



# STAFF Q&A

## TOPIC 326, NO. 1

### WHETHER THE WEIGHTED-AVERAGE REMAINING MATURITY METHOD IS AN ACCEPTABLE METHOD TO ESTIMATE EXPECTED CREDIT LOSSES

#### BACKGROUND

Topic 326, Financial Instruments—Credit Losses, requires entities (and other organizations) to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts with the objective of presenting an entity’s estimate of the net amount expected to be collected on the financial assets. Under this guidance, entities will use reasonable and supportable forecasts to better inform their credit loss estimates. The standard does not require a specific credit loss method; however, it allows entities to use judgment in determining the relevant information and estimation methods that are appropriate in their circumstances.

Questions have been posed to the staff on acceptable, practical methods that may be relevant and appropriate for smaller, less complex pools of assets. Specifically, the FASB has received questions about whether the weighted-average remaining maturity (WARM) method is an acceptable method to estimate expected credit losses.

The WARM method uses an average annual charge-off rate (see calculation in Question #3 below). This average annual charge-off rate contains loss content over several vintages and is used as a foundation for estimating the credit loss content for the remaining balances of financial assets in a pool at the balance sheet date. The average annual charge-off rate is applied to the contractual term, further adjusted for estimated prepayments to determine the unadjusted historical charge-off rate for the remaining balance of the financial assets. The calculation of the unadjusted historical charge-off rate does not include a reasonable and supportable forecast period. Like other loss rate methods that can be used to estimate expected

credit losses, consideration of reasonable and supportable forecasts when applying the WARM method can be accomplished in other ways, as illustrated later in this Q&A (See Question #5).

#### QUESTION 1

Is the WARM method an acceptable method to estimate allowances for credit losses under Subtopic 326-20?

#### RESPONSE

The WARM method as described in the background section above may be an acceptable method to estimate expected credit losses under Topic 326. Specifically, the WARM method considers an estimate of expected credit losses over the remaining life of the financial assets (that is, losses occurring through the end of the contractual term).

Paragraph 326-20-30-3 states that “...the allowance for credit losses may be determined using various methods.” The Board elaborated on its intent in paragraph BC50 of the basis for conclusions to Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*:

The Board has permitted entities to estimate expected credit losses using various methods because the Board believes entities manage credit risk differently and should have flexibility to best report their expectations.... The complexity of the portfolio, size of the entity, access to information, and management of the portfolio may result in

Management expects a rise in unemployment rates for 2021 and 2022 and cannot reasonably forecast beyond 2022. The example assumes a 0.25% qualitative adjustment for current conditions and reasonable and supportable forecasts discussed further below. It is important to note that this input will be a significant assumption when estimating expected credit losses under Update 2016-13 because it represents amounts for the current conditions and reasonable and supportable forecast. Moreover, because the example is for illustrative purposes, the staff has not assumed a specific type of financial asset pool given the breadth of products that exist in the market place and the specific facts and circumstances that may exist for a particular entity. Rather, the calculations are meant to depict the mechanics of the model in various ways. Therefore, as noted in the example calculations, an entity will need to determine if adjustments need to be made to historical loss data in accordance with paragraph 326-20-30-8 in addition to the reasonable and supportable forecasts.

*Step 1: Calculate Annual Charge-Off Rate*

Year	A		B	C = B/A
	Amortized Cost	Average Balance	Actual Annual Net Charge-offs	Annual Charge-off Rate
2015	\$ 5,126			
2016	8,969	7,048	21	0.30%
2017	11,220	10,094	51	0.51%
2018	12,312	11,766	42	0.36%
2019	12,936	12,624	32	0.25%
2020	13,980	13,458	49	0.37%
<i>Balances are in thousands except charge-off rate data</i>				
<b>Average annual charge-off rate</b>				<b>0.36%</b>

In Table 1 above:

1. Red bolded number of 0.36% is an average of 5 years of annual charge-off rates.
2. The historical time period used to determine the average annual charge-off rate is a significant judgment that will need to be properly supported and documented in accordance with paragraph 326-20-30-8. For this example, assume the entity compared historical information for similar financial assets with the current and forecasted direction of the economic environment, and believes that its most recent 5-year period is a reasonable period on which to base its expected credit-loss-rate calculation after considering the underwriting standards and contractual terms for loans that existed over the historical period in comparison with the current pool. Additionally, assume the entity considered whether any adjustments to historical loss information in accordance with paragraph 326-20-30-8 were needed before considering adjustments for current conditions and reasonable and supportable forecasts

but determined that none were necessary. It should be noted that this is a simplified example using a generic pool. An entity that estimates the allowance for credit losses using the WARM method (or any method) should determine if its historical loss information needs to be adjusted for changes in underwriting standards, portfolio mix, or asset term within the pool at the reporting date.

*Step 2: Estimate the Allowance for Credit Losses*

Year End	A		B	A*B
	Est. Paydown	Projected Amort Cost	Avg Annual Charge-off Rate	Allowance for Credit Losses
2020 Actual Amortized Cost	\$ 13,980		0.36%	\$ 50
2021	\$ 3,700	10,280	0.36%	37
2022	3,900	6,380	0.36%	23
2023	3,000	3,380	0.36%	12
2024	2,160	1,220	0.36%	4
2025	1,220	-	0.36%	-
Est. unadjusted charge-off amount for remaining balance				126
<i>Paydown &amp; amortized cost balances in thousands</i>				
Unadjusted historical charge-off rate for remaining balance				0.90%
Qualitative Adjustment				0.25%
Total allowance for credit losses rate as of 2020				<b>1.15%</b>
Total allowance of credit losses as of 2020 (\$13,980 x 1.15%)				<b>161</b>

In Table 2 above:

1. First column titled “Year End” displays subsequent years, until 2025, which represents the time anticipated for the pool to be paid off.
2. Second column titled “Est. Paydown” represents expected payments in the future periods until the pool is expected to fully pay off. Management will need to estimate the future paydowns, which includes the scheduled payments + prepayments.

**Note:** Do not include the expected credit losses in this column. Paydowns should include scheduled payments and non-credit related prepayments.

**Note:** Estimated prepayments are also a significant judgment that will need to be properly supported and documented.

3. Third column titled “Projected Amort Cost”:
  - a. Begin with \$13.98MM outstanding balance as of the balance sheet date of 12/31/2020.
  - b. Subtract projected paydowns from the “Est. Paydown” column to estimate future projected amortized cost for each of the remaining years of the pool’s life (for example, \$13,980M minus \$3,700M equals \$10,280M).
4. Fifth column titled “Allowance for Credit Losses”:
  - a. Take each of the future years’ projected amortized cost and multiply by the average annual charge-off rate, thereby estimating each of the remaining years’ losses and aggregating to estimate the cumulative losses (for example,

- a. For example, assume that all paydowns are provided on the last day of the year. Therefore, the numbers shown in the “Estimated Paydown” column will occur on December 31st of every year. Consequently, every single dollar of 12/31/2020’s outstanding amount of \$13.98MM will have a life of 1 year because some of that amount will be paid down at the end of the year. Therefore, the “remaining life” of \$13.98MM is 1 year. Applying the same logic to the “Projected Amort Cost” balance in year 2021, every single dollar of 2021’s ending balance of \$10.28MM will have a life of 2 years.

**Note:** The “Remg Life” column represents the number of years the entire “Projected Amort Cost” will be outstanding. For purposes of this example, the staff has made a simplifying assumption that all paydowns occur at the end of the year. Those numbers likely will be fractions of years (for example, 0.5, 1.5, 2.5, and so on) depending on when the paydowns are estimated to occur. Management will need to estimate and support the timing of those paydowns.

- 3. An entity should use the numbers in the table above to determine 2.52 years. This can be done in the following manner:

	B		C	D = BxC	D/A
Year End	Est. Paydown	Remg Life	Method 2:		
2020 Amort Cost	13,980	A			
2021	\$ 3,700	1.00	\$ 3,700	0.26	
2022	3,900	2.00	7,800	0.56	
2023	3,000	3.00	9,000	0.64	
2024	2,160	4.00	8,640	0.62	
2025	1,220	5.00	6,100	0.44	
Paydown balances in thousands					
		2.52	Sum	2.52	
<b>Method 1 (excel formula):</b>					
<b>2.52 = Sumproduct (column B: Column C) / A</b>					

- 4. 2.52 years are multiplied by the average annual charge-off rate of 0.36% to arrive at 0.90% representing the unadjusted historical charge-off rate for the remaining balance.
- 5. In the example provided, the entity would add the same 0.25% of qualitative adjustment to arrive at the allowance for credit losses rate of 1.15%. The 1.15% is multiplied by \$13.98MM to arrive at the total allowance for credit losses of \$161K dollars.

The examples in questions #3 and #4 use simplifying assumptions to arrive at the answers calculated. Entities should be aware that all assumptions could have a significant effect on the ultimate allowance for credit losses estimated. Examples of those assumptions include, but are not limited to, the following: the estimated payoff profile considering contractual terms and any estimated prepayments (for example, straight line, amortizing or bullet loan), the historical time period an

entity references as representative of the current pool’s remaining contractual life (for example, the most recent past 5 years or a different 5-year period representing the characteristics of the current pool), and the qualitative factors considered (for example, any qualitative factors that may be used to adjust historical information as discussed in Step 1 of Question #3 above or those qualitative factors used to adjust historical information for reasonable and supportable forecasts as discussed in Question #5 below). Entities should consider the guidance in paragraph 326-20-30-8, which states:

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

**QUESTION 5**

When an entity implements CECL using a loss rate method such as the WARM method, is it acceptable to adjust historical loss information for current conditions and the reasonable and supportable forecasts through a qualitative approach as was done in the example rather than a quantitative approach?

**RESPONSE**

Yes. If adjustments to historical loss information are appropriate, an entity could use a qualitative approach to adjust its historical data for current conditions and reasonable and supportable forecasts. As noted below, Update 2016-13 does not require a quantitative analysis. Nevertheless, an entity should maintain appropriate documentation, commensurate with its complexity and sophistication to support its qualitative adjustments and the effect of the relevant qualitative factors on the measurement of expected credit losses. Paragraph 326-20-30-9 states in part:

An entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed

**326-20-55-22** The expected loss rate to apply to the amortized cost basis of the loan portfolio would be 1.65 percent, the sum of the historical loss rate of 1.5 percent and the adjustment for the current conditions and reasonable and supportable forecast of 15 basis points. The allowance for expected credit losses at the reporting date would be \$49,500.



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