Council of Mortgage Lenders

RETIREMENT BORROWING:
Reality, Perceptions, Projections and Potential

Foreword

By Paul Smee,
Director General, Council of Mortgage Lenders

In a time of defined benefit pensions and pretty standard retirement ages, working lives and mortgage lives were aligned. Mortgages were for 25 years and people did not borrow into retirement.

We are now in an era of much less well-defined life stages. Retirement is a moveable feast and for many, somewhat less of a feast, as pensions are increasingly defined contribution and more subject to the vagaries of the market. This is in contrast to those fortunate still to have defined benefit ('final salary' and 'career average') schemes.

Following the introduction of 'pension freedoms' from the age of 55; pension pots are now more accessible to the pensioner. At the same time, people are entering the mortgage market later; mortgage terms are extending; and those nearing the end of their terms on interest-only mortgages are in need of repayment vehicles.

Over a third of new mortgages being taken out today will extend beyond the borrower's 65th birthday. However, less than 1% of all new lending (including equity release lifetime mortgages) was to the 65 and over age group. This illustrates one of the many conundrums that exist in serving the needs of older home-owners in the future.

All this has elevated borrowing into and in retirement in the policy agendas of lenders, government and consumer groups. To rise to the challenge, the CML board established a working group with representatives from across our membership, to look at the landscape of borrowing into retirement and identify what obstacles exist to its development and seek ways of addressing them. We also commissioned independent research on consumer demand for retirement borrowing; which accompanies and should be read in conjunction with this CML report.

In our report, we address challenges for lenders presented by the new pension landscape; consider how traditional mortgage and equity release products relate to each other from both industry and consumer viewpoints; the position of advice around retirement borrowing, now and in the future. We also examine the role of regulators and the ombudsman, assessing the extent to which the potential for lenders in this area is shaped by the requirements of the Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA), the Financial Ombudsman Service and others.

Given the range of factors at play, we cannot – and do not – want to work in isolation. There are many technical aspects to the subject of retirement borrowing where leadership needs to be shown by the industry itself. But it has to be set into the wider context of an ageing society and a changing approach to older age, especially employment in older age. Our work also ties in with evolving debates on subjects such as appropriate accommodation for older age-groups and questions around inter-generational transfers of wealth.

Undoubtedly, the issues are complex; and the options will not be same for all consumers. But we sense there is now a groundswell to address these challenges. CML looks forward to addressing the issues and delivering the recommendations set out in this report, working in conjunction with individual lenders, consumer groups, regulators and government throughout 2016 and beyond.

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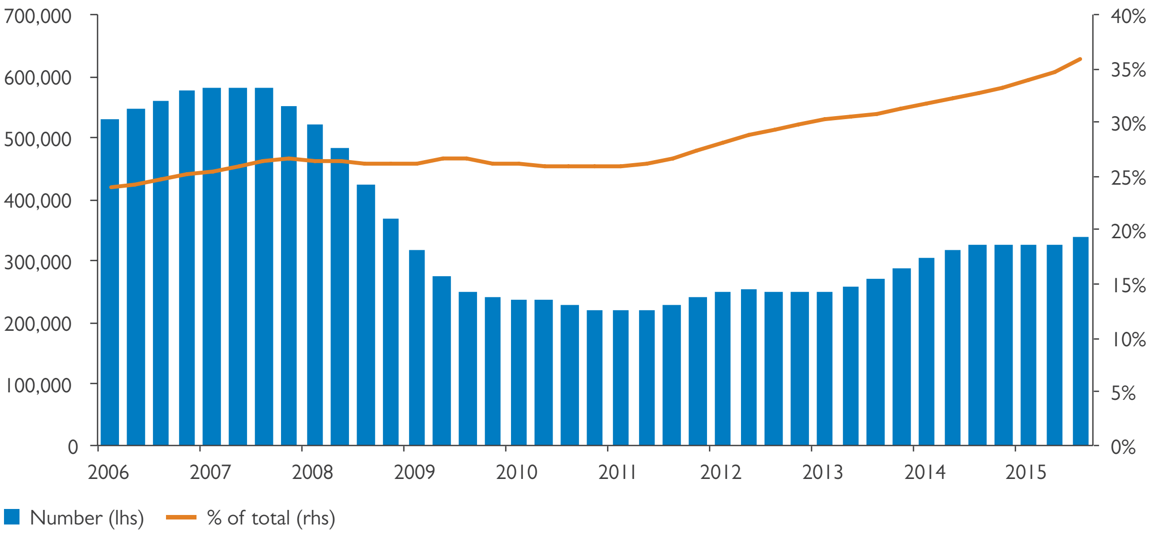
The Current Situation: Facts and Figures

In terms of <u>borrowing *into* retirement</u>, CML analysis of loans extending into retirement assumes a nominal retirement age of 65 – although the age at which people actually retire is generally rising but becoming less certain. As Chart 1 below shows, **the proportion of loans expected to extend beyond the age of 65 is continuing to increase, currently at 35%.**

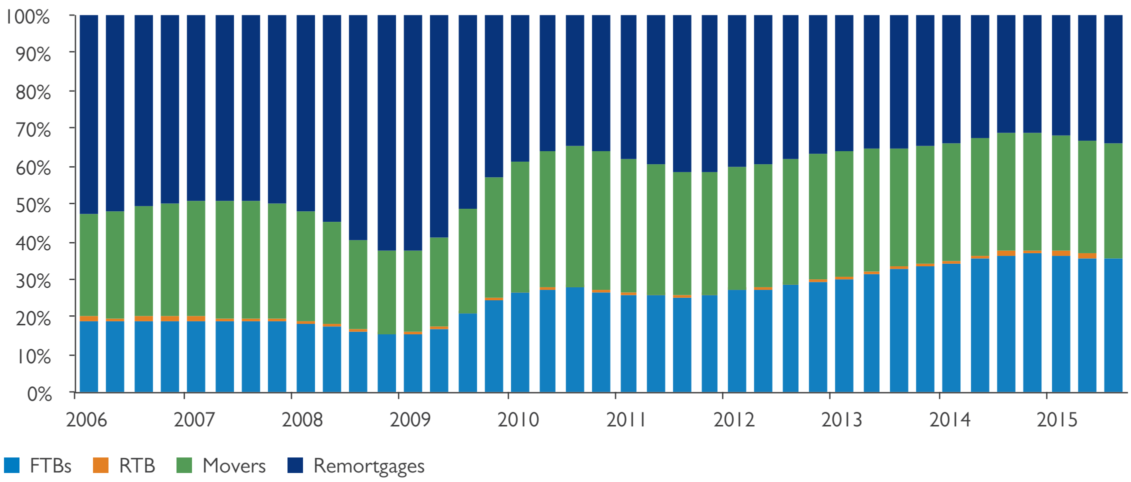
Chart 1: The number and proportion (% of mortgage loans advanced) extending to age 65 and beyond



Source: CML regulated mortgage survey

As Chart 2 below highlights, in recent times, a growing proportion of mortgages extending beyond the age of 65 have been taken out by home movers, with them now accounting for almost one-third (30%) of the total. The number of first-time buyers (FTBs) taking out mortgages that will mature beyond the age of 65 has also been edging upwards; currently accounting for over one-third (35%) of the total – double the proportion FTBs represented in 2009 (17%).

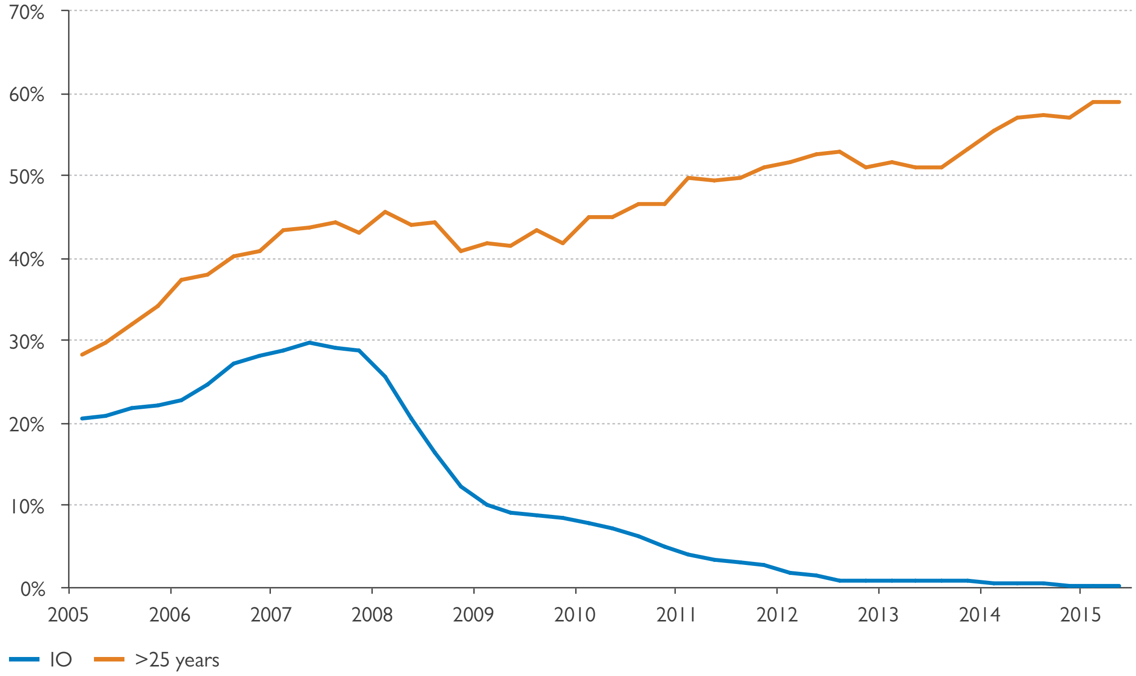
Chart 2: Mortgages extending beyond age 65 by borrower type



Source: CML regulated mortgage survey

An increase in the proportion of first-time buyers with longer mortgage repayment terms is contributing to this trend. Chart 3 shows that **more than half of first-time buyers are now taking out a mortgage that they expect to repay over a term of longer than 25 years.**

Chart 3: Mortgages advanced to first-time buyers, interest-only and with repayment terms of more than 25 years



Source: CML regulated mortgage survey

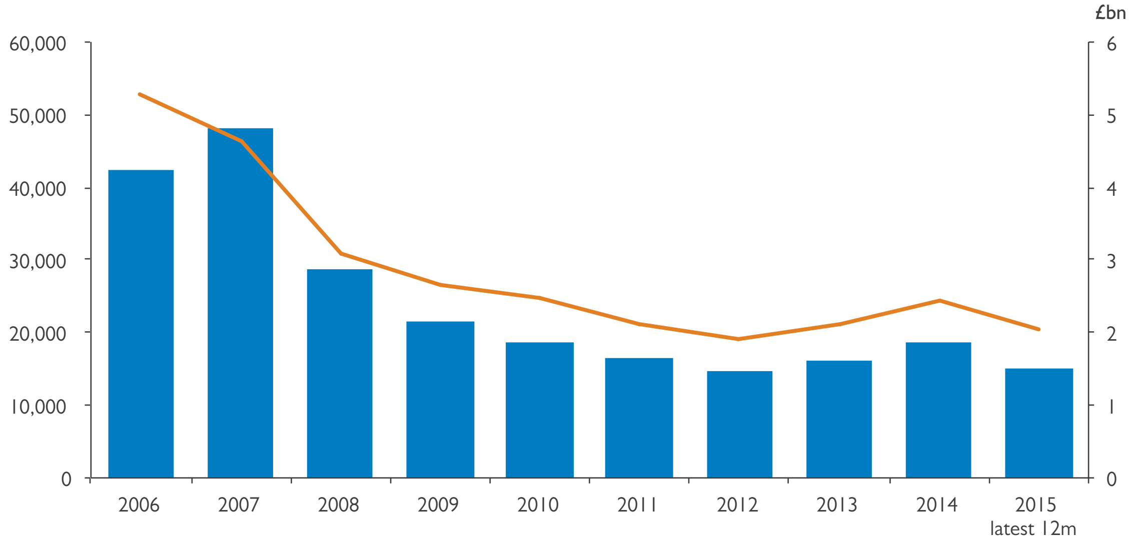
Longer terms make monthly repayments less expensive, and some first-time buyers may be choosing this option in response to affordability constraints, especially now that the option of borrowing on an interest-only basis is not generally available to them.

For those on the other end of the scale, who are **retired without a mortgage**, a recent index published by equity release specialist Key Retirement put the amount of property wealth owned outright by retired home-owners at almost £891 billion. The most recent English Housing Survey (2013-14) also showed that for the first time, the number of homes owned outright exceeded the number being bought with a mortgage. And it is older households that are more likely to own their home outright.

When it comes to **borrowing *in* retirement**, this occurs on a much smaller scale than borrowing into retirement; and has been in decline since 2007, with a recent tick-up attributable to strong growth in lifetime lending.

The value of mortgages (excluding lifetime mortgages) taken out by borrowers aged over 65 declined to around £1 billion in 2014 – accounting for only 0.5% of total annual advances of more than £203 billion. Including lifetime mortgages, total borrowing by this age group reached around £1.7 billion in 2014, accounting for less than 1% of all advances (see Chart 4).

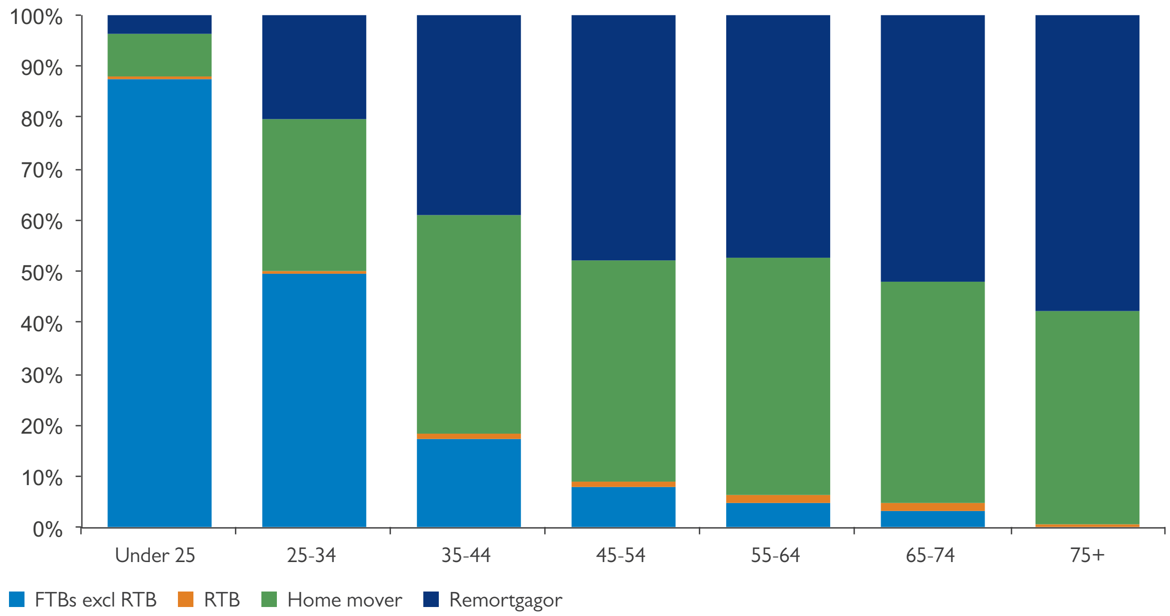
Chart 4: Borrowing by those aged 65 and over, by volume and value (including 2015 figures for Q1-3 inclusive)



Source: CML regulated mortgage survey

In terms of the loans advanced by age and borrower type, Chart 5 below shows an even split between those taking out a loan to move home and those remortgaging amongst borrowers aged over 65.

Chart 5: Distribution of loans advanced by age and borrower type (for twelve months ended September 2015, excluding lifetime mortgages)



Source: CML regulated mortgage survey

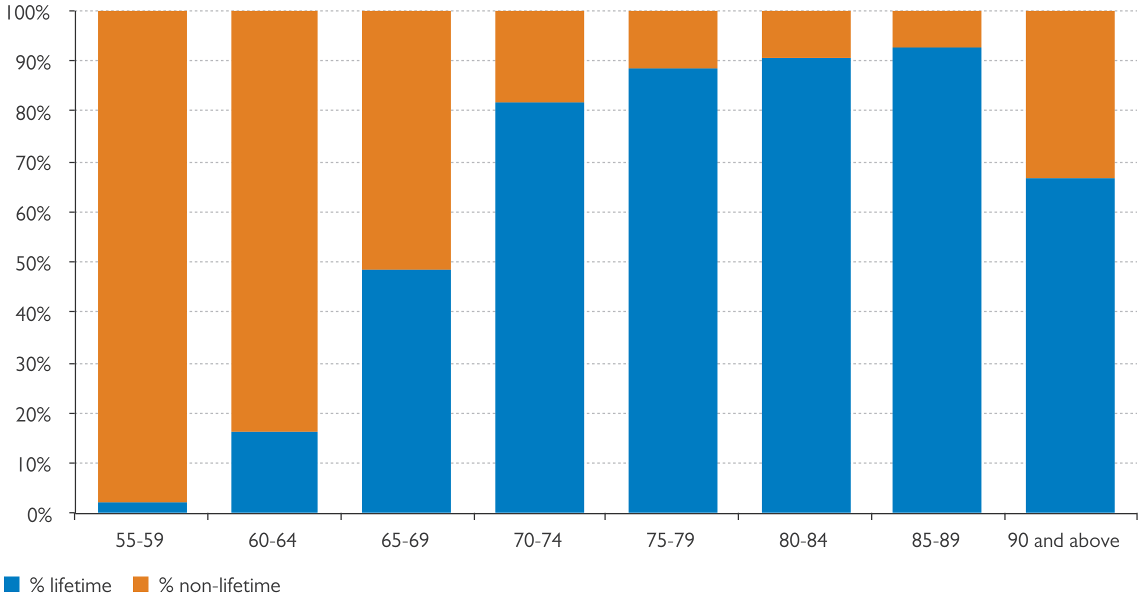
Lifetime Mortgages

CML now has materially whole-of-market coverage for the lifetime sector; allowing us for the first time to comprehensively analyse key characteristics of the lifetime market.

Our data has shown that just under half of all lifetime lending is to comparatively younger borrowers – aged between the minimum 55, up to age 69. But, as Chart 6 below shows, traditional mortgage products (regulated house purchase and remortgage) are more common than lifetime for these borrowers. It is only at ages 70 and beyond that lifetime really dominates the lending landscape; noting alignment with shifting state retirement ages in the UK.

This is also linked to the age-specific underwriting criteria for lifetime. The amount which a lender is able to advance for a lifetime loan relates to the expected repayment date of the loan, which is effectively the projected life expectancy of the borrower. Younger borrowers may borrow less relative to their property's value (a lower LTV) to ensure the total accumulated interest on repayment will be covered by the property sale. An older borrower may take out more relative to their property's value LTV because the mortgage will be expected to be repaid sooner. So depending on the size of loan they require, a lifetime mortgage may not always be suitable or those younger cohorts, even if they pass the basic minimum age and LTV criteria.

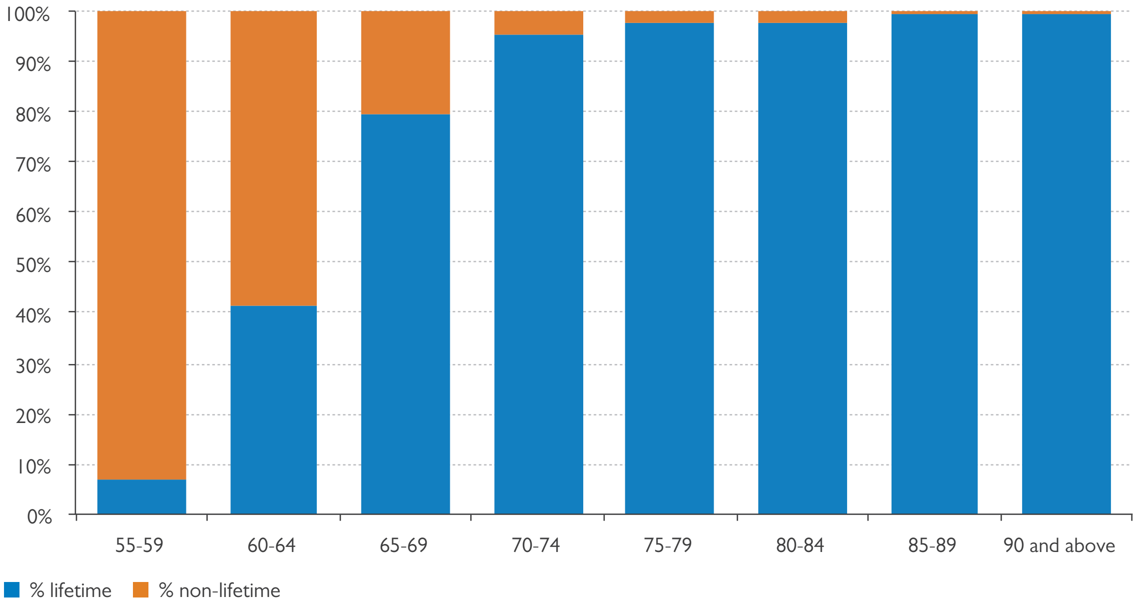
Chart 6: lending to borrowers aged 55 and older, Q1-Q3 2015



Source: CML Regulated Mortgage Survey

Looking at only *remortgages where equity is withdrawn* (of which lifetime is essentially a subset), we see that lifetime plays a prominent role. Lifetime accounts for 53% of all such equity release mortgages to borrowers aged 55 and over, and 74% of those to borrowers aged 60 and over. And, within this, lifetime becomes a prominent component of total lending at a much earlier age.

Chart 7: New lifetime lending vs remortgage with equity release, Q1-Q3 2015



Source: CML Regulated Mortgage Survey

Looking ahead: the demographic challenge

One factor likely to have a significant impact on retirement borrowing is the **rapidly ageing population** of the UK. There are currently more than 11 million people aged 65 or over (accounting for around 17% of the population). But the total is **expected to grow to around 17 million (or almost 25% of the population) by 2034**. Moreover, within this group, the largest percentage growth will be in those aged 85 or older – who are set to more than double to around 3.4 million from around 1.5 million today. [Source: ONS]

Key underlying messages from these facts and figures

- Demographic trends – particularly the UK's ageing population – means there is an ever-growing potential market of older people.
- Despite this, lending to those in retirement has been falling for much of the last decade.
- There is, however, an increase in the number of loans extending beyond the age of 65 – but there will be limits on how far this trend can continue.
- Equity release is, and will continue to be, the answer for some, but for the lending solutions to meet the wider requirements for in retirement lending especially, further innovation will require new funders and collaboration between funders and specialist manufacturers, to ensure that new products are meeting the innovative demands of the wider retirement lending sector.

The Current Situation: Retirement Borrowing Scenarios

People have different reasons for taking out loans at different stages of their lives. Some situations in which older customers can find themselves and on which our members must make lending decisions are highlighted in the case studies below.

Interest only mortgage, no means of repayment

- Miss A took out an interest only mortgage several years ago with the maturity repayment date for the capital set at just before the date that she was due to retire.
- That repayment date is now imminent, but Miss A has insufficient savings and investments; and too small a pension pot, to cover the balance owed.
- She does not want to have to sell her home and is looking to her mortgage company for help.

Mortgage beyond retirement date

- Mr and Mrs C, a couple in their mid 60s, have just inherited some money and would like to finally purchase their dream home.
- They cannot afford to purchase it outright and so need to finance.
- A low loan-to-value (LTV) loan will be required due to the large deposit available from the equity from their existing property (to be sold) and the inheritance.
- The term will take Mr and Mrs C beyond their expected retirement ages; although the mortgage will be comfortably repayable out of their joint pension incomes.

Bereavement / lower income

- Mrs E has recently been bereaved and no longer requires such a large home, so would like to downsize.
- As a couple, due to a combination of illness and periods of unemployment, they had been struggling to afford repayments on occasion.
- The equity available from the sale of the current property will provide a large deposit on a new smaller property, but a relatively small mortgage will still be required.
- Mortgage payments will be reduced, but Mrs E would like to have a mortgage term extending beyond her expected retirement date to keep repayments down, now that there is only one income.

Interest only mortgage, means of repayment = pension

- Miss B took out an interest only mortgage several years ago with the repayment date set at just before the date she was due to retire.
- That repayment date is now imminent and Miss B is planning to use her only sizeable asset – her pension pot – to cover the balance owed.
- But using almost the whole of the pension pot will mean that a proportion of it is lost to tax payable and its use will negatively affect her future income, meaning that she will more or less have to rely on the basic state pension.
- Miss B is wondering whether there is a way around this.

Older partner

- Mr D, a 54 year old married man, would like to remortgage the remaining balance on his mortgage over 10 years to reduce rate and monthly repayments; and repay the mortgage by his expected retirement date.
- His wife is five years older than him and already retired with her own pension income, but the 10 year term will take her beyond her statutory retirement date.
- Mr D is thinking about taking out the remortgage in his own name (as he will have sufficient income to cover the repayments) because he is wary of age limits for acceptance and believes that his wife's age means that they would be turned down.
- He is unsure whether he has to include his wife on the mortgage application.

Downsizing in advance

- Mr F is approaching retirement, with a plan to eventually downsize to a more manageable apartment.
- Ideally, he would like to purchase the new property in advance while prices are relatively low, with the intention of renting it out until it is required.
- Mr F would like to keep his current property – which has a small mortgage remaining – and buy the apartment using a buy-to-let mortgage.
- He intends to pay off the buy-to-let mortgage with the proceeds from the sale of his current house when he eventually moves into the apartment himself.

Using pension freedoms to invest in buy-to-let (BTL)

- Mr H and Mrs I, are a co-habiting couple resident in their family home and are both aged over 70.
- They have never converted to an annuity and can now access their pension pots through pension freedom legislation.
- They are considering using their tax-free sums as a deposit on a BTL property, with rental income set to cover the mortgage repayments.
- They are unsure if this is a good course of action and are looking for financial advice.

Lifestyle borrowing

- Mr and Mrs K – a couple in their 60s with a low residual balance (and repayments) on their residential mortgage – wish to purchase a holiday home, but cannot afford to purchase it outright.
- They require further finance in the form of a remortgage, which they would like secure on the family home, to keep their loan-to-value (LTV) ratio to a minimum and attract the best rates available to them.
- They need to know whether the mortgage company would accept the security on the family home for a loan intended to buy another property.

Reliance on different forms of income

- Miss G wants to purchase a residential property with a mortgage extending beyond her statutory retirement age.
- The mortgage will not be affordable beyond retirement age if Miss G were to rely only on regular pension income alone.
- She plans to supplement her pension income with part-time work, periodic consultancy work; and renting out a room.
- She intends to pay off the mortgage eventually with an expected inheritance.

Helping children onto the housing ladder

- Mr and Mrs J, a recently retired couple, have just paid off the mortgage on their family home.
- They would like to help one of their children onto the property ladder, but do not have sufficient cash savings.
- They would like to keep their existing home as an investment and to leave it to their children, but would be happy to take out a mortgage loan secured on it to pay for a deposit on behalf of their youngest son, who is the only child renting.
- They would be comfortable with making monthly repayments at roughly the same level as that paid in their previous mortgage.
- Their son has offered to meet a proportion of the repayments on his parents' mortgage (as well as paying his own repayments).
- Mr and Mrs J are wondering whether now that they are retired, they will meet the affordability criteria to take out a new mortgage.
- They would also like to know whether they could guarantee their son's repayments on a high loan-to-value (LTV) mortgage.

Sale of property as a repayment vehicle

- Mr L has always had a fairly modest income, but strives to afford the best possible home for his growing family.
- Now in his 50s and with teenagers in the family, he would like to take out an interest only mortgage over the remainder of his working life, to buy a large family home.
- His repayment strategy is to sell the property at the date capital repayment is due; downsizing to a smaller property once the children have (hopefully) left home.

Previously inherited property – borrowers are siblings who can't agree

- Miss M & Miss N are sisters who jointly own their family home.
- Although inherited, the home has a small mortgage on it, which was raised to buy out a third sibling at the time of inheritance.
- It is now the end of the mortgage term.
- The mortgage is interest only and the sisters don't have the means to repay.
- Miss M wants to move out and downsize.
- Miss N wants to remain in the family home, but with only pension income, cannot afford to repay the mortgage AND buy out her sister.

Age-related illness

- Mr Q has a mortgage and at 57, suffers from the early onset of senile dementia.
- His own parents in their 80s live at the secured property and also have dementia.
- It is now the end of Mr Q's mortgage term.
- All three residents in the property are dependant on benefits income and are in poor health.
- Mr Q's son has Power of Attorney (POA) and is asking for a term extension with small contribution to reduce the balance on-going.

Interest only mortgage and no means of repayment – one party to the mortgage is no longer in contact

- Mrs O has a joint mortgage with Mr P, but they divorced many years ago and are no longer in contact.
- Mr P has not contributed to the mortgage since the day they separated fifteen years ago.
- It is now the end of the mortgage term.
- Mrs O is now retired on pension income, but is desperate not to lose the family home.
- With the financial assistance of grown up children, she has been making significant overpayments to the mortgage, which would reduce the balance to zero in around eight years at the current mortgage rate.
- Efforts to engage with Mr P have proved fruitless and affordability cannot be proven from Mrs O alone.

Interest only Buy-to-Let (BTL) where is transpires the borrower is resident

- Mrs R, who was already a retiree at the time, took out a mortgage ten years ago on a BTL basis.
- She subsequently sold her residential home to live off the proceeds and moved into the BTL herself.
- It is now the end of the mortgage term and Mrs R wants to extend on an interest-only basis until her death.

The Issues

The key areas for the mortgage market in relation to older borrowers – and thus the core considerations for the CML's Retirement Borrowing work, are:

The position of borrowers who already have mortgages, whose mortgages are due to mature after their retirement. Will they be able to service them? If they have interest-only mortgages, will they be able to repay them?

Borrowers who wish to take out a mortgage in retirement – are there obstacles and barriers to sensible lending to people post-retirement, and if so how can they be addressed?

Older, "pre-retired" potential borrowers who want to take out a mortgage extending into retirement – what does the current lending situation look like for this group?

How does **pension reform** affect the market; and how does it affect lending affordability calculations and risk profiles?

The role of the regulators and government. For example, can and should the regulatory environment be changed to create greater clarity and confidence on lending into retirement; making it easier for lenders to take decisions to lend that they might otherwise see as fraught with conduct risk? Could government do more to support lending to older borrowers? The latter is explored in detail in our accompanying commissioned independent research.

What sort of **products and services** do older borrowers really want and need? Is there a need for more joined up thinking and more flexible transition products between mainstream mortgages and lifetime products?

Does the current **advice and distribution** system help or hinder the provision of a consistent experience for older consumers looking to borrow; and could it be improved?

The **interaction between borrowing and housing**. Does housing policy need to be more joined up and make it easier for those older borrowers who want to downsize to do so? Taxation policy, as well as housing supply and planning, are all relevant considerations here. These issues are also addressed in our accompanying commissioned independent research.

Borrowing *into* and *in* retirement

Looking first at existing borrowers whose mortgages are due to mature post-retirement, we can be reassured that many of them have no problems. We know that this is the case for many of those coming towards the end of their mortgage term, either with repayment mortgages or a robust plan for repaying their capital on an interest-only loan.

In terms of the **current and future situation for interest-only loans overall**, CML figures show that over the past two years, the total number of interest-only loans outstanding has fallen by over a quarter. As at the end of 2014, CML members reported that there were around 1.9 million pure interest-only mortgages outstanding, and around 460,000 part interest-only mortgages. This was around 300,000 fewer pure interest-only mortgages and 160,000 part interest-only mortgages than a year earlier.

A quarter of this reduction is down to natural attrition (loans maturing and repaying at the end of their term). Around a third can be attributed to full redemption of loans not set to mature until at least 2028 – suggesting that many borrowers are taking action well before problems could arise. This also suggests that a significant group of borrowers are successfully remortgaging onto full repayment terms without falling foul of new affordability rules.

Of those loans that have matured, few have failed to repay. In total, there are fewer than 16,000 loans outstanding which have matured but not yet repaid or restructured – and our previous experience shows that most such loans subsequently redeem within relatively few months of maturity.

While this is good news, there is no room for complacency. It remains a challenge to get borrowers to respond to lender contact designed to help them plan for their mortgage's repayment at maturity. Lenders contacted around 427,000 interest-only customers between April and December 2014 (about 17% of all interest-only borrowers). During 2014, the focus of lender communications moved beyond those whose mortgages are due to mature by 2020, and included borrowers whose mortgages are not due to mature until after this.

Response rates by borrowers varied. Around 27% of those contacted whose mortgages are due to mature between 2021 and 2028 responded , but only a disappointing 2% of those whose mortgages are not due to mature until after 2028 did. However, where lenders did succeed in getting customers to respond, 86% of those who responded had a repayment strategy, and those who did not appeared responsive to making changes (such as switching to repayment terms, overpayments and term extensions).

The steps that the industry and the regulator have been taking to encourage interest-only borrowers to communicate their repayment plans is an ongoing piece of work that is embedded as "business as usual" for lenders; as the industry continues to engage with interest-only customers reaching the end of their mortgage terms. But more can be done to encourage customers to engage with their lenders to discuss their plans.

Some of these borrowers will seek to **remortgage**; and may well seek new loans that **extend into retirement**. Here the picture is more mixed. Given the Financial Conduct Authority (FCA) Mortgage Market Review (MMR) regulatory requirement for lenders to satisfy themselves about the borrower's likely future income and capacity to be able to service the mortgage right to the end of its term, it is inevitable that some borrowers will be able to satisfy the requirements and some will not.

Those who are unable to demonstrate satisfactory evidence of their future income and capacity to service their loan may feel aggrieved, especially if they see their requirements as simply a like-for-like replacement for their existing loan.

The role of the regulators in creating an environment conducive to retirement borrowing

Conduct Regulation

The above is challenging territory for lenders (and, by extension, for intermediaries). On the one hand, lenders are reassured by the FCA's statements that the MMR is not meant to stifle the ability to lend into retirement, but on the other hand, lenders face uncertainty in terms of what a future regulatory or ombudsman perspective might be.

Lenders do want to lend to creditworthy customers, within regulatory constraints. But they also have to consider very carefully the consequences – for the customer and for themselves – of agreeing to lend to older customers who later, when they have only a limited income (and potentially other complicated circumstances) find themselves unable to keep up with their loan commitments.

An on-going challenge for lenders assessing the financial viability of older customers is that **there is no commonly agreed definition of 'retirement'**. Should this be defined as the point at which pension (and / or investment) income exceeds earned income; or when the customer makes a conscious decision to stop working, or makes a significant, permanent change to their working patterns, for example?

The FCA Thematic Review on Advice & Distribution also noted some advisers making assumptions that it is 'right' for customers to end their term before their expected retirement age. This can be based around the lender's own policy, for example, that customers must justify why they want to take the mortgage into retirement. There is a strong overlap here with the responsible lending rules, particularly where the customer is 'close to retirement'; as the evidence they need to provide increases significantly. And where lenders have age limits, they also have policies permitting exceptions and will often lend beyond an 'age limit' where they are satisfied that, in the individual circumstances of the case, the loan will remain affordable.

In summary, there are several reasons why **conduct regulation** risk may be heightened in the case of borrowers in later life.

- **Vulnerability:** in assessing applicants for borrowing into retirement, lenders will need to assess whether they are vulnerable, in line with the usual FCA assessment criteria. Account may also need to be taken of the risk of increased vulnerability with age. It must be appreciated by the FCA that, if customers develop conditions undetectable at the time of underwriting, this is no indication of a possible regulatory fault. Lenders and regulators have to accept heightened levels of uncertainty when borrowers are in later life and this should be further increased by added regulatory uncertainty over the reaction to such events. Do older borrowers need products with built-in safeguards, given that ageing is inevitable? Or should this be left down to lender forbearance policies?
- **Next Generation:** we are aware of cases where firms are criticised by relatives of their customers for having made a loan or provided a product. This especially applies to equity release types of product. Lenders may well want to have appropriate arrangements for involving relatives and need assurance that the FCA is happy with such arrangements. Differing regulatory requirements between mainstream and lifetime mortgages means that consideration of the role of family is currently more visible in the equity release industry.
- **Affordability:** older borrowers are subject to standard assessment of affordability. When assessing affordability, it is clearly sensible to take into account any reasonably likely changes to income or expenditure during the term of the mortgage (as set out in FCA rules MCOB 11.6.14R and 11.6.15G). However, this represents a significant challenge to a lender when lending deeper into retirement. For example, for joint borrowers it is likely that a borrower may die, and depending upon the spouse's pension entitlement, this may result in a significant reduction in pension income. Alternatively, a borrower may require domiciliary or residential care, resulting in a significant increase in expenditure.

  In practice therefore, lenders may assume that the highest income earner will die during the term and assess affordability at outset on the borrower with the lowest income, which can exclude many otherwise creditworthy borrowers from qualifying for retirement lending.

  Adding to the complexity, all income from investments and other assets must also be taken into account here as well.

Prudential Regulation

On the **prudential regulation** side, lenders will have to satisfy themselves that their borrowers have the necessary income with which to service a loan; and that they have the necessary capital to underpin their lending, to satisfy Prudential Regulation Authority (PRA) requirements.

Specifically in terms of new product development for the older demographic, alongside any new design of products for lending *into* retirement or *in* retirement is the need for lenders to hedge some of the risks within these new products. Such new products are likely to contain a variety of risks, for example, interest rate, asset price, morbidity and mortality/longevity; or indeed a combination of these risks. In addition, the cash flow and funding profile of equity release lending – long term with uncertain maturity and no current cash flows – makes funding these loans different and more challenging for a standard bank model.

For lenders it is important to ensure that any risk management strategy and derivatives employed achieve **hedge accounting** treatment. Failure to secure this would mean that the annual mark-to-market of any derivative/risk management strategy used would go through the lender's Profit and Loss sheet; in the process introducing an unacceptable volatility into lenders' accounts.

The requirements to qualify for hedge accounting are currently being reviewed under International Financial Reporting Standard (IFRS) 9, which is aligning risk mitigation strategies more closely to the accounting treatment. Lenders have expressed concern that this change may make it harder to achieve hedge accounting treatment for some risk mitigation strategies going forward; and act as a disincentive for some lenders to design new products for older borrowers.

The PRA is also a key 'gatekeeper' for the introduction of new lifetime mortgage funders and lenders in relation to EU prudential regulation – **'Solvency II'**. Existing funders and lenders are potentially at risk here too, as the PRA works to define its acceptable model/s for Solvency II, expected by the end of 2015. Requirements for matching assets should not lead to product withdrawal or failure of new entry, due to capital adequacy requirements that render products either unworkable; or too expensive for funder and consumer. Also on the near horizon are potential changes to the **Building Societies Sourcebook** around capital requirements for retirement lending.

With the proliferation of regulatory factors at play, the current **FCA Responsible Lending Review** and its recently launched **Call for Inputs (CfI) on competition in the mortgage sector** present a timely opportunity to assess how the regulatory environment post-MMR introduction is working for older borrowers.

Pension Reforms – implications for lenders and their borrowers

It will be some time before the full effects of the pension reforms which came into force in April 2015 are known, but it is a given that the end to compulsory annuitisation has major potential impacts on borrowing behaviour.

Although market evidence to date has shown that while consumers may well take advantage of their new-found freedoms to pursue routes other than annuities, this does not mean that they are being 'reckless' in the liberation of their pension pots.

According to figures published in July 2015 by the Association of British Insurers (ABI), savers had taken out over £1billion in 65,000 cash withdrawals from their pension pots, with the value of the average pot taken being £15,500. The data showed that people with smaller pots tended to be cashing them out, while those with larger pots tend to be buying a regular income product. It also highlighted an increase in the number of people putting money into income drawdown products that can take advantage of the new freedoms.

The CML will be monitoring for further **data on use of pension pots to pay off mortgage debt**, as it becomes available.

In terms of the approach lenders can take in their treatment of pension income in affordability calculations in this new pension freedoms era; annual post-retirement forecasts of income are now increasingly less certain, as they are based on the assumption that the customer buys an annuity with the pot. With regard to affordability calculations for those borrowing into (as opposed to in) retirement, consideration must also be given to those still investing in their pensions, as well as those decumulating.

Sample issues for consideration in lenders' treatment of pension income in affordability calculations

When lending *into* retirement the customer is likely to be in 'pension accumulation' i.e. still saving for retirement, which will require many assumptions, for example future contributions and investment returns. Areas to consider here are:
Defined Benefit (DB – including Final Salary and Career Average based schemes) and/or Defined Contribution (DC) schemes?
Current fund valuation?
Level of future DC contributions? (and treatment in committed expenditure during affordability calculations)
Future investment returns?
Retirement age?
Level of tax free cash? (consideration of recent taxation changes required here also)
If intention is to annuitise, then future annuity rate assumptions?
Use of and reliance on pension provider projections?
If intention is to use drawdown, drawdown rate assumptions and continued investment returns?
Customer longevity for drawdown?
Future changes to taxation of pension income?
Value of the pension at retirement, taking into account inflation?
For joint customers, consider loss of income on death of joint borrower?

When lending *in* retirement the customer is likely to be in 'pension decumulation' i.e. drawing from an existing pension. Areas for consideration here include:
Post pension freedoms – annuitisation, drawdown or cash?
Annuity income? – indexed linked for inflation? Spouse?
Drawdown rate assumptions and continued investment return rates?
Customer longevity for drawdown?
Future changes to taxation of pension income?
For joint customers, consider loss of income on death of joint borrower (unless life insurance in place, but cost may be prohibitive for this age group?)

In light of these new statutory flexibilities, lenders, therefore, have much to consider in terms of the treatment of pension income. It is regularly asserted that pension income is more predictable and reliable than income from employment, which is no longer necessarily the case.

This risk should be assessed as part of lenders' normal underwriting processes, but CML would not expect lenders to be held in breach if they found themselves obliged to take possession of a property as a result of depleted income, for example. An indication of the FCA approach to such cases would be welcome.

It is also possible that the associated **tax changes to inherited pension wealth** (also from April 2015, the 'death tax' was abolished; allowing remaining pension wealth not used to buy an annuity to be passed on to any beneficiaries – not just financial dependants). This **could incentivise earlier use of housing equity and later use of pension wealth**. If the latter trend materialises, policy expectations of housing equity as a care funding resource are likely to be undermined.

Also looking ahead, in terms of future prospects for the annuities market, although they are proving a less popular choice while gilt yields are low, what might this market look like when / if gilt yields start to rise again?

Advice and Distribution

Retirement borrowing advice is multi-faceted and changing, addressing whole of market; stage of life; and single products. The 'traditional' timing of when to offer (and advise on) product or service solutions has altered – end of term is no longer 65; and advising consumers on the role their property asset plays in their longer term and whole retirement is a different form of advice from considerations around paying off a mortgage. It is also in the consumer interest to plan for retirement as early as possible – issues can become much more complex if planning is left to a late stage.

The complexity of the individuals' financial affairs increases at and around retirement, although, we are mindful that some older customers will not necessarily need complex levels of advice.

At present, **there is a very limited cohort of advisers who can cover residential and lifetime mortgages and investment advice**. Advice is segmented, due to different regulatory regimes, different types of advisor; and different product heritage. The hand-off between different types of adviser dealing with different parts of the market can be clunky and discouraging for the customer. Anecdotal evidence suggests that this can partly be due to reluctance to hand over because of the disincentive of commissions going elsewhere, while in other cases it can be due to a lack of understanding between advisers of what their counterparts can offer and therefore, who would be the most appropriate referral. There could be a smoother process for consumers to understand the differences between them and, where appropriate, to transition between the two.

A key challenge is **how best to match consumer attitudes and behaviour with advice given?** As the FCA noted in its recent MMR Advice & Distribution Thematic Review, short-termism is still the predominant feature in consumer thinking; combined with consumers' over-optimistic assumptions on future product availability and their ability to rectify any compromises they have made to get their current mortgage and target monthly payment amount. The FCA noted:

> *"…we found consumers to be optimistic about future product availability, expecting comparable or cheaper products to be available when they next move or remortgage. This means that many consumers are also confident in their ability to rectify any compromises they have made to get their current mortgage, and target monthly repayment amount, through their future mortgage choices.*
>
> *"Due in part to this confidence in their future financial situation, and the future mortgage market, consumers are reluctant to lock in for long periods of time for fear of missing out on future offers. Current consumer behaviour (across all types) is very much driven by the search for the best initial 'deal'. Despite regarding a mortgage as a significant (if not the most significant) long-term financial commitment they are likely to make, consumers' choices are nonetheless predominantly short-term, thanks to high levels of certainty that they will move from one product to another throughout their time in one property, or over the course of their home-owning lifetime."*

There is also a **clear read across to the mortgage industry in terms of customer preferences for pension advice**. According to the National Association of Pension Funds (NAPF – now the Pensions and Lifetime Savings Association) [Source: *'The Unpredictability of Retirement'*, NAPF, January 2015], sources of expert help can be limited due to the limited availability of advice to those with moderate incomes and wealth. A significant proportion do not expect to seek help and among those that do, the majority will not seek formal advice but will consult organisations that can only give guidance.

The NAPF paper also highlighted distinct support is required for different pension outcomes and different preferences re formal help sought (financial advisers, employers; The Pension Advisory Service; Age UK; Citizens Advice; MAS); and identified an overall lack of awareness of the support provided by statutory agencies and charities.

In terms of **advice qualifications**, demographic challenges require later life advice to become more prevalent. Looking to the near future, should more mortgage advisers take such qualifications – and are sufficient ones available – to serve this market? What is dissuading these advisers from doing so currently? Anecdotal evidence points to a perception of lack of opportunity in the market; historic reputational issues with the equity release market; a lack of awareness of market opportunities; and low conduct risk appetite, given the distinctly different risk profile of older borrowers.

The EU **Mortgage Credit Directive**, which comes into force March 2016 for mainstream mortgage lenders, will present a further differentiation between the mainstream and lifetime markets. For example, mainstream mortgage customers will receive pre-contractual information through the European Standardised Information Sheet (ESIS) standardised format (by March 2019), whereas lifetime customers will receive such information via tailored Key Facts Illustration (KFI) document. Although much of the content of the ESIS will be familiar to mortgage lenders in the UK, there are a number of new information requirements and the ESIS looks quite different to anything lenders currently produce for their customers.

More widely, mortgage advice for older borrowers cannot be seen in isolation. Consideration must also be given to other sources of advice around pension income; provision for long term care; and the impacts on benefits and inheritance, for example. For many older people making borrowing decisions, lenders with advice permissions and intermediaries are often only one part of the picture, alongside legal and financial advice. No single band of advisers cover this span.

Conclusions, Recommendations & Calls to Action

CML has produced a series of 'calls to action' for the mortgage industry, government and regulators, to deliver good outcomes for older borrowers – which allow the market to develop to meet the needs of consumers, while providing proper safeguards.

We look forward to working with the various stakeholders involved throughout 2016 to make these calls to action a reality.

Calls to action for the mortgage industry

We recommend that mortgage lenders focus on guiding older borrowers through the options available to them; on exchanging ideas for best practice which have already demonstrated their worth; and in identifying those partners whose input and support will help secure a good end result.

CML / the mortgage lending industry will:

Share our 'Customer Decision Tree' for older borrowers (see Appendix) with key stakeholders, to provide a 'snapshot' for customers, lenders and policy makers, which highlights the range of factors (and actors) at play when older people seek to borrow in retirement.

Provide opportunities for sharing best practice in terms of dealing with older customers, via CML's continued membership of the Financial Services Vulnerability Taskforce and the money Advice Service (MAS) Older People's Steering Group, for example. We will also work with intermediary firms, especially those who have access to 'both sides of the balance sheet' (mortgages and investments).

Continue discussions with representatives of intermediaries to identify where changes in industry practice might improve seamless accessibility to advice. We will also explore the market to identify existing hand-off arrangements which display positive outcomes in response to the challenges highlighted, to help shape what "good" can and should look like going forward.

We will also ensure that other initiatives adequately reflect the work which we are doing with older borrowers. For example, updating the CML / AMI / IMLA *Working Together Industry Guide* to lender and intermediary accountabilities and responsibilities in mortgage sales and servicing, to include a specific focus on the older borrower market.

Continue to monitor the emerging evidence base around the interaction between pension freedoms and the mortgage market – including the ways in which pensions pots may be being used for mortgage-related purposes. For example, whether pension vehicles are being used to pay off the capital repayment on interest only mortgages.

We will also:

- **Seek to work more closely with the pensions industry** to explore opportunities to simplify, increase clarity and more closely align pensions illustrations and equity release affordability calculations. Currently, the borrower is heavily reliant on how his / her life insurer has laid out their illustration, which means that lender policies can differ depending on the illustration used.
- Explore what lessons can be learned from the NAPF research around the provision of pension advice – specifically, where should and does the mortgage market sit here; and what can we learn from these findings in terms of customer preferences for advice and how it should be given and by whom?
- With regard to how pension income is to be evidenced, the CML will explore read across from previous work done in conjunction with HMRC around tax returns and verification of income.

Calls to action for the mortgage industry (cont.)

In addressing the current and future needs of **interest-only borrowers**, CML will:

- Continue to build on progress already made by the industry to check that borrowers with interest-only mortgages have plans for how they will repay their loans at maturity; and explore options for customers who may not be able to repay their mortgages. This includes more partnering with third-party advice providers, including equity release firms, and product innovations that may help some borrowers.
- Work with lenders to help enhance approaches to customer contact strategies that most encourage customers to respond.
- Continue our work with our members to **explore the potential for a new product type for borrowers unable to make the capital repayment on their interest-only mortgage, but who can afford to continue making regular payments after the end of their interest-only mortgage term.**

We will also consider whether there could be a market in the 50-75 age group for a product that can switch between interest-only and capital repayment at different times; potentially ending up as interest-only or a rolled up interest product with the property providing the repayment vehicle.

Similarly, CML will explore the potential for product innovation for 65-74 year olds. As our figures show, older age cohorts (75+) account for more than half the lifetime mortgage loans/balances held.

With regard to **age limits**, this issue is addressed in detail in our commissioned independent research. CML will monitor trends in members' policies in this area.

Calls to action for regulators and government

The CML would like to see a regulatory framework for lending into retirement where:

- Lenders do not feel apprehensive about lending to borrowers beyond retirement age, because regulatory attitudes and constraints are well and consistently understood.
- There is no real or perceived obstacle to developing or adapting products to meet the needs of older borrowers.
- The implications of changing retirement income rules are properly reflected in the rule book and consequently in the evaluation of applicants.
- The are fewer regulatory barriers in the way of building a clearer, more fluid relationship between the Equity Release market and the residential mortgage market, which helps those in later life to secure appropriate advice and products.

We ask the **HM Treasury / FCA Financial Advice Market Review** and the FCA Call for Inputs on competition in the mortgage sector to address how the current regulatory environment could **encourage a more holistic approach in the longer term which would encompass mortgage, lifetime and investment advice and thus reflect the needs of many older borrowers**. It would also be timely for the **FCA's mortgage qualifications review** team to address this issue; and the CML welcomes the opportunity to contribute here.

As part of the FCA Call for Inputs, CML also aims to explore with regulators the future for **automated advice and increased digitisation**. For example, should regulators consider that advice requirements should reflect the assets held? Would it be more appropriate that those with relatively simple asset structures could avail of online advice alone? Online provision of mortgage services will be of particular interest to the upcoming generation of older borrowers, who are more used to carrying out much of their transactions and engagement with banking and utility providers online.

We ask regulators to consider how different reasons for borrowing should be reflected in distribution channels – for example, care driven reasons can also require advice outside of retail / financial services market. Health can be more of a barometer than age in terms of income assessments – and advice should be considered against that measure too, as appropriate.

We ask HM Treasury to **explore the provision of tax relief on professional advice received at retirement**, to encourage more customers to make the most appropriate, soundly based and realistic plans for their circumstances.

In the interest of clarity, **we urge the FCA to work with us to provide a standard definition of retirement, given that older age-based definitions are increasingly irrelevant**. Pension Wise and the Money Advice Service could also more prominently address the reality that retirement no longer happens at state pension age in their current engagement with consumers.

We would welcome **specific acknowledgement from the FCA regarding the treatment of pension income**, which recognises that lenders can only make informed judgements at the time of application / approval; and that they should be able to rely on this for future conduct risk purposes, when customers' circumstances may have changed, due to spousal death or care requirements, for example. We note that although the FCA has not made inclusion of specific pension contributions made by the customer in the affordability model assessment mandatory at this point, the increased focus on a solution that involves lending into retirement or lifetime mortgages may alter this position in time.

We also ask **Pension Wise to include substantial questioning around housing debt** – with both short and long term focus – in their engagement with those considering and using their new pension freedoms. CML would be happy to provide draft scripts for this purpose.

Calls to action for regulators and government (cont.)

We ask the FCA to **consider potential changes to MCOB rules, which could allow the mainstream mortgage and equity release markets to better work together** to provide joined up retirement borrowing solutions, for example, allowing lifetime mortgages to be an acceptable repayment strategy for interest-only mortgages. This might be supported with changes to MCOB 11.6.46E and MCOB 11.6.45G (covering 'reasonableness tests' for acceptable repayment strategies). The overall aim would be to establish a path for customers to transition from mainstream to a lifetime mortgage. We welcome the opportunity to explore this in more detail with the FCA.

The government clearly wants a housing market that works better, but its emphasis is on helping younger buyers. **We ask the government to look to other state's roles in promoting a market for older borrowers.** Our accompanying commissioned independent research looks, for example, at the experiences of the US and South Korean government's role providing stated backed guarantees.

On the **prudential** side, **we urge the Prudential Regulation Authority (PRA) to give more consideration to the often challenging demands of lenders having to satisfy themselves that their borrowers have the necessary income with which to service a loan; at the same time as ensuring they have the necessary capital to underpin their lending, to satisfy PRA requirements.**

The PRA's work to define acceptable model/s for Solvency II should ensure that requirements for matching assets should not lead to product withdrawal or failure of new entry, due to capital adequacy requirements that render products either unworkable; or too expensive for funder and consumer.

Similarly, we urge that the current review of hedge accounting requirements under **International Financial Reporting Standard (IFRS) 9**, does not result in an outcome that makes it more difficult to achieve hedge accounting treatment for some risk mitigation strategies going forward; acting as a disincentive for some lenders to design new products for older borrowers in the process.

Appendix:
Customer Decision Tree

Customer Decision Tree

WHY
Existing / potential customer identifies borrowing need, including…

HOW
Help and guidance with deciding and weighing up options

WHAT
Loan taken (or not)

WHO
Direct and Indirect influencers

WHEN
Changing circumstances

- Helping children onto housing ladder
- Interest only mortgage, capital repayment date imminent, but insufficient funds to pay off the balance owed
- Want to purchase ‘dream home’ following inheritance, but can’t buy home outright
- Want to remortgage remaining balance on mortgage to reduce rate and monthly payments
- Income reduction following bereavement / divorce
- Buying a holiday home
- Using new pension freedoms to invest in a buy-to-let property
- Downsizing to more expensive property
- Struggling to meet current mortgage repayments due to illness
- Home improvements / adaptations

- How much can I borrow?
- How much do I need to borrow?
- Is a mortgage / remortgage the best option for me?
- Is non-mortgage borrowing (credit cards, personal loans) more appropriate for my needs?
- What are the consequences for me / my family of borrowing?
- Go to a financial adviser
- Ask my family for advice
- Talk to a lender
- Go online – lender websites; comparison websites
- Contact the Money Advice Service (by phone, in person, online)
- Lender / professional advisor challenging borrower assumptions

- ‘Back to drawing board’ if amount wanting to borrow does not meet affordability criteria
- Take out a non-mortgage loan instead
- Take out a new mortgage
- Remortgage
- Equity release / lifetime mortgage

Direct:
- Lender accepting your mortgage application / providing your mortgage
- Conveyancer progressing the legal aspects of your mortgage
- Surveyer / valuer assessing the value of your property
- Mortgage advisors (or direct with lender for “execution-only” mortgages)
- Solicitor setting up Power of Attorney (POA) where necessary
- Financial Ombudsman Service (FOS) if you have a dispute with your mortgage provider
- Family and friends, who may help you make or be the reason for your borrowing decision
- HMRC – stamp duty, inheritance tax consideration etc.

Indirect (the customer cannot ‘see’):
- Financial Conduct Authority (FCA), who set the affordability rules mortgage lenders and advisors have to apply when assessing whether you can afford your repayments now and in the future

- Notifying lender of changes and impact they will have on ability to repay your mortgage, such as:
  - moving
  - care costs
  - death (including spousal death)
  - retirement
  - new dependants (adult children returning to the home for example)

Council of Mortgage Lenders

Retirement Borrowing:
Reality, Perceptions, Projections and Potential