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OTHER REAL ESTATE

Other real estate (ORE) consists of real property held for reasons other than to conduct bank business. Banks usually acquire ORE through foreclosure after a borrower defaults on a loan secured by real estate. Most states have laws governing the acquisition and retention of such assets.

Examiners should ensure management establishes appropriate policies and procedures for acquiring, holding, and disposing of ORE. Management should establish policies and procedures that:

- Protect a bank's interests in ORE while mitigating the impact on surrounding property values,
- Ensure ORE is accounted for in conformance with generally accepted accounting principles and Call Report Instructions, and
- Assure the institution's compliance with federal and state laws pertaining to holding ORE.

For regulatory reporting purposes, ORE includes:

- All real estate, other than bank premises, actually owned or controlled by the bank and its consolidated subsidiaries, including real estate acquired through foreclosure or deed in lieu of foreclosure, even if the bank has not yet received title to the property;
- Real estate collateral in a bank's possession, regardless of whether formal foreclosure proceedings have been initiated;
- Property originally acquired for future expansion but no longer intended for that purpose; and
- Foreclosed real estate sold under contract and accounted for under the deposit method of accounting.

Maintaining Other Real Estate

Part 364, Appendix A of the FDIC Rules and Regulations, Interagency Guidelines Establishing Standards for Safety and Soundness, requires institutions to identify problem assets and prevent deterioration in those assets. Institutions should maintain and protect ORE from deterioration to maximize recovery values. Typical expenses incurred during the ORE holding period relate to maintenance, tax, insurance, and miscellaneous costs.

Management should maintain ORE in a manner that complies with local property and fire codes. Other requirements, such as homeowner association covenants, may also require careful attention. Efforts to ensure an ORE property is maintained in a marketable condition not only improve an institution's ability to obtain the best price for the property, but also minimize liability and reputation risks.

Real estate taxes on ORE should be paid in a timely manner to avoid unnecessary penalties and interest.

Management should periodically review general insurance policies to determine if adequate hazard and liability coverage for ORE exists. If adequate general coverage is not in place, management should consider obtaining policies on each parcel of ORE. If an institution decides to self-insure, the decision should be board approved and appropriately documented.

Management should implement reasonable procedures for managing other miscellaneous expenses the institution may incur during the ORE holding period. These expenses could include, but are not limited to, sewer and water fees, utility charges, property management fees, and interest on prior liens.

OTHER REAL ESTATE ACCOUNTING

The accounting and reporting standards for foreclosed real estate are set forth in ASC 310-40, Receivables – Troubled Debt Restructurings by Creditors (formerly FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*), and ASC 360, Property, Plant, and Equipment (formerly FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*). The disposition of ORE is addressed in ASC 360-20, Property, Plant, and Equipment – Real Estate Sales (formerly FAS 66, *Accounting for Sales of Real Estate*). For regulatory reporting purposes, certain provisions of former AICPA Statement of Position (SOP) No. 92-3, *Accounting for Foreclosed Assets*, have been incorporated into the Call Report Instructions even though SOP 92-3 was rescinded subsequent to the issuance of FAS 144. Institutions must follow these provisions of SOP 92-3 when preparing their Call Reports.

Carrying Value

Call Report Instructions provide that foreclosed real estate received in full or partial satisfaction of a loan be recorded at the fair value less cost to sell the property. This fair value (less cost to sell) becomes the "cost" of the foreclosed real estate. If the recorded amount of the loan exceeds the "cost" 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 or repossession. However, if an asset is sold shortly after it is received in a foreclosure or repossession, it may be

appropriate to substitute the value received in the sale (net of the cost to sell the property) for the fair value, with any adjustments made to losses previously charged against the ALLL.

The recorded amount of a loan at the time of foreclosure is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest. An asset received in partial satisfaction of a loan should be accounted for at its fair value less cost to sell, and the recorded amount of the loan should be reduced by the fair value (less cost to sell) of the asset at the time of foreclosure. Legal fees and other direct costs incurred by the bank in a foreclosure should be expensed as incurred.

After foreclosure, each foreclosed real estate parcel must be carried at the lower of (1) the fair value of the real estate minus the estimated costs to sell the real estate or (2) the "cost" of the real estate. If the real estate's fair value minus the estimated costs to sell the real estate is less than its "cost," the deficiency must be recognized as a valuation allowance against the real estate 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 real estate's fair value or estimated selling costs.

FINANCED SALES OF ORE

ASC 360-20, which applies to all transactions in which the seller provides financing to the buyer of real estate, establishes five different methods of accounting for dispositions of real estate. Failure to apply the correct method may result in misstating ORE and earning assets (i.e., loans). The deposit method is the only one of five methods where disposition of ORE 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 ORE are listed below. Refer to ASC 360-20 for more detailed definitions.

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 meeting the minimum down payment are set forth in Appendix A to ASC 360-20. These vary from five to 25 percent of the property sales value. These guideline percentages vary by type of property and are primarily based on the inherent risk assumed for the type and characteristics of the property. To meet the continuing investment criteria, the contractual loan payments must be sufficient to repay the loan over the customary loan term for the type of property involved. 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 recognized as the bank receives payments. Interest income is recognized on an accrual basis, when appropriate.

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 achieved despite a small down payment if there is recourse to borrowers who have verifiable net worth, liquidity, and income levels, or if there is additional collateral 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 because 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 ORE. 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.

VALUATIONS AND CLASSIFICATION

Many states require institutions to obtain ORE appraisals or valuations when acquiring, holding, and/or disposing of real estate. Management should obtain ORE appraisals or valuations as required to ensure assets are reported at appropriate values and any material change in market conditions or physical property aspects is periodically recognized. If an institution is selling and financing the sale of an ORE parcel, Part 323 of the FDIC Rules and Regulations, Appraisals, and some state laws require updated appraisals or evaluations.

Examiners can test the general validity of appraised values by comparing the 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 ORE 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 about a property’s fair value less cost to sell with regard to classification. Any portion of the carrying value in excess of fair value less cost to sell should be classified Loss. The remaining carrying 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 ORE holdings.

ORE VALUATION ALLOWANCE

As previously mentioned, a valuation allowance is established for each parcel of ORE during the holding period when the real estate’s fair value minus the estimated costs to sell the real estate is less than the real estate’s “cost.” Call Report Instructions clarify that valuation allowances must be determined on an asset-by-asset basis. As a result, the individual valuation allowance should be subtracted from the related asset's "cost" to determine the property’s carrying value, which is the amount subject to classification.

Valuation allowances on foreclosed properties being held for sale are not recognized as a component of regulatory capital. The risk-based capital standards permit only the "allowance for loan and lease losses" to be included in Tier 2 capital up to a maximum of 1.25% of risk-weighted assets.