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Comptroller of the Currency  
Administrator of National Banks

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# Other Real Estate Owned

Comptroller's Handbook  
(Section 219)

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Assets

# Other Real Estate Owned (Section 219)

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# Other Real Estate Owned (Section 219)

## Introduction

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12 USC 29 established a bank's authority to hold real estate. It permitted a bank to hold "Other Real Estate Owned" under certain circumstances for a period no longer than five years. The Depository Institutions Deregulation and Monetary Control Act of 1980 amended 12 USC 29 to allow a bank to hold "Other Real Estate Owned" up to an additional five-year period beyond the original one, with the approval of the Comptroller. The Comptroller may approve the additional holding period if the bank has made a good faith effort to dispose of property, or if disposal within the initial five-year period would be detrimental. The Depository Institutions Act (DIA) of 1982 amended 12 USC 29 to permit a national bank to continue to hold, directly or indirectly, real estate which has been carried on the bank's books at a nominal amount since December 31, 1979, for the same time period which is permitted for a state chartered bank in the same state. Real estate eligible for this extended holding period includes any subsurface rights or interests. The aggregate earnings from such real estate, rights, and interests must be separately disclosed in the bank's annual financial statements. 12 CFR 7.3025 established procedures for accounting for "Other Real Estate Owned." The ruling was revised in February 1979 to bring the accounting into conformity with generally accepted accounting principles and, thus, provide more meaningful bank financial statement comparisons.

Real property becomes other real estate owned through:

- Purchases at sales under judgments, decrees, or mortgages when the property was security for debts previously contracted.
- Conveyance in satisfaction of debts previously contracted.
- Purchase to secure debts previously contracted.
- Relocation of banking premises.
- Abandonment of plans to use real estate acquired for future expansion for banking premises.

Although the borrower may still retain possession and legal title to the property, certain troubled loans secured by real estate are considered to be "in substance foreclosures" and are also treated as other real estate owned. An in substance foreclosure situation is generally characterized by a borrower with little or no equity and sale of the property being the only source of repayment.

In addition, other real estate owned includes real estate sold by a national bank after the effective date of the revised 12 CFR 7.3025 in a “covered transaction” for the period the transaction remains covered. A covered transaction is defined as a sale of other real estate owned when:

- Less than 10 percent of total sales price is in cash; or
- There is financing by the bank of all or a portion of the sales price on terms more favorable than those customarily required by the bank when it is involved only as lender; or
- The transaction does not transfer from the bank to the buyer the usual risks and all or most of the rewards of ownership.

A transaction ceases to be covered when those conditions no longer exist. A buyer can meet the 10 percent cash down payment requirement through use of private mortgage insurance or an equivalent guarantee and cash.

For real estate acquired for future expansion, three years is normally sufficient time for the bank to determine that the property will not be used for banking premises. However, within one year of acquiring real estate for future expansion, the board of directors must adopt a resolution indicating definitive plans for its use.

Property originally acquired for future expansion and abandoned banking premises should be accounted for at the lower of its net book value or its “fair value” at the date of transfer to other real estate owned. Any excess of net book value over fair value shall be charged to expense of the current period. Fair value is the cash price that might reasonably be anticipated in a current sale under all conditions requisite to a fair sale. A fair sale means that buyer and seller are each acting prudently, knowledgeably, and under no necessity to buy or sell, i.e., other than in a forced or liquidation sale. A current sale is one occurring within 12 months.

All other “Other Real Estate Owned” should be accounted for individually at the lower of “recorded investment in the loan satisfied” or its fair value on the date of transfer to that category. The recorded investment in the loan satisfied is the unpaid balance of the loan, increased by accrued and uncollected interest, unamortized premium, and loan acquisition costs, if any, and decreased by previous direct write down, finance charges, and unamortized discount, if any. Any excess of the recorded investment in the loan satisfied, over the fair value

of the property must be charged against the allowance for loan and lease losses. Legal fees and direct costs of acquiring title to the property shall be expensed when incurred.

When the bank acquires a parcel of property through foreclosure as a second lien holder, without assuming the first lien, the property should be booked at the loan amount, plus allowable costs. The total of unassumed first liens on other real estate owned should be recorded to the memorandum accounts for control purposes. If the bank assumes the first lien, the asset and liability should be recorded gross.

Upon transfer to other real estate owned, fair value must be substantiated by a current appraisal prepared by an independent, qualified appraiser. The requirement is waived when the entire property is recorded at or below the lower of 5 percent of the bank's equity capital or \$25,000. Further, it is deferred for three months after the bank takes title when the bank can document reasonable expectation of a sale other than in a covered transaction. All instructions from the bank to the appraiser must be in writing. Further, the appraisal must contain all of the bank's instructions to the appraiser. The appraiser should estimate the cash price that might be received upon exposure to the open market for a reasonable time, considering the property type and local market conditions. When a current sale is unlikely, i.e., when it is unlikely that the sale can be completed within 12 months, the appraiser must discount all cash flows generated by the property to obtain the estimate of fair value. Those cash flows include, but are not limited to, those arising from ownership, development, operation, and sale of the property. The discount applied should reflect the appraiser's judgment of what a prudent/knowledgeable purchaser, under no necessity to buy, would be willing to pay for the property in a current sale. Whenever the appraiser believes that more than one year is necessary for a fair sale of the property, the appraiser should state and justify the estimated time and should state the annual discount rate applied. To substantiate the carrying value and to insure that the property has not declined in value, a new appraisal or a certification in letter form from an independent appraiser must be obtained annually. However, the bank need not obtain either if the book value of the entire property is below the lower of 5 percent of equity capital or \$25,000. If the new appraisal reflects a permanent impairment of the value of the parcel, the bank may record the decline by a charge against current earnings. However, if a decline is not judged to be permanent, the bank must establish a valuation reserve in an amount at least equal to the excess of book value over fair value of the property. When a latter

appraisal indicates that fair value of the parcel has increased, the reserve for that parcel may be reduced but not below zero.

Documentation reflecting the bank's efforts to dispose of other real estate owned must be maintained. Such documentation might include:

- A record of inquiries and offers made by potential buyers.
- Methods used in advertising the property for sale whether by the bank or its agent.
- Other information reflecting sales efforts.

Other real estate owned must be disposed of within the holding period permitted by 12 USC 29, at any time that prudent judgment dictates. If at any time before the end of the holding period the bank can recover the amount of its original loan plus additional advances and other costs related to the loan or the parcel of other real estate owned, it should promptly dispose of the parcel. The holding period of 12 USC 29 begins on the date that legal title to the property is transferred to the bank, except for real estate for which banking use is no longer contemplated and property sold in a covered transaction. If title to property sold by the bank in a covered transaction reverts to the bank while the transaction is still covered, the holding period begins on the date the bank originally acquired title. An application must be filed with the Comptroller to hold other real estate owned beyond five years.

Regulatory policy requires that sales of foreclosed property be accounted for according to generally accepted accounting principles (GAAP). The sale of foreclosed property will be financed often by a loan at less than current market interest rates. In this situation, GAAP requires that the loan be discounted to bring its yield to a market rate. The effect of the discount will be either to increase the loss or to reduce the gain that results from the sales transaction. Interest income is then recognized at a constant yield over the life of the loan.

Banks may also facilitate the sale of foreclosed property by requiring little or no down payment. In these cases, GAAP requires that the profit on sales of the foreclosed property be deferred until an adequate down payment (depending on the type of property, up to 25 percent of the discounted sales price) has been received. However, losses should be recorded immediately. Additionally, loans arising from covered transactions must be included in other real estate owned on reports filed pursuant to 12 USC 161, and accounted for according to 12

CFR 7.3025 while the transaction remains covered.

The Depository Institutions Deregulation and Monetary Control Act of 1980 amended 12 USC 29 to allow a bank to develop and improve "Other Real Estate Owned," upon notification to the Comptroller and subject to conditions and limitations prescribed by the Comptroller, if outlays are needed to enable the bank to recover its total investment in that real estate.

Other real estate owned is frequently an unsound bank asset, even when carried at or below the appraised value. The bank's purchase of the property through foreclosure usually indicates lack of demand. As time lapses, the lack of demand becomes more firm, and the soundness of real estate for which there is no demand becomes more questionable. Banks usually lose money in liquidating other real estate owned despite the apparent adequacy of appraised value.

It is not agency policy to classify OREO assets routinely. To determine quality, the examiner should evaluate each parcel of other real estate owned on a case-by-case basis and classify or pass the property as appropriate. The examiner must consider the extent of sound value, conformity with the OCC ruling, and the plan and performance of the bank relative to disposition.

The examiner should review all relevant factors to determine the quality and risk of the parcel of other real estate owned and the degree of probability that its carrying value will be realized. In conducting the analysis, some of the factors the examiner should consider include:

- The property's carrying value relative to its appraised value, the bank's asking price, and offers received.
- The length of time the property has been on the market and local market conditions for the type of property involved, e.g., history of and trend of recent sales for comparable properties.
- Bank management's ability and track record in liquidating assets acquired in satisfaction of debts previously contracted.
- Income generated by the property and other economic factors affecting the probability of loss exposure.
- The manner in which the bank intends to dispose of the property.
- The source and quality of the appraisal.
- Other pertinent factors, including the title, statutory redemption privileges, zoning, other liens, tax status, and insurance, etc.

# Other Real Estate Owned (Section 219)

## Examination Procedures

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### General Procedures

These procedures are designed to determine the adequacy of a bank's other real estate owned (OREO) policies, procedures, practices and internal controls, which will be used to assess and quantify the level and direction of OREO risk.

The extent of examining, testing and performing certain examination procedures should be based on the examiner's overall assessment of the level and direction of OREO risk. This assessment should consider the work performed by other regulatory agencies, internal/external auditors, other internal compliance units, management's adherence to formal and informal policies and procedures, the effectiveness of internal controls and management information systems.

**Objective:** Determine the examination scope for OREO.

1. Review the following to identify if previous problems require follow-up. Determine if planned corrective action was effected, and if not, why not.
  - Bank correspondence involving OREO.
  - EIC's scope memorandum.
  - Supervisory strategy in the OCC's Electronic Information System.
  - Overall summary comments.
  - Previous examination report and working papers.
  - Audit reports, and working papers as necessary.
2. From the EIC, obtain the results of his or her analysis of the UBPR, BERT, and other OCC reports. Identify any concerns, trends, or changes involving other real estate owned.
3. Obtain and review reports used by management to supervise OREO. Examples include:
  - General and subsidiary ledger(s).
  - Reconciliation of OREO since the last exam.



- Most recent internal audit, regulatory compliance, and loan review reports.
  - Volume of nonperforming RE loans considered potential OREO.
  - OREO losses.
  - Concentrations.
  - Condition of local RE markets.
4. Obtain a listing of internal/external audit deficiencies noted in the latest review from the examiner assigned "Internal and External Audits." Determine if appropriate corrections have been made.
  5. Determine if any material OREO changes have occurred since the last examination that would influence the level and direction of OREO risk.
  6. Determine the following from discussions with management:
    - How management supervises OREO.
    - If there have been any significant changes in OREO policies, procedures, practices, internal controls, or personnel responsible for managing and supervising OREO.
    - If any additional internal or external factors exist that could affect OREO.
    - How management considers and quantifies environmental risks on properties prior to foreclosure.
  7. While performing specific examination procedures, determine if bank officers and employees are operating in conformance with the bank's OREO policy, procedures and practices, and applicable laws, rules and regulations.
  8. Based on the completion of the general procedures and discussions with the bank EIC, set the objective(s) and scope of the examination.

**Select specific examination procedures necessary to meet examination objectives from the following examination procedures. All examination procedures are seldom required in an examination.**

## Quantity of Risk

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**Conclusion: The quantity of risk is (low, moderate, high).**

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Objective: Evaluate the accuracy of risk identification and classification.

1. Ensure that management has accurately identified all OREO assets by discussing the following with examiners assigned “Loan Portfolio Management,” “Other Assets and Other Liabilities,” “Allowance for Loan and Lease Losses” and “Bank Premises and Equipment”:
  - If the institution holds any real estate acquired as salvage on uncollectible loans.
  - If there is any vacated bank premises or property originally purchased for future expansion, which is no longer intended for such usage.
  - If there are any troubled real estate that meet the criteria for in substance foreclosure (ISF).
  - If there are any OREO sales that didn’t qualify for sales treatment according to GAAP.
2. Based on examiner judgement, prepare a sample of OREO for in-depth review.
3. From bank credit files, liability records, and internal reports, transcribe the following information to line sheets:
  - Property description.
  - Date and how the OREO was acquired.
  - Current book value and balance at transfer to OREO.
  - The amount and date of the most recent appraisal/evaluation.
  - The bank’s asking price and the dates and amounts of any offers.
  - Amount of insurance (including liability coverage), whether it is adequate, and if the bank named as loss payee.
  - Date legal title obtained and when the asset was recorded as OREO.
4. Are there any properties contaminated with environmental problems?
5. Through discussions with management, assign appropriate risk ratings. Forward a listing of OREO classifications to the examiner assigned LPM.

Objective: Evaluate the level of compliance for OREO.

1. Determine that assets are accounted for and reported in accordance with OREO
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statutes and regulations by reviewing each parcel to test for compliance with the following:

- *12 U.S.C. 29—Authority to Hold Real Estate.*
  - *12 U.S.C. 161—Report of Condition, Call Report and/or SOP 92-3.*
  - *12 C.F.R. 34, subparts C and E—Real Estate Appraisals and OREO.*
2. Investigate any OREO insider transactions. If any exist, consult with the examiner performing Insider Activities and/or Related Organizations.

## Quality of Risk Management

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**Conclusion:** The quality of risk management is (strong, satisfactory, weak).

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### Policy

Conclusion: The board (has/has not) established effective policies for OREO.

Objective: Determine the adequacy of the bank's policies for OREO.

1. Review the adequacy of the bank's OREO policies to ensure that they:
  - Establish responsibilities and accountability.
  - Require that risk management processes be established.
  - Include written guidelines. If not, evaluate whether guidelines should be in writing, given the bank's complexity.
2. Determine if OREO policies are approved by the Board or a designated committee.
3. Determine if OREO policies are reviewed and updated at least annually by the Board.
4. Determine if management has a policy that addresses environmental risks.

### Processes

Conclusion: Management and the board (have/have not) established effective processes for OREO.

Objective: Determine the adequacy of risk management processes for OREO.

1. Assess how management ensures compliance with 12 U.S.C. 29—Authority to Hold Real Estate, 12 C.F.R. 34, subpart C—Real Estate Appraisals and subpart E—Other Real Estate Owned, 12 U.S.C. 161—Report of Condition, Call Report, and SOP 92-3.
2. Determine if management reviews OREO parcels at least annually for the following:
  - Valid appraisal or evaluation.

- Documented inquiries and offers.
  - Documented sales efforts.
  - Evidence of the prudence of additional advances.
  - Anticipated methods for disposal of the property.
  - Changes in tax status, zoning restrictions, other liens, etc.
  - Compliance with accounting requirements (SOP 92-3).
  - Acquisitions and disposal of OREO assets reported to the board or its designated committee.
3. Prior to foreclosure, consider if management:
- Evaluates property for the presence of contaminants? Examples include:
    - Lead based paint (11/97 HUD/EPA Guidance).
    - Under and/or above ground storage tanks (1995 EPA guidance).
    - Asbestos (OSHA 1995 guidance).
    - Other known contaminants indigenous to the area.
  - Obtains a Phase I environmental study to quantify potential or known contaminants?
  - Evaluates the risks of foreclosing on contaminated property when Phase I results are positive? Areas to consider include:
    - The need for a Phase II estimate of cleanup costs.
    - The need for a Phase III site cleanup.
4. Assess the adequacy of the bank's processes for holding the following real estate:

#### **Previously Used Bank Premises**

- If leased, is the lease nonconterminous (i.e., the sublease expires earlier than the master lease)?
- Does management follow adequate landlord (lessor) processes?
- Does management follow 12 U.S.C. 34e holding period suspension (tolling) guidelines?

#### **Real Estate Held for Future Expansion**

- Within one year of acquisition, did the Board or a delegated committee approve a resolution for use of the property?
  - Will the property be used within five years?
5. Review the process for recording and maintaining OREO on the bank's general and subsidiary ledgers. Consider whether:

- Properties are supported by an appraisal or an evaluation.
  - Properties are recorded in a manner consistent with GAAP and at the lower of cost or market.
  - Supervision of recording and documenting ongoing expenditures is adequate.
6. Review the adequacy of bank processes that ensure appropriate disposition of OREO. Consider:
- Whether management has requested/received OCC permission to hold OREO for more than five years.
  - If the bank accepted written bids for any sales.
  - If bids are maintained on file.
  - Whether there is acceptable documentation to justify the acceptance of a lower bid.
  - Whether management is aware of the various forms of sales treatment.
7. For OREO sales that did not qualify for sales treatment according to GAAP, determine that they continue to be carried as OREO until they qualify for sales treatment.

## Personnel

**Conclusion:** The board, management and effected personnel (do/do not) possess the skills and knowledge necessary to effectively manage and perform duties related to OREO.

**Objective:** Given the size and complexity of the bank, determine if bank management/personnel possesses and displays acceptable knowledge and technical skills to manage and perform duties related to OREO.

1. Determine significant current and previous work experience of OREO management and significant personnel. Consider:
  - Previous real estate management experience.
  - Previous problem loan workout experience.
  - Previous OREO administration experience.
2. Determine formal education and planned continuing education by management.
3. Assess management's technical knowledge and ability to manage OREO from the results of OREO administration evaluation and the determination of the quantity of risk.

4. For those areas where staff does not possess the necessary expertise (e.g., appraisals, environmental risks, etc.), evaluate how management obtains expert guidance?

## Controls

Conclusion: Management (has/has not) established effective control systems.

Objective: Determine that effective control systems are in place to monitor compliance with established policies and processes.

1. Determine the effectiveness of the loan review function in identifying risk in OREO. Consider the following:
    - Scope and coverage of review(s).
    - Frequency of review(s).
    - Qualifications of loan review personnel.
    - Comprehensiveness and accuracy of findings/recommendations.
    - Adequacy and timeliness of follow up.
  2. Determine the scope and adequacy of the audit/regulatory compliance review function. Consider the following:
    - Scope and coverage. The review should test for compliance with the following:
      - 12 U.S.C. 29—Authority to Hold Real Estate.
      - 12 C.F.R. 34, subpart C—Real Estate Appraisals and subpart E—Other Real Estate Owned.
      - 12 U.S.C. 161—Report of Condition, Call Report.
      - EPA/HUD environmental guidelines.
      - Internal controls.
    - Ongoing monitoring and disposition of OREO.
    - Frequency of review(s).
    - Qualifications of audit/compliance personnel.
    - Comprehensiveness and accuracy of findings/recommendations.
    - If violations/exceptions were noted, determine that management took appropriate and timely corrective action(s).
  3. Evaluate the effectiveness of other control systems that safeguard assets and ensure the integrity of accounting data/financial reports. Consider:
    - Are separate files maintained for each OREO parcel?
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- Does each file support the carrying value of the asset?
- Are the preparation, addition and posting of subsidiary OREO records performed and/or tested by persons who do not have direct, physical or accounting, control of those assets?
- Are subsidiary OREO records reconciled to the appropriate general ledger accounts at least annually by person who do not have direct, physical or accounting control of those assets?
- Are any reconciling items investigated by persons who do not post entries?
- Is posting to the general ledger OREO accounts approved, prior to posting, by persons who do not have direct, physical or accounting, control of those assets?



## Conclusion

**Objective:** To communicate findings and initiate corrective action when policies, processes, personnel, or controls are deficient or when violations have been noted.

1. Provide the LPM examiner or bank EIC with brief conclusions regarding:
    - The adequacy of policies, processes, and controls.
    - How bank officers conform to established policy and processes.
    - Adverse trends.
    - Significant internal control deficiencies.
    - Any recommended corrective actions needed to correct deficiencies.
    - The quality of departmental management.
    - The quantity of credit risk in the portfolio.
    - The adequacy of MIS and reporting.
    - Other matters of significance.
  
  2. Determine the impact on the aggregate and direction of risk assessments for any identified risks. Examiners should refer to guidance provided under the OCC's large and community bank risk assessment programs. Consider:
    - Risk Categories: Compliance, Credit, Foreign Currency Translation, Interest Rate, Liquidity, Price, Reputation, Strategic, Transaction.
    - Risk Conclusions: High, Moderate, or Low.
    - Risk Direction: Increasing, Stable, or Decreasing.
  
  3. Determine, in consultation with EIC, if identified risks are significant enough to bring them to the board's attention in the ROE. If so, prepare comments to include in Matters Requiring Board Attention.
    - MRBA should cover practices that:
      - Deviate from sound fundamental principles and are likely to result in financial deterioration if not addressed.
      - Result in substantive noncompliance with laws, rules or regulations.
    - MRBA should discuss:
      - Causative factors contributing to the problem.
      - Consequences of inaction.
      - Management's commitment for corrective action.
      - The time frame and person(s) responsible for corrective action.
  
  4. Discuss the following findings with management including conclusions regarding
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applicable risks:

- The adequacy of policies, processes, and controls.
  - The quantity of risk assumed in OREO (including classified OREO).
  - Internal control exceptions and deficiencies in, or noncompliance with, written policies, practices and procedures.
  - Uncorrected audit deficiencies.
  - Violations of law, rules or regulations.
  - Comments for the report of examination.
5. As appropriate, prepare a brief OREO comment for inclusion in the report of examination. Discuss:
- Quantity of risk.
  - Quality of risk management.
6. Prepare a memorandum or update the work program with any information that will facilitate future examinations.
7. Update the OCC's Electronic Information System and any applicable report of examination schedules or tables.
8. Organize and reference working papers in accordance with OCC guidance.