

---

**CECL Implementation Concerns on WARM  
And the Need for Comprehensive CECL Guidance  
For Community Banks**

*A Discussion Paper of the*

AMERICAN BANKERS ASSOCIATION

ABA Contacts:

Michael L. Gullette  
SVP, Tax and Accounting  
[mgullette@aba.com](mailto:mgullette@aba.com)  
202-663-4986

Joshua Stein  
VP, Accounting and Financial Management  
[jstein@aba.com](mailto:jstein@aba.com)  
202-663-5318

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in estimating and managing expected credit losses.

**Table of Contents**

**Executive Summary**.....3

**Summary of Technical Discussion Points**

    Purpose and Scope .....4

    Background.....4

    Non-Complex Banks Should NOT focus on the WARM Method.....4

    ABA Proposes a Framework to Review and Measure “Q Factors”.....5

    Regulators Need to Provide Non-Complex Banks Comprehensive Guidance.....6

    Regulators Should Request a CECL Practical Expedient, Provide Loss Rates to Banks...7

**Detailed Discussion**

    Background.....8

    Weighted Average Remaining Maturity (WARM) Method of Credit Loss Estimation....10

    ABA Recommended Community Bank Q Factor Analysis Framework.....16

    Final Assessment and Recommendations.....20

**Appendix A: CECL Q Factor Analysis vs. Current Practice**..... 23

**Appendix B: ABA CECL Resources**.....26

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

## **Executive Summary**

Portfolio-level life of loan credit loss measurement and analysis is inherently complex, no matter the complexity of the institution. In the two-and-a-half years since the CECL standard was issued, the only substantial guidance provided to community banks from FASB or the banking regulators is that the Weighted Average Remaining Maturity (WARM) credit loss estimation method “may be acceptable.” No guidance has addressed the critical “Q factor” risk analysis process or the foreseeable questions resulting from required disclosures. ABA believes banks that rely on WARM are setting themselves up for significant challenges that exceed those to be experienced if they used other estimation methods. In fact, a bank that relies on WARM will likely perform more procedures for both the starting point calculation and the Q factor analysis than if it first relied on other estimation methods to calculate a starting point calculation. This can also be dangerous to banks that may believe they can significantly reduce the data and processing costs of CECL by relying on WARM, as they will have limited flexibility to change as general CECL practice evolves through the industry.

ABA presents a four-part framework to address the 23 risk characteristics and factors detailed in the CECL standard that set the basis for Q factor risk analysis and invites others to provide other frameworks. However, ABA has three main recommendations:

1. Believing that the lack of quality guidance has prevented many smaller banks from making significant progress in their implementation efforts, ABA recommends that the banking regulators call for a delay to the CECL effective date until substantial practice guidance is issued.
2. To alleviate the burden many banks will have in forecasting losses in the future on a regular basis, ABA is recommending that FASB approve a practical expedient that would allow a bank to record a credit loss allowance based on “through the cycle” loss rates.
3. Since many banks will struggle to have sufficient credit loss history, ABA recommends that granular “through the cycle” loss rates be acquired by the banking agencies and provided to smaller banks on a regular basis. Whether used for the practical expedient or not, such rates will be easier to calculate than those in WARM and will provide a common basis for banks to discuss their risk characteristics.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

## **Summary of Technical Discussion Points**

### **Purpose and Scope**

- This Discussion Paper is part of a series of ABA papers that address CECL implementation. Many of the discussion points made in this paper are addressed in previous ABA papers, which are available on ABA.com/CECL. While this paper specifically addresses the “Q factor analysis process” in general, future discussion papers will address how specific estimation methods fit into the process.

### **Background**

- Many community banks and credit unions have voiced concerns over the complexity of modeling credit loss expectations within Accounting Standards Update 2016-13 (the CECL Accounting Standard). In response, banking regulators have publicly stated that the expected complexity of modeling credit losses under CECL will be consistent with the complexity of the institution. With that in mind, many institutions have requested that the regulators provide specific calculations, formulas, and examples to assist in their CECL estimates.
- FASB and banking regulators have presented the “Weighted Average Remaining Maturity” (WARM) method as a possible estimation method that “may be an acceptable method” as a starting point for CECL for non-complex institutions. ABA warns that a competent CECL implementation involves more than specific calculations. Given the larger playing field of CECL (“life of loan” charge-offs vs. the 12-24 months within incurred losses for many banks), the risk factor analysis (which often may be referred to as “Q factor analysis”) becomes the most critical aspect of any CECL implementation.

### **Non-Complex Banks Should NOT Focus on the WARM Method**

- While the CECL standard does not prescribe specific methods for estimating credit losses, ABA notes several critical issues relating to the WARM method that lead ABA to recommend that banks **not** rely on performing WARM when planning their CECL implementation process. Critical aspects of WARM, as they relate to use by a non-complex institution, include:
  - WARM’s primary reliance on an entity’s forecast of prepayments introduces significant new work on a quarterly basis and a skill-set that personnel at non-complex institutions normally do not have.
  - For certain loan products, WARM is not generally accepted by the auditing and credit loss modeling industry, as it assesses credit risk only over the average life – as opposed to the entire life – of a portfolio. Showing how WARM is the worst among several

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

estimation methods in providing early warnings toward higher losses, a paper sometimes cited by FASB during CECL discussions even notes “In short, WARM should not be used for CECL.”<sup>1</sup>

- During times of changing loan production, interest rate levels, and/or credit conditions, initial reliance on WARM calculations can make it more complicated (relative to using other estimation methods) for a bank to explain changes in credit conditions and to measure Q factor adjustments.

While regulators and FASB expect for banks to use WARM only to provide a starting point estimate, these issues cause ABA to believe bankers should merely record a loss rate that uses both the highs and the lows of an economic cycle for a starting point. Such a “through the cycle” calculation is easy, avoids the problems noted above, and also provides the board with an important metric that reflects the long-term level of risk in the portfolio.

- Since incremental data and processing requirements for a WARM calculation are minimal, if banks focus solely on WARM (or any specific other estimation method) during their CECL implementation, they will likely be insufficiently prepared to address critical foreseeable circumstances across their portfolios. This will likely result in more ongoing work, higher costs, and significant implementation problems subsequent to initial implementation. It could delay a competent CECL implementation by several years.

#### **ABA Proposes a Framework to Review and Measure “Q Factors”**

- Whether performed through WARM or through another estimation method as a starting point calculation, a basic Q factor analysis will be needed in CECL. There are 23 risk factors and characteristics listed in 326-20-30-4 and -5 that the CECL standard suggests could be factors. To streamline such an analyses, ABA proposes a process whereby smaller banks may focus on the quantitative impact of four general areas:
  - Changes in portfolio mix: Banks will need to recognize that certain loan types, terms and underwriting practices (such as policy exceptions) have significantly different loss expectations at origination.
  - Changes in loan performance: Certain estimation methods (including WARM) do not address changes in past due loans or risk ratings. Banks will, thus, need to address how changing loan performance affects the starting point estimate. Since a CECL estimate implies that this performance was anticipated at origination, this can be a challenge.

---

<sup>1</sup> See Breeden, Joseph, September 4, 2018: “CECL Procyclicality: It Depends on the Model.”

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

- Changes in loan age and maturity: Certain loan products (such as those subject to prepayment) have generally accepted expected loss patterns, based on loan seasoning. The very low likelihood of default during the first year of a residential mortgage and after the fifth year is one example. Other products (such as many in commercial real estate) have loss patterns focused on the time of maturity or renewal.
- Changes due to the forecast of the future and collateral: No matter the estimation method, a bank will need to perform analysis to quantitatively estimate the impact of forecasted economic conditions. A forecast of collateral prices is often an important part of this.

ABA provides recommendations on how community banks can perform these analyses to provide reasonable quantitative support for any needed adjustments and to credibly respond to commonly foreseen questions by examiners, auditors, and board members. Due to the complexities of CECL's requirement to forecast lifetime credit risk at a point in time, executing such a framework includes significant changes to the data and processes from current practice. However, without such a framework, quantitative estimates and explanations will often appear arbitrary and confusing and the ability for a bank to efficiently change as CECL industry practice evolves will be limited.

- During the CECL implementation process, bankers cannot focus on narrow calculations or specific methods. Bankers must take a comprehensive view, which also includes:
  - The Q factor analysis process and how specific estimation methods directly address certain critical credit risk factors.
  - How credit risk will be disclosed and discussed during board meetings, and
  - How readily available third-party credit loss data may be used by examiners, auditors, and board members.

Most importantly, however, banks need to remember that auditor, examiner, and management priorities will likely change in the future. Therefore, CECL practices (and resulting methods and data requirements) will likely change. Therefore, flexibility must be a critical aspect of any competent CECL implementation. This includes a wide range data points that enables a wide range of different analyses. With access to such data, banks can, over time, determine the best estimation processes, in light of their specific portfolios.

### **Regulators Need to Provide Non-Complex Banks Comprehensive Guidance**

- While non-complex banks may be allowed to utilize less complex models, life of loan credit risk analysis is not easy and smaller banks and credit unions are waiting on regulators and FASB to tell them how to proceed. In the two-and-a-half years since the CECL standard has been issued, the only guidance from FASB or the banking agencies to community banks has been to say that the questionable WARM method “may be an appropriate method.” There has been no guidance related to the critical Q factor analysis, how to satisfy disclosure

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

requirements, or how to discuss changes in lifetime credit risk with their boards of directors in a competent fashion. ABA believes this is a key reason why most regulators and auditors are observing that the vast majority of community banks have yet to begin significant efforts toward implementing CECL. FASB gave the industry an extended transition period precisely because of the significant changes in data and processes needed under the new standard and ABA fears that much of this extra time has been wasted at many institutions.

- In order for smaller institutions to become engaged into the CECL implementation process, banking regulators must proactively communicate with the institutions they supervise about specific CECL processes relating to specific lending products, based on the processes they are observing at large institutions and SEC registrants. As noted above, ABA has recommended a framework that streamlines review of the 23 risk characteristics and factors into four general areas. A large part of that simplified process can largely be automated, but it requires significant changes to the data points collected and processes performed. For many banks, reference to third-party data will also be needed to make up for the lack of critical mass, data-wise. For all banks, it likely means more required work on an ongoing basis. Until comprehensive guidance can be provided to the community banking industry, ABA recommends that FASB request delay of the effective date of the CECL standard.

#### **Regulators Should Request a CECL Practical Expedient, Provide Loss Rates to Banks**

- ABA observes that much of the complexity and cost of CECL is due to the requirement to forecast losses in the future. Understanding FASB and regulator concerns to reduce cost and complexity to smaller institutions, ABA recommends that regulators and FASB consider modifications to CECL to allow a practical expedient, whereby a “through the cycle” (TTC) credit loss estimate, which reflects both the highs and lows of at least one entire economic cycle, can be made without further adjustment. ABA anticipates that banking regulators can provide guidance as to the specific circumstances in which an institution will be permitted to apply the expedient, as well as practice modifications that may be needed to address individual situations.
- Along those lines, ABA recommends that the agencies acquire such data on a periodic basis and supply metrics to community banks so they can easily apply them in their estimation processes. TTC rates, for example, if not used under the practical expedient, are a straightforward and understandable benchmark on which community bankers can base their starting point life of loan loss estimates. Granular TTC rates also will help banks to better compare credit risk between different portfolio segments.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

## **Background**

### ***Need for this Paper***

Many community banks and credit unions have asked for comprehensive examples that could be relied upon to understand the nature and extent of operational changes needed in order to effectively comply with CECL. In response, FASB inserted two examples in the illustrative guidance of CECL (ASC 326-20-55-18 through 326-20-55-27) and the banking regulators have held webinars that use the Weighted Average Remaining Maturity (WARM) method as a method available to non-complex institutions.<sup>2</sup> The FASB staff also issued a “Staff Q&A” discussing WARM in January 2019.<sup>3</sup>

In each of these examples, however, the calculations performed do not represent the true amount of credit risk analysis that would be expected under CECL. Indeed, both FASB and the regulators clearly note that the calculations represent “starting points” to which qualitative adjustments (such adjustments are also referred to as “Q factor adjustments” in this paper) are then applied. Where qualitative adjustments are not made, it is assumed in these examples that analytical procedures were performed that conclude that quantitative adjustments are not needed. The rest of this paper will focus on the Q factor process and will also address specific issues with the WARM method.

### ***Assumptions in This Paper***

An underlying assumption that is made in this paper is that, due to the life of loss notion of CECL, Q factor adjustments will often have a greater impact on periodic earnings than it does now. Small changes to assumptions will often mean large change to credit loss provisions. Therefore, Q factor analysis will receive greater scrutiny from auditors, examiners, and bank board members, than is currently performed. With greater scrutiny comes the need to provide quantitative support for the estimate (and Q factor adjustments) as much as possible. Qualitative adjustments should not be viewed as arbitrary nor subject to significant management bias.

With this in mind, overall materiality is a significant assumption made in this paper. Depending on the materiality of individual credit loss provisions/amounts and the amount of excess regulatory capital an individual bank has, it may not matter what kind of estimation method is used. This paper addresses portfolios that will be significant to individual institutions. For the purposes of configuring CECL estimation systems during this transition period, the assessment of materiality should be made anticipating both benign and stressed economic times. The appropriateness of a specific estimation, likewise, can change during a stressed economy.

---

<sup>2</sup> An archived version of the February webinar can be found at <https://www.webcaster4.com/Webcast/Page/583/24368>.

<sup>3</sup> The FASB Staff Q&A can be found at [https://www.fasb.org/cs/ContentServer?c=Document\\_C&cid=1176171932989&d=&pagename=FASB%2FDocument\\_C%2FDocumentPage](https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176171932989&d=&pagename=FASB%2FDocument_C%2FDocumentPage).

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

With the availability of detailed third-party credit loss data, the reasonableness of the overall estimate, as well as the reasonableness of individual Q Factor adjustments, can be scrutinized easily. For example, the impact of a bank's change in portfolio mix over time can often be evaluated merely by sorting a report differently when the underlying data has such granularity. This cannot readily be done under incurred loss accounting, since there is little agreement as to when a probable loss has occurred. Most peer analysis can be performed today (through Call Report data) only at the high-level portfolio level. This new availability brings new challenges for a banker to provide coherent analysis (to explain differences from the external data). However, it also provides an opportunity for quick benchmarking. Indeed, perhaps a bank may even elect to primarily rely on such peer data. This may significantly reduce the time needed for ongoing analysis.

A final assumption in this paper is that CECL practice will evolve over time. As the industry learns more about how credit risk changes, regulators will recommend and expect different analyses to be performed as a regular part their supervisory functions. This should be a major consideration any bank should have as it plans its CECL implementation. A bank that does not plan for change will have insufficient flexibility to efficiently change as practice throughout the rest of the industry evolves.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

## **Weighted Average Remaining Maturity (WARM) Method of Credit Loss Estimation**

### ***Mechanics of WARM***

During their February 27, 2018 webinar, the Federal Reserve and FDIC, accompanied by FASB and the Securities and Exchange Commission, included examples of how the WARM method could be applied to a commercial real estate loan portfolio.<sup>4</sup> Recently, FASB staff released a “FASB Staff Q&A” paper that provides an example of how WARM can be applied to an auto loan portfolio. Using the FASB staff example, expected loan prepayment rates result in a weighted-average remaining life of the portfolio of 2.52 years. This is applied to an average annual charge-off rate of 0.36%, resulting in a 0.90% “unadjusted historical charge-off rate for remaining balance.” The 0.90% becomes the starting point estimate to which a 0.25% “qualitative adjustment” is added, ending with a “total allowance for credit losses” rate of 1.15%.

In summary, the WARM calculation is:

- Annualized charge-off rate, multiplied by:
- Weighted-average remaining expected life of the portfolio, multiplied by:
- Amortized cost of the portfolio at the measurement date, equaling:
- Starting point allowance for credit losses

FASB and banking regulators generally agree that WARM is a method that presents a starting point. Adjustments to the starting point will be needed after analyzing the related 23 credit risk characteristics and factors (herein referred to as Q factors) that are generally discussed in 326-20-55-4 and -5. Under CECL, such additional analysis is required, no matter the starting point estimation method. Therefore, banks will need to collect and retain data that should not only address the starting point calculations, but also the Q factor adjustments. With that in mind, use of WARM as a starting point causes specific concerns.

### ***WARM Requires New Auditing and Controls over Prepayments***

The key data that are used to develop WARM calculations – annualized charge-off rates and prepayment rates – are currently generally maintained by banks. In fact, contrary to earlier representations by FASB and banking regulators that banks will need to use different data sets in estimating credit losses, WARM calculations provide a basis to require little to no changes to credit loss estimation processes at most banks. Therefore, using WARM is initially very attractive to banks that desire to minimize the implementation costs of CECL.

With this in mind, however, WARM’s dependency on an explicit forecast of prepayments introduces auditing implications that community bankers and community bank auditors must address that would not necessarily be present using other estimation methods.<sup>5</sup> Practically

---

<sup>4</sup> An archived version of the webinar can be found at <https://www.webcaster4.com/Webcast/Page/583/24368>.

<sup>5</sup> ASC 326-20-30-6 allows an entity to consider prepayments as a separate input (as WARM does) or prepayments may be embedded in the credit loss information. Prepayment analysis will, however, be required. ABA believes **Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

speaking, the prepayment forecast system will need to be audited. ABA believes this will represent new processes for most banks. While certain control procedures are likely performed for asset/liability management procedures, they may not be subject to the stringent standards required for financial reporting. Auditors and examiners will need to understand and test the key prepayment calculations, assumptions, and the data that underlies them.

- Most community banks employ third-party vendors for asset/liability management analyses, which would include prepayment forecasting. Processes at the third-party vendors will need to be subject to audit of their internal controls. Testing of data integrity and of the specific calculations are likely necessary. It is likely that a Systems and Organization Controls (SOC-1) report will need to be obtained and assessed.
- Key underlying loan payment data will need to be reconciled to the system that produces prepayments rates. This is likely already performed for asset/liability management purposes. However, bankers will need to assess the impact if underlying prepayment data excludes impairment activity<sup>6</sup> or ignores changes in prepayment patterns due to loan modifications and troubled debt restructurings.<sup>7</sup>
- Much like CECL in general, unique segmentation decisions will need to be evaluated as they relate to prepayment activity and assumptions. Foreseeable segments could often be different from those that may be initially contemplated if prepayments were not explicitly forecast.
  - Commonly known factors affecting prepayment are note rate, loan age, and adjustable vs. fixed loan types.
  - Prepayment experience for certain loan products should now be a factor, as their experience is often significantly unique. On auto loans, for example, loans for the purchase of new cars, as well as for luxury cars, are generally thought to be subject to significantly higher prepayment expectations than those issued for used cars.

---

that significantly less detail will be required in the analysis for smaller banks when prepayment activity is embedded.

<sup>6</sup> Prepayment data quality is also an issue for banks that do not use WARM. However, ABA believes that banks that use WARM have far greater reliance on prepayment assumptions than those banks that, for example, use prepayment assumptions in a “bottom-up” approach that arrives at probability of default and/or loss given default estimates based on loan age on individual loans in the portfolio. WARM’s “top-down” approach generally assumes that all losses occur evenly throughout the life of the portfolio, thus putting most of the credit loss impact onto loan prepayment assumptions. This will be discussed in more detail when discussing “qualitative adjustments”.

<sup>7</sup> This challenge is present for banks that consider prepayments that are embedded in historical experience. However, by explicitly considering prepayments, banks will need to ensure that historical experience in both prepayment systems and credit loss systems are consistent with how CECL treats loan modifications and renewals.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

This greater potential segmentation appears to contradict banking regulator statements on webinars that bankers may use Call Reporting lines to define their segments. It is likely that the regulators believe that bankers who intend to use Call Report lines for their segmentation will then provide the relevant Q factor adjustments based on these factors. However, it is difficult to see how credible adjustments can be derived unless the more granular data is collected and analyzed in the first place.

- Prepayment assumptions that determine the average remaining life of the portfolio will need to be assessed for reasonableness. In changing interest rate environments (such as one existing in 2019), forecasts of changes to future interest rates and their impact on expected prepayments is appropriate.<sup>8</sup> ABA believes that, for community banks, such forecasts do not need to match in detail those forecasts used for asset/liability management purposes or forecasts that are inherent in current pricing of lending products (through forward rate curves). However, they should be directionally consistent with them.<sup>9</sup> Given this, ABA believes that knowledge of such prepayment concepts is a skill set many bankers lack. Evaluation of third-party vendors and the controls at the bank to manage vendor processes will be often be required.
- ABA understands that third-party vendors often apply market-based assumptions of prepayments for their clients (for residential mortgage portfolios, they may come from results from externally-acquired data or from the Standard Prepayment Model of the Securities Industry and Financial Markets Association). If this is the case, bankers will need to analyze their portfolio characteristics to support why the “market rates” are relevant to their individual portfolios. This may be challenging, as smaller portfolios will often have more volatile activity that differs from larger portfolios in the short-run.

ABA believes that these procedures on the prepayment-related assumptions would be significantly diminished (and, perhaps, unneeded) if bankers used estimation methods in which prepayments were embedded in the historical loss information and explicit prepayment assumptions were not used. Therefore, use of WARM can introduce significant other efforts and costs into the reporting process.

### ***WARM has Conceptual and Effectiveness Concerns***

The WARM method, which appears to be able to be performed using existing data maintained by a typical community bank, has had a controversial existence within the standard-making process. When the exposure draft for CECL was issued, FASB members took significant efforts to explain that using average life-based estimates was not how a CECL estimate would work, since

---

<sup>8</sup> This is especially true when Federal Reserve Board members make statements of adjusting interest rates over time.

<sup>9</sup> Having said this, small changes to prepayment rates could often result in large changes to credit loss provisions. Therefore, a community banker should understand how sensitive such estimates will be.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

credit losses do not often occur evenly over the life of the loan.<sup>10</sup> Further, members of FASB's Transition Resource Group also rejected a proposed illustrative example that was included in a "fatal flaw" draft of the standard. In the proposed example, a company was shown to ignore defaults that may be expected to occur after the date representing the time of the weighted average expected maturity.<sup>11</sup> With these things in mind, subsequent comments from certain large auditing firms and software firms appear to affirm that the WARM method can be problematic. While non-complex estimation methods are not needed, it is difficult to envision examiners allowing an estimation method that many believe to not conceptually represent a life of loan-based loss estimate.

The design of WARM also has significant credit loss forecasting flaws, according to well-respected modeling expert Joseph Breeden. In his paper "CECL Procyclicality: It Depends on the Model", Breeden notes that the WARM method is the worst among various estimation methods in providing forward-looking allowances for residential mortgages through the financial crisis.

"Regulatory expectation is that users would apply quantitative factors (Q-factors) to manually adjust the WARM starting point to expectations about the economic and credit cycles. However, because WARM is so out-of-phase with actual reserve needs, lenders would be better off using a completely flat (through-the-cycle) average loss rate than to try to back out the post-peak behavior of WARM. In short, WARM should not be used for CECL."<sup>12</sup>

Such an analysis surely puts the use of WARM in question – at least in the long-term. Since the ultimate purpose of CECL is for earlier loss recognition, it is difficult to see how regulators, in their responsibility to monitor safety and soundness of the banks they supervise, could approve of the use of WARM, at least as it relates to the estimation of credit losses for residential mortgages.

---

<sup>10</sup> In his September 17, 2015 address to the National Conference on Banks and Savings Institutions of the American Institute of CPAs, then-FASB member noted (in page 8 of his presentation) that applying a historical annual loss rate to a weighted average life was a "CECL Misunderstanding" and "Not a CECL Application". While there technically could be a difference between the "weighted average life" of a portfolio and a "weighted average remaining maturity", there was little confusion among conference participants of why either would be considered inappropriate methods of estimation.

<sup>11</sup> Addressing bankers, auditors, and regulators at a private pre-issuance CECL workshop, a FASB member clarified that the example would not be included in the final standard and that credit risk over the entire life of the loan (not just the average life of the loan) must be considered.

<sup>12</sup> See Breeden, September 4, 2018: "CECL Procyclicality: It Depends on the Model."

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

### *Q Factor Analysis is Difficult for the Non-Complex Bank When WARM is Used*

From a WARM calculation – like initial starting point calculations using any other method – risk factor adjustments are then applied to address the risks that are not reflected in the base calculation. As noted in the FASB Staff Q&A, a significant judgment bankers and auditors will need to make is the suitability of the look-back period used to determine the annual charge-off rate. This assessment is likely similar to what is performed in current incurred loss practice and will be required, no matter what estimation method is used. However, there will be profound differences.

- Applying annualized charge-off rates within the WARM method basically makes the assumption that charge-offs normally occur equally over the life of the portfolio. For consumer portfolios, such as auto loans and residential mortgages, this concept contradicts the widely-accepted understanding that loan age is a major factor in both the likelihood of default and the severity of loss. Such an understanding is noted in ASC 326-20-55-5-k “Historical or expected credit loss patterns”. Banks that use the WARM method will need to derive adjustments to the starting point WARM estimate that reflect such loss patterns. Such additional adjustments would be unnecessary if methods that directly consider loan age, such as vintage-based analysis.<sup>13</sup>
- Paragraph 326-20-50-11d appears to require a banker a discussion very similar to an SEC registrant’s “Management’s Discussion and Analysis.”

“A discussion of the changes in the factors that influenced management’s current estimate of expected credit losses and the reasons for those changes (for example, changes in portfolio composition, underwriting practices, and significant events or conditions that affect the current estimate but were not contemplated or relevant during a previous period).”

By mixing in different risks within the calculation, explaining changes to credit risk based on WARM calculations are then foreseeably challenging for a smaller institution. ABA does not expect the discussion to be detailed, but it, nevertheless, must make sense. Further, no matter the level of detail that will be required in disclosures, ABA believes that further detail will be needed for auditors, examiners, and board members so they can adequately assess the reasonableness of the final estimate. Examples of how WARM will complicate the analysis include:

- Changes in loan production should often be the most significant factor in a credit loss provision (as the CECL provision is initially recorded at origination). Therefore, charge-

---

<sup>13</sup> Vintage-based analysis includes simple charge-off based estimates based on loan age, as well as age-based probability of default/loss given default analyses.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

offs (which are a primary factor in WARM and which should have been anticipated within CECL) can often be a misleading indicator of changes in credit risk.

- Increasing interest rates normally result in longer expected lives (and higher credit loss provisions under WARM). Increasing interest rates, however, often occur during a growing economy, which would indicate lower credit risk.
- During times of economic stress, interest rates often decline. During those times, however, prepayments are often expected to decrease, due to the increase in default risk that have yet to be indicated through charge-offs.

Q factor analysis is inherently difficult and these are situations that institutions must all generally face, no matter the starting point estimation method. WARM's explicit integration of prepayments into the initial credit loss estimate, however, appears to introduce further confusion into the Q factor analysis for a non-complex institution.

### ***Final Thoughts on WARM and Expected Life Assumptions***

ABA expects credit loss estimates using explicit assumptions of expected life to exist at various banks for specific portfolios. ABA observes that larger bank use of expected life in preliminary implementation discussions, however, is normally applied at very granular levels (using each loan's individual term structure) or combined with other risk factors to develop loan-level probability of default and loss given default rates. Such a granular and "bottom up" approach is in contrast to the "top down" approach that non-complex institutions hope to use through WARM.

Overall, ABA believes WARM calculations can be used during benign economic times and also for portfolios in which prepayment is not a big factor. WARM also can be used by analysts for high-level estimates that initiate discussion with management. For a non-complex institution, WARM integrates prepayment and loss assumptions, thereby complicating discussions of credit risk. More importantly, however, is that its inherent design appears to ineffectively capture increasing credit risk. ABA believes, therefore, that a bank that relies on WARM will likely perform more procedures for both the starting point calculation and the Q factor analysis than if it first relied on other estimation methods to calculate a starting point calculation. Those banks will also struggle in addressing the related questions during board meetings.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

## **ABA Recommended Community Bank Q Factor Analysis Framework**

### ***Background***

In Example 1 of the illustrative guidance within CECL, it is noted that “Community Bank A” (CBA) uses a “loss rate approach” in estimating credit losses for its portfolio of loans collateralized by real estate. While the standard does not give more specificity as to what estimation method qualifies as a “loss rate approach”, loss rates are ultimately derived by a variety of estimation methods.<sup>14</sup> Since FASB Staff has issued the paper “Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate Expected Losses”, the WARM method will be assumed to derive the initial starting point loss estimate. From this estimate, in accordance with ASC 326-20-30-8 and -9, CBA will adjust historical loss information (the loss rate derived from the WARM method) to reflect current conditions and reasonable and supportable forecasts that differ from the conditions that existed for the period over which historical information was evaluated.

The risk factors that are evaluated when assessing the difference from initial historical loss calculations (also referred to herein as starting point calculations) are generally detailed in ASC 326-20-55-4 (as they relate to portfolio risk *factors*, of which eleven are listed) and 326-20-55-5 (as they relate to portfolio risk *characteristics*, of which twelve are listed). As noted in the ABA Discussion Paper “Risk Characteristics, Risk Factors, and Market Data Under CECL,” with a couple of exceptions, the risk factors and risk characteristics are largely similar to those noted in the 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* and several of the eleven risk factors in 326-20-55-4 are similar in substance to the twelve risk characteristics in 326-20-55-5.

### ***ABA Recommended CECL Framework***

Working from starting point estimate calculations (whether performed through WARM or through another estimation method), a bank would address the risk factors and risk characteristics within 326-20-55-4 and -5. Summarizing the eleven risk factors in 326-20-55-4 and twelve risk characteristics in 326-20-55-5, ABA believes a basic Q factor analysis under CECL would, at a minimum, consider four main areas:<sup>15</sup>

- **Changes in portfolio mix**: Banks will need to recognize that certain loan types, terms and underwriting practices have significantly different loss expectations at origination. For example, in addition to borrowers with significantly different credit scores or loans with abnormally high loan to value ratios at origination, commonly-known loan products with different loss rates include:

---

<sup>14</sup> ABA believes that “loss rate approach” would be contrasted to a “discounted cash flow” approach.

<sup>15</sup> Specific procedures are not in the scope of this discussion paper, but are expected to be addressed in future ABA papers.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

- i. Residential mortgage loan occupancy (investors) and purpose (cash-out refinancing)
- ii. Commercial real estate loan purpose (for example, health care vs. hotels)
- iii. Auto loan purpose (Used vs. new, among others)

ABA believes the analysis of portfolio mix can cover many different characteristics. However, most small banks will want to focus only on those that are generally well-known. ABA believes that most of the work on this entails review of life of loan credit loss estimates based on the different specific characteristics. Because of the granular data needed, many banks will likely consider acquiring third-party data.

- **Changes in loan performance:** Certain estimation methods (including WARM) do not consider changes in past due loans or risk ratings, so banks will need to address how changing loan performance affects the original estimate. Since a CECL estimate implies that this performance was anticipated at origination, this can be a challenge, especially as the current credit metrics are disclosed and, so, could be a key focus during board meetings.

As addressed in the ABA Discussion Paper “[Analyzing Current Loan Performance Under CECL](#)”, assessing the impact of current loan performance often means performing a migration analysis, a CECL estimation method that directly addresses loan performance by tracking specific loans that are past due (or have specific risk ratings) all the way to resolution (pay-off or charge-off). Such results can be compared to the initial starting point estimates, giving quantitative support for any qualitative adjustment made.

- **Changes in loan age and maturity:** Certain loan products (such as those subject to prepayment) have expected loss patterns based loan seasoning. The very low likelihood of default during the first year of a residential mortgage and after the fifth year is one example. Some auto loan portfolios also exhibit specific patterns (such as very low defaults the final year). Reviewing past due activity by age of loan can provide early warnings of poor performance, as past due levels not in accordance with expected patterns often indicates significant changes to loss expectations are necessary.

An analysis of activity by loan age is normally performed through vintage analysis, an estimation method that directly reflect loan loss patterns. As with the migration analysis, results from a vintage-based estimate can be compared to the initial starting point estimates, giving quantitative support for any qualitative adjustment made.

Analysis of loan age, however, can also address how changes in underwriting standards might impact the estimate. As underwriting standards often change over the course of an economic cycle or otherwise in periods when loan growth change, specific vintages can be identified as benchmarks for future vintage loss expectations.

ABA believes that, since amortized cost and charge-off/recovery information will be disclosed by public business entities, this will be a logical focus of discussion among examiners, auditors and board members. Therefore, being able to credibly address risk

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

exposure in specific vintages appears to require some kind of analysis, whether or not credit loss estimates are performed by vintage.

While analysis for loan age may enable a bank to estimate the impacts of collateral value changes, for certain product lines, such as commercial real estate loans, analyzing risk by loan maturity date may be more relevant to understand the risk of default, as many of these loans are subject to bullet/balloon terms or renewal. Combining high-level estimates of collateral values to an analysis by maturity can help a bank assess how more-immediately maturing loan facilities may be subject to impairment in the longer-term.

- **Changes due to the forecast of the future and collateral**: No matter the estimation method, a bank will need to perform analysis to quantitatively estimate the impact of forecasted economic conditions. ABA believes that, since a vintage-based analysis can show how loss activity on loans of different ages can be reflected based on periods of time (and, thus, the economic environment at the time), analysis of vintages can be a relatively easy way to perform a forecast of the future, as specific past vintage performance can be used as benchmarks for forecasts of future expectations.<sup>16</sup>

Knowing that collateral value analysis will be critical (especially in times of economic downturn), ABA also believes other simple vintage-based analysis can be performed over changes to collateral values in order to forecast losses. As current loan-to-value ratios can often be estimated by loan age (by applying changes in the relevant collateral value index to each loan or vintage), banks can also assess its exposure accordingly. When loans (whether individually or collectively) approach a 100% current LTV, the likelihood of loss increases (and, conversely, will largely diminish as LTVs drop).

ABA believes smaller banks can use each of these analyses to either form specific ranges of estimates or to merely make the exposure transparent (without a specific estimate of losses). The suggested approach above is a departure from current practice, as the Q factor analyses above result in ranges of life of loan estimates. Currently, starting point estimates are then supplemented by incremental adjustments that have little, if any, separate estimate of incurred loss.

These analyses require significant changes to the nature and amount of data that is maintained and analyzed. Much of the analysis can be automated, but would require significant ongoing data management activities (such as those relating to a data warehouse). While ABA would like to limit the amount of data that must be maintained, it is difficult to quantitatively support the life of loan impact of, say, increases in past due loans unless lifetime information is retained that follows past due loans to resolution. Likewise,

---

<sup>16</sup> In example 1 (326-20-55-21), “Management estimates the incremental 15-basis-point increase based on its knowledge of historical loss information during past years in which there were similar trends in real estate values and unemployment rates.” The reference of “similar trends” points to a similar process.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

quantitatively estimating the impact of changing loan portfolio mix would seem arbitrary unless lifetime data were granular enough to recognize the differences in historical losses by loan types, purposes, etc. More discussion needs to occur with auditors and examiners on the level of documentation required.<sup>17</sup> However, maintaining and managing lifetime credit loss data will be a big change for all banks that may not be possible to avoid.

It is this reason that ABA believes that, if the banking regulators wish to alleviate the burden that smaller banks face from the various analyses needed to perform a competent CECL analysis, the agencies should then request a practical expedient within CECL that allows a “through the cycle” based loss rate to be applied to portfolios. Such a practice would eliminate the need for a bank to perform much of the forecasting aspect of CECL and focus the work on appropriate segmentation in order to record the relevant loss rate. Without the practical expedient, detailed analysis as generally described above seems inevitable.

#### ***ABA Recommended Starting Point Calculation Method***

In contrast to starting with a complicated method like WARM (which requires significant assumptions of charge-off and prepayment activity), ABA believes that a “through the cycle” loss rate – one that includes the experience of both good and bad macroeconomic times – is both an easier and more understandable starting point loss rate to use for smaller institutions. It provides a consistent benchmark from which all risk factor adjustments can be applied, thereby assisting board members to understand the process from quarter to quarter. ABA also believes that such rates can even be acquired from third-party firms by the banking agencies and then provided to banks, making the process even easier for smaller banks that do not have the critical mass of loans to generate reliable estimates.

---

<sup>17</sup> ABA understands that other critical issues must be addressed within the quarterly closing process. For example, banks will need a process to assess and measure losses on nonaccrual loans and reasonably expected troubled debt restructurings and then integrate those results into its loss expectations within the remainder of its portfolio. This is planned to be addressed in future discussion papers.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

## **Final Assessment and Recommendations**

### ***Comprehensive Guidance is Needed***

As of the date of his paper, it has been two-and-a-half years since the issuance of the CECL accounting standard. For the thousands of small institutions that want to comply with the standard and provide a quality assessment and measurement of credit risk in their portfolios, the only substantial guidance provided thus far by regulators and FASB has been focused on possibly applying the WARM method to perform starting point estimates.<sup>18</sup> Although larger institutions are finding in their CECL implementation efforts that non-complex and high-level estimation methods are resulting in higher and less predictable allowances, as well as greater volatility in their quarter-to-quarter estimates, ABA acknowledges that smaller institutions should still be allowed to use non-complex methods. Given the challenges noted in this paper related to WARM, however, ABA believes that institutions need to seriously reconsider whether WARM is appropriate for specific portfolios and for their organization as a whole. Unless examinations and audits are performed “with a wink and a nod”, banks that primarily apply WARM will face more work and more challenge to credibly explain changes to credit risk, especially in times of economic change.

Primary reliance on WARM can possibly lead an institution to forego serious consideration of other credit loss data points that need to be collected and analyses (including Q factor analyses) that need to be performed to credibly address foreseeable situations throughout an economic cycle. Regulatory and auditing priorities are likely to change over time. Management and their strategies are also likely to change over time. With that in mind, CECL practice will evolve over time. A bank that does not build flexibility into its processes now will likely be unable to change in the future without significant new work needed. In other words, reliance on WARM may cause inflexibility that could make the initial CECL implementation a waste of time.

With all this in mind, the banking regulators must issue comprehensive guidance on CECL implementation practice in the community banking industry – guidance that addresses, by loan product, segmentation considerations, recommended estimation methods for starting point calculations, steps in the Q factor analysis, and discussions related to disclosures. ABA has laid out a four-part framework to address the 23 risk factors and characteristics that are detailed in the CECL standard and hopefully the framework can be used by smaller institutions. However, now that regulators have surveyed what is occurring at mid-sized and large banks, they should be able to “right-size” those practices to smaller institutions.

---

<sup>18</sup> ABA also notes that there has been no comprehensive audit guidance issued by the American Institute of CPAs regarding CECL. This has limited the amount of quality input a bank’s auditors can provide their bank clients. A draft “Technical Practice Aid” that exceeds forty pages is expected to be issued soon for comment.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

### ***CECL Should be Delayed until Comprehensive Guidance is Provided***

Through discussions with auditing firms and personnel at the banking agencies, there is a general feeling that little, if any, implementation progress has been made by many smaller institutions. Considering the significant changes to data and processes that are potentially needed for CECL, ABA believes that companies are holding back on implementation efforts because of the lack of substantive direction provided by the agencies. With this in mind, until such guidance can be issued, ABA recommends that the regulators request a delay to the effective date of CECL.

### ***Change is Needed to Address Smaller Institutions***

No matter the complexity of the institution, analyzing and forecasting credit risk is inherently complex and ABA believes that neither FASB nor the banking regulators intend for the cost burden of analyzing such complexity in a competent manner to be carried by non-complex institutions. With this in mind, ABA recommends that a practical expedient be added to the CECL standard that would allow a bank to record a credit loss reflecting “through the cycle” historical experience (loss rates that include both the highs and lows of at least one entire economic cycle). This allows a bank to forego specific forecasting of future economic conditions (in ASC 326-20-30-9), which appears to be the most difficult aspect of CECL credit risk analysis.

ABA believes that “through the cycle” credit loss rates satisfy the CECL “life of loan” loss objective and foresees that such an expedient could be permitted by banking regulators for non-SEC registrants or for banks under a certain asset threshold. For practical purposes, applying a through-the-cycle loss rate would predominately shift the focus of any CECL discussion to the portfolio segmentation decisions a bank makes. Therefore, since there has been a lot of focus by FASB on lax underwriting standards preceding the Financial Crisis, ABA believes the through the cycle loss rate would achieve the most significant objective of CECL – to recognize increased credit risk at the time of origination. Using third-party credit loss data, banking regulators could allow certain banks to merely use the rates provided with little other needed documentation. ABA recommends that the banking agencies obtain granular third-party credit loss data and share it with community banks on an ongoing basis.

If the practical expedient were allowed, supplemental regulatory guidance would likely be needed to address ways to ensure that credit loss expectations for banks with significant troubled assets are reasonably reflected. Some may be concerned that currently impaired assets would be “smoothed over” by long-term loss rates. Considering that CECL’s new concept of “reasonably expected troubled debt restructurings” extends the current forecast to identify future impaired assets, regulatory guidance could require, for example, the allowance for credit losses to be no less than the amounts provided for impairments. ABA invites others to provide recommendations in this regard.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

***Conclusion***

Portfolio-level life of loan credit loss measurement and analysis is inherently complex, no matter the complexity of the institution. Change in regulator priorities, audit requirements and even management strategies are bound to change in the long-term. Therefore, rather than myopically addressing specific estimation methods, ABA invites banking regulators, FASB, auditors, and bankers to address the long-term expectations and needs of CECL. Until such discussion takes place in earnest, small banks will continue to delay implementation efforts or pursue paths that will not necessarily be appropriate in the long-term.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

## **Appendix A: CECL Q Factor Analysis vs. Current Practice**

### ***Current Practice***

Banking regulator guidance note that it generally takes twelve months for loss events to result in charge-off, the most recent historical experience is normally considered a good starting point for incurred loss estimates.<sup>19</sup> Current Q factor analysis is, therefore, performed by community banks mainly to adjust an annualized charge-off rate to a final incurred loss estimate. While the qualitative assessments of the risks are relatively detailed, there generally appears to be little quantitative support for the adjustments. In other words, how a bank arrives at a 10 basis point adjustment from the rolling annual charge-off rate starting point calculation due to an increase in past due loans is largely unclear. The “anchor” of “directional consistency” normally guides the review for reasonableness of Q factor adjustments: Past due loans and nonaccrual loans increase, credit loss provisions increase (and vice versa).

Required disclosures are then largely focused on identifying loans that are impaired (nonaccrual loans and others individually evaluated for impairment) and those not impaired (loans collectively evaluated for impairment).

### ***Q Factor Analysis Should Change Because of the Emphasis on Risk***

While all this focuses on *losses* in the portfolio, CECL focuses on *risk* in the portfolio – risk that starts at origination. This has significant implications. Since risk is assumed at origination, recent charge-off history is not often a good starting point from which incremental qualitative adjustments are made. A focus on risk characteristics such as key underwriting terms and borrower/collateral characteristics becomes critical to the Q factor analysis, as different risk characteristics can often have significantly differently life of loan-based credit loss expectations. The “anchor” of “directional consistency” is drastically diminished in many cases, since an increase in past due loans, for example, could result in lower credit loss provisions:

- If the increase was less than previously expected,
- If a forecast of the future indicates improvement, or
- If current loan production declines.

The WARM method’s emphasis on recent charge-offs, therefore, provides a difficult starting point from which Q factor analysis will begin.

### ***Q Factor Analysis Will Normally Not be “Qualitative”***

The nebulous concept of “incurred loss” allows much of the current estimation process to truly be “qualitative”. Quantitatively estimating how a decrease in collateral values impacts a bank’s

---

<sup>19</sup> This guidance has made intuitive sense, since credit loss events tend to be systemic – borrowers lose their main income source (whether a customer or job), causing them to default on their mortgages and reduce other spending, which causes other businesses to deteriorate, and so on.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

estimate of impaired loans that have yet to be individually identified, for example, is very difficult and, therefore, highly judgmental. Backtesting of the estimation process is futile, as when a loss event occurs and when the loss becomes probable are not generally accepted.

In contrast, whether using data collected by a bank or acquired from third parties (to be further discussed later), quantitative life of loan loss expectations can often be derived at any point of time, sorted by virtually any major risk characteristic or risk factor.<sup>20</sup> As a result, many aspects of the Q factor analyses can be embedded in a bank's base estimate. Larger banks, for example, often analyze losses in relation to collateral values in order to quantitatively estimate losses given default. An increase in past due loans may sometimes be used to quantitatively estimate an increase in the probability of default. Banks that are unable to provide a quantitative basis for their Q factor adjustments will naturally face higher scrutiny to ensure their overall estimates do not appear arbitrary.

With this in mind, ABA believes that, in the long run, qualitative adjustments will tend to truly be "qualitative." Since the various key risk factors and characteristics can be quantitatively analyzed all the way to loss, qualitative adjustments will eventually be limited to those for modeling imprecision or from considering various assumptions of future economic conditions. Therefore, non-complex banks must plan to capture such data so that, eventually, they will be able to quantify these "qualitative" factors.

### *Specific Estimation Methods Address Specific Q Factors*

Certain CECL estimation methods directly may address certain risks, while disregarding other risks. An example is a calculation based on charge-off data: A focus on charge-offs does not directly address recent increases in past due or nonaccrual loans. Conversely, using a migration based on current risk rating or past due loans may address current loan performance, but disregard an expected charge-off pattern commonly experienced in, say, auto loan portfolios. CECL estimates require assessment of all significant risks. Therefore, depending on the estimation method selected to perform the starting point calculation, multiple other calculation methods may often be needed to supplement the starting point calculation by setting the basis for qualitative adjustments that focus on those other risks.

---

<sup>20</sup> ABA anticipates meaningful third-party data to be available for consumer loans, as well as commercial real estate. It is not clear of how such trends will develop for bank commercial and industrial (especially small business) lending portfolios.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

### ***CECL Q Factor Analysis is Inherently Complex***

Q factor analysis for forecasts of the future are needed and these will be challenging merely because forecasting life of loan credit risk is inherently complicated. Many use the term “nonlinear” to point this out. Some examples:

- A 100 point decrease in FICO score from 800 to 700 increases the likelihood of serious delinquency from 1% to 7%, but a 100 point decrease from 700 to 600 increases the likelihood to 28%.
- Changes in collateral prices often have little impact to expected losses – that is, until borrowers become underwater. Thereafter, future declines in prices have significant impact on loss expectations. Anticipating the point of a cliff is difficult on a portfolio basis.
- An optimistic economic forecast often has little impact to expected losses, except when forecast at the bottom of a recession. Conversely, a pessimistic forecast normally has significant adverse impact, no matter the current state.

ABA notes that estimating losses during the reversion period (the time between that when a bank can make reasonable and supportable forecasts and when long-term historical experience is used) can also be complicated. During a recent meeting at the ABA that included both banking regulators and auditors, it was generally agreed that the immediate reversion estimation process performed by “Community Bank A” in 326-20-55-21 would be appropriate only in very limited cases. Indeed, it is often observed that increases in home prices, for example, occur slowly and steadily over time while decreases often occur suddenly and acutely. During a time when housing prices have declined by 15% over the past year, for example, it is generally considered inappropriate to believe that they would immediately bounce back and revert to previous levels. This dynamic further complicates the estimation process for a community bank. Of course, non-complex methods can be used to revert to long-term historical experience, but they must produce results that inherently make sense.

### ***Q Factor Analysis Must Support CECL Disclosures and Foreseeable Board Discussions***

- Disclosures of current credit risk (such as, among other things, past due loans) will continue. Currently, increasing past due and nonaccrual loans normally result in Q factor adjustments that increase the credit loss provision from the starting point estimate. As already noted, under CECL, since the impact of increasing past due loans should have been anticipated at origination, an increase in this metric could often be accompanied by a decrease in the credit loss provision. With this in mind, more granular Q factor analysis will likely be needed merely to help board members understand periodic changes in credit risk to the entity.
- Disclosures of vintage-based information of amortized cost, charge-offs, and recoveries will provide transparency that invite questions from auditors, board members, and investors that will likely require explicit attention as to how they impact the final estimate. Namely, the question of “how much loss is expected on this balance of loans?” can be applied to each line of detail within the current schedule of amortized cost by credit quality. Likewise, such

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

questions can be applied to each vintage. For banks that disclose the amortized cost of their loans by regulatory-based classifications, the question of “how does the level of criticized loans impact your expectation of losses on loans rated “Pass?” When assessing its Q Factor Analysis, banks need to ensure that its analyses can address such questions.

- New CECL disclosures will require a bank to explain not only how it uses historical experience and applies qualitative adjustments, but also how credit risk in the portfolio has changed as a whole. This new second aspect, combined with the directional disconnect of current metrics to current provisions, has caused many to believe that period-over-period changes in credit risk will become an industry standard. In such a schedule, the allowance for credit losses would reflect changes due to originations, pay-downs, and changes in forecasted conditions. Such explanations will need to harmonize with the Q factor adjustments applied. ABA believes such an analysis can be performed by smaller banks. However, this incremental process may take longer for portfolios that do not estimate losses by age of loan.<sup>21</sup>

***Q Factors (and Related Credit Loss Estimates) will be Scrutinized through Third-Party Data***

The availability of granular third-party, life of loan credit loss data will allow auditors, examiners, investors, and board members to scrutinize expectations of loss on both an overall basis and based on specific risk factors. Bankers need to be able to support differences from such loss rates. This is currently available only at high levels detailed within Call Reporting lines. Auditors, examiners and investors who have access to third-party data, however, are able to analyze it on very granular terms. Competently responding to foreseeable questions will be a challenge unless a bank already has performed such analyses.

In light of such anticipated scrutiny, ABA believes that referring to third-party data should be a common practice among banks that lack critical mass in their portfolios. ABA recommends that the banking agencies acquire and distribute relevant such data to banks on a periodic basis. Depending on the level of granularity, if formatted to include historical periods throughout an economic cycle, a bank may then often have much of what it needs for an overall estimate and overall CECL analysis.

---

<sup>21</sup> See ABA.com/CECL for the Discussion Paper “[Disclosures and Discussions of Credit Risk Under CECL.](#)”

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.

## **Appendix B: ABA CECL Resources**

In addition to PowerPoint presentations, CECL FAQs, and a CECL introductory video, ABA has a variety of discussion papers available to the general public at [ABA.com/CECL](http://ABA.com/CECL) that address CECL implementation. They are:

- [CECL Implementation Concepts: Reasonable and Supportable Forecasts](#)
- [Disclosures and Discussions of Credit Risk Under CECL](#)
- [Analyzing Current Loan Performance Under CECL](#)
- [Loss Rate Calculations and the Use of Historical Data Under CECL](#)
- [Risk Characteristics, Risk Factors, and Market Data Under CECL](#)

These papers form the basis for the points discussed in this paper.

**Qualification:** ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. The ideas conveyed in this paper are meant to provoke thoughtful discussion between bankers, auditors, and regulators related to implementation of the CECL accounting standard. Unless otherwise noted, the ideas are not meant to reflect minimum requirements or best practices, but implementation processes that will address the practical and ongoing issues that can be expected in recording and managing expected credit losses.