FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout
Financial Instruments—Credit Losses
March 11, 2020

Meeting Purpose

1. The purpose of this non-decision-making meeting is to share with the Board a technical inquiry that the staff received on freestanding contracts and the staff's response. In addition, the staff will provide the Board with an update on the credit loss workshops, including upcoming workshops that the staff will hold in 2020.

Topic 1: Technical Inquiry on Freestanding Contracts

Technical Inquiry

2. The question raised by the Big Four accounting firms is whether it would be appropriate to recognize an insurance recovery asset at the same time as an insured expected credit loss recorded under the amendments in Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses.*

Background

3. The Big Four accounting firms submitted a memo to the FASB staff regarding the accounting for recoveries from freestanding insurance contracts covering credit losses on financial instruments under the amendments in Update 2016-13. The Big Four accounting firms noted that they have received questions relating to the recognition threshold and measurement model that should be used for a freestanding insurance contract not accounted for as a derivative under Topic 815, Derivatives and Hedging.

4. The Big Four accounting firm memo includes three views on the implementation question. An acceptable view in the memo would analogize to relevant guidance on insurance recoveries and indemnification assets to support recording an insurance recovery at the same time that an insured expected loss is recorded, while the other views would prohibit analogizing to this guidance and, instead, only record an insurance recovery when an insured loss is "incurred."

Scope of the Technical Inquiry

5. The types of freestanding contracts that the FASB staff was contemplating when responding to this technical inquiry include lender paid mortgage insurance and investor paid mortgage insurance and lender loss participation and pool insurance. In addition, those freestanding insurance contracts (a) meet a derivative scope expectation for certain insurance or certain financial guarantee contracts in paragraph 815-10-15-13(c) and (d) and (b) pass the risk transfer test in Subtopic 340-30, Other Assets and Deferred Costs—Insurance Contracts That Do Not Transfer Insurance Risk, and Subtopic 944-20, Financial Services—Insurance—Insurance Activities.

6. The staff believes that it would be inappropriate to include other freestanding contracts such as credit default swaps or similar instruments when determining whether it is appropriate to recognize an insurance recovery asset for the total expected loss at the time that an insured expected credit loss is recorded under the amendments in Update 2016-13.

Applicable Accounting Guidance

7. The guidance in paragraph 326-20-30-12 states that a freestanding contract (such as a freestanding insurance contract) may not offset the expected credit losses on that asset:

> **326-20-30-12** The estimate of expected credit losses shall reflect how credit enhancements (other than those that are **freestanding contracts**) mitigate expected credit losses on **financial assets**, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity shall not combine a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) shall not be offset by a freestanding contract (for example, a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).

8. Update 2016-13 does not provide guidance on the accounting for recoveries of credit losses from freestanding contracts. The Master Glossary definition of a *freestanding contract* is as follows:

> A freestanding contract is entered into either:
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> a. Separate and apart from any of the entity's other financial instruments or equity transactions
> b. In conjunction with some other transaction and is legally detachable and separately exercisable.

FASB Staff Analysis

9. The staff has had discussions with some preparers on the topic discussed above. The staff's response is based on specific fact patterns discussed in outreach with preparers as well as the broader question outlined in the Big Four accounting firm memo. In those fact patterns, the freestanding insurance contracts held by these entities meet the scope exception from applying derivative accounting for certain insurance or certain financial guarantee contracts in paragraph 815-10-15-13(c) and (d). This response is applicable only to contracts that meet one of those scope exceptions and those contracts that pass the risk transfer test in Subtopic 340-30 and Subtopic 944-20. If those criteria are not met, then the staff believes that it would be inappropriate for an insurance recovery asset related to a freestanding contract to be recognized at the time of recording expected credit losses under the amendments in Update 2016-13.

10. The staff notes that the guidance for indemnification assets within the business combination guidance in Topic 805, Business Combinations, is an appropriate area of the accounting guidance to analogize the accounting for recoveries from freestanding insurance contracts. That guidance states the following:

> **> > Indemnification Assets**
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> **805-20-25-27** The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer shall recognize an indemnification asset at the same time that it recognizes the indemnified item, *measured on the same basis as the indemnified item*, subject to the need for a valuation allowance for uncollectible amounts. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer shall recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value. [Emphasis added.]

11. The guidance above requires an indemnification asset to be measured on the same basis as the indemnified item. When analogizing to this guidance for credit losses under the current expected credit losses (CECL) model, the indemnified item is the amount of insured credit losses and the basis of measurement is an expected loss model. Therefore, the staff believes that the timing of recognition of expected credit losses and the insurance recovery asset would be the same when analogizing to this guidance.

12. Additionally, the staff notes that Accounting Standards Update No. 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution,* contemplated indemnification assets arising from government-assisted acquisitions of financial institutions for which loans may be accounted for under an expected loss model (Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality). The guidance below was added by Update 2012-06 and supports the same basis of accounting being used for measurement of an indemnification asset related to loans accounted for under Subtopic 310-30. The staff believes that the Board allowing consistent timing in this circumstance supports analogizing to the guidance in Topic 805 for expected credit losses under Update 2016-13.

> **> > > Indemnification Assets Arising from Government-Assisted Acquisitions of a Financial Institution**
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> **805-20-35-4B** An indemnification asset recognized at the acquisition date in accordance with paragraphs 805-20-25-27 through 25-28 as a result of a government-assisted acquisition of a financial institution involving an indemnification agreement shall be subsequently measured on the same basis as the indemnified item. In certain circumstances, the effect of the change in expected cash flows of the indemnification agreement shall be amortized. Any amortization of changes in value shall be limited to the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets. For example, for indemnified assets accounted for under paragraph 310-30-35-10, if the expected cash flows on the indemnified assets increase (and there is no previously recorded valuation allowance), an entity shall account for the associated decrease in the indemnification asset by amortizing the change over the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets. Alternatively, if the expected cash flows on the indemnified assets increase such that a previously recorded valuation allowance is reversed, an entity shall account for the associated decrease in the indemnification asset immediately in earnings. Any remaining decrease in the indemnification asset shall be amortized over the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets.
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> **Pending Content:**
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> **805-20-35-4B** An indemnification asset recognized at the acquisition date in accordance with paragraphs 805-20-25-27 through 25-28 as a result of a government-assisted acquisition of a financial institution involving an indemnification agreement shall be subsequently measured on the same basis as the indemnified item. For example, if the expected cash flows on indemnified assets increase such that a previously recorded valuation allowance is reversed, an entity shall account for the associated decrease in the indemnification assets immediately in earnings.

Staff Conclusion

13. Subject to meeting the scope exception from applying derivative accounting for certain insurance or certain financial guarantee contracts in paragraph 815-10-15-13(c) and (d) and passing the risk transfer test in Subtopic 340-30 and Subtopic 944-20, the staff believes that it would be appropriate for an insurance recovery asset to be recognized at the time of recording expected credit losses under the amendments in Update 2016-13. Alternatively, the staff notes that other views, such as recording the insurance recovery asset on an incurred basis, also are appropriate.

14. The staff believes that allowing the recoveries from these types of freestanding insurance contracts to be recognized consistently with the recorded expected credit losses will provide better information on the credit risk management strategies that an entity has in place and the amount of credit losses that the entity ultimately expects. If the recovery is recognized at a time after the credit losses are recorded, the economics of the credit risk management strategy may not be faithfully represented.

15. Under this view, the recovery asset would be estimated using consistent assumptions as the loss estimate. The staff notes that under this view, the effect of the freestanding contract would be recorded outside the allowance for credit losses (in accordance with paragraph 326-20-30-12), but the timing of the loss and insurance receivable would be aligned.