Equity Release

Quick reference Guide Chapter 1

By the end of this guide you will know the definition
of equity release, home reversion plans, lifetime mortgages and alternative
methods of releasing equity.

Introduction to Equity Release

Definitions

There are some terms that you need to be familiar with in connection to equity release:

Equity	• In the context of this course, equity refers to the residual wealth of a property owner tied up in their property. This is the value of the property less the total value of any debts secured on it.
Positive equity	• Arises when the value of the property exceeds the value of any obligations secured on it.
Negative equity	• Arises when the total value of the obligations secured on the property exceeds the market value of the property.
Capital repayment mortgage	• Some of the capital is repaid each month, together with some interest.
Interest only mortgage	• The capital debt remains constant until the mortgage is redeemed at the end of the term.
Lifetime mortgage	• The generic term that applies to a wide range of products targeted at elderly borrowers such as home income plans, cash plans, capital drawdown schemes and open-ended mortgages.

MCOB rules	• Mortgages and Home Finance: Conduct of Business rules. Relevant to providers of regulated mortgage contracts, lifetime mortgages and home reversion plans.
Open-ended mortgage	• Enable the customer to borrow money and generate an income by investing in a long-term investment, usually an annuity.
Cash plans with regular payments	• An open-ended mortgage with interest only payments made to the lender.
Home reversion plan	• Enables a homeowner to sell all or a proportion of their property to a reversion provider in order to raise funds, with the customer continuing to live in the property, as a tenant, or until they die or it is permanently vacated.
Defined benefit pension scheme	• Provides a guaranteed minimum pension based on the individual's wage/salary in the last few years of employment, the number of years of service and an accrual rate specified by the scheme.
Defined contribution pension scheme	• Does not provide a minimum guaranteed pension. It is a money purchase scheme in which the eventual pension will depend entirely on investment performance and the condition of the financial markets when money is taken from the arrangement.

Cash plans with rolled up interest	• An open-ended interest only mortgage on which no payments are made and the interest rolls up until the borrower dies or goes into long term care.
Shared appreciation mortgage	• A plan that enables the customer to raise capital and make no payments. The lender foregoes interest completely but takes its income (profit) from a share in the increase in the property value that has occurred between creating the mortgage and the redemption date.

1.A What is Equity Release?

Equity Release is a means of releasing equity in a property, but which allows the borrower to remain in their home. Please see the definitions above of **equity, both positive and negative** also **capital repayment** and **interest only** mortgages together with two generic types of equity release product i.e. **lifetime mortgages** and **home reversion plans**.

1.A.1 Why release equity?

It is possible to have income and no capital wealth and just as possible to have capital wealth but little income, which is where equity release comes in.

- Some people need to **generate income** to maintain standard of living, probably in later life.

- Some may need to **liquidate capital** because a cash sum is required for any number of reasons e.g. replace car, major repairs, pay off debts.

1.A.2 The need for equity release

Demographic trends of declining birth and death rates, leading to pension crisis, **state provision** only provides subsistence level of income.

Demise of **defined benefit schemes** and move towards **defined contribution schemes** with no guarantees.

Despite ongoing reforms, changes to **personal pensions** regimes and favorable tax treatment for contributions, there are still hundreds of thousands of people with inadequate or no retirement provision.

Market performance, **low inflation** and falling **annuity rates** together with **demise of the "job for life"** all pointing towards lower than expected returns from pensions when it comes to retirement.

Current lifestyle choices and aspirations mean that people are increasingly running up large debts, deferring marriage, children and long-term investments until later in life.

1.B Lifetime mortgages

As most equity release methods require the customer to take out a mortgage, the **Financial Conduct Authority (FCA)** classifies most of these products as **lifetime mortgages** under **Mortgages and Home Finance: Conduct of Business (MCOB) rules.**

1.B.1 Home income plans

These enable customers to borrow money and generate income by investing in a long-term investment, usually an annuity. An annuity provides an income for life, some of which is used to meet mortgage repayments with the remainder available for personal needs.

These plans were somewhat discredited in the late 1990s as in some cases, the mortgage was tied to an income bond with variable returns which failed to keep pace with high mortgage interest rates.

Most current equity release products no longer insist that funds are invested in any particular manner.

1.B.2 Cash plans

There are two main types of cash plans; with regular payments or rolled up interest.

1. **Open-ended mortgage** with **interest only payments made to the lender.**

2. **Open-ended interest only mortgage** on which **no payments are made** by the borrower; interest rolls up until the borrower dies or goes into residential care.

This is a contract between the customer and the lender, who would usually hold **a first legal charge (standard security in Scotland)** on the Property**.**

In both cases, MCOB rules require the lender to assess suitability of the contract, but where payments to the lender are involved, affordability must also be assessed.

1.B.3 Shared appreciation mortgages

A plan that enables a customer to raise capital and make no payments. The lender foregoes interest completely but takes its income (profit) from a share in the increase in property value that has occurred between creating the mortgage and redemption date.

These are virtually unknown today.

1.C Home reversion plans

Home reversion plans enable a homeowner to sell all or a proportion of the property to a reversion provider in order to raise funds, with the customer continuing to live in the property as a tenant, until death or until it is permanently vacated.

This is not a mortgage, but the scheme involves a **legal conveyance**; the former owner becomes a **tenant**.

Capital that can be released is often a much greater percentage of open market value of property than that would be available under a conventional lifetime mortgage.

Home reversion will never enable the customer to raise the full value of the property, as the finance provider has to balance **reward** with **risk**.

1.D Comparing lifetime mortgages with home reversion plans

A Home reversion plan is not a mortgage or even any type of loan. It involves a sale of the property with a consequent impact on customer's estate, whereas most mortgage-based plans enable the customer to retain full legal ownership.

Home reversion plans enable a higher proportion of the market value of the property to be raised.

More detailed product comparisons are provided in subsequent chapters.

Equity Release Chapter 1 (ER01) – End of Module Test

Multiple Choice Questions

Question		Answer
1 – In the later years of a capital repayment mortgage, the monthly payment to the lender comprises…	A.	all interest
	B.	mainly interest
	C.	all capital
	D.	mainly capital

2 - A final salary scheme…	A.	will provide a guaranteed minimum pension for the employee
	B.	is less risky than a defined contribution scheme
	C.	will not provide a guaranteed minimum pension for the employee
	D.	is more risky for the employee than a defined contribution scheme

3 - With a home income plan, the income is usually provided by investing in an…	A.	insurance bond
	B.	investment bond
	C.	annuity
	D.	endowment policy

4 - For an open-ended mortgage where interest payments are made by the customer, the lender is obliged to assess the contract for…	A.	suitability only
	B.	suitability and affordability
	C.	affordability only
	D.	risk and reward

5 - For an open-ended mortgage where no interest payments are made by the customer, the lender is obliged to assess the contract for…	A.	suitability only
	B.	suitability and affordability
	C.	affordability only
	D.	risk and reward

6 - A home reversion plan...	A.	is a type of mortgage
	B.	does not involve a legal conveyance
	C.	enables the customer to raise the full value of the property
	D.	will never enable the customer to raise the full value of the property

7 - For which group of individuals is equity release the most likely to be suitable?	A.	The unemployed
	B.	Divorcing couples
	C.	Retired individuals
	D.	First-time buyers

8 - Jack and Jill started an equity release plan in which they became tenants in the property. The plan is...	A.	a shared appreciation mortgage
	B.	an interest roll-up plan
	C.	a drawdown mortgage
	D.	a home reversion plan

9 - What regular payments are required under a shared appreciation mortgage?	A.	Capital payments only
	B.	Both capital and interest payments
	C.	Interest payments only
	D.	Regular payments are not required

10 - Christine, aged 80, lives alone in a property valued at £400,000, has very little income and needs to raise £40,000. She is considering taking out a lifetime mortgage. What option should she consider first?	A.	A shared appreciation mortgage
	B.	Trading down to a smaller property
	C.	An interest-only mortgage over 10 years
	D.	A home reversion plan

- **End of Questions** -

Answers

Question	Answer	
1 – In the later years of a capital repayment mortgage, the monthly payment to the lender comprises…	D	mainly capital
2 - A final salary scheme…	A	will provide a guaranteed minimum pension for the employee
3 - With a home income plan, the income is usually provided by investing in an…	C	annuity
4 - For an open-ended mortgage where interest payments are made by the customer, the lender is obliged to assess the contract for…	B	suitability and affordability
5 - For an open-ended mortgage where no interest payments are made by the customer, the lender is obliged to assess the contract for…	A	suitability only
6 – A home reversion plan…	D	will never enable the customer to raise the full value of the property
7 – For which group of individuals is equity release most likely to be suitable?	C	Retired individuals
8 – Jack and Jill started an equity release plan in which they became tenants in the property. The plan is…	D	a home reversion plan

9 – What regular payments are required under a shared appreciation mortgage?	D	Regular payments are not required
10 – Christine, aged 80, lives alone in a property valued at £400,000, has very little income and needs to raise £40,000. She is considering taking out a lifetime mortgage. What option should she consider first?	B	Trading down to a smaller property