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Technical Director – File Reference No. 1530-100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116



LETTER OF COMMENT NO. 69

The Planning Subcommittee of the Accounting Standards Executive Committee (PSC) and the Insurance Expert Panel, both of the AICPA, appreciate the opportunity to comment on the FASB proposed Statement of Financial Accounting Standards, Accounting for Financial Guarantee Contracts- an interpretation of FASB Statement No. 60.

Overall, we agree that the FASB should provide guidance to help reduce diversity in the accounting for financial guarantee insurance contracts. We do not agree however, with the proposed method of premium revenue recognition, and have several questions regarding the calculation of the unearned premium revenue liability and claim liability.

A more complete response to the Board's specific questions on the Exposure Draft is included in the attached Appendix. Representatives of the Planning Subcommittee of AcSEC and the Insurance Expert Panel are available to discuss our comments with the Board members and staff.

Yours truly,

Ben Neuhausen, Chair Planning Subcommittee of the Accounting Standards Executive Committee

Donald Doran, Chair Insurance Expert Panel

Appendix

RESPONSES TO SPECIFIC ISSUES

Proposed FASB Statement, Accounting for Financial Guarantee Contracts- an interpretation of FASB
Statement No. 60

General

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 PSC and Insurance Expert Panel believe that the new format is helpful in focusing the reader on the accounting principle, and that the inclusion of examples in the body of the standard makes it easier to directly apply the concepts.

Scope

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)?

We understand the Board's need to limit the scope of the proposed Statement, to focus on the timely resolution of practice issues relating to financial guarantee insurance contracts issued by insurance enterprises. We would recommend that the final Statement further clarify which products are excluded from the Statement's scope, and why. It appears to us that the mortgage guaranty insurance and credit insurance on trade receivables described in paragraph 5b of the Exposure Draft as "similar to financial guarantee insurance contracts issued by insurance enterprises" meet all of the conditions in paragraph 3 of the Exposure Draft. It would be helpful if the final document included more examples and discussion of what characteristics are not in accordance with paragraph 3. For example, would an asset backed security that supports a mortgage guaranty be included in or excluded from the scope of this Statement?

We also question if the phrase at the end of the last sentence in paragraph 4 of the Exposure Draft (bolded below) is intended to be a definitive criterion for a contract to be considered a financial guarantee insurance contract (and thus in the scope) or just an observation on how financial guarantee insurance contracts generally work:

For purposes of this Statement, a financial guarantee insurance contract obligates the insurance enterprise to pay a claim upon the occurrence of a default, and the insurance enterprise does not have the ability to negotiate the claim amount prior to payment (that is, the claim amount must be paid as submitted).

The Planning Subcommittee finds the prohibition on analogy to this guidance to be unusual and requests the FASB to explain the reasons for the prohibition.

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?

We are aware of certain implementation issues related to the application of paragraph 10(d) of FASB Statement No. 133 for financial guarantee contracts that we believe should be resolved, but do not believe this Statement is the appropriate mechanism for providing guidance on Statement 133.

Premium Revenue Recognition

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?

At this point in time, we agree with the Board's decision that it would not be appropriate to require financial guarantee insurance contracts to be measured at fair value without also considering if other types of contracts should be measured at fair value.

The revenue recognition model proposed in the ED is inconsistent with existing guidance for financial services companies and does not reflect the economics of the transaction. Therefore, we believe the Exposure Draft's revenue recognition guidance is inconsistent with the Board's stated objective of not introducing a new accounting model.

We believe the Board's consideration of revenue recognition guidance for financial guarantee insurance contracts should have been limited to the following models. Regardless of the model chosen, we strongly believe the best revenue recognition model would recognize premium revenue over the life of the borrowing:

1. Short-Duration Insurance Model - The FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, short duration revenue recognition model for single event covers such as fire, hurricane and the like is to recognize the revenue ratably over the period of coverage in proportion to the amount of insurance protection provided. This differs from the release from risk model proposed in the Exposure Draft. Applying the current Statement 60 short duration revenue recognition model

to financial guarantee contracts would result in recognition of premium revenue over the expected term of the debt (and in proportion to the amount of debt outstanding). We are concerned that the Exposure Draft inappropriately portrays the proposed release from risk model as consistent with the current Statement 60 short duration model. The Exposure Draft could therefore potentially be viewed as amending existing literature relating to an insurer's premium recognition for certain short duration coverages.

- 2. Effective Yield Model In a financial guarantee transaction, the insurer has effectively allowed the debt issuer to borrow its credit rating to lower the issuers cost of funds; one Board member described this as the "economic renting" of the financial guarantor's capital structure. A similar way of thinking about it is that the financial guarantee insurer has purchased the debt of the debt issuer and issued its own debt to the debt purchaser (the guaranteed party). FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, permits purchased debt to be accounted for at amortized cost if the intent is to hold until maturity, and the current accounting for issued debt is also an amortized cost model. The net result of these two implicit components of a financial guarantee transaction is recognition of the net interest income spread on an effective yield method over the life of the two instruments, reflecting the amounts outstanding. The default risk of a financial instrument is represented by the increased interest required over a similar risk free financial instrument. This spread is recognized each period the instrument is outstanding using an effective yield method similar to the one we propose.
- 3. Alternative Release from Risk Model: The proposed release from risk model uses a single factor, contractual payments on the underlying insured obligation, as the sole determinant of the reduction in risk. An alternative view would recognize both the passage of time and expected payments rather than contractual cash flows in determining the revenue recognition pattern.
- 4. Long-Duration Insurance Model In the existing long-duration insurance models, including both FASB Statements No. 60 and 97, revenue is recognized over the life of the insurance contract, even though the release from risk does not occur until the end of the policy (upon death of the insured). For example, Statement 97 provides guidance for Statement 60 limited pay contracts. The model in the Exposure Draft essentially considers all financial guarantee insurance contracts to have a single up-front premium payment, either in cash or in the form of an interest bearing receivable. The limited pay model defers all premiums in excess of capitalized acquisition costs but then requires an amortization of the deferred revenue over the lives of the block of insurance contracts.

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.

We believe the proposed premium revenue recognition approach does not sufficiently capture the impact on the guarantor's risk due to the passage of time. If an obligor issues a 5-year zero coupon bond and a 10-year zero coupon bond, on the same day, all else being equal, we would believe that the guarantor would charge a smaller premium to insure the 5-year bond than the 10-year bond, as there is a smaller risk of default. This would lead to the conclusion that the passage of time has an effect on the guarantor's risk. We believe that effect should be captured in the premium revenue recognition model for financial guarantee insurance contracts.

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 exist and is measurable? If so, please provide examples of these arrangements and a description of how reliable prepayment estimates are.

Using contractual terms rather than estimated prepayments for both measurement of the premium receivable and the revenue recognition basis is inconsistent with the economics and pricing of financial guarantee transactions, which consider such prepayments, as well as with existing accounting literature. The Board notes in the Exposure Draft that in the absence of observable information about prepayment expectations, it would be difficult to reliably assess the likelihood of prepayment. However, in other situations in which such observable information does not exist, current literature would allow for consideration of estimated prepayments. For example, in financial instrument accounting guidance, Statement 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, paragraphs 19 and 58 permit consideration of estimates of future principal prepayments in calculating an effective yield in situations in which the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated. Many of the financial guaranty insurance contracts are on borrowings backed by pools of investments for which we believe prepayments can be reasonably estimated. In addition, the claim recognition model proposed in the Exposure Draft considers expectations of future cash flows; it seems inconsistent that the premiums receivable and revenue recognition components of the model would ignore expectations of future cash flows. In addition, it is unclear how an asset (premiums receivable) whose value is determined based on contractual payments that are not probable of occurring would meet the definition of "a probable future economic benefit obtained or controlled by" the insurer.

If the Board decides nevertheless to pursue a contractual payment model, we believe additional guidance is needed on how to adjust premium revenue recognition as contractual payments change due to actual prepayments. When an obligor begins to prepay, future payments decrease relative to the predetermined schedule agreed to at the time the guarantee contract was entered, and accordingly wouldn't the contractual payments need to be recomputed? We believe it would be helpful if the final Statement provided guidance (cumulative catch-up or prospective adjustments) as to how the premium revenue recognition should be impacted as a result of a change in the total amount of contractual payments

Claim Liability

Issue 13: This proposed Statement would require that an insurance enterprise recognize a claim liability on a financial guarantee insurance contracts 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 believe that the proposed methodology for recognizing a claim liability for a financial guarantee insurance contract is economically the same as recognizing a premium deficiency under FASB Statement No. 60. The Exposure Draft requires that the claim liability recognition test be performed on a contract level as opposed to grouping the contracts consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability as allowed under Statement 60. We believe that the final Statement should allow for grouping of similar contracts in determining if a claim liability should be recognized, and hence the expensing of any previously deferred associated acquisition costs.

We believe that the wording in the Exposure Draft (specifically paragraph 20 on measurement of the claim liability) is unclear as to how the unearned premium revenue liability is considered when an insurance enterprise recognizes a claim liability. For example, if the unearned premium revenue liability is \$50, and an insurance enterprise expects a claim loss of \$60, should a claim liability be established for \$60 and would the unearned premium revenue liability and the deferred acquisition costs (DAC) be fully written off or continue to run off? We recommend that the final Statement clarify how the accounting should interact with the unearned premium revenue liability when a claim liability is recognized.

We also believe the interplay between DAC, the unearned premium revenue liability, and installment premiums receivable requires clarification. The Exposure Draft would require a claim liability when expected future payments (claim loss) exceed the unearned premium revenue liability. The unearned premium revenue liability, especially under the Exposure Draft model of recognizing installment receivables based on contractual payments as opposed to estimated payments, is needed to demonstrate the recoverability of the recorded contractual premiums in excess of estimated claim losses as well as demonstrate the recoverability of DAC. Therefore, we believe that both the unamortized DAC and the installment receivable balance should be included in the determination of the claim liability to be recognized.

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 believe the appropriate discount rate depends on how the Board resolves our comments on Issue 13. If the claim liability is a separate liability apart from the unearned premium liability, then using a discount rate at the time of the initial recognition of the claim liability would be appropriate. Conversely, if the claim liability encompasses the unearned premium liability, like a premium deficiency, then it seems more appropriate to use the discount from the time of contract inception.

Other

We believe that EITF Issue No. 85-20, Recognition of Fees for Guaranteeing a Loan, should be included in Appendix C of the proposed Statement, as it appears that the Exposure Draft effectively removes financial guarantee insurance contracts issued by insurance enterprises from the consensus in EITF Issue No. 85-20.