

MINUTES



**To:** Board Members  
**From:** Benson (ext. 446)  
**Subject:** Minutes of the August 9, 2006 Board Meeting: Financial Guarantee Insurance  
**Date:** August 14, 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

Basis for Discussion: Board Memorandums dated July 26, 2006

Length of Discussion: 9:00 a.m. to 9:40 a.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Linsmeier, Seidman, Trott, and Young
Board members absent:	None
Staff in charge of topic:	Trench
Other staff at Board table:	Golden, Cropsey, Benson
Participation by phone:	L. Smith
Outside participants:	Leisenring

### **Summary of Decisions Reached:**

The Board decided to explore further a claims recognition approach for financial guarantee insurance contracts that would value the stand-ready loss liability using only certain transaction-specific inputs, such as the credit rating of the underlying insured security and the time value of money. The Board noted that consideration of revenue recognition approaches in conjunction with the claims recognition approach is necessary before concluding on the appropriate claims recognition approach.

### **Objective of Meeting:**

The objective of the meeting was for the Board to determine a claims recognition approach for financial guarantee insurance contracts. A financial guarantee insurance contract guarantees the holder of a financial obligation the full and timely payment of principal and interest when due and is typically issued in conjunction with municipal bond offerings and certain structured finance transactions. The objective of the meeting was met.

### **Matters Discussed and Decisions Reached:**

1. Mr. Trench began the discussion by stating that the staff will request that the Board select a claims recognition approach for financial guarantee insurance contracts. The staff grouped eight potential claims recognition models into three approaches for the Board's consideration. Each of the three approaches would establish a claim liability for incurred losses. Approach A is a traditional incurred loss model, and Approach B is a fair value model. Approach C is an expected loss model and is a compromise between the first two approaches. Approaches A and C differ in the timing of recognizing a liability for expected claim losses. The majority of the staff recommended Approach C. Using information from the financial guarantor's surveillance activities provides users with management's views of any credit deterioration and potential losses. Users already request information concerning credit deterioration from the financial guarantors each reporting period, and Approach C would provide similar information in the financial statements. Finally, the costs to the financial guarantors would be minimal since they already track deteriorating credits. One staff member believes that Approach B is appropriate, noting that financial guarantee

- insurance appears to be similar to the derivative contracts also written by these financial guarantors.
2. Mr. Trott asserted that under Approach A, the unearned premium comprises the pre-claim liability and a claim liability exists upon the occurrence of a claim. Approaches B and C focus primarily on the treatment of a pre-claim liability. In Approaches B and C, the claim liability still exists. Mr. Trench affirmed Mr. Trott's assertions and he noted that all three approaches value the claim liability equally. Mr. Trott stated that most of the description of Approaches B and C focuses on adjusting the stand-ready obligation, that is, the pre-claim liability. Mr. Trench agreed.
  3. Mr. Leisenring questioned whether in Approach A, if the insuree files for bankruptcy but no payment has become due and thus no default has occurred, would no liability be recorded by the insurer until payment became due? Mr. Trench replied that the event causing a liability would be default notice as Approach A is described in the memorandum. Mr. Smith noted that in most instances in which a declaration of bankruptcy occurs, the principal becomes due immediately.
  4. Ms. Seidman asked for clarification regarding Mr. Trench's agreement that the claim liability is measured similarly under all three approaches. She noted that under Approach B, the claim liability for incurred losses would be recognized at fair value, which she believed would be dissimilar treatment to that of the other two approaches. Mr. Trench responded that there is not a large difference between the treatment of the claim liability in Approach B and the claim liability under Approach A. In Approach A, the principal and interest payments are scheduled ahead of time and there is little risk of deviation from the payment schedule. Therefore, there would be little difference between the fair value of the claim liability and the traditionally discounted cash flows for recording the claim liability under Approach A. Mr. Trott responded that the difference between the fair value of the claim liability and the discounted cash flows would become important if the discount rate used in valuing the claim liability was subsequently adjusted.
  5. Mr. Trott asserted that the claim recognition approach selected by the Board must be integrated with the revenue recognition approach. The integration of the two approaches must occur before the Board may decide which claim recognition approach is best. Mr. Linsmeier agreed with Mr. Trott. Mr. Linsmeier stated that

- if the Board agrees on Approach C, the premium is measuring a projected cost of the stand-ready obligation in a pre-claim circumstance. In order to support Approach C, Mr. Linsmeier noted that he must understand how the revenue is recognized and the expense is accrued in determining the net recognition of the pre-claim liability.
6. Ms. Seidman stated that she believes the present discussion of the three approaches will help the staff understand the sort of revenue recognition approaches to bring to the Board in the future. Mr. Trench noted that the staff is hoping to garner a general consensus from the Board so that the staff may proceed with the next steps of the project.
  7. Mr. Batavick noted that he is not in favor of Approach A, but he would like the staff to develop a revenue recognition model that aligns with Approaches B and C. Mr. Trench stated that the staff would like to determine if it should focus on a fair value model that incorporates all cash flows or an insurance model aligned with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. Mr. Linsmeier stated that revenue recognition is not a crucial determinant in choosing Approach B because of the net cash flows in that approach, whereas revenue recognition is an important determinant in choosing Approaches A and C.
  8. Mr. Herz noted that if the fair value option project continues as proposed, insurance will be included within the scope of the project and people may have the option to use fair value measurement for insurance contracts. Thus, if the Board decides either Approaches A or C is most appropriate, financial guarantee insurers may still have an option to implement fair value in the future. Mr. Trott stated that financial guarantee insurance is clearly a financial instrument that does share some of the complications of Approaches B and C.
  9. Mr. Herz requested that the Board give the staff its preference. Mr. Trott stated that Approach A does not solve the financial guarantee insurance accounting issue because users have indicated that such an approach does not provide useful information. He noted that Approaches B and C focus on accounting for liability exposure prior to an incurred claim. Mr. Trott emphasized the importance of clarifying the accounting treatment for when a claim liability is incurred, including the measurement attribute for that incurred claim liability. He also noted that adjusting the pre-claim liability (unearned premium) and the presentation of that adjustment (whether as a separate liability or as part of the

- unearned premium) is a display issue. He believes Approach B is the most appropriate approach because it seems the financial guarantee insurance industry is in the business of fair value. The insurers price the uncertainty of fulfilling the debt service cost. Mr. Trott noted that opponents of Approach B argue that remeasurement of the value of each individual policy would be arduous and costly. However, unless the insurers have information indicating a change in risk, a large, difficult fair value adjustment would not be necessary. Mr. Trott's first preference is Approach B, followed by Approach C. He stated that Approach C mitigates the use of the words *fair value* and some of the perceived level of monitoring, but it is difficult to describe the measurement attribute for the adjusted unearned premium using Approach C.
10. Mr. Golden requested clarification from Mr. Trott regarding the phrase, "Changes in the pre-claim liability represent unearned premium." Mr. Golden asked Mr. Trott if he believes the unearned premium eventually becomes premium revenue. Mr. Trott answered affirmatively. Mr. Golden asked Mr. Trott a hypothetical question regarding an insurance premium of \$25 and a pre-claim liability of \$75. Mr. Golden inquired whether Mr. Trott believed the insurer would have \$75 revenue overtime in such a situation. Mr. Trott responded negatively and explained that he views such a question as an indication that revenue recognition models must be presented along with claims recognition approaches. He explained that the unearned premium is based on the initial pricing of the contract. Mr. Golden agreed. Mr. Trott stated that whether an insurance contract gives rise to a single premium or an annual premium, the risk is same for the entire life of the debt instrument. Thus, it is necessary to clarify the amount of revenue received from the insurance contract. He noted that, in his view, the adjustment off of unearned premium (aside from the earning of the initial transaction) should be reflected as an adjustment of loss. Mr. Trott referenced Mr. Golden's hypothetical situation, extending the situation to the end of year 6 in which (a) the risk remains substantively unaltered, (b) there is an unearned premium of \$80, and (c) under Approaches B or C it is determined that the unearned premium ought to be \$120. He stated that if there is an appropriate recognition of revenue, the \$40 would be recorded as an expense. However, the \$80 premium remeasured to \$120 premium would not change the future revenue recognition stream. Mr. Golden stated he somewhat agrees with Mr. Trott's hypothetical situation, but he believes unearned premium revenue becomes

premium revenue. He noted the importance of clearly defining the term *pre-claim liability* and not confusing that term with *unearned premium*. Mr. Trott stated that the confusion of such terms emphasizes that claim recognition and revenue recognition must be addressed simultaneously. Mr. Herz noted that the Board must address the issue of disaggregation of changes in fair value and determine the components that should be shown in such an insurance transaction. Mr. Golden asked for clarification regarding whether Mr. Herz and Mr. Trott were referencing revenue display or revenue recognition. Mr. Trott stated that he was discussing both display and revenue recognition. Mr. Herz clarified that in using a fair value model such as Approach B, he was referencing revenue display. However, in using Approaches A or C, his comments referenced revenue recognition.

11. Mr. Linsmeier stated that with Approaches A and C, it is possible to report the change in obligation as a net amount. As such, an insurer begins the first period with a stand-ready obligation, and once an event occurs that results in a claim, the insurer switches to the claim model. Mr. Linsmeier expressed concern regarding Approaches A and C because these approaches separate revenue from the stand-ready obligation related to the potential expense. He referenced the Board memorandum which notes that Approach C can be viewed in conjunction with the unearned premium as part of the stand-ready obligation that changes over time. The cash at date zero is the anticipated cost of the stand-ready obligation given the risks of the contract that may change overtime as certain credit circumstances change. Mr. Linsmeier noted that he may be comfortable with net presentation in the end, but he would like to know what the net consequence is in net recognition of the changes.
12. Mr. Leisenring stated that he does not agree with Approach A. In terms of Approaches B and C, he referenced Mr. Trott's hypothetical situation. After determining that a liability of \$120 should be recognized, Mr. Leisenring asked if \$80 is revenue and \$120 is expensed. He questioned how to disaggregate fair value changes (presentation). He also inquired as to the timing of when \$80 would be recognized. Mr. Linsmeier noted that he can see the arguments for and against both Approaches B and C. Though Approach B captures the economics of the industry better, he asserted that such an approach is a piecemeal move to fair value measurement in the entire insurance industry. He questioned whether the Board should introduce fair value measurement to the

entire insurance industry through financial guarantee insurance contracts before analyzing all insurance contracts in a larger context. He stated that if the Board adopts Approach C, there will be noncomparability in like-economic guarantee circumstances within the financial guarantee insurance industry. The financial guarantee insurance industry uses derivatives that are accounted for using fair values, and Approach C will implement alternative accounting for contracts with similar sorts of economics related to guarantees. Ms. Seidman noted that the only way to reduce the lack of comparability between economically-similar transactions is to remove the scope exception from FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. She noted that the Board acknowledged the similarities between derivative and insurance accounting during deliberations of Statement 133. However, at that time, the Board chose not to redeliberate the insurance accounting model.

13. Mr. Batavick stated that the staff has worked with industry experts and users to determine an appropriate claims recognition approach. He noted that when the Board began the project, the Board's goals included choosing a conceptually-sound model, properly displaying the economics of financial guarantee insurance contracts, and improving financial reporting. Mr. Batavick stated that he believes Approach C is most appropriate with regard to cost-benefit considerations. The costs and benefits associated with developing a new accounting approach within the financial guarantee insurance industry must be weighed against adopting an accounting policy that aligns somewhat with the current insurance accounting approach. Approach C is most appropriate because it captures the economics of the expected losses. Mr. Batavick ruled out Approach A and noted Approach B would be too costly because it would introduce a completely new model for this type of insurance. Concerning the argument that significant judgment is necessary to develop the expected amounts in Approach C, Mr. Batavick stated that the years of experience that companies in the industry possess make the judgment required less risky. In addition, the industry has relatively few companies and, thus, comparability is not a large issue. Mr. Batavick added that he agrees that the Board must discuss revenue recognition models in addition to claim recognition approaches before finalizing its decision.
14. Mr. Crooch stated that he will not support Approach A. He believes Approach B is the best answer because that approach best embodies the economics of the insurance transactions. In addition, he believes that the insurance companies

- will be able to implement fair value. Most importantly, the liability should be measured at the exit price (fair value). Mr. Crooch noted that he would not object to Approach C.
15. Mr. Young supports Approach C. He stated that he does not understand how the fair value of the pre-claim liability would be measured under Approach B. The probability of loss in a financial guarantee insurance contract is extremely low, so the value of the pre-claim liability would be almost ignored until an event causes sudden deterioration on the contract. As such, fair value measurement would not provide enough information to investors. Approach C gives far more useful information. If an active market existed for such contracts, then Approach B would be more conceptually sound. However, since no such market exists, Approach C is more practical. Mr. Trott asked Mr. Young whether he believes the industry cannot price its product over time. Mr. Young responded that the pricing of contracts is not based on losses, but rather on renting the balance sheet. Mr. Batavick noted that industry experts previously explained that financial guarantees are priced by competitiveness in the marketplace. Mr. Young stated that the pricing of insurance contracts is dependent on the capital cost of the ability to loan the balance sheet in addition to the claim expectation. The capital cost far exceeds the claim cost in many cases.
16. Ms. Seidman stated that the Board initially regarded the financial guarantee insurance issue as a narrow scope project to resolve diversity in practice for an industry with very few players. Accounting approaches for the industry can be divided into two categories: fair value and insurance accounting. According to staff research, analysts view financial guarantee insurers as insurance companies, not derivatives dealers. In addition, analysts expressed concern over fair value accounting for the credit default swaps. Analysts request disaggregated, insurance-like information from the financial guarantors. The Board may view the project as a conceptual accounting issue or a narrow scope project to resolve diversity in the industry. Ms. Seidman asserted that she prefers the narrow scope approach given that there are other efforts underway to address conceptual issues in insurance accounting. Ms. Seidman stated that she supports Approach C because it is an improvement to financial reporting and is responsive to the type of information that the analysts indicate should be disclosed by the industry.

17. Mr. Herz stated that he supports Approach C for many of the reasons Mr. Batavick, Ms. Seidman, and Mr. Young described. Generally, he prefers fair value accounting but realizes the importance of an active marketplace for fair value measurement. He noted that the input from users was helpful in reaching his decision. He stated that significant debate concerning measurement and recognition in the conceptual framework is necessary before he will support level 3-type fair value measurement approaches in general.
18. Mr. Leisenring asked whether the industry is clearly defined as to what companies apply which accounting method. In addition, he questioned the difference between financial guarantee insurance contracts and contracts entered into by banks. Mr. Trench responded that the staff currently relies on the distinction between banks and insurance enterprises as described in Statement 60.
19. Mr. Herz noted that four Board members prefer Approach C, two Board members prefer B, and Mr. Linsmeier is undecided until revenue recognition is discussed. Mr. Linsmeier stated that he would be more comfortable with Approach C if it were clear how the accounting in that approach is consistent with the conceptual framework. If the unearned premium is treated as unearned revenue and recognized over time, a partial settlement of the stand-ready obligation will be recognized. The stand-ready obligation would be netted against the accrued expense representing the change in the stand-ready obligation. Such a revenue recognition expense approach is disturbing because if the premium turns to revenue without consideration of how it nets with the expense, the Board will promote an outcome inconsistent with the conceptual framework.
20. Ms. Seidman noted that FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, indicates the typical accounting treatment for reducing the stand-ready obligation as risk is released. The important issue the staff must address when proposing a revenue recognition approach to the Board is when risk is released for financial guarantee insurance instruments. Mr. Herz noted that the staff should proceed with the Board's tentative preference of Approach C, with the understanding that the Board is interested in analyzing claim recognition approaches concurrently with revenue recognition approaches.

**Follow-up Items:**

None.

**General Announcements:**

None.