
Home Reversion Plans

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1 Introduction – what are Home Reversion Plans?

Objectives

By the end of this chapter, you should be able to:

- Explain the main purposes of equity release products.
 - Describe the main features of a home reversion plan.
 - Explain the nature of the relationship between the home reversion plan provider and the customer.
 - Describe how a home reversion plan differs from alternative methods of releasing equity from a residential property.
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Introduction

Home reversion plans are one way of enabling a homeowner to obtain a capital sum, an income or both from his or her residential property. Owing to various factors that we will consider in detail shortly, equity release is big business in the UK and is likely to increase in popularity over the next few years.

This chapter defines the different types of equity release product available in the UK market and provides a comparison of the various products, serving as a platform on which to base more detailed analyses in subsequent chapters.

Principles of equity release

The increase in demand for equity release products in the UK in recent years underlines the fundamental difference between income and wealth. Most of us have an income of some kind, and more fortunate or more diligent people have more than one income. This is a flow of funds into the household on a (hopefully) continuous basis. By contrast, wealth is different – it is a pool or stock of wealth, built up or dissipated according to desire or need.

It is possible to have a very high income and no wealth. If this is the case, the individual or family simply chooses to spend (or give away) all the income received. Conversely, it is possible to be very wealthy and have little income. The wealth may be financial or non-financial in nature. If the former, there is no problem, as the wealth can be liquidated to buy the goods and services required to live. If the latter, there can be problems. This is where equity release comes in.

Economic trends have been kind to owners of real estate in the UK over many years. House prices have risen consistently for long periods of time throughout the twentieth century and into the early part of the twenty-first century. Brief periods of stagnation have occurred, such as the deflation in house prices witnessed in the late 1980s and early 1990s, when negative equity became the unanticipated nightmare for many homeowners, but in the long term, British homeowners have done rather well.

There are many thousands of people in the UK who can unlock the value in their homes by using equity release products. There are many reasons for doing so, and it is highly likely that the demand for equity release will increase in the future under the influence of a whole range of social and economic trends that will be considered later.

When in gainful employment, the need to release equity is not always compelling, although there is evidence to suggest that there is some “profit taking” when many families trade up (that is, they spend some of the appreciation in value of the home or use it to pay off debts, instead of ploughing it all into the new home). For more elderly people, equity release is becoming more appealing, and to some a necessity.

So why release equity? There are really only two reasons for doing so, although the underlying purposes may be more diverse:

- some people need to generate an income in order to maintain their standard of living or to avoid the effects of a reduction in income from other sources

Example

A stereotypical case in point is the person who has contributed to a personal pension for many years and finds that the income provided is disappointing; with a personal pension there are absolutely no guarantees of course. This may be more common in the future as many employers can no longer sustain their commitment to the more secure final salary pension schemes.

The unexpected need to enhance income in middle age or later life is nothing new. Many pensioners in the 1960s and early 1970s saw their incomes heavily diluted in real terms by persistently high levels of inflation (4% in the early 1960s; 24% in 1975).

- the need to liquidate capital

Example

The individual or family may require a cash sum for many reasons – to replace the car or carry out a major repair, to help out a relative's ailing business, get rid of high cost existing debts or simply to maintain a perceived minimum standard of living. Some people do not have such specific needs but just like to have a "nest egg" on which they can depend when unexpected demands arise.

What is a home reversion plan?

A home reversion plan enables a homeowner to sell his property, or a proportion of it, to a finance provider in order to raise funds immediately. The homeowner continues to live in the property as a tenant until he dies or until it is permanently vacated, such as when the occupier has to go into permanent residential care.

From this description it can be seen that:

- a home reversion plan is not a mortgage and therefore differs from other types of equity release product
- the plans involve a legal conveyance of the property or a share of it to the finance provider
- the former owner becomes a tenant.

Home reversion plans are not new. The first such plan was introduced in the 1960s as an income reversion scheme and was in fact the precursor to all forms of equity release.

The earliest schemes compelled the individual who raised the finance to invest in an annuity to generate an income for life. It is only in recent years, however, that equity release has become more popular, and with this popularity there has been a growth in the number of firms willing to offer such plans and a significant level of product innovation. There is no single home reversion model; plans vary widely from firm to firm, although they are based on the same idea.

The home reversion plan is designed to unlock capital tied up in a property. Crucially, the capital that can be released is often a much greater percentage of the open market value than that enabled by conventional equity release products.

The finance provider has to balance reward with risk, therefore the home reversion will never enable the customer to raise the full value of the property. There are two broad approaches that are adopted by providers:

- some reversion firms are prepared to purchase a 100% stake in the property
- others will purchase a proportion of the open market value.

How much capital can be raised?

The amount that can be raised varies widely, but a home reversion plan should enable the customer to raise between 35% and 60% of the value of the property or proportion of its value that is transferred. The percentage offered depends on the age of the customer; generally, older customers are able to obtain a higher value than younger customers.

Many reversion plans require the customer to pay rent. This can be a nominal value, such as £1 per month. Although this may seem pointless, even such a small payment serves as consideration (value) for the lease, thereby fulfilling one requirement for a legal contract to come into effect. If the customer is prepared to pay a higher rent, the reversion provider may be prepared to increase the capital value offered at inception.

The application process

Before a home reversion provider is prepared to offer finance, it is necessary for the property to be valued. This may be carried out by a physical inspection of the property by a suitably qualified person, in much the same way as a property is valued for conventional mortgage purposes. Some providers are prepared to forego the need for an inspection by valuing the property with reference to a national house values database.

Once the customer is satisfied with the reversion provider's offer, two contracts are created:

- the first contract transfers the legal ownership of the property, or the agreed proportion of the property, from the customer to the reversion provider

- the second contract is an open-ended lease in which the reversion provider, as the new owner of the property, is the lessor and the customer is the lessee.

The transfer of ownership incurs legal costs that are normally paid by the customer. However, the market for home reversion plans is a competitive one, so many providers are prepared to pay some of all of the legal costs involved. Some providers advertise a fixed amount (say £100) that they are prepared to put towards the legal costs. All transfers of ownership of real estate are subject to compulsory land registration, so there are also these costs to be taken into account. As nearly all home reversion plan customers are elderly, their properties may have been owned for many years. They may therefore be unregistered (compulsory land registration extended to the whole of Scotland from 2004 and the whole of England and Wales from 1990), in which case the reversion provider is compelled to make a first registration when the conveyance takes place.

The contracts

As the purchase contract transfers the ownership of the property, it differs little in principle to a conventional sale of a property. The process undertaken by the solicitor or licensed conveyancer is also similar to any other house purchaser arrangement. However, the purchase/sale arrangement is contingent on a lease coming into effect between the customer and the reversion provider. Stamp duty land tax is payable by the purchaser, with the rate dependent on the consideration paid. Although the purchaser pays for this, in reality this additional cost is probably factored into the price paid for the property.

Where only a proportion of the property is purchased, the registration particulars of the property will show two owners in the Land Register records. This means that when the property is eventually sold by the reversion provider, the price obtained will be split in the agreed proportions between the customer and the provider.

The lease between the customer and the home reversion provider is open-ended and creates a right for the customer to live in the property until one of the following events occurs:

- if the customer is a sole tenant, on his or her death
- if there are joint tenants, on the death of the second (or last) tenant
- if a sole tenant goes into permanent residential care with no reasonable prospect of returning to the dwelling
- if the last surviving tenant goes into permanent residential care with no reasonable prospect of returning to the dwelling
- if there is any material breach of the conditions of the lease by the tenant.

The provisions of the lease are similar to the conditions that apply to most residential mortgage customers.

The tenant is responsible for maintenance and repair of the property and for insuring it for its reinstatement value on a continuous basis. The tenant is obliged to comply not only with the conditions of the lease but also relevant legislation (such as planning laws), servitudes and covenants affecting the title. These conditions would of course already have applied to the owner.

The practical implications of home reversion plans

As far as the customer is concerned, raising finance by way of home reversion makes little difference to everyday life. The customer can still live in the property and the reversion provider does not interfere with this right in any way, unless there is some fundamental breach of the conditions of the arrangement.

The factors that may affect the customer would ideally have been taken into consideration at application stage:

- raising finance can affect the customer's right to claim State benefits, as some of these benefits are means tested with reference to savings
- it can also affect the right to claim grants and allowances for certain home improvements or energy-saving alterations (such as cavity wall and roof insulation)
- the value of the customer's estate will be diluted on death; the extent to which this occurs very much depends on how long the customer lives after purchasing the reversion plan
- the inheritance tax position of the customer may be affected by the purchase of the reversion plan.

These factors are considered in more detail in later chapters.



Quick question

What other types of equity release do you know of?

Write your answer before reading on.

Other types of equity release

In order to view home reversion in context, it is useful at this stage to provide an overview of other equity release products in the market. These are considered in greater detail in the CIOBS study book for lifetime mortgages. The purpose here is to give a broad but fairly shallow perspective on the products and services in the market place.

Virtually all methods of releasing equity (apart from disposing of the property and “trading down”) involve the customer in taking out a mortgage. The Financial Services Authority (FSA) classifies most of these products as lifetime mortgages. The main products are described in this section.

Home income plans

Home income plans enable the customer to borrow money and generate an income by investing the funds in a long term investment designed to generate income. The most suitable vehicle for this is an annuity. By purchasing an annuity, the borrower becomes entitled to a (usually) fixed income for life, some of which is used to meet the repayments on the mortgage.

These plans were developed in the 1980s and 1990s and were offered by specialist providers and some life assurance companies. Very few mainstream mortgage lenders introduced products of this type, although some forged strategic alliances with annuity providers to bring the product to market. Although the plans attracted some interest, they suffered some considerable adverse publicity in the late 1990s, particularly where the mortgage was tied into an income bond with variable returns.

It is still possible to purchase a home income plan today, but most equity release products no longer insist on the funds raised being invested in any particular manner.

Cash plans with regular payments or rolled-up interest

The most popular product is the mortgage that enables the customer to raise capital and use it at his or her own discretion. If a customer borrows money to raise a lump sum or generate an income, most lenders now adopt an entirely non-prescriptive attitude to what the customer actually does with the money.

There are two main product variations:

■ Open-ended basis

The mortgage may be set up on an open-ended basis with interest payments made to the lender. The capital balance remains constant in the same way as any other interest only mortgage. As interest is cleared on an ongoing basis, the capital value is predictable and is discharged on the death of the borrower or when the borrower goes into permanent residential care. The contract between the customer and the lender is usually a standard security (legal charge in England, Wales and Northern Ireland) and stipulates no redemption date for the mortgage.

When the contract involves payments of interest, the lender is obliged by law to assess both suitability of the product and its affordability.

■ **Open-ended interest only mortgage**

The second variant is an open-ended interest only mortgage on which no payments are made by the borrower at all. Interest is charged to the account and rolls up until the borrower dies or goes into residential care. This has a rather profound effect on the level of debt, as the interest charged to the account increases over time due to compounding. As a general rule, it can be assumed that the capital debt will double after about ten years.

When the contract involves no payments to the lender, it is not necessary to take account of affordability but the lender must assess the suitability of the product before the contract is settled.

Both of these product types are restricted by lenders to customers over a particular age threshold. As we shall see, most of the products in the market are regulated lifetime mortgage contracts and lenders therefore have to comply with FSA rules.

Shared appreciation mortgages

The shared appreciation mortgage was introduced in the 1990s and commanded considerable publicity as its design departed from any existing mortgage arrangement at the time. Like the rolled-up interest arrangement, it enables a customer to raise capital and make no payments to the lender. However, the shared appreciation mortgage foregoes interest completely, with the lender taking its income (and therefore profit) from a share in the increase in the value of the property that has occurred between creating the mortgage and the redemption date.

After a high level of interest initially, this product became less attractive to mortgage providers as the ability to manage risk is heavily dependent on being able to purchase suitable hedging instruments in the financial markets. This became difficult during the late 1990s due to prevailing market conditions. As a result, shared appreciation mortgages are now relatively uncommon today.



Quick question

How do home reversion plans and lifetime mortgages differ, or are there similarities?

Write your answer before reading on.

Home reversion plans and lifetime mortgages compared

We shall make a detailed product comparison in subsequent chapters, but it is useful at this stage to consider the crucial basic differences.

The nature of the contracts between customer and provider differs fundamentally. Most forms of equity release involve taking out a mortgage, but a reversion plan is not a mortgage or even any type of loan – it involves a sale of the property.

As a home reversion plan requires the legal transfer of a property, this has a massive impact on the make-up of the customer's estate and therefore has a profound potential effect on rights to benefits while living and liability for inheritance tax on death. By contrast, most mortgage-based equity release products enable the customer to retain full ownership of the property. Although the net value of the estate may be diluted by the rolled-up debt on a lifetime mortgage, the property itself will be vested in the personal representatives when the borrower dies.

A major practical implication of the type of product used is the amount of capital that the customer wishes to raise. Generally, mortgage-based equity release arrangements restrict the customer to borrowing up to 25% of the value of the property. Home reversion plans enable a higher proportion to be raised (perhaps up to 70% of market value), but does involve the “emotional baggage” associated with selling off the family home. Rationally or otherwise, sentiment can have a significant impact on the customer's decision.

Review

Now consider the main learning points which were introduced in this chapter.

Go through them, match them to the objectives at the beginning of the chapter and only move on when you are happy that you fully understand each point.

Reread any section you are unsure of.

- Home reversion plans are a method of raising funds by selling a residential property to a reversion provider.
- The customer becomes a tenant with the right to occupy the property for life or until it is necessary to enter permanent residential care.
- Under a home reversion plan, the owner of a property can sell either the whole property or a proportion of it to the reversion provider.
- The customer can usually raise 35 - 60% of the market value of the property under a reversion plan. The maximum percentage usually depends on the age of the customer.
- By entering into a lease, the customer continues to enjoy most of the rights of an owner-occupier. The obligations for repairs, maintenance and insurance are retained.
- Under most reversion plans, a small rent is paid by the customer to the reversion provider. The lease lays down the rights and obligations of the two parties to the agreement.
- Home reversion plans differ fundamentally from most other methods of equity release. Unlike lifetime mortgages, reversion plans are not loans. They are a specific type of sale and leaseback arrangement.
- Other types of equity release products include home income plans, cash plans with or without repayments, and shared appreciation mortgages.



Key words in this chapter are given below. Use them to write your own revision notes and add any other words or phrases that you want to remember.

equity release

lifetime mortgages

home income plans

cash plans

rolled-up interest

shared appreciation mortgage

2 Regulation of the Equity Release Market

Objectives

By the end of this chapter, you should be able to:

- Describe the regulations administered by the Financial Services Authority.
 - Explain whether different products and services are regulated or unregulated.
 - Define the terms “home reversion plan” and “lifetime mortgage” in the context of official definitions provided by the Financial Services Authority.
 - Explain the underpinning rationale for regulation of equity release products and services.
 - Describe the ways in which product providers regulate themselves.
 - Explain how consumers are protected by the law.
-

Introduction

This chapter deals with the regulatory system applicable to equity release products and services. It is important to point out that the system is relatively new, having been given a complete overhaul by the introduction of the *Financial Services and Markets Act 2000*. The system continues to evolve through actions taken on an ongoing basis by the Financial Services Authority (FSA) to create a more integrated system of regulation.

Prior to the *2000 Act*, the main focus of regulation was on providers of savings and investment products rather than personal borrowers. This changed fundamentally under the new system.

Regulation

The FSA regulatory structure

The powers of the FSA came into effect in 2001. In creating a new regulatory structure, the FSA carried over some features of the system previously adopted but introduced some entirely new features.

Central to the system of regulation is the FSA Handbook. This is a definitive reference for all regulated firms. Some parts of the Handbook are applicable to all firms, while others apply to specific groups of institutions.

The High Level Principles apply to all regulated firms and set down generic standards with which all providers are expected to comply. Although their precise content has changed over time, the principles have substantially the same purpose as those introduced under the previous regime administered by the Securities and Investments Board (SIB).

The FSA High Level Principles

Principle	Obligation
Integrity	Business must be conducted with integrity
Skill, care and diligence	Business must be conducted with due care, skill and diligence
Management and control	Reasonable care must be taken to organise and control the affairs of the business with adequate risk management systems
Financial prudence	Adequate financial resources must be maintained
Market conduct	Proper standards of market conduct must be observed

Customers' interests	The provider should pay due regard to interests of customers and treat them fairly
Communications with clients	The provider must pay due regard to the information needs of its clients, and communicate in a manner that is clear, fair and not misleading
Conflicts of interest	Conflicts of interest must be managed fairly, in relation to itself and its customers and between customers
Customers: relationship of trust	Reasonable care must be taken to ensure suitability of advice and discretionary decisions for any customer entitled to rely on it
Clients' assets	The provider must arrange adequate protection for the assets of clients
Relations with regulator	Dealings with the regulator must be conducted in an open and cooperative manner, and disclosures must be made to the FSA in relation to anything of which the FSA would expect reasonable notice

Specific regulations are set down in various sets of rules, including:

- the Conduct of Business rules (COB), relevant to providers of regulated investments
- the Insurance Conduct of Business (ICOB) rules, relevant to providers of general insurance products and some life assurance products
- the Mortgage Conduct of Business (MCOB) rules, relevant to providers of regulated mortgage contracts.

Further regulations and guidelines are laid down in sourcebooks, including prudential management, training and competence and systems and controls. Some sourcebooks are tailored to specific providers, such as the rules relevant to credit unions.

Over time, the FSA system continues to evolve. Some sets of rules have been introduced and then replaced, the most recent example of which was the Money Laundering Sourcebook in 2006.

A major shift in FSA philosophy has been the move towards a risk-based approach, which abandons the "one size fits all" approach through prescriptive rules in favour of a requirement to compel regulated firms to make a risk assessment in relation to compliance and then create appropriate controls.

Regulation of mortgages and other financing products

Although it has long been recognised that those who save and invest should be the focus of regulatory measures in order to protect their interests, the FSA has in recent times expanded its rules to cover lending and insurance business.

In the late 1990s the government considered whether residential mortgages should be regulated and the ensuing consultations resulted in the introduction of the Mortgage Conduct of Business (MCOB) rules in October 2004. These rules are administered by the Financial Services Authority (FSA) as sole regulator of the UK financial services sector. They regulate most types of residential mortgage, though not commercial mortgages or those not secured by standard security (legal charge in England, Wales and Northern Ireland). As we have already seen, home reversion plans are not mortgages, so they fall outside the MCOB regulations. Subsequent debate on this has resulted in the regulation of home reversion plans for the first time with effect from 2007, with tailored regulations built into the MCOB rules.

Straightaway, therefore, we can differentiate between products and services which are regulated and those which are unregulated as at March 2007:

Regulated products	Unregulated products
Conventional mortgages and lifetime mortgages secured by first mortgage on land held for residential use by private individuals	Home reversion plans
	Commercial mortgages
	Second and subsequent mortgages

Even before regulating home reversion plans, the FSA introduced a framework by providing some basic definitions of terms. The MCOB rules refer to all regulated equity release mortgage-based products as lifetime mortgages. This term is generic and applies to a wide range of products targeted at elderly borrowers, such as home income plans, cash plans, capital drawdown schemes and open-ended mortgages.

Home reversion plans

The FSA definition of a home reversion plan (the word “plan” is preferred to “scheme”) is set out in the Regulated Activities Order. It is an arrangement that includes the following conditions when the agreement is made:

- the reversion provider buys all or part of a qualifying interest in land from an individual or a trustee acting on behalf of a beneficiary
- the reversion occupier or related person is entitled under the arrangement to occupy at least 40% of the land in question as or in connection with a dwelling and intends to do so
- the arrangement specifies that the entitlement to occupy will end on the occurrence of one or more of the following:

- the reversion occupier becomes a permanent resident of a care home
- the reversion occupier dies
- the end of a specified period of at least 20 years from the date of the arrangement.

To clarify some of the terminology:

- the reversion provider is the company providing the finance under a home reversion plan
- the reversion occupier is the person who will occupy the property used to finance the reversion plan
- a related person can be a spouse or civil partner, a person whose relationship with the reversion occupier resembles that of husband or wife (whether opposite or same sex), parent, brother, sister, grandparent or grandchild
- the definition of “qualifying interest in land” is detailed and differs depending on the part of the UK in which the property is situated – it basically refers to freehold, leasehold or commonhold in all of the UK except Scotland, and to an interest of the owner in land in Scotland, but excludes timeshare property.

It is usual for the FSA to refer to organisations that are the subject of regulation as “firms”, thereby dispensing with the need to refer to different types of business, such as partnerships, companies and so on.

The FSA definition by no means includes all home reversion arrangements but does capture most products that enable the individual to raise equity by selling some or all of a residential property. It should be noted that the definition has some common ground with that of a residential lifetime mortgage contract, in particular the types of customer affected (private individuals and beneficiaries of trusts), the 40% limit and the open-ended nature of the product. One key difference is that, unlike the definition of a regulated lifetime mortgage contract, that of the home reversion plan makes no reference to the fact that the customer is likely to be elderly. As we shall see shortly, this is a feature of the FSA definition of a lifetime mortgage.

There are certain home reversion arrangements that would fall outside the criteria laid down in the FSA definition, including arrangements relating to:

- land and dwellings that do not meet the 40% criterion
- property that is not for residential use at all
- reversion plans relating to timeshare property
- reversion plans for relatives more distant than those included in the FSA definition
- commercial arrangements
- property outside the UK.

Lifetime mortgages

The MCOB rules include two specific sections relating to lifetime mortgages. This term is a generic one that refers to most types of open-ended borrowing by elderly people for equity release purposes. The MCOB rules only cover arrangements that meet the definition of regulated lifetime mortgage contracts.

There are four types of firm that have to adhere to all or specific sections of the MCOB regulations:

- mortgage lenders – this term is self explanatory and refers to the organisations that actually finance the mortgage
- mortgage advisers – these are individuals who give advice to customers on behalf of regulated firms
- mortgage arrangers – these are firms that arrange mortgages on behalf of customers or other firms
- mortgage administrators – these firms carry out certain functions within the mortgage application process and in some cases post-completion administration (such as arrears and default management).

With the introduction of home reversion plan regulation in April 2007, the term “mortgage lender” has been broadened to include “providers” wherever a regulation applies to both lifetime mortgages and home reversion plans.

The definitions of regulated mortgage contracts and regulated lifetime mortgage contracts are convoluted but important to our study.

Under the MCOB rules, a regulated mortgage contract is one that meets the following conditions:

- a lender provides credit to an individual or to trustees
- the obligation of the borrower to repay is secured by a first legal charge on land (other than timeshare accommodation) in the UK, at least 40% of which is used, or is intended to be used, as or in connection with a dwelling by the borrower or (in the case of credit provided to trustees) by an individual who is a beneficiary of the trust, or by a person who is in relation to the borrower or (in the case of credit provided to trustees) a beneficiary of the trust:
 - that person’s spouse or civil partner, or
 - a person (whether or not of the opposite sex) whose relationship with that person has the characteristics of the relationship between husband and wife, or
 - that person’s parent, brother, sister, child, grandchild or grandparent.

The FSA definition refers specifically to “first legal charge”. This term is replaced by “standard security” for mortgages created in Scotland.

It can be seen, therefore, that the description of a home reversion provided by the FSA has much similarity to the definition of a regulated mortgage contract. The latter was produced much earlier, having been included in the original MCOB rules published in 2004.

A regulated lifetime mortgage contract has a more detailed definition. First of all, it should be emphasised that in order to be a regulated lifetime mortgage contract, it must meet all the criteria of a regulated mortgage contract.

A regulated lifetime mortgage contract is a contract under which:

- **entry into the mortgage is restricted to older customers above a specified age,**

and

- **the mortgage lender may or may not specify a mortgage term, but will not seek full repayment of the loan (including interest, if any, outstanding) until the occurrence of one or more of the following:**

- **the death of the customer, or**
- **the customer leaves the mortgaged land to live elsewhere and has no reasonable prospect of returning (for example by moving into residential care) or**
- **the customer acquires another dwelling for use as his main residence, or**
- **the customer sells the mortgaged land, or**
- **the mortgage lender exercises its legal right to take possession of the mortgaged land under the terms of the contract**

and

- **while the customer continues to occupy the mortgaged land as his main residence:**
 - **no instalment repayments of the capital and no payment of interest on the capital (other than interest charged when all or part of the capital is repaid voluntarily by the customer) are due or capable of becoming due, or**
 - **although interest payments may become due, no full or partial repayment of the capital is due or capable of becoming due, or**
 - **although interest payments and partial repayment of the capital may become due, no full repayment of the capital is due or capable of becoming due.**

It is worth spending a moment rereading the above definitions to understand their full meaning. The definition of a regulated mortgage contract basically takes in virtually all personal house purchase mortgages secured by first mortgage, but excludes mortgages secured by second or subsequent charge, commercial mortgages (including most buy-to-let mortgages) and those on properties to be occupied by distant relations. The definition of regulated lifetime mortgage contracts takes in most open-ended equity release products secured by first mortgage in which product eligibility is restricted with reference to age.

The MCOB rules

The MCOB rules provide a detailed framework for regulated mortgage contract sales, processing and administration. There are in excess of 700 individual rules. This section therefore provides an overview of the most important rules. Remember, these rules do not apply to home reversion plans; they are described here purely to provide an overview of the regulation of mortgage-based equity release products.

Advertising and promotion

The rules set out requirements in respect of marketing of regulated mortgages. They compel providers of information to adopt specified minimum standards, such as providing information through a durable medium (basically, a medium that cannot facilitate alteration). The rules distinguish between real time and non-real time promotions, with specific rules for each.

Pre-application disclosure

The provider of advice or information to the customer must disclose certain information at different stages of the pre-application process.

Anyone who is likely to do business with the provider must be given an initial disclosure document (IDD) which provides basic information such as:

- name, address, registration number and other contact details of the firm
- the level of service provided – whether advice will be given or simply information to help the customer make a choice
- whether the firm is acting for a single mortgage provider, a range of providers or the whole market
- details of the FSA, including how to check the firm's registered information on the FSA database
- whether the firm is a member of the Financial Ombudsman Service and the Financial Services Compensation Scheme.

If the firm does not give advice, it can help the customer narrow down the choice of product by asking questions that have been scripted in advance by a competent person.

Disclosure during the application process

When the customer has been given advice on a product, or has selected a product, they must be provided with a key facts illustration (KFI). This document is a hybrid of the key features document and suitability letter issued by investment advisers and sets out the full specification of the relevant product. This must include features, benefits and limitations as well as statutory warnings for certain products.

For lifetime mortgages, there are several tailored warnings for certain products.

Example

If the borrower takes out an interest only lifetime mortgage and is to make repayments, the lender must warn of the effects of an increase in interest rates and give a numerical illustration. For shared appreciation mortgages, the lender must demonstrate the effects of changes in house prices at different annual rates.

Most products involve payment of interest or charging of interest to the account. Where an interest rate is applicable, the lender must use the annual percentage rate (APR), calculated to a specified formula. This rate is mainly used to compare like-for-like products and takes into account the interest rate, the charging interval and the setting up costs of the loan. It excludes post-completion fees and charges except the fees payable at the end of the full term of the mortgage.

Post-completion rules

Customers must be provided with an annual statement setting out prescribed information.

Certain changes affecting the mortgage trigger new disclosure requirements. These include more obvious matters, such as a change in interest rate, but there are also rules on contract variations, such as adding or removing a name from the mortgage.

The MCOB rules also lay down specific requirements in relation to borrowers experiencing financial difficulties.

Quick question

What is the case for regulation?

Write your answer before reading on.

Why regulate at all?

Although it is generally accepted that savers and investors should be protected, not least from drastic events such as the insolvency of service providers, it has not always been accepted that borrowers or those who raise finance from their homes should necessarily enjoy the attention of regulators. However, there are several compelling arguments for regulation:

■ More complicated products and services

The financial services sector has been extremely innovative in recent years, providing a better choice for customers and designing products and services that are more tailored to customer needs. With this has come a greater complexity of the products themselves. A significant proportion of the population admits that they do not understand how a basic deposit account works, so the understanding of more “heavyweight” products must be far from universal. Regulation compels providers to adopt a transparent approach. This may attract accusations of a “nanny state” attitude, but it should be remembered that mortgage and financing products have very long term implications. Without regulation, there would be a much bigger problem of mis-buying – customers purchasing products that they do not need or products that may even be detrimental to them.

■ Mis-selling

The track record of the financial sector in selling to the public is not entirely clean. The majority of financial services providers are both reputable and professional, but the very fact that the industry deals with other people’s money is bound to attract providers of lower integrity. Regulation does not make them disappear, but it makes it more difficult for them to operate.

■ Protecting the vulnerable

Some products can be targeted at the most vulnerable people in society. This has long been a feature of consumer credit lending; for example, the salesman who sells kitchen improvements to old people but makes his profit from the high interest rate loan used to finance the improvement.

The markets for home reversion plans and equity release are excellent examples of how potentially vulnerable people can be attracted to products with rather compelling features and benefits. Regulation forces providers to adopt a transparent approach. Again, it may not solve all problems, as customers cannot be forced to read or pay full attention to statutory warnings, but it does reduce the prospect of exploitation.

The case for regulation of home reversion plans

In relation to home reversion plans, there are certain additional areas of vulnerability that have caused the FSA to extend its regulations to cover these plans, including:

■ Valuations of property

As the amount of equity that can be transferred is expressed as a percentage of the open market value of the property, it is essential that the valuation is a true and accurate one.

Example

If a property is worth £100,000 and a reversion plan enables the borrower to sell it for 40% of valuation, the customer is placed in an immediately disadvantageous position if the valuation states that it is worth only £85,000.

■ Tenancy agreements

Few tenants go through every word of a tenancy agreement, so there is potential for exploitation of the customer by including clauses in the agreement that are:

- plainly disadvantageous to the customer (for example, conditions that prejudice the security of tenure of the occupier) or
- too difficult for the typical customer to understand.

There is some statutory protection already in place, notably the *Unfair Contract Terms Act 1977* and the *Unfair Terms in Consumer Contract Regulations 1999*. Both pieces of legislation empower a court to set aside a term in a contract that is deemed to be unreasonable (which may apply if the term is not expressed in plain language or given insufficient prominence to reflect its significance). There is also specific legislation applicable to landlords and tenants.

■ Complaints and compensation

Under the MCOB rules, regulated firms must be members of the Financial Ombudsman Service and the Financial Compensation Scheme. Prior to regulation of home reversion plans, neither has applied to those who raise finance by selling their properties in return for a long lease.

In addition, many elderly people are unaware of their existing statutory rights or are reluctant to take legal action to defend themselves, mainly due to the prohibitive costs of litigation should their case fail.

Review

Now consider the main learning points which were introduced in this chapter.

Go through them, match them to the objectives at the beginning of the chapter and only move on when you are happy that you fully understand each point.

Reread any section you are unsure of.

- The system of regulation of financial services providers in the UK is administered by the Financial Services Authority.
- The cornerstone of the system is the high level principles, which apply to all providers. Specific regulations and guidance are set down in sourcebooks and sets of regulations applicable to certain products, services and activities.
- The FSA has now adopted a risk-based approach to its own operations, prioritising resources according to the perceived risks, and in some operational areas requires firms to apply a risk-based approach to compliance.
- Mortgage regulation is relatively new, with the introduction of the Mortgage Conduct of Business (MCOB) rules in 2004. These rules include specific sections devoted to lifetime mortgages.
- The FSA provides formal definitions of regulated mortgage contracts, regulated lifetime mortgage contracts and home reversion plans.
- The main focus of regulation is to protect the customer by requiring firms to make specified minimum disclosures both before and after a contract comes into existence, thereby enabling customers to make informed choices and responses to certain events.



Key words in this chapter are given below. Use them to write your own revision notes and add any other words or phrases that you want to remember.

FSA High Level Principles

Mortgage Conduct of Business rules

sourcebooks

regulated products

unregulated products

regulated activities order

reversion provider

reversion occupier

initial disclosure document

key facts illustration

3 Regulation of Home Reversion Plans

Objectives

By the end of this chapter, you should be able to:

- Explain the purposes of regulating home reversion plans.
 - Describe the position of the regulations within the FSA regulatory structure.
 - Explain the main provisions of the regulations on home reversion plans.
-

Introduction

The extension of FSA regulation to different types of financial products has been gradual. Investment products have been regulated for many years, with the substance of the regulations largely based on the system created by the Securities and Investments Board (the predecessor to the FSA) under the *Financial Services Act 1986*.

Mortgages and mortgage business came within the scope of FSA regulation for the first time in October 2004 with the introduction of the MCOB rules, then insurance became regulated with effect from January 2005.

The regulation of home reversion plans has been effective from 6 April 2007. The relevant law is the *Mortgages: Conduct of Business Sourcebook (Home Reversion and Purchase Activities) Instrument 2006*. This new set of regulations amends the MCOB rules and introduces an entirely new framework to which home reversion plan providers must adhere.

The position of the rules in the FSA framework

As indicated in the title of the new rules, they comprise a sourcebook, relevant to:

- lenders and providers (the first MCOB rules specified lenders only in this category)
- administrators
- arrangers
- advisers.

The last two of these are referred to generically as intermediaries. All of the above are referred to as “firms”, irrespective of whether they are sole traders, partnerships, companies or mutuals.

The rules are applicable to all firms that fit the FSA definitions of such providers. They have the force of law under powers vested in the FSA by the *Financial Services and Markets Act 2000*. Like all other sourcebooks, they are consistent with the high level principles and in many instances indicate which of these principles the individual rules seek to amplify or reinforce.

Although the rules introduce regulation of home reversion for the first time, it is important to note that the basic underlying principles of the original MCOB rules remain in place. For example, the requirement to issue pre-application and pre-settlement documentation in the form of the initial disclosure document and the key facts illustration is extended to reversion providers.

Scope of the rules

In relation to home reversion plans, the rules identify one single market with two distinct sectors:

- the market for lifetime mortgages
- the market for home reversion plans.

This is an important feature when dealing with disclosure requirements.

The rules remind providers that when sold alongside other regulated products, those other products must comply with other sets of rules, even where information is provided in a single document such as a combined initial disclosure document.

Communications with customers

Regarding home reversion products, providers must refer to them only as home reversion plans. No other name can be used. This is a forced change in style, as the majority of providers have previously referred to them as home reversion schemes which is no longer permitted.

All communications with customers must meet the overarching requirement of being:

- clear, fair and not misleading.

Customers should be provided with information at the various stages of the process using a durable medium (one that cannot be altered). The customer has the right to change the means of communication.

Amplifying the requirements of unfair contract terms legislation, the rules state that communications should be in plain, intelligible language.

Quick question

What is the difference between real time and non-real time promotions?

Write your answer before reading on.

Financial promotions

Any promotion of home reversion plans must be clear, fair and not misleading. It is permitted to engage in image or brand advertising, such as use of logos and general “straplines”, provided these do not convey detailed information on products that could induce customers to act without seeking further information and advice. If detailed information is provided in advertisements, then the content of these advertisements is subject to the rules, including the need to give the appropriate risk warnings.

The rules distinguish between real time and non-real time promotions. Real time promotions are those in which the company interacts with the potential customer instantly, such as through a telephone conversation. Non-real time promotions include advertisements and fliers. No unsolicited real time promotion of home reversion plans is permitted, unless the customer envisages it.

Non-real time promotions can only use the term “home reversion plan” to describe the type of product. The promotion should state prominently that it refers to a home reversion plan and that the customer should ask for a personalised illustration to understand the product features and risks. If made to or directed at an unauthorised home reversion provider, the promotion should state that a home reversion plan is a long term investment and a complex legal arrangement, and that expert independent legal advice should be obtained before commitment.

Any promotion should include all matters without which it would not be clear, fair and not misleading. Where a product feature is described, no less prominence should be given to the disadvantages than to the benefits. For example, if the plan advertises that a substantial cash sum can be liquidated from the property, the promotion should also state that the cash sum may be less, *pro rata*, than the value of the property transferred.

Plain, intelligible language should be used in all promotions. If the promotion is broadcast or otherwise made orally, it must be clearly audible.

The reversion provider must not misrepresent the purpose of the promotion; for example, it must not “dress up” the home reversion plan as something else. Any factual content or opinion should be substantiated. Opinions should be honestly held, and where another source is being quoted, the consent of that source is necessary.

Statements of fact, promises and predictions must be clear, fair and not misleading. Comparisons and contrasts should be verified. If assumptions are made, these should be prominently disclosed and presented in a fair and balanced manner.

The firm may not give a false indication of its independence and must not mislead potential customers in respect of its size or scale of activities.

Any warnings that the rules require to be given must not be diluted.

Promotions may not indicate that the FSA or any other government organisation have given approval to the product without permission.

Inducements

Where products are offered on a direct basis, it is forbidden to offer inducements to purchase where the inducements will give rise to a conflict with the firm's duties to the customer. If inducements are offered to sell products, they should not be expressed in sales volume terms, such as financial incentives to sign up so many customers within a given time period.

Quick question

What is the difference between an advised sale and a non-advised sale?

Write your answer before reading on.

Sales

In common with sales of other financial products, the FSA regards sales as either advised or non-advised. An advised sale is where a recommendation is given. A non-advised sale is where there is no recommendation but the customer chooses the product himself. In the case of advised sales, the provider is permitted to ask scripted questions prepared by a competent person. The competency of the person is judged with reference to the Training and Competence Sourcebook requirements.

Recommendations

The customer must be informed of the service to be provided by the adviser. This may be:

- offered independently, considering products across the whole market
- advice on products from a limited range of providers
- advice on a single product.

Independent advice

"Independence" requires further explanation. The firm must advise the customer whether it offers products from the equity release market in general (mortgage-based products such as lifetime mortgages and home reversion plans). If so, independence relates to giving advice on all products across this market place. If the firm only offers home reversion plans and not other types of equity release, it can still hold itself out to be independent provided it informs the customer that it only operates in that market.

Suitability

Any product offered must be suitable which means that it must fit the customer's needs, objectives, circumstances and preferences. Suitability may also be judged by evaluating whether the benefits outweigh the drawbacks. By implication, suitability suggests that other methods of raising funds and other products designed for this purpose are less suitable. How appropriate the product may be can be considered with reference to eligibility criteria, such as the amount required, and the need or preference for other features.

If more than one product is suitable, it is not appropriate to make a recommendation on both simultaneously. The recommendation is not regarded as suitable if it has been evaluated on the basis of being the "least worst" option.

The rules permit a firm to make a recommendation if the customer declines to seek advice on means-tested benefits, tax allowances and the scope for grants. A recommendation may also be made if the customer rejects the firm's conclusions on the suitability of alternative methods of raising finance. Similarly, a new recommendation can be made if an initial recommendation is rejected.

Where the customer is encountering financial difficulties or seeks to consolidate existing debts, the firm is obliged to take into account the broader considerations, including potential alternative courses of action, such as negotiating with creditors.

The adviser is not obliged to give advice on the implications of alternatives to home reversion such as:

- trading down
- renting
- delaying a decision due to changes in prices or interest rates.

Specific features of home reversion plans that must be considered in relation to suitability include:

- the duration of the right to occupy the property
- the protections applicable if dealing with an unauthorised provider.

Non-advised sales

The firm may use scripted questions that relate to:

- eligibility criteria
- customer preferences for his estate
- health and life expectancy
- future plans and needs
- preferences
- the need for stability
- other features.

The customer should be advised to consider all the alternative ways of raising finance. The customer services person is not expected to be an expert on taxation or State benefits, but should be prepared to advise the customer to seek advice if unsure from outside bodies such as the Citizens Advice Bureau.

Fair treatment

Firms are forbidden to apply high pressure sales techniques and methods. Customers may not be committed to the product before being given the opportunity to consider the illustration and the offer.

The rules oblige firms to protect the interests of customers to a reasonable standard. Special reference is made to certain events or matters that can expose the customer to risk, including:

- failure of the provider
- transfer of the provider's business to a third party
- other dealings with third parties
- failure to perform obligations to third parties.

If a reasonable degree of protection cannot be provided, the provider cannot offer the plan.

Specifically in relation to home reversion plans, the customer's interests would include the rights under the plan, in particular the right to occupy the property, and the right to retain an interest in the property.

Protection should be considered in relation to:

- quality of tenure afforded to the customer
- registration of title and other documents
- full and clear understanding by the customer of matters of importance
- confirmation where necessary from the customer's legal adviser that the customer's legal rights are protected to a reasonable standard and that the adviser has informed the customer of this.

Quick question

In what other ways should home reversion providers treat customers fairly?

Write your answer before reading on.

Reversion providers should treat customers fairly in other respects:

- there should be due regard to the interests of the customer in drafting, amending or imposing obligations and in exercising rights and discretion
- the grounds for termination of the plan by the adviser should not be unduly wide
- the grounds for termination of the plan by the customer should not be unduly narrow
- the customer should be given reasonable notice of termination of rights
- on termination of the plan, the customer should not be denied his beneficial interest that he expected to retain
- any rights of inspection should be subject to reasonable notice
- inspections must not be biased or contrary to the customer's interests
- there should be no unreasonable terms that affect occupation and uses of the property
- there should be no unreasonable terms imposed in relation to non-permanent vacation of the property
- any obligation to maintain the property should not exceed the standards at commencement of the contract.

The rules remind providers of their obligations under the Unfair Terms regulations which give the right to a court to set aside any term in a contract that it regards as unreasonable, where the consumer is a private individual and the provider is a business.

Valuation of the property

Any valuation of a property that is to be partly or wholly acquired under a home reversion plan should be valued by a competent valuer, independent of the provider. This rule appears to eliminate the existing practice of some providers of valuing a property with reference to a database, which can be quicker and cheaper but less thorough. However, the rules fall short of stating that the assessment must be a physical inspection.

- "Competent" is defined as being a suitably qualified member of a professional body.
- "Independent" means that the customer can choose the valuer; however the firm does have a right to reject the customer's choice based on competence to value.

The customer should also have appropriate remedy if the valuer fails in his duty of care. The rules use the complaints system of the Royal Institution of Chartered Surveyors as an example of this.

Partial home reversion plan

Where the customer retains a stake in the property, the rules compel the provider to:

- take reasonable steps to sell the property within reasonable period of time of termination of the contract, and
- obtain the best price reasonably obtainable.

In deciding what is meant by a reasonable time, the rules acknowledge that the firm must pay due regard to market conditions. There may also be other legitimate reasons for deferring a sale, such as waiting for a clawback period on a grant to elapse or putting right a defect in title that might otherwise prejudice obtaining the best price possible.

Where the firm arranges its reversion plan with an unauthorised provider, the firm remains responsible for protecting the customer's interests.

The sales cycle – disclosure requirements

The rules extend the requirements already applicable to regulated mortgage contracts and regulated lifetime mortgage contracts by requiring the provider to give specified minimum information at different stages of the sales cycle.

Where it is apparent that the customer is likely to do business with the firm, it is necessary to issue an Initial Disclosure Document (IDD). The purpose of this is to provide the customer with basic information on the provider, level of service, fee basis of advice, the FSA and redress schemes such as the Financial Ombudsman Service and the Financial Services Compensation Scheme.

Information and advice on specific products must be supported by a Key Facts Illustration (KFI), which is the broad equivalent of the key features document issued by the regulated investments adviser under the COB rules.

Both documents must be set out in the format prescribed by the FSA. The detailed notes that accompany the rules state the degree of discretion permitted in relation to layout and use of own company logo.

The rules acknowledge that any offer made to a customer may differ in content to the KFI, in which case material information must be disclosed.

Initial disclosure document

This document has eight sections:

1 The Financial Services Authority

This states that the FSA is the watchdog for the financial services industry and it is an FSA requirement to issue the IDD.

2 Whose products do we offer?

The firm indicates here whether it offers products from the whole market, from a limited range of providers or a single product of one provider.

3 What service will we provide you with?

The firm must state whether a recommendation will be made, or alternatively what information will be given from which the choice of product can be made by the customer.

4 What will you have to pay us for this service?

In this section the firm must state whether there is:

- no fee, but a commission on the transaction, or
- a fee at the outset.

5 Refund of fees

The firm states whether the fee, or any part of it, is refundable.

6 Who regulates us?

The firm confirms here that it is regulated by the FSA. This section must also include the communication details of the firm, its permitted business and how details can be checked on the FSA Register.

7 What to do if you have a complaint

The regulations bring home reversion providers within the Financial Ombudsman Service (FOS) for the first time. FOS provides a complaints service where the complaint cannot be resolved through the internal channels of the provider. If a complaint is upheld, FOS can award up to £100,000 to the customer. The customer also has the right to take the matter further through the courts if dissatisfied with the outcome of a FOS referral.

8 Are we covered by the Financial Services Compensation Scheme?

Again, home reversion providers are brought within this scheme for the first time. The Scheme provides for compensation for funds lost due to the insolvency of the provider. The maximum award payable is 100% of the first £30,000 lost, plus 90% of the next £20,000 lost. The maximum total award is therefore £48,000.

Illustrations

The purpose of an illustration is to provide in-depth information to the customer on a product or service that is being considered. As such, the rules require it to be an accurate reflection of actual costs. Under a proposed home reversion plan the full costs may not be known until some of the work is carried out. For example, it is likely that the legal fees for conveyancing and the insurance premiums will have to be estimated. The rules require these costs to be “reasonably accurate”. If an estimated property valuation is used, this must also be reasonable.

It is permitted to quote costs using a higher estimate, but this is not allowed if the purpose is to distort the relative costs of different products.

Where the customer accesses a quotation using an interactive medium such as the internet or interactive television, the system must display the relevant risk warning:

“This information does not contain all of the details you need to choose an equity release product. Make sure that you read the separate key facts illustration before you make a decision.”

The illustration must be personalised to the customer. Only one illustration can be issued for any single product considered by the customer. Where there are joint applicants, the illustration must be based on the longest life expectancy of the joint applicants.

Content of the illustration

1 About this information

This is a standardised statement of the requirement of the FSA to issue the illustration and its purpose. It encourages the customer to ask for information on other products and states that further information is available from the FSA.

2 What service are we providing you with?

The illustration states whether a recommendation will be given, or alternatively information only, from which an informed choice may be made.

3 What is a home reversion plan?

The home reversion plan is described using standard information laid down by the FSA. The content of this section may not be changed by the provider.

4 What you have told us

This describes the information provided by the customer that is relevant to the choice of product.

5 Description of this home reversion plan

The product is described in this section.

6 Benefits

This section states the benefits of the home reversion plan to the customer. It will usually state the sum that can be obtained by transferring the property or a share of it to the provider, plus a summary of the rights of the customer.

7 Risks – important things that you must consider

The risks can be given no less prominence than the benefits, so the impact on the customer's right to claim means-tested State benefits or grants and any adverse effects of the customer's tax situation must be included here.

8 What you will have to pay and when

The actual costs, or reasonably accurate estimates, must be set out here.

9 What fees you must pay

The fees payable to the provider and any other professionals are set out.

10 Insurance

This should be the actual cost of insurance or a reasonable estimate of the premiums to be paid.

11 What happens if you do not want this home reversion plan any more?

The illustration sets out the consequences of the customer changing their mind after the plan is in place. In most cases the effects of the plan are irreversible unless the plan offers a buy back.

12 Using a home reversion intermediary

This states the nature of intermediation and what can be expected by the customer.

Contact details

The firm must provide details of how it may be contacted by the customer.

Charges

The rules require firms to adopt a transparent approach to charges. For example, fees payable by way of commission or setting up the plan must be included in the IDD, and other fees and charges must be detailed in the KFI.

Although the rules are not prescriptive on the actual amount of charges that will be incurred, they oblige providers not to make excessive charges. "Excessive" is not defined in the rules.

Review

Now consider the main learning points which were introduced in this chapter.

Go through them, match them to the objectives at the beginning of the chapter and only move on when you are happy that you fully understand each point.

Reread any section you are unsure of.

- The MCOB rules are amended with effect from 6 April 2007. From this date, home reversion plans are regulated for the first time.
- Home reversion products must be described as home reversion plans.
- The rules support the FSA high level principles, especially in relation to communications with customers. All communications must be clear, fair and not misleading. The principles underpinning the duty to treat customers fairly are set out.
- The existing rules on real time and non-real time promotions are extended to home reversion plans.
- Promotional standards are set out, with emphasis on a transparent and balanced approach. Any drawbacks or risks cannot be given lesser prominence than benefits. The provider must make an assessment of suitability.
- Sales are advised or non-advised. An advised sale is where a recommendation is made on a specific product. A non-advised sale is where information is provided from which the customer may make an informed choice. Providers may use questions scripted in advance to help the customer narrow down the choice of product. These must be prepared by a competent person.
- A firm can only state that it is independent if it offers products from the whole market. In this context, the firm must make it clear whether “whole market” refers to the equity release market in general or one sector of it.
- Firms are obliged to issue standard documentation in prescribed format to the customer. The documents are the Initial Disclosure Document and the Key Facts Illustration.
- Charges must not be excessive.



Key words in this chapter are given below. Use them to write your own revision notes and add any other words or phrases that you want to remember.

Mortgages: Conduct of Business Sourcebook (Home Reversion and Purchase Activities) Instrument 2006

providers

intermediaries

clear, fair and not misleading

plain, intelligible language

real time promotion

non-real time promotion

advised sales

non-advised sales

fair treatment

competent, independent valuer

partial home reversion plan

initial disclosure document

key facts illustration

Financial Ombudsman Service

Financial Services Compensation Scheme

4 Home Reversion Providers and Customer Types

Objectives

By the end of this chapter, you should be able to:

- Explain the types of organisation that provide home reversion plan services.
 - Describe the target market for home reversion plans.
 - Identify different customer types that may purchase home reversion plans.
-

Introduction

The market for home reversion plans is very different to that for other types of equity release product. Most forms of equity release take the form of long term, open-ended loans, repayable on death or when the property is vacated by the borrower. By contrast, home reversion plans involve a partial or whole disposition of the property. Therefore, mainstream mortgage lenders have not led the market for home reversion plans and have not been active in provision of this product.

The target market for home reversion plans is however very similar to that for other equity release products. The providers in the market seek to attract older customers who for various reasons may wish to unlock capital in a residential property.

This chapter describes the providers in the market and the customer stereotypes to whom their products and services are targeted.

Home reversion plan providers

The nature of a home reversion plan lends itself more to property investment than to mortgage provision, therefore the main providers are mainly specialist companies with expertise in the home reversion market.

Banks, life assurance companies and building societies are all very actively involved in lifetime mortgage provision. As the lifetime mortgage is a variant of a conventional mortgage, these organisations already had considerable expertise in lending that could naturally be extended to the provision of lifetime mortgages when the market initially took off.

As the home reversion market expands (as it is expected to) it is likely that the major banks will become more actively involved, probably through specialist subsidiaries.

The building societies are not expected to diversify into home reversion schemes to any large extent. One reason for this is that at least 75% of the commercial assets of a building society must be advances secured on land for residential use. Although home reversion plans involve residential land, they are not advances and therefore fall outside this definition.

The main home reversion plan providers are some life assurance companies and specialist organisations. Very few such companies are household names, although major life assurance companies see home reversion plans as a natural extension to their existing equity release products. They vary in size from major players to smaller organisations. Many operate through the internet, as witnessed by in excess of one million "hits" when home reversion plans are searched on a popular search engine.

Home reversion plans are not provided directly by many high street financial institutions, although there are many financial intermediaries who are prepared to offer both lifetime mortgages and home reversion plans through agency arrangements.

How do home reversion providers operate?

Home reversion providers are usually limited companies, accountable to their shareholders. They will be funded by their own capital or that raised from the markets. They balance return with risk, trading off current capital expenditure for long term future capital growth. The prosperity or otherwise of the company will be determined by many factors:

- the cost of their own capital
- the ability to contain overheads and other costs
- the efficiency with which actuarial figures are deployed to price the reversion values paid and percentages offered to different age groups
- the rate of price inflation, and particularly the rate of increase in house prices
- the ability to market properties for the right price and sell on quickly and efficiently.

Quick question

What are the implications for reversion providers of increased life expectancy?

Write your answer before reading on.

As the sum to be provided to the home reversion customer depends on life expectancy, home reversion providers have to pay due regard to actuarial information. Life expectancy is a statistical concept rather than an exact science. One study suggests that the average male will live to 80 years of age and the average female will live four years longer than this. However, there are wide regional disparities across the UK, and in some towns and cities there can be a difference of as much as 10 years in how long people are expected to live.

It is thought that some of these variations can be dependent on factors as disparate as climate, lifestyle and genetics. Life expectancy is expected to increase with advances in medicine and changes in lifestyle. It should also be remembered that these increases affect those of all ages to a differing extent – the increase in life expectancy during one's lifetime results in the so-called "mortality drag" effect.

Just as lifetime mortgages can be arranged through financial intermediaries, so too can home reversion plans. Intermediaries can represent:

- one provider only
- a panel of providers, with any number of firms on the panel
- the customer.

If the intermediary represents the customer, it acts as agent for the customer in obtaining the most appropriate product in the market place. However, the arrangement is only subject to the general rules of agency. Now that home reversion plans are regulated, intermediaries must make similar disclosures to those applicable to lifetime mortgages.

The customer must be made aware of the level of service provided (whether advice or information will be given) and the basis of the service (independent, acting for one provider or for a range of providers). They must belong to the Financial Ombudsman Service and the Financial Services Compensation Scheme.

Customer types

The target market for home reversion plans is broadly similar to the market for lifetime mortgages. Generally, home reversion plans limit access to those over a specified minimum age, usually 50 years. The maximum percentage of the value of the property that will be provided varies directly with the age of the customer, therefore older customers will be able to raise more than younger customers.

The main requirements of home reversion customers are:

- the need to raise a cash sum
- the need to generate an income in retirement
- a combination of these.



Quick question

Why might the need for a cash sum arise?

Write your answer before reading on.

The need for a cash sum

Many people are entitled to receive a cash sum commuted from their pension at retirement. However, this is not something that everyone will receive, and even those who do expect such a payment can get a nasty surprise. One major reason for this is that final salary schemes have become increasingly unsustainable for employers in recent times and many schemes have been abandoned in favour of the less precarious defined contribution (money purchase) schemes. These shift all the risk away from the employer and on to the employee. The result is that the cash sum may be bigger or smaller than expected, and so too may the annual pension payable thereafter.

There are numerous reasons why an individual may want to generate a capital sum:

- the pension may provide less than anticipated
- the funds may be required to pay off high cost borrowings that cannot be serviced when income falls at retirement
- it is usually more difficult to borrow money, and to service new debt, as the person gets older
- the home may need to be modified or adapted, or consumer durables replaced
- it may be necessary to replace an asset, such as a car
- the individual may wish to help the children or grandchildren financially
- there may be no need other than the reassurance provided by having a cash sum available to draw upon as required in later years.

If the borrowing is to pay off existing debts, equity release can be an effective way of debt consolidation. This enables the borrower to bring together all existing debts and reschedule repayments over a longer time horizon. With a lifetime mortgage, the time horizon effectively becomes the individual's life expectancy.

Despite the obvious appeal of consolidating debts in this way, it may not necessarily be the best course of action. There are many other ways of dealing with debt, and advice is readily (and freely) available from bodies such as the Citizens Advice Bureau. For those with serious financial difficulties, the Consumer Credit Counselling Service provides specialist advice.

Of course, there are many more reasons for buying a home reversion plan for capital purposes. One major benefit over other methods of capital raising is that the home reversion plan generally provides a much greater percentage of the value of a property than a lifetime mortgage, perhaps up to double the amount.

The need for income

At retirement the individual is faced with two alternative scenarios:

- if appropriate plans have been in place for some time, income will reduce but to a manageable extent
 - those fortunate enough to be members of final salary occupational pension schemes will be able to predict their income for the long term; the income will be lower, but the size of the shortfall will depend on factors such as years of service, previous pension contribution history, the multiple used by the pension scheme and whether additional contributions have been made to top up future entitlement.
 - those who are members of defined contribution (money purchase) schemes have no guarantees at all; the defined contribution model is used for all personal pensions and stakeholder pensions, as well as a rapidly increasing number of occupational schemes. Income in retirement is unpredictable under the defined contribution scheme, though (in theory at least) the forecasts provided by the pension scheme should be increasingly accurate as retirement age approaches.



Quick question

What alternatives might have to be considered if an individual has not planned for retirement?

Write your answer before reading on.

- much more serious, the individual may not have planned for retirement at all
 - to most people in this position there is the drastic prospect of living at subsistence level, relying on State benefits such as Income Support and Pension Credit for perhaps 15 - 20 years or even longer, yet the reality is that this is precisely the problem that thousands of people face. They include not only those who live for today and are unconcerned about the future, but others who entered pension schemes too late (including many self employed persons) and some whose pension schemes ran into difficulties; so the stark reality for many households in this position is a consideration of some of the following alternatives:
 - sell up and trade down
 - sell up and live with the children or grandchildren
 - sell up and hope that the local authority can provide housing
 - take in tenants (not an ideal option for many elderly people)
 - take out a lifetime mortgage
 - sell part or all of the property to a home reversion provider.

The last two options are becoming increasingly popular and are likely to grow in demand in the future as the effects of the ageing population take hold.

The income generation capability of a home reversion plan is quite potent and at face value appealing in comparison with a lifetime mortgage.



Case study

Consider a 70 year old with a mortgage-free property valued at £200,000. He has been offered 25% of the value if he takes out a lifetime mortgage. This will be repaid on his death. He has also been offered 55% of the value of the property if he transfers ownership under a 100% reversion plan.

Another benefit of the home reversion plan is that by paying a higher rent, the reversion provider may be prepared to pay a bigger sum to the customer, trading future inward cash flows for more capital outlay now.

The lifetime mortgage will provide him with a cash sum of £50,000. If this is invested in a purchased life annuity with a rate of 4% he will receive £2,000 per annum. The home reversion plan will provide him with a cash sum of £110,000 which at the same annuity rate will provide an income of £5,500 per annum. This may be the deciding factor between the two products. As we shall see, it is not the money alone that should determine the choice of product.

Quick question

What other needs or concerns might an individual have?

Write your answer before reading on.

Other needs

The decision to take out a home reversion plan should not turn on monetary considerations alone. A typical customer may have more concerns such as the following factors:

Suitability

Quite simply, the customer may ask "is it for me?" It must be remembered that the majority of customers will have no mortgage at all or a very small balance outstanding. In most cases they think that the days of worrying about housing finance are permanently over, therefore the prospect of talking about a home reversion plan is understandably daunting. Under the regulations, providers of home reversion plans *must* make an assessment of suitability.

Affordability

This is not an issue for most home reversion plans, as the only outlay is normally a nominal rent. However, the customer may be concerned about set-up costs, including:

- legal fees and outlay, including fees associated with setting up the lease
- valuation
- arrangement or administration fee
- other expenses.

Simplicity

Research has established that many people find basic savings and borrowing products difficult to understand. Lifetime mortgages go one step further and can be highly confusing.

Arguably, home reversion plans can be more difficult, particularly if the adviser proposes a partial transfer of the property, therefore the adviser needs to explain the features, benefits and drawbacks of home reversion very carefully.

Security

A sale of a part or all of one's home implies a loss of control. Customers may be concerned that the change from owner-occupier status to tenant will result in a dilution of rights. In fact, very few equity release schemes make much material difference to the circumstances or lifestyle of the customer other than to provide finance.

In relation to home reversion specifically, the rights and obligations of the tenant are no more onerous than under a conventional residential mortgage.

Emotional attachment

This is a real concern for many elderly people. The implication is that by selling part or all of the property this means that the "family silver is being sold". It may be especially difficult for those whose home has been in the family for several generations.

Inheritance

All equity release products have the potential to reduce the value of the estate left to the beneficiaries. Under a home reversion plan, this has a drastic effect if the person raising the finance dies soon after entering into the contract, as all that will have happened is that a high value asset (the property) will have been exchanged for a lower value asset (the cash).

A further consideration is that, unlike the lifetime mortgage, a home reversion plan transfers all the benefits of rising property values away from the customer and his successors in favour of the reversion provider.

Example

If a property was sold under a reversion plan in 2005 for £100,000 but was worth £200,000 at that time, and is then sold on the death of the occupant in 2007 for £275,000, the estate will have lost out on the £75,000 increase in the value of the property as well as the £100,000 shortfall suffered by entering into the plan.

Inheritance tax mitigation

A home reversion plan has the potential to reduce the inheritance tax burden on the estate as it transfers some or all of the ownership to the reversion company. As the sum paid is a percentage of the market value, this has an immediate effect of reducing the value of the customer's net assets and also eliminates the prospect of increases in property values taking the owner over the inheritance tax threshold.

Although home reversion plans have some advantages over lifetime mortgages for inheritance tax purposes, it must be stressed that they are a relatively inefficient way of reducing a liability. There are better ways of escaping from tax liabilities. Therefore, the potential reduction in inheritance tax is only relevant when comparing products in a situation where a decision has already been taken that equity release is the only way forward.

The "better off" test

The customer needs to be certain that he will be better served by taking out a home reversion plan than by not doing so which means in practice that the overall benefits should outweigh the overall disadvantages.

One major consideration here is the potential loss of State benefits. Some benefits are means tested on the basis of savings, so they will be lost automatically if a capital sum is placed on account and exceeds the means test threshold.

As a general rule, benefits that are means tested with reference to the level of savings are lost if the individual has £16,000 or more in savings, with higher thresholds as the claimant gets older. However, some benefit rates are reduced at lower savings levels.

The right to certain grants for home improvements and environmentally-friendly modifications (such as cavity wall insulation and loft insulation) may also be affected by the individual's level of savings.

Advisers are obliged to bring these matters to the attention of potential customers, although they are not expected to be experts on taxation, benefits or grants.

Eligibility criteria

The borrower's circumstances

Home reversion plans are not available to everyone. They are specifically designed for elderly persons. Some reversion providers make their plans available to those over 50 years of age, which is hardly elderly, but others restrict entry to those over a higher age than this. There are numerous reasons for this. The risk to the reversion provider would be greater if plans were sold to younger persons, and in any event the product has little or no appeal to those who can raise finance by alternative means, such as borrowings that can be serviced out of regular income.

Apart from a nominal rent charge, the home reversion plan does not require the customer to make regular payments, so there are very few persons who would be excluded from the product on the basis of their income. It is necessary of course for the customer to be able to afford the running costs of the property, such as gas, electricity and water charges. Most reversion providers also require the occupier to continue to pay the council tax on the property, which for most is probably the largest monthly outgoing associated with running the property.

The borrower must have the legal capacity to enter into the legal conveyance transaction and be a party to the lease.

The borrowers must have unencumbered absolute title (freehold, leasehold or commonhold title in England, Wales and Northern Ireland) to the property at the time the reversion plan is set up. If there is a mortgage outstanding on the property, the reversion provider will normally insist that this is discharged before the contract is finalised. As the reversion provider will become the new (or partial) owner of the property, any other debts secured on the property will also either have to be discharged or converted to unsecured loans. It is up to existing lenders whether they are prepared to do this.

Many of those who take out home reversion plans are couples. This is not a major issue for the home reversion provider, who will construct the lease on the survival or continued occupation of the property by the last survivor. This means that if one spouse or partner dies, the survivor will be permitted to continue to occupy the dwelling until death, going into permanent residential care or vacating the property permanently for other reasons.

If there are other, younger occupiers of the property, the home reversion provider would be concerned to ensure that they do not secure a right of residence that extends beyond the death or vacation of the property by the last surviving party to the reversion agreement. Such a right is called an overriding interest, which can be created under the *Land Registration Act 2002* by the non-owning occupier in any part of the United Kingdom except Scotland. If created, the overriding interest may prevent the home reversion provider from obtaining vacant possession when it wishes to sell the property.

Therefore, the provider will ask for details of all residents in the property and require those who are not party to the scheme to waive any rights of residence. This complication does not apply under Scots law.

The property

The concerns of the home reversion provider are similar to those of a mortgage lender. The eventual sale of the property is the only practical way for the home reversion provider to get the money back and hence make a profit. Therefore, it has to be confident that the property will be marketable and that it will hold (and hopefully increase) its value over a relatively long period of time.

Real estate is different to most other types of asset in that it should increase in value over time. However, the value may be affected by many factors, including its structural integrity, tenure, location and method of construction. In addition, external factors may affect the value of the property, such as local development plans for the area in which it is located and any initiatives planned for buildings and land that are immediately adjacent to the property.

The policies of home reversion providers vary. Some require a valuation to be carried out, while others make a more superficial assessment based on the information available from databases.

Review

Now consider the main learning points which were introduced in this chapter.

Go through them, match them to the objectives at the beginning of the chapter and only move on when you are happy that you fully understand each point.

Reread any section you are unsure of.

- Most home reversion providers are specialist organisations. They are mainly limited companies. As home reversion plans are a focus or niche market, they have attracted little attention from mainstream mortgage lenders such as banks, building societies and life assurance companies.
- Some of the participants in the market are financial intermediaries. These may represent one provider, a panel of different providers or act as agent for the customer in seeking the most appropriate product in the market for the customer.
- The main target customer base for home reversion plans is elderly persons. Entry to the plans is restricted with reference to age, and the amount that can be raised is dependent on the age of the customer at the time the contract is completed.
- Home reversion plans are potentially suitable for those who need to release a one-off capital sum from their property and those who wish to generate a regular income in retirement to complement their existing income. These needs are likely to grow in the future.
- A major attraction of home reversion plans is that it is generally possible to raise a larger sum than through alternative forms of equity release.
- In order to apply for a home reversion plan the customer must have reached a specified age and be capable of meeting any other eligibility criteria laid down by the plan provider. Joint applicants are usually accepted on the basis of the plan subsisting until the last survivor dies or vacates the property permanently.
- Not all properties are acceptable for reversion plan providers. The property must be in sufficiently good condition to persuade the provider that it can be sold for a profit eventually. Other factors affecting marketability of the property are also important.



Key words in this chapter are given below. Use them to write your own revision notes and add any other words or phrases that you want to remember.

final salary (defined benefit) pension scheme

money purchase (defined contribution) pension scheme

need for cash sum

need for income

suitability

affordability

simplicity

security

emotional attachment

inheritance tax

“better off” test

5 The Application Process

Objectives

By the end of this chapter, you should be able to:

- Explain the legal and administrative processes through which a home reversion plan is set up.
 - List the matters that should be considered by the applicants when deciding on whether to release equity through a home reversion plan, including the features, benefits and drawbacks in comparison with other products.
 - Explain the risk factors that should be considered.
 - Explain why it is essential for the customer to take independent legal advice before committing to a home reversion plan.
-

Introduction

In this chapter we deal with how a home reversion plan is set up. We consider the actual process and the role of the different parties involved in it. A home reversion plan involves two initial transactions – the sale of part or all of the property to the reversion provider and the creation of a lease in which the provider is the lessor and the occupant is the lessee. We look at the rights and obligations of the parties and their future ramifications.

Most home reversion customers have other options that they can explore in order to assess the suitability or otherwise of the product; for example, they may consider a lifetime mortgage or trading down. As the home reversion is irreversible, careful attention should be given to all the options and advice should be sought from appropriate qualified or experienced persons in order to evaluate the benefits and risks. In particular, potential home reversion plan customers should take independent legal advice before entering into any legally binding agreement.

The process

The process of setting up a home reversion plan may be summarised as follows:



Consideration of equity release options

The options available to a potential equity release customer are:

- trade down to a smaller property, thereby releasing some surplus funds for future needs
- sell the property and rent another or live with relatives
- take out a conventional mortgage if eligible
- borrow from relatives or low cost sources of finance
- take out a lifetime mortgage
- rent part of the property to tenants to generate income
- rent the whole property and make alternative living arrangements
- take out a home reversion plan.

All of these options have benefits and drawbacks. Some customers will rule out certain options immediately and others may not have all of the options at their disposal. For example, not everyone can live with their relations, and many would not want to do so.

Quick question

What are the benefits and drawbacks of trading down?

Write your answer before reading on.

Trading down

Many owner-occupiers regard trading down as a viable option for them. It involves selling an existing property and buying one for a smaller price.

Generally, families tend to trade up while in regular employment. This is entirely logical, as families get bigger and need more space. Eventually the children leave home so the space that has been created by many is now superfluous to their needs. Bigger homes are more expensive to maintain as there are more physical spaces to look after, heating and lighting costs can be higher and council tax bills are larger, the bands being dependent on value.

Trading down can be a highly efficient way of raising funds. The owner of the property does not leave the property market entirely and so has a physical asset (and one that will hopefully increase in value) to pass on to the family. The value of the asset is less than the previous one, but dilution of the value of the estate is a constant feature of most equity release options anyway.

The benefit of trading down is determined by the differentials in the prices of dwellings. If the owner is prepared to move to a different area of the country, it may be possible to move from an area in which prices are high to one in which prices are low. Some people who do this are not trading down at all in relation to the size of the property they buy, such as a person selling a house in Edinburgh and moving to the Highlands.

The downside of trading down to most is the emotional attachment to the property that was discussed briefly in the last chapter. If the property has been in the family for many years, there may be a reluctance to sell it. There is also the problem that many people feel that they are depriving the children of their future wealth.

Sell the property and rent

This is not a universally available option. In many parts of the country it is as expensive, or even more so, to rent a property than to own one. If there is a stock of suitable accommodation for rent, then the customer may consider this option. However, it is increasingly difficult to rely on the local authority to provide rented property, as the stock simply does not exist. In many areas the demand outweighs the supply of available property. It may be possible to sell up and move in to smaller rented accommodation, which has a similar effect to trading down except that the rent must be paid.

A major risk factor with this option is that many rental agreements are fixed term and are not guaranteed to be renewed on the same terms and conditions.

It is possible for the individual to sell the property and live with relatives. This assumes of course that the individual wishes to do so and that there is a relative willing to offer accommodation on a potentially long term basis. This approach is suitable for many families as the release of equity by selling the property can be used for the benefit of all parties. Some families sell two properties and agree to purchase a single property that they can all occupy. The benefits and drawbacks are obvious – the financial gain is made by selling the property but the potential snag is whether the family can all live together on a long term basis.

Conventional mortgage

It is a mistake to believe that all mortgage lenders will refuse persons over a certain age. Whilst it is true that lenders will be more careful when considering elderly applicants, some lenders offer specially designed products for this market.

The main consideration of a mortgage lender is the ability of the applicant to repay the loan on a long term basis. One very real problem to lenders is that they do not wish to be seen to litigate for possession against elderly persons, as this tends to attract high profile coverage in the newspapers. They are therefore extremely careful when assessing applications for a mortgage from those whose repayments extend beyond the date on which regular employment ceases.

Some lenders are prepared to offer mortgages over relatively long terms of years, sometimes on an interest only basis.



Case study

One lender agreed to enter into a mortgage with an 85 year old man over a term of 25 years. The prospect of the borrower surviving the full mortgage term was quite low to say the least, but the intention of both parties was that the mortgage would be repaid eventually out of the proceeds of the estate. This was not a lifetime mortgage, though under MCOB rules it would be considered to be a regulated mortgage contract and therefore subject to the suitability and affordability requirements.

Why was it not a lifetime mortgage? Because:

- it had a specific terms of years in the same way as most other mortgages
- the repayment of the mortgage was not explicitly contingent on the death of the borrower or vacation of the property.

Theoretically, if the man lived to the age of 110 years, the mortgage would have been serviced and eventually repaid like any other conventional residential mortgage.

A mortgage may be a suitable way forward for those who can afford the monthly repayments and are considered eligible under the provider's lending criteria. Those who can be certain that their income will not fall significantly in the future may consider this. This is the main risk factor to be considered.

Borrow from relatives or low cost sources of finance

Borrowing from relatives is probably the least expensive source of funds but often the most difficult to contemplate for emotional reasons. Even when relatives are willing to lend, this course of action is often ignored due to personal pride. However, if there is someone willing to lend and the individual is capable of repaying the loan, then why should it not be seriously considered? The main risk factor here of course is a possible change in circumstances that may make repayment impossible.

There are very few sources of low cost finance. Personal loans and credit cards are expensive, and interest rates tend to be higher if the lender considers the risk to be higher. It is highly significant that many consumer lenders advertise their products with "rates from" a specified level. Lenders who state that rates are tailored to circumstances usually mean that the rate increases with the level of desperation of the applicant.

Some regions, towns and cities are served by credit unions which are mutual organisations, owned by their members. They make loans available only to members, with typical rates of 12.7% APR. A multiple often used is that the member can borrow up to three times the level of savings, subject to a minimum qualifying membership period. The risk here is again the ability to repay the loan.

Lifetime mortgage

The lifetime mortgage offers many alternatives. The customer may consider:

- a lifetime mortgage with no repayments to be made but with interest rolling up until the property is sold on death or permanent vacation of the property
- a lifetime mortgage with repayments made (usually interest only) and capital repaid from sale of the property on death or permanent vacation of the property
- a home income plan through which the capital borrowed is invested in an annuity, with the annuity providing an income and meeting the repayments
- a shared appreciation mortgage through which no repayments are made, but with capital and a share in the increase in the value of the property claimed by the lender on death or permanent vacation of the property.

There are additional choices that can be made by the borrower. Most lenders are unconcerned with what the borrower actually does with the money, so the borrower can bank the capital and draw down funds as and when required or can use the capital sum to invest in an annuity and generate regular income for life. Some lenders are prepared to permit the borrower to draw down only the funds that are required immediately, thereby reducing the overall interest payment.

It is possible to set up an arrangement similar to the operation of a credit card through which the capital sum agreed serves as the “credit limit”. If this is the case, the lender is obliged under the MCOB rules to advise the borrower that the statutory protection enjoyed by conventional credit card customers will not apply.

The benefits of the lifetime mortgage are numerous, therefore:

- the customer can choose capital sum or income and is generally free to decide on what to do with the money
- the product can be set up with or without repayments, depending on the borrower’s personal circumstances
- ownership of the property is retained, which means that the property forms part of the estate on death and there may be some wealth to pass on to beneficiaries
- if important to the borrower, there is no emotional problem with selling the property.

The risk factors are:

- assuming that the funds are used and do not remain in an account, the value of the estate is reduced
- in particular, the rolled-up interest can quickly dilute the value of the estate and deprive beneficiaries of wealth that would otherwise be expected
- the rate of interest on lifetime mortgages is usually higher than that for conventional residential mortgages, so this compounds the effects on the borrower's net assets on death or redemption of the mortgage
- if repayments are made, the borrower has to be sure that these can be serviced
- lifetime mortgages are not designed to be repaid early; although any borrower has a legal right to redeem any loan at any time, the costs of doing so may be prohibitive
- the loss of entitlement to means-tested State benefits and grants for home improvements.

Quick question

What are the potential drawbacks of renting all or part of the property?

Write your answer before reading on.

Renting all or part of the property

By renting out some of the property it is possible for the owner to generate a regular income. In addition, the owner may decide to rent the entire property and make alternative living arrangements, such as renting another property or living with relatives.

The benefits of renting are the regular income that this can provide and the relative ease with which arrangements may be changed if unsatisfactory. During the 1970s and 1980s it was extremely risky to create tenancies as the law gave considerable protection to tenants. Legislation now offers a more balanced scenario, with both landlords and tenants enjoying certain protection. Tenancy agreements can be drafted to enable vacant possession to be obtained within a relatively short period of time, notably shorthold tenancy contracts.

For those who rent out some space in their property but remain in residence, they are entitled to tax breaks under the "Rent a Room" scheme, although the maximum annual permitted income from rent is modest.

The property continues to be owned by the borrower and therefore forms part of the estate on death. The impact that this has on inheritance tax liability depends on:

- the appreciation in value of the property since the lifetime mortgage was taken out
- where interest has rolled up, the compounding effects of this on the debt relative to the value of the property.

There are various risk factors that the potential landlord should consider:

- renting a property to unsuitable tenants can have major detrimental effects on the property and can be distressing
- many elderly people are uncomfortable with the idea of living in the same property as strangers
- there is no foolproof way of vetting suitability of tenants
- renting is only suitable for generating income, not for raising a cash sum
- rental income is assessable for income tax
- if the rental is construed as business use, the proceeds of any subsequent sale of the property may be assessable for capital gains tax
- future cash flows from rent are not guaranteed as there will almost certainly be voids (periods in which there is no tenant)
- if the whole property is rented out, costs of maintenance and repair must be met and there is no guarantee that tenants will have the same perceptions of what comprises adequate maintenance
- if a professional letting agent is used, this will cost approximately 10 - 15% of the monthly rent, depending on the level of service required.

Home reversion plan

The home reversion plan transfers ownership of some or part of the dwelling. Apart from any rent specified in the contract, there are no outgoings other than the normal running costs of a dwelling house. Although the owner becomes a tenant (or part tenant and part owner), there is little practical impact on the occupier's use of the property.

The main advantage of the home reversion plan is the ability to obtain more capital immediately than through any alternative means, other than selling the property outright.

As the choice of reversion plans is wide, the potential customer can choose:

- to sell all or just part of the property to the reversion company

- to opt for a higher rent in favour of a larger capital sum
- to use the funds for whatever purpose is required – income, capital or a combination of these.

As ownership is transferred, the property does not form part of the estate on death of the occupier – the lease simply comes to an end. This means that for inheritance tax purposes any value of the property that continues to reside in the net assets of the estate is the unspent portion of the capital originally raised. Generally, the longer the person lives, the lower will be the inheritance tax burden.

The risk factors to be considered are:

- the loss of ownership, which as well as the emotional considerations will mean that the benefit of any appreciation in the value of the property will pass to the reversion provider (unless a part share in the property is retained)
- the immediate reduction in wealth brought about by the fact that the reversion provider will pay substantially less for the property than its market value
- building on the last point, the prospect that on unexpectedly early death, the estate will have been diluted with no great benefit
- the loss of entitlement to means-tested State benefits and grants for home improvements.

Obtaining advice

Any form of equity release is a major step, so it is vitally important that the owner of the property seeks advice from appropriately qualified persons and firms.

The provider is compelled to make disclosures at various stages of the sales cycle, including the initial disclosure document and the key facts illustration. Depending on the type of product required, these include statutory risk warnings that must be worded in the prescribed manner. There is additional protection in the form of the Financial Ombudsman Service, which deals with complaints and can make awards of up to £100,000 if a complaint is upheld, and the Financial Services Compensation Scheme, which provides protection for the customer in the event of insolvency of the lifetime mortgage provider or intermediary.

Providers of individual products can give advice on product features, benefits and drawbacks but will naturally be better informed on their own offerings and also subjective in their judgements. Even independent financial advisers cannot know every product in the market all the time.

For regulated products, advisers do not have to be experts on taxation and benefits. The MCOB rules require advisers on regulated mortgage contracts and regulated lifetime mortgage contracts to direct the customer to relevant organisations on these matters if the adviser does not have the expertise.

Sources of advice on taxation and benefits

There are many sources of advice available to potential equity release customers, including:

- product providers
- financial intermediaries
- the internet
- HM Revenue and Customs (on income tax, capital gains tax and inheritance tax matters)
- Department for Work and Pensions
- Jobcentre Plus
- Citizens Advice Bureaux
- Money Advice Centres

In particular, HM Revenue and Customs and the Department for Work and Pensions have comprehensive websites [www.hmrc.gov.uk and www.dwp.gov.uk]. The Department for Work and Pensions website has links to the Jobcentre Plus website. Most post offices have general publicity leaflets on State benefits.

Independent legal advice

For most families, residential property is the most valuable physical asset that they own, so a decision to use this for mortgage purposes or to sell to a home reversion company should not be taken lightly.

For regulated products, the MCOB rules compel the provider to advise the customer to seek independent legal advice before entering into a legally binding contract. A qualified solicitor should be able to provide objective guidance on the implications of any contract into which the customer subsequently enters. The word “independent” implies that the adviser should be independent of both the customer and the provider. Furthermore, where there are joint applicants, this strictly means that each applicant should seek advice independently of one another; in other words, they should go to different solicitors.

By taking independent legal advice, the customer’s attention will be drawn to all matters of material significance and they will be able to take a more informed decision on the most appropriate way forward.

It is also in the product provider’s interest to recommend that independent legal advice be taken. There have been cases in the past in which parties to a contract have been able to escape from the contract by asserting that they were subject to undue influence which means that they were able to persuade the court that they were influenced by another person (usually a spouse or partner).

The well-known case of *Barclays Bank plc -v- O'Brien (1994)* underlines the dangers of this.



Case study

Barclays Bank plc -v- O'Brien, 1994

A charge was granted over Mr and Mrs O'Brien's jointly owned matrimonial home in security of Mr O'Brien's business borrowing. Mrs O'Brien signed the charge in the bank but was not advised by the bank of the effect of the charge nor was she recommended to take independent legal advice. When the bank later tried to enforce the charge, Mrs O'Brien claimed that she had been induced to sign the charge by her husband's misrepresentation. He had falsely represented to her that the charge was to cover borrowing of £60,000 alone and was to be released three weeks later but the charge was in all monies form without a time limit. It was held that the charge should not be set aside simply on the grounds that Mrs O'Brien did not understand the transaction but was enforceable against her although only to the extent of £60,000.

The application

The application for a home reversion plan resembles that of a mortgage application. This may involve a personal interview with an adviser or intermediary in which the plan is explained and details provided from which the plan provider can make an informed decision.

The borrower

The application requires the customer to provide personal details and information on the property. The personal details will provide the plan provider with information that enables it to match the customer with the eligibility criteria, to confirm identity and initiate credit checks.

Although a home reversion plan is not a form of credit, it is in the interest of the reversion provider to carry out appropriate checks through a credit reference company such as Equifax or Experian.

Quick question

Apart from confirming the person's identity, what other purpose lies beneath this?

Write your answer before reading on.

Apart from confirming that the person is who he purports to be, there is another more important underlying purpose. A home reversion plan legally transfers an asset for less than its market value. Under insolvency legislation this is described as a transfer at an “undervalue”. If the customer deliberately raises money in this way to avoid obligations to creditors, any trustee in bankruptcy subsequently appointed may pursue legal action to recover the funds in the interests of the creditors. Home reversion plan providers will therefore wish to confirm that insolvency proceedings are not imminent, and that the applicant’s financial situation is such that proceedings are unlikely in the foreseeable future.

Identity checks are also necessary to avoid any contravention of the *Money Laundering Regulations*.

The reversion provider must establish the basis of ownership of joint occupiers. Most of those who own private residential property do so on a joint property basis (joint tenancy in England, Wales and Northern Ireland). This means that both persons own all of the property, with no formal division between them. For practical purposes, this means that on death of one party the whole of the property is already owned by the survivor. It does not form any part of the estate of the deceased.

By contrast, some properties are owned on a common property basis (tenancy in common in England, Wales and Northern Ireland) which means that each owner has a specified share of the property. On the death of one person, his share passes to his estate and not automatically to the survivor.

The manner in which ownership is vested is unimportant in practical terms but does affect how the property retained by the occupier is split when a partial reversion is set up.

The property

The application process will also involve gathering details of the property. As we have seen earlier, the reversion provider will want to confirm that the property is suitable for purchase or part purchase and that it is likely to be marketable in the medium to long term.

The provider’s solicitor will carry out a Land Register search to confirm the current ownership details and learn of any matters relevant to the property itself and existing charges over it. If the property is unregistered, a search of the Register of Sasines is carried out and the solicitor examines any charges or other matters affecting the property.

The matters to be considered are:

- type of property
- tenure (absolute in Scotland; freehold, leasehold, commonhold in England, Wales and Northern Ireland)

- if leasehold, number of years remaining on the lease
- age of the property
- method of construction
- condition
- location
- rights over the property
- conditions of title (burdens in Scotland; easements, positive covenants, restrictive covenants in England, Wales and Northern Ireland)
- common areas with other properties.

The reversion provider will also require the solicitor to check local development plans to ascertain whether these are likely to affect the future value of the property.

The decision on suitability of the property may be supported by a valuation. This should confirm the open market value and insurance (reinstatement) value as well as provide details of obvious matters of concern to the reversion provider.

The features of the plan

The reversion provider will advise the customer on the product options available. Some reversion providers have only one product model while others can offer different variations.

At this stage the customer is informed of:

- the maximum that can be raised
- any rent to be paid under the lease
- whether it is possible to sell all or a part share of the property
- if the whole property is sold, the implications of this for the capital sum that can be raised and the eventual sale on death or vacation of the property
- if a part share is sold, the implications of this for the capital sum that can be raised and the eventual sale on death or vacation of the property
- whether it is possible to pay a higher rent in return for a larger capital sum
- if the plan is required for income purposes, the investment options that are available to provide income
- fees, charges and other expenses connected with the transaction
- the rights and obligations under the lease.

At this stage also, the reversion provider should suggest that independent legal advice be sought.

Sanction or decline of the application

The reversion provider's decision on whether to move forward with the transaction will be based on an assessment of the customer's circumstances, the suitability of the plan for his purposes and the acceptability of the property. The decision will be supported by an assessment of the property, usually by commissioning a valuation report.

Legal conveyance of the property

The home reversion plan requires a legal conveyance of the property to be made. This transfers the legal ownership of the property, or the agreed proportion of it, to the reversion provider. This work is carried out by a solicitor or a licensed conveyancer. If he wishes, the customer can appoint his own solicitor. The legal costs are usually met by the customer, although some reversion providers are prepared to meet some or all of these costs as a value added marketing feature.

Where the whole property is to be transferred, the conveyancing process is straightforward, although finalisation of the transaction is contingent on the creation of a lease between the customer and the reversion company.

If a proportion of the property is to be transferred, the conveyance will create a specified interest in favour of the reversion provider, with the customer retaining ownership of the remainder.

The solicitor deals with the purchase/sale transaction, gives general advice and handles all monetary transfers between the various parties.

Stamp duty land tax is payable on the transaction, based on the consideration paid by the purchaser. This is charged on a sliding scale:

Consideration paid	SDLT rate
Less than £125,000	Nil
£125,001 - £250,000	1%
£250,001 - £500,000	3%
£500,001 +	4%

The details of ownership must be registered at the Land Register. If the reversion provider becomes the absolute owner, its details replace those of the customer on the register. If there is a proportion of the property transferred, the reversion provider and the customer become joint owners on a common property basis (tenancy in common in England, Wales and Northern Ireland). This means that when the property is eventually sold, each share will revert to the respective owner in the proportions initially agreed.

Not all land is registered, as compulsory registration only extended to the whole of Scotland in 2004 and the whole of England and Wales in 1990. Compulsory registration does not apply throughout Northern Ireland. Therefore, if the property has not changed hands since compulsory registration was introduced to the region in which the property is located, it will remain unregistered. In such cases, the solicitor must make a first registration, for which a fee is payable. This is a relatively straightforward exercise as details can now be registered on-line.

The lease

The lease is the agreement between the reversion provider and the customer and entitles the customer to live in the property subject to the conditions laid down in the lease. If the property is leasehold (England, Wales and Northern Ireland only), the new lease between the reversion provider and the customer becomes a sublease.

In addition to registering the details of ownership of the property, it is also necessary to register the lease, as it represents a disposition in land. It is in the interest of the reversion provider to ensure that this is done as the company's rights may be compromised by failure to do so.

The lease sets down:

- the rights of each party
- the obligations of each party.

A typical lease should contain the following:

■ Names of parties to the lease

These are the reversion provider and all the persons who wish to remain in the property while the lease remains in force.

■ Date

This is the date on which the provisions of the lease come into force.

■ The property

This condition describes the property covered by the lease.

■ Rent

This clause sets down the rent payable by the lessee to the lessor, the frequency of payment and the date of payment.

■ Condition subsequent

This is an important feature of a home reversion lease. It states the events in which the lease will be terminated and therefore triggers the right of the reversion provider to sell.

Most conventional leases have an expiry date. The lease can be for a very short period, as is common with commercial leases for offices or shops, or very long, as in the case of leasehold properties in England and Wales, where there may be an original term of perhaps 999 years. In the case of home reversion plans, the term of the lease is set with reference to a condition being fulfilled subsequent to its creation. This will normally be:

- the death of the occupant, or in the case of joint occupants, the death of the last surviving occupant, or
- the permanent vacation of the property, or in the case of joint occupants, the permanent vacation of the property by the last surviving occupant.

There will also be a condition that the rights under the lease are forfeited by the lessee(s) if there is a breach of any condition of the lease.

■ **Good repair and material changes**

The property is the reversion provider's asset, so the lessee undertakes to keep the property in good repair, thereby maintaining the value of the property.

The lease will also forbid material alterations to the property without the prior consent of the lessor. It is unlikely of course that a reversion plan customer will make subsequent major property enhancements if the benefits of these fall eventually to the reversion provider.

■ **Repairs and maintenance**

The lease makes it the occupier's responsibility to carry out repairs and maintenance at his own expense. The lease may include an authorisation for the reversion provider to carry out repairs and maintenance and charge the customer if the latter fails in these obligations. This is of course a common feature of most property rental contracts.

■ **Duty to insure the property**

The lease sets down who is responsible for insurance of the property and the basis of insurance. Normally the insurance premium is paid by the occupant. If it is not paid, the lessee will reserve the right to pay this and charge it to the occupant.

Insurance should be for full reinstatement value, which is the cost of putting the property in the same condition that existed before any insured peril occurred. The insurance value should be index linked to prevent the prospect of future under-insurance and hence application of the average clause. Averaging entitles the insurer to reduce the value of the claim proportionate to the value of under-insurance.

As most property insurances are only effective if the property is occupied, the lease may compel the lessee to inform the reversion company of any prolonged periods of absence from the property. It may also compel the lessee to put additional insurance in place to cover such periods of absence.

■ Duties of compliance

The lessee is responsible for complying with:

- conditions of title, which are set out in the title deeds; these include easements and covenants (in England, Wales and Northern Ireland) such as maintenance of boundaries and restrictions on use created by previous owners
- national legislation, including the *Town and Country Planning Acts*
- local authority conditions, bylaws and regulations.

■ Subletting

The lessee may not sublet the property without the permission of the reversion company. This is an important restriction on future disposal of the lease. There may be other restrictions on granting occupancy rights over the property.

The lease may permit occupancy by persons who are not parties to the lease subject to waiving of rights of residence. This protects the lessor from any overriding interest being created under the *Land Registration Act 2002* (England, Wales and Northern Ireland only).

■ Dilapidations

This clause is not always included. It enables the lessor to reclaim any costs of restoring the property to the condition at inception of the lease if the lessee has made major alterations.

■ Events of default

This clause sets out the conditions under which the rights of the lessee are terminated and the rights of the lessor to terminate the lease. In England, Wales and Northern Ireland there are various statutory protections in place to prevent a lessor exploiting this clause on a technicality, notably some of the provisions of the *Commonhold and Leasehold Reform Act 2002*.

Review

Now consider the main learning points which were introduced in this chapter.

Go through them, match them to the objectives at the beginning of the chapter and only move on when you are happy that you fully understand each point.

Reread any section you are unsure of.

- The process of taking out any form of equity release should commence with taking appropriate advice from both providers in the market and professional persons. Specialist advice is available from various persons and organisations.
- The customer should assess the relative benefits and risks of various alternative ways of meeting his requirements. These may include trading down, letting the property and lifetime mortgages as well as home reversion plans.
- Before committing to equity release, the customer should be strongly advised to seek independent legal advice.
- The process of applying for home reversion is similar to that of a mortgage application. The provider gathers and assesses information on the customer and the property before coming to a decision.
- The home reversion involves a legal conveyance of the property through which whole or part ownership is transferred to the reversion provider.
- The process also involves the creation of a lease, which sets down the rights and obligations of the parties.



Key words in this chapter are given below. Use them to write your own revision notes and add any other words or phrases that you want to remember.

equity release options

trading down

Department for Work and Pensions

Jobcentre Plus

independent legal advice

joint property

common property

legal conveyance

Stamp Duty Land Tax

conditions subsequent

subletting

dilapidations

events of default

6 Meeting Customer Needs

Objectives

By the end of this chapter, you should be able to:

- Explain how the various equity release products can address the needs of different types of customer.
 - Explain the factors that influence the choice of product to meet individual circumstances.
 - Describe the long term implications of equity release products for the customer.
 - Identify how different products address future changes in circumstances and needs.
-

Introduction

We have already considered the different needs of potential equity release customers. In this chapter we explore how these needs can be addressed and how the choice of product impacts on the customer.

Some of the implications of equity release are not realised until the customer dies or has to go into residential care on a permanent basis. Although the adviser will rightly bring these matters to the attention of the customer at the outset, some of the effects of the decision to take out equity release are not fully known at that time. We therefore need to consider the actual performance of the product and its effects on the customer and the eventual beneficiaries of his estate.

Suitability and affordability

A product is considered to be suitable if:

- it meets the actual needs of the customer and is appropriate to his financial position and other circumstances
- the customer is happy with the product
- the overall benefits of the product outweigh the drawbacks.

A product is affordable if any setting-up costs and subsequent payments that have to be made can be serviced from the customer's personal financial resources.

Sales of regulated products are governed by the MCOB rules which compel the adviser to take account of suitability during the sales cycle. In addition, if the product involves regular payments or repayments, the adviser must also make an assessment of affordability. These rules apply even if the provider sells mortgages on a self-certification basis or is a sub-prime lending organisation.

For home reversion plans, affordability is only an issue in relation to setting-up costs, as, other than a small rent, the majority of schemes do not involve payments to the provider. However, the adviser does have at least a moral duty to ensure that the product is suitable. This cannot be assumed of all providers – in the late 1980s and early 1990s there were several cases of equity release products being mis-sold, often linked to purchases of highly speculative investment bonds.

Factors influencing the performance of the product

When an equity release product is considered, there are many factors that must be taken into account. Some are known and predictable, while others may be unknown or subject to change in the future.

The amount that the customer wishes to raise

All equity release products enable the customer to raise a capital sum. Even when a regular income is required, it is usually the capital sum that is liquidated that is used to generate the income. The customer may consider the full range of equity release products for the purpose of releasing capital. In addition, there are many other ways of raising capital, all with their own different costs and implications.

If a small capital sum is required, it may not necessarily be appropriate to consider equity release. The cost of borrowing is relatively high – remember that interest rates on lifetime mortgages are higher than market rates for conventional residential mortgages. It may be possible to raise the capital by taking out a top up to an existing mortgage, which would then be considered by the lender in the context of its suitability and affordability at application stage. If a home reversion plan is used to secure a small capital sum, this may be the proverbial “sledgehammer to crack a nut”. The customer enters into a fairly major and irreversible transaction when other simpler methods could be used.

Assuming that the borrower intends to raise a significant capital sum, for example, to invest in order to provide a regular income, then equity release may be the way forward. The demand for home reversion plans is often dependent on the actual amount that the customer wishes to raise. There are no lifetime mortgages in the market place that will release the same value as a typical home reversion plan, therefore, if the need for capital is substantial, the home reversion plan may be the only way forward.

Additional future capital raising

Suppose the customer may wish to release more money in the future, which may have been a consideration when purchasing the product was first contemplated. How do the different options compare for this purpose?

A lifetime mortgage enables the customer to borrow a relatively small percentage of the value of the property. Depending on the product chosen, the capital owed will increase (under a rolled-up interest scheme) or remain constant (where payments are made to the lender). The value of the property should increase over time. Also, as the customer gets older, lifetime mortgage providers tend to permit larger loan-to-value ratios. This means that the customer may be able to top up the mortgage in future, depending on the relative value of the debt to the value of the property as well as the willingness or otherwise of the lender to facilitate this. There is more prospect of equity being available for this purpose where payments of interest are made than under a rolled-up interest scheme. This is because, as we have seen, the debt under a rolled-up interest scheme compounds rapidly over time and at an increasing rate.

Under a home reversion plan where 100% of the property has been sold to the provider to raise funds, there is no prospect at all of further capital raising. The property has been divested by its former owner, who is now a tenant.

However, if only a proportion of the property has been sold, it may be possible to sell a further share in the property, or the remaining share in the property, to the reversion provider. This is the only way in which a home reversion plan may facilitate further capital raising.

If the occupier wishes to use the property for capital raising from another finance provider, the lifetime mortgage is rather more flexible than the home reversion plan. It may be possible to secure second or subsequent charges on the mortgaged property if the owner-occupier has a lifetime mortgage. However, this is only possible under a home reversion plan if the occupier retains a stake in the property and the reversion provider permits the further borrowing.

Interest rates

Changes in interest rates affect all mortgage-based equity release products.

For lifetime mortgages where the borrower makes payments of interest to the lender, a change in interest rates will affect the customer's monthly repayment, thereby affecting affordability. This can be avoided to some extent by choosing a product with a fixed, capped or stepped interest rate, although the periods for which these conditions apply are unlikely to last for the life of the mortgage.

If interest rolls up on the lifetime mortgage, an increase in interest rates will result in more interest being charged to the account each year, and the effect of this will compound the debt more quickly over time.

A shared appreciation lifetime mortgage is affected only indirectly by a change in interest rates. This product requires the borrower to make no payments at all, but an increase in interest rates is likely to cause a deflationary effect on the value of the property and *vice versa*, meaning that the share of the increase in the value of the property will affect the lender's capital gain on the eventual sale of the property.

A home reversion plan is affected indirectly by a change in interest rates, again given the inverse relationship between interest rates and changes in property values. As a home reversion plan is not a mortgage, there are no payments to be made. However, if the customer retains a stake in the property, the value of this stake will be indirectly affected by movements in interest rates while the home reversion plan provider holds its stake in the property.

For those using the capital to generate income, changes in interest rates have an effect on annuity rates. An annuity rate is the annual percentage return that the annuitant will receive. It is usually fixed at the time that the annuity is purchased.

Life expectancy

We all have a perception of how long we should live, but this is perhaps the greatest unknown factor when considering equity release products.



Case study

Consider an individual who purchases an equity release product at the age of 60 years. He borrows £25,000 by way of a lifetime mortgage, secured on a property with a market value of £100,000. He could make payments of interest to keep the capital debt constant, or alternatively could roll up interest, allowing the debt to increase over time, to be repaid from the estate. Alternatively, he could enter into a partial reversion arrangement, selling a 50% share in his property for £25,000, again to be recouped by the reversion provider when he dies.

The performance of any of the three products (lifetime mortgage with payments, lifetime mortgage with no payments, home reversion plan) is entirely dependent on his life expectancy.

If he dies one year after purchasing a product, what is the situation?

- For the lifetime mortgage with payments of interest, he has raised £25,000 and has enjoyed the use of this for one year, and now the lender will be able to claim the capital debt from the estate – so the question here is whether taking the £25,000 now was full value for this transaction.
- For the lifetime mortgage with no payments of interest, the estate will owe £25,000 plus interest rolled-up for one year at the prevailing interest rate(s) – so the estate will be diluted by rather more.
- For the home reversion plan, only 50% of the value of the customer's house will form part of the estate, so he will have raised £25,000 in return for the £50,000 plus the capital accumulation that the reversion provider has gained.

In fact, on very early death, the reversion plan is spectacularly bad business, with the full impact being on the estate rather than on the individual. From an inheritance tax perspective, the estate will have been reduced by the 50% reversion interest that has been transferred, but there is a prospect that the customer may not have spent all of the £25,000 raised in the one year that he survived, so any cash left over is part of the estate. The risk of dying very soon after taking out a home reversion plan can be mitigated by purchasing a plan with a minimum inheritance guarantee (see below).

If the customer lives for ten years, the situation may change, although there are many variables to consider, some of which cannot be predicted accurately.

If the customer rolls up the interest, this can increase the debt massively, depending on the rate of interest charged. As a general rule, it can be assumed that the debt on a rolled-up loan will double every ten years, so if this is the case, the estate will owe £50,000. However, it will benefit from any accumulation in the value of the property over the time that the owner survived.

What if the customer makes payments of interest on a lifetime mortgage? What is the situation on death? The lender will claim £25,000 from the estate, thereby reducing the value of net assets on death.

If the customer has a home reversion plan, he will have had the use of the £25,000 for the ten years that he survived and perhaps paid a nominal rent. The property will be sold with half the value going to the estate and therefore forming part of the net assets. However, the main difference between this and the lifetime mortgage with payments is that the reversion provider will take 50% of the accumulation in the value of the property over the ten year period.

Hardly anybody knows how long they will live, but it is worth posing “what/if” scenarios to consider the alternative effects of different forms of finance before taking an informed decision.

If the need is for a sum that can only be raised by a home reversion plan (for example, the amount required is greater than any lifetime mortgage lender will advance), then the decision between the products is much simpler.



Quick question

How do you think that a minimum inheritance guarantee works in practice?

Write your answer before reading on.

Minimum inheritance guarantees

The risk of early death occurring very soon after taking out a home reversion plan can be reduced by purchasing a plan that has a minimum inheritance guarantee. This guarantee is included in the schemes of some but not all reversion providers. It guarantees a minimum payment to the estate if the individual leaves the property to go into permanent care, or if he dies, within the specified initial number of years.

It is calculated with reference to the open market value of the property when the plan is set up or when the property is sold. If the cash sum received by the customer is less than the guaranteed minimum payment, the reversion provider repays the difference to the estate. How does this work? The following figures are based on the reversion plan offered by a major life assurance company.

Example

A customer sells a 50% share in a property with an open market value of £100,000 for £20,000. This figure would be based on the customer's age at application stage and therefore life expectancy. The reversion plan provider will pay a specified percentage of the guaranteed minimum payment to the customer or the estate, depending on whether the property is vacated to go into long term care or the customer dies, at any time in the first four years. The minimum payment is set on a sliding scale:

Qualifying termination event	Guaranteed minimum payment
Up to 6 months	90%
7 - 12 months	80%
Year 2	75%
Year 3	65%
Year 4	55%

Therefore, if the customer dies within nine months of inception, his estate will receive 80% of the reversion provider's share, which, based on open market value at inception, is 80% of £50,000 (£40,000), less the amount received under the plan (£20,000). The estate will be paid £20,000.

In this case the estate receives a full return of the capital. If the customer dies in the fourth year, the minimum guarantee is 55% of £50,000, less the cash received. Here the 55% is £27,500 and the initial cash sum was £20,000, so the estate will receive £7,500.

Providing for beneficiaries

All equity release products have an impact on the eventual value of the estate. Advisers must therefore discuss the implications of this carefully with customers who wish for others to benefit on their death.

When a lifetime mortgage is taken out, the borrower retains full ownership of the mortgaged property, therefore the value of the estate continues to include the property, with the outstanding debt reducing the value of net assets at any given time. This has very little effect in the short term, but over time the capital raised will be used up by the borrower. Generally, there is a greater prospect of the cash sum being eroded the longer the person lives. If the funds are used to purchase an annuity, this is usually not refundable on death (unless the type of annuity purchased provided for this), so there is an immediate reduction in the value of assets owned by the customer from the time it is purchased. The effects on the estate of increased longevity are different for customers who pay interest than for those who roll up interest. For the former, the capital debt remains constant, while for the latter the value of the estate will diminish at an increasing rate over time.

Under a home reversion plan, there is an immediate and irreversible reduction in the value of the estate when the plan is taken out. The property is transferred to the reversion plan provider in return for a cash sum worth considerably less than the value of the property. Unless the customer retains a stake in the property, the only residual value that remains an asset of the customer is the unspent portion of the capital received from the reversion provider.

The customer can of course choose to retain a specified proportion of the property so that value can be passed on to beneficiaries. It is also possible to decide on the proportion to be sold based on an estimate of how much needs to be transferred to remain outside the inheritance tax threshold on death. This involves making assumptions about life expectancy, which will only be correct by coincidence rather than scientific calculation, as well as assumptions about future government policy on inheritance tax rates and thresholds.

Under certain circumstances, the home reversion plan may provide for repurchase of the property. This may be set out in the original conditions of the plan, or may be negotiated by the occupier or his beneficiaries. If this is the case, the consideration payable will be determined with reference to the reversion provider's own policy or by negotiation between the parties concerned.



Quick question

What are the implications regarding home reversion plans of moving house?

Write your answer before reading on.

Moving house

The right of the equity release provider is triggered by the permanent vacation of the property or death of the customer, whichever occurs earlier. Therefore, the lifetime mortgage becomes repayable if the borrower wishes to sell the property and move to another.

For most lifetime mortgages there are built-in exit charges which can be a formidable disincentive to pay off the debt early. However, many lifetime mortgages are portable, which means that the borrower can move house and transfer the terms and conditions of the existing lifetime mortgage to another secured on the new property. The precise terms and conditions for doing so are laid down by the lender in the standard security.

Home reversion plans are not portable. If 100% of the value of the property is transferred to the reversion provider, then the customer no longer holds any stake in the property. By choosing to leave the property, the lease is terminated and the reversion provider is free to sell the property. If a proportion of the property is retained, vacation of the property to live elsewhere is an event that terminates the lease. The property can be sold, with the occupier's stake being realised at that time. The sum thus liquidated may or may not be sufficient to purchase another property.

As a general rule, therefore, lifetime mortgages are more flexible if there is any future prospect of the customer wishing to move house.

Changes in occupier and lettings

Virtually all equity release arrangements restrict the right of the owner or occupier to create tenancies or sublet the property.

Under mortgage-based arrangements, the standard security prohibits the letting of the property without the prior permission of the lender. In practice, lenders are relatively relaxed on this matter. When tenancy laws provided a high level of protection for tenants, there was a real danger that a "sitting tenancy" could be created. This is less likely today, as most types of modern tenancy agreement enable the landlord to remove the tenant subject to specified conditions.

Under lifetime mortgage contracts where payments are made to the lender, it is more desirable to permit the borrower to take in a tenant than to encounter difficulties in servicing the debt. Therefore, requests to let the property will be almost routinely agreed, subject to the tenancy agreement containing appropriate conditions that enable the tenant to be removed.

In reality, many owner-occupiers either do not know about the restriction on letting or choose to ignore it. This is not a problem for the mortgage lender, as the creation of an unauthorised tenancy is overridden by the rights of the mortgagee under the mortgage contract. In the event of default, the mortgage lender would be able to secure vacant possession.

Quick question

What is the position regarding subleases?

Write your answer before reading on.

A home reversion plan always includes an express condition to the effect that subleases are not permitted. Depending on the wording of the relevant condition in the lease, this may refer just to formal tenancy agreements or may go further and restrict the use of the property solely to the tenant at will. If this is the case, any occupation of the property by a third party is not permitted. It may even preclude family members from sharing the property on an informal basis (however, there is a distinction between a “tenant” and a “guest”, so if the latter does not pay a rent, there is probably no consequence at all).

Again, the main aim here is not to create difficulties for the occupier but simply to protect the position of the reversion provider. The express or implied consent of the reversion provider to a sublease could result in the creation of an overriding interest that could preclude the reversion provider from securing vacant possession when the property is to be sold. Therefore, the reversion provider may, if approached, permit the creation of a letting provided this was of a fixed term nature with no prospect of the subtenant securing permanent rights of residence. In practice, such problems do not arise in Scotland, where overriding interests cannot be created.

If the occupier creates a sublease in favour of a third party without permission, this would not be binding on the reversion provider.



Quick question

What do you think are the potential consequences of vacating the property?

Write your answer before reading on.

Vacating the property

All equity release contracts include a condition that permanent vacation of the property triggers a direct or indirect right to sell the property. This is sometimes referred to as a “qualifying termination event”.

In the case of lifetime mortgages, if the borrower has to go into long term care, the whole debt becomes immediately repayable. The onus is then on the owner-occupier to sell the property to repay the debt, or to repay the debt from other resources. This may be an imperative of course, as the remaining equity in the property may be required to pay for or contribute to the costs of the long term care.

Home reversion plans include a similar clause in the lease. The reversion provider has a right to sell the property when it is permanently vacated by the tenant. At this stage, the lender will recoup its capital and any appreciation in value since the property was acquired. If the occupier retained a stake in the property, this would be returned to the borrower with reference to the proportion of sale proceeds.

Those who have to go into care may encounter practical difficulties at this time. In many cases, it will not be known whether the need for care is permanent or not. Many elderly people go into care homes only to recover and return to their homes. Their time away from the property may be a few days or several months. Furthermore, some individuals may go in and out of care several times over a prolonged period.

The practical consideration for the equity release provider is that it is undesirable for a property to be unoccupied for a lengthy period. As well as the obvious deterioration that can occur when a property is empty, there is also an implication for insurance. Most household insurance policies restrict full cover to a maximum number of consecutive days for which the property is unoccupied (this varies from 60 to 90 days in typical policies). If the property is unoccupied for longer than the specified period, the scope of the cover is usually reduced to fire damage only.

Equity release providers protect themselves from exposure to these risks by:

- requiring the occupier to inform them of sustained periods of absence from the property
- defining exactly what is meant by “permanently going into care” in terms of medical conditions, certification of these conditions by a qualified medical practitioner and prolonged vacation of the property
- inclusion of an “adverse material change” clause in the contract.

The third of these is a “catch all” clause that states that it is the occupier’s responsibility to notify the provider of any change material to the contract. This is fairly subjective and it is questionable whether courts would enforce it, but it does at least place some onus on the occupier to keep the provider informed.

To protect themselves, long term care is defined precisely by reversion providers. One major life assurance company defines this as the care that is required from other people due to dementia (mental illness) or help is required to perform two or more activities of daily living which include feeding oneself, washing and going to the toilet.

Death

All equity release schemes enable the provider to insist that the property be sold on death. This is another “qualifying termination event”.

For mortgage-based products, the whole sum due under the mortgage contract becomes immediately repayable on death. The property will be sold to repay the debt, or the personal representatives will have to meet the mortgage debt from other resources. Once the mortgage is repaid, any surplus remaining is passed to the estate. The exception to this is where there are lower-ranking charges on the property, such as second or subsequent mortgages. In such cases, some (or all) of the surplus has to be used to discharge these obligations.

For home reversion plans, the property is already wholly or partially owned by the reversion provider. The property can be sold and any equity is retained by the provider. Where the occupier retained a proportion of the property, the estate will be entitled to its proportion of the sale proceeds.

One crucial difference between the two types of scheme is that under a lifetime mortgage the property forms part of the estate, which means that it will come to the attention of the capital taxes department of HM Revenue and Customs for inheritance tax clearance purposes. This only applies to a home reversion plan where a proportion of the value of the property has been retained.

Review

Now consider the main learning points which were introduced in this chapter.

Go through them, match them to the objectives at the beginning of the chapter and only move on when you are happy that you fully understand each point.

Reread any section you are unsure of.

- Providers of equity release products should take account of the suitability and affordability of products. An assessment of suitability should be made for all products. Affordability should be assessed for products that require the customer to make payments to the provider.
- There are several matters that should be considered before committing to an equity release product. An informed view should be taken of the potential impact of life expectancy, future movements in interest rates, changes in property prices, the impact on beneficiaries of the estate and the possible need to raise more capital in the future.
- Different types of equity release product should be considered in terms of future flexibility. Lifetime mortgages are often portable and may enable the customer to raise further borrowings, whereas home reversion plans are generally less enabling in these respects.
- All equity release products restrict the occupier's right to let or create a sublease. However, the main consideration here is that the product provider is protecting itself from the creation of occupancy rights in favour of third parties.
- Permanent vacation of the property and death are qualifying termination events which trigger the right of the provider to sell the property, or in the case of mortgage-based products, to demand full repayment of the debt.



Key words in this chapter are given below. Use them to write your own revision notes and add any other words or phrases that you want to remember.

suitability

affordability

future capital raising

life expectancy

minimum inheritance guarantee

qualifying termination event