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SMARTER PERSPECTIVE: ENTERPRISE VALUATION

Ensuring Robust Valuations in a Volatile Market – Impact on Financial Institutions

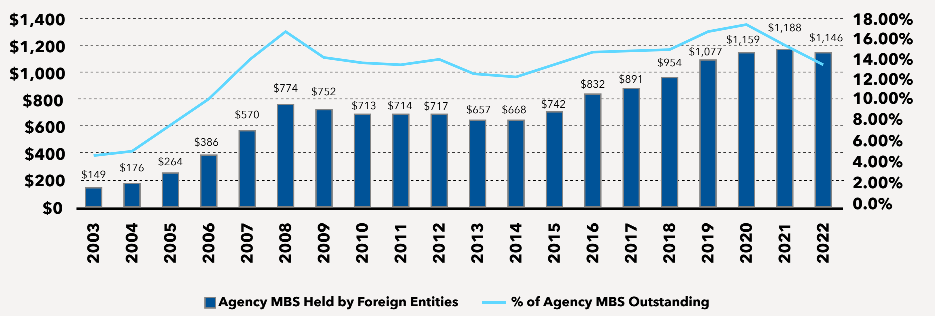
By Joseph Mevorah

May 2025 With recent market volatility, it is becoming increasingly important for US banks, credit unions and others to ensure that their ability to mark portfolios to market is extremely robust and accurate. Given Currently Expected Credit Losses ("CECL") reporting requirements, it is imperative that financial institutions have their models validated to ensure the accuracy and timeliness of valuation and reporting. This is particularly important not only in today's market, but also in consideration of a potential market sell-off by foreign investors. With the current economic tensions between the US/China and other nations, it is not unreasonable to consider the impact on portfolio valuations should China, and other foreign investors, embark on a massive, coordinated sell-off of US Mortgage-Backed Securities ("MBS"), Asset-Backed Securities ("ABS") and other securities.

According to GNMA "the pattern of aggregate foreign agency holdings over the past two decades has been one of growth, with the exception of the economic crisis years."

As of April 2025, China's holdings of MBS are significant, though decreasing. In 2024, China's MBS exposure was reduced by 8.7% year-over-year, and by early 2025, that decline reached 20%. Given that, it is not unreasonable to consider that China, and other countries, could significantly increase MBS sales, particularly as an economic or political defense.

Agency MBS Owned by Foreign Entities (USD Billions)



Source: TIC and Recursion data. As of June 30, 2022. Note: Data source changed from prior year as SIFMA Agency MBS database is under maintenance.

Collectively, foreign governments hold about $1.3 trillion in MBS. China, along with Japan, Taiwan, and Canada, is among the largest international holders. It is likely that the foreign ownership share varies from Fannie Mae to Freddie Mac to Ginnie Mae MBS. Ginnie Mae securities, with their explicit full-faith and credit guaranty of the United States generally have greater appeal to foreign investors than Fannie Mae or Freddie Mac securities, which are implicitly guaranteed. As of 4/11/2025 Foreign-Related institutions owned $1,783.3982 Trillion of Treasury and Agency Securities, of which $41.9876 Billion was comprised of MBS (FRED St. Louis Fed). Deposits from Foreign-Related institutions totaled $1,412.2453 Trillion as of 4/2/2025.

A big sell-off in MBS could have a variety of ripple effects across not only financial institutions, but on financial markets, the housing sector, and the broader economy. Initially, if investors sell off MBS prices will start to fall. Because of the inverse relationship between prices and bond yields, as prices fall, yields will rise. Higher MBS yields translate directly to higher mortgage rates. This means that there will be less activity in refinancing existing mortgage loans, and potentially a slowdown of new loan origination as mortgages become more expensive for consumers. Because of this, banks will not generate new loan origination fees.

Additionally, the value of loan and

MBS portfolios held by banks, pension funds and insurance companies will deteriorate as rates rise. A sell-off of MBS could mean mark-to-market losses on balance sheets of institutions holding loans and securities portfolios. As valuations deteriorate, banks with portfolios classified as available-for-sale ("AFS") may show paper losses. Though institutions with held-to-maturity ("HTM") pools may not show such losses, declining values can hurt institutions' capital ratios and reduce their flexibility to manage portfolio composition (i.e. note the Silicon Valley Bank situation where they had low yielding HTM MBS portfolios. As rates rose, values dropped, and the bank could not sell loans without taking losses). Though these losses may be unrealized there are regulatory implications. Potential losses may reduce regulatory capital (like Tier 1 or "core" capital) which can limit banks' ability to absorb such losses and continue to lend, forcing institutions to tighten credit. This means that banks may not be able to generate higher yielding new loans, and benefit from corresponding new loan origination fees.

Further, banks may experience liquidity issues due to falling MBS prices which will make it more difficult to sell loans for cash or make MBS portfolios held to be sold at a loss, as investor sentiment deteriorates due to fear of defaults, inflation and rate volatility. Having to hold these lower yielding portfolios can cause interest rate mismatch between assets held and the institution's cost of funds (including rates paid on deposits), negatively impacting net interest margin and capital positions.

A sell-off of MBS can also lead to changes in Fed Strategy which will impact both the broader economy as well as US banking institutions. As we noted in our previous market commentary, the Fed's mandate is to both keep markets stable and inflation at manageable levels (currently at a 2% target rate). To stabilize the market, the Fed may start buying MBS, as it did in 2020. Moreover, while the threat of inflation due to tariffs has caused the Fed to reconsider rate cuts, a declining MBS market will put further pressure on the Fed to pause rate cuts to stabilize pressure on yields.

All of this will be reflected in banks' accounting and regulatory reporting. The current expected credit loss ("CECL") model under Accounting Standards Update (ASU) 2016-13 aimed to simplify US GAAP and provide for more timely recognition of credit losses. CECL was implemented for financial institutions in phases, starting with public SEC filers in 2020 and then for all other entities, including credit unions, in 2023. Specifically, CECL became effective for fiscal years, beginning after December 15, 2019, for SEC filers, excluding smaller reporting companies (SRCs). For all other entities, including SRCs, CECL became effective for fiscal years beginning after December 15, 2022.

Because economic conditions have been generally positive since the implementation of CECL, many financial institutions' models have not been tested under much more volatile conditions we are currently experiencing. Given that, there is a significantly increased need for banks to validate their CECL models to ensure their accuracy and appropriate marking to market. Hilco Global is uniquely positioned to assist financial institutions in validating their CECL, and other models. Our experts will perform statistical analysis of model inputs to ensure that those models accurately reflect institution's adopted policies as well as portfolio composition and performance. Additionally, our experts will run comparative analysis to ensure that the inputs incorporated reflects current market conditions so that the output of banks' CECL models is both timely and accurate.

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