Get the right mix for you

Equity Release

Quick reference Guide Chapter 5

By the end of this guide you will understand the need for equity release, the types of products features and options available in the marketplace.

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Equity release products

Definitions

There are a number of terms that you need to be familiar with in relation to this chapter:

Term	Definition
Standard variable rate	• Headline rate promoted by the lender, changing with movements in general market interest rates.
Discounted rate	• Interest rate is variable but discounted by a specific percentage below standard variable rate.
Tracker rate	• Interest rate set in the same way as a discounted rate but by reference to some market indicator e.g. Bank of England Base Rate or London Interbank Offered Rate (LIBOR)
Deferred rate	• Interest rate variable but some of the interest rate is deferred and rolled-up to a future specified date.
Fixed rate	• The interest rate is either fixed for a specified initial period after which it changes to variable rate, or fixed for the entire life of the loan.
Capped rate	• The interest rate is variable but will not exceed a specified maximum level for a specified period or for the life of the loan.

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Term	Definition
Capped and collared rate	The interest rate can fluctuate but only between maximum and minimum specified levels.
Stepped rate	The account is subject to different interest rates, triggered at future dates.
Condition subsequent	An event occurring after completion of the contract referred to by providers as a qualifying termination event.
Qualifying termination event	Point at which the right of the provider to sell the property crystallises. See 'condition subsequent' above.
Minimum inheritance guarantee	Ensures that some capital is returned to the estate if the occupier dies within a specified number of months or years of the agreement being made.

5.A Customer needs

The two needs addressed by equity release products are the need to generate:

- a capital lump sum from residual equity in family home
  and/or
- a regular income using capital released.

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5.B Equity

Equity in property is the difference between the market value and monies due to others that are secured on it.

Many lenders will offer 25% of property value under a lifetime mortgage cash scheme.

The majority of lifetime mortgage providers set the maximum percentage loan-to-value with reference to the age of applicant; as age increases, the maximum percentage increases.

House prices are not guaranteed to increase in value over long periods of time but the Equity Release Council (SHIP) no negative equity guarantee ensures that the customer or their estate shall not be liable to pay more than the net sale proceeds of the property, meaning the selling price of the property less solicitors and selling agent's fees.

5.C Lifetime mortgages

There are many different types of **lifetime mortgages** but they tend to share the following characteristics:

- They are available to borrowers above a specified age.
- Secured by a **first legal charge** (**standard security** in Scotland) over residential property.
- Aimed at releasing capital with or without a view to generating income.
- Usually open-ended with the capital sum due on the loan repaid from the estate of the borrower on death or sale of property, if the borrower goes into long-term care or sheltered accommodation.
- Majority of schemes are set up as interest only mortgages with or without repayments during the term.
- Most lifetime mortgages taken out since 31 October 2004 fall within the definition of a **regulated lifetime mortgage contract** and are regulated under MCOB.

The principles underlying acceptability of security are broadly similar to those governing conventional mortgages.

For leasehold properties, the lender would expect to lend where the unexpired term of the lease is 20-30 years after the estimated end date of the mortgage.

Rights of lender and Obligations of borrower (table 5.1 of study text) should be reviewed.

5.D Home income plan

A Home income plan enables the customer to borrow a proportion of the residual equity in their property, which is then invested - usually in an annuity.

5.D.1 Annuities

An annuity is a lump sum investment designed to provide income on an open-ended basis (for life) or for a fixed period, though the capital is not usually refundable. They are mainly sold by life assurance companies.

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Annuities can be purchased with a wide choice of options:

- Income can commence immediately or deferred to future date.
- Income can be guaranteed for a term whether the customer dies or not.
- Contingent annuity can be used to generate income for third party on death of the annuitant.
- Escalating annuity is index-linked providing protection against inflation.
- Annuity can be purchased with some of the capital protected.

With Purchased Life Annuities (i.e. an annuity purchased with the customer's own funds as distinct from funds arising from an approved pension scheme) the income payments contain two elements. Each annuity payment consists of a return of capital element which is tax-free whilst the interest element is assessable for income tax. Interest in excess of the client's Personal Savings Allowance is taxed at the customer's highest tax rate. Currently, 20% income tax is deducted at source. A non-tax payer can arrange for gross payments or reclaim the tax deducted. Where interest falls within the personal savings allowance, a reclaim can also be made.

The split between the two elements is dependent on life expectancy and determined by mortality tables and agreed with HMRC.

5.D.2 Home income plans – product variations

- Some plans require repayments to the lender (often interest only) so any repayment due is deducted from the regular income from the investment (annuity).

- Some do not require repayments in which case the interest is rolled up until death of the borrower or when the borrower leaves or sells the property.

5.E Cash schemes

Cash schemes work in much same way as home income plans but funds released can be used entirely at the borrower's discretion.

Two variations:

- Borrower takes out an open-ended interest only mortgage on which the capital owed remains constant until the mortgage is repaid, with monthly interest paid to lender with due consideration to affordability.
- Borrower takes out an open-ended interest only mortgage but no payments are made to the lender so interest due accumulates on a compound basis until the whole sum due is repaid.

The main features are:

- Loan-to-value dependent on age at inception – the older the borrower the higher the loan-to-value.
- Maximum loan-to-value quite low (typically 25%) but this will vary among product providers.
- Loan is secured by a first legal charge over the property.
- Customer may or may not make repayments to lender.
- If regular payments of interest are made, normally the capital is repaid on death or sale of the property.
- If no repayments are made, interest is rolled up over the full term, and accumulated total of compounded interest and capital becomes due on death or sale of the property.

If repayments are to be made, the provider is obliged to take account of **affordability** under MCOB rules.

Some lenders offer equity release to older customers as **open-ended interest only mortgages**. Interest is paid on a constant capital balance until the loan is repaid from estate or when the house is sold.

It is possible to **link an** interest only mortgage to an investment (usually an annuity). The customer generates income from the capital released, with repayments deducted from the income monthly. Income generated by the product is reduced significantly. This arrangement is susceptible to repayment problems if interest rates rise significantly.

If interest is **rolled up**, it can have a different effect on the value of the estate depending on how long the customer lives, how long the house is retained and the prevailing property values.

The calculation is dependent on the interest rate but generally, for rolled up interest mortgages, total debt tends to double over 10 years.

Bear in mind that the borrower does not benefit from all cash which is released.

Likely to have to pay:

- Valuation fee.
- Legal costs.
- Redemption fees (paid from estate or on sale).
- Booking or administration fee possible.

5.F Drawdown schemes

Some cash schemes offer a **drawdown mortgage**. Cash is made available but sums can be drawn at monthly or other intervals.

This is becoming increasingly popular because:

- overall interest burden is reduced over the life of the mortgage as funds are only drawn when required, incurring interest only on debt outstanding in any given period
- if interest is paid, monthly outgoings are reduced

5.G Shared appreciation mortgages

Main characteristics of **shared appreciation mortgages** are:

- The borrower is able to release a set percentage loan-to-value sum from the property (usually up to 25%).
- Up-front costs are met by the borrower or added to the advance.
- No repayments are made until death or sale of the property.
- Instead of interest, the lender is entitled to a specified percentage of any appreciation in value of the property.
- Capital is repaid along with the appreciation share on death of the borrower or sale of the property.

5.H Optional features

Where regular interest payments are made, as with a conventional mortgage, **there are interest rate options:**

- **Standard variable**
- **Discounted**
- **Tracker**
- **Deferred**
- **Fixed**
- **Capped**
- **Capped and collared**
- **Stepped**

5.H.2 Overpayments, underpayments and borrow back facilities

For lifetime mortgages where regular payments are required, **overpayments, underpayments and borrow back facilities** may be available if the product is set up on a flexible basis.

5.H.3 Payment holidays

Payment holidays and changing the number of payments each year may be possible.

5.H.4 Further borrowing

Lifetime mortgages may provide a top up or **further borrowing** facility or further separate borrowing on a secured basis. Sometimes referred to as Additional Borrowing.

5.H.5 Foreign currency mortgages

Foreign currency mortgages – some lenders are prepared to lend in other currencies.

5.I Home reversion plans (HRP)

An HRP has the same **purpose** as a lifetime mortgage but achieves this in a **different way**.

Two variants of plan:

- Owner sells the property to the reversion provider and becomes a tenant.
- Owner sells a percentage of the property to the reversion provider becoming part owner and part tenant in the property.

If the whole property is sold, ownership is transferred to the provider who is registered in the Proprietorship Register at the Land Registry as sole owner.

The former owner becomes a tenant with a lifetime tenancy and the end of the tenancy is brought about by a **condition subsequent**, usually on death or entry into long-term care.

Under a partial reversion, relevant shares are registered in the names of occupier and provider. Once the condition subsequent occurs, the property is sold and proportionate shares revert to each party.

Condition subsequent is referred to by providers as a **qualifying termination event** i.e. the point at which the right of the provider to sell the property crystalizes.

Several product variations:

- Provider may be prepared to offer a **larger cash sum** in return for payment of a **higher monthly rent.**
- Partial reversion providers may permit the occupier to **raise more capital** by selling the remainder or further part of the property.
- Provider may be prepared to **sell the property back** to the occupier/family/beneficiaries.
- **Minimum inheritance guarantee** may be available ensuring some capital can be returned to the client's estate.
- Customer should be able to raise between 35% and 60% of the property value or proportion of value transferred dependent on age and health, with older customers able to obtain a higher value.
- Life expectancy is a major factor in determining what the provider is prepared to offer.
- Customer may be required to pay a nominal or peppercorn rent e.g. £1 per month.

5.J Comparison of benefits – borrowing v. home reversion plan

Comparison of benefits – borrowing v. reversion plan (table 5.2 of study text) should be thoroughly reviewed.

Equity Release Chapter 5 (ER05) – End of Module Test

Multiple Choice Questions

Question		Answer
1 - How do lifetime mortgage providers set the maximum percentage loan to value?	A.	As the age of the applicant increases, the percentage loan-to-value decreases
	B.	As the age of the applicant increases, the percentage loan-to-value increases
	C.	The percentage loan-to-value is lower for a single applicant than for joint applicants
	D.	The percentage loan-to-value is higher for joint applicants than for a single applicant

Question		Answer
2 - Lifetime mortgages have been regulated under MCOB since	A.	31 October 2004
	B.	06 April 2007
	C.	31 October 2007
	D.	06 April 2004

Question		Answer
3 - For leasehold properties, the lender would normally expect to lend where the unexpired term of the lease is:	A.	5 – 10 years after the end date of the mortgage
	B.	10 – 20 years after the end date of the mortgage
	C.	20 – 30 years after the end date of the mortgage
	D.	30 – 40 years after the end date of the mortgage

Question		Answer
4 - James is a basic rate taxpayer and is using a home income plan to release equity of £50,000 to purchase an annuity. Which part of the annuity, if any, will be tax-free?	A.	The capital content only
	B.	The interest element only
	C.	Both the capital content and the interest element
	D.	Neither the capital content of the interest element

Question		Answer
5 - Lisa has an interest only lifetime mortgage. Calculate her monthly payments if she owes £50,000 at an interest rate of 9%.	A.	£250.00
	B.	£275.00
	C.	£300.00
	D.	£375.00

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6 - A discounted rate is where the interest rate is:	A.	fixed for a specified period after which it reduces
	B.	variable but reduced by a specific percentage
	C.	variable but will not exceed a specified maximum
	D.	subject to different rates triggered at future dates

7 - A minimum inheritance guarantee ensures that some capital is returned to the estate if:	A.	the occupier dies at any time during the agreement
	B.	the occupier dies within a specified period of the agreement being made
	C.	the occupier dies within a specified period of the end of the agreement
	D.	a qualifying termination event occurs at any time

8 - Under a home reversion plan, a customer should be able to raise between which percentages of the property value?	A.	5% and 30%
	B.	15% and 40%
	C.	25% and 50%
	D.	35% and 60%

9 - Keith has sold all of his property to a home reversion provider. Who is responsible for the maintenance and repair of the building?	A.	The insurance company
	B.	The reversion provider
	C.	Keith
	D.	Both Keith and the reversion provider

10 - Karen is a higher rate taxpayer who has just taken out a purchased life annuity with some of the equity released from her property. What rate of income tax is deducted at source from any part of her annuity?	A.	10%
	B.	20%
	C.	40%
	D.	There is no deduction at source

- **End of Questions** -

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Answers

Question	Answer	
1 - How do lifetime mortgage providers set the maximum percentage loan to value?	B	As the age of the applicant increases, the percentage loan-to-value increases
2 - Lifetime mortgages have been regulated under MCOB since	A	31 October 2004
3 - For leasehold properties, lenders would expect to lend if the unexpired term of the lease is:	C	20 – 30 years after the end date of the mortgage
4 - James is a basic rate taxpayer and is using a home income plan to release equity of £50,000 to purchase an annuity. Which part of the annuity, if any, will be tax-free?	A	The capital content only
5 - Lisa has an interest only lifetime mortgage. Calculate her monthly payments if she owes £50,000 at an interest rate of 9%.	D	£375.00
6 - A discounted rate is where the interest rate is:	B	variable but reduced by a specific percentage
7 - A minimum inheritance guarantee ensures that some capital is returned to the estate if:	B	The occupier dies within a specified period of the agreement being made
8 - Under a home reversion plan, a customer should be able to raise between which percentages of the property value?	D	35% and 60%

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9 - Keith has sold all of his property to a home reversion provider. Who is responsible for the maintenance and repair of the building?	C	Keith
10 - Karen is a higher rate taxpayer who has just taken out a purchased life annuity with some of the equity released from her property. What rate of income tax is deducted at source from any part of her annuity?	B	20%

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