

BOARD POLICY

SECTION: FINANCIAL

SUBJECT: ACCOUNTING FOR FORECLOSED REAL ESTATE

APPROVED BY BOARD OF DIRECTORS: 03/19/2010

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Accounting at Foreclosure

Statement of Financial Standards No. 15 (SFAS 15), SFAS No. 114, and SFAS No. 121 generally provide the accounting treatment for REO including in-substance foreclosures. The Credit Union must initially record foreclosed assets deemed held for sale at the lower of one of the following amounts:

- Recorded investment (that is, carrying value before deduction for valuation allowances) in the loan.
- Fair value less costs to sell the foreclosed asset.
- The costs to sell an asset include the estimated incremental direct costs to transact the sale of the asset. This includes such costs as broker commissions, legal and title transfer fees, and closing costs. Costs to sell generally exclude insurance, security service, and utility costs.

Upon foreclosure (including in-substance foreclosure), the Credit Union must compare the recorded investment in the loan (carrying value before deduction for valuation allowances) to the fair value less costs to sell the foreclosed property.

The Credit Union must classify as loss and charge off any amount in excess of recorded investment over fair value less costs to sell. The Credit Union cannot represent this loss classification by a valuation allowance.

The Credit Union must expense, as incurred, legal fees and direct costs of acquiring title to foreclosed assets.

Hold or Sell Decision

Once the Credit Union acquires a property through foreclosure or repossession, management should begin the decision-making process of whether to hold the property or sell it (possibly in an unfavorable market). A primary consideration when selling the asset is whether the Credit Union will have to make a loan to facilitate the sale. The Credit Union must consider the overall cost if it regains 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 Credit Union initially took possession. Moreover, if the most recent borrower failed to service the debt at all, the Credit Union 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 Credit Union, 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, and enhancing the project.
- Cost to prevent deterioration of the asset during the anticipated holding period (Insurance, Physical security (fencing, security service, etc.), Maintenance (mowing, utilities, structural repair, etc.), Intangible (lost goodwill, etc.).
- Cost of selling the property (advertising, broker's commission, defects observed at inspection, etc.).
- Opportunity costs to the credit union, for example, based on the alternative uses of the sales proceeds.
- Cost of providing favorable financing (discount future and probable cash flows to present value).
- Anticipated appreciation or depreciation during the holding period.
- Benefit when property sold at end of holding period (discount proceeds to present value, determine yield based on current market rates).
- Benefit of interim use of the property in a lease or rental arrangement.
- Requirements imposed 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 NCUA approves a longer period.

The above analysis will assist management in making an informed decision on the disposition of the credit union's REO and repossessed assets.

Holding Period

NCUA defines an equity investment to exclude real property the Credit Union obtained in satisfaction of a debt or acquired under a judgment or mortgage. This is true if the Credit Union does not intend to hold the property for real estate investment purposes and plans to dispose of the property within a reasonable time period. If requested, NCUA may approve a longer period. NCUA considers the extension of time a supervisory decision. For NCUA to consider such extensions, the Credit Union should address the following items in its request letter:

- The term of the extension and the reason for the request.
- Whether the credit union, in good faith, tried to dispose of the property.
- How the accountants regard the property for GAAP purposes.

Internal Asset Review

As a sound practice, credit unions will conduct periodic reappraisals and reassessments of REO and other repossessed assets.

The Credit Union will consider each repossessed item on an individual basis and, if necessary, classify it adversely on the basis of facts supporting your 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.

Accounting after Foreclosure

For periodic evaluations of REO for impairment, *after* foreclosure, the Credit Union must classify as Loss, and charge off or represent by a specific valuation allowance, any excess of recorded investment over current fair value less cost to sell. The Credit Union must deduct valuation allowances from the recorded investment to arrive at carrying value. NCUA policy does not automatically require general valuation allowances (GVA's) on REO. The Credit Union should establish GVAs when it is likely to experience losses when disposing of REO or is likely to incur holding costs that are not reflected in the fair value estimate. The Credit Union should base the level of any required GVAs on REO on its historical net loss experience, adjusted for current conditions and trends.

NCUA does not recognize loss allowances (general or specific) on foreclosed (REO) assets held for sale as a component of capital. The regulatory capital standard only includes GVAs related to loans and leases in capital up to a certain limit.

Real Estate Owned (REO) Workouts

Management must assess the level of in-house expertise available to manage REO workouts.

Management will consider the possibility of looking outside the association for the necessary level of expertise. This should include 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 out-sourcing REO disposition plans.

Accounting for Sales of Real Estate

Accounting for the sale of real estate requires the determination of the following two issues:

- The point at which a sale actually occurs.
- How the credit union recognizes the gain on the sale.

When an association does not recognize a sale they should classify the asset as REO. Generally, the Credit Union may consummate a sale once the following events occur:

- The terms of a contract bind the parties.
- The exchange of all consideration.
- The seller, if responsible, arranges for any permanent financing.
- The parties perform on all conditions precedent to the closing.

See SFAS 66, Accounting for Sales of Real Estate, paragraph (6).

Gains

Generally, a credit union does not recognize a gain for accounting purposes if the seller retains some type of continuing involvement in the property without transferring the risks and rewards of ownership to the buyer. Continuing involvement includes any of the following situations:

- The seller makes an obligation to repurchase the property.
- The seller retains an equity interest in the property.
- The seller guarantees an investment return to the purchaser.
- The seller must initiate or support operations or continue to operate the property at the seller's own risk.

If, after the transaction, the Credit Union retains some type of continuing involvement in the property, the transaction may not qualify for gain recognition. The Credit Union should defer any gain and credit to an account descriptive of unearned gain on the sale of real estate.

Credit unions must account for all gains under generally accepted accounting principles (GAAP).

SFAS No. 66 specifies the amount and timing of gains the seller of real estate may recognize when the sale depends upon the seller's continuing involvement and retention of risks. The Credit Union may recognize all gains at the time of sale as long as the sale meets the following conditions:

- The Credit Union did not finance the sale.
- The Credit Union has no continuing involvement with the property. In the more common situation where the Credit Union makes a loan to facilitate the sale of REO, the Credit Union may recognize the full gain if the sale meets all of the following conditions:
 - The Credit Union and buyer consummate the sale.
 - The buyer has adequate initial and continuing investments that demonstrate a commitment to pay for the property.
 - The seller's receivable is not subject to future subordination.
 - The seller transfers 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.

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

GAAP describes circumstances where a credit union may use its salvage powers to exceed the Loans to One Borrower rules.

Losses

GAAP requires that if the sale of REO results in a loss, the Credit Union shall account for the loss in the period it sustained the loss. It is an unsafe and unsound practice for a Credit Union to fail to recognize losses from the sale of REO where the price is inflated above the market value. The inflated price may be a result of favorable terms the Credit Union provided in a loan to facilitate.

GAAP requires discounting sales prices to reflect market interest rates for loans of similar terms and risk.