James Hambro &Partners

Charles Calkin
Partner, Financial Planning Consultant

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Can equity release help your children and grandchildren climb the property ladder?

If house prices had risen in line with inflation during the past 50 years, the cost of the average home would have gone from just over £4,000 to £72,500. In fact, it is more than £256,000. House price inflation has taken numbers in some parts of the country to extraordinary levels. Savills estimates more than half a million homes are now worth at least £1m.

Unsurprisingly, many older people who have benefited from this boom feel uncomfortable watching their grandchildren struggle to mount the housing ladder.

Helping might undermine their own financial security, given that it is hard to know how much is needed for later-life care. It may involve downsizing and moving out of a much-loved family home. Or it may result in tax charges if it means selling other assets to release capital.

Equity release can offer a solution. You take out a loan – a "lifetime mortgage" – against the equity in your house and then give the cash (or some of it) to loved ones. Many allow the interest to compound year by year. The loan is usually settled on death.

Taking on debt late in old age may go against your personal doctrines of financial prudence. And equity release has such a terrible reputation. But work through the arguments and you can see why so many are embracing this supposed heresy.

In the first three months of 2021 some £1.14bn housing equity was released, up 7 per cent on the same period last year, according to the latest figures from the Equity Release Council. The average new lump sum borrower took out £123,028 up 20 per cent on the first quarter of 2020.

First, let's address concerns about equity release, whose dubious reputation is built on malpractices in the 1980s – when the industry was less regulated.

There are many horror stories of people sold loans at far higher interest rates than now by heavily commissioned salesmen simply to buy a car or a conservatory. A few years later the borrowers found themselves owing huge debts – often more than the value of their property. Worse still, some were encouraged by the same salesmen to use cash raised to buy high-risk investments, which then crashed.

Today you have to be at least 55 to get a lifetime mortgage, though a broker we use, Professional Mortgage Services (PMS), says late 70s is more typical. Another respected broker, Knight Frank, puts the average age of its equity release clients at 75.

There are also limits on how much you can borrow – up to 60% of the value of the property – but PMS and Knight Frank say 25%-30% is typical.

Most importantly, if the lender is a member of the Equity Release Council – and all reputable providers are – there is now a guarantee that the debt on death will not exceed the value of the house, even if the housing market crashes and/or you live to well over a hundred.

You and your spouse or civil partner are allowed to stay in your home lifelong or until you move permanently into care. Lenders must ensure the product has been sold correctly through a specialist adviser with an equity release qualification. The adviser must ensure the arrangement does not impact on means-tested benefit entitlements or your tax position, and you have to show you have considered the alternatives.

Helping hand

Equity release is particularly attractive at the moment, because interest rates are close to an all-time low. By the end of last year you could get deals as low as 2.3%. Brokers say this has now moved to just over 2.5% and is rising. But for most lifetime mortgages the agreed rate is fixed for life. At that rate it will take 28 years for the debt to double.

So if you have a home valued at £1.6m and take out £400,000 in equity release, the loan will be £800,000 in three decades (assuming you live that long). What will the home be worth then?

Meanwhile, you could give enough to any grandchildren now to bring the loan-to-value (LTV) ratio on their first time home down to 75 per cent, where mortgage rates currently start from 1.19 per cent — far lower than the rates of more than 3 per cent charged on 95 per cent LTV mortgages. And you should remember that higher-LTV loans could become much more expensive at the end of the term if interest rates rise.

What is the impact on monthly mortgage payments for grandchildren? If they were buying a £250,000 home on a 25-year mortgage and had a £12,500 deposit they would currently pay more than £1,130 a month with the cheapest lender. A gift of £50,000 reduces the size of the loan and interest rates, bringing their monthly payments down to £723.

Re-mortgaging an existing equity release arrangement, to take advantage of current rates, can make sense too. I know of one couple who recently re-mortgaged saving 4% interest each year for life.

Paying back the debt on death

On death the executors of your estate will generally have a grace period of six to 12 months to sell your property and settle the outstanding loan. Any sizeable gift can incur Inheritance Tax (IHT) charges if you die within seven years of making it – an argument for handing over money now and setting the clock ticking.

But the outstanding loan is considered a debt against the estate from day one in terms of calculating your allowances, including the residence nil-rate band (RNRB). This is the £175,000 we each have on top of the £325,000 nil-rate band if passing a main residence to what HMRC calls “direct lineal descendants”.

For every £2 an estate is worth over £2m, £1 is knocked off the RNRB. This can reduce a couple’s joint IHT allowances from £1m to just £650,000. This makes the effective rate of IHT on estates between £2m and £2.7m 60 per cent.

Gifting from released equity is particularly effective for RNRB tapering. Gifts leave the estate immediately for calculation purposes and you do not need to survive for seven years for them to count.

By entering into an equity release arrangement you not only get to see your loved ones benefit from a legacy in your lifetime – you could bring the taxable element of your estate to beneath £2m on death and significantly reduce the IHT liability.

Giving money in this way can be better than drawing on your pension, which is IHT-free and therefore not counted when calculating the value of your net estate. And it can be better than selling other assets that might trigger a capital gains tax bill.

Take advice

Obviously, equity release is not suitable for everyone, and you must consider all the alternatives and take advice. Never give more than you can afford – and ensure your family knows your plans. It can be upsetting for beneficiaries on your death to discover a mortgage against a family home that they perhaps expected to inherit.

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