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Insurance

Life Insurers Flag Mortgage, Other Impacts From Credit-Loss Rules

Some life insurers have already started flagging potential pain points from adopting—two-to-three years from now—new rules for reporting loan losses.

The new U.S. accounting rules might impinge on investments in mortgage loans, and reserves booked for loan losses would have to be leveraged, life insurers said.

The rules, typically associated with banks, apply to any company that holds financial assets subject to credit losses, certain trade receivables, reinsurance receivables and certain off-balance sheet credit exposures. The Financial Accounting Standards Board edict also will require additional disclosures.

''The standard focuses on the types of financial instruments you hold, not the industry you operate in, and a lot of insurers, particularly large insurers, hold loans,'' KPMG partner Michael Lammons told Bloomberg BNA.

''Lots of life insurers make a lot of commercial mortgage loans, they primarily make commercial mortgage loans related to office, retail, or condo or other multifamily properties. Some insurers also make residential mortgage loans,'' he said.

MetLife Expects Mortgage Loan Impacts Life insurers like MetLife Inc. provided an early teaser for what its investors might expect. ''The company believes that the most significant impact upon adoption will be to its mortgage loan investments,'' MetLife said in its quarterly report, filed early August with the Securities and Exchange Commission.

MetLife didn't disclose the nature of those impacts. The company instead said it's still assessing the accounting and reporting system changes that it will need to comply with the rules.

MetLife has a $53-billion commercial mortgage portfolio. Last year it originated $15 billion in commercial real estate loans.

Some of MetLife's commercial real estate loan transactions included a $150 million first mortgage on The Modern, a Class A high rise apartment community in Fort Lee, N.J. Among other loans, the company also holds a $275 million co-lender position in a $550 million leasehold mortgage loan on Cherry Creed Shopping center, a super-regional mall in Denver, Colo.

Loss Allowances to Affect Mortgage Investments Practitioners told Bloomberg BNA that mortgage loan investment impacts would stem from changes under the new credit loss model that requires them to establish an allowance for estimated lifetime losses.

''Securities that are recorded as held-to-maturity have been historically recorded at amortized cost, which meant that they did not have to record credit losses unless the 'impairment was considered other-than-temporary,' '' John Vandermeulen, managing director at data management firm RiskSpan Inc. told Bloomberg BNA.

''There are a bunch of criteria that determine whether or not the impairment was other-than-temporary, but generally it required credit impairment to only be recorded when there was significant impairment, and it looked like the entity would not be able to hold it long enough to recover the impairment,'' Vandermeulen said.

The credit loss rules will change this because an allowance will need to be established for estimated lifetime losses, Vandermeulen said.

AIG to Increase Loss Allowance The rules, Financial Instruments—Credit Losses (ASC 326)—don't take effect until 2020. Companies that want to adopt them earlier can do so in 2019.

The standard was issued in response to the 2007-2008 global financial crisis when companies were too slow to record their expected losses from sour loans. One contributing cause was accounting rules that allowed them to report losses on loans only when they were incurred.

The new rules would rectify that. On the first day of applying the guidance, a company would look at its portfolio and determine what its current expected credit losses would be and record them. Credit losses have to be measured based on historical loss information, current conditions, and reasonable and supportable forecasts.

Multinational insurance conglomerate American International Group Inc., a central player in the financial crisis, said they ''expect an increase in our allowances for credit losses.''

The amount of an increase will be affected by its portfolio composition and quality at the adoption date of the rules, AIG said in its quarterly filing with the SEC Aug. 4. The company's loan loss allowance will also be affected by economic conditions and forecasts at the time of adoption, AIG's 10-Q states.

AIG's role in the financial crisis came from its sale of huge amounts of credit default swaps without putting up initial collateral and setting aside capital reserves for hedging its exposure. The federal government bailed out the company for $180 billion and took control. In 2011 the company was able to pay back the government from the bailout after it sold two of its Japanese life insurance units to Prudential Financial, Inc.

Practitioners told Bloomberg BNA that AIG's expectation of booking an increase to its loan loss allowance won't be unique to that company.

''Most companies will be seeing an increase in its allowance since the CECL requires lifetime loss reserving and current accounting rules only have you reserve incurred losses,'' Vandermeulen said. ''I would expect that we will see a lot of this type of disclosure as we get closer to the 2020 implementation date.''

Attractive Bet for Life Insurers Commercial mortgages have grown in importance for life insurers, representing $404 billion, or 93 percent of U.S. mortgages held by life insurers at the end of 2015, according to a 2016 report from the American Council of Life insurers.

Mortgages from residential properties were $14 billion, or 3 percent of total mortgages held by life insurers on U.S. properties. Almost all of the mortgages held by life insurers were in good standing in 2015. Of industry held mortgages, only 0.5 percent were either restructured, overdue, or in foreclosure in 2015, according to the report.

Unlike banks, which make loans as a front office activity as part of their primary revenue generation activities, life insurance companies make loans because they have long-tailed life insurance liabilities that often have minimum guaranteed crediting rates.

Mortgage loans offer attractive yields on the asset side that are higher than their minimum guaranteed crediting rates on the insurance liability. Minimum guaranteed crediting rates will often vary based on the type of life insurance annuity contract policy.

''Insurers can often obtain better yields from mortgage loans than they can in the debt markets, so a lot of them will issue commercial mortgage loans, a lot of them specialize,'' KPMG's Lammons said. ''The mortgage loan balance compared to total assets on insurance companies balance sheet isn't near as substantial as it would be to banks but it can be material; it can be significant,'' he said.

For some assets held by insurers, there may be zero losses, Deloitte & Touche LLP's senior consultation partner Jon Howard told Bloomberg BNA. ''Things like Fannie Mae and Freddie Mac and Ginnie Mae guaranteed mortgage backed securities—when was the last time anybody had a loss on those,'' he said.

''There are a lot of insurance companies that invest in those because they're guaranteed returns, and it's a decent return, and the duration of those assets may line up better with when they think they're going to need money,'' he said.

Preventing Another Global Crisis FASB's rules on credit losses are especially important because of the broader implications they bring, practitioners said. ''One of the goals of the new rules is to prevent another global crisis,'' Graham Dyer, partner in Grant Thornton LLP's accounting principles group, told Bloomberg BNA.

''And today there are too many different impairment standards and models for loans and securities that are economically similar, which hinders comparability.''

The new rules incorporate forward looking information, Dyer said, however they are still not globally aligned with international financial reporting standards.

Practitioners warn that companies should start assessing their data now. ''Developing loss models require data and the ideal is data covering a full business cycle which could last 10 years,'' RiskSpan's manager of quantitative analytics, David Andrukonis, told Bloomberg BNA.

''So companies are going to be in the best position that have long histories of internal data that include not only loss history but characteristics of associated assets so that they can build cause and effect models that show what the drivers of credit losses are.''

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