

# RESCINDED

## Regulatory Bulletin RB 37-66

Handbook: **Examination**  
Subject: **Asset Quality**

This rescission does not change the applicability of the conveyed document. To determine the applicability of the conveyed document, refer to the original issuer of the document.



Section: 251

### Real Estate Owned and Repossessed Assets

**Summary:** This Regulatory Bulletin transmits a revised Examination Handbook Section 251, Real Estate Owned and Repossessed Assets.

*For Further Information Contact:* Your Office of Thrift Supervision (OTS) Regional Office or the Examination Programs Division of the OTS, Washington, DC. You may access this bulletin and the Examination Handbook at our web site: [www.ots.treas.gov](http://www.ots.treas.gov).

*Regulatory Bulletin 37-66*

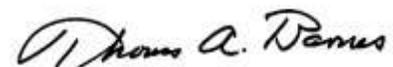
#### SUMMARY OF CHANGES

OTS is issuing revised Examination Handbook Section 251, Real Estate Owned and Repossessed Assets. We restructured the entire section so we did not include change bars in the margins. A summary of all substantive changes are noted below.

#### 251 Real Estate Owned and Repossessed Assets

We revised the narrative to expand and update discussions in many areas and add some new information:

- Revised the definition of “in-substance foreclosure.”
- Added a reference to the OCC’s Bank Accounting Advisory Series (OCC BAAS).
- Provided more detail information on costs incurred related to foreclosure activities and holding costs, discussing those that are eligible for capitalization and those that must be expensed as incurred.
- Revised the References section.



—Thomas A. Barnes  
*Deputy Director*  
*Examinations, Supervision, and Consumer Programs*

## Real Estate Owned and Repossessed Assets

A rapid rise in foreclosures, like that experienced during the 2008-2009 global financial crisis with extensive weakness in the housing market, increases the potential for higher levels of real estate owned (REO) for savings associations. An REO property is a property that is in the possession of a savings association as a result of foreclosure or forfeiture by a borrower. When a savings association repossesses property, there is a distinct possibility of loss on the liquidation of the property; otherwise the borrower would not have defaulted on the loan. REO is typically a poor or non-earning asset. A savings association's acquisition of a limited amount of REO is an unavoidable result of normal business operations. REO includes real estate acquired in the following ways:

- Real estate in judgment.
- Real estate acquired through foreclosure.
- Real estate acquired through deed in lieu of foreclosure.
- Any real property exchanged for foreclosed real estate.
- In-substance foreclosure.<sup>1</sup>

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### LINKS

 [Program](#)

 [Questionnaire](#)

To be considered an “in-substance foreclosure,” it is only necessary for the savings association to have received **physical** possession of the property. It is not necessary for formal foreclosure proceedings to have taken place. This occurs when the savings association becomes aware that the borrower abandoned the property. During the financial crisis, it was not uncommon for borrowers to mail the keys to the property to the savings association, a practice referred to as “jingle mail.”

Other repossessed assets may include non-real estate property the savings association takes possession of to satisfy some or all of a borrower's debt.

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<sup>1</sup> If the savings association does not expect full payment of all amounts due for an impaired, collateral-dependent loan, the savings association should measure the loan's impairment based on the fair value of the collateral less costs to sell when those costs are expected to reduce the proceeds from the sale. Pursuant to ASC 310, the lender should report the impaired loan as an in-substance foreclosure if it has physical possession of the collateral. Other collateral-dependent loans that the lender does not possess remain categorized as loans.

The usual types of other repossessed assets may include the following:

- Personal property: vehicles, mobile homes, boats, airplanes, etc.
- Commercial goods: equipment, furniture, fixtures, inventories, accounts receivable, lease receivables, etc.
- Investments: stocks, bonds, certificates of deposit, etc.
- Other: intangible assets, cash surrender value of life insurance policy, etc.

## Supervisory Concerns

An increase in a savings association's REO and repossessed assets portfolios should serve as red flags to both OTS and management. Increases in these portfolios may indicate deteriorating economic conditions, lax adherence to loan underwriting standards, or deficient loan administration. The absence of REO may be indicative of overly restrictive loan underwriting criteria or a lax foreclosure policy.

You should perform the following steps:

- Review the savings association's internal asset review program.
- Evaluate the adequacy of internal controls for internal asset review.
- Interview management concerning:
  - Detection of potential problem credits.
  - Effectiveness of resolutions (workouts) and collection of problem loans.

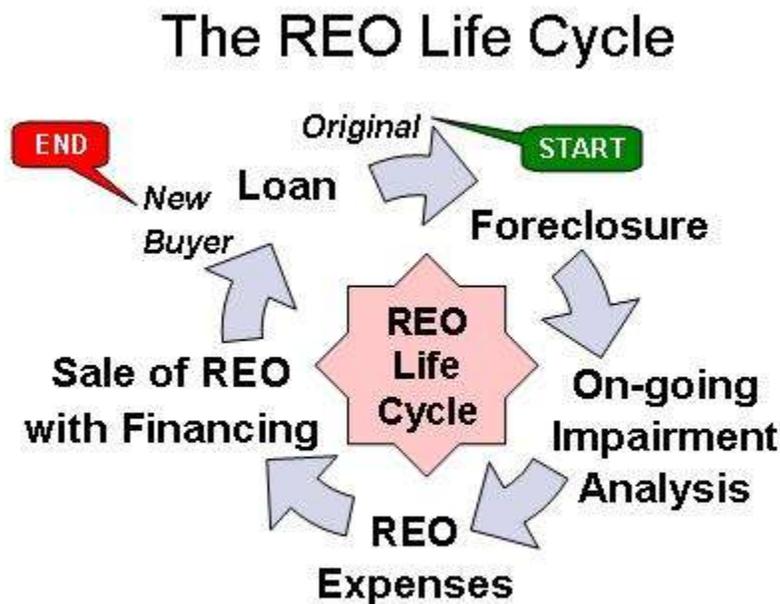
The savings association should evaluate the likelihood of repossessing an asset for all seriously delinquent loans. The savings association should also consider alternatives to repossession. Prior to foreclosure or repossession, management should check with the proper authorities to verify the existence of a valid recorded lien. At that time, the savings association should determine the market value of the collateral. The savings association should also assure sufficient insurance coverage on the asset continues after the savings association takes possession.

The OCC Bank Accounting Advisory Series (OCC BAAS), November 2010, includes many useful practical questions and answers on various topics. Topic 5a addresses issues with real estate owned. The OCC BAAS is located at <http://www.occ.gov/static/publications/BAAS.pdf>

Additionally, examiners may need to evaluate the actual foreclosure processes and procedures of the savings association to assure they are fully complying with all legal requirements. For example, during the financial crisis, systematic signing of legally required documents for foreclosure proceedings, so called "robo-signing" of affidavits was identified. Failure to comply with all legal requirements for foreclosure can, at a minimum, delay the savings association's ability to timely foreclose on the

property, which exposes the savings association to further losses on the property over the extended foreclosure period and, in the worst case, may result in legal determinations that the savings association *does not* have appropriate legal standing to foreclose on the property. Although such practices could be deemed to be a consequence of the overwhelming volume of foreclosure activity occurring during the financial crisis, nonetheless, savings associations have the responsibility to assure that all necessary processes and procedures are followed. It is management’s responsibility to maintain adequate staff, thereby assuring appropriate oversight of these activities, whether performed internally or contracted to vendors. Noncompliance with such practices is considered unsafe and unsound due to the savings association’s loss exposure for failure to comply with legal requirements.

Throughout this Section, we use the terms foreclosure and repossession (and other forms of those terms) interchangeably. The life cycle of foreclosed real estate consists of three phases: acquisition (foreclosure), holding period, and disposition (sale).



### **Accounting for Acquisition of REO**

At the time that the savings association forecloses or an in-substance foreclosure occurs, the lender records the REO asset and removes the related loan from its books. Accounting Standards Codification (ASC) 310-40-40-3 requires that **at acquisition**, foreclosed assets initially be recorded at the fair value of the asset less cost to sell. Generally, the savings association intends to sell the REO and assuming certain accounting criteria<sup>2</sup> are met, the REO would be classified as a “held for sale” asset. Costs to sell **includes** broker commissions, legal and title transfer fees, and closing costs as they are anticipated to reduce the savings association’s proceeds from the sale. (Other costs associated with the REO

<sup>2</sup> ASC 360-10-45-9 through 45-11 Property, Plant and Equipment addresses the Initial Criteria for Classification as Held for Sale.

disposition process, for example, marketing or advertising of the property, are expensed as incurred.) The recording of the REO establishes its new cost basis. (Refer to the following section, **Classification**, for an example of the initial recording of REO.)

In general, savings associations must expense as incurred, any direct foreclosure costs. Such costs may include legal fees, filing fees, and legal notice advertising expenses. Costs incurred by the institution to perfect their lien position *prior to foreclosure* – for example the payment of (1) delinquent property taxes to clear tax liens, (2) payment of contractors/sub-contractors to clear mechanic’s and material men’s liens, or (3) paying off the first lien position on a property where the savings association holds the second lien – may be eligible for capitalization to the cost basis in the *loan*. However, as mentioned previously, at acquisition the REO is recorded at its fair value less costs to sell, so costs incurred to perfect title in the property that are capitalized as an adjustment to the loan’s cost basis may simply result in the recognition of a larger loan loss at foreclosure.

**Classification** – Any excess of the recorded investment in the loan (before any loan loss allowances) over the fair value of the asset received less costs to sell is a loss that shall be recognized by a charge-off against the allowance for loan and lease losses (ALLL). If this loss amount was not previously provided for via an expense charged to the provision for loan and lease losses (PLLL), an additional PLLL may be needed to return the ALLL to an appropriate level. The savings association cannot establish a valuation allowance for this Loss classification as no valuation allowance may be established on the initial recording of REO.

For example, assume a loan is collateral dependant when the savings association takes physical possession of the property.

Loan balance	\$100,000
ALLL previously established for the loan	\$ 10,000
Fair value of asset	\$ 75,000
Costs to sell	\$ 4,000

To record this transaction, remove the loan from the books, record the REO asset, and adjust the ALLL, as appropriate, to charge-off the calculated loss. The journal entry is as follows:

REO (\$75,000 - \$4,000)	\$ 71,000
Allowance for Loan and Lease Losses (\$100,000 - \$71,000)	\$ 29,000 <sup>3</sup>
Loan	\$100,000

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<sup>3</sup> Note that the savings association may need to record an additional provision for loan loss expense for the \$19,000 excess of the charge off over the \$10,000 previously established ALLL to return the ALLL to an appropriate level.

## **Accounting for REO during the Holding Period**

Account for REO after foreclosure at the *lower of*:

- Cost (fair value less costs to sell *at acquisition* or after any direct write-downs, if any), or
- *Current* fair value less costs to sell.

This determination is made on an asset-by-asset basis at each subsequent reporting period.

**Valuation allowances** – The savings association may directly write-off or use a valuation allowance to recognize declines in fair value less cost to sell that occur subsequent to foreclosure. Subsequent recoveries in fair value may be recognized up to cost (fair value of the REO less cost to sell at the acquisition date), i.e., up to the amount of previously recognized valuation allowances. Changes in the valuation allowance are reported in the Thrift Financial Report on SO Line 570 - Net provision for losses on non-interest-bearing assets. Savings associations must report REO on Schedule SC net of any valuation allowances.

OTS policy does not automatically require general valuation allowances (GVA's) on REO. The institution should establish GVAs when the savings association's experience with REO dispositions has been to sell properties at less than their respective fair value estimates. The savings association should base the level of any GVAs on REO on its historical net loss experience, adjusted for current conditions and trends.

Valuation allowances on foreclosed assets (REO) held for sale, whether general or specific, are not recognized as a component of Tier 1 (core) or Tier 2 capital. The regulatory capital standard only allows for allowances related to loans and leases (ALLL) -to be includable in Tier 2 capital up to a certain limit, currently 1.25 per cent of total risk-weighted assets.

**Holding costs** – Costs related to REO while held by the savings association such as insurance, maintenance, real estate taxes, and utility costs should be expensed as incurred. Improvements that either increase the value or extend the useful life of the property (e.g., a new roof, windows, etc.) are eligible for capitalization to the REO balance. However, the resulting new cost basis should be assessed to ensure the REO property continues to be reported at the lower of cost or fair value less cost to sell. Depreciation expense is not recognized for assets held for sale, including REO.

**Classification** – After foreclosure, REO should continue to be evaluated for impairment on at least a quarterly basis. The savings association must classify as Loss and either charge-off any excess of cost over fair value less cost to sell or establish a specific valuation allowance.

## **Accounting for Sales of Real Estate Financed by the Seller**

### **Treatment of Gains and Losses**

ASC 360-20 *Real Estate Sales* describes the accounting treatment for gains and losses incurred at disposition. This standard applies to all transactions in which the seller provides financing to the buyer.

## **Losses**

GAAP requires that if the sale of REO results in a loss, the savings association shall account for the loss in the period it sustained the loss. Any loss on the disposition of REO is always recognized **immediately**.

It is an unsafe and unsound practice for a savings association to fail to recognize losses from the sale of REO where the sales price is inflated above the REO's market value. The inflated price may be a result of favorable terms, such as a below market interest rate, the savings association provided in a loan to facilitate the sale of the REO. In such situations, GAAP requires discounting the sales prices to reflect market interest rates for loans of similar terms and risk. The resulting discount will result in a lower gain or higher loss on the REO sale with the discount recognized as a yield adjustment over the life of the loan. Examiners should take exception and prompt supervisory action when savings associations finance significant amounts of their REO by loans at interest rates substantially below the current market rates for loans of similar quality and risk.

## **Gains**

There are five methods to account for the disposition of REO – full accrual, installment, cost recovery, reduced profit, and deposit. If the sale of REO results in a profit, each method describes the manner in which that profit is recognized.

- Profit shall be recognized *in full* when real estate is sold, *provided*:
  - (a) the profit is determinable, that is, the collectability of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and
  - (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit.
- Unless both conditions exist, recognition of **all** or **part** of the profit shall be postponed.

Recognition of **all** of the profit at the time of sale, or at some later date when both conditions exist, is referred to as the full accrual method.

- Profit on real estate sales transactions shall not be recognized by the full accrual method until all of the following criteria are met:
  - a) A sale is consummated (see ASC paragraph 360-20-40-5).
  - b) The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property (see ASC paragraphs 360-20-40-9 through 40-24).
  - c) The seller's receivable is not subject to future subordination (see ASC paragraph 360-20-40-25).

- d) The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is, in substance, a sale and does not have a substantial continuing involvement with the property.

Depending on which condition for the full accrual method is not met, one of the other methods must be followed until all the conditions are met, at which time, the full accrual method shall be used. The OCC BAAS Topic 5a, questions 10-15 provide information on the various profit recognition methods and examples of their appropriate use. Further guidance can be found in the Call Report instructions and glossary.

The accounting for REO sales can be complex. Examiners should consider consulting with their regional accounting staff as appropriate.

## **Appraisals**

In accordance with 12 CFR § 560.172, savings associations must appraise each parcel of REO at acquisition, consistent with the requirements of Part 564. A savings association must appraise each parcel of REO at the earlier of an in-substance foreclosure or at the time of the savings association's acquisition of the property. Thereafter, prudent management policy dictates the timing of appraisals. The regional director (or designee) may require subsequent appraisals if they deem necessary under the circumstances. Savings associations must carry REO on the books at the lower of recorded cost or fair value less costs to sell.

Although the fair value of the property normally will be determined by an appraisal (or other evaluation), circumstances may justify another prudent valuation method in between appraisals. This may be necessary due to changes in economic conditions since the last appraisal, stale appraisals, or imprecision in the appraisal process (i.e., actual sales for less than the appraised amount). Note that OTS does not require an appraisal upon disposition of the property; however, the savings association's policies may require one.

## **Loans to One Borrower Rule**

Loans to facilitate the sale of real estate do not fall under the loans to one borrower rule *if* the association takes a purchase money mortgage note from the purchaser and meets the following two conditions:

- The savings association does not advance any new funds to the borrower.
- The association is not in a more detrimental position as a result of the sale.

[Examination Handbook Section 211](#) describes circumstances where a savings association may use its salvage powers to exceed the loans to one borrower rules.

## **Five-Year Holding Period**

OTS defines an equity investment in 12 CFR § 567.1 to exclude real property the savings association obtained in satisfaction of a debt or acquired under a judgment or mortgage. This is true if the savings

association does not intend to hold the property for real estate investment purposes and plans to dispose of the property within five years. If requested by the savings association, OTS may approve a longer holding period. OTS considers the extension of time to hold REO a supervisory decision. For OTS to consider such extensions, the savings association should address the following items in its request letter:

- The term of the extension and the reason for the request.
- Whether the savings association, in good faith, tried to dispose of the property.
- How the property is classified for GAAP purposes.

## **REO Hold or Sell Considerations**

Once a savings association acquires a property through foreclosure or repossession, management should begin the decision-making process of whether to hold the property (for example, for use as savings association premises or as a real estate investment<sup>4</sup>) or sell it (possibly in an unfavorable market.) A primary consideration when selling the asset is whether the savings association will have to make a loan to facilitate the sale. The savings association must consider the overall cost should it regain the property by later having to foreclose on the loan to facilitate. If a subsequent foreclosure becomes necessary, the condition of the property may be worse than when the savings association initially took possession. Moreover, if the most recent borrower failed to service the debt at all, the savings association has sacrificed any income it could have received from an interim use of the property.

In making the decision when and if to sell the repossessed property at the least cost to the savings association, management should attempt to quantify, at a minimum, the following costs and benefits:

- Loss on an encumbered quick sale of property “as is.”
- Cost of completing, restoring, or enhancing the property.
- Cost to prevent deterioration of the asset during the anticipated holding period, including:
  - Insurance and property taxes
  - Physical security (fencing, security service, etc.)
  - Maintenance (mowing, utilities, structural repair, etc.)
  - Intangible (lost goodwill, etc.).

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<sup>4</sup> Savings associations are allowed to make direct investments in real estate as premises used in their business or as real estate investments **through subsidiaries**. However, direct investments in real estate through subsidiaries results in the subsidiary being deemed “non-includable” for regulatory capital purposes, which has significant regulatory capital impacts.

- Cost of selling the property (advertising, broker's commission, correction of defects observed at inspection, etc.).
- Opportunity costs to the savings association, for example, based on the alternative uses of the sales proceeds.
- Cost of providing favorable financing (i.e., discount future and probable cash flows to present value based on an appropriate market interest rate).
- Anticipated appreciation or depreciation in REO fair value during the holding period.
- Benefit when the property is sold at the end of the holding period (e.g., discount proceeds to present value and determine yield based on current market rates).
- Benefit of interim use of the property in a lease or rental arrangement.
- Requirements imposed by 12 CFR § 567.1 to dispose of equity investments in real property within a specified time period to maintain capital rule treatment as REO. This period is generally five years unless OTS approves a longer period.

The above analysis should assist management in making an informed decision on the disposition of the savings association's REO and other repossessed assets.

## Internal Asset Review

As a sound banking practice, savings associations should conduct periodic reappraisals and reassessments of REO and other repossessed assets. Exceptions to this requirement are discussed in the Appraisals section presented earlier. The classification of assets regulation does not mandate that the institution *automatically* classify all foreclosed property. [Handbook Section 260](#), Classification of Assets, discusses the specific considerations for the classification of REO. REO is sometimes an unsound asset even when recorded at fair value. REO can often be non-income generating. The savings association's acquisition of the property normally indicates a lack of demand. As time passes without disposition, the lack of demand becomes more apparent and the quality of the asset becomes more doubtful.

The savings association should consider each repossessed item on an individual basis and, if necessary, classify it adversely on the basis of facts supporting the evaluation. For instance, if a developed parcel of REO is receiving steady cash flows at a market yield, an adverse classification may not be necessary.

## Real Estate Owned (REO) Workouts

Management must assess the level of in-house expertise available to manage REO workouts. Management should consider looking outside the association for the necessary level of expertise when appropriate. This includes recruiting and employing real estate workout specialists and using real estate workout companies on a contract basis.

Management is responsible for reviewing the economic merits of outsourcing REO disposition plans. If any savings association identifies any regulatory issues of concern during its process of selecting an outside REO workout program, it should raise these issues with the appropriate examination or supervisory personnel. They will provide advice on whether the vendor's proposal conforms to regulatory procedures and safe and sound practices. Savings associations should be aware that OTS neither approves nor endorses specific REO workout proposals. Savings associations should bring to OTS's attention any representations by any organization to the contrary.

## REFERENCES

### Code of Regulations (12 CFR)

§ 560.30	General Lending and Investment Powers
§ 560.93	Lending Limitations
§ 560.100-101	Real Estate Lending Standards
§ 560.160	Asset Classification
§ 560.172	Re-Evaluation of Real Estate Owned
§ 567.1(i)(4)	Definition of Equity Investment in Real Property

### OTS CEO Letters

CEO Letter 292, Temporary Suspension of Home Mortgage Foreclosures, February 12, 2009 (<http://www.ots.treas.gov/files/25292.pdf>)

CEO Letter 325, Guidance on Prudent Commercial Real Estate Loan Workouts, October 30, 2009 (<http://www.ots.treas.gov/files/25325.pdf>)

### Financial Accounting Standards Board Accounting Standards Codification (ASC)

ASC 310-40 *Accounting for Troubled Debt Restructurings by Creditors* (formerly SFAS 15 and SFAS 114)

ASC 360-10-35 through 10-45 *Impairment or Disposal of Long-Lived Assets* (formerly SFAS 143 and SFAS 144)

ASC 360-20 *Real Estate Sales* (formerly SFAS 66)

### Other Guidance

OCC Bank Accounting Advisory Series, December 2008 (Many practical questions and answers) <http://www.occ.gov/static/publications/BAAS.pdf>

Federal Financial Institutions Examination Council, February 10, 1995, Implementation Issues Arising from FASB Statement No. 114, “Accounting by Creditors for Impairment of a Loan”  
[Federal Register](#)

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# Real Estate Owned and Repossessed Assets Program

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## EXAMINATION OBJECTIVES

To determine if the savings association's policies, procedures, practices, internal controls, and accounting treatment regarding real estate owned (REO) and repossessed assets are adequate to maintain safe and sound operations at the following stages:

- Acquisition
- Valuation
- Management and maintenance
- Completion and improvement
- Disposition.

To determine the extent of the savings association's compliance with applicable state and federal regulations and its own policies.

To evaluate the quality of the saving association REO and repossessed assets.

To determine the adequacy of the internal asset review and audit functions in this area.

To determine whether the current or anticipated level of REO and repossessed collateral is consistent with the savings association's business plan and safe and sound banking practices.

To determine the extent of the repossessed assets' effect on operations.

To determine whether the savings association continues to pursue repayment from the borrowers after it sells the collateral.

To determine management's and the board's willingness and ability to initiate corrective action when policies, procedures, practices, and internal controls are deficient.

To summarize findings and to initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note, and bring to their attention, violations of laws or regulations.

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<b>Reviewed By:</b>	
<b>Docket #:</b>	

# Real Estate Owned and Repossessed Assets Program

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WKP. REF.

## EXAMINATION PROCEDURES

### LEVEL I

1. Review scoping materials applicable to this program. If another examiner performed the review of scoping materials, obtain a written or oral summary of the information in the scoping materials relating to this program. Refer to the examiner in charge (EIC) or EIC-designee for instruction, if needed.

Scoping materials might include the following items:

- Prior examination report.
- Exception sheets and work papers.
- Internal/independent audit reports.
- OTS financial analysis reports.
- Supervisory analysis.
- Correspondence.
- Business plan.
- Minutes of the meetings of the board of directors.
- PERK information.
- Review of market area economic conditions.

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2. Review the preceding report of examination and all REO and other repossessed asset-related exceptions and determine whether management has taken corrective action.
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# Real Estate Owned and Repossessed Assets Program

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WKP. REF.

3. Determine the adequacy of the savings association's policies and procedures on REO and other repossessed assets by thoroughly reviewing pertinent items such as: policy statements, the internal asset review program, procedures manuals, the savings association's business plan, and board and committee minutes.

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4. Conduct interviews with management and ascertain compliance with policies and procedures. Determine whether management reviews policies and procedures periodically and communicates changes to the appropriate savings association personnel.

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5. Determine if the savings association's procedures, controls, and objectives in this area are safe and sound and in compliance with applicable laws and regulations.

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6. Ascertain the major causes of repossessions and foreclosures (for example, inadequate credit or collection policies, loan concentrations, unsound construction lending procedures, poor appraisal policies or inadequate appraisal reports, depressed economic conditions, reacquisitions). Determine if management is aware of the underlying causes. Determine if they improve or correct policies and procedures when necessary.

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7. Determine if the savings association has adequate staff to manage its current and projected levels of REO. Ascertain if management informs the employees responsible for managing these assets of relevant policies and procedures.

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# Real Estate Owned and Repossessed Assets Program

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8. Determine if management has realistic plans for disposing of the REO and other repossessed assets portfolios. Determine whether management has considered the need for professional consulting or management firms to manage its more sophisticated acquisition, development, or construction type projects. If management is opting to retain the property, the analysis and documentation justifying such a decision should be on file.

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9. Determine whether the savings association's real estate workout personnel have sufficient expertise to effectively manage the savings association's REO. Additionally, consider whether the savings association uses REO workout consultants or other third-party professionals to assist in this area, and whether the savings association's management adequately scrutinized these arrangements.

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10. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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## LEVEL II

11. Obtain a detailed listing of the assets and reconcile to the general ledger balances. Determine if the savings association correctly reports REO and other repossessed asset balances on the Thrift Financial Reports (TFR). Request that the savings association make corrections to the TFR(s) or correct reporting on the next TFR, if you determine that they incorrectly report REO and other repossessed asset balances.

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# Real Estate Owned and Repossessed Assets Program

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12. Determine whether the savings association established any specific loss reserves and made charge-offs where warranted. In establishing valuation allowances, determine if management reviews the following considerations:

- Vandalism to the property.
- Anticipated demolition or razing.
- Additional construction costs to complete, restore, or improve.
- Obsolescence.
- Compliance with zoning requirements.
- Failure to sell at asking prices.
- The costs of managing and maintaining REO.

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13. Prepare the proposed asset classification write-ups (if warranted) and determine management's concurrence. Leave a list of all proposed REO and repossessed asset classifications with management.

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14. Review a list of all loans to facilitate the sale of REO or significant other repossessed assets.

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15. Determine if the terms of sale are realistic and that the savings association structured the loan to a creditworthy borrower such that reacquisition is unlikely. Determine if the savings association overstates sales and prices to defer losses. Analyze the effective cost of below-market financing and whether the savings association recorded the proper profit or loss.

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# Real Estate Owned and Repossessed Assets Program

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16. On a selected sample of asset files, check source documents (receipts, invoices, etc.) against general ledger entries. Ensure the association made accurate accounting entries to capitalize certain REO costs. Appropriate capitalizations limited to fair value might include the following items:

- Unpaid loan balances, excluding accrued uncollected interest.
  - Taxes and assessments advanced and due, or those accrued up to the time of acquisition.
  - Insurance premiums advanced.
  - All other unpaid advances due at the time of acquisition.
  - Improvements or enhancements that add to value.
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17. Determine whether the savings association capitalizes expenses of REO operations in an attempt to defer operating losses. Request that the savings association correct the entries where necessary.

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18. From a selected sample, determine whether the savings association holds a valid title for REO and other repossessed assets.

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19. Determine that the savings association paid any taxes due on REO parcels as required by local law.

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20. Determine if the savings association obtained adequate hazard and public liability insurance for REO selected for review.

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# Real Estate Owned and Repossessed Assets Program

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21. Review a selected sample of REO acquisition appraisal reports for conformance with the savings association's appraisal policies and determine whether the savings association obtained the appraisals promptly upon foreclosure. Ensure that the savings association obtains annual reappraisals when appropriate and in conformance with the savings association's appraisal policies. Calculate fair values when necessary.
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22. Reconcile foreclosed and repossessed property totals for this examination to totals from the previous examination using the following documents:
- Current listing of foreclosed and repossessed assets.
  - Summaries of assets sold.
  - Attorneys' letters.
  - Minutes of the board of directors and applicable committees.
  - Work papers from the previous examination.
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23. Review the sales of all foreclosed and repossessed property since the previous examination. (A sampling is acceptable if there a large number of transactions.) Determine if management is pursuing personal liability judgments against borrowers, if allowed by law. Obtain management's response if it is not.
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24. Prepare a summary income statement dealing only with REO operations to determine the carrying cost of the REO portfolio. The statement should cover the period since the previous examination and be comparable with similar analyses performed during prior examinations. Where significant, determine net operating income (NOI) (or net operating loss (NOL)) from REO operations. Note that the savings association must consider the cost of funds attributable to the average monthly balance of REO. Use the actual composite cost of money for the period being reviewed. That means apply the weighted average rate payable on deposits and borrowings to the balance of the REO account. Determine whether the savings

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WKP. REF.

association modified objectives, policies, and procedures for REO operations (acquisition, management, and disposition) based on the levels of income or loss reported.

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25. Ascertain the effectiveness of management's efforts to prudently dispose of REO and other repossessed assets by determining if the savings association performs the following procedures:

- Sets reasonable sales (asking) prices compared with appraised values.
  - Lists and advertises properties with brokers.
  - Maintains reasonable selling expenses.
  - Maintains sales volume commensurate with market conditions.
  - Documents whether and why it holds properties off the market.
  - Analyzes the overall cost of previously sold REO now brought back into the portfolio, noting the increased cost, if any, to reclaim the property and restore it to its previous condition.
  - Modifies disposition objectives (as stated in the business plan) and policies based on sales experience and market characteristics.
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26. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

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## LEVEL III

27. Consider the following and determine the need for property inspections:

- Comparisons of book values and appraised values.
- A review of the asset files.

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- Interviews with management.

Inspect appropriate properties to determine the following:

- Marketability.
- Reasonableness of appraised values.
- Quality of property maintenance.
- Whether OTS should require independent appraisals.

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28. In the event the independent auditor's work papers are not available, you should take the following actions:

- Test check accounting entries for any property disposed of since the previous examination.
- Review bids on sold assets for propriety.
- Review any transactions with insiders or affiliates.
- Ensure that the savings association properly recognized gains and losses on sales.
- Review sales made on the basis of loan terms that were unreasonably favorable to the purchaser or borrower.
- Determine whether the savings association gave excessive commissions, fees, or other preferential treatment to dealers, brokers, or attorneys involved in handling foreclosures or repossessions.

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## EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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# Real Estate Owned and Repossessed Assets

## Questionnaire

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Yes No

### GENERAL QUESTIONNAIRE

1. Does the institution give proper notification to the borrower prior to foreclosure or repossession?
2. Does the institution promptly foreclose or repossess to minimize the risk of loss?
3. Does the institution hold valid title to REO?
4. Does the institution review REO it acquires by deed in lieu of foreclosure for encumbrances of prior liens?
5. Does the institution appraise real estate it acquires subsequent to its acquisition?
6. Does the institution use a current appraisal to establish the asking price of property?
7. Are there maintenance procedures in effect to ensure that properties will retain their market value?
8. Are procedures in effect to ensure that the institution maintains and updates hazard insurance as necessary?
9. Does the institution maintain separate subsidiary records and files for each parcel showing items capitalized, expenses, rentals, etc.?
10. Does the institution reconcile subsidiary ledgers for the individual properties to the general ledger at least monthly?  
By whom? \_\_\_\_\_
11. Does the institution control rental income received from REO?
12. Do any unbonded agents collect rents and/or manage properties?
13. Does the board of directors periodically review the status of each REO parcel and repossessed asset?  
How frequently? \_\_\_\_\_
14. Does an officer that reports to the board of directors approve sales of REO and other repossessed assets?

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