Other Real Estate: Examination Issues and Frequently Asked Questions

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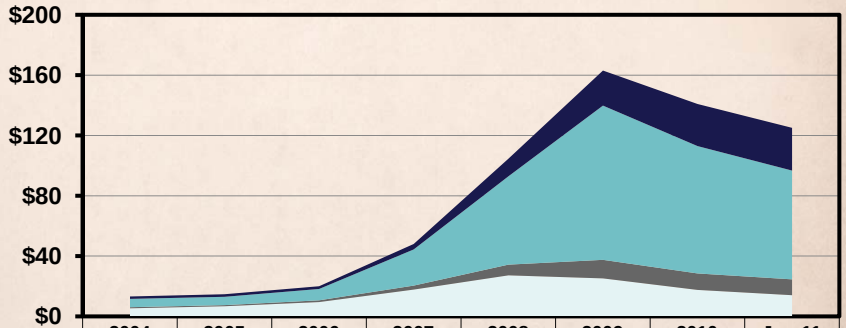
CRE Problem Pipeline Indicates Long-Term Workout;

However, Nonaccrual Loans Are Beginning To Decline

(All US Commercial Banks)

$ Billions

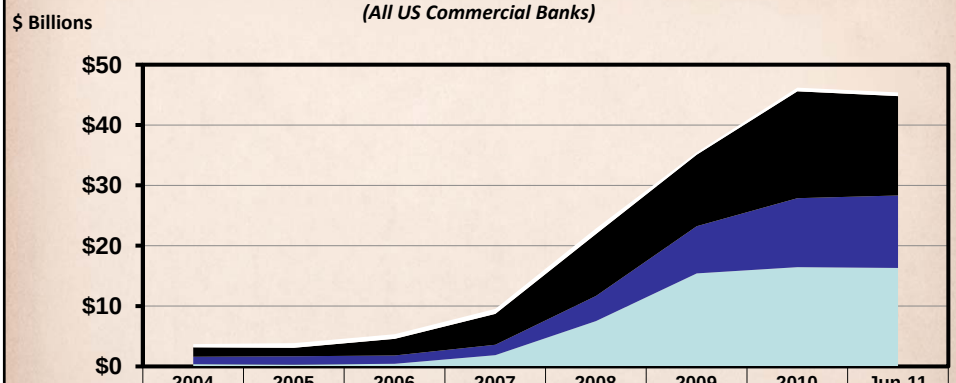


	2004	2005	2006	2007	2008	2009	2010	Jun-11
OREO	1.6	1.7	1.8	3.6	11.7	23.2	27.9	28.3
Nonaccrual	5.5	5.5	7.5	24.0	58.6	102.4	84.6	72.1
90+ Days Delq	0.7	0.8	1.2	2.7	7.0	12.2	10.9	10.5
30-89 Days Delq	5.4	6.7	9.5	17.8	27.3	25.3	17.6	14.1

Source: Reports of Condition and Income

OREO Remains High

(All US Commercial Banks)



	2004	2005	2006	2007	2008	2009	2010	Jun-11
Other	0.5	0.8	0.8	0.8	0.9	0.4	0.6	0.6
1-4 Family	1.6	1.4	2.8	5.1	10.3	11.8	17.7	16.5
Other CRE	1.2	1.4	1.4	1.7	4.2	7.8	11.4	12.0
CLD	0.4	0.3	0.4	1.9	7.5	15.4	16.5	16.3

Source: Reports of Condition and Income

Other Real Estate: Examination Issues and Frequently Asked Questions

Accounting Considerations:

- Acquisition
- Holding Period
- Disposition
- Documentation

Acquisition

1. Is an appraisal required when real estate pledged as collateral for a loan is transferred to Other Real Estate?

   No. The transfer is considered a "transaction involving an existing extension of credit" under 12 CFR 225.63(a)(7) and is exempt from Regulation Y appraisal requirements.

2. Is an evaluation required when real estate pledged as collateral for a loan is transferred to Other Real Estate?

   Yes. Under 12 CFR 225.63(b), the institution must obtain an "appropriate evaluation" to establish the fair value of the ORE. The institution may elect, but is not required, to obtain an appraisal to serve as the appropriate evaluation.

Acquisition

3. How should property that was originally acquired for future use as bank premises but for which plans have now been abandoned be reported?

   The property should be moved to ORE. It should initially be booked at the lower of (1) fair value less costs to sell or (2) the carrying value of the asset on the date of transfer.

4. Can the amount established as the initial carrying value of an ORE parcel exceed the recorded amount of the loan?

   Yes, although in practice this is not common. The excess should be reported as noninterest income unless there has been a prior charge off, in which case a recovery to the ALLL would be appropriate.

Holding Period

1. After a property is initially booked into ORE, can the net carrying amount later be written up to reflect the property's current fair value?

   Only to the extent that the fair value does not exceed the "cost" of the asset. "Cost" is defined as the fair value of the property at foreclosure less costs to sell plus any capitalized improvements.

2. Is an annual appraisal required while a property is held in ORE?

   Some state laws require an annual appraisal for each property held in ORE. While there is no FRS-prescribed time frame for when ORE must be reappraised or reevaluated, financial institutions should ensure appropriate policies and procedures exist for determining the fair value of ORE properties and ensuring regulatory reports are accurately filed.

Holding Period

3. At 6/30/10, the initial carrying value in ORE for a multi-family property is $2MM. In the first quarter 2011, the bank funds the completion of a swimming pool and parking lot at a cost of $200M. A new appraisal supports a fair value (less costs to sell) of $2.3MM at 3/31/11. What is the net carrying value of the ORE at 3/31/11?

   $2.2MM. Expenditures associated with more permanent improvements to an incomplete property generally may be capitalized to the extent they increase fair value. However, only the costs are eligible for capitalization, not the added benefit to fair value beyond the funds spent.

4. Consider the same scenario as above, but the improvements instead cost $400M. The new appraisal supports a fair value (less costs to sell) of $2.3MM at 3/31/11. What is the net carrying value of the ORE at 3/31/11?

   $2.3MM. Expenditures associated with more permanent improvements to an incomplete property generally may be capitalized, but only to the extent fair value is increased.

Disposition

1. Is an appraisal required when an institution finances the sale of ORE?

   Generally, yes. Because the sale or disposal of ORE does not arise from an existing extension of credit, there is no exemption from the Regulation Y appraisal requirements. An evaluation may permitted if sale price is below the $250M threshold.

2. What are the five methods of accounting for ORE sales?

   - *Full Accrual Method*
   - *Installment Method*
   - *Cost Recovery Method*
   - *Reduced Profit Method*
   - *Deposit Method*

Disposition

3. Bank consummates the sale of an ORE parcel (residential unimproved development) at 102% of net carrying value. Bank finances the sale to a builder who was not affiliated with the original borrower or the bank. There is no down payment. Further, Bank loaned additional funds to the new borrower at the time of the sale to permit property improvements (paving, lighting, etc.). Thus, the ORE has been financed at an approximate 110% LTV. The note terms are interest only for the first 3 years. The note bears a market rate of interest.

   Which ORE disposition method should be used?

Disposition

3. (continued)

A. *Full Accrual Method – used when a sale has been consummated and the buyer's initial investment and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay.* **No down payment; deferred repayment.**
B. *Installment Method – 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. Immediate sales recognition is permitted; however, any profits on the sale are recognized as the bank receives the payments from the buyer.* **At a 110% LTV, repayment is questionable if the buyer defaults.**
C. *Reduced Profit Method - used when 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 PV of the lowest level of periodic payments.* **No, there was no down payment.**
D. *Cost Recovery Method - used when dispositions don't qualify under full accrual or installment. All income recognition is deferred. The loan is maintained on nonaccrual status while this method is being used. 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 is appropriate.* **Potentially, yes.**
E. *Deposit Method - used when sale of ORE has not been consummated. It also may be used for dispositions that could be accounted for under the cost recovery method. No sale is recorded and the property remains in ORE. 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 all of the use of one of the other methods.* **No, a sale has occurred.**

Documentation

- Maintain procedures for general foreclosure decision-making process.
  - Consider general foreclosure timelines within each state.
- Ensure appropriate accounting policies and procedures exist for determining the fair value of ORE properties and ensuring regulatory reports are accurately filed.
- Document ORE by category: construction & land development, 1-4 family residential, multi-family residential, etc.
  - Consider location and length of time held.
- Roll forward individual ORE balances: beginning balance, additions, capitalized improvements, valuation adjustments, dispositions and ending balance.
- Document analysis of actual prices received upon sale of ORE versus book balance.