

MINUTES



To: Board Members
From: Trench (ext. 455)
Subject: Minutes of the January 9, 2008
Board Meeting: Financial Guarantee Insurance—Redeliberations **Date:** January 28, 2008
cc: FASB: Golden, Bielstein, MacDonald, Leisenring, Cropsey, Cospers, Stoklosa, Reager, Chookaszian, Posta, Gabriele, Allen, Lott, Mayer, Glotzer, Sutay, Klimek, FASB Intranet; GASB: Attmore, Bean, Finden

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Topic: Financial Guarantee Insurance—
Redeliberations

Basis for Discussion: Board memorandum dated January 9,
2008

Length of Discussion: 9:00 a.m. to 10:30 p.m.

Attendance:

Board members present:	Herz, Batavick, Linsmeier, Seidman, Smith, Crooch, and Young
Board members absent	None
Staff in charge of topic:	Trench
Other staff at Board table:	Golden, Cropsey, Cospers, Stoklosa, and Staniszewski
Outside participants:	None

Summary of Decisions Reached:

The Board continued redeliberations of the Exposure Draft, *Accounting for Financial Guarantee Insurance Contracts*, which included the use of the expected term in relation to the measurement of the premium receivable (asset) and the related unearned premium revenue (liability) for installment premium insurance contracts. The Board decided:

1. That an insurance enterprise should recognize an asset for the premium receivable and a liability for the unearned premium revenue at inception of a financial guarantee insurance contract where premiums are received in installments.
2. To allow prepayment assumptions (where reliable and probable) to be used to determine an expected term only if the pool of assets underlying the insured financial obligation are subject to prepayment. Adjustments for subsequent changes in those prepayment assumptions for such instruments would be on a prospective basis. For other types of insured obligations (not subject to prepayment), the contractual term would be used and adjustments would be made for early principal payments as they occur. This provision will be subject to certain disclosure requirements that will be addressed at a future meeting.
3. That the discount rate to be used to discount the premium receivable (asset) and the unearned premium revenue (liability) should be the risk-free rate updated upon a change in estimate.
4. That prescriptive guidance will not be provided regarding the accounting for the discount amount accreted on the premium receivable (asset) over the period of the contract.

Objective of Meeting:

The objective of the meeting was for the Board to continue redeliberations of the Exposure Draft. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Issue 1—Recognition of Asset and Liability

1. **Staff Recommendation:** An insurance enterprise should recognize an asset for the premium receivable and a liability for the unearned premium revenue at inception of a financial guarantee insurance contract where premiums are received in installments.
2. **Board Vote:** The Board voted in favor of the staff recommendation.
3. **Board Comments:** Mr. Smith asked the staff about the nature of the contracts where premiums are paid in installments. Mr. Trench responded that those contracts are non-cancelable. Mr. Young questioned the use of the word *installment* to describe financial guarantee insurance contracts where premium is paid over time. He stated that he viewed these insurance contracts as a pay-as-you-go arrangement. He further stated that he interprets “installment” to mean the payment of a fixed amount rather than the payment of a fixed rate based on the principal outstanding at a given time. Ms. Seidman commented that even though the contracts themselves are non-cancelable, the underlying assets can be prepaid. Further, she commented that if the underlying assets are prepaid, the underlying cash flows will cease; thus, resulting in the cancellation of the insurance contract.
4. Mr. Young stated that if the premium payments were considered rent, they would be accounted for on a pay-as-you-go basis. Therefore, there is no asset at inception. Mr. Linsmeier countered that at inception the insurance company has provided a non-cancellable right to a benefit. Therefore, the arrangement would meet the definition of an asset. He noted that the issue raised by Mr. Young pertains to measurement and not to the existence of an asset. Mr. Linsmeier explained that the measurement would include the expected term of the insurance contract. Ms. Seidman stated that the guarantor has undertaken an obligation and it does not have the ability to cancel that obligation. As a result, there is an unconditional obligation that drives the recognition of an asset.
5. Mr. Young stated that the key information for investors for a single premium insurance contract is whether the expected term built into the premium charged is correct. In contrast, Mr. Young pointed out that for installment premium insurance contracts, the premium will continue to be paid as long as there is principal

outstanding. He reiterated that he views these contracts as pay-as-you-go arrangements and the term outstanding is not relevant. Mr. Herz stated that there is a right to payment as long as the underlying is outstanding and an asset is recognized reflecting that right.

6. Mr. Smith stated that the recognition of an asset and liability for installment contracts is linked to premium revenue recognition. He further stated that if the asset and liability are not recognized, premium revenue recognition will be based on how the insurance companies structure a transaction (that is, single or installment premiums). Mr. Trench pointed out that one of the key aspects of this project is that on day one the unearned premium revenue represents the stand-ready obligation of the financial guarantee insurance contract. Further, claim liability recognition is based on this notion and uses the unearned premium revenue as a starting point. Therefore, if the Board decided to not recognize an asset (and liability) for installment premium insurance contracts, then the determination of whether there is a claim liability would be based on off-balance sheet amounts. As a result, additional disclosures would be needed.

Issue 2—Contractual Term Versus Expected Term and the Adjustment to Cumulative Premium Revenue Recognition; Issue 4—Adjustment to Cumulative Premium Revenue (Retrospective, Cumulative Catch-up, or Prospective) for Installment Premium Insurance Contracts; Issue 6—Adjustment to Cumulative Premium Revenue (Retrospective, Cumulative Catch-up, or Prospective) for Single Premium Insurance Contracts

7. **Staff Recommendation:** Consistent with the decision reached by the Board regarding the use of prepayment data to shorten the term of a financial guarantee insurance contract for premium revenue recognition, prepayments should be incorporated when eligibility requirements similar to those in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, are met. The staff also recommended that adjustments for subsequent changes in those prepayment assumptions for both single premium and installment premium insurance contracts should be on a prospective basis.
8. **Board Vote:** The Board voted to allow prepayment assumptions (where reliable and probable) to be used to determine an expected term only if the pool of assets

underlying the insured financial obligation are subject to prepayment. Adjustments for subsequent changes in those prepayment assumptions for such instruments would be on a prospective basis. For other types of insured obligations (not subject to prepayment), the contractual term would be used and adjustments would be made for early principal payments as they occur. This provision will be subject to certain disclosure requirements that will be addressed at a future meeting.

9. **Board Comments:** Ms. Seidman commented that perhaps the term *installment* is a misnomer. She stated that the term *installment* suggests that there is a fixed amount and only the pattern of cash flows is being changed (ultimately arriving at the same fixed amount). She commented that there is a difference between a fixed premium that will be received versus instances where the premium is not fixed and there is uncertainty regarding the amount of premium that will be received. Ms. Seidman stated that these arrangements are different and the accounting should reflect that difference. However, the accounting should not be based on whether or not the premium is paid up-front or as an installment. She also noted that the accounting should not be based on whether the insured financial obligation is an asset-backed security.
10. Mr. Golden agreed with Ms. Seidman. He stated that the ability to estimate the expected term should be based on whether there is a pool of assets underlying the insured financial obligation that is subject to prepayment. Mr. Herz commented that Mr. Golden's view was closer to a Statement 91 approach for determining instances when the expected term could be used. Mr. Golden commented that the prospective adjustments to those assumptions would occur on an interim basis as well as on an annual basis as changes in prepayment assumptions occur; thus avoiding a situation where the difference between a cumulative catch-up adjustment and a prospective adjustment are significant.
11. Mr. Linsmeier stated that the issue that needs to be considered is whether or not the insurance company is correctly pricing the insurance contracts for single premium insurance contracts. He supports premium revenue being recognized based on an expected term and stated that changes in the expected term should be made as a cumulative catch-up adjustment to revenue for single premium insurance contracts. This approach would highlight that the pricing of the contract did not capture the true term of the contract. Mr. Linsmeier also stated that those cumulative-catch up

adjustments would have to be displayed above the line so that revenue is not being double counted.

12. Mr. Trench stated that the insurance companies use contractual term to price insurance contracts for municipal bonds (which, in most instances, is a single premium insurance contract). This occurs because the rating agencies do not recognize partial and/or unexpected payments as shortening the term of the insurance contract (at least not from the perspective of capital adequacy). Mr. Young stated that he would be surprised if the expected life was not included in the pricing of the contracts. Mr. Linsmeier pointed out that a disparity exists between the assertion that the contracts are priced using the contractual term versus Mr. Herz's statement that his municipal bond investments are called on a regular basis. Ms. Seidman stated that the issue is not whether municipal bonds are called, but whether the pricing of the insurance contracts fluctuates widely based on the expectation of the insurance company regarding whether the contract is callable. Mr. Herz stated that he believes the pricing would be different between a 30-year bond callable in 10 years versus a non-callable 30-year bond.
13. Ms. Seidman stated that the scope needs to be determined; that is, which financial obligations would be eligible to consider prepayments in determining an expected term? She further stated that a key consideration is whether the determination of an expected term would be available for all financial obligations or a subset of financial obligations where, for example, there is a pool of assets.
14. Mr. Smith commented that the determination of the probable expected term for a single premium insurance contract (a municipal bond) callable in Year 7 would not be determined until significant evidence existed to support that expected term. As the call date approaches, the ability to estimate the expected life increases. Mr. Smith believes that the expected term of a single premium insurance contract would not be adjusted until just before the call date. Mr. Golden provided an example where a financial guarantee insurance contract has a single premium covering years 1–10 (the first call date) and subsequent to Year 10, premiums are received in installments. He pointed out that requiring a cumulative catch-up adjustment for one type of contract (single premium) and a prospective for another (installment premium) may not be appropriate given the ability to structure the payment terms. In addition, he commented that different approaches to the adjustment for changes in

the expected term based on the mode of premium payment would be difficult to apply in this instance.

15. Mr. Herz commented that the assumption is that for a prospective approach, the underlying assets are prepayable. Therefore, an approach similar to Statement 91 would be applied (as far as which contracts can use an expected term), and if the criteria were not met, the contractual term would be used.
16. Mr. Young stated that he would rather lock the term in at inception of the contract and not make any adjustments. He further stated that all of the cash flows for a single premium are up-front. If the actual term is longer than the expected term, he would not adjust for the change in term and would show no revenue for the periods beyond the expected term for a single premium. He stated that this treatment would provide a better indication of performance and, in this instance, the mispricing of the insurance contract. Mr. Linsmeier stated that entities may purposefully use a shorter life to accelerate revenue. Mr. Smith reiterated his point that for an insurance contract insuring a municipal bond, an insurance company would have to be confident that the bond would be called on the call date before the expected term could be used. Otherwise, the contractual term would have to be used.
17. Mr. Herz stated that he supported an approach that allowed for prepayment assumptions (where reliable and probable) to be used to determine an expected term if there was a pool of instruments that were subject to prepayment. Adjustments would be on a prospective basis. He also advocated clear disclosure of adjustments to expected terms when they are different than originally expected.
18. Ms. Seidman stated that a significant amount of the feedback received through the comment letters stated that the problem was that the guidance did not allow for an expected term to be used where there was a possibility of prepayment. She further stated that the comments received were not related to municipal bonds, as most respondents would not consider these bonds subject to prepayments. Mr. Herz commented that he would require disclosure for callable bonds where premium revenue is being accelerated. Ms. Seidman stated that there should be disclosure for instances where the insurance contract is being accounted for using the contractual term but in which the insurance company expects the term to be shorter than the contractual term.

19. Mr. Batavick stated that the project is developing a unique model for a limited amount of companies in an important industry. He further stated that it is important not to base the accounting on how these contracts are written today, but rather to develop concepts and principles that are applicable to all financial guarantee insurance contracts regardless of the mode of premium payment. Mr. Batavick stated that prepayment assumptions should be included where those assumptions are probable and estimable and that adjustments to those assumptions be on a prospective basis.
20. Mr. Golden agreed with Mr. Batavick, but believes that qualifying for using prepayment assumptions (and the use of an expected term) would require a pool of assets and would not be operable for a single asset. Mr. Batavick clarified that he believes that on day 1 for a municipal bond the expected term would equal the contractual term. However, if the municipal bond is callable he believes that at some point the expected term could be shorter than the contractual term (for example, one year prior to the call date under certain conditions). Ms. Seidman questioned whether that view was pervasive in GAAP. For example, she pointed out that when a bond is callable, the issuer does not accelerate expenses to the call date. She stated that there is no need to establish new concepts in this project. Mr. Herz commented that irrespective of the approach chosen, there needs to be a means for separately identifying premium revenue that has been accelerated. He also stated that partial calls should be reflected when they occur.
21. Mr. Young supported expected term for a single premium and stated that *that* can be achieved through either recognition in the balance sheet or disclosure. Ms. Seidman questioned whether volatility in the performance statement due to the change in estimates from period to period based on unobservable information is better information for the user. Mr. Smith pointed out that allowing different assessments of the expected term for the same municipal bond by different entities would not be operational. Mr. Linsmeier stated that the guidance should not be based on the type of contract, but should rather be based on a pool of instruments in which the expected term can be reliably estimated. Thus, the accounting will not be defined based on the type of premium and, in most instances, will not be applicable to the single premium insurance contracts. Mr. Linsmeier stated that he would support an approach based on a Statement 91 estimability criteria. Mr. Batavick pointed out that even if a municipality had the ability to call an outstanding bond, it may not call the

bond. Therefore, he supported the approach as previously described by Mr. Golden. Mr. Linsmeier described the approach as one in which the contractual term is used except where the ability exists to reliably estimate prepayment speeds based on pools of observable instruments. In those instances, the expected term may be used. Mr. Smith clarified that those pools can be pools of underlying loans.

22. Mr. Smith also clarified that actual partial prepayments would result in a pro rata adjustment. The other Board members agreed that the partial prepayments would be accounted for as they occur.

23. Mr. Linsmeier stated that in rare instances, for a callable bond, an expected term could be determined based on the current interest rate cycle (and where that bond falls in that cycle). He further stated that one needs multiple observations to justify the use of an expected term and not just a homogenous pool. Mr. Herz did not agree with allowing an expected term to be used for callable contracts because of the complexity involved. He further stated that he would like to limit the guidance to existing accounting guidance. Mr. Herz pointed out that there needs to be a separate presentation of accelerated premium revenue related to early calls. Mr. Trench stated that the Exposure Draft has a disclosure requirement for premium accelerated due to refundings and that the industry currently voluntarily discloses this information.

24. Mr. Golden commented that the staff will bring back disclosures regarding (a) a separate line item for presentation of adjustments related to changes in prepayment assumptions, (b) changes in the expected term, (c) changes from the contractual term to the expected term, and (d) when the contractual term is used and the expected term is a shorter period. Mr. Herz also stated that disclosures should be made regarding the future cash premium payments expected to be received and expected term.

Issue 3—Discount Rate

25. **Staff Recommendation:** The present value of the premium receivable (asset) should be determined using a discount rate that reflects the credit standing of the enterprise that has the payment obligation at inception of the contract.

26. **Board Vote:** The Board voted that the discount rate used to discount the premium receivable (asset) and the unearned premium revenue (liability) should be the risk-free rate, updated upon a change in estimate.

27. **Board Comments:** Mr. Crooch asked how the contracts were being priced relative to the insured financial obligation's rating. Mr. Trench stated that the pricing would be based on the credit standing of the financial obligation as compared to the credit standing of the insurance enterprise. Therefore, each contract would be priced differently since financial obligations' credit standings would differ.
28. Mr. Linsmeier mentioned that if the discount rate is different for the asset and the liability, there will be day 1 gains or losses. Mr. Trench clarified that day 1 gains or losses would not occur because at inception the discount rate used would be the same for both the asset (premium receivable) and liability (unearned premium revenue). That is, the liability is measured at inception based on the asset. Therefore, the discount rate used for the asset and the liability are the same. The unearned premium is only adjusted for premium revenue recognition and is not accreted. However, once a claim liability is recognized (which is measured using a risk-free rate) and if a discount rate other than the risk-free rate were used to measure the unearned premium at inception, then there would be a difference in discount rates. However, the nature of the claim liability (that is, when expected cash flows exceed the unearned premium) is such that the different discount rates would not be relevant to the measurement.
29. Ms. Seidman pointed out that changes in the expected term would require a recalibration of the asset and liability and, therefore, the same discount rate should be used (otherwise a discount rate change would result in gains or losses). Mr. Trench commented that the adjustment made to the asset would be the same as the adjustment made to the liability due to the fact that they are the same amount on day 1. Mr. Golden views the future installment premiums as being measured for the entire contract, but displayed on a gross basis in the balance sheet.
30. Mr. Linsmeier did not feel comfortable having a different discount rate for the unearned premium liability and the claim liability. Mr. Smith commented that the discount rate would change once the claim liability exceeds the unearned premium liability. Mr. Linsmeier stated that using different discount rates creates a complexity that he does not support. Ms. Seidman commented that there would be double-counting if the credit risk was used in the discount rate and in the pricing (which is based on the credit standing of the financial obligation being insured).

31. Mr. Young inquired as to why the cost of capital could not be used. He proposed locking in the discount rate based on the cost of capital at inception. Mr. Herz proposed using the risk-free rate because it is simple to apply and objective. Mr. Young noted that he would not be opposed to using the risk-free rate. Mr. Herz further stated that the rate would have to be updated periodically. Ms. Seidman stated that there should only be an update when there is a change in estimate. Mr. Golden pointed out that a change in estimate would occur when there is a change in the expected term or an increase in the claim liability.

Issue 5—Accretion of the Premium Receivable (Asset) and Display in the Income Statement

32. **Staff Recommendation:** The staff did not have a consensus regarding a recommendation on this issue.
33. Some staff members recommended that the discount amount be accreted on the premium receivable (asset) through premium revenue over the period of the contract (that is, the accretion should be recognized in the income statement, included as part of premium revenue).
34. Some staff members recommended that the appropriate financial statement presentation for a contract that is determined to be a financing is to display the interest income separately. Those staff members recommended a presentation where the interest income and premium revenue are shown separately but added together to arrive at the total revenue recognized.
35. **Board Vote:** The Board voted that prescriptive guidance should not be provided regarding the accounting for the discount amount accreted on the premium receivable (asset) over the period of the contract.
36. **Board Comments:** Mr. Linsmeier questioned where the unearned premium liability was flowing through in the income statement. Mr. Trench stated that the unearned premium was going through the premium revenue line item. Mr. Linsmeier stated that it seemed that there was interest expense implicit within the arrangement.
37. Mr. Golden stated that the accretion of the premium receivable is a form of interest income, but that he does not believe that it should be shown as interest income. He noted that it should be in revenue, but that it should be a different component of revenue. Mr. Golden believes that the ultimate goal of the project is to depict

38. Mr. Linsmeier asked if there is other accounting literature where it is prescriptive regarding where interest income is displayed. Mr. Golden stated that in certain instances, such as a payroll servicing company, the interest income will be shown as a separate component of revenue. He also stated that another approach may be to require a disclosure regarding the interest accretion.

39. Mr. Batavick noted that he would not be prescriptive and would let industry practice develop. Mr. Young commented that disclosure is needed to understand the amount of accretion that flows through the income statement.

Follow-up Items:

40. None.

General Announcements:

41. None.