

Avoiding OREO Indigestion

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When a business line or asset category grows rapidly, it makes the management of that area, including the enactment and enforcement of appropriate policies and procedures, all the more important. What has been the fastest growing category on banks' balance sheets this past year? OREO (= Other Real Estate Owned), by quite a margin. From Q3/07 through Q3/08, FDIC data shows a 157% increase in OREO across all commercial banks, jumping from \$7.2 billion up to \$18.5 billion. And that growth does not look likely to ease in the near term.

While OREO includes property purchased or used in the past for banking premises, most of it represents property acquired via foreclosure. Managing it introduces various constraints on an institution. There is the practical constraint of avoiding disrupting or undermining the value of neighboring properties. During the holding period, the bank as owner must ensure proper maintenance and operating standards. There are accounting requirements – in particular, SFAS 15 (troubled debt restructurings), 66 (sales of real estate), and 144 (impairment or disposal of long-lived assets). There are specific Call Report requirements, consistent with these FASB pronouncements, but going further in terms of how data is classified and presented.

All of this (and more) is codified in 12 CFR 34 and spelled out more accessibly in the FDIC's recent (July, 2008) Financial Institution Letter, FIL-62-2008. It is critical at a time of real estate market disruption like this to ensure that internal policies are consistent with the provisions of these documents. Key provisions can be split out into the three components of the OREO life-cycle:

1. **Acquiring:** When an institution acquires a foreclosed property in settlement of a troubled debt, the property is recorded on the books at its fair value less the estimated costs to be incurred in selling it. So an updated valuation is required. This may be a full appraisal, but not necessarily (e.g., if the property was recently appraised, or if the dollar amount falls below the bank's policy requirement for an appraisal). Should the fair value net of sales costs fall short of the loan amount due, then the shortfall is to be charged to the ALLL.
2. **Holding:** There are limitations on the holding period (typically, five years but extendible), which vary by jurisdiction. There may also be requirements to document efforts made to dispose of the property. The property must be periodically reviewed and revalued while it's being held. If the net fair value falls further from what was estimated at the acquisition date, then that additional shortfall amount is to be charged to a valuation allowance, with the corresponding income statement effect showing as "net gains/losses on sales of OREO." (Note that valuation could increase but cannot take the net fair value higher than the original cost base at time of acquisition.) During the holding period, any maintenance costs incurred are to be expensed, while improvement costs are generally to be capitalized. In some cases, there are requirements to notify regulators if additional loan advances are made to complete construction in order to reduce the ultimately anticipated shortfall on the loan.

3. **Disposing:** If an OREO property is sold for less than its current carrying value, the (additional) loss is immediately recognized in the “net gains/losses on sales of OREO” account. Detailed accounting specifications will vary, depending among other considerations, on whether the bank has financed the transaction.

We've laid emphasis here on the accounting issues specific to OREO. But we certainly shouldn't lose sight of the more prosaic governance and control considerations. Ensure that property sales (above some dollar threshold) get board pre-review and approval. And that OREO expenses get due scrutiny and authorization. Other aspects such as reconciliations, revaluations and monthly reporting are certainly important, though how much attention to give them depends on the amount of OREO exposure which varies widely from bank to bank. But keep in mind that OREOs are a lagging indicator of credit stress (i.e., they can still be growing as other credit measures eventually begin to improve), and that the best time to devise, implement and test new policies and procedures is before the institution first faces a surge in its OREO holdings.

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