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Look Forward to a New Lease of Life for Equity Release

Eilert Hinrichs, Partner

OUTLOOKS

L.E.K. Look Forward Into 2024

Hit hard by 2022's mini-budget driven financial markets uncertainty, Equity Release's (ER) fall from grace was swift and dramatic. While many predicted the end for ER, L.E.K. Consulting partner **Eilert Hinrichs** sees a continued need for a product focused on providing much-needed solutions for an asset-rich aging population lacking the pension provision of previous generations.

Look Forward to a New Lease of Life for Equity Release

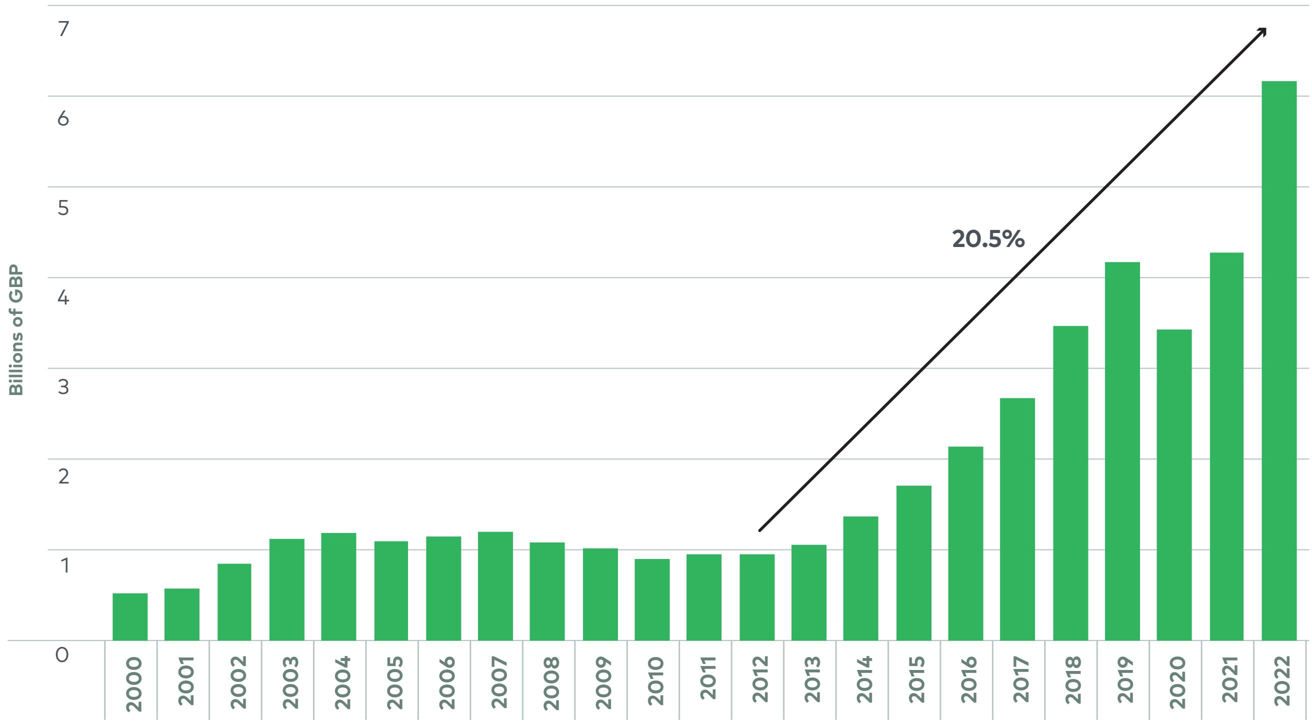
Economic pressure and the realities of an ageing population saw equity release, or ER, surge in popularity for a decade. Fast-forward to 2022's government 'mini-budget' and widespread uncertainty in the financial markets which caused seismic shocks in the pension market. ER products were hit hard by volatility in the gilts market and experienced a sharp decline, leaving many asking what the future might hold for equity release. But with the unchanged needs of an ageing population and a pressing need for a product to fill the vacuum left by ever-decreasing numbers of defined benefit (DB) pension schemes, reports of ER's early retirement are greatly exaggerated.

Equity release comes out of retirement

The ER market in the UK experienced significant growth at c.20% p.a. between 2012 and 2022, reaching record activity levels in 2022, with total gross new lending of £6bn. This strong growth is attributed to both structural demand drivers and improved supply dynamics (see Figure 1).

Figure 1

Equity release market in the UK (2000-22)



Source: Equity Release Council

Increased demand for ER is driven by a number of factors. Greater awareness of the existence of these products is driving uptake, as is a significantly broader range of propositions taking account of individual situations and preferences. The reality of an ageing population with amplified need to supplement their retirement income due to financial pressure from increasing mortgage rates is playing a major part in the increase in ER, along with the cost of living crisis and the rising cost of health and social care. Similarly, awareness levels amongst higher-income/higher-wealth individuals have increased, mainly through the engagement of independent financial advisers and cash planning tools as part of their financial planning and wealth structuring to optimise retirement income and generational wealth transfer.

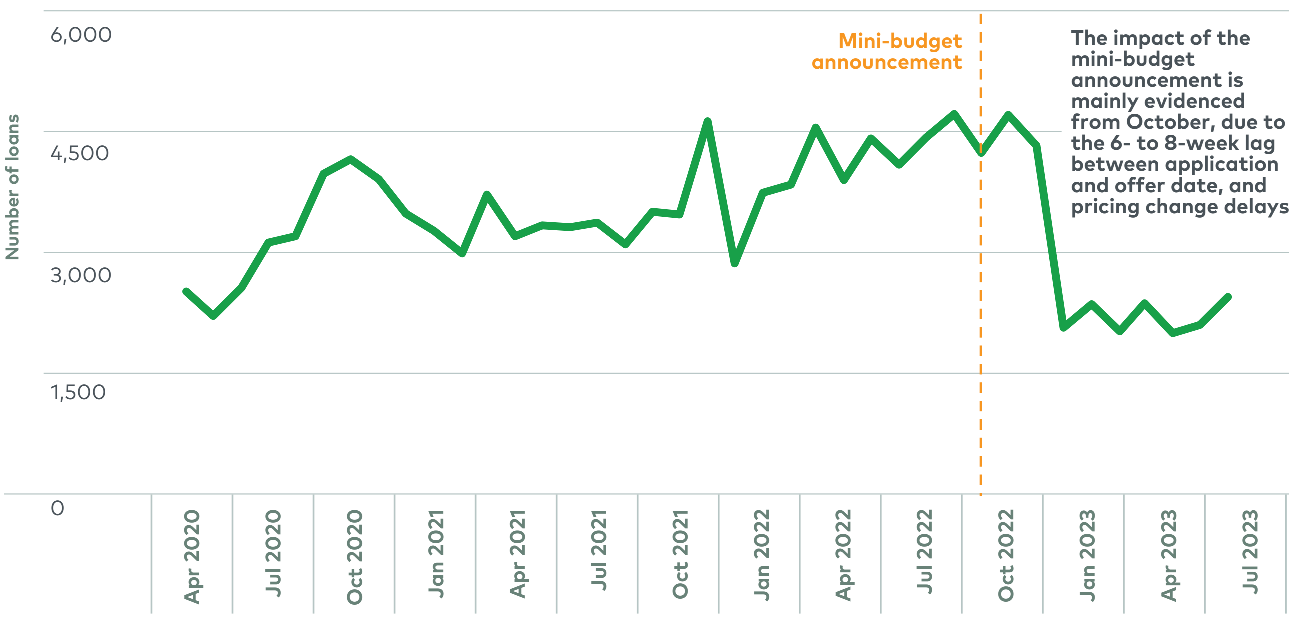
On the supply side, the growth of the ER market has been supported by product availability and large scale from companies that manage and invest in pension liabilities (traditional funders) and use ER as an asset class to efficiently manage the tail of their annuity books.

The broadening range of funders (i.e. alternative asset managers, global investment banks with ER experience, international investment funds) that have taken interest in ER products' long-term nature is also an important factor.

Given the continuing and structural nature of the underlying need and funding dynamics, the ER market was expected to continue on its long-term growth trajectory. However, the September 2022 mini-budget announcement threw the ER market off track, and volume and value of newly written ER loans declined sharply across all customer segments in the following three months of 2022 (see Figure 2). This article assesses the reasons for the ER market collapse and its likelihood of revival.

Figure 2

New ER loans agreed per month (April 2020 – June 2023)



Source: Equity Release Council

Key takeaways

Recent volatility has led to a marked decrease in the availability of ER products.

An ageing population, rocketing cost of living, sharply increased servicing cost of debt (especially mortgages) and rising care costs, alongside a decrease in DB pension schemes, all point towards ER as a vital funding solution for later life.

Opportunities exist for providers, but a clear understanding of consumer needs, good strategic vision and the ability to innovate are all vital.

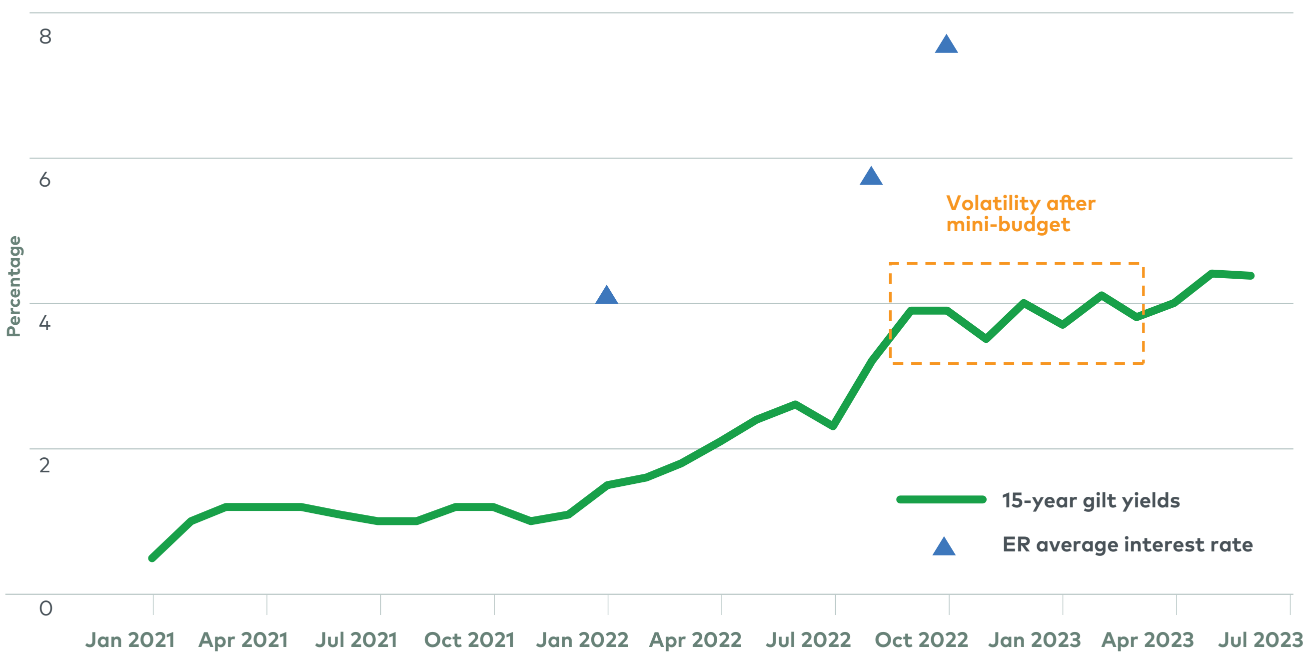
The September 2022 mini-budget nightmare

The UK gilt yields (mainly the 15-year gilt yield) typically evolve slowly, reflecting macroeconomic and political trends and dynamics, and are widely used as reference rates by ER funders in the UK to set ER pricing. The yield on UK government gilts had been in steady decline since the global banking crisis in 2008, a situation compounded by Brexit and the impact of the Covid-19 pandemic in 2020. However, UK government yields saw a reversal following the Ukraine crisis in February 2022, high inflation and ongoing supply chain issues. ER interest rates followed this trend and started to slowly increase from the beginning of 2022, as one would expect, but with no material effect on product availability and continued buoyant new lending, H1 2022 was a record half year.

All remained well until late summer 2022. It was the September 2022 mini-budget that generated widespread uncertainty in financial markets (at home as well as internationally) and fuelled almost unprecedented volatility in the UK government bond yields (see Figure 3), in turn causing seismic shocks in the pension world, including the ER market.

Figure 3

UK government 15-year gilt yields (August 2022 – June 2023)



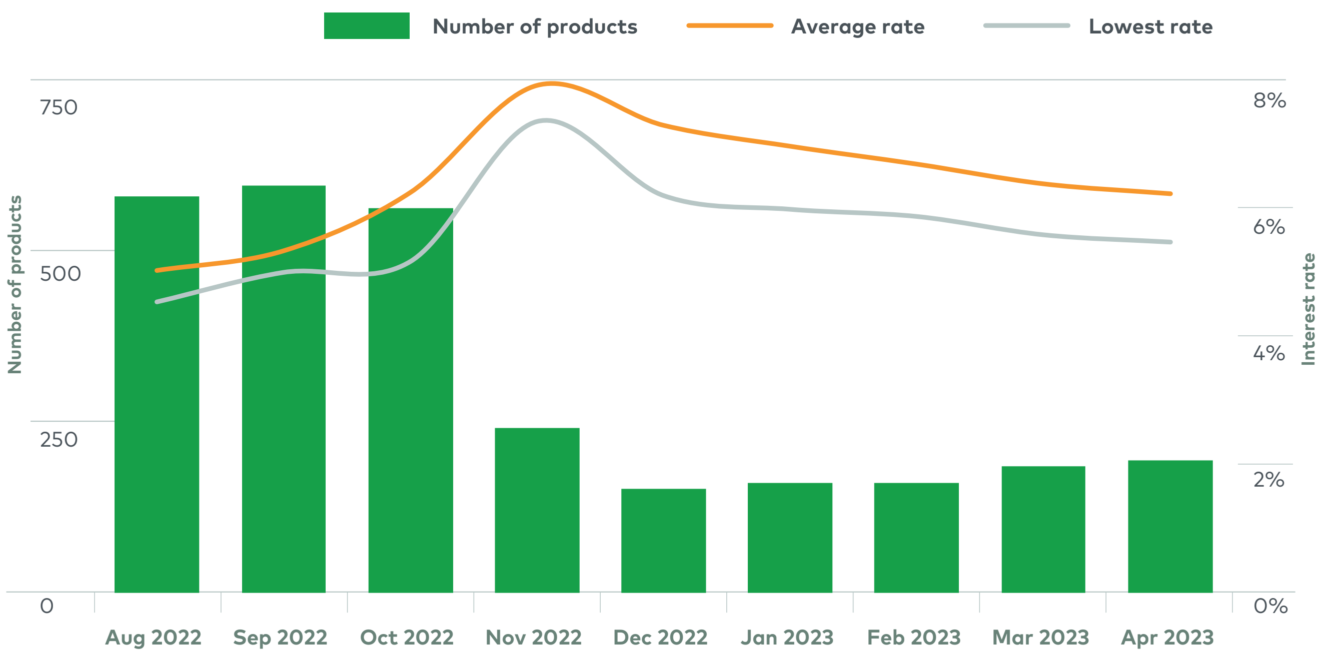
Source: Bank of England, L&G website (ER average interest rates)

It was this gilt volatility that required companies that manage pension liabilities and pension schemes to review and restructure their asset-liability matching strategies and subsequently reduced funders' short-term need for ER products. With higher ER interest rates, funders also decreased availability of higher loan-to-value (LTV) products (30%

and above)(see Figure 4), especially for younger customers (ages 55-75), due to an inability to accurately price products and the impact/costs of a 'no negative equity' guarantee requirement — a guarantee stipulating that the ER estate will never owe more than the property is worth at the time the ER mortgage is due for repayment.

Figure 4

Product availability and pricing (August 2022 – April 2023)



Source: Equity Release Council: Spring market report 2023

This significant drop in product availability (i.e. a drop of c.75% in number of products in the market), combined with reduced marketing activity of leading ER providers, caused the reduction in the total value and volume of ER loans in the closing months of 2022.

This was primarily a supply-side driven decline, not a needs driven decline.

The outlook of the ER market remains strong

Despite the sharp decline in the last three months of 2022, the ER market is now on a robust recovery path, with leading providers experiencing attractive month-on-month increases in enquiries and flows of new loans. Flows in some customer segments (mainly lower LTV products) are already back to pre-mini-budget levels, and are set to outgrow them in 2023. In our view these are early proof that the UK ER market as a whole has far from gone into retirement.

The underlying, structural need drivers of this market all remain unchanged:

- We have an ageing population, with a growing number of consumers reaching retirement age (>600k growing at c.3% p.a. for the next 10 years)
- Inflation remains above long-term averages, continuing to drive up cost of living
- Consumers with rich DB schemes are in long-term decline (2%-3% p.a.)
- Property remains the largest proportion of retirees' wealth
- Care costs are continuing to increase
- Rising interest rates are contributing to higher mortgage costs

In summary, the underlying need for ER is not an issue and has remained robust throughout the period, perhaps even intensifying. This was driven by financial pressure from higher interest rates, escalating cost of living and the rising cost of care. Even more, the temporary decrease in availability of high LTV products has resulted in significant latent demand from 'younger' consumers with unmet needs who are 'forced' to use lower LTV loans out of necessity to pay off existing debts. This increased and latent demand is not going away and will need to be addressed.

There also continues to be sufficient funding from traditional and established funders to support the short-, medium- and long-term growth of the ER market. This is because funders' underlying need to structure pension liabilities is unaffected and continues to be driven by a buoyant DB de-risking market. Leading DB de-risking advisory firms estimate an annual flow of £40bn-£50bn for the medium term. Assuming an average of 10%-20% will be deployed in ER loans (as it has in the past), this alone would suggest an annual flow of c.£10bn is possible. In addition, leading providers are exploring increasing interest from alternative funders and funding sources (domestically as well as internationally).

While the consumer need is unchanged and remains robust, we do not expect a V-shape bounce back. This is partially due to changes in consumer behaviour that can already be observed in the market. ER customers are coming back to the market, but higher interest rates and lower LTV products have resulted in a shift from one-off lifetime mortgages to increasingly popular drawdown facilities, with an initial lower drawdown amount. However, as time goes by and cost pressures remain, these consumers will in due course return again to draw down to release equity from their property as they continue to need funding in their later years. This means a delayed flow, but not a lost flow, for ER.

Strategy and innovation are key requirements to win

The ER market could recover faster if products with higher LTVs become available to all consumer age segments. This could, and in our mind will, be achieved through product innovation, changes in traditional funders' appetite and continued entrance of alternative funders. The market could also recover faster if demand for lower LTV products increases well beyond historical levels — a likely outcome given current macroeconomic conditions and some consumers in younger-age cohorts using existing offers instead of waiting for the return of higher LTV products.

ER is only one piece of the 'retirement income puzzle', and not the answer to all questions. An ageing population with a deep need for funding during retirement is (increasingly loudly) calling for innovation of the overall later-life lending market. Traditional and alternative funders have a long path ahead to find answers to this demand, but alongside the obvious challenges there are clear opportunities for those with the right strategy.

Having a clear understanding of consumer needs, thinking strategically and acting innovatively are all required to win in this market environment. Please get in touch if you would like to discuss the content of this paper in more detail and benefit from our experience in having advised firms in navigating the ER and later-life lending markets for over a decade.

About the author

Eilert Hinrichs, Partner | e.hinrichs@lek.com

Eilert Hinrichs is a Partner in L.E.K. Consulting's London office. Eilert has 20 years of consulting experience and is a senior member of L.E.K.'s European Healthcare Services practice and European Financial Services practice. In both sectors he has completed a large number of assignments across Europe, working closely with senior management teams in addressing key strategic issues, developing market entry strategies, improving commercial effectiveness, and providing transaction support on both the buy and sell sides.

The impact of the ageing population on healthcare systems and the financial services needs of this 'golden generation' are key topics that touch many of Eilert's assignments, as they pose challenges but also offer significant opportunities for providers in both sectors.

Eilert has profound understanding of the CEE healthcare systems, where he advised on all major transactions over the past five years.

Prior to joining L.E.K., Eilert worked in retail banking in Germany. He received a Master's Degree in Industrial Engineering from the Fridericiana University of Karlsruhe (KIT). He is married and has two young boys who keep him on his toes outside of work, and he likes outdoor activities, including cycling and skiing.

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