Accounting for Debt Securities Under CECL

An interview with Rahul Gupta, Partner, National Professional Standards Group, Grant Thornton LLP

Now that the CECL and the related FASB Guidance have been released, institutions are in the process of getting a handle on how they will estimate their allowances based on expected credit losses. For one, CECL will be more inclusive – all financial assets "that have the contractual right to receive cash," according to the Guidance. Notably, that includes debt securities.

According to Grant Thornton's Rahul Gupta, there was considerable discussion among FASB members about not changing the way credit losses on debt securities are accounted for. But in the end, the Board determined that all debt securities will be treated under an allowance model.

"You are holding a security to collect your principle and interest payments, so you apply CECL," he explained. "The words in the Guidance are '*financial asset.'* It doesn't distinguish between a debt security and a loan. It simply refers to financial assets that are carried at amortized cost. This is how you will calculate your allowance for all such assets."

The two types of securities that must be included in allowance projections are those intended to be held to maturity (HTM) and those that are available for sale (AFS). A main difference between the two, for purposes of the estimating allowance, is that HTM securities must be pooled based on similar risk characteristics; AFS securities cannot be pooled and will be assessed on an individual basis.

"For HTM, you will have to look for reserves on a pooled basis," Gupta offered, "but for AFS, you're actually prohibited from looking at them on a pool basis."

Q&A

To learn more about how securities must be treated under CECL, we asked Rahul Gupta a series of questions:

Q. What does the Guidance say as to how to go about estimating credit losses on HTM securities?

Gupta. With securities, there is a little bit of disconnect from loans because the starting point on a loan is historical loss experience, which you might not have on a debt security. So the Guidance would say that you should not only look at the internal data but you should also look at external data – for example, many credit rating agencies

publish loss data on securities, which tell you the default rate on a AA rated security, and that is what you would use as an input to come up with your estimate for a held-to-maturity debt security.

Q. Are loans and securities grouped into a single reserve or are they separate?

Gupta. Loans are presented separately from securities. Therefore the allowance will also be presented separately on the balance sheet.

Q. What about credit enhancements?

Gupta. The Guidance says the estimate of expected credit losses shall reflect how credit enhancements, other than the freestanding contracts such as credit default swaps, mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and any subordinated interests. So if you have a credit default swap, you have to ignore that. But if you have a guarantee, you should include it.

Q. What does the guidance say about estimating AFS securities?

Gupta. The Board decided to retain most of the current guidance to assess losses on AFS securities, but made three changes to the current guidance. The most important is that the loss on AFS securities will be recorded through an allowance, instead of a direct write-off of amortized cost and the allowance will be limited to the difference between fair value and the amortized cost.

Q, Won't that be complicated?

Gupta. It will be complicated for institutions that have large AFS debt security portfolios.

Q. What were the other two changes?

Gupta. The second is that irrespective of whether the security has been under water for one day or 12 months, you have to assess it for impairment. The current practice is to wait for six to 12 months before a security is assessed for impairment because, it is asserted, it has not been under water long enough to be recognized as an impairment loss.

The third change is that any subsequent changes to the fair value of the security after the balance sheet date are to be ignored.

Rahul Gupta is a Partner in the National Professional Standards Group (NPSG) of Grant Thornton LLP and is based in the Chicago office. Rahul assists engagement teams and clients with technical accounting issues and monitors current accounting developments, under both U.S. GAAP and IFRS. Rahul is also involved in developing the firm's thought leadership on accounting issues, including liaising with Financial Accounting Standards Board (FASB), International Accounting Standards Board (IASB), AICPA and Securities and Exchange Commission (SEC). Rahul was a staff member at FASB from 2011 through 2015, first as a practice fellow and then as a senior project manager, where he provided technical depth and practical insight to assist the FASB in improving U.S. generally accepted accounting principles.