

A·F·G·I

ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty®

October 10, 2006



LETTER OF COMMENT NO. 1

Mr. Lawrence Smith, Director
Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Smith,

This letter is submitted on behalf of the Association of Financial Guaranty Insurers ("AFGI" or "we") in response to the recent Financial Accounting Standards Board ("Board") meeting held on September 13, 2006 pertaining to the proposed premium revenue recognition accounting models for financial guaranty insurance contracts ("the Meeting"). As you know, revenue recognition for both single premium ("upfront") and installment premium contracts were discussed at that meeting. As a result of Board decisions made at the Meeting, the FASB Staff ("Staff") has been instructed to prepare an exposure draft scheduled to be published in the fourth quarter of 2006. We believe that additional clarification of facts as well as our observations and comments on theoretical and implementation issues would be helpful to the Board now, rather than later, and could affect the drafting process and conclusions reached. We are available to meet and discuss our concerns or respond to questions that the Staff or Board may have.

We would also encourage the FASB to speak with the financial statement user community, primarily the equity analysts and rating agencies which cover the financial guaranty industry. Through recent discussions with this user community, we believe they share many of the concerns outlined in this letter.

This letter describes our theoretical concerns with the proposed accounting model, the significant operational issues introduced by the new revenue recognition model and, based on our understanding of the Board's objectives, a suggested alternative revenue recognition model framework.

Summary of Board Decisions:

Based upon the Board's deliberations at the Meeting, there was a desire to develop a consistent revenue recognition model regardless of the premium collection method (that is, upfront or installment) and to not impose a fundamentally new accounting model. We believe the Board wanted to follow the general concept of revenue recognition contained within FAS 60. That standard establishes that revenue should be recognized "in proportion to the amount of insurance protection provided."

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At the Meeting a variety of approaches to revenue recognition were identified and labeled as approaches A thru E. The Board chose Approach D as the most appropriate model. Under this model, revenue is to be earned each accounting period based upon the ratio of exposure (defined as par and interest insured) paid each period relative to the total exposure insured at inception. The Board decided that total debt service (i.e. principal and interest) should be the measure of exposure because financial guarantors guarantee the timely payment of both principal and interest.

With respect to policies where premiums are collected in installments, the Board decided that Alternative B was most appropriate. Alternative B requires recognition on the balance sheet of a premium receivable and an unearned premium revenue at the inception of the contract. The asset and liability is to be measured as the present value of contractual cash flows owed to the guarantor utilizing the general guidance provided by APB 21. The PV accretion of the premium receivable would be recognized as investment income based on the effective yield method. The unearned revenue liability would be recognized as premium revenue applying the "ratio of exposure" approach consistent with Approach D. The Board decided that the expected debt schedule which anticipates prepayments was not to be considered for purposes of making the "ratio of exposure" calculations. However, the Board recognized this as an open question and directed the Staff to query constituents in order to determine situations in which the expected life of the insured debt (and related expected premium cash flows) should be used instead of contractual maturity.

Theoretical concerns:

Overall revenue recognition approach:

AFGI's fundamental concern with Approach D is that, although it was presented to the Board as a "ratio of exposure" method, it assumes that "exposure" or insurance risk is constant over time and therefore fails to recognize the passage of time as a component of exposure reduction (i.e. - risk reduction or insurance protection provided). The relationship of risk and time to maturity is reflected in the pricing of financial guaranty contracts, that is, more premium is charged for bond issuances with longer terms to maturity, all other factors being equal. In addition, rating agency capital charges assessed on each insured risk increase with a longer term to maturity. For instance, the premium charged for a 1 year instrument will be less than that charged the same issuer for a 30 year term to maturity. The weakness of Approach D is most apparent when considering a coupon bond with a bullet principal payment, typical of a utility issuer. Revenue recognition in such case is severely "back-loaded". The "ratio of exposure" revenue recognition approach ignores the passage of time as a component of exposure. We believe this is a fundamental and fatal flaw of the proposed accounting model.

We consider the Board's proposed approach to be a new accounting model in the context of existing GAAP literature, both for financial instruments broadly and insurance contracts specifically. Financial instrument accounting, almost without exception and including APB 21, utilizes the interest method or level-yield approach and considers the passage of time. Approach D is inconsistent with insurance accounting under both the long-duration and short-duration models established under FAS 60. The long-duration model requires premiums to be recognized as revenue when due from policyholders. The short-duration model requires revenue to be recognized evenly over the insurance protection period. A property and casualty insurance company, for instance, does not recognize revenue only upon the policy expiration date (examples could include homeowners, auto, and workers compensation).

There appeared to be some confusion at the Meeting regarding a financial guarantor's obligation for ongoing interest payments after the guarantor accelerates the insured bonds. To clarify this point, after the bonds have been accelerated with par and accrued interest paid there would be no further payment obligation as the policy would be extinguished upon such claim payment event. We believe the Board's discussion overlooked the important risk element of time passage which led to a faulty conclusion that total debt service (principal and interest) being the best measure of exposure for purposes of revenue recognition. We believe that insured principal is a better measure of an insurer's exposure because it approximates the present value of insured principal and interest at any point in time. For reasons previously mentioned, we also strongly believe that time passage is an important element of exposure reduction which should be considered in the proposed revenue recognition model.

Installment premium approach:

We would like to make the following points regarding proposed Alternative B, which would require recognition of an asset and a bifurcated approach to installment premium revenue recognition:

1. There was a view taken by certain Board members that a policyholder who pays installment premiums, as opposed to a single upfront payment, is in some way being financed by the financial guarantor. While we acknowledge the theoretical argument behind this viewpoint, the Board should consider that a) the mode of premium payments under a financial guaranty policy is almost entirely dependent on the bond type being insured and b) the payment mode is generally not an option provided to the policyholder by the guarantor. The payment mode is governed almost entirely by market convention. For example, the municipal sector issues bonds that have little to no uncertainty with respect to principal payments and therefore the overwhelming majority of premiums are collected upfront. On the other hand, the structured finance sector typically issues securities that have cash flow uncertainty with respect to the timing of principal payments and therefore premiums are primarily collected periodically as installments based on the actual outstanding insured principal balance.
2. Alternative B requires bifurcation of the characterization of revenue between investment income and premiums earned and bifurcation of the timing of revenue recognition between effective yield for investment income and the "ratio of exposure" for premiums earned. We believe bifurcating installment premiums adds an unnecessary level of complexity for users and preparers of the guarantors' financial statements, particularly when revenue for the asset discount accretion is recognized under the yield or interest method and premiums are recognized under a different method.
3. The proposed financial guaranty claims recognition approach which the Board approved at its August 9, 2006 meeting would value the claim liability using transaction-specific inputs, which include the time value of money. The resulting present value discount on the claim liability would be recognized as a financial guaranty loss (instead of investment expense). This accounting result is inconsistent with the proposed installment premium approach of accreting the premium receivable discount through investment income. It would be more consistent to accrete the premium receivable discount through premiums earned.

4. The Board expressed a preference for using the contractual life to measure the initial premium receivable and unearned premium revenue, while also requesting the Staff to ask for comments as to circumstances to apply the expected contract life. Based on our considerable experience observing mortgage and asset-backed securitizations (collectively "ABS") paydown behavior, we believe expected life is appropriate for the vast majority of assets we insure and on which we charge premium on an installment basis. Additionally, other capital markets participants (e.g. - investors, broker/dealers, etc.) would always use expected life when developing fair values for ABS being analyzed. Using contractual life for ABS will always result in the over-statement of both the premium receivable and the "stand ready" obligation at inception. Consequently, using contractual life to estimate the present value of future premiums is inconsistent with the guidance in APB 21, particularly paragraph 12, which requires the receivable to be recorded at an amount that approximates the market value on that date (presumably a cash equivalent concept), and Concepts Statement No. 6, which defines assets as "*probable* future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." The on-going accounting adjustments required to "true up" the initially established asset and liability will cause misleading earnings volatility (again considering different earnings methodologies between premiums and the receivable) depending on the "true-up" method selected. Such method would confuse users of our financial statements and would be difficult and costly to maintain. To illustrate this point, we have attached Exhibit A, which was excerpted from the prospectus of a recent mortgage-backed securitization offering whose capital structure included several classes of senior and subordinated certificates. The table in Exhibit A indicates the weighted average life and percentage of initial principal amount outstanding each year the senior notes (Class A-1 and A-2) remain outstanding under different prepayment scenarios, as measured by the constant prepayment rate ("CPR"). The Class A-2 notes, which were insured by the financial guarantor in this particular structure, have dramatically different amortization profiles under different prepayment scenarios. The 0% CPR scenario assumes no prepayments and therefore we believe would be used to compute "contractual" cash flows consistent with Alternative B. The weighted average life under the 0% CPR scenario is 24.2 years. However, these certificates were underwritten by the financial guarantor and priced by capital market investors using a 25% CPR assumption, which is the "expected" cash flow scenario and which equates to an average life of 3.1 years. Considering this fact pattern, at origination we would recognize an asset for the present value of 24.2 years of premium versus the expected scenario of 3.1 years. We would proceed to recognize investment income on this non-economic asset. Consequently, using the "contractual" 0% CPR scenario to project future premiums would result in a) a gross overstatement of the initial premium receivable and unearned premium revenue established on day one and b) significant "catch-up" adjustments to premium earnings and investment income for subsequent periods.

Recording a premium receivable based on contractual cash flows would also require guarantors to consider recording an impairment charge on day one under existing GAAP literature. For example the guidance under FAS 5, which encompasses the collectibility of receivables, requires the accrual of a loss contingency if a) it is probable that an asset has been impaired and b) the amount of loss can be reasonably estimated. Furthermore, under FAS 5 if it is probable than an enterprise will be unable to collect all amounts due according to the contractual terms of the receivable, the condition of a "probable" occurrence has been met. Additional analogies can be made to accounting guidance found in FAS 114 and 115, covering loan and investment impairments, respectively.

We also believe inherent in the guidance of APB 21, requires one to consider all events that could alter the contractual life including call dates, step-up premiums and other features that might be an incentive to an issuer to call the obligation before the contractual maturity date.

Implementation concerns:

Our concerns relate to the proposed installment premium methodology and are set forth below:

1. *"Catch-up" adjustment methodology* - Should the same approach be used when adjusting the premium receivable and unearned premium revenue for changes in cash flow assumptions? For example, under the investment accounting model, FAS 91 and EITF 99-20 are followed when determining whether to apply a retrospective or prospective approach when recording "catch-up" adjustments to premium/discount amortization. Would this guidance also apply to Alternative B for both the premium receivable and unearned premium revenue?
2. *Appropriate discount rate* - What is the appropriate discount rate to use when establishing the premium receivable and unearned premium revenue? The Board discussed this process as being in conformity with APB 21, which seems to indicate a market based rate that is locked in. We agree with the Board's conclusion.
3. *Reinsurance* - Would Alternative B apply to reinsurance of installment contracts? In other words, would we bifurcate payments made to reinsurers between ceded premium earned and investment expense?
4. *Ceding commissions* - Would an asset and liability be created for future expected ceding commissions similar to the asset and liability created for future expected installment premiums?
5. *Used vs. unused premiums* - In certain structures financial guarantors receive different premium rates on funded and unfunded portions of securitization facilities. How would the estimation process work for bifurcating such highly uncertain revenue streams?
6. *Variable rate debt* - When using the "ratio of exposure" approach to recognize revenue, what interest rate assumptions should be used for making interest projections on variable rate debt? Note that this is an operational concern for both upfront and installment premium contracts, which would be resolved if the approach were based on principal or par.
7. *Deferred acquisition costs (DAC)* - Should the amortization of DAC be based solely on premium revenue recognition or should the amortization be bifurcated in a manner consistent with the bifurcation of premium revenue and investment income?

Alternative proposal:

AFGI members understand the Board's desire to establish a consistent revenue recognition approach regardless of the method of premium collection, but avoid the creation of a fundamentally new accounting model (such as fair value). To accomplish these objectives, we suggest that the Board adopt a "level yield" approach (which is based on average principal for the period) for all policies regardless of the method of collection. This approach was illustrated in a presentation the AFGI provided to the FASB entitled *Follow up to February FASB Education Session on Financial Guaranty Accounting Model, April 21, 2006*. Exhibit 2 of that presentation illustrated the level yield approach for upfront premiums and installment premiums, respectively. This approach would make consistent the methodology of recognizing earned premiums, investment income, and the accretion of discount on installment premiums (if that accounting is retained). Adopting such approach would make unnecessary the need to bifurcate the accretion of discount and earned installment premiums which would solve numerous operational concerns. Moreover, we believe the alternative approach would be most relevant to the readers of our financial statements as it is more consistent with existing GAAP literature, including the underlying Concept Statements, and the general guidance of FAS 60 for insurance companies.

Sincerely,



Sean Leonard
Chairman of the Financial Affairs Committee
Association of Financial Guaranty Insurers

Percent of Initial Certificate Principal Balance Outstanding at the Following Percentages of CPR

CLASS A-1 AND CLASS A-2 CERTIFICATES

<u>Distribution Date</u>	<u>0%</u>	<u>10%</u>	<u>25%</u>	<u>35%</u>	<u>50%</u>
Initial Percentage	100	100	100	100	100
June 25, 2007	100	93	75	63	46
June 25, 2008	100	86	56	39	21
June 25, 2009	99	76	39	23	8
June 25, 2010	99	67	29	15	4
June 25, 2011	98	58	22	10	2
June 25, 2012	97	50	16	6	1
June 25, 2013	96	44	12	4	*
June 25, 2014	94	38	9	3	*
June 25, 2015	93	34	7	2	*
June 25, 2016	92	30	5	1	*
June 25, 2017	90	27	4	1	*
June 25, 2018	89	24	3	*	*
June 25, 2019	87	21	2	*	*
June 25, 2020	85	18	1	*	*
June 25, 2021	83	16	1	*	*
June 25, 2022	81	14	1	*	*
June 25, 2023	79	12	1	*	*
June 25, 2024	76	11	*	*	*
June 25, 2025	73	9	*	*	*
June 25, 2026	70	8	*	*	*
June 25, 2027	67	7	*	*	*
June 25, 2028	63	6	*	*	*
June 25, 2029	59	5	*	*	*
June 25, 2030	55	4	*	*	*
June 25, 2031	50	3	*	*	*
June 25, 2032	45	3	*	*	*
June 25, 2033	40	2	*	*	*
June 25, 2034	34	2	*	*	*
June 25, 2035	28	1	*	*	*
June 25, 2036	24	1	*	*	*
June 25, 2037	22	1	*	*	*
June 25, 2038	20	1	*	*	*
June 25, 2039	18	1	*	*	0
June 25, 2040	16	*	*	*	0
June 25, 2041	14	*	*	*	0
June 25, 2042	11	*	*	*	0
June 25, 2043	8	*	*	*	0
June 25, 2044	5	*	*	*	0
June 25, 2045	2	*	*	*	0
June 25, 2046	0	0	0	0	0
Weighted Average Life in Years to Call**	24.1	7.9	3.1	2.0	1.3
Weighted Average Life in Years to Maturity**	24.2	8.3	3.4	2.2	1.3

(*) Indicates a number that is greater than zero but less than 0.5%.

(**) The weighted average life of an Offered Certificate of any class is determined by (i) multiplying the amount of each net distribution in reduction of Certificate Principal Balance by the number of years from the date of issuance of the Offered Certificate to the related Distribution Date, (ii) adding the results, and (iii) dividing the sum by the aggregate of the net distributions described in (i) above.

This table has been prepared based on the assumptions described under the caption "*Certain Yield and Prepayment Considerations—Structuring Assumptions*" above (including the assumptions regarding the characteristics and performance of the Mortgage Loans which may differ from the actual characteristics and performance thereof) and should be read in conjunction therewith.