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OF THE
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DIVISION OF BANKING
SUPERVISION AND REGULATION

DIVISION OF CONSUMER AND
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On October 1, 2025: This letter's attachment, *Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO) Assets*, was revised to remove references to reputational risk.

**TO THE OFFICERS IN CHARGE OF SUPERVISION AND APPROPRIATE
SUPERVISORY AND EXAMINATION STAFF AT THE FEDERAL RESERVE
BANKS AND FINANCIAL INSTITUTIONS SUPERVISED BY THE FEDERAL
RESERVE**

**SUBJECT: Questions and Answers for Federal Reserve-Regulated Institutions Related to
the Management of Other Real Estate Owned (OREO)**

Applicability to Community Banking Organizations: This guidance applies to all institutions regulated by the Federal Reserve with OREO, including those with \$10 billion or less in consolidated assets.

This letter conveys various questions and answers regarding the management of OREO by institutions regulated by the Federal Reserve. During the recent financial crisis, financial institutions have experienced a rise in OREO caused by general weaknesses in the housing market, including increases in delinquencies and defaults, house price declines, and weaknesses in the structure of a number of commercial real estate financings. The attached *Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO) Assets* document (Q&A document) is intended to clarify existing policies and promote prudent practices for the management of an institution's OREO assets, addressing both safety-and-soundness policies and consumer compliance issues.

The Federal Reserve's longstanding guidance for the management and financial reporting of OREO assets is set forth in Section 2200 of the *Commercial Bank Examination Manual* and the instructions to regulatory reporting forms for banks and bank holding companies.¹ However, given the increase in OREO on financial institutions' balance sheets, the Federal Reserve is issuing the attached Q&A document to reiterate this longstanding guidance and to highlight key concepts on the financial reporting, loss recognition, and management of OREO assets. Topics covered in the Q&A document include:

- Transferring an Asset to OREO
- Reporting Treatment and Classification
- Appraisal Concepts
- Ongoing Property Management
- Operational and Legal Issues
- Sale and Transfer of OREO

Reserve Banks are asked to distribute this letter and the attached Q&A document to state member banks, bank holding companies, and savings and loan holding companies, as well as to supervisory and examination staff. Questions regarding this letter should be directed to the following individuals:

- Division of Banking Supervision and Regulation: Mary Aiken, Manager, at (202) 452-4534; Donald Gabbai, Senior Supervisory Financial Analyst, at (202) 452-3358; or Carmen Holly, Supervisory Financial Analyst, at (202) 973-6122, in Credit, Market, and Liquidity Risk Policy; and Matthew Kincaid, Senior Accounting Policy Analyst, at (202) 452-2028, in Accounting Policy; or
- Division of Consumer and Community Affairs: Timothy Robertson, Senior Supervisory Consumer Financial Services Analyst, RB Oversight/CBO Supervision, at (202) 452-2565.

In addition, institutions may send questions via the Board's public website.²

Michael S. Gibson
Director
Division of Banking Supervision
and Regulation

Sandra F. Braunstein
Director
Division of Consumer
and Community Affairs

¹ See, for example, *Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041)* and *Instructions for Preparation of Consolidated Financial Statements for Bank Holding Companies* (FR Y-9C). Refer to the Federal Reserve's public website under the tab "Reporting Forms" for reporting instructions. <http://www.federalreserve.gov/reportforms/default.cfm>

² See <http://www.federalreserve.gov/apps/contactus/feedback.aspx>

Attachment:

- *Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO) Assets*

Cross-references to:

- SR letter 12-5/CA letter 12-3, “Policy Statement on Rental of Residential Other Real Estate Owned (OREO) Properties
- SR letter 10-16, “Interagency Appraisal and Evaluation Guidelines”
- CA letter 09-5, “Information and Examination Procedures for the “Protecting Tenants at Foreclosure Act of 2009”
- CA letter 05-3, “Servicemembers Civil Relief Act of 2003”
- SR letter 03-5, “Amended Interagency Guidance on the Internal Audit Function and its Outsourcing”
- SR letter 00-17, “Guidance on the Risk Management of Outsourced Technology Service”
- SR letter 95-16, “Real Estate Appraisal Requirements for Other Real Estate Owned (OREO)

**Questions and Answers
For Federal Reserve-Regulated Institutions¹
Related to the Management of
Other Real Estate Owned (OREO) Assets**

**June 27, 2012
Revised October 2025**

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¹ For purposes of this Q&A document, “institution” refers to a financial institution regulated by the Federal Reserve, including state member banks, bank holding companies, and savings and loan holding companies.

I. TRANSFERING AN ASSET TO OREO

1. Q: When should an institution re-categorize its asset from “Loans and lease financing receivables” to “Other real estate owned” on the *Consolidated Reports of Condition and Income* (Call Report)?²

A: In accordance with Call Report instructions, an institution should re-categorize its asset from “Loans and lease financing receivables” to “Other real estate owned” on the Call Report when the institution takes physical possession of the property, regardless of whether formal foreclosure proceedings have taken place.

2. Q: At what value should an institution initially report an OREO asset?

A: In accordance with Call Report instructions, when an institution receives an asset, such as real estate, from a borrower in full satisfaction of a loan, the institution initially reports the asset at its fair value less cost to sell.³ Similarly, a real estate asset received in partial satisfaction of a loan should be initially reported as described above and the carrying amount of the loan should be reduced by the fair value less cost to sell of the asset at the time of foreclosure.⁴ The fair value less cost to sell becomes the “cost” of the OREO asset. The amount, if any, by which the carrying amount of the loan plus recorded accrued interest (that is, the recorded loan amount) exceeds the fair value less cost to sell of the OREO asset is a loss that must be charged to the allowance for loan and lease losses (ALLL) at the time of foreclosure or repossession.

If the fair value less cost to sell of the OREO asset when taken into possession is greater than the recorded loan amount, the excess should be reported either as “Other noninterest income” on the Call Report or as “Recoveries on loans and leases” if there had been a prior charge-off of the loan. In a situation when the OREO asset appears to be worth more than the balance of the loan, the appraisal or other information on the property’s value should be reviewed to understand why the borrower would risk losing the equity in the property. Additionally, in some states, lenders are required to return recovered amounts, in excess of the amount owed, to the borrower.

3. Q: Do Call Report requirements differ when a borrower has the ability to redeem a property after foreclosure?

A: Reporting requirements will depend on who has physical possession of the property after foreclosure. If state law allows the borrower to live in the property during the redemption

² While the Q&As reference the schedule and line item (shown in italics) on the Call Report, a holding company should refer to the corresponding schedule and line item in the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

³ For financial reporting purposes, fair value reflects the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date (that is, the financial reporting date).

⁴ In accordance with Call Report instructions, if an institution sells the OREO asset shortly after foreclosure or repossession, it is generally appropriate to substitute the value received in the sale (net of cost to sell) for the asset’s fair value (less cost to sell) which had been estimated at the time of foreclosure or repossession.

period, then the asset would remain in “Loans and lease financing receivables” on the Call Report until expiration of the redemption period and the institution takes physical possession of the property. However, if the institution has physical possession of the property during the redemption period (that is, the borrower has vacated the property or has been evicted from the property), then the asset would be moved to “Other real estate owned” on the Call Report.

II. REPORTING TREATMENT AND CLASSIFICATION

4. Q: When an institution forecloses on its subordinate lien position, how are the outstanding senior liens on the OREO asset treated for financial reporting purposes?

A: In accordance with Call Report instructions, the amount of any senior debt (principal and accrued interest) to which an OREO asset is subject at the time of foreclosure is reported as a liability in “Other borrowed money” on the Call Report.

5. Q: What are the reporting consequences when the value of an OREO asset changes?

A: In accordance with Call Report instructions, an OREO asset is carried at the lower of (1) the fair value of the asset less the estimated cost to sell the asset or (2) the cost of the asset (that is, the OREO asset’s fair value less cost to sell recorded at the time of foreclosure, as discussed in Question 2).

Changes in fair value must be determined on each OREO asset individually. In subsequent periods, if the fair value of the OREO asset minus the estimated cost to sell is less than the cost of the asset, the deficiency must be recognized as a valuation allowance against the asset, which is created through a charge to expense. This valuation allowance is increased or decreased (but not below zero) through charges or credits to expense for changes in the OREO asset’s fair value or estimated selling cost. On the Call Report, the balance reported for the OREO asset is net of any valuation allowances.

6. Q: Should an OREO asset be adversely classified?

A: As discussed in the “Classification of OREO,” subsection of section 2200.1 “Other Real Estate Owned” of the *Commercial Bank Examination Manual*, an OREO asset is generally considered an adversely classified asset. For purposes of classification, any carrying value of the OREO asset in excess of its fair value, less cost to sell, should be classified as Loss, net of any applicable valuation allowance. The institution should periodically evaluate the OREO asset’s carrying value and factors affecting potential recovery that may require classification of the asset’s remaining book value.

In determining the classification of the remaining book value, an institution may consider a pending sale of the OREO asset or rental income from the OREO asset. If the institution has a sales contract to sell the OREO asset to a third party and the net sale proceeds are expected to cover the carrying value, the institution may not need to classify the asset. The institution should be able to demonstrate that the purchaser has the financial resources to complete the

purchase and that the institution has no contingent liability to repurchase the property or guarantee the property's financial performance.

With regard to residential rental OREO properties, a property with a lease in place and demonstrated rental cash flow sufficient to generate a reasonable rate of return would generally not be adversely classified. For further guidance, refer to SR letter 12-5/CA letter 12-3, "Policy Statement on Rental of Residential Other Real Estate Owned (OREO) Properties."

7. Q: How should an institution report the operating income and expenses for an OREO asset on the Call Report?

A: Operating income related to an OREO asset (for example, gross rental income) is recognized as "Other noninterest income" on the Call Report, while expenses are reported as "Other noninterest expense." Operating expenses include, but are not limited to, legal fees and direct costs incurred for foreclosure, property maintenance, and state and local government assessments.

8. Q: How does an institution account for real estate taxes and insurance on an OREO asset?

A: In accordance with generally accepted accounting principles (GAAP), real estate taxes and insurance would be expensed if the institution is merely holding the property for future sale. If an institution forecloses on an incomplete project and decides to complete construction, costs incurred for real estate taxes and insurance are capitalized during the construction period until it is substantially complete and ready for its intended use. Once the OREO asset is substantially complete and ready for its intended use, those costs are expensed.

9. Q: If an OREO asset is partially completed and the institution decides to complete construction, how should the institution report these capital improvement expenses?

A: In accordance with GAAP, capital improvement expenses clearly associated with the construction of the project should be capitalized as part of the cost of the OREO asset and reported on the balance sheet as part of the fair value less cost to sell of the asset. Once the property is ready for its intended purpose, subsequent carrying costs should be expensed as incurred. As noted in Question 5, each OREO asset must be carried at the lower of (1) the fair value of the asset less the estimated cost to sell the asset or (2) the cost of the asset. Therefore, while the capital improvements will increase the cost of the asset, the capitalized expenses may not increase the OREO asset's recorded value to an amount greater than the asset's fair value after improvements and less cost to sell.

III. APPRAISAL CONCEPTS⁵

10. Q: What are the Federal Reserve’s supervisory expectations for a regulated institution’s practices to obtain an appraisal upon a property’s transfer to OREO?

A: In accordance with the regulatory appraisal exemption for an existing extension of credit in the Federal Reserve Board’s appraisal regulation,⁶ a regulated institution is required at minimum to obtain an evaluation when a property is transferred to OREO through foreclosure or a deed in lieu of foreclosure. Although the appraisal regulation’s minimum requirement is an evaluation, the regulated institution may decide to obtain an appraisal, considering the type, complexity, use, and location of the property, as well as current market conditions. Refer to SR letter 10-16, “Interagency Appraisal and Evaluation Guidelines,” for a discussion of the development and content of an evaluation. While the Federal Reserve Board’s regulation may not require an appraisal, a state member bank also needs to consider whether state banking laws and regulations require an appraisal at the time the state member bank forecloses or takes possession of the property. Refer to SR letter 95-16, “Real Estate Appraisal Requirements for Other Real Estate Owned (OREO).”

11. Q: What are the supervisory expectations for an institution’s practices to determine the value of a property upon transfer to OREO?

A: In accordance with the Board’s appraisal regulation, an institution must, at a minimum, have an evaluation or may elect to obtain an appraisal to determine the value of a property upon transfer to OREO. The evaluation or appraisal should reflect an opinion of the property’s market value as defined in the Board’s appraisal regulation (12 CFR 225.62 (g)). Market value is defined as:

The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition are the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- (1) Buyer and seller are typically motivated;*
- (2) Both parties are well informed or well advised, and acting in what they consider their own best interests;*
- (3) A reasonable time is allowed for exposure in the open market;*

⁵ In this Q&A document, unless the discussion pertains to the Board’s appraisal regulation, “appraisal” refers to both an appraisal and evaluation. The Board’s appraisal regulation (12 CFR 225.62(a)) defines an “appraisal” as a written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information. An evaluation must comply with the requirements outlined in the attachment to SR letter 10-16, “Interagency Appraisal and Evaluation Guidelines.”

⁶ See the Board’s Regulation H for state member banks (12 CFR 208, subpart E) and the Board’s Regulation Y for holding companies (12 CFR 225, subpart G).

- (4) Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
- (5) The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*

The term “market value” that is defined in the Board’s appraisal regulation is based on similar valuation concepts as “fair value” for accounting purposes under GAAP. In accordance with GAAP, the term “fair value” reflects the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Therefore, to comply with GAAP, an institution must initially report the fair value of the property less cost to sell on its financial statements, as discussed in Question 2.

12. Q: How should an institution assess the adequacy of an appraisal (or an evaluation if permitted) to support its valuation of a particular OREO property?

A: The appraisal should fully support the market value opinion of the OREO asset with sufficient information and analysis of the property’s current “as is” condition (considering the property’s highest and best use) and other relevant risk and market factors affecting the property’s market value. This includes an assessment as to whether the appraisal’s assumptions on market conditions, events, and trends are reasonable and supportable. Refer to SR 10-16 for further supervisory expectations for an institution’s appraisal process. An institution should consider whether:

- The appraisal addresses the current condition of the property and reflects any deferred maintenance.
- For a property under construction, construction costs are reasonable and are adequate to cover completion of the project in accordance with plans and any possible contingencies.
- The assumptions support any anticipated change in the permissible use of the property, supported by information on market conditions.
- For a special-purpose property, the appraisal considers the value of the property under more conventional use and identifies the value of any special-purpose features and fixtures.
- The sources of data are current and timely, recognizing that there are data lags when public records are used.
- If there are few comparable sales, the appraisal addresses supply and demand factors, and identifies recently closed sales and not just properties listed for sale.
- For an income-producing property, the appraisal provides information on and consideration of typical rental concessions.
- The holding and absorption period to achieve stabilized occupancy or to sell-out the project are reasonable and supportable by current market conditions and trends.

- Terms and conditions of lease renewals consider the current market and rental rates and not just historical trends.
- On an existing property, the appraisal explains whether contract rents differ from market rents and discloses the effect on the property's market value.
- Capitalization and discount rates are realistic and reflective of current investor expectations.

13. Q: What are the supervisory expectations for an institution's practices to monitor the value of OREO, including obtaining a new appraisal?

A: While the Federal Reserve has no regulatory requirement governing when and how often to obtain a new appraisal for an OREO asset, SR 10-16 provides supervisory expectations that an institution should have policies and procedures for the monitoring of collateral values. Further, current market value information of an OREO asset is necessary to determine the property's fair value and support the carrying value of the OREO asset on the institution's financial statements. Therefore, a regulated institution should have a policy establishing procedures for monitoring the market value of the OREO property over the holding period.

The institution's policy should consider whether the existing appraisal or collateral valuation information is still current. The policy should consider procedures for determining the validity of an existing appraisal or collateral valuation information, with which to determine whether the appraisal or collateral valuation reflect current market conditions, based on factors such as: the property type, current market supply and demand, current use of the property, and the passage of time since the most recent appraisal. Updated collateral valuation information is particularly important during rapidly changing market conditions (including both declining and improving markets), and when there are changes in project plans.

A state member bank also needs to consider whether state banking laws and regulations require the state member bank to update the property's market value on an annual or periodic basis. These requirements vary by state and are addressed in state regulations on the booking and holding of other real estate or bank-owned real estate.

IV. ONGOING PROPERTY MANAGEMENT

14. Q: How long may a Federal Reserve-regulated institution hold an OREO asset on its books?

A: Generally, the Federal Reserve allows bank holding companies to hold an OREO asset for up to five years, with an additional five-year extension subject to certain circumstances.⁷ Regardless of the allowable holding period, the Federal Reserve generally expects bank holding companies, their nonbank subsidiaries, and state member banks to seek to dispose of

⁷ Refer to the Board's Regulation Y (12 CFR 225.22(d)(1)).

OREO assets as soon as prudent and reasonable, taking into account market conditions.⁸ Under difficult market conditions, Federal Reserve regulations and policies permit the rental of OREO properties to third-party tenants as part of an orderly disposition strategy within statutory and regulatory limits. For further guidance on this matter, refer to SR 12-5/CA 12-3.

Savings and loan holding companies generally may acquire real estate for rental and are not subject to the same statutory and regulatory restrictions as bank holding companies.⁹

State member banks and licensed branches of foreign banks are subject to the holding periods and other limitations on OREO activity established by their licensing authority, which vary on initial holding period, extensions of holding period, and total length of the holding period, as well as requirements for the write-down of the OREO carrying value.

15. Q: If an institution decides to enter into an agreement with a third party to manage or maintain an OREO asset, what due diligence should the institution's management consider before entering into a management agreement, and what are sound practices for entering into and managing outsourcing arrangements for OREO activities?

A: To manage the cost and to supplement its own resources, an institution may use a third-party service provider for property management, maintenance or improvements, compliance with local laws and regulations, or other services. However, the outsourcing of all or part of the OREO management function poses risks that an institution needs to address, as is the case with any outsourced function. Therefore, the supervisory guidance for managing the risks associated with other types of outsourcing arrangements¹⁰ may be used as guidance for sound risk management practices for the selection, contract review, and monitoring of a third-party provider. In entering into these third-party arrangements, an institution should:

- Identify, assess, and monitor the risk of the outsourcing arrangement.
- Implement policies and procedures for monitoring and managing the risk of outsourcing OREO activities, consistent with the institution's OREO policies and procedures.
- Perform due diligence and evaluate vendors, considering such factors as competence, expertise, management quality, financial strength (for example, the ability to obtain insurance and bonding), and professional accreditation. Other considerations include the vendor's experience with a particular property type or in a particular geographic market, and presence of, or access to, specialized legal expertise.

⁸ See *Commercial Bank Examination Manual*, Section 2200.1, "Other Real Estate Owned," and *Bank Holding Company Supervision Manual*, Section 3030.0, "Section 4(c)(2) and (3) of the BHC Act (Acquisition of DPC Shares, Assets, or Real Estate)."

⁹ See 12 U.S.C. 1467a(c)(2) and 12 CFR 238.53(b).

¹⁰ See Federal Financial Institutions Examination Council *IT Examination Handbook*, "Outsourcing Technology Services Booklet;" SR letter 03-5, "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing;" and SR letter 00-17, "Guidance on the Risk Management of Outsourced Technology Services."

A contractual arrangement may address the following items:

- Expectations and responsibilities under the contract for both parties. Among other things, vendor responsibilities should include providing information related to the work performed, expenses, compliance with all applicable laws and regulations, and other relevant activity or risk-exposure information necessary for sound risk management by senior management and directors;
- The scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
- The process for changing the terms of the contract or agreement, especially for expansion of work if significant repair or maintenance issues are found, and conditions of default and causes for contract termination;
- The location(s) where OREO activity documentation will be maintained by the vendor, the length of time documents will be archived by the vendor, and provisions for the institution to have reasonable and timely access to the documents;
- Audit and regulatory review of the vendor's services, including stipulations that examiners have access to records or documents prepared or maintained by the vendor; and
- A process (for example, arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence.

16. Q: When an institution forecloses on a partially completed real estate project, what factors should be considered before deciding to finish the project or sell the project in its "as is" condition?

A: While each situation presents varying challenges and risks, an institution should analyze the economic cost and risk before deciding to complete a project, considering the feasibility of the project under current market conditions. The institution should also consider whether it has the skill and management resources to manage a construction project. Furthermore, an institution should evaluate whether investing additional funds to complete the project will minimize its losses as compared to marketing and selling the property in its "as is" condition.

17. Q: What steps should institutions take to ensure that a property is appropriately maintained after a notice of foreclosure is issued to the current homeowner but prior to the foreclosure being completed?

A: Institutions are expected to have controls to ensure compliance with state and local laws related to entering properties during a foreclosure redemption period. Furthermore, institutions should secure properties to the best of their ability during the foreclosure process.

V. OPERATIONAL AND LEGAL ISSUES

18. Q: What ownership risks or liabilities arise when an institution takes title to OREO, and what are the sound risk management practices associated with the ownership of foreclosed property (both occupied and vacant properties)?

A: Based on its risk assessment, an institution should consider seeking legal advice on the risks posed by taking possession of the property. The risk assessment should be performed before the institution takes title to the property and should consider local market conditions and any local and state government requirements governing the institution's ownership, maintenance, and sale or disposal of the property. If the property is located outside of the institution's market footprint, the institution may need to retain experts with knowledge of local legal requirements and market conditions.

Ownership risks and potential liability exposures include:

- Obligations under property governing documents, tenant lease agreements, or contracts;
- Requirements to provide a safe and secure environment to tenants;
- Requirements to maintain or operate the property in conformance with federal, state, and local laws, including those addressing health and safety standards;
- Payment of property taxes; and
- Obligations to address possible environmental risks.

Examples of risk management practices for vacant properties include:

- Remediating obvious hazards to health and safety;
- Securing exterior openings to the property and all exterior mechanical systems;
- Adjusting utility services to a level appropriate to preserve the property;
- Scheduling the property for periodic field inspection and maintenance;
- Posting emergency contact information and ownership information on the main entrance door to the property, on a laminated waterproof notice;
- Posting and executing "No Trespassing" signage at the front and rear of the property, and executing all required "No Trespass" documents in accordance with local law enforcement agencies; and
- Analyzing the potential environmental liability to the institution and the implications for the property's value.

19. Q: What are some potentially useful measures for monitoring and managing OREO risk?

A: An institution should develop measures to assess and monitor the risk in its OREO assets that are consistent with the nature, extent, and complexity of its OREO portfolio.

Management should have an information system to monitor and analyze OREO properties that is appropriate for the institution's OREO portfolio size and complexity.

The following are examples of performance ratios that the institution may choose to monitor:

- Net disposition proceeds as a percentage of original book value of the property
- Valuation reserve as a percentage of OREO values
- Volume and dollar amount of former OREO currently being financed
- OREO holding and management costs as a percentage of OREO
- Legal expense (since foreclosure) related to OREO as a percentage of OREO
- OREO as a percentage of internally criticized assets (which include special mention and classified assets) plus past due
- OREO (by type) as a percentage of corresponding loan type

20. Q: What controls and processes should institutions have in place to ensure that properties in the OREO inventory are properly maintained and meet local code-enforcement ordinances and other laws?

A: Institutions should have policies and procedures in place to ensure that properties are maintained in compliance with federal, state, and local laws, including laws governing health and safety, property preservation, fair housing, and property registration. An institution's failure to adhere to these legal requirements can result in fines and litigation. Further, institutions engaging third-party vendors to carry out functions related to these requirements should ensure that vendors maintain appropriate compliance controls. Reliance on third-party vendors does not relieve an institution of its compliance responsibilities or liability.

21. Q: In addition to considerations regarding health and safety violations, how should institutions determine which repairs to make before disposition?

A: Expending funds to repair a property is one strategy for an institution to consider for improving potential recovery on the sale of OREO assets. For instance, repairs may be necessary for the property to qualify for a Federal Housing Administration (FHA)-insured loan, which in turn may attract a greater number of qualified buyers. Institutions should have controls in place to comply with all federal, state, and local laws, including fair housing laws. For example, institutions may not avoid or delay the maintenance or repairs of dwellings based on the racial or ethnic composition of the geographic area where they are located.

22. Q: What steps should an institution take to comply with existing laws protecting tenants?

A: Institutions should have controls in place to comply with all federal, state, and local laws related to protecting the rights of tenants, including the federal Protecting Tenants at Foreclosure Act of 2009 (CA letter 09-5), Servicemembers Civil Relief Act (CA letter 05-3), the Fair Housing Act, and the Americans with Disabilities Act. For example, an institution

or its agent should have consistent processes in place to provide proper and timely notice of the institution's ownership of the foreclosed property and provide the tenant with the allowable timeframes, as established under law, to remain in the foreclosed property before eviction proceedings commence. Institutions that lack experience as a landlord may wish to engage the services of a property management firm. However, as previously stated, reliance on third-party vendors does not relieve an institution of its compliance responsibilities or liability.

VI. SALE AND TRANSFER OF OREO

23. Q: What is the primary source of accounting guidance for sales of OREO?

A: The primary accounting guidance for sales of real estate (including foreclosed real estate) is Accounting Standards Codification Subtopic 360-20, "Property, Plant, and Equipment – Real Estate Sales" (formerly FASB Statement No. 66, "Accounting for Sales of Real Estate") (ASC 360-20). This standard, which applies to all transactions in which the seller provides financing to the buyer of the real estate, establishes several methods (discussed in questions 25 to 27) to account for the disposition of real estate. The methods established in ASC 360-20 are the full accrual, installment, cost recovery, reduced-profit, and deposit methods. Each of these methods is also summarized in the Call Report Glossary entry titled "Foreclosed Assets."

While the methods established in ASC 360-20 are briefly described in the questions below, this document does not contain a comprehensive list of all considerations that need to be made when analyzing sales of real estate. This area of GAAP is very complex and requires significant judgment; therefore, a thorough review of ASC 360-20 is usually required when analyzing sales of real estate because it provides detailed guidance necessary to determine the appropriate accounting for these transactions. As a result, it is not possible to cover all of the details of this area of GAAP in this document.

24. Q: When an institution sells an OREO asset, how is a gain or loss on the sale reported on the Call Report?

A: Any loss on the sale of an OREO asset should be recognized immediately and reported as "Net gains (losses) on sales of other real estate owned" on the Call Report. A gain on the sale of an OREO asset is also reported on the same line; however, recognition of a gain depends on the accounting method used in the transaction, as noted in Questions 25-26.

25. Q: When may an institution immediately recognize the gain on an institution-financed sale of OREO?

A: Under GAAP, when the transaction meets the qualifications for the full accrual method of sale accounting, the following applies: (1) a sale is recognized, (2) the asset resulting from the institution's financing of the transaction is reported as a loan, (3) the gain or loss on the sale is recognized immediately, and (4) interest income is accrued on the new loan. This method may be used when all of the following conditions have been met:

- A sale has been consummated,¹¹
- The buyer's initial investment (for example, a cash down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property,
- The receivable is not subject to future subordination, and
- The usual risks and rewards of ownership have been transferred.

Further details regarding the minimum initial investment, including detailed guidance regarding what must be included or excluded in this amount, can be found in ASC 360-20. The Appendix to this Q&A document contains guidance on the minimum initial investment for various types of real estate that is provided in ASC 360-20-55. To meet the continuing investment (periodic payment) requirement, the contractual loan payments must be sufficient to repay the loan in level annual payments over the customary term for the type of property involved. In order for the usual risks and rewards of ownership to be transferred, the institution cannot have substantial continuing involvement with the property. ASC 360-20 provides detailed guidance on the forms of continuing involvement that result in prohibition on the use of the full accrual method.

26. Q: What other accounting methods could apply to an institution-financed sale of OREO? How are gains on sales and interest income recognized under those methods?

A: The following methods are used when a sale has been consummated as prescribed by GAAP, but the conditions for full accrual have not been met:

- **Installment method:** For use when the buyer's initial investment is not adequate for full accrual, but recovery of the cost of the OREO asset is reasonably assured if the buyer defaults. This method recognizes a sale of the OREO asset and the corresponding new loan. Any gain on the sale is recognized as payments are received and interest income may be accrued, when appropriate.
- **Cost recovery method:** For use when the disposition does not qualify for full accrual or installment methods. This method recognizes a sale of the OREO asset and the corresponding new loan on nonaccrual status, and all income recognition is deferred. Principal payments reduce the loan balance and interest increases unrecognized gross profit. No gain or interest income is recognized until either the aggregate payments exceed the recorded amount of the loan, or a change to another accounting method is appropriate.
- **Reduced-profit method:** For use when the down payment is adequate, but the amortization schedule does not meet full accrual method requirements. This method recognizes a sale of the OREO asset and a corresponding new loan. However, only a

¹¹ Under GAAP, a sale has been consummated when all of the following conditions are met: (1) the parties are bound by the terms of a contract, (2) all consideration has been exchanged, (3) any permanent financing for which the seller is responsible has been arranged, and (4) all conditions precedent to closing have been performed. Usually, these four conditions are met at the time of closing or after closing, not when an agreement to sell is signed or at a preclosing.

portion of the gain on the sale is recognized as payments are received based on the present value of the lowest level of periodic payments required under the loan agreement.

If the transaction eventually meets the requirements for the full accrual method, the institution may switch to that method at that time and recognize any unrecognized gain on the sale. As stated in Question 24, any loss on the sale of the OREO asset is recognized immediately under all methods.

27. Q: Under what circumstances would an institution-financed sale of OREO not result in a sale for accounting and reporting purposes, and what method of accounting would be appropriate for the transaction?

A: Under GAAP, certain conditions exist for a sale to be consummated for accounting purposes (see Question 25). If a sale is not consummated for accounting purposes, the transaction is accounted for under the deposit method. Because there is no sale for accounting purposes, the asset remains reported as an OREO asset and no gain on sale or interest income for the new loan is recognized. If, however, the net carrying amount of the OREO asset exceeds the sum of the deposit received, the fair value of the unrecorded note receivable, and the debt assumed by the buyer, the institution must recognize the loss on the date the agreement to sell is signed. Payments received from the borrower are reported as a liability until sufficient payments have been received to qualify for a different accounting method. The deposit method may also be used if a sale is consummated for accounting purposes, but the initial investment is inadequate and recovery of the cost of the property is not assured.

Finally, certain forms of continuing involvement in the OREO asset by the institution may limit its ability to recognize a sale. One example is when the institution may be required to initiate or support operations for an extended period of time, which results in accounting for the transaction as a financing, leasing, or profit-sharing arrangement. One common type of condition that indicates a presumption of support is when the institution holds a receivable from the buyer for a significant part of the sales price and collection of the receivable depends on the operation of the property. ASC 360-20 includes detailed guidance on the types of continuing involvement that should be considered when determining whether a sale has occurred for accounting and reporting purposes.

28. Q: May an institution sell or transfer an OREO asset to a related party (such as the bank holding company or a non-bank affiliate)?

A: The Federal Reserve does not have a regulation prohibiting the sale of an OREO asset to a related party. When a transaction with a related party occurs, an institution should verify that the asset is recorded at fair value. The sale of an asset to an affiliate must comply with the market terms requirement of the Board's Regulation W (12 CFR 223.51). The terms must be substantially the same, or at least as favorable to the institution, as those to nonaffiliates for comparable transactions. Similarly, if an insider purchases an OREO asset, the transaction must be recorded at fair value in accordance with GAAP and not create a disadvantage to the institution by an artificially low sales price. Additionally, the Board's Regulation O

(12 CFR 215) limitations apply when an institution finances an OREO asset sale to an insider. Moreover, transfers of an OREO asset within a holding company do not extend any period for the required divestiture of the property. Refer to the Board's Regulation Y (12 CFR 225.22(d)(1)(iii)).

29. Q: What procedures and internal controls should an institution have in place to assess the reasonableness of an offer to purchase an OREO asset and to support the decision to sell the property?

A: The institution's procedures should ensure that the sale of an OREO asset maximizes recovery and adheres to applicable federal and state laws and regulations. The procedures should also address the approval process for the sale of a particular property, including the level of management required to approve a sale. Moreover, the procedures should address whether the institution will consider an offer to purchase an OREO asset from a related party (for example, a member of the board of directors, an employee, or a relative of an employee).

Procedures should address documentation requirements for the institution's plans to market and sell the property, the approval of the sale, and, if applicable, the approval of a loan to finance the purchase of an OREO asset. Such documentation should include:

- A plan for the marketing and sale of the property in accordance with applicable federal and state laws, including the Fair Housing Act. The plan should be revised as needed to reflect changes in market conditions;
- A record of inquiries and purchase offers made by potential buyers, including reasons for rejecting an offer or accepting an offer. Acceptance of an offer should include confirmation that the potential buyer has the financial ability and motivation to close the sale;
- Methods used to market, advertise, and sell the property, whether by the institution or its agent (for example, documentation should address the method of sale, including bulk sales or auction);
- The establishment of the property's sales listing price and any changes to the listing price;
- An assessment of market conditions affecting the ability of the institution to sell the property, including regular updates;
- Listing and sales agreements with the institution's agent, including terms of sales commissions;
- The purchase agreement and the terms of sale, including any representations and warranties made by the institution, transaction closing costs to be paid by the institution, and documentation on the transfer of ownership and recordation of the title;
- Legal review of the sale transaction documents;

- Approval of the sale by the appropriate level of management and, if applicable, the approval of the institution's loan to the purchaser of the property and executed loan documents;
- Confirmation of the institution's receipt of the funds from the purchaser of the property; and
- Other documentation related to the sale and transfer of ownership, including cancellation or assignment of a property management agreement, transfer of property management documents (for example, lease agreements) to the new owner, and notification to the institution's insurance company of the sale.

30. Q: What incentives exist to encourage institutions to sell residential OREO properties to owner-occupants and groups involved in neighborhood stabilization efforts, before considering selling to investors?

A: Many institutions have implemented “first look” programs that give prospective homeowners brief exclusive opportunity to purchase bank-owned properties in certain neighborhoods so these homes can either be rehabilitated, rented, resold, or demolished. Giving prospective homeowners and communities a “first look” can help to limit neighborhood blight, stabilize property values, and maximize recovery.

Under the Community Reinvestment Act (CRA) and the Neighborhood Stabilization Program rules, institutions can receive investment credit for OREO donations made in U.S. Department of Housing and Urban Development-designated Neighborhood Stabilization Areas, in line with this provision of CRA.

31. Q: What legal requirements should institutions consider when deciding how to market and sell residential properties, including whether to sell residential properties (or pools of properties) to investors or at auction?

A: An institution should ensure that its policies and procedures governing the marketing, sale, and disposition of OREO properties comply with applicable laws, including the Fair Housing Act and the Equal Credit Opportunity Act (if the institution makes or facilitates credit). For example, an institution's marketing and sales strategies may not be based on the racial or ethnic composition of the geographies where the properties are located. Additionally, when selling to investors, an institution should conduct proper due diligence. Institutions may also consider implementing controls to evaluate purchaser actions following the sale of OREO property to an investor. Some institutions now evaluate bulk purchasers to determine whether properties are resold to responsible buyers or are contributing to neighborhood blight due to negligence. Robust oversight of investor purchase transactions of OREO properties can reduce an institution's financial and legal risks.

Appendix

GAAP Guidance on Minimum Initial Investment Requirements

As noted in ASC 360-20-40, a buyer's initial investment shall be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable. The minimum initial investment requirements for various types of real estate are provided in ASC 360-20-55 (see the following table). The minimum initial investment is expressed as a percentage of sales value. Although the table does not cover every type of real estate property, an institution may make analogies to the types and associated risks of properties specified in this table to evaluate initial investments for other property types.

Further, institutions need to consider the other requirements in ASC 360-20-55 to determine whether the institution needs to modify the minimum initial investment requirement. If a recently placed permanent loan or firm permanent loan commitment for maximum financing of the property exists with an independent, established lending institution, the minimum initial investment should be whichever of the following is greater:

- a. The minimum percentage of sales value of the property specified in the ASC 360-20-55 table, or
- b. The lesser of:
 1. The amount of the sales value of the property in excess of 115% of the amount of a newly placed permanent loan or firm permanent loan commitment from a primary lender that is an independent established lending institution; or
 2. 25% of the sales value.

Table from ASC 360-20-55

	Minimum Initial Investment Expressed as a Percentage of Sales Value
Land	
Held for commercial, industrial, or residential development to commence within two years after sale	20
Held for commercial, industrial, or residential development to commence after two years	25
Commercial and Industrial Property	
Office and industrial buildings, shopping centers, and so forth:	
Properties subject to lease on a long-term lease basis to parties with satisfactory credit rating; cash flow currently sufficient to service all indebtedness	10
Single-tenancy properties sold to a buyer with a satisfactory credit rating	15
All other	20
Other income-producing properties (hotels, motels, marinas, mobile home parks, and so forth):	
Cash flow currently sufficient to service all indebtedness	15
Start-up situations or current deficiencies in cash flow	25
Multifamily Residential Property	
Primary residence:	
Cash flow currently sufficient to service all indebtedness	10
Start-up situations or current deficiencies in cash flow	15
Secondary or recreational residence:	
Cash flow currently sufficient to service all indebtedness	15
Start-up situations or current deficiencies in cash flow	25
Single-Family Residential Property (including condominium or cooperative housing)	
Primary residence of the buyer	5 ^(a)
Secondary or recreational residence	10 ^(a)

Note (a): If collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience, the minimum initial investment shall be at least 60 percent of the difference between the sales value and the financing available from loans guaranteed by regulatory bodies such as the Federal Housing Authority (FHA) or the Veterans Administration (VA), or from independent, established lending institutions. This 60 percent test applies when independent first-mortgage financing is not utilized and the seller takes a receivable from the buyer for the difference between the sales value and the initial investment. If independent first mortgage financing is utilized, the adequacy of the initial investment on sales of single-family residential property should be determined in accordance with ASC 360-20-55-1.

A seller of owner-occupied single-family residential homes that finances a sale under an FHA or VA government-insured program may use the normal down payment requirements or loan limits established under those programs as a surrogate for the down payment criteria set forth above and may record profit under the full accrual method, provided that the mortgage receivable is fully insured from loss under the FHA or VA program. In that specific circumstance, departure from the minimum initial investment criteria above is justified because all of the credit risk associated with the receivable from the sale is transferred to the governmental agency. However, in all other circumstances (for example, FHA or VA programs that provide for less than full insurance or seller financing using private mortgage insurance), the minimum initial investment criteria set forth above shall be followed.