Financial Accounting Standards Board

ORIGINAL PRONOUNCEMENTS

AS AMENDED

Statement of Financial Accounting Standards No. 163

Accounting for Financial Guarantee Insurance Contracts

an interpretation of FASB Statement No. 60

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STATUS

Issued: May 2008

Effective Date: For financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years; disclosure requirements in paragraphs 30(g) and 31 are effective for the first period (including interim periods) beginning after May 23, 2008

Affects: Amends FAS 60, paragraph 6
Amends FAS 107, paragraph 8(c)
Amends FAS 133, paragraph 10(c)
Amends FIN 45, paragraph 6(d)

Affected by: No other pronouncements

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: Partially nullifies EITF Issue No. 85-20

Interpreted by: No EITF Issues

Related Issues: No EITF Issues

SUMMARY

Why Is the FASB Issuing This Statement and When Is It Effective?

Diversity exists in practice in accounting for financial guarantee insurance contracts by insurance enterprises under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. That diversity results in inconsistencies in the recognition and measurement of claim liabilities because of differing views about when a loss has been incurred under FASB Statement No. 5, *Accounting for Contingencies*. This Statement requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. This Statement also clarifies how Statement 60 applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities. Those clarifications will increase comparability in financial reporting of financial guarantee insurance contracts by insurance enterprises. This Statement requires expanded disclosures about financial guarantee insurance contracts. The accounting and disclosure requirements of the Statement will improve the quality of information provided to users of financial statements.

This Statement is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years, except for some disclosures about the insurance enterprise's risk-management activities. This Statement requires that disclosures about the risk-management activities of the insurance enterprise be effective for the first period (including interim periods) beginning after issuance of this Statement. Except for those disclosures, earlier application is not permitted.

What Is the Scope of This Statement?

The scope of this Statement is limited to financial guarantee insurance (and reinsurance) contracts, as described in this Statement, issued by enterprises included within the scope of Statement 60. Accordingly, this Statement does not apply to financial guarantee contracts issued by enterprises excluded from the scope of Statement 60 or to some insurance contracts that seem similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance or credit insurance on trade receivables). This Statement also does not apply to financial guarantee insurance contracts that are derivative instruments included within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

How Will This Statement Change Current Practice?

The changes to current practice in accounting for financial guarantee insurance contracts that result from applying this Statement relate to recognition and measurement of premium revenue and claim liabilities and to disclosures.

The premium revenue recognition approach for a financial guarantee insurance contract links premium revenue recognition to the amount of insurance protection and the period in which it is provided. For purposes of this Statement, the amount of insurance protection provided is assumed to be a function of the insured principal amount outstanding, since the premium received requires the insurance enterprise to stand ready to protect holders of an insured financial obligation from loss due to default over the period of the insured financial obligation. That approach is similar to the premium revenue recognition approach for a short-duration insurance contract in Statement 60 (even though the period of the financial guarantee insurance coverage may not be short duration).

The recognition approach for a claim liability relating to a financial guarantee insurance contract requires that an insurance enterprise recognize a claim liability when the insurance enterprise expects, based on the present value of expected net cash outflows to be paid under the insurance contract discounted using a risk-free rate, that a claim loss will exceed the unearned premium revenue. That approach is similar to the recognition approach for some liabilities for future policy benefits relating to a long-duration insurance contract in Statement 60.

An insurance enterprise is required to measure the claim liability equal to the present value of expected net cash outflows. Expected net cash outflows are probability-weighted cash flows that reflect the likelihood of all possible outcomes for payments by the insurance enterprise under the insurance contract. Under this Statement, the expected net cash outflows are developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise (including relevant market information). This Statement clarifies that those assumptions should be consistent, where applicable, with the information tracked and monitored through the risk-management activities of the insurance enterprise to evaluate credit deterioration in its insured financial obligations. Changes in the expected net cash outflows are reflected as they occur. The expected net cash outflows are discounted using a current risk-free rate at the date the claim liability is initially recognized. That rate is updated each reporting period.

An insurance enterprise is required to provide expanded disclosures about financial guarantee insurance contracts. Those disclosures would focus, in part, on the information included in the risk-management activities used by the insurance enterprise to evaluate credit deterioration in its insured financial obligations, including (1) the groupings or categories used to track insured financial obligations with credit deterioration, (2) the insurance enterprise's policies for placing an insured financial obligation in and monitoring each grouping or category, and (3) financial information about the insured financial obligations included within those groupings and categories.

What Is the Effect of This Statement on Existing Accounting Pronouncements?

This Statement interprets Statement 60 and amends existing accounting pronouncements to clarify their application to the financial guarantee insurance contracts included within the scope of this Statement. Specifically, this Statement:

1. Amends Statement 60 to clarify that financial guarantee insurance contracts issued by insurance enterprises are included within the scope of that Statement as interpreted by this Statement
2. Amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (paragraph 8(c)), to clarify that the requirements of that Statement apply to financial guarantee insurance contracts included within the scope of this Statement
3. Amends Statement 133 (paragraph 10(c)) to clarify that its scope exception for some insurance contracts does not apply to financial guarantee insurance contracts included within the scope of this Statement
4. Amends FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (paragraph 6(d)), to clarify that it does not apply to financial guarantee insurance contracts included within the scope of this Statement
5. Nullifies EITF Issue No. 85-20, "Recognition of Fees for Guaranteeing a Loan," for financial guarantee insurance contracts included within the scope of this Statement.

What Is the Effect of This Statement on Convergence with International Financial Reporting Standards?

The International Accounting Standards Board (IASB) has on its agenda a project to comprehensively address the accounting for insurance contracts. In May 2007, the IASB issued for public comment its Discussion Paper, *Preliminary Views on Insurance Contracts*, setting out its preliminary views reached on that project to date. In August 2007, the FASB issued for public comment the Invitation to Comment, *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders Including the IASB Discussion Paper,* Preliminary Views on Insurance Contracts. The FASB Invitation to Comment seeks input on whether to add to its agenda a joint FASB/IASB project to comprehensively address the accounting for insurance contracts, which ultimately could result in changes to existing U.S. generally accepted accounting principles (GAAP) for all insurance contracts, including those addressed in this Statement.

While the FASB acknowledges that the issues addressed in this Statement may be addressed by the IASB's project on the accounting for insurance contracts, the FASB addressed this project at the request of the staff of the Securities and Exchange Commission and identified an approach to address the diversity in practice by building on existing requirements (in Statement 60) without creating a comprehensive new model. Accordingly, the FASB decided to interpret existing U.S. GAAP insurance accounting literature for financial guarantee insurance contracts rather than create a new model. If the FASB subsequently adds a joint project on insurance contracts to its agenda, the accounting guidance in this Statement ultimately may change and be converged with IASB literature.

Statement of Financial Accounting Standards No. 163

Accounting for Financial Guarantee Insurance Contracts

an interpretation of FASB Statement No. 60

CONTENTS

OBJECTIVE

1. Prior to issuance of this Statement, diversity existed in the accounting for financial guarantee insurance contracts by insurance enterprises under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.* That diversity resulted in inconsistencies in the recognition and measurement of claim liabilities. Accordingly, this Statement clarifies how Statement 60 applies to financial guarantee insurance contracts, including the recognition and measurement of premium revenue and claim liabilities. This Statement also requires expanded disclosures about financial guarantee insurance contracts.

All paragraphs in this Statement have equal authority.
Paragraphs in **bold** set out the main principles.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

2. **This Statement applies to financial guarantee insurance (and reinsurance) contracts issued by enterprises that are included within the scope of paragraph 6 of Statement 60 and that are not accounted for as derivative instruments. The recognition and measurement provisions of this Statement shall be applied on a contract-by-contract basis.**

3. Financial guarantee insurance (and reinsurance) contracts are contracts issued by insurance enterprises that provide protection to the holder of a financial obligation from a financial loss in the event of a default. Examples of such financial obligations include a municipal bond or an asset-backed security. For purposes of this Statement, a financial guarantee insurance contract is a contract that obligates the insurance enterprise to pay a claim upon the occurrence of an event of default.

4. The event of a default (insured event) refers to nonpayment (when due) of insured contractual payments (generally principal and interest) by the issuer of the insured financial obligation.

5. Although the direct or indirect beneficiary of the contract is the holder of the insured financial obligation, the holder of the financial guarantee insurance contract (policyholder) will vary. In some cases, the policyholder will be the issuer (for example, a municipality or a corporation) of the insured financial obligation because it is seeking to increase the marketability of the insured financial obligation while reducing future interest costs (by attaining a higher credit standing for the insured financial obligation through the financial guarantee insurance contract). In other cases, the policyholder will be both the holder of the insured financial obligation and beneficiary because it has purchased a financial obligation in the secondary market and seeks to protect itself from a financial loss in the event of a default.

6. Because the scope of this Statement is limited to financial guarantee insurance (and reinsurance) contracts issued by insurance enterprises, this Statement does not apply to the following:

a. Financial guarantee contracts issued by enterprises excluded from the scope of Statement 60 (for example, some financial institutions and government-sponsored enterprises)
b. Insurance contracts that are similar to financial guarantee insurance contracts (as defined in this Statement) issued by insurance enterprises (for example, mortgage guaranty insurance and credit insurance on trade receivables).

7. This Statement also does not apply to a financial guarantee insurance contract that is accounted for as a derivative instrument within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Accordingly, an insurance enterprise shall consider the application of this Statement only if the contract is not within the scope of Statement 133 and is not accounted for as a derivative instrument.

Unearned Premium Revenue

Initial Recognition and Measurement

8. **An insurance enterprise shall recognize a liability for the unearned premium revenue at the inception of a financial guarantee insurance contract. Initial measurement of the unearned premium revenue shall be equal to the present value of the premiums due or, if the criteria in paragraph 12 are met and used, expected to be collected over the period of the financial guarantee insurance contract.**

9. If the premium is a single premium received at the inception of the financial guarantee insurance contract, the insurance enterprise shall initially measure the unearned premium revenue at the amount received.

10. If the premiums are received as payments over the period of the financial guarantee insurance contract, the insurance enterprise shall initially measure the unearned premium revenue at an amount equal to the present value of the premiums due or expected to be collected over the period of the financial guarantee insurance contract (see paragraph 11 for a discussion of the discount rate and the period used). For example, if the insurance enterprise expects to receive total premiums due over the period of the financial guarantee insurance contract of $28 million and the present value of that amount is $24.3 million, both the unearned premium revenue and the premium receivable initially shall be recognized at $24.3 million.

Receivable for future premiums

11. An insurance enterprise shall determine the present value of the premiums due or expected to be collected using a discount rate that reflects the risk-free rate at the inception of the contract. In this Statement, that risk-free rate shall be based on the contract period of the insurance contract unless the insurance enterprise is permitted to consider prepayments pursuant to paragraph 12. The discount amount shall be accreted on the premium receivable through earnings over that same period using the method of accretion shown in Example 1 in Appendix A.

12. The period of a financial guarantee insurance contract is the expected period of risk that generally equates to the contract period. However, in some instances, the expected period of risk is significantly shorter than the full contract period due to expected prepayments. The expected period may be used only if a homogenous pool of assets underlying the insured financial obligation is contractually prepayable. In those instances, prepayment assumptions may be used to determine an expected period if those prepayments are probable and the timing and amount of prepayments can be reasonably estimated. The election to use prepayment assumptions to determine an expected period is an accounting policy decision (that is, it is not a contract-by-contract election).

Subsequent Measurement

13. **In instances where an expected period is used as the period of the financial guarantee insurance contract to measure the unearned premium revenue, an insurance enterprise shall adjust the prepayment assumptions when those assumptions change.** The adjustment to the unearned premium revenue shall equal the adjustment to the premium receivable with no effect on earnings at the time of the adjustment. The discount rate shall be updated to a current risk-free rate only when prepayment assumptions change. (See Example 1 in Appendix A for an illustration of the accounting when prepayment assumptions change.)

Receivable for future premiums

14. An insurance enterprise shall adjust the premium receivable for uncollectible premiums with a corresponding adjustment to earnings. The insurance enterprise shall consider as part of its assessment of recognition and measurement of the claim liability (see paragraphs 22–28) whether the premiums expected to be collected (the premium receivable) are fully collectible.

Derecognition

15. **In instances where a contract period is used as the period of the financial guarantee insurance contract to measure the unearned premium revenue, an insurance enterprise shall adjust the unearned premium revenue to reflect early principal payments as they occur.** The adjustment to the unearned premium revenue shall equal the adjustment to the premium receivable.

Premium Revenue Recognition

16. **An insurance enterprise shall recognize the premium from a financial guarantee insurance contract as revenue over the period of the contract in proportion to the amount of insurance protection provided. As premium revenue is recognized, a corresponding adjustment (decrease) in the unearned premium revenue shall occur.**

17. The amount of insurance protection provided is assumed to be a function of the insured principal amount outstanding. Therefore, the proportionate share of premium revenue to be recognized in a given reporting period shall be a constant rate calculated based on the relationship between the insured principal amount outstanding in a given reporting period compared with the sum of each of the insured principal amounts outstanding for all periods. Accordingly, the premium revenue for each reporting period shall be determined by multiplying the insured principal amount outstanding for that period by the ratio of (a) the total present value of the premium due or expected to be collected over the period of the contract to (b) the sum of all insured principal amounts outstanding during each reporting period over the period of the contract (either contract period or expected period). (See Example 1.)

(**Note:** The examples included in this Statement are simplified and are not intended to serve as a guide for the detailed calculations that may be necessary in applying this Statement.)

Example 1—Insured Principal Payments Made over Period of Contract

On January 1, 200X, an insurance enterprise issues a single-premium financial guarantee insurance contract for a financial obligation (municipal bond) with a contract period of 10 years. The premium amount is $5 million. Insured principal payments of $100 million will be made by the issuer of the bond over the period of the contract. The following is the contractual schedule of expected insured principal payments:

Year	Insured Principal Amounts Outstanding (a)	Principal Payments	Premium Revenue Recognized	Unearned Premium Revenue
				$5,000,000
1	$ 100,000,000	$ 5,000,000	$ 877,193	4,122,807
2	95,000,000	5,000,000	833,333	3,289,474
3	90,000,000	10,000,000	789,474	2,500,000
4	80,000,000	10,000,000	701,754	1,798,246
5	70,000,000	15,000,000	614,035	1,184,211
6	55,000,000	15,000,000	482,456	701,755
7	40,000,000	15,000,000	350,877	350,878
8	25,000,000	15,000,000	219,298	131,580
9	10,000,000	5,000,000	87,719	43,861
10	5,000,000	5,000,000	43,861	-
Total	$ 570,000,000	$ 100,000,000	$ 5,000,000	

(a) Insured Principal Amounts Outstanding represents beginning-of-the-year balances.

The ratio of the premium to the sum of all contractual insured principal amounts outstanding during each reporting period (the constant rate) is 0.00877193 (calculated as $5 million divided by $570 million). Accordingly, the insurance enterprise would recognize $877,193 of premium revenue (calculated as $100 million of insured principal amount outstanding multiplied by 0.00877193) in the first year of the contract. In the second year of the contract, the insurance enterprise would recognize $833,333 (calculated as $95 million multiplied by 0.00877193) of premium revenue. Thus, premium revenue is recognized based on the insurance protection being provided (represented by the constant rate and the insured principal amounts outstanding).

18. In instances where an insured financial obligation accretes to the principal amount over its life and has a single principal payment at maturity, the sum of all insured accreted principal amounts outstanding during each reporting period shall be used as the denominator of the ratio and the insured principal amount outstanding is the accreted principal amount outstanding. (See Example 2.)

Example 2—Insured Principal Payment Made at End of Period of Contract

On January 1, 200X, an insurance enterprise issues a single-premium financial guarantee insurance contract for a financial obligation (a zero-coupon municipal bond). The insured financial obligation was issued at $61.4 million, resulting in an effective yield of 5 percent. The premium amount is $5 million. The insured principal payment of $100 million will be made by the issuer of the bond in total at the end of the 10-year period of the contract. In this instance, the insured accreted principal amount outstanding represents the obligation of the insurance enterprise. The schedule of the insured accreted principal amounts outstanding during each reporting period is as follows:

Year	Insured Accreted Principal Amounts Outstanding (a)	Principal Payments	Premium Revenue Recognized	Unearned Premium Revenue
				$5,000,000
1	$ 61,400,000	-	$ 397,514	4,602,486
2	64,500,000	-	417,584	4,184,902
3	67,700,000	-	438,301	3,746,601
4	71,100,000	-	460,313	3,286,288
5	74,600,000	-	482,973	2,803,315
6	78,400,000	-	507,575	2,295,740
7	82,300,000	-	532,824	1,762,916
8	86,400,000	-	559,368	1,203,548
9	90,700,000	-	587,207	616,341
10	95,200,000	$ 100,000,000	616,341	-
Total	$ 772,300,000	$ 100,000,000	$ 5,000,000	

(a) Insured Accreted Principal Amounts Outstanding represents beginning-of-the-year balances and is calculated based on the effective yield of the insured financial obligation.

The ratio of the premium to the sum of the insured accreted principal amounts outstanding (the constant rate) is 0.006474168 (calculated as $5 million divided by $772.3 million). Accordingly, the insurance enterprise would recognize $397,514 of premium revenue (calculated as $61.4 million of insured accreted principal amount outstanding multiplied by 0.006474168) in the first year of the contract. Premium revenue is recognized based on the insurance protection being provided (represented by the constant rate and the insured accreted principal amount outstanding).

19. In instances where an expected period is used (see paragraph 12) and that period changes due to changes in prepayment assumptions, the insurance enterprise shall recalculate the constant rate based on the new prepayment assumptions (and current risk-free rate) and apply that new constant rate to the principal amounts outstanding for the remaining expected period of the contract. (See Example 1 in Appendix A for an illustration of the accounting when prepayment assumptions have changed.)

Early Retirement and Replacement of an Insured Financial Obligation

20. In some cases, the issuer of an insured financial obligation will retire the insured financial obligation before its maturity and replace it with a new financial obligation. That situation, referred to as a refunding, often occurs when interest rates decrease and the insured financial obligation is replaced with a new financial obligation at a lower interest rate.

21. In a refunding, the financial guarantee insurance contract on the retired financial obligation is extinguished (that is, the financial guarantee insurance contract must be extinguished to be considered a refunding for purposes of this Statement). The insurance enterprise shall immediately recognize any nonrefundable unearned premium revenue related to that contract as premium revenue and any associated acquisition costs previously deferred under paragraph 29 of Statement 60 as an expense. If the insurance enterprise insures the new financial obligation, the insurance enterprise shall recognize the unearned premium revenue on the new financial obligation that is commensurate with the premium it would charge to insure a similar financial obligation in a separate (standalone) transaction. If that premium differs from the premium actually charged, the difference shall be recognized in current earnings. (See Example 3.)

Example 3—Early Retirement and Replacement of an Insured Financial Obligation Where the Same Insurance Enterprise Insured the New Financial Obligation

On January 1, 200X, an insurance enterprise issues a nonrefundable, single-premium financial guarantee insurance contract for a 30-year financial obligation (municipal bond). The premium amount is $5 million. On the municipal bond's 10th anniversary, the issuer of the insured financial obligation retires the municipal bond. Premium recognized by the insurance enterprise for the financial guarantee insurance contract over the first 10 years was $2 million. Therefore, at early retirement on the 10th anniversary, the insurance enterprise would recognize as premium revenue the remaining unearned premium revenue ($3 million) because the risk to the insurance enterprise is extinguished. In addition, any remaining associated deferred acquisition costs are expensed.

The issuer of the financial obligation facilitated the early retirement of the municipal bond by issuing a new municipal bond at a lower interest rate. The same insurance enterprise insures the new municipal bond. The premium amount for the financial guarantee insurance contract for the new financial obligation is $3 million. However, the amount of premium charged to insure a similar financial obligation in a separate standalone transaction is $4 million. Accordingly, the insurance enterprise would recognize unearned premium revenue of $4 million. It also would recognize a debit to earnings in the amount of $1 million. This represents the difference between the amount of premium charged ($3 million) and the amount of premium that would be charged for a similar financial obligation in a separate standalone transaction.

Claim Liability

Recognition

22. **An insurance enterprise shall 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 for that contract based on the present value of expected net cash outflows to be paid under the insurance contract.**

23. The unearned premium revenue represents the insurance enterprise's stand-ready obligation under a financial guarantee insurance contract at initial recognition. Subsequently, if the likelihood of a default (insured event) increases so that the present value of the expected net cash outflows expected to be paid under the insurance contract exceeds the unearned premium revenue, the insurance enterprise shall recognize a claim liability (in addition to the unearned premium revenue).

Measurement

24. **An insurance enterprise shall measure a claim liability equal to the present value of expected net cash outflows to be paid under the insurance contract discounted using a current risk-free rate. That current risk-free rate shall be based on the remaining period (contract or expected, as applicable) of the insurance contract.**

Expected net cash outflows

25. Expected net cash outflows (cash outflows, net of potential recoveries, expected to be paid to the holder of the insured financial obligation, excluding reinsurance) are probability-weighted cash flows that reflect the likelihood of all possible outcomes. For purposes of this Statement, the expected net cash outflows shall be developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise (including relevant market information). Those assumptions shall consider all relevant facts and circumstances and, where applicable, be consistent with the information tracked and monitored through the insurance enterprise's risk-management activities and used to assist in making operational decisions.

Initial measurement

26. At initial recognition of a claim liability, an insurance enterprise shall discount the expected net cash outflows under the insurance contract using the current risk-free rate at that date based on the remaining period (contract or expected, as applicable) of the insurance contract. (See Example 4.)

Example 4—Expected Net Cash Outflows Used to Measure Claim Liability

An insurance enterprise determines that there is an expectation that a claim loss on an insured financial obligation (a bond) will exceed the unearned premium revenue for that contract. The present value of expected net cash outflows used to measure the claim liability considers the amount, timing, and probability of possible net cash outflows, that is, cash outflows, net of potential recoveries, to be paid to the holder of the insured financial obligation, excluding reinsurance. The present value of expected net cash outflows is developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise (including relevant market information).

Discounted Possible Net Cash Outflows [(a)]	Probability	Probability-Weighted Net Cash Outflows
$ 70,000,000	5%	$ 3,500,000
50,000,000	15%	7,500,000
40,000,000	20%	8,000,000
20,000,000	45%	9,000,000
10,000,000	10%	1,000,000
-	5%	-
Present value of expected net cash outflows		**$ 29,000,000**

(a) Discounted Possible Net Cash Outflows includes different probabilities of realization related to potential recoveries. The discount factor is the current risk-free rate.

At the date the expected net cash outflows are calculated, the remaining unearned premium revenue is $1.2 million. Accordingly, a claim liability of $27.8 million is recognized in the statement of financial position ($29.0 million less $1.2 million).

Subsequent measurement

27. In periods after initial recognition of a claim liability, an insurance enterprise shall update the discount rate each reporting period. An insurance enterprise also shall revise expected net cash outflows when increases (or decreases) in the likelihood of a default (insured event) (and related amounts of net cash outflows) and potential recoveries occur. The claim liability shall not be reduced below zero. The discount amount shall be accreted on the claim liability through earnings.

28. Revisions to the claim liability in periods after initial recognition shall be recognized as claim expense in the period of the change (as a change in accounting estimate).

Disclosures

29. **An insurance enterprise shall disclose information that enables users of its financial statements to understand the factors affecting the present and future recognition and measurement of financial guarantee insurance contracts.**

30. To meet the disclosure objective in paragraph 29, an insurance enterprise shall disclose the following information for each annual period (and in an interim period if a significant change has occurred in that interim period):

a. For financial guarantee insurance contracts where premiums are received as payments over the period of the contract, rather than at inception:
    (1) The premium receivable and the unearned premium revenue as of the date(s) of the

statement of financial position and the line item in the statement of financial position where those amounts are reported (if not presented separately)
   (2) The amount of accretion on the premium receivable and the line item in the statement of income where that amount is reported (if not presented separately)
   (3) The weighted-average risk-free rate used to discount the premiums expected to be collected and the weighted-average period of the premium receivable

b. A schedule of premiums expected to be collected related to the premium receivable detailing the following:
   (1) The four quarters of the subsequent annual period and each of the next four annual periods
   (2) The remaining periods aggregated in five-year increments

c. A rollforward of the premium receivable for the period, including:
   (1) The beginning premium receivable
   (2) Premium payments received
   (3) New business written
   (4) Adjustments to the premium receivable, including at a minimum:
      (a) Adjustments for changes in the period of a financial guarantee insurance contract and an explanation of why those adjustments occurred
      (b) Accretion of the premium receivable discount
      (c) Other adjustments with explanations provided for significant or recurring adjustments
   (5) The ending premium receivable

d. For premium revenue recognition that has been accelerated, the amount and reasons for acceleration

e. A schedule of the future expected premium revenue as of the latest date of the statement of financial position detailing the following:
   (1) The four quarters of the subsequent annual period and each of the next four annual periods
   (2) The remaining periods aggregated in five-year increments

f. For the claim liability:
   (1) The weighted-average risk-free rate used to discount the claim liability
   (2) The significant component(s) of the change in the claim liability for the period (such as changes in the discount rate, the accretion of the discount on the claim liability, changes in the timing, changes in the likelihood of default), the amount relating to that component(s), and the line item in the statement of income where that amount or amounts are reported (unless separately disclosed)

g. A description of the insurance enterprise's risk-management activities used to track and monitor deteriorating insured financial obligations, including the following:
   (1) A description of each grouping or category used to track and monitor deteriorating insured financial obligations
   (2) The insurance enterprise's policies for placing an insured financial obligation in, and monitoring, each grouping or category
   (3) The insurance enterprise's policies for avoiding or mitigating claim liabilities, the related expense and liability reported during the period for those risk mitigation activities (not including reinsurance), and a description of where that expense and that liability are reported in the statement of income and the statement of financial position, respectively.

31. An insurance enterprise shall disclose the following information for each annual and interim period related to the claim liability:

a. A schedule of insured financial obligations at the end of each interim period detailing, at a minimum, the following for each category or grouping of these financial obligations (see Example 2 in Appendix A):
   (1) Number of issued and outstanding financial guarantee insurance contracts
   (2) Remaining weighted-average contract period
   (3) Insured contractual payments outstanding, segregating principal and interest
   (4) Gross claim liability
   (5) Gross potential recoveries
   (6) Discount, net (both claim liability and potential recoveries)
   (7) Net claim liability
   (8) Reinsurance recoverables
   (9) Unearned premium revenue.

EFFECTIVE DATE AND TRANSITION

32. This Statement shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. However, the disclosure requirements in

paragraphs 30(g) and 31 are effective for the first period (including interim periods) beginning after issuance of this Statement. The disclosure requirements in paragraphs 30(g) and 31 shall be provided unless deemed impracticable (as described in paragraph 11 of FASB Statement No. 154, *Accounting Changes and Error Corrections*) and shall be based on an insurance enterprise's existing accounting policies that may or may not be consistent with the principles of this Statement at this earlier effective date. If those disclosures are deemed impracticable at this earlier effective date, an explanation of why they are impracticable at this time and a description of the insurance enterprise's existing accounting policy for claim liabilities shall be provided. Except for the disclosures effective for the first period (including interim periods) beginning after issuance of this Statement, earlier application is not permitted.

33. This Statement shall be applied to existing and future financial guarantee insurance contracts issued by an insurance enterprise as of the beginning of the fiscal year in which this Statement is initially applied. An insurance enterprise shall recognize the cumulative effect of initially applying this Statement as an adjustment to the opening balance of retained earnings for that fiscal year. An insurance enterprise also shall disclose the cumulative effect of the change on retained earnings in the statement of financial position in the first interim period of the fiscal year in which this Statement is initially applied.

34. The cumulative-effect adjustment is the difference between the amounts (if any) recognized in the statement of financial position before the initial application of this Statement and the amounts recognized in the statement of financial position at the initial application of this Statement, measured using information that is current at that date. Accordingly, discount rates shall reflect the relevant risk-free rate at the date this Statement is initially applied.

35. The disclosure requirements of this Statement (see paragraphs 29–31) shall be applied beginning in the first interim period of the fiscal year in which this Statement is initially applied with earlier disclosure for information specified in paragraph 32. The disclosure requirements of this Statement need not be applied for financial statements for periods presented before initial application of this Statement except as stated in paragraph 32.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Robert H. Herz *Chairman* George J. Batavick	G. Michael Crooch Thomas J. Linsmeier Leslie F. Seidman	Lawrence W. Smith Donald M. Young

Appendix A

IMPLEMENTATION GUIDANCE

This appendix is an integral part of this Statement.

Introduction

A1. This appendix describes in general terms certain provisions of this Statement and provides two examples of their application. The examples are simplified and are not intended to serve as a guide for all of the detailed calculations that may be necessary in applying this Statement.

Change in Prepayment Assumptions Used to Measure the Premium Receivable

A2. This Statement states that the period of a financial guarantee insurance contract is the expected period of risk, which is generally the contract period. However, in some instances, the period of risk is significantly shorter than the full contract period due to expected prepayments. The expected period may be used only if a homogenous pool of assets underlying the insured financial obligation is contractually prepayable. In those instances, prepayment assumptions may be used to determine an expected period if prepayments on the insured financial obligation are probable and the timing and amount of prepayments can be reasonably estimated. If an expected period is used, an insurance enterprise should adjust the prepayment assumptions when those assumptions have changed. The adjustment to the unearned premium revenue shall equal the adjustment to the premium receivable with no effect on earnings at the time of the adjustment. The accounting when prepayment assumptions change and the resulting change to the expected period required by paragraph 13 is illustrated below.

Example 1—Change in Prepayment Assumptions

A3. The example below assumes that annual premiums are received as payments over the expected period of the financial guarantee insurance contract. The following are the relevant assumptions used in this example:

Key Facts:

Total principal outstanding	$75,000,000
Premium rate	100 basis points, annually, received at the beginning of the period
Contract period	10 years
Initial expected period	7 years
Discount rate at inception	5% (a)

(a) For simplicity, the current risk-free discount rate has not been updated in this example when the prepayment assumptions change as required by paragraph 13 of this Statement. If the discount rate had changed at the time of the change in prepayment assumptions, that new discount rate would be used.

A4. Table 1 illustrates the following amounts, estimated at inception: (a) the expected insured principal amounts outstanding during each period, (b) the expected insured principal payments, (c) the expected premium payments, and (d) the present value of premiums expected. The constant rate is calculated as the ratio of the present value of the premiums expected to be collected and the sum of all insured principal amounts outstanding during each reporting period.

Table 1

Year	Expected Insured Principal Amounts Outstanding	Expected Insured Principal Payments	Expected Premium Payments	Present Value of Premiums Expected
1	$ 75,000,000	$ 6,500,000	$ 750,000 [(a)]	$ 750,000 [(b)]
2	68,500,000	7,800,000	685,000	652,381
3	60,700,000	9,100,000	607,000	550,567
4	51,600,000	11,700,000	516,000	445,740
5	39,900,000	15,600,000	399,000	328,258
6	24,300,000	15,600,000	243,000	190,397
7	8,700,000	8,700,000	87,000	64,921
8	-	-	-	-
9	-	-	-	-
10	-	-	-	-
Total	$ 328,700,000	$75,000,000	$3,287,000	$2,982,264

Constant rate 0.0090729 ($2,982,264 ÷ $328,700,000)

(a) Calculated as expected insured principal amount outstanding multiplied by the premium rate, which for Year 1 is $75,000,000 × 0.01 (100 basis points).

(b) Calculated as the present value of the expected premium payments for the appropriate number of periods, which for Year 1 is $750,000 ÷ $(1 + 0.05)^{t-1}$, where t represents the current year.

A5. Table 2 illustrates the rollforward of the premium receivable from period to period. The premium receivable will decrease during the year as expected premium payments are received, and it will increase as a result of the accretion of the discount on the premium receivable each period that is recognized in earnings.

Table 2

Year	Premium Receivable at Beginning of Year	Expected Premium Payments	Accretion of Discount on Premium Receivable	Premium Receivable at End of Year
1	$ 2,982,264	$ 750,000	$ 111,613 (a)	$2,343,877 (b)
2	2,343,877	685,000	82,944	1,741,821
3	1,741,821	607,000	56,741	1,191,562
4	1,191,562	516,000	33,778	709,340
5	709,340	399,000	15,517	325,857
6	325,857	243,000	4,143	87,000
7	87,000	87,000	-	-
8	-	-	-	-
9	-	-	-	-
10	-	-	-	-
Total		$3,287,000	$ 304,736	

(a) Calculated as the premium receivable balance at the beginning of the year less the expected premium payment multiplied by the discount rate, which for Year 1 is ($2,982,264 – $750,000) × 5%.

(b) Calculated as the premium receivable balance at the beginning of the year less the expected premium payments, plus the accretion of the discount on the premium receivable, which for Year 1 is $2,982,264 – $750,000 + $111,613.

A6. Table 3 illustrates that the expected total revenue recognized each period will be the sum of the expected premium revenue recognized each period based on the constant rate of 0.0090729 and the accretion of the discount on the premium receivable each period. (**Note:** The depiction of "expected premium revenue recognized" and "accretion of discount on premium receivable" in this table is not intended to draw any conclusions about the presentation of these amounts in the statement of income.)

Table 3

Year	Expected Insured Principal Amounts Outstanding	Expected Principal Payments	Expected Premium Revenue Recognized	Accretion of Discount on Premium Receivable [(b)]	Expected Total Revenue Recognized
1	$ 75,000,000	$ 6,500,000	$ 680,468 [(a)]	$ 111,613	$ 792,081 [(c)]
2	68,500,000	7,800,000	621,494	82,944	704,438
3	60,700,000	9,100,000	550,725	56,741	607,466
4	51,600,000	11,700,000	468,162	33,778	501,940
5	39,900,000	15,600,000	362,009	15,517	377,526
6	24,300,000	15,600,000	220,472	4,143	224,615
7	8,700,000	8,700,000	78,934	-	78,934
8	-	-	-	-	-
9	-	-	-	-	-
10	-	-	-	-	-
Total	$ 328,700,000	$75,000,000	$ 2,982,264	$ 304,736	$ 3,287,000

(a) Calculated as the expected insured principal amount outstanding multiplied by the constant rate, which for Year 1 is $75,000,000 × 0.0090729.

(b) See column titled Accretion of Discount on Premium Receivable in Table 2 of paragraph A5.

(c) Calculated as the sum of the expected premium revenue recognized and the accretion of the discount on the premium receivable, which for Year 1 is $680,468 + $111,613.

A7. Table 4 illustrates the reduction of the unearned premium revenue due to the recognition of premium revenue during each reporting period.

Table 4

Year	Beginning Unearned Premium Revenue	Expected Premium Revenue Recognized [(a)]	Ending Unearned Premium Revenue
1	$2,982,264	$ 680,468	$2,301,796 [(b)]
2	2,301,796	621,494	1,680,302
3	1,680,302	550,725	1,129,577
4	1,129,577	468,162	661,415
5	661,415	362,009	299,406
6	299,406	220,472	78,934
7	78,934	78,934	-
8	-	-	-
9	-	-	-
10	-	-	-
Total		$ 2,982,264	

(a) See column titled Expected Premium Revenue Recognized in Table 3 of paragraph A6.

(b) Calculated as the beginning unearned premium revenue balance less the expected premium revenue recognized during the period, which for Year 1 is $2,982,264 – $680,468.

A8. At the beginning of Year 3, the insurance enterprise estimates that prepayments will differ from its initial assumptions. Its new estimate is that the expected period is nine years from inception (the change represents a change in assumptions and not a change due to an error, which would be accounted for in accordance with Statement 154). Tables 5–8 illustrate the information presented in the tables in paragraphs A4–A7 as if these new prepayment assumptions were used from inception. Tables 5–8 are provided for informational purposes and are designed to assist in understanding the required adjustment of the premium receivable and unearned premium revenue. The constant rate calculated in Table 5 is not the new constant rate, but, rather, is presented here to assist in understanding the calculations necessary to determine the adjustment.

Table 5

Year	**Expected Insured Principal Amounts Outstanding**	**Expected Principal Payments**	**Expected Premium Payments**	**Present Value of Premiums Expected**
1	$ 75,000,000	$ 6,500,000	$ 750,000 [(a)]	$ 750,000 [(b)]
2	68,500,000	7,800,000	685,000	652,381
3	60,700,000	5,350,000	607,000	550,567
4	55,350,000	7,450,000	553,500	478,134
5	47,900,000	11,600,000	479,000	394,074
6	36,300,000	11,600,000	363,000	284,420
7	24,700,000	8,450,000	247,000	184,315
8	16,250,000	8,250,000	162,500	115,486
9	8,000,000	8,000,000	80,000	54,148
10	-	-	-	-
Total	$ 392,700,000	$75,000,000	$3,927,000	$3,463,525

Constant rate 0.00881977 ($3,463,525 ÷ $392,700,000)

(a) Calculated as expected insured principal amount outstanding multiplied by the premium rate, which for Year 1 is $75,000,000 × 0.01 (100 basis points).

(b) Calculated as the present value of the expected premium payments for the appropriate number of periods, which for Year 1 is $\$750{,}000 \div (1 + 0.05)^{t-1}$, where t represents the current year.

(**Note**: For simplicity, the discount rate has not been updated in this example when the prepayment assumptions change as required by paragraph 13 of this Statement. If the discount rate had changed at the time of the change in prepayment assumptions, that new discount rate would be used.)

Table 6

Year	**Premium Receivable at Beginning of Year**	**Expected Premium Payments**	**Accretion of Discount on Premium Receivable**	**Premium Receivable at End of Year**
1	$ 3,463,525	$ 750,000	$ 135,676 (a)	$ 2,849,201 (b)
2	2,849,201	685,000	108,210	2,272,411
3	2,272,411	607,000	83,270	1,748,681
4	1,748,681	553,500	59,759	1,254,940
5	1,254,940	479,000	38,797	814,737
6	814,737	363,000	22,587	474,324
7	474,324	247,000	11,366	238,690
8	238,690	162,500	3,810	80,000
9	80,000	80,000	-	-
10	-	-	-	-
Total		$3,927,000	$ 463,475	

(a) Calculated as the premium receivable balance at the beginning of the year less the expected premium payment multiplied by the discount rate, which for Year 1 is ($3,463,525 – $750,000) × 5%.

(b) Calculated as the premium receivable balance at the beginning of the year less the expected premium payments, plus the accretion of the discount on the premium receivable, which for Year 1 is $3,463,525 – $750,000 + $135,676.

(**Note:** The depiction of "expected premium revenue recognized" and "accretion of discount on premium receivable" in this table is not intended to draw any conclusions about the presentation of these amounts in the statement of income.)

Table 7

Year	Expected Insured Principal Amounts Outstanding	Expected Insured Principal Payments	Expected Premium Revenue Recognized	Accretion of Discount on Premium Receivable [(b)]	Expected Total Revenue Recognized
1	$ 75,000,000	$ 6,500,000	$ 661,483 [(a)]	$ 135,676	$ 797,159 [(c)]
2	68,500,000	7,800,000	604,155	108,210	712,365
3	60,700,000	5,350,000	535,360	83,270	618,630
4	55,350,000	7,450,000	488,175	59,759	547,934
5	47,900,000	11,600,000	422,467	38,797	461,264
6	36,300,000	11,600,000	320,158	22,587	342,745
7	24,700,000	8,450,000	217,848	11,366	229,214
8	16,250,000	8,250,000	143,321	3,810	147,131
9	8,000,000	8,000,000	70,558	-	70,558
10	-	-	-	-	-
Total	$ 392,700,000	$75,000,000	$ 3,463,525	$ 463,475	$ 3,927,000

(a) Calculated as the expected insured principal amount outstanding multiplied by the constant rate, which in Year 1 is $75,000,000 × 0.00881977.

(b) See column titled Accretion of Discount on Premium Receivable in Table 6 of paragraph A8.

(c) Calculated as the sum of expected premium revenue recognized and the accretion of the discount on the premium receivable, which for Year 1 is $661,483 + $135,676.

Table 8

Year	Beginning Unearned Premium Revenue	Expected Premium Revenue Recognized (a)	Ending Unearned Premium Revenue
1	$3,463,525	$ 661,483	$2,802,042 (b)
2	2,802,042	604,155	2,197,887
3	2,197,887	535,360	1,662,527
4	1,662,527	488,175	1,174,352
5	1,174,352	422,467	751,885
6	751,885	320,158	431,727
7	431,727	217,848	213,879
8	213,879	143,321	70,558
9	70,558	70,558	-
10	-	-	-
Total		$ 3,463,525	

(a) See column titled Expected Premium Revenue Recognized in Table 7 of paragraph A8.

(b) Calculated as the beginning unearned premium revenue balance less expected premium revenue recognized during the period, which for Year 1 is $3,463,525 – $661,483.

A9. Based on the new constant rate, the adjustment to the premium receivable and unearned premium revenue is an increase of $530,590 (calculated as the premium receivable end-of-year balance in Year 2 using the updated prepayment assumptions [$2,272,411 from Table 6] less the premium receivable end-of-year balance in Year 2 using the initial prepayment assumptions [$1,741,821 from Table 2]).

A10. The following calculation illustrates how the unearned premium revenue balance is determined at the beginning of Year 3:

Beginning unearned premium revenue using original assumptions	$	2,982,264 [(a)]
Less: Premium revenue recognized to date in Years 1 and 2	$	1,301,962 [(b)]
Adjustment for change in prepayment assumptions	$	530,590 [(c)]
Adjusted unearned premium revenue at beginning of Year 3	$	2,210,892
Sum of all expected insured principal amounts outstanding during each reporting period for Years 3–9	$	249,200,000 [(d)]
New constant rate		0.00887196 [(e)]

(a) See column titled Present Value of Premiums Expected in Table 1 of paragraph A4.

(b) Calculated as $680,468 + $621,494 (expected premium revenue recognized in Years 1 and 2 in Table 3 of paragraph A6).

(c) See calculation in paragraph A9.

(d) Calculated as the sum of all insured principal amounts outstanding for Years 3–9 in Table 5 of paragraph A8 ($60,700,000 + $55,350,000 + $47,900,000 + $36,300,000 + $24,700,000 + $16,250,000 + $8,000,000).

(e) Calculated as the adjusted unearned premium revenue at the beginning of Year 3 divided by the sum of all expected insured principal amounts outstanding during each reporting period for Years 3–9, which equals $2,210,892 ÷ $249,200,000.

A11. Table 9 illustrates (a) the actual premium revenue recognized and discount accreted on the premium receivable for Years 1 and 2 and (b) the revised expected premium revenue recognition and accretion on the premium receivable from Years 3–9 based on the new prepayment assumptions. (**Note:** The depiction of "premium revenue recognized," "expected premium revenue recognized," and "accretion of discount on premium receivable" in this table is not intended to draw any conclusions about the presentation of these amounts in the statement of income.)

Table 9

Year	Premium Revenue Recognized	Accretion of Discount on Premium Receivable	Expected Premium Revenue Recognized	Accretion of Discount on Premium Receivable	Total Revenue Recognized
1	$ 680,468	$ 111,613			$ 792,081
2	621,494	82,944			704,438
3			$ 538,528 [(a)]	$ 83,270	621,798
4			491,063	59,759	550,822
5			424,967	38,797	463,764
6			322,052	22,587	344,639
7			219,137	11,366	230,503
8			144,169	3,810	147,979
9			70,976	-	70,976
10			-	-	-
Total	$ 1,301,962	$ 194,557	$ 2,210,892	$ 219,589	$ 3,927,000

(a) Calculated as the insured principal amount outstanding multiplied by the new constant rate, which for Year 3 is $60,700,000 × 0.00887196.

Claim Liability Disclosures

A12. This Statement requires, at a minimum, disclosure of a schedule of insured financial obligations that are subject to an insurance enterprise's risk-management activities at the end of each interim period. The risk-management activities are those used by the insurance enterprise to track and monitor credit deterioration in its insured financial obligations. In addition, this Statement emphasizes that in measuring the claim liability, the present value of expected net cash outflows should be developed using the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise (including relevant market information). Those assumptions, where applicable, should be consistent with the information tracked and monitored through the risk-management activities maintained by the insurance enterprise. Insurance enterprises often aggregate information related to the credit standing of their insured financial obligations in a watch list or surveillance list to evaluate credit deterioration in those insured financial obligations. Those lists often are separated into groupings or categories to assist management in identifying varying degrees of credit deterioration of insured financial obligations in its portfolios.

Example 2—Schedule of Insured Financial Obligations with Credit Deterioration

A13. The example below assumes the insurance enterprise uses a surveillance list with four surveillance categories to track and monitor its insured financial obligations. The surveillance list and four surveillance categories are used for illustrative purposes only. The surveillance categories shown below describe the claim liability before the mitigating effects of potential recoveries. The following are brief descriptions of each surveillance category to provide context to the example:

a. Category A includes insured financial obligations that are still currently performing (that is, insured contractual payments are made on time but the likelihood of an event of default has increased since the financial guarantee insurance contract was first issued), but if economic conditions persist for an extended period of time, they may not be performing in the future. The issuer of the insured financial obligation may have experienced credit deterioration as a result of a general economic downturn. As a result, the present value of expected net cash outflows may exceed the unearned premium revenue of the financial guarantee insurance contract some time in the future.
b. Category B includes insured financial obligations that are currently characterized as potentially nonperforming and may require action by the insurance enterprise to avoid or mitigate an event of default.
c. Category C includes insured financial obligations that are characterized as nonperforming and for which actions to date by the insurance enterprise have not been successful in avoiding or mitigating an event of default. The insurance enterprise continues its efforts to cure the claim, but an event of default is imminent.
d. Category D includes insured financial obligations where an event of default has occurred.

For those insured financial obligations, that financial information might be presented as follows:

	Surveillance Categories				
	A	B	C	D	Total
Number of policies	37	16	5	4	62
Remaining weighted-average contract period (in years)	16	14	11	12	
Insured contractual payments outstanding:					
Principal	$ 656,000,000	$ 409,000,000	$ 196,000,000	$ 111,000,000	$ 1,372,000,000
Interest	478,000,000	298,000,000	150,000,000	73,000,000	999,000,000
Total	$ 1,134,000,000	$ 707,000,000	$ 346,000,000	$ 184,000,000	$ 2,371,000,000
Gross claim liability	$ 1,045,000,000	$ 690,000,000	$ 330,000,000	$ 184,000,000	$ 2,249,000,000
Less:					
Gross potential recoveries	752,000,000	381,000,000	29,000,000	7,000,000	1,169,000,000
Discount, net	159,000,000	153,000,000	125,000,000	78,000,000	515,000,000
Net claim liability	$ 134,000,000	$ 156,000,000	$ 176,000,000	$ 99,000,000	$ 565,000,000
Unearned premium revenue	$ 7,000,000	$ 4,000,000	$ 2,000,000	$ - [(b)]	$ 13,000,000
Claim liability reported in the balance sheet [(a)]	$ 120,000,000	$ 148,000,000	$ 170,000,000	$ 99,000,000	$ 537,000,000
Reinsurance recoverables	$ 10,000,000	$ 19,000,000	$ 25,000,000	$ 27,000,000	$ 81,000,000

(a) The claim liability is determined on a contract-by-contract basis. As such, instances may arise where the unearned premium revenue exceeds the present value of the expected net cash outflows (and therefore, the net claim liability less the unearned premium revenue may not equal the claim liability reported in the balance sheet).

(b) In this instance, it is assumed that once an insured financial obligation is in Category D, the only remaining obligation of the insurance enterprise is making claim payments. As such, all related balances of the insured financial obligation are written off, including the unearned premium revenue.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

B2. In June 2005, the Board added the financial guarantee insurance contracts project to its agenda. The Board agreed that the accounting for financial guarantee insurance contracts by insurance enterprises should be an interpretation of Statement 60 because building on existing requirements (in Statement 60) avoids creating a comprehensive new model for these contracts at a time when the IASB has a project considering the accounting for all insurance contracts. This Statement is a result of the FASB project. Prior to issuance of this Statement, diversity existed in the accounting for financial guarantee insurance contracts by insurance enterprises under Statement 60. That diversity resulted in inconsistencies in the timing of the recognition and measurement of claim liabilities. Accordingly, this Statement clarifies how Statement 60 is applied to financial guarantee insurance contracts, focusing on premium revenue and claim liabilities. This Statement also requires expanded disclosures about financial guarantee insurance contracts.

B3. In April 2007, the Board issued an Exposure Draft, *Accounting for Financial Guarantee Insurance Contracts*, and received 87 comment letters in response to that Exposure Draft. In September 2007, the Board held a public roundtable meeting with some of the respondents to discuss significant issues raised in the comment letters. In developing this Statement, the Board considered comments from respondents to the Exposure Draft as well as input from the roundtable and reconsidered and/or clarified some aspects of the proposals in the Exposure Draft.

Scope

B4. The issues addressed in this Statement arise from the application of the insurance accounting models in Statement 60 by insurance enterprises that issue financial guarantee insurance contracts (including reinsurance contracts). In setting the scope, it was the Board's understanding that a small number of insurance enterprises believe that neither the short-duration accounting model nor the long-duration accounting model under Statement 60 addresses their financial guarantee insurance contracts. The Board acknowledged that insurance enterprises issue other types of contracts that seem similar to financial guarantee insurance contracts (for example, mortgage guaranty insurance and credit insurance on trade receivables). However, the Board is not aware of any significant diversity in practice in the accounting for claim losses at this time for those similar types of insurance contracts. Accordingly, the Board decided to limit the scope of this Statement to financial guarantee insurance contracts issued by enterprises within the scope of Statement 60. A financial guarantee insurance contract within the scope of this Statement generally insures investment securities in the form of municipal bonds or asset-backed securities. The Board's intent in setting the scope of this Statement was to address the narrow issue relating to those contracts for which diversity existed in the accounting for claim losses.

B5. Enterprises excluded from the scope of Statement 60 (for example, some financial institutions) also issue financial guarantee contracts. However, the Board decided not to expand the scope of this Statement to include those contracts. Expanding the scope would delay issuance of needed guidance to resolve current practice issues relating to financial guarantee insurance contracts issued by insurance enterprises. In addition, at a future date, the Board expects to consider whether to add a joint FASB/IASB project to its agenda to comprehensively consider the accounting for all insurance contracts. The guidance in this Statement interprets accounting literature that applies only to insurance enterprises. However, the Board did not deliberate whether provisions of this Statement would be appropriate for other similar arrangements not covered by specific accounting literature.

B6. Some respondents to the Exposure Draft commented that the scope of this Statement increases complexity and reduces comparability among economically similar contracts by providing specialized industry accounting guidance for a limited number of insurance enterprises. The Board acknowledged these issues but concluded that it was more important to provide accounting guidance for those insurance enterprises, since the broader issues raised by respondents will be addressed in other projects. The Board also noted that the project that led to this Statement was a result of a request from the staff of the Securities and Exchange Commission for the Board to address the diversity in practice related to claim liabilities arising from financial guarantee insurance contracts by insurance enterprises. In subsequent deliberations, the Board expanded that request to include premium revenue recognition because of the interrelationship between premium revenue recognition and claim liability recognition and measurement. However, in trying to increase comparability among economically similar contracts, the Board has asked the staff to research a disclosure project that could expand the information provided to users of financial statements for credit derivatives (such as credit default swaps). The Board observed that the disclosures in this Statement about the risk-management activities of the insurance enterprise are expected to assist users of financial statements in understanding the extent of exposure and mitigating factors related to insurance contracts. Accordingly, the Board believes it should consider requiring disclosures of similar information about credit derivatives.

Overall Approach

B7. In developing this Statement, the Board considered whether to establish a fair value model for financial guarantee insurance contracts. In contrast to the insurance accounting models in Statement 60, which separate recognition and measurement for premium revenue and claim liabilities, a fair value model would include in one measurement attribute all potential future cash flows (that is, premium revenue and claim liabilities). Some Board members agree that, conceptually, a fair value model might provide a more relevant measurement of the insurance enterprise's obligation to perform under a financial guarantee insurance contract. These Board members also point out that a fair value model would appropriately reflect the passage of time in the measurement of the financial guarantee insurance contract. However, the Board concluded that it is not appropriate to require that financial guarantee insurance contracts be measured at fair value without also considering whether other types of insurance contracts should be measured at fair value. Consistent with its decision to limit the scope of this Statement to financial guarantee insurance contracts issued by insurance enterprises within the scope of Statement 60, the Board decided to address the issues in this Statement in the context of the insurance accounting models in Statement 60.

B8. The Board considered the two accounting models described in Statement 60 for insurance contracts—the short-duration and the long-duration accounting models. In reviewing the application of those two models to financial guarantee insurance contracts, the Board determined that neither accounting model fully captured the economics of financial guarantee insurance contracts. For example, a short-duration accounting model, while appropriately linking premium revenue recognition to the decrease in the amount of insurance protection provided (insured principal amount outstanding), would not adequately reflect changes in the likelihood of default of the insured financial obligation in the recognition and measurement of the claim liability. Alternatively, a long-duration accounting model, while appropriately capturing changes in the likelihood of a default in the claim liability, would not adequately reflect the decrease in the amount of insurance protection provided by insured principal payments made on the insured financial obligation in the premium revenue recognition approach. Therefore, the Board expanded the accounting model for financial guarantee insurance contracts by incorporating attributes of both the short-duration and the long-duration models.

Unearned Premium Revenue

B9. In current practice, insurance enterprises that issue financial guarantee insurance contracts generally recognize a liability for the unearned premium revenue when the premium is received. If the premium is received at inception (single premium), a liability for the unearned premium revenue is recognized at inception. If the premiums are received as payments over the period of the financial guarantee insurance contract (premium payments), a liability for the unearned premium revenue is recognized as those payments are received over the payment period and each payment of premium received is accounted for as a renewal premium.

B10. The Board decided that a liability for the unearned premium revenue should be recognized in its entirety at inception of a financial guarantee insurance contract, regardless of when the premium is received. The obligation under a financial guarantee insurance contract is created at the contract's inception (the "stand-ready" obligation) for the entire period of the insured financial obligation. Further, the insurance enterprise will continue to receive the premium specified by a financial guarantee insurance contract at the contract's inception to the extent the insured financial obligation remains outstanding.

B11. The Board concluded that the premium specified by a financial guarantee insurance contract represents the best measure of the obligation created by the contract at the contract's inception. The premium calculation factors in expectations about the likelihood of default based on information available at the contract's inception. Accordingly, the liability for the unearned premium revenue is measured based on the related asset, that is, the cash received (single premium) or expected to be collected over the period of the contract (premium payments).

Receivable for Future Premiums

B12. Some respondents to the Exposure Draft stated that an asset does not exist because the future receipt of the premium payments is not certain and, therefore, the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements,* has not been met. The Board disagreed with this analysis. On issuing the insurance contract, the insurance enterprise has a right to payment as long as the underlying financial obligation is outstanding. The asset recognized reflects that right. The Board observed that uncertainty in the receipt of premium is an issue of measurement and not recognition. The Board noted that premium revenue recognition is linked to recognition of an asset for contracts where premium payments are made over the period of the contract and that if the asset were not recognized, the mode of premium payment (that is, a single payment or premium payments) would dictate recognition of premium revenue. The Board decided that no conceptual distinction should exist between contracts based on the mode of premium payments. Consequently, the Board concluded that an asset does exist and should be recognized for insurance contracts where premium payments are made over the period of the contract.

B13. When developing the Exposure Draft, the Board reasoned that if the measurement is based on the premiums due or expected to be collected over the period of the contract (premium payments), the contractual arrangement is, in effect, a form of premium financing between the insurance enterprise and the policyholder. That is, the premium payments do not represent renewal premium payments, but, rather, they are part of the overall premium pursuant to the terms of the financial guarantee insurance contract. Therefore, in the Exposure Draft, the Board proposed that (a) the premium receivable should be discounted (to reflect the time value of money) using a discount rate that reflects the policyholder's credit standing at the inception of the financial guarantee insurance contract and (b) the discount amount should be accreted on the premium receivable through investment income over the period of the contract. In other words, a portion of the premium specified by the financial guarantee insurance contract is compensation (recognized through investment income) to the insurance enterprise for entering into the premium financing arrangement.

B14. Some respondents to the Exposure Draft commented that determining the discount rate based on each policyholder's credit standing was impracticable and would be too costly to apply. Respondents also commented that characterizing a contract where premium payments are made over the period of the contract as a premium financing was not representative of the terms of the contract and that requiring the accretion to be recognized as investment income was confusing for users of financial statements. During redeliberations, the Board maintained that the most relevant discount rate considers the credit standing of the policyholder and that these contracts are a form of premium financing. However, the Board considered the cost-benefit ramifications and concluded that the current risk-free rate should be used because it is simple to apply and is an observable input. As part of this decision, the Board decided that the current risk-free rate should be updated only when prepayment assumptions change. The Board did not provide prescriptive guidance on where the accretion should be reported in the statement of income because (a) the Board is currently deliberating a broader project about financial statement presentation and (b) users of financial statements expressed concerns with separate reporting in this instance. Thus, the Board was not opposed to the accretion being reported as part of premium revenue, as part of investment income (as a subcomponent of total revenue), or as a separate line item in the statement of income with disclosure of the insurance enterprise's accounting policy.

B15. In the Exposure Draft, the Board proposed that the initial measurement of the unearned premium revenue should be the present value of the premiums due or expected to be collected over the full contract period, rather than the expected period in which the financial guarantee insurance contract would be outstanding. During redeliberations, the Board reconsidered the use of an expected period for financial guarantee insurance contracts insuring prepayable financial obligations because many respondents to the Exposure Draft stated that in some instances prepayment assumptions are available and can be reliably measured. The Board observed that the period of the contract and the amount of premiums due or expected to be collected will vary in some instances for financial guarantee insurance contracts where premium payments are made over the period of the contract. These variances occur when the financial obligation is contractually prepayable. Constituents told the Board that prepayment assumptions are used in pricing financial guarantee insurance contracts. Accordingly, the Board concluded that prepayment assumptions may be used to determine an expected period if specified criteria are met.

B16. The Board decided that the use of prepayment assumptions in determining the expected period is appropriate only if a homogenous pool of assets underlying the insured financial obligation is contractually prepayable. In those instances, prepayment assumptions may be used to determine an expected period if prepayments on the insured financial obligation are probable and the timing and amount of prepayments can be reasonably estimated. The Board reasoned that a homogenous pool of assets that are contractually prepayable is necessary to establish a sufficient number of observations, history, or both to support the assertion that prepayments are probable and that the timing and amount can be reasonably estimated. The Board considered allowing the use of an expected period for individual callable insured financial obligations but decided not to because an underlying homogenous pool of assets does not exist.

B17. The Board decided that an insurance enterprise should adjust the initial prepayment assumptions when there has been a change in those assumptions. Those adjustments should be applied to both the unearned premium revenue and the premium receivable with no effect on earnings at the time of the adjustment. The Board observed that this approach would remove the need to recalibrate previously recognized premium revenue. Because the premium receivable and unearned premium revenue are equal at inception, the Board concluded that even though the subsequent measurement of these two balances will differ, subsequent changes in prepayment assumptions should result in an equal adjustment to both balances. Accordingly, when the financial guarantee insurance contract expires, the amount of premium received will equal the amount of revenue recognized.

B18. The election to use prepayment assumptions to determine an expected period is an accounting policy decision (that is, it is not a contract-by-contract election). Accordingly, either an insurance enterprise decides that its accounting policy is to use an expected period when the specified criteria described in paragraph B16 are met or it decides to use the contract period for all financial guarantee insurance contracts.

Premium Revenue Recognition

B19. The Board decided to address premium revenue recognition for financial guarantee insurance contracts issued by insurance enterprises because of the interrelationship of revenue recognition with claim liability recognition and measurement. Financial guarantee insurance contracts provide insurance protection to the holder of the insured financial obligation. Therefore, the Board decided to address premium revenue recognition issues in the context of the short-duration insurance accounting model in Statement 60, which links premium revenue recognition to the amount of insurance protection provided. Paragraph 13 of Statement 60 states:

> Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

B20. In its deliberations leading up to the Exposure Draft, the Board clarified aspects of the short-duration insurance accounting model in Statement 60 in the context of financial guarantee insurance contracts (focusing on the notion of insurance protection and the appropriate period of risk). During its redeliberations, the Board maintained that the premium revenue recognition approach should be based on Statement 60 because the contracts provide insurance protection.

B21. In the Exposure Draft, the Board considered whether the amount of insurance protection provided should be determined based on (a) the insured principal of the insured financial obligation or (b) the insured contractual payments (generally principal and interest) made by the issuer of the insured financial obligation. At that time, the Board proposed that the amount of insurance protection provided should be determined based on the insured contractual payments made by the issuer of the insured financial obligation. The Board observed that the insurance enterprise is at risk to the extent of the insured contractual payments that have not yet been made by the issuer of the insured financial obligation. Accordingly, the Board concluded that the insured contractual payments made by the issuer of the insured financial obligation provide a better measure of the reduction of risk associated with the insured financial obligation than the insured principal of the insured financial obligation. In the event of default, the insurance enterprise must assume the obligation to make those payments remaining on the insured financial obligation.

B22. Respondents to the Exposure Draft disagreed with the Board's conclusion. They stated that the insured principal of the insured financial obligation represents a present value of the insured financial obligation and is more consistent with the measurement of the claim liability (which incorporates the time value of money in the measurement). The Board agreed with respondents that the insured principal amount does represent a present value measurement. Yet, that present value measurement uses the coupon rate. The Board observed that the appropriate measure of the insurance protection is the present value using a current discount rate. However, the present value using current interest rates is more akin to a fair value measurement. The Board observed that it would be premature to consider in this limited-scope project whether a fair value measurement would be more appropriate. Further, constituents stated that determining the present value of the insurance protection using current rates would be onerous and that insured principal is a measure currently reported by insurance enterprises and understood by users of financial statements. Therefore, the Board concluded that the insured principal of the insured financial obligation represents a practical measure of the insurance protection provided by the financial guarantee insurance contract because it includes the time value of money. The Board also concluded (consistent with its conclusion that the time value of money should be included in the measurement of the insurance protection) that in instances where the insured financial obligation accretes to the principal amount over its life and has a single principal payment at maturity (such as a zero-coupon bond), the insurance protection should be measured based on the accreted principal amount outstanding.

B23. In the Exposure Draft, consistent with its decision to link the amount of insurance protection provided to insured contractual payments made by the issuer of the financial obligation, the Board clarified that the period of risk is the contract period; that is, the period over which the insured contractual payments are made by the issuer of the insured financial obligation. The Board reasoned that the insurance protection provided declines as the insured contractual payments are made by the issuer of the insured financial obligation according to a predetermined schedule. Therefore, premium revenue should be recognized over the contract period in proportion to the insured contractual payments made by the issuer of the insured financial obligation according to the predetermined schedule at the time that the insured contractual payment is made.

B24. In the Exposure Draft, the Board acknowledged that for a financial obligation subject to significant prepayment risk (for example, mortgage-backed securities), the exposure period might be shorter than the contract period (due to the prepayments). However, the Board concluded that in the absence of observable information about prepayment expectations, it would be difficult to reliably assess the likelihood of prepayment. The Board agreed that the premium revenue recognition approach should be consistently applied across all financial guarantee insurance contracts issued by insurance enterprises. Therefore, at that time, the Board proposed not to modify the premium revenue recognition approach in the Exposure Draft to address prepayments.

B25. Respondents to the Exposure Draft stated that prepayment assumptions for financial obligations that are contractually prepayable are available, reliable, and used in the pricing of the insurance contract. For these reasons, the Board concluded that, when specified criteria are met (see paragraph B16), prepayment assumptions may be used to determine an expected period for the insurance contract.

B26. In the Exposure Draft, the Board observed that when insured contractual payments are made by the issuer of an insured financial obligation in total at maturity (for example, a zero-coupon bond), the insurance enterprise would not recognize premium revenue until maturity under the premium revenue recognition approach. The Board acknowledged that waiting until maturity to recognize premium revenue might not reflect the reduction of risk associated with the insured financial obligation over the contract period (due to the passage of time). As a result, the Board considered, but rejected, as part of its initial deliberations an alternative premium revenue recognition approach under which an insurance enterprise would recognize premium revenue evenly over the contract period, based on the insured contractual payments to be made by the issuer of the insured financial obligation.

B27. Respondents to the Exposure Draft overwhelmingly disagreed with the premium revenue recognition approach because it did not incorporate the passage of time as evidenced by the accounting for an insured zero-coupon bond described in paragraph B26. The Board observed that by issuing the financial guarantee insurance contract the insurance enterprise has created an obligation to stand ready to make insured principal payments in the event of default. That obligation covers the entire period of the contract. Accordingly, the Board concluded that the premium revenue recognition approach in the Exposure Draft did not completely reflect the coverage provided by the financial guarantee insurance contract because, in the case of an insured zero-coupon bond, premium revenue would not be recognized until the maturity of the contract even though the insurance enterprise stands ready during the entire period of the contract.

B28. During its redeliberations, the Board reconsidered the basis underlying the alternative premium revenue recognition approach described in paragraph B26 and considered a variation of that approach (revised approach). The Board observed that this revised approach incorporated both the insurance protection being provided (represented by the insured principal amounts outstanding on the insured financial obligation) and the passage of time. This premium revenue recognition approach for a financial guarantee insurance contract links premium revenue recognition to the insurance protection being provided by the insurance enterprise. That is, the insurance enterprise is obligated to assume any insured principal amounts outstanding in the event of a default. This approach incorporates both the reduction of insurance protection and the passage of time by including the insured principal amounts outstanding during each reporting period and applying a constant rate to those outstanding payments. The underlying presumption is that the insurance enterprise has agreed to set aside capital for that insured financial obligation to stand ready to make payments upon the occurrence of an event of default. The premium revenue recognition approach in effect results in compensation (the constant rate), based on the premium, for that capital set aside. Accordingly, premium revenue is recognized based on that compensation, which is a function of the insured principal amounts outstanding at each reporting period. The Board concluded that the incremental improvement in comparability among insurance enterprises afforded by this approach and the reduced effort to implement it justified the costs.

B29. The Board also considered a straight-line approach for premium revenue recognition. A straight-line approach provides an understandable and easy-to-implement solution. Furthermore, that approach focuses on the passage of time as the main component for premium revenue recognition. The Board rejected that approach because it does not reflect the reduction of the insurance protection that occurs as insured principal payments are made over the period of the contract. The Board concluded that the reduction of the insurance protection was integral in the recognition of premium revenue for financial guarantee insurance contracts.

Early Retirement and Replacement of an Insured Financial Obligation

B30. The Board decided to clarify how the premium revenue recognition approach in this Statement applies in a refunding; that is, when the issuer of an insured financial obligation retires the obligation before its scheduled maturity and replaces it with a new financial obligation. For purposes of this Statement, the Board concluded that a refunding has occurred when the financial guarantee insurance contract is extinguished (that is, the obligation of the insurance enterprise to perform under the insurance contract no longer exists). When the financial guarantee insurance contract has been extinguished and the premium is nonrefundable, the insurance enterprise should recognize premium revenue to the extent of any unearned premium revenue for that contract.

B31. The Board further considered the situation in which the new financial obligation is insured by the same insurance enterprise (that is, the insurance enterprise that previously insured the financial obligation that is retired). The Board observed that where there is a preexisting relationship between the insurance enterprise and the issuer of the insured financial obligation, the transaction might not be at arm's length. Accordingly, if the premium received to insure the new financial obligation is not commensurate with the premium that the insurance enterprise would charge to insure a similar financial obligation in a separate (standalone) transaction, an additional liability should be recognized. Thus, the unearned premium revenue recognized reflects the obligation of the insurance enterprise under the new financial guarantee insurance contract.

Claim Liability

B32. Information is available with which to evaluate the likelihood of default over the period of the contract (for example, information about the credit deterioration of the insured financial obligation). The Board decided that the claim liability recognition and measurement approach for financial guarantee insurance contracts should incorporate that information through expected net cash outflows reflecting the potential payment of claims by the insurance enterprise related to an insured financial obligation. The claim liability recognition and measurement approach in this Statement is a new approach that incorporates aspects of the long-duration insurance accounting model in Statement 60 and represents a departure from practice under FASB Statement No. 5, *Accounting for Contingencies.* The Board decided, in this instance, that claim liability recognition based on when a default has occurred does not provide sufficient information to users of financial statements of insurance enterprises because it ignores information about credit deterioration of an insured financial obligation.

Expected Net Cash Outflows

B33. Expected net cash outflows (cash outflows, net of potential recoveries, expected to be paid to the holder of the insured financial obligation, excluding reinsurance) are probability-weighted cash flows that, conceptually, reflect the likelihood of all possible outcomes. For purposes of this Statement, expected net cash outflows are developed using the insurance enterprise's own assumptions about the likelihood of default of all possible outcomes based on all information available to the insurance enterprise (including relevant market information), including information derived from the risk-management activities used by the insurance enterprise to identify and track credit deterioration in its insured financial obligations.

B34. The risk-management activities of the insurance enterprise often use a surveillance or watch list detailing the insurance enterprise's own assessment of the credit standing of each insured financial obligation on the list, that is, those that have a deterioration in credit standing. It is updated regularly based on information provided by the issuer of the financial obligation pursuant to the terms of the financial guarantee insurance contract. Thus, the surveillance or watch list reflects current information specific to each insured financial obligation on the list. The Board believes that the information in the insurance enterprise's own surveillance list often is integral to understanding how the insurance enterprise evaluates its claim liability. To improve the quality of the information provided to users of financial statements about insured financial obligations, expected net cash outflows that incorporate such enterprise-specific information (including relevant market information) should form the basis for the claim liability recognition and measurement approach in this Statement.

Recognition

B35. Financial guarantee insurance contracts generally (a) provide insurance protection over an extended period of time and (b) are noncancellable. Therefore, in the Exposure Draft, the Board proposed to address claim liability recognition in the context of the long-duration insurance accounting model in Statement 60. Consistent with its view that the premium specified by a financial guarantee insurance contract represents the best measure of the obligation created by the contract (the "stand-ready" obligation) at inception of the contract, the Board concluded that the liability for the unearned premium revenue at inception of the financial guarantee insurance contract provides the best representation of that obligation. Accordingly, a claim liability is recognized when the expected net cash outflows exceed the liability for the unearned premium revenue. If a claim liability is subsequently recognized, the insurance enterprise's obligation under the financial guarantee insurance contract would be conceptually represented by combining (a) the liability for the unearned premium revenue on that contract and (b) the claim liability recognized for that contract under this Statement.

B36. Some respondents to the Exposure Draft disagreed with the Board's decision that a claim liability should be recognized when the present value of the expected net cash outflows exceed the unearned premium revenue. Those respondents commented that linking premium revenue recognition and claim liability recognition reduces the usefulness of the financial statements and delays the recognition of the claim liability. The Board disagreed noting that the unearned premium revenue represents the obligation to stand ready at inception and, by definition, links all of the potential cash flows of the insurance contract. Furthermore, the Board observed that the claim liability and unearned premium revenue are recognized on a contract-by-contract basis, not on a portfolio basis. Therefore, the entire amount of the expected claim payments are recognized, albeit partly as the unearned premium revenue and partly as the claim liability.

Measurement

B37. The Board decided that the claim liability, recognized based on expected net cash outflows, should be measured equal to the present value of those expected net cash outflows.

B38. Because this Statement does not require a fair value measurement, the expected net cash outflows used to measure the claim liability are not adjusted for market participant assumptions that might be different from the insurance enterprise's own assumptions. The measurement approach in this Statement represents an exception to the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* which establishes that the objective of a present value technique is to measure fair value. However, that measurement approach is similar to the long-duration insurance accounting model in Statement 60, which relies on the insurance enterprise's own assumptions about varying factors to measure other policy benefits. The measurement approach in this Statement uses the insurance enterprise's own assumptions about the likelihood of all possible outcomes based on all information available to the insurance enterprise (including relevant market information). Those assumptions need to consider all relevant facts and circumstances and, where applicable, be consistent with the information tracked and monitored through the insurance enterprise's risk-management activities and used to assist in making operational decisions. The measurement approach in this Statement is subject to a cost-benefit constraint similar to the cost-benefit constraint described in paragraph 51 of Concepts Statement 7.

B39. The Board concluded in the Exposure Draft that because the claim liability is an obligation of the insurance enterprise, the expected net cash outflows should be discounted using a discount rate that reflects the credit standing of the insurance enterprise at initial recognition of the claim liability. During redeliberations, the Board observed that, in this instance, including the credit standing of the insurance enterprise in the discount rate reduces the comparability of similar financial obligations insured by different insurance enterprises. Accordingly, the Board decided to require a current risk-free rate because (a) it improves comparability by using similar discount rates and (b) significant differences in the measurement of the claim liability are generally included as part of the expected net cash outflows. In addition, a current risk-free rate provides increased transparency to users of financial statements (that is, users are aware that an observable rate is being used). This discounting approach represents a departure from the guidance in Statement 60, which requires the use of interest assumptions based on estimates of expected investment yields when estimating the liability for future policy benefits. The measurement guidance in Statement 60 is based on the view that the claim liability should be discounted using the investment yields on an insurance enterprise's investments because those investments will be used to make the eventual claim payments. In this Statement, the Board disagreed with that view because it believes the investment yields on the investments held by the insurance enterprise are not relevant to the measurement of the claim liability.

B40. In periods after initial recognition, an insurance enterprise should update the expected net cash outflows for changes that increase (or decrease) expectations about the likelihood of default as those changes occur. The Board proposed in the Exposure Draft that those changes to the claim liability in subsequent periods should continue to be measured using the same discount rate used at the initial recognition of the claim (that is, the discount rate that reflects the credit standing of the insurance enterprise at the date the claim liability is initially recognized) so that the measurement is not affected by general changes in interest rates. The Board also proposed that the claim liability should be remeasured using a current interest rate only upon the event of default. The Board reasoned at that time that the event of default is a significant event that changes the nature of the insurance enterprise's obligation. However, respondents to the Exposure Draft pointed out that determining when a default has actually occurred is subject to interpretation and varies by insurance enterprise. During its redeliberations, the Board acknowledged the potential for diversity in practice and concluded that because a risk-free rate was being used, updating that rate each period increases the relevance of the measurement because changes in general market conditions are included in that measurement. Consequently, the Board decided that the risk-free rate should be updated each reporting period.

Disclosures

B41. The Board's disclosure objective is to provide information that enables users of financial statements to assess factors affecting recognition and measurement of financial guarantee insurance contracts. As a basis for developing the disclosures, the Board obtained input from users of financial statements that evaluate insurance enterprises that issue financial guarantee insurance contracts, focusing on key information for premium revenue and claim liabilities that would provide insight and improve the understandability of the accounting for a financial guarantee insurance contract. The Board also considered the voluntary disclosures made by insurance enterprises outside the basic financial statements (for example, operating supplements, created as a result of information requests by users, that are not required by generally accepted accounting principles [GAAP]). The Board concluded that the disclosures in this Statement will provide useful information for understanding the financial obligations insured under financial guarantee insurance contracts.

B42. The Board determined that disclosure of the amounts relating to financial guarantee insurance contracts is important where premiums are paid over the period of the contract that are recognized in the statement of financial position (premium receivable and unearned premium revenue) and in the statement of income. In particular, separate disclosures of these amounts would allow users of financial statements to identify and compare amounts (and identify significant changes) relating to the financial guarantee insurance contracts between periods. The Exposure Draft required that the accretion of the premium receivable be reported as investment income. Some respondents to the Exposure Draft stated that this requirement would increase complexity as that accretion is generally viewed as a component of premium revenue. During its redeliberations, the Board acknowledged that while the accretion for the premium receivable represents interest income from the premium financing, reporting the accretion in this manner may increase complexity for users of financial statements who view that accretion as a component of premium revenue. Accordingly, the Board decided not to prescribe where the accretion should be reported in earnings but did require disclosure about the amount and location of the accretion.

B43. During redeliberations, the Board decided to allow the use of an expected period in measuring the premium receivable and unearned premium revenue when specific criteria are met. In subsequent periods, the prepayment assumptions used to measure the expected period are changed when those assumptions have changed. However, the Board was concerned that changes in the prepayment assumptions that would either accelerate or decelerate revenue recognition were not readily observable by users of financial statements due to the number of components that would affect the premium receivable. Accordingly, the Board decided that a rollforward of the premium receivable detailing key components of the asset provides insight into the major factors that make up the measurement of that asset. The rollforward includes the beginning balance, recurring items such as new business and premium cash receipts received in the period, adjustments to the asset, and the ending balance. The Board decided that within the adjustments to the asset, separate disclosure should be required for those adjustments that result from a change in prepayment assumptions that affect the expected period. The Board observed that this required disclosure will help users of financial statements in understanding the trends and types of business affected by prepayment assumptions as well as allow them to observe the effect of current market conditions.

B44. Some respondents to the Exposure Draft requested that additional disclosures be required. Those additional disclosures include a schedule of expected cash receipts related to the premium receivable, the discount rates used to measure the claim liabilities, the amount and location of the accretion of the claim liability, an accounting policy for accretion, and a sensitivity analysis of the inputs to the measurement of the claim liability. The Board decided that disclosure of a schedule of expected cash receipts related to the premium receivable will help users of financial statements in understanding the expected cash flows related to that receivable. The Board also decided that disclosures about the discount rate used to measure the claim liability and the significant components of the change in the claim liability should improve the transparency of the financial statements. If users of financial statements know the weighted-average discount rate, they can understand better how discounting affects the claim liabilities. Disclosing the significant components of the change in the claim liability for the period (such as changes due to accretion, changes in the discount rate, changes in the timing, changes in the likelihood of default) and the amount of those components provides additional transparency to these balances. The Board rejected an explicit requirement to disclose an accounting policy for accretion because it reasoned that other existing accounting literature addresses disclosures for accounting policies. The Board also rejected requiring a sensitivity analysis of the inputs to the measurement of the claim liability. While the Board noted that information provided through sensitivity analysis is useful, the lack of a disclosure framework creates the potential for divergence because the objectives and acceptable forms of sensitivity analysis have not been established.

B45. Some users of financial statements emphasized the importance of understanding the amount of premium revenue recognized that has been accelerated (such as upon the early retirement of an insured financial obligation). Because the decision to retire an insured financial obligation early often is based on external factors (changes in interest rates) and is discretionary (subject to the terms of the insured financial obligation), it is a nonrecurring event (that is, it is not readily predictable). Accordingly, the users of financial statements view accelerated premium revenue differently from premium revenue recognized through the premium revenue recognition approach. Therefore, the Board concluded that requiring disclosure of accelerated premium revenue helps users of financial statements assess the sustainability of an insurance enterprise's revenue.

B46. In the Exposure Draft, the Board observed that some users of financial statements emphasized the importance of disclosing a schedule of future premium revenue, noting that insurance enterprises usually disclose that information outside the basic financial statements (for example, in the non-GAAP operating supplements). In the Board's view, disclosing that information would help users of financial statements in projecting the future revenues of the insurance enterprise. Accordingly, that disclosure would allow users of financial statements to identify and compare significant changes in the liability for the unearned premium revenue related to the future revenue stream. Respondents to the Exposure Draft stated that the disclosure would better serve their needs if it included the expected period of the insurance contract as this would provide more relevant information. As a result of its decision to allow the use of the expected period (when specified criteria are met) to measure unearned premium revenue, the Board decided that the disclosure also should reflect the expected period.

B47. A key disclosure under this Statement relates to an insurance enterprise's risk-management activities. The expected net cash outflows that form the basis for the claim liability recognition and measurement approach in this Statement rely heavily on the information derived from those activities. Consistent with its view that the information in an insurance enterprise's risk-management activities are integral in understanding how an insurance enterprise evaluates its claim liability, the Board decided to require disclosures about those activities to further improve the quality of the information disclosed about insured financial obligations that are deteriorating. The Board observed that in many instances an insurance enterprise tracks its risks through the use of a surveillance or watch list. Further, some insurance enterprises already disclose in non-GAAP operating supplements information related to those lists. While the Board did not intend to prescribe how an insurance enterprise carries out its risk-management activities, it concluded that financial information related to those activities helps users of financial statements understand how an insurance enterprise manages its risks and the extent of exposure to those risks. The Board decided that information used to measure the claim liability should be consistent, where appropriate, with the information derived from the risk-management activities of the insurance enterprise.

Effective Date and Transition

B48. In the Exposure Draft, the Board proposed that this Statement should be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Because the Board understood that insurance enterprises that issue financial guarantee insurance contracts often use risk-management activities that include some form of surveillance or watch list already and the disclosures required by this Statement rely on information previously provided voluntarily by insurance enterprises (in the non-GAAP operating supplements), the Board concluded that the effective date of this Statement provides sufficient preparation time for insurance enterprises, their auditors, and users of financial statements to implement the provisions of this Statement. The Board decided not to permit early application because the application of this Statement in an interim period reduces the overall comparability of the financial statements. At issuance of this Statement, the proposed effective date had passed. Accordingly, the Board decided that this Statement should be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years.

B49. During its redeliberations, the Board acknowledged that the disclosures about the risk-management activities of an insurance enterprise provide useful and relevant information to readers of the financial statements and could be provided earlier than other disclosures. Consequently, the Board decided those disclosures should be required beginning the first period after issuance of this Statement due to the current state of the credit markets. Those disclosures will help in providing transparent information about insured financial obligations that have credit deterioration. In instances where it is impracticable to provide some or all of the disclosures, an insurance enterprise must disclose an explanation of why those disclosures are impracticable at this time, a description of its existing accounting policy for claim liabilities, and the rationale for establishing claim liabilities.

B50. The Board proposed in the Exposure Draft to require a cumulative-effect adjustment to retained earnings for existing and future financial guarantee insurance contracts, applied as of the beginning of the fiscal year in which this Statement is initially applied. Respondents agreed with that proposal. Because the guidance in this Statement requires estimates of amounts not previously recognized in the financial statements, a full retrospective transition approach would require the use of hindsight. The Board also decided that it is not practicable to require the application of this Statement to expired or matured financial guarantee insurance contracts. Therefore, the Board decided that this Statement should not be applied retrospectively in all prior periods.

B51. On initial application of this Statement, an insurance enterprise should measure the cumulative effect of initially applying this Statement (recognized as an adjustment to the opening balance of retained earnings for that fiscal year) using information that is current at that date. Therefore, discount rates should reflect the relevant risk-free rate at the date this Statement is initially applied.

B52. To achieve comparability in future periods, the information in paragraphs 29–31 of this Statement should be disclosed in the first interim period in which this Statement is initially applied with earlier disclosure for certain information as described in paragraph 32. The disclosure requirements of this Statement need not be applied to financial statements for periods presented before initial application of this Statement except as stated in paragraph 32 of this Statement.

Benefits and Costs

B53. The mission of the FASB is to establish and improve standards of financial accounting and reporting to provide information that is useful to users of financial statements (present and potential investors, creditors, and other capital market participants) in making rational investment, credit, and similar resource allocation decisions. In fulfilling that mission, the Board endeavors to determine that a standard will fill a significant need and that the costs imposed to apply that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

B54. In assessing the benefits and the costs of establishing a separate accounting model for financial guarantee insurance contracts, the Board obtained input from investors, preparers, and auditors. The Board concluded that the benefits relate principally to improved financial reporting resulting from a more consistent application by insurance enterprises to financial guarantee insurance contracts and enhanced disclosures about those contracts. Specifically, the Board noted that providing consistent accounting for premium revenue recognition and claim liability recognition and measurement improves the comparability between insurance enterprises. In addition, disclosures about the risk-management activities of an insurance enterprise improve the transparency of the claim liability and related potential recoveries. The Board understands that insurance enterprises will need to develop modified or new systems to initially apply the premium revenue recognition provisions (for example, separately track the accretion of the premium receivable and develop the expected period from prepayment assumptions). Furthermore, any new or modified systems will require the establishment and maintenance of internal controls subject to audit. The Board considered the costs of the necessary new systems and internal controls in reaching its decisions.

B55. Consequently, the Board considered existing accounting practices and voluntary information already provided by insurance enterprises as a result of user requests. For example, the Board observed that most insurance enterprises use similar risk-management activities to track and monitor credit deterioration on their insured financial obligations. The Board concluded that incorporating information from these risk-management activities in the measurement of the claim liability not only improves the quality of the measurement but also incorporates existing information used by management. Another example is that the majority of the disclosures required by this Statement are already provided by insurance enterprises voluntarily as part of non-GAAP operating supplements. By requiring these disclosures, the Board provided users of financial statements with more comparable disclosures that are subject to an independent audit.

Appendix C

AMENDMENTS TO EXISTING PRONOUNCEMENTS

C1. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* is amended as follows: [Added text is <u>underlined</u> and deleted text is ~~struck out~~.]

a. Paragraph 6, as amended:

> This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock **life insurance enterprises, property and liability insurance enterprises,**[2] **title insurance enterprises,** mutual life insurance enterprises, **assessment enterprises,** and **fraternal benefit societies.** Except for the sections on premium revenue and claim cost recognition and **acquisition costs** (paragraphs 9–11, 13–18, and 20–31), this Statement applies to **mortgage guaranty insurance enterprises.** <u>Except for the sections on premium revenue and claim cost recognition (paragraphs 9, 10, and 13–18), this Statement applies to financial guarantee insurance contracts included within the scope of FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts.*</u> FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts,* addresses the accounting for certain long-duration participating life insurance contracts.[2a]

C2. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* is amended as follows:

a. Paragraph 8(c):

> Insurance contracts, other than financial guarantees (including financial guarantee insurance contracts within the scope of FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts*) and investment contracts, as discussed in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

C3. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* is amended as follows:

a. Paragraph 10(c):

> *Certain insurance contracts.* Generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises* (except for financial guarantee insurance contracts as defined in FASB Statement No. 163, *Accounting for Financial Guarantee Insurance Contracts*), No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:
>
> (1) *Traditional life insurance contracts.* The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.
>
> (2) *Traditional property and casualty contracts.* The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.
>
> However, insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises combine derivative instruments, as defined in this Statement, with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12.

C4. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* is amended as follows:

a. Paragraph 6(d):

> A guarantee (or an indemnification) that is issued by either an insurance company or a reinsurance company and accounted for under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* ~~or~~ No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts,* or No. 163, *Accounting for Financial Guarantee Insurance Contracts* (including guarantees embedded in either insurance contracts or investment contracts).

C5. EITF Issue No. 85-20, "Recognition of Fees for Guaranteeing a Loan," is amended as follows:

> **[For ease of use, only the portion of the STATUS section affected by this Statement has been reproduced.]**

STATUS

For those guarantees that are not accounted for as derivatives in accordance with Statement 133, this Interpretation partially nullifies the consensus by requiring that guarantees within the scope of this Issue be initially recognized as a liability for which the measurement objective of that initial recognition is fair value. Furthermore, the Interpretation requires expanded disclosures about those guarantees. Interpretation 45 does not impact the consensus in this Issue related to the recognition of guarantee fee income subsequent to initial recognition of the liability.

Statement 163, which was issued in May 2008, provides accounting guidance for financial guarantee insurance contracts issued by insurance enterprises. That Statement nullifies the consensuses of this Issue for those financial guarantee insurance contracts that are within its scope.

No further EITF discussion is planned.