

# Financial Accounting Series

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EXPOSURE DRAFT

## Proposed Statement of Financial Accounting Standards

**Accounting for Financial  
Guarantee Insurance Contracts**

**an interpretation of FASB Statement No. 60**

This Exposure Draft of a proposed Statement is issued by the Board  
for public comment. Written comments should be addressed to:

Technical Director  
File Reference No. 1530-100

Comment Deadline: June 18, 2007



Financial Accounting Standards Board  
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by June 18, 2007. Interested parties should submit their comments by email to [director@fasb.org](mailto:director@fasb.org), File Reference No. 1530-100. Those without email may send their comments to the “Technical Director—File Reference No. 1530-100” at the address at the bottom of this page. Responses should *not* be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB’s website and will be included in the project’s public record.

An electronic copy of this Exposure Draft is available on the FASB’s website until the FASB issues a final document. Any individual or organization may obtain one copy of this Exposure Draft without charge until June 18, 2007, on written request only. *Please ask for our Product Code No. E193.* For information on applicable prices for additional copies and copies requested after June 18, 2007, contact:

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**Financial Accounting Standards Board**  
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<p style="text-align: center;"><b>Notice for Recipients of This Exposure Draft</b></p>
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## **Proposed Statement of Financial Accounting Standards**

This proposed Statement would clarify how FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, applies to financial guarantee insurance contracts, including the methodology to be used to account for premium revenue and claim liabilities. The scope of this proposed Statement is limited to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises included within the scope of Statement 60.

This proposed Statement defines financial guarantee insurance (and reinsurance) contracts as contracts issued by insurance enterprises that provide protection to the holder of a financial obligation (for example, a municipal bond or an asset-backed security issued by a trust) from a financial loss in the event of a default. The event of a default (insured event) refers to nonpayment (when due) of insured contractual payments (generally principal and interest) by the issuer of the insured financial obligation. For purposes of this proposed Statement, a financial guarantee insurance contract obligates the insurance enterprise to pay a claim upon the occurrence of a default, and the insurance enterprise does not have the ability to negotiate the claim amount prior to payment (that is, the claim amount must be paid as submitted).

In this proposed Statement, the premium revenue recognition approach for a financial guarantee insurance contract links premium revenue recognition to the insured contractual payments made by the issuer of the insured financial obligation. The underlying presumption is that the risk to the insurance enterprise is reduced to the extent of the insured contractual payments made by the issuer of the insured financial obligation.

The recognition approach in this proposed Statement for a claim liability relating to a financial guarantee insurance contract would require that an insurance enterprise recognize a claim liability when the insurance enterprise expects, based on the expected cash flows, that a claim loss will exceed the unearned premium revenue (liability) for that contract. An insurance enterprise would be required to measure the claim liability based on the present value of expected cash flows. Under this proposed Statement, the expected cash flows would be developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise. The expected cash flows would be discounted using a discount rate that reflects the credit standing of the insurance enterprise at the date the claim liability is initially recognized.

This proposed Statement would require that an insurance enterprise provide expanded disclosures about financial guarantee insurance contracts.

## **New Format for FASB Documents**

This proposed Statement has been written in a new format intended to improve its understandability. Notable changes from previous formats used in Statements issued include the use of bold text at the beginning of each section to convey the accounting principle for that section and the inclusion of examples in the body of the standard to illustrate the proposed accounting guidance for certain paragraphs. In addition, this Exposure Draft has been drafted as a proposed Statement rather than as a proposed Interpretation in an effort to eliminate multiple types of accounting guidance formats that are at the same level within the generally accepted accounting principles hierarchy (Level A). That is, interpretations, amendments, and revisions would no longer be used and would all be considered Statements with clarifying language included in the title to describe whether the Statement interprets, amends, or revises existing accounting literature (for example, this proposed Statement is an interpretation of Statement 60).

## **Information for Respondents**

The Board invites individuals and organizations to send written comments on all matters in this proposed Statement. Comments are requested from those who agree with the provisions of this proposed Statement as well as from those who do not.

Comments are most helpful if they identify the issues or specific paragraph or paragraphs to which the comments relate and clearly explain the problem or question. Those who disagree with provisions of this proposed Statement are asked to describe their suggested alternatives, supported by specific reasoning.

## **General (New Format)**

*General:* This proposed Statement uses a new format in an effort to improve understandability of FASB documents. Do you believe the new format increases the understandability of this proposed Statement? What changes do you like? What changes do you not like? What additional improvements could be made to increase the understandability?

## **Scope (Paragraphs 2–6)**

*Issue 1:* The scope of this proposed Statement defines a financial guarantee insurance contract as a contract issued by insurance enterprises that provides protection to the holder of a financial obligation from a financial loss in the event of a default. The event of a default (insured event) refers to nonpayment (when due) of insured contractual payments by the issuer of the insured financial obligation. Do you agree with the definition used to identify a financial guarantee insurance contract subject to the provisions of this proposed Statement? If not, why not?

*Issue 2:* This proposed Statement would apply to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises included within the scope of Statement 60. Do you agree with the scope of the proposed Statement? If not, why not? Should the scope include other insurance contracts that are similar to financial guarantee insurance contracts issued by insurance enterprises? Should the scope include all financial guarantee contracts (that is, those issued by insurance and noninsurance enterprises)?

*Issue 3:* The scope of this proposed Statement would not apply to a financial guarantee insurance contract that is a derivative instrument included within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Should more guidance be provided regarding paragraph 10(d) of Statement 133 and how to apply that paragraph?

### **Unearned Premium Revenue (Paragraphs 7–11)**

*Issue 4:* This proposed Statement would require that an insurance enterprise recognize a liability for unearned premium revenue at inception of a financial guarantee insurance contract. Further, a premium receivable (asset) would be recognized at inception of the financial guarantee insurance contract for which the premiums are received in installments (since each installment premium is not considered a renewal premium but merely a form of financing). Do you agree? If not, why not?

*Issue 5:* Under this proposed Statement, the measurement of the initial unearned premium revenue (liability) would be the present value of the contractual premium due pursuant to the terms of the financial guarantee insurance contract. Further, for premiums received in installments, the initial measurement of the unearned premium revenue (liability) would be based on the present value of the contractual premium receivable (asset). Do you agree? If not, why not?

*Issue 6:* This proposed Statement would require that the present value of the premium receivable (asset) be determined using a discount rate that reflects the policyholder's credit standing at the inception of the contract. The discount rate would be accreted on the premium receivable (asset) through investment income over the period of the contract in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*. Do you agree? If not, why not?

*Issue 7:* This proposed Statement does not provide specific guidance related to changes in contractual premiums, such as changes due to interest rates on a floating-rate insured financial obligation or partial prepayments of an insured financial obligation. How often are floating-rate financial obligations insured by insurance enterprises within the scope of this proposed Statement? How often do partial prepayments of an insured financial obligation occur? Do you believe the Board should provide additional guidance for these changes in contractual premiums?

## **Premium Revenue Recognition (Paragraphs 12–17)**

*Issue 8:* This proposed Statement would require that an insurance enterprise recognize a premium from a financial guarantee insurance contract as revenue over the period of the contract in proportion to the insured contractual payments made by the issuer of the insured financial obligation. The premium revenue for each reporting period would be determined based on the ratio of (a) the insured contractual payments made on the insured financial obligation during the reporting period to (b) the total of all insured contractual payments to be made on the insured financial obligation over the period of the contract. During its deliberations, the Board considered measuring at fair value a financial guarantee insurance contract, noting that a fair value measurement would include changes caused by the passage of time. However, the Board did not pursue a fair value measurement because it is unwilling at this time to change to the fair value measurement attribute within the insurance accounting model for only one type of insurance contract. Do you agree with the proposed premium revenue recognition approach? If not, why not? Also, if not, what should be the appropriate determinant of revenue recognition?

*Issue 9:* The Board concluded that insured contractual payments of the insured financial obligation are the most appropriate measure of exposure in a financial guarantee insurance contract. Do you agree? If not, why not? Also, if not, what would be a more appropriate measure of exposure and why?

*Issue 10:* Under the guidance in this proposed Statement, premium revenue would not be recognized for an insured zero coupon bond until the insured contractual payments are made at maturity. Do you agree that the proposed premium revenue recognition approach sufficiently incorporates the passage of time? Why or why not? How are these insured financial obligations affected by the passage of time (that is, how does the premium charged for the financial guarantee insurance contract change over time and what is the ability to subsequently price the contract)? Please provide examples.

*Issue 11:* The Board concluded that the contractual period covered by the insured financial obligation should be used in determining the period over which premium revenue should be recognized. Do you agree? If not, why not? When prepayment information is available, should this information be used to adjust the contract term when a homogenous pool of underlying contracts exists and is measurable? If so, please provide examples of these arrangements and a description of how reliable prepayment estimates are.

*Issue 12:* In instances where the issuer of an insured financial obligation that had a nonrefundable premium retires an insured financial obligation before its maturity and replaces it with a new financial obligation, this proposed Statement would require that any unearned premium revenue (liability) related to that contract and associated deferred acquisition costs be immediately recognized as premium revenue and expense, respectively. Further, if the insurance enterprise insures the new financial obligation, the insurance enterprise would record a premium on the new financial obligation that is

commensurate with the premium it would charge to insure a similar financial obligation in a separate (standalone) transaction. If that premium differs from the premium actually charged, the difference would be recognized in current income. Do you agree? If not, why not?

### **Claim Liability (Paragraphs 18–24)**

*Issue 13:* This proposed Statement would require that an insurance enterprise recognize a claim liability on a financial guarantee insurance contract when the insurance enterprise expects that a claim loss will exceed the unearned premium revenue (liability) for that contract based on expected cash flows rather than when a default (insured event) occurs. Do you agree? If not, why not? Does this provide an appropriate point of recognition for a claim liability related to a financial guarantee insurance contract?

*Issue 14:* This proposed Statement would require that an insurance enterprise measure a claim liability based on the present value of expected cash flows discounted using a risk-adjusted rate at the time of the initial recognition of the claim liability. For purposes of this proposed Statement, that risk-adjusted rate shall be based on the risk-free rate, adjusted for the credit standing of the insurance enterprise. The discount rate would be updated only when a default occurs. Do you agree? If not, why not?

*Issue 15:* This proposed Statement would require that in measuring the expected cash flows of the claim liability, the expected cash flows be developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise and those assumptions be consistent with the surveillance list maintained by the insurance enterprise. Do you believe that the surveillance list maintained by the insurance enterprise should affect the measurement of the claim liability? If not, why not and what alternative approach could be used? Do all insurance enterprises maintain a surveillance list and, if so, is the Board's understanding of the maintained surveillance list (as described in paragraph B21) accurate? Do you believe the Board should provide additional guidance about the surveillance list and what it contains? Can (or should) insurance enterprises follow the claim liability approach in this proposed Statement for financial guarantee insurance contracts not included on the surveillance list?

### **Disclosures (Paragraphs 25 and 26)**

*Issue 16:* This proposed Statement would require that specific disclosures be provided about (a) premium revenue recognition accelerated due to early retirement of the insured financial obligation, (b) financial guarantee insurance contracts for which premiums are received in installments, (c) the future contractual runoff of the unearned premium revenue (liability), and (d) the surveillance list used to recognize and measure claim liabilities. Do you agree? If not, why not? Do you believe these disclosures will assist financial statement users in better understanding the financial information for insurance enterprises that issue financial guarantee insurance contracts?

## **Effective Date and Transition (Paragraphs 27–30)**

*Issue 17:* The final Statement is expected to be issued in the third quarter of 2007. The Board concluded that this proposed Statement should be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Earlier application is not permitted. Do you agree with the Board's conclusions on the effective date? If not, what would be a reasonable period of time for implementation for applying the provisions of this proposed Statement? Also, if not, please provide a description of the process changes necessary to implement this proposed Statement that would require additional time.

*Issue 18:* This proposed Statement would require that an insurance enterprise recognize the cumulative effect of initially applying this proposed Statement as an adjustment to the opening balance of retained earnings for that fiscal year. Retrospective application is not permitted. Do you agree with not permitting retrospective application? If not, do you believe that retrospective application is possible and that sufficient information exists so that hindsight would not be used or required in reporting prior-period balances?

## Summary

### **Why Is the FASB Issuing This Proposed Statement?**

Diversity exists in practice in accounting for financial guarantee insurance contracts by insurance enterprises under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. That diversity results in differences in the recognition and measurement of claim liabilities because of the difficulty and differing views of when a loss has been incurred under FASB Statement No. 5, *Accounting for Contingencies*. Specifically, this proposed Statement would require that an insurance enterprise recognize a claim liability prior to a default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation, thus providing more useful information to users of financial statements. Additionally, this proposed Statement would address how to account for premiums. Accordingly, this proposed Statement would clarify how Statement 60 applies to financial guarantee insurance contracts, including the methodology to be used to account for premium revenue and claim liabilities, thereby increasing comparability in financial reporting of financial guarantee insurance contracts by insurance enterprises. This proposed Statement also would require expanded disclosures about financial guarantee insurance contracts, thereby improving the quality of information provided to users of financial statements.

### **What Is the Scope of This Proposed Statement?**

The scope of this proposed Statement would be limited to financial guarantee insurance (and reinsurance) contracts, as described in this proposed Statement, issued by insurance enterprises included within the scope of Statement 60. Accordingly, this proposed Statement would not apply to financial guarantee contracts issued by noninsurance enterprises or to certain insurance contracts that seem similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance or credit [trade receivable] insurance). This proposed Statement also would not apply to financial guarantee insurance contracts that are derivative instruments included within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

### **How Will This Proposed Statement Change Current Practice?**

The changes to current practice in accounting for financial guarantee insurance contracts that would result from applying this proposed Statement relate to recognition and measurement of premium revenue and claim liabilities and to disclosures.

The premium revenue recognition approach for a financial guarantee insurance contract links premium revenue recognition to the insured contractual payments (generally principal and interest) made by the issuer of the insured financial obligation, since the premium received requires the insurance enterprise to stand ready to protect holders of an insured financial obligation from loss due to default over the contractual term of the insured financial obligation. That approach is similar to the premium revenue recognition approach for a short-duration insurance contract in Statement 60 (even though the period of the insurance coverage is not short duration). The underlying

presumption is that the risk to the insurance enterprise is reduced to the extent of the insured contractual payments made by the issuer of the insured financial obligation. Accordingly, an insurance enterprise would be required to recognize premium revenue in proportion to the ratio of (a) the insured contractual payments made on the insured financial obligation during the reporting period to (b) the total of all insured contractual payments to be made on the insured financial obligation over the period of the contract, regardless of when the premium is received from the policyholder.

The recognition approach for a claim liability relating to a financial guarantee insurance contract would require that an insurance enterprise recognize a claim liability when the insurance enterprise expects, based on expected cash flows, that a claim loss will exceed the unearned premium revenue (liability). That approach is similar to the recognition approach for certain liabilities for future policy benefits relating to a long-duration insurance contract in Statement 60.

An insurance enterprise would be required to measure the claim liability based on the present value of expected cash flows. Expected cash flows are probability-weighted cash flows that reflect the likelihood of all possible outcomes. Under this proposed Statement, the expected cash flows would be developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise. This proposed Statement would clarify that those assumptions should be consistent with the information tracked and monitored through the surveillance list maintained by the insurance enterprise to evaluate credit deterioration in its insured financial obligations. Changes in credit standing of the insured financial obligation would be reflected as they occur. The expected cash flows would be discounted using a discount rate that reflects the credit standing of the insurance enterprise at the date the claim liability is initially recognized.

An insurance enterprise would be required to provide expanded disclosures about financial guarantee insurance contracts. Those disclosures would focus, in part, on the information included in the surveillance list maintained by the insurance enterprise to evaluate credit deterioration in its insured financial obligations, including (a) the surveillance categories, (b) the insurance enterprise's policies for placing an insured financial obligation in those categories and monitoring those categories, and (c) detailed information about the insured financial obligations included within those categories.

### **What Is the Impact of This Proposed Statement on Existing Accounting Pronouncements?**

This proposed Statement is an interpretation of Statement 60 and would amend existing accounting pronouncements to clarify the application of the guidance in those pronouncements to the financial guarantee insurance contracts included within the scope of this proposed Statement. Specifically, this proposed Statement would:

- Amend Statement 60 to clarify that financial guarantee insurance contracts issued by insurance enterprises are included within the scope of that Statement as interpreted by the provisions of this proposed Statement
- Amend FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (paragraph 8(c)), to clarify that the requirements of that Statement

apply to financial guarantee insurance contracts included within the scope of this proposed Statement

- Amend Statement 133 (paragraph 10(c)) to clarify that the scope exception provided in that Statement for certain insurance contracts does not apply to financial guarantee insurance contracts in the scope of this proposed Statement
- Amend FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (paragraph 6(d)), to clarify that the requirements of that Interpretation do not apply to financial guarantee insurance contracts included within the scope of this proposed Statement.

### **What Is the Impact of This Proposed Statement on Convergence with International Financial Reporting Standards?**

The International Accounting Standards Board (IASB) has on its agenda a project to comprehensively address the accounting for insurance contracts. In 2007, the IASB plans to issue for public comment a Discussion Paper setting out its preliminary views reached in that project to date. The FASB and the IASB have decided to approach that project as a modified joint FASB/IASB project. Accordingly, the FASB plans to issue for public comment an Invitation to Comment incorporating the IASB Discussion Paper. The FASB Invitation to Comment will seek input on whether to add to its agenda a joint FASB/IASB project to comprehensively address the accounting for insurance contracts, which could ultimately result in changes to existing U.S. generally accepted accounting principles for all insurance contracts, including those addressed in this proposed Statement.

While the FASB acknowledges that the issues addressed in this proposed Statement may be addressed by the IASB's project for the accounting for insurance contracts, the FASB identified an approach to address the diversity in practice now without increasing potential future convergence issues. Accordingly, the FASB decided to interpret existing U.S. insurance accounting literature for financial guarantee insurance contracts rather than create a new accounting model. If the FASB subsequently adds a joint project on insurance contracts to its agenda, the accounting guidance in this proposed Statement ultimately may change and be converged with IASB literature.

### **What Is the Effective Date of This Proposed Statement?**

This proposed Statement would be effective for financial statements issued for fiscal years beginning after December 15, 2007, and all interim periods within those fiscal years. Earlier application would not be permitted.

**Proposed Statement of Financial Accounting Standards**  
**Accounting for Financial Guarantee Insurance Contracts**  
**an interpretation of FASB Statement No. 60**

**April 18, 2007**

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## **Proposed Statement of Financial Accounting Standards**

### **Accounting for Financial Guarantee Insurance Contracts**

#### **an interpretation of FASB Statement No. 60**

**April 18, 2007**

#### **OBJECTIVE**

1. Prior to issuance of this Statement, diversity existed in the accounting for financial guarantee insurance contracts by insurance enterprises under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. That diversity resulted in differences in the recognition and measurement of claim liabilities. Accordingly, this Statement clarifies how Statement 60 applies to financial guarantee insurance contracts, including the methodology to be used to account for premium revenue and claim liabilities. This Statement also requires expanded disclosures about financial guarantee insurance contracts.

#### **STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING**

##### **Scope**

2. **This Statement applies to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises included within the scope of paragraph 6 of Statement 60.**

3. Financial guarantee insurance (and reinsurance) contracts are contracts issued by insurance enterprises that provide protection to the holder of a financial obligation from a financial loss in the event of a default. Examples of such financial obligations include a municipal bond or an asset-backed security issued by a trust. The term of a financial guarantee insurance contract is the contractual term of the insured financial obligation regardless of the manner in which the premium is paid to the insurance enterprise (that is, a single premium at inception or in installments). The holder of the financial guarantee insurance contract (policyholder) will vary. In some cases, the policyholder will be the issuer (for example, a municipality, a corporation, or a trust) of the insured financial obligation because it is seeking to increase the marketability of the insured financial obligation while reducing future interest costs (by attaining a higher credit rating for the insured financial obligation through the financial guarantee insurance contract). In other cases, the policyholder will be the holder of the insured financial obligation because it has purchased a financial obligation in the secondary market and wants to protect itself from a financial loss in the event of a default.

4. The event of a default (insured event) refers to nonpayment (when due) of insured contractual payments (generally principal and interest) by the issuer of the insured

financial obligation. For purposes of this Statement, a financial guarantee insurance contract obligates the insurance enterprise to pay a claim upon the occurrence of a default, and the insurance enterprise does not have the ability to negotiate the claim amount prior to payment (that is, the claim amount must be paid as submitted).

5. Because the scope of this Statement is limited to financial guarantee insurance (and reinsurance) contracts and insurance enterprises that issue those contracts, this Statement does not apply to the following:

- a. Financial guarantee contracts issued by noninsurance enterprises (for example, some financial institutions and government-sponsored enterprises)
- b. Insurance contracts that are similar to financial guarantee insurance contracts issued by insurance enterprises (for example, mortgage guaranty insurance and credit insurance on trade receivables).

The guidance in this Statement shall not be applied or analogized to by enterprises not in the scope of this Statement.

6. This Statement also does not apply to a financial guarantee insurance contract that is a derivative instrument included within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

## **Unearned Premium Revenue**

### **Initial Recognition and Measurement**

**7. An insurance enterprise shall recognize a liability for the unearned premium revenue at the inception of a financial guarantee insurance contract. Initial measurement of the unearned premium revenue (liability) shall be the present value of the premium due over the contractual term of the financial guarantee insurance contract.**

8. If the premium is a single premium received at the inception of the financial guarantee insurance contract, the insurance enterprise shall initially measure the unearned premium revenue (liability) based on the amount of the premium received. In periods after initial recognition, the insurance enterprise shall adjust (reduce) the unearned premium revenue (liability). The adjustment to the unearned premium revenue (liability) is described in paragraphs 12–15.

9. If the premiums are received in installments over the period of the financial guarantee insurance contract, the insurance enterprise shall initially measure the unearned premium revenue (liability) based on the present value of the premium receivable (asset) over the contractual term of the financial guarantee insurance contract, not the expected term (see paragraph 10). For example, if the insurance enterprise receives total installment premiums over the period of the financial guarantee insurance contract in the amount of \$28 million and the present value of that amount is \$24.3 million, both the unearned premium revenue (liability) and the premium receivable (asset) shall be initially recognized at \$24.3 million. In periods after initial recognition, the insurance enterprise

shall adjust (reduce) the unearned premium revenue (liability) as described in paragraphs 12–15.

#### *Receivable for Future Premiums*

10. The present value of the premium receivable (asset) shall be determined using a discount rate that reflects the credit standing of the policyholder at the inception of the contract. The discount amount shall be accreted on the premium receivable (asset) through investment income over the period of the contract in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*.

11. In periods after initial recognition, the insurance enterprise shall adjust the premium receivable (asset) for collectibility issues with an offsetting adjustment to bad-debt expense. The insurance enterprise shall consider its assessment of recognition and measurement of the claim liability (see paragraphs 18–24) in determining whether the premium receivable (asset) is fully collectible.

#### **Premium Revenue Recognition**

**12. An insurance enterprise shall recognize a premium from a financial guarantee insurance contract as revenue over the period of the contract in proportion to the insured contractual payments made by the issuer of the insured financial obligation. The premium revenue for each reporting period shall be determined based on the ratio of (a) the insured contractual payments made during the reporting period to (b) the total of all insured contractual payments to be made over the period of the contract.**

13. The premium revenue recognition approach for a financial guarantee insurance contract links premium revenue recognition to the insured contractual payments made by the issuer of the insured financial obligation. The insurance enterprise is obligated to assume any remaining insured contractual payments to be made by the issuer of the insured financial obligation in the event of a default. The underlying presumption is that the risk to the insurance enterprise is reduced to the extent of the insured contractual payments made by the issuer of the insured financial obligation. Accordingly, once an insured contractual payment is made by the issuer of the insured financial obligation, revenue is recognized.

14. If insured contractual payments made by the issuer of the insured financial obligation are made over the period of the financial guarantee insurance contract, premium revenue is recognized over that period.

(Note: The examples included in this Statement are simplified and are not intended to serve as a guide for the detailed calculations necessary in applying this Statement.)

**Example—Insured Contractual Payments Made over Period of Contract**

On January 1, 200X, an insurance enterprise issues a single-premium financial guarantee insurance contract for a financial obligation (municipal bond). The premium amount is \$5 million. Insured contractual payments of \$100 million (principal and interest) will be made by the issuer of the bond over the period of the contract. Of that amount, \$9 million (9 percent of the total) will be paid in the first year of the contract. Accordingly, provided the insured contractual payments are made by the issuer of the bond, the insurance enterprise would recognize 9 percent of the premium received (\$450,000) as revenue in the first year of the contract. The risk to the insurance enterprise is reduced after the first year to the extent of those insured contractual payments.

15. If insured contractual payments made by the issuer of the insured financial obligation are made at the end of the period of the financial guarantee insurance contract, premium revenue is not recognized until the end of that period.

**Example—Insured Contractual Payments Made at End of Period of Contract**

On January 1, 200X, an insurance enterprise issues a single-premium financial guarantee insurance contract for a financial obligation (municipal bond). The premium amount is \$5 million. The insured contractual payment of \$100 million (principal and interest) will be made by the issuer of the bond in total at the end of the period of the contract. Accordingly, the insurance enterprise would not recognize premium revenue until the end of the contract period. At that time, the insurance enterprise would recognize the premium revenue in full (\$5 million) when the risk to the insurance enterprise has been eliminated. Up until the day before the final and only payment, the insurance enterprise is at risk for the entire \$100 million in the event of default.

## **Early Retirement and Replacement of an Insured Financial Obligation**

16. In some cases, the issuer of an insured financial obligation will retire the insured financial obligation before its maturity and replace it with a new financial obligation. That situation, referred to as a refunding, often occurs when interest rates decrease such that the insured financial obligation is replaced with a new financial obligation at a lower interest rate.

17. In a refunding situation, the financial guarantee insurance contract on the retired financial obligation is terminated. The insurance enterprise shall immediately recognize any nonrefundable unearned premium revenue (liability) related to that contract as premium revenue and any associated acquisition costs previously deferred under paragraph 29 of Statement 60 as an expense. If the insurance enterprise insures the new financial obligation, the insurance enterprise shall recognize the unearned premium revenue (liability) on the new financial obligation that is commensurate with the premium it would charge to insure a similar financial obligation in a separate (standalone) transaction. If that premium differs from the premium actually charged, the difference shall be recognized in current income.

**Example—Early Retirement and Replacement of an Insured Financial Obligation Where the Same Insurance Enterprise Insured the New Financial Obligation**

On January 1, 200X, an insurance enterprise issues a nonrefundable, single-premium financial guarantee insurance contract for a 30-year financial obligation (municipal bond). The premium amount is \$5 million. On the municipal bond's 10th anniversary, the issuer of the insured financial obligation retires the municipal bond. Premium recognized by the insurance enterprise for the financial guarantee insurance contract over the first 10 years was \$1 million. Therefore, at early retirement on the 10th anniversary, the insurance enterprise would recognize as premium revenue the remaining unearned premium revenue (liability) (\$4 million) because the risk to the insurance enterprise is eliminated. In addition, any remaining deferred acquisition costs are expensed.

The issuer of the financial obligation facilitated the early retirement of the municipal bond by issuing a new municipal bond at a lower interest rate. The same insurance enterprise insures the new municipal bond. The premium amount for the financial guarantee insurance contract for the new financial obligation is \$3 million. However, the amount of premium charged to insure a similar financial obligation in a separate standalone transaction is \$4 million. Accordingly, the insurance enterprise would recognize an unearned premium revenue (liability) of \$4 million. An adjustment (a debit) to the statement of income in the amount of \$1 million would represent the difference between the amount of premium charged (\$3 million) as compared with the amount of premium that would be charged for a similar financial obligation in a separate standalone transaction.

## **Claim Liability**

### **Recognition**

**18. An insurance enterprise shall recognize a claim liability on a financial guarantee insurance contract when the insurance enterprise expects that a claim loss will exceed the unearned premium revenue (liability) for that contract based on expected cash flows.**

19. The unearned premium revenue (liability) represents the insurance enterprise's stand-ready obligation under a financial guarantee insurance contract at initial recognition. That obligation is adjusted (through the claim liability) to reflect changes in periods after initial recognition of the financial guarantee insurance contract that increase the likelihood of a default (insured event). Decreases in the likelihood of a default (insured event) occur only to the extent that a claim liability exists, and those decreases shall not reduce the claim liability below zero. When a claim liability has been recognized, any associated acquisition costs previously deferred under paragraph 29 of Statement 60 shall be expensed.

### **Measurement**

**20. An insurance enterprise shall measure a claim liability based on the present value of expected cash flows discounted using a risk-adjusted rate at initial recognition of the claim liability. For purposes of this Statement, that risk-adjusted rate shall be based on the risk-free rate, adjusted for the credit standing of the insurance enterprise.**

### ***Expected Cash Flows***

21. Expected cash flows are probability-weighted cash flows (cash outflows net of potential recoveries to be paid to the holder of the insured financial obligation, excluding reinsurance) that reflect the likelihood of all possible outcomes. For purposes of this Statement, the expected cash flows shall be developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise. Those assumptions shall be consistent with the information tracked and monitored through the surveillance list maintained by the insurance enterprise to evaluate credit deterioration in its insured financial obligations. The surveillance list maintained by the insurance enterprise represents the aggregation of information related to the credit standing of an insured financial obligation obtained through the insurance enterprise's risk management activities and used to assist in making operational decisions. (See the example in Appendix A for an illustration of the disclosure of an insurance enterprise's surveillance list.)

**Example—Expected Cash Flows Used to Measure Claim Liability**

An insurance enterprise determines that there is an expectation that a claim loss on an insured financial obligation (a bond) will exceed the unearned premium revenue (liability) for that contract. The expected cash flows used to measure the claim liability consider the amounts and probabilities of possible cash flows, that is, cash outflows net of potential recoveries to be paid to the holder of the insured financial obligation, excluding reinsurance. The expected cash flows are developed using the insurance enterprise’s own assumptions based on all information available to the insurance enterprise, including assumptions about potential recoveries (excluding reinsurance), consistent with the information shown in the surveillance list:

**(\$ in millions)**

<u>Possible Net Cash Outflows</u>	<u>Probability of Default</u>	<u>Probability- Weighted Cash Outflows</u>
\$70	5%	\$3.5
\$50	15%	\$7.5
\$40	20%	\$8.0
\$20	45%	\$9.0
\$10	10%	\$1.0
\$ 0	5%	<u>\$0.0</u>
<b>Expected cash flows</b>		<b><u>\$29.0</u></b>

***Initial Measurement***

22. At initial recognition of a claim liability, an insurance enterprise shall discount the expected cash flows using a risk-adjusted rate at that date. Because the claim liability is an obligation of the insurance enterprise, a discount rate that reflects the credit standing of the insurance enterprise reflects the ability of the insurance enterprise to make the claim payments.

***Subsequent Measurement***

23. In periods after initial recognition of a claim liability, an insurance enterprise shall revise the expected cash flows for changes that increase (or decrease) the likelihood of a default (insured event). The insurance enterprise shall discount the revised expected cash flows using the same risk-adjusted rate used at initial recognition of the claim liability. The discount rate at initial recognition of the claim liability shall be updated only if the event of default (insured event) occurs. Holding the discount rate constant until default eliminates from the measurement the effect of general changes in interest rates. If the

event of default (insured event) occurs, the insurance enterprise shall revise the expected cash flows for changes that increase (or decrease) the claim liability. The insurance enterprise shall discount the revised expected cash flows using the risk-adjusted rate at the date the default (insured event) occurs. The discount rate at the date the default (insured event) occurs shall be held constant in subsequent periods.

24. Revisions to the claim liability in periods after initial recognition shall be recognized as claim expense in the period of the change (as a change in accounting estimate).

## **Disclosures**

**25. An insurance enterprise shall disclose information that enables users of its financial statements to understand the factors affecting the recognition and measurement of financial guarantee insurance contracts.**

26. To meet the disclosure objective in paragraph 25, an insurance enterprise shall disclose the following information for each annual period (unless otherwise specified below or if a significant change has occurred in an interim period [in these instances the disclosure requirements also pertain to interim periods]):

- a. Premium revenue recognition that has been accelerated due to the retirement of an insured financial obligation before its maturity
- b. For financial guarantee insurance contracts where premiums are received in installments:
  - (1) The premium receivable (asset) and the unearned premium revenue (liability) reported in the statement of financial position (if not separately discernible)
  - (2) The amount of accretion on the premium receivable (asset) reported as a component of investment income for the period (if not separately discernible)
  - (3) The range of discount rates used to discount the premium receivable (asset)
- c. A schedule of the future contractual runoff of the unearned premium revenue (liability) detailing the following:
  - (1) The remaining quarters of the current annual period
  - (2) The four quarters of the subsequent annual period
  - (3) The next three annual periods
  - (4) The remaining periods aggregated in five-year increments
- d. A description of the surveillance list used to recognize and measure claim liabilities, including the following:
  - (1) A description of each surveillance category
  - (2) The insurance enterprise's policies for placing an insured financial obligation in and monitoring each surveillance category
  - (3) The insurance enterprise's policies for avoiding or mitigating claim liabilities, the related expense and liability reported during the period for those risk mitigation activities, and a description of where that expense

is reported in the statement of income and the statement of financial position

- (4) A schedule of insured financial obligations included on the surveillance list at the end of each period detailing, at a minimum, the following for each surveillance category (see the example in Appendix A):
  - (a) Number of financial guarantee insurance contracts
  - (b) Insured contractual payments outstanding, segregating principal and interest
  - (c) Remaining weighted-average contractual term
  - (d) Claim liability (net of potential recoveries to be paid to the holder of the insured financial obligation, excluding reinsurance).

## **EFFECTIVE DATE AND TRANSITION**

27. This Statement shall be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Earlier application is not permitted.

28. This Statement shall be applied to existing and future financial guarantee insurance contracts issued by an insurance enterprise as of the beginning of the fiscal year in which this Statement is initially applied. An insurance enterprise shall recognize the cumulative effect of initially applying this Statement as an adjustment to the opening balance of retained earnings for that fiscal year. An insurance enterprise also shall disclose in the first interim period of the fiscal year in which this Statement is initially applied the cumulative effect of the change on retained earnings in the statement of financial position.

29. The cumulative-effect adjustment is the difference between the amounts (if any) recognized in the statement of financial position before the initial application of this Statement and the amounts recognized in the statement of financial position at initial application of this Statement, measured using information that is current at that date. Accordingly, discount rates shall reflect the credit standing of the policyholder or of the insurance enterprise, as appropriate, at the date this Statement is initially applied.

30. The disclosure requirements of this Statement (paragraph 26) shall be applied in the first interim period of the fiscal year in which this Statement is initially applied. The disclosure requirements of this Statement need not be applied for financial statements for periods presented before initial application of this Statement.

<p style="text-align: center;"><b>The provisions of this Statement need not be applied to immaterial items.</b></p>
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## Appendix A

### IMPLEMENTATION GUIDANCE

#### Introduction

A1. This appendix describes in general terms certain provisions of this Statement and provides an example of the application of those provisions. This example is simplified and is not intended to serve as a guide for the detailed calculations necessary in applying this Statement.

#### Claim Liability Disclosures

A2. This Statement requires disclosures about the surveillance list, used to recognize and measure claim liabilities, maintained by an insurance enterprise to evaluate credit deterioration in financial obligations it has insured. Qualitative (narrative) disclosures are required at the end of each annual period (unless a significant change has occurred in an interim period) describing (a) each surveillance category, (b) the insurance enterprise's policies for placing an insured financial obligation in and monitoring each surveillance category, (c) the insurance enterprise's policies for avoiding or mitigating claim liabilities, and (d) where the cost related to an insurance enterprise's efforts to avoid or mitigate claim liabilities is reported in the statement of income and the statement of financial position. At a minimum, for each surveillance category, quantitative disclosures are required at the end of each annual period (unless a significant change has occurred in an interim period) about the number of financial guarantee insurance contracts, the amount of insured contractual payments outstanding (segregating principal and interest), the remaining weighted-average contractual term, and the claim liability (excluding reinsurance). The disclosures required by paragraph 26(d)(4) are illustrated below.

#### Example—Schedule of Insured Financial Obligations Included on the Surveillance List

A3. This Statement requires, at a minimum, disclosure of a schedule of insured financial obligations included on an insurance enterprise's surveillance list at the end of each annual period (unless a significant change has occurred in an interim period) for each surveillance category (paragraph 26(d)(4)). This Statement requires that, after initial recognition, subsequent adjustments for changes in the likelihood of a default should be tracked and monitored through the surveillance list maintained by the insurance enterprise to evaluate credit deterioration in its insured financial obligations. In addition, this Statement emphasizes that in measuring the claim liability, the expected cash flows should be developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise. Those assumptions should be consistent with the information tracked and monitored through the surveillance list maintained by the insurance enterprise. The example below assumes the insurance enterprise uses four surveillance categories to track and monitor its insured financial obligations. Four surveillance categories are used for illustrative purposes only. The following are brief descriptions of each surveillance category to provide context to the example.

- a. Category A includes insured financial obligations that are still currently performing (that is, insured contractual payments are made on time but the likelihood of a default has increased) but if economic conditions persist for an extended period of time may not be performing in the future. The issuer of the insured financial obligation may have experienced credit deterioration as a result of a general economic downturn. As a result, the related cash flows are less than the projected cash flows at inception to the point where there is an expectation that a claim will exceed the unearned premium revenue (liability) of the financial guarantee insurance contract some time in the future.
- b. Category B includes insured financial obligations that are currently characterized as potentially nonperforming and may require action by the insurance enterprise to avoid or mitigate a default.
- c. Category C includes insured financial obligations that are characterized as nonperforming and for which actions to date by the insurance enterprise have not been successful in avoiding or mitigating a default. The insurance enterprise continues its efforts to remedy the claim, but a default is imminent.
- d. Category D includes insured financial obligations that have defaulted.

For these insured financial obligations, that information might be presented as follows:

(\$ in millions)	<u>Surveillance Categories</u>				
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Total</u>
<u>Description</u>					
Number of policies	37	16	5	4	62
Insured contractual payments outstanding:					
Principal	\$ 656	\$409	\$196	\$111	\$1,372
Interest	<u>478</u>	<u>298</u>	<u>150</u>	<u>73</u>	<u>999</u>
Total	<u>\$1,134</u>	<u>\$707</u>	<u>\$346</u>	<u>\$184</u>	<u>\$2,371</u>
Remaining weighted-average contractual term (in years)	16	14	11	12	
<u>Claim liability (discounted):</u>					
Net of potential recoveries to be paid to the holder of the insured financial obligation, excluding reinsurance	\$134	\$156	\$176	\$99	\$565
Net of reinsurance	\$124	\$137	\$151	\$72	\$484

## Appendix B

### BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEWS

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## **Appendix B**

### **BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEWS**

#### **Introduction**

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this proposed Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

#### **Background Information**

B2. Prior to issuance of this proposed Statement, diversity existed in the accounting for financial guarantee insurance contracts by insurance enterprises under Statement 60. That diversity resulted in differences in the timing of the recognition and measurement of claim liabilities. Accordingly, this proposed Statement clarifies how Statement 60 is applied to financial guarantee insurance contracts, focusing on premium revenue and claim liabilities. This proposed Statement also requires expanded disclosures about financial guarantee insurance contracts.

#### **Scope**

B3. The issues addressed in this proposed Statement arise from the application of the insurance accounting models in Statement 60 by insurance enterprises that issue financial guarantee insurance contracts (including reinsurance contracts). Accordingly, the Board decided to limit the scope of this proposed Statement to insurance enterprises within the scope of Statement 60 and the financial guarantee insurance contracts issued by those enterprises. In reaching its scope decision, the Board acknowledged that insurance enterprises issue other types of contracts that seem similar to financial guarantee insurance contracts (for example, mortgage guaranty insurance and credit insurance on trade receivables). Further, noninsurance enterprises (for example, some financial institutions) issue financial guarantee contracts. However, the Board decided not to expand the scope of this proposed Statement to include those contracts. That scope expansion would delay issuance of needed guidance to resolve current practice issues relating to financial guarantee insurance contracts issued by insurance enterprises. At a future date, the Board expects to consider whether to add a joint FASB/IASB project to its agenda to comprehensively consider the accounting for insurance contracts. The Board also restricted the application of this guidance by analogy by enterprises not within the scope of this proposed Statement because this model is an interpretation of accounting literature that only applies to insurance enterprises.

## **Overall Approach**

B4. In developing this proposed Statement, the Board considered whether to establish a fair value model for financial guarantee insurance contracts. In contrast to the insurance accounting models in Statement 60, which separate recognition and measurement for premium revenue and claim liabilities, a fair value model would include in one measurement attribute all potential future cash flows (that is, premium revenue and claim liabilities). Some Board members agree that conceptually a fair value model might provide a more relevant measurement of the insurance enterprise's obligation to perform under a financial guarantee insurance contract. In addition, these Board members point out that a fair value model would appropriately reflect the passage of time in the measurement of the financial guarantee insurance contract. However, the Board concluded that it would not be appropriate to require that financial guarantee insurance contracts be measured at fair value without also considering whether other types of insurance contracts should be measured at fair value. Consistent with its decision to limit the scope of this proposed Statement to financial guarantee insurance contracts issued by insurance enterprises within the scope of Statement 60, the Board decided to address the issues in this proposed Statement in the context of the insurance accounting models in Statement 60.

B5. The Board considered the two accounting models described in Statement 60 for insurance contracts—the short-duration and the long-duration accounting models. In reviewing the application of those two models to financial guarantee insurance contracts, the Board determined that neither accounting model fully captured the economics of financial guarantee insurance contracts. For example, a short-duration accounting model, while appropriately linking premium revenue recognition to the reduction of risk (insured contractual payments [generally principal and interest]), would not adequately reflect changes in the likelihood of default of the insured financial obligation in the recognition and measurement of the claim liability. Alternatively, a long-duration accounting model, while appropriately capturing changes in the likelihood of a default in the claim liability, would not adequately reflect the reduction of risk through insured contractual payments made on the insured financial obligation in the premium revenue recognition approach. Therefore, the Board created a new accounting model for financial guarantee insurance contracts that incorporates attributes of both the short-duration model and the long-duration model.

## **Unearned Premium Revenue**

B6. In current practice, insurance enterprises that issue financial guarantee insurance contracts generally recognize a liability for the unearned premium revenue when the premium is received. If the premium is received at inception (single premium), a liability for the unearned premium revenue is recognized at inception. If the premiums are received in installments over the contract term (installment premiums), a liability for the unearned premium revenue is recognized over the installment period and each installment premium received is accounted for as a renewal premium.

B7. In its deliberations, the Board decided that a liability for the unearned premium revenue should be recognized in its entirety at inception of a financial guarantee insurance contract, regardless of when the premium is received. The obligation under a financial guarantee insurance contract is created at the contract's inception (the "stand-ready" obligation) for the entire contractual term of the insured financial obligation. Further, the insurance enterprise is entitled to the premium specified by a financial guarantee insurance contract at the contract's inception.

B8. The Board concluded that the premium specified by a financial guarantee insurance contract represents the best measure of the obligation created by the contract at the contract's inception. The premium calculation factors in expectations about the likelihood of default based on information available at the contract's inception (for example, default probability tables). Accordingly, the liability for the unearned premium revenue should be measured based on the related asset, that is, the cash received (single premium) or premium receivable (installment premiums).

#### **Receivable for Future Premiums**

B9. The Board reasoned that if the measurement is based on the premium receivable (installment premiums), the contractual arrangement is in effect a premium financing arrangement between the insurance enterprise and the policyholder and is not similar to an annual guaranteed renewable contract (that is, the installment premiums do not represent renewal premium payments but rather part of the overall premium pursuant to the terms of the financial guarantee insurance contract). Therefore, the premium receivable should be discounted (to reflect the time value of money) using a discount rate that reflects the policyholder's credit standing at the inception of the financial guarantee insurance contract. The discount amount should be accreted on the premium receivable through investment income over the period of the contract in accordance with Opinion 21. In other words, a portion of the premium specified by the financial guarantee insurance contract is compensation (recognized through investment income) to the insurance enterprise for entering into the premium financing arrangement.

#### **Premium Revenue Recognition**

B10. The Board decided to address premium revenue recognition for financial guarantee insurance contracts issued by insurance enterprises. Financial guarantee insurance contracts provide insurance protection to the holder of the insured financial obligation. Therefore, the Board decided to address premium revenue recognition issues in the context of the short-duration insurance accounting model in Statement 60, which links premium revenue recognition to the amount of insurance protection provided. Paragraph 13 of Statement 60 states:

Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the

amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

B11. In its deliberations, the Board clarified aspects of the short-duration insurance accounting model in Statement 60 in the context of financial guarantee insurance contracts (focusing on the notion of insurance protection and the appropriate exposure period).

B12. The Board considered whether the amount of insurance protection provided should be determined based on (a) the par value of the insured financial obligation or (b) the insured contractual payments made by the issuer of the insured financial obligation. The Board decided that the amount of insurance protection provided should be determined based on the insured contractual payments made by the issuer of the insured financial obligation. The Board observed that the insurance enterprise is at risk to the extent of the insured contractual payments that have not yet been made by the issuer of the insured financial obligation. Accordingly, the Board concluded that the insured contractual payments made by the issuer of the insured financial obligation provide a better measure of the reduction of risk associated with the insured financial obligation than the par value of the insured financial obligation. In the event of default, the insurance enterprise must assume the obligation to make those payments remaining on the insured financial obligation.

B13. Consistent with its decision to link the amount of insurance protection provided to insured contractual payments made by the issuer of the financial obligation, the Board clarified that the exposure period is the contract term, that is, the term over which the insured contractual payments are made by the issuer of the insured financial obligation. The Board reasoned that the insurance protection provided declines as the insured contractual payments are made by the issuer of the insured financial obligation according to a predetermined schedule. Therefore, premium revenue should be recognized over the contract term in proportion to the insured contractual payments made by the issuer of the insured financial obligation according to the predetermined schedule at the time that the insured contractual payment is made.

B14. The Board observed that for a financial obligation subject to significant prepayment risk (for example, mortgage-backed securities), the exposure period might be shorter than the contract term (due to the prepayments). In that situation, one could argue that a premium revenue recognition approach that considers the likelihood of prepayment, for example, using expected cash flows instead of the insured contractual payments made by the issuer of the financial obligation, might better reflect the reduction of risk over the contract period. However, the Board concluded that in the absence of observable information about prepayment expectations, it would be difficult to reliably assess the likelihood of prepayment. The Board agreed that the premium revenue recognition approach in this proposed Statement should be consistently applied across all financial guarantee insurance contracts issued by insurance enterprises. Therefore, the Board

decided not to modify the premium revenue recognition approach in this proposed Statement to address prepayments.

B15. The Board further observed that when insured contractual payments are made by the issuer of an insured financial obligation in total at maturity (for example, a zero coupon bond), the insurance enterprise would not recognize premium revenue until maturity under the premium revenue recognition approach in this proposed Statement. One could argue that waiting until maturity to recognize premium revenue might not reflect the reduction of risk associated with the insured financial obligation over the contract term (due to the passage of time). In response, the Board considered an alternative premium revenue recognition approach under which an insurance enterprise would recognize premium revenue evenly over the contract term, based on the insured contractual payments to be made by the issuer of the insured financial obligation.

B16. In the case of a zero coupon bond, the Board observed that the alternative premium revenue recognition approach could accelerate premium revenue recognition. Because the insured contractual payments to be made by the issuer of the insured financial obligation would remain unchanged over the contract term (since the only change in the insured contractual payments would occur at maturity), premium revenue would not necessarily be recognized in proportion to the reduction of the economic risk associated with the insured financial obligation over that period. (In this case, under the alternative premium revenue recognition approach, an insurance enterprise would recognize premium on a straight-line basis, which, in most instances, would not reflect the economic risk to the insurance enterprise. Alternatively, as previously discussed in paragraph B4, measuring the financial guarantee insurance contract at fair value would appropriately reflect the passage of time in the measurement of the claim liability and the economic risk to the insurance enterprise.) However, the Board further observed that there might not be a reduction of the economic risk associated with the insured financial obligation until maturity, when the insured contractual payments are made by the issuer of the insured financial obligation. That might be the case if, for example, the credit standing of the issuer of the insured financial obligation deteriorates over the contract term. In that case, the premium revenue recognition approach in this proposed Statement would appropriately reflect the reduction of risk at maturity. Consistent with its view that the premium revenue recognition approach in this proposed Statement should be consistently applied across all financial guarantee insurance contracts issued by insurance enterprises, the Board decided not to modify the premium revenue recognition approach in this proposed Statement to address situations in which insured contractual payments are made in their entirety at the end of the contract term.

#### **Early Retirement and Replacement of an Insured Financial Obligation**

B17. The Board decided to clarify the application of the premium revenue recognition approach in this proposed Statement in a refunding situation, that is, when the issuer of an insured financial obligation retires the obligation before its scheduled maturity and replaces it with a new financial obligation. The Board concluded that in that situation, the insurance enterprise's obligation under the financial guarantee insurance contract is eliminated. Therefore, if the premium is nonrefundable, the insurance enterprise should

recognize premium revenue to the extent of any unearned premium revenue (liability) for that contract.

B18. The Board further considered the situation in which the new financial obligation is insured by the same insurance enterprise (that is, the insurance enterprise that previously insured the financial obligation that is retired). The Board observed that where there is a preexisting relationship between the insurance enterprise and the issuer of the insured financial obligation, the transaction might not be at arm's length. Accordingly, if the premium received to insure the new financial obligation is not commensurate with the premium the insurance enterprise would charge to insure a similar financial obligation in a separate (standalone) transaction, an additional liability should be recognized. Thus, the unearned premium revenue (liability) recognized reflects the obligation of the insurance enterprise under the new financial guarantee insurance contract.

### **Claim Liability**

B19. The financial obligations insured under financial guarantee insurance contracts generally have high credit ratings (an underwriting requirement imposed by the credit rating agencies). Accordingly, the expectation of a default is low. However, defaults occur. Further, information is available with which to evaluate the likelihood of default over the contract term (for example, information about the credit deterioration of the insured financial obligation). The Board decided that the claim liability recognition and measurement approach for financial guarantee insurance contracts should incorporate that information through expected cash flows. The claim liability recognition and measurement approach in this proposed Statement is a new approach that incorporates aspects of the long-duration insurance accounting model in Statement 60 and represents a departure from practice under FASB Statement No. 5, *Accounting for Contingencies*. The Board decided that claim liability recognition based on when a default has occurred, which ignores information about credit deterioration of an insured financial obligation, does not provide useful information to users of financial statements of insurance enterprises.

### **Expected Cash Flows**

B20. Expected cash flows are probability-weighted cash flows that, conceptually, reflect the likelihood of all possible outcomes. For purposes of this proposed Statement, expected cash flows are developed using the insurance enterprise's own assumptions about the likelihood of default of all possible outcomes based on all information available to the insurance enterprise, including information derived from the surveillance list used by the insurance enterprise to identify and track credit deterioration in its insured financial obligations.

B21. The surveillance list details the insurance enterprise's own assessment of the credit standing of each insured financial obligation on the list. It is updated regularly based on information provided by the issuer of the financial obligation pursuant to the terms of the financial guarantee insurance contract. Thus, the surveillance list reflects current information specific to each insured financial obligation on the list. The Board believes

that the information in the insurance enterprise's own surveillance list is integral in understanding how the insurance enterprise evaluates its claim liability. To improve the quality of the information provided to users of financial statements about insured financial obligations, expected cash flows that incorporate that information form the basis for the claim liability recognition and measurement approach in this proposed Statement.

### **Recognition**

B22. Financial guarantee insurance contracts generally provide insurance protection over an extended period of time and are noncancellable. Therefore, the Board decided to address claim liability recognition issues in the context of the long-duration insurance accounting model in Statement 60. Consistent with its view that the premium specified by a financial guarantee insurance contract represents the best measure of the obligation created by the contract (the "stand-ready" obligation) at inception of the contract, the Board concluded that the liability for the unearned premium revenue at inception of the financial guarantee insurance contract establishes a threshold for claim liability recognition in subsequent periods. Accordingly, a claim liability should be recognized when a claim loss in excess of the liability for the unearned premium revenue is expected based on expected cash flows that represent the likelihood of all possible outcomes. If a claim liability is subsequently recognized, the insurance enterprise's obligation under the financial guarantee insurance contract would be represented by combining the liability for the unearned premium revenue and the claim liability recognized under this proposed Statement.

### **Measurement**

B23. The Board decided that the claim liability, recognized based on expected cash flows, should be measured based on the present value of those expected cash flows.

B24. Because this proposed Statement does not require a fair value measurement, the expected cash flows used to measure the claim liability are not adjusted for market participant assumptions that might be different from the insurance enterprise's own assumptions. That measurement approach represents an exception to the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which establishes that the objective of a present value technique is to measure fair value. However, that measurement approach is consistent with the long-duration insurance accounting model in Statement 60, which relies on the insurance enterprise's own assumptions about varying factors to measure other claim liabilities.

B25. Because the claim liability is an obligation of the insurance enterprise, the expected cash flows should be discounted using a discount rate that reflects the credit standing of the insurance enterprise at initial recognition of the claim liability. That discounting approach represents a departure from the guidance in Statement 60, which requires the use of interest assumptions based on estimates of investment yields when estimating the liability for future policy benefits. Under Statement 60, that measurement guidance is based on the view that the claim liability should be discounted using the investment

yields on an insurance enterprise's investments because those investments will be used to make the eventual claim payments (a matching concept). In this proposed Statement, the Board rejected that view because it believes the investment yields on the investments held by the insurance enterprise are not relevant to the measurement of the claim liability (using expected cash flows). While insurance enterprises achieve asset-liability yield matching by using a discount rate that incorporates the investment yield, the Board concluded that reflecting the insurance enterprise's ability to make claim payments in the discount rate used to measure the claim liability provides users of financial statements with a better indication of an insurance enterprise's ability to meet its obligations when due.

B26. In periods after initial recognition, an insurance enterprise should update the expected cash flows for changes that increase (or decrease) expectations about the likelihood of default as those changes occur. However, those changes to the claim liability in subsequent periods should continue to be measured using the same discount rate used at the initial recognition of the claim (that is, the discount rate that reflects the credit standing of the insurance enterprise at the date the claim liability is initially recognized) so that the measurement is not affected by general changes in interest rates. As a practical matter, the Board observed that the credit standing of an insurance enterprise (particularly those suited to issue financial guarantee insurance contracts) is not expected to change in subsequent periods and that the insured financial obligation acquires the credit standing of the insurance enterprise, from the perspective of investors, through the financial guarantee insurance contract. Accordingly, changes in the insurance enterprise's credit standing likely would not have a significant effect on the measurement of the claim liability.

B27. The Board decided that the claim liability should be remeasured using a current interest rate only upon the event of default. The event of default is a significant event that changes the nature of the insurance enterprise's obligation. The Board believes that the remaining insured contractual payments (net of potential recoveries, excluding reinsurance) should be recognized using current information about general interest rates and the insurance enterprise's credit standing.

## **Disclosures**

B28. The Board's disclosure objective is to provide information that enables users of an insurance enterprise's financial statements to assess factors affecting recognition and measurement of financial guarantee insurance contracts. As a basis for developing the disclosures, the Board obtained input from users that evaluate insurance enterprises that issue financial guarantee insurance contracts, focusing on key information for premium revenue and claim liabilities that would provide insight and improve the understandability of the accounting for a financial guarantee insurance contract. The Board also considered the voluntary disclosures made by insurance enterprises outside the basic financial statements (for example, financial operating supplements that are not required by generally accepted accounting principles [GAAP]). The Board concluded that the disclosures in this proposed Statement, required in annual periods, would provide useful

information for understanding the financial obligations insured under financial guarantee insurance contracts.

B29. Some users emphasized that disclosure of premium revenue recognized upon the early retirement of an insured financial obligation (accelerated premium revenue) is important. Because the decision to retire an insured financial obligation early often is based on external factors (changes in interest rates) and is discretionary (subject to the terms of the insured financial obligation), it is a nonrecurring event (that is, it is not predictable). Accordingly, they view accelerated premium revenue differently from premium revenue recognized through the premium revenue approach. Segregating premium revenue would facilitate the ability of users of financial statements to assess sustainable premium revenue.

B30. The Board determined that disclosure of the amounts relating to financial guarantee insurance contracts where premiums are received in installments that are recognized in the statement of financial position (premium receivable and unearned premium revenue [liability]) and in the statement of income (investment income) is important. In particular, separate disclosure of these amounts would allow users of financial statements to identify and compare amounts (and identify significant changes) relating to the financial guarantee insurance contracts between periods.

B31. Some users emphasized that disclosure of the future contractual runoff of the liability for the unearned premium revenue is important, noting that insurance enterprises usually disclose that information outside the basic financial statements (for example, in the non-GAAP operating supplements). In their view, that information, disclosed in the notes to the financial statements, would assist users of the financial statements in projecting the future profitability of the insurance enterprise based on its existing portfolio of financial guarantee insurance contracts using the premium revenue recognition approach in this proposed Statement. Accordingly, that disclosure would allow users of financial statements to identify and compare amounts (and identify significant changes) in the liability for the unearned premium revenue between periods.

B32. A key disclosure under this proposed Statement relates to the insurance enterprise's surveillance list. The expected cash flows that form the basis for the claim liability recognition and measurement approach in this proposed Statement rely heavily on the information contained in that list. Consistent with its view that the information in the insurance enterprise's surveillance list is integral in understanding how the insurance enterprise evaluates its claim liability, the Board decided to require detailed disclosures about the information included in the surveillance list to further improve the quality of the information provided to users of financial statements about insured financial obligations on that list.

### **Effective Date and Transition**

B33. The Board decided that this proposed Statement should be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Because the Board understands that insurance enterprises that

issue financial guarantee insurance contracts generally use some form of surveillance list already and the disclosures required by this proposed Statement rely on information previously provided voluntarily by insurance enterprises (in the non-GAAP operating supplements), the Board concluded that the effective date of this proposed Statement would provide sufficient preparation time for insurance enterprises, their auditors, and users of financial statements to implement the provisions of this proposed Statement. The Board decided not to permit early application because the application of this proposed Statement in an interim period would reduce selectively the overall comparability of the financial statements.

B34. The Board decided to require a limited retrospective transition approach, applied as of the beginning of the fiscal year in which this proposed Statement is initially applied. Because the substantive guidance in this proposed Statement requires estimates of amounts not previously recognized in the financial statements, a full retrospective transition approach would require the use of hindsight in periods before initial application of this proposed Statement. Further, the Board decided that it would not be practicable to require the application of this proposed Statement to expired or matured financial guarantee insurance contracts. Therefore, the Board decided that this proposed Statement should not be applied retrospectively in all prior periods.

B35. On initial application of this proposed Statement, an insurance enterprise should measure the cumulative effect of initially applying this proposed Statement (recognized as an adjustment to the opening balance of retained earnings for that fiscal year) using information that is current at that date. Therefore, discount rates should reflect the credit standing of the policyholder or of the insurance enterprise, as appropriate, at the date this proposed Statement is initially applied. The Board concluded that the incremental costs involved in determining discount rates reflecting the credit standing of either the policyholder or the insurance enterprise in prior periods would exceed the incremental benefits of incorporating the related information in the measurements.

B36. To achieve comparability in future periods, the information in paragraph 26 of this proposed Statement should be disclosed in the first interim period in which this proposed Statement is initially applied. That information need not be presented in periods before initial application of this proposed Statement.

### **Benefits and Costs**

B37. The mission of the FASB is to establish and improve standards of financial accounting and reporting to provide information that is useful to users of financial statements (present and potential investors, creditors, and other capital market participants) in making rational investment, credit, and similar resource allocation decisions. In fulfilling that mission, the Board endeavors to determine that a standard will fill a significant need and that the costs imposed to apply that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, users of financial information benefit from improvements in financial reporting, thereby

facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

B38. The Board's assessment of the benefits and costs of establishing a separate accounting model for financial guarantee insurance contracts was based on discussions with preparers and auditors of financial statements and on consideration of the needs of users for more consistent application of Statement 60 for these types of insurance contracts. The Board acknowledges that this proposed Statement may increase the costs of applying Statement 60 for some insurance enterprises. The expected benefit of this proposed Statement is improved financial reporting resulting from a more consistent application by insurance enterprises of Statement 60 to financial guarantee insurance contracts and from enhanced disclosures about those contracts. Financial statements of insurance enterprises will be more comparable because the accounting for premium revenue and claim liabilities will be consistent for financial guarantee insurance contracts that are within the scope of this proposed Statement. Specifically, this proposed Statement would require that a claim liability be recognized when there is evidence of credit deterioration of the insured financial obligation rather than when a default (insured event) has occurred. In this way, the information provided to users will be significantly improved because changes in the credit standing of an insured financial obligation will be identifiable and reflected in the financial statements on a timely, consistent basis across insurance enterprises.

#### **Alternative Views**

B39. One Board member does not support the proposed premium revenue recognition approach because (a) it does not adequately reflect the reduction of risk due to the passage of time and (b) exposure is defined according to the insured contractual payments (generally principal and interest), rather than expected cash flows, which might differ significantly for a prepayable insured financial obligation. Because the insured financial obligations being guaranteed are generally debt instruments, that Board member believes that the passage of time and the likelihood of prepayment should both be factors in the premium revenue recognition approach.

B40. First, under the premium revenue recognition approach in this proposed Statement, no revenue would be recognized until maturity for insured financial obligations with payments of principal at maturity, such as a zero coupon bond. This approach does not fairly portray the service being provided by the insurer over the term of the insured financial obligation. Second, in cases in which premiums are received in installments over the period of the financial guarantee insurance contract, the premium receivable (asset) and the unearned premium revenue (liability) that would be recognized under this proposed Statement will be overstated when the insured financial obligation is likely to be prepaid before maturity.

B41. That Board member would support a premium revenue recognition approach that views the passage of time as an element of risk reduction (for all types of insured financial obligations), along with a reduction of risk that is based on declining expected cash flows rather than insured contractual payments for prepayable insured financial

obligations such as mortgage-backed securities, for which there is readily observable information about prepayment expectations. That Board member believes that such an approach is consistent with how market participants value debt instruments and related contracts (that is, consideration of both amount and timing of cash flows) and would be consistent with the notion of risk reduction that is currently employed in Statement 60 for insurance contracts.

B42. Another Board member agrees with the views discussed in paragraphs B39–B41 and is further concerned that the proposed premium revenue recognition approach (using the insured financial obligation’s contract term as the period over which to recognize premium revenue) fails to capture the economics of the insured financial obligation because implicit in the pricing of the financial guarantee insurance contract and the performance of the insured financial obligation is a forecast of the expected term of the insured financial obligation. The insurance enterprise, with limited capital-constrained capacity, bases its pricing of the financial guarantee insurance contract on the expected term rather than the contract term of a prepayable insured financial obligation. That Board member believes that prepayment information is a critical parameter for determining if the insurance enterprise has adequately charged for the “economic renting” of its capital structure. That Board member also believes that the proposed premium revenue recognition does not provide any indication for the investor about the economic performance of the insurance enterprise for insured financial obligations subject to significant prepayment.

B43. That Board member also disagrees with the inclusion of interest payments in the methodology for determining premium revenue to be recognized in a period. While acknowledging that the insurance enterprise is often obligated for principal and interest payments, in effect, the insurance enterprise is only obligated for at most one interest payment in the event of a default. Whether the insurance enterprise settles the claim with an immediate payoff of the outstanding principal (and payment for a limited number, if any, of defaulted interest payments) or continues to make payments of principal and interest for the duration of the insured financial obligation is a financing decision of the insurance enterprise and should not be the basis for recognizing premium revenue. Further, the “economic rent” for providing the financial guarantee insurance contract is based on the capital cost of the insurance enterprise and not the interest payments of the insured financial obligation.

B44. That Board member believes that the proposed premium revenue recognition approach would result in misleading reporting when the insured financial obligation’s only payment is at maturity (such as a zero coupon bond) or when the cost of capital is dramatically different for the insurance enterprise compared to the financial guarantee insurance contract. That Board member believes that a conceptually superior and more representationally faithful approach would be to base premium revenue recognition on the capital exposure, which is better represented by the insured notional amount not including contractual interest payments.

## Appendix C

### AMENDMENTS TO EXISTING PRONOUNCEMENTS

C1. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

- a. Paragraph 6, as amended:

This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock **life insurance enterprises, property and liability insurance enterprises,<sup>2</sup> title insurance enterprises, mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies.** Except for the sections on premium revenue and claim cost recognition and **acquisition costs** (paragraphs 9–11, 13–18, and 20–31), this Statement applies to **mortgage guaranty insurance enterprises.** Except for the sections on premium revenue and claim cost recognition (paragraphs 9–10 and 13–18), this Statement applies to insurance enterprises that issue financial guarantee insurance contracts included within the scope of FASB Statement No. XXX, *Accounting for Financial Guarantee Insurance Contracts*. FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, addresses the accounting for certain long-duration participating life insurance contracts.<sup>2a</sup>

C2. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, is amended as follows:

- a. Paragraph 8(c):

Insurance contracts, other than financial guarantees (including financial guarantee insurance contracts included within the scope of FASB Statement No. XXX, *Accounting for Financial Guarantee Insurance Contracts*) and investment contracts, as discussed in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

C3. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows:

- a. Paragraph 10(c):

*Certain insurance contracts.* Generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by*

*Insurance Enterprises (not including financial guarantee insurance contracts within the scope of FASB Statement No. XXX, Accounting for Financial Guarantee Insurance Contracts), No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, and No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:*

- (1) *Traditional life insurance contracts.* The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.
- (2) *Traditional property and casualty contracts.* The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

However, insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises combine derivative instruments, as defined in this Statement, with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12.

C4. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, is amended as follows:

- a. Paragraph 6(d):

A guarantee (or an indemnification) that is issued by either an insurance company or a reinsurance company and accounted for under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain*

*Long-Duration Contracts and Realized Gains and Losses from the Sale of Investments, No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, ~~or~~—No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts, or No. XXX, Accounting for Financial Guarantee Insurance Contracts (including guarantees embedded in either insurance contracts or investment contracts).*