Equity release mortgages: magic bullet or poison pill?

Jamie Stevenson *examines whether these mortgages really are the attractive assets that some people claim and highlights their illiquidity risks and regulators' concerns*

Providing pensions for Generation X with long bond rates at just 2 per cent is one of the most pressing financial challenges our society faces. Annuity providers think that they may have cracked it, by buying up defined benefit schemes ("bulk annuities") and backing them with higher-yielding long-term assets. Bulk annuity purchases have risen from £4.5bn in 2012 to £12.3bn in 2017 (see Chart 1) and are heading for a record in 2018.

In the same period, sales of high-yield "lifetime mortgages" to cash-poor, asset-rich baby boomers have trebled to more than £3bn per annum (see Chart 2). Increased competition in this equity release mortgage (ERM) market has brought yields down from 7 per cent to 5.25 per cent but that still represents a comfortable spread over 3 per cent annuity rates and it is double mainstream mortgage rates.

But this magic bullet has a catch – or two. First, an ERM is the ultimate illiquid asset, with no interest payments required until redemption. Second, it has an unknown redemption date (death or care home) at which the borrower's estate enjoys a "no negative equity guarantee" (NNEG). This is the acronym that critics believe could be reverberating around panicking financial markets by 2035, if not before, echoing what sub-prime did to the markets 10 years ago.

NNEG converts this latest financial concern from a "conduct" issue (protecting customers) to a "prudential" issue (protecting the financial system). So let us defer any debate as to whether rolling up debt at double the market mortgage rate in exchange for lifetime deferral of interest payments and the elimination of all risk exposure through NNEG is a good deal for any 70-year-old, and their children.

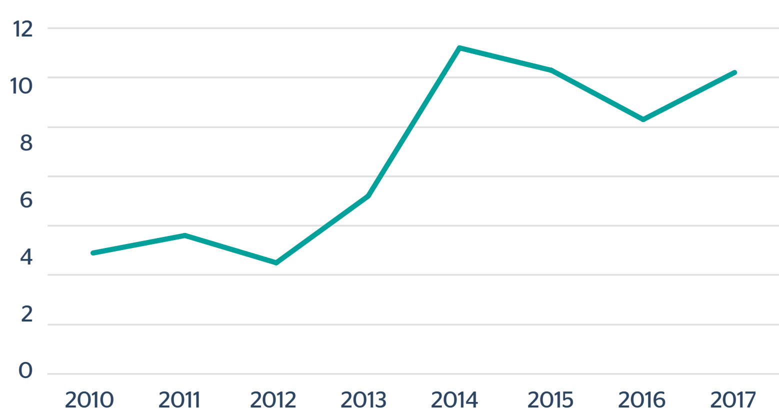
> *Equity release mortgages have consumed a remarkable amount of lenders' and supervisory time*

The current hot debate focuses instead on the lenders' exposure to the illiquidity and NNEG risk. How much further will the Prudential Regulation Authority (PRA) go to restrict this risk and will it go far enough? Or will it go too far and kill growth in an innovative market, which efficiently transfers liquidity and financial certainty between baby boomers and millennials to suit the life cycles of both?

The debate is indeed hot. When a mild-mannered 60-year-old economics professor and a retired PRA lifer can attract a volley of hostile questions from a packed room at the London School of Economics, in response to slides comprising mostly option modelling equations, you know that something is up.

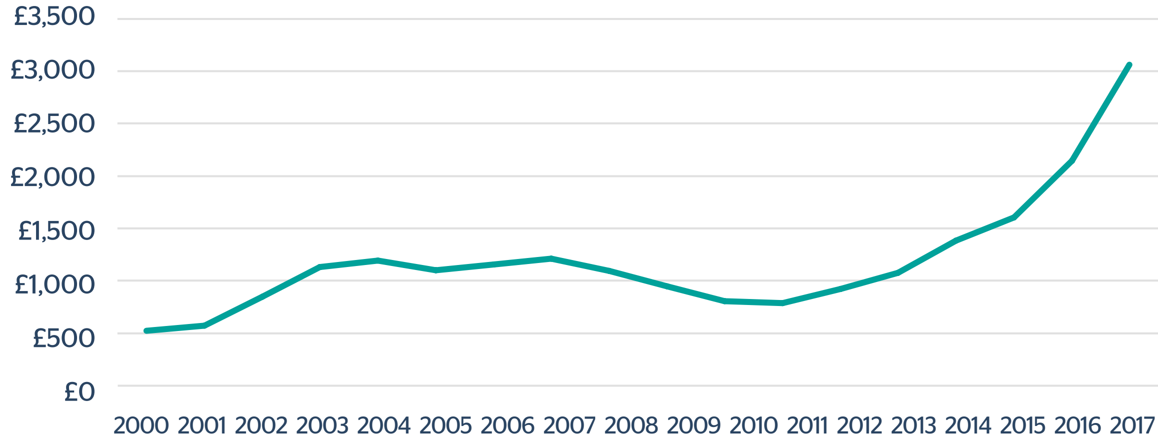
Professor Kevin Dowd, of Durham University, has recently raised the stakes not just with that presentation but with the publication of a paper (Dowd K, *Asleep at the Wheel: The Prudential Regulation Authority and the equity release sector*. Adam Smith Institute, 6 August, 2018.) At the same time, he appeared with

Bulk annuity purchases (£ bn)



Source: Willis Towers Watson, Bulk Annuity Market Update, May 2018

Value of equity release mortgage transactions (£ m)



Source: Equity Release Council, Spring 2018 Market Report

his colleague, and former PRA valuation specialist, Dean Buckner, in a Radio 4 programme, *The Equity Release Trap* (7 August, 2018). But the storm had been brewing during the previous 18 months with three significant moves by the PRA: a new solvency standard, issued in March 2017; a speech in April 2018 by the PRA's executive director of insurance supervision, David Rule, raising queries about the exposure of insurers to illiquid housing assets; and in July a consultation paper, which may lead to tighter rules on annuity and loan providers by the end of 2018.

These rumblings have been sufficient to halve the market capitalisation of Just, a leading specialist provider of retirement products. For other big ERM lenders, such as Aviva, Legal & General, Liverpool Victoria and Nationwide, the fall-out is less severe since ERM is a small proportion of their business. Andrew Bulley, of Deloitte and the former director of life insurance supervision at the Bank of England, noted in a September 2017 blog: "For an asset class that represents just 1.4 per cent of insurers' asset holdings, equity release mortgages have consumed a remarkable amount of firm and supervisory time."

Dowd is not predicting systemic collapse, but he is comparing the cost of NNEG (and its alleged under-valuation by the providers) with the guaranteed fixed returns of Equitable Life, whose under-valuation caused its costly implosion in 2000. Why does the valuation of NNEG matter so much? There is no space here to go into the technical formulae that a full explanation would require and purists can find the minutiae in the Dowd and Buckner papers.

An NNEG valuation attempts to measure the cost to the lender of providing what is in effect a put option to the borrower at some unspecified date, a date decided by the borrower's health. The lower the NNEG valuation, the higher the "matching adjustment" that the lender can credit to the available capital in its solvency ratio. Conversely, any increase in the NNEG valuation, caused by tighter PRA rules on the calculation formula, will reduce the lender's solvency ratio. In the case of specialist retirement providers who depend solely on this market, this may trigger the need both to raise fresh capital and to cut back on their highly profitable (in spread terms) ERM lending.

> *Tighter PRA regulations may trigger the need for specialist retirement providers to raise fresh capital*

The recommended "Black '76" option pricing formula for calculating NNEG contains many moving parts. But the most crucial is the net annual percentage rental value (ie the "rent" the lender is forgoing by deferring access to the property). Dowd and Buckner argue that 2.5 per cent is the minimum net rental value, or deferment rate, that should be used and that house price growth should not be included.

That is a crude summary of a fascinating and more complex calculation involving rules around the deferment price (ie that it should always be lower than the price to be paid for current occupation). Crucially, Dowd and Buckner challenge the lenders to acknowledge that they are using much lower net rental rates in their calculations of NNEG than is justified.

And that they are wrongly including house price growth assumptions, thus deflating NNEG and inflating the estimate of available capital used in the solvency ratio calculation.

The PRA is pushing in a similar direction. The original solvency standard set in March 2017 gave discretion for lenders' management to adopt "appropriate" valuations of NNEG. The 2018 consultation looks to set tighter and more specific rules, stating "the PRA's view [is] that firms should not use assumptions about future house price growth in excess of the risk-free rate" and that "a best view of the deferment, or net rental value, rate would be 2 per cent… and an assumption of less than 1 per cent would be difficult to justify". This presages a more hands-on, firm-by-firm PRA approach to increase NNEG values, alongside the offer of a three-year transition period. For Dowd and Buckner, this still does not go far enough and shows the PRA bending under sector lobbying pressure.

> *Housing wealth has now become integral to many people's financial plans for later life*

The sector counters that, with a 30 per cent average loan-to-value ratio and a predictable average loan life (the rise in longevity has stalled over the past five years), ERMs offer a massive cushion against potential deficits on redemption – of which there have been precious few since this market started 15 years ago. Even Dowd's charts do not show a cross-over between loan value and realisable value until year 20 and that, sadly for many 70-year-olds but happily for ERM lenders, is well past the mode survival length.

Why restrict a recognised success story that is fulfilling the textbook role of financial intermediaries, namely to offer both sides a more attractive asset than they could achieve otherwise? This is in addition to going some way to address the vexed pension funding issue. The industry's stance is: "There is growing recognition from consumers, government, industry and regulators that *housing wealth has become integral to many people's financial plans for later life* and we anticipate a continued rise in activity as older homeowners seek out safe and flexible equity release products in greater numbers."

In those italics (mine) lies the big theme here – and the justification for tightening the NNEG calculation. As Rule highlighted in his April speech, "Illiquid assets currently make up more than 25 per cent of the assets backing UK insurers, whose business plans suggest this proportion might increase to around 40 per cent by 2020". Most of this is in housing. That means the annuity market is heavily dependent on the cycles of the housing market.

For Rule, "from a prudential perspective, the main risk is long-term stagnation in UK house prices". Ultimately, no amount of tweaking the NNEG calculation can avoid that harsh truth. If the UK were to reverse its past 40 years of house price growth and follow the post-1990 course of the Japanese housing market, annuity providers would be facing a funding hole about 15 years from now. ■

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