

June 18, 2007

Ms. Sue Bielstein  
Technical Director  
Financial Accounting Standards Board  
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LETTER OF COMMENT NO. 74

**File Reference No. 1530-100**

**Exposure Draft — Proposed Statement of Financial Accounting Standards, *Accounting for Financial Guarantee Insurance Contracts* — an Interpretation of FASB Statement No. 60.**

Dear Ms. Bielstein:

Deloitte & Touche LLP is pleased to comment on the Exposure Draft of the proposed Statement of Financial Accounting Standards, *Accounting for Financial Guarantee Insurance Contracts* — an Interpretation of FASB Statement No. 60 (the “Exposure Draft” or the “proposed Statement”).

We do not support issuance of this proposed Statement as drafted as a final Standard because we believe the proposed Statement does not provide clear guidance and will add to, instead of improve, the complexity of U.S. accounting standards. In light of the criticism of the complexity of U.S. accounting literature, improving the understandability, consistency, and usability of existing literature is paramount for standard setters.

Although, we recognize there is diversity in practice relating to the recognition and measurement of claim liabilities, we believe the benefit of addressing this diversity is compromised by the following deficiencies in this proposed Statement:

- The guidance in the proposed Statement is specific to insurance enterprises only, and other entities that enter into contracts with the same terms are precluded from applying and analogizing to this guidance. Thus, similar transactions of entities in different industries might be subject to different guidance.
- The guidance in the proposed Statement is specific to financial guarantee insurance contracts only and does not apply to contracts with similar terms. Thus, similar contracts might be accounted for differently. In addition, because the proposed Statement does not clearly define the characteristics of financial guarantee insurance contracts so as to distinguish them from other contracts for which the guidance is not applicable, constituents may be confused as to which insurance contracts are within the scope.
- The Board has not provided a sufficient framework for how to determine the unit(s) of account for executory contracts. That framework should address when separate assets and liabilities for the components of an executory contract should be recognized as opposed to recognizing only one amount for the entire contract.
- The proposed Statement does not provide adequate guidance regarding the initial and subsequent measurement of the premium receivable asset.

- This proposed Standard would create a new accounting model for the recognition of premium and claims liabilities that is different from other similar types of insurance contracts, and the rationale for certain of these differences are not adequately explained.

With respect to some of these points, the Exposure Draft explains that the Board did not want to *expand the scope of the project and delay the issuance of guidance to resolve a current practice issue*. We do not believe this is an appropriate response. The continual issuance of new models to resolve small amounts of diversity without reconciling those new models to existing frameworks or the accounting for similar transactions only adds to the overall complexity of GAAP.

Our comments on the issues identified in the Exposure Draft are submitted in the Appendix.

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Deloitte & Touche LLP appreciates the opportunity to comment on the Exposure Draft. If you have any questions concerning our comments, please contact Robert Uhl at (203) 761-3152.

Yours truly,

Deloitte & Touche LLP

cc: Mark Parkin  
Georganne Gage Walters

**Deloitte & Touche LLP**  
**Appendix**  
**Responses to Notice for Recipients**

**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?*

The understandability of the Exposure Draft is improved by the new format. In particular, presenting the principle at the beginning of a section helps the reader understand what concept is being developed in the following paragraphs. Additionally, presenting examples within the section helps better support the principle that is being developed.

**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)?*

**Response to Issues 1 and 2:** We are concerned about the issuance of new specialized industry standards (unless such guidance addresses transactions unique to that industry) and their contribution to the increasing complexity of GAAP. We believe that the scope of accounting standards should be based on the transaction or activity for which accounting guidance is needed and not based on the particular industry in which the entity operates. For example, this Exposure Draft will require that a specific accounting model be used for financial guarantee insurance contracts simply because an enterprise is

considered an insurance enterprise, when there is no specific standard for accounting for similar guarantees written by entities in other industries. The Exposure Draft goes a step further and indicates that entities that are not insurance enterprises shall not apply or analogize to the guidance in the Exposure Draft. Leaving such entities confused as to what guidance to follow and adds to the complexity within GAAP.

Further, insurance contracts written by insurance enterprises that are similar to financial guarantee insurance contracts, such as mortgage guaranty insurance contracts and credit insurance contracts on trade receivables, are also excluded from the scope of the Exposure Draft. Excluding similar contracts that provide the same economics also adds to the complexity within accounting standards.

In the Basis for Conclusions of the Exposure Draft, the Board does not provide a conceptual basis for limiting the scope of this guidance as proposed and only notes that the limitations were necessary because a scope expansion would delay the issuance of guidance. We do not believe this is an appropriate response to the issue of diversity. While the guidance may narrow diversity for these specific contracts within this specific industry, it potentially creates confusion in comparing similar contracts within an entity and in comparing similar contracts among entities that may be in different industries.

If the Board determines that a final standard providing guidance only for financial insurance guarantees written by insurance enterprises should be issued, we think the standard should provide further guidance defining the characteristics of financial guarantee insurance contracts. Without defining characteristics, it may be difficult to distinguish between financial guarantee insurance contracts and similar insurance contracts. Paragraph 5(b) of the Exposure Draft limits the scope to financial guarantee insurance contracts and provides names of contracts that would be outside the scope of the proposed Statement (“for example, mortgage guaranty insurance and credit insurance on trade receivables”), but does not provide any guidance on differentiating between contracts. This is not sufficient guidance to ensure that the standard is applied as intended by the Board.

Another example of the potential pitfalls stemming from a failure to include defining characteristics in the standard can be seen with the example in paragraph 3 of the proposed Statement. Paragraph 3 names a financial obligation to provide protection from financial loss on an asset-backed security issued by a trust as an example of a contract within the scope of the guidance. Would the following example of an insurance contract providing protection to asset-backed security holders be within the scope of the guidance?

A trust holds publicly-traded dividend-paying equity securities and issues one class of a debt security and a residual tranche. The dividend cashflows generated from the equity securities are expected to be sufficient to pay a coupon on the debt security equal to 3M Libor+10 bps. A financial guarantee is purchased by the trust, and guarantees the timely payment of principal and interest on the debt

securities only (i.e., the financial guarantee does not guarantee any cash flows to the holders of the residual tranche). The residual tranche in the trust will absorb first dollar loss if the fair value of the equity securities decreases. The debt securities will mature in 10 years, at which time the equity securities will be sold to pay off the principal amount and final coupon on the debt securities. If the proceeds collected are not sufficient to fully pay the matured principal and interest on the debt, the financial guarantee will cover that shortfall. Excess proceeds, if any, collected from the sale of the equity securities will flow to the holders of the residual tranche.

We believe that such a contract should not be included in the scope of the proposed Statement, but the guidance regarding what constitutes a financial guarantee insurance contract is not clear.

*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?*

There has been much uncertainty and diversity in applying paragraph 10(d) of Statement 133. Since the Board is proposing to change the overall accounting model for financial guarantee contracts, this would be an appropriate opportunity to provide guidance to help clarify the application of paragraph 10(d) of Statement 133.

### **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?*

**Response to Issues 4, 5, 6, and 7:** We believe that the Board should provide, in the Basis for Conclusions, further clarification of why the contract is separated into components for recognition purposes (i.e., recognition of a separate asset and liability under the same contract) whereas only one net amount (i.e., one unit of account) is recognized for similar executory contracts (e.g., credit default swaps). Under a model in which it is appropriate to separate a contract into its components, we agree with recognizing future installment premiums at the inception of the contract as an asset and initially measuring this asset at the present value of the installment premiums using a discount rate that reflects the policyholder's credit standing at inception of the contract. The premium receivable should be subject to the same accounting as similar receivables with respect to recognition of interest income and impairments. However, as noted below, we are not sure of the accounting for the asset when the premiums may vary.

We also agree that in a transaction between willing parties, unless there is evidence of additional transfer of value, the initial measurement of the premium receivable is the most appropriate initial measurement of the unearned premium revenue (liability).

However, we do not believe the Exposure Draft provides sufficient guidance on how to account for future premiums that are based on the principal balance of prepayable receivables backing an insured security. The premiums for insuring mortgage-backed bonds are often paid as installments, with the installment amount due according to the remaining principal of the underlying mortgages. Because the mortgage loans may be prepaid, the insurer is not able to determine the amount of future premiums with absolute certainty.

Some may conclude that the initial recognition of the asset should be based on the contractual premiums due as if there are no prepayments. This conclusion would be based on the guidance regarding the accounting for the unearned premium liability in which potential prepayments should not be considered in the measurement of the liability in connection with the principle that the initial measurement of the asset and liability should be equal. However, clear guidance should be provided regarding how the initial measurement of the premium receivable asset is (or is not) affected by potential prepayments of the underlying assets, which may adjust the premiums due.

In addition, guidance should be provided on how prepayments of the underlying assets resulting in decreases in contractual premiums due affect the subsequent measurement of the asset. For example, because the insurance enterprise may not recover substantially all of its recorded receivable through premiums (i.e., prepayments of the principle amount of the underlying assets will contractually reduce premiums due, thus reducing the recorded receivable without receiving cash or another asset), must the asset be measured like an investment in a debt security classified as available for sale or trading pursuant to paragraph 14 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*? Should adjustments to the unearned premium revenue for the effect of prepayments be viewed as recoveries of the recorded investment (even though such adjustments are recognized directly to revenue)? An example clarifying this principle would be helpful.

### **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.*

**Response to Issues 8, 9, and 10:** The revenue recognition model of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, incorporates the passage of time into all of its recognition models, including both the short and long duration model. However, the Exposure Draft would eliminate this concept for financial guarantee insurance contracts. The passage of time is an inherent consideration in providing insurance protection. The insurer is providing a service, standing ready to perform throughout the entire contract. Recognizing revenue only at the end of the term, in the example of the zero coupon bond, does not fit conceptually within the Statement 60 model.

In the case of the financial guarantee, the bond does not “go bad” at one point in time. There would be deterioration throughout the term. For a zero coupon bond, the most uncertainty could potentially be at the beginning of the policy period when the principal payment is farthest away. As time passes, assuming the entity’s credit rating remains unchanged, the risk of default should be declining because there is less time for circumstances to change. Therefore, the insurer is providing service during this entire contract period. A financial guarantee contract would be priced differently for a 10-year bond compared to a 20-year bond with the same par value, illustrating that the passage of time has value and should be considered in the premium recognition model.

Statement 60 allows for premium recognition in proportion to the amount of insurance protection provided; however, it does not require an insurer to apply this method. A model that fits within the guidance established by Statement 60 would be to allow an insurer to choose its recognition method depending on the specific facts of the contract. The model could allow an insurer to recognize premium either evenly over the contract period or in proportion to the amount of insurance protection provided.

*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.*

We believe that prepayments should be incorporated into the model, particularly when the prepayments relate to a large number of similar loans that can be reasonably estimated (e.g., similar to the process described in paragraph 19 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases*). We believe incorporating prepayments of underlying loans that may affect the premiums will more closely measure the asset and liability components of the insurance contract at their fair values upon initial recognition.

*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?*

It is our understanding that the pricing of the new contract would still go through the insurer's underwriting process, essentially establishing a new premium. Pricing could be affected by several factors, including the available capital of the insurer, investment returns in the market, and competitive pressures. We have concerns about whether insurers will be able to reliably determine a hypothetical premium on the new policy.

The proposed Statement is clear that when a retirement or replacement occurs, the unearned premium should be recognized as premium revenue and any deferred acquisition costs are recognized as an expense. However, the proposed statement does not specify which line item in the income statement the write off of any remaining receivable should be charged. Paragraph 11 of the proposed Statement could be interpreted to indicate that the reduction of the receivable should be presented as a bad debt expense. We do not believe that bad debt expense would reflect the economics of the transaction, but rather that the reduction of the receivable should be charged as a reduction of premium revenue.

### **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 the basic principle of the claim liability model; however, we submit the following comments to clarify the claim model and to eliminate apparent inconsistencies within the model.

An initial concern with the claim liability model is the treatment of deferred acquisition costs. The claim liability model is similar to a premium deficiency model. Under

Statement 60, after determining there is a premium deficiency, one first applies the deficiency to reduce deferred acquisition costs, and then records any excess as a liability. The Exposure Draft appears to take a different approach and states in paragraph 19 that “when a claim liability has been recognized, any associated acquisition costs previously deferred under paragraph 29 of Statement 60 shall be expensed.” This does not appear to be consistent with the model in Statement 60. Thus, in an extreme example, if at a reporting period end the claim liability exceeds the unearned premium by \$1, would all DAC be expensed? To make the model consistent with Statement 60, the claim liability should first be applied to reduce any deferred acquisition costs, and then any excess amount would be recorded as a claim liability.

Secondly, we do not believe that the proposed statement is clear regarding how much is ultimately recorded for the claim liability. For example, if the present value of the expected cash outflow is \$80 and the unearned premium is \$30, is the claim liability \$50 plus the unearned premium of \$30 for a total liability of \$80, or is the claim liability \$80 plus the unearned premium of \$30 for a total liability of \$110? Paragraph 19 states that the insurer will measure a claim liability on the basis of the present value of the expected cash flows, discounted, which would seem to indicate that in our example the insurer would record a claim liability for \$80 plus the unearned premium of \$30, for a total liability of \$110. Paragraph B22 in the Basis for Conclusions seems to indicate that the claim liability recorded is the incremental amount, in our example the \$50 plus the unearned premium of \$30, for a total liability of \$80. Perhaps the best conceptual model is to measure the claim liability as the excess of the present value of the amount expected to be paid to the insured party over the amount of the expected unearned premium liability at the expected date of settlement. We believe that the Board should provide an example clarifying the principle in the final standard.

Finally, our understanding is that the unearned premium would continue to be recognized as premium revenue even if there is a claim liability; however, we don't believe that the Exposure Draft is clear on this point. Paragraph B22 states in part that “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.*” One could read this to mean that the unearned premium is now a claim liability and no further revenue is recognized. This could also cause confusion on presentation of the liability. For example, is the unearned premium presented as a loss reserve once a claim liability is recognized or does it continue to be presented as unearned premium?

We believe the Board should clarify these points. Adding examples to illustrate the recognition and measurement aspects of the claim liability model will help to answer the questions we have raised.

*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 that the liability should be discounted and the rate should not be changed until a default occurs. However, we believe that the rate should be established on the original date of the contract. The stated intent of establishing a discount rate upon recognition of a claim liability and not changing it until a default occurs is so that measurement is not affected by general changes in interest rates. If that is the purpose of fixing the discount rate, then the appropriate time to fix the discount rate would appear to be at the inception of the contract. At this point, the pricing of the policy and the original estimate of claim liability would be established. Then, at each reporting date, the analysis of the claim liability would be updated. General changes in the interest rate should not affect the assessment from the point the original analysis is made to a later date, just as it should not affect the assessment after the claim liability exceeds the unearned premium and a claim liability is recorded

*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?*

Preparers are better suited to respond to this question.

### **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?*

We agree that these disclosures, combined with the disclosures required by Statement 60, should provide users of financial statements with the information they need.

**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.*

Preparers are better suited to answer questions on process changes necessary to implement the proposed Statement. However, we would have concerns about the time afforded for implementation if the proposed Statement is not issued until later in the third or fourth quarter.

*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 while the preference is to adopt a new standard using a retrospective application, that preference should not apply to this proposed Statement. Management judgments that are required to assess the claim liability at past balance sheet dates would not be meaningful with the availability of hindsight.