Personal Finance News

Would house price crash be a blow for equity release?

HOMEOWNERS who have turned to equity release to raise much-needed cash in their final years may have been shocked by last week's warning that a “major scandal” is brewing in the sector.

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Savings expert Martin Lewis explains equity release schemes

Equity release mortgages allow the over 55s to raise tax-free cash by borrowing against the value of their home, with the capital and interest paid off from the proceeds of selling the property after they die.

It is a lifeline for many retired homeowners struggling with low incomes or high debts.

The market is heavily regulated by the Financial Conduct Authority and the Prudential Regulation Authority (PRA), which has boosted customer confidence and driven rapid growth.

However, last week the free-market Adam Smith Institute suggested the sector is in "deep trouble", with the regulator missing opportunities to manage the risks.

Should you be alarmed?

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Negative

The Adam Smith Institute's warning centred on one of the most attractive equity release features, the no-negative equity guarantee.

This pledges that nobody can owe more than the value of their mortgaged property, regardless of what happens to house prices.

Even if the amount raised by the house sale is not enough to repay the outstanding loan, neither the customer nor their estate is liable to pay any more.

The guarantee shifts risk from customer to lender, because if house prices crash and it cannot recoup its money from the property sale, it must still stand by the guarantee even if it means making a loss.

Report author Kevin Dowd, professor of finance and economics at Durham University, warned that providers have undervalued their guarantees, creating "a ticking time bomb".

Would a house price crash be a blow for equity release? (Image: ALAMY)

He said the PRA had knowingly allowed firms to use valuation methods that are "unfit for the task", even though its own stress tests suggest a 30 per cent house price fall could trigger losses of between £2-3 billion.

Positive

Not everybody is convinced. The former pensions minister and now House of Lords member Baroness Ros Altmann said that she did not believe the problem is as huge as Professor

Baroness Ros Altmann said that she did not believe the problem is as huge as Professor Dowd has suggested: "All risk models will show different outcomes, depending on the assumptions used and there can be no 'right' way of assessing these things in advance, because nobody knows what will happen."

She said she would not wish to go back to the days when people did not have a no-negative equity guarantee: "The fall in house prices in past cycles caused enormous misery to those who found they owed much more than the value of their home and were at risk of losing it."

Baroness Altmann said she thought equity release loans were "rather expensively priced" but at least this gives lenders a financial buffer: "Property prices would have to fall enormously and people with these mortgages would have to live a very long time, before losses are incurred."

She said that for some, an equity release loan may still be the best way to raise short-term fi nance to pay for emergencies, such as care.

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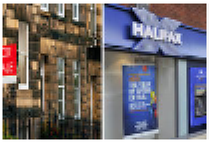

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Dean Mirfin, chief product officer at specialist equity release advisor Key Retirement, said the research suggested not only that house prices fell sharply, but also failed to recover.

"Our typical customer is 71-years old, which means these loans typically have 15 or more years to run, giving plenty of time for prices to bounce back."

Equity release mortgages will mature over many years rather than all at once, again limiting any losses. "Our typical loan-to-value is just 28 per cent of property value, which gives lenders a large financial cushion," he added.

Crucially, customers should not lose out, even in the highly unlikely event that their lender goes bust.

He said: "Terms and conditions on your loan cannot be changed in any way."

Equity release may be growing quickly, but it remains a small market, around 2 per cent of all mortgage lending.

"A sustained 30 per cent house price crash with no recovery would inflict much greater damage on the standard mortgage market than on the equity release sector," he said.

Even if there was a catastrophic house price crash, equity release customers should be immune (Image: GETTY)

Safeguards

Stephen Lowe, director at specialist retirement group Just, said Professor Dowd had not shown how he had arrived at his numbers so it is impossible to say if they are correct:

“However, we agree firms should be prudent and set aside suffi cient resources to allow for shocks in the economy.”

Just has set aside enough financial resources to cope with an overnight 28 per cent house price collapse with no recovery ever.

Lowe added: “This is much stronger than the more severe economic scenarios that the Bank of England prescribes for the banking sector.”

Equity Release Council chief executive Jim Boyd said customers have a range of safeguards, including stringent regulation and a code of conduct for members.

“Our customers enjoy three levels of protection: structured and regulated financial advice, independent face-to-face legal advice, and clear product safeguards.”

Even if there was a catastrophic house price crash, equity release customers should be relatively immune.

Those over-borrowing on standard mortgages may bear the brunt of negative equity.