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OTHER REAL ESTATE

Other real estate (ORE), also referred to as Other Real Estate Owned (OREO), consists of real property held for reasons other than to conduct the business of the bank or savings association (referred to as “institutions”). Institutions 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 determine whether management establishes appropriate policies and procedures for acquiring, holding, and disposing of ORE. Prudent management establishes policies and procedures that generally:

- Protect the institution’s interests in ORE while mitigating the impact on surrounding property values,
- Ensure ORE is accounted for in conformance with U.S. generally accepted accounting principles (GAAP) 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 institution premises, actually owned or controlled by the institution and its consolidated subsidiaries, including real estate acquired through foreclosure or deed in lieu of foreclosure, even if the institution has not yet received title to the property;
- Real estate collateral in an institution’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 transferred, but not meeting the requirements for sales accounting under the revenue recognition standard.¹

Maintaining Other Real Estate

Section 39 of the Federal Deposit Insurance Act, *Standards for Safety and Soundness*, requires each federal banking agency to establish safety and soundness standards for all insured depository institutions. Appendix A to Part 364 of the FDIC Rules and Regulations, *Interagency Guidelines Establishing Standards for Safety and Soundness*, sets out the safety and soundness standards that the agencies use to identify and address problems at insured depository

institutions before capital becomes impaired. Operational and managerial safety and soundness standards pertaining to asset quality require 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.

Examiners should assess whether management maintains ORE in a manner that complies with local property ordinances 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.

Maintenance of adequate hazard and liability insurance helps mitigate the risk of loss due to unforeseen events during the holding period. Prudent management periodically reviews general insurance policies to determine the adequacy of hazard and liability coverage for ORE. Where adequate general coverage is not in place, management may obtain policies on each parcel of ORE. If an institution decides to self-insure, the decision is generally board approved and appropriately documented.

Examiners should also assess whether management implements 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.

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OTHER REAL ESTATE ACCOUNTING

The accounting and reporting standards for the receipt and holding of foreclosed real estate are set forth in ASC Subtopic 310-20, *Receivables – Nonrefundable Fees and Other Costs*, and ASC Topic 360, *Property, Plant, and Equipment*. Subsequent to the issuance of ASC Topic 360, AICPA Statement of Position (SOP) No. 92-3, “*Accounting for Foreclosed Assets*,” was rescinded. However, certain provisions of SOP 92-3 were retained for regulatory reporting because the application of these provisions represents prevalent practice in the banking industry and is consistent with safe and sound banking practices and the

¹ Reference is to the “revenue recognition standard” in ASC Topic 606, *Revenue from Contracts with Customers* and ASC Subtopic 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*.

accounting objectives set forth in Section 37(a) of the Federal Deposit Insurance Act. These specific provisions are included in the glossary entry “Foreclosed Assets” in the Call Report Instructions.

ASC Subtopic 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets* is the standard for transfers of most nonfinancial assets, including ORE. ASC Subtopic 610-20 requires the application of specified portions of ASC Topic 606, *Revenue from Contracts with Customers* to an institution’s sale of foreclosed real estate.

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 amortized cost of the loan exceeds the “cost” of the property, the difference is a loss which must be charged to the Allowance for Credit Losses (ACL) for loans and leases 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 ACL for loans and leases.

The amortized cost of a loan is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount and net deferred fees or costs, collection of cash, charge-offs, foreign exchange, and fair hedge accounting adjustments. An asset received in full or partial satisfaction of a loan should be accounted for at its fair value less cost to sell, and the loan’s amortized cost should be reduced by the fair value (less cost to sell) of the asset at the time of receipt. Legal fees and other direct costs incurred by the institution 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.

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FINANCED SALES OF ORE

ASC Subtopic 610-20 requires the application of specified portions of ASC Topic 606, to an institution’s sale of ORE.

In determining the appropriate accounting for a transfer of ORE under ASC Topic 606, the institution assesses whether the buyer is a legal entity and if so, whether the selling institution has a controlling financial interest in the legal entity. If an institution determines that it has a controlling financial interest in the buying legal entity, it should not derecognize the ORE and should apply the guidance in ASC Topic 810, *Consolidation*. If a controlling financial interest in the buyer does not exist or the buyer is not a legal entity, which is typically the case for most sales of ORE, the entire gain or loss, if any, along with the derecognition of the ORE are recorded if certain requirements in ASC Topic 606 and ASC Subtopic 610-20 are met.

In determining whether gain or loss recognition is appropriate and, accordingly, whether the ORE should be derecognized, examiners will need to determine whether:

- A contract (within the meaning of the revenue recognition standard) exists for the transfer of ORE,
- The institution meets its performance obligations identified within the contract, and
- The institution uses the appropriate transaction price for calculating the gain or loss on the sales date.

These standards apply to all transfers of ORE, but greater judgement will generally be required when the transfer is seller-financed.

Evaluating the Existence of a Contract

In the context of an ORE sale or transfer, the transaction with the buyer must meet all the following criteria:

- (a) The parties to the contract have approved the contract and are committed to perform their respective obligations;
- (b) The institution can identify each party’s rights regarding the ORE to be transferred;
- (c) The institution can identify the payment terms for the ORE to be transferred;
- (d) The contract has commercial substance (that is, the risk, timing, or amount of the institution’s future cash flows is expected to change as a result of the contract); and
- (e) It is probable that the institution will collect substantially all of the consideration to which it will be entitled in exchange for ORE that will be transferred to the buyer, i.e., the transaction price. In

evaluating whether collectability of an amount of consideration is probable, an institution shall consider only the buyer's ability and intention to pay that amount of consideration when it is due.

Although all five criteria require careful analysis for seller-financed sales of ORE, two criteria in particular could require significant judgment. These criteria are (a) the commitment of the parties to the contract to perform their respective obligations and (e) the probability of collecting the transaction price. When determining whether the buyer is committed to perform its obligations under criterion (a) and collectability under criterion (e), all facts and circumstances related to the buyer's ability and intent to pay the transaction price is generally evaluated, which may include:

- Amount of cash paid as a down payment;
- Existence of recourse provisions;
- Credit standing of the buyer;
- Age and location of the property;
- Cash flow from the property;
- Payments by the buyer to third parties;
- Other amounts paid to the selling institution, including current or future contingent payments;
- Transfer of non-customary consideration (i.e., consideration other than cash and a note receivable);
- Other types of financing involved with the property or transaction;
- Financing terms of the loan (reasonable and customary terms, amortization, any graduated payments, any balloon payment);
- Underwriting inconsistent with the institution's underwriting policies for loans not involving ORE sales; and
- Future subordination of the selling institution's receivable.

While there are no longer prescriptive minimum down payment requirements, the amount and character of a buyer's equity (typically the down payment) and recourse provisions remain important factors when evaluating seller-financed ORE. Specifically, the buyer's initial equity in the property immediately after the sale is an important consideration in determining whether a buyer is committed to perform its obligations.

All relevant information is generally weighed collectively in evaluating whether the five contract criteria have been met when determining the appropriate accounting for a seller-financed ORE. As such, a transaction with an insignificant down payment and nonrecourse financing

generally would not meet the definition of a contract unless there is considerable support from other factors, such as very low risk of default and the buyer's expertise in operating the business or property.

If the five contract criteria have not been met, the institution generally may not derecognize the ORE, or recognize revenue (gain or loss) as an accounting sale has not occurred. Assessment of the transaction should continue to determine whether the contract criteria have been met in a later period. Until all criteria are met, any consideration received from the buyer should be recorded as a deposit liability.² In circumstances where a sale is not recognized and the transaction price is less than the carrying amount of the ORE, examiners should consider whether the decline in fair value of the ORE should be recognized as a valuation allowance, or an increase in an existing valuation allowance.

Evaluating the Performance Obligations

If the five contract criteria have been met, the institution determines whether it has satisfied its performance obligations as identified in the contract by transferring control of the ORE to the buyer. Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from the asset (e.g., ORE). Indicators of the transfer of control include the following:

- (a) The institution has a present right to payment for the asset,
- (b) The buyer has legal title to the asset,
- (c) The institution has transferred physical possession of the asset,
- (d) The buyer has the significant risks and rewards of ownership of the asset, and
- (e) The buyer has accepted the asset.

For seller-financed sales of ORE, the transfer of control generally occurs on the closing date of the sale when the institution obtains the right to receive payment for the ORE and transfers legal title to the buyer. However, all relevant facts and circumstances must be considered in determining whether control of the ORE has transferred, which may also include the selling institution's:

- Involvement with the property following the transaction,
- Obligation to repurchase the property in the future,
- Obligation to provide support for the property following the sale transaction, and
- Retention of an equity interest in the property.

² Although ASC Topic 606 describes the consideration received (including any cash payments) using such terms as "liability," "deposit," and "deposit

liability," for regulatory reporting purposes these amounts should be reported as an other liability, and not as a deposit.

In particular, if an institution has an obligation or right to repurchase the ORE, the buyer does not obtain control of the property because the buyer is limited in its ability to direct the use of, and obtain, substantially all of the remaining benefits from the asset even though the buyer may have physical possession. In this situation, an institution should account for the contract as a lease in accordance with ASC Topic 842, Leases, or as a financing in accordance with the revenue recognition standard.

Situations may exist where the selling institution has legal title to the ORE, while the borrower whose property was foreclosed upon under the original loan still has redemption rights to reclaim the property in the future. If such redemption rights exist, the selling institution may not be able to transfer control to the buyer of the ORE and recognize revenue until the redemption period expires.

Only when a contract exists and an institution has transferred control of the property, can the institution derecognize the ORE and recognize a gain or loss on the transaction.

Transaction Price

The transaction price in a sale of ORE is generally the contract amount in the purchase/sale agreement if the seller-financed agreement is at market terms. However, the transaction price may differ from the amount stated in the contract due to the existence of a significant financing component. Under the revenue recognition standard, a significant financing component exists if the timing of the buyer's payments explicitly or implicitly provides the selling institution or the buyer with a significant benefit of financing the transfer of the ORE (e.g., a below market rate). A seller-financed transaction of ORE at off-market terms generally indicates the existence of a significant financing component. If a significant financing component exists, the contract amount in the purchase/sale agreement should be adjusted for the time value of money to reflect what the cash selling price of the ORE would have been at the time of its transfer to the buyer. The discount rate used in adjusting for the time value of money should be a market rate of interest considering the credit characteristics of the buyer and the terms of the financing. The transaction price or the adjusted transaction price, when appropriate, is used for determining the gain or loss, if any, on the transfer of ORE.

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VALUATIONS AND CLASSIFICATION

Many states require institutions to obtain appraisals or evaluations when acquiring, holding, and disposing of real estate. Management should obtain appraisals or evaluations as required to ensure assets are reported at appropriate

values and that 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, governing 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 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. However, any amount classified Loss in the report of examination should not be charged-off by the institution, rather the Loss should be recognized as a valuation allowance, or an increase in an existing valuation allowance. The remaining carrying value should then be evaluated and adversely classified, as appropriate. Regulatory definitions of Substandard, Doubtful, and Loss (as discussed in this manual's Section 3.2 - Loans) should be used in the analysis of ORE holdings.

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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 that apply to non-Community Bank Leverage Ratio institutions permit only the "adjusted allowance for credit losses" to be included in Tier 2 capital up to a maximum of 1.25% of risk-weighted assets. Advanced approaches institutions must also comply with Part 324 of the FDIC Rules and Regulations, section 324.10(d)(3)(ii)(B).