

Financial Reporting Center – Credit Losses

Working Draft: Allowance for Credit Losses Implementation Issue

(with a focus on Lending Institutions and
Insurance Companies)



Issue #1: Zero Expected Credit Losses

Wording to be Included in the Allowance for Credit Losses- Audit and Accounting Guide (with a focus on Lending Institutions and Insurance Companies):

Background:

1. The FASB issued ASU 2016-13: Financial Instruments – Credit Losses (the “ASU”) in June 2016. The ASU provides a new current expected credit loss (“CECL”) model to measure impairment for financial assets (and instruments) measured at amortized cost. Under CECL, a measure of expected credit losses is required even if the expected risk of credit loss is remote. However, the ASU goes on to state that no measure of expected credit losses is required for a financial asset or group of financial assets if historical credit loss information, adjusted for current conditions and reasonable and supportable forecasts, results in an expectation of nonpayment of the amortized cost basis of zero. ASC 326-20-30-10 states:
2. *“326-20-30-10 An entity’s estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses. However, an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. Except for the circumstances described in paragraphs 326-20-35-4 through 35-6, an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral.”*
3. Consistent with Example 8 in the ASU, FinREC believes that the analysis of whether no measure of expected credit loss is required, focuses on an asset’s loss given default (LGD). The ASU explicitly contemplates the probability that an asset could default, but the lender would not experience any loss in such an event. While ASU uses a US Treasury security as an example of an instrument where an entity may conclude that the expectation of nonpayment is zero, the guidance notes that it is not intended to be applicable only to US Treasury securities. For example, there are other instruments that are explicitly or implicitly guaranteed by the US government that an entity may conclude that the expectation of nonpayment is zero.

4. Entities are responsible for the continuous evaluation and monitoring of the instruments within their portfolios and the associated factors which may impact the expectation of non-payment. Documented conclusions should be revisited to evaluate the impact of changes in current conditions and reasonable and supportable forecasts of future conditions, which may result in changes to previous conclusions.
5. For example, changes in current and/or future forecasted events such as periods of higher political uncertainty, heightened government budgetary concerns and widening credit or credit default swap spreads in liquid markets, along with other market, economic, geopolitical, and idiosyncratic factors, should be considered and may lead to conclusions different than those reached earlier. The underlying assumptions and considerations, and the forecasts of future conditions, should be consistent with those used in other internal analyses at the company (unless there is a documented explanation justifying any differences).

Products and Examples

6. The analysis of each product/example includes positive factors that may indicate that expectation of nonpayment is zero as well as negative factors that may indicate expectation of nonpayment should not be zero. The relative weighting of the factors will depend on the specific facts and circumstances.
7. BC63 of FASB ASU 2016-13 states:
 “The Board understands that an expectation of zero loss is entirely based on the nature and characteristics of a financial asset, which may change over time. As a result, the Board concluded that a ‘bright-line’ approach would be inappropriate for all facts and circumstances and decided not to provide explicit guidance on what specific assets are appropriate for zero credit losses. The Board determined that an entity should determine at the reporting date an estimate of credit loss that best reflects its expectations.”
8. Accordingly, FinREC believes management should document its analysis on a recurring basis and reasonable judgments regarding the same or similar assets might result in different conclusions on the expectation of nonpayment being zero.
9. The following examples are meant to be illustrative of an approach to evaluating whether the expectation of nonpayment is zero.

Example 1 – US Treasury Securities

10. Example 8 in the ASU (ASC 326-20-55-48 through 55-50) illustrates an example where the expected credit loss determination is zero, and outlines certain factors that may have had a bearing on the analysis. The ASU focuses on US Treasury securities broadly, and does not distinguish between short and long-term US Treasuries. The example assumes term is not an indicator of credit loss for this product.
11. The example includes the following qualitative factors, which may indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts.

<u>Indicators for zero loss</u>	<u>Indicators for loss > \$0</u>
<ul style="list-style-type: none"> ● High credit rating by rating agencies ● Long history with no credit losses (adjusted for current conditions and reasonable and supportable forecasts) ● Explicitly fully guaranteed by a sovereign entity of high credit quality ● Widely recognized as a “Risk free rate” ● It can print its own currency, and ● Its currency is routinely held by central banks, used in international commerce, and commonly viewed as a reserve currency 	<ul style="list-style-type: none"> ● Experience of a downgrade

12. Consistent with Example 8 in paragraphs 48-50 of FASB ASC 326-20-55, FinREC believes an entity’s management may conclude US Treasury securities with the above characteristics have an expectation of nonpayment of zero.

Example 2 - Ginnie Mae (GNMA) mortgage-backed security

13. Ginnie Mae provides liquidity to the secondary mortgage market by purchasing certain types of mortgage loans and issuing guaranteed mortgage-backed securities. Ginnie Mae guarantees investors the timely payment of principal and interest on mortgage-backed securities backed by federally insured or guaranteed loans, mainly loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA). GNMA mortgage-backed securities carry an explicit government guarantee (GNMA is an agency of the US government) and typically have a term of 30 years. The first GNMA MBS was issued in 1970.

<u>Indicators for zero loss</u>	<u>Indicators for loss > \$0</u>
<ul style="list-style-type: none"> • Long history with no credit losses (adjusted for current conditions and reasonable and supportable forecasts) • The product did not experience credit losses during the financial crisis. • Principal and interest payments are explicitly guaranteed by an agency of the US government. • The underlying collateral carries an US government guarantee on portions of amounts due, which provides an additional layer of risk protection. • Rates of return on these instruments are generally priced above risk-free; however, this is generally considered to be attributable primarily to non-credit related risk (prepayment risk and liquidity). Market participants generally do not price this instrument with the expectation of a credit loss. • Many market participants believe GNMA is essential in providing liquidity and stability to the US housing finance market. The implications of allowing it to collapse would be significant; thus, it is unlikely that the ultimate guarantor (US government) would not perform on its guarantee obligation in the event of a default. • Ultimate guarantor (US government) can print its own currency 	<ul style="list-style-type: none"> • Market does not price the product the same as risk free. • GNMA (as the guarantor) is a government agency and is subject to government appropriations.

14. FinREC believes an entity's management may reasonably conclude that GNMA mortgage-backed securities with the above characteristics have an expectation of nonpayment of zero.

Example 3 - Agency mortgage-backed securities

15. Fannie Mae and Freddie Mac (collectively referred to as issuers or agencies) provide liquidity to the secondary mortgage market by purchasing conventional conforming mortgage loans and issuing guaranteed mortgage-backed securities. The agencies guarantee the timely payment of principal and interest to investors in the mortgage-backed securities. Since September 2008 both entities have been under government conservatorship, operating under the direction of the Federal Housing Finance Agency (FHFA).

<u>Indicators for zero loss</u>	<u>Indicators for loss > \$0</u>
<ul style="list-style-type: none"> • Principal and interest payments on the product are guaranteed by the "issuing" agency. 	<ul style="list-style-type: none"> • Market does not price the product the same as risk free. • The explicit government guarantee is

- As part of entering into conservatorship, the agencies entered into a Purchase Agreement (through the FHFA) with the US government. Under the terms of the Purchase Agreement, the agencies can draw funds from the US Treasury in the form of additional investments up to a stated amount. Thus, the product carries an “explicit guarantee” from the US government up to this stated amount. Many market participants believe that the agencies benefit from an “implicit” guarantee in excess of the current available funding.
- Rates of return on these instruments are generally priced above the risk-free rate; however, this is generally considered to be attributable primarily to non-credit related risk (prepayment risk and liquidity). Market participants generally do not price this instrument with the expectation of a credit loss.
- Many market participants believe the issuers were essential in providing liquidity and stability to the US housing finance market. These market participants believe the implications of allowing them to collapse would be significant; thus, it is unlikely that the ultimate guarantor (US government) would not perform on its explicit and implicit guarantee in the event of a default. The US government performed on the guarantee during the 2008 financial crisis (which was, at best, “implicit” at that time), as the government stepped in and supported the issuers.
- The agencies issue standardized instruments (each security from each issuer is homogeneous from a credit risk perspective). Efforts are ongoing to “standardize” perceived credit and liquidity risk among Freddie and Fannie.
- Long history of no credit losses due to explicit and implicit guarantees by US government (on top of explicit support).
- The “guarantor” (US government) can print its own currency.

subject to a cap.

- Since 2012 the issuers have been required to distribute all profits to the US Treasury, i.e., the issuers are unable to build equity reserves (as they will decrease to zero in 2018) and would likely continue to rely on government support in the event of another financial crisis.
- Even though the issuers were bailed out during the last financial crisis in 2008, there is no guarantee that the issuers would be bailed out in the future.

16. FinREC believes an entity’s management may reasonably conclude US Agency mortgage-backed securities with the above characteristics have an expectation of nonpayment of zero.

Comments should be received by October 10, 2018, and sent by electronic mail to Jason Brodmerkel at Jason.Brodmerkel@aicpa-cima.com, or you can send them by mail to attention: Jason Brodmerkel, 1455 Pennsylvania Avenue NW, 10th Floor, Washington D.C., 20004.

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