



NatEquity, Inc. National Equity Access For Senior Homeowners

NatEquity Knowledge Base

SEC Intervention Will Again Lead to Change in the Home Equity Investment and Reverse Mortgage Markets

Home equity investment and shared appreciation reverse mortgage product design has been an iterative process since the first commercial home equity access products were introduced in the early 1990s. Major shifts in available products have been driven by economic forces and resultant regulatory changes. Senior home equity access products have a lot of moving parts that need to be fitted together if the product is to get traction with the various stakeholders and be successful for the population of senior households needing financial relief. Different segments of the senior population have different needs based upon their savings, retirement benefits, cost of living, lifestyle and actions. Usually, an event beyond their control triggers the need to draw upon the equity in their homes to fill their needs. Different products fill different needs, but product designers need to have deep knowledge of both the broad and specific markets to captivate seniors to take action. The product's value proposition must be significant enough to overcome the hurdle of tapping the home equity homeowners work so hard to accumulate. This knowledge base paper is not to critique of past or present products.

The 2008 mortgage crisis accelerated changes in home equity investment products. Equity option products, first developed but never released by Transamerica HomeFirst, proliferated. Reverse mortgage product offerings were modified to satisfy the financial needs of senior homeowners who were frozen out of the conventional borrowing market. History tells us that regulators react to problems that get too big to continue to overlook. For the first time in 50-years the SEC has weighed into Level 3 Mark-to-Fair Value, requiring reporting entities to value assets and liabilities using "Net Present Value" of future portfolio cash flows. SEC Rule 2a-5 (2020) is significant and cannot be overlooked. The original effective date was December 31, 2021. This was moved to cover financial statements starting in 2024.

In 2006, the Financial Accounting Standards Board (FASB) issued FAS 157 that classified assets and liabilities into three levels: Level 1, Level 2 and Level 3. Level 1 are typically stocks and bonds with available daily closing prices. Level 2 are where fair value must be inferred from financial statements or similar traded products. Level 3 are where the fair value is "unknowable" / "unobservable". This category includes all real estate, mortgages, derivatives, life settlements and non-government guaranteed reverse mortgages. For reverse mortgages the value is dependent upon the death/moveout of the homeowner(s). In 2011, ASC 820 further clarified that fair value for Level 3 assets is the discounted net present value of future portfolio cash flows. This

rule was applied to all assets except mortgages in 2014. Mortgages came under the rule in 2020.

1 HISTORICAL CONTEXT

Early 1990s reverse mortgage products focused on offering senior homeowner's monthly income. Financial Freedom offered a trade your house for an insurance company annuity which paid lifetime income. This was a pure longevity play Unum Insurance understood. Once originated this product required little or no loan servicing. The Government backed Home Equity Conversion [Reverse] Mortgage (HECM) and Transamerica HomeFirst (THF) offered senior homeowners enough cash to get a "fresh start" and paid them the balance as lifetime monthly income for as long as they live in their home. This author was the founder, product designer and CEO of THF and our team assisted in the initial design of the HECM product. These were the early days of the market and it was difficult to overcome conservative skeptics and get market traction. THF did sell a substantial number of lifetime products. Initially Financial Freedom and Transamerica both outsold the Government HECM product.

HECM had the advantage of the Treasury's balance sheet which allowed HECM to offer product with a lower-cost of funds than private market products. HECM also embraced unrealistic product design assumptions, like 4% annual compounded nationwide home price appreciation. The amount of home value HECM would lend against (principle limit) used/uses Social Security mortality tables which have mortality higher than that of a typical homeowner. These three factors allowed HECM to offer more money per dollar of future home value than private for-profit companies were willing to embrace.

HECM's real edge was a federal government guaranty that meant when the accumulated principal advances and accrued interest hit 98% of origination home value, each loan was "put" back to the Treasury and the American taxpayers took the loss at foreclosure. Because of the guarantee HECM also cut corners on closing costs like title insurance. All of this meant that originators could securitize HECM loan portfolios at low U.S. Government guaranteed yields and monetize the 300 bps spreads for immediate profit – the arbitrage. This arbitrage and the need to build more and larger securitized portfolios lead to fundamental changes in both the HECM and private jumbo reverse mortgage markets.

In 1992, the SEC imposed an early form of fair value accounting that took issue with radical revenue recognition accounting. One competitor, Providential Home Income Plan, offered a product where they immediately owned 20% of each home. They recognized this as immediate profit to boost earnings. This profit outlook allowed Providential to be the hottest IPO of 1991. The SEC ruling forced Providential to restate earnings and they were out of business in six months. THF's conservative fair value accounting saved the day. In the mid-1990s, Transamerica's auditors forced THF to stop pricing and valuing contracts based upon activities of daily living (ADLs) as a gauge of mortality. The auditors forced the use of very long-lived annuity mortality

tables. This forced the THF loan portfolios held by the parent company to fall below Transamerica's value added threshold.

Eventually in 1999, Transamerica sold the lifetime reverse mortgage portfolio to a Wall Street bank. Financial Freedom was exempt from fair value accounting because it was an insurance annuity. Financial Freedom ultimately owned the THF operating company and its patents and product designs. Key amongst these was a life of credit product named "House Money". The original intent of House Money was to allow senior homeowners the flexibility of a line of credit they could drawdown as need over their lifetime as they aged in place. At the same time in the early 2000s Wells Fargo and other banks started aggressively marketing Home Equity Lines of Credit (HELOCs) to senior homeowners to tap the equity in their homes. These were interest only loans that reset after year ten as fully amortized high monthly repayments of principal and interest. Others in the private jumbo market, like Financial Freedom's House Money, modified products to compete. HECM followed suit with a similar line of credit/large lump product.

Quickly these products found a large market niche of seniors who needed large lump sums to deal with accumulated debt. The roaring 2000s found a willing market that expanded after the 2008 mortgage crisis. Immediate large loan draws available from the House Money and revamped HECM product made them attractive to securitizers because of volume. A HUD Inspection General's report in 2014 presented the findings of a HECM program audit. 87% of senior homeowners who took advantage of these lump sum loans engage in fraud at time of loan originationⁱ. The 2016 foreclosure on 32,000 seniors with HECMs led to the tightening of lump sum loophole in the HECM program.

2 REGULATORY FRAMEWORK MUDDIES THE WATER

In 2014, the recently formed Consumer Financial Protection Bureau (CFPB), introduced rules implementing the Ability-to-Repay (ATR) provision – aimed at discouraging risky mortgage lending practices that proliferated during the housing boom. This meant that seniors without W-2 salaried income were deemed "non-qualified mortgage (Non-QM) borrowers. Immediately this discouraged bank HELOC lending which had not recovered from the 2008 downturn. To add fuel to the fire, in 2008 lenders froze HELOC loan draws. These eventually lead to loan resets as high monthly amortized short-term loans. Between 2014 and 2017, \$350 billion of HELOCs reset, mostly for senior households in retirement who could not refinance without W-2 incomeⁱⁱ.

HECM loans and jumbo "HECM look alike loans" mimicking federal HECM provisions were exempt from the ATR rule. They jumped in to fill the void for senior homeowner's needing to refinance. For the most part this jumbo lump sum space is where the HECM and private jumbo reverse mortgage market has operated since 2014. Originators offer HECM-to-HECM refis, maxed out HECM-to-private jumbo refis and mortgage consolidation jumbo proprietary reverse mortgages.

3 GOING FORWARD IN A MIXED PRODUCT ENVIRONMENT

Friends who originate both HECM and jumbo private reverse mortgages have expressed concerns that this refi market opportunity would go away and they will have no alternative products to sell. The recent rate increases and significant volume reductions in conventional refinancing foretell of market saturation. These originator's biggest concern is that lump sum products serve only a small percentage of the possible senior home equity access market. To breakout of this forever lull of only serving 1-2% of the possible market, products to serve the larger senior market in need for financial relief must be introduced. This is NatEquity's experience driven goal. NatEquity's goal draws upon THF's product design, unique valuation IP, market experience and early success providing lifetime income contracts, mostly in California.

Market knowledge and understanding of the regulatory landscape are harder factors to understand than pure product design. When vendors offer limited product options, consumers with various financial needs can only select from what is out there. One size does not fit all in the senior home equity access marketplace. Coastal California is not Florida, nor suburban Chicago or the suburban Tri-state area of metro New York. Weather, the desire and ability to move and property tax structure all play a hand in what senior homeowners want when they need to access their hard-earned home equity. In California, with temperate weather and low property taxes, coastal California seniors want to age in place. Suburban coastal California, close to major tech and biotech job centers, continue to see escalating home values because of limited buildable land and high demand from highly compensated knowledge workers. 2020 Census data evaluated by the California Department of Finance shows that coastal California has 3.5 million senior households over age 70. By 2030, California will have 6 million senior households over age 70 who have aged in place – the most of any state.

NatEquity's product design is unique: NatEquity agrees to buy half or more of your home at today's appraised value. NatEquity advances any "fresh start" monies for improvements or to pay down debt and then makes cost of living adjusted monthly payments for as long as the homeowners remain in their home. When the home is sold, NatEquity collects principal advances, accrued interest and our share of each home's appreciated future value. NatEquity caps its share of cumulative compound share of HPA at 4%, in exchange for investor downside protections. In a typical coastal California single family suburban home this means the homeowner(s) receives 62% to 70% of the sales proceeds, the balance shared with NatEquity. This is in a target market where annual compound HPA has averaged better than 6% for the past 35-years. Because NatEquity and our investors share in the future value of each home we make sure the homes are maintained in resale ready condition to get top dollar at future sale.

4 GAAP AND SEC INTERVENTION

The last point is knowledge of the regulatory environment. The scares from the improper mark-to-fair value accounting rules imposed on Transamerica in 1992 are vivid in this author's memory. After 30-years of formulation, proper GAAP Mark-to-Fair value rules were finally imposed on all but the mortgage industry in 2014. These rules began applying to mortgages and commercial real estate in 2020. The rule is simple but complex: a portfolio of Level 3 longevity dependent products is only worth today the discount "net present value" of predictable future cash flows. I added the word predictable because if you have access to methodology that can repeatably predict future cash flows you get a balance sheet and income statement premium. If you cannot, you are subject to a higher discount rate that negatively impacts both your balance sheet value and current book income.

Life settlements, derivatives and other Level 3 asset portfolios like lump sum proprietary reverse mortgages have consistently abused the NPV rule and wiggle their way into Level 2 reporting treatment: what similar asset portfolios sell for in the open markets, with a few adjustments to appease auditors. After much internal study, the SEC issued Rule 2a-5 on December 3, 2002. This rule requires the preferred use of "Net Present Value" [their emphasis] valuation and presentation for financial statements issued by reporting entities. SEC enforcement requires Boards to hire outside pricing/valuation firms. The unique enforcement twist is that third party auditors will be held accountable for improper and misleading financial statements issued by clients. Because of repeated non-compliant audits, the SEC asked FASB to review the audit standards for fair value accounting to remove any ambiguity. No rewrite was necessary and Rule 2a-5 is expective for reporting entities issuing financial statements in 2024.

NatEquity is fortunate to have the exclusive rights to a mortality predictive tool that is a component of a GAAP and SEC compliant valuation methodology. This methodology was first presented to the SEC in 2009 and later published in a peer reviewed paper in 2011. Information of that methodology is publicly available in the Knowledge Base tab of NatEquity's web site.

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ⁱ *HUD Policies Did Not Always Ensure That HECM Borrowers Complied With Residency Requirements*, HUD Inspector General Audit Report 2014-PH-0001, September 30, 2014

ⁱⁱ *Will HELOC Resets Lead to New Wave of Mortgage Defaults?* Spencer Agnew, University of St. Thomas, undated post.
<https://blogs.stthomas.edu/realestate/2013/12/08/will-heloc-resets-lead-to-new-wave-of-mortgage-defaults>