



BERMUDA MONETARY AUTHORITY

INSURANCE DEPARTMENT

GUIDANCE NOTES

APPLICATION OF CHANGES IN US GAAP ACCOUNTING TO THE STATUTORY FINANCIAL STATEMENTS OF FINANCIAL GUARANTY COMPANIES

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1. Purpose and Executive Summary

- 1.1. This paper provides an overview of the implications for the Bermuda statutory financial statements of financial guaranty companies arising from the introduction of new accounting standards under US generally accepted accounting principles (“US GAAP”) for financial guaranty insurance contracts.
- 1.2. In April 2008, the Bermuda Monetary Authority (“the Authority”) released the Financial Guaranty Liabilities and Bermuda Statutory Returns “Clarification of Guidance Note 4” (“CGN4”) to clarify the determination of loss and loss expense provision (line 17) and unearned premium provision (line 16) for Bermuda statutory financial statements for financial guaranty business.¹
- 1.3. Subsequently, in May 2008, the Financial Accounting Standards Board (“FASB”) released the FAS 163: Accounting for Financial Guarantee Insurance Contracts - an interpretation of FASB Statement No. 60 (now known as ASC 944 under the FASB’s new codification). This standard was effective for financial statements issued for fiscal periods beginning after December 15, 2008. This standard clarified the recognition and measurement to be used to account for premium revenue and claim liabilities. It applies only to financial guaranty contracts and not those with similar economic exposures (e.g. credit default swaps) which are accounted for as derivatives.
- 1.4. In cases where the Insurance Act 1978, related regulations and amendments thereto (“the Act”) are silent and no policy guidance has been issued by the Authority, companies have historically been advised to prepare their statutory financial statements using a recognised GAAP and apply these principles on a consistent basis from period to period. This includes adopting such new accounting pronouncements as may be applicable in that underlying GAAP.
- 1.5. The adoption of the new US GAAP standard could have a significant impact on the reported statutory capital and surplus and other statutory financial statement balances of companies writing financial guaranty business. Accordingly, the Authority is reviewing the current requirements for this type of business to ensure that companies have appropriate guidance to apply to their statutory financial statements. This paper addresses the current position with respect to measurement of loss and loss expense provision (line 17) and unearned premium provision (line 16); and to address other potential issues caused by the new US GAAP pronouncement in respect of premium recognition, loss provisions and deferred acquisition costs. It also addresses the statutory accounting for contracts which are classified under US GAAP as derivatives but which represent substantially the same economic exposure as financial guaranty insurance contracts.
- 1.6. In summary, the Authority believes that a number of the changes made to the US GAAP rules result in greater consistency with the guidance already contained in CGN4. There are however a number of areas where adopting the new US GAAP guidance for statutory financial statements would result in some anomalies which would not be helpful in ensuring the appropriate level of regulatory attention and oversight. Therefore, certain changes to the US GAAP guidance for the purpose of completing the statutory financial statements may be necessary.
- 1.7. In addition, the Authority plans to explore and discuss with industry an enhanced regulatory approach to be applied to the financial guaranty sector on an ongoing basis in the near future.
- 1.8. Questions or enquiries relating to this paper should be directed via e-mail to Brant Kizer at bkizer@bma.bm or to the Authority’s Policy, Research & Risk Assessment Department at policy@bma.bm.

¹ In this paper, loss and loss expense provision (line 17) and unearned premium provision (line 16) for Bermuda statutory financial statements refer to line items in Form 1 or 1A of the Insurance Accounts Regulations 1980.

2. Summary Impact of new US GAAP Accounting Guidance on Financial Guaranty Contracts

2.1. The key changes required in the application of ASC 944 arise in the following areas:

- a) Premium recognition – Written premiums will now include future installment premiums, which will be result in higher unearned premium and premium receivable balances;
- b) Premium earning – Premiums will now be required to be earned in proportion to the risk profile of the underlying coverage;
- c) Liability recognition – Loss provisions are recognised when the present value of expected net cash outflows to be paid under the insurance contract exceeds the unearned premium revenue for that contract, and unallocated loss reserves are no longer permitted;
- d) Additional disclosures are required for financial guaranty contracts and for accounting and risk management activities used to evaluate credit deterioration in companies' insurance obligations and surveillance lists; and
- e) The new standard excludes from its scope any contracts which meet the definition of derivatives (e.g. credit default swap contracts (“CDS”)) although in substance these can have very similar attributes and risk exposures to financial guaranty insurance contracts.

2.2. *Premium Recognition*

2.2.1. Premiums covering financial guaranty exposures can arise in various legal forms. Under US GAAP, depending on the legal form and the methodology used for loss reimbursement, contracts are either treated as insurance contracts (and follow the guidance prescribed by ASC 944) or are treated as derivative financial instruments. Derivatives are accounted for in accordance with the provisions of ASC 815 (formerly known as FAS 133) and do not reflect the amounts received as premiums.

2.2.2. *Issue 1 – Should the Bermuda statutory financial statements treat exposures that are written as insurance contracts and those with similar exposures but written in derivative format in the same way?*

2.2.3. In addition, prior to the introduction of ASC 944, contracts classified as insurance would have different income statement recognition for written premiums depending on whether a single premium was collected up front at the inception of the policy or if they are collected over the period of risk of the policy.

2.2.4. *Issue 2 – Should the Bermuda statutory financial statements make a differentiation for premium recognition between single premium and installment premium contracts?*

2.2.5. Companies adopting ASC 944 in their US GAAP financial statements will have recorded a one time cumulative catch up adjustment to retained earnings and will recognise a lower level of written premium in future periods (as the installment premiums business has already been written and will no longer appear in written premium each year as it is received). If a similar cumulative catch up adjustment were to be computed for statutory accounting purposes, then a potentially significant amount of written premium would never have been included as an input in the calculation of the general business solvency margin.

2.2.6. *Issue 3 – Would the adoption of ASC 944 for Bermuda statutory financial statement purposes result in the general business solvency margin being understated by virtue of the exclusion of significant amounts of written premium from the calculation?*

2.2.7. Under ASC 944, the present value of future installment premiums and the related commissions are required to be recognised. Correspondingly, the present value of future premiums receivable on installment policies, with a corresponding credit to the unearned premium revenue liability, are recognised as assets and liabilities respectively. In addition, to the extent that there are commission costs associated with the unearned premium liability, these will be recorded as a deferred acquisition costs.

2.2.8. Under Bermuda Statutory Accounting Principles, deferred acquisition costs are a non-admitted asset. Accordingly, adopting ASC 944 for statutory reporting purposes would require companies to recognise and then write-off the acquisition costs associated with future installment premiums. The write-off of deferred

acquisition costs would have a direct impact on their statutory capital as the income associated with the future installment premiums will still be unearned and included in liabilities at the period end.

2.2.9. *Issue 4 – How should the increase in deferred acquisition costs balances arising from the adoption of ASC 944 be treated for Bermuda statutory financial statement purposes?*

2.3. *Premium Earnings*

2.3.1. ASC 944 has changed the methodology to be used to earn premiums in proportion to the risk profile of the underlying coverage. This has generally resulted in a more premiums being treated as unearned and companies taking a reduction in their shareholders' equity when they have applied the new guidance.

2.3.2. CGN4 notes that the unearned premium provision ("UPP") in line 16 of the Bermuda statutory financial statement reflects the portion of premium relating to risks which have been written prior to the balance date for which cover has not expired. This is determined in accordance with GAAP, where premiums are earned in proportion to the risk profile of the underlying coverage.

2.3.3. It also noted that to the extent that associated future losses are expected to exceed the UPP, accounting principles require a premium deficiency provision ("PDP") be established and that this should be included as part of the liabilities under line 17 (loss and loss expense provision).

2.3.4. *Issue 5 – Should companies adopt the guidance contained in ASC 944 for their premium earning methodology for the purposes of their statutory financial statements (i.e. was the intention in CGN4 that a calculation in accordance with GAAP would be an evolving calculation that would follow changes in GAAP or did it refer to GAAP at that point in time)?*

2.4. *Liability Recognition*

2.4.1. ASC 944 has changed the guidance for liability recognition such that loss provisions are now only recognised when the insurer expects, based on the probability weighted present value of an expected net claims loss to be paid under the insurance contract, net of unearned premium revenue for that contract. Unallocated loss reserves are no longer permitted under the standard. Generally this will lead to a reduction in reserves. In addition, under the new GAAP, the risk-free rate is used to determine the present value of the loss and loss expense provisions.

2.4.2. *Issue 6 – Does the change in the US GAAP approach for liability recognition have any impact on the Bermuda statutory financial statements?*

2.5. *Liabilities Carried at Fair Value*

2.5.1. The new US GAAP standard does not apply to financial guaranty insurance contracts that meet the definition of a derivative instrument under ASC 815-10 (typically CDS contracts). Under US GAAP, these liabilities are carried at fair value and are marked-to-market, net of discount for an entities' own non-performance risk. In addition, companies have the option to elect (under ASC 825-10) to carry other liabilities at fair value (which would be calculated with a similar adjustment for non-performance risk).

2.5.2. Non-performance risk refers to the risk that the obligation will not be fulfilled, and therefore affects the value at which the liability is transferred. Non-performance risk includes but may not be limited to an entity's own credit risk. Accordingly, under ASC 820-10, liability remeasurements at fair value reflect the effect of changes in the entity's credit standing. This can result in dramatic decreases in the carrying value of liabilities, as observed in a number of cases in the US GAAP financial statements of companies in the financial guaranty sector during the credit crisis.

2.5.3. *Issue 7 – How should liabilities which are fair valued under US GAAP be treated in the Bermuda statutory financial statements?*

2.6. *Disclosures*

2.6.1. The new US GAAP standard requires additional disclosures for financial guaranty contracts and for accounting and risk management activities used to evaluate credit deterioration in companies' insurance obligations and surveillance lists. These additional disclosures requirements are extensive.

2.6.2. *Issue 8 – What level of the additional US GAAP financial statement disclosures are applicable to the Bermuda statutory financial statements?*

3. Consideration of Issues Identified and Preliminary Conclusions

- 3.1. *Issue 1 – Should the Bermuda statutory financial statements treat exposures that are written as insurance contracts and those with similar exposures but written in derivative format in the same way?*
- 3.1.1. Although CGN4 speaks to the manner in which reserves should be calculated as being unrelated to whether the contracts are written in insurance contract or derivative format, it is silent on how contracts written in derivative format should be treated in the income statement. Accordingly, there may be some diversity in practice as to whether there are recorded as premiums (which would be consistent with the approach taken for the statutory balance sheet) or within realised gains / losses (which would be the treatment under US GAAP).
- 3.1.2. Although derivative contracts may involve payment of premiums / fees on an installment basis, US GAAP does not require that these be recognised in a similar fashion to insurance contracts. Rather, those future premiums are accounted for as part of the overall calculation of the fair value of that derivative contract.
- 3.1.3. The Authority believes that any consideration which is received in respect of financial guaranty exposures (regardless of whether it is written in insurance contract or derivative format) should be included within line 1 of Form 2 – Gross Premiums Written.
- 3.2. *Issue 2 – Should the Bermuda statutory financial statements make a differentiation for premium recognition between single premium and installment premium contracts?*
- 3.2.1. CGN4 already provided companies with the option to include the present value of future installment premiums. As such, the Authority believes that the new US GAAP guidance represents an improvement and should be applied to the statutory financial statements for financial guaranty contracts.
- 3.2.2. The Authority recognises that in the case of CDS contracts which are reinsured (which is generally the case for Bermuda financial guaranty companies), the assuming companies may not have access to information on the future installment premiums that would enable them to recognise those future installments in a manner consistent with US GAAP. The Authority believes that the key regulatory question to be assessed for companies with financial guaranty exposures is whether the reserve levels held will be sufficient to meet the present value of future expected payments (as calculated in accordance with the guidance contained in CGN4). There are clearly practical difficulties for certain companies in compiling information on CDS contracts that would enable alignment of premium recognition with the accounting treatment for financial guaranty contracts under ASC 944. Accordingly, it is proposed that the recognition of future installment premiums on CDS contracts as a component of gross premiums be permitted, but not required for statutory purposes. Recognition of loss and loss expense provision (line 17) should make adequate provision for any expected losses on such CDS contracts and should be calculated in accordance with the methodology outlined in CGN4.
- 3.3. *Issue 3 – Would the adoption of ASC 944 for Bermuda statutory financial statement purposes result in the general business solvency margin being understated by virtue of the exclusion of significant amounts of written premium from the calculation?*
- 3.3.1. CGN4 noted that at that time that future contracted premiums (installment premiums) for financial guaranty business were not reflected in a company's US GAAP financial statements (they were simply a note disclosure). CGN4 specifically permitted companies (although did not require) to include future contracted premiums as part of UPP and were available as an offset to line 17 liabilities and an associated matching asset can also be recognised as written premium receivable on the balance sheet. CGN4 required that in such a case, an appropriate prudent allowance for lapse and other risks of non-payment should be included.
- 3.3.2. The Authority has identified the fact that switching to the new accounting methodology and applying the cumulative catch up adjustment principle would mean that a potentially significant amount of gross written premiums would drop out of the statutory capital calculation and accordingly there is a risk that the capital requirement (by reference to premiums) may be understated. The Authority believes that the recent

financial crisis has highlighted that capital requirements for financial guaranty business need to be significantly different from those for other classes of insurance. The Authority is currently in the process of developing proposals for a revision to the regulatory framework for companies writing financial guaranty business. Accordingly, the omission of certain premiums from the statutory calculation for minimum capital requirements is not believed to represent a material issue as an alternative capital basis is more likely to be applied in the future.

- 3.4. *Issue 4 – How should the increase in deferred acquisition costs balances arising from the adoption of ASC 944 be treated for Bermuda statutory financial statement purposes?*
- 3.4.1. CGN4 did not include any guidance on how acquisition costs associated with future installment premiums should be treated (where companies availed the option to recognise future installments). It is the Authority's understanding that at least in some cases, companies did not elect to recognise future installment premiums as it would have resulted in the recognition of deferred acquisition costs which would then have needed to be written off immediately, resulting in a significant charge against statutory capital.
- 3.4.2. In performing the assessment of whether or not a PDP would be required, the Authority believes that any acquisition costs which would need to be paid on future installment premiums must be included (either implicitly or explicitly) in the calculation of whether the future losses are considered likely to exceed the UPP.
- 3.4.3. Recognising that there has been no change in the economic substance behind the underlying exposures, the Authority believes that adoption of the new accounting guidance for statutory purposes with consequent write-off of deferred acquisition costs may result in an unduly onerous reduction in statutory capital. Provided that the PDP calculation specifically only factors in net future cash flows (i.e. after allowing for commissions to be paid) as opposed to the gross premium cash flows, then any additional reserve requirement should be automatically recorded.
- 3.4.4. Accordingly, should they choose to do so, financial guaranty companies may seek approval from the Authority, pursuant to Section 56 of the Act, to modify statutory accounting rules to allow deferred acquisition costs associated with future installment premiums to be treated as an admitted asset. To the extent that the insurer also seeks to classify the deferred acquisition costs as a contra liability against unearned premium on line 16, it should include that in its request. Further, if the insurer's basis is that the application of ASC 944 results in a significant reduction to Statutory Capital and Surplus when the economic substance of the transactions have not changed, it would be appropriate to articulate that in the application to the Authority.
- 3.5. *Issue 5 – Should companies adopt the guidance contained in ASC 944 for their premium earning methodology for the purposes of their statutory financial statements (i.e. was the intention in CGN4 that a calculation in accordance with GAAP would be an evolving calculation that would follow changes in GAAP or did it refer to GAAP at that point in time)?*
- 3.5.1. The Authority considers the changes in the earning pattern required under ASC 944 to be a closer representation of the economic substance of the underlying transactions and accordingly would represent an improvement to the previous methodology.
- 3.5.2. The Authority has considered whether it would be more efficient to maintain the status quo with respect to the earning of premium for financial guaranty business (or to at least permit it as an option). The Authority understands that a number of companies have had to undergo significant system changes in order to calculate the amount of earned premiums in accordance with ASC 944. In certain circumstances (particularly reinsurance), companies may not have access to information that would enable them to calculate earned premiums on a basis consistent with previous years. Accordingly, given these changes, it may no longer be practical or efficient for companies to present information under the historical basis. As such, the Authority believes that companies should adopt the ASC 944 guidance for the purpose of calculating unearned premiums in the statutory financial statements.

- 3.6. *Issue 6 – Does the change in the US GAAP approach for liability recognition have any impact on the Bermuda statutory financial statements?*
- 3.6.1. CGN4 specifically includes guidance with respect to setting reserves for financial guaranty business which states that an appropriate probabilistic allowance for potential adverse scenarios be added as a component of line 17. The discounting of the loss provisions by a risk free rate is also aligned with the Authority's current guidance of discounting nominal cash flows at rates reflecting risk free returns and does not require amendment. It is therefore believed that the existing guidance contained in CGN4 for loss and loss expense provisions (line 17), which applies to both financial guaranty and CDS contracts, continues to be appropriate and does not require further amendment.
- 3.7. *Issue 7 – How should liabilities which are fair valued under US GAAP be treated in the Bermuda statutory financial statements?*
- 3.7.1. CGN4 contains guidance on how policyholder liabilities for CDS contracts should be reflected in the statutory financial statements. It does not, however, explicitly consider the concept of liabilities being carried at fair value.
- 3.7.2. In the interests of clarity, the Authority confirms that for statutory reporting purposes it would be inappropriate to show any reduction in a liability to reflect a company's own non-performance risk. In addition, non insurance liabilities should be recorded at their nominal values (i.e. unadjusted for the time value of money).
- 3.8. *Issue 8 – What level of the additional GAAP financial statement disclosures are applicable to the Bermuda statutory financial statements?*
- 3.8.1. The Authority believes that incorporation of additional disclosures in the statutory financial statements will be useful in assisting with the assessment of a company's risk exposures. Accordingly, additional guidance will be issued as part of the review of the overall regulatory approach to the financial guaranty industry.