

Technical Team to the Pensions Working Group

**Research Report**

## Use of Property for Retirement. Supplementary Paper to the Final Report of the Pensions Working Group

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## **Use of Property for Retirement**

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**Supplementary Paper to the Final Report of the Pensions Working Group  
Supplementary Paper No: 04**

**Prepared by the Technical Team to the Pensions Working Group**

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## Executive Summary

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This Paper aims to answer two questions – (i) is property savings a viable alternative source of retirement income? and (ii) how can property be used to fund retirement income, if at all?

A brief analysis of statistics regarding, amongst others, personal savings, household debts and property prices and ownership, seems to indicate that an element of savings have been targeted towards housing. In addition, while no data is available as to what percentage of household assets are in housing assets, it is likely that housing assets may represent a high percentage of household wealth given the trend of rising property prices in Malta over the recent years.

However, most housing wealth is different from other forms of wealth or savings. The impact of use of property for retirement income is uncertain and would be unevenly distributed:

- There are various reasons while people may not want to release equity locked in their property.
- Even if equity in property is released, it will not necessarily be channelled towards funding retirement income but may be used to finance other purchases or other needs such as health care.
- In addition, the spread of wealth including housing wealth is likely to be uneven and unequal. Variation in house values and holdings of dwelling types among income earners leads to wide variations in the amount of property equity that can be released by different categories of people.
- Moreover, equity in property has a fluctuating value like other investments despite the general idea that property prices do not go down in Malta.

It is thus considered that savings in property and housing assets should not be considered as a substitute to other supplementary forms of or Second and Third Pillar pension provisions, but rather as assets that individuals can use to supplement their private pension savings should they so wish.

Financial products, known as Equity Release Plans, exist which enable the release of equity held in residential property without the need to move out of the property. There are two main types of Equity Release Plans known as ‘Home Reversion Schemes’ and ‘Lifetime Mortgages’ (or Mortgage-Backed Equity Release Plans). Each have their own advantages and disadvantages.

Research has not yielded information regarding the use of financial products for the release of equity in property in countries other than the United Kingdom (“UK”). In the UK, these arrangements are used as a source of voluntary third pillar pension provision – namely targeting (although not only) those pensioners who receive a low pension and who may not necessarily have any other liquid savings.

Research did not yield any international regulatory guidelines for financial products aiding release of equity tied up in property for retirement purposes. The experience of the UK market shows that there may be scope for regulating Equity Release Plans. In fact, the UK is moving towards regulating this market namely due to three common factors: the relative complexity of the products per se; the relatively aggressive sales of these products; and the consumers who purchase these products are largely unable to understand the details or risks involved. So far in the UK, only the sale of first charge Lifetime Mortgages is regulated by the Financial Services Authority (“FSA”), while the UK Government has completed a consultation exercise with stakeholders regarding the regulation of Home Reversion Plans. It is probable that the latter will be regulated post 2006 by the FSA.

In so far as the local market is concerned, although saving in housing appears to be increasing, only few people appear to plan or see their property as a potential source of retirement income according to a recent survey. However, Equity Release Plans may prove to be an attractive option in due course, to certain segments of the population in Malta which are on the increase and to whom these plans are ordinarily attractive outside of Malta, such as single persons, childless couples and elderly people living independently rather than with their family. These demographic changes in households

and the population, coupled with a high home-ownership percentage which appears set to increase through increasing savings in housing assets, and possibly a culture change towards property, may lead to the emergence of equity release markets in due course. Detailed research would need to be carried out to assess the potential for development of this market in Malta.

Moreover, there is no legal framework which provides for the regulation of Equity Release Plans. Hence, should there be market demand for these types of products, it is considered that further research is carried out regarding the development of a proper regulatory regime to address the risks identified and discussed in the UK as a result of their experience in the use of Equity Release Plans. A number of factors (such as taxation and inheritance law amongst others) would also need to be looked into in further detail.

## **Recommendations**

Property should not be seen as a substitute source of retirement income to Second and Third Pillar pensions – but rather as a complement thereto. There is scope for considering property as an optional Third Pillar pension.

A detailed study should be carried out in due course to assess the potential for the development of an Equity Release market in Malta.

If demand for Equity Release products results, it is recommended that further research is carried out regarding the need or otherwise of a tailored regulatory regime for such plans, and other related areas such as inheritance law and taxation. A supporting educational campaign should accompany at any time any availability of these types of products.

## **01. Introduction**

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### **01.1 Remit of Paper**

The remit of this Paper is to consider the comments received on the area of property as an alternative source of retirement income, following the national consultation and discussion process of the White Paper – Pensions: Adequate and Sustainable (“the White Paper”) issued in November 2004.

### **01.2 Consultation Exercise**

Some of the respondents to the White Paper, raised the issue that many people in Malta have saved a good part of their money into property and many in fact own or end up into owning their own property residence. It was recommended that this aspect should be considered when analysing savings patterns, and that it is important to design policies and strategies taking also this factor into account.

Reference was also made to the dramatic increase in the purchase of property and accordingly the consequent potential to release the equity held by many people in their property residence upon retirement or upon approaching the retirement age. Reference was also made that any schemes devised to turn property equity into income for retirement purposes should be adequately and properly regulated.

The above two comments recommend that property savings should be taken into account and that proper ways how pensioners can have the option to release the equity tied up in their property are devised within a regulated framework.

One respondent also raised the question why people should be asked to save more for pensions through supplementary pension schemes when they are already paying for the PAYG national insurance and paying their loans to have a ‘debt free residential property upon retirement’.

This appears to suggest that the current First Pillar Scheme and property savings should not be supplemented by Second and Third Pillar Schemes.

The majority of the respondents who made reference to the property aspect in providing their feedback to the Pension White Paper, also made reference to the need of a reform of the local rental framework.

### **01.3 Aims of the Paper**

The Paper aims to discuss the following questions arising from the feedback received:

- is property savings a viable alternative source of retirement income?
- how can property be used to fund retirement income, if at all?

This Paper will not discuss the merits of reforming the local rental policies, which market falls outside the scope of this Paper.

### **01.4 Structure of the Paper**

The Paper is structured as follows:

- Chapter 02 takes a look at the Savings Patterns and Property Sector in Malta.
- Chapter 03 discusses the different ways property can be used to fund retirement.

- Chapter 04 looks at the use of property for retirement in other countries.
- Chapter 05 concludes with recommendations.

## 02. Savings and Property in Malta

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### 02.1 Savings and Property Investment Patterns

As already indicated in Chapter 3 of the White Paper, statistics show that personal or retail deposits and savings per capita have been on the increase since 1985 as can be seen in Table 01.

**Table 01: Deposits of Households Resident in Malta with All Banking Institutions**

Year	Total Deposits <sup>1</sup> Lm1000s	Total Population <sup>2</sup>	Per Capita Deposits (000s)
1985	362,832	340,907	1.06
1986	359,609	343,514	1.05
1987	396,878	345,636	1.15
1988	452,890	349,014	1.30
1989	523,196	352,430	1.48
1990	609,524	355,910	1.71
1991	681,830	359,543	1.90
1992	766,751	362,977	2.11
1993	877,873	366,431	2.40
1994	1,029,646	369,451	2.79
1995	1,170,640	371,173	3.15
1996	1,322,162	373,958	3.54
1997	1,466,011	376,513	3.89
1998	1,615,056	378,518	4.27
1999	1,704,669	380,201	4.48
2000	1,786,776	382,525	4.67
2001	1,955,817	385,077	5.08
2002	2,121,567	386,938	5.48
2003 <sup>3</sup>	2,180,340	388,867	5.61

Source: National Statistics Office/Central Bank of Malta

<sup>1</sup>Represents end of year position

<sup>2</sup>Maltese Population

<sup>3</sup>Since October 2003 the compilation of deposits has been harmonised with internationally agreed statistical concepts. This sector now comprises individuals and non-profit institutions.

Notwithstanding the increase in per capita deposits, data also shows that the savings ratio has decreased substantially over the same period, as reflected by the figures in Table 02. This decreasing trend continued in 2004, when the savings ratio stood at 2.1% (compared to 3.6% in 2003)<sup>1</sup>. (NB the change in the quoted savings ratio for 2003 from the figure quoted in Table 02 relates to the change in the compilation of deposits since October 2003).

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<sup>1</sup> Central Bank of Malta, Annual Report for 2004, p. 29



**Table 02: Savings Ratio**

Year	Consumers' Expenditure Lm Thousands	Savings Lm Thousands	Household Disposable Income Lm Thousands	Savings Ratio %
1985	333,239	32,440	365,655	8.87
1986	343,369	37,930	381,237	9.95
1987	351,187	62,530	413,621	15.12
1988	387,567	55,870	443,524	12.60
1989	425,515	59,620	485,164	12.29
1990	460,845	73,270	534,120	13.72
1991	494,504	89,660	584,160	15.35
1992	531,530	98,270	629,620	15.61
1993	561,498	105,430	666,930	15.81
1994	608,288	123,280	731,570	16.85
1995	700,425	85,280	785,710	10.85
1996	764,901	82,670	847,580	9.75
1997	803,493	70,720	874,210	8.09
1998	846,002	90,720	936,730	9.68
1999	915,014	92,980	1,008,000	9.22
2000	994,273	45,300	1,042,000	4.35
2001	1,041,866	21,600	1,066,200	2.03
2002	1,079,361	14,200	1,096,000	1.30

Source: National Statistics Office / Central Bank of Malta

This decrease in the savings ratio indicates prima facie<sup>2</sup>, that people are saving less in relation to consumption and disposable income, especially since inflation rate increased by 1.3% from the previous year and stood at 2.8% as at end-December 2004<sup>3</sup>. Moreover, in 2004 household debt increased by 18.7% from the previous year<sup>4</sup>, servicing of which carries a cost, thus impinging further on disposable income. Also 2004 registered a lower growth in disposable income, even though growth in private consumption is also estimated to have slowed down to 1% in 2004 from 2% in 2003, as shown by Chart 3.2 'Household Savings Ratio and Disposable Income' from the Annual Report for 2004 published by the Central Bank of Malta in Appendix 1<sup>5</sup>.

However, statistics show that loans for the acquisition of land or property for own use are the major component of household debt, as shown in Chart 6.5 'Household Borrowings' from the Annual Report for 2004 published by the Central Bank of Malta in Appendix 1. The total amount of house loans, which can be considered as a form of savings, have increased sharply over the same period, as shown in Table 03. This trend also continued in 2004, which also saw an increase in domestic credit, most of which reflected borrowing by households to finance house purchases<sup>6</sup>. In fact, lending to the non-bank private sector rose by Lm137 million, or 7.1% in 2004 from the previous year, mainly reflecting further lending to households and individuals, most of which was intended for house purchases<sup>7</sup>. The borrowing by households for the purchase and construction of houses increased by 21% to Lm544 million during 2004<sup>8</sup>.

<sup>2</sup> This assessment is not intended to be a comprehensive assessment of household wealth (which is not the purpose of this Paper), but rather a general overview of any savings directed by households in property.

<sup>3</sup> op cit, Central Bank of Malta (2004), p. 35

<sup>4</sup> ibid, p.53

<sup>5</sup> ibid, p.29

<sup>6</sup> ibid, p.52, 53

<sup>7</sup> ibid, p.23

<sup>8</sup> ibid, p.53

**Table 03: House Loans to Resident Households with All Banking Institutions (balances as at end of period)<sup>1</sup>**

Year	Total Resident Lending for House Purchase Lm 000s
1985	37,692
1986	42,047
1987	46,488
1988	54,352
1989	64,440
1990	77,328
1991	84,427
1992	94,287
1993	98,885
1994	120,031
1995	132,559
1996	151,166
1997	173,690
1998	195,054
1999	224,089
2000	257,943
2001	306,722
2002	367,124
2003	442,245

Source: National Statistics Office, Central Bank of Valletta

<sup>1</sup>includes lending for the construction, modernisation or extension of dwellings

In this regard, it is worth noting, that the increase in the average value of loans corresponds a matching increase in property prices. In fact, house prices have increased between four to eight times from 1970 – 1995, as shown in Chart 2.8 ‘Average Property Prices (1970-1995)’ from the Structural Plan for the Maltese Islands (Housing Topic paper 2004) in Appendix 1, depending on the type of property with larger properties commanding higher prices<sup>9</sup>. Prices of all property types continued to increase since, and in 2004 it is estimated that prices increased by 24.2% on average – which estimate was to an extent inflated by development in up-market units, as growth on median prices was somewhat slower<sup>10</sup>.

Therefore, while it may be said that whilst a part of people’s expenditure is being directed towards investing in acquiring houses as personal and long term assets, it can be argued that the increase in the amount of house loans is a natural increase given the performance of the property market in Malta where property prices have continued to increase dramatically over the recent years. Moreover, saving in property may not be a choice – but a necessity for many people, especially given the problems associated with the local rental sector.

Ideally, this increase in the amount of house loans should be assessed in relation to the actual number of house loans and categories of house-buyers taking out the loans (example first-time versus second time buyers; developers versus home owners etc.) and the demographics of the population. However in the absence of such data, reference is made to the Structure Plan for the Maltese Islands – a Housing Topic paper dated February 2004, which indicates that (page 58) “*further loans are being issued for clients buying property as an investment rather than a home*”. Data shows that the number of vacant properties has increased. In 1995 vacant property amounted to 23% of total. And between 1985 and 1995, there was an increase of 11,668 vacant units. The 1995 census indicates that 36% of these vacant properties are used as summer residences while others are permanently vacant.

One main reason for the directing of savings in housing and for people to carry increased debt, may be the recent performance of the housing market versus performance of alternative investments such as equities and bonds, and the low interest rates on savings deposits in banks<sup>11</sup>.

9 Structure Plan for the Maltese Islands - Housing Topic Paper, February 2004, p.50

10 Op cit, Central Bank of Malta (2004), p.38

11 ibid, p.38

Also, Malta has a large percentage of home ownership compared to other European countries as shown in Table 04.

**Table 04: Homeowner occupation in EU Member States and in Malta, 1990**

Country	Percentage in Owner-Occupation	Country	Percentage in Owner-Occupation
Ireland	81	Belgium	65
Greece	79	Portugal	58
Spain	76	France	54
Luxembourg	68	Denmark	51
<b>Malta</b>	<b>68</b>	Austria	50
Italy	67	Netherlands	45
United Kingdom	65	Germany	38

Source: Structure Plan for the Maltese Islands Housing Topic Paper, February 2002, p.46 / Statistics on Housing in the European Community

However, it is not clear how much is saved in property versus other alternative savings (such as in insurance policies, securities, cash etc.). To note that in 2004, amongst other forms of savings, shareholders' funds in locally based collective investment schemes increased by Lm47.1 million, or 10.3% during the year, after surging by over 30% in 2003<sup>12</sup>. In addition, both general and life insurance premia increased significantly during 2004<sup>13</sup>. Also portfolio shifts in newly issued Government bonds were seen<sup>14</sup>.

Further to the above, it appears that an element of savings have been targeted towards housing. In addition, while no data is available as to what percentage of household assets are in housing assets, however it is noted that the cost of property is high relative to wages<sup>15</sup>, and together with the high home-ownership percentage, this may mean that housing assets may represent a high percentage of household wealth.

## 02.2 Is Housing Wealth a suitable source of retirement income?

However, most housing wealth is different from other forms of wealth or savings. First and foremost, property is one of the basic social needs. The predominant and primary benefit of house ownership will be to reduce residence costs rather than to provide a significant amount of income throughout retirement, unless the individual holds more than one property. There is a cost with releasing residential property – as rent or other form of payment would have to be paid to provide alternative accommodation. Not all homeowners necessarily own more than one property. In addition, property very often carries with it an emotional attachment and many people are reluctant to move house. Also, property is often seen as a family asset to be preserved for their children or grandchildren. So the use of property for retirement is uncertain<sup>16</sup>.

Moreover, even if equity in property is released, no definite rule exists that people will use it to finance retirement income rather than for other purchases or other needs such as health care. This means that not all housing wealth would actually be available to use or will be channelled to finance retirement<sup>17</sup>, even if it may be large compared to financial wealth.

In addition, it is not documented how and where wealth is tied up – particularly how savings or house loans or dwelling types (which vary by price) are distributed among earnings categories. Variation in house values and holdings of dwelling types among income earners leads to wide variations in the amount of equity that can be released by different categories of people. It is likely that most people will have property and other forms of savings – but neither type of wealth is spread evenly among everyone. The majority of people would probably have low levels of savings and relatively small

<sup>12</sup> *ibid*, p.22

<sup>13</sup> *ibid*, p.53

<sup>14</sup> *ibid*, p.20, 26

<sup>15</sup> *op cit.*, Housing Topic Paper (2004), p.50

<sup>16</sup> Pensions Policy Institute (2004), Property or Pensions? p.8

<sup>17</sup> *OP Cit* Pensions Policy Institute (2004), p. 6

amounts of housing equity. A minority of people will probably have sufficient housing equity to provide a reasonable amount of retirement income, together with other savings. A relatively few number of people will have sufficient amounts invested in property to allow them to use investment income from property instead of private pension provision<sup>18</sup>.

In addition, it is not clear what percentage of household assets are in housing assets, and where these are held. In any case, even if housing assets feature as a large component of housing wealth, this percentage, as well as the value of property held, may fluctuate. In Malta exists a notion that the value of local property never goes down, particularly given the performance of this sector during the last three decades. However, this uprising trend in property prices does not necessarily mean that the local property market is immune from fluctuations prevalent in any other investment market<sup>19</sup>.

Further to the above, it is considered that savings in property and housing assets should not be considered as substitute retirement income to other supplementary forms of or Second and Third Pillar pension provisions, but rather as assets that individuals can use to supplement their private pension savings should they so wish.

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<sup>18</sup> *ibid*, p.21

<sup>19</sup> Mr J D Camilleri, one of the respondents of to the White Paper – Pensions Adequate and Sustainable? makes reference to the downturn in prices of property in Malta in the 1960s and 1970s. Mr Camilleri raises the point that "Few seem to remember the huge markdown in Maltese property prices in the late 60s/ early 70s, and none of use seem able to visualise that since we are now part of the open economy in the EU, we are not immune from the property cycles that in the past wrought havoc in countries such as the UK, USA, Hong Kong and Japan.

## 03. How can Property supplement retirement income?

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### 03.1 Different ways how property can be used for retirement provisioning

One primary way property can be used to increase or fund income during retirement is through the sale of the house – the primary residence or a second property. However the equity received on the sale of the primary residence would be reduced by the purchase of another presumably smaller property or by living costs of renting alternative accommodation or moving into a retirement home. In addition, this requires the homeowner to move out of the property.

However there are financial products, known as Equity Release Plans, which enable the release of equity held in residential property without the need to move out of the property.

### 03.2 Equity Release Plans

Equity Release Plans are “*financial products, or sale and purchase arrangements, that allow homeowners to release the value of their property above any amount owed on a mortgage. These scheme involve a provider giving the homeowner either a lump sum or income (or both) on the basis of the value of the home. Providers receive their returns when the home is sold*”<sup>20</sup>.

There are two main types of Equity Release Plans, known as ‘Home Reversion Schemes’ and ‘Lifetime Mortgages’ (or Mortgage-Backed Equity Release Plans).

#### 03.2.1 Home Reversion Schemes

The following are the main characteristics of Home Reversions Schemes:

- A homeowner would sell all or part of his home at a discount, in return for a lump sum payment and/or a regular income (usually within a range of 30-65% of the property value), and the right to continue living in the house until they die or move home.
- The whole or part of the home would usually be sold to a ‘reversion company’ or an individual.
- The seller would accordingly no longer remain the owner of the home or the part of the home sold.
- The ‘reversion company’ would either own the property itself or find an investor for the property.
- The lump sum generated from the sale of property depends on a number of factors, including the value of the property, the age of the owners and the actuarial assessment of the life expectancy of the owners.
- The lump sum may be drawn down in whole or it could be invested (for example into an annuity or some other type of investment) in order to provide a regular income.
- The terms of the leases giving the pensioner the right to carry on living in their home vary – some do not require payment of rent but some do, in return for more money from the sale.
- The pensioner generally will continue to remain responsible for the maintenance of the house;
- The plan can be taken out in joint names. The plan ordinarily continues until the second partner dies or is no longer living in the house.
- The plan will end and the property sold if one (or in the case of joint partners, both parties) move/s to a nursing home or dies. At that point in time, the Plan provider may sell the property.
- The buyer of the property will benefit from any increase in the property value.
- Professional and independent valuations of the property are important as such valuations determine how much money one gets.

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20 HM Treasury (2003), Regulating Home Reversion Plans – Consultation Document, UK, p.5

- The total income paid out will depend on how long the pensioner lives. The longer one lives, the better the value obtained and vice versa.
- These plans cannot be cancelled or reversed.

**Table 05: The advantages and disadvantages associated with Home Reversion Plans<sup>21</sup>**

Advantages	Disadvantages
Schemes that offer a one-off lump sum provide a substantial amount to spend or to invest	The value of the assets will be reduced by a significant sum and so reduce the amount of inheritance for the heirs
Schemes do not involve any on-going repayments. The reversion company makes all of its money when the property is sold	The Plan can turn out quite expensive if the homeowner dies soon after taking out the plan. This could mean that the homeowner would have sold out his/her house or a portion of it quite cheaply – given that the home reversion company buys the property from the homeowner at a discount in return for the right of the homeowner to continue living in the house.
It is clear the share of the home (but not the value) that will be left to the heirs, unless the homeowner opts to sell all of his/her home	Some Plans take a long time to arrange and some reversion companies are selective about the property they take.
The homeowner will continue to share in any increase in the value of the property for the amount that he/she has retained (unless the entire value is sold to the reversion company)	The homeowner will not gain from any increase in the value of the property on the portion sold. No gain is made if the property is sold entirely at the outset to the reversion company.
The home owner can take extra cash advances, depending on the amount taken at the outset	May involve certain maintenance costs as the homeowner ordinarily remains responsible for the up-keep of the house.

Source: Age Concern (2004), Raising income or capital from your home

### 03.2.2 Lifetime Mortgages

The following are the main characteristics<sup>22</sup> of Lifetime mortgages:

- The homeowner takes out a loan secured against his/her home.
- Ownership remains with the homeowner in the case of such plans.
- The loan is used either to provide a lump sum payment or used to purchase an annuity and provide regular income.
- The amount of the loan is based on the value of the property, the age of the homeowners and actuarial assessment of their life expectancy.
- The loan, with interest, is repaid when the property is sold either upon death of the owner or if the borrower moves house or into long-term care. However some of these plans provide the option that the homeowner / borrower pays interest on the loan and the capital is paid when the property is sold.
- One can pay off lifetime mortgages loans at any time but charges may apply.

There are three main types of Lifetime Mortgages, including 'Home Income Plans', 'Interest-only Mortgages' and 'Roll-up mortgages'.

<sup>21</sup> Age Concern (2004), Raising income or capital from your home, UK, p.9

<sup>22</sup> Financial Services Authority (nd), FSA Factsheet – Raising money from your home, UK, p.2-7

## Home income plans

These Plans loan out a cash lump sum to the homeowner against the value of his/her home. The lump sum is used to buy an annuity to provide regular income. Part of such income is used to pay the interest on the loan, usually at a fixed rate and the remaining money left may be used by the homeowner. The lump sum originally borrowed is repaid when the home is sold. This type of plan is suitable for older people (around 80) given the low extra income one has available for spending – the older the person is when the annuity is purchased, the higher is the income received as there are fewer years over which the income will need to be paid<sup>23</sup>.

**Table 06: The Advantages and Disadvantages of Home Income Plans**

Advantages	Disadvantages
If the Plan has a fixed interest rate, then the income received will remain unchanged over the person's lifetime, subject to any changes in tax rates	Not suitable for people requiring a substantial lump sum of money.
Ownership of property is retained, thus the homeowner gains from any future increases in the its value (and similarly lose from any fall in its value)	Income from these Plans may be effected by inflation if not indexed.
	This Plan will reduce the value of the assets of the homeowner and can turn out quite expensive if the homeowner dies soon after taking out the plan, unless protected to a certain extent through a capital protection plan.
	These Plans are most suitable for older people who get better annuity rates because their life expectancy is shorter.

Source: Age Concern (2004), Raising income or capital from your home

## Interest-Only Mortgages

These Plans loan out a cash lump sum to the homeowner against the value of his/her home. The homeowner in turn pays interest on the loan on a monthly basis, which can be fixed or at a variable rate. The amount originally borrowed is repaid when the home is sold. One needs to ensure that he is in a position to pay the monthly interest payments. If the interest rates are variable one would also be exposed to increases in the interest rates and hence higher monthly interest payments<sup>24</sup>.

## Roll-Up Mortgages

These Plans loan out a cash lump sum to the homeowner against the value of his/her home. The loan is taken by the homeowner either as a lump sum or regular income. No payment of interest is required until the home is sold as the interest is added on the loan. The amount borrowed may be relatively low, since interest is not to be repaid until the property is sold. However the interest accumulates both on the original amount of loan take out and the interest that has already been added. This compounding of interest can increase the final amount owed quite rapidly. There is the danger that one could end up owing more than the actual value of his property. Interest rates can be fixed or variable<sup>25</sup>.

<sup>23</sup> op cit, Financial Services Authority (nd), p.4

<sup>24</sup> ibid, p.4

<sup>25</sup> ibid, p.4-5

**Table 07: Advantages and Disadvantages of Roll-Up Mortgages**

<b>Advantages</b>	<b>Disadvantages</b>
These Plans provide a substantial sum for investment or for spending, without the payment of interest	The loan debt accumulates rapidly through the compounding of the interest
The homeowner retains ownership of the property	It reduces the value of the homeowners estate, and so reduce the amount left the heirs
These Plans are generally available to people aged 55 onwards	Interest rates can be high, as the rate is fixed for the life of the loan which can take quite a long time

Source: Age Concern (2004), Raising income or capital from your home

### **Shared Appreciation Mortgages**

These Plans loan out a cash lump sum to the homeowner against the value of his/her home. However, in these Plans the lender of the loan renounces from receiving a part of or all of the interest on the loan and in return he takes a share in any increase in the value of the home when this is sold.<sup>26</sup>

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<sup>26</sup> *ibid*, p,6



## 04. Equity Release Markets and Regulation

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### 04.1 Equity Release Markets in the United Kingdom

Equity Release Plans appear to be prevalent in the United Kingdom (“UK”). The research has not yielded information regarding the use of financial products for the release of equity in property in other countries.

In the UK, these arrangements are used as a source of voluntary third pillar pension provision – namely targeting (although not only) those pensioners who receive a low pension and who may not necessarily have any other liquid savings.

There does not appear to be accurate information on the size of the equity release market in the UK – conflicting information has appeared in the press about the total value of this market<sup>27</sup>. However the Pensions Commission in the UK in its report titled ‘Pensions: Challenges & choices’ (issued in 2004)<sup>28</sup> estimated that only around 1% of pensioner households are using these type of products – due to higher interest rates generally associated with lifetime mortgages; the inherent risks of borrowing without knowing the maturity date of the loans, emotional attachment to their homes and the wish of many to leave property to their children<sup>29</sup>. However it appears that particularly the demand for Lifetime Mortgages is increasing – equity release lending grew by 10% in 2004, which followed an exceptional 70% growth rate in 2003<sup>30</sup>. The equity release market is expected to grow further, as the number of older households and the proportion of pensioners with housing equity increases in the UK<sup>31</sup>.

### 04.2 Regulation or no Regulation?

The research did not yield any international regulatory guidelines for financial products aiding release of equity tied up in property for retirement purposes.

In the UK, only the sale of first charge Lifetime Mortgages is regulated to date<sup>32</sup>, while the UK Government has completed a consultation exercise with stakeholders regarding the regulation of Home Reversion Plans, which will probably only be regulated post 2006.

The general rationale for the regulation of this sector is namely based on three common factors: the relative complexity of the products per se; the relatively aggressive sales of these products, and the consumers who purchase these products are largely unable to understand the details or risks involved<sup>33</sup>.

#### 04.2.1 Lifetime Mortgages

First charge Lifetime Mortgages have been regulated in the UK by the Financial Services Authority (“the FSA”), which is the single Regulator of financial services in the UK, since October 2004.

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27 op cit, HM Treasury (2003), p.6

28 Pensions Commission (2004), Pensions: Challenges & Choices – The First Report, p.194

29 op cit Pensions Policy Institute (2004), p.13-15

30 Lifetime mortgages increasing in popularity, 7th February 2005. Available online: <http://www.fairinvest.co.uk/news-Lifetime-mortgages-increasing-in-popularity>. Last accessed 18th June 2005

31 Pensions Policy Institute (2004), p.12

32 op cit, HM Treasury (2003), p.8. The Financial Services Authority regulates the sale of first charge mortgages. However, much mortgage lending not covered by the FSA will fall to be regulated by the Office of Fair Trading under the Consumer Credit Act.

33 Tiner J (2003), ‘Regulation, regulation, more regulation ....and complaints’, CML Annual Conference UK

The specific regulatory requirements applicable to Lifetime Mortgages are targeted towards avoiding certain detrimental features that have surfaced in the past in the UK. For example due to variable interest rates, people ended up owing more than their home was worth in total. In fact, post such scandals, Safe Home Income Plans - a trade body for those selling equity release plans whereby membership is voluntary - required its member product providers to include 'no-negative' guarantees to cater against this risk. 'No-negative' guarantees require product providers to guarantee plan holders that the value of the granted loans would not rise beyond the value of the property.

FSA regulation of Lifetime Mortgages in the UK is based namely on rules about what providers must tell lifetime mortgage borrowers when they take out such plans, competence of retail staff selling such mortgage plans and internal control requirements of authorised firms<sup>34</sup>.

Specific rules on disclosure have been established, requiring firms to issue consumers with a "key facts illustration" in a standard format. In this way, consumers are able to compare products between themselves, and so consumers will be in a better position to take an informed decision about the most suitable product for them, reducing the likelihood of future mis-selling. The use of this standard "key facts illustration" contributes towards transparency of pricing, also encouraging competition.

Mortgage regulation focuses also on advertising requirements, requiring mortgage adverts to be balanced, clear, fair and not misleading. The FSA has set various rules with which firms selling these types of plans need to comply with when issuing adverts about their products.

Another key requirement is for lifetime mortgage providers to assess the suitability of these products for the individual. Also, authorised firms are expected to train their staff properly and ensure that they have proper internal controls in place for monitoring the sales activities. These products are not reversible and in the majority of cases involve the major asset of an elderly individual who may not necessarily be in a position to assess all the implications involved on his/her own, particularly if subjected to aggressive sales techniques. There are various aspects one needs to consider and hence the provision of adequate advice is essential.

Senior management is also expected to take responsibility for the product design and marketing process.

Moreover, through regulation, if lifetime mortgage providers do not follow the conduct of sale rules and something goes wrong, the borrower will have a right to seek redress.

The FSA is also developing a consumer educational campaign about these type of products.

#### 04.2.2 Home Reversion Plans

Home Reversion Plans are not regulated so far in the UK, although the sale of an annuity is regulated by the FSA. However, providers of Equity Release Plans may elect to join the Safe Home Income Plans Association and abide by this Association's voluntary code of practice<sup>35</sup> (copy in Appendix 2) in the meantime. This Code of Practice does not apply to intermediaries selling these Equity Release Plans but solely to product providers who elect to join the Association.

However the UK Government has been consulting whether Home Reversion Schemes should be regulated and if so, whether they should be regulated by the FSA<sup>36</sup>. The conclusion of this exercise appears to have been that this market should be regulated by the FSA similar to the first charge Lifetime Mortgages.

The case for regulation lies principally on the basis that the target market tends to be elderly people who have paid off their mortgage. The implications of mis-selling for a consumer are likely to be great as the home reversion transaction involves the consumer's largest assets and elderly customers may

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<sup>34</sup> FSA web-site: <http://www.fsa.gov.uk>  
op cit, Age Concern (2004) p.13

<sup>35</sup> SHIP web-site <http://www.ship-ltd.org>

<sup>36</sup> op cit HM Treasury (2003)

be vulnerable – particularly given the information asymmetry prevalent in these scenarios. Furthermore it is argued that these products are complex and relatively high risk. Moreover the full cost of the product may not become apparent for a certain period of time (due to fluctuations in house prices, usual problems associated with annuities and longevity) and in view of the fact that transactions are non-reversible.

Regulation<sup>37</sup> will ensure that:

- Sale of these products is carried out in a proper manner. This would help to address concerns of mis-selling. Rules may require sale is effected only through competent advisors and impose certain conduct of business rules, similar as in the case of lifetime mortgages. This is important given the impact on tax and social benefits and inheritance an investment in such products may bring. Moreover there are various aspects (e.g. taxation, continued eligibility for state benefits etc.) that a consumer would need to take into account, hence it is important that advisors ensure that consumers are sold products that are suitable given their particular circumstances.
- An independent valuer (as defined) is appointed in the valuation of the home property and proper pricing (proportion of valuation paid out etc). The pricing of the home reversion plan in an important area of consumer concern.
- An under-valuation of the property would mean that a consumer would receive a lower lump sum when he/she sells the property or part of his/her property to a reversion company. This would also mean higher profits to the reversion company should house prices rise post the commencement of the house reversion plan.
- Another important pricing aspect is the proportion of the valuation that is paid out to the customer, which depends on the value of the property as well as on the age and life expectancy of the consumer.
- Adequate and clear disclosure of information exists about the features of these products. These products are complex and consumers are generally at an information disadvantage in comparison with the product provider. Adequate and clear disclosure of information empowers the consumer to take better informed decisions and reduces the risk of mis-selling by product providers.
- Consumers who have a complaint, will have the opportunity to seek redress. This puts more onus on providers to act in a fair and proper way and reduces risks of abuses. Moreover, in cases where things have gone wrong, the consumer is not left helpless but can seek action for the wrong doing done to him/her.

The experience of the UK market shows that there may be scope for regulating Equity Release Plans.

## **04.3 Local Scenario**

### **04.3.1 Is there a market for Equity Release Plans in Malta?**

Although saving in housing appears to be increasing, as seen in Chapter 01, only few people appear to plan or see their property as a potential source of retirement income. According to a survey carried out by the National Statistics Office – Perceptions on retirement and pensions, 2005, only 1.5% of respondents see property as a possible source of retirement income, as shown in Table 08.

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<sup>37</sup> *ibid*

**Table 08: Distribution of potential pensioners by possible main sources of income on retirement and by age group**

Possible Sources of Income on retirement	18-24		25-34		35-54		55-64		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
Government Pension	18	32.1	18	40.9	67	79.8	14	93.3	117	58.8
Private Pension	15	26.8	13	29.5	7	8.3	-	-	35	17.6
Interest and/or other investment income	7	12.5	6	13.6	3	3.6	-	-	16	8.0
Income from part-time work	5	8.9	2	4.5	1	1.2	-	-	8	4.0
Income from sale of property	-	-	2	4.5	1	1.2	-	-	3	1.5
Do not know	11	19.6	3	6.8	5	6.0	1	6.7	20	10.1
<b>Total</b>	<b>56</b>	<b>100.0</b>	<b>44</b>	<b>100.0</b>	<b>84</b>	<b>100.0</b>	<b>15</b>	<b>100.0</b>	<b>199</b>	<b>100.0</b>

Source: Survey Perceptions on retirement and pensions, 2005, National Statistics Office

From the data in the above Table, it is interesting to note that only people in the age groups 25-34 and 35-54 considered property as a potential source of their retirement income. No-one from the age groups of 18-24 and 55-64 linked property to retirement funding. Possible reasons could be because property ordinarily does not form part of the assets of the younger age group, while the older age group may be more attached to their property. There could be various other reasons why these age groups did not consider property as a potential source of retirement income. However, although the question in the survey did not refer specifically to equity release but rather to sale of property for retirement, did not distinguish between property being the main or second property, these statistics may hypothetically indicate the beginning of a culture change as to how some homeowners may look at their property and as to how much they are attached to their property.

The sale of Equity Release products would imply a culture change in the Maltese society where individuals pride themselves in leaving inheritance, including houses, to their children or immediate family. Equity Release Plans affect the amount of inheritance, if any, from housing assets, one leaves to his/her family.

However, coupled with a culture change, equity release plans may prove to be an attractive option to certain segments of the population in Malta which are on the increase and to whom these plans are ordinarily attractive outside of Malta, such as single persons, childless couples and elderly people living independently rather than with their family. Statistics in the Structure Plan for the Maltese Islands (2002) indicate that the number of single person households in Malta is increasing. In 1985, 13.4% of total households were single person households, while in 1995, the percentage rose to 14.8%. The Structure Plan for the Maltese Islands (2002) considers this increase in single person households is due because the number of young married couples remaining childless, mature persons living independently, single parent households and returned migrants have all increased. Moreover the number of single person households is expected to increase by 2020. It is hypothesised that the main increase in this population category will arise from the growing number of such households between the ages of 20 and 40, as well as a rise of 10 per year in single male (aged 25 – 30) households, amongst other reasons<sup>38</sup>. Moreover, the population category that is increasing most drastically in Malta is persons over the age of 60 – it is estimated that by 2020 the number of persons aged 60 and over will constitute approximately one fourth of the population<sup>39</sup>.

These demographic changes in households and the population, coupled with a high home-ownership percentage which appears set to increase through increasing savings in housing assets, and possibly a culture change towards property, may lead to the emergence of equity release markets in due course. Although no data and official information is available, it appears that there are some incentives already available on the market related to care arrangements for elderly couples which involve some form of use of property equity by the elderly individuals. Detailed research would need to be carried out to assess the potential for development of this market in Malta.

<sup>38</sup> op cit, Housing Topic Paper (2004), p.22-23

<sup>39</sup> ibid, p.23

#### 04.3.2 Regulation?

Currently, there is no legal framework which provides for the regulation of Home Reversion Plans, although sale of Lifetime Mortgage Plans could potentially be catered for under the Banking and Financial Institutions Laws which already regulate the provision of loans to the public. Hence, should there be market demand for these types of products, it is considered that further research is carried out regarding the development of a proper regulatory regime to address the risks identified and discussed in the UK as a result of their experience in the use of Equity Release Plans.

In addition, a number of factors would need to be looked into in further detail, including amongst others, any implications arising as a result of laws regarding property and in particular inheritance laws. The taxation aspect would also need to be assessed. There may also be scope for these type of Plans are assessed from a property / housing policy perspective – particularly in home reversion plans where product providers as well as consumers would be actually taking a position on the property market.

## **05. Recommendations**

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Property should not be seen as a substitute source of retirement income to Second and Third Pillar pensions – but rather as a complement thereto. There is scope for considering property as an optional Third Pillar pension.

A detailed study should be carried out in due course to assess the potential for the development of an Equity Release market in Malta.

If demand for Equity Release products results, it is recommended that further research is carried out regarding the need or otherwise of a tailored regulatory regime for such plans, and other related areas such as inheritance law and taxation. A supporting educational campaign should accompany at any time any availability of these types of products.

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