This document and any attachments are replaced by Comptroller's Handbook - Other Real Estate Owned

Real Estate Owned and Repossessed Assets

A rapid rise in foreclosures, like that experienced during the 2008-2009 global financial crisis with extensive weakness in the housing market, increases the potential for higher levels of real estate owned (REO) for savings associations. An REO property is a property that is in the possession of a savings association as a result of foreclosure or forfeiture by a borrower. When a savings association repossesses property, there is a distinct possibility of loss on the liquidation of the property; otherwise the borrower would not have defaulted on the loan. REO is typically a poor or non-earning asset. A savings association's acquisition of a limited amount of REO is an unavoidable result of normal business operations. REO includes real estate acquired in the following ways:

- Real estate in judgment.
- Real estate acquired through foreclosure.
- Real estate acquired through deed in lieu of foreclosure.
- Any real property exchanged for foreclosed real estate.
- In-substance foreclosure.[1]

LINKS

Program

Questionnaire

To be considered an "in-substance foreclosure," it is only necessary for the savings association to have received **physical** possession of the property. It is not necessary for formal foreclosure proceedings to have taken place. This occurs when the savings association becomes aware that the borrower abandoned the property. During the financial crisis, it was not uncommon for borrowers to mail the keys to the property to the savings association, a practice referred to as "jingle mail."

Other repossessed assets may include non-real estate property the savings association takes possession of to satisfy some or all of a borrower's debt.

[1] If the savings association does not expect full payment of all amounts due for an impaired, collateral-dependent loan, the savings association should measure the loan's impairment based on the fair value of the collateral less costs to sell when those costs are expected to reduce the proceeds from the sale. Pursuant to ASC 310, the lender should report the impaired loan as an in-substance foreclosure if it has physical possession of the collateral. Other collateral-dependent loans that the lender does not possess remain categorized as loans.

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The usual types of other repossessed assets may include the following:

- Personal property: vehicles, mobile homes, boats, airplanes, etc.
- Commercial goods: equipment, furniture, fixtures, inventories, accounts receivable, lease receivable, etc.
- Investments: stocks, bonds, certificates of deposit, etc.
- Other: intangible assets, cash surrender value of life insurance policy, etc.

Supervisory Concerns

An increase in a savings association's REO and repossessed assets portfolios should serve as red flags to both OTS and management. Increases in these portfolios may indicate deteriorating economic conditions, lax adherence to loan underwriting standards, or deficient loan administration. The absence of REO may be indicative of overly restrictive loan underwriting criteria or a lax foreclosure policy.

You should perform the following steps:

- Review the savings association's internal asset review program.
- Evaluate the adequacy of internal controls for internal asset review.
- Interview management concerning:
  - — Detection of potential problem credits.
  - — Effectiveness of resolutions (workouts) and collection of problem loans.

The savings association should evaluate the likelihood of repossessing an asset for all seriously delinquent loans. The savings association should also consider alternatives to repossession. Prior to foreclosure or repossession, management should check with the proper authorities to verify the existence of a valid recorded lien. At that time, the savings association should determine the market value of the collateral. The savings association should also assure sufficient insurance coverage on the asset continues after the savings association takes possession.

The OCC Bank Accounting Advisory Series (OCC BAAS), November 2010, includes many useful practical questions and answers on various topics. Topic 5a addresses issues with real estate owned. The OCC BAAS is located at http://www.occ.gov/static/publications/BAAS.pdf

Additionally, examiners may need to evaluate the actual foreclosure processes and procedures of the savings association to assure they are fully complying with all legal requirements. For example, during the financial crisis, systematic signing of legally required documents for foreclosure proceedings, so called "robo-signing" of affidavits was identified. Failure to comply with all legal requirements for foreclosure can, at a minimum, delay the savings association's ability to timely foreclose on the

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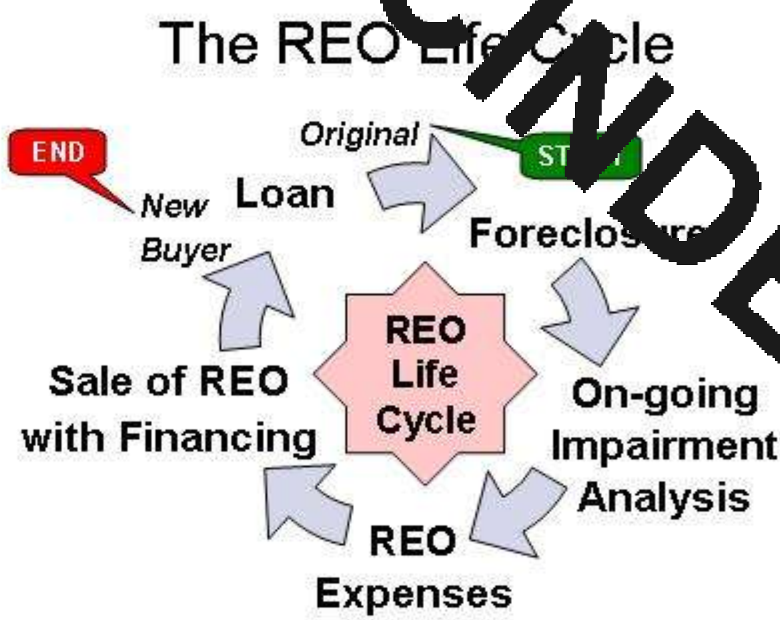
property, which exposes the savings association to further losses on the property over the extended foreclosure period and, in the worst case, may result in legal determinations that the savings association *does not* have appropriate legal standing to foreclosure on the property. Although such practices could be deemed to be a consequence of the overwhelming volume of foreclosure activity occurring during the financial crisis, nonetheless, savings associations have the responsibility to assure that all necessary processes and procedures are followed. It is management's responsibility to maintain adequate staff, thereby assuring appropriate oversight of these activities, whether performed internally or contracted to vendors. Noncompliance with such practices is considered unsafe and unsound due to the savings association's loss exposure for failure to comply with legal requirements.

Throughout this Section we use the terms foreclosure and repossession (and other forms of those terms) interchangeably. The life cycle of foreclosed real estate consists of three phases: acquisition (foreclosure), holding period, and disposition (sale).



Accounting for Acquisition of REO

At the time that the savings association forecloses or an in-substance foreclosure occurs, the lender records the REO asset and removes the related loan from its books. Accounting Standards Codification (ASC) 310-40-40-3 requires that **at acquisition**, foreclosed assets initially be recorded at the fair value of the asset less cost to sell. Generally, the savings association intends to sell the REO and assuming certain accounting criteria[2] are met, the REO would be classified as a "held for sale" asset. Costs to sell **includes** broker commissions, legal and title transfer fees, and closing costs as they are anticipated to reduce the savings association's proceeds from the sale. (Other costs associated with the REO

[2] ASC 360-10-45-9 through 45-11 Property, Plant and Equipment addresses the Initial Criteria for Classification as Held for Sale.

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disposition process, for example, marketing or advertising of the property, are expensed as incurred.) The recording of the REO establishes its new cost basis. (Refer to the following section, **Classification**, for an example of the initial recording of REO.)

In general, savings associations must expense as incurred, any direct foreclosure costs. Such costs may include legal fees, filing fees, and legal notice advertising expenses. Costs incurred by the institution to perfect their lien position *prior to foreclosure* – for example the payment of (1) delinquent property taxes to clear tax liens, (2) payment of contractors/sub-contractors to clear mechanic's and material men's liens, or (3) paying off the first lien position on a property where the savings association holds the second lien – may be eligible for capitalization to the cost basis in the *loan*. However, as mentioned previously, at acquisition the REO is recorded at its fair value less costs to sell, so costs incurred to perfect title in the property that are capitalized as an adjustment to the loan's cost basis may simply result in the recognition of a larger loan loss at foreclosure.

Classification – Any excess of the recorded investment in the loan (before any loan loss allowances) over the fair value of the asset received less costs to sell is a loss that shall be recognized by a charge-off against the allowance for loan and lease losses (ALLL). If this loss amount was not previously provided for via an expense charged to the provision for loan and lease losses (PLLL), an additional PLLL may be needed to return the ALLL to an appropriate level. The savings association cannot establish a valuation allowance for this Loss classification as no valuation allowance may be established on the initial recording of REO.

For example, assume a loan is collateral dependant when the savings association takes physical possession of the property.

Loan balance	$100,000
ALLL previously established for the loan	$ 10,000
Fair value of asset	$ 75,000
Costs to sell	$ 4,000

To record this transaction, remove the loan from the books, record the REO asset, and adjust the ALLL, as appropriate, to charge-off the calculated loss. The journal entry is as follows:

REO ($75,000 - $4,000)	$ 71,000	
Allowance for Loan and Lease Losses ($100,000 - $71,000)	$ 29,000[3]	
Loan		$100,000

[3] Note that the savings association may need to record an additional provision for loan loss expense for the $19,000 excess of the charge off over the $10,000 previously established ALLL to return the ALLL to an appropriate level.

Accounting for REO during the Holding Period

Account for REO **after foreclosure** at the *lower of*:

- Cost (fair value less costs to sell *at acquisition* or after any direct write-downs, if any), or
- *Current* fair value less costs to sell.

This determination is made on an asset-by-asset basis at each subsequent reporting period.

Valuation allowances – The savings association may directly write-off or use a valuation allowance to recognize declines in fair value less cost to sell that occur subsequent to foreclosure. Subsequent recoveries in fair value may be recognized up to cost (fair value of the REO less cost to sell at the acquisition date), i.e., up to the amount of previously recognized valuation allowances. Changes in the valuation allowance are reported in the Thrift Financial Report on SO Line 570 - Net provision for losses on non-interest-bearing assets. Savings associations must report REO on Schedule SC net of any valuation allowances.

OTS policy does not automatically require general valuation allowances (GVA's) on REO. The institution should establish GVAs when the savings association's experience with REO dispositions has been to sell properties at less than their respective fair value estimates. The savings association should base the level of any GVAs on REO on its historical REO loss experience, adjusted for current conditions and trends.

Valuation allowances on foreclosed assets (REO) held for sale, whether general or specific, are not recognized as a component of Tier 1 (core) or Tier 2 capital. The regulatory capital standard only allows for allowances related to loans and leases (ALLL) -to be includable in Tier 2 capital up to a certain limit, currently 1.25 per cent of total risk-weighted assets.

Holding costs – Costs related to REO while held by the savings association such as insurance, maintenance, real estate taxes, and utility costs should be expensed as incurred. Improvements that either increase the value or extend the useful life of the property (e.g., a new roof, windows, etc.) are eligible for capitalization to the REO balance. However, the resulting new cost basis should be assessed to ensure the REO property continues to be reported at the lower of cost or fair value less cost to sell. Depreciation expense is not recognized for assets held for sale, including REO.

Classification – After foreclosure, REO should continue to be evaluated for impairment on at least a quarterly basis. The savings association must classify as Loss and either charge-off any excess of cost over fair value less cost to sell or establish a specific valuation allowance.

Accounting for Sales of Real Estate Financed by the Seller

Treatment of Gains and Losses

ASC 360-20 *Real Estate Sales* describes the accounting treatment for gains and losses incurred at disposition. This standard applies to all transactions in which the seller provides financing to the buyer.

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Losses

GAAP requires that if the sale of REO results in a loss, the savings association shall account for the loss in the period it sustained the loss. Any loss on the disposition of REO is always recognized **immediately**.

It is an unsafe and unsound practice for a savings association to fail to recognize losses from the sale of REO where the sales price is inflated above the REO's market value. The inflated price may be a result of favorable terms, such as a below market interest rate, the savings association provided in a loan to facilitate the sale of the REO. In such situations, GAAP requires discounting the sales prices to reflect market interest rates for loans of similar terms and risk. The resulting discount will result in a lower gain or higher loss on the REO sale with the discount recognized as a yield adjustment over the life of the loan. Examiners should take exception and prompt supervisory action when savings associations finance significant amounts of their REO by loans at interest rates substantially below the current market rates for loans of similar quality and risk.

Gains

There are five methods to account for the disposition of REO – full accrual, installment, cost recovery, reduced profit, and deposit. If the sale of REO results in a profit, each method describes the manner in which that profit is recognized.

- Profit shall be recognized *in full* when real estate is sold, *provided*:

  (a) the profit is determinable, that is, the collectability of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and

  (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit.

- Unless both conditions exist, recognition of **all** or **part** of the profit shall be postponed.

Recognition of **all** of the profit at the time of sale, or at some later date when both conditions exist, is referred to as the full accrual method.

- Profit on real estate sales transactions shall not be recognized by the full accrual method until all of the following criteria are met:

  a) A sale is consummated (see ASC paragraph 360-20-40-5).

  b) The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property (see ASC paragraphs 360-20-40-9 through 40-24).

  c) The seller's receivable is not subject to future subordination (see ASC paragraph 360-20-40-25).

d) The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is, in substance, a sale and does not have a substantial continuing involvement with the property.

Depending on which condition for the full accrual method is not met, one of the other methods must be followed until all the conditions are met, at which time, the full accrual method shall be used. The OCC BAAS Topic 5a, questions 10-15 provide information on the various profit recognition methods and examples of their appropriate use. Further guidance can be found in the Call Report instructions and glossary.

The accounting for REO sales can be complex. Examiners should consider consulting with their regional accounting staff as appropriate.

Appraisals

In accordance with 12 CFR § 560.172, savings associations must appraise each parcel of REO at acquisition, consistent with the requirements of part 564. A savings association must appraise each parcel of REO at the earlier of an in-substance foreclosure or at the time of the savings association's acquisition of the property. Thereafter, prudent management policy dictates the timing of appraisals. The regional director (or designee) may require subsequent appraisals if they deem necessary under the circumstances. Savings associations must carry REO on the books at the lower of recorded cost or fair value less costs to sell.

Although the fair value of the property normally will be determined by an appraisal (or other evaluation), circumstances may justify another prudent valuation method in between appraisals. This may be necessary due to changes in economic conditions since the last appraisal, stale appraisals, or imprecision in the appraisal process (i.e., actual sales for less than the appraised amount). Note that OTS does not require an appraisal upon disposition of the property; however, the savings association's policies may require one.

Loans to One Borrower Rule

Loans to facilitate the sale of real estate do not fall under the loans to one borrower rule *if* the association takes a purchase money mortgage note from the purchaser and meets the following two conditions:

- The savings association does not advance any new funds to the borrower.
- The association is not in a more detrimental position as a result of the sale.

Examination Handbook Section 211 describes circumstances where a savings association may use its salvage powers to exceed the loans to one borrower rules.

Five-Year Holding Period

OTS defines an equity investment in 12 CFR § 567.1 to exclude real property the savings association obtained in satisfaction of a debt or acquired under a judgment or mortgage. This is true if the savings association does not intend to hold the property for real estate investment purposes and plans to dispose of the property within five years. If requested by the savings association, OTS may approve a longer holding period. OTS considers the extension of time to hold REO a supervisory decision. For OTS to consider such extensions, the savings association should address the following items in its request letter:

- The term of the extension and the reason for the request.
- Whether the savings association, in good faith, tried to dispose of the property.
- How the property is classified for GAAP purposes.

REO Hold or Sell Considerations

Once a savings association acquires a property through foreclosure or repossession, management should begin the decision-making process of whether to hold the property (for example, for use as savings association premises or as a real estate investment[4]) or sell it (possibly in an unfavorable market.) A primary consideration when selling the asset is whether the savings association will have to make a loan to facilitate the sale. The savings association must consider the overall cost should it regain the property by later having to foreclose on the loan to facilitate. If a subsequent foreclosure becomes necessary, the condition of the property may be worse than when the savings association initially took possession. Moreover, if the most recent borrower failed to service the debt at all, the savings association has sacrificed any income it could have received from the interim use of the property.

In making the decision when and if to sell the repossessed property at the least cost to the savings association, management should attempt to quantify, at a minimum, the following costs and benefits:

- Loss on an encumbered quick sale of property "as is."
- Cost of completing, restoring, or enhancing the property.
- Cost to prevent deterioration of the asset during the anticipated holding period, including:
  - Insurance and property taxes
  - Physical security (fencing, security service, etc.)
  - Maintenance (mowing, utilities, structural repair, etc.)
  - Intangible (lost goodwill, etc.).

[4] Savings associations are allowed to make direct investments in real estate as premises used in their business or as real estate investments **through subsidiaries**. However, direct investments in real estate through subsidiaries results in the subsidiary being deemed "non-includable" for regulatory capital purposes, which has significant regulatory capital impacts.

- Cost of selling the property (advertising, broker's commission, correction of defects observed at inspection, etc.).
- Opportunity costs to the savings association, for example, based on the alternative uses of the sales proceeds.
- Cost of providing favorable financing (i.e., discount future and probable cash flows to present value based on an appropriate market interest rate).
- Anticipated appreciation or depreciation in REO fair value during the holding period.
- Benefit when the property is sold at the end of the holding period (e.g., discount proceeds to present value and determine yield based on current market rates).
- Benefit of interim use of the property for a lease or rental arrangement.
- Requirements imposed by 12 CFR § 567.1 to dispose of equity investments in real property within a specified time period to maintain capital rule treatment as REO. This period is generally five years unless OTS approves a longer period.

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The above analysis should assist management in making an informed decision on the disposition of the savings association's REO and other repossessed assets.

Internal Asset Review

As a sound banking practice, savings associations should conduct periodic reappraisals and reassessments of REO and other repossessed assets. Exceptions to this requirement are discussed in the Appraisals section presented earlier. The classification of assets regulation does not mandate that the institution *automatically* classify all foreclosed property. Handbook Section 260, Classification of Assets, discusses the specific considerations for the classification of REO. REO is sometimes an unsound asset even when recorded at fair value. REO can often be non-income generating. The savings association's acquisition of the property normally indicates a lack of demand. As time passes without disposition, the lack of demand becomes more apparent and the quality of the asset becomes more doubtful.

The savings association should consider each repossessed item on an individual basis and, if necessary, classify it adversely on the basis of facts supporting the evaluation. For instance, if a developed parcel of REO is receiving steady cash flows at a market yield, an adverse classification may not be necessary.

Real Estate Owned (REO) Workouts

Management must assess the level of in-house expertise available to manage REO workouts. Management should consider looking outside the association for the necessary level of expertise when appropriate. This includes recruiting and employing real estate workout specialists and using real estate workout companies on a contract basis.

Management is responsible for reviewing the economic merits of outsourcing REO disposition plans. If any savings association identifies any regulatory issues of concern during its process of selecting an outside REO workout program, it should raise these issues with the appropriate examination or supervisory personnel. They will provide advice on whether the vendor's proposal conforms to regulatory procedures and safe and sound practices. Savings associations should be aware that OTS neither approves nor endorses specific REO workout proposals. Savings associations should bring to OTS's attention any representations by any organization to the contrary.

REFERENCES

Code of Regulations (12 CFR)

§ 560.30	General Lending and Investment Powers
§ 560.93	Lending Limitations
§ 560.100-101	Real Estate Lending Standards
§ 560.160	Asset Classification
§ 560.172	Re-Evaluation of Real Estate Owned
§ 567.1(i)(4)	Definition of Equity Investment in Real Property

OTS CEO Letters

CEO Letter 292, Temporary Suspension of Home Mortgage Foreclosures, February 12, 2009 (http://www.ots.treas.gov/_files/25292.pdf)

CEO Letter 325, Guidance on Prudent Commercial Real Estate Loan Workouts, October 30, 2009 (http://www.ots.treas.gov/_files/25325.pdf)

Financial Accounting Standards Board Accounting Standards Codification (ASC)

ASC 310-40 ***Accounting for Troubled Debt Restructurings by Creditors*** (formerly SFAS 15 and SFAS 114)

ASC 360-10-35 through 10-45 ***Impairment or Disposal of Long-Lived Assets*** (formerly SFAS 143 and SFAS 144)

ASC 360-20 ***Real Estate Sales*** (formerly SFAS 66)

Other Guidance

OCC Bank Accounting Advisory Series, December 2008 (Many practical questions and answers)
http://www.occ.gov/static/publications/BAAS.pdf

Federal Financial Institutions Examination Council, February 10, 1995, Implementation Issues Arising from FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"
Federal Register