

Federal Reserve Policy Statement on Rental of Residential Other Real Estate Owned Properties

April 5, 2012

In light of the large volume of distressed residential properties and the indications of higher demand for rental housing in many markets, some banking organizations may choose to make greater use of rental activities in their disposition strategies than in the past. This policy statement reminds banking organizations and examiners that the Federal Reserve's regulations and policies permit the rental of residential other real estate owned (OREO) properties to third-party tenants as part of an orderly disposition strategy within statutory and regulatory limits.¹ This policy statement applies to state member banks, bank holding companies, nonbank subsidiaries of bank holding companies, savings and loan holding companies, non-thrift subsidiaries of savings and loan holding companies, and U.S. branches and agencies of foreign banking organizations (collectively, banking organizations).²

The general policy of the Federal Reserve is that banking organizations should make good-faith efforts to dispose of OREO properties at the earliest practicable date. Consistent with this policy, in light of the extraordinary market conditions that currently prevail, banking organizations may rent residential OREO properties (within statutory and regulatory holding-period limits) without having to demonstrate continuous active marketing of the property, provided that suitable policies and procedures are followed. Under these conditions and circumstances, banking organizations would not contravene supervisory expectations that they show "good-faith efforts" to dispose of OREO by renting the property within the applicable holding period. Moreover, to the extent that OREO rental properties meet the definition of community development under the Community Reinvestment Act (CRA) regulations, they would receive favorable CRA consideration.³ In all respects, banking organizations that rent OREO properties are expected to comply with all applicable federal, state, and local statutes and regulations.

Background

Home prices have been under considerable downward pressure since the financial crisis began, in part due to the large volume of houses for sale by creditors, whether acquired through foreclosure or voluntary surrender of the property by a seriously delinquent borrower (distressed sales). Creditors, in turn, often seek to liquidate their inventories of such properties quickly. Since 2008, it is estimated that millions of residential properties have passed through lender

¹ The term "residential properties" in this policy statement encompasses all one-to-four family properties and does not include multi-family residential or commercial properties.

² This policy statement supplements other relevant Federal Reserve guidance, including the Board's policy statement on disposition of property acquired in satisfaction of debts previously contracted (see 12 CFR 225.140).

³ The Federal Reserve's CRA regulations define community development to include activities that provide affordable housing to low- and moderate-income individuals as well as those activities that revitalize or stabilize low- and moderate-income areas (see 12 CFR 228.12(g)(1) and (4)).

inventories. These distressed sales represent a significant proportion of all home sales transactions, despite some ebb and flow, and thus are a contributing element to the downward pressure on home prices. With mortgage delinquency rates remaining stubbornly high, the continued inflow of new real estate owned properties to the market--expected to be millions more over the coming years--will continue to weigh on house prices for some time.⁴

Banking organizations include their holdings of such properties in OREO on regulatory reports and other financial statements.⁵ Existing federal and state laws and regulations limit the amount of time banking organizations may hold OREO property.⁶ In addition, there are established supervisory expectations for management of OREO properties and the nature of the efforts banking organizations should make to dispose of these properties during that period.

Risk Management Considerations for Residential OREO Property Rentals

In all circumstances, the Federal Reserve expects a banking organization considering such rentals to evaluate the overall costs, benefits, and risks of renting. The banking organization's decision to rent OREO might depend significantly on the condition of individual properties, local market conditions for rental and owner-occupied housing, and its capacity to engage in rental activity in a safe and sound manner and consistent with applicable laws and regulations.

Banking organizations should have an operational framework for their residential OREO rental activities that is appropriate to the extent to which they rent OREO properties. In general, banking organizations with relatively small holdings of residential OREO properties--fewer than 50 individual properties rented or available for rent--should use a framework that appropriately records the organizations' rental decisions and transactions as they take place, preserves key documents, and is otherwise sufficient to safeguard and manage the individual OREO assets.⁷ In contrast, banking organizations with large inventories of residential OREO properties⁸-- 50 or

⁴ For further discussion of housing market conditions and the obstacles to conversions of OREO properties to rental, see "The U.S. Housing Market: Current Conditions and Policy Considerations," Federal Reserve staff white paper, January 4, 2012 (housing white paper), available at <http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>.

⁵ "Other real estate owned" is comprised of all real estate other than (1) bank premises owned or controlled by the bank and its consolidated subsidiaries and (2) direct and indirect investments in real estate ventures.

⁶ Generally, the Federal Reserve allows bank holding companies to hold OREO property for up to five years, with an additional five-year extension subject to certain circumstances (see 12 CFR 225.140). National banks are subject to similar restrictions. State member banks and licensed branches of foreign banks are subject to the holding periods and other limitations on OREO activity established by their respective licensing authorities, which vary. Savings and loan holding companies generally may acquire real estate for rental (see 12 USC 1467a(c)(2) and 12 CFR 238.53(b)).

⁷ A preliminary analysis of Call Report data suggests that roughly ninety-eight percent of community banks held 50 or fewer residential OREO properties.

⁸ For purposes of this guidance, the supervisory expectations for OREO rentals and the number of properties available for rent should include those properties for which tenants were already in place at the time of foreclosure or transfer of ownership, and for which tenants are afforded certain protections under the Protecting Tenants at

more individual properties available for rent or rented--should utilize a framework that systematically documents how they meet the supervisory expectations described in the next section. All banking organizations that rent OREO properties, irrespective of the size of their holdings, should adhere to the guidance set forth in this section.

Compliance with maximum OREO holding-period requirements

Banking organizations should pursue a clear and credible approach for ultimate sale of the rental OREO property within the applicable holding-period limitations. Exit strategies in some cases may include special transaction features to facilitate the sale of OREO, potentially including prudent use of seller-assisted financing or rent-to-own arrangements with tenants.

Compliance with landlord-tenant and other associated requirements

Banking organizations' residential property rental activities are expected to comply with all applicable federal, state, and local laws and regulations, including: landlord-tenant laws; landlord licensing or registration requirements; property maintenance standards; eviction protections (such as under the Protecting Tenants at Foreclosure Act); protections under the Servicemembers Civil Relief Act;⁹ and anti-discrimination laws, including the applicable provisions of the Fair Housing Act and the Americans with Disabilities Act. Prior to undertaking the rental of OREO properties, banking organizations should determine whether such activities are legally permissible under applicable laws, including state laws. When applicable, banking organizations should review homeowner and condominium association bylaws and local zoning laws for prohibitions on renting a property. Banking organizations may use third-party vendors to manage properties but should provide necessary oversight to ensure that property managers fully understand and comply with these federal, state, and local requirements.

Other considerations

Banking organizations should account for OREO assets in accordance with generally accepted accounting principles and applicable regulatory reporting instructions.¹⁰ Banking organizations should also provide the appropriate classification treatment for their residential OREO holdings. Residential OREO is typically treated as a substandard asset, as defined by the interagency classification guidelines.¹¹ However, residential properties with leases in place and

Foreclosure Act of 2009. See Federal Reserve Consumer Compliance Handbook, Section IV for further information at <http://www.federalreserve.gov/boarddocs/supmanual/cch/i-v.pdf>

⁹ See CA letter 09-5, "Information and Examination Procedures for the 'Protecting Tenants at Foreclosure Act of 2009,'" July 30, 2009, and CA letter 05-3, "Servicemembers Civil Relief Act of 2003," May 6, 2005.

¹⁰ See the instructions for the Consolidated Reports of Condition and Income (Call Report) as to the reporting of OREO transactions and to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C). See more generally the Federal Reserve's *Commercial Bank Examination Manual* (CBEM) section 2200.1, "Other Real Estate Owned."

¹¹ The interagency classification guidelines are summarized in CBEM section 2060.1, "Classification of Credits."

demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return¹² should generally not be classified.

Specific Expectations for Large-Scale Residential OREO Rentals

Banking organizations with large inventories of residential OREO properties that decide to engage in rental activities should have in place a documented rental strategy, including formal policies and procedures for OREO rental activities, and a documented operational framework. Policies and procedures should clearly describe how the banking organization will comply with all applicable laws and regulations. Policies and procedures should include processes for determining whether the properties meet local building code requirements and are otherwise habitable, and whether improvements to the properties are needed in order to market them for rent. In addition, policies and procedures should establish operational standards for the banking organization's rental activities, including that adequate insurance policies are in place, that property and other tax obligations are met on a timely basis, and that expenditures on improvements are appropriate to the value of the property and to prevailing norms in the local market.

Policies and procedures should also require plans for rental of residential OREO properties, down to the individual property level, that cover the full holding period from the time the bank received title to ultimate sale by the bank. Plans should identify which properties would be eligible for rental. Plans also should establish criteria by which properties are chosen for marketing as rental properties, and the process by which rental decisions should be made and implemented. Plans should describe the general conditions under which the organization believes a rental approach is likely to be successful, including appropriate consideration of rental market and economic conditions in respective local markets.

Finally, policies and procedures should address all risk management issues that arise in renting residential OREO properties. Some risk elements parallel those found in other banking activities, for example, the credit risk associated with tenants' potential failure to make timely rent payments, or potential conflict of interest issues such as the use of a firm by a banking organization to both provide information on a property's value and list that property for sale on behalf of the banking organization. Other risks unique to such rental include:

¹² Whether a rate of return is reasonable depends on a number of considerations including local market conditions, the time horizon of the rental, and the nature of the property. Commonly used measures include a capitalization rate (known as a "cap rate," which generally is the expected annual cash flows from renting the property relative to the price at which the property holder could expect to sell it in the owner-occupied market), as discussed in the housing white paper, or other measures of internal rate of return. Depending on the circumstances and risks associated with the property, valid indications that a level of return is reasonable could include (but would not be limited to) comparisons with normal returns for single-family rentals in the relevant local market; rates of return on other similar local real estate investments; or cap rates or other measures of internal rate of return on investments with similar risk profiles. For example, in many markets a cap rate above 8 percent would likely represent a reasonable rate of return. Large one-time expenditures that are idiosyncratic to a given year but are normal to residential properties over their lifetime, such as replacement cost for worn-out appliances, should generally not be the reason that a property would be classified. Costs of improvement should be treated as capital expenditures with a corresponding effect on properties' carrying value to the extent the improvements improve the properties' values.

- Dealing with vacancy, marketing, and re-rental of previously occupied properties;¹³
- Liability risk arising from rental activities, along with the use and management of liability insurance or other approaches to mitigate that liability and risk; and
- Legal requirements arising from the potential need to take action against tenants for rent delinquency, potentially including eviction. Such requirements may include notice periods.

Banking organizations may need to develop new policies and risk management processes to address properly these categories of risk.

In many cases, banking organizations will use third-party vendors (for example, real estate agents or professional property managers) to manage their OREO properties. Policies and procedures should provide that such individuals or organizations have appropriate expertise in property management, be in sound financial condition, and have a good track record in managing similar properties. Policies and procedures should also call for contracts with such vendors to carry appropriate terms and provide, among other key elements, for adequate management information systems and reporting to the banking organization, including rent rolls (along with actual lease agreements), maintenance logs, and security deposits and charges to these deposits. Banking organizations should provide for adequate oversight of vendors.¹⁴

Additional Materials for Reference¹⁵

- The Board’s Policy Statement on Disposition of Property Acquired in Satisfaction of Debts Previously Contracted, July 28, 1980. See 12 CFR 225.140.
- Instructions for Preparation of Consolidated Reports of Condition and Income (Call Report, FFIEC 031 and 041), Schedule RC-M item 3, available at http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_FFIEC041_201109_i.pdf.
- Instructions for Preparation of the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), available at <http://www.federalreserve.gov/reportforms/>.
- Accounting Standards Codification (ASC) 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly known as FAS 15, “Accounting by Debtors and Creditors for Troubled Debt Restructurings”).
- ASC 360-10-30, Property, Plant and Equipment-Initial Measurement (formerly included in FAS 144, “Accounting for the Impairment or Disposal of Long-Lived Assets”).

¹³ Various jurisdictions may apply specific requirements to landlords in their marketing and re-rental activities (for example, an obligation to offer potential tenants an initial lease term of two years).

¹⁴ See Federal Financial Institutions Examination Council statement on *Risk Management of Outsourced Technology Services* (November 28, 2000, SR letter 00-17), which provides illustrative guidance on constructing outsourcing risk assessments, due diligence in selecting a service provider, contract review, and monitoring a third party that provides services to a regulated institution.

¹⁵ Referenced Federal Reserve regulations and guidance documents may be found on the Board’s public website under “Banking Information and Regulation” available at <http://www.federalreserve.gov/>

- ASC 360-10-35, Property, Plant and Equipment-Subsequent Measurement.
- The disposition of other real estate is addressed in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within FAS 66, “Accounting for Sales of Real Estate”), which includes specific criteria for the recognition of profit.
- *Commercial Bank Examination Manual* section 2200.1, “Other Real Estate Owned” available at <http://www.federalreserve.gov/boarddocs/supmanual/cbem/2000.pdf>.
- SR letter 10-16, “Interagency Appraisal and Evaluation Guidelines,” December 2, 2010. For the sale of OREO property with a value of \$250,000 or less, a bank holding company or state member bank may obtain an evaluation in lieu of an appraisal.
- SR letter 00-17, “Statement on Risk Management of Outsourced Technology Services,” November 28, 2000.
- SR letter 95-16, “Real Estate Appraisal Requirements for Other Real Estate Owned (OREO),” March 28, 1995.
- CA letter 09-5, “Information and Examination Procedures for the ‘Protecting Tenants at Foreclosure Act of 2009,’” July 30, 2009.
- CA letter 05-3, “Servicemembers Civil Relief Act of 2003,” May 6, 2005.