Working Draft:

Allowance for Credit Losses Implementation Issue

Issue #6: Reasonable and Supportable Forecast – Developing the Period and Use of Historical Information

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. FASB ASC 326-20 is a measurement standard, the objective of which is for an entity to use all reasonably available information to arrive at its estimate of expected credit losses ("ECL"). While a key overarching principle of FASB ASC 326-20 is for an entity to "report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current **estimate** of expected credit losses on financial asset(s)" (326-20-30-1), there is a range of considerations included in the standard that an entity will likely consider in arriving at its estimate.

2. The notion that FASB ASC 326-20 is a measurement standard on how to estimate ECL is supported in various sections of the Basis for Conclusions in FASB Accounting Standards Update (ASU) No. 2016-13 ("BC"), particularly BC 50-53 & 63. As a measurement standard that fundamentally involves management's estimate of ECL, significant judgment is required. FASB acknowledged that entities manage credit risk differently and should have flexibility to best report their expectations. Accordingly, FASB ASC 326-20 provides significant flexibility in the method or approach used to measure expected credit losses.

3. Certain parts of FASB ASC 326-20 provide explicit boundaries on how management may estimate ECL. For example, an entity is precluded from estimating credit losses when its credit exposure is unconditionally cancellable or from estimating an extended contractual term of an instrument that it expects to extend, modify or renew (other than a Troubled Debt Restructuring ("TDR")). Further, there are several practical expedients (i.e., explicit accounting policy elections) that may be chosen such as for financial assets that are collateral-dependent or secured by collateral maintenance provisions.

4. In certain other instances FASB ASC 326-20 has minimal or no constraint regarding the process or considerations by which management's estimate may be made. For example, an entity may use various methods to determine the allowance for credit losses and is not required to use a discounted cash flow method, nor reconcile the estimation technique it uses with a discounted cash flow method.[1]

[1] At its meeting on Sept. 6, 2017, FASB "agreed with the staff's recommendation that at the point at which an individual loan is specifically identified as a reasonably expected TDR, an entity must use a Discounted Cash Flow (DCF) method

5. However, implementation issues have been raised regarding whether certain paragraphs in FASB ASC 326-20 impose additional practical boundaries or limits on elements of management's ECL estimate. Many of those questions relate to the judgments included in FASB ASC 326-20-55-6, which states:

> Estimating expected credit losses is highly judgmental and generally will require an entity to make specific judgments. Those judgments may include any of the following:
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> a. The definition of default for default-based statistics
> b. The approach to measuring the historical loss amount for loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off and whether there should be adjustments to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest
> c. The approach to determine the appropriate historical period for estimating expected credit loss statistics
> d. The approach to adjusting historical credit loss information to reflect current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period
> e. The methods of utilizing historical experience
> f. The method of adjusting loss statistics for recoveries
> g. How expected prepayments affect the estimate of expected credit losses
> h. How the entity plans to revert to historical credit loss information for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses
> i. The assessment of whether a financial asset exhibits risk characteristics similar to other financial assets

FASB ASC 326-20-55-6 provides that an entity may use both historical loss information adjusted for its reasonable and supportable forecast and reversion to historical loss information in its estimate of expected credit losses.

6. Specifically, questions have been raised regarding what limitations or parameters may exist (if any) with respect to how certain of these judgments, both individually and in the aggregate with other judgments, are made and how such judgments interact with each other. In particular, questions have arisen relative to the interaction of the reasonable and supportable forecast period ("forecast period") and the period following the reasonable and supportable forecast period ("reversion period") through the end of the asset's contractual life.

7. In BC53, FASB discusses the reasons that FASB ASC 326 provides guidance on how to measure estimated credit losses as "an entity moves into periods of increasing uncertainty and decreasing precision" with respect to its forecast of future economic conditions. That method involves the using a reversion period that places a high degree of emphasis on historical losses. However, FASB ASC 326-20-30-9 is clear that some entities may be able to use a forecast period that is consistent with the contractual life of the asset.

8. Whether and when the reversion period begins is a matter of significant judgment and will vary from entity to entity. In BC 52, FASB acknowledged that "as the forecast horizon increases, the degree of judgment involved in estimating expected credit losses also increases." Despite the increasing uncertainty, it is clear that because the fact that the reversion period begins after the forecast period does not mean the estimate in the reversion period is not required to be both reasonable and supportable, in the context of the overall estimate of expected losses. This is because ASC 326 requires estimation of lifetime expected credit losses (i.e., over the contractual term, adjusted for prepayments). Consequently, expected credit losses during the period beyond the reasonable and supportable forecast period must be captured. Reversion is a way to accomplish that. The reversion period serves to some degree as a backstop to ensure entities do not estimate zero losses during the period when increasing uncertainty and declining precision become more significant.

9. Decisions about the length of the forecast period, forecasting methodologies and the existence, length and use of historical data in the reversion period must be evaluated in contemplation of each other, and in the context of the estimate as a whole.

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if the TDR involves a concession that can be captured using only a DCF method (or a reconcilable method)." (https://www.fasb.org/jsp/FASB/FASBContent_C/ActionAlertPage&cid=1176169315419&rss=1).

10. Further, though these issues are important individually, they are more important when considered together along with **all** of the other judgments, techniques and methods that contribute to management's ECL estimate.

11. The use of forecasted financial information is prevalent in accounting; however, FASB ASC 326 does not provide prescriptive guidance on how long the forecast period should be or how a forecast should be developed. In addition, FASB ASC 326 provides for flexibility in the use of reversion techniques for estimating expected credit losses. As a result, differing approaches to forecasting, including determining the forecast period, and reversion will exist among entities.

12. For example, some entities may utilize statistical concepts in their process to arrive at a reasonable and supportable forecast for certain or all relevant economic variables. Such statistical concepts sometimes are referred to as "reversion techniques." Reversion in this context should not be confused with reversion as it is described in ASC 326-20-30-9, i.e., reversion in the period beyond the reasonable and supportable forecast period. Other entities may not use statistical or "reversion techniques" in their reasonable and supportable forecasts and only utilize reversion as contemplated in FASB ASC 326-20-30-9.

13. As previously noted, entities will need to support the estimate of expected credit losses in its entirety. As such, either of the approaches described in paragraph 13 is acceptable.

14. Though the standard necessarily discusses the various judgments individually, ultimately management must also support its estimate for each individual or pool of in-scope financial assets as discussed in FASB ASC 326-20-30-2.

15. Certain implementation issues have been identified with respect to developing reasonable and supportable forecasts and reverting to historical losses in accordance with FASB ASU No. 2016-13: *Financial Instruments – Credit Losses*. This exposure draft discusses two of those issues independently, even though the estimate of expected credit losses ultimately requires the issues to be contemplated together along with all other elements of the estimate as noted previously. The first topic addresses considerations an entity would use to determine its reasonable and supportable forecast period. The second topic discusses how an entity would determine the historical loss information it will revert to once it is beyond a period in which it can make or obtain reasonable and supportable forecasts of future conditions that affect expected credit losses. [2]

Accounting Guidance

16. FASB ASC 326-20-30-6 requires "an entity to estimate expected credit losses over the contractual term of the financial asset(s)". In order to do this, an entity is required to consider available information relevant to assessing collectability of cash flows. This available information may include internal and external information relating to past events, current conditions, and reasonable and supportable forecasts.

17. FASB ASC 326-20-30-9 recognizes that some entities may be able to develop reasonable and supportable forecasts over the entire contractual term of the financial asset. However, an entity is not required to develop forecasts using solely forward-looking information over the entire contractual term. Further, FASB ASC 326-20-30-9 states: "For periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses", the entity shall "revert" to historical loss information determined in accordance with FASB ASC 326-20-30-8.

18. Per FASB 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 to reflect 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."

[2] The exposure draft does not contemplate all of the stand-alone or interrelated issues associated with the topics summarized herein. Examples may include, certain general forecasting considerations (as opposed to focusing on the length of the forecast period), the depth of the loss data maintained by the entity, changes in underwriting, the strength of the correlation between loss drivers and loss experience.

19. FASB ASC 326-20-30-9 further states that when an entity is beyond the reasonable and supportable forecast period, it should not adjust historical loss information for existing economic conditions or expectation of future economic conditions.

Considerations when developing the reasonable and supportable forecast period

20. Paragraphs 7-9 of FASB ASC 326-20-30 provide guidance on the development of reasonable and supportable forecasts. Specifically, FASB ASC 326-20-30-9 states, "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 conditions that existed for the period over which historical loss information was evaluated."

21. FinREC believes the considerations listed here may be useful to entities in determining their reasonable and supportable forecast period.

    a. The entity's process for determining the reasonable and supportable period should be consistent with the guidance of SEC Staff Accounting Bulletin: No. 102 – Selected Loan Loss Allowance Methodology and Documentation Issues. For example, the entity should apply a process consistently, in a systematic manner, and ensure that it is well documented.

    b. The length of the reasonable and supportable forecast period is a judgmental determination based on the level to which the entity can support its forecast of economic conditions that drive its estimate of expected loss.

    c. The reasonable and supportable forecast period should reflect management's estimate at the balance sheet date based on all relevant data that is reasonably available without undue cost and effort.

    d. It is expected that actual economic conditions will, in many circumstances, turn out differently than forecasted. This is because the ultimate outcomes during the forecast period may be affected by events that were unforeseen, such as fiscal or monetary policy actions. This is exacerbated the longer the forecast period management used when estimating an allowance. This uncertainty would be relevant to the entity's confidence level as to the outcomes being forecasted. That is, an entity is likely less confident in the ultimate outcome of events that will occur at the end of the forecast period as compared to the beginning. As a result, actual future economic conditions may not be an effective indicator of the quality of management's forecasting process, including the length of the forecast period. However, significantly missing near-term forecasts *may* be an indicator of a deficient forecasting process.

    e. It is important to distinguish between "back-testing" the entity's forecast of future economic conditions versus "back-testing" the allowance for credit losses. Efforts to compare the entity's actual experienced losses against prior overall estimates of expected credit losses may be of little value due to the uncertainty involved in the estimate. For instance, an economist is likely to use back-testing to assess potential forecasting process refinements and evaluate the modeled effects of projected economic conditions on historical loss information.

    f. There are no bright lines in selecting the reasonable and supportable forecast period, which adds to the complexity of the judgments involved.

    g. An entity should support its determination of a reasonable and supportable forecast period by documenting the factors considered and judgments applied, as opposed to simply selecting a period.

    h. Since the ability to support economic forecasts has an impact on the reasonable and supportable forecast period selected, selection of a period will be influenced by the sources of information chosen by the entity to develop the forecast and, more specifically, the period of time covered by that information.

    i. Due to the extent of judgment being applied the reasonable and supportable forecast period often may differ among entities (similarly, it is expected that overall ECL methodologies will vary among entities).

j. The economic assumptions and forecast period should be relevant to the portfolio. For example, a national economic forecast might not be appropriate, or might need to be adjusted, for a portfolio of borrowers within a narrow geographic area.

k. Since different economic forecasts might be used for different geographies, in some circumstances the length of the reasonable and supportable forecast period may differ among entities or among asset portfolios within an entity. Similarly, the length of the reasonable and supportable period may differ when different economic assumptions are relevant for different types of financial assets. For example, unemployment rates may be a key assumption for some assets, but a home price index may be a key assumption for other assets, and an entity might conclude that those inputs may be supportable for different periods. However, an entity would be expected to consider whether the assumptions underlying its economic forecasts among various asset portfolios are consistent with one another and reflect a "common view" of future economic conditions within an entity, especially when different sources are used for different assumptions.

l. An entity is not required to use a consistent set of inputs throughout the forecast period. Instead, it may determine that the availability of inputs may decline later in the forecast period. However, that does not mean that the entity would not be able to develop a reasonable and supportable forecast for the entire period. For example, an entity may develop a forecast for a five-year period using a significant number of inputs for years 1, 2, and 3, and find that fewer inputs are available for years 4 and 5. In this situation, the entity may determine that, in its judgment, the forecast is reasonable and supportable for the entire five-year period. In this example, the entity would conclude that, while the precision of its estimates may decrease over the five-year period, in its judgment the forecast is reasonable and supportable for that entire period.

m. If an entity has forecasted future economic conditions in the development of other estimates in the financial statements (e.g., goodwill impairment tests, fair value) or for business planning and those economic conditions are relevant to the allowance estimate, then the reasonable and supportable forecast would take into consideration the assumptions of future economic conditions forecasted in the other estimate. If different assumptions are used, the entity would be expected to be able to explain the rationale for the difference and provide appropriate supporting documentation. For example, management's assumptions for key economic conditions (baseline/ up/ down, as applicable) are expected to be consistent across relevant financial statement estimates that use forecasted economic conditions.

n. Though some entities may be able to develop reasonable and supportable forecasts for longer periods than other entities, all entities are expected to be capable of developing forecasts for some reasonable and supportable period. As described in FASB ASC 326-20-30-9, an entity should not rely solely on past events to estimate expected credit losses.

22. FinREC believes entities should consider the appropriateness of the reasonable and supportable forecast period along with all other judgments required to arrive at management's current estimate of expected credit losses at each reporting date. Circumstances that may occur and cause an entity to change the length of the reasonable and supportable forecast period include when the sources of supporting information for the forecast changes or when the period of time covered by the supporting information changes. FinREC believes processes and related controls are necessary to support this ongoing evaluation.

Determining appropriate historical loss information for the reversion period (use of long-term average versus other methods)

23. Beyond the forecast period that is reasonable and supportable, an entity is required to revert to historical experience determined in accordance with FASB ASC 326-20-30-8 and that is reflective of the contractual term of the financial asset or group of financial assets. FASB ASC 326-20-30-9 states, "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."

24. FinREC believes that FASB Accounting Standards Update No. 2016-13: *Financial Instruments – Credit Losses,* provides flexibility when choosing the historical period information to be used for reversion.

25. FinREC believes that all components of the expected credit loss estimate should be supported. While FASB ASC 326 differentiates between the reasonable and supportable forecast and reversion periods, such delineation is generally not a determinative factor in evaluating the appropriateness of the overall ECL estimate[3]. For example, as part of its overall estimate of expected credit losses, an entity may within the FASB ASC 326-20-30-9 reversion period:

    a. Select a historical data set(s) for reversion that includes a view of what economic conditions may look like in the future for management to arrive at its current estimate of expected credit losses; or

    b. Use a combination of different historical data sets in the reversion period (e.g., point in the cycle data for initial reversion years and long-term average for the tail).

26. FinREC believes that FASB ASC 326 does not preclude either of these approaches. Further, entities will need to use judgement, including consideration of economic conditions in the FASB ASC 326-20-30-9 reversion period, in determining its reversion period approach.

27. FinREC believes the estimate in the reversion period is required to be both reasonable and supportable in the context of the overall estimate of expected losses. Further and consistent with FASB ASC 326-20-55-6 h., entities will need to support both the reversion technique selected (e.g., immediate, on a straight-line basis or any other rational and systematic method) and the historical data selected that an entity will revert to (e.g., long-term average, through the cycle loss rates, etc.) in the context of the overall estimate. FinREC believes processes and related controls are necessary to support this ongoing evaluation.

28. FinREC believes decisions about the length and use of historical data in the reversion period should be evaluated in conjunction with all other judgments, including those listed in FASB ASC 326-20-55-6, and in the context of the estimate as a whole.

29. FinREC believes that while consideration of FASB ASC 326-20-30-9 is important individually, it is more important when considered together along with **all** of the other judgments (FASB ASC 326-20-55-6), techniques and methods that contribute to management's ECL estimate. While the standard necessarily discusses the various components of the expected credit loss estimate individually, ultimately management must also support its estimate for each individual or pool of in-scope financial assets as discussed in FASB ASC 326-20-30-2.

30. According to FASB ASC 326-20-30-9, an entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions in the reversion period. However, the guidance in FASB ASC 326 does not preclude using statistical reversion techniques to adjust historical information in order to arrive at a best estimate of expected credit losses if such techniques are part of the reasonable and supportable forecast period. Reversion in this context should not be confused with reversion as it is described in FASB ASC 326-20-30-9.

31. If an entity determines its initial expected credit loss estimate does not appropriately reflect its expectations, including consideration of future economic conditions, it might consider adjusting the estimate by reconsidering the length of the reasonable and supportable forecast period (i.e., it may determine that additional adjustments are required to be made to historical loss information and therefore the reasonable and supportable forecast period is longer and the reversion period is shorter than its initial estimate).

Comments should be received by December 31, 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.

[3] FASB ASC 326-20-50-10 requires disclosure by portfolio segment and major security type about management's method, information used and circumstances that led to changes in the allowance for credit losses. In order to meet those objectives, FASB ASC 326-20-50-11 lists several elements of the estimate that an entity must disclose including information related to the "reasonable and supportable forecasts about the future" and "the reversion method applied for periods beyond the reasonable and supportable forecast period."