OTHER REAL ESTATE

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Reference Material

Other real estate (ORE) consists of real property held for reasons other than to conduct bank business. Financial institutions often 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 be mindful of the resources below when completing this module:

- **Applicable state laws pertaining to ORE;**
- **Federal banking agency appraisal regulations (FDIC: Part 323, FRB: 12 CFR 225 subpart G);**
- **Interagency Appraisal and Evaluation Guidelines (FDIC: FIL-82-2010, FRB: SR 10-16 and SR 95-16 (SUP);**
- **Federal regulations regarding permissible banking activities (FDIC: Part 362, FRB: 12 CFR 225 subpart C);**
- **Call Report Instructions Glossary entry for Foreclosed Assets;**
- **Guidance on Other Real Estate (FDIC: FIL-62-2008; FRB: SR 12-10 and SR 12-5);**
- **Guidance on Managing Third Party Risk (FIL-44-2008) (FDIC only);**
- **Applicable Accounting Guidance (Accounting Standards Codification (ASC) Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors; ASC Subtopic 360-20, Property, Plant, and Equipment – Real Estate Sales; ASC Topic 606, Revenue from Contracts with Customers and Topic 610, Other Income;[1] ASC Subtopic 835-30, Interest, Imputation of Interest; and ASC Topic 820, Fair Value Measurements; and**
- **Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings (FDIC: FIL-50-2013, FRB: SR 13-17).**

For institutions that are public business entities (as defined in U.S. GAAP) ASC Topics 610 and 606 replace ASC Topic 360 and are effective for fiscal years beginning after December 15, 2017, including interim reporting periods within those fiscal years. For institutions that are not public business entities, the new standard is effective for fiscal years beginning after December 15, 2018, and interim reporting periods within fiscal years beginning after December 15, 2019[2]. Early application of the new standard is permitted for all institutions for fiscal years after December 15, 2016, and interim reporting periods as prescribed in the new standard.

Preliminary Review

1. Identify previous concerns by reviewing prior examination reports, file correspondence, and audits.

---

[1] Topic 610 provides guidance on gains or losses recognized upon the de-recognition of nonfinancial assets, if those assets are not in a contract with a customer within the scope of Topic 606, such as ORE transactions with financial institutions. Therefore, Topic 610 effectively requires financial institutions to follow the guidance in Topic 606.

[2] For institutions that are non-public business entities and have fiscal year ends that are the same as the calendar year end, the effect of adopting Topic 610 should be measured as of January 1, 2019; however, the first reporting date for Call Report purposes will not be until December 31, 2019.

2. Develop a preliminary view of financial trends. Review Uniform Bank Performance Reports (UBPRs), financial statements, and other applicable data to identify material factors (levels, changes, or trends) that may require analysis or help in scoping the review.
3. Determine the primary responsibilities of the board of directors, board committees, and executive management.[3]
4. Determine whether any material changes (e.g., strategic, operational, economic) occurred or are expected that may affect ORE. Discuss the changes and implications with management.
5. Determine the dollar amount and types of ORE held.
Policy Considerations
6. Determine whether policies, procedures, and practices are appropriate for the size, volume, and nature of the institution's ORE. Appropriate policies often include guidelines that: • **Establish administrative procedures and documentation requirements for acquiring, managing, and disposing ORE;** • **Establish effective accounting practices that conform to U.S. GAAP and Call Report Instructions;** • **Implement prudent ORE valuation protocols consistent with applicable state and federal laws and appraisal regulations;** • **Address selection and oversight of property managers and other third party contractors, as applicable; and** • **Address bank financing to facilitate the sale of ORE that considers accounting requirements.**
Administration
7. Determine whether the bank acquired ORE assets and whether acquisitions conform to applicable state law and federal regulations.

[3] Through discussions with management or by reviewing applicable policies.

8. Determine whether management appropriately identifies all foreclosed assets, including real property that the institution controls but has not yet taken title. ORE includes:

- **Real estate, other than premises, owned/controlled by the bank or its consolidated subsidiaries;**
- **Real estate acquired for debts previously contracted, including real estate acquired through foreclosure or acquired by deed in lieu of foreclosure (even if the institution has not yet received title to the property), and equity holdings that indirectly represent such real estate;**
- **Certain direct and indirect investments in real estate ventures;**
- **Property originally acquired for future expansion but no longer intended for that purpose (*Note: the bank could still be carrying the property in premises or fixed asset accounts*); and**
- **Seller-financed transfers of ORE that do not qualify for sales accounting under ASC Subtopic 360-20 or, if applicable, ASC Topics 610 and 606.**

Note: Foreclosed assets (other than residential real estate collateralizing a consumer mortgage loan) include loans where the bank, as creditor, has received physical possession of a borrower's assets, regardless of whether formal foreclosure proceedings take place.

An institution, as creditor, is considered to have received physical possession (resulting from an in-substance repossession or foreclosure) of residential real estate collateralizing a consumer mortgage loan only upon the occurrence of either of the following:

- ***The institution obtains legal title to the residential real estate property upon completion of a foreclosure even if the borrower has redemption rights for a period of time after a foreclosure to reclaim the property by paying certain amounts specified by law, or***
- ***The borrower conveys all interest in the residential real estate to the bank through completion of a deed in lieu of foreclosure or similar legal agreement.***

9. Determine whether management adequately documents ORE files. Consider the following:

- **Evidence of ownership or control;**
- **Evidence of current, ongoing use of the property (particularly by insiders);**
- **Book value (at time of acquisition and currently - see procedures 16 and 17);**
- **Support for capitalized costs, if any;**
- **Current appraisals or valuations;**
- **Analysis of cost to carry (break-even analysis);**
- **Formal purchase offers, if applicable;**
- **Sales efforts or listing agreements;**
- **Periodic inspection reports;**
- **Current hazard and liability insurance;**
- **Environmental risk assessments, as appropriate;**
- **Rent rolls and leases, as applicable;**
- **Property management agreements and reports, as applicable;**
- **Receipts evidencing payment of real estate taxes and other required fees (i.e., condominium or homeowner association dues);**
- **Receipts evidencing payments for maintenance (e.g., lawn care, snow removal, inspections, common repairs, utilities); and**
- **Disposal (when, to whom, how financed).**

10. Determine whether management established appropriate processes to maintain and protect ORE from physical deterioration and additional liens. Consider whether management:

- **Maintains adequate insurance coverage;**
- **Makes timely expense payments (e.g., real estate taxes, utility charges, property management fees, prior liens);**
- **Complies with local property and fire codes;**
- **Complies with homeowner association covenants; and**
- **Maintains the property's interior and exterior in marketable condition.**

11. Determine whether the institution uses a property management company to manage ORE assets. If yes, consider whether management:

- **Conducts adequate due diligence on the property management company,**
- **Ensures that written agreements clearly outline the responsibilities of both parties and detail reimbursable expenses and property management fees, and**
- **Maintains adequate controls to ensure fees charged and bills submitted by the property management company conform with the property management agreement and accurately reflect services performed on the bank's behalf.**

12. Assess the institution's compliance with state laws and regulations that may:

- **Limit the amount of ORE an institution may hold,**
- **Limit the time an institution may hold ORE,**
- **Require formal requests to extend holding periods, or**
- **Require updated appraisals or valuations within specified timeframes.**

13. If the institution finished partially completed development or construction projects, determine whether:

- **Prior approval was required from the institution's primary federal regulator or state authority;**
- **The institution maintains appropriate documentation to support its decision to finish a project (such as feasibility studies, appraisals, cost estimates, and cost-benefit analysis);**
- **The appraisal, including projected absorption or sales period, appears reasonable;**
- **The estimated cost to complete the project appears reasonable relative to the recorded investment amount and the as-completed appraised value;**
- **The development and construction activity complies with federal banking regulations (FDIC: Part 362; FRB: 12 CFR 225 subpart C).**

  Note: At a minimum, funds advanced to complete the projects should:

  - ***Reasonably reduce any shortfall between the parcel's market value and the institution's recorded investment amount;***
  - ***Not involve speculation in real estate; and***
  - ***Be consistent with safe and sound banking practices.***

Valuation

14. Determine whether the institution obtains appraisals and valuations (at acquisition and periodically thereafter) in accordance with state and federal laws and regulations. Ensure appraisals/evaluations address a property's as-is condition, highest and best use, relevant risks, and pertinent market factors in estimating market values.

15. Determine whether the institution has procedures for obtaining updated valuations to ensure recognition of material deterioration in market or property conditions.

Accounting

16. Assess the accounting practices at acquisition. Consider whether management:

- **Records each ORE asset at its fair value less the estimated costs to sell the property *(*See *ASC Subtopic 310-40* and *Call Report Instructions on Foreclosed Assets,* including the exception on reporting *Reporting Certain Government-Guaranteed Mortgage Loans upon Foreclosure);***
- **Charges the recorded amount of the loan or amortized cost of the loan[4] that exceeds the fair value, (less cost to sell the foreclosed property) to the allowance for loan and lease losses (ALLL) or allowance for credit losses (ACL),[5] (when applicable) at foreclosure (or when the bank effectively owns or controls the property, even if the institution has not yet received title to the property);**
- **Reports any senior debt (principal and interest) encumbering the property as a liability as *other borrowings* in schedule RC-M and as *other borrowed money* in schedule RC; and**
- **Expenses legal and other direct costs in a foreclosure as incurred.**

17. Assess the accounting practices during the holding period. Consider whether management:

- **Carries each ORE asset at the lower of its fair value, less the estimated costs to sell the asset, or the cost of the asset;**
- **Establishes a valuation allowance created through a charge to expense that represents the cost of each asset that exceeds fair value less cost to sell (the analysis for a valuation allowance must be made on an asset-by-asset basis);**
- **Increases or decreases the valuation allowance through charges or credits to expense for changes in fair value or selling costs; *(Note: The valuation allowance cannot fall below zero.)***
- **Records valuation allowance changes in "net gains (losses) on sales of other real estate owned" in the Call Report;**
- **Expenses holding costs (such as maintenance) as incurred and reports the costs as other noninterest expense in the Call Report; and**
- **Capitalizes expenses only for permanent improvements that increase the property's value.**

[4] ASU 2016-13 uses amortized cost, which replaces the term "recorded amount of the loan."
[5] ACL replaces the term ALLL for those banks that adopted ASU 2016-13.

18. Assess the accounting practices at disposition. Consider whether management:

- **Accounts for sale (including any gain from sale) of ORE financed by the bank in accordance with ASC Subtopic 360-20, which establishes accounting methods (full accrual, installment, cost recovery, reduced-profit, and deposit). If ASC Topic 610 has been adopted, determine whether a contract (within the meaning of Topic 606) exists for the sale or transfer of ORE; whether the institution has met its performance obligations identified in the contract; and what the transaction price is to calculate the gain or loss;**
- **Confirms that the interest rate (for seller financing) charged by the lender is a market interest rate given the risk and credit quality of the borrower. If the rate is a below market rate, follow the guidance in ASC Subtopic 835-30, Interest, Imputation of Interest, ;**
- **Recognizes loss on the sale of ORE immediately (if ORE is sold shortly after it is acquired, the loss may be charged to the ALLL (or ACL, when applicable); otherwise, the loss should be reported in "net gains (losses) on sales of other real estate owned" in the Call Report);**
- **Recognizes gains and interest income (when the institution is financing the ORE) only to the extent established by, and when using, the appropriate accounting method under ASC 360-20; and**
- **Recognizes a gain on the sale of ORE (not financed by the bank) in "net gains (losses) on sales of other real estate owned" in the Call Report (if ORE is sold shortly after it is received, the gain may be credited to the ALLL or (ACL, when applicable)).**

19. Review income and expense accounts related to income producing ORE, if any, for proper accounting and reporting. (*Note: Rental income should be reported in the Call Report as other noninterest income. Expenses should be reported as other noninterest expense. They should not be netted.)*

Oversight and Insider Involvement

20. Determine whether institution-related parties use ORE properties, or have an interest in the acquisition, management, maintenance, or disposition of ORE properties. Assess that use or involvement and the adequacy of disclosures to the institution's board.

21. Assess management's ORE workout strategies and effectiveness in managing and disposing of these properties.

Classification

ORE assets often represent distressed, non-earning assets that are subject to adverse classification. However, examiners should apply regulatory definitions of Substandard, Doubtful, and Loss (as generally applied to loan classifications) and use appropriate judgment when considering adverse ORE classifications. For example, adverse classification may not be warranted for an ORE asset (with a reasonably supported carrying value) that generates positive net cash flow and a reasonable rate of return.

22. Ensure that management carries ORE at the lower of cost or fair value minus estimated costs to sell. If the carrying amount of an ORE asset exceeds the fair value less estimated costs to sell, the difference should be classified as Loss in the Report of Examination. Discuss adverse classifications with management and document supporting analysis. ***(Note: The amount of Loss should not be charged-off, but management should be instructed to increase the valuation allowance on the ORE asset for the amount of Loss classification.)***
End of Core Analysis.