



Moody's Investors Service

99 Church Street
New York, New York 10007

June 18, 2007



LETTER OF COMMENT NO. 63

Technical Director- File Reference 1530-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference 1530-100 – Proposed Statement of Financial Accounting Standards: *Accounting for Guarantee Insurance Contracts*

Dear Sir or Madam:

We appreciate the opportunity to comment on the FASB's Proposed Statement of Financial Accounting Standards: *Accounting for Guarantee Insurance Contracts*. While we recognize the proposed statement reflected by the exposure draft (the "ED") is intended to serve the needs of a broad audience of users, the perspective we offer is that of credit analysts.

Moody's supports the underlying rationale for the proposed statement, which is to address diversity in practice in the accounting for financial guarantee insurance contracts. We agree that existing literature does not adequately address certain key aspects of the accounting for financial guarantee insurance, including revenue recognition and claims reserving, and welcome additional guidance that would allow greater comparability among firms thus facilitating analysis by creditors and other financial statement users.

With respect to accounting for losses and claims liabilities, Moody's believes that the proposed statement would enhance the usefulness of financial statements prepared by financial guarantors. The requirement to measure claim liabilities based on expected cash flows will be an improvement over current practices employed by the industry. Furthermore, the disclosures of claim information required by the ED, including the components of the entity's surveillance list and the description of the insurers' claim monitoring and mitigation policy would be particularly useful to analysts in assessing the quality of a guarantor's book of business, and the adequacy of its loss reserves.

However, Moody's believes there are features of the ED that may decrease the usefulness of financial statements, requiring users to make additional analytical adjustments to convert GAAP financial statements to a presentation which better reflects economic reality. This letter will describe our concerns with the ED's proposals regarding revenue recognition and installment premiums receivable.

Revenue Recognition

The ED proposes that insurers recognize premium from financial guarantee contracts as revenue “in proportion to the insured contractual payments made by the issuer of the insured financial obligation.” Such a methodology assumes that risk is reduced solely as a function of the reduction in debt service remaining on an insured obligation, without regard for the passage of time. Consequently, the ED, if adopted in its current form, would result in earnings patterns which lag the reduction in insured risk over the term of financial guarantee contracts.

In our role as a rating agency, Moody’s tracks historic default patterns on various issues and structures, and this analysis suggests it is unlikely that the reduction in risk associated with insured obligations would be congruent with the earnings pattern proposed in the ED. Rather, default patterns tracked by Moody’s suggest that credit risk is reduced as a function of the passage of time as well as the reduction in remaining debt service.

Moody’s bond default studies indicate that cumulative default rates rise with the investment horizon (See Exhibit A for our idealized 10-year cumulative probability of default tables for municipal obligations). Therefore, longer-dated maturity wrapped securities will result in higher capital charges in our analysis than similar short-dated maturity securities. This pattern is mirrored in guarantors’ pricing models, as we understand that guarantors will typically charge higher premiums to insure securities with longer periods to maturity, all else being equal. As such, any methodology that does not consider the passage of time as a function of risk reduction will likely result in unrealistic earnings patterns in comparison to the reduction in risk inherent in guarantors’ business.

Zero-Coupon Bonds

In the invitation for comment and background sections, the ED specifically discusses the impact of the proposed methodology on the earning of premium on insured zero-coupon bonds, acknowledging that no premium would be earned until maturity on such insured obligations. Moody’s believes that this earnings pattern is counter-intuitive, as it presumes that risk assumed by a guarantor in wrapping a zero-coupon bond does not decline with the passage of time, but expires only upon final maturity.

We understand that zero-coupon municipal bonds only represent a small minority of guarantors’ obligations. Nevertheless, we believe that the counter-intuitive earnings pattern that is most prominently revealed when considering zero-coupon securities also affects both bullet and level debt-service bonds that make up the majority of guarantors’ insured municipal books of business.

In effect, the ED would treat an insured bullet or level debt-service security as a series of zero coupon bonds; in other words, each individual debt-service payment (principal or interest) would be allocated a portion of the aggregate premium received, with that specific premium being earned fully at “maturity” (the remittance of the individual interest or principal payment by the issuer).

Given this, the concerns noted when considering the impact of the ED on zero-coupon bonds become relevant for all insured securities, regardless of the timing of debt service.

Possible Alternatives

We suggest that the board consider an earnings methodology that recognizes the passage of time as well as the reduction in outstanding debt-service payments as components of risk reduction.

Follow Guarantors’ Pricing Models

One possible alternative would be to require guarantors to earn premium in proportion to the reduction in risk over time as determined by their internal pricing mechanism. Factors used by guarantors in estimating the risk of loss and in determining appropriate pricing would include the timing of expected cash flows and time to maturity. If the guarantor’s internal pricing mechanism suggests that the risk of a given security would decline by 5% over the ensuing year, then 5% of the premium charged for the

guarantee should be earned in the first year of coverage. Guarantors should presumably be able to consult their “price-book” at the inception of a guarantee contract to allocate premium to be earned in each subsequent period to maturity.

A ‘price book’ earnings methodology would most precisely match premium recognition with a guarantor’s assessment of risk reduction over the term of a contract. Primary drawbacks to this methodology would be: a) complexity to implement, as guarantors would need to determine revenue patterns at the inception of each contract, and b) variability between entities in risk assumptions and therefore premium recognition patterns.

Level-Yield and Debt Service Allocation Methods

Alternatively, the board may consider a formulaic methodology that recognizes both the passage of time and the reduction in outstanding principal/remaining debt service payments as elements of risk reduction. Potential approaches include a ‘level-yield’ methodology, earning premium in proportion the average outstanding principal for each period, or a ‘debt-service allocation’ methodology, which would allocate premium to each debt service payment and earn such allocated premium over the period extending from inception to the date of the applicable debt service payment.

Either of these approaches would result in a more conservative earnings pattern than that currently used by guarantors, reflect that both passage of time and reduction in outstanding principal contribute to risk reduction, and provide uniformity in earnings patterns between guarantors. The table below compares the earnings pattern on a 10-year bullet bond with a 6% coupon, for which a premium of \$1,000 was charged under the level yield methodology, the debt service allocation methodology, the approach proposed by the ED, and current practice for the majority of guarantors:

Year	Debt Service	Principal	Beg Outs	Level Yield (a)	Premium Earned		
					DS Alloc (a)	ED	Current
1	\$13,587	\$7,587	100,000	167	182	100	259
2	\$13,587	\$8,042	92,413	155	164	100	183
3	\$13,587	\$8,525	84,371	141	145	100	143
4	\$13,587	\$9,036	75,847	127	127	100	115
5	\$13,587	\$9,578	66,811	112	109	100	92
6	\$13,587	\$10,153	57,233	96	91	100	73
7	\$13,587	\$10,762	47,080	79	73	100	56
8	\$13,587	\$11,408	36,318	61	55	100	41
9	\$13,587	\$12,092	24,910	42	36	100	26
10	\$13,587	\$12,818	12,818	21	18	100	13
Total	\$135,868	\$100,000	\$597,799	\$1,000	\$1,000	\$1,000	\$1,000

(a) – See Exhibit B for additional discussion of the Level Yield and Debt Service Allocation methodologies

Although the level yield or debt service allocation approaches would not reflect risk reduction as precisely as the price-book methodology described above, Moody’s believes that either would be an improvement on both current practice and that proposed in the ED, and has the advantages of enhanced comparability and relative ease of implementation.

Installment Premium Receivable and Unearned Premium Revenue

The exposure draft proposes that financial guarantors record installment premiums to be received in the future on the balance sheet as a receivable and as an offsetting unearned revenue liability, in an amount equal to the present value (discounted at an issuer-specific rate) of the premium receivable for the *contractual* term of the policy. In periods after initial recognition, the board proposes that discount on the premium receivable be accreted through investment income over the period of the contract. This approach presumes that multi-year financial guaranty contracts are non-executory, and collecting premium on an installment basis rather than at policy inception is substantially similar to the guarantor providing premium financing to policyholders.

Business written on an installment basis generally guarantees structured finance securities that are subject to significant principal and premium uncertainty due to paydowns. Moody's believes that recording installment premium receivable based on the contractual term rather than the expected term results in an unrealistic balance sheet presentation. At inception, both recorded installment premium receivable and unearned revenue liabilities will be significantly greater than the premium that guarantors will probably receive on the contract.

Furthermore, the initial recording of installment premiums receivable and corresponding unearned premium reserve based on contractual maturity will lead to significant volatility on the income statement in subsequent years and will result in unrealistic earnings patterns for premium revenue.

Currently, guarantors earn premium received on installment premium contracts over the corresponding installment period. Under the ED, installment premium revenue would be earned in the same manner as up-front premium, in proportion to debt service paid by the issuer. Problems unique to installment premium contracts result, however, due to the use of contractual maturity rather than expected maturity in the earnings calculation.

Moody's understanding of the ED's proposals suggests that in certain circumstances, applying the proposed revenue recognition and installment premium methodologies could lead to guarantors earning premium in the initial years of an insured structured security that exceeds the total premium that the guarantor will ultimately receive on the contract (with negative premium earned in later years 'trueing-up' inception-to-date ("ITD") earned premium with actual premium received). Our current interpretation of the guidance would indicate that the calculation of ITD earned premium at each measurement date would be calculated as follows:

$$\frac{\text{Debt service (P+I) paid by issuer to date ("A")}}{\text{Total contractual debt service (P+I) for the issue ("B")}} \times \text{Total contractual premium for the life of the issue ("C")}$$

- A. Total debt service paid by the issuer to date on the insured structured security.
- B. Total debt service to be paid by the issuer over the contractual life of the security, recalculated at each measurement date (Debt service paid to date plus debt service that will be paid for the remaining life, assuming no further early paydowns of principal.)
- C. Total contractual premium to be received over the life of the issue, recalculated at each measurement date (premium received to date plus that which will be received for the remaining of the contractual term, assuming no further paydowns of principal.)

As investors receive interest and principal paydowns on such securities over time, (A) will increase and (B) will decrease, causing the first half of the calculation to approach 1. The second half of the calculation will decrease because paydowns in each period will reduce the remaining contractual premium to be received on the contract.

Structured securities often 'mature' far earlier than the contractual ("legal final") maturity, therefore total contractual premium for the life of the issue (C), as calculated in early years, may be significantly greater than the actual ultimate premiums that the guarantor will receive over the life of the issue, leading to excessive premium earnings recognition in these periods, and negative premium in later periods. Additionally, interest income on the accretion of discounted installment premiums receivable may also "go negative", as interest income will be accreting in early years on installment premiums that will never be received due to principal paydowns.

In addition to adding significant volatility to the income statement, the ED's methodology could serve to 'front-load' revenue recognition on installment premium contracts in comparison to the methodology currently utilized by the industry, as demonstrated above.

Moreover, the recording of unearned premium reserves for future installments could have another unintended side-effect on loss reserving. The ED requires that guarantors recognize a claim liability "when the insurance enterprise expects that a claim loss will exceed the unearned premium revenue"

for that contract. In early years of installment premium contracts, unearned premium revenue could be significantly greater than actual premiums that will be received; in such situations, loss reserve thresholds in those periods may be set at unrealistic levels.

Moody's believes that the counter-intuitive premium and interest income earnings patterns, as well as the unrealistic balance sheet presentation, will reduce the usefulness of guarantors' financial statements. If the ED is adopted as proposed, it is likely that Moody's and other users will make analytical adjustments to undo, or to at least modify, the disruptive effects of the ED.

Possible Alternatives

Endorse Existing Practice

The board may consider allowing guarantors to continue using their current earnings methodology for installment premium contracts, treating such contracts as a series of one-year guarantees. The current methodology reflects the passage of time, as well as the reduction of outstanding principal, as components of risk reduction, which we believe is critical for appropriate revenue recognition in the industry.

Although guarantee contracts are non-cancelable, premium charged for each installment period is a function of the outstanding principal balance. Guarantors have a contractual right to future premiums – but only to the extent that principal remains outstanding on the structured security. Therefore, Moody's does not consider such contracts to be premium-financing arrangements between the guarantor and the policyholder, as future premiums are a function of remaining risk for each installment period and are indeterminable at inception.

Impose "Premium Financing Treatment" Over Expected Maturity

Alternatively, if the board maintains its position that installment policies are financing contracts, and chooses to record an asset on the balance sheet for discounted future contractual premiums, we would strongly recommend that the consideration is given to abandoning the "contractual maturity" concept in favor of expected maturity. Using expected maturity would avoid the revenue recognition concerns that were addressed in previous paragraphs and thus would result in a balance sheet presentation that would be more relevant to users than contractual maturity.

Thank you for considering our comments. We would be pleased to discuss any questions you may have at your convenience.

Sincerely,

Gregory Jonas
Managing Director

Wallace Enman
VP – Senior Accounting Analyst

Exhibit A

Moody's Municipal Idealized 10-Year Cumulative Probability of Default Rates

Time Horizon (in years)	1	2	3	4	5	6	7	8	9	10
Aaa	0.0001%	0.0002%	0.0007%	0.0018%	0.0029%	0.0040%	0.0052%	0.0066%	0.0082%	0.0100%
Aa1	0.0002%	0.0011%	0.0035%	0.0074%	0.0109%	0.0147%	0.0189%	0.0235%	0.0287%	0.0350%
Aa2	0.0005%	0.0027%	0.0086%	0.0156%	0.0226%	0.0296%	0.0369%	0.0449%	0.0545%	0.0665%
Aa3	0.0009%	0.0058%	0.0181%	0.0311%	0.0437%	0.0563%	0.0698%	0.0837%	0.1006%	0.1230%
A1	0.0018%	0.0117%	0.0370%	0.0598%	0.0826%	0.1044%	0.1284%	0.1518%	0.1813%	0.2214%
A2	0.0035%	0.0226%	0.0717%	0.1114%	0.1508%	0.1883%	0.2293%	0.2677%	0.3171%	0.3875%
A3	0.0142%	0.0549%	0.1318%	0.1976%	0.2672%	0.3331%	0.4063%	0.4758%	0.5563%	0.6588%
Baa1	0.0365%	0.1135%	0.2270%	0.3365%	0.4460%	0.5554%	0.6770%	0.7987%	0.9203%	1.0541%
Baa2	0.0772%	0.2133%	0.3767%	0.5446%	0.7171%	0.8941%	1.0938%	1.2934%	1.4704%	1.6338%
Baa3	0.1687%	0.4218%	0.6870%	0.9562%	1.2254%	1.4865%	1.7396%	1.9967%	2.2378%	2.4507%
Ba1	0.3402%	0.7900%	1.2241%	1.6425%	2.0649%	2.4442%	2.7610%	3.0856%	3.3984%	3.6761%
Ba2	0.6372%	1.4173%	2.1158%	2.7775%	3.4351%	3.9906%	4.3705%	4.7626%	5.1670%	5.5141%
Ba3	1.3161%	2.5807%	3.6860%	4.5852%	5.5547%	6.3182%	6.8474%	7.3579%	7.8263%	8.2712%
B1	2.6155%	4.6833%	6.4717%	7.7403%	9.0089%	9.9981%	10.6911%	11.3059%	11.8703%	12.4068%
B2	4.8989%	7.9846%	10.6393%	12.4045%	14.1698%	15.4971%	16.4276%	17.2076%	17.9397%	18.6102%
B3	9.2945%	13.2858%	16.8212%	19.2288%	21.6364%	23.3561%	24.7959%	26.0597%	27.0195%	27.9154%
Caa1	14.2411%	19.0362%	23.4642%	26.6105%	29.7525%	31.9261%	33.9078%	35.7690%	37.4198%	39.0815%
Caa2	21.8856%	27.3571%	32.8285%	36.9362%	41.0356%	43.7713%	46.5070%	49.2427%	51.9784%	54.7141%
Caa3	48.3995%	54.1123%	59.2770%	62.8763%	66.2737%	68.4472%	70.5537%	72.5992%	74.5886%	76.5998%

The above table represents provides "idealized" cumulative probability of default (PD) rates for municipal debt obligations, by rating category. For instance, municipal obligations rated in the Ba1 category have an idealized cumulative PD of 3.6761% within ten years of the initial rating date. The idealized cumulative default rate table represents Moody's prospective look at default probabilities and adjusts historical default data for statistical anomalies.

Exhibit B – Discussion of Revenue Recognition Alternatives

Level Yield

The level-yield methodology allocates premium earnings to each period based on the outstanding principal for each period. In the example discussed on page 3, the average outstanding principal for year 1 is \$100,000 (the example assumes zero debt service payments until the end of each year). The total of each year's average outstanding principal is \$597,799 (\$100,000 year 1 plus \$92,413 year 2, etc.). Therefore, premium to be earned in year 1 is (\$100,000/\$597,799) or 16.728% of total premium written, or \$167.

Debt Service Allocation

The debt service allocation methodology allocates premiums written to each debt service (principal plus interest) payment and earns that premium straight-line from inception to the time of the actual payment. The allocation of premium written for each debt service payment is calculated as follows:

$$\frac{\text{Debt Service payment} * \text{time until that debt service payment}}{\text{Sum of all (Debt Service payments} * \text{time until each payment)}} \times \text{Premium Written}$$

Premium written allocated to the debt service payment made in period 1 will be earned fully in period 1. Premium allocated to the debt service payment due in period 2 will be earned ½ in period 1, and ½ in period 2, etc.

Premium earned in each period will be the sum of that period's earnings of each of the allocated premium written amounts (i.e., period 1 earnings will be all of period 1's written premium allocation plus ½ of period 2's written premium allocation plus 1/3 of period 3's written premium allocation plus 25% of period 4, etc.

The below table displays the allocation and earning pattern of premium for the example displayed on page 3:

Period	Payments			Debt Service Allocation	Prem Written Allocation	Premium Earned by Period										
	Debt Service	Principal	Interest			1	2	3	4	5	6	7	8	9	10	
1	\$13,587	\$7,587	\$6,000	13,587	18	18	-	-	-	-	-	-	-	-	-	-
2	\$13,587	\$8,042	\$5,545	27,174	36	18	18	-	-	-	-	-	-	-	-	-
3	\$13,587	\$8,525	\$5,062	40,760	55	18	18	18	-	-	-	-	-	-	-	-
4	\$13,587	\$9,036	\$4,551	54,347	73	18	18	18	18	-	-	-	-	-	-	-
5	\$13,587	\$9,578	\$4,009	67,934	91	18	18	18	18	18	-	-	-	-	-	-
6	\$13,587	\$10,153	\$3,434	81,521	109	18	18	18	18	18	18	-	-	-	-	-
7	\$13,587	\$10,762	\$2,825	95,108	127	18	18	18	18	18	18	18	-	-	-	-
8	\$13,587	\$11,408	\$2,179	108,694	145	18	18	18	18	18	18	18	18	-	-	-
9	\$13,587	\$12,092	\$1,495	122,281	164	18	18	18	18	18	18	18	18	18	-	-
10	\$13,587	\$12,818	\$769	135,868	182	18	18	18	18	18	18	18	18	18	18	18
	\$135,868	\$100,000	\$35,868	747,274	\$1,000	\$182	\$164	\$145	\$127	\$109	\$91	\$73	\$55	\$36	\$18	