Credit impairment reference card

Key questions for management to consider related to the use of third parties when determining the allowance for credit losses

Implementing Accounting Standards Codification (ASC) 326, Financial Instruments – Credit Losses, may require complex calculations, including developing a reasonable and supportable forecast and making the estimate of expected lifetime losses. In some cases, we expect entities to engage third parties to help them develop this estimate. If you plan to use a third party to help you determine your allowance for credit losses (ACL), you will need to make sure you have sufficient information to take responsibility for the estimate, including the appropriateness of methods and models used, the relevance and reliability of data, and the reasonableness of assumptions. This document lists some considerations related to the use of third parties in the determination of the ACL.

Governance

- If you are considering engaging a third party, do you have a well-defined process for selecting the third party? What criteria will you use in making the selection?
- What governance process will be put in place to oversee the third party?

Model

- If you will use a third party’s model or use a third party to develop a custom model:
  - How will you determine that the third party’s model will produce a result consistent with the requirements of ASC 326?
  - How will you know that the data and assumptions were appropriately used in the model?
  - How will you evaluate whether the model is appropriate for the entity (i.e., fit for purpose)?
  - How will the third party make the model transparent and explain aspects such as its selection of inputs, assumptions, parameter values and the mathematical theory driving the model calculations?
  - If the model has already been selected, what model limitations has the third party identified, and how will you address those limitations?
  - What will be the nature and extent of customization of the model that will be used by the third party?
    - How will changes to the model be tested, distributed and implemented?
    - What role will the third party play in determining what changes may be required in the future?
    - How will those changes be provided to the entity?
    - How will you document your customization decisions and the reason for each decision?
    - Will the third party’s model provide the information you need to make required disclosures?
    - Will you have a contingency plan in place if the third party decides to no longer support the model?
    - Will the service organization, if used, provide a type 2 service organization controls report (SOC 1) related to the information it collects, processes (if applicable) and provides? (A type 2 SOC 1 report includes tests of the operating effectiveness of controls.)
    - Will the third party provide ongoing monitoring of the model? How will you evaluate if model changes are required?

Assumptions

- If you will use a third party to determine or provide the data and assumptions to be used in the model:
  - How will you obtain sufficient information about the data and assumptions, and how the data relates to current and forecasted economic information?
  - What assumptions will the third party use, assist in determining or provide, and how will you evaluate the reasonableness of those assumptions? (The third party’s assumptions become management’s assumptions.)
  - What information will be collected, or used, by the third party and what will be its source? How will you evaluate the reliability of such information? How will you know the information will be aggregated accurately?
  - How will you know that information collected, or provided, by the third party is relevant (e.g., whether the loss information provided by the third party relates to finance receivables similar to the entity’s finance receivables)?