New Developments Summary

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FASB staff issues Q&As on credit losses

Q&As address 'WARM' estimation approach and other FAQs

Contents

As part of its ongoing efforts to assist entities with implementing the new guidance on credit losses in ASC 326, the FASB staff has issued two Staff Q&As:

- The first Q&A describes a simplified method for estimating the allowance for credit losses, known as the weighted-average remaining maturity (WARM) method.
- The second Q&A addresses frequently asked questions about using historical loss information and developing reasonable and supportable forecasts, as well as the requirements for applying the reversion to historical loss information.

A. Background

ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*, introduced the current expected credit loss (CECL) model for estimating expected credit losses. Under the CECL model, entities establish an allowance for credit losses (ACL) on financial assets measured at amortized cost by estimating lifetime expected credit losses. (For more on the CECL model, see NDS 2016-10 summarizing the guidance in ASU 2016-13 and NDS 2019-02 summarizing subsequent Codification improvements impacting the CECL model.)

After issuing ASU 2016-13, the FASB established the Transition Resource Group for Credit Losses (TRG) to assist entities with the implementation of the CECL model. The TRG has since held four public meetings to discuss questions submitted by stakeholders about applying the CECL model, which are summarized in the following NDSs:

- NDS 2017-07
- NDS 2018-08
- NDS 2018-15

The FASB staff identified several questions from stakeholders that were not discussed at the TRG meetings, however, and recently issued two separate Q&As to address these issues:

- FASB Staff Q&A – Topic 326, No. 1: *Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate Expected Credit Losses*
- FASB Staff Q&A – Topic 326, No. 2: *Developing an Estimate of Expected Credit Losses on Financial Assets*

B. Q&A No. 1: The WARM method

ASC 326 does not prescribe a method for estimating expected credit losses under the CECL model. Rather, the FASB has said consistently that a variety of methods may be acceptable under the CECL model and that even simple methods may be acceptable for less complex portfolios of financial assets, as stipulated in ASC 326 and in the Basis for Conclusions of ASU 2016-13.

ASC 326-20-30-3

The allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule. An entity is not required to utilize a discounted cash flow method to estimate expected credit losses. Similarly, an entity is not required to reconcile the estimation technique it uses with a discounted cash flow method.

Paragraph 50 in the Basis for Conclusions of ASU 2016-13

The Board acknowledges that any approach to estimating the collectibility of financial assets is subjective. The Board has permitted entities to estimate expected credit losses using various methods because the Board believes entities manage credit risk differently and should have flexibility to best report their expectations. The Board recognizes that different methods may result in a range of acceptable outcomes. Given the subjective nature of this estimate and certain fact patterns, one methodology's consideration of time value may have a more direct impact on the estimate of expected credit losses than other methods. Some entities may be able to forecast over the entire estimated life

> of an asset, while other entities may forecast over a shorter period. The complexity of the portfolio, size of the entity, access to information, and management of the portfolio may result in approaches with varying degrees of sophistication. Because entities may have different levels of sophistication, the Board did not prescribe one type of methodology for measuring expected credit losses for financial assets measured at amortized cost. The Board concluded that different outcomes for expected credit losses due to these and other factors are acceptable under the amendments in this Update. Furthermore, using terms such as *reasonable* and *supportable* does not imply a single conclusion or methodology upon which an entity must base its estimate. Different parties using different methodologies do not make a particular estimate unreasonable. While the range of reasonable outcomes is not unlimited, the Board concluded that it is rare that there will only be one acceptable choice in estimating credit losses. Estimates of credit losses may not precisely predict actual future events and, therefore, subsequent events may not be indicative of the reasonableness of those estimates.

In the first Q&A, the FASB staff describes the WARM method for estimating the ACL. The WARM method is a simplified method for estimating the ACL for a portfolio of financial assets that may be acceptable under the CECL model in certain circumstances. While certain aspects of this Q&A are summarized below, entities should read the full text before evaluating whether the WARM method may be appropriate in their particular circumstances.

How the WARM method works

The WARM method utilizes an average annual historical net charge-off rate for a portfolio of financial assets with similar risk characteristics to estimate expected credit losses over the weighted-average remaining maturity of that portfolio as of the balance-sheet date. The average annual net charge-off rate is adjusted to the extent that current conditions and reasonable and supportable forecasts differ from the conditions that existed during the historical period from which the entity's average annual historical net charge-off rate was derived.

This Q&A illustrates two different approaches for applying the WARM method but indicates that there may also be other acceptable approaches. The following steps illustrate one approach described in the Q&A in Question 3.

Step 1 – Calculate an average annual historical net charge-off rate

First, an entity is required to determine its historical average annual historical net charge-off rate. Although the guidance in ASC 326 does not prescribe how to determine the historical loss experience for a given portfolio of financial assets, an entity should consider the guidance in ASC 326-20-30-8 when determining the historical loss experience that is appropriate for a portfolio of financial assets when calculating the annual average historical net charge-off rate.

Q&A No 1 – Question 3 – Step 1

Table 1: Calculate Average Annual Charge-off Rate				
		A	B	C = B/A
Year	Amortized Cost	Average Balance	Actual Annual Net Charge-offs	Annual Charge-off Rate
2015	5,126			
2016	8,969	7,048	21	0.30%
2017	11,220	10,094	51	0.51%
2018	12,312	11,766	42	0.36%
2019	12,936	12,624	32	0.25%
2020	13,980	13,458	49	0.37%
			Average Annual Charge-Off Rate	**0.36%**

Grant Thornton insights: Determining the historical loss period

The CECL model requires an entity to make adjustments to its historical loss experience to the extent that current conditions and reasonable and supportable forecasts of future conditions differ from the conditions that existed during the historical period from which the historical loss experience was derived. The historical period from which credit loss experience is derived to calculate the average annual historical net charge-off rate is a significant judgment that needs to be properly supported and documented by the entity, and will influence the nature and level of adjustment necessary for current conditions and reasonable and supportable forecasts under the CECL model. For example, a longer historical period may result in a more stable average annual net charge-off rate, but it may also be more likely to include a diverse set of economic conditions, which might make it challenging to determine appropriate adjustments to the average annual net charge-off rate for current conditions and reasonable and supportable forecasts.

If the historical loss experience from which the annual average charge-off rate is calculated includes offsetting changes in economic conditions over a long period of time, it may be difficult to determine the expected impact of changing economic conditions on the single loss rate in the future.

Assume that an entity chooses a 15-year historical loss period that covers both an economic expansion and a recession to determine a single average annual historical net charge-off rate. Based on its reasonable and supportable forecast, the entity expects that economic conditions over the forecast period will be more adverse than 7 of the 15 years in the historical period, but less adverse than 8 of the 15 years. The entity may find it difficult to support the level of adjustment needed to the average annual charge-off rate for its assessment of current conditions and its reasonable and supportable forecast.

Step 2 – Estimate the ACL

In estimating the ACL under the WARM method (using the approach described in Question 3 in Q&A No. 1), an entity may apply the following approach, beginning with the actual amortized cost basis of a portfolio of financial assets that share common risk characteristics at the balance-sheet date:

- Project estimated annual paydowns for each year of the remaining contractual life of the portfolio, including both contractually required payments and estimated prepayments.
- Determine the projected amortized cost of the portfolio for each year of the remaining contractual life of the portfolio.
- Apply the average annual historical net charge-off rate to the projected amortized cost basis at each year-end over the remaining contractual life of the portfolio.
- Determine the expected lifetime unadjusted historical net charge-off rate over the remaining contractual life of the portfolio.
- Adjust the unadjusted historical net charge-off rate for current conditions and reasonable and supportable forecasts (called a "qualitative adjustment").

The table below, reprinted from Q&A No. 1, illustrates Step 2. From discussions with the FASB staff, we understand that the adjustment presented in the example below (25 basis points) is not intended to signal any expectations regarding the level of adjustments that may be required under the WARM method.

Q&A No. 1 – Question 3 – Step 2

Table 2: Estimated Amortized Cost Basis

		A	B	A*B
Year End	**Est Paydown**	**Projected Amortized Cost**	**Ave Annual Charge-off Rate**	**ACL**
2020 Actual Amortized Cost		13,980	0.36%	50
2021	3,700	10,280	0.36%	37
2022	3,900	6,380	0.36%	23
2023	3,000	3,380	0.36%	12
2024	2,160	1,220	0.36%	4
2025	1,220	-	0.36%	-
				126
Unadjusted historical charge-off rate for remaining balance				0.90%
Qualitative adjustment				0.25%
Total allowance for credit losses rate as of 2020				1.15%
Total allowance for credit losses as of 2020 (13,980*1.15%)				161

Grant Thornton insights: Assessing whether the WARM method is appropriate

When estimating the ACL under the CECL model, an entity should select an estimation method that results in the entity's best estimate of expected credit losses. The WARM method is not a practical expedient or a simplification of the CECL model, but instead is a simplified approach to applying the full CECL model, which may be appropriate for less complex portfolios of financial assets. The FASB staff indicates in Q&A No. 1 that entities should consider whether the WARM method is commensurate with the level of sophistication and complexity of their credit risk management processes when evaluating whether the WARM method is appropriate for a given portfolio of financial assets.

In addition, determining if the WARM method is appropriate for a portfolio of financial assets will also depend on whether certain assumptions that are inherent in the WARM method are characteristic of the portfolio of financial assets.

Some of the assumptions inherent in the WARM method include:

- The composition of the pool of financial assets at the measurement date is consistent with the composition of the pool during the historical period from which the historical loss experience was derived. An entity may consider relevant credit risk factors, such as the types of financial assets, geography of the borrower or collateral, collateral types and values, terms or underwriting, relative age of assets, and whether the assets were acquired or originated, among other factors.
- The portfolio of financial assets has sufficient size and historical loss experience to derive a reasonably predictive pattern of losses.
- The portfolio of financial assets exhibits a "flat loss curve." That is, the WARM method assumes that the annual rate of loss will be consistent for each remaining year of the portfolio's remaining contractual life. For many portfolios of financial assets, the rate of annual losses changes as the relative "seasoning" of the financial assets in the portfolio changes.
- The entity has sufficient historical experience to predict projected paydowns of the amortized cost basis, including both contractually required payments and expected prepayments

To the extent that assumptions inherent in the WARM method are not characteristic of a given portfolio of financial assets, an entity should consider making adjustments, which should be appropriately documented and supported, to the expected lifetime unadjusted historical net charge-off rate over the portfolio's remaining contractual life. If these adjustments cannot be adequately documented and supported for a portfolio of financial assets, the WARM method might not be appropriate for that portfolio.

C. Q&A No. 2: Estimating expected credit losses on financial assets

The CECL model requires entities to develop estimates of expected credit losses on portfolios of financial assets that share common risk characteristics by following these sequential steps:

- Determine historical credit loss experience of financial assets with similar risk characteristics, making any necessary adjustments for asset-specific risk characteristics.

- Adjust the historical credit loss experience for current conditions and reasonable and supportable forecasts to the extent that current and forecasted conditions differ from the conditions present during the period from which the historical credit loss experience was derived.
- Revert to historical credit loss experience for the portion of the contractual life of the portfolio of financial assets that extends beyond the entity's reasonable and supportable forecast period.

ASC 326-20-30-8

Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. Historical loss information can be internal or external historical loss information (or a combination of both). An entity shall consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the contractual term of the financial asset or group of financial assets.

ASC 326-20-30-9

An entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data (such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets). Some entities may be able to develop reasonable and supportable forecasts over the contractual term of the financial asset or group of financial assets. However, an entity is not required to develop forecasts over the contractual term of the financial asset or group of financial assets. Rather, for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity shall revert to historical loss information determined in accordance with paragraph 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets. An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.

The second FASB Staff Q&A addresses certain questions related to each of the three steps described above. While certain questions and answers in this Q&A are summarized below, entities should read the full text before implementing the staff's guidance.

General

Use of computer-based modeling

The FASB staff emphasizes that entities are not required to utilize complex, computer-based modeling to make adjustments to historical credit loss experience for current conditions and reasonable and supportable forecasts. Further, the staff indicates that such adjustments may be either quantitative or qualitative in nature.

Grant Thornton insights: Qualitative adjustments

While adjustments to historical loss experience for current conditions and reasonable and supportable forecasts may be qualitative in nature, these adjustments must still be both well documented and well supported. Qualitative adjustments may or may not be based on complex mathematical analysis (such as statistical regressions or econometric analysis), and entities often use historical data to support not only that the adjustment is directionally consistent with the change in current conditions and reasonable and supportable forecasts, but is also quantitatively sufficient.

Modifying forecast methodologies

Estimates of expected credit losses are inherently imprecise, and differences between actual losses and forecasts of losses may not indicate that a prior estimate was in error. However, the FASB staff indicates in Q&A No. 2 that entities should continue to refine future estimates of expected credit losses based on actual experience.

Historical loss information

Use of only historical loss information

An entity may not base its estimate of the ACL solely on historical loss information, but must also consider whether adjustments for current conditions and reasonable and supportable forecasts are necessary.

Determining what historical loss information to use

Entities must use judgment when selecting historical loss information. Nonsequential historical loss information is acceptable, and an entity is not required to use the most recent historical loss information.

Grant Thornton insights: Determining what historical loss information to use

In addition to determining the length of the historical charge-off period from which an entity derives its historical credit loss experience (as discussed above under Q&A No. 1), entities may also make judgments about which historical periods to use when estimating credit losses. Some entities may consistently utilize more recent historical periods and then make adjustments to reflect the differences between conditions present during the historical period, and current conditions and reasonable and supportable forecasts. Other entities may make their reasonable and supportable forecasts, and then use the historical loss information from historical periods where similar economic conditions were present. Both approaches, as well as the use of nonsequential historical information, may be acceptable.

Reasonable and supportable

Consideration of internal and external sources of information

Q&A No. 2 clarifies that an entity is not required to perform an exhaustive search of all available information when estimating the ACL. However, an entity should consider all information that is reasonably available without undue cost and effort. Additionally, if external information is not unduly costly, but the entity determines that its internal data is more relevant, it is not required to obtain or use the external data. An entity should document its considerations of the various data sources, including why it chose the information it uses and why it did not choose to use other information.

Reasonable and supportable forecast period

The reasonable and supportable forecast period is an element of an entity's estimate of expected credit losses. Accordingly, as facts and circumstances change, the entity might change the length of its forecast period. For instance, an entity may be able to forecast for a longer period during times of relative economic stability but for a shorter time during periods of relative economic instability. Additionally, an entity is not required to forecast for the full contractual life of a portfolio of financial assets. An entity should assess its reasonable and supportable forecast period at each financial reporting date.

An entity should consider forecasts that are most relevant to its estimate of expected credit losses for a given portfolio of financial assets, which may not include correlating expected credit losses to macroeconomic variables. For instance, a portfolio of loans in a particular geographic region may be significantly impacted by a discrete event, such as the closure of a major employer in the region. An entity should document its considerations of the various matters considered in its forecast, including why it chose to forecast certain matters and why it chose not to forecast other matters.

Reversion

Method and timing of reversion

An entity is not required to develop a reasonable and supportable forecast for the full contractual life of a portfolio of financial assets. For the contractual life of a portfolio of financial assets that extends beyond the forecast period, the entity should revert to its historical loss experience. The method and timing of this reversion is an element of an entity's estimate of expected credit losses and should be evaluated at each reporting period. The method selected should be the method that results in the entity's best overall estimate of expected credit losses, and the entity should document its basis for selecting that method.

During the reversion period (and any contractual period beyond the reversion period, known as the "post-reversion period"), an entity should not adjust its historical loss experience for current conditions or its expectations about future conditions. However, an entity should adjust historical loss information for asset-specific differences, such as changes in the composition of the portfolio of financial assets or changes in terms of the financial assets that comprise the portfolio.

Grant Thornton insights: Reversion to historical loss experience

While an entity must revert to unadjusted historical loss experience (except for asset-specific factors), it may revert to different historical loss experience than the baseline historical loss experience that it adjusted for current conditions and reasonable and supportable forecasts.

For instance, assume that an entity determines that a particular unemployment rate is the most relevant predictor of credit losses for a particular portfolio of financial assets. At the reporting date, the relevant unemployment rate is 8 percent, and the entity derives its historical loss information from a historical period in which the unemployment rate averaged 8 percent. However, over the next two years, the entity forecasts that the unemployment rate will rise to 10 percent. The entity may revert to unadjusted historical loss information derived from a historical period during which the unemployment rate averaged 10 percent, but may also revert to other appropriate historical loss information.

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