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June 19, 2007



LETTER OF COMMENT NO. 75

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft: Proposed FASB Statement, *Accounting for Financial Guarantee Insurance Contracts – an Interpretation of FASB Statement No. 60* - File Reference No. 1530-100

Dear Technical Director:

We support the Board's efforts to clarify how FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, applies to financial guarantee insurance contracts and we appreciate the opportunity to comment on the proposed Statement of Financial Accounting Standards, *Accounting for Financial Guarantee Insurance Contracts – an interpretation of FASB Statement No. 60*.

We have set forth a number of observations below for consideration by the Board. However, our primary concern involves the proposed premium revenue recognition approach. Given that we believe that both the passage of time and the likelihood of prepayment should be factors in recognizing premium revenue, we do not support the approach described in the proposed Statement.

Scope (Issues 1-3)

The scope of the proposed Statement is limited to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises. It does not seem reasonable that similar contracts issued by companies in different industries would be accounted for differently. We believe that the scope of the proposed Statement should be based on the characteristics of the contract and not on whether the issuing enterprise is an insurance company.



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We acknowledge the Board's concern that expanding the scope of the proposed Statement would delay the issuance of guidance relating to financial guarantee insurance contracts issued by insurance enterprises. However, by not applying the guidance in the proposed Statement to financial guarantee contracts issued by noninsurance enterprises or insurance contracts that are similar to financial guarantee insurance contracts (paragraph 5), the appropriate accounting model for these other contracts becomes unclear. In addition, different models for the same or similar contracts adds unnecessary complexity to accounting standards.

Depending on which approach is followed, it may be necessary to include additional examples of the types of products that are excluded from the scope of the proposed Statement (e.g., whether surety products, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period are included).

The definition of a financial guarantee insurance contract, included in paragraph 3 of the proposed Statement, is broader than in paragraph 10(d) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This could result in circumstances where a financial guarantee insurance contract might be within the scope of both the proposed Statement and Statement 133. In other words, a contract could meet the criteria for a derivative and not be within the paragraph 10(d) exclusion in Statement 133 and also be within the scope of the proposed Statement. The Board, in combination with our first comment on scope, should consider making the definitions in the proposed Statement and paragraph 10(d) of Statement 133 the same. Use of different definitions for the same terms also adds unnecessary complexity to accounting standards.

In addition, we believe that the guidance provided by paragraph 10(d) of Statement 133 needs to be clarified for the various financial guarantee contracts available in today's environment. For example, with the adoption of FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, many of the guaranteed beneficial interests issued by securitization trusts contain an embedded derivative, often of a de minimis value, that needs to be bifurcated. Many of the financial guarantees being offered today may be determined to provide, in extremely remote scenarios, for a guarantee of that embedded derivative as well as the rest of the beneficial interest. The discussion of guaranteeing a nonderivative contract in paragraph 10(d) needs to be clarified to assist in determining which contract is being guaranteed – the entire beneficial interest or the host plus embedded derivative. Another alternative might be permitting the guarantor the option to choose fair value or bifurcate the guarantee between the two pieces (similar to the option provided to investors in beneficial interests by Statement 155).



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Unearned Premium Revenue (Issues 4-7)

While we agree that an unearned premium liability should be recognized at the inception of a financial guarantee insurance contract, and that it should reflect future installments, we believe that measuring it based on the present value of the contractual premium overstates the obligation under a financial guarantee insurance contract when that contractual premium is not expected to be received (e.g. when the insured obligation is subject to prepayment). We believe using fair value to measure the unearned premium liability would be appropriate, and we continue to support, as an ultimate objective, fair value measurement for substantially all financial instruments. However, based on the narrow scope of the proposed Statement, we recommend the Board consider amending the proposed Statement to measure the unearned premium liability based on the present value of the expected cash flows.

The following represent related questions that the proposed Statement does not address:

- How should the insurance enterprise account for reinsurance related to financial guarantee contracts with installment premium? Would a ceded premium be recognized? A commission receivable?
- Should premium taxes, or other costs that vary with or are primarily related to future installment premiums, be deferred at the inception of the contract?

The proposed Statement should address these concepts.

Premium Revenue Recognition (Issues 8-11)

We do not support the proposed premium revenue recognition approach, as we believe that both the passage of time and the likelihood of prepayment should be factors in recognizing premium revenue. The proposed Statement would require that an insurance enterprise utilize expected cash flows in determining its claim liability but require its revenue to be based on contractual cash flows and be deferred until the enterprise is released from risk. It would seem more consistent to determine revenues, and the related premium receivable, based on expected cash flows and recognize the revenues in proportion to the insurance protection provided, portraying an appropriate representation of the stand-ready obligation of the insurance enterprise and thus recognizing the passage of time element in the revenue recognition model. It is unclear to us how the proposed revenue recognition model is consistent with the short-duration insurance model in Statement 60 as referred to in paragraph B10 of the proposed Standard.

The Board indicated that it is concerned that there may be an absence of observable information about prepayment expectations making it difficult to reliably assess the likelihood of prepayment. However, this observation is inconsistent with paragraph 58 of



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FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, where respondents argued that the timing and amount of prepayments on loans such as mortgages can be reliably estimated and the Board acknowledged that in certain circumstances it may be possible to estimate reasonably an event beyond an enterprise's control, such as prepayments, if the population of loans is large and their characteristics are similar. Therefore, if the criteria of Statement 91 are met, we believe that prepayments should be considered.

Claim Liability (Issues 13-15)

We support the proposed expected loss approach for recognizing a claim liability on a financial guarantee insurance contract. However, we believe that requiring the use of a risk-adjusted rate to discount expected claim cash flows is inconsistent with Concept Statement 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, which indicates the following (paragraph 82):

The effect of an entity's credit standing on the measurement of its liabilities is usually captured in an adjustment to the interest rate, as illustrated above. This is similar to the traditional approach to incorporating risk and uncertainty in the measurement of assets and is well suited to liabilities with contractual cash flows. An expected cash flow approach may be more effective when measuring the effect of credit standing on other liabilities. For example, a liability may present the entity with a range of possible outflows, ranging from very low to very high amounts. There may be little chance of default if the amount is low, but a high chance of default if the amount is high. In situations like this, the effect of credit standing may be more effectively incorporated in the computation of expected cash flows.

We recommend that the Board consider allowing enterprises to incorporate credit standing into the expected cash flows rather than a risk-free rate adjustment. This also has the advantage of allowing the enterprise to reflect changes in its credit standing while using the same discount rate used at the initial recognition of the claim (so that measurement is not affected by general changes in interest rates).

We also encourage the inclusion of examples that illustrate the interaction of the claim liability and the unearned premium reserve. It is clear from the proposed Statement that a claim liability on a financial guarantee insurance contract should not be recognized until the insurance enterprise expects the claim loss to exceed the unearned premium reserve for that contract based on expected cash flows. However, it is unclear whether, upon recognition of the claim liability, the resulting unearned premium reserve should be reclassified to a claim liability. If not, should premium recognition cease for that



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contract? What happens if the claim liability reverts to zero? Is the unearned premium reinstated (or if not reclassified then would revenue recognition begin again)?

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If you have questions regarding information included in this letter, please contact Enrique Tejerina at (212) 909-5530 or Darryl Briley at (212) 909-5680.

Sincerely,

KPMG LLP