



TEXAS DEPARTMENT OF BANKING

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SUPERVISORY MEMORANDUM – 1008

October 1, 2020

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

FROM: Charles G. Cooper, Banking Commissioner

SUBJECT: Policy for Other Real Estate Owned (OREO)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 banks.

Section 34.003 of the Texas Finance Code (TFC) authorizes a state bank to hold real estate other than its banking premises in limited circumstances. Section 34.004 of the TFC further permits a state bank to hold nonparticipating royalty interests as personal property in specific instances. Title 7, Section 12.91 of the Texas Administrative Code (7 TAC §12.91) defines other real estate; describes the limited circumstances under which it can be lawfully acquired by a bank; 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 bank.

ACCOUNTING FOR THE ACQUISITION OF OREO

Initial Booking

Under 7 TAC §12.91 OREO must be accounted for in accordance with regulatory accounting principles,² 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.

¹This policy revises and supersedes the policy dated November 7, 2016. Current revisions include accounting updates and changes to the appraisal and evaluation requirements in 7 TAC §12.91 which became effective on September 10, 2020.

² In general, the accounting and reporting standards for the initial booking of foreclosed real estate are set forth in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 310-40, *Receivables- Troubled Debt Restructurings by Creditors*, and ASC Topic 360, *Property, Plant, and Equipment-10-35, Impairment or Disposal of Long-Lived Assets*.

Each parcel of OREO should be recorded at the fair value less costs to sell the property, which becomes the “cost” of the foreclosed real estate. If the fair value (less the estimated costs to sell) exceeds the recorded amount of the loan, the excess should be reported as a recovery of a previous charge-off on the loan or in current earnings, as applicable.³ If the recorded value of the loan exceeds the fair value of the foreclosed property minus estimated selling costs upon initial booking, the deficiency is a loss which should be charged to the Allowance for Loan and Lease Losses.⁴ Further accounting guidance for OREO can be found in the Federal Financial Institutions Examination Council (FFIEC) Call Report Instructions, which require that OREO be accounted for in accordance with GAAP.

The recorded value is the outstanding principal balance of the loan *plus* any booked accrued and unpaid interest (not to exceed 90 days) *plus* any unamortized premium and loan acquisition costs, *less* previous write-downs, finance charges, and any unamortized discount. Direct costs incurred by the bank in a foreclosure, such as legal fees, should be expensed when they are incurred.

Accounting for Other Liens

In accordance with FASB ASC Topic 360 *Property, Plant, and Equipment* (formerly FASB 144, Accounting for the Impairment of Disposal of Long-Lived Assets) the amount of any senior debt (principal and accrued interest) to which the property is subject (even if not formally assumed by the bank) should be reported as a liability at the time of foreclosure. The carrying amount of the asset would, therefore, be increased by such amount; however, the resulting carrying amount cannot exceed the market value, net of estimated sales costs, of the property. Any subsequent payments of principal should reduce the liability. Interest that accrues after foreclosure should be recognized as interest expense and added to the liability account balance if left unpaid.

Subsequent Costs

Ongoing expenses *not* associated with acquiring clear title to the property (i.e., taxes, hazard insurance, utilities, etc.) should be expensed as incurred. Costs incurred to protect a bank's investment in OREO which is improved or under construction, and necessary to place a property in a saleable condition, may be capitalized in accordance with GAAP. Additional investments which alter the current status or intended use of the property or made for the purpose of speculating in real estate are not allowed under the law.

APPRAISALS AND EVALUATIONS

Appraisals and Evaluations at Acquisition

As provided in 7 TAC §12.91(d), when OREO is acquired, a state bank must substantiate the market value by obtaining an appraisal within 90 days of the date of the property's acquisition by the bank, 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 bank has already

³ Instances of this are rare and would need to be supported by a strong appraisal and positive economic conditions.

⁴ Also see FDIC FIL-62-2008.

obtained an appraisal or appropriate evaluation within the year prior to foreclosure, as provided in 7 TAC §12.91(d) (2), then a new valuation is not yet required.

Subsequent Appraisal and Evaluation Requirements

An evaluation of the value of OREO 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 bank 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 bank'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 must be supported by documentation that indicates that the write-down was appropriate.

Obtaining an Appraisal Extension

The banking commissioner may extend the deadline for when an appraisal is required on OREO property per 7 TAC §12.91(d)(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 a state bank dispose of 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 bank facility; or
- ceases to be considered future expansion property as a bank facility as provided by Section 34.002(b) of the TFC.

When a state bank acquires OREO 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-charter, 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.

The banking commissioner may grant an extension of time for disposing of an OREO property if, in the commissioner's opinion, the bank 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 bank. Should the extension request be denied, failure to dispose of the property may result in citing a violation of 7 TAC §12.91 at the next examination. Examining personnel will review the bank'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.

Holding Period Extensions

All requests for extensions of holding periods must be in writing. The required form for submitting an extension request, "[Extension on Holding Period for OREO](#)," is available under the Applications & Forms section of 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 bank facility was reclassified as OREO.

Holding Nonparticipating Royalty Interest Beyond Disposal Period

A nonparticipating royalty is an interest in the minerals that is non-possessory and does not entitle the owner to produce the minerals, join in a lease of the mineral estate to which the royalty is appurtenant, or share in bonuses or delay rentals that may be paid under the lease, but merely

entitles the owner to a share of the production under the lease free of exploration and production expenses.

If acquired for the purpose of avoiding or minimizing a loss on a loan or investment previously made in good faith, under certain circumstances a bank may retain a limited interest in OREO in the form of a nonparticipating royalty interest, subject to Section 34.004 of the TFC. The commissioner may order the bank to dispose of the interest if it is determined at any time that continued ownership is detrimental to the bank.

In order to own and retain any nonparticipating royalty interest beyond the disposal period for OREO, a written request must be submitted to the commissioner. The request form, "[Application to Hold Non-Participating Royalty Interest](#)," is available on the Applications & Forms section of the Department's [website](#). The written request must be accompanied by a copy of the instrument creating the royalty. Upon receiving approval by the Department, a letter application to the FDIC must be submitted requesting permission to hold the reclassified property at the bank level, pursuant to 12 CFR §362.3(b)(2)(i).

DISPOSAL OF OREO

Minimum Documentation Requirements

Under 7 TAC §12.91(g), banks are expected to maintain documentation showing compliance with the regulation and good faith efforts to dispose of each parcel of OREO. Required minimum documentation includes:

- Specific action plans for disposal of each parcel of OREO showing review and approval by the bank'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 bank'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*.⁵

⁵ 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

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*.⁶

Bank Financing of OREO Purchases

It is not uncommon for a bank to provide financing upon sale of OREO to facilitate the orderly liquidation of such assets. The receivable resulting from the sale of the OREO should be reported as a loan if the transaction meets five contract criteria in ASC Topic 606. Any dispositions which do not initially qualify for sales treatment should continue to be reported as OREO and monitored for subsequent reclassification to a sale when the minimum criteria are met. Payments received from the borrower are reported as a liability until the requirements in ASC Topic 606 are met. In addition, if the transaction price is less than the carrying amount of the OREO, the bank should consider whether this indicates a decline in fair value of the OREO that should be recognized as a valuation allowance, or as an increase in an existing valuation allowance. For additional guidance, refer to ASC Subtopic 610-20 and ASC Topic 606.

When a financed property remains OREO for reporting purposes, it is not subject to the disposal efforts and holding period limits incorporated in law and this policy. Also, Section 34.201(a)(15) of the TFC specifically excludes the portion of a purchase money mortgage taken by a bank in consideration for the sale of OREO owned by the bank from the legal lending limit, if the sale was in the bank's best interest.

Exchange, Acceptance or Additional Purchases

As provided in 7 TAC §12.91(c)(4), a state bank may exchange or acquire real estate or personal property in order to avoid or minimize loss potential on OREO with the prior written approval of the banking commissioner. Alternate or additional real estate so acquired should be accounted for on the bank's books as OREO, 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 bank. 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 will be made after considering all relevant factors of the transaction, particularly the following:

- Has the bank demonstrated good faith efforts to dispose of the original OREO?
- Has the bank reduced its loss exposure as evidenced by current market value appraisals of the properties involved?

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.

⁶ 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.

- Does the bank have specific plans to market the newly acquired property?
- What is the amount of cash to be received by the bank in connection with a transaction where the bank 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 bank's aggregate investment in the existing OREO plus the property to be acquired in relation to equity capital?

Transfer of OREO to a Bank Subsidiary

7 TAC 12.91 (h) (4) provides that a bank may dispose of other real estate owned by: (1) transferring the property to a majority-owned subsidiary; and (2) complying with FDIC regulation 12 CFR §362.4(b)(5)(i). In the event that the bank does not already have a majority-owned subsidiary for this purpose, the bank must submit a notice to the Department pursuant to Section 34.103(e) of the TFC. The instructions for submitting the required subsidiary notice to the Department, “[Notice to Applicants – Subsidiary Notice Filings](#),” is available under the Applications & Forms section of the Department’s [website](#).

If a bank (and its subsidiary) meet the core eligibility requirements of 12 CFR §362.4(c), it can transfer OREO to the qualifying subsidiary under 12 CFR §362.4(b)(5)(i) after filing notice with the FDIC and that notice is processed without objection.

Transfer of OREO to an Affiliate

7 TAC 12.91(h) (5) provides that a bank may dispose of real estate by transferring the real estate for market value to an affiliate. This is subject to Section 33.109 of the TFC and applicable federal law, including 12 U.S.C. §§371c, 371c-1, and 1828(j) relating to transactions with affiliates. Section 33.109 of the TFC requires that a bank may not directly or indirectly sell or lease an asset of the bank to an officer, director, or principal shareholder of the bank or of an affiliate of the bank 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.

A bank may also dividend in kind the real property to an up-stream subsidiary or affiliate at the market value of the asset on the date of the dividend.

According to 12 C.F.R § 225.22 (d), the Federal Reserve Board may, upon request, permit a bank holding company or a nonbank subsidiary of the bank holding company that receives the real estate through sale, transfer, or dividend in kind from the bank, to hold the property for a maximum of 10 years. The holding period requirement is based upon the date that the property was acquired by the bank or the date a former bank facility became OREO.

CLASSIFICATION STANDARDS

The Department evaluates OREO in the same manner as any other bank-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 bank's most recent federal 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 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** - Market rate of return equals or exceeds the average yield of the bank's real estate loans plus 100 basis points.
- **Substandard** - Market rate of return does not equal or exceed the average yield of the bank's real estate loans plus 100 basis points.
- **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.