

Gary Ransom
Managing Director
Fox-Pitt, Kelton
970 Farmington Ave.
West Hartford, CT 06107
gransom@foxpitt.com

June 18, 2007

director@fasb.org



Financial Accounting Standards Board

LETTER OF COMMENT NO. 37

File Reference: 1530-100

Subject: Proposal for the Accounting for Financial Guarantee Insurance Contracts

This letter is in response to the Invitation to Comment on the above-referenced matter.

My Background and Use of Financial Statements

By way of background I have been involved in analysis of the insurance industry—mostly property-casualty—for nearly 30 years, and have been a security analyst for the past 15 years. I am a Fellow of the Casualty Actuarial Society and a Member of the American Academy of Actuaries. Specifically, I have been the Fox-Pitt, Kelton financial guaranty analyst for the past five years, and was involved in the start-ups of financial guaranty companies in the early 90s.

I frequently use and analyze the financial statements of both public and privately held financial guaranty companies, and I am familiar with the current accounting and disclosure practices of the companies.

It is my view that the proposed accounting for financial guaranty insurance does not reflect the economics of the financial guaranty business. The discussion below integrates consideration of the issues labeled 5, 8, 9, 10, 11, 13 and 16 in the exposure draft.

As a frequent and heavy user of financial statements, I have long believed that financial statements should reflect the underlying economics of the business and be consistent with the information that managements use for making decisions. I believe the current accounting proposal, especially the portion associated with revenue recognition, moves the financial statements further away from the underlying economics of the business. I will outline why I believe this from several vantage points.

First, the proposal does not capture one of the main attributes of the insurance business—spread of risk. One of the main features of insurance is the spread of risk and the Law of Large Numbers. By collecting and pooling a large number of risks

together the standard deviation of possible aggregate outcomes is greatly reduced compared to the standard deviation of possible outcomes for an individual risk.

In insurance, this means that the premiums of the many pay for the losses of the few. FAS 60 implicitly takes this into account in both short-duration and long-duration contracts, whereby premium revenue from insureds without losses runs through the income statement at the same time as losses from the few. This is not just a timing issue; it is intrinsic to the nature of insurance to recognize premiums from an entire portfolio of risks as an offset to the relatively few losses that occur. Indeed, the profitability of those risks without losses is a critical ingredient to the ongoing successful operations of an insurer.

To further emphasize this point, consider the example of a zero-coupon bond, like that used in the FASB proposal: \$5 million of premium and \$100 million of debt service, all paid, say, after 20 years. If the condition of the underlying credit deteriorates requiring the recognition of a loss, then the proposal, in essence, allows only the premium of that single contract to help offset the loss (by only recognizing the loss above the unearned premium reserve).

A better example would be to assume there were 100 such contracts issued, all with bullet payments 20 years out, with an aggregate of \$500 million of premium and \$10 billion of debt service. If, for example, one of the credits deteriorates (say, 5 years out) and generates a total loss with no recoveries, the new proposal would still only allow the premium of that one contract to offset this loss. The financial statements would not show any premium revenue to help offset this loss until many years later. Such financial statements from an insurer would at best hide the true profitability of the book of business, and at worst, be misleading to a user. The standard deviation of results at the insurance company would not be appropriately reduced to reflect the pooling of risks.

Again this is not just a timing issue; the proposal specifically only allows the unearned premium reserve from a stressed credit itself to offset the loss, while the condition, health, and profitability of the rest of portfolio is entirely decoupled from that loss event, contrary to the spread of risk principle of insurance.

Second, the proposed revenue recognition does not reflect actual reductions in risk that can occur over time. The proposal's concept of reduction of risk is tied only to the underlying payment of debt service, and does not reflect the underwriting, terms or conditions, structuring, and other protections that can serve to reduce risk as conditions evolve over time.

For financial guaranty insurance, there are many ways that an underlying credit can show improvement and reduce the probability of loss. Here are some examples:

- A municipality makes sinking fund payments into a trust, which are specifically held to make debt service payments, essentially eliminating the probability of loss on the portion of the debt service covered by the sinking fund.

- Revenues supporting an insured revenue bond are well above original expectations, a situation which reduces the risk of loss below that contemplated in the determination of the premium.
- Credit experience in a subordinated tranche of a structured credit is much better than expected, resulting in greater protection to the more senior insured tranche.

In all these situations, the probability of a loss has actually decreased from the initial expectations. When considered from the point of view of an entire portfolio of credits, stable or improving credits are the norm, while the deteriorating credits tend to be in the minority. Yet, the proposed accounting for revenue recognition has no provision to reduce the unearned premium reserve for such reduction in risk.

The actual market place recognizes a reduction in risk merely with the passage of time. Financial guarantors quote lower premiums for a five-year zero coupon bond compared to a ten-year bond. This may not be as evident today because the yield curve is so flat, yet financial guarantors definitely charge a higher premium for a longer duration. But as noted in the examples above, risk can be reduced by the specific performance of a credit and the proposed accounting for revenue recognition makes no allowance for this fact.

Third, the proposed accounting treatment for losses is conceptually removed from the treatment of revenue recognition. The short-duration contracts and long-duration contracts from FAS 60 are each internally consistent in that the approach to revenue recognition has some correspondence with the approach to loss recognition. The proposed financial guaranty accounting takes short-duration contract concepts for revenue recognition and combines it with long-duration contract concepts for losses.

Long-duration contract accounting essentially assumes that there will always be a loss. In the particular case of life insurance, this is clearly appropriate, and revenue recognition corresponds with the required build up of reserves needed to pay an ultimate death benefit. In general, losses are accrued for long-duration contracts along with revenue recognition.

Short-duration contract accounting assumes more uncertainty in whether there will be a loss. But revenue recognition is “in proportion to the amount of insurance protection provided,” i.e. revenue is recognized during the time period when a loss is most likely to be recognized.

The proposed accounting for financial guaranty insurers mingles these two concepts in a way that does not convey how managements view the business, or how users of financial statements analyze the business. The proposal recognizes revenue only at the time when a loss might be paid, not when the loss might be incurred. Yet losses are recognized when underlying fortuitous events occur.

Insurance always insures against fortuitous events, resulting in losses that are uncertain in timing, amount, or both. In the case of financial guaranty insurance, the fortuitous events are those financial circumstances within the underlying credit that may give rise to stress

potentially leading to a default—for example, a revenue bond might have revenue flows below expectations, there may be higher than expected losses within a structured finance transaction, or in extreme cases, there can be fraud. Such stress or deterioration is the fortuitous event that is being insured against.

It is entirely appropriate to recognize losses when such fortuitous events occur, but to recognize revenue only at the time when such losses will be paid is inconsistent with insurance concepts. A better matching of revenue recognition with the time when losses are recognized would provide a truer representation of the economics of the business.

Fourth, the revenue recognition proposal does not consider or incorporate the concept of capital utilization in insurance or specific features of financial guaranty insurance where losses are rare. The insurance of low frequency, but potentially high severity events always must incorporate a consideration of capital. In financial guaranty insurance, the rating agencies, analysts, managements, and buyers of insurance recognize that there is a cost associated with having the capital support the risk of loss.

Intrinsic to the financial guaranty business is maintaining the highest rating agency ratings in order to provide costs savings to the issuers of debt. There is a cost to the capital needed to attain those highest ratings, a cost that is continuous over time.

Financial guarantors must monitor and control their risks, to make sure the risks are diversified across asset classes, geographies, and issuers, with no unacceptable concentrations of risk. The capital supports all the outstanding credits at any given time and that capital is needed over the entire duration of the contracts.

The proposed accounting for revenue recognition does not recognize ongoing costs of capital which is being utilized over the entire course of the contract, not just when underlying debt service is paid. The result is having returns on equity or returns on capital calculated from the financial statements that may be far removed from the actual economic returns of the business, potentially for a significant number of years.

In addition, a major function of financial guaranty insurance is to provide a savings to issuers. A case can be made that this is the major function of financial guaranty insurance, since losses are relatively rare. The savings generated by financial guaranty insurance results from the utilization of the financial guarantor's capital. Again, the cost of this capital is continuous over time, not just when debt service is paid.

Fifth, holders of insured bonds receive a benefit over the course of the entire duration of the bond, not just at the time of underlying debt service payment. In particular, the holder of the bond receives market value protection while holding the bond, even when the underlying credit deteriorates materially. This benefit received by the holder of the insured bond is not matched by any revenue recognition.

Finally, the proposal creates balance sheet values that no one expects to ever be realized. I believe that values on the balance sheet should in all cases be amounts that represent actual likely realizable value, regardless of whether they incorporate discounted, undiscounted, or market values. The amounts on the balance sheet should be consistent with plausible and realistic scenarios.

For installment premium contracts, the FASB proposal places a full contractual unearned premium reserve and a full contractual receivable on the balance sheet, even though in many cases, these are values that no party to the financial guaranty contract expects to be realized. This is particularly true for mortgage backed securities where pre-payments significantly reduce the duration of the contracts from as long as a 30 year contractual duration to a 5 to 7 year expected duration. Indeed, this shortened duration is anticipated by all parties to the contract.

As a user of financial statements, I will want to know what management believes is likely to be realized. The contractual premium on the balance sheet will not be useful to me as an analyst, and I will find myself asking for further disclosure.

This portion of the proposed accounting will also create other issues for analysts. We will want disclosures for future earned premium based on management's estimates of likely future earned premium, not on contractual premiums. We will want an adjusted book value calculation based on expected premiums rather than contractual premiums.

Other observations on Issue 6 (discounting installments at a rate based on the credit standing of the issuer, and the accretion of that discount):

Since revenue recognition for installment premiums is proposed to be over the contract period, the discount accretion (and the amount treated as investment income) could potentially be overstated, and would have to be adjusted downward as prepayments are made. Investment income from imputed finance charges would be high early in the contract period and would probably be negative later as pre-payments are made to correct for the (known) overstatement of imputed finance charges. This would add volatility to the investment income line and, as an analyst, I would want to have such portions of the investment income disclosed, so I could consider it as part of the revenue paid in by customers.

Also, discounting the installment premiums at a rate based on the credit standing of the issuer implies lower present values would be recognized for weaker credits, all other things being equal. So for weaker credits, more of the amounts they pay would be treated as investment income rather than premium revenue. This could result in the situation where the relatively higher amount charged to insure a lower quality credit translates into higher investment income rather than a higher premium. This result is counter-intuitive from an insurance perspective; higher risk should be fully measured in the premium charged, not in the finance charges. In other kinds of insurance, credit risk is not a large factor in the business. For financial guaranty, credit risk is central to the entire operation.

It makes more sense to view the credit risk assumed as correlated with the premium charged. To the extent that finance charges are imputed, it would make more sense to do so at a risk-free or investment portfolio rate, and place all the credit risk components into the premium. Again, as an analyst, I would associate those imputed finance charges as premiums charged for assuming credit risk and I would encourage managements to disclose this portion of the investment income so I can treat it as risk assumption revenue.

Concluding Remarks:

I believe that the current approach to revenue recognition is superior to the proposed approach because it recognizes that the contracts are insuring against fortuitous events that lead to a default, not the default itself, which merely represents the realization of a potential claim payment. The existing approach assumes that the probability of a fortuitous event is even over time, and takes into account that such an event early in the contract period usually generates a larger loss. It also appropriately recognizes a cost of capital utilized during the contract period and recognizes tangible benefits (market value protection) received by the holder of the bond.

Expected installments provide more information than contractual installments. I believe using expected premiums rather than contractual premiums is a better foundation for other metrics used in analyzing financial guarantors, such as adjusted book value and future earned premium disclosures. It also would avoid putting values on the balance sheet that no one expects to be realized.

The proposed loss recognition and reserve methodologies are acceptable. I have not commented in detail on the proposed loss reserving methods. I want to emphasize, however, that I believe the recognition of losses should occur when underlying stress in individual credits or a portfolio of credits emerges, i.e. when the fortuitous insured event occurs. The proposed accounting does this, but I would be opposed to any changes that move loss recognition away from the emergence of stress.

The accounting proposal would require users to acquire additional information from financial guarantors. The insurance business incorporates concepts such as spread of risk, managing or reducing risk, fortuitous events, and cost of capital. To the extent possible, accounting for insurance should reflect these concepts. In my opinion, the proposed accounting, particularly the revenue recognition proposal, will produce financial statements that will be far removed from the true economic profitability of the business, potentially for a period of many years.

As a user of the financial statements, under the proposed accounting, I would encourage managements to expand disclosures to those that would be more useful to analysts. I would find no value in disclosures of contractual installment premiums, and would look to managements to disclose expected installments. I would have no interest in treating portions of installment premiums as investment income, and would look to managements to disclose that portion of the investment income that I would want to treat as premium. I

would have no interest in schedules of future earned premium that mimic future debt service. While I have an interest in underlying debt service, I would ask managements for additional information that would help me understand the reduction of risk over time.

I would be happy to discuss these comments further.

Sincerely,

Gary Ransom
Managing Director