



Learning to Ski

Lifetime Mortgages and other ways to Spend the Kids' Inheritance



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Baby Boomers: the Skier Generation

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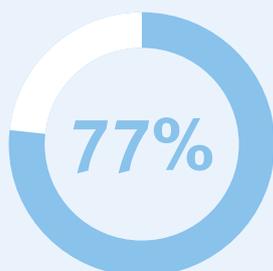
The last of the baby boomer generation – those born between World War II and the mid-1960s – are now reaching the age at which they can access their pensions. While many have chosen to do so, there is a growing trend for working in later life. Women in particular have been working later as a result of the deferral of their state pension by the Government in recent years.

On top of this the employment rate among over 65s has doubled from 5% to just over 10%¹ (around 1.2 million workers) in the past 20 years. Over half do so as they are simply not ready to stop working. However one in six have carried on working to pay for essential items, one in twelve to pay for desirable items and a further one in fourteen to boost their pension pots.

Baby boomers are the first generation with a significant proportion of their pension savings in Defined Contribution (DC) pots where their parents more typically enjoyed benefits from Defined Benefit (DB) schemes. Even among those with some DB provision, the recent spike in transfers into DC schemes shows the Pension Freedoms genie is truly out of the bottle. The numbers relying wholly or mainly on topping up their state pensions with less generous DC pensions without guaranteed income is set to grow year on year.

Yet boomers are also the most likely group to own property; 77% of over-55s have net property wealth of more than £50,000, and 26% more than £250,000². This white paper sets out to explore how the asset-rich but cash-poor segment of this population might use property and other assets to supplement their incomes in retirement, and what good looks like in terms of the optimum customer journey from enquiry to completion and ongoing support. Along the way we'll be looking at some of the challenges facing lenders and other participants in this market, and asking whether "Spending the Kids' Inheritance" is the right solution for those with a shortfall in pension savings.

Net property wealth of over 55s



of over-55s have net property wealth of **more than £50,000**



of over-55s have net property wealth of **more than £250,000**

¹ <https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/ageing/articles/livinglongerhowourpopulationischangingandwhyitmatters/2018-08-13#how-many-older-people-work-and-has-this-changed>

² Wealth and Assets Survey (Wave 5), Feb 2018, Office for National Statistics

The Oncoming Avalanche of Retirees

Retirement Funding Gap for the pension-poor and property-rich

The UK has an estimated eight million baby-boomers in the 55-64 year-old age group (and 6.8 million aged 65-74). This is the generation reaching retirement now, and most have a realistic understanding of roughly how long their money has to last. Our recent survey showed that over 80% of baby boomers expect to live between 15 and 25 years in retirement, with 42% planning for around 20 years (broadly in line with the latest ONS average life expectancy data).

For people in this age group who were automatically enrolled in Defined Contribution pensions, more than 95% have little or no previous pension savings and will not achieve an adequate income³. This cohort will be largely dependent on State Pension plus any non-pension wealth they have accrued.

In fact, 1.6 million people, mainly baby boomers, are not even on track to meet the Joseph Rowntree Foundation's Minimum Income Standard. For a pensioner living alone this is £9,154 a year outside of London, rising to £19,466 for Inner London⁴.

8 million
baby boomers

1.6 million
will not meet
minimum income
standard

80%
expect to live
20 years or more
in retirement

£1.6 trillion
savings gap

Where's the money?

It is widely quoted that the UK holds private pension savings in the region of £2.1 trillion. This appears to have originated from Government research in 2011⁵. The ONS's separate Wealth and Assets Survey study from this period, using a different methodology, produced an estimate of £3.5 trillion comprising active plans, deferred pensions and those in payment.

On this same measure, the latest estimate for private pensions wealth in the UK, from 2014-16's survey, is £5.3 trillion. Through automatic enrolment, pensions are the UK's fastest-growing segment of wealth. Added to this, combined state pension and public sector pension liabilities exceed £5.3 trillion⁶. These include about £4 trillion State Pension liabilities and around £334 billion from funded schemes such as the Local Government Pension Scheme. Combined personal and occupational pensions are worth in the region of £5 trillion to £7 trillion. Put another way, that's over £100,000 for every adult aged 22 and over in the UK.

This wealth is extremely unevenly distributed. The poorest 10% of the country's households have less than 0.1% of total private pension savings and the richest 10% almost half⁷. Self-reported median household private pensions wealth (for baby boomers who have a pension) is £97,500 – enough for a sustainable income of around £3,000⁸. But for the 34% of 55-64-year-olds who have any DC savings at all, the median amount is a mere £26,200.

³ PLSA: Retirement Income Adequacy: Generation by Generation, November 2016

⁴ Centre for Research in Social Policy, <https://www.minimumincome.org.uk/>, March 2019

⁵ HM Treasury: Freedom and choice in pensions March 2014

⁶ ONS, Pensions in the national accounts, a fuller picture of the UK's funded and unfunded pension obligations: 2010 to 2015, March 2018

⁷ Wealth and Assets Survey (Wave 5), Feb 2018, Office for National Statistics

⁸ For a joint life annuity increasing at 3%

When the Chalet Pays You Back

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Filling the funding gap

For most older people, their home will be the single biggest asset they own. Self-declared property wealth in Great Britain (net of mortgage debt) is in the region of £4.6 trillion⁹ – not too far short of private pension wealth. The over-65s alone have amassed £1.1 trillion worth of properties which are mortgage-free¹⁰.

These huge sums of money locked up in bricks and mortar (predominantly in the hands of the over-50s) are an obvious source of funds to bridge the pension savings gap running into the hundreds of billions of pounds. Based on the abundance of equity release adverts on television, the industry has woken up to this opportunity too and there is widespread awareness of equity release as a means to access tax-free cash in later life. There are now 14 lenders active in the equity release and home reversion plan market.

And it's a growing market; the Equity Release Council (ERC) reported withdrawals of £3.94bn¹¹ from housing wealth in 2018. In the context of the £275bn¹² residential mortgage lending market this number is still small. But set against pension withdrawals under the new freedoms, this equates

to roughly fifty pence for every pound withdrawn from pension plans.

Median household private property wealth of British homeowners is around £300,000. ERC data shows that the average value of properties used as security for lifetime mortgages is a little higher than this; £312,000 for the 36% of customers taking out lump sums and £353,000 for the 64% taking out a drawdown plan (this is like an overdraft facility – where the customer takes an initial sum at outset and can access further instalments when needed).

At age 65, a typical 30% loan-to-value (LTV) mortgage would release around £90,000 on a £300,000 home. Taken as a lump sum or in several drawdown tranches this could create a tax-free income. Recently firms have started offering monthly income plans. Alternatively, a purchased life annuity would create an increasing income of around £2,700 a year¹³, but part of this would be taxable. Advisers do need to be aware though, before making recommendations, that taking equity release can impact a customer's eligibility for means-tested benefits such as pension guarantee credit and council tax reduction.



⁹ Wealth and Assets Survey (Wave 5), Feb 2018, Office for National Statistics

¹⁰ Jake Carter, Mortgage Strategy, 22nd February 2019

¹¹ Equity Release Council - Q4 2018 Lending Figures Press Release

¹² Bank of England/FCA MLAR, March 2019

¹³ For a joint life annuity increasing at 3% a year

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Case Study: Martha

Martha retired at age 69, repaying her mortgage using her voluntary redundancy payout. She draws a state pension supplemented by a small workplace pension and is “just about managing”.

The family home was built by her late husband, and is now regularly filled with her four grown children, their partners and three granddaughters. Situated in a community with long-standing friendships, she feels safe and neighbours look out for each other.

Now aged 75, Martha had not been able to make any necessary home improvements, other than a new boiler, during the years. In addition two of her children are, at times, financially reliant on her. Faced with these needs, she had to choose between downsizing or taking an equity release mortgage. She discussed the situation with her children, all of whom wanted her to enjoy the money and be able to stay in the family home she loved.

She used an adviser recommended to her by a friend and arranged her mortgage. She gave each of her children a lump sum and spent the remainder on home improvements including kitchen, bathroom and conservatory and replaced her carpets for the first time in over 40 years. She was surprised at how quickly and easily the money she had drawn down evaporated but was happy with the resulting improvements.

However, her car was 15 years old and had started to become unreliable and she had yet to finish renovating the upstairs rooms. She spoke with her lender as she had now increased the value of the property, but was unable to meet their criteria for a further advance. Her adviser switched her to a new deal, but she was forced to pay a substantial early redemption charge.

For Martha, the worst part of the experience was her initial guilt at not being able to pass down the house to her children. She would be wary of early repayment charges in the future and is glad to be on a fixed interest rate. She is now more cautious with the money she is spending. Overall, she would recommend equity release, which has improved her quality of life and enabled her to see her children and grandchildren enjoy their inheritance.



Stock image for illustrative purposes only

A Look at the Resort

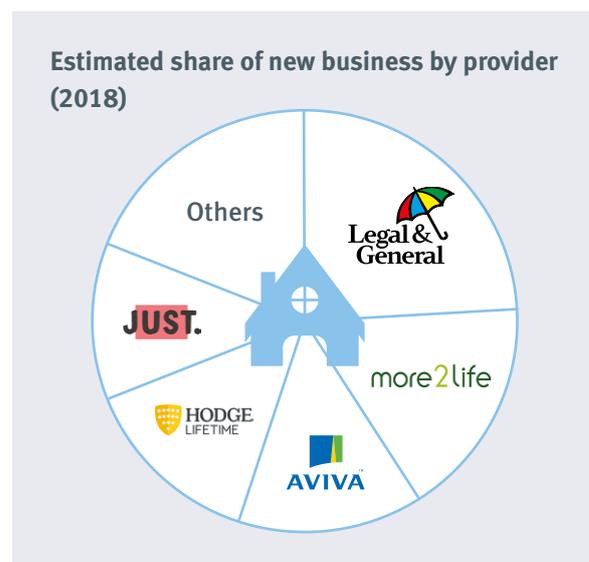
Introduction to the Equity Release Mortgage market

Equity release was first launched in the UK in 1965 by the Hodge Life Assurance Company – still in the market today as Hodge Lifetime. Known in much of the rest of the world as a reverse mortgage, the product is a mortgage loan available to older people, secured on the unencumbered value (or equity) of the customer’s home. The customer retains ownership of the property and the right to live in it, in return for a commitment to maintaining and insuring the home. They usually do not have to make repayments; instead the lender recovers the debt when the property is sold after the customer dies or moves into residential care.

The market to date has been relatively small, comparative to conventional residential mortgages as well as to the pensions and investments market. Today, though, a number of factors have combined to create a £4bn market for equity release lending¹⁴ in 2018:

- Housing shortages and rapid property price growth
- Mass closure of defined benefit (DB) pension plans
- Declining pension plan membership, reversed since 2012 when automatic enrolment was introduced
- Increasing numbers of self-employed, excluded from automatic enrolment
- Insufficient rates of contribution to defined contribution (DC) plans

As a result, a generation of the UK public are faced with much lower pension savings and less secure income in retirement than their parents. However, on average they have much higher property wealth in real terms, and equity release is being advertised to them as a means to achieve a number of lifestyle goals in their retirement.



¹⁴ Equity Release Council - Q4 2018 Lending Figures Press Release

Types of Later Life Lending

The two types of equity release plans available today are Lifetime Mortgages and Home Reversion Plans. Retirement Interest-Only (RIO) mortgages are also available in later life, but are not classed as equity release.

Lifetime Mortgage

Payable as a lump sum, regular income or as flexible drawdown payments. The borrowers are permitted to stay in the property for life or until the last-named owner moves into residential care. Interest typically not paid but accrues onto the loan value to be recovered on sale of the property.



Home Reversion Plan

The customer sells a proportion of their property to the provider and receives a lump sum or regular income. The customer is permitted to stay in the property for life, until they move into residential care or for a minimum of 20 years. No interest payments are due. The provider claims their share of the sale proceeds at the time of sale.



Retirement Interest Only (RIO)

The customer borrows a lump sum against the value of their property. This is similar to a residential interest-only mortgage but available only to over-55s. The customer must keep up interest repayments or risk losing their home. This is not an equity release plan – as a standard mortgage the customer must pass affordability checks.



A Look at the Resort (cont)

Equity Release

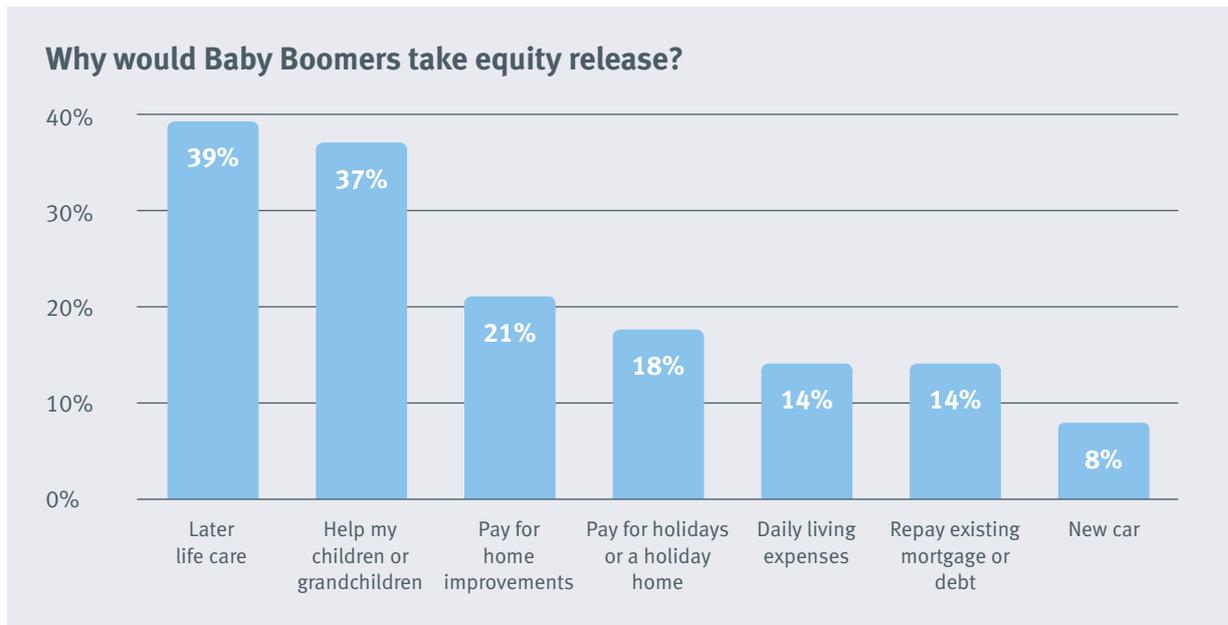
Lifetime Mortgages are unlike standard residential mortgages, in that usually repayments are not due – hence affordability checks do not have to be made. Instead, compound interest accrues to the loan and the mortgage is repaid on sale of the home.

Home Reversion Plans are less common, with only a few specialist providers offering them and fewer than 1% of customers taking them up¹⁵. The provider purchases a share of the home (at below market value) and receives their share of the sale proceeds when the home is vacated and sold. The discount to market value reflects the provider’s view of the life expectancy of the property’s occupants. Customers can often release more of their home’s equity in this way and this product can also be suited to those from long-lived families.

The amount of cash available for withdrawal using equity release increases with the age of the customer at outset. Lenders base their calculations on certain assumptions about the return of capital plus interest. Key factors are how long the customer (and their spouse or partner) will live on in the property, the cost of capital and the property valuation (with associated risk factors around all of these reflected in the interest rate of the loan).

Retirement Interest-Only (RIO) mortgages

Regulated like standard residential mortgages, these are subject to affordability checks and the home can be repossessed if payments are not kept up. They still have a role to play where customers’ investments are not yet sufficient to repay the capital on an interest-only mortgage.



Source: Altus research 2019

¹⁵ Equity Release Council: Market Report, Autumn 2018

Parallel Turns

It's interesting to note growing similarities between the Pension and LTM markets – as the two product segments have much to learn from each other.

Drawdown

Drawdown-style mortgages are becoming increasingly popular with a 64% share of new lending. With this form, a total lending amount is reserved and the customer can choose to draw on this as and when they need it, keeping borrowing costs to a minimum and effectively retaining a larger share in the property until funds are needed.

Longevity protection

Just as a lifetime annuity provides a guarantee of an income for life, so the lifetime mortgage guarantees that the customer can live rent-free in their home for life or until they enter care. With a

fixed or capped rate of interest, in the early years of the mortgage there will also be an inheritance from the proceeds of the house sale (after repaying the loan and costs) – in effect similar to an annuity guarantee.

Inheritance

Under the post-2015 rules, pensions are potentially free of inheritance tax. Meanwhile, a residence falls within the estate and there is an additional IHT allowance for direct descendants only. This opens up a potential IHT saving opportunity where wealthier clients could release funds via equity release and leave their pension intact to pass down.

Now some providers are offering inheritance guarantees so that part of the home's value can be retained by the estate.

The Benefits and Drawbacks of Equity Release

BENEFITS

- ✓ Release cash tax-free – for whatever you need
- ✓ Can stay in family home, avoiding emotional upheaval and financial costs of downsizing
- ✓ No requirement to make repayments
- ✓ No debt passed to children – guaranteed

DRAWBACKS

- ✗ Reduces the inheritance you can pass on
- ✗ May affect entitlement to state benefits
- ✗ With interest compounding, amount owed can double in less than 15 years
- ✗ Must maintain the home to keep the 'No Negative Equity guarantee'

The Big Wipe-Out

The Bad Old Days

During the early days of equity release, the sector was very poorly regulated and, much like most of the financial sector, the market was driven more by salespeople than advisers. There was no industry body promoting product or advice standards and consequently, poor practice was widespread.

In the most extreme cases, during the late '80s and early '90s thousands of customers were advised to borrow equity from their homes (on variable rate mortgages) to re-invest in investment bonds from which tax-deferred income could then be taken. The rate of return needed on the bond to cover the investment charges, mortgage interest and withdrawals proved to be unachievable in practice. The recession of the early '90s hit bond values while property prices fell in response to a hike in interest rates. Pensioners found themselves unable to service their mortgage payments.

Even worse news was the unlimited exposure of families to the mortgage debt. Without a “no negative equity guarantee”, those inheriting the estate on death of the last borrower could be pursued to pay off any outstanding debt where this was greater than the sale proceeds from the home – and many were. The damage this did to the equity release brand has been hard for the industry to shake off.

During the mid-1990s, the industry launched shared-appreciation mortgages, whereby banks took on ownership of part of the property in exchange for a higher share in any future price growth. These products were short-lived as the risks could not be hedged at sufficiently low cost by the providers.

Case Study¹⁶: John

John became homeless when he was evicted in 2009 from the home he shared with his late mother. A Building Society had lent £64,000 on the property in 1990, at an interest rate of 16.3%. By the time John's mother died in 2005, the total debt was £450,000, 150% of the value of the home.

John claimed he had never understood the contract and pursued legal action against the Society – which had been subject to litigation for mis-selling during the 1990s.



Stock image for illustrative purposes only

¹⁶ Source: This Is Money article 24th August 2009. The outcome of the case was not disclosed.

Back on the Piste

How things have improved

In 1991, lender Hodge Lifetime led the creation of the first set of industry standards, known as Safe Home Income Plans or SHIP. The SHIP code of conduct included for the first time a “no negative equity guarantee”. This meant that when a property was sold – on death or moving into care – if the sale proceeds were insufficient to cover the outstanding mortgage plus agents’ and legal fees, the lender could not pursue the estate for the remaining shortfall.

In 2004, equity release became a regulated product under the FSA’s MCOB rules. This meant only qualified specialist advisers could recommend the product. Standards have steadily improved over time, with SOLLA – the Society of Later Life Advisers – formed in 2008. SHIP became the Equity Release Council in 2012.

All members of the ERC must sign up to the Council’s Principles, Rules and Guidance. In addition to the no negative equity guarantee, today’s customers have a number of significant protections, including:

- A requirement to take regulated specialist mortgage advice
- A requirement to take separate independent legal advice
- The right to remain in their homes for life or until they move into care
- The right to move to another property (subject to a suitable valuation)
- Interest rates that are fixed, or if variable, subject to a cap for the life of the loan
- Property valuations must be by independent surveyors who are RICS members

Not all lenders are members of the ERC (although most of these are appointed representatives of firms which are). **Also, not all products offered by members comply with the ERC’s product standards.**



Importantly, Retirement Interest-Only (RIO) mortgages, are regulated like standard residential mortgages under FCA rules, and customers may fall foul of the tighter affordability checks that were introduced in 2014 and up-rated in 2017. RIOs are an important product for many of the estimated 1.6 million customers on interest-only or part-repayment mortgages who may not have sufficient savings built up to repay their debts. Lifetime mortgages – free from the requirement to make monthly repayments – are not subject to affordability checks so are helping to plug this gap for some.

Are the Kids OK?

Moral Argument and Generational Attitudes

With a mature market for later life lending, and a strong consumer protection framework, the pistes look free from obvious hazards and surely our baby boomers can borrow against their property wealth with confidence? But how do this generation feel about doing this, and equally important, what does this mean for their children?

Intergenerational unfairness is a much-discussed topic of late, with talk that over-55s have it better than any generation before or since. Where their parents suffered through war-time and post-war rationing and endured genuine austerity, baby boomers saw unprecedented growth in living standards from the 1960s on. They enjoyed free university education. Their mortgage debt was eroded by inflation, while they saw a rapid explosion in house price values. Their non-cash assets have inflated massively too, helped by central banks' actions after the global financial crisis.

“I have no expectations of inheritance, and believe that parents and grandparents should do whatever is right for them and gives them the best lives possible.”

Millennial survey respondent

Meanwhile, baby boomers' children and grandchildren leave further education with an average debt exceeding £50,000¹⁷. For 2018 graduates, the interest rate on this is 6.3% - 3% over RPI inflation and more than eight times the Bank of England base rate at the time of writing. UK house prices are almost eight times full-time average earnings, up from just over three times in 1990¹⁸. Help-to-Buy, a measure designed to help, led to a doubling of house-price growth for new-builds against existing housing stock between 2014 and 2017¹⁹. And while employment rates are at their best since the 1970s, there are 2.8 million workers in the gig economy. Over half of these are aged 18-34 and 25% of gig-economy workers report earning less than the minimum wage of £7.50 per hour²⁰.

Given this disparity in financial security, and with so many other social, environmental and political issues impacting disproportionately on the young, it would not be surprising to find resentment among the millennial generation – those aged 18-34. To test our theory that there would be a generational split in attitudes between people retiring today and their children and grandchildren, Altus surveyed both baby boomers and millennials to ask them about their attitudes to inheritance, later life spending and equity release, which led to some surprising findings.

¹⁷ IFS, 2017

¹⁸ ONS

¹⁹ Ministry of Housing, Communities and Local Government, October 2018

²⁰ Department for Business, Energy and Industrial Strategy, February 2018

Inheritance

65% of baby boomers plan to leave an inheritance, while only around 12% definitely or probably do not. The remainder are hedging their bets depending on whether they need the money to see them through retirement or fund care needs.

Among millennials, our survey found that just under half expect to inherit from their parents or grandparents. Often, if they do, this is because their parents have spoken about it. However, reassuringly more than three quarters of respondents are not relying on inheriting wealth to get them on the property ladder or fund their later years.

“It’s up to [my parents] how they want to spend their hard-earned money. I just wouldn’t want to see them taken advantage of financially.”

Millennial survey respondent

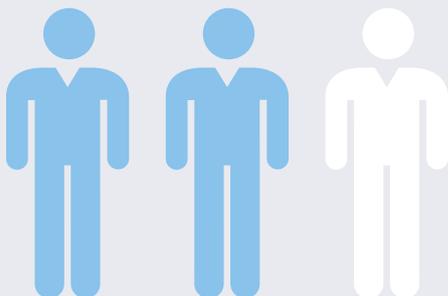
Later life spending and equity release

Our survey of baby boomers showed that over 80% of this group expect to have to fund between 15 and 25 years in retirement, with 42% expecting around 20 years (broadly in line with the latest ONS average life expectancy data).

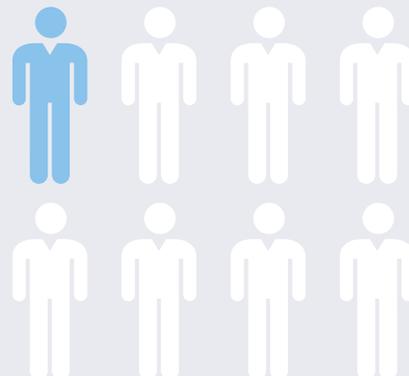
Only 14% of baby boomers would definitely consider equity release to fund daily retirement living expenses, with just over a quarter saying it would depend on their circumstances. Respondents were more likely to consider borrowing for larger purchases or projects, with 21% saying for home improvements, 18% for holidays or a holiday home and 8% for a new car. 14% would think about it as a way of paying down an outstanding mortgage or other debt. Overwhelmingly, though, the most popular reasons would be to help children or grandchildren (37%) or to pay care home fees (39%).

Most millennials are very supportive of their parents’ plans to spend all the means they have to make the most of retirement, even though more than 90% recognise that it is harder for them to join the housing ladder than for their parents. But while baby boomers were remarkably well-informed about equity release, one in five millennials did not understand the terms equity release or lifetime mortgage, while around 15% had heard bad things about it.

2/3rds of baby boomers plan to leave an inheritance



Only 1 in 8 millennials are relying on an inheritance



Moguls and Other Obstacles

High costs

The two main parties in the manufacture of an equity release mortgage are the Funder and the Lender. As with all lending, lifetime mortgages require a capital base on which to lend. Traditionally, banks funded mortgages out of their deposits, but more latterly made use of capital markets and inter-bank lending. Lifetime mortgages are more usually issued on funds raised from sales of insurance policies such as individual and bulk annuities.

Funding costs represent over 90% of the total cost of issuing a lifetime mortgage. The lender's margin will be typically around 5%, with the remaining costs in the distribution chain – between 2% and 4.5%.

Cost is the hardest of the challenges to address. Fundamentally, equity release is always going to be an expensive way of funding later-life spending. Even at interest rates currently a little over 5% on average, the period of the loan coupled with the compounding effect (most customers do not service any interest payments) means that the mortgage amount owed will double after less than 15 years. So how much can costs for the end consumer be reduced?

- Funding costs cannot easily be addressed, owing to the requirements of Solvency II.
- The lender's margin will fluctuate based on competitor activity and underlying interest rates. However, cost savings can be made by implementing straight-through loan application processing and improving post-sale loan servicing.
- Advice and distribution costs are potentially addressable, through smarter use of technology to automate more of the journey. We expect to see increased use of algorithmic decisioning alongside human advice.

The No Negative Equity Guarantee

Actuaries at insurance companies like equity release mortgages, seeing them as a perfect matching asset against the liabilities of their annuity businesses. The current trend for defined benefit pension schemes to de-risk their liabilities through bulk buyout annuity arrangements offers insurers the opportunity to lend similar amounts out to equity release customers. The customers are in similar age brackets, thus, their likely longevity profiles are too, so it's reasonably easy to predict the cash flows between the books. The insurer takes a margin on both books of business while simultaneously solving an accounting challenge.

This beautiful symmetry relies, as with all insurance, on a great many assumptions. There's concern in some quarters that some of these assumptions will turn out to be wide of the mark. Kevin Dowd, Professor of Finance and Economics at Durham University, and Dean Buckner, formerly of the PRA and Bank of England, are particularly concerned about the "no negative equity guarantee" (NNEG). They point out that some equity release lenders are using a "Real World" valuation method to value the NNEG, as opposed to today's proven "Market Consistent" method which is appropriate to pricing of forward contracts²¹.

"This is Equitable Life all over again, i.e., the undervaluation of long-term guarantees!"

**Prof Kevin Dowd & Dean Buckner,
The Eumaeus Project**

In non-actuarial speak, these insurers are over-valuing the properties they are using as security for their loan books. In pricing up the risk of losing money on a mortgage, they are using the "future price" of the home (what it is expected to be worth when the home is sold) rather than the "forward price" (the price you would pay today for owning it later – which would be much lower). As a result, funders are underestimating the risk of the NNEG taking effect. The researchers also questioned assumptions about the future rate of house price inflation and the expected volatility of prices, arguing that some insurers have historically used more risky assumptions than the PRA recommends.

This has the potential for serious consequences. As described above, the customers who depend on positive yields from equity release are annuity policyholders. These current and future pensioners will lose out if large numbers of NNEGs kick in during a property downturn. Dowd and Buckner assert that this situation presents a future scandal of Equitable Life proportions just waiting to happen.

²¹ Equity release: another equitable in the making; D. Buckner and K. Dowd, November 2018

Moguls and Other Obstacles (cont)

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Image problem

In spite of the length of time the ERC (and SHIP, its predecessor) have been managing industry standards, some customers are still suspicious of equity release. A combination of factors is to blame, with examples including:

- Research tools that focus overly on the maximum available loans, rather than the needs of the customer; such tools can also lead to unrealistic expectations as customers input their perceived valuations rather than those of a specialist
- Customers researching products on the internet are often unable to find sufficient information without giving up personal contact details
- Having given out contact details, less scrupulous firms have been known to hound customers with repeated calls or emails seeking to set up a meeting with an adviser
- Sometimes, the true costs of completing a loan are hidden amid complex structures and lengthy documentation
- High early repayment charges may apply for a number of years from mortgage inception, and are not necessarily waived when a customer's circumstances change

A reputable firm will avoid these practices, but a few cases of bad practice damages the industry. The FCA will take more interest as the market grows. However, some factors are outside of the industry's control. For example, in spite of ERC guidelines to advise customers to talk to their relatives before taking out equity release, some borrowers prefer not to, which can lead to unpleasant surprises for their family when they die or go into care.

Regulation

In addition to the issue of customer vulnerability discussed above, there's a broader challenge facing equity release mortgages; the way they are regulated also creates a barrier to the consideration of these products as part of a holistic advice process.

Regulation coupled with the ERC code of practice, has gone a long way to establishing LTM as a safe option for retirement funding. However, equity release is regulated under the FCA's MCOB handbook, as for other mortgage business, whereas protection sales are regulated by ICOBS and all other pension and wealth advice falls under COBS. This simple disconnect makes it harder for an adviser to qualify and become a specialist across the full suite of retirement products, and goes a long way to explaining why the advice market has become polarised into wealth, protection, mortgage and later-life mortgage segments.

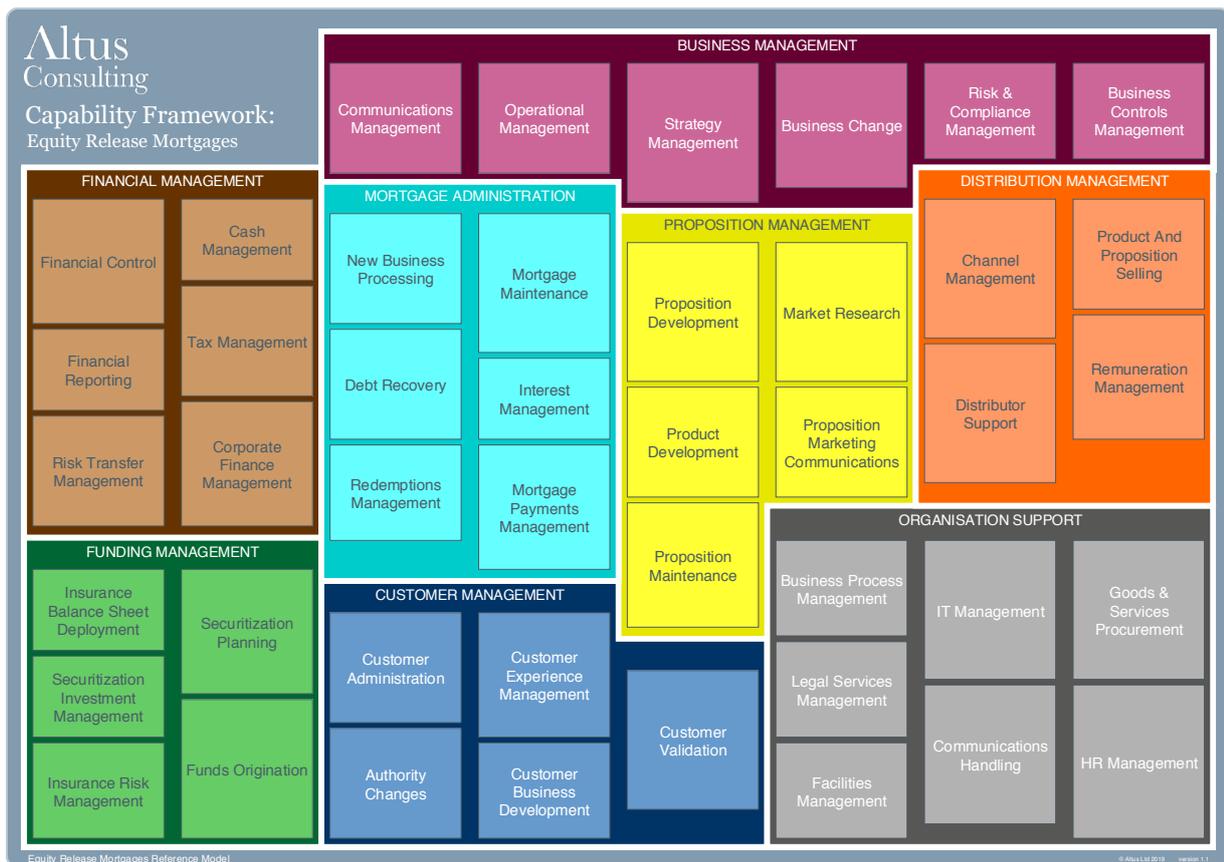
This does create a risk that an equity release specialist may not adequately consider a client's alternative sources of wealth, or of wealth advisers turning away customers whose needs could be addressed with later-life lending. This risk must be managed through carefully designed advice processes, as well as by advice firms employing the appropriate mix of specialist advisers or referral partners.

The image shows three overlapping regulatory document pages. The top page is titled 'MCOB 1.1 Application and purpose' and includes a table with columns for version, status, and date. The middle page is titled 'COBS 1.1 General application' and describes the scope of the sourcebook for designated investment and long-term insurance businesses. The bottom page is titled 'ICOBS 1.1 The general application rule' and lists specific activities covered by the rule, such as insurance distribution, effecting contracts, and managing underwriting capacity. A 'Previous' button is visible on the left side of the middle page.

Inefficient Processing

Customers complain about delays throughout the process. Problems range from inefficient or disjointed processes within the lender or adviser firm, to delays caused by outside parties such as solicitors and surveyors. Many parts of the mortgage application process originate from the last century – NatWest have only recently launched their signature-free mortgage service – and there is still plenty of scope for improvement across the industry.

In order to fully effect change, first it's vital to understand what a business does and how it works. Altus does this by building pictorial models to represent the intangible world of financial services. Through understanding the flows of information in the business, we a build comprehensive picture of what a business does – our Capability Framework – and how it does it – our Process Model.



The Altus Equity Release Capability Framework

Queueing at the lifts: the LTM client journey today

1 Research

The customer often starts by researching equity release online, to find out as much as possible about how it works and what the options are. This may take place over several weeks or even months.

2 Advice

Advice is mandatory for equity release, so the customer will approach or be directed to an adviser. Firms will usually perform a basic fact-find on customers to check whether they qualify for equity release, before passing qualified leads to the adviser. The adviser takes the customer through the regulated advice process to determine whether equity release is the right solution to their needs.

3 Initial Application

The application process consists of sourcing and packaging steps, and can be either fully automated (3a) or include manual steps or hand-overs (3b).

The adviser typically uses a sourcing system to find the best deal for the customer's needs and create a quote. The packager then collects all the required client data and evidence, applies for the mortgage, creates illustrations and returns the decision in principle.

4 Decision in Principle and Recommendation

The adviser then issues their recommendation to the customer and produces a suitability letter if the customer is proceeding.

5 Appoint Solicitor

The customer appoints an independent legal adviser. The solicitor will check that the customer has the mental capacity to enter the contract and has fully understood the terms and conditions. The customer signs the contract and the product application is submitted.

6 Survey and Valuation

Before the loan can proceed, the property must be inspected. A surveyor is appointed to value the property and check it qualifies against the lender's offer terms.

7 Survey & Valuation Complete

The lender is satisfied there is adequate security for the mortgage.

8 Mortgage Completion

The completion of legal contracts.

9 Mortgage Advance

Next, the mortgage account is opened. The lender releases the funds to the customer. Some firms are more efficient than others at doing this. The customer usually has the option for their legal adviser to process the payments, as for a standard residential mortgage.

10 Enjoying the Money

Equity release requires the customer to first repay any debts secured on the property. After this they are free to spend the rest as they choose.

11 Additional Drawdown Requests

With a drawdown mortgage, in most cases the customer no longer has an ongoing relationship with the adviser. Instead, they must contact the lender to request a further advance of funds.



Skiing Lessons

The Advice & Distribution landscape



Advice has been mandatory for customers seeking an equity release mortgage since 2004. The FCA Handbook²³ considers equity release customers vulnerable by default, therefore execution-only transactions are explicitly forbidden unless the customer has taken advice and rejected it.

This need for specialist understanding of rules applying to equity release advisors has led to a reduced availability of advice. At the time of writing, ERC membership comprises only 852 advisers from 257 firms. This compares to around 35,000 retail investment advisers on the FCA register – a number already inadequate to meet demand. Just 3 specialist groups (Key, Age Partnership and members of the Equity Release Club) have approximately a two-thirds market share – including the white-labelled advice services they offer to firms such as Legal & General and the Family Building Society.

L&G recently announced plans to offer advice directly, signalling a shift into vertical integration. Clearly this will increase the capacity of the market to cope with rising demand. How long will it be before they are followed by other insurers and retail banks already active in equity release lending?

How it works

The customer's journey often starts with weeks or months of research before reaching out to (or being proactively contacted by) an advice firm. It's then not unusual for a customer to speak first with an appointment booker, then a specialist paraplanner (for the initial fact find and eligibility checks) before finally talking to an adviser. These multiple hand-offs are often cited by customers as off-putting and can lead to an unnecessarily high drop-out of leads.

Because of the emotive nature and significant financial implications of the decision, most equity release advice at some point involves a face-to-face session. This is important as it is the point at which any vulnerability can most likely be detected.

Once the application is submitted, there is usually a further hand-off to a separate team to package and process the application. Independent legal advice, which customers are encouraged to take before completion, provides a further check to ensure that borrowers have mental capacity to sign the contract and have not been unfairly influenced to take out the loan.

²² List not intended to be exhaustive

²³ MCOB 4.2.1, MCOB 8.5A.1

Carving Out the Best Deals

The World of Mortgage Sourcing

Advisers and paraplanners will rely on sourcing software to select the best deal for the customer, based on their situation, needs and property type. These systems will either be directly integrated into the adviser's CRM system or as a standalone tool, and will filter out and rank suitable products and provide illustrations. For a lender to seriously compete in this market, they will need to provide quotes and illustrations to the top 3 or 4 sourcing systems.

There are many systems used across the mortgage market as a whole, but the main solutions in play for the equity release Market are Twenty7Tec's MortgageSource, AiR Sourcing (owned by Key), DPR, Iress, MortgageBrain and Knowledge Bank.

Package Deals

Application Packaging to cut administration overheads

You could be forgiven for thinking that the mortgage market has been stuck in the late 20th Century. It's long been possible to search for the best deals on comparison websites, but as soon as a customer wants to proceed with a chosen deal, there is an immediate need to sign forms and provide physical paperwork as proof of identity, source of wealth and earnings. Even where electronic copies of documents are permitted, firms often do not have secure portals for clients to use to send these.

As a result, customers have been using unsecure standard email to deliver documents which, if intercepted, could lead to identity theft or other fraud. Often the only secure way to communicate is via overland mail. This creates a mini industry in the mailrooms of adviser and lender firms and adds to the cost and time taken for an application to be approved.

Fortunately, things are changing. The Government's Verify service allows clients to prove their identity and digitally sign their mortgage deeds fully online. Challenger banks such as Atom have shown what is possible in terms of a fully electronic, straight-through journey from application to decision in

principle, with electronic paperwork submission and customer case updates by mobile phone app. Equity release lender More 2 Life offers a similar service to advisers through fastpath, with claimed service levels of 41 seconds to produce a KFI and less than 4 hours from application to offer. Case tracking on the app addresses one of the customer's biggest gripes – that they are left in the dark after submitting the application.



Après-Ski

Improving the Post-Sale Experience

Where a customer has an existing relationship with an adviser or wealth manager – who may be managing the client’s investment portfolio – the customer can expect regular meetings. They are most likely to approach their adviser about a need for an additional drawdown advance, at which point potential vulnerability could be reassessed.

For most lifetime mortgage customers, however, the advice is a one-time event. The adviser is paid their procurement fee up-front for the full amount reserved, even for drawdown where the initial advance may be only a fraction of the total authorised mortgage. This gives the adviser no incentive to provide further advice; in fact, doing so would incur additional cost and compliance risk. There is also no further trigger or requirement for legal advice. This means that the lender themselves must operate a customer service centre to facilitate further drawdowns, each time reassessing the customer’s situation for vulnerability.

The FCA’s Retirement Outcomes Review has placed focus on protection for customers of pension drawdown. Now, Independent Governance Committees (IGCs) have been given additional oversight duties to ensure pension customers receive fair value from their drawdown arrangements. Given this focus and the wider FCA work on vulnerability, we expect the regulator to implement further measures to protect equity release customers.

In the shorter term, this may take the form of mandating ongoing advice for drawdown customers and we would expect the FCA to issue guidance on a level of ongoing advice proportionate to the value of additional advances. If there is wider evidence of consumer detriment, the FCA could go as far as an RDR-style ban on procurement fees in favour of explicit adviser charging.

Summing up the Season

Lifetime mortgages or mortgages for life?

With property ownership concentrated among the over-40s, equity release looks like a short-term opportunity. At 32 years old on average, first time buyers are already older than ever, while mortgage terms of 30 to 40 years are becoming increasingly common. In Sweden the maximum mortgage term is 105 years, bringing a whole new meaning to the term “lifetime mortgage”. Millennials, a.k.a. “Generation Rent”, may never own their own homes. Yet they still aspire to do so. Our research shows a house deposit is the main savings goal for almost half of our respondents.

We will see more innovation

The equity release market is still evolving to meet the diverse needs of the growing numbers of customers, with the range of products more than doubling in 2018. Recent innovations include inheritance guarantees, to set a minimum value in the home to leave as legacy, and payment of regular income. Interest servicing, paying regular interest instead of letting it roll up and compound, is now more widely available, while some lenders now allow lending on second homes and AirBnB lets.

More firms will vertically integrate

We expect more firms to enter the market to meet the rapidly increasing demand. The addition of in-house advice at Legal & General is likely to lead others to consider vertical integration as a way of capturing more margin and reducing the cost to the consumer. Vertical integration also reduces the number of hand-offs and therefore, potentially, delays to the customer.

There will be new market entrants

A number of new players in the defined benefit de-risking market are set to expand the capacity for bulk annuities, and by extension create additional funding for more equity release lending. We also expect more banks and other firms to join or re-enter the lending market.

Millennials’ retirement will be very different

Millennials will live most or all of their working lives in the automatic enrolment era. Assuming current participation rates with minimum contributions, as well as the continuation of State Pension, their pension will never make them rich but most will reach today’s target for income adequacy.

Retirement will be very different for Millennials. Most people now in their 20s and 30s will retire from job types that don’t even exist today, or even move periodically between work, education and retirement, and back again, several times over a hundred-year life.

Their spending patterns will also be very different, with rental widely replacing ownership. Millennials don’t own music or films, they subscribe to Spotify or Netflix or watch YouTube for free. Instead of car ownership they favour Uber, and cabs will surely be self-driving well before 2050. There’s a sharing app for every need, from Spinlister for bikes, ski and surf equipment, to JustPark to park your car, SpareRoom to share your (rented) house and EatWith to host dinners for complete strangers. People will earn extra income from infrequently-used belongings.

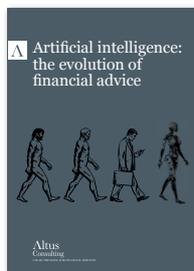
In summary

With the success of auto-enrolment, the kids will be mostly okay. Meanwhile their parents’ generation is looking to plug the gap in their pension saving by unlocking equity from their homes in record numbers. The industry has a duty to these customers to make equity release as affordable and sustainable as possible. Faced with exponential sales growth and increasing product complexity, technology and automation will play a key role in making sure firms can meet market demand while keeping costs low. The signs are good, as providers and FinTech firms continue to innovate, while new entrants will put further pressure on margins, to the ultimate benefit of the end customer.

Altus white papers

With our focus firmly on the regulatory, strategic, propositional, operational and technological challenges our clients face, Altus understands the most pressing issues for financial services. We publish market insight, industry commentary and are at the forefront of industry debate.

ARTIFICIAL INTELLIGENCE



The evolution of financial advice

‘Artificial intelligence: the evolution of financial advice’ considers how computers can now ‘outsmart the humans’, and whether Artificial Intelligence can really deliver financial advice.

ADDRESSING COSTS



Giving your platform wings

‘Giving your platform wings’ is an uncompromising look at the challenge facing investment platforms as they continue to seek sustained profitability.

AUTOMATING ADVICE



Rise of the Machines

‘Rise of the Machines’ explores the theme of robo-advice and looks past current implementations to the future of a smart-connected, personal financial management, well-being and lifestyle digital adviser.

DISSECTING INDUSTRY ISSUES



The Lose-Lose Game

‘The Lose-Lose Game’ pulls apart the true cost of pension saving for vulnerable workers and questions the foresight of government policy.

INSURTECH



The InsurTech Journey... are we there yet?

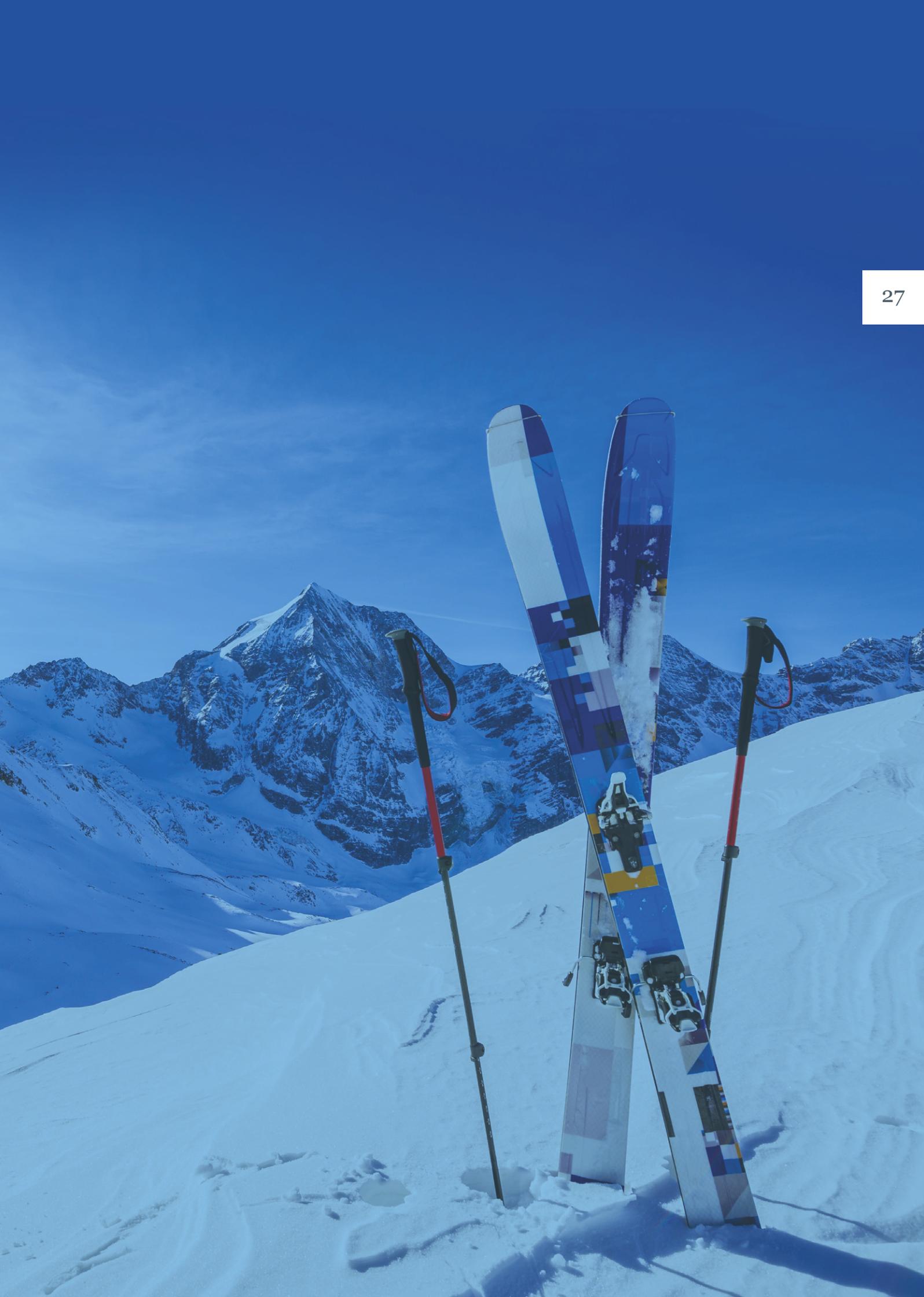
‘The InsurTech journey’ reviews the range of emergent trends in the insurance industry and predicts what the direction of travel means for the future.

REGTECH



Regulation is eating the world

‘Regulation is eating the world’ examines how firms currently deal with the growing volume of regulation, some of the challenges involved and how new technology might help.





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