



Financial Institution Letters

Guidance on Other Real Estate

Continued weakness in the housing market and the rapid rise in foreclosures have increased the potential for higher levels of other real estate (ORE) held by FDIC-supervised institutions ("institutions"). In this regard, as stated in Financial Institution Letters 35-2007, "Working With Residential borrowers: FDIC Encourages Institutions to Consider Workout Arrangements for Borrowers Unable to Make Mortgage Payments," and 76-2007, "Servicing for Mortgage Loans: Loss Mitigation Strategies," the FDIC encourages institutions to avoid unnecessary foreclosures of residential properties through loan modifications that achieve affordable, sustainable mortgage obligations. Where foreclosures are unavoidable, this Financial Institution Letter reminds institutions of the need to establish policies and procedures for acquiring, holding, and disposing of ORE. These policies and procedures should ensure that the institution's interests in the ORE are protected while mitigating the impact on the value of surrounding properties; ORE is accounted for in conformance with the *Instructions for the Consolidated Reports of Condition and Income (Instructions for Call Reports)*; and the institution complies with applicable federal and state laws and regulations pertaining to holding ORE.

For regulatory reporting purposes, ORE consists of:

- all real estate, other than bank premises, actually owned or controlled by the institution and its consolidated subsidiaries, including real estate acquired through foreclosure, even if the institution has not yet received title to the property;
- certain direct and indirect investments in real estate ventures;
- property originally acquired for future expansion but no longer intended to be used for that purpose; and
- foreclosed real estate sold under contract and accounted for under the deposit method of accounting.

Safety and soundness matters regarding ORE are discussed below, and a summary of the primary accounting issues associated with ORE is provided in the Appendix – "Accounting for Other Real Estate (ORE)."

VALUATION OF ORE

Institutions typically acquire ORE through foreclosure or deed in lieu of foreclosure after a borrower defaults on a loan. Institutions should obtain a new or updated valuation that complies with state law at the time of acquisition.

Many state laws require institutions to obtain an annual valuation for each parcel of ORE. Institutions should implement procedures to obtain updated ORE valuations as needed to ensure that any material change in market conditions or the physical aspects of the property are recognized.

Further, upon the disposition of ORE, certain state laws may govern appraisals and/ or valuations. If an institution is selling *and* financing the transaction, Part 323 of the **FDIC Rules and Regulations** and applicable state laws require an appraisal or an evaluation.

MAINTAINING ORE

Part 364, Appendix A of the **FDIC Rules and Regulations**, *Interagency Guidelines Establishing Standards for Safety and Soundness*, requires institutions to identify problem assets and prevent deterioration in those assets. Institutions are reminded that maintaining and protecting ORE from further deterioration is critical to maximizing recovery value. Typical expenses incurred during the ORE holding period include:

- **Maintenance.** ORE should be maintained in a manner that complies with local property 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 risk.
- **Real Estate Taxes.** Taxes on ORE should be paid in a timely manner to avoid unnecessary penalties and interest.
- **Insurance.** A review of an institution's umbrella insurance policies should be performed to determine if adequate hazard and liability coverage for ORE exists. If not, management should consider obtaining policies on each parcel of ORE. If an institution decides to self-insure, this decision should be documented in the ORE file.
- **Other Expenses.** Management should implement reasonable procedures for managing any 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.

Appendix – Accounting for Other Real Estate (ORE)

In general, the accounting and reporting standards for foreclosed real estate are set forth in Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings (FAS 15)*, and Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144)*. In addition, certain provisions of the American Institute of Certified Public Accountants (AICPA) Statement of Position 92-3, *Accounting for Foreclosed Assets (SOP 92-3)*, have been retained because they represented prevalent and safe and sound banking practices. The provisions retained from AICPA SOP 92-3 include that when an institution receives ORE from a borrower in full satisfaction of a loan, the long-lived asset is presumed to be held for sale, and the institution should initially record the ORE at its fair value less cost to sell.

The life cycle of foreclosed real estate consists of three phases: acquisition, holding period, and disposition. Banks should ensure that proper accounting policies and controls are in place during each phase (see summary of the three phases below). Management should refer to the applicable accounting standards and the *Instructions for Call Reports* to determine the appropriate regulatory reporting of ORE based on the specific facts and circumstances relating to the property and related transactions. Management is encouraged to consult with knowledgeable accounting professionals as necessary, especially in those situations where the transaction is uncommon or complex in relation to the bank's expertise.

Accounting for ORE at Acquisition

Foreclosed real estate received in full or partial satisfaction of a loan should be recorded at the fair value less costs to sell the property at the time of foreclosure. This amount becomes the "cost" of the foreclosed real estate. According to FAS 144, "costs to sell are the incremental direct costs to transact a sale," which include "broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred."

When foreclosed real estate is received in full satisfaction of a loan, the amount, if any, by which the recorded amount of the loan exceeds the fair value less cost to sell the property is a loss which must be charged to the allowance for loan and lease losses at the time of foreclosure.¹ The amount of any senior debt (principal and accrued interest) to which foreclosed real estate is subject at the time of foreclosure must be reported as a liability in the Call Report as "Other borrowed money." Legal fees and other direct costs incurred in a foreclosure should be expensed as incurred.

Accounting for ORE during the Holding Period

After foreclosure, each foreclosed real estate asset must be carried at the lower of (1) the fair value of the asset minus the estimated costs to sell the asset or (2) the "cost" of the asset. This determination must be made on an asset-by-asset basis. If the fair value of a foreclosed real estate asset minus the estimated costs to sell the asset is less than the asset's cost, the deficiency must be recognized as a valuation allowance against the asset which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) through charges or credits to expense for changes in the asset's fair value or estimated selling costs. Changes in the valuation allowance should be recorded in Schedule RI – Income Statement, item 5.j, "Net gains (losses) on sales of other real estate owned," of the Call Report.

In preventing ORE from further deterioration during the holding period, institutions typically incur a variety of expenses. These holding costs generally should be expensed as incurred and reported in Schedule RI – Income Statement, item 7.d, "Other noninterest expense," of the Call Report, except for interest on prior liens, which should be reported in item 2.c, "Interest on trading liabilities and other borrowed money."

If permanent improvements are made to a foreclosed real estate asset that increase the property's value, these expenditures generally would be eligible for capitalization to the cost of the ORE. In addition, banks that complete the construction of foreclosed real estate projects should refer to such standards as Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Cost (FAS 34)*, and Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects (FAS 67)*, for relevant accounting guidance. In addition, if the property generates revenue during the holding period, the institution should recognize the income generated from the property and report it in Schedule RI – Income Statement, item 5.l, "Other noninterest income," of the Call Report.

Accounting for ORE in the Disposition Phase

The primary source of accounting guidance for sales of foreclosed real estate is Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate (FAS 66)*. This standard, which applies to all transactions in which the seller provides financing to the buyer of

real estate, establishes five methods to account for the disposition of ORE -- full accrual, installment, cost recovery, reduced profit, and deposit. If a profit is involved in the sale of real estate, each method sets forth the manner in which the profit is to be recognized based on the terms of the sale. However, regardless of which method is used, any loss on the disposition of ORE should be recognized immediately. Refer to the *Instructions for Call Reports* and FAS 66 for further guidance on the appropriate method to be used based on the individual facts and circumstances relating to the sale of ORE, including such factors as the buyer's initial investment (down payment).

In situations where ORE is sold *shortly* after it is received in a foreclosure (i.e., the holding period was minimal), the *Instructions for Call Reports* state that it would generally be appropriate to substitute the value received in the sale (net of the cost to sell) for the fair value (less cost to sell) estimated at the time of foreclosure. Any adjustment made to the loss originally recognized at the time of foreclosure would be charged against or credited to the allowance for loan and lease losses. In all other instances where the foreclosed real estate is held for more than a minimal period, any declines in value after foreclosure and the gain or loss from the sale or disposition of the real estate should be reported in Schedule RI – Income Statement, item 5.j, "Net gains (losses) on sales of other real estate owned."

¹ The "recorded amount of the loan" is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest.