ARCSys™

Effects of CECL on Investment Portfolios

Effects of CECL on Investment Portfolios

Michael Umscheid, President and CEO of ARCSys

Introduction

The CECL standard has enormous ramifications for accounting for investments. All investments need to be re-evaluated, based on the expected credit losses that may need to be calculated based on the security type, HTM or AFS, and whether the investment is explicitly or implicitly guaranteed by the federal government. This whitepaper will give you the information you need to know about investments with CECL.

Recognition and Measurement

FASB has changed the accounting for credit risk for all debt securities that fall under the Held-to-Maturity (HTM) and Available-for-Sale (AFS) categories. These changes include the following:

- **AFS Debt Securities:** Credit Risk as measured on Debt Securities will be adjusted through Net Income, not Other Comprehensive Income (OCI). The holding gains and losses (non-credit risk) will continue to be adjusted through OCI. Therefore, you have to bifurcate credit risk from other risk.
- **Held-to-Maturity (HTM):** HTM or amortizable debt securities will be measured using any CECL calculation method. Fundamentally, the same measurement as loans.
- **Available-for-Sale (AFS):** AFS securities will be measured for credit risk using a Discounted Cash Flow (DCF) Method. However, an allowance calculation is only required when the security is in a loss position. Securities in a gain position are not required to have an allowance calculated. The model will calculate the cash flows expected to be collected compared to the amortized cost. The DCF calculation needs to be adjusted for reasonable and supportable forecasts including credit losses and prepayments.
- **Time Consideration:** FASB has removed the requirement to consider the length of time that the fair value of an available-for-sale debt security has been less than its amortized cost basis when estimating whether a credit loss exists.

- **Evidence:** Evidence you may consider in reaching a conclusion about the allowance for credit loss may include any of the following performance indicators of the underlying assets in the security:
    - Default rates
    - Delinquency rates
    - Percentage of non-performing assets
    - Debt-to-collateral-value ratios
    - Third-party guarantees
    - Current levels of subordination
    - Geographic concentration
    - Industry analyst reports
    - Credit ratings
    - Volatility of the security's fair value
    - Any other information that the investor considers relevant including information about the investee
    - A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee. Government Sponsored Entities (GSE) would qualify here for GSE Bonds.
    - A significant adverse change in the regulatory, economic, or technological environment of the investee
    - A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates
    - A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
    - Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

Which Investments Qualify for Allowances

In theory, all investments have risk; however, under CECL, you can consider the guarantor in the allowance decision modeling. Therefore, investments that are explicitly or implicitly guaranteed by the federal government will have risk, but should have a zero allowance. This rule applies to both HTM and AFS securities, which are guaranteed.

U.S. Treasury Securities

The following qualitative factors can suggest that historical credit loss information is minimally impacted by current conditions and reasonable forecasts:

- A high credit rating from rating agencies
- A long history without credit losses
- Being explicitly guaranteed by a sovereign entity with a high credit rating
- Being widely recognized as a "risk-free rate"
- Originating their own currency

However, the experience of a downgrade can indicate that there may be some risk of nonpayment. Most people believe that U.S. Treasury securities with the characteristics mentioned above can reasonably be expected to have zero nonpayment risk, according to an entity's management.

Government National Mortgage Association (Ginnie Mae) Mortgage-Backed Securities

Ginnie Mae helps the secondary mortgage market by buying certain types of mortgage loans and issuing mortgage-backed securities with a government guarantee for timely payment of principal and interest. These securities typically have a 30-year term and are backed by federally insured or guaranteed loans, mainly from the Federal Housing Administration or the Department of Veterans Affairs.

There are several indicators that suggest Ginnie Mae mortgage-backed securities have a low risk of nonpayment, including a long history without credit losses being passed through to purchasers, explicit government guarantees on principal and interest payments, and the underlying notes being guaranteed by the U.S. government. Additionally, these securities are generally priced above risk-free rates of return.

However, there are also indicators that suggest there may be some risk of nonpayment, such as the market not pricing the product the same as risk-free securities and the fact that Ginnie Mae is a government agency subject to appropriations. Nonetheless, most people believe that entities can reasonably conclude that Ginnie Mae mortgage-backed securities with these characteristics have a very low to zero expectation of nonpayment.

Agency Mortgage-Backed Securities

Fannie Mae and Freddie Mac are two government sponsored entities (GSEs) that provide liquidity to the secondary mortgage market by purchasing conventional conforming mortgage loans and issuing guaranteed mortgage-backed securities. They guarantee the timely payment of principal and interest to investors in the mortgage-backed securities.

Indicators for zero loss include the fact that principal and interest payments are guaranteed by the issuers and that the product carries an implicit guarantee from the US government up to a certain amount. Rates of return on these instruments are generally priced above the risk-free rate, but this is primarily attributable to non-credit related risk.

Market participants generally do not price this instrument with the expectation of a credit loss due to the implicit guarantees by the US government. Efforts are ongoing to standardize perceived credit and liquidity risk among Freddie and Fannie. Purchasers of GSE mortgage-backed securities have a long history of no credit losses due to the implicit guarantees; however, after the last credit crisis, GSEs have been under the purview of the Federal Housing Finance Agency (FHFA). This oversight has established new types of securities called Credit Risk Transfer securities. These securities do transfer risk to the purchaser, however, the risk is limited by a trust created out of the activity of the security.

Indicators for loss greater than zero include the fact that the implicit government guarantee is subject to a cap, and since 2012, the issuers have been required to distribute all profits to the US Treasury. In the event of another financial crisis, the issuers would likely continue to rely on government support, as they are unable to build equity reserves.

Most people believe that an entity's management may reasonably conclude that US agency mortgage-backed securities with these characteristics have an expectation of zero nonpayment risk.

Other Government-Guaranteed Investments

- Small Business Administration (SBA) securities
- Certificates of Deposit (CD) under $250,000

Investments That Do Not Qualify as Federal Government-Guaranteed

- Municipal securities: states and localities cannot issue currency
- Private mortgage-backed securities (MBS) and commercial mortgage-backed securities (CMBS)

- Corporate Bonds, including GSE Agency Bonds
- Other private securities, such as credit card pools or auto securitizations

How ARCSys Can Help

The ARCSys System can calculate and aggregate your investments into risk pools, model your pools, and calculate your allowance. Additionally, ARCSys will do your financial disclosures for you.

Contact ARCSys to discuss your investment portfolios!

arcsysonline.com 757-962-6130 sales@arcsysonline.com