MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Staniszewski (ext. 445)		
Subject:	Minutes of the November 21, 2007 Board Meeting: Financial Guarantee Insurance—Redeliberations	**Date:**	January 3, 2008
cc:	FASB: Golden, Bielstein, MacDonald, Leisenring, Cosper, Cropsey, Chesney, Staniszewski, Stoklosa, Posta, Lott, Gabriele, Allen, Glotzer, Gabriele, Mayer, Sutay, Klimek, Chookaszian, Project Team, FASB Intranet		

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—Redeliberations
Basis for Discussion:	Board memorandum dated November 6, 2007
Length of Discussion:	10:30 a.m. to 12:00 p.m.
Attendance:	
Board members present:	Herz, Batavick, Linsmeier, Seidman, Smith, and Young
Board members absent	Crooch
Staff in charge of topic:	Trench
Other staff at Board table:	Golden, Cropsey, and Staniszewski
Outside participants:	None

Summary of Decisions Reached:

The Board began redeliberations of the Exposure Draft, *Accounting for Financial Guarantee Insurance Contracts*, which included the scope, claim liability recognition and measurement, and premium revenue recognition. The Board decided that:

1. The application of the final Statement should be limited to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises.
2. An insurance enterprise should recognize a claim liability on a financial guarantee insurance contract when the insurance enterprise expects that a claim loss will exceed the unearned premium revenue (liability) for that contract based on expected cash flows. The discount rate used to measure the claim liability should be based on the risk-free market rate and updated each quarter (with additional disclosures to be addressed at a future meeting).
3. Premium revenue recognition guidance will be provided and the premium revenue recognition approach will be based on applying a fixed percentage of premium to the amount of exposure outstanding at each reporting date (referred to as the level-yield approach). The term of financial guarantee insurance contracts should be the contractual term unless the insured financial obligation is subject to prepayments and those prepayments are probable and reasonably estimated (however, the Board requested that the staff draft and present at a future meeting a principle that prescribes when prepayment data are used to shorten the term of the contract). The measurement of the outstanding exposure should be based on the remaining principal payments (in the case of an insured financial obligation that does not pay interest [such as a zero-coupon bond], the outstanding exposure is the accreted principal amount).

Objective of Meeting:

The objective of the meeting was for the Board to begin redeliberations of the Exposure Draft. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Issue 1—Expansion of the Scope

1. **Staff Recommendation**: The staff recommended that the scope of the proposed Statement should apply to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises and should not be expanded to other types of financial guarantee contracts.
2. **Board Vote**: The Board unanimously voted that the application of the final Statement should be limited to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises.
3. **Board Comments**: Mr. Herz agreed that maintaining a narrow scope reduces comparability and increases complexity across the financial reporting system. However, he stated that the main issue being addressed in this project was raised by the SEC and that he would not object to a narrow scope to address that issue. Mr. Batavick said that he would not object to keeping the scope narrow and that there does not appear to be a high level of diversity in practice related to other types of insurance contracts issued by insurance enterprises, such as mortgage guaranty insurance contracts and credit insurance contracts.
4. Mr. Smith pointed out that there is no diversity among small groups of insurance contracts, but that there is extreme diversity across similar instruments or economic transactions within the financial markets. Ms. Seidman stated that the diversity across similar instruments can be addressed in either the insurance contracts project or the financial instruments project. Ms. Seidman stated that it does not seem appropriate to address that diversity within the financial guarantee insurance project when these broader projects exist.

Issue 2—Recognition of Claim Liability

5. **Staff Recommendation**: The staff recommended that an insurance enterprise should recognize a claim liability on a financial guarantee insurance contract when the insurance enterprise expects that a claim loss will exceed the unearned premium revenue (liability) for that contract based on expected cash flows.

6. **Board Vote**: The Board voted that an insurance enterprise should recognize a claim liability on a financial guarantee insurance contract when the insurance enterprise expects that a claim loss will exceed the unearned premium revenue (liability) for that contract based on expected cash flows

7. **Board Comments**: Mr. Smith asked whether the respondents to the Exposure Draft who supported reporting the claim liability separate from the unearned premium revenue (liability) were viewing the unearned premium as deferred revenue. Mr. Trench stated that the staff's focus has been from a balance sheet perspective (that is, getting the balance sheet correct), while many respondents were focused on the income statement effects. That is, the staff views the unearned premium as a stand-ready obligation on Day 1. Mr. Golden stated that in many instances he would not view deferred revenue as meeting the definition of a liability. However, within this project, he believes that the deferred revenue does represent the obligation created by the contract. Further, Mr. Golden believes that the recognition of the claim liability has been accelerated because claim liability recognition has been linked to the fair value of the stand-ready obligation and that linkage should be clarified in the final Statement. Ms. Seidman pointed out that clarification also should be provided that the assessment of whether a claim liability exists should be performed on a contract-by-contract basis and not a portfolio basis.

8. Mr. Linsmeier questioned whether or not the label of the stand-ready obligation would change once the expected claim loss exceeds the unearned premium revenue liability. Ms. Seidman stated that she did not feel it was appropriate to provide guidance as to the label that should be used. Mr.

Trench pointed out that the separation of the stand-ready obligation between the unearned premium revenue and the claim liability preserves the "insurance" presentation that users are comfortable with analyzing. Mr. Linsmeier commented that *that* information would be lost in terms of the amount of unearned premium revenue that would be recognized if the unearned premium liability was changed to a claim liability (at the point when the expected cash flows exceed the unearned premium revenue (liability). Mr. Trench explained that when a claim liability is recognized, the unearned premium revenue would continue to be recognized based on the premium revenue recognition approach. Upon a default, the unearned premium revenue (liability) is replaced by a claim liability (the reasoning is that any unearned premium revenue would be used to offset the claim liability).

9. Mr. Young noted that it appears that this issue may not be material because the unearned premium revenue (liability) is not going to be enough of a buffer to delay the expected loss due to the nature of the pricing of these insurance contracts (determined in basis points). Mr. Golden stated that Mr. Young was correct and that analyzing the insurance contracts on an individual basis would not be sufficient to delay the claim recognition. However, he noted that the guidance would need to illustrate that the analysis should not be on a portfolio basis. An analysis performed on a portfolio basis would lead to potential delays in the recognition of the expected claim liability.

Issue 3—Discount Rate Used to Measure Claim Liability

10. **Staff Recommendation:** The staff recommended that the claim liability be measured based on the present value of the expected cash flows discounted using the risk-adjusted rate (adjusted for the credit standing of the insurance enterprise). The staff also recommended that the discount rate used to measure the claim liability be set at initial recognition of the claim liability and updated only when a default has occurred.

11. **Board Vote:** The Board voted that the discount rate used to measure the claim liability should be based on the market risk-free rate and updated each quarter (with additional disclosures to be addressed at a future meeting).

12. **Board Comments:** Mr. Trench stated that the following questions are related to this issue: (a) which discount rate should be used, (b) should the discount rate be locked in and, if so, when, and (c) should the discount rate be updated upon a specific event?

13. Mr. Batavick supported using the risk-adjusted rate because it provides more useful information. Mr. Batavick also stated that the discount rate should be locked in because it would be difficult to try to define all of the different events that could trigger an update of the discount rate.

14. Ms. Seidman supported the risk-adjusted rate and locking it in. She commented that the cost-benefit concerns and practicability for purposes of this narrow project support her decision. Further, requiring the claim liability to be updated each period seems to be contrary to the guidance that the Board requires for an entity to report its own debt.

15. Mr. Herz supported using a risk-free market rate and adjusting that rate every period. Mr. Herz noted that this approach would provide a comparable rate across all entities. He also noted that updating the risk-free market rate would allow for changes in the specified market rate and in the expected cash flows to be reflected in the measurement of the claim liability.

16. Mr. Young stated that the insured financial obligation will always be a weaker credit and he therefore believes that the insurance enterprise will always accelerate a claim payment. Based on this assumption, he questioned the relevancy of the discount rate. Mr. Young stated that he would support a risk-free market rate because it would provide information to users (such as how long until pay-off of the claim liability) and improve transparency. He believes that the pricing of a financial guarantee insurance contract is driven off of the balance sheet capacity of the insurance enterprise and not off of claims. Mr. Young also commented that he would support not discounting the claim liability because the claim would always be paid off once it is recognized.

17. Mr. Smith supported the use of the risk-free market rate, updated each period, and pointed out that this would provide better information to users.

18. Mr. Golden commented that the alternatives being discussed are: (a) use the risk-adjusted rate and lock it in or (b) use the market risk-free rate and update it each period. Messrs. Herz, Smith, Young, and Linsmeier supported using the risk-free market rate and updating that rate each period. Ms. Seidman and Messrs. Batavick and Crooch supported using the risk-adjusted rate and locking it in at the point when the claim liability is recognized.

Issue 4—Scope of Premium Revenue Recognition

19. **Staff Recommendation:** The staff recommended that premium revenue recognition guidance should be provided for financial guarantee insurance contracts within the scope of this project.

20. **Board Vote:** The Board unanimously voted to provide guidance on premium revenue recognition for financial guarantee insurance contracts.

21. **Board Comments:** Mr. Smith noted that the issue was originally brought to the Board to address claim liability recognition. The Board expanded the scope to include guidance for more than claim liability recognition. If the Board decides not to address premium revenue recognition, it is probable that the SEC may provide the guidance.

Issue 5—Proposed Premium Revenue Recognition Approach

22. **Staff Recommendation:** The staff did not have a consensus recommendation for the Board. However, the staff believes that a level-yield approach (applied by determining a level premium amount [in basis points] that is applied to the principal outstanding) or a straight-line approach to premium revenue recognition would be considered an improvement when compared to the current premium revenue recognition used in practice.

23. **Board Vote:** The Board voted that the premium revenue recognition approach should be based on applying a fixed percentage of premium to the amount of exposure outstanding at each reporting date (referred to as the level-yield approach).

24. **Board Comments:** Mr. Linsmeier stated that the level-yield approach is a contract-by-contract accounting approach. He pointed out that the notion of an entity renting its whole balance sheet is not a contract-by-contract analysis and, conceptually, a straight-line approach is more appropriate.

25. Ms. Seidman stated that she does not agree with the notion of renting the balance sheet. However, she pointed out that if one were to except that notion, then (if the unit of account remains at the contract level consistent with the claim liability recognition approach) the level-yield approach is appropriate because it depicts the yield for an individual contract for a given period. She also stated that there is an insurance element associated with financial guarantee insurance contracts and not just the service element of renting out the balance sheet to an entity with a lower credit rating. Mr. Linsmeier stated that he believes that the insurance element is being accounted for in the claim liability and not in the premium revenue recognition. Ms. Seidman pointed out that the insurance entity is being paid in part (in the form of a premium) for the insurance element.

Issue 6—Contractual Term versus Expected Term

26. **Staff Recommendation:** The staff recommended that the term of the financial guarantee insurance contract should be adjusted for prepayments when those prepayments are probable and reasonably estimable.

27. **Board Vote:** The Board voted that the term of the financial guarantee insurance contracts should be the contractual term unless the insured financial obligation is subject to prepayments and those prepayments are probable and reasonably estimated.

28. **Board Comments:** Ms. Seidman commented that the term should be based on the expected cash flows, which would be the contractual term unless prepayments can be reasonably estimated. Ms. Seidman stated that a principle should be developed that requires the use of the expected cash flows if prepayments are expected to occur **and** the timing and amount can be reasonably estimated (similar to the guidance in FASB Statement No. 91,

Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases). Ms. Seidman also stated that updating the expected term for changes in prepayment assumptions should occur only when those changes are significant.

29. Mr. Young commented that he believes that information regarding the expected term is helpful in understanding the pricing related to financial guarantee insurance contracts. Specifically, the expected term communicates whether the pricing is appropriate and provides insight into the pricing assumptions. Mr. Young stated that it would be more transparent to not allow a threshold to determine whether or not the expected term can be reasonably estimated.

30. Mr. Golden stated that the Board appears to agree with Ms. Seidman's approach to using the expected term. Mr. Golden commented that the staff would (a) develop draft language for a principle for when the expected term can be used, (b) provide an analysis regarding changes in prepayment assumptions, and (c) provide disclosures for the Board at a future meeting.

Issue 7—Insured Payments

31. **Staff Recommendation:** The staff recommends that the insured payments (exposure outstanding) should be measured based on the remaining principal payments.

32. **Board Vote:** The Board voted that the measurement of the insured payments (exposure outstanding) should be based on the remaining principal payments.

33. **Board Comments:** Mr. Smith asked how an insured zero-coupon bond would be accounted for under the proposed guidance. Mr. Herz stated that it would be based on the accreted amount (outstanding).

34. Mr. Linsmeier stated that the Board should be consistent with the notion of renting the balance sheet and use principal only. Mr. Golden stated that if the Board decides that exposure should be defined as principal only then the Board would have to answer the question of what is the appropriate treatment

when interest is not paid out (for example, a zero-coupon bond). Mr. Trench pointed out that many respondents used the argument that the proposed premium revenue recognition approach does not work because it does not reflect the passage of time for an insured zero-coupon bond. He further noted that this assertion could lead one to believe that a significant number of zero-coupon bonds are insured when in fact the financial guarantee insurance enterprises do not generally insure zero-coupon bonds.

35. Mr. Young stated that it would be appropriate to use principal only, unless it is a zero-coupon bond, in which case it would be based on the accreted amount. All other Board members agreed with Mr. Young's statement.

Follow-up Items:

36. None.

General Announcements:

37. None.