MINUTES

Financial Accounting Standards Board

To: Board Members

From: Benson (ext. 446)

Subject: Minutes of the December 6, 2006 Board Meeting: Financial Guarantee Insurance—Interest Rates Used in Discounting

Date: December 12, 2006

cc: FASB: L. Smith, Bielstein, MacDonald, Leisenring, Polley, Gabriele, Allen, Glotzer, Sutay, Carney, Project Team, FASB Intranet; GASB: Attmore, Bean

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic:	Financial Guarantee Insurance—Interest Rates Used in Discounting
Basis for Discussion:	Board memorandum dated November 15, 2006
Length of Discussion:	3:10 p.m. to 3:20 p.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Linsmeier, Seidman, Trott, and Young
Staff in charge of topic:	Trench
Other staff at Board table:	L. Smith, Cropsey, and Benson
Outside participants:	Leisenring

Summary of Decisions Reached:

The Board discussed the appropriate interest rate to use and whether that interest rate should be locked-in at inception or updated periodically in discounting the expected present value of installment premiums (both the asset and the liability), pre-claims liabilities, and claims liabilities. Concerning future installment premiums, the Board decided to use an interest rate that reflects the guidance in APB Opinion No. 21, *Interest on Receivables and Payables,* and the credit standing of the policyholder (the issuer of the financial obligation) and to lock-in the interest rate at the inception of the insurance contract. For the pre-claims liabilities, the Board decided to use an interest rate that reflects the guidance in Opinion 21 and the financial guarantee insurance entity's credit standing and to lock-in the interest rate when an insured financial obligation is first placed on the internal surveillance list (also referred to as a watch list). For claims liabilities, the Board decided to use an interest rate that reflects the guidance in Opinion 21 and the financial guarantee insurance entity's credit standing and to lock-in a new interest rate when a default occurs.

Objective of Meeting:

The objective of the meeting was for the Board to determine what interest rate to use and whether that interest rate should be locked-in at inception or updated in discounting (1) installment premiums (the asset and the liability), (2) pre-claims liabilities, and (3) claims liabilities. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Mr. Trench began the discussion by stating that the Board will discuss the appropriate interest rate to use and whether that interest rate should be locked-in at inception or updated in discounting installment premiums (the asset and the liability), pre-claims liabilities, and claims liabilities with regard to financial guarantee insurance contracts. This topic was previously discussed at the November 29, 2006 Board meeting, but because the Board received the requested information on the topic the morning of that meeting, the Board decided to delay making a decision and treated the discussion as educational.

Expected Present Value of Installment Premiums

2. At the September 13, 2006 Board meeting, Mr. Trench stated that the Board had decided that for financial guarantee insurance contracts where the premium is received on an installment basis, a premium receivable and an unearned revenue liability should be recognized and measured at the expected present value. The following are the alternatives for selecting an interest rate:

   a. **View A**—Published interest rates (such as a risk-free interest rate or LIBOR)

   b. **View B**—Average rate of return on the investment portfolio

   c. **View C**—Use the criteria set forth in Opinion 21 to determine the interest rate.

   The following are the options with regard to updating the interest rate:

   (1) **Option 1**—Lock-in at inception of the insurance contract

   (2) **Option 2**—Reset each reporting period.

   During the November 29, 2006 Board meeting, all Board members agreed that the asset and the liability should be equal. For clarification, the staff believes the asset should be measured first using an interest rate reflecting the counterparty's credit and the liability should equal that amount.

3. Mr. Trott clarified that the liability referred to by Mr. Trench was the unearned premium liability. The Board decided to use an interest rate that reflects the guidance in Opinion 21 and the credit standing of the policyholder (View C), and to lock-in the interest rate at the inception of the insurance contract (Option 1) (all Board members agreed).

Pre-claims Liabilities

4. Mr. Trench stated that the Board previously decided that for claims recognition an expected loss approach should be used (which would include credit deterioration and the time value of money). The following are the alternatives for selecting an interest rate:

   a. **View A**—Published interest rates (such as a risk-free interest rate or LIBOR)

   b. **View B**—Average rate of return on the investment portfolio

   c. **View C**—Use the criteria set forth in Opinion 21.

The following are the options with regard to updating the interest rate:

(1) **Option 1**—Lock-in when the insured obligation is included on the watch list

(2) **Option 2**—Reset each reporting period.

5. Mr. Linsmeier asked which entity's credit risk is reflected in the discount rate in View C (paragraph 4). Mr. Trench responded that the financial guarantee insurance company's credit risk is reflected in the discount rate. Mr. Trott stated that the pre-claims liability should be the current market premium that would be charged for the particular risk once an insured financial obligation is included on the watch list.

6. Mr. Linsmeier noted that the expected loss should reflect the credit risk of the insured and should change as the credit risk of the insured varies. Conceptually, the credit risk of the insured has implications for the credit risk of the financial guarantee insurance company. However, the effect of the insured's credit risk on the insurer's credit risk will usually be small enough that it seems most practical to lock-in the interest rate once a financial obligation is placed on the watch list.

7. Ms. Seidman stated that she supports View C and Option 1 (paragraph 4), as the Board's previous decisions lie somewhere between a historical cost model and an expected value model. Thus, when a significant event occurs (such as a financial obligation being placed on a watch list), it seems reasonable to update the estimate of how much the insurer must pay out. She noted that conceptually, it could be argued that the estimate should be updated as the insured obligation changes placement within the watch list. However, it would not be cost-beneficial to do so. The Board decided to use an interest rate that reflects the guidance in Opinion 21 and the financial guarantee insurance entity's credit standing (View C) and to lock-in the interest rate when an insured financial obligation is first placed on the watch list (Option 1) (all Board members agreed).

Claims Liabilities

8. Mr. Trench stated that claims (or case) liabilities arise once a default has occurred. The following are the alternatives for selecting an interest rate:

a. **View A**—Published interest rates (such as a risk-free interest rate or LIBOR)

b. **View B**—Average rate of return on the investment portfolio

c. **View C**—Use the criteria set forth in Opinion 21.

The following are the potential approaches for updating the interest rate:

(1) **Approach A**—Use the same interest rate used to discount the pre-claims liability

(2) **Approach B**—Lock-in a new interest rate once a default has occurred

(3) **Approach C**—Change the interest rate each reporting period.

9. Mr. Trott stated that he favors View C (paragraph 8) from the perspective of the credit standing of the financial guarantee insurance company. Mr. Linsmeier stated that when there is a default, the insurer takes responsibility for the remaining obligation. If there is a possibility that the insured will pay back part of the obligation, that should be accounted for as an asset. Mr. Smith stated that the expected loss should be calculated net of recoveries. Ms. Seidman clarified that the debt obligation would reflect the debt service. Mr. Linsmeier responded affirmatively to Mr. Smith, and noted that as long as those assumptions are true, he supports using a discount rate from the perspective of the insurer. He noted that the default could potentially be recorded net of collections, and that the Board does not have to address that issue if the potential subrogation rights are recognized as an asset. The Board decided to adopt View C; that is, use an interest rate that reflects the guidance in Opinion 21 and the financial guarantee insurance entity's credit standing (all Board members agreed).

10. Mr. Trott stated that he supports Approach B because he thinks that the insurer's assumption of the liability once default occurs qualifies as a new, significant event. The Board decided to lock-in a new interest rate when a default occurs (Approach B) (all Board members agreed).

11. Mr. Trott stated that in applying Opinion 21, one must always identify the entity's credit risk under evaluation. Mr. Young noted that the guidance in Opinion 21 did

not appear to envision that an entity could use its own credit risk in the determination of an interest rate. Mr. Smith stated that the distinction must be clearly stated in the proposed FASB Interpretation on financial guarantee insurance contracts.

12. Mr. Herz asked for an indication of the next step in the project. Mr. Smith responded that the staff will draft the Exposure Draft of the proposed Interpretation and submit it to reviewers within the next week.

Follow-up Items:

The staff will draft the Exposure Draft of the proposed Interpretation for the Board's review and expose the document in the first quarter of 2007.

General Announcements:

None.