OTHER REAL ESTATE

For examination and reporting purposes, other real estate consists of all real estate, other than bank premises, actually owned or controlled by the bank and its consolidated subsidiaries, including real estate acquired through foreclosure, even if the bank has not yet received title to the property. Other real estate also includes certain direct and indirect investments in real estate ventures, property originally acquired for future expansion but no longer intended to be used for that purpose, and foreclosed real estate sold under contract and accounted for under the deposit method of accounting under Statement of Financial Accounting Standards (FAS) 66 (as discussed further below). Most states have laws restricting both the acquisition and retention of such assets.

There are three major phases of the other real estate owned life cycle: acquisition, holding period, and disposition. The accounting and reporting standards for the acquisition phase are set forth in FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, and FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The treatment of holding period costs is covered by basic accounting conventions, and to a lesser extent by FAS 34, *Capitalization of Interest Cost*, and FAS 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, each as amended by FAS 144. The disposition of other real estate is addressed in FAS 66, *Accounting for Sales of Real Estate*, which sets forth specific criteria for the recognition of profit.

Book Value

The Reports of Condition and Income (Call Report) Instructions provide that foreclosed real estate received in full satisfaction of a loan, provided that the real estate will be sold, should be booked at the time of foreclosure at its fair value less cost to sell. If the recorded amount of the loan exceeds the fair value (less cost to sell) of the property, the difference is a loss which must be charged to the Allowance for Loan and Lease Losses (ALLL) at the time of foreclosure. If the fair value (less cost to sell) of the property exceeds the recorded amount of the loan, the excess should be reported as a recovery of a previous charge-off or in current earnings, as appropriate. The recorded amount of the loan at the time of foreclosure is the unpaid balance of the defaulted loan adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged-off, plus recorded accrued interest. Real estate received in partial satisfaction of a loan should be similarly accounted for and the recorded amount of the loan should be reduced by the fair value (less cost to sell) of the asset received at the time of foreclosure. Legal fees and other direct costs incurred by the bank in a foreclosure should be included in expenses when they are incurred.

The fair value of the real estate less the cost to sell the property becomes the "cost" of the foreclosed real estate. After foreclosure, each foreclosed real estate parcel must be carried at the lower of its fair value less cost to sell or its "cost." If the property's fair value less cost to sell is lower than its "cost," the deficiency must be recognized as a valuation allowance against the asset which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) for changes in the asset's fair value or cost to sell.

Guidance for treatment of certain troubled debts and collateral dependent loans is found in FAS 15, as amended by FAS 114. Additional guidance is contained in Accounting Principles Board Opinion No. 21 (APB 21), *Interest on Receivables and Payables*. Collateral dependent loans are those for which repayment is expected to be provided solely from the underlying collateral, where there are no other available and reliable sources of repayment. These assets would be reported as other real estate only if the lender has taken possession of the collateral; otherwise, they would remain categorized as loans. Impairment of a collateral dependent loan must be measured using the fair value of the collateral. In general, any portion of the recorded amount of a collateral dependent loan in excess of the fair value of the collateral that can be identified as uncollectible should be promptly charged-off against the ALLL.

Financed Sales of Other Real Estate

FAS 66 establishes five different methods of accounting for dispositions of real estate. In practice, most banks have primarily used only two, the full accrual or the deposit method. The full accrual method accounts for the transaction as a sale of the real estate, while the deposit method does not. For this reason it is important that these methods be appropriately applied. Failure to correctly designate the transaction may result in overstatement of other real estate and, correspondingly, an understatement of earning assets. The deposit method is the only one of five methods where disposition and financing by the seller of real estate does not result in a sale and corresponding recognition of a loan. Brief descriptions of the five accounting methods for seller-financed dispositions of other real estate are listed below. Reference to FAS 66 should be made for specific and more detailed requirements.

Full Accrual Method

Under this method, the disposition is recorded as a sale. Any resulting profit is recognized in full and the seller-financed asset is reported as a loan. The following conditions must be met in order to utilize this method.

- A sale has been consummated,
- The receivable is not subject to future subordination,
- The usual risks and rewards of ownership have been transferred, and
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property.

Guidelines for the minimum down payment are set forth in Appendix A to FAS 66. They range from five to 25 percent of the property sales price and are based upon the type and characteristics of the property. The continuing investment standards require that payments be sufficient to repay the loan over the customary term for the type of property. For instance, the customary repayment term for a loan secured by a single-family residential property could range up to 30 years.

Installment Method

This method recognizes a sale and corresponding loan. Profits are recorded as the bank receives payments. Interest income is recognized on an accrual basis.

The installment method is used when the down payment is not adequate to allow for use of the full accrual method, but recovery of the cost of the property is reasonably assured in the event of buyer default. Reasonable assurance of cost recovery may be achievable despite a small down payment if there is recourse to borrowers with verifiable net worth, liquidity, and income levels, or if additional collateral is pledged.

Cost Recovery Method

This method also recognizes a sale and corresponding loan and may apply when dispositions do not qualify under the full accrual or installment methods. No profit or interest income is recognized until either the aggregate payments exceed the recorded amount of the loan or a change to another accounting method is appropriate. The loan is maintained on nonaccrual status while this method is used.

Reduced-Profit Method

This method is appropriate in those situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements of the full accrual method. Like the installment method, any profit is recognized as payments are received. However, profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement. This method is seldom used in practice since sales with adequate down payments are generally not structured with inadequate loan amortization requirements.

Deposit Method

The deposit method is used in situations where a sale of the real estate has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method a sale is not recorded and the asset continues to be reported as other real estate. Furthermore, no profit or interest income is recognized. Payments received from the borrower are reported as a liability until sufficient payments or other events have occurred which allow the use of one of the other methods.

Appraisal and Classification

Banks should make periodic reappraisals of other real estate. Examiners can test the general validity of appraised values by comparing sale prices and appraised values of properties previously held. The fact of foreclosure is presumptive, but not conclusive, evidence that takeover value exceeds market or appraised value. Therefore, each parcel of other real estate is to be reviewed and classified on its own merits.

Often a reliable appraisal may not be available or the appraisal on file may be suspect for various reasons. Nevertheless, a careful evaluation of all the relevant factors should enable the examiner to make an accurate and reliable judgment with regard to classification. Any portion of the carrying value in excess of appraised value should be classified Loss. The remaining book value should then be evaluated and adversely classified, if appropriate. Regulatory definitions of Substandard, Doubtful and Loss (as discussed in the Loans section) should be utilized in the analysis of other real estate holdings.

Additional examiner guidance is provided in the Loan Portfolio Management and Review Examination Documentation Modules.

OTHER REAL ESTATE RESERVES

Reserves on foreclosed properties being held for sale may be encountered. Such reserves, whether general or

specific, are not recognized as a component of leverage or risk-based capital. The risk-based capital standard only permits general reserves in the form of "allowances for loan and lease losses" to be included in Tier 2 capital. Other real estate reserves are also excluded from the definition of capital under the leverage capital standard.

Classification Treatment of Reserves

As previously mentioned, valuation allowances are created during the holding period when the fair value less cost to sell is lower than the "cost" of a parcel of other real estate. FAS 144 requires the establishment of valuation allowances, and the Call Report Instructions clarify that valuation allowances must be made on an asset-by-asset basis. As a result, individual valuation allowances should be netted from the asset's "cost" to determine the amount for classification.

Although not required by any accounting standards, some banks have established general reserves to cover inherent losses within an entire portfolio of other real estate, rather than establishing valuation allowances on an individual asset basis. To the extent that any portion of the general reserve should have been established on an individual property basis in accordance with accounting standards, that portion should be treated as a specific reserve. General reserves, on the other hand, should be viewed as a "contra-asset" to other real estate and netted from the "Other Real Estate Owned" category in the Report of Condition. General reserves are not deducted from any individually classified parcels of other real estate.

The existence of any general reserve for other real estate should be considered in determining the amount of other real estate adversely classified Loss to subtract from Tier 1 capital. Although assets classified Loss are considered an "identified loss" as defined in Part 325 of the FDIC Rules and Regulations, deduction from Tier 1 capital may not always be appropriate. The definition of Tier 1 Capital contained in Part 325 only requires deduction of identified losses from capital to the extent appropriate accounting entries to reflect losses would result in reduced Tier 1 capital. To the degree general reserves adequately cover the risks inherent in the other real estate portfolio as a whole, the amount of other real estate assets classified Loss will not need to be deducted in determining Tier 1 capital.

When a bank has established valuation allowances for individual parcels of other real estate in accordance with accounting standards, but additional Loss is identified, the existence of a general reserve for other real estate may minimize (or eliminate) the need for Tier 1 capital deductions that would otherwise occur as a result of the Loss classifications. This treatment is similar to the manner in which an adequate general ALLL may be used to reduce the amount of any Tier 1 capital deduction for loans classified Loss.

The existence of significant general reserves for other real estate and/or significant other real estate Loss classifications, may imply the bank has not appropriately established valuation allowances against individual parcels. In those instances, the bank should be encouraged to establish valuation allowances on an asset-by-asset basis in accordance with accounting standards and the Call Report Instructions.