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Credit Losses for Insurance Companies, MGAs, and Related Organizations

Your Accounting Guide to Adopting Topic 326

Johnson Lambert LLP is dedicated to keeping you current on the impact of the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 326 - *Financial Instruments – Credit Losses*. This white paper presents the most significant changes related to applying ASC Topic 326 to insurance companies, managing general agents (MGAs), and related organizations.

Background

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses*, the first of several ASUs that created and amended ASC Topic 326. The standard requires entities to record the current expected credit loss (CECL) on certain financial assets, taking into consideration historical information, current losses, and, for the first time, reasonable and supportable forecasts to project expected future losses.

The CECL model addresses perceived shortcomings of the previous incurred loss impairment model by taking into consideration future economic changes (allowing credit losses to be recognized earlier). The model also permits recognition of potential improvements in estimated losses in the income statement in future periods, rather than the one-way "permanent impairment" model used prior to this standard.

Additionally, the guidance amends the impairment model for available-for-sale (AFS) debt investment securities.

AFS debt securities do not follow the CECL model as they are recorded at fair value rather than amortized cost. Amendments were made to the impairment model for these securities, which is discussed later in this paper.

The standard is effective for calendar years beginning after December 15, 2022, for nonpublic companies.

Financial Assets in Scope

Several financial assets commonly held by insurance companies, MGAs and other related entities are subject to the CECL reporting model, including:

CECL Reporting Model

- Held-to-maturity debt securities
- Premiums and commissions receivable
- Reinsurance recoverables (paid and unpaid)
- Receivables from adjustable features (profit contingent commissions and swing rate commissions)
- Deductible receivables
- Funds withheld
- Escrow accounts
- Contract assets under Topic 606, Revenue from Contracts with Customers (receivable from adjustable features such as volume incentive commissions receivable by agents/ producers)
- Lease receivables resulting from sales-type or direct financing leases
- Premium financing loans receivable
- Loans including loans to employees, officers and directors
- Promissory notes receivable
- Off-balance-sheet credit exposures such as loan commitments, standby letters of credit and financial guarantees not accounted for as insurance

Exclusions from the scope of the CECL reporting model include:

Scope Exceptions

- Financial assets measured at fair value through net income
- **Loans and receivables between entities under common control**
- Receivables arising from operating leases under Topic 842
- Policy loan receivables of an insurance entity

The CECL model excludes related party loans and receivables between entities under common control based on feedback received during the exposure process. The term common control is mentioned in several codification topics and generally is present when an entity or individual (including immediate family members) controls more than 50% of the voting interest of each of the entities.

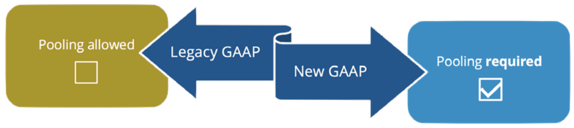
Contracts between entities under common control may include insurance or reinsurance agreements issued to related parties under common control, intercompany pooling agreements, or a promissory/demand note issued to a subsidiary or parent company. These transactions and related receivables between entities under common control are not subject to the CECL model.

CECL Reporting Model

ASC 326-20 introduces a model for estimating credit losses that generally accelerates the recognition of impairment on financial assets. An entity must estimate expected future credit losses on financial assets in scope and record an allowance, with an offsetting charge to net income. The allowance (contra-asset) can increase or decrease over time, which is expected to increase volatility in the income statement.

Under the CECL model, assets with similar risk profiles are required to be pooled and analyzed collectively to arrive at a lifetime estimated loss rather than waiting for a specific asset to be probable of impairment under the previous incurred loss impairment model.

Under CECL, entities will report financial assets at the net amount the entity ultimately expects to collect over the life of the asset.



Financial Asset Pooling

Financial assets with similar risk characteristics are required to be reviewed collectively as a pool to determine the credit allowance. Similar risk characteristics may include:

+ Credit quality or rating
+ Past due status
+ Asset type, size, or term
+ Geographic location
+ Vintage
+ Industry of borrower
+ Effective interest rate

When a pooled asset ceases to share similar risk characteristics, the asset must be removed from the pool and assessed either with another pool, or separately when no other pools share similar risk characteristics. The entity must review asset pool(s) for similar risk characteristics at each reporting period.

Measurement

Entities are required to estimate and record a credit allowance against financial assets (or asset pools) in scope, with an offsetting charge or credit to net income. The credit allowance is updated for subsequent increases and decreases at each reporting period. The following data may be used in management's analysis:

- Historical data
- Characteristics of the financial assets
- Current economic conditions
- **Reasonable and supportable forecasts**

Qualitative and quantitative aspects of the data are required to be considered. Management should also consider expected recoveries of amounts previously written off or expected to be written off. The expected recoveries cannot exceed the aggregate of amounts previously written off and expected to be written off.

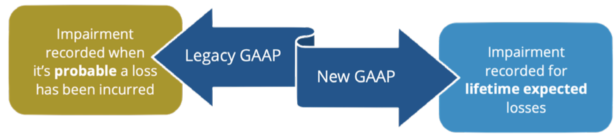
Estimation Methods

While the guidance does not prescribe a method to estimate the current expected credit losses, it requires management to use a reasonable estimation method. This provides entities the flexibility to choose an estimation method that works for their organization and the available data. Judgment is involved in determining estimation methods that are appropriate under the circumstances.

Management can leverage the same estimation methods used under previous guidance to develop the credit allowance, which may include some or all of the following:

- Discounted cash flow method - frequently used, projects future principal and interest cash flows
- Loss rate method - calculates the average lifetime rate of loss on a pool of financial assets
- Roll-rate method (or migration analysis) - calculates ultimate losses based on the frequency of assets transitioning from one delinquent stage to another
- Probability-of-default method - estimates the probability a loan in the pool will default based on total exposure
- Aging schedule - considers the length of time an asset has been outstanding; commonly associated with trade and premium receivables

New inputs into the estimation methods need to be incorporated to reflect the use of reasonable and supportable forecasts in accordance with the CECL model. When prospective forecasts cannot be evaluated for the entire contractual life of the asset, an entity is required to revert back to historical loss information.



Collateral

An entity is required to consider the effects of a collateral agreement when measuring the credit allowance including the nature of the collateral, potential future changes in the collateral values and historical loss information for financial assets secured with similar collateral.

An entity may elect a practical expedient to measure the allowance for credit losses using the fair value of the collateral at the measurement date without consideration of future changes in the fair value of the collateral. This election is permitted provided the borrower is expected ***to replenish the collateral on a continual basis based on the fair value changes***. No allowance is required if the fair value of the collateral held and estimated costs to draw upon the collateral exceeds the asset's amortized cost. If the fair value of the collateral is less than amortized cost, the CECL model is applied only to the difference between the fair value of the collateral and amortized cost.

Credit Enhancements

The allowance for credit losses should take into account non-freestanding credit enhancements that mitigate expected credit losses. To be non-freestanding, the credit enhancement must be embedded in the financial asset and cannot be legally detachable or separately exercisable. A freestanding credit enhancement is accounted for as a separate asset.

Disclosures

Appendix A includes a disclosure checklist summary for financial assets subject to the CECL model.

CECL Considerations for Common Holdings

The table below lists common financial asset holdings for insurance companies, MGAs, and other related entities that are subject to the CECL model, and allowance considerations for each:

Held-to-maturity debt securities | Loans receivable

- Required to pool when similar risk characteristics are present, which may include credit scores, risk ratings, financial asset type, collateral type, size, effective interest rate, term, geographic location, the industry of the borrower and vintage.
- Collateral (ex: house, car, receivable) and non-freestanding credit enhancements (ex: co-signer) are considered in the allowance.

Premiums receivable

- Required to pool premiums receivable provided similar risk characteristics are present.
- Credit loss allowance should be based on the portion of the premiums receivable balance that has been earned (net of unearned premium) and the premium that would be due from the policyholder for the grace period.
- Certain laws may require coverage to be provided for the remaining term regardless of delinquency or default by the policyholder. In these cases, an entity should consider credit losses on the entire premium receivable without consideration of the unearned premium.

Reinsurance recoverable

- Required to pool reinsurance recoverables provided similar risk characteristics are present, which may include credit ratings, geographic concentration of business written by the reinsurer, size of reinsurer and type of agreements written by the reinsurer.
- Factors to consider to estimate the allowance could include the expected period of exposure under the contract (including termination clauses), historical losses of similar reinsurers, geographic and coverage type concentration of the reinsurer and financial health of the reinsurer.
- Reinsurers may set aside funds in a trust account and have a right to offset provision or enter into a letter of credit for the benefit of the ceding insurer. The trust account is considered collateral and management may elect the practical expedient to evaluate the collateral if the terms meet the criteria. To qualify, collateral must be reported at fair value and updated continually for changes in the fair value of the collateral. The AICPA Financial Reporting Executive Committee (FinREC) believes trust accounts will likely not qualify for the practical expedient. If it does not qualify, the allowance analysis needs to consider the impact of future fair value changes in the collateral. As a credit enhancement, a non-freestanding letter of credit (included within the reinsurance contract and cannot legally be detachable or separately exercisable) would be considered in the determination of the credit loss allowance.
- Entities should measure contingent losses relating to disputed amounts in accordance with the loss contingency guidance.

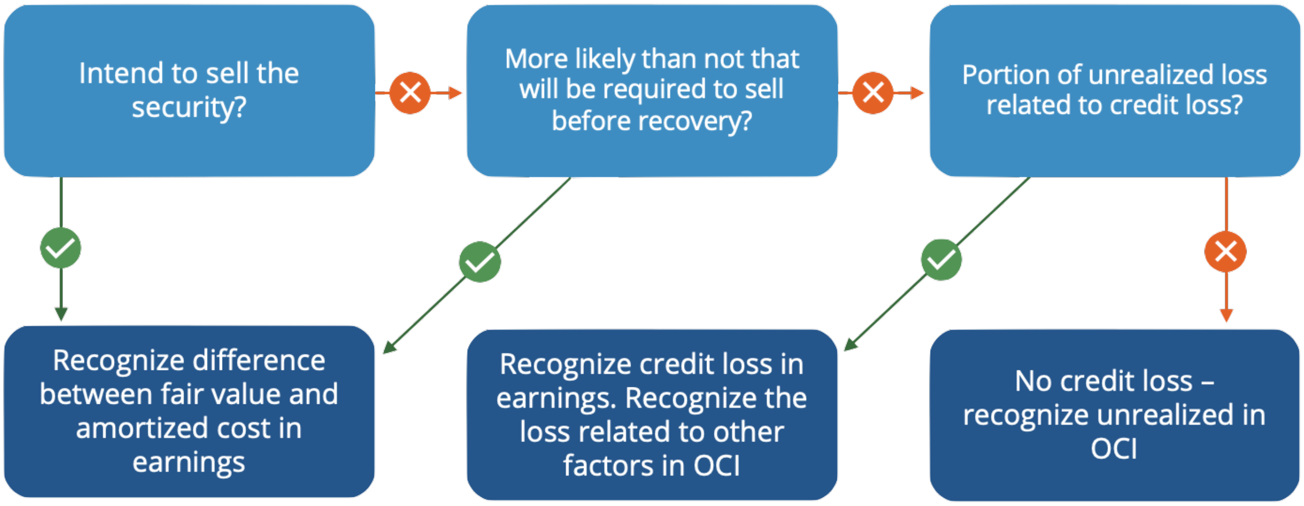
Contract assets

- Required to pool contract assets provided similar risk characteristics are present, which may include credit ratings, geographic concentration of business written and type of contract assets.
- Contract assets represent a conditional right to consideration for services transferred when the condition is due to the requirement of satisfying future conditions. Contract assets are recorded when collection of the transaction price is probable. An MGA may have an incentive volume commission based on meeting certain volume triggers. When the commission is probable to be received, for example based on meeting a certain volume historically and expected to meet the volume this year, a contract asset is recorded.
- Consider credit risk of pools of related receivables, such as commissions receivable, when evaluating the allowance for credit losses on contract assets.

Available-for-Sale Debt Securities

Available-for-sale (AFS) debt securities are those not otherwise classified as trading securities or held-to-maturity securities and are carried at fair value, which is outside the scope of the CECL model. ASC 326-30 eliminates the current other-than-temporary impairment concept and makes targeted enhancements to the impairment analysis for AFS debt securities.

An illustration of the AFS Impairment Model (Fair Value < Amortized Cost) is as follows:



Impairment Changes

The concept of impairment remains the same. An AFS debt security is considered impaired if the fair value of the investment is less than its amortized cost.

The amendments distinguish between credit related impairment and non-credit related impairment to allow for the recognition of credit impairment sooner through the use of an allowance account (contra-asset) and offsetting charge to net income. The allowance (contra-asset) can increase or decrease over time, similar to the CECL model, which is expected to increase volatility in the income statement. Non-credit related impairments are recorded through other comprehensive income (OCI).

Unlike the CECL model, the credit impairment analysis for AFS debt securities is required to be performed ***at the individual security level, and pooling is not permitted.***

If management intends to sell the AFS debt security, or if it is more likely than not that it will be required to sell the security before it can recover the amortized cost basis, impairment is recorded in the income statement for the amount of the difference between the security's fair value and it's amortized cost.

Management must reassess the allowance for credit losses at each reporting period. Previously recorded allowances for credit losses may be reversed at subsequent valuation dates as conditions change and expected credit losses decline. Reversals of previously recorded allowances for credit losses are credited to earnings.

The guidance prescribes the ***discounted cash flow method*** for AFS debt securities. Investment managers should be able to provide entities with an investment holding report displaying the credit loss for each individual security in an unrealized loss position.

Assessing Credit Factors

When an entity determines that an AFS debt security is impaired, does not intend to sell the security, and concludes it is not more likely than not required to sell the security, the entity must assess whether the impairment is due to credit or non-credit factors. Credit loss factors may include:

- The extent to which fair value is less than the amortized cost basis
- Adverse conditions specifically related to the security, an industry, or geographic area, for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors
- The payment structure of the security
- Failure of the issuer to make scheduled principal or interest payments
- Changes in the security's rating by a rating agency

Not included above is the length of time the security has been in an unrealized loss position, as that should no longer be considered.

Management may need to review and revise impairment policies to remove this criteria from their analysis and to include the new forward looking forecast criteria.

Measurement

The allowance for credit losses on an AFS debt security is equal to the difference between the present value of the future cash flows expected to be collected from the security (i.e. discounted cash flow method), and the security's amortized cost. Any remaining difference between the fair value and the amortized cost of the security is a non-credit loss recorded in other comprehensive income. The total allowance for credit losses is limited to the fair value of the security, recognizing that management has the option to sell the security immediately at its reported fair value.

ASC 326-30 requires management to use a discounted cash flow analysis in its assessment of impairment for AFS securities to account for the time value of money. All of the following information should be included:

- The remaining payment terms of the security
- Prepayment speeds
- The financial condition of the issuer(s)
- Expected defaults
- The value of any underlying collateral

When prospective forecasts cannot be evaluated for the entire contractual life of the asset, an entity is required to revert back to historical loss information.

Entities are required to use the security's effective interest rate for discounting future expected cash flows and to consider the impact of potential prepayments when estimating future expected cash flows. Entities may include prepayments in the estimated future cash flows analysis or make an accounting policy election to adjust the effective interest rate for potential changes in the timing of estimated future prepayments. This election is made by major security type.

If the impaired AFS debt security includes a variable interest (e.g. the rate varies based on an index or some other independent factor), the entity may make an accounting policy election to estimate future interest payments based on the rate in effect at the date the credit loss is identified, or based on future interest rate projections. Regardless of the election, the interest rate must be consistent between estimated future expected cash flow projections and the discounted cash flow analysis used for estimating expected credit losses.

Disclosures

Appendix B includes a disclosure checklist summary for AFS debt securities.

Other Considerations

The following items apply to both financial assets under the CECL model and AFS debt securities.

Accrued Interest

An entity may make an accounting policy election to exclude accrued interest from the measurement of the allowance for credit losses provided it writes off the uncollectible accrued interest receivable balance in a timely manner.

Zero Allowance

If management deems there is a low risk (or no risk) of credit loss on a specific financial asset, an evaluation must still be performed to support the conclusion. For these cases, it may be reasonable to recognize a zero credit loss.

Financial Assets with Purchased Credit Deterioration

The standard eliminates the legacy model in ASC 310-304 for purchased credit impaired assets for loans and securities. In lieu, a Day 1 accounting model for financial assets with purchased credit deterioration (PCD) was created. The entity recognizes the initial expected credit loss on the asset with PCD through an adjustment to increase the asset's amortized cost and to increase the allowance for credit losses contra-asset account.

Subsequent changes to the allowance for credit losses of PCD assets are the same as for non-PCD assets, with increases or decreases to the allowance for credit losses recorded in earnings. ASC 326 also clarifies that only non-credit related discounts or premiums may be accreted or amortized to interest income.

Transition

The guidance is required to be adopted using a modified retrospective approach for most financial assets (exceptions noted below). Nonpublic entities are required to make the following disclosures in the year of adoption:

- Adoption of the standard
- Recognize a cumulative effect adjustment to the opening balance of retained earnings
- The effect of the change on impacted financial statement line items in the current reporting period and an explanation of significant changes

Debt securities where other-than-temporary impairment has been recognized before the effective date of the standard are required to use a prospective approach, which allows the entity to maintain the same amortized cost basis before and after adoption of the standard.

For PCD assets, entities are required to use the prospective approach. This will result in an adjustment to the amortized cost basis to reflect the addition of the allowance for credit losses at the date of adoption.

Implementation Best Practices

Implementing ASC 326 requires a shift in thinking. The FASB expects companies to adopt forward-looking forecasts in addition to looking back in time. Additionally, the allowance for credit losses must be revisited at each reporting period, which will require companies to implement tracking mechanisms and additional oversight over the credit loss estimate since it impacts the balance sheet.

Estimation methods used and policies and practices will vary and can be entity specific. An entity should look at the information available to estimate the credit allowance and determine its appropriateness under the guidance. The CECL model provides flexibility over estimation methods and forecasting data, as long as it is reasonable and supportable. Regulators, auditors and other users of the financial statements will expect to see consistency of the estimation methods used (including forecasting inputs) from one reporting period to the next.

When judgment is involved and management needs to support consistent application, management is responsible to maintain sufficient, appropriate documentation to support its conclusions.

Documentation should include:

- Internal controls around gathering the data and inputs in the analysis
- Risk assessment and characteristics of each asset pool
- Selection and rationale for estimation methods used
- Inputs and data (including quantitative and qualitative factors considered)
- Selection and rationale for forecasts used, specifically how they are reasonable and supportable
- Calculation of reported credit loss
- Consistency and/or changes as compared to prior assessments

Additionally, management may need to revisit the entity's impairment policies for its financial assets. For example, the length of time an AFS debt security has been in an unrealized loss position is no longer relevant to the impairment analysis and would need to be removed from the impairment policy.

Finally, start on implementation early. It will take additional time in the first year to establish internal controls around the new data sources and forecasting inputs to the impairment models. Once management develops a plan, share it with the auditors early. Expect additional inquiries in the initial year as the auditors gain comfort over the new data sources and forecasts.

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Appendix A: CECL Model Disclosure Checklist Summary

Credit Quality Information

- [ ] Quantitative and qualitative information by class of financing receivable and major security type about the credit quality of financial assets, including all of the following: credit quality indicators, amortized cost basis by credit quality indicator, and for each credit quality indicator, the date the information was last updated for that credit quality indicator
- [ ] If internal risk ratings are disclosed, provide qualitative information on how those internal risk ratings relate to the likelihood of loss

Allowance for Credit Losses

- [ ] Accounting policy and methodology to estimate the allowance for credit losses by asset pool and major security type, and a discussion of factors that influenced management's current estimate of expected credit losses including: past events, current conditions, reasonable and supportable forecasts about the future
- [ ] Risk characteristics relevant to asset pooling
- [ ] Changes in the factors that influenced management's current estimate of expected credit losses and reasons for those changes
- [ ] Changes to the entity's accounting policies and changes to the methodology from the prior period, its rationale for changes and quantitative effect of changes
- [ ] Reasons for significant changes in writeoff amounts
- [ ] A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period, if applicable
- [ ] Amount of significant purchases of financial assets during each reporting period
- [ ] Amount of significant sales of financial assets or reclassifications of loans held for sale during each reporting period
- [ ] Rollforward of the allowance for credit losses

Other Disclosures

- [ ] For past due amounts, the nature and amount of past due status, disaggregated by class of financial assets and major security type
- [ ] For financial assets on nonaccrual status, amortized cost basis at the beginning of the reporting period and the end of the reporting period, amount of interest income recognized during the period, amortized cost basis of financial assets that are 90 days or more past due but are not on nonaccrual status as of the reporting date, and the amortized cost basis of financial assets on nonaccrual status for which there is no related allowance for credit losses at the reporting date, disaggregated by class of financial assets and major security type
- [ ] For collateral-dependent financial assets when repayment is expected through the operation or sale of the collateral, describe the type of collateral by class of financing receivable and major security type, the extent to which collateral secures its collateral dependent financial assets, and significant changes in the extent to which collateral secures its collateral dependent financial assets
- [ ] For off balance sheet credit exposures, the accounting policy, and related methodology the entity used to estimate its liability for off balance sheet credit exposures and related charges. Identify factors that influenced management's judgment and the risk elements relevant to particular categories of financial assets

Other Disclosures (continued)
☐ For contracts with customers, credit losses recorded on receivables or contract assets arising from contracts with customers, which the entity shall disclose separately from credit losses from other contracts
☐ For purchased assets with credit deterioration, a reconciliation of the difference between the purchase price of the financial assets and the par value of the assets
☐ Policy election to exclude the accrued interest from the disclosed amortized cost basis, including time period considered timely, by class of financing receivable or major security-type level

Appendix B: AFS Debt Security Disclosure Checklist Summary

AFS Securities in Loss Position without an Allowance for Credit Losses
☐ Disclose quantitative information in tabular format aggregated by category of investment, the aggregate related fair value of investments with unrealized losses and the aggregate amount of unrealized losses, disaggregated by investments that have been in a unrealized loss position for less than 12 months and those in an unrealized loss position for 12 months or longer
☐ Additional narrative to describe the information the entity considered (positive and negative) in reaching the conclusion that an allowance is unnecessary. The disclosure could include: nature of investment, cause of the impairments, number of investments in an unrealized loss position, severity of impairments, and other evidence

Allowance for Credit Losses
☐ The methodology and significant inputs used to measure the amount related to credit loss by major security type
Significant inputs may include: performance indicators of underlying assets in the security (default rates, delinquency rates, percentage of nonperforming assets), debt to collateral value ratios, third party guarantees, current level of subordination, vintage, geographic concentration, industry analyst reports and forecasts, credit ratings, or other market data
☐ Accounting policy for recognizing writeoffs of uncollectible AFS debt securities
☐ Rollforward of the allowance for credit losses
☐ For purchased assets with credit deterioration, a reconciliation of the difference between the purchase price of the financial assets and the par value of the available for sale debt securities