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LETTER OF COMMENT NO. 79

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Technical Director – File Reference No. 1530-100
Financial Accounting Standards Board
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American International Group, Inc. (AIG) appreciates the opportunity to comment on the FASB proposed Statement of Financial Accounting Standards, *Accounting for Financial Guarantee Contracts- an interpretation of FASB Statement No. 60*.

AIG is the world's leading international insurance and financial services organization, with operations in more than 130 countries and jurisdictions. AIG member companies serve commercial, institutional and individual customers through the most extensive worldwide property-casualty and life insurance networks of any insurer. In the United States, AIG companies are the largest underwriters of commercial and industrial insurance and AIG American General is a top-ranked life insurer. AIG's global businesses also include financial services, retirement services and asset management.

In general, we agree that additional guidance is needed with respect to the accounting for financial guarantee insurance contracts, due to their unique characteristics and the diversity in practice that exists with respect to the recognition of claim costs under Statement 60 for these contracts. We believe that the scope of the document and its applicability require more clarification. Additionally, we do not believe that the premium revenue recognition guidance outlined in the proposed Statement is consistent with the short duration revenue recognition model as described in Statement 60. That model generally requires that premiums associated with the contract be earned over the contract period as insurance protection is provided, thereby taking into consideration the gradual release of the insurer's obligation with the passage of time, as opposed to deferring the recognition of premium until the insurance risk is ultimately released at the very end of the contract period.

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Responses to the questions posed in the Exposure Draft are included in the attached Appendix. If you have any questions with regard to this letter, please call me at 212-770-6463 to discuss. We would be pleased to discuss our comments with the Board members and staff at your convenience.

Very Truly Yours,

/s/ Mr. Anthony Valoroso
Deputy Comptroller
Director, Accounting Policy

CC: David Herzog, Comptroller

Appendix

RESPONSES TO QUESTIONS POSED:

Proposed FASB Statement, *Accounting for Financial Guarantee Contracts- an interpretation of FASB Statement No. 60*

General

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?

We believe that the new format does increase the understandability and usefulness of the proposed Statement. We like the clear delineation of the principle, presented together with examples/implementation guidance to assist in understanding the application of that principle.

Scope

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?

We agree with the description and characteristics of a financial guarantee contract, as described in paragraph 3 of the proposed Statement. However, we recommend that the last sentence of paragraph 4 of the proposed Statement be moved to the second sentence of paragraph 3, as it appears to describe a distinguishing characteristic of a financial guarantee insurance contract subject to the scope of the proposed Statement.

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)?

We agree that the scope of the proposed Statement be limited to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises within the scope of FAS 60. Paragraph 5 states that the provisions of the proposed Statement are not applicable to (1) financial guarantee contracts issued by noninsurance enterprises and (2) insurance contracts that are similar to a financial guarantee, such as mortgage guaranty and credit insurance on trade receivables. Paragraph 5 also states that the guidance in the proposed Statement shall not be applied, or analogized to, by noninsurance enterprises. While we agree with the guidance in this paragraph, we also believe that paragraph 5 should clarify that the guidance in the proposed Statement shall not be applied by analogy to any contract issued by insurance enterprises that is not within the scope of this Statement, regardless of whether such contract is similar to a financial guarantee insurance contract as defined in the proposed Statement.

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?

We do not believe that it is appropriate for this proposed Statement to provide guidance on Statement 133. Application guidance on Statement 133 has historically been relegated to Statement 133 Implementation Issues, which has the benefit of keeping all Statement 133 application guidance in one location.

Unearned Premium Revenue

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?

We agree with this accounting treatment, presuming that the timing and amount of the future premiums can be estimated with reasonable accuracy.

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?

We agree with this accounting treatment, presuming that the timing and amount of the future premiums can be estimated with reasonable accuracy.

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?

We agree with this accounting treatment.

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?

We have no comment on this Issue.

Premium Revenue Recognition

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?

We do not agree with the proposed premium revenue recognition approach described in the proposed Statement, as we believe it is not consistent with paragraph 13 of Statement 60. The insurance enterprise writing a financial guarantee contract is providing a service to the insured by protecting them from loss, in this case, over an extended period of time. Therefore, like any other short duration insurance contract, we believe the insurer should, under Statement 60, recognize revenue ratably over the contract period during which the insurer has the obligation to perform (in this case pay losses upon a default) under the contract.

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?

It is common practice throughout the property casualty industry to recognize revenue evenly over the contract period, in accordance with the short-duration revenue recognition in paragraph 13, because the amount of insurance protection provided over the period is generally constant and the period of risk for the insurance company generally corresponds to the period of the contract. There are two main exceptions to this treatment: (1) cases where the period of risk does not correspond to the contract period and (2) cases where the level of insurance protection declines over the course of the contract.

In the case of financial guarantee insurance, the period of risk (i.e. the term of the debt) corresponds to the contract period. An example of a case where the period of risk does not correspond to the contract period is an extended warranty contract. In the case of an extended warranty contract, a premium payment is often received in full at the time the underlying product is purchased. However, in practice, the premium is generally not earned evenly over the contract period, because the insurance company is exposed to little, or no, risk during the period of time the manufacturer's warranty is still in effect. FASB Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, provides revenue recognition guidance for extended warranty contracts and refers to the Statement 60 revenue recognition model as one requiring the recognition of revenue over the period in which there is an obligation to perform, as opposed to deferring the recognition of revenue until the point at which risk is entirely released. An excerpt from paragraph 10 of FTB 90-1:

...This Technical Bulletin concludes that sellers of extended warranty or product maintenance contracts have an obligation to the buyer to perform services throughout the period of the contract and, therefore,

revenue should be recognized in income over the period in which the seller is obligated to perform. This treatment is consistent with revenue recognition under Statement 60.

An example of a case where the level of insurance protection declines over the course of the contract is credit life and disability insurance. In the case of a credit insurance product, a premium payment is often received in full at the time the underlying loan (for example a 5-year car loan) is entered into, but it is generally not earned evenly over the contract period, because the underlying loan balance, and therefore the level of insurance protection provided, decreases over the period of the contract. Under these circumstances, industry practice is to earn the premium ratably over the contract period in proportion to the declining outstanding balance of the underlying loan rather than evenly over the contract period.

In the case of a financial guarantee on a zero-coupon debt issuance, the level of insurance protection provided increases over the contract period. Because the level of insurance protection increases over the course of the contract, recognizing revenue ratably over the contract period in proportion to the increasing balance of the underlying debt would seem to better reflect application of the guidance in Statement 60.

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.

We do not believe that the current premium revenue recognition approach sufficiently incorporates the passage of time. The term of a short duration insurance contract is an essential element to the pricing of the contract. All else equal, the longer the term of the contract, the more services (i.e. insurance protection) to be provided and thus the more premium charged. A one-year homeowner's insurance policy embodies the standby obligation of the insurer to step in and pay a loss that may occur at any time during that annual period. After each month passes, the insurer has been relieved of its obligation for that month and, under a Statement 60 short duration model, would recognize a pro-rata portion of the premium attributable to that period of service, such that on the very last day of the one-year period there is essentially one day's premium that remains unearned, even though a loss could occur on that last day up to the policy limit. For a financial guarantee contract, the insured is paying for perhaps 30 years of coverage, rather for six months, but the concept is the same. Each month (or year) that passes will result in the insurer being relieved of an obligation to pay for a default that month (or year), warranting, we believe, the recognition of a portion of the premium attributable to the contract in proportion to the relative level of protection provided in relation to the contract as a whole.

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.

Yes, we agree that the contractual period is appropriate, however, if prepayment information is available for the portfolio of assets, it should be used to adjust the contractual term.

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?

We do not agree with the proposed accounting treatment because it fails to take into consideration the writedown of any premium receivable balances. We believe that the guidance should clarify that premium revenue should be reduced in this circumstance by any remaining premium receivable that needs to be written off.

Claim Liability

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?

We agree with this accounting, however it should be noted that recognizing a claim liability prior to when the insured event occurs is a departure from Statement 60.

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?

We agree with this treatment.

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?

We agree with the claim liability recognition model described in the proposed Statement and do not believe that the further guidance is required with respect to the maintained surveillance list.

Disclosure

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?

We agree with these disclosure requirements and believe that they will assist users in better understanding the financial information with respect to financial guarantee insurance contracts.

Effective Date and Transition

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.

We have no comment on this Issue.

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?

We agree that retrospective application is not appropriate for reasons cited by the Board.