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2023 Adopter CECL Implementation Road Map Series: Debt Securities & Unfunded Commitments

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Meet the Presenters

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Debt Securities

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CECL Scope

Held-to-maturity (HTM) debt securities	• Must follow the CECL model of the ASU
Available-for-sale (AFS) debt securities	• ASU provides separate impairment model • Modified version of today's OTTI model
Purchased credit deteriorated (PCD)	• Debt securities purchased after original issuance must consider if PCD accounting applies

Stay tuned. We'll cover PCD in an upcoming webinar

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HTM Debt Securities Under CECL

Key CECL considerations potentially impacting estimating credit losses HTM debt securities

- Management's determination of zero loss securities under ASC 326-20-30-10
- Pooling considerations
- Determining CECL life
- Due to lack of loss experience, most institutions' source of historical experience will be external
- Can use both DCF & non-DCF methodologies
- No fair value floor for estimating credit losses

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Zero Credit Loss for HTM Debt Securities

- **326-20-30-10** requires an entity to include a measure of expected credit losses even if that risk is remote (not the most likely outcome)

✓Not required to measure expected credit losses if management's expectation of nonpayment is zero at default **(zero credit loss)**. **PD >0, but LGD = 0**

✓Does not specify specific financial assets that would be zero loss (management's judgment)

✓Example 8 in the implementation guidance illustrates the process to document a conclusion of zero credit loss on HTM U.S. Treasury securities

Zero Credit Loss for HTM Debt Securities

Securities issued by Ginnie Mae, a U.S. agency

- 40+ years of history of no credit losses to investors
- Payments are explicitly guaranteed by U.S.
- Underlying mortgage loans are either insured by the FHA or guaranteed by the VA, both U.S. agencies
- U.S. can print currency to retire GNMA's obligations

Fannie Mae & Freddie Mac MBS

- P&I payments are guaranteed by the issuing agency
- Explicit guarantee by the U.S. subject to a cap (part of the purchase agreement when the agencies were taken into conservatorship in 2008)
- Widely believed to have an implied guarantee by the U.S.
- Long history of no credit losses to investors

HTM Debt Securities Under CECL

Three potential outcomes for HTM debt securities under CECL

- Management determines & documents zero loss **(no CECL reserve)**
- Management determines a CECL allowance is necessary **(CECL reserve through an allowance for credit losses)**
- Management determines CECL reserve is technically necessary but decides it is not material **(no CECL reserve)**

Note: this would need to be considered for each different pool of (or individual) HTM debt securities

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HTM Debt Securities Under CECL

Expectation is, for most community financial institutions, impact on HTM will be mostly in municipal bonds (& maybe corporate bonds)

- Unless there are additional credit enhancements, can an institution get to an answer of zero, even if probability of default is remote?
- How do you calculate an estimate of credit loss where you have had no experience of loss?
- How should we think about the life of callable bonds?

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HTM Securities – Nonrated Munis

- What about nonrated securities? Many municipalities choose not to get a bond issue rated
- Institutions are already likely using third-party municipal credit analysis as a part of their municipal credit program
- Nonrated securities need to be pooled together based on municipal credit metrics & related back to a Moody’s &/or S&P rating
- From there, the security can then go through the same (or comparable) analysis as their rated counterparts

HTM Securities – Example Areas to Consider in a Memo

- Analysis separate for each pool/segment
- Consider both loss given default & probability of default (can be qualitative, quantitative, or both)
- Nature of any guarantees (implicit, explicit, strength of guarantor, past defaults, & outcomes)
- Collateral value (current & potential volatility in future)
- Credit enhancements (only embedded) & cash flow priority
- Moody’s, S&P, Fitch, etc. ratings
- Yield trends *i.e.*, do spreads imply changes in credit factors?
- Portfolio concentrations & correlated exposures

HTM Securities – Example Areas to Consider in a Memo (cont.)

- Changes in tax base, political unrest, or demographic information, *e.g.*, for municipal or international securities
- Macroeconomic factors, *e.g.*, unemployment, GDP, local economic conditions
- News about the issuer stability or financial condition
- Issuer/guarantor's willingness to pay
- Include both positive & negative evidence

Similar to CECL estimates for loans, think about the factors that could drive losses & document considerations around those factors

Utilize information from brokers, ALM model providers, or bond accounting providers

AFS Debt Securities

Highlights of the New Impairment Model

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- ✓ Unrealized loss position = impaired
- ✓ Time is no longer a factor in the determination
- ✓ Portion of impairment due to credit-related factors should be recorded through an allowance for credit losses
- ✓ Should be analyzed at the individual security level on a discounted cash flows basis at the EIR implicit at the date of purchase
- ✓ Amount of credit loss limited to amount by which FV is below amortized cost

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AFS Debt Securities

Qualitatively vs. quantitatively assessing whether credit loss exists

- The standard is unclear as to whether you must perform a DCF calculation when a security is in an unrealized loss position (impaired)
- However, FASB clarified it may be done qualitatively or quantitatively similar to today
- If management believes credit loss may exist then DCF must be performed to estimate the amount

AFS Debt Securities

Items to consider when determining credit related issues

- The extent to which the fair value is less than the amortized cost basis
- Adverse conditions specifically related to the security (including the issuer), an industry, or geographic area
- The payment structure of the debt security
- Failure of the issuer of the security to make scheduled interest or principal payments
- Any changes to the rating of the security by a rating agency

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Off-Balance Sheet Commitments

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Common Off-Balance Sheet Commitments

- Legally binding agreements to extend credit can expose an institution to credit losses
- Common Types of Commitments

✓Commitments to extend credit

- Commitments to originate
- Unfunded lines of credit

✓Standby letters of credit

✓Commercial letters of credit (excluded from the scope of ASC 326)

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Accounting Today vs. Going Forward

Current Accounting Treatment (ASC 825)

- Follow ASC 450-20 which requires recognition if loss is both probable & reasonably estimable
- Report separately as a liability on the balance sheet & P&L impacts are recorded through non-interest expense
- Excludes commitments recorded as derivatives under ASC 815

Going Forward (CECL)

- Estimate expected losses over the contractual period obligated to extend credit
- Consider the likelihood that funding will occur
- Not required to estimate losses if unconditionally cancellable by the issuer
- Report separately as a liability on the balance sheet & P&L impacts are recorded through provision for credit losses
- Excludes commitments recorded as insurance & derivatives under ASC 815

Unconditionally Cancellable by the Issuer

- For accounting purposes, institutions must be able to, at any time, with or without cause, refuse to extend credit*
- Assets that are unconditionally cancellable are excluded from the scope, *e.g.*, credit cards
- There are differences in the requirements to identify unfunded commitments per regulatory capital rules – a fresh look is needed to ensure that all off-balance sheet commitments are identified for purposes of CECL

*Source: OCC Bank Accounting & Advisory Series

Unconditionally Cancellable by the Issuer

- Management will need to undergo an identification exercise to ensure that they have the complete population of off-balance sheet commitments
  - Obtain & review a sample of loan documents to understand contractual obligations for different products
  - This should be a coordinated effort between Finance & Credit teams
  - A legal analysis may be required to determine whether a contract is unconditionally cancellable
- Document conclusions reached!

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Key Considerations in Estimating the Reserve

- Appropriate segmentation
  - ✓Typically follow pooling for funded loans
  - ✓Could have different pools or individually assessed loans based on unique risk characteristics
- Likelihood that funding will occur (funding rate)
- Contractual period of exposure
- Leveraging methodology used in estimating credit losses on funded loans (usually calculated through the same modeling process)
  - ✓Risk of loss
  - ✓Economic forecast assumptions

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Other Considerations

- Estimating revolving commitments could be more challenging as management will need to consider the possibility of timing & frequency of future draws & repayments
- Ensuring accurate system information regarding funded vs. unfunded balances – once a portion of unfunded balance gets funded, it is now analyzed under the on-balance sheet CECL reserve
- If acquiring another financial institution after adopting CECL, would need to understand their off-balance sheet products in order to estimate a Day 1 liability
- Disclosure is required regarding the accounting policies & method used to estimate the liability

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Questions

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