

Defining Home Reversions

Consultation Document

July 2004



HM TREASURY

DEFINING HOME REVERSIONS

This document seeks views on the definition of home reversions, which are to fall within the scope of Financial Services Authority (FSA) regulation.

The Government would welcome feedback on the proposals explained here. It would be helpful if responses could cover the issues listed in Annex A. Other relevant input would also be welcome.

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This paper is available on the Treasury's public website www.hm-treasury.gov.uk. For hard copies, please use the contact details above.

It would be helpful to receive your response **by 28 September 2004**. We cannot guarantee to consider your response if it arrives after that date. Please explain in your reply if you represent an organisation, and if so, its membership and coverage. For individual firms and brokers, it would be helpful to know the numbers of home reversions (and other equity release schemes) that you sell and what proportion of the market you cover. **In accordance with the code of practice on open government, comments will be made publicly available unless respondents specifically request otherwise.** Any e-mail response sent from a corporate system may carry an automatically generated message stating that the content of the message should be treated as confidential. If you are replying by e-mail, please make it clear in the body of your response whether or not you wish your comments to be treated as confidential.

CONTENTS

	Page No.
1. INTRODUCTION	3
2. BACKGROUND TO THE CONSULTATION	3
What are equity release schemes	3
What is a lifetime mortgage	3
What is a home reversion	4
Legislative background	4
3. ISSUES FOR CONSIDERATION	5
The aim of regulation	5
The definition of home reversions in primary legislation	5
Islamic mortgages	6
The regulatory position of Islamic mortgages	6
Flexible tenure	7
Should age be relevant to the primary legislation definition?	8
A de minimis threshold	8
Other comments	9
ANNEX A LIST OF QUESTIONS	10
ANNEX B REGULATORY IMPACT ASSESSMENT	11

In this consultation document:

"FSA" the Financial Services Authority (the financial services regulator)

"FSMA" means the Financial Services and Markets Act 2000

"RAO" means The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544).

1 - Introduction

1. On 5 June 2003, the Chief Secretary to the Treasury, Paul Boateng, announced that the Government would carry out an open consultation on whether home reversion equity release plans should be regulated by the FSA. This full public consultation was opened on 11 November 2003, and final responses were requested by 13 February 2004.

2. In the light of the responses received, on 10 May 2004 the Financial Secretary to the Treasury, Ruth Kelly, announced that home reversions would be regulated by the FSA, saying:

“Buying a home reversion policy is a huge financial decision involving the most important, and sometimes only significant, asset of elderly people. It can have significant implications for tax, benefits, inheritance and long-term financial planning. Regulation will help people to make informed choices, offer valuable consumer protection and ensure that there is a level playing field in the equity release market.”

3. The Government intends to bring forward primary legislation to bring home reversions into regulation as soon as the parliamentary timetable allows.

4. The purpose of this consultation is to seek views on the types of sales and purchases of land and interests in land that should or should not fall into the definition of a home reversion for the purposes of the primary legislation.

2 - Background to the consultation

What are equity release schemes

5. Equity release schemes are financial products, or sale and lease arrangements, that allow homeowners to release the value of their property above any amount owed on a mortgage. These schemes involve a provider paying the homeowner either a lump sum or income (or both) on the basis of the value of the home in return for all or a share of the homeowner’s interest in the home. Providers receive their returns when the home is sold or vacated. There are two basic types of scheme: lifetime mortgages (mortgage-backed equity release plans) and home reversion equity release plans.

What is a lifetime mortgage?

6. With a lifetime mortgage, the homeowner takes out a mortgage loan secured on the property. The loan can be used to fund an annuity and provide regular income, or provide a lump sum payment. There are also draw-down products that provide a regular income but are not linked to investments. The amount of the loan is based on the age of the owners, their life expectancy and the value of the property. Ownership remains with the

homeowner. The loan, with interest, is repaid when the property is sold, either on the borrower's death or if the borrower moves into long-term care or possibly sheltered accommodation. There are also some schemes where the borrower chooses to pay interest on the loan and the capital is repaid when the property is sold.

What is a home reversion plan?

7. Under a home reversion plan, a homeowner sells part or all of the home in return for a lump sum payment (usually within a range of 30-65% of the property value) and the right to remain in the house until they die or move home. The lump sum depends on a number of factors including the age of the owners, an actuarial assessment of life expectancy, and the value of the property. As with lifetime mortgages, the lump sum may be drawn down or be used to purchase an investment in order to provide additional income, or paid straight to the former owner to do with as they please. When the former owner dies or moves house the reversion provider can sell the property.

Legislative background

8. From 31 October 2004 the FSA will have the power to regulate the selling of first charge mortgages under FSMA. Regulation will be applicable to all first charge mortgages, including lifetime mortgages, on a UK property where at least 40% is used as or in connection with a dwelling by the borrower or a member of their immediate family.

9. The FSA also has limited powers to make rules relating to the unregulated activities of regulated firms, where this would help protect the interests of consumers of regulated activities. However the FSA regime will not extend to firms that offer reversion plans and carry on no other regulated activity.

10. FSMA sets the framework within which the FSA operates. Under Section 22(1) of FSMA, an activity may be regulated if it is carried on by way of business and is a specified activity relating to specified investments and property. Schedule 2 supplements section 22 by describing, non-exhaustively, the sorts of activities that may in particular be specified for the purposes of regulation under Section 22(1). Home reversions are not specifically described in Schedule 2 and so it is not completely clear if they can be included in the scope of regulation under section 22(1). Including a description of such activities in Schedule 2 of FSMA would put the matter beyond doubt.

11. The RAO is the Order under section 22 of FSMA (as read with Schedule 2 to FSMA) which sets out the specific activities that have been brought into the scope of FSA regulation.

12. Even if an activity falls within the scope of the RAO, it is only regulated if it is carried on "by way of business", thus avoiding for example purely family and some other non-commercial arrangements from being regulated. Whether a person is selling home reversions "by way of business" will be a matter to be

determined on a case-by-case basis. Relevant factors are likely to include: the frequency with which the activity is carried on; the nature of the activity; whether the person is acting in the course of a trade or a profession; and whether the person receives payment or other economic benefit, and the nature of that payment.

13. The stages needed to bring home reversion plans into regulation are as follows.

- 1) The Government first intends to bring forward primary legislation to amend Schedule 2 to FSMA to make it clear that home reversion plans are within the potential scope of regulation under section 22.
- 2) The Government will bring forward secondary legislation to amend the RAO to bring home reversion plans into FSA regulation.
- 3) The FSA will draw up and consult on rules to regulate the selling of home reversion plans.
- 4) Firms will need to apply for authorisation or variation of permission from the FSA to sell home reversion plans.

The purpose of this consultation is to inform step 1 above by seeking views on the parameters of the definition of a home reversion to be included in Schedule 2 to FSMA.

3 - Issues for consideration

The aim of regulation

14. The aim of the regulation is to increase protection for consumers who are purchasing, or considering purchasing, a home reversion plan. Buying a home reversion plan can be a big financial decision involving the most important, and sometimes the only significant asset of elderly people. It can have significant implications for tax, benefits, inheritance and long-term financial planning. FSA regulation of home reversion plans will also ensure a level playing field in the equity release market as equity release mortgages¹ will be regulated by the FSA from 31 October 2004, as noted above.

The definition of home reversion plans in primary legislation

15. The reference to home reversion plans in Schedule 2 must be broad enough to capture the home reversion arrangements we would want to regulate. We can then use secondary legislation to adjust the scope of what actually falls within FSA regulation as appropriate as the market develops. **We intend to consult fully on the RAO definition of a home reversion when the amendment to FSMA has been made.**

¹ Falling within the definition of a regulated mortgage contract as defined in the Regulated Activities Order

16. In broad terms, a home reversion involves arrangements whereby the consumer takes, in return for selling the title to all or some of the property, both a monetary consideration and an entitlement to continue living in the property. **However we need to ensure that we do not include in the meaning of the Schedule 2 definition of “home reversion plans” arrangements within this broad concept that we would not want to regulate.** Therefore we need to consider whether the following arrangements should be specifically excluded from the primary legislation definition.

Islamic mortgages

17. Interest-based mortgages do not comply with Islamic (Shari’a) Law. Such mortgages had historically been the only type available in the UK, which meant that many Muslims had to test their Islamic principles against the pragmatic need for accommodation when deciding whether or not to take out a mortgage. However, the Qu’ran and Islamic law do permit a return to be made from the provision of finance as long as risk is explicitly taken by the supplier of funds. Hence, Islamic law can accommodate contracts to facilitate house purchase.

18. There are now two broad types of Shari’a-compliant arrangements available in the UK, based on Ijara and Murabaha methods. These are available to all consumers and not just Muslims. In both types, the financial institution receives a rate of return on its investment, although it is not ‘interest’ in the conventional sense.

a) Murabaha

A financier buys the property and sells it immediately on to the customer at a higher price, payable in instalments usually over 25 years.

b) Ijara

The property is purchased by a financier and sold to the customer for the same sum, with payment spread over an agreed term. Whilst the customer is purchasing the property from the financier, he leases it and pays additional rent for its use.

Regulatory position of Islamic mortgages

19. A Murabaha arrangement falls within the definition of a regulated mortgage and will be regulated by the FSA with effect from 31 October 2004. However, Ijaras are effectively sale and lease arrangements and fall outside the scope of FSA mortgage regulation. Ijara arrangements may fall within a number of definitions of a reversion plan.

20. We wish to consider whether Ijara home finance arrangements should fall within the scope of regulation under FSMA as a “home reversion plan”. Regulating Ijara home finance arrangements would have the benefit of protecting consumers and ensuring a level regulatory playing field with Murabaha mortgages. On the other hand Ijara arrangements are not conventional equity release products, their purpose being to purchase the

house rather than to release equity from the house. It is therefore questionable whether regulation needs to extend to such products.

21. It should be possible to craft a definition of a regulated home reversion which either includes Ijara arrangements or which excludes them, depending on the policy decision taken following this consultation. If we included Ijara arrangements in the Schedule 2 definition of a home reversion, such arrangements would still fall outside the scope of FSA regulation unless they were brought within the RAO definition.

Q1 a) Should Ijara home finance arrangements fall within the scope of FSMA as a home reversion plan?

b) Are there further types of Islamic finance arrangements for home purchase that might be caught by the description of a home reversion plan? If so please provide details of such arrangements and indicate whether you consider such arrangements should fall within FSMA definition of a home reversion plan.

Flexible tenure

22. Some local authorities and Registered Social Landlords (RSLs) offer a form of flexible tenure in the low-cost home ownership market, where they buy back portions or shares in a property if the owners find themselves in financial difficulty. Such arrangements resemble home reversion schemes.

23. Mortgage business when carried on by local authorities or RSLs within the meaning of the Housing Act 1996 (“exempted RSLs”) is exempt from FSA regulation. The Government intends to exclude the activities of local authorities and exempted RSLs from the proposed regulation of home reversion plans in order to remain consistent with the current approach on mortgages.

24. However such flexible tenure arrangements where they involve buying back of portions of the property by the provider may be carried on “by way of business” where the provider is not a local authority or an exempted RSL. We need to consider whether such arrangements should fall within the scope of FSMA. Regulation of such products would protect consumers who may be vulnerable and on low incomes, and who may need advice about the implications of such products on their tax and benefit position, and for their longer term financial position.

Q2: Should flexible tenure products provided by providers other than local authorities and exempted RSLs fall within the scope of FSMA as a home reversion plan where such products involve the buying back of portions of the property from the homeowner?

Should age be relevant to the primary legislation definition of a home reversion?

25. The traditional home reversion products are targeted towards the elderly. Current products tend to have a lower-age limit stipulation, which tends to be age 55 or higher.

26. An important reason for regulation is that buying a home reversion policy can have significant implications for tax, benefits, inheritance and long-term financial planning. These wider individual financial implications of a home reversion plan are arguably greater for older people at or nearing retirement age, who may be using a home reversion to supplement their income in retirement.

27. There is an argument for limiting the scope of regulation of home reversion plans to those products sold to persons above a certain age. However the Government considers it would be inappropriate to limit the scope of regulation in this way. Such a limitation in primary legislation would be hard to change. Even if FSMA does not impose any age limit it would still be possible to insert an age limit later in the RAO definition, although arriving at an appropriate age which did not produce arbitrary results might be easier said than done. For example a home reversion might be taken out by someone in poor health and with a reduced income due to having to change their job or cease employment but who was younger than the specified age limit. That person would arguably need as much protection as an older purchaser.

Q3. Do you agree that there should be no age limit in the definition of a home reversion in Schedule 2 to FSMA?

A de minimis threshold

28. Home reversion plans can vary from those involving the sale of the entire house to those where only a small percentage of the house is sold, perhaps for a few hundred pounds. A home reversion can also take the form of a series of partial reversions.

29. We consider that it would not be appropriate to set a *de minimis* threshold for home reversions. There is a risk that providers could offer reversions just below the *de minimis* threshold. Also the implications for a consumer who buys several small reversions from either the same or different providers are potentially as great as those for a consumer who buys one larger reversion.

Q4: Do you agree that the scope of regulation of home reversion plans under FSMA should not have a de mimimis threshold?

Other comments

30. Readers are invited to make any other comments about the scope of home reversion plans for the proposed amendment to Schedule 2 to FSMA. In particular there may be other arrangements that should be considered suitable for potential regulation as a home reversion plan or which should definitely be excluded. For example some inheritance tax planning schemes may fall within some definitions of a home reversion and it would be useful to have readers' views on whether this is the case and if so whether such arrangements should be specifically excluded from the scope of the home reversion regulation.

Q5: Do you have any other comments on the FSMA definition of a home reversion? Specifically, are there any other arrangements that should definitely be included or excluded from the definition?

ANNEX A - List of Questions

Q1 a) Should Ijara home finance arrangements fall within the scope of FSMA as a home reversion plan?

b) Are there further types of Islamic finance arrangements for home purchase that might be caught by the description of a home reversion plan? If so please provide details of such arrangements and indicate whether you consider such arrangements should fall within the FSMA definition of a home reversion plan.

Q2: Should flexible tenure products provided by providers other than local authorities and exempted RSLs fall within the scope of FSMA as a home reversion plan where such products involve the buying back of portions of the property from the homeowner?

Q3. Do you agree that there should be no age limit in the definition of a home reversion in Schedule 2 to FSMA?

Q4: Do you agree that the scope of regulation of home reversion plans under FSMA should not have a de minimis threshold?

Q5: Do you have any other comments on the primary legislation definition of a home reversion? Specifically, are there any other arrangements that should definitely be included or excluded from the definition?

ANNEX B- DRAFT REGULATORY IMPACT ASSESSMENT

1. On 5 June 2003, the Government published a separate regulatory impact assessment covering all regulated mortgages. That document took account of the costs and benefits of regulating mortgages, including lifetime mortgages. This regulatory impact assessment purely covers the regulation of home reversions, and was previously included in the consultation document published on 3 November 2003. There were relatively few comments on the RIA in the previous consultation on whether to regulate home reversions. Therefore the RIA from that consultation is reproduced below, and the Government would welcome any further comments on the RIA in this consultation.

2. In calculating the costs, this RIA assumes that the FSA will adopt a similar regime for reversions to that it is planning to introduce for lifetime mortgages. Whilst we cannot anticipate the exact regime that the FSA might apply, we assume that the regime would cover the regulation of firms, advice and advisers, the disclosure regime, financial promotions, and other conduct of business issues as well as providing access to the Financial Ombudsman Service (FOS). It should be noted that this RIA reflects the information available in November 2003 when the previous consultation on whether to regulate home reversions was issued.

Benefits of giving the FSA responsibility for regulating reversions

3. The main benefits of FSA regulation may include:
- all equity release products will be subject to the same regulatory regime, creating a level regulatory playing field for firms
 - reduced confusion to customers wanting to make a fair comparison between products offering broadly similar benefits
 - advice would be received during the sales process in relation to an individual's tax and benefit position
 - information asymmetry between the reversion provider and the consumer may be reduced
 - The FSA might stipulate the providers ensure an accurate, independent property valuation
 - consumers would have access to the Financial Ombudsman and Financial Services Compensation Schemes
 - the possibility of regulatory arbitrage would be avoided

Calculating the costs

4. Complete and accurate information on the size of the home reversion market itself is difficult to obtain. In total we have been able to trace forty-one firms currently in the equity release market. There may be many more intermediaries that sell equity release products, including reversions as part of their range of business. This consultation seeks further information about the equity release market.

5. If home reversions were to be subject to FSA regulation then the costs of regulation for those firms that only sell reversions and are not regulated by the FSA could be substantial. The costs would include the one-off costs of setting up systems, training staff, and so on, as well as ongoing compliance costs. However, the costs for firms that are already regulated by the FSA, for example, because they sell lifetime mortgages as well, would be less. They would not need to apply for formal authorisation from the FSA and would already be subject to some rules governing the unregulated activities of regulated firms. However, they would need to apply to vary their permission and it is likely there would be some systems, training and ongoing conduct of business costs associated with complying with FSA requirements governing the selling of home reversions, when the selling of reversions becomes a fully regulated activity.

6. The overall cost of regulation will depend on whether the equity release market expands as the CML has projected and new reversion companies come into the market. But it is not possible to assess or predict the total costs with any degree of accuracy, not least because we have no way of knowing how many new firms would sell reversions in the future.

7. In calculating the costs for individual firms, we have attempted a read across to the arrangements that the FSA is putting in place for firms that will be selling lifetime mortgages when mortgage regulation comes into force as from 31 October 2004. We have used the cost benefit analyses that the FSA carried out for this purpose in CP 174² and CP 186³. These papers are available from the FSA website – www.fsa.gov.uk.

8. We have chosen to look at implications for types of individual firm. We are assuming that the one-off costs for year one for each type of firm are:

- pure reversion providers that are not already regulated by the FSA - £475,000;
- providers already regulated by the FSA for lifetime mortgages - £233,000;
- intermediaries and property firms that are currently unregulated by the FSA - £11,000; and
- intermediaries already regulated by the FSA for lifetime mortgages - £6,000.

Small firms impact test

9. When home reversions are regulated there may be some reduction in the number of small firms in the market as such firms may be discouraged by the costs of compliance with FSA regulation. However the estimated costs of compliance (see above) are much lower for a small firm than for a larger one, and therefore we do not expect many firms to exit the market. Also,

² Prudential and other requirements for mortgage firms and intermediaries – FSA March 2003.

³ Mortgage regulation: draft conduct of business rules and feedback on CP 146 – FSA May 2003.

regulation may improve consumer confidence in the home reversions market leading to more opportunities for new entrants, including small firms.

Enforcement, sanctions, monitoring and review

10. It would be for the FSA to enforce and monitor compliance. The FSA will have a number of sanctions available if lenders and intermediaries fail to comply including fines, and ultimately withdrawal of permission to carry on the business. But firms have the safeguard of the right of appeal to an independent tribunal against FSA decisions.

Consultation

11. This document provides an opportunity for formal consultation with stakeholders.

Summary

12. It would be helpful to receive views on both the costs and the benefits to businesses and consumers of the proposed regulation. The Government would particularly welcome views on the likely impact on competition and small firms.

The estimated costs of FSA regulation of home reversions to individual firms

	Reversion provider – unregulated	Reversion provider – regulated for lifetime mortgages	Unregulated intermediary	Intermediary – regulated for lifetime mortgages
Compliance costs	£	£	£	£
Authorisation				
Application	622	-	476	-
Variation of permission		311	-	238
Application fees	15,000	7,500	1,200	600
FOS	Not known	Not known	Not known	Not known
Total	15,622	7,811	1,676	838
Conduct of business				
IT Systems	235,000	Minimal	5,000	500
Training and competence	25,000	25,000	2,500	2,500
Management and supervision	200,000	200,000	2,000	2,000
Total	460,000	225,000	9,500	5,000
Grand total	475,622	232,811	11,176	5,838
(Rounded)	475,000	233,000	11,000	6,000

Notes

1. The figures used assume that the FSA will regulate home reversion schemes in a similar way to lifetime mortgages and therefore firms will incur similar kinds of costs. The precise costs will, of course, depend on the regime the FSA decides based on consultation and its own cost benefit analysis.
2. The figures are year 1, one-off costs.
3. Estimates based on FSA cost benefit analyses in CP 174⁴ and CP 186⁵.
4. Application fees based on the FSA policy statement on consultation paper CP 180⁶.
5. The unregulated reversion provider is assumed to be the equivalent of a medium-sized mortgage lender with annual gross advances of between £10 and £100 million.

⁴ Prudential and other requirements for mortgage firms and intermediaries – CP 174 – FSA March 2003

⁵ Mortgage regulation: Draft conduct of business rules and feedback on CP 186 – FSA May 2003

⁶ Fees for mortgage firms and insurance intermediaries – FSA October 2003

6. The provider regulated for lifetime mortgages is assumed to be the equivalent of a medium-sized mortgage lender with annual gross advances of between £10 and £100 million.
7. The unregulated intermediary is assumed to be a small mortgage broker.
8. The intermediary regulated for lifetime mortgages is assumed to be a small mortgage broker.
9. The costs of completing the application for the first time are based on the figures in CP 174 – large mortgage lender = £622, and a small intermediary = £476.
10. The costs of completing the application to vary permission are based on the figures in CP 174 – large mortgage lender = £311, and small intermediary = £238.
11. Application fees based on the FSA policy statement in response to comments on CP 180. We have assumed that the unregulated reversion provider would pay £15,000 for a medium-sized mortgage lender, and the unregulated broker would pay the maximum of £1,200 for a small mortgage broker. Those firms that are already regulated would pay 50% of these fees.
12. The costs of IT systems for an unregulated reversion provider are estimated to be £235,000. This is based on the average cost of mortgage lenders set out in CP 186. (£36.4 million divided by 155 lenders.) We do not think that there would be any significant additional IT costs for reversion providers that are already regulated for lifetime mortgages. As to an unregulated intermediary, and a regulated intermediary, we have assumed there would be costs of £5,000 and £500 respectively. This is based on an estimate of the need for an unregulated intermediary to set up new IT systems from scratch, and for minimal adjustments to a regulated intermediary's IT systems.
13. On training and competence, we have assumed that 100 advisers in both the unregulated reversion and regulated providers would require training which is assumed to cost £250 each. Similarly, each of the 10 advisers in the unregulated and regulated intermediaries will require similar training.
14. The management and supervision time is assumed to be £200,000 for unregulated and regulated reversion providers, which is the approximate average cost of mortgage lenders as set out in CP 186 (£31.2 million divided by 155 firms.)
15. We assume that management and supervision time for unregulated and regulated intermediaries would be £2,000, which is the approximate average cost of mortgage intermediaries as set out in CP 186 (£23.9 million divided by 13,725 firms rounded).