The market for equity release products: lessons from the international experience

J.M. Luiz & G. Stobie

ABSTRACT

Home Equity Release Products (ERPs) are innovative financial instruments that enable elderly, retired people to use their unencumbered houses as a source of income/funding while they continue to reside in them, thereby seeking to address the constraints of the life cycle hypothesis. The loan and outstanding amounts are normally settled through the sale of the property, either on death or when the client voluntarily vacates. This research is an exploration of demand and supply issues that affect the suppliers of ERPs (both internationally and in South Africa). Interviews were held with established suppliers in Britain (where the market is more advanced), as well as with several financial services companies in South Africa.

The ERP industry has grown slowly over the last decade. Factors such as increased life expectancy, decreased savings rates and changing attitudes towards debt are just some of the driving forces of demand. However, the growth of the ERP industry has consistently fallen short of analysts' predictions, highlighting some of the difficulties facing the market – not least of which is to gain the acceptance of both the market and government as a mainstream option for the elderly, who are often asset-rich but income-poor. A number of impediments to market growth are explored in detail in this research.

Key words: life cycle hypothesis, reverse mortgages, equity release products, South Africa

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Introduction

According to Rajagopalan (2002), many countries face budgetary constraints in terms of sustaining old-age income and social schemes. He argues that government's inability to provide such schemes at the level required, combined with the quality of life that elderly people now expect, will fuel a massive demand for financial products tailored to the elderly. These would need to be safe and may involve systematic liquidation of assets to finance consumption, the managing of longevity and inflation risks, and the imparting of liquidity to illiquid assets. ERPs are well positioned to provide this (Rajagopalan 2002).

In many developed countries, Home Equity Release Products (ERPs) have been promoted as a means of accessing equity locked up in a residence, particularly after the holder of the property has retired (Gibler & Reed 2003). Research shows that debt-free property forms the major part of most elderly people's net assets (Caplin 2000; Actuarial Profession 2005). However, despite this wealth of property ownership, many elderly people do not have sufficient income to meet their retirement needs, leading to the phrase 'Asset Rich, Income Poor' (ASIC 2005). ERPs have been developed to address this dilemma and are designed to provide elderly people with income while using the equity they have in their homes as security.

The ERP industry (which is still relatively small) is, however, plagued by teething problems and complexities. There are both demand and supply constraints hampering the growth of the industry. The impediments to demand include a suspicion of the market and its size, fears of indebtedness, the costs involved and the bequest motive. Suppliers and potential suppliers face similar issues and, in addition, are also faced with risks such as longevity of the client, interest rates and property price movements, not to mention softer concerns such as possible moral hazards that would emerge should the structure go wrong.

This research explores those issues influencing the demand and supply of ERPs from the perspective of the suppliers of such products in Britain. The ERP industry is still in its infancy in South Africa. By conducting an up-to-date analysis of the current issues affecting the industry in Britain, it may be possible to gain valuable insights for the South African market.

The concept of home equity release

Equity Release Products (ERPs) generally relate to either a Reverse Mortgage Product or a Home Reversion Scheme (Terry & Gibson 2006). A reverse mortgage can be defined as follows: the consumer borrows money against the equity in his or her home, and the principal and interest are not repaid until the home is sold, usually when the consumer dies or voluntarily vacates the home (ASIC 2005). Reverse mortgages are designed for elderly homeowners to access their home equity while continuing to live in their homes (Bartel, Daly & Wrage 1980; Gibler & Reed 2003). Most often, a reverse mortgage is described as an annuity to the homeowner for the length of time that he/she remains in the house.

Mayer and Simons (1994) draw comparisons with normal mortgages: A reverse mortgage allows the elderly homeowner to borrow against the equity accumulated in the home, without moving or being forced to sell the house. Unlike a conventional mortgage where the homeowner makes periodic payments to the lender, a reverse mortgage provides payments from the lender to the homeowner. The loan is repaid with interest when the borrower sells the house, moves permanently, or dies. Reverse mortgages are usually available only to borrowers aged 62 or older.

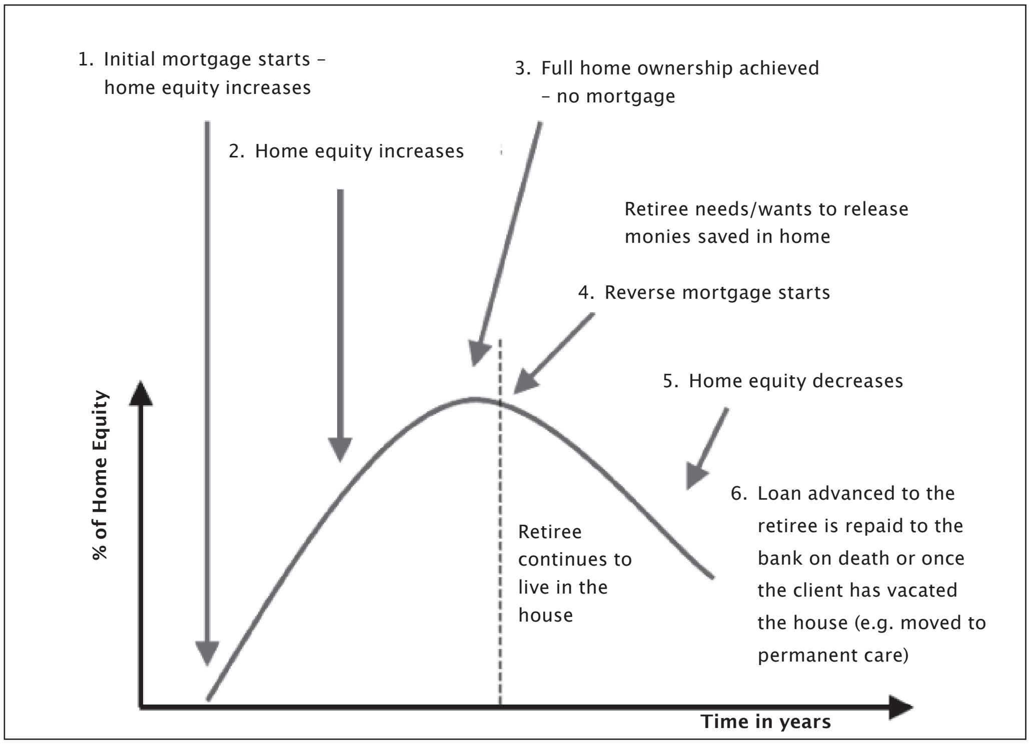
The main advantage of a reverse mortgage over other means of tapping home equity lies in its repayment schedule. In contrast to conventional second mortgages or home-equity lines of credit, a reverse mortgage does not require the homeowner to make payments of interest and principal during the term of the loan. Since the elderly homeowner may need to tap home equity precisely because his/her income is insufficient to cover living expenses, it is likely that he/she would not have the income to make payments on a second mortgage or a home-equity line of credit (Mayer & Simons 1994).

The amount of money that can be borrowed by means of a reverse mortgage generally depends on the borrowers' age and the value of the home. Typically, the older the borrower and the greater the home value, the more funds can be made available via loan advances (Redfoot, Scholen & Brown 2007).

A typical mortgage culminating in a reverse mortgage is described below and is presented in Figure 1:

- A conventional housing loan is commenced that requires the security of a lien over the house via a mortgage.
- Over time, the household equity increases; this is due both to the value of the property increasing and the outstanding loan decreasing.
- Complete home ownership is often achieved in the middle to late years of the working life when the mortgage has been completely repaid.
- Retirement commences and regular cash flows cease. The retiree has to rely on savings from earlier years. A reverse mortgage can commence. The bank advances new funding to the retiree. The retiree may stay in his/her home and is not required to service the new funding.

- Equity that is in the house is returned to the owner (via loan funding) either as a once-off amount or over a period of time. This will result in the equity decreasing over time (Gibler & Reed 2003).
- The funding is repaid to the bank when the house is sold, usually on death or on voluntary vacation.



Source: Gibler & Reed (2003); ASIC (2005)

Figure 1: Home equity over time using an ERP

Home Reversion Schemes are the other main form of ERP. The consumer sells part or all of his/her home to a reversion company. The home is sold for less than its market price (typically between 35% and 60%), but the consumer can remain on the property until he/she dies or voluntarily vacates the home. There are at least two types of home reversion schemes – a sale and lease model, and a sale and mortgage model (ASIC 2005). In this research, ERPs are generally treated as a single homogeneous product. Most ERPs come with a 'No negative equity' guarantee, which ensures that possession of a property subject to an equity release deal will never be sought, even if the growth of the property value falls well short of expectations (Terry & Gibson 2006). In other words, if the value of the loan (capital and interest) surpasses the market value of the property, the right of the client to occupy that property is not prejudiced. Reverse mortgages are typically 'non-recourse' loans, which means that the borrower's debt is limited by the value of the home. Borrowers must, however, continue to maintain the home, pay their property taxes, and keep the home insured.

Current practice in developed economies: a literature review

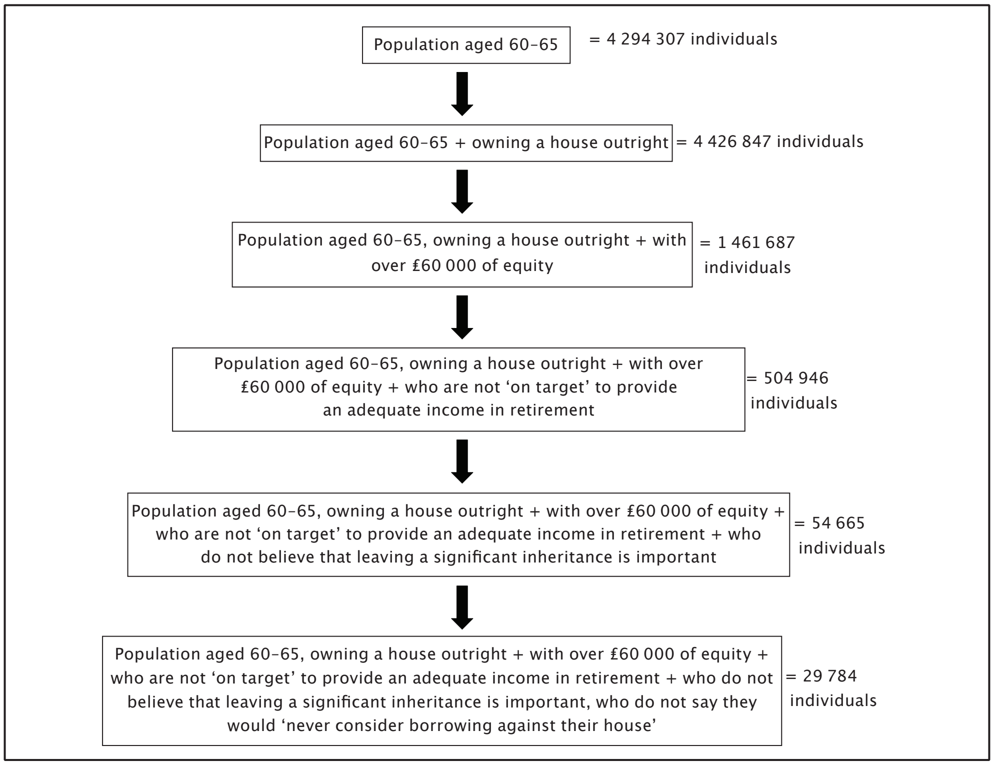
Demand factors and the international experience

From its low point of £23.7 million (for new business in 1993), the ERP market recovered steadily through the 1990s, primarily through growth in the reversion market. The introduction of the first roll-up mortgage scheme by Norwich Union in November 1998 saw the first real impetus for the mortgage market, and it is now the mortgage market that dominates (Actuarial Profession 2005). The market has continued to grow, and the UK *Equity Release Market Monitor* report for 2007 (Key Retirement Solutions 2008) highlighted that the total amount released in 2007 was approximately £1.4 billion (up 15% year-on-year).

In terms of forecast demand, the Actuarial Profession (2005) has attempted to forecast future demand in Britain by defining the various users and then projecting the demand using a bottom-up and a top-down approach. These two approaches are essentially the reverse of each other and consider the same factors with which to filter the population. The flow chart in Figure 2 takes the whole population and filters it down to the potential market for ERPs. The diagram starts with the total population and then filters out those who do not own a house outright, then those with >£60 000 equity, then those who have more than £60 000 equity but who have insufficient income, and finally those who are prepared to forego leaving an inheritance. Through this process, the market (of 60–65 year olds) is reduced from approximately 4.2 million potential users to only 30 000 (Deloitte 2002).

The Australian market has also shown signs of growth. Whilst remaining only a tiny fraction of total consumer lending, the reverse mortgage sector has grown significantly in the 12 months to March 2005, growing from $468 million to $770 million, with 8 899 new loans provided. A recent industry report estimates that the potential opportunity market for reverse mortgages could increase to $12–15 billion by 2010 (ASIC 2005). In a follow-up report in 2007, the ASIC (2007) put the market at $1.8 billion, comprising over 31 000 reverse mortgages.

There are approximately 350 000 homes that make use of ERPs in the United States, which represent approximately 1% of the 30.8 million households with a



Source: Deloitte (2002)

Figure 2: The bottom-up approach to forecasting demand for ERPs

member older than of 62 years of age. The Federal Housing Administration expects the value of loans advanced to increase to approximately US$25 billion by 2015 (Redfoot et al. 2007).

In assessing the potential market size, one must consider not only those customers who might have a need for ERPs, but also whether the individuals have the means to qualify for equity release (in other words, they have sufficient sums of equity). The client must have an appetite for equity release that is driven primarily by attitudes towards taking on debt and spending potential inheritance as well as the existence of a 'die-broke' mentality. Customer groupings have been created within the ERP market by existing providers (Deloitte 2002). The criteria used to determine customer segmentation include the wealth status of the individual, income status of the individual and primary drivers for equity release, namely:

- Lifestyle: to enhance own life (and property)
- Survival: to meet basic financial needs and pay bills
- Altruistic: to be able make financial gifts to family and friends.

According to the life cycle hypothesis of savings and consumption, one would predict that individuals would pay off debts and build savings in their working years, then divest those savings to support consumption in their older years (Redfoot et al. 2007). This concept of consuming one's savings seems to support the concept of a reverse mortgage. "Reverse mortgages would be attractive to elderly homeowners if they become less risk averse and more economically rational, they need to understand the great opportunity cost of not utilising their housing assets" (Williams & Kao 1997). Skinner (1993) explains the concept of home equity in the context of the life cycle hypothesis as follows:

> The conventional life cycle model implies an active reduction of housing equity at retirement, either by way of moving to a rental unit or by reverse mortgage arrangements. That is, if housing prices rise while people are young, life cycle homeowners save less for retirement in other forms. To finance retirement consumption, they cash out the now increased housing wealth. No rational life cycle homeowner dies with any housing equity remaining (Skinner 1993).

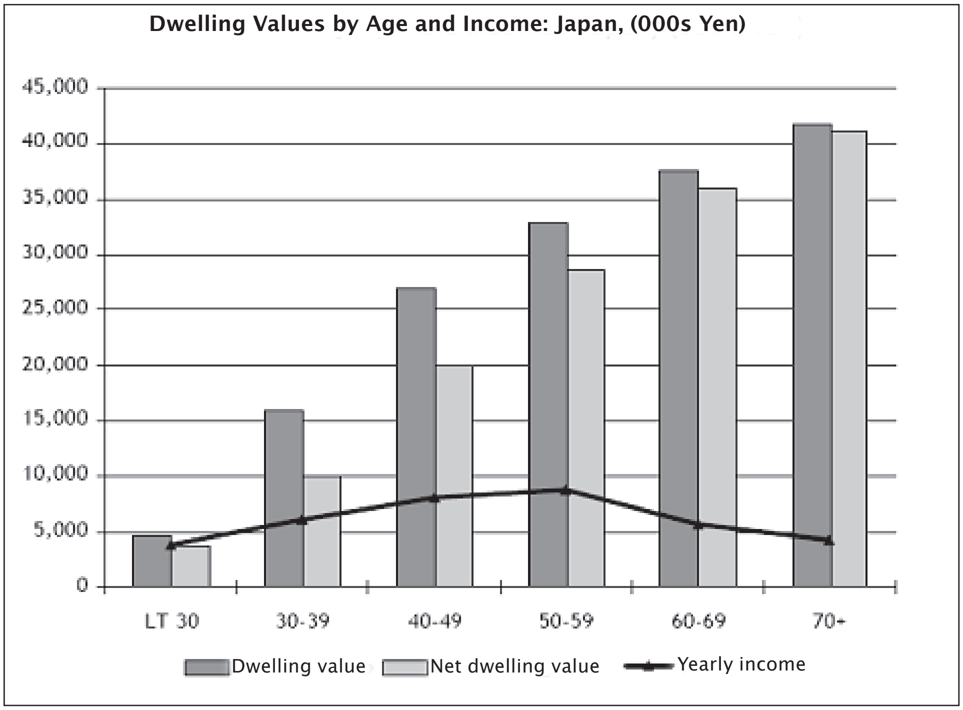
Factors supporting demand

ERPs are supported by various demographic and economic trends, which are discussed below.

Housing wealth as a driving factor

One of the key driving forces in the development of the ERP market is the very high percentage of wealth that elderly people have tied up in property (Gardner 2003). Home equity is the major type of wealth held by most elderly people, and according to the 1989 survey of consumer finances in the USA, more than 80% of retired households own their own homes (Williams & Kao 1997). Mitchell and Piggott (2004) claim that in most developed countries, enormous wealth is held in residential property. They argue that from the perspective of strategic asset allocation, an owner-occupied dwelling is illiquid and undiversified. They also state that elderly households have lower incomes and yet, on average, possess greater housing wealth. Mitchell and Piggott's comments are supported by Figure 3, which looks at Japanese housing data, clearly showing the trend of growing housing wealth and a similarly declining income.

Sodha (2005) found that the number of pensioners who will be 'income poor' but relatively 'housing-rich' is set to grow over the next 10–15 years. Of those aged over 50, who were yet to retire, 15.6% were projected to have an accumulated state and private pension wealth of less than £160 000 on retirement and owned gross housing



Source: Mitchell & Piggott (2004)

Figure 3: Average housing equity and income by age

equity worth £100 000. This is the amount required to secure a modest but adequate retirement income. The Actuarial Profession (2005) points out the following for the UK market: 75% of the population have inadequate retirement income, and 70% of the retired population are homeowners. Assuming that the 25% with adequate income are homeowners, this means that 45% of the current retired population, or 4.3 million people, are homeowners but do not have sufficient income.

Increased life expectancy

Improved health among the population results in both increased life expectancy and the ability to maintain an active lifestyle into retirement, both of which have associated costs (Actuarial Profession 2005). Life expectancy has increased sharply in Britain – male life expectancy was 40 years in 1841, 49 in 1900, and 76 in 2000, and is projected to rise to 79 by 2020 (Actuarial Profession 2005). This increased life expectancy leads to an aging population.

Poor retirement planning and saving trends

Mitchell and Moore (1997) and Dazinger, Van der Gaag, Smolensky & Taussig (1983) state that retirees will bear increasing responsibility for ensuring their own well-being in retirement. Household saving rates in the United States have dropped from over 10% in the 1950s to around 3% in the first half of the 1990s. "This discouraging pattern raises serious concerns about Americans' ability to maintain consumption levels in old age" (Mitchell & Moore 1997). They also conclude that United States households are saving at only one-third the rate needed to fund a comfortable retirement.

State and employer support decreasing

Davey (1998) found that in many countries the state is seeking to reduce its level of support for older people in the face of increasing aging populations. This means that greater responsibility for supporting retired people will shift to retirees themselves and their families. There is also evidence to suggest that while state pension support is decreasing, so too is employer support. It was found that employers' contributions to occupational schemes in Britain have decreased from an average of 11.1% to 5.1% over the last two decades (Actuarial Profession 2005).

Property price boom and low interest rates

The housing boom since the late 1990s has resulted in significant value being embedded in the residential property market even with the dramatic slow-down due to the financial and banking crisis of late 2008.

Tax consequences

There are two tax benefits in making use of ERPs. Firstly, the draw-downs on the loan are not taxable income but loans. Secondly, the estate is reduced towards the time of death, which will lower the ultimate estate duty payable (Fisher-French 2006).

Health needs

Chen (2003) claims that the need for spendable cash among retirees is likely to increase, as more and more individuals of the baby boom generation face the risk of requiring long-term care in the next several decades. Chen states that converting home equity would seem to be a means of satisfying several desires. It can augment the income needed for health and long-term care, or for other needs or desires in later life. It can enable older adults to stay in their homes, providing substance to the often-repeated ideal of 'aging in place'.

Changing attitudes

In forecasting the demand for ERPs, one needs to look at whether some of the current deterrents such as attitudes towards debt and inheritance are likely to change in the foreseeable future. Masnick, Di and Belsky (2006) state that while ERPs are not particularly popular among elderly homeowners today, their use may increase among the next generation, which already has a different perspective on tapping into home equity, and accordingly we could see greater use of ERPs for cash-strapped households.

The Australian Housing and Urban Research Institute (AHURI) survey found that while most retirees expected to leave assets to their estate, a significant younger minority expected to use up all their assets while alive (about one fifth of males and one third of females). The survey found that 35% of those aged 50–59 expected to use up all their assets while alive, as did 33% of those aged 60–69. By comparison, only 18% of those aged 70–79 and 11% of those aged over 80 expected to do so. This suggests that there may be a growing willingness among some future retirees to access home equity (Dolan, McLean & Roland 2005).

Factors hindering demand

The economic potential of the reverse mortgage market has been much debated. Even the most pessimistic assessment would suggest that this market should be larger than it is by an order of magnitude (Caplin 2000). This section identifies and explores those issues that are said to be negatively impacting demand.

Lack of confidence in the market

The strongest argument against the importance of the ERP market is the relatively low demand for existing products (in other words, 'If the market was important, surely it would be here already?') (Caplin 2000). Older people are wary of schemes that entail risk to what is possibly their only asset. The Actuarial Profession (2005) claims that there is wide suspicion of ERPs, including concern over value for money, fear of indebtedness, attitudes to inheritance, misgivings about the future direction of government policies and high administrative costs. It also claims that the lack of consistent regulation and the lack of participation in the market by the big brands (particularly the banks) are contributing factors. "There is a low awareness and understanding of ERPs. The products are also perceived in the market as being a distress purchase (rather than a life style purchase)" (Actuarial Profession 2005).

Fear of indebtedness

Davey (2005) argues that current older generations are traditionally financially conservative and risk adverse. However, there is an understanding of how mortgages work, as the potential user would have made use of a mortgage at some stage during his/her life. The use of ERPs may come with an element of stigma (it may signal dire financial circumstances).

The rainy day approach

Many older people strongly believe in preserving their assets for some emergency in the future. The contemplation of future health problems often underpins this attitude, which is linked to the last-resort theory. Others accept that their rainy day has come or that there is something to be said for enhancing their standards of living while they are alive (Davey 2005).

Expectations and suspicions of government

Expectations of government support for retired people have been fostered by decades of welfare state provision. Older people have often seen it as their right as citizens to receive income and services at the tax-payers' expense, especially given their own contributions over a working lifetime. This makes them reluctant to draw down on their own housing assets (Davey 2005).

Inheritance

Attitudes surrounding inheritance are central to the debate on whether housing wealth could or should be used to supplement income in old age. Many authors agree that attitudes to inheritance or bequests are very important with regard to ERPs (Caplin 2000; Mitchell & Piggott 2003; Gardner 2003). Caplin (2000) argues that two of the strongest reasons for avoiding the market may be a desire to move from a current home and a powerful bequest motive.

Lower value properties

There is a paradox that will always challenge the ERP market, namely that homeowners with the lowest incomes are likely to live in properties with the lowest value, and their properties are most likely to have fallen into disrepair. Those in the greatest need of equity release therefore find that their property does not meet the underwriting criteria for schemes offered by commercial organisations. Furthermore, they may find that any income or capital they raise through an ERP affects their entitlement to means-tested state benefits (Actuarial Profession 2005).

Means-tested benefits

For older home owners entitled to means-tested benefits, equity release deals can be very unattractive, because they may lose substantial amounts of entitlement by entering into such a deal (Terry & Gibson 2006). In Britain, about 9% of retired individuals potentially in a position to release housing wealth face disincentives to do so from the benefits system (Sodha 2005).

Costs

The Australian Securities and Investments Commission (ASIC 2005) states that the costs cannot always be assessed upfront with ease. They involve a number of elements in varying proportions, including initial and ongoing fees, interest charges, rental or licence costs, and capital gain or equity foregone. For example, Williams and Kao (1997) claim that the small increase in income that would result from reverse mortgages (4–10%) may not be worth the transactional cost.

Movements in property prices and interest rates

Reverse mortgages can be an expensive way to generate cash income, especially in periods of high interest rates. In a reverse mortgage, a borrower is borrowing his or her own money (equity) and for this privilege is paying out a substantial amount of interest and loan charges. People living alone, especially the very old with lower incomes, may benefit the most in percentage gains from reverse mortgages. Unfortunately, many in this low-income group are living in low-valued homes with low appreciation potential because of declining neighbourhoods. As a result, financial institutions do not consider them attractive options for reverse mortgages (Williams & Kao 1997).

Supply-side factors

This section deals primarily with the risks and challenges facing suppliers. Rajagopalan (2002) claims that the basic source of risk facing suppliers is the unique problem of predicting accumulated future loan balances under a reverse mortgage at the time of origination. A reverse mortgage is a 'rising debt' instrument. Since reverse mortgages are non-recourse loans, even if the collateral property appreciates in value, it might still be lower than the loan balance at the time of disposal of the property.

Insufficient return for the supplier is mentioned as a supply problem (Terry & Gibson 2006). There could be a very long period before the provider receives any return (usually when the property is sold because the homeowner has died or has moved into permanent care). There is also difficulty in fixing the funding rate, as the period is uncertain. The supplier has a perception that the return has a relatively large margin of adverse risk, which cannot be readily hedged.

Davey (2005) points out that the payment of annuities or lump sums is a major drain on the cash resources of the lender. This may present serious liquidity problems depending on cash flows, the range of other assets held and the likely maturity dates of the portfolio (which are difficult to predict). Providers should therefore have diversified streams of cash flows so as to hedge this complication. The longevity of clients or the point at which they decide to sell their homes dictates the payback of capital. Lenders need to protect themselves against the worst-case scenario – that the borrower or spouse will remain in permanent occupancy longer than anticipated and that the loan balance will exceed the equity. It is possible for lenders to take a loss in cases where no-negative equity guarantees, security of tenure and/or life annuities are involved (Mitchell & Piggott 2003; Davey 2005).

Lastly, there is the problem of moral hazards that impact suppliers:

- The homeowner may become ill or incapable of maintaining the property. Some contracts provide for foreclosure under such conditions, but this seems to be impractical and is sure to result in litigation and bad publicity for the supplier. The same holds true for non-maintenance of rates and taxes on the property (Caplin 2000).
- The homeowner, realising that the debt accrued on the house has surpassed the equity, may be more inclined to stay in the property at the lender's expense. At this point, the homeowner will also have no incentive to maintain the house so as to preserve or enhance market value (Caplin 2000; Rajagopalan 2002).

Research methodology

In this exploratory research, the methodology is qualitative and takes the form of a collective case study involving in-depth interviews with key personnel of financial services providers of ERPs in Britain. The suppliers are all members of the Safe Home Income Plans (SHIP) organisation. SHIP currently has 20 registered members and is the main industry body regulating the Home Equity Release market in Britain. Themes and issues emerging from these interviews are also discussed with other general mortgage providers (both in Britain and South Africa) that have not yet entered the market. The interviews (data) are analysed using content analysis as well as other qualitative methods.

A total of 12 interviews were conducted between January and March 2009. Of the 20 SHIP members, representatives from eight firms were interviewed (representing 40% of the total population). An interview was conducted with the industry body SHIP, and the remaining interviews were with local South African financial firms. The broad themes covered in the questionnaire related to: the target market, attitudes towards debt and inheritance, housing wealth and savings trends, the role of government, the reputation of the industry and the presence of the big brands, the cost of ERPs, moral hazards, supply constraints, health costs, and the general state of the residential property market.

Application of research results

Factors driving demand for ERPs

Increased housing wealth (supported by increased property prices and lower interest rates) has led to a demand for products that will unlock value. Interviewees were unanimous that the increase in housing wealth has driven the demand for ERPs, and despite an increasing trend of people entering retirement with debt, the potential market is still described as significant.

Increased life expectancy has meant that there is a longer period in which people need to sustain their income. Moreover, poor retirement planning and savings trends mean that retirees are generally not well prepared for a long retirement. All interviewees agreed with these factors. Decreasing state and employer support has meant that more is left up to the individual. This particular issue was raised by only one of the interviewees.

There is an opportunity cost of not spending ones' assets before death (life cycle hypothesis). While the terms 'life cycle hypothesis' and 'opportunity cost' were not used specifically, the SHIP members spoke of treating the home in its own asset class.

There were mixed views on whether attitudes towards inheritance had changed. There was, however, more widespread consensus that attitudes towards debt had changed. Interviewees cited the number of users that use ERPs to replace debt.

ERPs are useful in affording health care. Due to the well-established national health care system in Britain, health does not rank very high in terms of the end use for ERPs. However, there was recognition that older people are increasingly looking towards private health care. Some interviewees pointed out that good health rather than poor health was a driving factor for demand, as the client was healthy now and wanted to enjoy life while still healthy.

Other themes and driving factors emerging from the interviews were:

- Debt consolidation in retirement is a common use for ERPs.
- Financial assistance for younger generations (children and grandchildren).
- Altruistic reasons (for example, gifts to charity or family).
- Factors driving demand for ERPs will differ in different economic cycles.
- ERPs are often used to free up cash for other investments (for example, annuities).
- Demand will differ depending on loan design.

Factors hindering demand for ERPs

Fear of indebtedness was not regarded as a major impediment, because there was widespread consensus that attitudes towards debt had changed and that generations now entering retirement were more accustomed to using debt.

Many of the interviewees discussed the pressures facing Britain's government in terms of funding the needs of retirees. It was felt that government might turn to ERPs as a solution. Government has used ERPs indirectly by using peoples' houses to pay for ongoing state-funded medical care. Most of the suppliers were critical of the complications arising with regard to means-tested benefits, and they believed that government should make exemptions for ERP use.

Lower value properties and higher interest rates may mean less home equity to utilise. There were mixed views on whether the house price environment or the interest rate environment had a direct impact on demand. The roll-up of interest in a higher interest rate environment was highlighted as an issue for both the user and the lender. While the real interest rate argument was advanced, commentators were careful to point out that growth in house prices cannot be guaranteed.

Cost was only considered to be a problem if the amount advanced was not significant enough to warrant the upfront costs. Most of the suppliers believed that it depended on what the money was actually used for (in other words, was the benefit worth the cost?). ERPs are not more expensive than standard mortgages, and increasing competition contributes to lowering costs.

There was mixed feedback as to the role that the bequest motive still plays, and indeed that has also emerged in various criticisms of the life cycle hypothesis. Some research has pointed to the importance of bequests in determining savings rather than the life cycle hypothesis. For example, Kotlitoff and Summers (1981) argue that the desire to make bequests was the most important motive for saving. This has been disputed by Modigliani (1988), who argues that only 15–20% of savings is for bequests. The desire for bequests is therefore a limiting factor in the ERP market, although the extent of its impediment is disputed.

The implications of the research results for South Africa

There has been little research on the potential market for ERPs in South Africa. However, the market is beginning to take shape. Seniors Finance and Nedbank have both entered the market, but take-up has been slow. In drawing lessons from Britain, it is necessary to assess the environment and contextualise the setting in South Africa.

The economic and social environment in South Africa is complex and diverse. South Africa is considered an upper middle-income economy by the World Bank, but with an array of social and economic ills ranging from high poverty and inequality rates to high levels of unemployment. It has elements of both first and third world economies, but its financial sector falls into the former. In line with the other developed countries that make use of ERPs, South Africa has also experienced a decreasing trend in household savings rates.

Table 1 is an attempt to estimate the potential market for ERPs in South Africa in 2010. The methodology used is similar to that in Figure 2, which took the total British population aged 60–65 years and whittled it down to the potential market for ERPs. South Africa has a population of approximately 49 million (CIA 2008). Of a total population older than 60 years of age (5.61 million), it is estimated that there are approximately 91 000 people (or approximately 1.7%) who may be in a position to take up ERPs.

In describing the market in South Africa, Nic Craig (a founder member of the South African Home Equity Release Protection Association) divides the market into three (Masie 2008):

- Needs-based users (most of the market share in South Africa)
- Wants-based users (who want to enhance their quality of life by travelling and so on)

- Smarter money-based users (who might, for example, use a home equity release loan to lower their estate duties).

In South Africa, property ownership is highly rated in the national consciousness. For most working South Africans, their house and retirement provision account for the bulk of the wealth they have accumulated throughout their working lives (Luus 2003). The residential property market in South Africa comprises approximately seven million formal dwellings. There are no formal data, but the value of the residential property market in 2002 was estimated at roughly R750 billion. The government succeeded in building almost 1.5 million low-cost housing units during the period 1994–2003 (Luus 2003). The higher end of the market (houses larger than > 80 m^2) has also experienced a significant increase in activity over the past few years. House prices have fluctuated significantly over the last decade, and the major boom between 2002 and 2006 has led to greatly enhanced values of residential property. This large increase in house prices (as well as the recent decline) is important in establishing the context for this study.

Table 1: Sizing the potential market in 2010

Sizing the market for equity release in South Africa: 2010	
South Africa: total population 2008	48.5 million
Population older than 60 (projected 2010)	5.61 million
Population older than 60 who own their own home	4.62 million
Population older than 60 who own their own home and who have in excess of R550 000 worth of equity	498 000
Population older than 60 who own their own home, who have in excess of R550 000 worth of equity and who do not have sufficient income	169 000
Population older than 60 who own their own home, who have in excess of R550 000 worth of equity, who do not have sufficient income and who do not want to leave an inheritance	91 000

Source: Authors' calculations based on Stats SA data

Due to South Africa's political legacies, housing wealth is still distributed largely along racial lines, with the white population owning the lion's share. Families in South Africa vary in their structure and complexity. In some homes, for example, a number of generations may live together under one roof.

These issues present a number of problems for the ERP industry in South Africa:

- The percentage of the elderly population who are able to take up ERPs is small and limited mostly to the white population. There were no black users of the Nedbank offering, and it was felt by one commentator that the product would probably be best suited to the affluent white community.
- If housing wealth in the previously disadvantaged communities were greater, family structures and cultural diversity could present additional barriers to demand (that are not common in Britain). Furthermore, if the products were to be used by the elderly generations in those households, the question would arise as to how the bank would deal with the younger generations also living in that home when the loan came to maturity.
- From a reputational risk perspective, banks would have to ensure that they were not seen to be discriminatory. It was felt that that the development of the emerging black middle class would need to be monitored – both from a wealth accumulation and from a cultural perspective.

British interviewees believed that South Africa's higher interest rate environment would be problematic. They said that it would result in the loan escalating very quickly and that this in turn would increase the risk to the lender. The higher interest rate environment would mean low loan-to-value ratios (LTVs), and firms would be restricted to servicing only the older age groups. Knowledge of the local housing environment and house price inflation was deemed important and should decrease the aforesaid risk.

Research outcomes that support the growth of the industry in South Africa are as follows:

- Attitudes towards debt: South Africa was described as a credit market. Consumption debt (although frowned on by government) is high.
- Big bank entry: The fact that Nedbank (one of the four big retail banks in South Africa) was one of the first to enter the market is encouraging. However, the reality that it is no longer offering new products is worrying.
- International learning curve: South Africa is joining the ERP industry relatively late in its life cycle. Suppliers in South Africa are able to learn from the mistakes and best practices of overseas firms.
- Housing wealth and savings trends: The interviewees confirmed that savings trends and housing wealth patterns have tracked those in countries such as Britain.
- Government regulation: There are currently no regulatory or government obstructions to industry growth, and the product is clearly regulated by the

National Credit Act (Act No. 34 of 2005). It was felt that the socialist factions within government would support the development of a product such as ERP.
- Health care: South Africa differs from Britain, which has an established national health care framework. More is left to the responsibility of the individual, and ERPs may be a solution to funding private health care.
- Lack of relevant social nets: Similar to the previous point on health care, South Africa's social nets are generally designed for the lower-income groups. Middle-income homeowners do not benefit from these to the same extent as their first world counterparts might (and once again, more is again left up the individual).

Research outcomes that do not support industry growth in South Africa include:
- The socio-demographic issues that have already been dealt with.
- Cost: The LTVs are likely to be lower in South Africa due to the higher interest rate environment. Thus the fixed costs involved in taking out the product are more problematic (in other words, the cost as a percentage of the amount advanced would be higher). The point has been made that as ERPs are a niche product, banks are likely to charge more. The independent financial adviser (IFA) market is not yet geared up for ERP products, and the firms would therefore have to take on much of the sales process. This process has been described as 'high touch' and costly.
- Systemic risk: Although the problem is not unique to South Africa, there was concern with the concept of lending against an asset rather than against an income stream. Banks may be more inclined to favour the latter in future.

Conclusion

The life cycle hypothesis asserts that saving and consumption decisions of households reflect an optimal consumption pattern over their lifetime, subject to the constraint of their resources. ERPs represent a direct vehicle that seeks to address these constraints by providing retired people with access to liquidity based on their home equity. In this way, it frees up household consumption for those that have otherwise not saved sufficiently for their retirement. If the ERP market were to grow sufficiently, it would force us to re-evaluate the life cycle hypothesis, as consumption decisions before retirement would be less driven by the need to save for retirement, which could result in higher marginal propensities to consume. The bequest motive would thus become a more dominant motive for savings.

Turning to the South African market for ERPs, it would appear that while the South African market size is limited given socio-economic and demographic factors, there may still be sufficient numbers with a need for ERP products for a supplier nevertheless to realise profit. While wealth distribution patterns currently point to a limited grouping within South Africa, it is impossible to predict how the economy and its people will change over time. For example, South Africa is currently experiencing rapid growth in black middle-class wealth creation. While cultural barriers may still exist, it is unclear what the future wealth patterns of the country will look like. Innovation in the ERP, housing and financial markets over time may mean that people with less equity in their homes are able to access ERPs. Furthermore, South Africa is not immune from some of the macro issues that drive the demand for ERPs, including increased life expectancy and decreasing savings trends, both of which have serious ramifications for retirement funding.

The ERP industry may yet have growth potential in South Africa, especially if the means can be found to extend the product to low income households (at the bottom of the pyramid scenario) and allow the poor to capitalise on their most important asset, namely their home. More than two decades ago, Hernando de Soto (1989) maintained that people in developing economies were sitting on a rich source of dormant capital with their land and home ownership (often without formal property rights) and argued that if the poor were able to leverage this ownership (as collateral for capital), this could form the basis for a new productive economy. A more innovative ERP market may provide the base to do just that.

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