to 7%, which in turn will help to keep state spending on pensions constant at about 5% GDP over the same period (HM Treasury, 2002), despite an increase in the proportion of the population over the age of 65 from 16% to 26% over the same period (Government Actuary's Dept, 2004).

### 2.2.2. Decrease in employer's contributions

The increased cost of defined benefit schemes and the move to realistic reporting standards under FRS17 have precipitated a significant shift away from defined benefit schemes.

This is the most significant factor in reducing employers' contributions to occupational schemes from an average of 11.1% salary to 5.1% (NAPF, 2002)

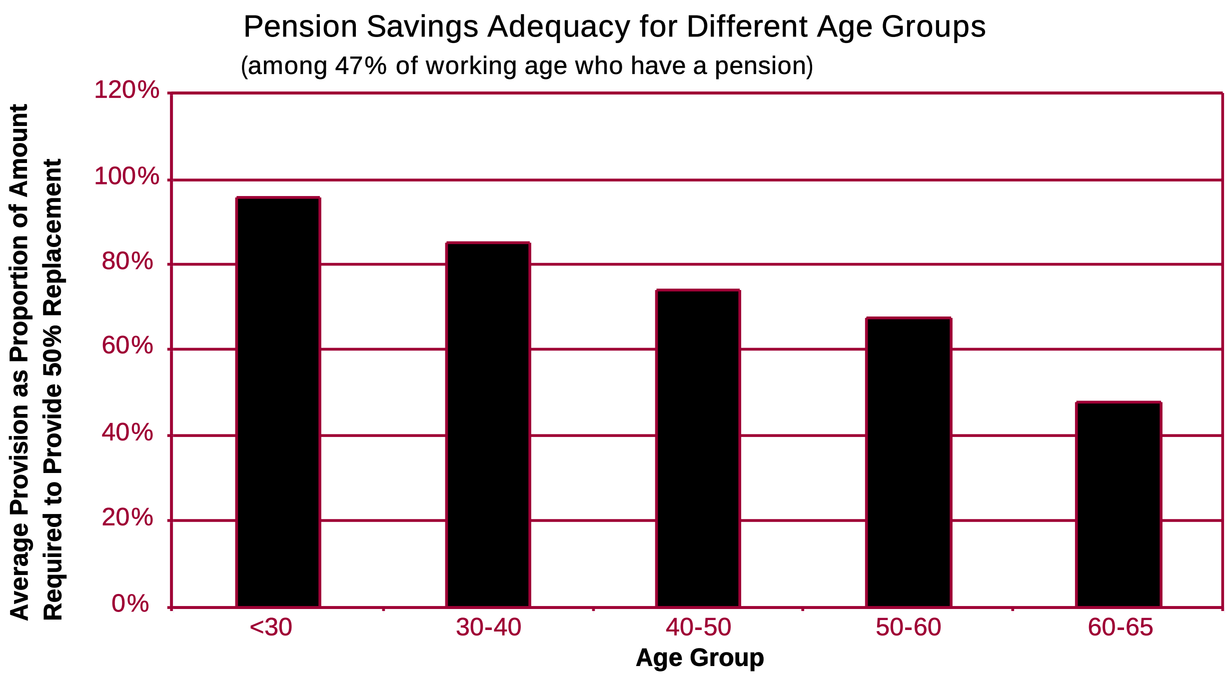
## 2.2.3. Consumer inertia towards saving for retirement

The reductions in employers' pension contributions, and the shift from state to private provision mean that employees will have to make material increases to their pension contributions if they are to achieve the same level of retirement income.

However, both quantitative and qualitative studies indicate widespread mistrust of state and private pensions, based on perceptions of broken promises by governments and scandals in the private sector. This lack of trust makes increasing pension provision difficult to achieve because it weakens individual propensity to invest and voter willingness to pay higher taxes (Taylor-Gooby, 2004).

The consequence is that only 47% of the population of people of working age have any pensions savings in excess of state provision (Deloitte, 2002). Of the people who do have some private pension provision, only around 60% are on target to achieve an income replacement ratio of half salary (i.e. less than 30% of the overall working population), with the proportion reducing with decreasing age (Figure 2.2.3).

**Figure 2.2.3** **Pension adequacy by age now**




(Source: Deloitte 2002)

## 2.2.4. Other structural changes

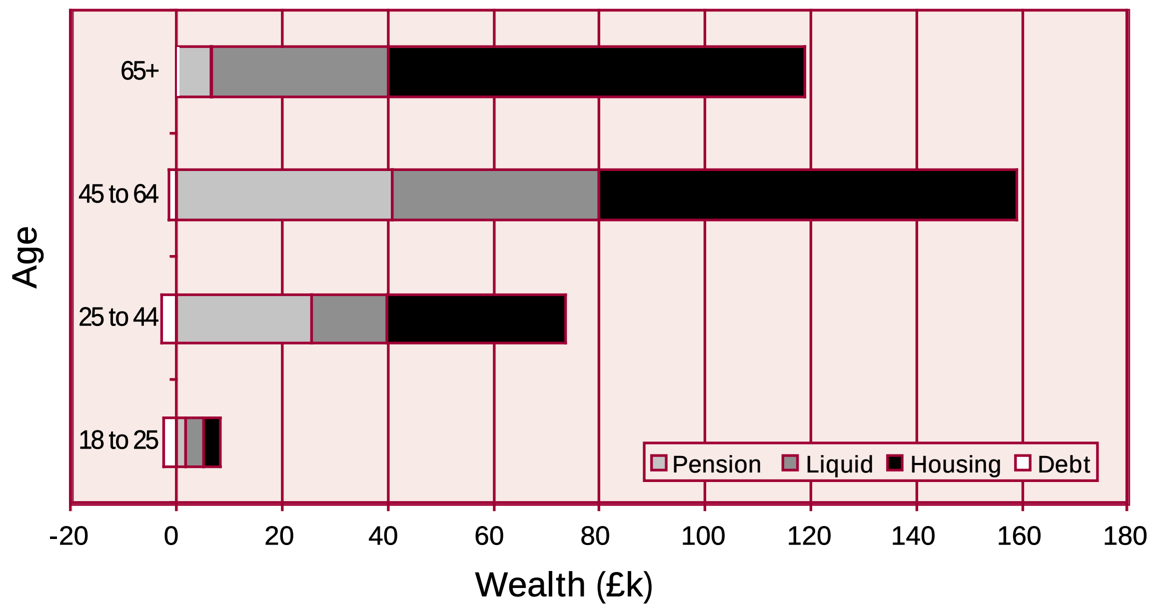
Continued employment of the population at older ages is one of the main measures by which the current projected shortfall in retirement provision is likely to be met (Pensions Commission, 2004). The government has been active in this area. It has sought to eliminate disincentives to continue working embedded in public and occupational pensions arrangements. It has sought to change employer attitudes through its 'Age Positive' campaign and 'Code of Practice on Age Diversity in Employment'. In terms of active labour market programmes, it has introduced 'New Deal 50 plus' and 'Experience Works'. The government is also currently considering whether to adopt the 'European Directive on Age Discrimination', and separately whether to give employees the right to a flexible retirement age. Each of these measures could have a significant impact on employment rates at older ages.

However, many people will be unable to continue working to older ages, and if in possession of an asset that enables them to fund earlier retirement, many people will be unwilling to continue working. For the 50% of the working population with no pensions savings there is likely to be a shortfall in provision whenever they retire. Equity release will therefore be increasingly important in the future.

# 2. The Case for Equity Release Developments

## 2.3. Extent to which Equity Release can fill the gap

**Figure 2.3 Types of wealth by age.**




*Note: Housing wealth is net of mortgage and includes the value of any endowment. Debt excludes mortgages.*

(Source: Deloitte 2002)

Figure 2.3 shows the split of asset wealth by category for different age groups. The figure only considers capital assets, and so pensions in payment are excluded. Even taking their capitalised value into account, it is clear that the retired population hold the vast majority of their wealth in housing, with average housing wealth for the 65+ population being £80,000 in 2002 (Deloitte, 2002). The further growth in house prices over 2003 and 2004 means that the average wealth is perhaps around £120,000 at the end of 2004 (the Halifax House Price Index grew around 50% from mid-2002 to mid-2004). With 9.5 million people currently aged over 65, this means that the aggregate housing wealth owned by this sector is currently around £1,100 billion.

Although ownership of property wealth is clearly skewed towards those who have least need, this vast wealth can still make a significant contribution towards the gap between retirement provision and retirement needs. 75% of the population have inadequate income in retirement (Deloitte, 2002), and 70% of the retired population are homeowners (ONS, 2002). Assuming that most of the 25% with adequate income are also homeowners, 45% of the current retired population – or 4.3 million people – are homeowners but have inadequate retirement income. For these people ERMs may provide the means to replenish some if not all of the shortfall between retirement income and retirement needs. With reducing state and employer support for retirement income, and with a growing numbers of retired people, ERMs are likely to become even more important in the future.

## 2.4. Public policy

This is the backcloth against which government policy has been evolving over the past decade, and it has changed significantly since 1991 when John Major declared that he wanted to see “wealth cascading down the generations”. The cost of providing pension provision and long term care for the growing numbers of retired Britons has persuaded the government to promote the use of private resources where pensioners are able to provide for themselves.

# 2. The Case for Equity Release Developments

## 2.4.1. Developments in governmental policy

At present governmental policy has been confined to enabling local authorities to access homeowners' housing wealth either to meet the cost of long term care, or to pay for essential repairs to the homeowner's property.

The Regulatory Reform (Housing Assistance) Order 2002 gives local authorities powers to develop equity release loan vehicles to provide assistance for homeowners to fund repairs or improvements to their homes. There is an obligation on local authorities to have policies in place setting out how they will use these powers.

At the end of 2001 the Department of Health gave instructions to local authorities allowing long term care costs to be charged against an individual's home instead of the property being sold.

Partnerships between the public and private sectors have also emerged to provide equity release for homeowners whose properties would be in too poor condition or have too low a value for them to access the mainstream commercial market. The Home Improvement Trust and the West Pennine Housing Association operate two such schemes.

These practical measures have been supported by the FSA providing a regulatory framework for equity release mortgages, which is expected to improve the confidence of consumers in the private market.

## 2.4.2. Government support for equity release

There has been no direct government support for the equity release market since MIRAS was withdrawn on home income plans in March 1999. Indeed, it is unclear what the government's policy on the equity release market is. Although it is reasonable to assume that the government would want to support wealth decumulation vehicles for pensioners in the same way as it supports wealth accumulation vehicles, a very large equity release market could have significant macro-economic effects that should be considered. First, there might be some impact on house prices if individuals were to start to invest more heavily in their own properties as a means of providing retirement income (but note that this will happen anyway after direct property investment becomes permissible for pensions). Secondly, there will be some macro-economic impact from the retired population spending their housing resources on themselves rather than leaving them as an inheritance for their children.

The first thing the government must do is investigate the overall effect of a larger equity release market, and then decide on a clear policy of support or otherwise.

## 2.4.3. Potential government support

Whatever the government's aims for the wider equity release market, it should improve access to the market for people on lower incomes.

### Recommendations

- The complexity of the current pensions and means-tested benefits system in the UK, further confused by inconsistent rules regarding the impact of capital and income raised from ERMs, acts as a disincentive to lower income groups contemplating equity release and to financial advisers considering such mechanisms for their clients. The government should simplify and make coherent the way the benefits system and ERMs fit together.
- The government should provide access to advice for people on benefits who may otherwise be excluded from the market.

If the government decides that it does want to support the development of the equity release market, then some of the following measures might also be considered. Note that these are listed as individual considerations – they are not recommendations and are not intended to be viewed as a package of measures.

# 2. The Case for Equity Release Developments

## Considerations

- Provision of a complete disregard for income or cash sums generated by ERMs when assessing Pensions Credit, Council Tax Benefit or other means-tested benefits.
- Reintroduction of MIRAS on equity release loans
- Introduction of government-backed funding vehicles similar to US Fannie Mae which supported the development of equity release mortgages in the US.
- Payment of Income Support Mortgage Interest on actual interest charged rather than a notional rate. This is especially relevant for equity release mortgages where the structure of the loans means that interest rates are higher than for standard mortgages.
- Provision of a tax break on annuities bought using equity release loans, perhaps allowing them to be completely disregarded for income tax purposes.
- Provision of a government backing for annuities making the use of equity release to provide income more affordable for consumers. One mechanism would be for the consumer to purchase a fixed term annuity, perhaps running for a maximum of 130% of their life expectancy, with the government providing income at the same level if they survive beyond the term of the annuity.
- Provision of ISMI (Income Support Mortage Interest) for loans taken out to bring the home up to the Decent Home standard rather than the lower “fit for human habitation” standard as at present.

# 3. Market Developments and Forecasts

## 3.1. Historic market size

From its low point of £23.7m new business in 1993, the equity release market recovered steadily through the 1990s, primarily through growth in the reversion market. The introduction of the first roll-up mortgage scheme by Norwich Union in November 1998 saw the first real impetus for the mortgage market, and it is now the mortgage market that dominates.

**Table 3.1 Value of new business in year (£m)**

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| **Mortgage Sales** | 6.3 | 84.7 | 297.4 | 359.2 | 651.1 | 1032.0 |
| **Reversion Sales** | 121.0 | 155.4 | 226.8 | 213.0 | 200.8 | 129.4 |
| **Total** | 127.3 | 240.1 | 524.2 | 572.2 | 851.9 | 1161.4 |

(Source: SHIP)

At the time of writing, figures are not available for 2004, but it is expected that the mortgage market will show a modest growth against 2003, although this growth may be inhibited by the introduction of mortgage regulations which distract providers and intermediaries from routine business. The reversion market has seen a near collapse in 2004 following the withdrawal of the biggest provider from the market (AMP), and the closure of the second biggest player's main source of business (the GE Life direct sales force). However, the trend for reversion sales is once again on the increase, and it is expected that 2005 will see strong recovery in the market.

The trend towards mortgage products has been largely driven by a combination of two factors. First, a lot of new entrants into the market have been mortgage lenders who would naturally sell mortgages rather than reversions. Secondly, the mortgage product is a less complex sale for the broker or IFA. Neither of these is a reflection on the relative attractiveness of the reversion product to the customer. Unpublished research by Consensus Research International has found that when different product variants have been presented to customers in an even-handed way, many customers prefer the certainty of reversion schemes. It is entirely possible that reversion products will become more popular in the future, perhaps as a result of higher interest rates, but in any event as more reversion providers enter the market seeking to take share in an increasingly competitive market.

## 3.2. Projected market size

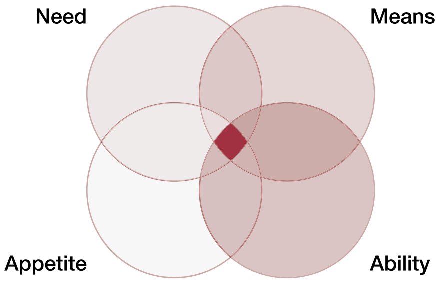
Although market growth has been dramatic, it still falls some way short of the predictions that were made several years ago. These predictions were usually based on top-down assumptions regarding the anticipated need for equity release, and perhaps the assumption that by now some of the very big mortgage providers would have joined the equity release market.

In assessing the potential market size we must consider not only those customers who might have a need for an ERM, but also whether the individuals have:

- The means to qualify for equity release – for example whether they have sufficient sums of equity in their property (and outstanding mortgages can affect eligibility)
- The appetite for equity release – primarily driven by attitudes such as attitudes to taking on debt, to spending potential 'inheritance' and the existence of a 'die-broke' mentality
- Access to the equity release market. Groups such as those with little financial experience and those averse to using advisers/IFAs may find accessing the market difficult. (This might be considered analogous to unclaimed state benefits, where people clearly have a need for the benefit, but not necessarily the information that the benefit is available).

# 3. Market Developments and Forecasts

**Figure 3.2 Equity release: defining the potential market**




(The darker the shading, the more likely Equity Release activity is to be considered).

(Source: Deloitte 2002)

## 3.2.1. Projecting market size: bottom-up approach

Customer segments within the equity release market have been constructed in a number of ways by existing providers. Criteria that have been used to determine customer segmentation are:

- Wealth status of the individual
- Income status of the individual
- Primary driver for equity release, i.e:
  - 'Lifestyle' – to enhance own lifestyle (and property)
  - 'Survival' – to meet basic financial needs/pay bills
  - 'Altruistic' – to be able to make financial gifts to family and friends

The chart below shows segmentation (for the UK adult population) based on wealth and income status. The darker shading, the more likely equity release activity is to be considered.

**Table 3.2.1 Wealth and income segmentation**

| Income \ Wealth | Poor | Modest | Aspiring | Rich | Total | Income |
|---|---|---|---|---|---|---|
| Poor | Popn = 2.9m<br>Tot Wealth = -£6bn<br>Avg Wealth = -£2.2k<br>Avg Income = £4.6k | Popn = 3.4m<br>Tot Wealth = £72bn<br>Avg Wealth = £21k<br>Avg Income = £4.1k | Popn = 2.4m<br>Tot Wealth = £282bn<br>Avg Wealth = £116k<br>Avg Income = £4.0k | | Popn = 9m<br>Tot Wealth = £441bn<br>Avg Wealth = £49k<br>Avg Income = £4.2k | Poor |
| Modest | Popn = 4.2m<br>Tot Wealth = -£4bn<br>Avg Wealth = -£1k<br>Avg Income = £8.7k | Popn = 5.2m<br>Tot Wealth = £115bn<br>Avg Wealth = £22k<br>Avg Income = £8.7k | Popn = 3.9m<br>Tot Wealth = £462bn<br>Avg Wealth = £117k<br>Avg Income = £8.9k | | Popn = 15m<br>Tot Wealth = £803bn<br>Avg Wealth = £58k<br>Avg Income = £8.7k | Modest |
| Aspiring | Popn = 2.1m<br>Tot Wealth = -£7bn<br>Avg Wealth = -£4k<br>Avg Income = £16.3k | Popn = 5.7m<br>Tot Wealth = £137bn<br>Avg Wealth = £24k<br>Avg Income = £17.2k | Popn = 7.2m<br>Tot Wealth = £940bn<br>Avg Wealth = £129k<br>Avg Income = £19.2k | Popn = 1.9m<br>Tot Wealth = £703bn<br>Avg Wealth = £381k<br>Avg Income = £22.5k | Popn = 15m<br>Tot Wealth = £1.8tr<br>Avg Wealth = £105k<br>Avg Income = £18.5k | Aspiring |
| Rich | | | Popn = 1.7m<br>Tot Wealth = £294bn<br>Avg Wealth = £166k<br>Avg Income = £52.1k | Popn = 2.2m<br>Tot Wealth = £1.2tr<br>Avg Wealth = £590k<br>Avg Income = £66.0k | Popn = 5m<br>Tot Wealth = £1.5tr<br>Avg Wealth = £335k<br>Avg Income = £58.1k | Rich |
| Total | Popn = 9m<br>Tot Wealth = £18bn<br>Avg Wealth = £2.0k<br>Avg Income = £9.5k | Popn = 14m<br>Tot Wealth = £344bn<br>Avg Wealth = £23k<br>Avg Income = £12.6k | Popn = 17m<br>Tot Wealth = £2.0tr<br>Avg Wealth = £128k<br>Avg Income = £18.0k | Popn = 5m<br>Tot Wealth = £2.2tr<br>Avg Wealth = £475k<br>Avg Income = £38.9k | Popn = 44m<br>Tot Wealth = £4.5tr<br>Avg Wealth = £102k<br>Avg Income = £16.6k | Total |
| | Poor | Modest | Aspiring | Rich | Total | |
| | Wealth | | | | | |

(Source: Deloitte 2002)

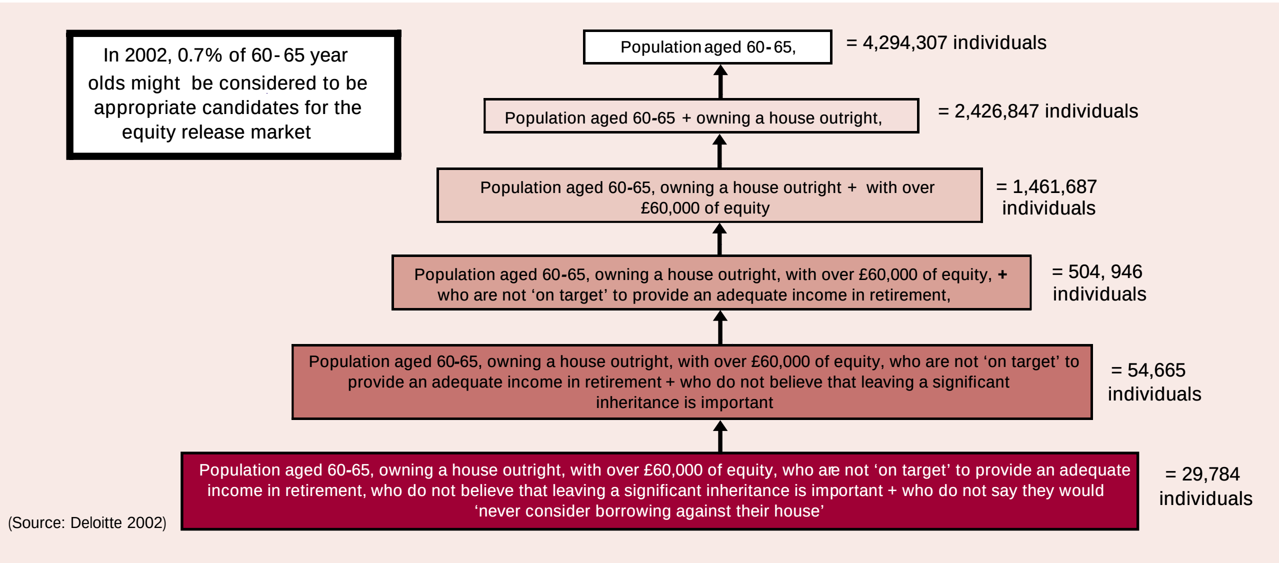
= 'Lifestyle' equity release segments

= 'Survival' equity release segments

# 3. Market Developments and Forecasts

To these base population figures must be applied estimates of customers' propensity to purchase in order to project market sizes. In Figure 3.2.1 this method is demonstrated in order to estimate the potential size of the next generation of equity release customers. Note that this analysis is based on attitudes in 2002, and ignores the potential market in non-core cells, where sales may nevertheless arise. The issue of changing attitudes and of an untapped potential market is considered further in Section 3.2.2

**Figure 3.2.1 Sizing the market for the next generation of equity release customers**




## 3.2.2. Projected market size: top-down approach

With the top-down approach we consider the same factors as with the bottom-up approach, but start with the overall population and then filter out proportions that do not fit with our criteria for being willing and able to purchase.

With house prices held constant, this provides us with the following projections:

**Table 3.2.3 Sustainable Annual Sales**

| | Current (e.g. 2005) | Short Term (e.g. 2010) | Med. Term (e.g. 2015) | Long Term (e.g. 2031) |
|---|---|---|---|---|
| Population ('000)[1] | 12,776 | 14,076 | 15,067 | 19,429 |
| Proportion homeowners[2] | 70% | 72% | 73% | 78% |
| Average number in household[3] | 1.45 | 1.45 | 1.5 | 1.55 |
| Number of qualifying households[4] ('000) | 6,168 | 6,989 | 7,332 | 9,777 |
| Proportion of population buying equity release scheme at some time[5] | 6% | 10% | 13% | 15% |
| Stable market size (in force cases) | 370,063 | 698,946 | 953,239 | 1,466,576 |
| Sustainable annual sales (number)[6] | 20,000 | 40,000 | 50,000 | 80,000 |
| Sustainable annual sales (aggregate loans, £m)[7] | 1,000 | 2,000 | 2,500 | 4,000 |

# 3. Market Developments and Forecasts

## Footnotes

1. Population aged 60 or over (Government Actuary's Department, 2002).
2. Currently 70% of retired population are homeowners. Assumed to increase progressively to 78% in long term, in line with ownership profiles for people currently in their 40s and 50s (ONS, 2002).
3. Currently 1.45, (derived from 2001 Census data), assumed to increase slightly with improving mortality.
4. Ignores ineligibility due to poor standard or low value property (these should be eligible for local authority schemes once more widely available), or e.g. existing mortgages
5. Proportions of homeowners responding to the Council of Mortgage Lenders – Hanover Housing Association questionnaire (Hanover Housing Association, 2004) saying that they are likely or very likely to purchase an equity release scheme at some time in the future. Current propensity given by homeowners currently aged 65+; long term propensity by homeowners currently aged 45-54.
6. Assumes peak buying age around 70, and so average contract runs for 18 years. Annual sales = in force market / 18.
7. Assumes average case size £50,000 (average loan size on Norwich Union mortgages funded through Equity Release Funding (No 4) plc is £52,013).

It is important to note that these projections refer in real terms (i.e. today's house prices) to the level of sustainable annual sales we would see in a mature and efficient market. At the end of the 3rd quarter 2004, the number of in force mortgages and reversions was only 83,000 (Source: SHIP) rather than the 370,000 we would expect had the market been operating efficiently for a number of years. There should therefore be a period of catch-up with sales significantly higher than those indicated above for the next 5 – 10 years.

However, current annual sales are only slightly above the long-term sustainable level, at perhaps 25,000 in number, or £1,300 million in aggregate loans. This suggests that the market is not currently efficient: either it is being under supplied, or current products and distribution methods do not reach all potential customers. This position is likely to continue until the very large mortgage providers join the market.

Apart from house price inflation, the factor that could lead to significantly higher sales in the long term is a change in consumer attitudes. The proportions assumed are based on the current attitudes of consumers in different age groups. In practice, greater awareness and acceptance of ERMs, the increasing savings gap and progressive reduction in concerns over inheritance are expected to result in higher sales.

## 3.3. Product and pricing developments

There is a variety of products available in the market, the two main categories of which are:

- Mortgage Schemes, under which the provider lends the customer cash and takes a mortgage charge over the consumer's property. There are (usually) no repayments during the customer's lifetime, and capital and interest are repaid from the property sale proceeds when the customer dies or moves into care.
- Reversion Schemes, where the provider buys a share (or all) of the customer's property, and the customer continues to live in the property for the rest of their life. The provider pays a discounted price for the property (e.g. £30,000 for a 60% share of a £100,000 house), reflecting the fact that it will be some years before the property is sold and they get a return on their investment, and the customer does not pay rent in the meantime.

### Lifetime Mortgages

The majority of these are fixed interest rather than variable interest, although exact sales figures according to this split are not available. Fixed interest lifetime mortgages are attractive to borrowers because the rate is fixed and there should be no surprises, even though the initial interest rate on variable rate loans may be lower.

# 3. Market Developments and Forecasts

## Fixed Interest Lifetime Mortgages

The product design for fixed interest mortgages focuses on two main variables, interest rate and maximum loan to value (MLTV). There is competition for business in both these areas with some lenders competing on low interest rates, others on high MLTVs, and some on both factors.

At 30 November 2004, the interest rates available on fixed rate lifetime mortgages ranged from 6.59% pa (accrued monthly giving an annual equivalent of 6.79%) to 7.49% pa (accrued annually). Using these two interest rates, a loan of £100,000 would increase to between £372,000 and £424,000 respectively after 20 years.

In June 2004, the MLTV available to a 70 year old ranged from 22.5% to 35%. For many borrowers, this may be a very important factor as they may wish to release the maximum amount possible. For others, the low interest may be of more important, as it minimises the chance of negative equity which, although a risk covered by the lender, will ultimately reduce the potential equity available to the borrower's estate.

To get the overall picture, it is helpful to forecast and compare the accrued debt relative to the property value taking into account the MLTV and interest rate for each lender. This comparison is shown in Table 3.3.1 and shows that, assuming a borrower aged 70, a property value of £200,000 and future house price inflation of 3% pa, the residual equity remaining in the property after 20 years could vary between £79,000 and £212,000, bearing in mind that the initial loan may be quite different.

**Table 3.3.1 Comparison of Projected Mortgage Repayments, November 2004**

| | |
|---|---|
| House Value | £200,000 |
| Male Aged 70 | 70 |
| House Price Growth | 3.0% |

| Product Provider | Interest Rate | Interest Rate Convertible Period | Effective Annual Interest Rate | Initial Loan | Debt after 20 years | Residual equity after 20 years |
|---|---|---|---|---|---|---|
| GE Life | 7.19% | 1 | 7.19% | £54,000 | £216,511 | £144,712 |
| Hodge Equity Release | 6.89% | 12 | 7.11% | £54,000 | £213,373 | £147,849 |
| Key Retirement-Fixed | 6.99% | 12 | 7.22% | £64,000 | £257,966 | £103,256 |
| Key Retirement-Stepped Fix ** | 7.15% | 12 | 7.39% | £64,000 | £263,303 | £97,919 |
| Mortgage Express | 6.99% | 12 | 7.22% | £70,000 | £282,150 | £79,072 |
| Northern Rock Standard Lower % | 6.59% | 12 | 6.79% | £40,000 | £148,900 | £212,322 |
| Northern Rock Standard | 6.79% | 12 | 7.01% | £50,000 | £193,678 | £167,545 |
| Northern Rock Fee Saver Lower % | 7.10% | 12 | 7.34% | £40,000 | £164,794 | £196,428 |
| Northern Rock Fee Saver | 7.30% | 12 | 7.55% | £50,000 | £214,348 | £146,874 |
| Norwich Union IFA | 7.19% | 1 | 7.19% | £54,000 | £216,511 | £144,712 |
| Norwich Union Direct | 7.49% | 1 | 7.49% | £54,000 | £228,958 | £132,265 |
| Portman | 6.75% | 1 | 6.75% | £60,000 | £221,569 | £139,653 |
| Prudential | 6.99% | 12 | 7.22% | £50,000 | £201,536 | £159,686 |
| Scottish Widows | 6.89% | 12 | 7.11% | £56,000 | £221,276 | £139,946 |
| Standard Life | 6.90% | 1 | 6.90% | £45,000 | £170,910 | £190,313 |

**Note - Interest is Stepped - 6.74% in years 1 & 2, 6.99% in years 3 & 4

(Source: Watson Wyatt)Source: Watson Wyatt

Another key product feature is the early redemption penalty and in a June 2004 survey this ranged between zero and 7% in the first 5 years with one company applying a market based adjustment which could rise as high as 25%.

It can, therefore, be seen that although there is a high concentration of sales in the fixed interest lifetime mortgage product, there are significant differences in product pricing within this market. It is, nevertheless, a relatively immature market with differences in product terms but relatively little innovation. As the market grows, it is expected that there will be greater innovation in product design and that is beginning to happen with some recent developments.

- Flexible drawdown or fixed income products allowing the borrower to draw down regular or ad hoc amounts (within given parameters) up to an allowed maximum.
- Protected capital product which bases the loan on a proportion of the property only (say 90% although it can be lower). This guarantees that an amount (10% of the value of the property in this example) will be available to the estate regardless of whether the rolled up loan exceeds the value of the remaining 90% of the property. MLTVs are applied to the unprotected part of the property, so that loan amounts are lower than if the full property is used (90% of loan available in the example).

## Variable interest lifetime mortgage

Variable interest lifetime mortgages are generally linked either to the lender's standard variable rate or to RPI, usually with a cap. These loans offer a lower interest rate at outset but with the possibility that they may increase later. As interest is only notionally paid, the attraction to the borrower of reduced initial interest is limited, although to the product provider, they may be seen as giving some hedge against interest rate or house price movements and thus could arguably be cheaper for the borrower in the longer term.

## Fixed-repayment lifetime mortgage

This variation is a mortgage equity release product. However, rather than the loan being repaid with rolled up interest on death, a fixed amount is repaid regardless of the length of the loan. The amount to be paid is based on life expectancy at the time the loan is taken out. Relative to the rollup mortgage, the amount repaid will be more if the borrower lives less than average life expectancy and less if the borrower lives longer.

## Cash reversions

In the market, at present, most reversions are sold as cash products. This results from a general trend for the market to provide unbundled products and the fact that only a life assurance company can be authorised to offer an income version. Most providers offer cash reversions with the optional purchase of an annuity if required.

## Income reversions

At present, income reversions are not common as it is generally assumed that that an annuity could be bought with the proceeds of a cash reversion. It is not clear that there is any great advantage to the client with an income reversion although, for the reversion company, there will be an improvement in the funding and cash flow position.

## Future trends in product design

Although in many respects the roll-up mortgage market is commoditised with brokers and IFAs making recommendations on the basis of interest rate or MLTV, there is a trend towards innovation and variation in product design in the mortgage market and some product design is becoming aimed at specialist markets. This degree of innovation is seen less, although there is opportunity for it, in the reversion market.

A change in economic conditions such as an increase in interest rates or a continuing slowdown in property price increases may make rollup mortgage products seem relatively expensive and could lead to an increased demand for reversions, or perhaps to the development of hybrid schemes.

Another possible development is a market for impaired life equity release products, which would allow greater cash withdrawals based on a reduced life expectancy.

## 3.4. Equity Release to meet care costs

Much has been said and written about the possibilities of using equity release to fund long term care. Indeed there is growing use of equity release to fund at-home care, and local authorities may place a charge on a customer's property to meet the cost of residential long term care, if the customer has no other means of meeting the cost. In some cases customers will use their property to fund an immediate needs long term care insurance policy, effectively an impaired life annuity bought at the time of moving into residential long term care. However, very few equity release schemes have been used to pay for pre-funded long term care insurance policies, a fact not surprising in a market that has failed to deliver its promise in the less complicated cash-purchase schemes. The reasons for this are perhaps obvious; the underlying market has failed principally because the schemes are considered expensive cover for a contingency that may never happen. Using equity release to fund a scheme would exacerbate this problem because equity release schemes are in themselves considered to be expensive. Nevertheless it is a market that should be appealing both to customers, who obtain peace of mind, and to government, which will otherwise often have to meet the cost of care. We have noted below some thoughts on how the market could develop.

### Support

The asset which is being traded, the property, is a depreciating asset. It requires regular maintenance and the people who take advantage of equity release may not be in a position to maintain the property. Providing a maintenance service would be attractive to the equity release client and at the same time would help to preserve the value of the property for the equity release provider. Why not take this a little further and provide personal care services? This would have obvious attraction for the individual buying the arrangement and would have equally obvious attraction for the long term care insurer by deferring a full claim. However, the attraction for the equity release provider, if it were a separate entity from the insurer, is less clear as it may defer the time when the property will become available, and this would have to be reflected in its product pricing.

### Division of cost

If the provider of the funding and the insurance were the same entity, there is scope for dual pricing. For reversion schemes, insurance for home care could be charged at full cost but insurance for nursing home care could be discounted to reflect the releasing of the house and the return of finance that entails. For roll-up mortgage schemes, there will have been no claim for nursing home care while the mortgage is in force (except for some joint-life cases), perhaps allowing a discount to reduce the impact of roll-up on the mortgage scheme at longer durations.

### Limited cover

For the purchaser of a policy for long term care insurance, the attraction must be that they can fund the cover without any impact on their day to day lives. They continue to live in their own house, enjoy the same net income but have the protection of the insurance. When disability strikes to such an extent that the individual needs to go into a nursing home, the property can be sold. This would suggest a product which provided support and home care only would be attractive to those who might have substantial equity to be released. A portion would initially be released to provide for the home care and then the home would be sold to provide the nursing care.

### Broader cover

Product providers slip easily into talking about their products. Less knowledgeable consumers may be less aware of the boundaries between products. Insurers separate long term care and private medical insurance cover but to a consumer they are both health care. Would it not be a compelling proposition to use equity release to provide for your health care in old age? The consumer would continue to live in his own home. He would have the same disposable income. However, if his health deteriorated, he would have the backing of his insurance, whether it was to avoid the waiting list for hip replacements or to have a carer to come into the home and look after him. Pricing for such a product would be extremely interesting. Cash outflows would be indeterminate and vary by the state of health of the purchaser. No income from the ERM would result until entry to a nursing home or death. There is moral hazard in that the insured could use, in particular, his private medical insurance when it would not have been used had he to pay himself. The medical profession, knowing there is insurance in the background might recommend much more treatment than they would otherwise do. Claims control would, prima facie, appear to be problematic. Furthermore, there is the chance that this excessive medical intervention might actually achieve its objective of prolonging the healthy live of the insured, thereby invalidating the initial pricing assumptions.

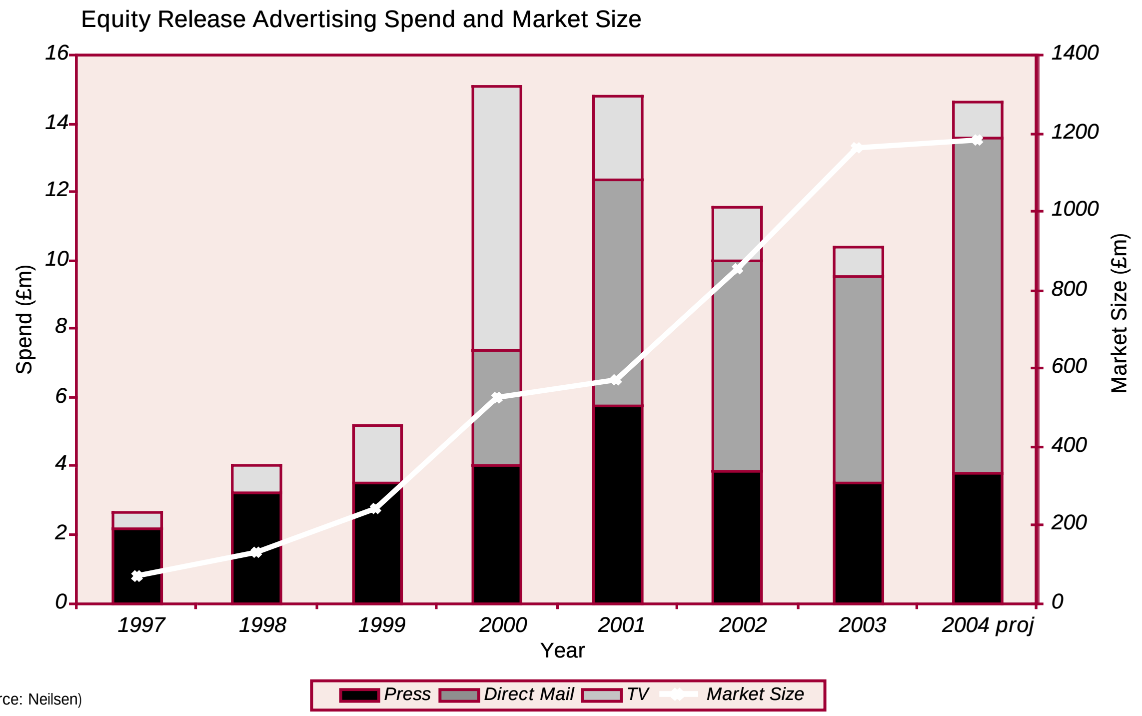
## 3.5. Provider developments

HM Treasury estimated in 2003 that there were around 30 providers of equity release products in the UK, with the majority of these concentrating only on lifetime mortgages. In addition, there are about 5 'brokers' of significant scale specialising in each of the lifetime mortgage and reversion markets. Many further IFAs sell equity release on a small scale as part of a wider portfolio.

New entrants to the market over the last two years or so include Mortgage Express, Standard Life Bank, Prudential (white-labelling a product provided by Northern Rock) and Saga, although there have also been recent withdrawals, e.g. by Portman Building Society, and Stroud and Swindon Building Society. It is believed that the companies who have withdrawn from the market have done so because of difficulties with mortgage regulation, and they may rejoin in the future. Other significant players are poised to enter the market when they deem the appropriate moment has arrived, although some of the largest potential providers consider the equity release market as yet too small to merit attention.

Although the number of product providers has been increasing in recent years, advertising expenditure has generally been in decline, and despite a recovery in 2004 it is still below its peak in 2000 (see Figure 3.5). This perhaps reflects the market shift from the less efficient direct advertising – direct sales approach taken by the earlier providers (e.g. GE Life and AMP) to the mortgage providers who dominate the market today, and who, with the exception of Norwich Union, use very little direct advertising. It is expected that this trend will continue in the future, with larger and more efficient providers taking increasing market share.

**Figure 3.5 Advertising expenditure on equity release products**




(Source: Neilsen)

## 3.6. Distribution developments

The distribution of equity release sales has moved strongly from a direct sales dominated position 10 years ago, to one where intermediary sales are now the largest source of new business. Historic figures are not available, but returns to SHIP (Safe Home Income Plans) show that direct sales represented around 40% through 2003 and 2004 to the end of September.

At present intermediary sales are dominated by lifetime mortgages, and in the 3rd quarter of 2004 only 3% of intermediary business was for reversions. In 2004 a survey of members of the Society of Financial Advisers showed that 29% of independent financial advisers (IFAs) currently write more mortgage schemes than reversion schemes because reversion schemes are not currently regulated. Perhaps more importantly, for 71% of IFAs this was not an issue, so the reasons for the much lower reversion sales obviously go well beyond concerns over regulation. Indeed, only 17% of IFAs said that they would write more reversion business if it became regulated in the future.

In the same survey, a surprisingly high 23% of IFAs said that equity release is currently important to their business (perhaps reflecting some selection in the IFAs who responded to the survey), and almost 60% said that equity release will be more important to their business in the future.

## 3.7. Regulatory developments

## 3.7.1. Mortgages

Residential mortgages have been regulated by the FSA since 31 October 2004. All the regulatory requirements that apply to other types of mortgage apply to Lifetime Mortgages. However Lifetime Mortgages are deemed by the regulator to be "higher risk". This reflects the fact that the customers who buy these mortgages are at a vulnerable time of their lives rather than the products themselves being intrinsically complex. Lifetime Mortgages are treated separately within the Conduct of Business Rules with more demanding requirements in the prescription of sales process and product disclosure.

### Projected repayments on Lifetime Mortgages

The new regulations are welcomed by all concerned, and will be an important part of continuing to build consumer confidence in the market. However, there is one aspect of the regulations that should be reviewed at the earliest opportunity, and that is the term to which repayments are illustrated. This is currently prescribed by the FSA as the average life expectancy or 15 years if longer. At present, for roll-up mortgages, repayments are presented in a table showing the repayment at the end of each year until the maximum illustrated term, and there is a footnote to the table stating that the amount to be repaid may be higher if the mortgage runs for a period longer than that illustrated.

The presentation of illustrations in this format will lead some customers to view repayments above the maximum illustrated as, at best, unlikely. In fact, and by definition, around 50% of the customers will still be alive at the end of the maximum illustrated term, and a significant proportion of these can be expected still to have their mortgage outstanding – and so will have to repay more than the maximum amount illustrated. With interest rates at current levels (typically 7.0% - 7.5%) the loans double every 10 years, so the customer who remains in their house for 10 years beyond their average life expectancy will repay double the maximum amount illustrated. In the future, customers or their estates may therefore question whether the contract was properly explained at the time of sale, and challenge its validity. This is obviously a bad thing in itself, but it could have serious consequences for the industry running from some damaging press coverage to a wide scale review of the cases sold.

It is recommended that the rules be changed so that repayments are illustrated after, say, 2 years, average life expectancy and 150% of average life expectancy. This would demonstrate to customers a wide range of outcomes without giving the impression that these are all of the possibilities.

### Basis for calculating life expectancy

The Profession is also concerned that the basis and method of calculating life expectancies under MCOB seriously understates to true average life expectancy, so that the projected repayments are themselves understated. There are 2 aspects to this.

- First, the table selected, PMA92(C=2010) and PFA92(C=2010), makes some allowance for future improvements in mortality, but understates the improvements that will be seen beyond 2010. This situation will clearly become worse as the date of calculation gets nearer to 2010. A more appropriate projection method would be a cohort approach for the year of use relevant to the projection, such as PMA92(U=2005)mc and PFA92(U=2005)mc.
- Secondly, joint life expectancy is taken as the longer of the 2 individual single life expectancies. This is incorrect as there is a chance that the life with the shorter life expectancy will outlive the life with the longer life expectancy, so the joint life expectancy will be greater.

In aggregate the choice of table and method of calculation will lead to understatement of 25-35% for couples of a similar age, as against an up-to-date basis and more accurate method. This might equate to a 50% understatement of the projected loan at the average life expectancy.

### In force statements

One further concern is that providers are currently only required to provide a statement of the accrued loan to date for annual statements. Lessons from other sectors of the financial services industry have demonstrated the importance of managing consumers' expectations through repeated disclosure on a regular basis (consider, for example, endowments and personal pensions). This approach would clearly benefit the equity release market, where long term contracts are being sold to a vulnerable sector of society. It is recommended that the FSA should also strengthen information for in force business, and require an annual statement showing new illustrations to demonstrate the progression of the customer's loan, and restated projections for their revised life expectancy and beyond.

## 3.7.2. Reversions

Initially reversions will not be regulated by the FSA because they currently fall outside the scope of their terms of reference. However, following a consultation process the Treasury announced in May 2004 that it will empower the FSA to regulate reversions.

In the meantime, SHIP has introduced a strengthened Code of Practice for its reversionary members, taking on a similar role to that of the Council of Mortgage Lenders (CML) in the mortgage market when they provided a Mortgage Code for providers to follow before full regulation was introduced by the FSA. SHIP's Code covers advice and sales, and complaints and compensation, and will be an important consumer protection in the period until reversions are fully regulated. However, there will still be a regulatory gap between Lifetime Mortgages and reversions that will cause market inequalities and may cause confusion among customers. SHIP is not a statutory body and can only regulate its members. Only product providers are members of SHIP and so intermediaries are not covered by the Code. In 2004 the majority of reversion schemes were sold by non-SHIP members, underlining these concerns. The Treasury should therefore be encouraged to bring in legislation enabling the FSA to regulate reversions at the earliest opportunity.

### 3.7.3. The role of SHIP in the regulated environment

SHIP is the UK equity release industry's representative body, and has played an important role in the recovery of the market from its low point in the early 1990s. It has done this by ensuring that its members offer products that meet important minimum criteria, and for as long as the FSA concentrates its regulations on disclosure, there will continue to be a role for SHIP in this regard. SHIP's criteria are:

- Right of tenure for life
- Freedom to move home without financial penalty
- No negative equity guarantee
- Independent legal advice confirmed by a certificate signed by lawyer acting for the client

There are 2 aspects in which providers' interpretations of SHIP's rules present customers with a different position between different products or between different providers, and it is recommended that SHIP should strengthen its Code to protect customers across the market.

First, the usual approach for roll-up mortgage providers to document the customer's right to move is to pay the old mortgage off from the property sale proceeds, and to offer a new mortgage on the new property. However, the amount available on the new mortgage will depend on the MLTVs applying to the customer's age at that time, and it is entirely possible that a customer would not be able to borrow as much on a new property as they had to repay on the old property, in extreme cases leaving them in the position where they cannot afford to move. Market practice is that the provider would not require a net repayment greater than the difference in the 2 property values, but there is nothing explicit either in SHIP's rules or in the customer's mortgage documentation that protects them in this situation.

Secondly, there is a difference between mortgage providers in how the "no negative equity guarantee" is expressed. Some providers state that the amount of repayment will not exceed the net proceeds of the property sale, i.e. gross sale price less reasonable sale expenses, so that the customer knows that the property meets the mortgage liability without any risk of a further call on the estate. Other providers state that the amount of mortgage repayment cannot exceed the gross sale price of the property, thereby leaving the estate liable for the costs of sale.

# 4. Barriers to the Development of the Equity Release Market

## 4.1. Consumer issues

The equity release market has traditionally been considered unappealing to both potential providers and potential customers. The reasons are manifold. Research by Davey (1997) identified the following reasons for the lack of expansion of such schemes;

- Suspicion over the schemes
- Concern about value for money
- Fear of indebtedness
- Attitudes to inheritance
- Misgivings about the future direction of government policy
- High administrative costs

Other commonly cited reasons are: lack of (consistent) regulation across the equity release market; (relatedly) lack of participation in the market by big brands, particularly the banks; low awareness and understanding among consumers of equity release products; constraints on sourcing funding for equity release schemes for some providers; traditional positioning of equity release as a 'distress purchase' (rather than a lifestyle purchase) may have restricted the potential appeal of equity release.

However, these barriers are gradually eroding. Rowlingson (2005) has found that the current 65-75 group are more likely to spend their resources on themselves rather than scrimp and save for their children. This attitude was supported by a favourable view on ERMs from some of her respondents, although there remain significant emotional barriers for others.

These perceptions are supported by CML findings that 9% of homeowners viewed themselves as being either likely or very likely to use an ERM at some time in the future (Hanover Housing Association Research, 2004). Of those who said that they were unlikely to use an ERM, 32% said they were wary of the schemes and 25% wanted to leave an inheritance (there may be overlap in these categories).

## 4.2. Lower value properties

There is a paradox that will always challenge the equity release market: those homeowners on the lowest incomes are likely to live in the lowest value properties and their properties are most likely to have fallen into disrepair. So those in greatest need of equity release may find that their property does not meet the underwriting criteria for schemes offered by commercial organisations. What is more, they may find that any income or capital they raise through an ERM affects their entitlement to means-tested state benefits (the position is complicated: see Age Concern (2003) for a comprehensive summary).

This lower end of the market will necessarily require subsidy to work, and if that is to be on a significant scale then it will require government backing. Recent government developments have provided some support (see Section 2.4), but a more concerted and more accessible initiative will be required if this is to operate on a worthwhile scale, and should extend to providing advice for people on means-tested benefits, as well as support of funding mechanisms.

It is also recommended that the government should simplify and make coherent the way the mean-tested benefits system and ERMs fit together in order to remove this barrier to the market for consumers and financial advisers (who have to provide information to their customers on this complicated area).

## 4.3. Distribution issues

An ERM is likely to be the last major financial transaction of the customer's lifetime. If the arrangement delivers what it promises then it should be instrumental in improving the customer's quality of life, and this perhaps contributes to the high satisfaction levels that are consistently seen in surveys of customers who already have equity release schemes in place. However, if the customer experiences difficulties with their scheme then it can be disastrous both for the customer and for the provider – consider, for example, the Shared Appreciation Mortgages sold in the late 1990s where customers were unhappy, often unable to move, and providers received extensive bad press.

There is a need for good and comprehensive advice and sound selling standards to be applied so that customers can understand fully the contracts they are entering into. It is only by providing and documenting this advice that product providers or intermediaries can demonstrate that a sale was valid, and protect themselves against complaints from customers or their estates.

The interaction between state benefits and private resources means that holistic financial planning needs to have regard to both. This is considered by Gay (2004) who says

"The Financial Services Authority should make pre-retirement advice a priority in its financial capability strategy, and government and industry should provide adequate funding to make this a reality. Consumers need access to good quality advice on retirement planning. Advice needs to be impartial and trustworthy, and be genuinely focused on the consumers' needs. It should cover not only financial products but also state benefits and other entitlements, and perhaps address wider issues related to the lifestyle changes that go with retirement".

In practice, of course, the complexities of the benefit and pensions systems means that this will be very difficult to achieve.

## 4.4. Provider issues

For most potential providers ERMs are unfamiliar financial mechanisms sold to customers considerably older than their usual target market. For most mortgage providers, the depth of financial advice required will also be different to their main product lines. Combine these high risk factors with the relatively small size of the market, and it is easy to see why many potential providers have chosen not to introduce schemes for their customers. However, increasing numbers of providers have joined the market in recent years (see Section 3.5), and it is expected that the increasing importance of the equity release market will encourage more providers to join in the future.

Product pricing and reserving are among the more difficult practical aspects for product providers in the equity release market. Few providers have direct experience of ERMs, and few of those that do have sufficient data on which to set assumptions. This necessarily means that providers will charge appropriate risk premia and have to set aside a greater amount of risk capital than if data were more widely available. Ultimately these costs must be passed on to customers, which reduces the appeal of the market. It is recommended that the Actuarial Profession, perhaps through the Continuing Mortality Investigation, carry out a decrement investigation for the equity release market. A number of providers have already indicated their willingness to participate in this research.

Although some products superficially resemble traditional mortgages, a quick review of their mechanics soon identifies financial risks that are different or more significant than those that providers may be more familiar with. However, standard actuarial techniques, and in particular the abilities to analyse risks contingent on mortality or other decrements, are as relevant to ERMs as they are to any other financial product. These skills and approaches can be used to identify the risks, model a range of potential outcomes, and thereby to quantify exposure. The product provider can then compare this exposure with its appetite for risk, and the increasing availability of financial engineering and risk placement means that it can lay off most risks that it is not comfortable with. However, some risks remain difficult to place – in particular the NNEG risk – and providers may have to retain some or all of this on their own balance sheet.

In the Technical Supplement we investigate these risks and consider appropriate pricing and reserving methods in some detail. An overview of the conclusions of the Supplement is provided in Section 5.

# 5. Product Pricing, Risk Capital and Reserves

## 5.1. Financial risks

The Technical Supplement identifies and analyses the financial risks associated with ERMs. The degree of exposure depends on the product variant, product design, and the provider's internal financial dynamics. Each provider will have an assessment of risk that is unique to itself. However, we have attempted to summarise a median position for the main product variants in Sections 5.1.1 and 5.1.2. (Fixed-repayment mortgages, which are covered in the Technical Supplement, have not been summarised in this section as they are of minority interest). Unless otherwise stated, these summaries assume that no risk mitigation strategies are in place. While the facilities available in the capital markets have improved significantly in recent years, there is very limited capacity for some of the risk mitigation strategies proposed.

Classification of risks is as follows;

**Low (L)** Risk may affect level of profit earned, but on its own is unlikely to result in material portfolio losses.

**Medium (M)** Risk may result in portfolio losses, but these should be of an order of magnitude similar to target profits.

**High (H)** Risk may result in significant portfolio losses.

**Table 5.1.1 Financial Risks on Roll-up Mortgages**

| Risk | Impact | Issue | Mitigate Via.... |
|---|---|---|---|
| **Mortality** | M | Provider takes annual margin over cost of funds. Heavier mortality will shorten the term of the mortgage, reducing the period for which the margin is earned. Lighter mortality will increase the company's exposure to negative equity. | Redemption profile insurance or Securitisation |
| **Long term care entry** | L | Same as mortality, but lower incidence rate means lower exposure. | Redemption profile insurance or Securitisation |
| **Miscellaneous home exits (e.g. move in with family)** | L | Same as mortality, but lower incidence rate means lower exposure. | Redemption profile insurance or Securitisation |
| **Remortgaging** | H | Same issue as mortality, but likely to occur very early in contract life when origination costs won't have been covered. May result in significant losses on hedged interest rates as most likely to arise in volume when long term interest rates have fallen. | Redemption profile insurance or Securitisation and/or Product design |
| **Interest rates** | H | Loan generates fixed rate of interest which may fall behind (floating rate) cost of funds. | Interest rate swap or Securitisation or Raise fixed rate funds |
| **House price exposure** | H | Impacts cost of "no negative equity guarantee". May be significant in protracted period of stagnant or very low house price growth. | Insurance or Securitisation or House price swaps |
| **Expense Risks** | L | Expenses may exceed allowances in product loadings, or business volumes may not reach critical mass. | Outsourcing |

**Table 5.1.2** **Financial Risks on Reversions**

| Risk | Impact | Issue | Mitigate Via.... |
|---|---|---|---|
| Mortality | H | Provider is implicitly insuring the period of the contract in the product terms. This is because the provider's cost of funds will be higher than expected house price inflation, and so the longer the expected term of the contract, the greater the discount to face value. Lighter mortality will result in returns being spread over a longer period, and therefore being lower on an annualised basis. | Longevity Insurance or Securitisation (Longevity Insurance depends on the mortality risk being separated from the house price exposure) |
| Long term care entry | M | Same as mortality, but lower incidence rate means lower exposure. | Longevity insurance or Securitisation or Product Design |
| Miscellaneous home exits | L | Same as mortality, but lower incidence rate means lower exposure. | Longevity insurance or Securitisation or Product Design |
| Voluntary early repayments | Not a risk as results in profit to provider | Very unlikely on reversion contracts where financing terms have been set on expected period of occupancy and there is no advantage to the customer in repaying early. | |
| Interest rates | H | The reversion contract is effectively financed at fixed rate of expected cost of funds over expected house price inflation. In theory there should be some offset within this in the longer term (i.e. higher interest rates should reflect higher inflation which should result in higher property growth, keeping the discount factor more stable), but there is significant exposure to short term deviations in either market. | Interest rate swap and/or House price swaps or Securitisation |
| House price exposure | H | | |
| Expense Risks | L | Expenses may exceed allowances in product loadings. | Outsourcing |

## 5.2. Setting central assumptions

What represents central or "best guess" assumptions may differ significantly from one product to another, and from one product provider to another, and perhaps for different cohorts of business (e.g. direct/intermediary). Accordingly, it is very important that each product provider carries out its own investigation before setting its pricing assumptions. In the Technical Supplement we have set out an approach that can be adopted to provide conclusions, but the conclusions we have reached are unlikely to suit any one company in practice.

### 5.2.1. Decrement assumptions

One of the obvious difficulties when setting a pricing basis for ERMs is the lack of publicly available experience data and standard tables for this particular market. In the Technical Supplement we have derived our pricing and reserving bases from first principles, but it would clearly help existing providers and potential market entrants if more market data were available. One of the Working Party's recommendations is that the Profession should carry out ongoing investigations into decrement experience for the in force market to date. This investigation would depend on the support of existing providers, but with appropriate safeguards in place indications are that a sufficient number would join the investigation to make it worthwhile.

## 5.2.2. Remortgaging

Repayments due to remortgaging are only likely to occur at any significant level on roll-up mortgages; providers of reversions and fixed-repayment mortgages should not anticipate windfall profits from this source.

Where a customer remortgages on a roll-up mortgage, it will usually be because term interest rates have fallen, and a cheaper rate is available elsewhere. In this situation, under the assumption that the provider has either raised fixed rate funds (which now look expensive) or has swapped out its interest rate exposure, there will be significant losses in closing out the position. This will be exacerbated if the remortgage occurs early in the product life, as the margins accrued to date may not then be adequate to meet the acquisition costs incurred.

Ideally providers would like to charge a "mark to market" penalty to cover these losses - in which case there would be no incentive for customers to remortgage (other than narrowing of margins, which will be less significant). The FSA's Mortgages: Conduct of Business (MCOB) regulation 12.3.2G makes it clear that the FSA has not ruled out any method of calculating early repayment charges other than the "Rule of 78". However, most providers have interpreted MCOB 12.3.1, "A firm cannot impose an early repayment charge other than one that can be expressed as a cash value" as meaning that they must have a clear penalty fee scale that does not depend on complicated formulae (which marking to market would require). Providers must also not levy "excessive" charges (12.5.2), where "excessive" refers to …. Charges for similar products or services on the market (12.5.3), and charges must be capped in order to comply with MCOB 12.3.4R. This has left us with a situation where nearly all providers charge a penalty of 5%/4%/3%/2%/1% for surrender in years 1/2/3/4/5, penalties that may seriously understate losses where interest rates have fallen, but are unable to move away from the market norm.

The consequence is that providers are exposed to significant risk from this feature.

Existing mortgage providers may have some experience of the levels of early repayment they may anticipate in these circumstances, and it is likely to be influenced by the distribution method (broker business more likely to remortgage than direct sales), duration of mortgage (early durations more likely to remortgage) and amount of interest rate movement (greater movements provide greater incentives to remortgage).

Providers can protect themselves against these potential losses through derivatives, although this may be regarded as an expensive and far from perfect solution (in that remortgage rates are unpredictable so the proceeds from the options will not necessarily match the losses to the providers). Providers with sufficient financial strength may decide they do not need to provide this cover, but they should still recognise these potential losses in their product pricing, and ensure that an appropriate charge is made for the capital that will be required to support this position.

## 5.2.3. The "no negative equity" guarantee

The NNEG is a feature of most modern equity release schemes, and is compulsory for schemes following the SHIP Code. Through the NNEG the provider guarantees the borrower that the redemption amount of the mortgage will be capped at the lesser of the face amount of the mortgage and the sale proceeds of the home (sometimes) net of all sale expenses.

The NNEG cannot be priced accurately using a deterministic approach because of its option-like features. Furthermore, the NNEG cost on a portfolio of mortgages is the sum of a number of binary outcomes on the different mortgages in the portfolio, and the circumstances of each will be different (i.e. the average portfolio experience does not matter, the portfolio loss is the sum of losses on individual cases with no offset for cases where there was surplus equity cover). Thus, if house price growth across the entire portfolio averages 3% p.a. then there will likely be some regions where growth averages more than 4% p.a. and some where growth is under 2% p.a. (see the Technical Supplement, Table 3.10). Within these regions there will be further diversification, so that some individual properties may experience no or negative growth, while others may have enjoyed growth at over 6% p.a. All other things being equal, the properties that have enjoyed higher growth rates may not result in NNEG claims even if the householders live towards the tail of the mortality curve. However, the properties with the lowest growth may have NNEG claims even if the householder does not live significantly beyond their average life expectancy.

In the Technical Supplement, Section 3.7 we model the NNEG using the Black-Scholes option pricing methodology. Even on relatively modest assumptions our conclusion is that the NNEG is a very valuable customer benefit. Across all age ranges the theoretical Black-Scholes cost of the NNEG is perhaps in excess of 60 basis points per annum (see the Technical Supplement, Table 3.13). However, as there does not generally appear to be an effective means to hedge this risk, customer charges will also need to service the capital set aside to back this risk.

Negative equity claims will arise principally on the longest surviving cases; by the time claims emerge the profits from contracts that ran off at earlier durations may well have been booked and spent if no provision is made. It is therefore important that providers should allow for the cost of this benefit in their customer pricing, and then regularly reappraise the appropriate level of reserves to hold as the portfolio evolves.

Clearly, the higher the permitted MLTV, the greater the risk of adverse experience from this feature, and providers will want to consider their product terms as an integral part of their product pricing and profitability.

The significant value of the NNEG and differences in life expectancies between single males, single females and couples, and between different ages within the 5 year rating bands adopted by some providers, mean that if the portfolio is to be profitable overall, some individual cases will be very profitable and others loss making. Providers should therefore consider age and sex dependent MLTVs.

## 5.3. Risk capital and reserves

What reserves a provider should establish will depend on its financial exposure to this product when set against its overall financial strength. Insurance and other risk placement mechanisms may reduce, or even completely eliminate, the amount of capital it must set aside to guard against potential future adverse experience (but credit risk may be increased). However, the risk must always rest somewhere, and so there will be a cost of capital that must be reflected in the end price to customers either explicitly or implicitly. Regulatory capital requirements must also be considered, and where these exceed the provider's own assessment of the necessary risk-based capital, additional provision must be made.

The items for which reserves should be considered are those summarised in Tables 5.2.1 and 5.2.2 (see accompanying Volume 2). Section 4 of the Technical Supplement considers risk capital and reserving issues in further detail.

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## APPENDIX

### UPDATE ON JANUARY 2001 REPORT AND RECOMMENDATIONS

#### Recommendation 1

*"Providers should give better explanations of the ERM and the advantages and disadvantages, risks and safeguards. Providers need to develop structures so that people can be confident that the arrangement is safe if the provider is bought or sold, or goes into liquidation."*

The FSA started regulating mortgages in October 2004, and this regulation extends to the mortgage variants of equity release mechanisms (which the FSA has termed "lifetime mortgages"). The Treasury has also announced its intention to authorise the FSA to regulate home reversions, although this will require primary legislation and as yet no timescales have been suggested.

#### Recommendation 2

*"Value for money and confidence could be improved if more major financial institutions came into the market with competitively priced products. New improved products are required to suit a larger sector of the population."*

The equity release market is now gaining momentum, and this has been supported by a number of major brands introducing products since the first report in January 2001. In the last 2 years new products have been introduced by Standard Life, the Prudential, Mortgage Express and Saga. Norwich Union have extended their product range, and the potential market, by introducing an interest roll-up mortgage where the interest rate is expressed as a margin over inflation, enabling higher loan to value ratios, and extending the minimum age to 55. Several medium-sized building societies (e.g. Chesham) have also introduced schemes. Against this, the withdrawal from the market of Legal and General, and Stroud and Swindon will bring caution to other potential new entrants.

The market is becoming more competitive, but still suffers bad press for being poor value for money. In fact margins have reduced significantly over the last 5 years, with headline rates having reduced by around 1.5% from November 1998 to October 2004, but long term cost of funds being stable. Headline rates on equity release mortgages remain higher than standard mortgages, but there are good reasons for this:

- Interest rates on equity release mortgages are usually fixed for life, and so should be compared to 10-20 year fixed rates rather than standard variable rates.
- The term of the mortgage is not known at outset, and this uncertainty will be reflected in the interest rate offered.
- All schemes include a "no negative equity guarantee", which provides that the repayment will not exceed the property sale proceeds, even if the loan has grown to a higher amount. As discussed in Section 5 and the Technical Supplement, this is a valuable benefit, the cost of which must be met from the interest rate charged.
- Although there are a variety of practices, many providers – quite properly – provide full financial advice, and possibly a home visit, on an equity release mortgage sale. This is obviously a more expensive method of distribution than those common in the wider mortgage market.

However, profit margins on equity release mortgages remain higher than those on standard mortgages. The relative size of the markets means that this will always be the case to some extent, but the introduction of more new products by major financial institutions would help to reduce the differential.

# Appendix

## Recommendation 3

*"The Financial Services Authority should bring in regulation to cover all types of ERM and introduce CAT marked standards on a voluntary basis."*

See Recommendation 1 regarding mortgage regulations and the proposed reversion regulations.

## Recommendation 4

*"Financial advisers should extend their advice to ERMs when considering retirement and inheritance tax planning, and also how ERMs can assist (or otherwise) in planning for long term care costs. More training and knowledge on ERMs is required by financial advisers."*

Regulation (see Recommendation 1) will support this, but this is an area which would benefit from more attention. Northern Rock runs training courses for IFAs which are always over-subscribed. There is also an increasing number of industry equity release conferences targeting IFAs and mortgage advisers. Most significantly, the Financial Services Skills Council has set appropriate standards for advisers providing advice on Lifetime Mortgages, and in future advisers will have to pass an exam to this standard before they can provide advice to customers.

## Recommendation 5

*"New products at appropriate margins are needed so that elderly customers can afford home repairs, improvements and maintenance. CAT marking is essential to give these customers confidence and so that the administration cost can be kept to a minimum."*

There are 2 aspects to this: the first is the development of new products at appropriate margins. One new product worth mentioning is the Houseproud Scheme set up by the Home Improvement Trust and local authorities. The scheme gives advice, approved builders, inspection of work and finance if required (grants to cover fees, surveys etc are usually available up to £500 maximum).

See also Recommendation 2.

The second issue is that of CAT standards, and it is interesting to review this recommendation in the light of experience in other markets where CAT standards have been introduced. Generally CAT standards have not been widely adopted, and concerns are now being raised that they disenfranchise the less well-off sectors of society – which is the core market for equity release. In view of these developments, the working party's view is now that CAT marking should not be introduced.

## Recommendation 6

*"Long term investors and the Treasury should work together to develop a special purpose investment vehicle so that the long term investors can invest in residential property and mortgages on residential properties."*

In 2002 the Investment Property Forum put forward a proposal to the Treasury which was turned down. This recommendation remains outstanding, and there does not appear to be any momentum to move it forward.

## Recommendation 7

*"Government should reconsider the interface between income from ERMs and means tested State benefits. The equivalent of pension credit for people with income just above the Minimum Income Guarantee should be extended to income from ERMs."*

This has now been adopted for annuity income generated by ERMs within the regulations for Pensions Credit (which replaced the Minimum Income Guarantee in April 2003). However, there is no standard disregard for money raised through equity release schemes, and this continues to cause confusion among customers and advisers. It is recommended that the government should simplify and make coherent the way the benefit system and ERMs fit together in order to remove these barriers.

### Recommendation 8

*"The definition of quasi-derivatives under Regulation 56 of the Insurance Companies Regulations should be reviewed since the current interpretation has fallen behind valid developments in the market."*

There has been some press commentary suggesting that there has been a change to the regulations to allow the inclusion of property index derivatives as admissible assets. In fact, there have been no changes to these rules since prior to N2 and they remain as set out in the FSA's handbook of rules and guidance. The press articles stemmed from a number of insurance firms themselves, through the ABI and the property derivatives users association, gathering sufficient evidence to satisfy themselves that simple derivatives based on the IDP indices met the objective tests. Current market practice therefore seems to provide adequate flexibility without the need for regulatory changes.

### Recommendation 9

*"Government should encourage and promote indices to show the change in value of residential properties. Research is required on how this could be accomplished. Several indices may be required for geographical area, type of property and age of owner."*

The government introduced a new house price index earlier this year, details of which are available on the Office of the Deputy Prime Minister's website. Most previous indices had been based only on mortgage transactions, and therefore excluded cash purchases which represent around 25% of the market. The sample size is significantly higher, and suffers from less selection, than any other available index. The index is based on information taken at the land registry at the completion stage, which is reliable, but means that data is usually several months out of date as against deals being struck in the current market.

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