NatEquity, Inc. National Equity Access for Senior Homeowners

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Mark-to-Fair Value Accounting Should Not Inhibit Private Reverse Mortgages

Larkspur, CA, February 20, 2019. A seldom acknowledged downside of private reverse mortgages is the GAAP accounting requirement to mark contracts to fair value. Reverse mortgages are level-3 assets: the value is dependent upon an “unknowable” future event, moveout or death of the homeowners. This is a new underwriting element not required for HECMs which are valued at cost under a GAAP rule exemption based upon their federal government guaranty. Private reverse mortgages, without the exemption and ability to predict homeowner life expectancy/moveout, must use a higher discount rate to net present value (NPV) the portfolio’s future income stream. This high discount rate, often resulting in a discount to cost, significantly penalizes the contract portfolio’s value. Exchange listed originators are either unaware of this GAAP requirement or are energetically attempting to avoid it.

The solution is to medically underwrite each borrower to permit a statistically repeatable methodology of predicting future portfolio cash flows. This justification will lead to valuations approximating cost or to accrete value in excess of cost. Because reverse mortgage applicants are all seniors, medical underwriting does not suggest age discrimination. Medical underwriting can both influence contract pricing and provide a tool for valuation; and is at the core of marking level-3 longevity dependent assets to fair value.

Mark-to-fair value has had a 25-year controversial climb to legitimacy and is finally recognized as the measure of value for commercial transactions and financial disclosure. Historically GAAP allowed assets and liabilities to be valued at cost which often masked real value because of subsequent events. Day to day valuation of level-1 assets, like stocks and bonds, are accepted as the average of published bid and ask pricing. This simplicity encourages the common perception that mark-to-fair value is the same as mark-to-market (what a willing buyer and willing seller agree to pay). That analogy gets murky for level-2 assets where the value is interpolated from an analysis of an entity’s financial statements. So long as assets and liabilities are marked up or down to fair value, the mark-to-fair value equals mark-to-market analogy has become accepted practice. Where this analogy falls apart are level-3 assets where the value is based upon a measure of value dependent upon an “unknowable” future event: the duration of a derivative or the live expectancy of a person. That uncertainty requires portfolio managers, at the insistence of their third-party auditors, to use higher discount rates when estimating the net present value of an asset or liabilities’ future stream of income.

NatEquity, a California-centric senior home equity access option originator and funder, employs a mortality predictive tool previously used to value and price life insurance contracts. This tool, the Longevity Cost Calculator (LCC), is combined with three commercially obtained life expectancy underwriting reports for each homeowner. At contract origination NatEquity believes they know the expected maturity for each contract. As contracts mature and by employing Bayesian Inference, the reliability is tested in an actual-to-expected format. After sufficient contracts mature and demonstrate the accuracy of the methodology, a lower discount rate can be used to determine the NPV of future portfolio cash flows – the standard measure of fair value in accordance with GAAP.

Peter Mazonas, CPA, created and managed Transamerica HomeFirst, today the most successful private reverse mortgage company. His team was additionally instrumental in the early design of HECM products. Currently, he is founder and CEO of NatEquity, a senior home equity access option product company. peter.mazonas@NatEquity.com