Shared Appreciation Mortgages

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This note outlines some of the basic features and problems of equity release type mortgages. The long period of steady house price appreciation has meant that the sums owed to banks when the mortgage is repaid appear exorbitant to some borrowers. The note illustrates examples of how problems can arise with these financial products and charts the move towards full regulation of them by the Financial Services Authority and then the Financial Conduct Authority.

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1 Introduction

The phenomenon of being 'cash poor asset rich' is quite common amongst the elderly. Someone with a small, inadequate, pension might still be living in the large family home worth hundreds of thousands of pounds. Various permutations of loans now exist which enable homeowners to 'release' part of the equity that is 'locked up' in their house and let them stay in the property. The money released is used to supplement the pension.

Shared appreciation mortgages (SAMS) are an extreme version of other equity release schemes which have been taken up by thousands of, primarily, elderly people. They are extreme in the sense that whereas other schemes require some repayment of the principal sum advanced SAMS do not. In this case, the loan is paid off from the proceeds of the sale of the property.

1.1 The schemes

The consumer advice organisation *Which?* published a survey of equity release schemes in August 2003, as reported by the BBC news website:

> Some plans could leave you out of pocket Equity release schemes can be expensive and inflexible - and should be a 'last resort' for pensioners looking to boost their income, says Which? magazine. Equity release schemes are being tipped as the "next big thing" in financial services, and are mostly aimed at people aged 65 and over. Retired homeowners are estimated to be sitting on property worth £700bn. The plans are marketed as ideal for people who have paid off their mortgage, as they allow owners to release cash tied up in their home without having to sell up. But the Consumers' Association said there were big flaws with some of the plans, which could be punitive, complicated and expensive.
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> Unlocking cash
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> There are two main types of equity release plans: Interest roll-up loans and home reversion plans. An interest roll-up loan lets people borrow money against the value of their home and, in most cases, receive a lump sum. Unlike a normal mortgage or loan, interest is added to the loan, rather than repaid while living in the property. The amount owed can grow quickly as interest is charged on the interest added to the loan each year, as well as on the original amount borrowed. This could eat up the bulk of the value of the property, the Consumers' Association warns. Interest rates on equity release mortgages tend to be higher than on ordinary mortgages - around 7%. In home reversion schemes, home-owners sell all, or part, of their home to a reversion provider and receive a lump sum, an income or both. People who do this won't get anything like the full market value; companies typically pay between 40% to 60% of the property's current value.
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> Serious drawbacks
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> One of the main problems with equity release plans arise when circumstances change, reports Which?. For example, if someone wanted to move to sheltered accommodation, or a cheaper property, they may have to repay some of the loan. In addition, roll-up loans might leave someone with too little equity to buy the new property they want. People can also be hit with big redemption charges, if they decide to pay off the loan early. While there is a general criticism about equity release plans, because they reduce the value of an estate, meaning the family will receive little or

nothing when the plan holder dies. Someone should first consider whether they would be better simply selling up and trading down, Which? said.

Think carefully

The Financial Services Authority takes over mortgage regulation in October 2004. While mortgage based products will fall within its remit, the rules will not cover home reversion schemes. Helen Parker, editor of Which?, said: "We advise people considering equity release schemes to view them as a last resort. "These 'lifetime mortgages' don't have to be paid off until you die, but while this means you don't have to worry about paying off the loan now, it can cause problems if your circumstances changes, and of course you will also have less to leave behind."[1]

The factor behind the row over SAMS has been the extremely high rate of increase in house prices and the effect that this has had upon the rewards to the lenders. This is best demonstrated by an arithmetic example which is based on the commonest form of the loan a 25% advance linked to the bank receiving 75% of any appreciation. Other arrangements are possible.

	Annual % increase in house prices		
£'s	2%	5%	10%
Property value at start	100,000	100,000	100,000
Mortgage advance for 25% of house	25,000	25,000	25,000
Property value after ten years	121,899	162,889	259,374
Return to bank	41,425	72,167	144,531

This example supposes that the bank lends £25,000 of the original value of the house in return for a 75% stake in its appreciation (if any) in the property when the loan is repaid. The rate of increase in house prices makes a crucial difference to the return the bank makes. At the higher levels of price increase, the bank effectively makes more than £10,000 a year on the loan. In some circumstances even this might not matter too much. The individual would have had the £25,000 to see them through their life and when they died the heirs would still benefit from a substantial legacy from, the remainder of the property.

Of course it should be pointed out, that had property prices fallen over the period the individual would have had an interest free loan for the duration of the loan.

The real problems occur when, to put it bluntly, the borrower does not die at a convenient moment or as *Which?* put it, circumstances change for the borrower.

Imagine that the same transaction takes place but, after 10 years, the borrower is still alive but now wants to move to a smaller house, which in the example costs £70,000 compared to the £100,000 that the original house is worth. A common scenario is illustrated below:

1 "Equity release warning", *BBC news site*, 6 August 2003

	Annual % increase in house prices		
£'s	2%	5%	10%
Home Property value at start	100,000	100,000	100,000
Retirement property price at start	70,000	70,000	70,000
Mortgage advance for 25% of house	25,000	25,000	25,000
Property value after ten years	121,899	162,889	259,374
Return to bank	41,425	72,167	144,531
Money to buy retirement property	80,475	90,722	114,844
Retirement property price at end	85,330	114,023	181,562

In this case, the smaller 'retirement' house now costs more than the individual has left from the loan. The elderly person is now effectively trapped in their current property.

An appeal for a 'class action' (group litigation order) on behalf of SAMs mortgage holders was approved in January 2010.[2]

1.2 Parliamentary debate

There have been a significant number of debates in the House about equity release mortgages in general and SAMS in particular, as the consequences of policies taken out some years ago now come to be appreciated.

There was a general debate on 14 January 2003 in an adjournment debate in Westminster Hall launched by Angela Browning.[3] During the debate, a number of members specifically mentioned 'shared appreciation' mortgages, including Vincent Cable, Stephen O'Brien and the then Financial Secretary to the Treasury, Ruth Kelly. Part of the Minister's speech is reproduced below (*emphasis added*):

> Equity release schemes are financial products that allow home owners to release the value of their property over and above any amount owed on a mortgage. Those schemes involve providers giving home owners a lump sum or income, or both, based on the value of the home. The providers receive their return when the home is sold. There are two basic types of scheme. One is mortgage-based; the other is the reversion plan. In the mortgage-based scheme, the householder retains ownership of the property; but in reversion plans, the reversion provider becomes the owner of whatever proportion of the property is sold.
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> There are several variants of the mortgage-based scheme. The mortgage annuity scheme, usually called the home income plan, allows the home owner to take out a fixed-interest mortgage, which is used to buy an annuity for a fixed income for life. The rolled-up interest mortgage allows the interest on the mortgage to be rolled up and added to the amount owed, which is repaid on death or when the property is sold. The shared appreciation mortgage expresses the cost of the loan as a percentage of any growth in the property value, payable on death or the sale of the property. Finally,

2 High Court of Justice EWHC, 203, (CH) case 2009/PTA/0603
3 HC Deb 14 January 2003 cc 181-202WH

some interest-only loans are available. I am aware of the concern expressed about many of those categories.

Under the home reversion plan, home owners sell their house at a discounted rate in return for a lump sum and/or income, and they continue to live in the house rent-free or for a peppercorn rent for life. The amount paid to the house owner is based on a number of factors, including the value of the property, the proportion of the property being sold, the life expectancy of the home owner, long-term interest rates and expected house-price inflation.

As with other regulated mortgage contracts, mortgage-based equity release schemes will be covered by the Financial Services Authority's regulatory regime that is due to come into force in October 2004. The FSA considers that such mortgages, which it calls lifetime mortgages, are high risk, and it has accordingly devised a regulatory regime for them. The proposals are set out in consultation paper 146—the FSA's approach to regulating mortgage sales—which was published in August 2002 …

To continue on appreciation mortgages … concerns have been raised about the returns that lenders receive if borrowers sell their property, having received a shared appreciation mortgage. The return a lender receives from a shared appreciation mortgage is dependent on the increase in property value. In most cases, no interest is payable. The borrower repays the amount borrowed, plus three times the agreed percentage of any increase in value. For many shared appreciation mortgages, the maximum percentage is 25 per cent., so at most the borrower will be charged three times the increase in value. With the value of some properties rising substantially, however, lenders could receive a large return—indeed, some have done so …

Few people could have foreseen the extent to which house prices would grow. However, if house prices had fallen or risen more slowly, borrowers would have received a lower interest or even an interest-free loan. The risks should be properly understood and explained, and people should exercise an informed choice. I am pleased to say that, when the FSA's mortgage regulation comes into force, the proposed advice and disclosure regime will enable borrowers to become fully aware of the implications of all equity release loans before they take a decision on the right one for them … In the meantime, if hon. Members' constituents believe that they have been badly advised, or that their mortgage was miss-sold, and, assuming that all internal complaints procedures have been completed, they may be able to seek redress from the financial ombudsman service.

Home reversion plans are not currently covered by the FSA regime. That is because they are considered to be pure sale and purchase agreements, and not financial services products ... Just because home reversion plans are not financial services products does not mean that there is no scope for abuse. Vulnerable consumers may still be at risk of miss-selling and a lack of redress if things go wrong. There is also the possibility of distortion of the equity release marketplace in favour of the unregulated plans if there is not a level playing field and regulation between reversion-based plans and mortgage-based plans …

The Government recognise the concerns that have been expressed and are concerned—for the reasons that I have described—about creating a level playing field for the regulation of both equity release and home reversion plans, aiming to protect consumers better and to make the market work better. We have already begun to meet interested parties to find out how a system of regulation might work. We are still gathering evidence of possible and likely consumer detriment in order to decide the appropriate degree of regulation. We do not want to over regulate—I am sure that the Opposition would have us bang to rights if we pursued that route. We want to get things right and we want consumers to be properly protected. Were we to go ahead on the basis of consultation, the process would be to publish a consultation paper—probably later this year—and then to decide after taking legal advice whether regulation could be implemented using secondary legislation or whether primary legislation should be pursued …

It is not the case that consumers have no protection at present, or that they will have no protection in future. As has been pointed out, the main reversion scheme providers are members of SHIP—safe home income plans—which is supported by leading providers of equity release plans. Members of SHIP agree to comply with a code of practice and undertake to provide fair, simple and complete presentation of any plan that they offer. I understand that the charity Age Concern has welcomed that code of practice; it may well improve the code, as the hon. Member for Twickenham has suggested. A SHIP plan guarantees that consumers will not lose their home whatever happens to the stock market or interest rates. In addition, and importantly, consumers' solicitors act on consumers' behalf—they are independent of the providers—when advising on the sale.

For the future, the FSA proposes that those firms that sell both mortgage-based equity release schemes and reversion plans will be required to take account of both types of product when giving advice. The proposed training and competence requirements will also include knowledge of lifetime mortgages and reversion schemes, whatever the Government's decision. That is because the FSA is able to make rules in respect of the unregulated activities of regulated firms.[4]

Following a consultation[5] initiated in June 2003 by the then Chief Secretary to the Treasury, Paul Boateng, the minister announced in response oral questions in July 2003 that

All mortgage-based equity release schemes will be regulated by the Financial Services Authority with effect from 31 October 2004. I announced on 5 June that an open consultation would take place in the autumn on whether home reversion plans should also be regulated by the FSA.

Ms Keeble : I thank my right hon. Friend for that reply. Given that these schemes are so important for pensioners—many of them are asset-rich but cash-poor—is the Treasury prepared to look at some options to provide further support or relief for equity release schemes where essential building repairs are required?

Mr. Boateng: I shall treat that—as, no doubt, will my right hon. Friend the Chancellor—as an early Budget submission and it will be given careful consideration, as all such submissions are. On the wider point of consumer protection of the elderly, lessons have been learned from the failures of the '80s in relation to home income plans. In the light of the consultation on home reversion plans, I commend the work done by Age Concern with responsible members of the industry in setting up a code of practice under the safe home income plan scheme. That gives my hon. Friend's constituents and many others the sense of security and certainty to which they are entitled in their old age.[6]

4 HC Deb 14 January 2003 cc 197-9WH

5 HM Treasury press notice 67/03, 5 June 2003. Prior to this announcement, in the pensions green paper *Simplicity, Security and Choice: Working and Saving for Retirement* (Cm 5677, December 2002), the Government had stated the Treasury would be "looking at options to create a level playing field for the regulation of equity release and home reversion plans to protect consumers and make the market work better" (pp 90-91).

6 HC Deb 10 July 2003 cc 1369-70. Full details available here.

I turn now to the specific points that my hon. Friend made about mortgages. Of course, he is right to point out that a mortgage is one of the biggest financial decisions that a consumer makes. Equity release falls into that category too. They are very significant financial decisions. It is absolutely essential to protect consumers adequately. Indeed, I should point out that the FSA is the only statutory regulator in the world, as far as we aware, that has consumer protection as one of its statutory objectives. As he knows, there will be better protection for consumers when the regulation of mortgages and mortgage advice comes into force on 31 October 2004. The new regime will give the borrower greater confidence in the decisions that he or she is making.

A further debate was held in December 2003 in Westminster Hall. The Financial Secretary's remarks are shown below:

Regulation of mortgages, alongside the regulation of general insurance, will also simplify the regulatory landscape by ensuring that there is a single regulator for mortgage advice, general insurance and retail investment business. As my hon. Friend said, the FSA will regulate the selling of mortgages by first legal charges on UK property where at least 40 per cent. is residential accommodation to be occupied by the borrower or their immediate family. That definition was derived following consultation and is designed to protect loans when a person's home may be at risk as a result of being sold an unsuitable product.

[…]

The pensions Green Paper, "Simplicity, Security and Choice: Working and Saving for Retirement", which was published in December 2002, stated that the Treasury would be "looking at options to create a level playing field for the regulation of equity release and home reversion plans to protect consumers and make the market work better".

In the wake of that Green Paper, my officials held a number of discussions with stakeholders in the first half of this year. Although stakeholders were unable to provide any evidence of significant consumer detriment at present, they were concerned about the projected expansion of the home reversion market and the potential for consumer detriment in the future.

It was in the light of those concerns that we announced that the Government would carry out an open consultation on whether home reversion equity release plans should be regulated by the FSA. We published our consultation paper on 11 November, and responses are expected by 13 February 2004. The primary purpose of the consultation will be to arrive at a more in-depth analysis of the costs and benefits of regulation. As I am sure that my hon. Friend knows, we never extend the scope of regulation without considering the costs and benefits extremely carefully.

We hope that the consultation will provide evidence on consumer detriment in particular, and on the basis of that evidence, we will need to establish whether regulation would be appropriate.

[…]

We are also interested in evidence as to whether the current system of voluntary protection works or whether, as my hon. Friend is suggesting, it does not protect consumers adequately. It is only right that we ask people to submit evidence so that we can make an informed judgment on the issues. He is right to draw attention to the issue, and in the interim period, the FSA is already working on information that it can provide to consumers on the pros and cons of engaging in equity release, so that they can make an informed decision without having to wait for any subsequent regulatory decision that the Treasury may make.[7]

The outcome of the consultation was announced by the then Financial Secretary, Ruth Kelly, on the 10th May 2004 that Home Reversion plans would be regulated by the FSA. Legislation would be required to effect this and before that was introduced the Treasury issued a consultation document *-Defining Home Reversions-* which consulted on the parameters surrounding the definition of a Home Reversion plan.

1.3 Home Reversion plans

The distinguishing feature of Home Reversion plans is that part of the house is actually sold to the lender. In this case ownership of the property passes (in part) to the lender. Under SAMS type loans, ownership is retained by the borrower.

Home Reversion plans were brought within the scope of FSA regulation by virtue of the *Regulation of Financial Services (Land Transactions) Act 2005*. This, one section, Act empowered the FSA to bring forward high level rules governing the sector at a later date.

The FSA produced a consultation document *Regulation of Home Reversion and Home Purchase Plans* in April 2006. Chapter 8 of the document set out the proposed redress arrangements:

> Complaints handling and the Financial Ombudsman Service
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> 8.2 We propose to extend the compulsory jurisdiction of the Financial Ombudsman Service (FOS) to cover all HR and HPP providers, intermediaries and administrators and to apply the rules in the DISP sourcebook to these firms. As with our other rules, these will also apply indirectly to appointed representatives through their principals.
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> 8.3 So these firms will need to have appropriate internal procedures for dealing with complaints. They will have up to eight weeks to resolve a complaint to the satisfaction of the consumer. If a firm fails to do so, it will have to tell the consumer that he has the right to refer his complaint to the FOS, which provides an independent mechanism for settling complaints.
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> 8.4 The FOS will try to resolve the complaint by conciliation in the first instance, but the Ombudsman has the power, if necessary, to make an award of up to £100,000, which is binding on the firm, but not the consumer. The Ombudsman may recommend a higher award with the firm's agreement. He can also direct a firm to take such steps as he considers appropriate to remedy a complaint.
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> Compensation and the Financial Services Compensation Scheme (FSCS)
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> 8.6 The FSCS provides a final safety net for consumers if an authorised firm is unable or likely to be unable to meet its financial obligations towards its customers. The rules covering compensation are in the COMP sourcebook of our Handbook.
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> 8.7 Most regulated activities in the retail markets (including mortgage advice and arranging) are covered by the FSCS. However, mortgage lending and administration activities (but not lenders' arranging activities) are excluded from FSCS coverage on proportionate and cost-effectiveness grounds because the circumstances in which a borrower is likely to suffer loss in the event of a provider defaulting are limited and

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7 HC Deb December 17 2003 c278WH

there is potential scope for a market solution, such as the transfer of a portfolio to another lender, generally without loss to the borrower.

8.8 The sale and lease nature of HRs and HPPs and the fact that the provider, rather than the consumer, has title to the property creates some significantly different consumer risks in the event of a provider default. The scope for a market solution may be more limited in these relatively small markets.

8.9 In developing our proposals for the compensation arrangements for these new activities, as explained in Chapters 6 and 7, we began by analysing the nature of the potential risks to consumers in the event of an authorised HR or HPP firm (provider, intermediary or administrator) becoming insolvent. We then considered the extent to which these risks are addressed by existing property law across the UK. As we have already noted, the picture is a complex one, but property law already provides significant protections and we believe these can be further strengthened by a combination of our rules and the involvement of professionally qualified legal advisers.

8.10 Our proposals in relation to the FSCS take account of this analysis. They also take account of the need for compensation limits on any business covered by the FSCS, the viability of funding claims in relatively small markets and the limitations on the FSCS's ability to provide redress for certain types of potential loss (for example, loss of tenure under a lease).

8.11 As with mortgages, there is a clear distinction between the risks arising from the default of an HR or HPP provider and those arising from the default of an HR or HPP intermediary (including a provider acting as an intermediary). We deal with these separately below. Within this framework, most of the risks apply to both products, but where they differ, we highlight this fact.

HR and HPP Intermediaries

8.12 The position for intermediaries is relatively straightforward. We believe that those who are advising on or arranging the sale of HRs and HPPs (including providers if they are carrying on these activities) give rise to similar scope for consumer detriment (through mis-selling) as those who advise on or arrange regulated mortgage contracts. This could include, for example, unsuitable advice to take out or provide an HR or take out an HPP, inadequate explanation of risk or unfair charging of fees. So we need to ensure that the consumer is protected in the event of the failure of a firm which has mis-sold these products or been negligent in arranging the sale of these products.

8.13 We therefore propose that, as with mortgages, these activities should be covered by the FSCS up to a maximum of £48,000 per claim. We adopted the £48,000 limit for mortgage advice and arranging following full public consultation in 2003.

HR and HPP providers and administrators

8.14 As noted in Chapters 6 and 7, the potential risks to consumers arising from the default of an HR or HPP provider are much more complex – and the nature and extent of these vary for different products or types of products.

8.15 There is, for example, relatively little risk from a provider default for a consumer with a full HR, who has received a lump sum at the outset, since he no longer has a financial interest in the property. However, for an Ijara customer whose payments towards buying a house do not give him any beneficial interest in the property until ownership transfers at the end of the plan, the risks requiring mitigation are significantly greater.

> 8.16 In summary, we need to satisfy ourselves as far as possible that:
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> (i) the consumer's right to stay in his home is unaffected (that is, preservation of security of tenure) (HRs and HPPs);
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> (ii) the consumer's beneficial interest in the property is properly protected and ring-fenced from other creditors (partial HRs and Diminishing Musharakas);
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> (iii) where the consumer has no formal beneficial interest in the property during the life of the plan, but has made pre-payments on account towards buying the property, his financial interest in that property is properly protected (Ijara);
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> (iv) where the consumer has opted for a regular income stream, rather than a lump sum, this income is properly safeguarded (HRs); and (v) any outstanding rights under the contract (eg to buy or sell further tranches of the property) are preserved as far as possible (HPPs and HRs).
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> 8.17 We are satisfied, in the light of the analysis in Chapters 6 and 7, that these risks can be mitigated in the ways explained in those chapters. So we do not propose to bring HR and HPP providers and administrators into the scope of the FSCS. While the risks posed by provider defaults are different from those for standard mortgage lenders and administrators, we believe that the alternative tools we have outlined in those chapters provide us with an appropriate means of mitigating the risks posed to consumers of HR and HPP products in the event of a provider or administrator insolvency.
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> 8.18 We believe this represents a proportionate approach, taking due account of the size and nature of the markets, the impact and probability of potential claims and the costs and benefits and viability of funding such claims through the FSCS.

Consultation on this document ended in July 2006 and new rules were published in March 2007, and came into force from 6 April 2007. An FSA factsheet described the main features as:

Firms need to ensure that any financial promotions they issue are clear, fair and not misleading.

The 'Keyfacts' disclosure documents (i.e. IDD and KFI) need to be clear and provided to consumers in a timely way.

Firms can sell HRPs with or without advice, although it is likely that most consumers will consult an adviser.

There is an obligation on regulated firms to ensure consumer interests are protected to a reasonable standard. These interests include right of tenure, protection of any legal or beneficial interest in the property and protection of income stream for income plans.
Firms will usually be required to obtain confirmation from a customer's legal adviser that they have been instructed to ensure the customer's legal rights under the plan are protected and that all relevant legal matters have been discussed.

Home finance appointed representatives are now allowed to register with up to four different principal firms. This means they could have a different principal for home purchase plans, mortgages, lifetime mortgages, and HRPs.

A property valuation needs to be carried out by a competent valuer who is independent of the provider. An intermediary will need to ensure this if the provider is unauthorised.

Advisers need to meet the relevant training and competency requirements (this also applies to providers who have an advisory function).

Further issue relevant to intermediaries Corresponding rules
On some occasions a home reversion provider will not need to be authorised, for instance, a one-off investment by a wealthy individual. The duty is on the regulated firm to ensure that consumer receives a reasonable level of protection.

2 Responses to criticism

There have been three main responses to criticisms over SAMS and other equity release products besides the legislative response

First, the establishment of a SAMS Action Group. This originally co-ordinated moves to start legal action against the banks but has since dissolved and become part of the wider SAFE (Struggle Against Financial Exploitation) action group.

Secondly, those banks involved with equity release products set up a code of conduct agreement under the SHIP logo. The main promise made by this group was that borrowers could not find themselves in a situation of negative equity because of a mortgage they had taken out.

Last, Barclays, one of the main sellers of SAMS established a hardship fund that specifically looked to help people who were trapped by their circumstances.

3 Constituent help

General advice from the FCA can be found on the Money Advice Service website consumer web pages which has a specific equity release page.

The SHIP scheme mentioned above (an industry code of conduct scheme) remains in place. Information on its guarantee and other matters can be found on the Equity Release Council's website:

Complaints, if they are unresolved by the lender can be addressed in the first instance to the office of the Financial Ombudsman. They can be contacted:

- phone consumer helpline on 0300 123 9 123 or 0800 0 234 567, 8am to 6pm, Monday to Friday
- email **complaint.info@financial-ombudsman.org.uk**