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May 29, 2007

Financial Accounting Standards Board c/o Technical Director – File Reference No. 1430-100 401 Merrit 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116



LETTER OF COMMENT NO.

Re: Comments on Exposure Draft: Accounting for Financial Guarantee Insurance Contracts; File Reference No. 1430-100

Ladies and Gentlemen:

We applaud FASB's recent Exposure Draft of new accounting guidance that illuminates FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, as it applies to financial guarantee insurance. In our view, the resulting accounting guidance will serve to greatly enhance market transparency by, among other things, more closely tying accounting treatment to the true economic activity of financial guarantors.

As you may know, we have been perhaps the most vocal advocates for improvements in accounting standards for financial guarantors and have closely followed FASB's deliberations on this matter over the past few years. We believe that, if adopted in full, the Exposure Draft addresses the inconsistencies in the accounting and business practices employed by insurers across the financial guarantee market. The stakes and risks involved are enormous, as financial guarantors currently guarantee trillions of dollars in financial obligations.

Perhaps most importantly, if adopted, the Exposure Draft will enable market participants (including the insurers themselves) to more easily identify the true economic profitability of, and potential risks of loss to, insurers who are active in the financial guarantee marketplace. The capital allocation decisions that emanate from these accounting changes are substantial and impact everything from a beneficiary's ability to assess the financial wherewithal of its insurance provider to the adequacy of the pricing charged by the insurer and the valuation of each insurer's common equity.

The Exposure Draft addresses two fundamental aspects of accounting in the financial guarantee market: premium revenue recognition and claim liability (including loss recognition, measurement, and disclosure). First, insurers would be required to link

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insurance premium recognition to the insured contractual payments made by the issuer of the insured financial obligation. In so doing, the Exposure Draft ties the recognition of an insurance premium from a guarantee to the elimination of risk to the insurer over time. In short, insurers will be required to match recognition of revenue to actual diminution of risk. This is obviously the most sensible approach to revenue recognition and will cause insurers' financial statements to more accurately and fairly present revenue and accounting and economic profits.

Second, insurers will be required to more closely measure (and disclose) losses across their portfolio. Under the Exposure Draft's approach, insurers will be required to adjust, through a claim liability, changes in periods after initial recognition of the financial guarantee that increase the likelihood of a default.

In particular, under the proposed approach, each insurer will have to make probability-weighted assessments of potential losses and payouts, and mark losses (or gains) accordingly. The Exposure Draft therefore corrects possible distortions and inconsistencies that stem from the traditional analysis under FASB Statement No. 5, Accounting for Contingencies, which does not necessarily reflect true economic expected values. We believe the Exposure Draft's new approach to be the most sensible with respect to recording losses. If adopted, we believe that this approach will cause insurers' financial statements to more accurately and fairly present risks and liabilities over time.

With respect to loss monitoring, measurement, and disclosure, we note that the Exposure Draft continues to leave in the hands of management the probability judgments with respect to any given troubled credit under surveillance. Reflecting on the phenomenon of managerial bias in the context of loss reserves, in a 2001 letter to Berkshire Hathaway stockholders, Warren Buffett observed:

"In effect, insurance accounting is a self-graded exam, in that the insurer gives some figures to its auditing firm and generally doesn't get an argument. (What the *auditor* gets, however, is a letter from management that is designed to take his firm off the hook if the numbers later look silly.) A company experiencing financial difficulties — of a kind that, if truly faced, could put it out of business — seldom proves to be a tough grader. Who, after all, wants to prepare his own execution papers?"

We share the same sentiment in that we believe that any management-determined loss analysis may be prone to manipulation in the worst case, or judgment biases that obscure the true risk associated with any troubled credit. This problem is exacerbated by the mismatch between the duration of the insured obligations (which can range up to 30 years) and the average tenure of insurance company managers (which tends to be only a fraction of that period).

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Whether consciously or otherwise, there is a natural incentive for management to understate losses and related reserves in current periods, as the perception of short-term financial health raises the value of restricted stock and options that form the basis of management compensation. That illusion can quickly dissipate when losses related to long-dated risks come to roost. By that time, however, management may have long left the enterprise, leaving beneficiaries and equity holders exposed.

In order to address the issue of management bias, we would advocate a system of independent review of capital, reserves, and loss contingencies by an independent party, such as a regulator. Simply put, financial guarantors have evolved from monoline municipal bond insurers to complex financial institutions that engage in activities indistinguishable from commercial banks and other regulated depositary institutions. Those institutions operate under a strict capital adequacy regime administered by the Federal Reserve System and the Office of the Comptroller of the Currency (among others). That regulatory framework manages systemic risk by monitoring and actively regulating capital adequacy. The system ultimately ensures solvency, limits risk to the capital markets generally, and protects sympathetic constituents such as depositors and other beneficiaries.

At any rate, a credit-by-credit approach that requires management to continuously monitor potential losses and to provide up-to-date qualitative disclosure regarding changes in probability-weighted outcomes is a far preferable approach than current industry practices, which could be described as opaque at best. In that regard, we view the Exposure Draft's approach as a vast improvement over the status quo.

In light of the inconsistent methodologies employed by various financial guarantors, it is imperative that FASB move the industry to accounting standards and methodologies that can and should be consistently applied across these enterprises. Insurance companies are generally viewed (and valued) as a function of book value. For instance, book value as a percentage of debt, guarantees and other liabilities, is a common valuation metric for insurers.

Currently, a number of insurers effectively accelerate revenue recognition in a manner that does not relate to the underlying risk that they have assumed. Consequently, in our view, these insurers have substantially inflated book values. By rationalizing the timing of revenue and loss recognition, the Exposure Draft's proposals may ultimately have the impact of decreasing book value for these insurers. That decrease in book value, however, would more accurately reflect the true financial position of these companies. Armed with this information, market participants will be empowered to better understand the business fundamentals of each of these businesses.

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Examples of the divergence between accounting and true economic activity are all too prevalent – particularly amongst financial institutions whose accounting standards and methodologies drive market perception of risk and value. In the case of the financial guarantors, current accounting policies bare little relationship to the underlying economic earnings and risks that these insurers face. We believe that the Exposure Draft goes a long way toward correcting this problem. We strongly endorse the new approach that FASB has developed and congratulate FASB and its staff for a job well done.

PERSHING SQUARE CAPITAL MANAGEMENT, L.P.

Very truly yours,

William A. Ackman