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AFGI

Association of Financial Guaranty Insurers

31 October 2003

Mr. Peter Clark
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London, England EC4M 6XH
United Kingdom
VIA Email: CommentLetters@iasb.org.uk

Re: Exposure Draft ED 5 Insurance Contracts

Dear Mr. Clark:

The Association of Financial Guaranty Insurers ("AFGI") is pleased to comment on the International Accounting Standard Board's (IASB) proposal, Exposure Draft No. 5 Insurance Contracts (ED 5). AFGI is the trade association representing nine insurers and reinsurers of municipal bonds and asset-backed securities. AFGI members conduct substantially all of the financial guaranty business written in the world. AFGI member companies are ACE Guaranty Corp., Ambac Assurance Corporation, CDC IXIS Financial Guaranty North America, Inc., Financial Guaranty Insurance Company, Financial Security Assurance Inc., MBIA Insurance Corporation, Radian Reinsurance Inc., RAM Reinsurance Company Ltd. and XL Capital Assurance Inc. In 2002, AFGI members insured $431.2 billion in par value of securities.

A number of AFGI members are subsidiaries of companies that will be adopting International Accounting Standards. The industry's international business component, comprising public finance and asset-backed activity, totaled $71 billion of par insured for the year ended December 31, 2002. Five years ago, the value of international par insured was only $17 billion. This growth has been, and is expected to continue to be driven by budgetary restraints imposed by the Maastricht Treaty, where privatization of public infrastructure projects has been steadily increasing over the past several years, and bond insurance has become the dominant form of credit enhancement. In addition, the range of assets securitized and companies making use of the securitization techniques have broadened dramatically, as evidenced by the fact that securitizations now incorporate government assets, non-performing loans, whole business assets, and commercial real estate. The growth and increase in diversity of the market, coupled with the "flight to quality" from other, less stable markets, has significantly broadened the investor base for securities enhanced with financial guarantees.

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

All current AFGI member firms carry the triple-A or double-A claims paying ability rating from one or more of the major credit rating agencies. Further, the United States-based financial guarantors operate under the strict risk-based capital provisions of Article 69 of the New York Insurance Law. Article 69 establishes a so-called “monoline” financial guaranty insurance industry by limiting financial guaranty insurance corporations to writing only financial guaranty insurance and a few closely related lines of insurance (surety, credit and residual value insurance). The New York State insurance law has served as a template for the other states that have enacted so-called “monoline” financial guaranty insurance laws. All major participants in the United States financial guaranty insurance market are licensed under Article 69, and are therefore subject to the restrictions imposed by Article 69.

In addition, AFGI members have established operations in Europe that are regulated by local insurance regulators and follow the Directives of the European Parliament and the Council of the European Union, or EU Insurance Directives.

To safeguard the rating of the insured obligations and to protect the interests of insured bond investors, AFGI firms subscribe to a “remote loss” underwriting standard. Securities insured by AFGI members receive the unconditional and irrevocable guaranty of scheduled principal and interest payments to holders of these obligations. In the 32-year history of the financial guaranty industry, no member company has ever failed to fulfill its payment obligations to insured bond investors when due.

AFGI members support the IASB mission to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, investors, and other users of financial information. As such, AFGI believes the comments, observations and suggestions herein are consistent with the IASB’s mission statement, particularly considering the needs of AFGI member firms and users of their financial information.

There has been some debate as to how to account for financial guaranty insurance under International Accounting Standards. We agree with the principles articulated in ED 5.

Specifically per ED 5, Appendix A, an insurance contract is a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary". Furthermore per ED 5, Appendix B17 (g), "credit insurance, as a precondition for payment, requires that the holder has incurred a loss on the failure of the debtor to make payments when due. These contracts could have various legal forms such as that of a financial guaranty, letter of credit, credit derivative, default product or insurance contract." It is understood that if the issuer incurred or retained the risk of loss via a financial guaranty contract when it transferred financial or non-financial assets or liabilities to another party, these contracts would then fall within the scope of IAS 39, Financial Instruments: Recognition and Measurement.

Financial guaranty insurance contracts only pay when the holder has incurred a loss arising from the failure of the debtor to make payment when due. Furthermore, AFGI members are not the transferors when financial assets or financial liabilities are being de-recognized. Based upon the definitions described above, financial guaranty insurance contracts issued by AFGI members would clearly and appropriately fall within the definition of an insurance contract.

In reviewing the Basis for Conclusions on Exposure Draft ED 5 Insurance Contracts, we concur with the observations made in BC45 that argues that contracts against credit risk found in the banking industry are different from financial guaranties and that financial guaranties should fall within the scope of the International Financial Reporting Standard (IFRS) on Insurance Contracts. In addition to the arguments outlined within BC45, our general principles differentiating financial guaranty insurance contracts from other contracts are as follows: a) the writer of the insurance contract or policy must be an insurance company, regulated as a financial guaranty insurance company by an insurance regulator operating within a robust regulatory regime, b) the insured obligations must be insurable risks for financial guaranty insurance companies as determined under the New York Insurance laws, c) the insurance policy must be irrevocable by the bond insurer, and must include rights of subrogation against the underlying obligor and d) at inception of the insurance policy, the credit-related risk insured under the insurance policy *is* the equivalent of investment-grade without the benefit of the insurance (that is, the risk of payment undertaken must be a low frequency event).

We agree that the following contracts currently within the scope of IAS 39 should remain so:

- A financial guaranty given or retained by a transferor when it de-recognizes financial assets or financial liabilities.
- A financial guaranty that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due.
- A financial guaranty contract that provides for payments to be made in response to changes in a specified interest rate, security price, commodity price, or other variable, provided in the case of a non-financial variable that the variable is not

specific to a party to the contract. The contract features described are consistent with a derivative that does not meet the definition of an insurance contract.

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

Sincerely,

David L. Boyle
AFGI Chair

Vice Chairman
Ambac Assurance Corporation