

would be realizable in an outright sale to an unrelated third party for cash.⁵ The same concepts should be applied in determining fair value of the transferred assets, *i.e.*, if an active market exists for the assets transferred, then fair value is equal to the market value. If no active market exists, but one exists for similar assets, the selling prices in that market may be helpful in estimating the fair value. If no such market price is available, a forecast of expected cash flows, discounted at a rate commensurate with the risks involved, may be used to aid in estimating the fair value. In situations where discounted cash flows are used to estimate fair value of nonperforming assets, the staff would expect that the interest rate used in such computations will be substantially higher than the cost of funds of the financial institution and appropriately reflect the risk of holding these nonperforming assets. Therefore, the fair value determined in such a way will be lower than the amount at which the assets would have been carried by the financial institution had the transfer not occurred, unless the financial institution had been required under GAAP to carry such assets at market value or the lower of cost or market value.

Question 3: Where the transaction may appropriately be accounted for as a sale to an unconsolidated party and the financial institution receives a note receivable or other redeemable instrument from the new entity, how should such asset be disclosed pursuant to Item III C, "Risk Elements," of Industry Guide 3? What factors should be considered related to the subsequent accounting for such instruments received?

Interpretive Response: The staff believes that the financial institution may exclude the note receivable or other asset from its Risk Elements disclosures under Guide 3 provided that: (a) the receivable itself does not constitute a nonaccrual, past due, restructured, or potential problem loan that would require disclosure under Guide 3, and (b) the underlying collateral is described in sufficient detail to enable investors to understand the nature of the note receivable or other asset, if material, including the extent of any over-collateralization. The description of the collateral normally would include

material information similar to that which would be provided if such assets were owned by the financial institution, including pertinent Risk Element disclosures.

The staff notes that, in situations in which the transaction is accounted for as a sale to an unconsolidated party and a portion of the consideration received by the registrant is debt or another redeemable instrument, careful consideration must be given to the appropriateness of recording profits on the management fee arrangements or interest or dividends on the instrument received, including consideration of whether it is necessary to defer such amounts or to treat such payments on a cost recovery basis. Further, if the new entity incurs losses to the point that its permanent equity based on GAAP is eliminated, it would ordinarily be necessary for the financial institution, at a minimum, to record further operating losses as its best estimate of the loss in realizable value of its investment.⁶

W. Contingency Disclosures Regarding Property-Casualty Insurance Reserves for Unpaid Claim Costs

Facts: A property-casualty insurance company (the "Company") has established reserves in accordance with Statement 60 for unpaid claim costs, including estimates of costs relating to claims incurred but not reported ("IBNR").¹ The reserve estimate for IBNR claims was based on past loss experience and current trends except that the estimate has been adjusted for recent significant unfavorable claims experience that the Company considers to be nonrecurring and abnormal. The Company attributes the abnormal claims experience to a recent acquisition and accelerated claims processing; however, actuarial studies have been inconclusive and subject to varying interpretations. Although the reserve is deemed adequate to cover all probable claims, there is a reasonable possibility that the abnormal claims experience could continue, resulting in a material understatement of claim reserves.

Statement 5 requires, among other things, disclosure of loss contingencies.²

⁶ Typically, the financial institution's claim on the new entity is subordinate to other debt instruments and thus the financial institution will incur any losses beyond those incurred by the permanent equity holders.

¹ Paragraph 18 of Statement 60 prescribes that "[t]he liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience." [Footnote reference omitted]

² Paragraph 10 of Statement 5 specified that "[i]f no accrual is made for a loss contingency because

However, paragraph 2 of that Statement notes that "[n]ot all uncertainties inherent in the accounting process give rise to contingencies as that term is used in [Statement 5]."

SOP 94-6³ also provides disclosure guidance regarding certain significant estimates.

Question 1: In the staff's view, do Statement 5 and SOP 94-6 disclosure requirements apply to property-casualty insurance reserves for unpaid claim costs? If so, how?

Interpretive Response: Yes. The staff believes that specific uncertainties (conditions, situations and/or sets of circumstances) not considered to be normal and recurring because of their significance and/or nature can result in loss contingencies⁴ for purposes of applying Statement 5 and SOP 94-6 disclosure requirements. General uncertainties, such as the amount and timing of claims, that are normal, recurring, and inherent to estimations of property-casualty insurance reserves are not considered subject to the disclosure requirements of Statements 5. Some specific uncertainties that may result in loss contingencies pursuant to Statement 5, depending on significance and/or nature, include insufficiently understood trends in claims activity; judgmental adjustments to historical experience for purposes of estimating future claim costs (other than for normal recurring general uncertainties); significant risks to an individual claim or group of related claims; or catastrophe losses. The requirements of SOP 94-6 apply when "[i]t is at least reasonably possible that the estimate of

one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss, or state that such an estimate cannot be made." [Footnote reference omitted and emphasis added.]

³ SOP 94-6 provides that disclosures regarding certain significant estimates should be made when the following criteria are met. The SOP provides that:

The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by [Statement] 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required. (footnote references omitted)

SOP 94-6 requires disclosures regarding current vulnerability due to certain concentrations which may be applicable as well.

⁴ The loss contingency referred to in this document is the potential for a material understatement of reserves for unpaid claims.

Issue 88-25 that the newly created "liquidating bank" should continue to report its assets and liabilities at fair values at the date of the financial statements.

⁵ The EITF reached a consensus on issue 11 of Issue 01-02 that an enterprise that distributes loans to its owners should report such distribution at fair value.