Equity Release

Quick reference Guide Chapter 4

By the end of this guide you will understand the range of product providers and customer types.

Product providers and customers

Definitions

Here are some terms that you need to be familiar with in relation to this chapter:

Term	Definition
Purchased life annuity	An income purchased with a lump sum, by a private individual, where part of the payment (the return of capital) is tax-free and the balance is taxable. It usually ceases on death.
MCOB rules	Mortgages and Home Finance: Conduct of Business rules. Relevant to providers of regulated mortgage contracts, lifetime mortgages and home reversion plans.
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.
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, until they die or it is permanently vacated.
Final salary 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.

4.A Equity release providers

4.A.1 Lifetime mortgage providers

Original equity release plans introduced in the 1980s were home income plans where the provider sold a loan alongside a purchased life annuity. The intention was that the annuity provided an income from which the loan interest was repaid with some to spare. Rising interest rates made these plans largely unsustainable.

Few lenders now prescribe the way in which the customer should use money released.

Providers range from large financial institutions to many smaller specialized firms.

4.A.2 Home reversion providers

From a provider's perspective, the nature of these plans lends itself more to property investment than mortgage provision and main providers tend to be specialist companies with expertise in the home reversion market, plus some life assurance companies.

4.A.3 How do equity release providers operate?

The main providers of lifetime mortgages are banks, life assurance companies and building societies funded from retail savings and deposits markets, wholesale markets or a combination of these.

Building Societies must raise at least 50% of their funding from retail deposits market under provisions of **Building Societies Act 1997**.

Lifetime mortgages are part of a wider portfolio of products and lenders tend to regard them as a focused product that will always represent a comparatively small proportion of their business.

Home reversion plan providers are mainly limited companies, accountable to shareholders and funded by their own capital or that raised from markets. They balance return with risk, trading off current capital expenditure for long-term future capital growth.

As the sum to be provided to a home reversion customer depends on life expectancy, home reversion providers must pay regard to actuarial information.

4.B Customer types

Both lifetime mortgages and home reversions limit access to those over a specified minimum age, usually 60 years.

No minimum age is prescribed under MCOB rules and it is purely a matter of policy.

The maximum percentage of the value of the property that will be provided varies directly with age. Older customers are able to raise more than younger customers.

Customers are usually able to raise a larger sum under a home reversion plan than under a lifetime mortgage.

Main requirements of equity release customers are:

- need to raise cash sum
- need to generate income in retirement
- a combination of these.

4.B.1 The need for cash

An individual may want to generate a capital sum for numerous reasons including:

- Their pension arrangements may provide less than anticipated.
- Funds required to pay off high cost borrowings that cannot be serviced when income falls in retirement.
- Usually more difficult to borrow money and service new debt as individual gets older.
- Home may need to be modified or adapted or consumer durables replaced.
- May be necessary to replace expensive asset such as a car.
- Individual may wish to help children or grandchildren financially.
- May be no need other than reassurance provided by having an emergency cash sum available to draw upon as required in later years.

4.B.2 The need for income

Members of final salary occupational pension schemes can predict, with some accuracy, the income they hope to receive in retirement. This enables them to work with some certainty to determine any shortfall and how to meet it.

Members of defined contribution schemes have no guarantees, so income in retirement can be unpredictable.

More often, many individuals may not have made any plans and expect to rely heavily on State benefits.

If an individual has not planned for retirement, or entered a pension scheme too late, some of the following alternatives may have to be considered:

- live on subsistence level state benefits
- sell up and trade down
- sell up and live with children or other relatives
- sell up and hope that local authority can provide housing
- take in tenants (not ideal option for many elderly people)
- take out a lifetime mortgage
- sell part or all of property to a home reversion plan provider.

4.C Customer considerations

4.C.1 Suitability

Rules require equity release providers to take account of **suitability** when giving advice.

It is important to consider **for example** how the customer feels about home ownership, the wish to leave a legacy for beneficiaries, their life expectancy and expected movement in property values.

4.C.2 Affordability

Affordability affects lifetime mortgage customers considering a product that will require payments to be made to a lender. Where no such payments are to be made, there is no need to assess affordability.

Affordability is not an issue for most home reversion plans, as the only regular outlay may be a nominal rent.

All customers may be concerned about set up costs such as:

- legal fees and outlay, including fees associated with setting up any lease
- advice fee to intermediary
- valuation
- arrangement or administration fee.

4.C.3 Simplicity

Lifetime mortgages and home reversion plans are potentially complex products. However, they are also significant financial commitments and it is therefore vital that the adviser is able to explain the product features, benefits and drawbacks of products very carefully and at a level which the customer can fully understand.

4.C.4 Security

By providing finance, equity release products can make a material difference to the circumstances or lifestyle of a customer. However, this needs to be balanced with the nature of the commitment in the contract.

For lifetime mortgage customers, the rolled-up interest can accumulate to a significant amount and erode all the equity in the property. The No-negative Equity Guarantee included by providers who are members of the Equity Release Council means that the amount owed will never be more than the value of the property.

For those plans that do require regular repayments to the lender, the risk exists of the customer defaulting.

For home reversions, the rights and obligations as a tenant are no more onerous than under a conventional residential mortgage and unless there is serious breach of contractual conditions, the customer’s lifetime security of tenure is guaranteed.

4.C.5 Emotional attachment

This is mainly an issue with home reversion plans where home ownership is given up and this can be a real concern for elderly people, especially those whose home has been in the family for several generations.

Even with a lifetime mortgage, the property may have to be sold to repay the loan and accumulated interest.

4.C.6 Inheritance

All equity release products have the potential to reduce the value of the client’s estate.

Under a home reversion plan, this has significant effect in event of early death and some products offer a degree of protection against this. By contrast, if death occurs in the early years with a lifetime mortgage, all that is due is the original loan plus interest to the date of repayment. The customer has not parted with a significant portion or all of the value of their property.

A home reversion plan usually transfers all benefits of rising property values away from the customer in favour of the provider. Some products also offer a degree of equity share to mitigate this loss.

Lifetime mortgages enable a customer or his estate to benefit to some extent by inflation in house prices over time, though this will be offset by the accumulating interest.

4.C.7 IHT mitigation

Both generic types of equity release can enable the individual to reduce future inheritance tax burden on the estate.

Lifetime mortgages reduce the net value of the estate by creating a mortgage obligation.

Home reversion plans have the potential to reduce inheritance tax as they transfer some or all of ownership to the reversion provider.

It must be stressed that both types of plan are relatively inefficient ways of reducing a potential Inheritance tax liability.

4.C.8 The "better off" test

This **"test"** means that overall, the benefits of the product should outweigh the overall disadvantages, with particular regard to potential loss of means tested state benefits and entitlement to other grants which may be affected by the customer's level of savings. This is most likely to happen if the funds that have been released are retained as cash rather than being spent on the expenditure identified under the know your client / fact find.

4.D Eligibility criteria

4.D.1 The customer's circumstances

- Equity release products are not available to everyone.
- They are specifically designed for older persons.
- Unless interest is payable, the customer is not usually required to make regular payments.
- The on-going running costs of the property need to be affordable.
- The customer must have legal capacity to enter into a mortgage contract or legal conveyance or this may be done on their behalf under a Lasting Power of Attorney.
- Customer must have unencumbered freehold, leasehold or commonhold title to property.
- Outstanding mortgages and/or subsequent charges normally have to be discharged or paid off.
- Residents not party to the scheme/plan normally have to waive their rights of residence established under **Land Registration Act 2002.**

4.D.2 Property

For lifetime mortgages, the eventual sale of property is usually the only practical way for the provider to recover its outlay and make profit. Therefore it must be confident that property will be marketable and will hold value over a relatively long period of time.

Properties that are built of a non-standard construction and those located near contaminated sites may, as a result, be unacceptable.

Some properties such as flats or retirement apartments may be acceptable but on less favourable terms, although some providers no longer lend on retirement apartments.

Multiple Choice Questions

Question	Answer	
1 - What minimum percentage of funding must a building society raise from the retail deposits market under the provisions of the Building Societies Act 1997?	A.	50%
	B.	75%
	C.	90%
	D.	There is no prescribed minimum

2 - Home reversion plan providers are mainly:	A.	limited companies
	B.	limited partnerships
	C.	partnerships
	D.	life assurance companies

3 - Affordability is not an issue for most home reversion plans as normally the only regular outlay after finalising the contract is:	A.	the market rent
	B.	a nominal rent
	C.	compulsory life insurance
	D.	the cost of an annuity

4 - The lifetime mortgage reduces the net value of the estate by:	A.	transferring some of the ownership to the mortgage provider
	B.	transferring all of the ownership to the mortgage provider
	C.	creating a mortgage obligation
	D.	the inflation in house prices over time

5 - If there is a mortgage outstanding on the property, the provider will normally insist that:	A.	it is subordinated to the lifetime mortgage contract
	B.	it is converted to a secured loan
	C.	it is converted to an unsecured loan
	D.	it is discharged

6 - One essential difference between lifetime mortgages and home reversions is that the customer:	A.	must give up ownership with a lifetime mortgage
	B.	becomes a tenant with a lifetime mortgage
	C.	is usually able to raise a larger sum under a home reversion
	D.	is usually able to raise a larger sum under a lifetime mortgage

7 - The original equity release plans introduced in the 1980s were:	A.	Home reversion plans
	B.	Drawdown mortgages
	C.	Shared appreciation mortgages
	D.	Home income plans

8 - Lifetime mortgages and home reversion plans limit access to those over a specified minimum age because:	A.	it is purely a matter of policy
	B.	younger customers will be able to raise more than older customers
	C.	under MCOB rules, the minimum age is set at 60 years
	D.	life expectancy is a statistical concept rather than an exact science

9 - A younger occupier of the property who is not party to the scheme may secure a right of residence under the provisions of:	A.	The Land Registration Act 2002
	B.	The Financial Services and Markets Act 2000
	C.	The Building Societies Act 1997
	D.	MCOB rules

- **End of Questions** -

Answers

Question	**Answer**	
1 - What minimum percentage of funding must a building society raise from the retail deposits market under the provisions of the Building Societies Act 1997?	A	50%
2 - Home reversion plan providers are mainly:	A	limited companies
3 - Affordability is not an issue for most home reversion plans as normally the only regular outlay after finalising the contract is:	B	a nominal rent
4 - The lifetime mortgage reduces the net value of the estate by:	C	creating a mortgage obligation
5 - If there is a mortgage outstanding on the property, the provider will normally insist that:	D	it is discharged
6 - One essential difference between lifetime mortgages and home reversions is that the customer:	C	is usually able to raise a larger sum under a home reversion
7 - The original equity release plans introduced in the 1980s were:	D	Home income plans
8 - Lifetime mortgages and home reversion plans limit access to those over a specified minimum age because:	A	it is purely a matter of policy
9 - A younger occupier of the property who is not party to the scheme may secure a right of residence under the provisions of:	A	The Land Registration Act 2002