NatEquity, Inc. National Equity Access For Senior Homeowners

NatEquity Knowledge Base

Are Reverse Mortgages Subject to the Fair Value Accounting Rules?

You asked the fundamental question: are mortgages, not specifically reverse mortgages, subject to the GAAP fair value accounting rules. The simple answer is YES. The updated mark to fair value accounting rules were initiated in 2006 in direct response to the shenanigans going on in the mortgage markets that ultimately cause the financial crisis. Had the SEC not suspended the rules at that time, allowing the banks to continue to carry underwater mortgages at cost, the financial crisis would have been much worse. Unlike stocks and bonds, mortgages, and specifically reverse mortgages, are level 3 assets whose net present value are dependent upon unobservable future events which may cause write downs. HUD HECM reverse mortgages are valued at cost because they operate under a “guarantee” exemption specifically allowed under the rules. All other level 3 assets have unobservable events which can negatively impact valuation:

1. Unpredictable maturities,
2. Decreases in home FMV such that the loan to value (LTV) exceeds 100%, and
3. Foreclosure forced by the inability of the homeowner to make loan or property tax and homeowner’s insurance payments, just to name a few.

The GAAP fair value rules, AUC 820 and IFRS 13, require the asset manager to devise and employ a mathematically strict and repeatable valuation methodology. The outcomes from this methodology help determine the risk premium portion of the discount rate to be used in determining the net present value (NPV) of the future portfolio cash flows – the measure of current value. To the extent the measurement methodology is sound the independent auditors may challenge the outcome but not the methodology and process. To the extent the methodology is not sound the risk premium will jump from one or two times the risk free cost of capital to five or six times.

We at NatEquity have observed this first hand from our friends in the life settlement markets since the AU C§ 820 became effective in 2014. A big private equity fund spent millions and took years to convince their big 4 auditors to justify bring their valuation risk premium down from 6X to 4X, the rough equivalent of origination cost. This lack of methodology for longevity dependent assets which become more, not less, valuable over time cannot be over emphasized.

NatEquity has recently been exposed to a soon to be released jumbo reverse mortgage designed to “compete” with a NatEquity Contract. I wrote about and debunked an equity sharing product in a paper dated September 4, 2014. They all have their origins in reversed mortgage products I designed and patented 25-years ago. Even then the products were hampered by SEC accounting rules which were much less strenuous than the new GAAP and IFRS mark to fair value rules. We were challenged recently for creating an “annuity like product” and being overly concerned about longevity. In fact it is NatEquity’s product design, eye on longevity and having a published valuation methodology that allows portfolios of NatEquity Contracts to accrete NPV value far in excess of origination cost.