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Equity Release: A Sting in The Tail?

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According to equity release advisor Key, 2018 saw over 47,000 new loans taken out releasing £3.6 billion of equity. Strong growth across the first and second quarters of 2019 eased off in the latter two quarters so that 2019 merely replicated the prior year loan total. That said, with over 24 million people now in the over-55 category, technological innovation around product offerings and signs of strong performance at the start of 2020, some believe that borrowing could reach £5 billion in 2020. Indeed, leading trade body Equity Release Council, has recently reported that over the past two years its membership has grown by 97%.

So equity release looks like it is here to stay and, with an aging population, high equity levels in property amongst that age-group, mounting personal debt and an increasing appetite to boost retirement income, it could be set for significant growth.

But there is one obvious, yet crucial, difference between equity release products and the more traditional forms of mortgage; loan life. Traditional mortgages are fixed to usually between 10 to 25 years. Equity release, on the other hand, has no such limitations and endures for the borrowers' lifetimes. We would caution surveyors valuing property for such purposes to be fully alive to the underlying equity release concept and the risks which are likely to attach to their valuation work.

The General Concept

For many people, the home is their single biggest and most valuable asset, and into which most of their money has been tied up. Equity release is a means of unlocking that money, without losing the benefit of continuing to live there.

The demand for equity release products has been driven by a number of factors, encompassing both choice and necessity. The 2007 credit crunch gave a snapshot into the prevalence of interest-only mortgages, with many borrowers not having a suitable repayment vehicle to redeem the capital debt at expiry of the term. We have already seen large numbers of claims from lenders who had to repossess properties on interest-only accounts. Similarly, with increasing frequency, claims are emerging from those borrowers who contend that they did not understand what an interest-only mortgage meant, and that it was not suitable. Equity release is now considered, in the right circumstances, to be a feasible option to discharge such mortgage debt, when other more traditional forms of lending may not be readily available.

Equity release is also advertised as being able to help fund other uses: to pay off debts; help boost retirement income, invest in home improvements or lifestyle; or to be rolled back in to the lower end of the housing market by assisting family members with deposits.

The Options

The two most common forms of equity release are the Lifetime Mortgage and the Home Reversion plan. Both generate immediate funds but in different ways.

The Lifetime Mortgage expires upon the death of the (final) borrower or sale of the property. It involves an agreed lending limit and fixed interest rate, drawn down either immediately or at various stages when required, and with no repayment obligations. Upon death or disposal of the property, the interest charges are rolled up and fall due for repayment from the Estate and/or sale proceeds. In the meantime, the house remains entirely the property of the homeowner, subject to repayment of the debt upon sale. If the no repayment option is taken it can, of course, be very expensive as interest is regularly compounded.

With the Home Reversion plan, the homeowner is parting with a specified proportion of the legal interest in the property, but retains the right to continue to reside in it on a rent free basis. The major downside is that the lender's offer for a percentage share tends to be significantly lower than its actual market value, so as to build a cushion against which notional interest may ultimately be recouped.

The terms which are available, and the Loan to Value ratios that are offered, will be determined by the usual underwriting factors relevant to any such lending proposition, thus including the value of the property itself, as well as the age and health of the borrowers. However, youth and/or good health in this instance are negative factors given that repayment of the debt is delayed until death or sale; the longer the account is active, the greater the interest charges and the resultant risk to the lender of not making full recovery. As such, the more elderly and/or potentially unwell the homeowners are, the better the likely terms.

The Valuation Considerations

In broad terms, the duties upon a surveyor are as would be expected from any other Scheme 1 Mortgage Valuation Report instruction. Each lender will have its own guidelines with which the surveyor needs to be familiar and comply, including as to what constitutes acceptable security. Beyond that, the exercise as usual involves assessing current value as at that moment in time, having due regard to questions of location, condition, type of property, marketability and current market sentiment by reference to comparable houses in the vicinity (ideally as against recorded sales).

However, as the duration of a Lifetime Mortgage is not for a fixed term the RICS guidance under UKVS.3 states that comment should be made about the sustainability of the property to the extent that it may have a negative impact upon value over the longer term. This means that if there are any features of the property, including as to design or condition, that may influence market value in the future then it should be highlighted.

As for a Home Reversion application, development potential also becomes a factor for the surveyor to take into consideration as part of the valuation.

From a practical perspective, the applicants for equity release products will be a minimum of 55 years old, with the average age currently approaching 70 according to the Equity Release Council. Dealing with potentially ‘vulnerable’ homeowners will therefore necessitate care during the inspection, to ensure that they understand what the surveyor is doing, but also still afford the surveyor the necessary access to consider the property in its entirety, and properly gauge its condition and value.

Further, the surveyor needs to be able to accurately assess the state of the structure, as longer term maintenance and repair work may not be kept up to date as the homeowner gets older, which could materially detract from the future value in the event of failure. Again, potential concerns over condition will need to be factored into the report, so that the lender is aware of the true condition and the identifiable risks prior to agreeing any advance.

Surveyors know only too well the pain that was caused to the profession by the last market crash. In the event that the market falls again, and/or the lenders do not make a full recovery when the subject properties have been sold, inevitably there will be an attempt to look around for who else may be to blame. However, and unlike with a conventional mortgage, the homeowner’s estate will not be exposed if the provider is a member of the Equity Release Council due to its requirement for a ‘no negative equity guarantee’ to be provided.

Whilst such a guarantee is good news for the borrower, it rather isolates the surveyor as being the lenders’ only realistic target for recovery of any unexpected shortfall. And given the life time nature of the loan, that may only materialise many years after the event (but, obviously, not more than 15 due to the limitation longstop).

This heightens the need to ensure that there is a good record of valuation methodology applicable to equity release requirements; not just comparable data and rationale but also factors considered and/or dismissed as being relevant to the long tail nature of this type of product. It would also be prudent for surveyors to give careful thought to the terms of engagement and what additional terms ought to be expressly incorporated in the retainer when undertaking valuations for equity release purposes.

Overall

Equity release is an already significant aspect of the UK housing market, even during periods of declining sales. Surveyors undertaking valuation work for this purpose must ensure that they are alive to the risks, ensure that terms of engagement are fit for that particular purpose, be confident that reward fairly matches the risks, and that their retained records stand up to retrospective scrutiny.

The nature of equity release suggests to us that AVM technology is unlikely to be used by lenders active in this space due to the importance of issues such as form of construction, condition and the property’s useful life expectancy. So as the use of MVR’s for traditional lending products appears set to dwindle, the demand is expected to remain strong in the equity release sector.

But, in line with hard lessons previously learned, it is imperative that steps are taken to minimise risk and/or that the reward is truly reflective of the risk being assumed. Not doing so could result in a sting in the tail.

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