Statutory Issue Paper No. 69

Financial Guaranty Insurance

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 60

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Financial guaranty insurance provides protection against financial loss as a result of default, changes in interest rate levels, differentials in interest rate levels between markets or products, fluctuations in exchange rates between currencies, inconvertibility of one currency into another, inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental body, changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general. Financial guaranty insurance does not provide protection from losses which occur due to fortuitous physical events, failure or deficiency in the operation of equipment, or the inability to extract natural resources. Additionally, it does not provide coverage from losses related to various types of bonds (e.g., individual or schedule public official bond; a contract bond; a court bond), credit insurance, guaranteed investment contracts, and residual value insurance.

2. Current statutory guidance for financial guaranty insurance is provided in the Financial Guaranty Insurance Model Act. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides no guidance that is specific to financial guaranty insurance.

3. GAAP guidance for insurance contracts is provided by *FASB Statement No. 60*, *Accounting and Reporting by Insurance Enterprises* (FAS 60), however, FAS 60 does not contain guidance that is specific to financial guaranty insurance contracts. Under GAAP, premiums are generally earned in proportion to the amortization of the insured principal over the term of each insured debt obligation.

4. The purpose of this issue paper is to establish statutory accounting principles for the recording and recognition of premium revenue and unpaid losses, losses, and loss adjustment expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Premium Revenue Recognition

5. Written premium shall be recorded in accordance with *Issue Paper No. 53—Property Casualty Contracts - Premiums.*

6. When premiums are paid on the installment basis, premium revenue shall be recognized in the statement of operations using the monthly pro-rata method. Premiums not paid on the installment basis shall be recognized in the statement of operations in proportion with the amount and expected coverage period of the insured risk.

7. When the anticipated losses, loss adjustment expenses, and maintenance cost exceed the recorded unearned premium reserve and contingency reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations.

Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed. If an entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the notes to the financial statements.

Unpaid Losses and Loss Adjustment Expense Recognition

8. Unpaid losses and loss adjustment expenses shall be recognized in accordance with *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55). Each financial guaranty insurer shall establish and maintain reserves for unpaid losses and loss adjustment expenses. The initial date of default shall be considered the incident which gives rise to a claim. Such method shall be used to determine loss reserves, which shall include a reserve for claims reported and unpaid net of collateral. A deduction from loss reserves shall be allowed for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the financial guaranty insurer as of the date of the computation of the reserve. The discount rate shall be adjusted at the end of each calendar year. In addition, a reserve component for incurred but not reported claims shall be reasonably estimated if deemed necessary by the financial guaranty insurer or required by the commissioner following an examination or actuarial analysis.

Contingency Reserve

9. In addition to the unearned premium reserve and the liability established for unpaid losses and loss adjustment expenses, financial guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction.

10. The contingency reserve required shall be the greater of fifty percent of premiums written for each category or the amount provided by applying the following percentages to the principal guaranteed in each calendar year. The premiums written shall be net of reinsurance if the reinsurer has established a contingency reserve.

a.	Municipal obligation bonds	0.55 percent
b.	Special revenue bonds	0.85 percent
c.	Investment grade Industrial Development Bonds (IDBs) secured by collateral or having a term of seven years or less, and utility first mortgage obligations	1.00 percent
d.	Other investment grade IDBs	1.50 percent
e.	Other IDBs	2.50 percent
f.	Investment grade obligations, secured by collateral or having a term of seven years or less	1.00 percent
g.	Other investment grade obligations	1.50 percent
h.	Non-investment grade consumer debt obligations	2.00 percent
i.	Non-investment grade assetbacked securities	2.00 percent
j.	All other non-investment grade obligations	2.50 percent

11. Additions to the reserve for items a. through e. in paragraph 10 above shall be equal to the greater of one-eightieth of the amounts derived by applying the appropriate contribution specified above shall be made each quarter for a period of twenty (20) years. Additions to the reserve for items f through j. in paragraph 10 above shall be equal to the greater of one-sixtieth of the amounts derived by applying the appropriate contribution specified shall be made each quarter for a period of fifteen (15) years.

12. For contingency reserves required to maintained for 20 years, contributions may be discontinued if the total reserve established for all categories in subparagraphs 10 a. through 10 e. exceeds the sum of the percentages contained therein multiplied by the unpaid principal guaranteed. For contingency reserves required to maintained for 15 years, contributions may be discontinued if the total reserve established for

all categories in subparagraphs 10 f. through 10 j. exceeds the sum of the percentages contained therein multiplied by the unpaid principal guaranteed.

13. The contingency reserve may also be released in the following circumstances:

a. For contingency reserves required to be maintained for 20 years:

i. in any year in which actual incurred losses exceed 35% of the corresponding earned premiums, with commissioner approval;

ii. if the reserve has been in existence less than 40 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, with commissioner approval;

ii. if the reserve has been in existence more than 40 quarters, upon demonstration that the amount is excessive relation to the outstanding obligations under the insurer's financial guarantees, upon 30 days prior written notice to the commissioner.

b. For contingency reserves required to be maintained for 15 years:

i. in any year in which actual incurred losses exceed 65% of the corresponding earned premiums, with commissioner approval;

ii. if the reserve has been in existence less than 30 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, with commissioner approval;

iii. if the reserve has been in existence more than 30 quarters, upon demonstration that the amount is excessive relation to the outstanding obligations under the insurer's financial guarantees, upon 30 days prior written notice to the commissioner.

Any reductions shall be made on a first-in first-out basis. Changes in the reserve shall be recorded through surplus.

Disclosures

14. Financial guaranty insurers shall make all disclosures required by other issue papers within the codification, including but not limited to the requirements of Issue Paper No. 55 and *Issue Paper No. 77—Disclosures of Accounting Policies, Risks & Uncertainties, and Other Disclosures.*

DISCUSSION

15. This issue paper rejects current statutory guidance set forth in the Financial Guaranty Insurance Model Act. However, some of the circumstances that allow a reporting entity to reduce its contingency reserves in the model were adopted in this issue paper. One of these circumstances provide that the reduction is allowed if it is approved by the commissioner. Commissioner approval of a reserve reduction will only be considered as a viable means of reducing a reserve where the reporting entity can clearly demonstrate to the commissioner that the existing reserves are excessive. This issue paper is generally consistent with statutes adopted in New York with modifications to require an IBNR reserve in certain situations and recognition of a premium deficiency in certain instances as described in paragraph 7. The requirement to record a deficiency reserve was made for consistency with the requirements of Issue Paper No. 55. Additionally, this issue paper expands current statutory guidance by utilizing principal guaranteed to determine a maximum required contingency reserve.

16. The contingency reserve does not meet the definition of a liability which is set forth in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*. However, it is consistent with the "*ultimate objective of solvency regulations*" as stated in the Statement of Concepts. This states,

> the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.

Additionally, recording the contingency reserve as a liability is consistent with the Statement of Concepts which states:

> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

17. This issue paper is inconsistent with GAAP in that GAAP requires all premiums to be recognized in the statement of operations in a manner consistent with the expiration of the insured risk. This issue paper requires installment billings to be recognized in operations using the monthly pro-rata method. FAS 60 was rejected in *Issue Paper No. 50—Definitions and Classifications of Insurance or Managed Care Contracts In Force*.

18. Discounting the liability established for unpaid claims, losses and loss adjustment expenses is consistent with *Issue Paper No. 65—Property Casualty Contracts* because the payments to be made for losses incurred with respect to insured events are generally fixed and determinable once the insured event has occurred.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

19. The Financial Guaranty Insurance Model Act provides the following guidance: (only pertinent excerpts are included)

> **Section 1. Definitions**
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> A. As used in this article:
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> (1) Financial guaranty insurance means a surety bond, insurance policy or, when issued by an insurer, an indemnity contract and any guaranty similar to the foregoing types, under which loss is payable upon proof of occurrence of financial loss to an insured claimant, obligee or indemnity as a result of any of the following events:
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> (a) Failure of any obligor on any debt instrument or other monetary obligation (including common or preferred stock guarantied under a surety bond, insurance policy or indemnity contract) to pay when due principal, interest, premium, dividend or purchase price of or on the instrument or obligation, when the failure is the result of a financial default or insolvency, regardless of whether the obligation is incurred directly or as guarantor by or on behalf of another obligor that has also defaulted;
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> (b) Changes in the levels of interest rates, whether short or long term, or the differential in interest rates between various markets or products;

(c) Changes in the rate of exchange of currency;

(d) Inconvertibility of one currency into another for any reason, or inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental authority;

(e) Changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general; or

(f) Other events which the commissioner determines are substantially similar to any of the foregoing.

(2) Notwithstanding Paragraph (1) of this subsection, financial guaranty insurance shall not include:

(a) Insurance of any loss resulting from any event described in Subsection A(1) of this section, if the loss is payable only upon the occurrence of any of the following, as specified in a surety bond, insurance policy or indemnity contract:

(i) A fortuitous physical event;

(ii) A failure of or deficiency in the operation of equipment; or

(iii) An inability to extract or recover a natural resource;

(b) An individual or schedule public official bond;

(c) A contract bond, including bid, payment or maintenance bond, or a performance bond where the bond is guarantying the execution of a contract other than a contract of indebtedness or other monetary obligation;

(d) A court bond required in connection with judicial, probate, bankruptcy or equity proceedings, including waiver, probate, open estate and life tenant bond;

(e) A bond running to the federal, state, county, municipal government or other political subdivision, as a condition precedent to granting of a license to engage in a particular business or of a permit to exercise a particular privilege;

(f) A loss security bond or utility payment indemnity bond running to a governmental unit, railroad or charitable organization;

(g) A lease, purchase and sale or concessionaire surety bond;

(h) Credit unemployment insurance, meaning insurance on a debtor in connection with a specific loan or other credit transaction, to provide payments to a creditor in the event of unemployment of the debtor for the installments or other periodic payments becoming due while a debtor is unemployed;

Drafting Note: Subparagraph (h) is to be used by states which do not authorize credit unemployment insurance as a separate line of business but do permit this line to be written.

(i) Credit insurance, meaning insurance indemnifying manufacturers, merchants or educational institutions extending credit against loss or damage resulting from nonpayment of debts owed to them for goods or services provided in the normal course of their business;

(j) Guaranteed investment contracts issued by life insurance companies which provide that the life insurer itself will make specified payments in exchange for specific premiums or contributions;

(k) Residual value insurance authorized by Section [insert section];

(l) Mortgage guaranty insurance authorized by Section [insert section];

(m) Indemnity contracts or similar guaranties, to the extent that they are not otherwise limited or proscribed by this chapter, in which a life insurer:

(i) Guaranties its obligations or indebtedness or the obligations or indebtedness of a subsidiary (as defined in Section [insert section]) other than a financial guaranty insurance corporation; provided that:

(I) To the extent that any such obligations or indebtedness are backed by specific assets, the assets must at all times be owned by the insurer or the subsidiary; and

(II) In the case of the guaranty of the obligations or indebtedness of the subsidiary that are not backed by specific assets of the life insurer, the guaranty terminates once the subsidiary ceases to be a subsidiary; or

(ii) Guaranties obligations or indebtedness (including the obligation to substitute assets where appropriate) with respect to specific assets acquired by a life insurer in the course of normal investment activities and not for the purpose of resale with credit enhancement, or guaranties obligations or indebtedness acquired by its subsidiary, provided that the assets acquired pursuant to this item (ii) have been:

(I) Acquired by a special purpose entity, whose sole purpose is to acquire specific assets of the life insurer or the subsidiary and issue securities or participation certificates backed by such assets; or

(II) Sold to an independent third party; or

(iii) Guaranties obligations or indebtedness of an employee or agent of the life insurer; or

(n) Any other form of insurance covering risks which the commissioner determines to be substantially similar to any of the foregoing.

Section 2. Organization; Financial Requirements

(A) A financial guaranty insurance corporation may be organized and licensed in the manner prescribed in Section [insert section], except as modified by the following provisions:

(1) A corporation organized for the purpose of transacting financial guaranty insurance may, subject to all the applicable provisions of this chapter, be licensed to transact the following additional kinds of insurance:

(a) Residual value insurance, as authorized by Section [insert section];

(b) Surety insurance, as authorized by Section [insert section]; and

(c) Credit insurance, as authorized by Section [insert section].

(2) A corporation may only assume those lines of insurance for which it is licensed to write direct business.

(3) Prior to the issuance of a license, a corporation shall submit for the approval of the commissioner a plan of operation detailing the types and projected diversification of guaranties that will be issued, the underwriting procedures that will be followed, managerial oversight methods, investment policies and such other matters as may be prescribed by the commissioner.

(4) A financial guaranty corporation shall be subject to all of the provisions of this chapter applicable to property and casualty insurers to the extent that the provisions are not inconsistent with the provisions of this Act.

(5) A financial guaranty insurance corporation's investments in any one entity insured by that corporation shall not exceed one percent of its admitted assets as of the end of the prior calendar year.

(B) A financial guaranty corporation shall not transact business unless:

(1) It has paid-in capital of at least $10 million and paid-in surplus of at least $40 million, and shall at all times thereafter maintain a minimum surplus to policyholders of $35 million;

(2) It establishes a contingency reserve, net of reinsurance, as follows:

(a) The contributions to the reserve shall be calculated by applying the following percentages to the net principal written each calendar year of guaranties of:

(i) Municipal obligation bonds, 0.8 percent;

(ii) Special revenue bonds, 1.2 percent;

(iii) Industrial development bonds, 1.6 percent;

(iv) Secured investment grade obligations, 1.6 percent;

(v) Investment grade obligations not secured, 2.5 percent; and

(vi) All other obligations guarantied, 3.0 percent.

(b) (i) Quarterly additions to the reserve for Items (i), (ii) and (iii) of Subparagraph (a) above shall be equal to the greater of one-eightieth of the amounts derived by applying the appropriate contribution specified in Subparagraph (a) or fifty percent (50%) of the quarterly earned premiums on such guaranties and shall be maintained for a period of twenty (20) years; and

(ii) Quarterly additions to the reserve for Items (iv), (v) and (vi) of Subparagraph (a) above shall be equal to the greater of one-fortieth of the amounts derived by applying the appropriate contribution specified in Subparagraph (a) or fifty percent (50%) of the quarterly earned premiums on such guaranties and shall be maintained for a period of ten (10) years.

(c) The reserve may be released thereafter in the same manner, except that a part of the reserve may be released proportional to the reduction in net total liabilities resulting from reinsurance and the reinsurer shall, on the effective date of the reinsurance, establish a reserve in an amount equal to the amount released.

(d) Withdrawals from the contingency reserve, to the extent of any excess, may be made from the earliest contributions to the reserve remaining:

(i) With the approval of the commissioner, in any year in which the actual incurred losses exceed thirty-five percent (35%) of earned premiums, or

(ii) Upon thirty (30) days prior notice to the commissioner, provided that the contingency reserve has been in existence for forty (40) quarters, for reserves subject to Item (i) of Subparagraph (b) of this paragraph, and twenty (20) quarters, for reserves subject to Item (ii) of Subparagraph (b) of this section, upon demonstration that the amount carried is excessive in relation to the corporations outstanding obligations.

(3) In addition to the contingency reserve, the case basis method or other method as may be prescribed by the commissioner shall be used to determine loss reserves, in a manner consistent with Section [insert section], which shall include a reserve for claims reported and unpaid net of collateral. A deduction from loss reserves shall be allowed for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the insurer as of the date of the computation of the reserve. The discount rate shall be adjusted at the end of each calendar year.

(4) It shall maintain an unearned premium reserve, net of reinsurance, computed on the monthly pro rata basis, where premiums are paid on an installment basis. All other such premiums paid shall be earned proportionately with the expiration of exposure, or by such other method as the commissioner may prescribe or approve.

Generally Accepted Accounting Principles

20. FAS 60 provides the following guidance with respect to revenue recognition:

> 9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.
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> 13. 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.
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> Premium Deficiency
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> 32. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts. Insurance contracts shall be grouped consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.
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> Short-Duration Contracts
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> 33. A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.
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> 34. A premium deficiency shall first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability shall be accrued for the excess deficiency.

RELEVANT LITERATURE

Statutory Accounting

- The Financial Guaranty Insurance Model Act
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 53—Property Casualty Contracts - Premiums*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 65—Property and Casualty Contracts*
- *Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*

State Regulations

- Chapter 28, Article 69 of New York Statutes - Insurance Laws
- Chapter 1, Article 5 of California Statutes - Insurance Laws

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