Lifetime Mortgages
An untapped opportunity for pension funds

Over the last few years, Lifetime Mortgage ('LTM') assets have become a preferred investment used by annuity providers to back the liabilities they take on to pay pensioners. This is because the long dated cashflows produced by a portfolio of Lifetime Mortgages are a good match for pension payments. They also offer attractive returns with diversification benefits. For these very same reasons LTMs should be an attractive investment for pension funds.

However, it has been difficult for pension funds to invest because accessing this asset class does involve specialist skills and a certain amount of scale. Given the growing interest from pension funds, this paper provides a brief overview of LTMs and what makes it an attractive asset class for pension funds.

LTM Market growth

In recent years the market has grown and matured significantly; annual volumes have quadrupled from £1 billion to £4 billion of lending since 2014 and industry participants expect it to reach £10 billion p.a. within 10 years[1]. This growth has been helped by a number of factors, including:

- LTMs have shed the reputational issues associated with some historic equity release products sold 30 or so years ago. The market is now funded and operated by financial institutions that are household names, and the industry is underpinned by a highly regulated origination and sales process.
- LTMs are emerging as a core product that can help consumers meet financial needs in later life. An ageing population with substantial proportions of their wealth in residential property and inadequate retirement savings has led to increased consumer demand. These demographic trends will continue.

Pension funds are expected to drive much of this growth going forward. Indeed, in a recent survey from EY[2], while insurance companies have been the largest funders of LTMs, many respondents expected pension funds to represent the largest sources of increased funding over the next two years.

What are Lifetime Mortgages?

Lifetime mortgages are regulated loans available to borrowers aged 55 and over.

- Eligible borrowers can typically borrow up to 55% (age dependent) of the value of their property.
- There are no required monthly payments and the interest rolls up on the mortgage balance over time.
- The loan becomes due when the last surviving borrower either dies or moves into long-term care and is normally repaid using the proceeds from the sale of the property.
- Borrowers are protected against owing more than the property's net sale price by what is known as a 'No Negative Equity' guarantee.

Most borrowers chose one of two types of lifetime mortgage product. A **Lump Sum Lifetime Mortgage** or **Drawdown Lifetime Mortgage**, the latter providing both an initial lump sum payment and the facility to draw down further cash as required.

Other important features designed to protect LTM borrowers include the requirement to take financial advice from a regulated advisor to determine the suitability of the product and to receive legal advice prior to completion to confirm they understand the risks and obligations of the loan.

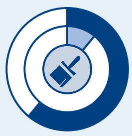
1 2020/21 EY Lifetime Mortgage Survey
2 2020/21 EY Lifetime Mortgage Survey

LTMs can offer social benefits

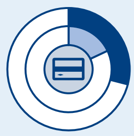
Proceeds from LTMs are typically used to improve the borrower's quality of life and to reduce the worry of financial commitments, for example to reduce the burden of debt payments at a time in life when income levels naturally reduce. Essentially LTMs allow borrowers to access the wealth locked away in the property they live in without having to sell the property, meaning they can continue to live in their homes, providing a clear social benefit. The following quote from David Burrowes, Chair of the Equity Release Council, sums it up well.

"Accessing property wealth will play a vital role in retirement planning, both now and in the years to come. For today's retirees, it can make the difference between making ends meet or enjoying a more comfortable lifestyle by boosting their pension income, improving or adapting their homes life and paying for domestic care support. For younger generations, it can open up the possibility of receiving a 'living inheritance' to support their own financial goals, such as getting on the property ladder."

Popular use of proceeds

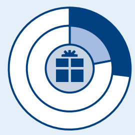


61% use 11% of proceeds for home & garden improvements

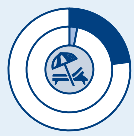


28% use 18% of proceeds for unsecured debt repayment

20% use 29% of proceeds for mortgage repayment



27% use 22% of proceeds for gifting



23% use 3% of proceeds for holidays

Source: Key Market Monitor Full Year 2020

What makes LTMs attractive for Pension Funds?

Pension funds invest for three reasons:

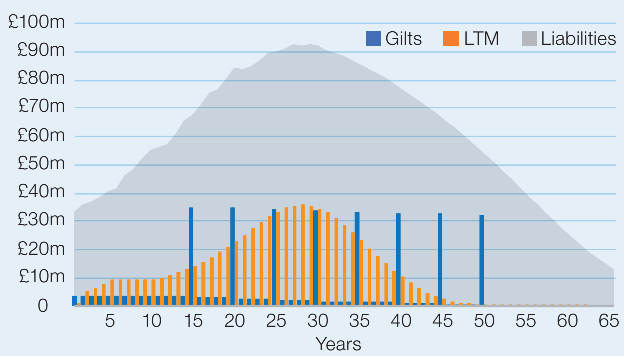
1 To meet liability cashflows
Ultimately pension funds are vehicles that exist to pay member benefits as they fall due

2 To earn acceptable returns
Seek returns that are higher than that implied by their liabilities, and attractive when adjusted for risk

3 To manage risks
Typically looking for liability hedging characteristics and assets that increase portfolio diversification

Bearing these reasons in mind, the chart below shows the liability cashflows for a typical pension scheme (grey background). It also shows the cashflow resulting from investing 25% of the value of the scheme's liabilities in an LTM portfolio, and also the cashflows that would be generated by investing the same amount in a portfolio of long-dated gilts.

Portfolio Cashflows: Lifetime Mortgages vs. Long Dated Gilts



Source: Alpha Real Capital, Barclays (for illustrative purposes only)

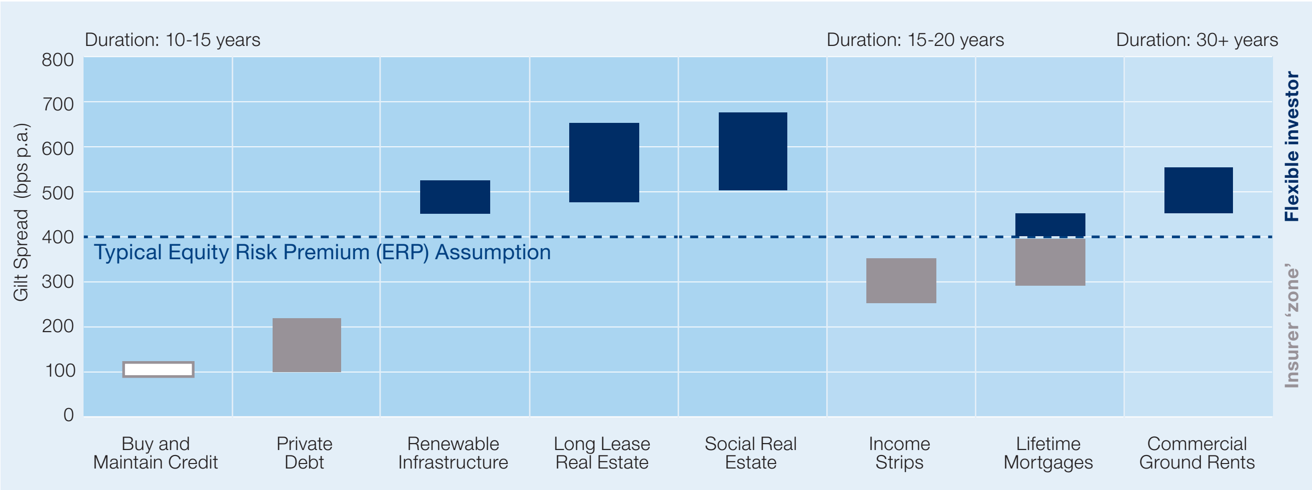
LTMs provide a long duration income stream that are a good match for the liabilities.

While the LTM cashflows are not inflation-linked, we note that circa 30% of pension scheme liabilities are fixed in nature. In any case, inflation exposure can be added through the scheme's liability driven investment manager.

The LTM cashflow profile also provides a better match to the schemes liabilities than investing in gilts. The latter generates very low ongoing cashflows, albeit with a few peaks when the gilts mature.

LTMs provide attractive spreads

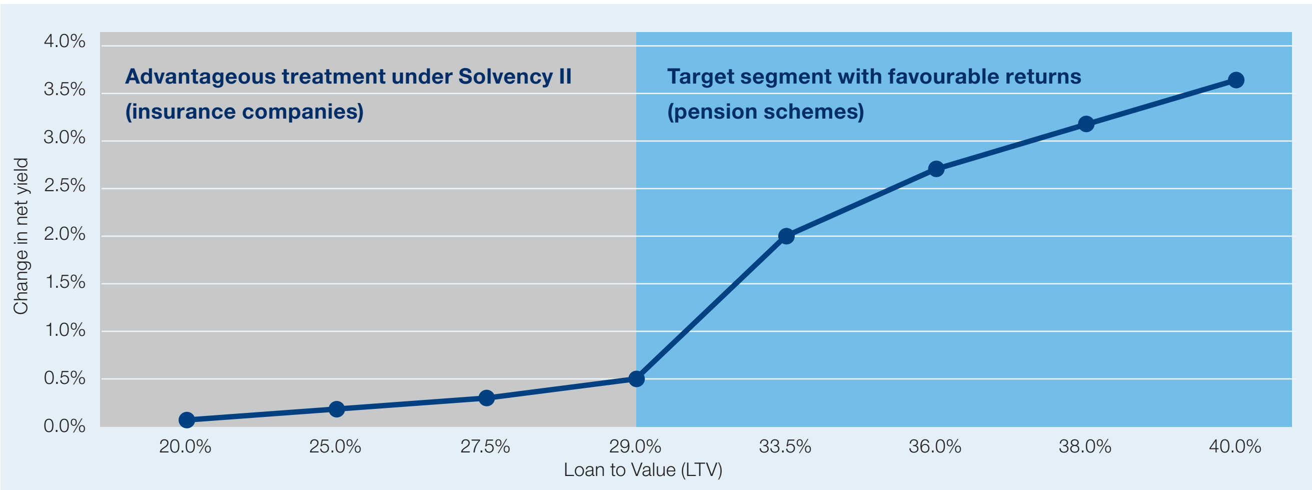
The chart below compares the additional yield versus equivalent maturity gilts on a LTM portfolio with other secure income asset classes. This shows that LTMs provide attractive spreads.



An added opportunity for pension funds exists because the regulatory framework for insurers constrains them from investing across the entire market, such as the higher LTV segment. Pension funds are able to access more favourable expected risk-adjusted returns without competing with insurers.

In the graph below, the blue line represents the incremental increase in net yield as the LTV is increased across several lump sum products available for a 65 year old borrower. Insurance companies compete heavily in the grey region of the graph which is why there's only a marginal increase in net yield (50bps) as you move from a 20% to 29% LTV product. But in the light blue region (which is unattractive to insurers given Solvency II), there's a steep increase in net yield as the LTV moves upwards. This yield increase reflects lower demand from insurers rather than a commensurate increase in underlying risk.

Impact on net yield generated from a lifetime mortgage – Lump sum products for a 65 year old single male



What are the main risks?

Interest rate risks:

The value placed on a LTM portfolio will change due to changes in prevailing interest rates – as rates fall the value of the LTM portfolio would rise (all other things being equal). This is similar to how pension scheme liabilities behave. These assets can therefore reduce the burden on a scheme's Liability Driven Investment portfolio to hedge interest rate risk.

Longevity and other risks:

As illustrated earlier, a portfolio of LTMs produces a set of long duration cashflows. The cashflow amounts generated will depend on the demography of the borrowers. For example if the borrowers live longer than initially assumed then cashflows will be paid later. If borrowers make more early repayments than initially assumed, then cashflows will be shorter dated. Similar to the longevity risks inherent in pension scheme liabilities.

Residential house prices:

Another area of risk exposure is to house prices. If the value of house prices fall due to a general decline in value and/or because properties are in disrepair at the time of repayment, there is a higher probability that the no negative equity guarantee mentioned earlier results in a loss. Conservative underwriting limits this risk, as does the relatively low loan to values for LTMs. Note that pension scheme's typically do not have direct exposure to such risks in their portfolios, therefore LTMs can have diversification benefits.

Illiquidity:

While liquidity of LTM portfolios have been more a function of the lack of sellers, not buyers, our analysis shows that a pension scheme would still earn an attractive return after a holding period of 10 years or more, even with punitive haircuts to the valuation upon sale. Historically, LTM portfolios have traded at a premium to book value.

Those familiar with defined benefit pension schemes may see some similarities in how actuaries value scheme liabilities – placing a value on cashflows based on demographic and financial assumptions – and the process for assessing and valuing LTM portfolios.

Summary

The LTM market has grown substantially in the last few years. Annuity providers have invested in these assets as they are a good match for their liabilities – that is to pay pensioner cashflows. Market demand is set to grow further given the increasing role LTMs can play in the financial well-being of a growing population of retirees.

For pension funds, LTMs provide good liability matching characteristics, they can also add diversification to a pension fund's portfolio while enhancing returns – all compelling arguments to explore this asset class in earnest.

About Alpha Real Capital

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We provide market leading and innovative real asset solutions across a range of investments such as commercial ground rents, UK renewable infrastructure, social real estate and lifetime mortgages, combining operational real estate expertise and fixed income skills.

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