

# Statutory Issue Paper No. 39

## Reverse Mortgages

### STATUS

Finalized March 16, 1998

**Original SSAP and Current Authoritative Guidance: SSAP No. 39**

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. A reverse mortgage is a loan against home equity that guarantees cash advances to the homeowner and requires no repayment until a future time, usually when the borrower dies, sells the property or permanently moves. The term reverse mortgage is used to describe the timing of repayment of the mortgage obligation which is at the end of the contractual period (i.e., the mortgagee does not repay the obligation until the underlying collateral is liquidated). The proceeds from the sale of the property are used to pay off the balance of the loan. The borrower's obligation is limited to the value of the home at the time of sale and the lender has no recourse to other assets of the borrower or the borrower's estate. Usually, the borrower receives an annuity payment either (a) for as long as the borrower lives or (b) until a set percentage of the value of the collateral is reached. In the first type, there is mortality risk, as well as the collateral, interest rate, and credit risk found in traditional mortgage loans.

2. Current statutory guidance is contained in the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the March 13, 1995 meeting. GAAP does not specifically address reverse mortgages.

3. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting of reverse mortgages that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

### SUMMARY CONCLUSION

4. For purposes of this issue paper, a reverse mortgage loan shall be defined as a non-recourse loan with the following characteristics:

- a. It is secured by a mortgage against the primary residence of the borrower;
- b. It guarantees a stream of cash disbursements to the borrower, either for the life of the borrower with no limit or up to a set percentage of the value of the residence or is a line of credit which the borrower can draw upon as needed; and
- c. It has no maturity date and requires no repayment until one of the following events occur:
  - i. The borrower dies,
  - ii. The borrower sells the residence,
  - iii. The residence ceases to be the borrower's primary residence, or
  - iv. The borrower terminates the loan by paying back the outstanding balance.

5. A reverse mortgage meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this issue paper. As such, it shall be recorded as an other invested asset on the reporting entity's balance sheet and Schedule BA, Other Long-Term Invested Assets, of the Annual Statement.

6. The accounting and reporting requirements for reverse mortgages shall be the same as those contained in paragraph 10 below. A reverse mortgage shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the reverse mortgage. "According to the contractual terms" means that both the contractual principal payments and contractual interest payments of the loan will be collected as specified in the reverse mortgage agreement. The three major categories of risk affecting reverse mortgages are described in paragraph 10. Reverse mortgages subject to these risks shall be reported net of an appropriate actuarial reserve. The assumptions, cash flow projections, and evaluation of risk are to be reviewed and updated at least annually with any resulting adjustment made to the valuation allowance (contra-asset) and unrealized gains and losses, if the impairment is temporary. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the risk factors affecting the value of the mortgage, the reporting entity shall adjust the valuation allowance; however, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan. The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of the valuation allowance, while the former term is not. The recorded investment (including accrued interest, net deferred loan fees, and unamortized premium or discount) in the loan does, however, reflect any direct write down of the investment. If the impairment is other than temporary, a direct write down (charge-off) shall be recognized and a new cost basis is established. Direct write-downs for other than temporary impairments of reverse mortgages shall also be included in realized losses. This new basis shall not be changed for subsequent recoveries in fair value.

7. The following disclosures shall be made for reverse mortgages in the financial statements:
- a. A description of the reporting entity's accounting policies and methods, including the statistical methods and assumptions used in calculating the reserve,
  - b. The reserve amount which is netted against the asset value,
  - c. Investment income or loss recognized in the period as a result of the re-estimated cash flows, and
  - d. General information regarding the reporting entity's commitment under the agreement.

## DISCUSSION

8. This issue paper adopts current statutory guidance.

9. Though, at the time a reverse mortgage agreement is ratified, the reporting entity has agreed to make payments to the borrower, this does not meet the definition of a liability, as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* (Issue Paper No. 5). Issue Paper No. 5 defines a liability as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s). By making payments to the borrower, the reporting entity is converting one asset (cash) to another (an outstanding reverse mortgage). It is, therefore, not sacrificing any economic benefit and is not incurring a liability up to the amount that the reporting entity can record as an asset (i.e., the value of the collateral).

**Drafting Notes/Comments**

- Accounting for real estate acquired in satisfaction of debt is addressed in *Issue Paper No. 40—Real Estate Investments*.
- Accounting for Mortgage Loans is addressed in *Issue Paper No. 37—Mortgage Loans*.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE****Statutory Accounting**

10. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the March 13, 1995 meeting contained the following to be added to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies:

**Description**

Reverse mortgages are primarily designed to allow senior citizens to convert home equity into cash without selling their home. A reverse mortgage is a non-recourse loan secured by the borrower's owner occupied principal residence. Loan proceeds are based on the current fair market value of the home and the age of the borrower and may be disbursed in a lump sum or periodically to provide cash flow to the borrower. In consideration of those payments, the borrower exchanges all or part of a claim to home equity.

Principal and interest payments on the loan are deferred until the borrower moves, sells the property or dies. The loan is then repaid in a lump sum with proceeds from the sale of the property. The borrower's obligation is limited to the value of the home at the time of sale and the lender has no recourse to other assets of the borrower or the borrowers estate.

Reverse mortgages are reported on Schedule BA of the Annual Statement as "Investment in Reverse Mortgages."

Payments can be structured in many different ways to fit the financial needs of the borrower. In some contracts the borrower shares a percentage of the home appreciation with the lender. Three common types of payment plans are:

1. Tenure plan - borrower receives fixed monthly payments until the borrower permanently moves, sells the property or dies.
2. Term plan - borrower receives fixed monthly payments for a specified period of time.
3. Line of Credit - borrower draws upon a pre-determined line of credit as needed.

**Authorization and Limitation**

To be considered admitted assets, investments in reverse mortgages are limited to first lien mortgages only. Reverse mortgages also may be subject to mortgage loan limitations established by the state of domicile, including loan to value limitations. Loan to value calculations will be based on the most current appraisal of the collateral. Reappraisal of the collateral is required when existing reverse mortgages are purchased by an insurer.

**Origination Expenses and Fees**

All expenses associated with entering into reverse mortgages shall be recognized immediately as investment expense.

Revenue associated with originating or otherwise acquiring reverse mortgages, including non-refundable fees, shall be amortized to investment income on a straight line basis over the period from inception to the expected maturity date.

Generally, fees are not paid by the borrower at the time of closing but become payable when the outstanding balance of the reverse mortgage becomes due. In these situations, no accounting entries are recorded at the time of closing. Investment income will be recognized and the outstanding balance of the loan will increase as the fees are amortized.

If fees are paid by the borrower at the time of closing, a liability should be established. Investment income will be recognized and the liability will decrease as the fees are amortized.

#### Interest Income and Accrued Interest Receivable

Interest is payable by the borrower when the outstanding balance of the reverse mortgage becomes due. Accrued interest should be calculated on the outstanding balance of the loan on a monthly basis. As it is earned, accrued interest should be recorded to investment income and added to the outstanding balance of the loan.

#### Valuation

The outstanding balance of the reverse mortgage will include the accumulation of amounts disbursed, accrued interest and amortized origination fees (origination fees not paid by the borrower at the time of closing). Neither the fair market value of the underlying collateral nor the liability for future cash payments guaranteed by the lender are recorded. They are, however, considered in cash flow projections and to the extent that estimated future cash payments exceed estimated future cash receipts, a valuation reserve is established. Future appreciation in property value beyond the valuation date is not included in the projection of cash receipts.

The lender's equity in the appreciation of the property, if any, is not recorded until realized upon the sale of the home.

The three major categories of risk affecting reverse mortgages are described below:

1. Mortality risk - risk of loan payments extending beyond the borrowers original projected life expectancy.

Since most reverse mortgages guarantee a continuing monthly payment to the borrower, there is the possibility that the borrower will collect cash payments and accrue interest exceeding the appreciated value of the collateral. In situations where loan payments extend beyond the borrower's original projected life expectancy, the insurance company will experience a diminished yield, and may experience a loss. Reverse mortgage contracts should be combined into groups which are of sufficient size to provide an actuarially and statistically credible basis for estimating life expectancy to project future cash flows.

2. Collateral Risk - risk of deterioration in the value of the collateral such that it is insufficient to cover the loan balance. This risk must be evaluated loan-by-loan and is based on information obtained from periodic real estate appraisals, as required by the state of domicile, and other pertinent information.
3. Interest Rate Risk - risk of interest rates rising on adjustable rate reverse mortgages to the extent that accrued interest creates a collateral risk.

Reverse mortgages subject to these risks shall be reported net of an appropriate actuarial reserve. The assumptions, cash flow projections and evaluation of risk are to be reviewed and updated at least annually, with any resulting adjustment made to the reserve. Assumptions should be applied consistently to similar loans.

### Disclosure Requirements

The following should be disclosed in footnote 2, Basis of Valuation of Invested Assets:

1. A description of the company's accounting policies and methods, including the statistical methods and assumptions used in calculating the reserve.
2. The reserve amount which is netted against the asset value.
3. Investment income or loss recognized in the period as a result of the re-estimated cash flows.
4. General information regarding the insurer's commitment under the agreement.

### Effective Date

These accounting and reporting guidelines are effective for the year ending December 31, 1995.

### Generally Accepted Accounting Principles

11. GAAP does not specifically address reverse mortgages. GAAP guidance addressing mortgage loans is contained in *Issue Paper No. 37—Mortgage Loans*.

### RELEVANT LITERATURE

#### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the March 13, 1995 meeting
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 37—Mortgage Loans*
- *Issue Paper No. 40—Real Estate Investments*

### Generally Accepted Accounting Principles

None

### State Regulations

- No additional guidance obtained from state statutes or regulations.

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