

MINUTES



**To:** Board Members  
**From:** Benson (ext. 446)  
**Subject:** Minutes of the September 13, 2006  
Board Meeting: Financial Guarantee Insurance **Date:** September 20, 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 Memorandum dated August 30, 2006

Length of Discussion: 8:00 a.m. to 9:00 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:	L. Smith, Cropsey, Benson
Outside participants:	Leisenring

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

The Board considered approaches to accounting by insurers for (1) premium revenue from financial guarantee insurance contracts, (2) installment premiums for those financial guarantee insurance contracts that have installment premiums, and (3) related contract acquisition costs. For premium revenue recognition, the Board decided on an approach that is based on release from risk (exposure) as measured by debt service (principal and interest) to be paid over the contractual duration of each contract. This approach would recognize premium revenues based on the ratio of debt service (principal and interest) paid each period to total contractual debt service (total principal and interest to be paid)—that is, insurance premium received or accrued is deferred as unearned revenue (premium) and recognized as revenue as the debt service payments are made by the issuer to investors. If an insured security has no interest or principal payments until maturity, the full contract premium will be recognized as revenue at the contract maturity date. The Board requested that the exposure document include a question related to when consideration of expected contract life (as opposed to the full contractual life) would be appropriate and that respondents provide examples of such arrangements.

The Board reaffirmed its tentative decision made at the August 9, 2006 Board Meeting that would value a stand-ready loss liability for expected losses using transaction-specific inputs concerning the credit rating of the underlying insured security and the time value of money. The stand-ready liability would be in addition to the unearned premium and claims liabilities.

The Board also decided that the expected value of installment premiums on financial guarantee insurance contracts should be recognized as a receivable at the inception of the contract. The same amount would be recognized as an unearned revenue liability. The discount on the receivable would be accreted over the life of the contract through investment income.

Finally, the Board decided that contract acquisition costs should be defined, deferred, and amortized in accordance with the relevant guidance in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*.

The Board directed the staff to draft an exposure document for Board consideration.

### **Objective of Meeting:**

The objectives of the meeting were for the Board to determine: (1) a premium revenue recognition model for single premium (upfront) financial guarantee insurance contracts, (2) how to account for installment premiums, and (3) the accounting for financial guarantee insurance contract acquisition costs. The objectives of the meeting were met.

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

1. Mr. Trench began the discussion by stating that at the August 9, 2006 Board meeting, the Board tentatively decided on a claims recognition approach for financial guarantee insurance contracts. The claims recognition approach is described as modified long-duration accounting for the pre-claim liability based on expected claim losses developed from an insured security's credit deterioration and current interest rates. Mr. Trench requested the Board select a premium revenue recognition approach (which may include how exposure should be measured if certain approaches are selected). In addition, he asked the Board to deliberate whether or not installment premium financial guarantee insurance contracts should be recorded in the balance as well as how acquisition costs should be accounted for. Finally, he noted that if the Board reaches a decision on premium revenue recognition, installment premium accounting, and amortization deferred acquisition costs, the staff will request that the Board reaffirm its tentative decision made at the August 9, 2006 Board meeting regarding the claims recognition approach.

### **REVENUE RECOGNITION APPROACHES**

2. Mr. Trench introduced each of the claims recognition approaches. He stated that certain revenue recognition approaches (that is, Approaches B, C, C1, and D) use either the remaining exposure outstanding or the reduction in that exposure to drive revenue recognition for a period. Within the financial guarantee industry, two measures of those exposures are currently used: debt service and par value—either in terms of amounts paid during a period or amounts outstanding at period end. *Debt service* refers to the total principal and interest payments for an underlying security. *Debt service outstanding* is the remaining principal and interest to be paid at a point in time. Debt service typically is not discounted. *Par value* refers to the face amount of the underlying insured security. *Par value outstanding* at a point in time is the face amount remaining after any principal

payments. At inception, par value is equal to the debt service discounted at the coupon rate of the underlying insured security. A third measurement of exposure would use a current interest rate to discount the expected exposure to the financial guarantor. That is, remaining principal and interest payments would be discounted at a current rate each reporting period. The revenue recognition approaches are as follows:

**Approach A**

Approach A is straight-line amortization. Premium revenue is recognized as the total amount of premium received or due divided by the number of periods covered by the insurance contract. This approach is based on the belief that insurance protection is provided evenly across the insurance contract term.

**Approach B**

Approach B starts with a pro rata allocation of premium to each exposure payment. The allocated premium is then amortized over the period that the sinking fund will be outstanding. This approach attempts to correlate revenue recognition and the remaining exposure outstanding (that is, the more remaining exposure outstanding the higher the premium revenue recognition). As the remaining outstanding exposure declines, the premium revenue recognition declines. This approach incorporates the notion of the passage of time and exposure.

**Approach C**

Approach C provides a revenue recognition approach whereby an upfront premium is recognized as a fixed percentage of the par value (or debt service) outstanding. As the exposure outstanding decreases due to periodic principal (or debt service) payments, the premium revenue recognized by the financial guarantee insurance company decreases. This approach also attempts to correlate revenue recognition and the remaining exposure outstanding similar to Approach B.

**Approach C1**

Approach C1 is the same as Approach C except financial guarantee insurance contracts with bullet principal payments at maturity would not recognize revenue until maturity.

**Approach D**

Approach D uses the ratio of exposure (either debt service or principal only) paid each period to the total exposure (either total debt service or total principal only)

as a means of determining revenue recognition. When an insured security has no payments until maturity, premium revenue would be recognized at the insurance contract's maturity date. If principle and interest payments are made over the life of the security, premium revenue is recognized in proportion to those payments. This approach links revenue recognition to the reduction of exposure.

### **Approach E**

Approach E recognizes premium when received or due. Under this approach, the execution of the insurance contract (which is noncancellable) results in premium effectively being received or accruable regardless of the mode of payment. The premise behind this approach to revenue recognition is that the expectation of a claim loss is remote. Therefore, the service provided to the issuer is completed at inception and the entire premium received is recognized as revenue at that time.

Mr. Trench also noted that another aspect of exposure measurement is the determination of whether to use the contractual maturity or the expected maturity in determining the period over which to recognize revenue.

3. Mr. Linsmeier stated that he favors Approach D and the use of debt service amortization. He believes the Board is developing a model which views risk both in terms of the claims as well as the demunitation of the risk on the revenue side. Demunitation of the risk on the revenue side occurs when interest or principal payments are made; risk decreases when the guaranteed insurance does not have to be paid. Mr. Linsmeier believes that entities should use contractual life as the starting point with which to measure premium reductions. However, an entity may use expected life to measure maturity if there are accelerated payments of a homogenous pool of insurance contracts, provided the entity can measure the expected value of those contracts and ascertain the expected life (which he does not believe will be very often).
4. Mr. Young stated that he prefers Approaches C or C1. He is uncomfortable with Approach D because it implies a guarantee of debt service (which would include interest payments). Mr. Young believes a financial guarantee is a par value (that is, principal only) guarantee, not an interest payment guarantee. Regarding Approach C, he believes par value exposure is most consistent with revenue recognition models in use today. Mr. Young believes Approach C1 is most consistent with an asset/liability model for revenue recognition.

5. Mr. Trott stated that he believes there is a time element and an exposure element in a financial guarantee arrangement. He noted that his first preference is to value the guarantees at fair value. However, Mr. Trott noted that, in earlier discussions, other Board members had not voted for valuing financial guarantees at fair value. He believes the stand-ready obligation of the financial guarantee is predominantly related to the service, and that both the principal and interest are guaranteed in financial guarantee insurance contracts. Mr. Young responded by stating that it is the option of the guarantor to continue the contract in its original structure (paying the contractual principal and interest as it becomes due) or to pay off the contract immediately once default occurs. Thus, only the par value is relevant, as he believes that the interest rate on the defaulted security is the same as the interest rate the financial guarantor would receive. Mr. Trott argued that if there is a default on the contract, the insurer is liable for the entire contract guaranteed (which includes both principal and interest). Mr. Young asked Mr. Trench if the guarantor is liable for principal and interest payments upon default. Mr. Trench responded affirmatively, noting that under the financial guarantee insurance contract, the financial guarantor is responsible for paying missed principal and interest payments. As part of that contract, a financial guarantor may have the right to accelerate payments.
6. Mr. Trott stated that he favors Approach D. He believes Approaches B and C do not fully address the element of time, and there are complications in trying to make time a component of the measurement in those two approaches. With respect to contractual maturity versus expected maturity, he believes a guarantor must measure contractual maturity, because the stand-ready obligation is not settled until payments are made. Mr. Smith asked Mr. Trott if he agrees with Mr. Linsmeier's statement that a homogeneous pool may allow an entity to use experience with regard to prepayments. Mr. Trott responded that he does not agree with Mr. Linsmeier's statement, because the monitoring is done on an individual instrument-by-instrument basis. He stated he did not believe that the law of large numbers was applicable to this industry. Mr. Linsmeier responded that he does not believe generally that the law of large numbers would apply to this industry either. However, he believes if a guarantor has experience with contracts in a large pool and there is demonstrable evidence that the contractual life is not the term of the expected life, the guarantor may use expected life, provided that the expected life is measurable. Mr. Trott stated that he still has

an issue with Statement 140 as far as defining what attribute is being described and how to derecognize the liability. Ms. Seidman responded that one could estimate over time the expected maturity of the bond and “true it up” period to period. She believes the only thing being described is the revenue recognition pattern and the time over which the obligation is expected to be satisfied, assuming prepayments.

7. Ms. Seidman stated that she believes there are elements of the passage of time and the reduction of exposure that should be reflected in the revenue recognition model that the Board agrees upon. She supports a variation of Approach D, whereby if there is no ability to contractually pre-pay the instrument, an entity would recognize the revenue using a ratio of the contractual principal and interest over the remaining contractual principal and interest. In this case, the denominator is debt service. If there is a contractual ability to pre-pay and the entity can reliably estimate the expected period of the maturity of the instrument, she would consider allowing the use of the principal and interest paid over par value only if the underlying items insured are a homogeneous pool. Such a calculation would reflect time value in the denominator. She noted that the difference between her variation of Approach D and Mr. Linsmeier’s suggestion is that she believes the insured items must be homogenous, and Mr. Linsmeier spoke of the insurance being homogenous. She believes that under her variation, expected life could only be used when an entity insures, for example, a large pool of mortgages that will be significantly prepaid before the contractual maturity (which she believes would be a narrow application). Ms. Seidman suggested as a compromise that a question be included in the exposure document regarding the use of expected life versus contractual life. She noted that the use of expected life requires an entity to use par value instead of debt service, because expected life reflects time value and contractual maturity does not. Ms. Seidman further explained that the use of par value reflects expectations discounted at the inherent (coupon) rate as opposed to a current rate (which would be fair value). Mr. Young asked Ms. Seidman how she would define “reliably determined expected life.” She responded that an entity must have observable data about prepayments, which is not common but clearly exists for mortgages.
8. Mr. Trott asked Ms. Seidman how an entity could estimate reliably municipal bond prepayments. Ms. Seidman responded that she does not believe an entity

could predict prepayments of a municipal bond. Mr. Herz clarified that Ms. Seidman's comment regarding observable data about prepayments concerned debt instruments, such as senior tranches in a securitization trust backed by mortgages.

9. Mr. Crooch stated that revenue should be recognized based on the relation of risk such that revenue is adjusted as the exposure decreases. Thus, he favors Approach D and the use of debt service. He believes that contractual maturity is best, because it would be rare to have enough quality data to justify the use of expected maturity.
10. Mr. Batavick stated that he favors Approach D, as it appropriately links revenue recognition and exposure. In terms of using contractual maturity versus expected maturity, he does not believe entities should be allowed to use expected maturity. However, he would not be opposed to asking constituents for an indication of the use of expected maturity for homogenous contracts in the exposure document.
11. Mr. Herz stated that he supports Approach D and the use of debt service amortization. He believes entities should be able to use contractual maturity or expected maturity (if an entity is able to reliably estimate prepayments). However, he supports issuing an exposure document that requires entities to use contractual maturity and requests constituent feedback concerning circumstances in which expected maturity should be used.
12. Mr. Trott stated that part of the difference concerning the use of contractual maturity versus expected maturity is that there are two different contracts being described (a municipal bond versus a securitization). Ms. Seidman noted that at the Education Session, the staff recognized that half of the transactions underwritten are securitizations. Mr. Herz further clarified that, of the securitizations that are underwritten, a subset of those have prepayments. Mr. Trott noted that in asking the question for constituent feedback regarding the use of expected maturity, examples of the arrangements should be provided.
13. Mr. Smith asked if any Board members' tentative decision changed concerning the claims loss recognition model previously chosen at the August 9, 2006 Board meeting based on the Board's decision to adopt Approach D for revenue recognition. Board members collectively agreed that they were satisfied with their previous decision on a claims loss recognition approach. The claims loss recognition approach adopted at the August 9, 2006 Board meeting values a

stand-ready loss liability for expected losses using transaction-specific inputs concerning the credit rating of the underlying insured security and the time value of money.

## **ACCOUNTING FOR INSTALLMENT PREMIUMS**

14. Mr. Trench introduced the second topic, accounting for installment premiums. Financial guarantors receive premium in two basic modes, either upfront or on an installment basis. When upfront premium is received, an unearned premium liability is recorded for the portion of the premium that relates to future periods. For installment premiums, current practice in the financial guarantee industry is to amortize installment premiums to revenue over the installment period. However, no asset or liability is established representing future installment premiums. A fundamental issue in accounting for future installment premiums is whether or not the expected value of those premiums should be included on the balance sheet at inception and, if so, how. Mr. Trench noted four alternatives in accounting for installment premiums:

### **Alternative A**

Under Alternative A, only disclosure of a rollforward of the expected value of future installment premiums would be provided.

### **Alternative B**

Under Alternative B, the expected value of premium receivable and the unearned revenue liability would be recorded on the balance sheet. The discount on the premium receivable would be accreted through investment income. The discount on the unearned revenue liability would be accreted through premium revenue.

### **Alternative C**

Under Alternative C, the expected value of premium receivable and unearned revenue liability would be recorded on the balance sheet. The premium receivable discount would be accreted with the credit to unearned revenue liability.

### **Alternative D**

Under Alternative D, to the extent that the premium collected is greater than or less than the revenue recognized, a net liability or net asset, respectively, would be recorded and adjusted over the duration of the contract.

15. Ms. Seidman clarified that with regard to the discount on the deferred revenue being accreted, one would use the premium revenue recognition pattern agreed on earlier in this meeting. She further noted that if the Board chose an alternative where a receivable would be recorded, it would not use the same pattern as would be used for the deferred revenue, but rather an effective yield pattern.
16. Mr. Linsmeier stated that he prefers Alternative B. He believes quality accounting will reflect the unearned premium revenue the same way whether cash is received upfront or over time. There is a contractual commitment to pay the receivable and premium over time. He would like to recognize the accretion of the receivable as investment income.
17. Mr. Young stated that he prefers Alternative B, or possibly Alternative C. He noted the true cost of guaranteeing debt is the cost of capital for equity. He added that the Board's prior decisions have not captured the true cost of the financial guarantee insurance business, and thus any decision will be a compromise. He believes Alternative B best fits with the Board's previous decisions regarding claims loss recognition and revenue recognition.
18. Mr. Trott described a version of Alternative B. He stated that he is not in favor of accreting the discount on deferred revenue through premium revenue because there is no accretion in the sense that the discount is being written up (and therefore the final sentence of Alternative B should be removed). He believes that the financing of the receivable should be recognized and there is no accretion of the liability. At a minimum, the stand-ready obligation should be measured at initial recognition. The display and the measurement of a single premium and an annual premium should essentially be the same. Thus, APB Opinion No. 21, *Interest on Receivables and Payables*, should be applied to the receivable. Mr. Trott noted that the Board will need to discuss the discount rate that is appropriate for the receivable. He stated that the contractual premium should be used for consistency purposes. Mr. Trott asked if an entity may negotiate selling a policy by offering the buyer a choice of a single premium or installment premium. Mr. Trench responded that there are no instances in which the option of either a single premium or installment premium is presented to the issuer for payment. He noted that, generally, the mode of premium payment is set by the particular sector and therefore a choice of mode of premium payment

- is usually not available. Mr. Trott stated that the measurement and display of premium should not be affected by the way premium is financed. Mr. Trench asked Mr. Trott how an entity would reconcile cash receipts if the installment premium is treated as a single premium and the premium written is at present value. Mr. Trott responded that the difference between the cash received and the present value of the premium written would be interest income.
19. Ms. Seidman stated that she supports Alternative B. The insurer's obligation is the same no matter how the obligation is financed, and constituents should account for the obligation at its present value according to Opinion 21, as amended by the Fair Value Measurements Statement.
  20. Mr. Herz asked the remaining Board members if any objected to Alternative B. Mr. Batavick stated that he originally preferred Alternative D. However, Alternative D lessens user information. He stated that, after listening to other Board members' reasons for supporting Alternative B, he agrees that Alternative B is the best alternative.
  21. Mr. Young stated that he was concerned about structured products with multiple payments that are linked to how the structured product behaves. For example, there is the assumption that payments over time pertain to interest costs but asked what would happen if these payments pertained to performance of the structured product. Mr. Crooch noted that revenue would be recognized as the payment occurs. Ms. Seidman noted, that under the revenue recognition approach agreed on (which recognizes revenue based on cash payments made on the underlying), if the underlying had any unusual cash payment pattern, it would affect revenue recognition. She stated that she had not contemplated a structured premium receivable. However, Ms. Seidman noted that in these instances, other GAAP may be applicable. Mr. Smith noted that this discussion is too granular at this time.
  22. Mr. Herz stated that the Board agreed on Alternative B, provided the staff strikes out the last sentence, "Accrete the discount on deferred revenue through premium revenue." Rather, constituents should account for the obligation at its present value according to Opinion 21.

#### **AMORTIZATION OF DEFERRED ACQUISITION COSTS**

23. Mr. Trench stated that the last issue concerns amortization of deferred acquisition costs. Financial guarantors defer costs that vary with and are primarily related to the acquisition of new insurance contracts. Potential views for the treatment of acquisition costs are:
- View A:** Expense acquisition costs when incurred.
- View B:** Expense acquisition costs when incurred and recognize sufficient premium revenue to offset the expense.
- View C:** Defer and amortize acquisition costs in accordance with Statement 60.
24. Mr. Linsmeier stated that most of the costs incurred by financial guarantee insurers are indirect costs, not direct costs. He noted that he is unsure if the Board should choose a view based on Statement 60. He prefers View A, though he would not object to View C in order to stay within the Statement 60 model. However, he does not believe there is an asset that should be amortized overtime; he believes the acquisition costs should be expensed.
25. Mr. Young stated that he supports View A. Mr. Trott stated that he supports View C. Ms. Seidman stated that she also supports View C.
26. Mr. Crooch stated that he prefers View A. He asked Mr. Trench if the industry believes they are in the insurance business. Mr. Trench responded that they are regulated by the each state as insurance entities. Mr. Crooch noted that acquisitions costs in a business combination are expensed. However, he does not believe that the financial guarantee insurance project is the appropriate project in which to require insurers to expense acquisition costs. Thus, he stated he would not object to View C.
27. Mr. Batavick stated that the financial guarantee project is too narrow in scope to address the expensing of acquisition costs. Thus, he supports View C in order to remain consistent with the guidance in Statement 60.
28. Mr. Leisenring questioned whether the acquisition costs deferred and amortized by financial guarantors are the same as those that are deferred and amortized by property and casualty and life insurance companies. Mr. Trench responded that, for example, a percentage of underwriting salaries are deferred. Mr. Cropsey noted that the acquisition costs identified by the financial guarantors are more expansive than the current practice in the life insurance industry.

29. Mr. Herz stated that he believes the Board has developed a lending model for claims recognition of financial guarantors. He noted that he would not object to View C. The Board adopted View C for amortization of deferred acquisition costs with no objections.

**Follow-up Items:**

The staff will draft an exposure document for Board consideration.

**General Announcements:**

None.