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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty

CL 20

VIA E-MAIL

October 7, 2004

Andrea Pryde
Assistant Project Manager
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH, United Kingdom
CommentLetters@iasb.org

Dear Ms Pryde:

The Association of Financial Guaranty Insurers ("AFGI") is pleased to comment on the International Accounting Standard Board's (IASB) exposure draft ("ED"), *Financial Guarantee Contracts and Credit Insurance*. AFGI is the trade association representing ten insurers and reinsurers of municipal bonds and asset-backed securities. AFGI members conduct substantially all of the financial guaranty business written in the world and are a significant participant in the United States capital markets. AFGI's member companies are ACA Financial Guaranty Corporation, Ambac Assurance Corporation, Assured Guaranty Corp., CDC IXIS Financial Guaranty North America, Inc, Financial Guaranty Insurance Company, Financial Security Assurance Inc., MBIA Insurance Corporation, Radian Asset Assurance Inc., and RAM Reinsurance Company Ltd., and XL Capital Assurance Inc. (XLCA). In 2003, AFGI members insured $392 billion in par value of securities.

This letter represents the viewpoint of nine of the ten AFGI member companies, with XLCA abstaining.

Presentation of AFGI members' activity

Financial guaranty insurance contracts written by AFGI members typically guaranty scheduled payments on an issuer's obligations. Upon a payment default on an insured obligation, AFGI members are generally required to pay the principal, interest or other amounts due in accordance with the obligation's original payment schedule or, at its option, to pay such amounts on an accelerated basis. The financial guaranty contract is an unconditional and irrevocable promise to pay when there has been a failure to pay by the obligor, it is not tradable, and it is intended to be held to maturity.

Of the ten AFGI members, nine are rated Triple-A or Double-A, and one is Single-A by design. Further, the United States based financial guarantors operate under the strict risk-based capital provisions of Article 69 of the New York Insurance Law. Article 69 establishes a so-called "mono-line" financial guaranty insurance industry by limiting financial guaranty insurance corporations to writing only financial guaranty insurance and a few closely related lines of insurance (surety, credit and residual value insurance). The New York State insurance law has served as a template for the other states that have enacted so-called "mono-line" financial guaranty insurance laws. All major participants in the

United States financial guaranty insurance market are licensed under Article 69, and are therefore subject to the restrictions imposed by Article 69.

To safeguard the rating of the insured obligations and to protect the interests of insured bond investors, AFGI firms subscribe to a “remote loss” underwriting standard. Securities insured by AFGI members receive the unconditional and irrevocable guaranty of scheduled principal and interest payments to holders of these obligations. In the 33-year history of the financial guaranty industry, no member company has ever failed to fulfil its payment obligations to insured bond investors when due.

Financial guaranty insurance contracts pay only when the holder has incurred a loss arising from the failure of the insured obligor to make payment when due. The general principles differentiating financial guaranty insurance contracts from other contracts are as follows:

a) the writer of the insurance contract or policy must be an insurance company, regulated as a financial guaranty insurance company by an insurance regulator operating within a robust regulatory regime,

b) the insured obligations must be insurable risks for financial guaranty insurance companies as determined under the New York Insurance laws,

c) the insurance policy must be irrevocable by the bond insurer, and must include allow for rights of subrogation against the underlying obligor, and

d) in addition, most financial guarantors have underwriting guidelines requiring that, at inception of the insurance policy, the credit-related risk insured under the insurance policy is the equivalent of investment-grade without the benefit of the insurance (that is, the risk of payment undertaken must be a low frequency event).

General Comment

AFGI supports the general accounting model proposed by IASB in the ED *Financial Guarantee Contracts and Credit Insurance*. However, we regret that the guidelines provided to implement this model are too general and do not address the specifics of financial guarantee insurance activities. Because financial guarantee insurance is insurance, and because the insurance framework, including disclosure and presentation standards, is to be addressed in Phase II of the Insurance Contract Project, we propose that financial guarantee insurance contracts be brought back under the scope of IFRS4.
We would also like to suggest that Phase II of the Insurance Contact Project take into consideration some of the specifics of financial guarantee insurance.

Answers to Specific Questions

Question 1 – Form of contract

The Exposure Draft deals with contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (financial guarantee contracts). These contracts can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. Under the proposals in the Exposure Draft the legal form of such contracts would not affect their accounting treatment (see paragraphs BC2 and BC3).

Do you agree that the legal form of such contracts should not affect their accounting treatment?

If not, what differences in legal form justify differences in accounting treatments? Please be specific about the nature of the differences and explain clearly how they influence the selection of appropriate accounting requirements.

Answer 1

We agree that the legal form of a financial guarantee contract should not affect its accounting treatment. In accordance with the IFRS Framework, we believe that the accounting treatment of a transaction should be based on its substance. Insurance companies issue financial guarantees that require payments to be made solely to reimburse the guaranteed party for failure of a debtor to satisfy its required payment obligations to the guaranteed party. Insurers intend to hold the risk to maturity of the underlying insured obligation. We view these transactions as true insurance contracts whether in the legal form of an insurance policy or of a swap. In contrast, insurance companies also enter into other transactions that do not necessarily require the guaranteed party to be exposed to the risk of loss from the debtor's failure to pay, or that does not necessarily require an actual failure of a debtor to trigger payment by the guarantor (i.e. synthetic transactions). We do not consider these contracts to be insurance because they are designed to be tradable.

Question 2 – Scope

The Exposure Draft proposes that all financial guarantee contracts should be within the scope of IAS 39 (see paragraph 2 of IAS 39 and paragraph 4 of IFRS 4), and defines a financial guarantee contract as "a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument" (see paragraph 9 of IAS 39).

Is the proposed scope appropriate?

If not, what changes do you propose, and why?

Answer 2

We believe that the proposed scope is inappropriate.

IAS39 has been written to deal with financial instruments and not with insurance contracts. Accordingly, IAS39 leaves unaddressed numerous insurance-related issues. The IFRS provides a very brief and general accounting model to be applied to credit insurance. In contrast, the other major sets of standards generally dedicate a complete standard to the specifics of insurance activity.

Since financial guarantee contracts meet the IFRS4 definition of insurance contracts, the inclusion within the scope of IAS39 could introduce confusion among the users of IFRS. It is inconsistent to exclude a whole activity clearly defined as insurance per IFRS from the scope of the insurance-specific standard. As a result, the financial guarantee insurance business will not benefit from the efforts the IASB will make through Phase II of the Insurance Contract Project, addressing the accounting specifics related to insurance activities.

Question 3 – Subsequent measurement

The Exposure Draft proposes that financial guarantee contracts, other than those that were entered into or retained on transferring financial assets or financial liabilities within the scope of IAS 39 to another party, should be measured subsequently at the higher of:

(a) the amount recognised in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and

(b) the amount initially recognised (ie fair value) less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue (see paragraph 47(c) of IAS 39).

Is this proposal appropriate? If not, what changes do you propose, and why?

Answer 3

We think this proposal is appropriate. Indeed, financial guarantee insurance contracts are not tradable and are generally held to maturity unless cancelled by the issuer through prepayment of the referenced debt. As a result, amortization of the related premium over the risk exposure period, combined with an estimated loss incurred gives a true and fair view of a financial guarantor's financial performance.

Question 4 – Effective date and transition

The proposals would apply to periods beginning on or after 1 January 2006, with earlier application encouraged (see paragraph BC27). The proposals would be applied retrospectively.

Are the proposed effective date and transition appropriate? If not, what do you propose, and why?

Answer 4

We are not able to answer this question to the extent that the issues we have highlighted remain unanswered.

Question 5 – Other comments

Do you have any other comments on the proposals?

Answer 5

Deferred Acquisition Costs

We understand from paragraph BC23 (b) of the ED's basis for conclusion that deferral of policy acquisition cost would be limited to those costs that meet the definition of transaction costs of IAS39. Transaction costs are defined as "incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability". We first note that the definition of direct costs provided in IAS39 is ambiguous. It appears that direct costs, as defined in IAS39, are not limited to external costs, nor extended to all incremental costs. We therefore see no way to assess clearly what a direct cost is.

Total incremental costs incurred by the mono-line insurers may represent very significant amounts, but only a small proportion of these costs can be unequivocally regarded as "direct". For instance, the amount paid through a share compensation program granted to selling agents, although directly attributed to the sales force, depends on the overall performance of the enterprise. Therefore, it is unclear whether such costs meet the definition of direct costs. Nevertheless, indirect incremental costs can often be allocated by contract on a reasonable basis. Excluding these costs from deferred expense would create an inconsistency between the revenue recognition principle and the cost recognition principle, therefore misleading the users of financial statements about the performance of credit insurers. For instance, in a period of growth, the revenue would increase slightly because the majority of any premium origination is deferred, while the related costs are only partially deferred. Symmetrically, a company that does not write a single new contract during an accounting period would experience relative stability in revenue by virtue of past origination activity, accompanied by a dramatic decrease in expense because both the direct and indirect variety would not be incurred. Such a discrepancy between revenue and expense recognition is inconsistent with the general principles that the IASB has applied in other standards, such as IAS11 "Construction Contracts", which allows and obliges one to defer indirect costs provided they can be allocated by contract on a reasonable basis.

In addition, under US GAAP, insurance acquisition costs are defined in SFAS60.28 as "costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts". US GAAP takes into account all incremental costs related to the acquisition of a contract, regardless of whether they are direct or indirect. Excluding indirect costs from insurance deferred acquisition costs would be a divergence from the convergence project shared by the IASB and the FASB. We suggest that the IASB adopt a view similar to US GAAP, which seems clearer and more relevant.

Disclosures

According to the ED, financial guarantee is under the scope of IAS39, but meets the definition of insurance contracts of IFRS4. Therefore, it is unclear which disclosures would apply. IAS39 does not provide for any disclosure since that is covered under the scope of IAS32. Financial guarantee is not clearly within the scope of IAS32, despite the proposed amendment of IFRS4 stating that it is (see ED, proposed amendment to IFRS4, B18(g)).

Presentation

Similarly, presentation issues related to financial instruments fall within the scope of IAS32. IFRS4 addresses presentation issues related to insurance activities, such as the prohibition to offset financial assets and liabilities against corresponding reinsurance liabilities and assets. Since financial guarantee insurance contracts are under the scope of IAS39, but are not considered financial instruments, it is unclear whether the presentation rules applicable to financial instruments per IAS32 would apply to financial insurance guarantee contracts as well.

If a representative of the International Accounting Standards Board wishes to discuss the contents of this comment letter or other matters that may arise during the re-deliberations of this proposed financial reporting guidance, please contact Tom Gandolfo, Chairman, of the AFGI Financial Affairs Committee at (212) 208-3349 (tgandolfo@ambac.com).

Sincerely,
Thomas J. Gandolfo

Chairman, Financial Affairs Committee
Senior Vice President and
Chief Financial Officer
Ambac Financial Group, Inc.