A state member bank's authority to hold real estate is governed by state law. A bank is permitted to include owned real estate in its premises account if the real estate serves as premises for operations or is intended to be used as premises. In addition, a bank may hold other real estate owned (OREO), which is defined below. State laws dictate the terms and conditions under which state-chartered banks may acquire and hold OREO.

DEFINITION

Other real estate comprises all real estate, other than bank premises, owned or controlled by the bank or its consolidated subsidiaries, including real estate acquired through foreclosure, even if the bank has not received title to the property. Bank holdings of OREO may arise from the following events:

- the bank purchases real estate at a sale under judgment, decree, or mortgage when the property secured debts previously contracted;
- a borrower conveys real estate to the bank to fully or partially satisfy a debt previously contracted (acceptance of deed in lieu of foreclosure);
- real estate is obtained in exchange for future advances to an existing borrower to fully or partially satisfy debts previously contracted;
- a bank takes possession (although not necessarily title) of collateral in a collateral-dependent real estate loan (i.e., an in-substance foreclosure);
- a bank has relocated its premises and has not yet sold the old premises;
- a bank abandons plans to use real estate as premises for future expansion; and
- a bank has foreclosed real estate that is under contract for sale.

There are three major phases of the OREO life cycle: acquisition, holding period, and disposition.

ACCOUNTING AND REPORTING STANDARDS

The accounting and reporting standards for the acquisition phase are set forth in Accounting Standards Codification (ASC)[1] 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly known as FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"); ASC 360-10-30, Property, Plant and Equipment-Initial Measurement (formerly included in FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets"); and ASC 360-10-35, Property, Plant and Equipment-Subsequent Measurement. The disposition of other real estate is addressed in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within FAS 66, "Accounting for Sales of Real Estate"), which includes specific criteria for the recognition of profit. Reference should also be made to the instructions for the FFIEC Consolidated Report of Condition and Income for a Bank with Domestic and Foreign Offices (Call Report) as to the reporting of OREO transactions.

TRANSFER OF ASSETS TO OREO

Real estate assets transferred to OREO should be accounted for individually (on an asset-by-asset basis) on the date of transfer. Each transferred real estate asset should be recorded at its "fair value" less estimated cost to sell the asset. This "fair value" becomes the cost of the asset. "Fair value" is the amount the creditor should reasonably expect to receive for the asset in a current sale between a willing buyer and a willing seller (that is, not a forced liquidation sale).

The recorded amount of a loan (or an investment in a loan) at the time of foreclosure involving real estate transferred to OREO is the unpaid balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest. Any excess of the recorded amount of the loan over the transferred property's fair value is a loss that must be charged against the allowance for loan and lease losses (ALLL) immediately upon the property's

1. This section uses the Financial Accounting Standards Board (FASB)'s *Accounting Standards Codification* (ASC) numbering system, references, and titles, which it approved in June 2009 for its authoritative pronouncements. Within this section, each first "ASC" reference is followed by its "pre-codification" FASB reference and title.

transfer to OREO. If the fair value (less costs to sell) of the property exceeds a recorded loan amount, the excess should be reported as a recovery of a previous charge-off or in current earnings, as appropriate. Legal fees and other direct costs incurred by the bank should generally be included in expenses.

The value of OREO properties must be reported at the fair value minus estimated selling expenses or the recorded loan amount. For example, if the recorded investment in the property is $125, the fair value of the property is $100, and the estimated selling expenses are $6, the carrying value for this property would be $94. The difference between the recorded loan amount of $125 and the fair value of $100 minus the $6 estimated cost to sell the property, or $31, would be charged to the ALLL at the time the property was transferred to OREO. Subsequent to the acquisition date, the OREO property should be reported at the lower of the cost of the property ($94 in this case) or the fair value of $100 less cost to sell of $6, which is also $94. Any subsequent declines in value should be recorded by creating a valuation allowance.

Alternatively, if the recorded loan amount is $250, the property's fair value is $275, and the estimated selling expenses are $18, the property's carrying value would be $257 (the property's fair value of $275 less estimated cost to sell of $18). The $7 difference between the fair value (less costs to sell) and the recorded loan amount would be recorded as a recovery of a previous charge-off or in current earnings, as appropriate. Before recording the $7 in earnings, significant scrutiny should be applied to understand why the borrower would risk losing the equity in the property. Additionally, in some states, lenders are required to return recovered amounts, in excess of the amount owed, to the borrower.

EVALUATIONS OF REAL ESTATE TO DETERMINE THE CARRYING VALUE OF OREO

The transfer of real estate pledged as collateral for a loan to OREO is considered to be a ''transaction involving an existing extension of credit'' under 12 CFR 225.63(a)(7) and is exempt from Regulation Y's appraisal requirement. However, under 12 CFR 225.63(b), the bank must obtain an ''appropriate evaluation'' of the real estate that is ''consistent with safe and sound banking practices'' to establish the carrying value of the OREO. A bank may elect, but is not required, to obtain an appraisal to serve as the ''appropriate evaluation.'' Until the evaluation is available, a bank should rely on its best estimate of the property's value to establish the carrying value. The federal banking agencies have issued appraisal and evaluation guidelines to provide guidance to examining personnel and federally regulated institutions regarding prudent appraisal and evaluation policies, procedures, practices, and standards.

The appraisal or evaluation should provide an estimate of the parcel's market value. (Refer to section 4140.1, ''Real Estate Appraisals and Evaluations.'') The subsection titled, ''Appraisal Content,'' includes a definition of *market value.* Generally, appraisals or evaluations contain an estimate of the property's fair value based on a forecast of expected cash flows, discounted at an interest rate that is commensurate with the risks involved. The cash flow estimate should include projected revenues and the costs of ownership, development, operation, marketing, and sale. In such situations, the appraiser or evaluator should fully describe the definition of value and the market conditions that have been considered in estimating the property's fair value.

PROPERTY ACQUIRED THROUGH FORECLOSURE—JUNIOR LIENHOLDER

When a bank acquires a property through foreclosure as a junior lienholder, whether or not the first lien has been assumed, the property should be recorded as an asset at its fair value less its estimated cost to sell. Any senior debt (principal and accrued interest) should be recorded as a corresponding liability. Senior debt should not be netted against the assets. Any excess of the recorded loan amount over the property's fair value less estimated cost to sell should be charged off to the ALLL. The recorded investment may not exceed the sum of any senior and junior debt. Payments made on senior debt should be accounted for by reducing both the asset and the liability. Interest that accrues on the senior debt after foreclosure should be recognized as interest expense.

COLLATERAL-DEPENDENT LOANS

Collateral-dependent loans are those for which repayment is expected to be provided solely from the underlying collateral when there are no other available and reliable sources of repayment. Guidance for the treatment of certain troubled debts and collateral dependent loans is found in ASC 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly within FAS 15, as amended by FAS 114 and Accounting Principles Board Opinion no. 21, ''Interest on Receivables and Payables''). According to the instructions in the Call Report, collateral-dependent real estate loans should be transferred to OREO only when the lender has taken possession (title) of the collateral; otherwise they should remain categorized as loans. To facilitate administration and tracking, however, banks may choose to include a collateral-dependent real estate loan in the OREO portfolio as potential or probable OREO. Impairment of a collateral-dependent loan must be measured using the fair value of the collateral. In general, any portion of the recorded amount of a collateral-dependent loan in excess of the fair value of the collateral (less the estimated cost to sell) that can be identified as uncollectible should be promptly charged off against the ALLL. Examiners should review these loans using the same criteria applied to OREO.

PROPERTY ACQUIRED FOR FUTURE USE

Property the bank originally acquired for future use as premises, but for which plans have been abandoned, and property that formerly served as bank premises, should be accounted for at the lower of (1) its fair value less cost to sell or (2) the cost of the asset on the date of transfer to OREO. Any excess of book value over fair value should be charged to other operating expense during the current period.

CARRYING VALUE OF OREO

A bank should have a policy for periodically determining the fair value of its OREO property by obtaining an appraisal or an evaluation, as appropriate. While the Federal Reserve has no prescribed time frame for when a bank should reappraise or reevaluate its OREO property, the bank's policy should conform to state law, if applicable, and take into account the volatility of the local real estate market. A bank should determine whether there have been material changes to the underlying assumptions in the appraisal or valuation that have affected the original estimate of value. If material changes have occurred, the bank should obtain a new appraisal or evaluation based on assumptions that reflect the changed conditions.

ACCOUNTING FOR SUBSEQUENT CHANGES IN FAIR MARKET VALUE

Charges for subsequent declines in the fair value of OREO property should never be posted to the ALLL. If an appraisal or evaluation indicates a subsequent decline in the fair value of an OREO property, the loss in value should be recognized through the income statement by a charge to earnings. Banks should attempt to determine whether a property's decline in value is not recoverable, taking into consideration each property's characteristics and existing market dynamics. The preferred treatment for nonrecoverable losses in value is the direct write-down method, in which the charge to expenses is offset by a reduction in the OREO property's carrying value. If the reduction in value is deemed temporary, the charge to earnings may be offset by establishing a valuation allowance specifically for that property. In the event of subsequent appreciation in the value of an OREO property, the increase can only be reflected by reducing this valuation allowance or recognizing a gain upon disposition, but never by a direct write-up of the property's value. A change to the valuation allowance should be offset with a debit or credit to expense in the period in which it occurs.

In addition to the preceding treatment of the write-down in the OREO value, the previous subsection ''Transfer of Assets to Other Real Estate Owned'' discusses setting up a valuation allowance for estimated selling expenses associated with the sale of the other real estate. The balance of this valuation allowance can fluctuate based on changes in the fair value of the property held, but it can never be less than zero. The following examples are presented to illustrate the treatment that subsequent depreciation and appreciation would have on OREO properties.

Depreciation in OREO Property Value

Assume a bank has written down its initial recorded investment in an OREO property from $125 to its fair value of $100 minus costs to sell (assume costs to sell of $6), or $94. Assume that a new appraisal indicates a fair value of $90, with reduced estimated selling expenses of $5. If the bank determines this decline in value is nonrecoverable, the bank must expense the depreciation of $9.

Appreciation in OREO Property Value

Assume a bank has written down its recorded investment in an OREO property to its fair value of $110 less costs to sell of $10, or $100, and it subsequently created a valuation allowance for the $10 temporary decline in value. A new appraisal indicates an increase in the fair value of the property to $112 less costs to sell of $9, or $103. Notwithstanding the property's increased fair value, the recorded investment value cannot be increased above $100. The valuation allowance for selling expenses can never be less than zero, thus prohibiting an increase in the value of the property above the recorded investment. In this case, the bank would reduce the valuation allowance to zero, which would increase the recorded value to $100.

Accounting for Income and Expense

Gross revenue from OREO should be recognized in the period in which it is earned. Direct costs incurred in connection with holding an OREO property, including legal fees, real estate taxes, depreciation, and direct write-downs, should be charged to expense when incurred.

A bank can expend funds to develop and improve OREO when it appears reasonable to expect that any shortfall between the property's fair value and the bank's recorded book value will be reduced by an amount equal to or greater than the expenditure. Such expenditures should not be used for speculation in real estate. The economic assumptions relating to the bank's decision to improve a particular OREO property should be well documented. Any payments for developing or improving OREO property are treated as capital expenditures and should be reflected by increasing the property's carrying value to the extent that those expenditures increase the value of the property.

DISPOSITION OF OREO

OREO property must be disposed of within any holding period established by state law and, in any case, as soon as it is prudent and reasonable. Banks should maintain documentation reflecting their efforts to dispose of OREO property, which should 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, and
- other information reflecting sales efforts.

The sale or disposition of OREO property is considered a real estate-related financial transaction under the Board's appraisal regulation. A sale or disposition of an OREO property that qualifies as a federally related transaction under the regulation requires an appraisal conforming to the regulation. A sale or disposition that does not qualify as a federally related transaction nonetheless must comply with the regulation by having an appropriate evaluation of the real estate, that is consistent with safe and sound banking practices.

The bank should promptly dispose of OREO if it can recover the amount of its original loan plus additional advances and other costs related to the loan or the OREO property before the end of the legal holding period. The holding period generally begins on the date that legal title to the property is transferred to the bank, except for real estate that has become OREO because the bank no longer contemplates using it as its premises. The holding period for this type of OREO property begins on the day that plans for future use are formally terminated. Some states require OREO property to be written off or depreciated on a scheduled basis, or to be written off at the end of a specified time period. The bank should determine whether such requirements exist and comply with them.

Financing Sales of OREO

Gains and losses resulting from a sale of OREO properties for cash must be recognized immediately. A gain resulting from a sale in which the bank provides financing should be accounted for under the standards described in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within Statement of Financial Accounting Standards 66 (FAS 66)). ASC 360-20-40 recognizes that differences in terms of the sale and in selling procedures lead to different profit recognition criteria and methods. The standards establish five different methods of accounting for dispositions of real estate. In practice, most banks have primarily used either the full accrual or the deposit method. The full accrual method accounts for the transaction as a sale of real estate, while the deposit method does not. The deposit method is the only method whereby disposition and financing by the seller does not result in a sale and corresponding recognition of a loan.

Banks may facilitate the sale of foreclosed real estate by requiring little or no down payment, or by offering loans with favorable terms. Profit shall only be recognized in full when the collectibility of the sales price is reasonably ensured and when the seller is not obligated to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit should be deferred. Collectibility of the sale price of OREO property is demonstrated when the buyer's investment is sufficient to ensure that the buyer will be motivated to honor his or her obligation to the seller rather than lose the investment. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

Bank records should (1) indicate the accounting method used for each sale of OREO, (2) support the choice of the method selected, and (3) sufficiently document that the institution is correctly reporting associated notes receivable, as either loans or OREO property, with valuation allowances when appropriate.

Full Accrual Method

Under this method, the disposition of the real estate is recorded as a sale. The practice of recognizing all profit from the sale of bank-financed OREO at the time of the sale is referred to as the full-accrual method. A bank shall not recognize profit using this method until all of the following general criteria are met:

- a sale is consummated,
- the buyer's initial and continuing investments adequately demonstrate a commitment to pay for the property,
- the bank's loan is not subject to future subordination,
- the bank has transferred to the buyer the usual risks and rewards of ownership, and
- the buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate the buyer's commitment to pay for the property.

A sale will not be considered consummated until the parties are bound by the terms of the contract, all consideration has been exchanged, and all conditions precedent to closing have been performed.

Initial investment, as defined within ASC 360-20-40, includes only cash down payments, notes supported by irrevocable letters of credit from an independent lending institution, payments by the buyer to third parties to reduce existing debt on the property, and other amounts paid by the buyer that are part of the sale price. In these situations, the standards require that profit on the sale be deferred until a minimum down payment has been received and annual payments equal those for a loan for a similar type of property with a customary amortization period. Payments must be sufficient to repay the loan over the customary term for the type of property. The amount of down payment required varies by property category: land, 20–25 percent; commercial and industrial, 10–25 percent; multifamily residential, 10–25 percent; and single-family residential, 5–10 percent. Ranges within these categories are defined further in the statement.

Continuing investment requires the buyer to be contractually obligated to make level annual payments on his or her total debt for the purchase price of the property. This level annual payment must be able to service principal and interest payments amortized for no more than 20 years for raw land, and for no more than the customary amortization term for a first-mortgage loan by an independent lending institution for other types of real estate. For example, the customary repayment term for a loan secured by a single-family residential property could range up to 30 years.

The Installment Method

This method is used when the buyer's down payment is insufficient to allow the full-accrual method, but when recovery of the cost of the property is reasonably assured if the buyer defaults. The installment method recognizes the sale of the property and the corresponding loan, although profits from the sale are recognized only as the bank receives payments from the buyer. Under this method, interest income is recognized on an accrual basis.

Since default on the loan usually results in the seller (the bank) reacquiring the real estate, the bank is reasonably assured that it will be able to recover its costs with a relatively small down payment. Cost recovery is especially likely when loans are made to buyers who have verifiable net worth, liquid assets, and income levels adequate to service the loan. Reasonable assurance of cost recovery also may be achieved when the buyer pledges adequate additional collateral.

The Cost-Recovery Method

This method recognizes the sale of the property and the booking of the corresponding loan. This method may apply when dispositions do not qualify under the full accrual or installment methods. All income recognition is deferred. Principal payments are applied by reducing the loan balance, and interest payments are accounted for by increasing the unrecognized gross profit. No profit or interest income is recognized until either the buyer's aggregate payments exceed the recorded amount of the loan or a change to another accounting method (for example, the installment method) is appropriate. Consequently, the loan is maintained on nonaccrual status while this method is being used.

The Reduced Profit Method

This method is used in certain situations when the sale of the real estate has not been consummated. The bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full-accrual method. The bank again recognizes the sale of the property and the booking of the corresponding loan, but, as under the installment method, profits from the sale are recognized only as the bank receives payments from the buyer. Since sales with adequate down payments generally are not structured with inadequate loan-amortization schedules, this method is seldom used.

The Deposit Method

This method is used when a sale of OREO has not been consummated. It also may 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 OREO. Further, no profit or interest income is recognized. Payments received from the buyer are reported as a liability until sufficient payments or other events allow the use of one of the other methods.

Nonrecourse Financing

Banks may promote the sale of foreclosed real estate by offering nonrecourse financing to buyers. These loans should be made under the same credit terms and underwriting standards the bank employs for its regular lending activity. Financing arrangements associated with this type of transaction are subject to the accounting treatment discussed above.

CLASSIFICATION OF OREO

The examiner should generally evaluate the quality of each OREO property to determine if classification is appropriate. OREO usually should be considered a problem asset, even when it is carried at or below its appraised value. Despite the apparent adequacy of the fair or market value, the bank's acquisition of OREO through foreclosure usually indicates a lack of demand. As time passes, the lack of demand can become more apparent, and the value of the real estate can become increasingly questionable.

When evaluating the OREO property for classification purposes, the examiner must consider the property's fair value, whether it is being held in conformance with state law, and whether it is being disposed of according to the bank's plan. The amount of an OREO property subject to classification is the carrying value of the property, net of any specific valuation allowance. The existence of a specific valuation allowance does not preclude adverse classification of OREO. The examiner should review all types of OREO for classification purposes, including sales that fail to meet the standards required for the full-accrual method of accounting. When the bank provides financing, the examiner should determine whether it is prudently underwritten.

The examiner should review all relevant factors to determine the quality and risk of the OREO property and the degree of probability that its carrying value will be realized. Some factors the examiner should consider include

- the property's carrying value relative to its fair value (including the date of any appraisal or evaluation relative to changes in market conditions), the bank's asking price, and offers received;
- the source and quality of the appraisal or evaluation, including the reasonableness of assumptions, such as projected cash flow for commercial properties;
- the length of time a property has been on the market and local market conditions for the type of property involved, such as history and trend of recent sales for comparable properties;
- bank management's ability and track record in liquidating other real estate and assets acquired in satisfaction of debts previously contracted;
- income and expenses 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;
- other pertinent factors, including property-title problems, statutory redemption privileges, pending changes in the property's zoning, environmental hazards, other liens, tax status, and insurance.

ENVIRONMENTAL LIABILITY

Under federal and state environmental liability statutes, a bank may be liable for cleaning up hazardous substance contamination of OREO. In some cases, the liability may arise before the bank takes title to a borrower's real estate collateral. A property's transition from collateral to bank ownership may take an extended period of time. As the financial problems facing a borrower worsen, a bank may become more involved in managing a company or property. Such involvement may become extensive enough that the bank is deemed to have met substantially all ownership criteria, the absence of a clear title in the bank's name notwithstanding. Generally, the more bank management is involved in such activity, the greater the bank's exposure to any future clean-up costs assessed in connection with the property. A more thorough discussion of environmental liability can be found in section 2040.1, "Loan Portfolio Management," of this manual, under the subsection "Other Lending Concerns."