TO: All Examination Staff and All State-Chartered Banks
FROM: George E. Myers, Director of Examinations
RE: OSBC Comprehensive Other Real Estate Policy and Guidelines
DATE: November 1, 2004

This memo revises the OSBC Comprehensive ORE Policy and Guidelines memo RM1997-6 dated 7/15/97 and replaces all prior ORE pronouncements issued by the Office the State Bank Commissioner (specifically, memo 94-8, issued 2/25/94 and 94-16, issued 6/23/94).

OTHER REAL ESTATE DEFINED
ORE consists of all real estate held by the bank, which is not a part of bank premises or expressly intended for future expansion as governed by K.S.A. 9-1102(2).¹

TRANSFER FROM LOANS TO ORE
The transfer from loans to the ORE account should be made when any one of the following three conditions are present: 1) the bank has received title or deed to the property; 2) the property is in a redemption period following the bank's purchase at sheriff's sale,² or 3) the bank has actual control of the property.

HOLDING PERIODS FOR ORE
A) Any real estate, which is not necessary for the accommodation of the bank's business, must be disposed of or charged off not later than seven (7) years after its acquisition. If the real estate is necessary and the bank has a plan approved by the Board, the bank may carry the real estate in Premises and Equipment; otherwise, it must be transferred to ORE. The Commissioner may grant an extension for a period of up to three (3) additional years.
B) Real estate acquired in satisfaction of any debts (DPC)³ may be carried on the bank's books for a period of 10 years. The Commissioner may grant extensions not to exceed four years. The Commissioner is required to review such extensions on an annual basis. In cases involving a sheriff's sale, the holding period begins immediately after the redemption period. If a bank reacquires ORE property through a default on a prior bona fide sales contract, the time period for holding the property starts over.

ORE ACCOUNTING TREATMENT
Banks acquire a majority of their ORE property for debts previously contracted, otherwise known as DPC. Typically, this property is acquired through foreclosure, or by deed in lieu of foreclosure. In either case, the property should be booked at its fair market value or cost (see definitions below), whichever is less. At the time the property is acquired, any excess of book value over fair market value should be charged off through the loan loss reserve. Subsequent changes in market value are discussed below under "ORE Reserves."

Fair Market Value - is defined as that amount which could reasonably be expected to be received in a current sale (within one year) from a willing buyer. This amount must be supported by an acceptable written appraisal.

¹ Updated 2019. New statutory cite is K.S.A. 9-1102(a).
² Updated 2019. Reference should be judicial sale.
³ Updated 2019. DPC stands for Debt Previously Contracted.
**Cost** - includes book amount of the loan, unpaid balance of any senior liens on the property (including back taxes) which are assumed or paid in full by the bank, plus accrued interest receivable.*

* The accrued interest receivable added to the cost figure consists only of that balance on the books at the time the ORE is acquired. Previously charged off accrued interest or lost interest since placing the loan on nonaccrual should not be reinstated.

**OTHER ACCOUNTING ISSUES**

**Capitalize or Expense**

Any funds expended by the bank for real estate taxes or property insurance prior to foreclosure may be capitalized providing the fair market value of the property supports the addition. Otherwise, such amounts should be expensed immediately regardless of any right to recover these costs from proceeds of a potential future sale.

Legal fees and other direct expenditures (recording fees, abstracts, etc.) paid by the bank to foreclose and acquire clear title should be expensed when incurred.

The treatment of holding costs, or cost associated with ORE during the period it is held by the bank, and whether those costs are capitalized or expensed, hinges on whether or not the property is "substantially complete." That is, is the property in such condition so as to be generally marketable under ordinary conditions.

Holding costs which are associated with property that is not substantially complete and which are required to bring the property up to a saleable condition may be capitalized, provided there is sufficient value in the property. Examples would include major structural repairs, etc. Holding costs associated with a property which is substantially complete should be expensed when incurred. Examples would include minor fix-up repairs, maintenance painting, etc. Other typical holding cost which should be expensed when incurred include current real estate taxes, utility fees, property insurance, routine maintenance, property management fees, and so forth.

**Prior Liens**

When a bank acquires ORE subject to a prior existing lien and assumes contractual liability for that lien, the balance is added to the cost for comparison against fair market value, and a corresponding liability (mortgage indebtedness) on the bank's books for the lien balance is necessary. As payments are made, the bank should debit the mortgage indebtedness account for the principal portion, and the noninterest expense account for the interest portion. The compensating credit entry would be to cash.

If the bank does not assume contractual liability for the prior lien, the balance is not added to the cost for comparison against fair market value. If the bank chooses to voluntarily make payments in order to forestall foreclosure, etc., the interest portion of the loan payment should be expensed (other noninterest expense) and the principal portion may be expensed or capitalized, based on the assumption that principal payments reduce the prior lienholder's interest in the property and increases the bank's equity position. Again, principal payments
may only be capitalized to the extent they are supported by the fair market value of the property.

Adjustments to Book Value of ORE

The book value of ORE may be increased to reflect subsequent increases in fair market value, but only to the extent of the outstanding loan balance at the time the property was moved to ORE. When the bank has foreclosed on the entire indebtedness of a borrower and ORE is acquired through foreclosure in partial satisfaction of a borrower's indebtedness, the debtor's total liability to the bank is compared against the fair market value of the property to determine the carrying amount of the ORE. The total liability includes all debt, whether or not secured by the real estate. Example: A borrower has two notes, one for $100,000 unsecured and one for $50,000 secured by a REM on property with a fair market value of $70,000. The bank forecloses and obtains the property. The ORE is booked at the lower of cost or market, in this case $70,000 since that is less than the total foreclosed debt of $150,000. In this example, the remaining $80,000 of debt would be charged against the loan loss reserve.

In any event, the amount at which ORE is booked may only be increased to the extent it offsets loan losses the bank would otherwise incur.

Short Term Charge Offs

When a bank receives property through foreclosure, any charge offs within 90 days may be taken through the loan loss reserve. Subsequent losses or gains should be treated as other noninterest income or expense, or a credit/debit to the ORE reserve (see below).

PROPER DOCUMENTATION

Proper documentation on ORE shall consist of a legal description of the property, the name of the original debtor, total amount of indebtedness for which the property was acquired, the cost of acquisition, the cost of alterations, the assessed valuation of the property, the book value, the amount and expiration of insurance, and the fair market value supported by an appraisal.** The bank's failure to maintain this documentation will be cited as a violation of K.A.R. 17-11-17.

** Per department policy, adequate ORE appraisal documentation shall consist of a current appraisal (within 90 days) when the property is moved to ORE. Every year thereafter, the fair market value shall be supported by an appraisal or appraisal update. The appraisal may be generated internally or one obtained from an independent source.

OTHER REAL ESTATE SWAPS

Swaps involve the bank trading an ORE property to some other entity for another property. In general terms, such arrangements are permissible, provided the proposed swap would be in the bank's best interest and adequate documentation exists which justifies that conclusion. Time limits for holding the property will not restart after the swap. The merits of any swap will be reviewed on a case-by-case basis.
SALE OF ORE BY BANK
In addition to a straightforward cash sale, there are several "sale on contract" methods by which a bank may reflect the sale of ORE property. These methods are defined under FASB 66\(^1\). The appropriate method for the bank to use largely depends upon various factors and conditions relating to the structure of the sale agreement. These methods involve timing on recognition of income from the sale, and to some extent, related tax implications. In the past, Call Report instructions provided two basic criteria necessary to move the ORE to the loan or contracts receivable category. These criteria are "Buyer's Initial Investment" or down payment, and the likelihood of collection of the receivable by way of a reasonable amortization period, or "Buyer's Continuing Investment". They were defined as follows:

Buyer's initial investment: or down payment, must equal or exceed 10% of the sale price of the ORE. The payment must be in the form of cash, either from personal sources or a lending institution unrelated to the selling bank; or, direct payments by the buyer to third parties to reduce existing indebtedness (liens) on the property. Other consideration provided by the buyer will only qualify as part of the initial investment when it is sold or otherwise converted to cash without recourse to the seller.

Payments by the buyer to third parties for improvements to the property; a permanent loan commitment by an independent third party to replace a loan made by the seller; any funds that have or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller; or, any loans guaranteed or collateralized by the seller for the buyer will not count toward the initial investment requirement.

Buyer's continuing investment: or amortization period, must be such that the buyer is contractually required to pay each year on the total debt for the purchase price an amount at least equal to the amount that would be necessary to amortize the debt within: A) 20 years for farm ground or unimproved land, or B) the normal first mortgage amortization period an independent institution would use for other types of real estate. If the buyer's initial investment (down payment) exceeds the 10% minimum requirement, the excess may apply toward the buyer's required annual continuing investment (amortization).

The FFIEC Interagency Guideline on Accounting for Dispositions of Other Real Estate (July 16, 1993)\(^2\) revised call report instructions, beginning with the 6-30-93 report date, and eliminated the minimum down payment requirement previously contained in the instructions. The result was that, in theory, the financed sale of ORE property without a minimum 10% down payment and normal amortization period could, under certain FASB 66\(^3\) options, be reported as a loan rather than continuing to be carried as ORE. In actual practice, however, it is unlikely most banks would choose this option for the following reasons: The accounting structure associated with these options may dictate the resulting booked loan be carried as nonaccrual or have an amortization period substantially in excess of similar type loans, both strong factors for potential adverse classification. Secondly, the holding period for ORE properties, as referenced previously, diminishes the possible pressure a bank may feel to move the asset out of the ORE category in order to avoid a mandated write off. Given the choice of continuing to report as ORE property sold under terms which do not qualify it for

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\(^1\) Updated 2019. Accounting Standards Codification 360.20.
\(^3\) Accounting Standards Codification 360.20.
treatment under the "full accrual method" vs. reporting it as a loan with high potential for adverse classification under one of the other FASB 66 methods, it appears most banks may opt for the former. In cases where the bank has chosen to record the financed sale ORE property which lacks a minimum 10% down payment and normal amortization period as a loan rather than ORE, examiners will request appropriate documentation from the bank which demonstrates compliance with the FASB 66 method utilized. Normal credit evaluation standards will apply.

ORE RESERVES

Subsequent to the initial recording of ORE at the lower of fair market value or cost (see definition above), AICPA statement of position "Accounting for Foreclosed Assets" (SOP 92-3) describes the use of valuation allowances for ORE (similar to the reserve for loan losses) for additional changes in the fair market value of the property. Historically banks have reflected subsequent changes in market value by a direct charge to earnings, or the postponement of gains until the property is sold. While this method is more conservative, Call Report instructions encourage the use of an ORE valuation reserve. Under this method, changes in value are recognized by a debit or credit to the reserve with a corresponding increase or decrease to income. Banks may have either a general ORE reserve based on some percentage of the total ORE balance, etc., or a specific ORE reserve tied to individual properties, or both.

The following guidelines should be followed for ORE reserves:

- ORE reserves (general or specific) are not counted as part of Part 325 risk based or leveraged capital components. General ORE reserves will be included for legal lending limit computations, while specific reserves will not;
- ORE reserves may be established for potential losses only. As with loan reserves, any actual losses should be taken as they become apparent; and
- For report of examination purposes, general ORE reserves will not be netted against the carrying value of individual ORE properties to determine the amount subject to classification. Specific ORE reserves, however, will be netted from amounts classified. The ORE balance reflected on page 2 of the report will be a balance net of both general and specific ORE reserves. This is consistent with the Call Report instructions for valuation of reserves.

CLASSIFICATION OF ORE

Any portion of ORE booked above the current fair market value of the property shall be listed as "Loss" for report purposes. All ORE parcels which do not, or are not reasonably projected to generate a level of earnings comparable to the bank's overall cost of funds shall, with limited exceptions, be listed as "Substandard". However, the property will be excluded from Substandard classification if the estimated fair market value of the property is such that, upon its liquidation in a reasonable period of time (generally not to exceed 2 years from the date of acquisition), the sale proceeds are expected to be sufficient for the bank to recoup both its principal investment and a rate of return of at least the overall cost of funds.

The cost of funds may be determined by use of a current UBPR (within 3 months), or calculated from Call Report data.