TEXAS DEPARTMENT OF BANKING

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SUPERVISORY MEMORANDUM – 1032

November 1, 2021

TO: All State-Chartered Trust Companies
All Bank and Trust Examining Personnel

FROM: Charles G. Cooper, Banking Commissioner

SUBJECT: Policy for Other Real Estate Owned (OREO) for State-Chartered Trust Companies[1]

OVERVIEW

This policy statement interprets the state statutes and rules governing other real estate and defines the Department's classification policy for OREO for state-chartered trust companies.

Section 184.003(a) of the Texas Finance Code (TFC) authorizes a state trust company to hold real estate other than its trust company premises, with its restricted capital in limited circumstances. Title 7, Section 19.51 of the Texas Administrative Code (7 TAC §19.51) defines other real estate; describes the limited circumstances under which it can be lawfully acquired by a trust company using restricted capital; outlines the appraisal/evaluation requirements; establishes a procedure whereby additional expenditures may be made; defines a maximum holding period for each parcel; and outlines the minimum criteria for disposition efforts by a trust company.

It is important to note that 7 TAC §19.51 applies specifically to other real estate held with restricted capital, rather than secondary capital. However, trust company managers should follow safety and soundness by exercising sound judgement and prudence in holding OREO with secondary capital in accordance with TFC §184.003(e). Examiners will evaluate and consider the requirements of TFC §184.101(e) to determine the prudent standards, which may include acquiring initial and periodic valuations of the property.

OREO is considered held with restricted capital if at any time during the holding period, secondary capital is less than total book value of all OREO held by the trust company. Therefore, the trust company should reevaluate the capital structure quarterly to determine which type of capital is used to hold the property to determine which sections of 7 TAC §19.51 shall apply.

[1] This policy revises and supersedes the policy dated December 5, 2016. The current revisions include accounting updates and changes to the appraisal and evaluation requirements in 7 TAC §19.51 which became effective on December 31, 2020. Further clarification was made to address the distinction between when OREO is acquired with restricted capital or secondary capital.

ACCOUNTING FOR OREO

Under 7 TAC §19.51, OREO, whether held with restricted capital or secondary capital, must be accounted for in accordance with regulatory accounting principles, defined in the TFC as generally accepted accounting principles (GAAP) as modified by rules adopted under the TFC or an applicable federal statute or regulation. In general, the accounting and reporting standards for foreclosed real estate are set forth in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 310-40, *Troubled Debt Restructurings by Creditors*, and ASC Topic 360-10-35, *Impairment or Disposal of Long-Lived Assets.*

APPRAISALS AND EVALUATIONS

Appraisals and Evaluations at Acquisition

As provided in 7 TAC §19.51(e), when OREO is acquired with restricted capital, a state trust company must substantiate the market value by obtaining an appraisal within 90 days from the date of the property's acquisition by the trust company, unless extended by the banking commissioner. An evaluation may be substituted for an appraisal if the recorded book value of the OREO is $500,000 or less.

If the trust company has already obtained an appraisal or appropriate evaluation within the year prior to foreclosure, as provided in 7 TAC §19.51(e)(2), then a new valuation is not yet required.

If OREO is held with secondary capital, trust company management should evaluate and consider the prudent standards set forth in TFC §184.101(e) to determine if an appraisal or evaluation is necessary, and examiners will review the appropriateness of the trust company's determination.

Subsequent Appraisal and Evaluation Requirements

An evaluation of the value of OREO held with restricted capital must be made at least once a year. An appraisal is required at least once every three years unless extended by the banking commissioner. An evaluation may be substituted for an appraisal if the recorded book value of OREO is $500,000 or less. The one-year period is measured from the date of the last appraisal or evaluation.

If any subsequent appraisal or evaluation indicates a reduction in the value of a property below the current book value, FASB ASC 360 requires the trust company to recognize the deficiency as a valuation allowance against the asset, which is created through a charge to expense. For reporting purposes, the reserve account should be netted against the book value of the OREO and is not considered as part of the trust company's capital structure. 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 value or estimated selling costs. In no event, however, should the carrying value of the property be increased to an amount greater than the original book value at the time of acquisition or transfer to the other real estate category.

Maintenance of a general reserve for losses on the sale of OREO and write-downs below appraised value are not consistent with generally accepted accounting principles. Write-downs below appraised value should be supported by reasonable documentation.

If upon a quarterly evaluation of its capital, a trust company determines that OREO ceases to be held with secondary capital and is held in any part with restricted capital, then the appraisal and evaluation rules of this section will apply.

If OREO is held with secondary capital, trust company management should evaluate and consider the prudent standards set forth in TFC §184.101(e) to determine if an appraisal or evaluation is necessary, and examiners will review the appropriateness of the trust company's determination.

Obtaining an Appraisal Extension

The banking commissioner may extend the deadline for when an appraisal is required on OREO property per 7 TAC §19.51(e)(1) and (3). Requests for an extension of the deadline for obtaining an appraisal within 90 days of acquisition of OREO or the deadline to obtain an appraisal of OREO property every three years must be submitted to the commissioner in writing. Extension requests must include information necessary to support the reason(s) for the extension. The required form for submitting an extension request, "Application to Extend Appraisal Deadline," is available under the Applications & Forms section of the Department's website.

Decisions to approve or deny requests for the extension of a deadline to obtain an appraisal will be made on a case-by-case basis after considering all relevant factors of the transaction. Reasons for granting an extension vary but may include a pending written sales agreement that is expected to close within the next 90 days.

HOLDING PERIOD FOR OREO

Holding Period Limit

Texas statutes require that if OREO is held with restricted capital, a state-chartered trust company must dispose of the OREO within five years from the date the real property:

- is originally acquired or transferred to that asset category;
- ceases to be used as a trust company facility; or
- ceases to be considered future expansion property as a trust company facility as provided in §184.002 (b) of the TFC[2].

When a state-chartered trust company acquires OREO held in restricted capital as the result of a merger with or an acquisition of another institution, the holding period of the newly acquired OREO commences on the date of merger or acquisition. If an entity converts to a state-chartered trust company, the OREO property held by the entity at the time of conversion will be considered acquired or transferred to OREO as of the conversion date.

[2] Although TFC §184.002(c) and §184.003(c) provide conflicting disposal periods for real estate formerly held as future expansion property, §184.002(c) takes precedence over §184.003(c) because it is more recently amended, as provided in the Code Construction Act (Gov't Code §311.025(a)).

The banking commissioner may grant an extension of time for disposing of an OREO property if, in the commissioner's opinion, the trust company has made a good faith effort to dispose of the property, or if the commissioner determines that disposal of the property within the initial five-year period would be detrimental to the trust company. Should the extension request be denied, failure to dispose of the property may result in citing a violation of 7 TAC §19.51 at the next examination. Examining personnel will review the trust company's efforts to dispose of each property and evaluate compliance with the regulation. Continued noncompliance and/or absence of good faith efforts to dispose of the property may result in the issuance of an enforcement action to effect correction.

If upon a quarterly evaluation of its capital, a trust company determines that OREO ceases to be held with secondary capital and is held with restricted capital, then the holding period limit of this section applies from the date the restricted capital was utilized for holding.

Holding Period Extensions

All requests for extensions of holding periods must be in writing. The required form for submitting an extension request, "Application to Extend Holding Period for OREO," is available under the Trust Companies section of Applications & Forms on the Department's website.

Extensions for future expansion will be handled on a case-by-case basis. Primary factors that are considered by the Department in evaluating compliance with the law and in deciding whether to approve requests for extensions of holding periods include the following:

- Carrying value of the property in relation to current market value, asking price, and purchase offers received;
- Length of time the property has been held and reason(s) why it has not been sold;
- Income and expenses associated with ownership and maintenance of the property for: (i) all prior years; (ii) the current year; and (iii) an estimate of next two years; and
- Potential or known contingent liabilities (e.g., environmental concerns, litigation, etc.) relative to the holding of the property.

Extensions for holding property, other than future expansion, are not normally granted if the extended time exceeds ten years from the original date of acquisition (or the date a former trust company facility was reclassified as OREO).

DISPOSAL OF OREO

Minimum Documentation Requirements

Under 7 TAC §19.51(h), trust companies are expected to maintain documentation showing compliance with the regulation and good faith efforts to dispose of each parcel of OREO held with restricted capital. Required minimum documentation includes:

- Specific action plans for disposal of each parcel of OREO showing review and approval by the trust company's board of directors or a designated committee thereof. Such action plans and reviews should be recorded in the official records of the board or committee meetings;

- Listing agreements executed with real estate agents/brokers detailing the asking price and terms of sale. If a property is not listed, adequate documentation showing the trust company's own marketing efforts must be maintained;
- Documented reasonableness of the asking price relative to the appraised market value of the property;
- Records of all verbal and/or written inquiries and offers received for each property;
- Decisions made and actions taken by the board, or designated committee, on all verbal or written offers received; and
- Files of all advertising media employed, e.g., signs, publications, and broadcast media.

Accounting for Disposition of OREO

FASB issued Accounting Standards Update (ASU) 2014-09 in May of 2014 which created ASC Topic 606, *Revenue from Contracts with Customers*, and amended ASC Topic 610, *Other Income*.[3] Per ASU 2014-09, sales of OREO should be accounted for in accordance with ASC Subtopic 610-20 *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets.*[4]

Exchange, Acceptance or Additional Purchases

With the prior written approval of the banking commissioner, a trust company may exchange or acquire real estate or personal property in order to avoid or minimize loss potential on OREO. Alternate or additional real estate so acquired should be accounted for on the trust company's books as OREO if acquired with restricted capital, and the initial holding period for such properties will be measured from the date legal title to the original OREO was first acquired by the trust company. Disposal of personal property should be within 90 days of acquisition.

Criteria for Exchanging or Acquiring Additional OREO

The commissioner's decision to approve or deny requests for the exchange or acquisition of real estate held with restricted capital will be made after considering all relevant factors of the transaction, particularly the following:

- Has the trust company demonstrated good faith efforts to dispose of the original OREO?

[3] ASU 2014-09, which includes ASC Topic 606 and ASC Topic 610 is effective for institutions that are public business entities (PBE), as defined under U.S. GAAP, for fiscal years beginning after December 15, 2017, including interim reporting periods within those fiscal years. For institutions that are not PBEs (i.e., that are private companies), the standards are effective for fiscal years beginning after December 15, 2018, and interim reporting periods within fiscal years beginning after December 15, 2019.

[4] ASC Subtopic 610-20 supersedes ASC Subtopic 360-20 for real estate sales not accompanied by a leaseback and is the primary accounting guidance for sales of foreclosed real estate.

- Has the trust company reduced its loss exposure as evidenced by current market value appraisals of the properties involved?
- Does the trust company have specific plans to market the newly acquired property?
- What is the amount of cash to be received by the trust company in connection with a transaction where the trust company is accepting an alternate parcel of real estate as partial consideration in the sale of existing OREO?
- Will the nature of the original OREO be changed?
- What is the trust company's aggregate investment in the existing OREO plus the property to be acquired in relation to equity capital?

Transfer of OREO to Affiliate

7 TAC §19.51(i) addresses the various options for disposition of OREO.

Under 7 TAC 19.51(i)(4), a trust company may dispose of real estate by transferring the real estate for market value to an affiliate. This is subject to TFC §183.109. In addition, if the trust company is a bank subsidiary or affiliate, then the transfer may also be subject to applicable federal law, including 12 U.S.C. §§371c, 371c-1, and 1828(j) (relating to transactions among banks, bank affiliates, and bank subsidiaries). Section 183.109 of the TFC requires that a trust company may not directly or indirectly sell or lease an asset of the trust company to an officer, director, manager, managing participant, or principal shareholder or participant of the trust company or of an affiliate of the trust company without the prior approval of a disinterested majority of the board. If a disinterested majority cannot be obtained, the prior written approval of the banking commissioner is required.

CLASSIFICATION STANDARDS

The Department evaluates OREO held with restricted capital in the same manner as any other trust company-owned asset, utilizing the same criteria for assessing quality and propriety. As warranted, adverse criticism is assigned in a manner consistent with the uniform classification standards used by state and federal bank regulatory agencies.

Income producing properties may be excluded from classification provided the annual net cash flow from the property yields a market rate of return on the entire book amount. "Net cash flow" is defined by GAAP as gross cash receipts less the cost of insurance, taxes, management fees, and other operating costs. For purposes of the classification treatment outlined below, the market rate of return must equal or exceed the average yield on real estate loans as reflected in the trust company's most recent reports of condition and income plus 100 basis points. If book value is materially less than the market value of the property due to previous unsubstantiated write downs, for classification purposes the rate of return is calculated using the market value of the asset.

Suggested classification treatments for OREO properties held with restricted capital are shown below and assume that the examiner has no material reservations with the validity of the appraisal or its assumptions. In the case of income producing properties, the assumption is also made that there are no significant reservations about the quality and continued viability of the future cash flow stream of the property. However, if an examiner has reasonable cause to question the appraisal, its assumptions, or the future cash flow stream, more severe classifications than those shown may be assigned.

Income Producing Properties

- **Pass** - Consider income and expenses generated by the property and any other factors affecting the probability of loss exposure.
- **Substandard** - Consider income and expenses generated by the property and any other factors affecting the probability of loss exposure.
- **Doubtful** - N.A. (this classification is generally not appropriate).
- **Loss** - Excess of book value over current appraised value.

Non-income Producing Properties

- **Substandard** - Current appraised value.
- **Doubtful** - N.A. (this classification is generally not appropriate).
- **Loss** - Excess of book value over current appraised value.