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AFGI

Association of Financial Guaranty Insurers

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The Association of Financial Guaranty Insurers ("AFGI") is pleased to comment on the Financial Accounting Standard Board's (FASB) exposure draft ("ED"), Proposed Interpretation, *Consolidation of Variable Interest Entities, a modification of FASB Interpretation No. 46*. AFGI is the trade association representing nine insurers and reinsurers of municipal bonds and asset-backed securities. AFGI members conduct substantially all of the financial guaranty business written in the world and are a significant participant in the United States capital markets. AFGI member companies are ACE Guaranty Corp., Ambac Assurance Corporation, CDC IXIS Financial Guaranty North America, Inc, Financial Guaranty Insurance Company, Financial Security Assurance Inc., MBIA Insurance Corporation, Radian Reinsurance Inc., RAM Reinsurance Company Ltd and XL Capital Assurance Inc. In 2002, AFGI members insured \$431.2 billion in par value of securities.

Financial guaranty insurance contracts written by AFGI members typically guaranty scheduled payments on an issuer's obligations. Upon a payment default on an insured obligation, AFGI members are generally required to pay the principal, interest or other amounts due in accordance with the obligation's original payment schedule or, at its option, to pay such amounts on an accelerated basis. The financial guaranty contract is an unconditional and irrevocable promise to pay when there has been a failure to pay by the obligor, it is not tradable, and it is intended to be held to maturity. In addition, all AFGI members disclose the total amount of obligations they insure.

All current AFGI member firms carry the triple-A or double-A claims paying ability rating from one or more of the major credit rating agencies. Further, the United States based financial guarantors operate under the strict risk-based capital provisions of Article 69 of the New York Insurance Law. Article 69 establishes a so-called "monoline" financial guaranty insurance industry by limiting financial guaranty insurance corporations to writing only financial guaranty insurance and a few closely related lines of insurance (surety, credit and residual value insurance). The New York State insurance law has served as a template for the other states that have enacted so-called "monoline" financial guaranty insurance laws. All major participants in the United States financial guaranty insurance market are licensed under Article 69, and are therefore subject to the restrictions imposed by Article 69.

Comment: Language should mirror the other letter to the SEC

To safeguard the rating of the insured obligations and to protect the interests of insured bond investors, AFGI firms subscribe to a "remote loss" underwriting standard. Securities insured by AFGI members receive the unconditional and irrevocable guaranty of scheduled principal and interest payments to holders of these obligations. In the 32-year history of the financial guaranty industry, no member company has ever failed to fulfill its payment obligations to insured bond investors when due.

Comment: Discuss S&P FER view?

AFGI members support the FASB mission to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including investors, and other users of financial information. As such, AFGI believes the comments, observations and suggestions herein are consistent with the FASB's mission statement, particularly considering the needs of AFGI member firms and users of their financial information.

Financial guaranty insurance contracts only pay when the holder has incurred a loss arising from the failure of the debtor to make payment when due. The general principles differentiating financial guaranty insurance contracts from other contracts are as follows: a) the writer of the insurance contract or policy must be an insurance company, regulated as a financial guaranty insurance company by an insurance regulator operating within a robust regulatory regime, b) the insured obligations must be insurable risks for financial guaranty insurance companies as determined under the New York Insurance laws, c) the insurance policy must be irrevocable by the bond insurer, and must include rights of subrogation against the underlying obligor and d) at inception of the insurance policy, the credit-related risk insured under the insurance policy is the equivalent of investment-grade without the benefit of the insurance (that is, the risk of payment undertaken must be a low frequency event).

Comment: What about non-US FG co's?

As noted above, the financial guaranty insurance policies of AFGI members generally cover municipal bonds and asset-backed securities. For municipal bonds, the financial guaranty insurance policy will typically cover the debt obligations of a municipal entity or of an entity directly benefiting from the relevant municipal credit. In the case of asset-backed securities issued in most jurisdictions, the financial guaranty insurance policy will typically cover the senior obligations of an entity (usually a special purpose vehicle ("SPV")) that owns the assets. In asset-backed securitization transactions the insurer's interest is a senior interest and therefore contains very little variability. Generally, there are multiple variable interest holders in the entity and the financial guarantor is not considered the primary beneficiary. (It is important to note that AFGI members are not the transferors when financial assets or financial liabilities are being derecognized.)

Comment: I believe MBIA and AMBAC have FAS 140 transactions - best to check with them.

Due to peculiarities of structuring certain overseas transactions to address issues of foreign law, tax withholding and unique counterparties (such as multinational development banks), multiple legal entities or SPVs are sometimes interposed. In these transactions, despite certain structural complexities, the role of the financial guaranty insurer is the same. That is, the financial guarantor provides an additional senior level of protection to the investors after the subordination in each transaction provided by the sponsoring entity. In return for taking on the contingent credit risk by guaranteeing the debt, the insurer is focused on making sure that it is a fully secured party with respect to the relevant assets that are supporting the debt obligations that are being guaranteed and that the insurer has effectively the same pre-defined control rights, rights of subrogation and remedies that it would have in a more straightforward structure. Some of these structures result in debt being issued from an "orphan" SPV whose assets consist of essentially a pass-through interest to the assets (held in another SPV) supporting the debt. It would appear that a literal application of FIN 46 might lead to the conclusion that the financial guaranty insurer is the primary beneficiary and must consolidate one of the SPVs in these transactions. We think this reading of FIN 46's

requirements would be inappropriate and would result in the inconsistent treatment of transactions that are economically the same for the financial guaranty insurer.

We have identified two different insured transaction structures, which due to their form, rather than substance, may require consolidation per FIN 46. Since the primary objective of the ED is to address certain technical corrections and implementation issues related to FIN 46, we provide background on two representative transactions that currently may require consolidation per FIN 46 and where we believe such result would be inappropriate and unintended. AFGI members support a principle-based approach to identifying a primary beneficiary. As such, AFGI members believe that the form of a transaction should not dictate the accounting conclusion, but rather a substance-based approach should be utilized. AFGI members suggest that the FASB provide additional clarification in the final interpretation to address this issue. AFGI's position in the following examples is that Account Conclusion "B" is the appropriate accounting treatment.

1. In a Korean auto loan securitization (see exhibit 1 attached):

In this section, we describe the legal construct of an existing Korean automobile loan securitization, the reasons for this legal construct, and the roles of each participant to the transaction.

Primary Credit: Notes are issued by a nominally capitalized Cayman SPV to third party investors, and secured primarily by a senior interest in Korean auto loan receivables that are not directly held by the Cayman Issuer. These notes are guaranteed by a financial guarantee insurer. The Note proceeds are on-lent to a Korean SPV in exchange for a senior interest in the Korean SPV.

Sale: Korean originator sells loan receivables denominated in KRW to a Korean SPV at a purchase price equal to the principal amount outstanding of the receivables. The Korean SPV pays the originator with a combination of cash and a subordinated bond (a subordinated retained interest in the assets transferred). The Subordinated Bonds amount to 25% of the principal balance of the receivables at closing. The Subordinated Bonds are denominated in KRW and carry a fixed coupon. Originator registers the sale with the Korean Financial Supervisory Commission to qualify for true sale characterization under Korea's asset-backed securitization ("ABS") Law. The Korean SPV is established pursuant to Korea's ABS law and is domiciled in Korea.

Bond Issuance: The Korean SPV sells bonds to Cayman SPV to fund the cash component of the purchase price of the receivables (the "Senior Bonds"). The Senior Bonds are denominated in US\$ and carry a floating coupon. The Senior Bonds have a principal amount in US\$ equal to approximately 75% of the principal balance of the receivables, converted at the fixed exchange rate provided in a foreign currency swap. The foreign currency swap is entered into by the Korean SPV. The Senior Bonds have a legal final maturity of six years and an expected final maturity of five years. Following an early amortization event, the Senior Bonds are repaid on a pass-through basis from the collections on the auto loans. The Cayman SPV purchases the Senior Bonds and sells US\$ insured notes to investors. The Cayman SPV is introduced to the structure to facilitate perfection of the collateral interest in the Korean SPV under Korean ABS law.

Requirement for 2 SPVs: Under Korean law it is very difficult to achieve a legal structure utilizing one issuing SPV where that one SPV can grant security over its assets in favor of all its bondholders. Under Korean law the security has to name specific secured parties. Therefore, if the bonds are sold, the benefit of the pledge needs to be assigned to the new bondholder as part of

each transfer. This is considered too cumbersome by the market and results in a legal structure where the Korean SPV issues the bonds to a Cayman SPV and grants security to the Cayman SPV. That is, the Cayman SPV is the secured party. Therefore, the need to continuously assign the security interest pledge has been addressed. The Cayman SPV in turn issues notes to its investors and grants security over all its assets in favor of the holders of the notes. The security granted by the Cayman SPV covers all its assets including the Korean SPV bonds it holds and its rights under the Korean law pledge.

Accounting Conclusion "A". Subordination does not exist at the Cayman issuer SPV level. The Cayman SPV is a VIE. It has no equity or subordinated debt and the financial guarantor is the only variable interest holder in this stand-alone entity. The Cayman SPV is the lender and Korean SPV is the borrower. As such the Korean SPV is considered to have a variable rate liability owed to the Cayman SPV. Before the proposed Interpretation, one would have considered the guidance in paragraph B8, which has been removed in the ED. Korean SPV is not considered a variable interest holder of Cayman SPV and therefore cannot be the primary beneficiary given this relationship per paragraphs B 11 and B12. The example presented in B12 would argue that Entity 2 parallels Cayman SPV while Entity 1 parallels Korean SPV. The primary distinction is that Cayman SPV issues only one type of interest in return for cash that is used to on-lend to Korean SPV. The Cayman SPV is required to be consolidated by the financial guarantor because the financial guarantor is considered to hold the subordinated interest of the Cayman SPV and is deemed the primary beneficiary.

Accounting Conclusion "B". The expected loss in the aggregate transaction will be absorbed by the asset transferor, not the financial guarantor, due to their 25% overcollateralization. To perfect a security interest in the Korean SPV collateral, it was deemed necessary to introduce Cayman SPV as the public note issuer. Cayman SPV and Korean SPV are more properly viewed as consolidated for purposes of evaluating accounting consolidation under FIN 46. It is unclear whether the Korean SPV liability owed to the Cayman SPV could be viewed as a variable interest in the Cayman SPV. Particularly since paragraph B.8 has been removed and paragraph B.12 has been retained.

Furthermore, AFGI members believe that the insertion of a nominally capitalized special-purpose entity should not change the accounting conclusion. This principle is similar to the one mentioned by the SEC staff in EITF Topic D-14 (since superseded). Topic D-14 states, in part, that "the SEC staff has objected to a proposal in which the accounting for a transaction would change only because an SPE was placed between the two parties to the transaction. The SEC staff believes that insertion of a nominally capitalized SPE does not change the accounting for the transaction."

In addition, one could assert that the Cayman SPV is merely a de-facto agent (as the Cayman SPV won't sell, transfer or encumber its interest other than the immediate pledge) of the Korean SPV and was established for one reason--to facilitate the securitization transaction. The party with the activities most closely related to the entity would be the transferor or sponsor. The analysis would be similar to a "two-step" securitization transaction that is used to achieve legal isolation under Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140). In paragraph 154 of FAS 140, the Board concluded that the legal isolation criteria could be met in a single transaction or a series of transactions considered as a whole. The Cayman SPV is utilized to achieve a legal and business result that could not be accomplished in one entity.

Lastly, under U.S. GAAP prior to FIN 46 one would have viewed the Korean and Cayman SPVs to have been “sponsored” by the transferor and not consolidated by the guarantor.

2. In a European Private Financing Initiative Transaction (see Exhibit 2 attached):

Primary Credit: Notes are issued by a UK SPC (Special Purpose Corporation) (“Finance Co”) to third party investors. The Note proceeds are on-lent to another UK SPC (“Project Co”). Project Co. guarantees the debt of Finance Co. Finance Co has nominal equity and no subordination. The Notes are publicly listed as international eurobonds. The Notes issued by Finance Co are guaranteed by a financial guaranty insurer.

Structure Overview

The primary asset of Project Co is a long term (30+ years) concession calling for the design and construction of a large acute care hospital and the subsequent provision of non-clinical services. The concession provides for periodic fixed payments from a National Health Service Trust. Project Co has multiple reserve accounts and benefits from significant equity and subordinated debt. In addition, Project Co benefits from certain contractual recourse against different service providers. Project Co is not a PLC and is therefore not permitted to issue tradable debt. Therefore, Finance Co was organized as a PLC in order to issue debt. The debt was issued in insured form and on lent by Finance Co to Project Co.

Accounting Conclusion “A”. Subordination does not exist at the Finance Co issuer SPV level. Finance Co has no equity and the financial guaranty insurer is the only VIE in this stand-alone entity. Finance Co SPV is the lender and Project Co is the borrower. Project Co cannot be the primary beneficiary given this relationship and per FIN 46 paragraphs B.11 and B.12, Finance Co would not be consolidated with Project Co. The example presented in B.12 would indicate that Entity 2 parallels Finance Co while Entity 1 parallels Project Co. Finance Co issues only one type of interest in return for cash that is used to on-lend to Project Co. The Finance Co SPV is required to be consolidated by the financial guarantor per FIN 46.

Accounting Conclusion “B”. The expected loss in this transaction will be absorbed by the equity and mezzanine financing parties of Project Co, not the financial guarantor. To issue public debt a PLC issuing vehicle was deemed necessary. Finance Co and Project Co are more properly viewed as consolidated for purposes of evaluating accounting consolidation under FIN 46.

Overall Conclusion:

We believe that the financial statement presentation resulting from consolidating the transactions referenced above is inconsistent with the objective of “fairly presents, in all material respects, the financial condition and results of operations of the Company” when referring to a financial guarantor. We believe that when multiple SPVs are tethered to one another in the economic evaluation of expected loss that the same perspective should be brought to bear when performing the accounting consolidation analysis under FIN 46. Without knowing the background of the transaction types cited in B.12, it is difficult to propose an appropriate alternative form of B.12. We would recommend that B.12 be clarified to address the types of transactions cited in this letter and require the parties to such securitization transactions to aggregate the legal entities utilized and consider them as one accounting entity for FIN 46 purposes.

If a representative of the Financial Accounting Standards Board wishes to discuss the contents of this comment letter or other matters that may arise during the re-deliberations of this proposed financial reporting guidance, please contact Tom Gandolfo, Chairman, of the AFGI Financial Affairs Committee at (212) 208-3349 (tgandolfo@ambac.com).

Sincerely,

Thomas J. Gandolfo
Chairman, Financial Affairs Committee
Association of Financial Guaranty Insurers

Senior Vice President and
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Exhibit 2

European Private Financing Initiative

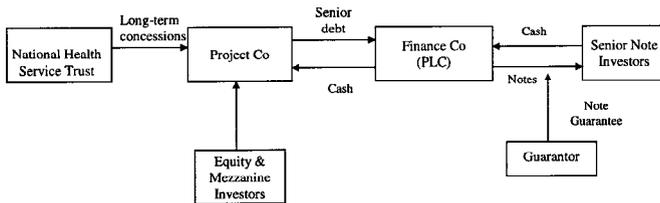


Exhibit 1

Korean Auto Loan Securitization

