Lifetime Mortgages

Addressing historical concerns and
the impact of proposed regulatory changes

Part of Alpha Real Capital's Cashflow Driven Investing series

Alpha Real Capital

Introduction

Alpha Real Capital LLP ("Alpha") is creating a new fund (the "Fund") for defined benefit pension schemes to invest in UK lifetime mortgages ("Lifetime Mortgages"), an equity release product regulated by the Financial Conduct Authority ("FCA") which offers investors an attractive risk-adjusted return as compared to other long-dated assets.

The Fund's objective will be to develop strategic relationships with Lifetime Mortgage originators and assist them in developing mortgage products that will be acquired by the Fund.

While equity release mortgages have been available in the UK for over fifty years, there have been periods when certain products have been subject to criticism and negative press, causing some investors to become uncomfortable with the sector. In addition, a recent Prudent Regulatory Authority ("PRA") announcement has drawn concern to the accounting practices used under Solvency II by insurance companies that originate and/or purchase Lifetime Mortgages as an investment to offset their annuity liabilities.

This paper aims to provide some background to the troubled products of the past and how the sector has matured to a point where it now has the lowest amount of FCA registered complaints as compared to all home finance products[1]. It also discusses some of the more common concerns of investors unfamiliar with the sector and provides background to the recent PRA announcement and its impact on the Lifetime Mortgage market and opportunity for the Fund.

Overview of Lifetime Mortgages

Lifetime Mortgages is the fastest growing segment in the UK mortgage market, reaching £3.06 billion in 2017 (42% increase over 2016)[2] and forecasted to grow to over £8 billion by 2021[3]. The mortgage product allows homeowners aged 55 years and older to release a portion of the equity in their property while still retaining 100% ownership and the right to reside there, rent free, for the rest of their lives.

There are no required monthly payments, interest is typically fixed and rolled-up/accrued into the mortgage balance and there is a No Negative Equity Guarantee ("NNEG") whereby the mortgage balance repayable can never exceed the net proceeds from the sale of the borrower's home. There's low principal risk to funders/investors since mortgages are initially underwritten at a low loan-to-value ("LTV") level and full repayment only becomes due when the last remaining borrower either dies or moves into long-term care.

There are two primary products available to borrowers:

Lump sum – borrower receives a single lump sum payment upfront (typically at the maximum LTV available)

Drawdown – borrower receives an upfront payment and has access to a cash reserve facility (upfront payment plus cash reserve limited to the maximum LTV)

Either product can have one or more of the following features:

Voluntary/partial repayments – allows ad hoc or regular repayments of the outstanding mortgage balance with no early repayment charge

Inheritance protection guarantee – guarantees a fixed percentage of the property's value reserved for the borrower's estate and beneficiaries

Fixed Early Repayment Charge ("ERC") – fixed charges on voluntary early repayments

Downsizing protection – ability to repay the mortgage and downsize to a smaller property of lesser value without incurring an ERC

Interest payments – ability to make full or partial interest payments each month

1 FCA Complaints Data Analysis: 2018 H1
2 Equity Release Council Spring 2018 Market Report
3 Legal & General Silver Spenders – February 2018

Primary funders of Lifetime Mortgages

The growth of the sector has been financed almost entirely by insurance companies and a few pension schemes which view Lifetime Mortgages as a suitable investment to meet guaranteed income for life and/or defined benefit liabilities. Lifetime Mortgages, with terms as long as 15-20+ years, have also proven to be an attractive investment for long-term asset liability management strategies since there are limited alternative investments with similar maturity dates.

Furthermore, the investment can provide a longevity hedge for annuity and pension scheme liabilities since Lifetime Mortgages can continue to provide a return in the event borrowers live longer.

Troubled products of the past

The equity release sector has received both criticism and negative press relating to certain products and the treatment of borrowers. The products which resulted in the reputational issues surrounding the sector were 'Home Income Plans' and 'Shared Appreciations Mortgages', both introduced over 20 years ago.

Home Income Plans

In the late 80's, an equity release product called a 'Home Income Plan' ("HIP") was marketed to retirees. The product had two financial instruments: a variable rate interest-only mortgage on the property and an annuity, equity-linked or bond investment purchased with the mortgage proceeds. The product was attractive since the cashflows from the investment were historically sufficient to pay the interest-only mortgage payment and provide additional income to the borrower.

But as UK interest rates soared from 8.88% in Q2 1988 to 14.88% in Q4 1989, so did the monthly mortgage payments of the variable interest rate HIPs. Concurrently, many of the investments attached to HIPs didn't perform well resulting in insufficient income to cover the monthly mortgage payment. This resulted in many elderly borrowers relying on their retirement savings to cover the shortfall or face repossession of their homes.

The crisis was further exacerbated with the UK entering into a recession accompanied by a housing market crash that would last for several years. As a result, many borrowers had 'negative equity' in their homes where the value of their outstanding mortgage debt exceeded the current value of the property. Accordingly, many properties that were repossessed and sold, had insufficient proceeds to repay the outstanding HIP balance causing lenders to pursue the shortfalls from borrowers and even their estates and beneficiaries.

In the aftermath, providers were rightfully criticised for inadequately explaining the risks of HIPs, charging exorbitant fees and basing the mortgage interest rates on complicated formulae. The scandal resulted in the Investors Compensation Scheme (now referred to as the Financial Services Compensation Scheme) paying out millions to victims of the plans.

Shared Appreciation Mortgages

The equity release sector was also tainted by the introduction of 'Shared Appreciation Mortgages' ("SAMs") in the mid 90's which were targeted at individuals approaching retirement and who wanted to top up their pensions. A typical SAM allowed a borrower to receive up to 25% of their property's value, interest fee, in return for giving up as much as 75% of the future appreciated value. Once the house was sold, both the original mortgage amount and the agreed percentage of its appreciated value were due to the lender.

While SAMs might have looked attractive in the 1990's, growth in UK property prices over the last 20 years has made the actual cost of the mortgage (up to 75% of the appreciated value) unreasonably expensive for borrowers. For some SAM borrowers that have recently sold their homes, the repayment to the lender has been as much as several times the original mortgage amount. It is therefore not surprising that many SAM borrowers felt they were misled by the lenders, claiming that they did not fully understand the overall costs of the mortgage product when considering potential housing appreciation.

Evolution of the equity release sector

The equity release sector has matured considerably over the last 20 years. The troubled products of the past are no longer offered and today, Lifetime Mortgages (introduced in 1997) represent over 99% of the market[4] (the other 1% being Home Reversion Plans[5]). Lifetime Mortgages include safeguards for customers that were introduced by the Equity Release Council (formerly Safe Home Income Plans or SHIP), the industry body for the equity release sector established in 1991. The Equity Release Council consists of over 290 member firms and 870 individuals, including providers, regulated financial advisors, surveyors and other professionals[6]; each member agreeing to follow a strict code of conduct and safeguard the interests of homeowners. These safeguards include[7]:

- Borrowers have the right to remain in their property for life;
- Borrowers have the right to transfer their mortgage to another eligible property;
- Borrowers must receive advice from an FCA regulated financial advisor to assess their financial situation and determine their suitability for a lifetime mortgage as compared to other options;
- Borrowers must engage a solicitor to explain the risks and benefits of the plan, evidenced by a signed solicitor's certificate; and
- Borrowers benefit from a 'No Negative Equity Guarantee' whereby they (or their estate) will never owe more than the net proceeds from the sale of their home.

4 Equity Release Council Autumn 2018 Market Report

5 Home Reversion Plans allow customers to sell all or part of their home to a scheme provider while still retaining the right to remain there, rent free, until they die or move into long-term care.

6 Equity Release Council Autumn 2018 Market Report

Further protections were put in place in 2004 when Lifetime Mortgages, along with other UK residential mortgages, became subject to statutory regulation by the Financial Services Authority (replaced by the FCA in 2013). While the new regulations required that residential mortgages be arranged and/or originated by an authorised party, the Equity Release Council further imposed that no direct consumer-to-lender Lifetime Mortgage originations were allowed. Instead, customers were required to use a regulated financial advisor who would also act as a broker/intermediary between the customer and Lifetime Mortgage lender throughout the mortgage application process.

> As a result of the regulatory changes and safeguards, the equity release sector now has the lowest FCA registered complaints per 1,000 outstanding accounts as compared to all UK home finance products[8].

Confidence in the sector has attracted companies such as Aviva and Legal & General to become the largest suppliers and funders of Lifetime Mortgages, together originating £1.7 billion (56% of the market) in 2017[9]. In addition, Nationwide Building Society, Santander, The Co-operative Bank and Virgin Bank are all marketing Lifetime Mortgages to their customers.

7 Equity Release Council

8 FCA Complaints Data Analysis: 2018 H1

9 Legal & General and Aviva's Annual Reports and Accounts 2017

Common reputational and investment concerns

Many investors unfamiliar with the equity release sector have similar concerns regarding the products and/or treatment of borrowers. Below are some of the more common concerns along with how the Lifetime Mortgage market mitigates them.

House repossession

Nearly all repossessions in the UK are the result of the borrower not remaining current on their required monthly mortgage payments. Since Lifetime Mortgages don't require monthly payments, and borrowers have the right to remain in their property for the rest of their lives (or until they move into long-term care), repossessions are extremely rare. Repossessions can occur, for example, if the last remaining borrower no longer resides in the property and it remains unsold for more than 12 months.

> Since Lifetime Mortgages don't require monthly payments, and borrowers have the right to remain in their property for the rest of their lives (or until they move into long-term care), repossessions are extremely rare.

Borrower vulnerability and mis-selling

Unlike traditional mortgages, a Lifetime Mortgage customer is required to receive both regulated financial advice and independent legal advice prior to the mortgage completion. This helps ensure they're fully aware of all their financial options, as well as the risks and obligations of a Lifetime Mortgage. The Financial Ombudsman Service ("FOS") has stated that, "Overall, we find most people receive suitable advice about releasing equity. We can give reassurance that someone wasn't taken advantage of".[10]

The majority of complaints involving vulnerability or mis-selling tend to come from family members who were unaware that their relative took out the mortgage. This is one of the reasons why customers are encouraged by their advisors, the FOS, the Equity Release Council and lenders to involve their families in their decision to take out a Lifetime Mortgage. It should be noted that while family members may register a complaint regarding the existence of the Lifetime Mortgage, they have no legal rights over the mortgage or its charge on the property.

In the unlikely event a borrower was deemed vulnerable or misled, the claim would nearly always be against the financial advisor who provided the advice and recommended the product and not the Lifetime Mortgage lender.

Family inheritance and indebtedness

Many Lifetime Mortgages offer an inheritance protection guarantee that will ring-fence a percentage (usually up to 50%) of the property's future value for the benefit of the borrower's estate and beneficiaries. This ensures that the beneficiaries will always receive a portion of the house proceeds.

Furthermore, because every Lifetime Mortgage comes with a 'No Negative Equity Guarantee', the mortgage amount repayable will never exceed the net proceeds received from the sale of the property, assuming it was sold at a fair market price. This safeguard ensures the borrower's estate will not have a negative value resulting from the mortgage.

Eviction of non-borrower occupants

As part of the mortgage completion process, the borrower must provide the lender a signed 'Occupiers Deed of Consent' from all non-borrower occupants of the property aged 17 or over. This deed evidences the occupant's knowledge of the mortgage and the lender's rights over the property. The lender will also send out a reminder with each annual statement to the borrower reminding them of their obligation to provide an additional signed deed for any new occupants. In the event an unauthorised occupant is identified after the death of the last borrower, the lender can take action to have them removed from the premises if the property needs to be sold to repay the mortgage.

In circumstances where family members reside in the property after the last borrower has either died or moved into long-term care, the lender will normally seek an amicable solution with the occupant. This may include continued occupancy until alternative accommodation is identified (during which the mortgage will continue to accrue), or the family repaying the mortgage and remaining in the property.

Dilapidation risk

Given the average age of a Lifetime Mortgage borrower (circa 70 years old), future dilapidation can be a concern. To help alleviate this risk, all properties are subject to a full valuation prior to the mortgage completion. If any repairs or necessary work is required, then it will need to be finished prior to the mortgage completion or alternatively, the lender may choose to withhold funds to ensure the work is completed thereafter.

Until the mortgage is repaid, the borrower has an on-going obligation to maintain the property in good condition. To ensure properties are maintained, lenders usually have right to inspect the property upon giving prior written notice to the borrower. And while some dilapidation is to be expected, surveys show that 64% of borrowers intend to use a portion of the mortgage proceeds to make home/garden improvements[11], which may provide an incremental benefit to the value of the property.

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10 Financial Ombudsman Service – www.financial-ombudsman.org.uk
11 Key Retirement – UK Equity Release Monitor Full Years Review 2017

Regulatory changes - PRA consultation paper CP13/18

Background

On 2 July 2018 the PRA released the consultation paper CP13/18 ("CP") which provided additional guidance to insurance and reinsurance companies on how to account for equity release mortgages ("ERMs" or namely 'Lifetime Mortgages') under Solvency II. The PRA's concern was that firms may be overstating the matching adjustment ("MA") and/or the transitional measure of technical provisions ("TMTP") benefit associated with ERMs. This issue was also referenced in a report issued by The Adam Smith Institute which claimed that firms were undervaluing the cost of the NNEG associated with ERMs and that the PRA needed to take further action.

The PRA had previously issued the Supervisory Statement SS3/17 which introduced an effective valuation test ("EVT") to assess whether firms were properly accounting for the risks associated with ERMs as it relates to the MA or TMTP benefit, but it provided no specific guidance on the assumptions to be used in calculating the NNEG. The CP addressed this issue and advocated the use of an options valuation approach (e.g. Black-Scholes model) to assess the NNEG along with the following recommended assumptions and calibrations:

House Price Inflation ("HPI") – should be no greater than the risk-free rate (a 'risk neutral' approach vs. a 'real world' approach); PRA stated that while firms may benefit from house price inflation in excess of the risk-free rate, they shouldn't be reflecting it in an 'upfront' higher MA;

Deferment rate of 2%[12] – PRA views the NNEG as a 'property put option' where the ERM borrower can settle their debt by handing over their property to the lender, so a deferment (discount) rate is required in determining the present value of a property that is possessed at some point in the future; and

Property volatility of 13% – PRA's central estimate given the typical holding period for ERMs.

The majority of insurers do use an options valuation approach to value the NNEG but have based certain assumptions on a 'real world' approach, assuming property prices will increase in-line with historical HPI trends. The current 'real world' HPI for insurers is believed to be circa 4% which is usually linked to inflation plus a premium.

The PRA has suggested that HPI should instead be linked to the Solvency II risk-free discount rate (circa 1.5%), so adopting this methodology will likely have an adverse effect on a firm's solvency position but not necessarily on the projected cashflows associated with ERMs. The adoption of the CP may also result in increased volatility of the firm's solvency balance sheet as the MA and TMTP benefit associated with ERMs will be sensitive to movements in the risk-free rate, regardless of movements in property prices.

The PRA is currently reviewing the feedback from industry participants regarding the CP and has proposed an implementation date of 31 December 2018.

The market impact

Most insurance companies are challenging the PRA on the proposed changes and consider the matter mainly an ERM back book issue. One of their primary arguments is that they deem it unfair and inappropriate to apply the proposed assumptions and calibrations to legacy ERM portfolios which were written in accordance with the rules and regulations at the time, especially those prior to Solvency II being introduced. In the event the proposed changes do apply to legacy books, insurers then request there is a sufficient phase in process to help mitigate the additional solvency capital requirements.

Furthermore, insurers argue that the adoption of the CP will give rise to further interest rate volatility associated with their Solvency II balance sheets. This will be due to the pro-cyclicality between the MA benefit and the risk-free rate which is inconsistent with how the MA operates with other asset classes including corporate bonds and infrastructure.[13]

While the final outcome of the CP will not be known until the PRA announces its final position towards the end of 2018, the immediate impact on the Lifetime Mortgage market has been mixed. While most product interest rates have remained firm, some lenders (on behalf of their funders, the insurance companies) have tightened up their underwriting criteria to minimise the potential impact of the CP on new business. This has included reducing the maximum LTV amounts available to many borrowers by circa 3-4%, or removing the higher LTV products altogether. Alternatively, some lenders have remained firm in their current product offerings, rates and maximum LTVs and are enjoying an up lift in volumes due to less competition.

12 Deferment rate reflects the annual discount to the current property price that would be agreed and settled today to take ownership of the property as some point in the future; it differs from the future house price in that the future price is also agreed today but is settled in the future. A higher deferment rate puts a lower price on the property to be acquired and therefore increases the cost of the NNEG.

13 Just – Results for the 6 months ended 30 June 2018 presentation – 6 September 2018

Implications for the Fund

Alpha believes the CP and its potential implementation will not have a material impact on the returns or offering of the Fund. Since the Fund will not be subject to any MA or Solvency II requirements, Alpha will continue to forecast Lifetime Mortgage cashflows, NNEG cost and the overall yield for investors using a 'real world' approach along with prudent market assumptions and stresses. This includes the use of an option valuation approach and deterministic analysis to provide the Fund with a yield comparison using different methodologies.

The CP has actually provided an opportunity for the Fund to deploy capital in the now underserved higher LTV segment of the market where Alpha believes the best risk-adjusted return for investors exists. Concurrently, this development means that the Fund will not need to develop and purchase Lifetime Mortgage products which offer lower interest rates and/or higher LTVs in order to gain marketshare. Furthermore, given the slight reduction in the maximum LTVs being offered in the market, there may also be a slight improvement in the forecasted yields for investors as a result of the reduction in the product's risk profile.

Lastly, if the CP is fully implemented by the PRA and adopted by the broader market, the Fund may consider reporting its' Net Asset Value ("NAV") using the recommended assumptions to support future liquidity. In doing so, this will not impact the NAV on the day the mortgages are purchased but will make the on-going portfolio's NAV more sensitive to movements in the risk-free rate over time regardless of actual HPI.

Conclusion

The UK equity release sector has evolved considerably since the first product was introduced over 50 years ago. Through regulatory reform, product development and the introduction of customer safeguards, Lifetime Mortgages have become the fastest growing segment of the UK mortgage market while generating the fewest registered complaints across all home finance products. They have also become a preferred investment for insurance companies and are now being offered by high street lenders to their customers.

With broader market acceptance, attractive yields and long-dated cashflows, Alpha views the Fund's investment in Lifetime Mortgages as an attractive opportunity for defined benefit pensions schemes seeking long-dated assets. In addition, changes to the accounting practices of insurers, as the largest funders of Lifetime Mortgages, have created an opportunity for the Fund to develop and acquire products aimed at the slightly higher LTV range of the market which Alpha believes provides the best risk-adjusted returns.

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