

MEMORANDUM

LETTER OF COMMENT NO. 8

To: Technical Director – Financial Accounting Standards Board

From: Darin Arita – Deutsche Bank

Date: June 14, 2007

Re: Comments on Exposure Draft – File Reference No. 1530-100

As an equity research analyst who covers the financial guaranty industry, I appreciate FASB's efforts to create a more uniform application of the accounting guidelines and to enhance the disclosure of the financial guarantors.

Some of the proposals, however, within the Exposure Draft on Accounting for Financial Guarantee Insurance Contracts would create change where the industry already has a uniform approach. Although FASB's proposed changes would have no effect on increasing or decreasing the capital adequacy of the companies, the changes could lead to GAAP financial statements that are less reflective of the true economics of the financial guaranty industry, making it more difficult for the investment community to produce timely and informed conclusions. Below are some of thoughts on the Exposure Draft:

Issue 6 – Accretion of discount distorts net investment income

The accretion of the discount on the present value of installment premiums should not flow through net investment income. In our view, the installment premiums have nothing to do with net investment income or the invested assets on the balance sheets. Installment premiums seem to have occurred more as a result of the evolution of the structure of bonds (i.e., emergence of mortgage-backed securities in the 1980s) rather than a decision by the financial guarantors to allow the premiums to be financed. The accretion should instead flow through premiums. Should the accretion flow through net investment income, as a user of the financial statements, I would back out the effect of the accretion, but others who may be less familiar with the sector may not be aware of the adjustment needed to correct this distortion.

Multiple discount rates would be subjective and difficult to implement. The financial guarantors just use one discount rate to calculate the present value of installment premiums, but the exposure draft proposes the financial guarantors use multiple discount rates based on each policyholder's credit standing at the inception of the contract. It is unclear on how those discount rates would be determined. In addition, the discount rates applied may not be uniform for the same credit, as each of the financial guarantors takes its own view on the discount rate to be applied.

Issue 10 - Premium recognition should also consider the passage of time

The proposed premium revenue recognition guidance does not give sufficient value to the passage of time. Under the example given with a zero coupon bond,

if we assumed that the bond matured after 10 years, the risk of incurring a loss on the transaction is much greater at the beginning of the 10-year period than on the last day of the period. Thus, the financial guarantor should have earned the premium over the 10-year period, as the passage of time reduces risk.

Other forms of insurance account for the passage of time. Life insurance companies recognize premiums into revenues on a 20-year term life policy each year even though the company is exposed to the face amount of the policy until the end of the term. Also, property and casualty insurers recognize premiums throughout the life of a homeowners policy, even though the insurers are liable for the insured amount until the policy expires. Thus, it would be inconsistent with other forms of insurance accounting if the financial guaranty industry did not recognize premiums into revenues with the passage of time.

Issue 11 – Contractual period does not factor in prepayment activity

The contractual period should not be used to determine the period over which premium revenue should be recognized for structured finance bonds, because the contractual period does not consider prepayment activity.

Structured finance bonds should account for prepayment activity. The expected term of insured obligations can be much shorter than the contractual term in bonds where prepayments frequently occur, such as mortgage-backed securities. Although it may be difficult to precisely estimate prepayment activity, having some sort of estimate would better reflect reality than assuming zero prepayment activity. The proposed methodology in the exposure draft could lead to sharp increases in recognized premiums at the tail of the bond's life, and that would not be a good match of revenue with the risk exposure.

Contractual period should apply to public finance bonds. The refunding activity on public finance bonds does not seem to differ from prepayment activity on structured finance bonds; however, one is more likely to produce a robust model that can forecast prepayments on a pool of homogenous securities than one could forecast the likelihood of a refunding on a single municipal bond. Thus, prepayment assumptions should be factored into the premium recognition methodology for structured finance bonds, such as mortgage-backed securities. (Note: On MBIA's first quarter 2007 conference call, the company noted that it has found no robust way to model the timing of refundings.)

Issue 17 - Effective date may be too soon

Should the final Statement occur in the third quarter of 2007, the financial guarantors may not have enough time to apply the accounting changes by the December 15, 2007 effective date. Not only would the financial guarantors have to assess the effect of the accounting changes on thousands of individual credits in the portfolios, the insurers would also need to have new financial and reporting systems in place to apply these accounting changes on a prospective basis. A hasty implementation of the accounting guidance, followed by financial restatements would not be the optimal outcome for any constituency.

I would be happy to participate in any roundtable forum to address these or other issues. Please note that the above comments are my own opinions and not necessarily those of Deutsche Bank. If you have any questions or would like to discuss the above matters further, please feel free to contact me at (212) 250-7321 or darin.c.arita@db.com.