INSIGHTS FROM THE BDO INSURANCE PRACTICE

HOW INSURERS WILL BE IMPACTED BY FASB'S CECL STANDARD

Billed as one of the biggest changes to bank accounting rules in decades, the Current Expected Credit Loss (CECL) standard is an enduring hot topic for executives at publicly traded banks. However, for insurance industry CFOs, it's important to understand that the CECL standard is based on the characteristics of an asset, as opposed to the characteristics of the entity itself. As a result, insurers with assets including reinsurance recoverables and investment portfolios will need to comply with this new rule from the Financial Accounting Standards Board (FASB).

CECL: AN OVERVIEW

ASC 326 requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model referred to as CECL. Under this model, entities will estimate credit losses over the entire contractual term of the instrument from the date of initial recognition of that instrument. In contrast, current U.S. Generally Accepted Accounting Principles (GAAP) is based on an incurred loss model that delays recognition of credit losses until it is probable the loss has been incurred. Accordingly, it is anticipated that credit losses will be recognized earlier under the CECL model than under the incurred loss model.

The FASB met on October 16, 2019, and, as expected, affirmed its decision to go forward with its changes to effective dates for CECL adoption as outlined below. The final standard is expected to be issued around mid-November which will require all SEC Filers excluding Smaller Reporting Companies (SRCs) to adopt this standard effective January 1, 2020. All other entities including SRCs will adopt this standard effective January 1, 2023, although early adoption is allowed.

INSURERS' ASSETS TO APPLY THE CECL STANDARD

Below are a few areas that will require additional review and analysis upon adoption of the CECL standard for insurers.

Reinsurance recoverables

Assessing credit risk on a reinsurance receivable is not a new concept and most entities assess the exposure to credit loss by reviewing factors such as credit ratings and assessing the collateral requirements under reinsurance contracts. What's new is that entities must now quantify and record an allowance upon inception of the contract.

Insurance companies historically have not experienced significant credit losses related to reinsurance recoverables. The counterparty risk is typically low due to long periods of strong capital position, as well as high credit ratings of reinsurers. As a result, the risk of default is generally low, but it does mean that no allowance will be required upon adoption of CECL. CECL is introducing a new concept of "expected" losses in contrast to the current "incurred" loss model. Under the new model an allowance will be necessary to reflect the future possibility of default, irrespective of the past experience of low or no default.

Reinsurance recoverables on paid losses are generally short term in nature and are settled in a matter of a few months. As such the credit losses on them are expected to be minimal. However, recoverables on unpaid losses or longer duration contracts tend to settle over a much longer period, which could range from one to twenty or more years based on the type of underlying policy. Hence, the analysis to project the loss on such longer term recoverables will require a more robust approach. The guidance does allow for a pooled approach if the underlying contracts exhibit similar risk characteristics, size, term, and geographic location.

Certain reinsurance contracts require the assuming entities to post collateral in the form of a trust account for the benefits of the cedant. These contracts require cash or investments be deposited in the trust accounts equal to or slightly above the recoverable amount. These contracts also include provisions whereby additional collateral is required to be posted if the performance of underlying investments deteriorate or dip below the minimum required thresholds. In these types of situations, the insurance companies will first need to determine if the collateral account qualifies as a credit enhancement and if necessary, if the reinsurer will have the capability to fund these accounts in case of economic downturn or other events affecting the reinsurer.

It is not uncommon in the insurance industry for there to be disputes between the insurer and the reinsurer over the amount of reinsurance receivable due/payable. The existence of these disputes can inject complexity in the issue of evaluating and/or using data on reinsurance receivable write-offs and default experiences.

Held to Maturity (HTM) and Available for Sale (AFS) debt securities

Under this standard, the HTM securities are treated similarly to loans and the lifetime expected losses are recognized upon purchase via an allowance account. Any recognition of subsequent changes in expected credit losses either favorable or unfavorable is immediately recognized in net income by adjusting the allowance. The new standard permits pooling or a collective assessment for HTM debt securities with similar risk characteristics and the use of a discounted cash flow approach is not required.

AFS securities are scoped out of CECL guidance, but the FASB used this opportunity to clarify the impairment guidance for them. The credit loss recognized on AFS debt securities will be limited to the difference between the security's amortized cost and fair value. In other words, the credit loss is limited to this fair value floor for AFS debt securities. There is no such floor for HTM securities. FASB also removed the requirement to consider the length of time the fair value of an AFS security has been below the amortized cost when determining whether a credit loss exists, and recoveries or subsequent declines in fair value after the balance sheet date should no longer be considered in determining the estimate of expected credit losses.

In conclusion, it's critical that insurers take a careful inventory of assets and ensure that, if applicable, they take steps to apply the CECL standard to their reinsurance recoverables and investment portfolios as described above.

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