CECL Implementation Concepts: Reasonable and Supportable Forecasts

*A Discussion Paper of the*

AMERICAN BANKERS ASSOCIATION

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Summary

This document is intended to address certain key concepts in the CECL accounting standard (ASU 2016-13) for the purpose of facilitating effective communication between bankers, regulators, investors, auditors and other stakeholders (collectively referred to as “stakeholders”) by documenting a common understanding and language of the key concepts of CECL. Additionally, this paper shares knowledge learned so far in the CECL implementation process by outlining broad practices and giving specific examples.

Key Concepts addressed in this document include:

- Economic Forecast
- Reasonable and Supportable Forecasts
  - Reasonable and Supportable (“R&S”) Period
  - Remainder Period
  - Reversion Period
  - Modeling Inputs and Outputs
1. **PREFACE: STARTING OFF ON THE SAME PAGE**

   **a. The Timing of Losses is Important within CECL**

   Per Accounting Standards Codification (ASC) paragraph 326-20-30-9, “an entity is not required to develop forecasts over the contractual term of the financial asset or group of financial assets. Rather, for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity shall revert to historical loss information determined in accordance with paragraph 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets. An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.”

   Based on this paragraph, while credit losses are first recorded at origination, it is clear that the timing of credit loss events (such as when the borrower’s financial condition has deteriorated, the loan has gone into nonaccrual status, or ultimately is charged-off) is important within the CECL standard. Based on the expected timing of the event, there can be different ways in which an entity may measure the credit loss. Therefore, estimates that do not take into account the timing of loss, such as a calculation of a straight lifetime loss rate, are at risk of mismeasuring (both understating and overstating) the credit loss expectation. Specific loan terms (amortizing loans vs. balloon/bullet, collateralized vs. unsecured), borrowers (prime vs. subprime), and forecasts (stable vs. stressed) can result in significantly different expectations if the timing of such risk is not considered.

   Therefore, such estimates require a separate analysis of how the forecast of the future takes into account the timing of loss. Estimation methods that explicitly take into account the timing of loss include most vintage and probability of default/loss given default analyses, as well as discounted cash flows. Some migration analyses do not explicitly address charge-off timing and, thus, may be supplemented by additional analyses that reflect migration of the current portfolio based on forecasted economic assumptions.

   **b. Common Terminology must be Understood when Addressing the CECL Forecast Period**

   The importance of understanding the CECL terminology is highlighted when communicating with stakeholders. For example, during a recent discussion between bankers and banking agency personnel, various bankers noted that economic forecasts are often unreliable past one year. Therefore, a “reasonable and supportable period” (R&S) of one year (as indicated in 326-20-30-9) is being considered. A representative from a bank regulator challenged the concept of having a one year R&S, initially viewing two years as a minimum length. The bankers, however, noted

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that, after one year, they expect to revert the economic variable model inputs to long term historical loss rate averages based on previous experience to adjust the economic forecast being fed into the model. The regulator responded with “that sounds like a longer than one year R&S period” and agreed that the process seemed reasonable, when considering the other periods within the contractual life.

ABA believes that CECL implementation will be greatly expedited if the banking industry stakeholders (including bankers, banking regulators, auditors, and investors) have common understanding of the components of the reasonable and supportable forecast.

2. The CECL Forecast Period

a. The Forecast Period has Three Components, No Matter How Expressed

Paragraph 326-20-30-9 explicitly names only the period in which reasonable and supportable forecasts can be made (or obtained) and the period that is beyond that. However, based on discussions with regulators and FASB staff, bankers believe that the CECL forecast period (that which represents an expected remaining contractual life of the asset or portfolio) is best understood in three components, as illustrated in Row 1 of the following diagram (next page):

- The Reasonable and Supportable (R&S) Period: Per 326-20-30-9, the period in which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses.
- The Remainder Period: The period beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses (and unadjusted historical loss experience is used) and
- The Reversion Period: The period which links the R&S Period to the Remainder Period.

These periods are discussed in more detail below. However, with this in mind, there are different ways these specific components may be expressed and discussed between stakeholders within the forecast of expected credit losses over the contractual life. In conversation, some may break the contractual life into two components. When this occurs, the period in which current forecast losses revert to historical loss experience is incorporated either into the Remainder Period (row 2) or into the R&S period (row 3). Lastly, some may consider the entire contractual life as the R&S period (row 4).
No matter whether a stakeholder refers to one, two, or three components of a forecast of the remaining contractual life of a portfolio, assessing the reasonableness of the estimate in total will require understanding the reasonableness of the three individual components.

**b. Some May Refer to a Reasonable and Supportable Forecast with Two Components: Row 2 and Row 3**

Within 326-20-30-9, the CECL standard does not explicitly refer separately to a Reversion Period and a Remainder Period. The standard merely describes reverting to the “historical loss information.” Therefore, some discussions about the CECL forecast period may refer to only two components, the R&S Period and the period of reverting to the historical loss information (the period “beyond the reasonable and supportable period”). However, bankers generally believe that both the Reversion Period and the Remainder Period are critical to the estimate made “beyond the reasonable and supportable period.”

The importance of defining a separate reversion period can be illustrated by the following example. CECL “allows an entity to revert to historical loss information, with a straight-line, other systematic and rational method, or immediate reversion all being acceptable methods.” In many cases, an immediate reversion to unadjusted long term historical loss rates would yield results that are unreasonable. For example, during a time of severe economic stress, an immediate reversion may imply unreasonably high increases in collateral prices during the

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reversion period to arrive at the long-term average loss rates. With that in mind, the reversion period should be thoughtfully considered separately from the other two components.

Another consideration is that separately defining the reversion period does not mean that the beginning of the reversion period (which is the end of the R&S period) in a 3 component model is not necessarily the same point in the future as the beginning of the reversion period (the end of the R&S period) in a 2 component model, as reflected in the graphic. Therefore, to avoid unnecessary confusion, it is important to reconcile the underlying points in time in either a one, two or three component model when making comparisons or in discussion with stakeholders.

c. Some May Refer to the Reasonable and Supportable Forecast Period with One Component: Row 4

In certain instances, stakeholders may refer to the R&S period as covering the entire remaining contractual life. Examples include when there is a short contractual life of the portfolio or when a bank uses an extended period economic forecast. When the latter, bankers should consider that reversion after a period of time to long-term historical norms is commonly used in the models of external providers of the forecast data. As the user of the model output it may not be clear when and how the reversion occurs and it may be necessary to discuss this with the forecast data provider.

In any event, such reversion to historical averages (or other metrics, such as medians) may be considered part of a reasonable and supportable forecast of credit losses by many bankers. Community bankers may also find their credit loss experience is not related to economic conditions. In these circumstances, the explicit reversion to long term loss rates may be less clear, but should be addressed to effectively communicate with stakeholders.

DEFINITIONS AND DISCUSSION

3. Economic Forecast

a. Sources of Forecasts and a “Common View”

CECL requires a forecast of expected credit losses based on relevant information about experience, current conditions, and expected future conditions that affect the collectability of the reported amount. A forecast of expected macroeconomic conditions specifically includes the economic variables used in the forecast of expected credit losses and does not include consideration of how effectively a bank uses the economic forecast to estimate expected credit losses. There is a wide range of sources for economic forecast data. Beyond more common

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sources (e.g. Federal Reserve), bankers are also using sources such as county or city level published economic development reports and regional economic newsletters. Some banks may use exclusively internal forecasts of economic activity.

There should be a “common view as a whole” within the entity. In other words, forecasts applied throughout the bank should be directionally consistent with the ones used for CECL estimates. An example of a common view is an interest rate forecast underlying prepayment assumptions used in CECL being directionally consistent with those used in ALM forecasts. For the purposes of CECL governance, ABA believes that mere directional consistency will be considered acceptable at the time of the effective date.

In practice, bankers expect a robust governance process to be sufficient to ensure the common view. While a detailed reconciliation between various forecasts in the organization will not be necessary to assert a common view, bankers expect to generally document why certain other forecasts used throughout the entity may not be appropriate for CECL purposes. With this in mind, forecasts used throughout an entity may vary for various legitimate reasons. For example, a CECL forecast may differ from a budget forecast which may use stretch goals or different time horizons. Forecasts made for fair value estimates (for example, goodwill impairment and acquisition accounting) can be different, based on market assumptions that often integrates each of forecast uncertainty, credit risk uncertainty, and market liquidity into one discount rate. Finally, the risk of forecast uncertainty within other processes (for example, for budgeting or planning purposes or for goodwill impairment estimates) is not nearly the risk within a CECL estimate, as those estimates do not normally impact regulatory capital levels. Therefore, ABA expects R&S periods to often be shorter than those periods use for these other purposes. In these cases, unless there is compelling evidence that similar assumptions would be used for these forecast purposes, the level of analysis and documentation required to dispel the presumption that such forecast assumptions should be identical should not be significant.

b. Use of Specific Economic Forecasts and Qualitative Adjustments

Generally, it appears that banks are expecting to base their credit loss estimates on "baseline" or “most expected outcome” economic forecasts. Additional economic forecasts may be included to provide sensitivity analyses around the baseline and also to base qualitative adjustments from the baseline. Diversity in practice is expected around the use of economic scenarios, including:

- Probability weighting of multiple scenarios
- Use of alternate scenarios to support qualitative adjustments from the base line economic forecast
- Adjusting the weight or impact of each scenario and the number of alternate scenarios

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Examples:

- Bank A may use a consensus forecast single scenario as its economic forecast for its models.
- Bank B may use a consensus single scenario as its baseline economic forecast for its models. Bank B then also considers an alternate scenario from the same consensus forecast provider to consider adjustments to the consensus forecast based on their management judgement. In considering the alternative scenario, management may choose to 1) make adjustments to the forecast utilized by the model or 2) make qualitative adjustments to the model output, using the alternate scenario to support the qualitative adjustment.
- Bank C uses a baseline and three alternate scenarios (adverse, severe adverse, and optimistic) provided from the chief economist office at the bank. The alternate scenarios are weighted based on bank management judgement. Weighting can also differ over the course of the forecast if bank management determines greater uncertainty occurs over the course of the forecast (e.g. the baseline has a higher weight through six months and a decreasing weight the further out the forecast runs). Managing the weighting of the scenarios may preclude the bank’s need to make a qualitative adjustment related to bank management’s view of future economic conditions.

Therefore, it is important to not only assess the economic forecast as an estimate but also consider the resulting credit loss expectations and assess them for reasonableness.

4. Reasonable & Supportable (R&S) Forecast Period

a. Understanding the R&S Period

The reasonable and supportable period is understood as the longest period in which a bank is comfortable in forecasting credit losses. Observing that assumptions underlying macroeconomic indicators can have an overwhelmingly significant impact on their resulting forecast of credit losses, many bankers may refer to the R&S period as that in which only the macroeconomic assumptions are “reasonable and supportable.” In other words, while a bank may have confidence that their credit loss estimation processes can forecast losses over a two or three year period based on the macroeconomic assumptions provided, it may have significantly less confidence in the underlying macroeconomic assumptions. With this in mind, a bank’s R&S period may often be limited and can be considerably shorter than the modeling and budgeting processes deployed throughout the rest of the bank.

Bankers generally understand that reversion to long-term historical rates is a common practice used by professional forecasters and, therefore, may be considered “reasonable and supportable”.

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Therefore, some banks may include the period in which long-term historical rates are used (herein referred to as the “Remainder Period”), as well as the period used to revert from rates determined in the R&S period to the Remainder Period (which is the Reversion Period), all within the reasonable and supportable forecast. This would conform to view #4.

Generally, the R&S forecast is expected to be of consistent length across the various products of the bank. However, different R&S lengths are possible. For example, Bank D has an oil & gas portfolio that is extremely sensitive to the price of oil, which is the biggest risk driver for this portfolio. Bank D may elect to use a one year R&S period for the oil and gas portfolio while using a two year R&S period for its other portfolios that are less sensitive to oil prices.

b. Expected Range of Practice in R&S Forecasts

In practice, R&S forecasts are generally expected to range from one to three years. While not as common, certain banks plan to use longer than three years, although, as previously noted, in some of these cases the reversion period and remainder period may be commingled with the R&S. In practice, an R&S length of zero (or no R&S forecast) is generally considered to be unacceptable.

The length of the R&S period can be dynamic (changing the length each period, based on a set of factors). For example, a bank may have less faith in the reasonableness of a longer dated forecast period in times of an adverse turn in the economic cycle and may shorten their R&S period once it believes it is in a recessionary period. During stable economic times, the R&S period may be longer.

The R&S forecast is generally not expected to be longer than the reasonableness and supportability of the underlying forecast of economic data. However, the length of the R&S period may exceed the forecast of economic data through the use of leading economic indicators. For example, Bank A forecasts building permits through 12/31/x2. This forecast informs credit loss expectations through 6/30/x3. The Bank then begins its reversion period at 6/30/x3. In this example, the R&S forecast period would extend through 6/30/x3 even though the forecast of the underlying economic input went through 12/31/x2.

c. Other considerations

- Economic cycles are typically characterized by long periods of low charge-off rates, followed by short periods of high charge-off rates. All else being equal, therefore, a longer R&S forecast normally results in greater volatility in total credit loss estimates throughout a credit cycle, due to the diminished influence of long-term rates that are used after the R&S period.
- For accounting purposes, as confirmed by the AICPA’s Depository Institutions Expert Panel, changes to the length of the R&S forecast are considered a change in estimate and not a

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change in accounting principle. This also means that the R&S length is a key assumption in the estimate and not an accounting policy election.

5. Remainder Period

a. Understanding the Remainder Period

In contrast to the R&S, which represents the nearest future period, the Remainder Period represents the end – the furthest future period in a reasonable and supportable forecast. Also called the post-reversion period, the Remainder Period is the period during which an entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions. Relevant loss estimates pertaining to the remainder period can be calculated by using historical loss information at the input or output level, no matter whether inputs or outputs were used during the other (R&S or Reversion) periods.

Some may refer to this period as that in which long-term credit loss rates are applied or when averages are used. However, the CECL standard neither mentions loss rates nor averages. Paragraph 326-20-30-9 notes “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.”

In light of a generally accepted notion that the credit loss estimate should be reasonable, bankers understand that a wide variety of historical information can be applied. Averages, medians, and other statistical metrics are acceptable, as are reasonable adjustments to those metrics, as long as they are not made in order to reflect existing or forecasted future economic conditions.

Understanding that “historical information” can have broad interpretation, bankers also believe that information from specific historical periods (vintages or past economic cycles) can also be used to reflect the most reasonable estimate.

b. Other Remainder Period considerations

- Loss estimates forecasted within the Remainder Period can be significant. If the portfolio life is expected to be long and the length of the R&S period is short, losses from the Remainder period can make up the majority of the total credit loss estimate.
- Historical periods that form the basis for estimates during the remainder period may change over time. For example, instead of always applying loss rates that reflect through-the-cycle experience, an entity may revert to one historical period when exiting a forecasted recession and revert to another historical period when the economic expansion has existed for several

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years. In this case, the bank is referring to historical experience that is most relevant to the remainder period at hand.¹

6. Reversion Period

a. Understanding the Reversion Period

The Reversion Period is the transitional period linking the R&S period to the Remainder Period. Per 326-20-30-9, “an entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.” Reversion may be performed using either inputs or outputs.

Prime considerations relating to the reversion period are the length and method of reversion, both with the objective of achieving a reasonable and supportable forecast of total credit losses.

c. Length of Reversion Period

Regulators, auditors, and bankers agree that the immediate reversion period applied in example one of the illustrations within the CECL standard (326-20-55-18 through 22) would not be appropriate in many cases. Indeed, when collateral prices fall (which was a significant factor in the example), they normally fall significantly and quickly, while recovering slowly. Say that real estate values had dropped by 20% in the example (which would not be an unreasonable assumption). An immediate reversion would imply a 25% recovery to previous levels. Such an assumption would likely be considered unreasonable.

Reversion period lengths can differ between specific products and can also be based on situations and circumstances. For example, when loss rates during the R&S period are estimated to be significantly higher than what has been experienced in the long-term, a bank may choose to revert to those long-term rates over a longer time period (say, over three years) than if its R&S estimates were closer to the long-term rates (say, over one year, or use immediate reversion). This can often occur on a product level, for example, as credit losses in a commercial and industrial portfolio may revert to long term rates within a year while a residential mortgage portfolio’s losses may revert over three years.

¹ While this may be perceived as adjusting historical experience in the remainder period for current conditions (point in the economic cycle), such an adjustment is considered reasonable and supportable. This is a circumstance in which the remainder period, given that there are corresponding reasonable R&S and reversion periods (see below), may be collectively considered to make up one reasonable and supportable forecast period (view 4).

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c. Reversion Methods

As noted above, the CECL standard explicitly states that immediate, straight-line or another rational and systematic methods are acceptable. Two examples of another rational and systematic method include:

- Using a mathematical functions (other than straight-line) to determine the rate of reversion to a long-term rate.
- Analyzing previous credit cycles and fitting a loss rate curve (through modeling) based on historical reversion to a long-term rate.

While bankers are finding that the length of the reversion period can have significant impact to the total loss estimate within their preliminary estimates, they also indicate that the specific reversion method may not be as impactful. In other words, the additional effort to model a reversion rate over historical experience as opposed to merely using the straight-line method over the same period may not provide significant additional benefit relative to the cost of the additional effort.

d. Range of Practice

In practice, reversion periods are generally expected to range from one to two years. As stated above, the standard explicitly allows immediate reversion to historical experience that is unadjusted for current and forecasted conditions. However, the length and method of reversion period should be evaluated in light of what provides a reasonable total credit loss estimate. It should be noted that when the loss rates at the end of the R&S period are generally aligned to the long term historical loss environment that the reversion period can be quicker, as there may be little difference to revert to.

e. Other Considerations

- It is important to be detailed about reversion practices in discussion with regulators, auditors, and investors to make sure everyone is on the same page regarding each individual’s view on the R&S period. As discussed in the preface, many stakeholders may be coming to the table with different perspectives on the individual components of the CECL Forecast.
- As discussed previously, professional forecasting organizations often incorporate some level of reversion to a long term rate after a couple of years. Therefore, some may include the reversion period (as well as the remainder) as part of their specific R&S period.

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7. Use of Modeling Inputs and Outputs

a. Understanding “Inputs” and “Outputs”

Estimation modeling inputs and outputs are critical aspects within all components of the CECL forecast. CECL specifically refers to inputs and outputs when estimating credit losses outside of the period in which a reasonable and supportable forecast can be estimated, as historical loss information at either the input level or the output level may be used. For the purposes of discussions between stakeholders, the following definitions are useful:

- Inputs: Historical loss information at the input level is generally understood to be data related to economic variables such as unemployment rates or changes in GDP.
- Outputs: Historical loss information at the output level generally includes the results of the economic variables as they are applied within an estimation model. These results can include rates of Probabilities of Default, Losses Given Default, and Exposures at Default; migration rates; roll rates; vintage curves; or components of any other estimation method.

As can be seen, in some estimation models, certain outputs, such as probabilities of default, can be used as an “input” to a subsequent model (with a resulting loss rate becoming an output). For the purposes of effective communication, since there can be several levels of calculation to a forecast of credit losses, factors that are used after the initial assumed macroeconomic factor will be assumed to be a model output. Further, reference to the specific factors (macroeconomic factors and other metrics, such as probability of default or loan to value ratios) may better facilitate the discussions, rather than just referring to “inputs” or “outputs”.

b. Observations from Bankers

- Historical loss information at the input level is generally more easily attainable. For example, archives relating to macroeconomic indices, such as unemployment levels, can be accessed that often spans decades. In contrast, due to limitations in retention of loan-level credit risk data over the life of a loan at most banks, loss rates and related other credit metrics specific to the current portfolio segments may be difficult to obtain.

- Results can significantly differ between historical averages and medians and between historical outputs (such as loss rates) and inputs (such as unemployment levels). This is because typical economic conditions normally produce losses below the historical mean (which are affected by large spikes over short periods of time). Bankers that have estimated credit losses based on typical (which may more closely be associated with medians, rather than averages) conditions are seeing lower estimates in their testing. Likewise, bankers that are estimating credit losses based on typical inputs (such as unemployment levels) are seeing lower estimates in their testing than levels seen when estimating on typical outputs, such as loss rates.

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c. Range of Practice

Bankers are expected to have significant diversity in practice when choosing the historical loss information to apply to both the Reversion and Remainder periods, as preliminary implementation feedback indicates they will utilize both inputs and outputs. With this in mind, bankers are emphasizing the importance of reviewing preliminary estimates of credit loss for reasonableness across the entire contractual life of the portfolio and assessing such estimates throughout an economic cycle. For example, bankers must take care that resulting loss rates do not imply unrealistically quick recovery of collateral values after a recession or unreasonably high borrower default rates in the midst of a recovering economy.

In practice, bankers believe that historical rates used for the remainder period should generally reflect experience from at least one economic cycle. Banks that do not have a full economic cycle of data should consider external data (for example, from Fannie Mae).

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