Lifetime Mortgages

A scalable, diversifying Cashflow Driven Investment
for defined benefit pension schemes

Part of Alpha Real Capital's Cashflow Driven Investing series

Alpha Real Capital

Introduction

As pension schemes mature, the demand for secure, contractual cashflows usually increases. This paper looks at lifetime mortgages as a possible Cashflow Driven Investment ("CDI") for pension schemes to help meet this demand.

With the pension shortfall for individuals in retirement expected to quadruple over the next 30 years[1], the unlocking of housing wealth will have an increasingly important role to play in helping older people cover their expenses in later life. It is estimated that total homeowner equity in England has reached an unprecedented £2.6 trillion, with £1.8 trillion belonging to over-55 households[2].

A lifetime mortgage, which makes up the majority of the equity release sector, is a financial product that allows homeowners, typically over the age of 55, the ability to unlock the equity accumulated in their property without the need to sell or move out. There are no required monthly payments and the interest accrues (rolls up) on the mortgage balance over time. The loan is repaid when the property is sold after the borrower either dies or moves into long-term care.

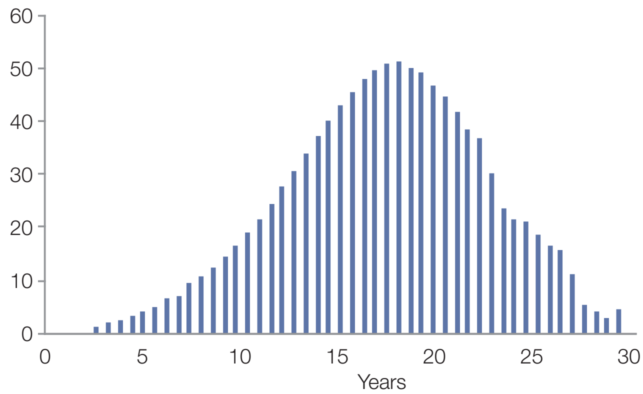
A number of readers might recall the equity release scandal of the late 80's or the negative press regarding Shared Appreciation Mortgages introduced in the early 1990's and have formed an adverse view of the sector. This paper argues that the market has significantly matured, the historical reputational issues have been addressed through effective market oversight and FCA regulation, and that today's lifetime mortgages are significantly different to the products of the past.

As at the end of 2017 new lending in lifetime mortgages was in excess of £3 billion representing a circa 40% increase since 2016[3] and is well positioned for future growth. The capital to service this demand has been led by large buy and hold life insurers to back their annuity liabilities (often long-term pension liabilities insured in bulk annuity transactions). In this review, we will show how pension schemes can co-exist with insurers in order to derive the following benefits:

- **Attractive risk-adjusted returns** – 200-300bps expected net yield pickup over fixed-interest gilts
- **CDI** – secure asset backed (low loan-to-value) contractual income to meet long-dated liabilities
- **Longevity hedge** – high correlation to longevity, generating additional returns if borrowers live longer than expected
- **Positive social impact** – provide borrowers with the capital required to fund their retirement and refinance expiring interest-only mortgages

> This paper provides pension funds and their advisors with an overview of the lifetime mortgage market, who is involved, how it works, why it is good for pension funds and how to assess and invest in the sector.

Chart 1: Lifetime mortgages generate secure asset backed cashflows (£m)



1 Pension shortfall is defined as the money required to maintain 70% of pre-retirement income. Source: World Economic Forum White Paper, We'll Live to 100 – How Can We Afford It? – May 2017

2 Equity Release Council, Equity Release Market Report – Autumn 2017

3 Key Retirement – UK Equity Release Market Monitor, Full year review 2017 – 10 January 2018

Market overview

A brief history

Equity release was first introduced in the UK over 50 years ago and has seen a number of iterations. Today, lifetime mortgages account for the majority of the market (circa 99%[1]) and are the focus of this paper.

In 2016, the equity release market was the fastest growing segment of the UK mortgage market with £2.15 billion in new lending (34% increase over 2015)[2] and reached £3.01 billion of new lending in 2017[3] (40% increase over 2016).

In its infancy, the reputation of the sector was tainted by two historical products; Home Income Plan ("HIPs") and Shared Appreciation Mortgages ("SAMs"):

- **HIPs** – launched in the late 80's, relied mainly on two financial instruments: a variable rate interest-only mortgage on the property, and an annuity or investment bond purchased with the proceeds from the mortgage. The structure was inappropriate to deal with the soaring interest rates of the late 80's, poorly performing annuity or investment bonds and subsequent falling house prices. This led to borrowers having insufficient income to pay their monthly mortgage payments, as well as negative equity if their homes were repossessed and/or sold
- **SAMs** – introduced in the early 90's, were mortgages whereby lenders loaned up to 25% of a borrowers property value in exchange for up to 75% of the future appreciated value. This structure failed to reward customers from the unprecedented growth in house prices over the last 20 years and resulted in lenders making significant profits at the borrower's expense

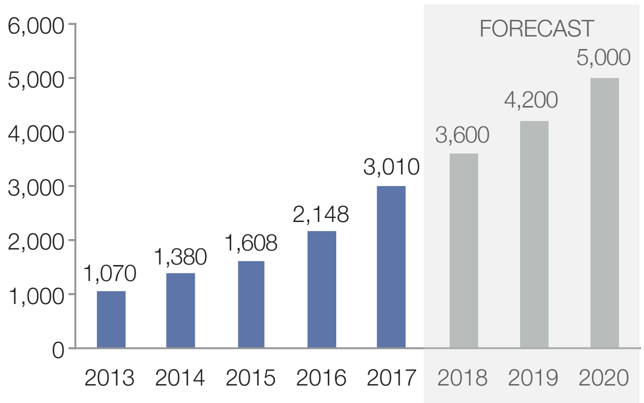
Restoring confidence through oversight and regulation

To help restore confidence, a trade body of equity release providers and affiliates called Safe Home Income Plans ("SHIP") was launched in 1991. Members of SHIP agreed to follow a strict code of conduct and safeguard the interests of homeowners, some of the fundamental safeguards of the code are set out on page 5.

In October 2004, the Financial Conduct Authority ("FCA")[4] became the body responsible for regulating all mortgage products including lifetime mortgages. This new regime of regulatory oversight sought to ensure that customers received clear information about the products and the services being offered by intermediaries and lenders. In addition, the FCA required that all mortgages be arranged by an FCA authorised mortgage broker, advisor, or directly with an FCA authorised lender.

In May 2012, SHIP broadened its membership and rebranded as the Equity Release Council ("ERC"). Today, the ERC represents over 180 member firms and over 500 individuals; including lenders, qualified financial advisors, solicitors/conveyancers, surveyors, and other industry professionals.

Chart 2: Lifetime mortgages - lending per annum (£m)[5]



The lifetime mortgage market has matured and its reputational issues have been addressed. The market is now dominated by long-term, buy and hold institutional investors such as Legal & General, Aviva, Rothesay Life and Just.

Recent equity release history

FCA Regulation

Safe Home Income Plans (SHIP) | **Equity Release Council (ERC)**

1991	1997	2004	2012	2016
Launch of SHIP	First lifetime mortgage launched	FCA regulation introduced	SHIP rebranded as ERC, broadening its membership	Fastest growing sector of the UK mortgage market[2]

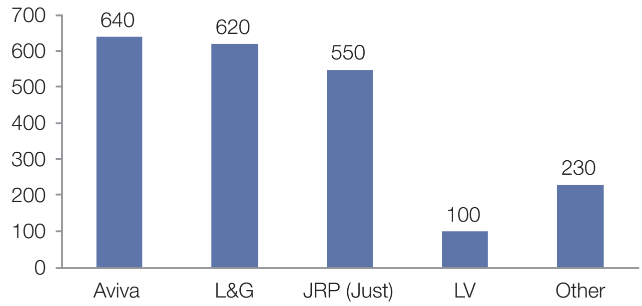
1 Equity Release Supermarket, www.equityreleasesupermarket.co.uk/home-reversion.html
2 Equity Release Council, Equity Release Market Report, based on customer numbers – Spring 2017
3 Key Retirement – UK Equity Release Market Monitor, Full year review 2017 – 10 January 2018
4 Formerly the Financial Services Authority
5 Equity Release Council, Market Reports, 2013-2016. Key Retirement, UK Equity Release Market Monitor, Full year review 2017 – 10 January 2018. Five things you should know about… later-life lending and equity release, mortgagestrategy.co.uk – 12 October 2017

Large institutional investor base

With the significant increase in regulation and oversight, the sector has become dominated by large buy and hold institutional investors. The largest funders/originators of lifetime mortgages in the UK market are the life insurers, led by Aviva and Legal & General ("L&G"), who accounted for £1,260 million (circa 60%) of new lending in 2016[1]. Insurers are typically attracted to lifetime mortgages to back their annuity liabilities, (often long-term pension liabilities insured in bulk annuity transactions) and provide diversification from conventional matching assets such as UK government and corporate bonds[2]. We discuss some of the key advantages for pension schemes on page 8, which also apply to insurers.

The second largest group are specialist lenders that have historically serviced niche lending markets and rely on intermediary channels to originate new business. Specialist lenders in the equity release sector are currently funded by UK annuity writers and one UK pension fund. Lenders in this group include more 2 life, OneFamily, Hodge Lifetime, Pure Retirement and Retirement Advantage (now part of Canada Life).

Chart 3: Lifetime mortgages – completed business volumes in 2016 (£m)[1]



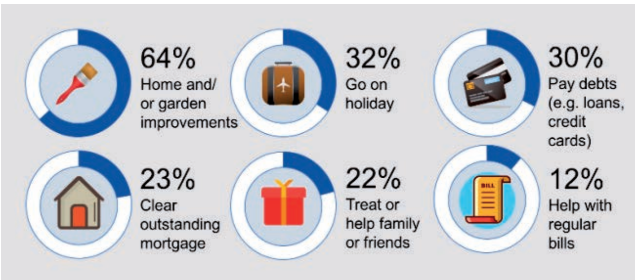
Only a few high street banks and building societies have entered the equity release market, however with increasing demand, momentum is building. Santander entered in 2016, signing a five-year deal with L&G to tackle their book of maturing interest only mortgages[3] and Nationwide Building Society announced their entry in November 2017 with their intent to offer their own lifetime mortgage product[4], which is believed to be funded by a UK bulk annuity provider.

Positioned for growth

The recent growth in the equity release sector is attributable to several factors including greater selection and availability of products, increased government support and broader acceptance of the market. Looking ahead, Alpha Real Capital also expects demand will be driven by:

- **Increasing pension gap** – the UK pension gap, defined as the shortfall of money required for a retiree to maintain 70% of pre-retirement levels, is expected to quadruple from US$8 trillion (£6 trillion) in 2015 to US$33 trillion (£25 trillion) by 2050[5]
- **Expiring interest-only mortgages** – at the end of 2016, 21% (1.9 million) of all outstanding UK mortgages were interest-only products[6], with circa £50 billion to be paid off by 2020[7]. It is estimated that nearly one-third of interest-only mortgage holders have no way of paying off their mortgage[8], with 40% of borrowers 65+ having interest-only products[9]
- **People living longer** – it has been estimated that the number of people reaching the age of 100 has more than quadrupled in the past 30 years[10] and is expected to nearly quadruple again by 2030[11], increasing the chances of individuals underestimating their required income during retirement

What do borrowers use the proceeds for?[12]



- **Old age care** – it is estimated that 873,500 people receive care in the home[13] whereby local authorities and health and social care trusts fund around £3.83 billion of the £4.62 billion total cost[14]. That leaves more than £700 million to be funded by pensioner savings
- **Annuity freedom** – since rules that forced individuals to spend their pension savings on annuities were abolished in 2015, annuity sales have fallen by 75%[15]. Many consumers are turning to products which allow them to spend their money as and when they choose, offering no protection for those who spend too much too early in their retirement

1 Mintel's Equity Release Schemes UK – May 2017
2 Lifetime Mortgages – A good and appropriate investment for life companies with annuity liabilities? – May 2014
3 Santander and Legal & General in lifetime mortgages partnership, Mortgage Finance Gazette – 13 July 2016
4 Nationwide enters equity release market, ftadviser.com – 17 November 2017
5 World Economic Forum White Paper, We'll Live to 100 – How Can We Afford It? – May 2017
6 Council of Mortgage Lenders, Economic Data
7 Centre for Economics and Business Research on behalf of Leeds Building Society
8 Citizens Advice – 1 million mortgage holders have no plan on how to repay – 4 September 2015
9 Financial reporter, 40% of over-65s on interest-only mortgages – 5th July 2017
10 Office for National Statistics: Estimates of the Very Old (including Centenarians): 2002 to 2016
11 Department for Work and Pensions: Number of Future Centenarians – December 2010
12 Key Retirement, UK Equity Release Market Monitor – Half Year 2017 (note, individuals could elect more than one category)
13 United Kingdom Homecare Association – APPG Housing and Care for Older People – 18 July 2016
14 United Kingdom Homecare Association – An Overview of the Domiciliary Care Market in the United Kingdom – May 2016
15 Pension freedoms leave people with 'little choice', ft.com – 20 November 2017

Product overview

Lifetime mortgages are a long-term low loan-to-value mortgage secured against a borrower's residential property. There are no required monthly payments and the interest accrues (rolls up) on the mortgage balance over time. The loan is repaid when the property is sold after the borrower either dies or moves into long-term care. The loan amount is dependent on the youngest borrower's age (if joint applicants), the value of the property and some lenders also take into account medical conditions and/or lifestyle factors (e.g. smoking).

Two main types of lifetime mortgages

Lump sum – customers receive a single, lump sum payment upfront (typically at the maximum loan-to-value available). Interest is either fixed or variable, and compounded monthly on the outstanding balance

Drawdown – this mortgage has many of the same characteristics as a lump sum, but customers can choose when to drawdown funds (limited to the maximum loan-to-value as agreed with the lender). Drawdowns can be taken as frequently as needed and are usually charged at the prevailing market interest rate when funds are taken. Borrowers may also be subject to further underwriting depending on the product

Drawdowns are currently the most popular type of lifetime mortgage accounting for 62% of new loans in 2017, compared with 38% for Lump sum[1].

Common features include[2]:

Right to remain in the property – the borrower can stay in the property for life or until borrower moves into long-term care

No Negative Equity Guarantee – guarantee that the borrower and/or their estate will never have to pay back more than the sale value of the property, as long as it is sold for a reasonable market price

Right to move – the borrower can move to another property subject to the new property being acceptable to the product provider as continuing security for the loan

Other features include:

There are a number of non-compulsory features in the market designed to meet customers needs, help to alleviate concerns or allow lenders to compete for business without competing directly on price. Examples include: sliding scale early redemption charges, voluntary/partial repayments of principle, inheritance protection guarantees, downsize protection, loans for sheltered/age restricted accommodation, and the voluntary payment of accrued interest.

Table 1: Lifetime mortgage characteristics[3]

	Lump sum	Drawdown
Average interest rate (AER)	5.30%	5.30%
Average age of new customer	68	71.5
Average house price	£306,414	£358,392
Average initial advance	£95,386	£59,959
Average extra reserves	n/a	£33,949
Average new customer LTV	31.10%	26.20% (16.70% initial +9.50% future drawdowns)

1 Key Retirement – UK Equity release market monitor, full year review 2017 – 10 January 2018

2 These are required to meet the Equity Release Council code of conduct

3 Equity Release Council, Equity Release Market Report – Autumn 2017

Originating lifetime mortgages

A borrower takes out a lifetime mortgage based on advice from an authorised and regulated intermediary. The intermediary manages the loan completion process between the borrower and the lender. Completion is also subject to the borrower receiving legal counsel (as evidence by a signed solicitor's certificate) explaining the terms and conditions of the loan. The lender will fund the loan either from their own balance sheet (e.g. L&G), or will lend the funds on behalf of third parties. We discuss the options for how pension schemes can invest on page 9.

Loan origination flow

Borrowers

- Homeowner 55+
- Required to receive FCA regulated advice about lifetime mortgages
- Solicitor signs a certificate certifying that the borrower understands the terms and implications

Intermediaries (Brokers/Distributors)

- FCA authorised and regulated
- Markets and distributes a selection of lifetime mortgages on behalf of lenders
- Provides borrower advice on suitable lifetime mortgage products
- Submits application on behalf of borrower
- Manages the loan completion process between the borrower and lender

Example intermediaries

Key Retirement, Age Partnership, the right equity release, Bower Retirement, Responsible Equity Release, Equity Release Supermarket

Plus a further c.1,500 advisers

Lenders (Originators & Servicers)

- FCA authorised and regulated
- Reviews and checks applications from brokers
- Lends to borrowers based on funder(s) underwriting requirements
- Instructs property appraisal and audits valuation process
- Issues offer and releases funds
- Services mortgage over the duration of loan

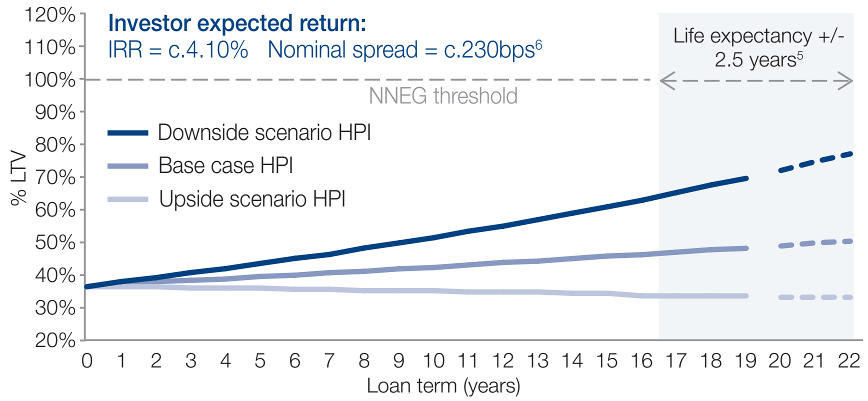
Example lenders

more2life, Aviva, Legal & General, OneFamily, Hodge Lifetime, Just., Liverpool Victoria, retirement advantage, Pure Retirement

Example lifetime mortgage

Chart 4 sets out an example of a single lifetime mortgage, projecting the expected LTV (rolled up loan value/projected house price) overtime based on a number of assumptions. Under our downside scenario, the value of the loan relative to the value of the property is significantly below the No Negative Equity Guarantee ("NNEG") threshold, demonstrating the asset backed income security of a lifetime mortgage. Chart 5 shows that if House Price Inflation ("HPI") is -2% per annum over the term of the loan the expected net IRR is still circa 1.9%, highlighting investors capital is protected under a pessimistic HPI assumption.

Chart 4: A lifetime mortgage loan as a % of LTV



Assumptions[1]

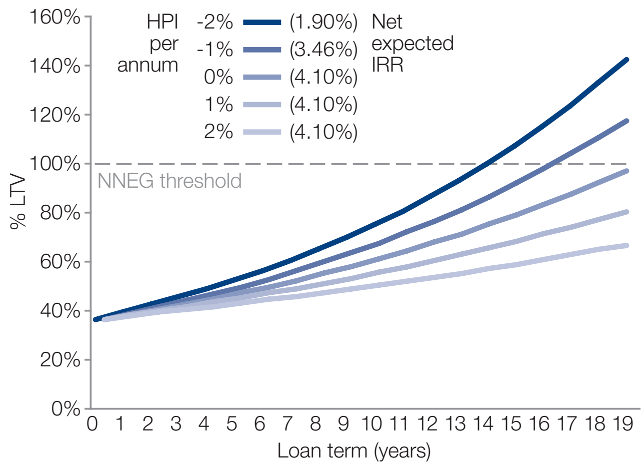
- Age: 70
- Lump sum loan: £120,000
- Interest rate: 5.3%
- Initial LTV: 36% (£330k house price)
- Loan term: 19 years[2]
- Acquisition fees: 7.0%[3]
- Ongoing fees: 70bps[3]
- HPI[4]:
  Base case: 3.75% (RPI + 0.75%)
  Upside: 5.75% (RPI + 2.75%)
  Downside: 1.75% (RPI - 1.25%)

1 Based on LTV offered by lifetime mortgage originators in 2017
2 Life expectancy based on CMI 2016, Male, long-term rate of 2% and base table PCMA00
3 Indicative acquisition and ongoing fees used for example purposes only
4 RPI assumed to increase by 3% per annum
5 Based on the average 1-in-200 longevity stress applied by UK annuity writers based 2017 Solvency II model survey
6 Spread is over 2046 nominal gilt yield (1.8% yield 11 January 2018)

Once the borrower has successfully been on boarded with the interest rate and LTV set, the following are the key variables that drive a lifetime mortgage's expected return:

- **HPI** – this impacts the LTV of the loan and the chance of crossing the NNEG threshold. In our single loan example, our downside scenario assumes the house price grows at RPI -1.25% (circa 1.75% per annum). UK house prices have grown by 5.5% over the past 30 years and are forecast to grow by 3.2% over the next 5 years[7]
- **Borrower mortality** – i.e. how long the borrower lives for. The longer they live, the longer the loan rolls up but also the greater the potential to cross the NNEG threshold. Based on a 1-in-200 longevity stress, we have assumed the borrower lives 2.5 years longer, which in our example under any scenario is not expected to cross the NNEG threshold
- **NNEG** – the loan is capped by the value of the property. NNEG risk should be assessed as part of the product design and the potential to cross this threshold should be priced into expected returns
- **Product features** – consideration of product features and how they impact borrower behaviour should be priced into any expected returns
- **Fees** – acquisition costs and ongoing

Chart 5: Investor capital is protected under pessimistic HPI assumptions



7 Halifax House Price Index, OBR forecast – 4 December 2017

Potential advantages for defined benefit pension schemes

Attractive risk-adjusted expected return

- Expected yield pick-up over other long-dated secure assets, with current net spreads circa 200-300bps over UK fixed-interest gilts – see chart 6
- Low principal value risk and yield risk given asset backing and low probability of crossing the NNEG threshold – see chart 5
- Returns are driven by residential house prices and longevity risk. Adding lifetime mortgages to an investment portfolio can potentially improve a pensions schemes risk-adjusted return through diversification

Large opportunity set

Pension schemes can invest alongside insurers as well as target areas of the market that do not work for insurers given their stricter capital treatment requirements. Opportunities include:

- Having product features in the loans which are not capital efficient for insurers but are attractive to borrowers. Ideally the features should expire overtime to improve future portfolio liquidity (i.e. ability to sell loans onto insurers). Examples include early repayment options for first 5 years or interest payment options
- Working with smaller lenders who have origination channels where loans are less competitively bid for
- Offering loans with slightly higher LTVs and that are not suitable for insurers matching adjustment. These loans are less competitively bid for by insurers but still have a low probability of crossing the NNEG

Cashflow Driven Investment

- Provide a secure source of contractual income to meet long-dated liabilities
- Typical duration of circa 15 years, with the valuation sensitive to changes in UK Government bond yields
- Capital protection – investment secured by borrower's primary residence (at low loan-to-values) which is unencumbered by any other mortgage balance or loan

Longevity hedge

- Can help to mitigate longevity risk by potentially generating additional returns if borrowers live longer than expected, which as pension funds mature and de-risk to liability matching assets, becomes increasingly significant

Positive social impact

- Lifetime mortgages are supported by the FCA and the UK government as part of the solution to prevent homeowners having insufficient capital to fund their retirement
- Allows borrowers to refinance their expiring interest only mortgages to prevent home owners becoming 'forced sellers'

Chart 6: Lifetime mortgage's expected return relative to other asset classes[1]

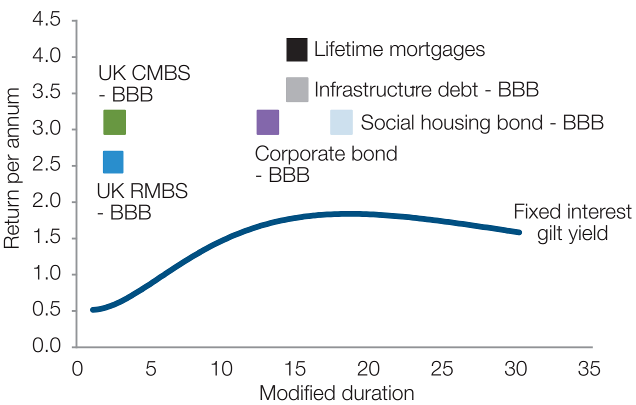
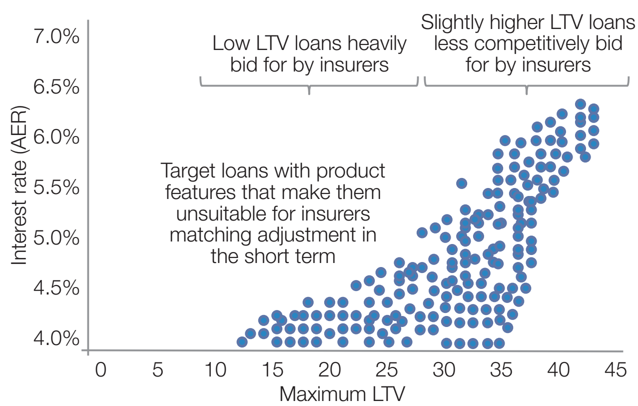


Chart 7: Illustration of the investment opportunities for pension funds - borrower 70 years old



1 Fixed interest gilt yield, UK CMBS AND RMBS – BARCAP, Social housing bond - JRCA – Social Housing News – December 2017, Corporate bond – IBOXX corporates BBB non financials, Infrastructure – Schroders, Infrastructure financing - an overview

How to invest in lifetime mortgages

	Investment Manager	In-house team	Build platform
Description	Provide funding to an Investment Manager who is responsible for product design, setting underwriting criteria, and overseeing the origination and servicing of the loans by the lender	Build a team that provides funding to lenders, designs products, sets underwriting criteria and oversees the origination and servicing of the loans by the lender	Launch a platform that funds, lends and potentially services the loans
Approach taken by	Yet to be done	Pension Insurance Corporation, Rothesay Life, Phoenix	L&G and Aviva
Advantages	• Dedicated full time mortgage, servicing and regulatory experts, protecting investor interests • Insulates investor from reputational risk as lender of record remains with the originator • Easier to stop the origination of new mortgages as no capital committed to building and maintaining a regulated platform or team • Lower set up costs and running costs, with the potential for economies of scale • Lower required governance budget	• Direct control and flexibility over investment strategy • Potential to utilise existing investment team • Insulates investor as lender of record remains with the originator • No external Investment Management fees	• Direct control and flexibility over investment strategy, origination and loan servicing • No external Investment Management fees
Disadvantages	• Less direct control over loan origination and servicing • Investment Management fees	• Costly to set up and administer • Requires large governance budget • Requires the hiring of mortgage experts if not in-house • Large allocation of time to manage investments and third parties (e.g. lender, auditors, etc.)	• Most costly to set up and administer • Requires large governance budget • Time to market – need to build a platform, FCA approval, hiring • Requires regulatory oversight • Large allocation of time to manage platform, investments and third parties

What are the attributes required from an Investment Manager?

Real estate expertise:

- An understanding of the collateral backing each loan
- Experience in property lending and property maintenance
- Residential exposure/expertise

Team experience:

- Track record of successfully launching and managing platforms
- Experience in running residential asset-backed lending businesses and assessing lending portfolios originated through intermediated channels
- Mortgage servicing

Understanding the needs of defined benefit pension funds:

- Understands the relationship between pension fund assets and liabilities
- Ability to assess products for appropriateness given the specific requirements of DB pension schemes
- Appreciate the on going requirements in relation to de-risking strategies and journey planning
- Ability to structure transactions to benefit from the stricter capital treatment requirements of insurers

Risks and mitigations – investing via an Investment Manager

REPUTATIONAL RISK

- Regulated and supported by the FCA and the UK government
- Effective market oversight from the Equity Release Council
- Pension fund investor insulated – lenders of record will be originator
- Transparent product attributes and loan terms
- Implement robust origination, underwriting and oversight processes
- Risk committees and non executive directors of major life companies and high street banks have become comfortable with investing in lifetime mortgages

LIQUIDITY RISK

- Increasing secondary market for Cashflow Driven Investments, particularly in optimal lot sizes
- For pension schemes considering buy-out:
  - In-specie the loans to insurers (subject to the future regulatory position of lifetime mortgages), given the significant long term demand anticipated for lifetime mortgages by insurers
  - Significant proportion of pension schemes intention is to run off or run off with tactical buy-ins rather than fully buy-out, providing a significant secondary market
- Low expected volatility of underlying cashflows
- Portfolios of equity release mortgages have been historically traded

OPERATOR RISK

- Undertake a detailed financial stability and management team assessment of each lender
- Ongoing monitoring and audits of lenders
- Ability for alternative providers to step in with a number of suitable providers available to choose from

INCOME RISK

- Prepayment risk – mitigated by product design e.g. early repayment charges
- NNEG risk – mitigated by a detailed risk assessment of borrower loans vs regional HPI and mortality assumptions
- Underwriting risk – mitigated by:
  - Detailed lending criteria including property and borrower due diligence
  - Oversight of lenders with frequent audits

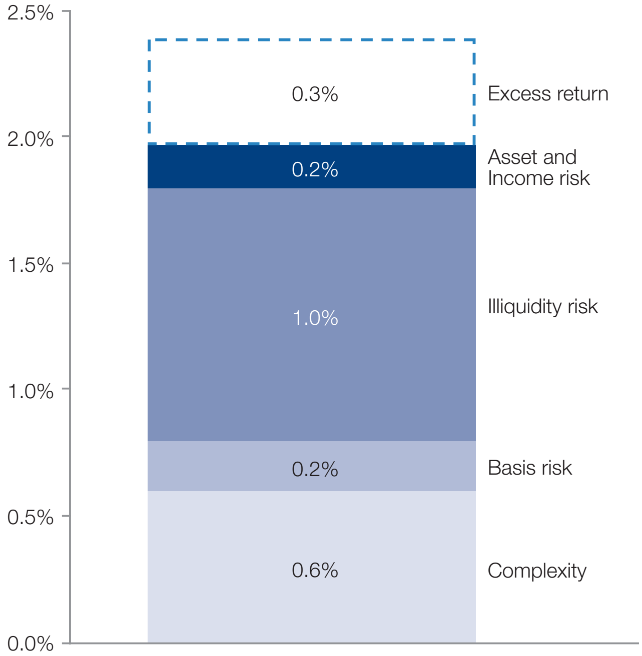
Assessing lifetime mortgages

It is important to consider if you are being correctly rewarded for running the various risks associated with an investment in lifetime mortgages, the example below is based on an investment via a fund structure:

Complexity risk – relative to other asset classes, lifetime mortgages have average complexity risk. There is some upfront work required to understand the product and the responsibilities of the Investment Manager for example, but once setup, only light monitoring of the Investment Manager is required from trustees and their advisors. The Investment Manager will need an effective risk management approach to make sure the asset complexity has been fully understood and is appropriately managed as well as considerable expert resources and a strong origination strategy to source, structure and analyse lending opportunities. Alpha Real Capital estimates that a circa 0.6% excess spread over nominal gilts should be rewarded for complexity risk

A lifetime mortgage portfolio can be valued on a gilt + spread approach, providing a direct balance sheet hedge against changes in interest rates, whilst still subject to credit risk and market pricing.

Chart 8: Estimated spread over UK fixed-interest gilts[1]



Basis risk – portfolios can be valued on a gilt + spread approach, providing a direct balance sheet hedge against changes in interest rates, whilst still subject to credit risk and market pricing. In terms of cashfows, a gilt has fixed cashflows whereas the cashflows of a lifetime mortgage, whilst largely predicable, also have an element of uncertainty. They can change for example, based on changes to HPI, early repayments or mortality expectations which directly impact a portfolio's valuation. We estimate a circa 0.2% excess spread over nominal gilts should be rewarded for basis risk

Illiquidity risk – by their nature, lifetime mortgages are long-term buy and hold illiquid assets, with a duration that is directly linked to the borrower's expected mortality. However there is a demonstrable secondary market, with portfolios of equity release having traded in the recent past and the volatility of the underlying cashflows is low (given their secure contractual nature), which increases the certainty of the value at exit. We estimate a circa 1.0% excess spread over nominal gilts should be rewarded for illiquidity risk

Asset risk & income risk – the risk of receiving the income is inextricably linked to the underlying asset risk, i.e. the value of the underlying residential property. Using market neutral HPI scenarios and mortality assumptions, we plot out expected LTV growth, considering product features to model the possibility of crossing the NNEG threshold. We estimate the required excess spread over nominal gilts to be circa 0.2%

The excess return of circa 0.4% is the expected additional return earned over nominal gilts from an investment which is not required by the risks being taken but is still rewarded

1 The lifetime mortgage portfolio has a net annual expected return of 4.1%. The benchmark used is the equivalent duration 2046 nominal gilt yield (1.8% yield as at 11 January 2018)

Trustee governance considerations

Investing via a Investment Manager – is relatively light from a trustee governance perspective, and essentially delegates a substantial amount of the oversight to a qualified identity. Compared to a traditional asset there is likely to be more of a focus on the initial set up, such as; reviewing the investment strategy, understanding the responsibilities of the Investment Manager, and getting comfortable that any potential reputational risks have been fully mitigated. However, once in place there should be a relatively low governance requirement, with emphasis on monitoring the Investment Manger to confirm loans are being originated as set out in the investment strategy, the portfolio value is moving in line with expectations and the loans are being serviced as expected. Investment Managers will be responsible for:

- **Product design and underwriting** – develop, audit and acquire loans consistent with investors risk and return requirements
- **Fund modeling and portfolio management** – develop and maintain asset pricing , performance and valuation models, continually assessing risks (e.g. concentration risks, regional HPI, mortality analysis, NNEG risks, etc.)
- **Cash management and reporting** – establish and audit the loan funding and collection bank accounts on behalf of investors and manage the ongoing drawdown requirements as well as fund reporting
- **Managing lender, servicer and third-party relationships** – initial due diligence, negotiate terms, set underwriting criteria, concentration limits, pipeline commitments, product development, back-up servicer(s)
- **Governance and oversight** – ongoing review of servicing policy, procedures, governance and audit frameworks. Monitor data provided by originator, servicer and third-party providers. Monthly joint management and performance meetings with originators and servicers

Building your own platform or team – either option is a large undertaking and would require a significant governance budget in the initial launch phase and on an ongoing basis. This would need to be weighed up against the advantages of these approaches set out on page 9.

Conclusions

Over the past 25 years, the lifetime mortgage market has matured significantly, with past reputational concerns having been addressed by oversight from SHIP since 1991 (rebranded as Equity Release Council in 2013) and FSA (Now FCA) regulation since 2004. This has helped a significant number of institutional investors, such as L&G, Aviva, Rothesay Life, Pension Insurance Corp and Just get comfortable to significantly invest in the sector, and should also provide comfort to pension schemes as well.

Defined benefit pension schemes should invest in lifetime mortgages for the same reasons insurers do: attractive risk-adjusted expected returns, secure, long dated, asset-backed cashflows, longevity hedging, diversification from traditional investments and a positive social impact to the borrower.

For pension schemes attracted to the sector but without the governance budget to set up their own platform or investment team to make this opportunity viable, investing via a Investment Manager is the most logical approach.

In conclusion, Alpha Real Capital feels that the lifetime mortgage market is positioned for growth, providing a much needed solution to the increasing financial pressure on individuals during retirement. Given the strict capital treatment of lifetime mortgages for insurers, there is an attractive opportunity for pension funds to invest in areas that do not directly compete, as well as alongside them.

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