

2nd Discussion DRAFT – OREO Rule

**WAC 208-476**

**WAC 208-476-010 – Reason for rule**

Why do Washington State-chartered credit unions need a rule on the handling of “other real estate owned” (OREO), property legally owned by the credit union as the result of foreclosure, or acquired as the result of default on a loan collateralized by real property?

Although most financial institutions that do real estate lending have experienced an occasional foreclosure, the volume and asset value of foreclosed property has significantly increased recently. Due to the economic downturn that began in **the fourth quarter of 2007**, credit unions are now experiencing a greater number of foreclosures and acquiring portfolios of OREO. Because this type of economic effect is cyclic, it is useful for credit unions to be prepared to handle OREO property in a safe and sound manner. Some credit unions may find their number of OREO properties is becoming more difficult to manage. Some credit unions may be dealing with OREO properties for the first time.

The Department of Financial Institutions, Division of Credit Unions, is responsible for regulating to protect the integrity of credit unions as cooperative institutions, and to ensure that they remain viable and competitive. RCW 31.12.015. It is important to provide regulatory standards for safe and sound management of OREO. RCW 31.12.005(24).

## **WAC 208-476-020 – Rulemaking authority**

What is DFI's rulemaking authority for these OREO rules?

The Division of Credit Unions is delegated rulemaking authority by the Director of DFI. DFI's rulemaking authority is based upon the of the Washington Credit Union Act, RCW 31.12.516(2), which allows the Director to adopt rules that are reasonable and necessary to carry out the purposes of the WCUA. The Director has the power and broad administrative discretion to administer and interpret the provisions of the WCUA. RCW 31.12.516 (4). In addition, the Director has specific rulemaking authority regarding secured or unsecured loans to members. RCW 31.12.426 (1).

## **WAC 208-476-030 – Authority of Director to require reports**

What legal authority does DFI have to require special reports from credit unions, accounting for OREO?

The Director has the statutory authority to require a credit union to file any financial or statistical report the Director may require. The Director, therefore, has the authority to require special reports on OREO properties held by Washington state-chartered credit unions. RCW 31.12.567.

## **WAC 208-476-040 – Authority for credit unions to hold real estate**

What is the legal authority for a credit union to acquire, hold and dispose of OREO?

A Washington state-chartered credit union is permitted to own foreclosed and other OREO property, based on its statutory power to make secured and unsecured loans to its members. RCW

31.12.426(1). If the borrower defaults on a loan secured by real property, the credit union has the authority to obtain title to the property as a power incidental to its normal course of business.

### **WAC 208-476-050 – Definitions**

For purposes of these rules, the following definitions apply:

“Appraisal” means a written report by a certified or licensed appraiser containing sufficient information to support the DCU’s evaluation of OREO, taking into consideration market value, analyzing appropriate deductions or discounts, and conforming to Generally Accepted Appraisal Standards, unless principles of safe and sound credit union practices require stricter standards.

“DCU” means the Division of Credit Unions of the Washington State Department of Financial Institutions

“DFI” means the Washington State Department of Financial Institutions

“Director” means the Director of the Department of Financial Institutions, or the Director’s designee, typically the Director of the Division of Credit Unions

“Fair value” and “fair market value” mean the cash price that might reasonably be anticipated in a current sale under all conditions requisite to a fair sale, in which the buyer and the seller are each acting prudently, knowledgeably and under no necessity to buy or sell. An appraisal at “fair value” estimates the cash price that might be received upon exposure to the open market for a reasonable time, considering the property type and local market conditions.

“Foreclosure” means the termination of all rights of a mortgagor or grantee in the property covered by a mortgage.

“GAAP” means “Generally Accepted Accounting Principles”

“GAAS” means “Generally Accepted Appraisal Standards,” as stated in the Uniform Standards of Professional Appraisal Practice by the Appraisal Standards Board.

“Home Valuation Code of Conduct” means the Federal Housing Finance Agency (FHFA)’s current “Home Valuation Code of Conduct” for the improved reliability of home appraisals.

**“Other Real Estate Owned” (“OREO”) means real estate acquired by a lender in whole or partial satisfaction of a debt owed to a credit union, by means of foreclosure or deed in lieu of foreclosure, and held in inventory until sold. “OREO” does not mean real property held for the credit union’s own business use or expansion under RCW 31.12.438.**

**“Recorded amount of the loan” means the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest.**

“Sheriff’s sale” means a sale of property by the sheriff under authority of a court’s writ of execution in order to satisfy an unpaid obligation.

## **WAC 208-476-100 – Limitations on Holding of OREO**

**[DRAFTING NOTE TO STAKEHOLDERS: there are several alternative approaches to defining the parameters for reasonable “holding” of OREO, from a business and**

regulatory perspective. This section presents a spectrum of possible approaches, for discussion purposes. After dialog and input from stakeholders, one approach will be chosen as optimal, and the draft text will be circulated to stakeholders for comment. The alternatives under consideration are:]

1. Office of the Comptroller of the Currency (OCC) model: 5 year holding, with 5 additional years upon showing of good faith effort to sell and regulatory approval. Total of 10 years.
2. Alaska model: 5 year initial holding period, with 20% write-down per year after the initial period.
3. Texas model: 5 years, with additional years upon application to DFI, approval at regulator's discretion, using a form.
4. RCW 31.12.438 timeframe model: can hold for 3 years, parallel with the investment for business use and expansion timeframe for CU real estate under RCW 31.12.438. DCU Director may waive the limitation.
5. NCUA model: can hold for 1 year.
6. DoB: can hold for 5 years. No reauthorization process.

**ROUGH DRAFT SECTION ON HOLDING [terms blank until determined]**

**How long is a credit union allowed to hold OREO?**

OREO must be disposed of as soon as prudent business judgment dictates, and in no case longer than \_\_\_\_\_ years, absent special circumstances and discretionary approval by the Director. The longer real estate is held, the more speculative an investment it becomes.

### **When does the holding period begin?**

The holding period begins on the date that the credit union exercises its legal right to take possession of the OREO property.

### **What if the OREO is not sold within the initial holding period?**

An application to hold other real estate owned beyond the \_\_\_\_\_ year initial holding period must be timely filed on the DFI form provided with this rule. The Director of DCU may require additional justifying information, and the granting of an additional holding period is at the regulatory discretion of the Director.

The Director may waive the holding period requirements for extension of holding OREA, at the Director's discretion.

### **What basic standards are used to determine the initial and ongoing regulatory acceptability of holding OREO?**

Holding requirements include, at a minimum, the following:

1. Accurate accounting for OREO. Refer to the accounting section of this rule at WAC 208-476-200
2. Obtaining independent written appraisals, updated annually or more frequently, to reflect changed market conditions
3. Diligent marketing efforts, including a written marketing plan, updated periodically to reflect changed market conditions
4. Compliance with safe and sound OREO practices, set forth in the safe and sound practices section of this rule at WAC 208-476-300.
5. Compliance with any determination or directive issued by the Director of DCU regarding the holding of OREO

## **WAC 208-476-200 – Accounting for OREO**

### **What accounting procedures and standards are state-chartered credit unions required to follow when accounting for OREO?**

In general, the accounting and reporting standards for foreclosed real estate are covered by GAAP. Credit unions may rely upon GAAP in performing accounting procedures for the OREO portfolio, unless otherwise specifically stated in this rule.

Accounting and reporting standards for OREO are set forth in Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings (FAS 15)*, and Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144)*. In addition, certain provisions of the American Institute of Certified Public Accountants (AICPA) Statement of Position 92-3, *Accounting for Foreclosed Assets (SOP 92-3)*, have been retained because they represented prevalent and safe and sound credit union practices. The provisions retained from AICPA SOP 92-3 include that when a credit union receives OREO from a borrower in full satisfaction of a loan, the long-lived asset is presumed to be held for sale, and the institution should initially record the OREO at its fair value less cost to sell.

After the preacquisition analysis and decision to acquire OREO, the life cycle of foreclosed real estate consists of three phases: acquisition, holding period, and disposition. Credit unions should ensure that proper accounting policies and controls are in place during each phase. Management should refer to the applicable accounting standards and the *Instructions for Call Reports* to determine the appropriate regulatory reporting of OREO based on the specific facts and circumstances relating to the property and related transactions.

Credit union management is encouraged to consult with knowledgeable accounting professionals as necessary, especially in those situations where the transaction is uncommon or complex in relation to the credit union's expertise.

### **Accounting for OREO at Acquisition**

Foreclosed real estate received in full or partial satisfaction of a loan should be recorded at the fair value less costs to sell the property at the time of foreclosure. This amount becomes the "cost" of the foreclosed real estate. According to FAS 144, "costs to sell are the incremental direct costs to transact a sale," which include "broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred."

When foreclosed real estate is received in full satisfaction of a loan, the amount, if any, by which the recorded amount of the loan exceeds the fair value less cost to sell the property is a loss which must be charged to the allowance for loan and lease losses at the time of foreclosure.

The amount of any senior debt (principal and accrued interest) to which foreclosed real estate is subject at the time of foreclosure must be reported as a liability in the Call Report as "Other borrowed money." Legal fees and other direct costs incurred in a foreclosure should be expensed as incurred.

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

After foreclosure, each foreclosed real estate asset must be carried at the lower of (1) the fair value of the asset minus the estimated costs to sell the asset or (2) the "cost" of the asset. This determination must be made on an asset-by-asset basis.

In preventing OREO from further deterioration during the holding period, credit unions typically incur a variety of expenses. These holding costs, including interest on prior liens, generally should be expensed as incurred.

If permanent improvements are made to a foreclosed real estate asset that increase the property's value, these expenditures generally would be eligible for capitalization to the cost of the OREO. In addition, if a credit union completes the construction of foreclosed real estate projects it should refer to such standards as Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Cost (FAS 34)*, and Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects (FAS 67)*, for relevant accounting guidance.

In addition, if the property generates revenue during the holding period, the credit union should recognize the income generated from the property

### **Accounting for OREO in the Disposition Phase**

The primary source of accounting guidance for sales of foreclosed real estate is Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate (FAS 66)*. This standard, which applies to all transactions in which the seller provides financing to the buyer of real estate, establishes five methods to account for the disposition of OREO -- full accrual, installment, cost recovery, reduced profit, and deposit. If a profit is involved in the sale of real estate, each method sets forth the manner in which the **profit** is to be recognized based on the terms of the sale.

However, regardless of which method is used, any **loss** on the disposition of OREO should be recognized immediately. Refer to the *Instructions for Call Reports* and FASB 66 for further guidance on the appropriate method to be used based on the individual facts and circumstances relating to the sale of OREO, including such factors as the buyer's initial investment (down payment).

**Can charge offs or special reserves be required for OREO property?**

Yes, the DCU has authority to require a credit union to charge off or set a special reserve for OREO property. RCW 31.12.545(2)(c).

**How will “Materiality” be determined for OREO accounting purposes?**

Determinations of accounting “materiality” will be strictly construed. In the event that a credit union or its Certified Public Accountant’s opinion differs from that of the DCU as to the materiality of an accounting interpretation, the DCU’s determination will prevail.

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