TOPIC 5: OTHER ASSETS

5A. REAL ESTATE

Question 1: (December 2008)

How should banks account for their investment in other real estate owned (OREO) property?

Staff Response:

Detailed accounting guidance for OREO is provided in the call report instructions. These instructions require that OREO and its sales be accounted for in accordance with generally accepted accounting principles. In this respect, Statement of Financial Accounting Standards Nos. 15, 114 and 144 (SFAS 144) provides the general guidance for the recording of OREO. Sales of OREO are accounted for in accordance with Statement of Financial Accounting Standards No. 66 (SFAS 66). Statement of Financial Accounting Standards No. 67 (SFAS 67) provides guidance on the accounting for costs during the development and construction period, and Statement of Financial Accounting Standards No. 33 (SFAS 33) provides guidance on capitalization of interest costs.

Upon receipt of the real estate, OREO should be recorded at the fair value of the asset less the estimated cost to sell, and the loan account reduced for the remaining balance of the loan. After the transfer to OREO, the fair value less cost to sell becomes the new cost basis for the OREO property. The amount by which the recorded investment in the loan exceeds the fair value (net of estimated cost to sell) of the OREO is charged to the ALLL.

Subsequent declines in the fair value of OREO below the new cost basis are recorded through the use of a valuation allowance. Changes in fair value must be determined on a property-by-property basis. An allowance allocated to one property may not be used to offset losses incurred on another property. Unallocated allowances are not acceptable. Subsequent increases in the fair value of a property may be used to reduce the allowance, but not below zero.

SFAS 157 provides guidance on measuring the fair value of OREO property. Although the fair value of the property normally will be based on an appraisal (or other evaluation), the valuation should be consistent with the price that a market participant will pay to purchase the property at the measurement date. Circumstances may exist that indicate that the appraised value is not an accurate measurement of the property’s current fair value. Examples of such circumstances include changed economic conditions since the last appraisal, stale appraisals, or imprecision and subjectivity in the appraisal process (i.e., actual sales for less than the appraised amount).

Facts:

A bank is in the process of foreclosing on a $150,000 loan. It is secured by real estate with a fair value, based on a current appraisal, of $180,000. The cost to sell this property is estimated at $15,000.

Question 2: (September 2004)

At what value should the OREO be recorded?

Staff Response:

Upon receipt of the real estate, the property should be recorded at $165,000 in accordance with SFAS 15, 114 and 144. This represents the fair value of $180,000 less the $15,000 cost to sell the property. However, because of safety and soundness concerns, the fair value determined in the appraisal should be scrutinized closely. Since the appraisal indicates that the borrower has equity in the property, the bank should address the issue of why the borrower would risk losing the property in foreclosure. If concern exists about the accuracy of the appraisal, further analysis should be performed. However, if the appraisal properly supports the fair value, the $15,000 increase in value is recorded at the time of foreclosure. This increase in value may be reported as noninterest income unless there had been a prior charge-off, in which case a recovery to the ALLL would be appropriate.

Facts:

A bank acquires real estate in full satisfaction of a $200,000 loan. The real estate has a fair value of $190,000 at acquisition. Estimated costs to sell the property are $15,000. Six months later the fair value of the property has declined to $170,000.

Question 3: (September 2003)

How should the OREO be accounted for?

Staff Response:

Upon receipt of the real estate, the property should be recorded at $175,000. This represents the fair value ($190,000) at acquisition less the cost to sell ($15,000) the property. The amount by which the recorded investment in the loan ($200,000) exceeds the fair value less cost to sell ($175,000) should be recorded as a charge against the ALLL. Accordingly, a $25,000 charge against the ALLL is recorded.

Subsequent to the acquisition date, the OREO is carried at the lower of cost ($175,000) or fair value less cost to sell. When the fair value declines to $170,000, the fair value less cost to sell would be $155,000. This represents a $20,000 decline in value, which is recorded through a valuation allowance in other noninterest expense.

Facts:

Continuing with Question 3, two years later the fair value of the property is $195,000.

Question 4: (September 2003)

How should the increase in value be accounted for?

Staff Response:

The increase in the fair value ($25,000) can be recognized only up to the new recorded cost basis of the OREO, which was determined at the foreclosure date. Accordingly, the valuation allowance of $20,000 would be reversed. The additional $5,000 increase in value would not be recognized.

Question 5: (September 2002)

May a bank retroactively establish a valuation for properties that was reduced previously by direct write-off?

Staff Response:

No. Since the bank did not establish an allowance at the time the properties were initially written down, a new basis of accounting was established. Reversing the previous write-down and rebooking the charged off asset is not in accordance with generally accepted accounting principles.

Question 6: (February 2004)

How should the revenues and expenses (including real estate property taxes) resulting from operating or holding OREO property be accounted for?

Staff Response:

Generally, the revenues and expenses from OREO property should be included in the Statement of Income for the period in which they occur. The call report instructions require that gross rentals from OREO be included in “Other noninterest income.” The expenses of operating or holding the property should be included in “Other noninterest expense.” Because the asset is held for sale, depreciation expense would normally not be recorded.

Statement of Financial Accounting Standards No. 67 (SFAS 67) provides an exception for real estate property taxes incurred "during periods in which activities necessary to get the property ready for its intended use are in progress." Therefore, real estate taxes incurred during the construction period can be capitalized, up to the fair value of the property. However, such costs incurred at other times must be expensed as incurred. In this respect, SFAS 67 states that "costs incurred for such items after the property is substantially complete and ready for its intended use shall be charged to expense as incurred." This limited exception would not cover periods in which the bank is merely holding property for future sale.

Facts:

A bank forecloses on a loan secured by a second lien on a piece of property. The bank does not formally assume the senior lien.

Question7:

How should the bank account for the senior debt?

Staff Response:

Although a bank may not assume formally the liability of the senior lien on the property, the amount of any senior debt should be reported as a liability at the time of foreclosure. The OREO balance would be increased by a corresponding amount. However, the resultant carrying value of the OREO cannot exceed the fair value, net of sales costs, of the property.

Any excess should be charged against the allowance for loan and lease losses at the time of foreclosure.

Question 8: (October 2010)

The bank pays delinquent real estate taxes on a property to avoid lien attachment by the taxing authority. How should the bank account for the tax payment?

Staff Response:

As noted in Topic 2B: Nonaccrual Loans, Question 23, delinquent real estate taxes should have been considered when assessing loan impairment prior to transferring the property to OREO. If the delinquent real estate taxes are not paid prior to or at the time of transfer to OREO, this amount should be recorded as a liability (see Topic 5A: Real Estate, Question 7). Real estate taxes incurred after the property becomes OREO are considered holding costs and expensed as incurred. Additionally, other such costs paid by the bank during, or in anticipation of, foreclosure should be expensed. These costs include items for which the bank may contractually be able to obtain reimbursement from the borrower, such as credit life insurance or property insurance premiums. An exception to this rule exists for property under construction. Generally accepted accounting principles allow for capitalization of property taxes during the development period of the property.

Question 9: (February 2004)

The bank purchases the real estate tax lien certificate on the property, rather than paying the delinquent real estate taxes. Would this change the response to Question 8?

Staff Response:

No. The substance of this transaction when the bank purchases the tax lien certificates on property on which it has a lien or has foreclosed is the same as if the bank were paying the property taxes on the property directly. Accordingly, the guidance in Question 8 would apply.

Question 10:

When can a sale of OREO be accounted for under the full accrual method of accounting?

Staff Response:

The full accrual method may be used when all of the following conditions have been met:

- A sale has been consummated.
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property.
- The receivable is not subject to future subordination.
- The usual risks and rewards of ownership have been transferred.

See Question 11 for further discussion.

Question 11:

What constitutes an adequate down payment for use of the full accrual method of accounting?

Staff Response:

The down payment requirement of SFAS 66 considers the risk involved with various types of property. The required down payments range from 5% to 25% of the sales price of the OREO.

For example, only a 10% down payment is required for commercial property subject to a long-term lease and that has cash flows sufficient to service all indebtedness. On the other hand, a 25% down payment is required for commercial property, such as hotels, motels, or mobile home parks, in a start-up phase or having cash flow deficiencies.

Question 12:

If a transaction does not qualify as a sale under the full accrual method of accounting, what other methods are available for accounting for the transaction?

Staff Response:

SFAS 66 provides four other methods for accounting for sales of real estate. They are: the installment method, the cost recovery method, the reduced-profit method, and the deposit method.

In the past, many banks have used only the deposit method to account for dispositions of OREO that did not qualify for immediate sales recognition under the full accrual method. However, depending on the circumstances, use of one of the other methods may be more appropriate. Often a disposition will qualify for immediate sales recognition under the installment method. This method recognizes a sale and the corresponding loan. Any profits on the sale are recognized as the bank receives the payments from the purchaser.

The installment method is used when the buyer’s down payment is not adequate to allow use of the full accrual method, but recovery of the cost of the property is reasonably assured if the buyer defaults. Assurance of recovery requires careful judgment case by case. Factors that should be considered include: the size of the down payment, loan to value ratios, projected cash flows from the property, recourse provisions, and guarantees.

Since default on the loan usually results in the seller's reacquisition of the real estate, reasonable assurance of cost recovery may often be achieved with a relatively small down payment. This is especially true for loans with recourse to borrowers who have verifiable net worth, liquid assets, and income levels. Reasonable assurance of cost recovery may also be achieved when the purchaser/borrower pledges additional collateral.

Dispositions of OREO that do not qualify for either the full accrual or installment methods may be accounted under the cost recovery method. It recognizes a sale and the corresponding loan, but all income recognition is deferred.

The reduced-profit method is used when the bank receives an adequate down payment, but the continuing investment is not adequate. This method recognizes a sale and corresponding loan, and apportions any profits over the life of the loan, based on the present value of the lowest level of periodic payments.

The deposit method is used when a sale of the OREO 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 OREO. Further, 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 that allow the use of one of the other methods.

Facts:

A bank sells a parcel of OREO property (undeveloped land) for $100,000 and receives a $40,000 down payment. But the bank agrees to extend a line of credit for $35,000 to the buyer.

Question 13:

Does this transaction qualify as a sale under the full accrual method of SFAS 66?

Staff Response:

No. SFAS 66 requires that funds provided directly or indirectly to the buyer by the seller (bank) be subtracted from the buyer's down payment in determining whether the down payment criteria have been met. Therefore, in determining the buyer's initial investment, the $40,000 down payment is reduced by the $35,000 line of credit.

There is one exception to this rule. If the bank makes a loan conditional on the proceeds being used for specified development or construction activities related to the property sold, the loan need not be subtracted in determining the buyer's investment in the property. However, the loan must be on normal terms and at market interest rates.

Facts:

The bank sells a parcel of OREO (undeveloped land) at a profit. The sales price is $200,000 and the bank receives a $50,000 down payment. The terms of the mortgage require that the purchaser make interest only payments for five years. The entire principle balance is due at that time.

Question 14:

May the bank account for this sale using the full accrual method of accounting?

Staff Response:

No. SFAS 66 establishes the requirements for recording the transaction under the full accrual method. It requires that the buyer's continuing investment (periodic payments) be at least equal to the level annual payments needed to amortize the debt over 20 years for land and the customary first mortgage period (usually 20 to 30 years) for other types of property. In this situation, the loan balance is not being amortized during the five-year period. Therefore, this transaction does not qualify for recognition under the full accrual method of accounting. The reduced-profit method probably would be used.

Facts:

OREO property with a book value of $110,000 is sold for $120,000. The bank finances the sale and receives no cash down payment. The terms of the note require 120 monthly payments of $1,000 plus interest at market rates. SFAS 66 requires a minimum initial investment of 20% for this type of property. Because of the inadequate initial investment, the bank has accounted for the sale using the deposit method of accounting. During the first year, the bank receives a total of $26,000 in payments - $12,000 in principal and $14,000 in interest.

Question 15: (December 2008)

Have the minimum initial investment requirements of SFAS 66 been met at the end of the first year?

Staff Response:

Yes. The minimum initial investment requirements of SFAS 66 have been met. This results because SFAS 66 allows the inclusion of both principal and interest payments in determining whether the down payment is adequate when the deposit method is used. Therefore, the $26,000 received by the bank during the first year exceeds 20% of the sales price ($24,000).

Facts:

A bank owns a piece of OREO recorded at an appraised value of $15 million. The bank agrees to sell the property for $13.5 million to a buyer after negotiating from an original offer of $11 million. Immediately prior to closing, the buyer has difficulty obtaining financing for the purchase, and the deal falls through.

Question 16: (December 2008)

Must the bank adjust its recorded investment in the OREO?

Staff Response:

Yes, the bank should reduce the carrying value of the OREO to $13.5 million. The bank received a better indication of the asset value by negotiating a fair sale price with a willing buyer. But for the buyer's last minute difficulties in obtaining financing, the bank (a willing seller) would have sold the property at a loss in a market transaction.

Question 17:

Assume the appraised value is the same as in Question 15, except that the bank places the property for sale in an auction. The bank must set a minimum acceptable bid to attract only serious bidders. The bank sets a minimum of $11 million. Must the bank write the OREO down to $11 million, if the property is not sold?

Staff Response:

Not necessarily. If the bid is set for the purpose described and the bank is not required to accept an $11 million bid if it is the only bid, then $11 million may not be a fair price negotiated by a willing buyer and seller.

Also, the absence of bids does not necessarily mean that the minimum bid was unacceptable to any buyer. In these situations, evidence of a market price is inconclusive because a market has not been established, i.e., no willing buyer or willing seller. Accordingly, a source of fair value independent of a single market transaction, such as an appraisal, would continue to be used to determine the carrying value of the property.

Facts:

In June 20XX, a bank sells for $2 million OREO property (a motel) with a book value of $1.9 million, and receives a cash down payment of $300,000 (15% of the sales price). At the time of sale, the cash flow from the motel is not sufficient to service all indebtedness.

Because of the insufficient cash flows, SFAS 66 requires a minimum initial investment (down payment) of 25% for use of the full accrual method of accounting in this situation.

Had the motel been generating sufficient cash flows to service all indebtedness, only a 15% down payment would have been required. Accordingly, this sale is accounted for using the installment method of accounting, and only a portion of the gain is recognized at the time of sale. This portion of gain recognized is based on the ratio of the down payment to the sales price. In this case, 15% of the gain or $15,000 is recognized at the time of sale. The remainder of the gain is deferred.

Question 18: (December 2001)

Can the bank recognize periodic interest income on this loan that is accounted for under the installment method of accounting?

Staff Response:

Yes. Under the installment method, interest income is recognized at the contractual interest rate. In addition, a portion of the deferred gain (from the sale) would be recognized with each payment. However, should the loan experience delinquency problems, the nonaccrual rules would apply.

Question 19: (December 2001)

Five months later, in November 20XX, the motel's business is thriving and its cash flows are now sufficient and are expected to remain sufficient to service all indebtedness. Can the bank now reduce the down payment requirement to 15% and recognize the sale under the full accrual method?

Staff Response:

Yes. Appendix B to SFAS 66 states that if the transaction later meets the requirements for the full accrual method, the seller (bank) may change to that method. The requirements for use of the full accrual method are met when the borrower's cash flow became sufficient to service the debt. Accordingly, at that time the bank can change to the full accrual method of accounting.

Question 20: (December 2001)

Would the remainder of the deferred gain be recognized at this time?

Staff Response:

Yes. The deferred gain would be recognized in earnings at the time of the change to the full accrual method of accounting.

Facts:

A bank sells a shopping center that currently is classified as Other Real Estate Owned and finances the transaction. The buyer makes a 30% down payment and enters into a 20-year amortizing mortgage at current market rates.

The mortgage is structured in two pieces, an A note and a B note. The B note is equal to 10% of the total loan amount. If a certain major tenant vacates the property within five years and the borrower refinances the A note with an independent third-party lender within the next 180 days, the B note is forgiven. If the tenant remains in the shopping center for at least five years, both loans remain in effect. Both loans also remain in effect if the tenant vacates, but the borrower does not refinance within the stated time period. All other terms are consistent with those generally included in a mortgage on commercial real estate.

Question 21: (February 2004)

How should this sales transaction be accounted for?

Staff Response:

This sale qualifies for sales treatment under the full accrual method of accounting. However, because of the bank's exposure with respect to note B, the bank has retained continuing involvement in the property in that it has retained certain risks of ownership. SFAS 66 establishes the accounting when a portion of the risk is retained.

In this respect, the Statement requires that when the risk is limited in amount, the profit recognition should be reduced by the maximum exposure to loss. Accordingly, the profit would be reduced (or loss increased) by the amount of note B.

Question 22: (February 2004)

When would this portion of the gain be recognized?

Staff Response:

The gain would be recognized into income when the contingency expires. That would occur at the end of five years, or if the tenant vacates the property, at the end of the 180-day refinancing period. However, if the tenant vacates the property and the borrower does not refinance, a careful evaluation of this loan for impairment would be appropriate.

Facts:

A bank forecloses on a construction loan on a house that is unfinished. The recorded balance of the loan is $120,000. The "as is" appraised value of the house is $100,000, and the estimated disposal costs are $10,000. The "when completed" appraised value of the house is $150,000, and the estimated disposal costs are $15,000. The estimated cost to complete construction of the house is $40,000.

Question 23: (September 2004)

At what value should the OREO be recorded?

Staff Response:

The OREO should be recorded at $90,000 in accordance with SFAS 15 and SFAS 144. This amount represents the current “as is” fair value of $100,000 less the $10,000 estimated costs to sell the property.

Question 24: (September 2004)

Can the bank capitalize the costs incurred to complete the construction of the house?

Staff Response:

Costs incurred to complete the construction may be capitalized; however the recorded balance of the OREO should not exceed the “when completed” fair value less estimated costs to sell. The bank should monitor the estimated cost to complete construction to ensure that the estimated cost does not exceed original estimates. The recorded balance of the OREO should never exceed fair value less estimated costs to sell.

Facts:

A bank acquired a commercial building upon the default of its borrower. The property was placed into OREO at $5,000,000. This amount represents the property’s fair value (less disposal costs) at the time the bank took possession. Subsequently, a tenant who was paying an above market rent rate terminated its lease by paying the bank an early termination penalty fee of $500,000.

Question 25: (April 2005)

How should this $500,000 fee be recorded?

Staff Response:

The $500,000 fee should be included in the bank’s other noninterest income. The loss of this tenant may be an indication of impairment in the value of the property. Therefore, the bank should update its appraisal to determine whether the estimated fair value of the building has become further impaired due to the departure of the tenant. Any decline in fair value should be recorded in an OREO valuation account, if the decline is temporary, or as a direct write down of the OREO balance.

Facts:

A bank sells a parcel of OREO property in a transaction that meets the four criteria (see Question 10) set forth in SFAS 66 for use of the full accrual method of accounting. However, the bank provides the purchaser/borrower with a mortgage loan at a preferential rate (i.e., below market rate) of interest.

Question 26: (January 2007)

Would the granting of a preferential interest rate preclude use of the full accrual method of accounting?

Staff Response:

No. As noted, this transaction meets the four criteria set forth in SFAS 66 (see Question 10 for a listing of the four criteria) for use of the full accrual method of accounting. Accordingly, the transaction qualifies for use of the full accrual method. The preferential rate of interest does not affect that determination. However, as discussed in Question 27, the sales price, amount of gain (or loss), and future recording of interest income would be affected.

Question 27: (January 2007)

How would the sales price, gain (or loss) on the transaction, and future interest income be determined?

Staff Response:

The loan should be discounted and recorded at its fair value, using a market rate of interest. This discount would also reduce both the effective sales price of the property and any gain (or increase the loss). The difference between the fair value and the contractual or face value of the loan is deferred interest income and is recognized into income as a yield adjustment over the life of the loan.

Facts:

A bank originates a mortgage loan and contemporaneously obtains lender paid mortgage insurance as part of the underwriting. Subsequently, the borrower defaults on the loan and the bank forecloses. The bank pays the premium for the insurance, and the cost is a factor in determining the loan’s interest rate. The mortgage insurance does not meet the scope of a credit derivative under SFAS 133.

Question 28: (December 2008)

At what amount should the OREO property be recorded?

Staff Response:

Upon receipt of the real estate, OREO should be recorded at the fair value of the asset less the estimated costs to sell, and the loan account reduced for the remaining balance of the loan (see Question 1). The receivable related to the mortgage insurance should not be included in determining the fair value less costs to sell of the mortgage loan nor recorded as part of OREO. It is recorded as a separate asset.

Question 29: (December 2008)

Should the bank record a mortgage insurance receivable?

Staff Response:

The bank should evaluate the probability that the mortgage insurance claim will be paid. SFAS 5 states that contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization. However, if realization of the mortgage insurance claim is assured, then a receivable may be recognized. Determining if the realization of the mortgage insurance claim is assured requires the bank to assess the mortgage insurance company's intent and ability to pay the claim. This includes assessing the mortgage insurance company's creditworthiness, propensity for litigating claims, and history of paying claims. The bank should not recognize a receivable for the mortgage insurance claim if there are concerns about the mortgage insurance company's creditworthiness, the mortgage insurance company's history of litigating claims, or the loans in question are subject to any uncertainty because of litigation.

Facts:

A bank sells the Small Business Administration (SBA) guaranteed portion of a loan. The borrower subsequently defaults on the loan. To facilitate foreclosure proceedings, the bank repurchases the guaranteed portion of the defaulted loan.

Question 30: (December 2008)

At what amount should the purchase of the defaulted SBA loan be recorded?

Staff Response:

The purchased loan should be recorded at its fair value. While the repurchased loan is "guaranteed" by the SBA, the fair value may be less than par because of the time value of money and the length of time it takes to get a liquidation plan accepted by the SBA. This difference would be recorded as a loan loss against the ALLL.

Question 31: (December 2008)

At what amount should a foreclosed SBA loan be recorded in OREO?

Staff Response:

The OREO should be recorded at fair value less estimated costs to sell when the loan is foreclosed or the bank receives physical possession of the property. The amount that the bank anticipates receiving from the SBA should be recorded as a receivable if the bank believes it is probable that its SBA claim will be paid.

Facts:

A bank has a nonaccrual SBA loan that is on the books for $150,000 secured by property with a fair value of $125,000. The bank estimates the cost to sell this property to be $12,500. The SBA guaranty is for 75% of any loss. The SBA will probably pay the guaranteed amount when the property is sold.

Question 32: December 2008)

What would the accounting entries be for this loan when it is transferred to OREO?

Staff Response:

The OREO property is initially recorded at $112,500 (fair value of $125,000 less cost to sell of $12,500). The estimated loss before the SBA guarantee is the recorded value of the loan ($150,000) less the fair value of the OREO ($112,500), including the costs to sell, or $37,500. Since the SBA guarantees 75% of the loss, the value of the SBA guaranty is expected to be $28,125. The value of the SBA guarantee reduces the total loss to $9,375.

The entry to record the transaction would be:

DEBIT		**CREDIT**
OREO	$112,500	
ALLL (Charge-Off)	9,375	
SBA Receivable	28,125	
Loans		$150,000