Other Real Estate Owned

Cynthia Saer
Senior Examiner
Federal Reserve Bank of Kansas City
Supervision and Risk Management

Accounting References – Foreclosed Assets (OREO)

- FAS 15 – Accounting by debtors and creditors for troubled debt restructuring (TDRs)
- FAS 144 – Accounting for the impairment or disposal of long-lived assets
- FAS 66 – Accounting for sales of real estate (RE) (OREO)

Acquiring OREO

- Foreclosure – DPC
- Deed in lieu of foreclosure
- Former bank premises
- Abandoning plans to use RE as premises for future expansion

Acquiring OREO (Cont’d)

- DPC: booked as OREO when the bank has obtained physical possession of the property, regardless of when title is received
- Former bank premises: when no longer used
- Held for expansion: when plans are abandoned

FAS 144 - Accounting for the Impairment or Disposal of Long-Lived Assets (OREO)

- A newly acquired, held-for-sale, long-lived asset is initially recorded at fair value (FV) less cost to sell
- OREO acquired or received in a TDR, foreclosure, or deed in lieu is: presumed to be held-for-sale

Accounting for OREO

- At FV less costs to sell:
  - recognize a charge to the allowance for loan and lease losses (ALLL) if the recorded amount of the loan exceeds the FV of the OREO, less cost to sell
  - recognize a gain (other noninterest income), if FV exceeds the recorded amount of the loan:
    - » RARE event - should be well supported
  - this assumes full satisfaction of the loan
  - the costs to sell charge is included in the calculation of any loan loss

OREO Appraisal Requirements

- OREO appraisal guidelines differ from state to state
- SR 95-16 requires an institution to obtain an evaluation prior to or immediately following a foreclosure or a deed in lieu (no appraisal because it is an existing extension of credit qualifying for an exemption)
- SR 95-16 requires a valid appraisal to support the sale or disposal of OREO (unless < $250M, when evaluation suffices) (an appraisal is needed because the transaction does not qualify for an existing extension of credit)

OREO Appraisal Requirements (Cont'd)

- Appraisals are required for any RE-related transaction:
  - purchase, sale, investment in, exchange of, or extension of credit secured by a loan (or) real property interest
- Exempted transactions:
  - transactions involving an existing extension of credit:
    - no obvious material change in market conditions or physical aspects of the property or advancements of new monies
- Valid appraisal:
  - no material change in the market value
  - factors to consider:
    - passage of time; market volatility; availability of financing; inventory of competing properties; new improvements; lack of maintenance; etc.

OREO Cost to Sell

- Represents the incremental direct costs to transact the sale:
  - Broker commissions, legal and title transfer fees, closing costs

Example: Satisfaction of the Loan

FMV OREO $75,000

Loan …………………………………..$100,000

Less: FMV of OREO less

10 percent cost to sell ($7,500) ….$67,500

Remaining Loan ……………… …....$32,500

- if full satisfaction - loan loss of $32,500
- if partial satisfaction - loan balance $32,500
- recorded balance of the OREO $67,500

Operating Expense, Capital Improvements, and Income

- Operating expenses: expense when incurred:
  - other noninterest expense
- Repairs: expense when incurred:
  - other noninterest expense
- Expenses necessary to develop the property are capitalized. Bank should have a valid appraisal with a "when completed" value that justifies the capitalized expenses. (only if: completed value > BV of OREO + Cap expenses)
- Rental income:
  - other noninterest expense - when realized

Other Considerations

- Recognize a loss for any subsequent write down to FV, less cost to sell:
  - loss is reported as other noninterest expense
- Recognize a gain for any subsequent increase in FV less cost to sell, but not greater than the cumulative loss previously recognized:
  - gain is reported as other noninterest income
- Recognize a gain or loss not previously recognized that results from the sale of OREO at the date of sale:
  - loss or gain from the sale of OREO does not go through the ALLL. The loss or gain is reported as an other noninterest item

FAS 66 – Accounting for Sales of Real Estate (OREO)

- Applies to all transactions in which the <u>seller</u> provides financing to the buyer of the RE
- Establishes 5 methods to account for dispositions of RE:
  - each method prescribes how profit is to be recognized
  - losses on the disposition of RE should be recognized immediately

FAS 66 – Accounting for Sales of Real Estate (OREO)

- Full Accrual Method:
  - disposition is recorded as a sale
  - profit is recognized in full, and the sold (“financed”) is reported as a sale
  - the following conditions must be met:
    - » a sale has been consummated
    - » buyers initial investment (down payment) and continuing investment (periodic payments) are adequate
    - » the receivable is not subject to future subordination
    - » the usual risks and rewards have been transferred

FAS 66 – Accounting for Sales of Real Estate (OREO)

- Initial investment:
  - range 5 - 25 percent of the property’s sales value
  - guideline percent depends on property type
- Continuing investment criteria:
  - contractual loan payments must be sufficient to repay the loan over a customary loan term for the type of property
  - periods may range up to 30 years for a loan on single-family residential property

FAS 66 – Accounting for Sales of Real Estate (OREO)

- Installment method:
  - used when the transaction does not qualify for the full accrual method
  - recognizes a sale and a corresponding loan
  - profits are recognized as the bank receives payments from the borrower:
    - » payments are apportioned between cost recovery and profit
    - » once the transaction meets the full accrual method criteria, the seller may change to the full accrual method and recognize the remainder of the profit

FAS 66 – Accounting for Sales of Real Estate (OREO)

- Cost recovery method:
  - used when the transaction does not qualify for the full accrual or installment methods
  - no profit or interest income is recognized until the aggregate payments by the borrower exceed the seller's recorded amount
  - seller recognizes a sale and corresponding loan, but all income recognition is deferred
  - principal payments are applied to reduce the loan balance
  - the loan is in nonaccrual status while this method is being used

FAS 66 – Accounting for Sales of Real Estate (OREO)

- Reduced profit method:
  - this method is used when the sale does not meet full accrual requirements
  - must have an adequate down payment; amortization schedules are limited to specified time frames, depending on the type of property
  - seller recognizes a sale and a corresponding loan
  - this method permits profit to be recognized over the life of the loan:
    - » uses a PV calculation to determine recognized profit
  - this method is seldom used

FAS 66 – Accounting for Sales of Real Estate (OREO)

Deposit Method

- The seller:
  - does not recognize a sale or any profit
  - does not record notes receivable
  - reports the property on its balance sheet
  - cash collected is reported as a liability

Nonaccrual Loans

Cynthia Saer
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Nonaccrual Loans

- General Rule: Interest is not accrued on:
  - loans maintained on a cash basis because of the financial deterioration of the borrower
  - loans for which payment in full of principle or interest is not expected
  - loans past due 90 days or more <u>unless</u>:
    - » the loan is well secured, <u>and</u>
    - » in the process of collection

Nonaccrual Loans

- Well Secured:
  - secured by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt including accrued interest
  - by the guarantee of a financially responsible party

Nonaccrual Loans

- In Process of Collection:
  - the definition is viewed very narrowly
  - the timing and amount of payment must be reasonably certain
  - there must be evidence that collection in full of amounts due and unpaid will occur shortly
  - it is more than initiating legal action or pursuing a well-reasoned plan for collection
  - commencement of collection efforts, plans to liquidate collateral, ongoing work outs, foreclosing or repossessing collateral, restructuring, do not by themselves allow a loan to meet the definition

Nonaccrual Loans

- Exceptions to reporting loans as nonaccrual:
  - SOP 03-3: purchase of impaired loans if meet criteria for accrual
  - Practice Bulletin 6: loans purchased at a discount
  - Consumer loans (does not include 1- to 4-Family)

Nonaccrual Loans

- Receipt of payment on nonaccrual loans:
  - if any doubt exists about the collectability of the principal: funds received are used to reduce principal
  - if no doubt exists about the collectability of the principal (because of charge-downs), funds received may be taken as interest income:
    - this situation is fairly rare

Nonaccrual Loans

- If income is taken on a cash basis:
  - must be well supported by a current written evaluation of the borrower’s financial condition and prospects for repayment
  - recognize interest at the contractual rate on the book balance with other “interest” payment going against principal

Nonaccrual Loans

- Restoring loan to accrual status:
  - general rule:
    - » when no principle or interest is due and unpaid and the bank expects repayment of the remaining contractual principle or interest, or
    - » when it becomes well secured and in the process of collection
- Bank can NOT go back and recognize interest income on amounts previously used to reduce principle when loan is restored to accrual status

Nonaccrual Loans

- Exceptions to meeting the no principle and interest due (Qualify to return to accrual status):
  - the loan has been formally restructured:
    - » AND the restructured/charged-off amounts are supported by the current written credit evaluation of the borrower's financial condition and prospects for repayment
    - » AND there has been at least 6 months of performance that would support the restructured terms
  - SOP 03 – 3 loans – purchase of impaired loans if meet nonaccrual criteria
  - Practice Bulletin 6 – purchased at a discount (failed bank, at a discount)

Nonaccrual Loans

- Exceptions to meeting the no principle and interest due (qualify to return to accrual status) continued:
  - borrower is paying per contract, although borrower may not be fully current:
    - ONLY if the contractual P and I is reasonably assured within a reasonable period
    - AND there has been sustained performance (6 months), in accordance with the contractual terms
  - even though loan is restored to accrual status, the loan is still reported as past due

Nonaccrual Loans

- Another way to return to accrual status:
  - restructuring into 2 notes:
    - » "A" note – "good" note
    - » "B" note – "bad" note
    - » "A" note may be returned to accrual status provided:
      - ❖ all principle and interest on note is reasonably assured within a reasonable time period
      - ❖ sustained performance (6 months)
      - ❖ AND "B" note has been charged-off