

A·F·G·I

ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty®

August 23, 2006

Mr. Lawrence W. Smith
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O.Box 5116
Norwalk, CT 06856-5516



LETTER OF COMMENT NO. 19

Re: File Reference No 1325-100

Dear Sir:

The Association of Financial Guaranty Insurers ("AFGI") appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB or the "Board") Invitation to Comment entitled *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting* (the "ITC").

The members of AFGI are "monoline" financial guaranty insurance companies ("Insurers"), engaged primarily in the regulated business of financial guaranty insurance. AFGI members provide credit enhancement for a wide variety of domestic and international transactions, with their business generally including public finance (municipal) and asset-backed security ("ABS") transactions. While U.S. domiciled AFGI members are generally prohibited by law from writing credit default swaps ("CDS") or other derivatives (other than for qualifying hedges of risks in their investment or insured portfolios), they are permitted to insure obligations of counterparties under CDS and other derivatives, including counterparties that are special purpose entities having no independent ability to perform the obligations. As such, AFGI members may be considered sellers of credit protection under CDS for GAAP accounting purposes. Certain AFGI members are financial guaranty reinsurers who serve the primary financial guaranty companies by assuming risks ceded by the primary guarantor. AFGI members have strong financial strength ratings, with most of the primary market financial guaranty insurers having "triple-A" ratings by one or more of the major securities rating agencies. In a traditional financial guaranty transaction, the Insurer guaranties for the life of a debt instrument scheduled bond principal and interest payments in exchange for an insurance premium. The Insurer's rating is attached to the insured obligation, allowing the obligation to bear a lower interest rate than it otherwise would require. As a matter of underwriting policy, AFGI members typically guaranty obligations that are investment grade without taking into account the benefit of insurance. All U.S. domiciled AFGI members are authorized to write financial guaranty insurance in New York and therefore are subject to Article 69 of the New York Insurance Law ("Article 69"), which is the most comprehensive statute established for financial guaranty insurance.

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ACA Financial Guaranty Corporation • Ambac Assurance Corporation • Assured Guaranty Corp. • BluePoint Re Limited • CIFG • Financial Guaranty Insurance Company
Financial Security Assurance Inc. • MBIA Insurance Corporation • Radian Asset Assurance Inc. • RAM Reinsurance Company Ltd. • XL Capital Assurance Inc.

The financial guaranty insurance industry has emerged over the past 35 years and, as the FASB knows; existing accounting guidance does not specifically address financial guaranty insurance. As such, financial guaranty accounting policies are based on analogy to the most directly comparable elements of GAAP literature. Although reporting practices differ by industry participant, insurance accounting and terminology have always played a large role in framing our financial accounting and reporting policies. In addition, the FASB has added a project to its agenda to specifically address financial guaranty insurance. The objective of this project is to provide guidance with respect to the timing of claim liability recognition, premium recognition, and the related amortization of deferred policy acquisition costs.

We have only provided comments to the questions of relevance to our industry in the attached Appendix A. In addition, we provide a summary of our conclusions below:

- We encourage the Board to specifically address financial guaranty insurance and define such policies as transferring significant insurance risk. Financial guaranty insurance is not always directly comparable to other forms of insurance as referenced in certain examples of the ITC (e.g. specific reference is made to life and property and casualty insurance while there is no such guidance provided for financial guaranty).
- We encourage the Board to emphasize simplicity and understandability. Bifurcation of a typical financial guaranty insurance and reinsurance contract, in our view, is too complicated as currently set forth and will not be easily applied by preparers or understood by the users of financial statements.

If you have any questions regarding our responses, please contact Sean Leonard at (212) 208-3177.

Sincerely,



Sean Leonard
Chairman of the Financial Affairs Committee
Association of Financial Guaranty Insurers

Appendix A

The specific questions posed by the ITC and our responses follow:

Issue 1: Does the IFRS 4 definition of *insurance contract* identify insurance contracts and sufficiently distinguish those contracts from other financial contracts?

We believe that the IFRS definition of Insurance contracts distinguish insurance contracts from financial contracts. It specifically addresses insurance risk to be any risk other than financial risk. Financial risk is defined in IFRS 4, *Insurance Contracts*, as the risk of a possible future change in one or more of the following: a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. Financial guaranty contracts are **specifically** scoped into IFRS 4 as long as the contract requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument provided that the resulting risk transfer is significant.

AFGI members sell credit protection in the form of financial guaranty insurance with respect to securities and with respect to obligors under credit default swap ("CDS"). Both forms reimburse the contract holder for specified credit losses and therefore expose the insurer to possible losses. However, under CDS, the contract holder is not required to "hold" the underlying assets. While U.S. domestic financial guaranty insurers are prohibited by law from writing CDS, they are permitted to insure the obligations of special purpose entities or subsidiary credit product companies that are CDS obligors and lack an independent ability to perform their obligations under the CDS. As such, under GAAP, the financial guarantor is deemed to have written the CDS itself. The Insurer's obligation under such an insured CDS contract qualifies as a permissible insurance risk under Article 69 of New York Insurance Law and is considered to be substantially similar to a financial guaranty. A CDS guaranteed by a financial guarantor typically references either (i) a pool of securities or loans (corporate or consumer), and requires a claim payment only in the event that losses on the referenced obligations exceed a pre-specified deductible or (ii) a specified security otherwise qualifying for insurance. When the insurer sells protection under such CDS transactions, the Insurer stays on risk for the term of the transaction, subject to the performance of the counterparty (the buyer of protection) who is obligated to make premium payments. The Insurer generally has no entitlement to settle its derivative position at a gain or loss. Also, the obligation of the Insurer to perform under the CDS is not supported by an obligation to post collateral at the outset of the transaction or upon a ratings downgrade. Additionally, the CDS counterparty (the buyer of credit protection) is not required to hold the referenced obligation during the term of the contract. We believe that these CDS contracts represent a

transfer of "insurance risk" and not "financial risk" to the financial guarantor and should be considered an insurance contract. We request that the FASB address this point specifically in the project.

Does the GAAP definition of *insurance risk* identify and separate that risk from other risks such as financial risk?

The current definition of insurance risk under GAAP refers to underwriting risk and timing risk as being elements of insurance risk and does not include financial risks. The definition of financial risk is not clear and should be addressed in a manner similar to the IFRS definition. In addition, risk transfer should be considered in the context of the risk inherent in the guaranteed obligation. For instance, a financial guaranty policy which assumes the risk of an issuer's non-payment of its obligations should be considered significant no matter how low the probability of issuer payment default. This concept is consistent with Statement 113, paragraph 67. This standard states in part " The Board concluded that, when the reinsurer has assumed substantially all of the insurance risk in the reinsured portions of the underlying policies, even if that risk does not result in the reasonable possibility of significant loss, the transaction meets the conditions for reinsurance accounting. In this narrow circumstance, the reinsurer's economic position is virtually equivalent to having written the insurance contract directly. The risks retained by the ceding enterprise are insignificant, so that the reinsurer's exposure to loss is essentially the same as the insurer's."

Do the descriptions of finite insurance and reinsurance contracts, including the risk-limiting features, identify those contracts? How could the definitions and descriptions be improved?

The description of the contract terms and features that can limit the transfer of insurance risk is adequate. We encourage the FASB to specifically identify contract types that would not cause concern with respect to risk transfer such as a standard quota share or excess of loss reinsurance contracts.

Furthermore, financial guaranty reinsurance contract termination provisions typically permit the ceding company at its option to recapture previously ceded exposure in the event (1) of a change in the control of the reinsurer, (2) the reinsurer fails to maintain minimum regulatory capital levels or insolvency, or (3) there is a decline in the reinsurer's credit status, which is generally evidenced by a downgrade in the reinsurer's credit rating, as issued by a major rating agency. We believe that these termination provisions should not be considered "finite triggers" as the business purpose of the provisions is to enable the primary insurer to recapture the business because rating agency capital credit is no longer available or has been significantly reduced (the rating agencies penalize AAA primary financial guaranty insurers that cede exposures to reinsurers rated AA or lower by requiring the primary insurers to hold more capital on the exposures ceded to the lower rated reinsurers). In such circumstances, the contract cannot be terminated

at a discounted amount. The reinsurance contract may provide that the reinsurer pay the ceding entity additional ceding commission income to compensate the ceding entity for the additional capital it has to maintain instead of termination. Paragraph 62 of Statement 113 indicates that insurance risk transfer requires that both the amount and timing of the reinsurer's payments depend on, and **directly vary with**, the amount and timing of claims settled under the reinsured contracts. We believe the reinsurance contracts are consistent with these risk transfer concepts. The termination payments discussed above are not as a result of the insured risks and does not result in the reinsurer's loss experience differing from the ceding company's experience as a result of an adverse loss experience. We believe the guiding principle should be that if the event triggering termination or increased ceding commission income is outside the control of the ceding party and is not probable to occur at inception, then no risk limiting features should be considered to exist.

Issue 2: Can the Statement 113 risk transfer guidance for reinsurance contracts be applied by corporate policyholders and insurers for determining whether an insurance contract transfers significant insurance risk? If not, how can Statement 113 guidance be modified or clarified to apply to insurance contracts?

Financial guaranty insurance is often described as an insurance product which provides credit protection against risks with low default frequency characteristics. The risk of loss can be significant if incurred. Under Statement 113 determining probable loss can be problematic for certain types of coverage, such as catastrophe coverage and financial guaranty insurance. Such coverage is deemed by most practitioners to be insurance, regardless of the probability of loss. Given the challenges faced by insurance companies with respect to the guidance in Statement 113 it would seem difficult to apply for corporate policyholders who are not in the business of assessing risk transfer.

Based on the IFRS guidance we believe that financial guaranty insurance transfers significant insurance risk because the insured event could cause an insurer to pay significant additional benefits even if the event is extremely unlikely to occur. This guidance can thus be applied to both corporate policyholders and insurers.

As mentioned in Issue 1 we believe that risk transfer should be considered in the context of the guaranteed obligation. For the purpose of defining risk, even though the absolute risk of default may be low, such risks which are defined as insurance should be presumed significant.

Issue 3: Does classifying an entire contract as insurance or bifurcating that contract into insurance and deposit components provide more understandable and decision-useful information? Which qualitative characteristics most influence your decision? Which approach more faithfully represents the economic substance of the contract? Why?

We believe that a financial guaranty contract should not be bifurcated into insurance and a deposit component unless the specific facts and circumstances support recognition of an asset as defined in the FASB's current literature. Concept Statement 6, *Elements of Financial Statements*, paragraph 25 states "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events". Based on this definition, we do not believe it is appropriate to set up an asset for any perceived deposit component of a financial guaranty contract (from the ceding company's perspective) since the economic benefit is not controlled by the ceding entity and the loss event, if any, has yet to occur. We believe this approach reflects the economic substance of the transaction and provides more understandable and decision useful information. Additional qualitative characteristics that most influence our decision are as follows:

A) Relevance and understandability:

- For economic decision-making and ease of use, a consistent single measurement basis would be more useful than mixing one measurement basis for the deposit component and one measurement basis for the insurance component.
- A financial guaranty contract is designed, priced and managed as one contract. The Insurer cannot unilaterally terminate the agreement and typically syndicates risk through the use of reinsurers at the time of origination.
- The components of a financial guaranty contract are interrelated and the value of the contract is not necessarily equal to the sum of the individual components.
- Financial guaranty contracts are regulated as insurance business by insurance regulators and should be treated similarly for financial reporting purposes. Financial Statements would become complex and difficult to understand if financial guaranty contracts required bifurcation.

B) Constraints:

- Bifurcation will likely require costly and extensive system changes.
- As highlighted by multiple DIG Issues, bifurcation will create numerous preparer challenges and the need for extensive implementation guidance.

- Corporate policyholders may not have the systems or information necessary to bifurcate insurance contracts purchased.

C) Reliability:

- Bifurcation will require an arbitrary allocation between the two elements (deposit and insurance) and is unlikely to result in more representationally faithful financial statements.
- Comparability of financial statements amongst insurers will become more difficult, if bifurcation is required, since methods and assumptions used may not be consistently applied.

Issue 5: Do you agree with the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk? If not, why not? Should other characteristics be added? Are the examples in Appendix B representative of the discussions in paragraphs 57-59?

We believe that financial guaranty insurance contracts unequivocally transfer significant insurance risk. This is based on the required characteristics set forth in paragraph 58 (d)-(f). We seek clarification from the Board on the following points:

We believe that a financial guaranty contract is a **single** contract for a **single** risk or event and should qualify for the unequivocal insurance contract exemption even though the contract is typically a tri-party contract (namely the Insurer, Insured [issuer of the underlying bond] and the Beneficiary). Even though financial guarantees are customarily issued to a trustee, on behalf of the note-holders, the financial guarantee documents look to the conduct and performance of the *issuer*, rather than the resulting payment or nonpayment to note-holders. Therefore, we view this arrangement as a single risk or event and not a group contract which should be clarified within Paragraph 58 (a).

Appendix B to the ITC states that a common characteristic of an unequivocal exempt insurance contract is that all of the risk insured has been transferred from the policyholder to the insurer. We believe that financial guaranty insurance meets this criteria for the following reasons: a) The insured event could cause an insurer to pay significant benefits even if the event is extremely unlikely to occur; b) Insurance policies are generally non-cancelable by the Insurer; and c) The premium is typically paid upfront and/or over time on an installment basis and there is no mechanism for premiums to be repaid to the Insured.

We request that the Board define a “market-equivalent level of premium”. Most financial guaranty insurance premiums are competitively bid and provide evidence of a market, but there are certain cases where contracts are privately negotiated. We believe that regardless of the mechanism for discovering price, third party agreements should provide the necessary evidence of a market. Please clarify within Paragraph 58 (d).

Certain financial guaranty reinsurance contracts contain profit commission clauses. The profit commission is paid in limited circumstances to the ceding company in the event that the net profit for a given underwriting year is positive. If the underwriting year has a net loss, no profit commissions are typically paid and both the ceding and assuming companies will suffer losses on that year’s underwriting risks. The profit sharing clauses typically have an **insignificant economic impact** on the contract (as discussed in paragraph 63), are not loss limiting features (i.e. do not mitigate the reinsurer’s losses or risk in the event of adverse loss experience in the underlying policy) and such a contract element should be further clarified within Paragraph 58 (e).

Certain financial guaranty reinsurance contracts provide for additional premium to be paid to the primary insurer should the reinsurer be downgraded or trip certain triggers set forth in the contract at inception. As discussed in Issue 1, these provisions are meant to compensate the guarantor for the additional capital the guarantor must maintain upon the deterioration in reinsurer credit rating. It should be noted that the additional premium typically represents a small fraction of the total exposure and an inadequate return on the additional capital required. As long as the event triggering the increased premium is outside the control of the insurer (i.e. not unilateral) and is not probable to occur at inception, no risk limiting features should be deemed to exist.

Issue 6: Do you think the characteristics described in paragraph 58 for unequivocal insurance contracts are an improvement over the exemption from cash flow testing in paragraph 11 of Statement 113?

We agree that the unequivocal insurance contracts exemption is an improvement over the current guidance in Statement 113. We do however encourage the Board to consider the points of clarification in Issue 5 above.

Issue 11: In view of the IASB’s project on insurance contracts, should the FASB be considering bifurcation of insurance contracts based on transfer of insurance risk?

We believe that there is a need for guidance that addresses how insurance contracts and reinsurance contracts should be accounted for and encourage the Board to continue with its current efforts.