Grant Thornton

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Accounting for freestanding credit enhancements

During the March 11, 2020 FASB meeting, the FASB staff discussed a technical inquiry regarding freestanding insurance contracts covering credit losses on financial instruments accounted for under ASC 326, *Financial Instruments – Credit Losses*. In particular, the staff discussed the recognition threshold and measurement model that apply when such contracts are not accounted for as derivatives under ASC 815, *Derivatives and Hedging*.

Scope

The technical inquiry addressed contracts that protect a reporting entity against credit losses on financial assets held by the reporting entity that are within the scope of ASC 326. A contract must meet three criteria to be within the scope of the technical inquiry:

- The credit insurance contract must be "freestanding." As defined in the ASC Master Glossary, "freestanding" means that the contract must be entered into either (a) separately and apart from any other financial instruments or equity transactions, or (b) in conjunction with another transaction and is legally detachable and separately exercisable.
- The credit insurance contract must not be accounted for as a derivative under ASC 815. Generally, freestanding insurance contracts are not accounted for as derivatives if they qualify for the exception for certain insurance or certain financial guarantee contracts in ASC 815-10-15-13(c) and 15-13(d).
- The credit insurance contract must pass the risk transfer test in ASC 340-30, *Other Assets and Deferred Costs: Insurance Contracts That Do Not Transfer Insurance Risk*, and in ASC 944-20, *Financial Services – Insurance: Insurance Activities.*

Examples of qualifying freestanding insurance contracts may include lender-paid mortgage insurance, investor-paid mortgage insurance, and lender-loss participation and pool insurance.

Recognition and measurement

The guidance in ASC 326-20-30-12 states that a freestanding contract may not offset an entity's estimate of expected credit losses. In other words, an entity would estimate its allowance for credit losses under ASC 326 without contemplating any potential recoveries from freestanding insurance contracts. However, ASC 326 does not provide separate recognition guidance for freestanding insurance contracts.

The FASB staff identified two accounting models to which an entity might appropriately analogize with regard to the recognition and measurement of an insurance recovery asset.

Model #1: indemnification asset

An entity may analogize to the guidance on indemnification assets in ASC 805-20-25-27. That guidance requires an indemnification asset to be measured on the same basis as the indemnified item (in this case, the indemnified item is insured credit losses on financial assets within the scope of ASC 326). Therefore, when applying this model to a qualifying freestanding insurance contract, an entity would recognize an insurance recovery asset at the same time it recognizes expected insured credit losses, using assumptions consistent with the loss estimate.

Model #2: incurred basis

An entity may recognize credit insurance recoveries on an incurred basis. That is, an entity would generally recognize an insurance receivable only when an insured loss has been incurred and it is probable that the entity will recover the insured amount from the insurer.

For more on recognizing insurance recoveries, see our publication "Accounting considerations for insurance recoveries."

Presentation

Regardless of the recognition and measurement model an entity applies, a recognized insurance recovery asset should be presented on the balance sheet separately from the allowance for credit losses associated with the underlying financial asset, as well as on the income statement separately from the credit loss expense.

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