



LETTER OF COMMENT NO. 13

June 15, 2007

Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116

Re: Exposure Draft relating to Accounting for Financial Guarantee Contracts

Dear Members of FASB:

We are writing to express our support for the changes in accounting for financial guarantee contracts, as outlined in the exposure draft. Since the exposure draft was released, various financial guarantee companies and sell side analysts have expressed a view that the proposed changes to the accounting, particularly the revenue recognition item should not be implemented. As that is the subject of most of the controversy, the balance of this comment letter focuses on revenue recognition. To be clear, we support all of the proposed changes.

For example, MBIA CFO Chuck Chaplin stated on MBIA's first quarterly earnings conference call, "I think the bigger problem may be that we don't believe that the recognition tracks the economics of the business. And the FASB is going to get a lot of – they are certainly going to receive feedback from us to that effect, and I would expect that they will receive feedback from sell-side analysts, from investors, from the Big Four firms that is quite consistent."

Or as brokerage firms William Blair wrote in an April 30, 2007 research report, "While the industry is generally in agreement regarding the need to bring more uniformity to loss reserving practices, the industry has been adamantly opposed to any accounting changes for revenue recognition and will continue to adamantly oppose the proposal with very credible support, in our opinion."

We disagree and would encourage FASB to not give in to this lobbying effort. The fact of the matter is that the proposed revenue recognition accounting better reflects the economics of financial guarantee contracts.

The exposure draft proposal properly captures the essence of financial guarantee insurance that premium should be recognized in proportion to the expiration of the related risk, which expires when the discrete guaranteed interest and principal payments are made. This contrasts with other Property and Casualty insurance (including homeowners, auto and workers compensation) where risk of loss diminishes ratably with the passage of time.

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Unlike most types of insurance where the risk expires continuously over time, in the financial guarantee business the risk expires on discrete dates when guaranteed principal and interest payments are due. In most Property and Casualty insurance policies, the possibility of a loss occurrence diminishes over time, and, as a result, it is generally proper to earn the premium over the policy period. For financial guarantee contracts the possibility of loss occurrences does not happen ratably over time. Instead, the possibility of loss occurs on a fixed schedule of individual payment dates, so the general standard is inapplicable.

We understand from Wall Street trading desks that financial guarantee insurers charge approximately the same amount of premium to insure a 5-year zero coupon bond, a 10-year zero coupon bond, or a 20-year zero coupon bond. If the risk is time dependent, the cost of guaranteeing longer duration credits would be proportionally higher than guaranteeing shorter duration credits. Twenty years of guarantee should cost twice as much as ten years. If the amount of time that risk is outstanding does not materially affect the price (value) of the insurance in this fashion, it is improper to earn premium as time goes by without risk expiration.

Compare this to other types of insurance. When a homeowner buys insurance for a year, each day that passes creates a proportional reduction in the probability of an event that will give rise to a claim. If the insurance company or the homeowner cancels the policy half way through, the homeowner has received half the benefit and should receive half the premium back. Here, it makes sense for the insurance company to recognize premium on a daily basis because risk expires continuously. Halfway through the policy, half the risk is gone. Similarly, two years of coverage costs about twice as much as one year of coverage.

In the case of a 10-year guaranteed zero-coupon bond, the holder of a guaranteed bond has not received any of the benefit after five years. The holder still expects to be paid at the end of the original ten years. Since financial guaranty insurance guarantees the timely payment of interest and principal, insurers are obligated only when an interest payment is not paid by the insured. The only day that the guarantee can create a claim is on the day the payment is due. From the insurer's perspective, prior to that point, the risk is outstanding and has not expired. Accordingly, FASB is correct in setting the revenue recognition policy that premium should not be recognized until the related risk expires (or is defeased).

Notwithstanding the industry protests, time is not a component of exposure reduction. Exposure is reduced when the underlying guaranteed payments are made (or not made) by the insured, rather than by the passage of time between payments. The FASB exposure draft captures this reality.

We note the letter from the Association of Financial Guaranty Insurers dated October 10, 2006 posted on the FASB website which argues, "The relationship of risk

¹ Other than the "peace of mind" of knowing that when the payment comes due, she has protection from a future loss bet.

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. ... For instance, the premium charged for a 1 year instrument will be less than that charged the same issuer for a 30 year term maturity."

The obvious question is: How much more? Unless the answer is 30 times more, which it is not, the passage of time is not the predominant measure of risk reduction, and the statement is misleading.

Industry participants all recognize that the leverage in the financial guarantee industry is a function of risk outstanding. Risk remains outstanding until it expires. The companies routinely use risk outstanding for other valuable measures. For example, they report the ratio of risk outstanding to claims paying ability or to equity as fundamental measures of risk and leverage. The rating agencies use similar ratios in assessing creditworthiness. The exposure draft concept of not recognizing revenue related to risk prior to expiration is consistent with industry risk metrics.

We believe that the financial guarantee industry has lived a long time based on an arbitrage between the economics of its business and its accounting. We applaud FASB's efforts to bring the aggressive accounting to a prompt end. As users of the financial statements, we support implementation of the exposure draft as is and without further delay.

Regards,

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