ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

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Effective Date	08-01-14
Supersedes	10-2
Approval	

SUBJECT: **Other Real Estate Owned OREO Defined**

OTHER REAL ESTATE OWNED (OREO) DEFINED

OREO generally consists of all real estate, other than bank premises, owned or controlled by the bank and its consolidated subsidiaries. OREO may also include certain receivables resulting from sales of OREO. State banks may acquire OREO by any of the following methods:

1) Real estate acquired in any manner for debts previously contracted (foreclosure, by deed in lieu of foreclosure) even if the bank has not yet received title to the property, but maintains possession of the property. Loans reclassified as OREO should be recorded at the fair value of the collateral less the cost to sell. Any write-down required at the time of foreclosure should be recorded as a charge to the bank's allowance for loan and lease losses. Subsequent write-downs should be charged to current period earnings as a noninterest expense.

2) Real estate formerly but no longer used for banking purposes and real estate originally acquired for future expansion but no longer intended to be used for that purpose. *After holding expansion property for one year from acquisition date, banks must submit to the Bank Commissioner a written plan, approved by the board of directors, detailing how and when the property will be utilized for banking purposes.* Future expansion property not utilized within one year of acquisition date will be considered OREO if a written plan has not been submitted to the Bank Commissioner.

3) Real estate sold under contract and accounted for under the deposit method of accounting in accordance with ASC Subtopic 360-20, "Property, Plant and Equipment - Real Estate Sales (formerly FASB No. 66), "Accounting for Sales of Real Estate". The deposit method is used when a sale has not been consummated and/or when recovery of the carrying value of the property is not reasonably assured. If another method in accordance with ASC 360-20 is used to account for the sale, the resulting receivable should be reported as a loan. The inappropriate use of the deposit method may cause a bank to report higher amounts of OREO causing nonperforming assets to be overstated.

4) Real estate acquired, directly or indirectly, by the bank or a consolidated subsidiary and held for development, resale, or other investment purposes. Banks must maintain a written plan, approved by the board of directors and the Bank Commissioner, which outlines the purpose and strategy for such investments. Federal regulations require the prior approval of federal regulators for certain types of real estate investments.

5) Real estate acquisition, development, or construction arrangements that are accounted for as direct investments in real estate.

SUBJECT: **Other Real Estate Owned OREO Defined**

APPLICABLE LAWS, REGULATIONS AND REGULATORY REQUIREMENTS REGARDING HOLDING AND VALUING OTHER REAL ESTATE OWNED

The Arkansas Banking Code of 1997, Section 23-47-508, specifies a state bank's authority to hold OREO. State banks must also comply with requirements contained in the instructions for Reports of Condition and Income issued by the Federal Financial Institutions Examination Council (FFIEC). FFIEC instructions refer to several accounting principles regarding accounting for OREO: ASC 310-40, Receivables, Troubled Debt Restructurings by Creditors (formerly FASB No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"); ASC 360, "Property, Plant and Equipment", (formerly FASB No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets"); and FASB No. 66, "Accounting for Sales of Real Estate").

Pursuant to provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), state chartered banks may not acquire or retain, directly or indirectly, equity investments of a type, or in an amount, that is not permissible for a national bank. Banks desiring to pursue restricted investments must obtain prior approval from the FDIC. Additional information regarding activities and investments of state banks can be found in Part 362 of FDIC Rules and Regulations.

State banks may not hold real estate acquired for the collection of debts previously contracted for more than five years. If not disposed of within five years, it shall be charged off as an asset unless the Bank Commissioner extends the time for its disposition.

Pursuant to FFIEC requirements and Generally Accepted Accounting Principles (GAAP), when property becomes OREO, it must be recorded at fair value less the cost to sell. A market valuation or qualifying appraisal should be prepared to substantiate fair value of the property. A current appraisal prepared by an independent, qualified appraiser must be obtained when the recorded value of the loan/asset exceeds $250,000. An appropriate market valuation must be performed when the recorded amount of the loan/asset is at or below $250,000. If a valid appraisal or valuation has been performed within the last twelve months, no new appraisal or valuation will be required when property is transferred to OREO, unless significant deterioration has occurred in the local market.

For OREO acquired as direct investments by banks and their consolidated subsidiaries, a written plan must be maintained. The plan must be approved by the board of directors and the Bank Commissioner, and state the purpose and strategy for such investments. OREO held for investment should be evaluated for quality and yield as are other bank investments (i.e. loans and securities). A bank's direct investment in real estate, directly or via a subsidiary, is limited to 150 percent of its capital base.

SUBJECT: **Other Real Estate Owned OREO Defined**

Real estate acquired for future expansion should normally be utilized within five years of its date of acquisition. *After holding future expansion property for one year from its date of acquisition, banks* ***shall*** *submit a board approved plan to the Bank Commissioner detailing its plans for utilizing the property. Future expansion property not utilized within five years of its date of acquisition must be transferred to OREO at fair value less the cost to sell, and disposed of within five years of the date of transfer* ***unless the bank requests permission from the Bank Commissioner and has submitted a board resolution to the Bank Commissioner detailing its plan for utilizing the property and reason(s) for failing to previously utilize the property within five years of its date of acquisition.*** *The Bank Commissioner will consider allowing the bank to retain the property, in the premises account, for an additional period of time, not to exceed five years, before requiring disposal of the property. Along with the board resolution detailing the bank's plan for utilizing the property and reason(s) for failing to previously do so; in its request for permission to retain the property in the premise account the bank must address and the Bank Commissioner,* ***on a case-by-case basis****, will consider the following:*

(1) The economic conditions of the community in which the real estate is located;

(2) The economic impact retaining the real estate for future expansion will have on the overall financial condition of the bank;

(3) Any other concerns the Bank Commissioner may wish addressed while considering the request.

Real estate originally acquired for future expansion but no longer intended to be used for that purpose will continue to be treated as OREO as stated above in section I (2). Once management determines that real estate acquired for future expansion will no longer be used for that purpose, the property must be immediately transferred to OREO at fair value less the cost to sell, and disposed of within five years of the date of transfer.

INFORMATION REQUIRED TO EVALUATE THE STATUS AND PROSPECTS FOR OTHER REAL ESTATE OWNED

Each parcel of OREO must be evaluated on its own merits. Adequate documentation must be maintained on all types of OREO in order that management and regulators can produce a thorough and accurate assessment of its status, value and probable disposition. Relevant information to review in ascertaining the quality of OREO includes:

1) Determine the reason the property was acquired and the bank's intentions as to its disposition;

2) Analyze the carrying value in relation to appraised value, the asking price, offers received, and sales prices of properties recently sold;

3) Ascertain the reason(s) the property has not been sold and review the bank's efforts to dispose of each parcel (the bank should maintain a record of inquiries and offers made by potential buyers);

4) Review other pertinent factors including the bank's title, other liens, tax status, insurance, occupancy, rental income, validity of capitalized expenses, and other expenses associated with carrying OREO;

5) Determine if the bank has assessed its potential liability regarding environmental hazards;

6) Evaluate bank management's ability and track record in liquidating assets acquired for debts previously contracted;

7) Determine whether additional improvements (repairs, renovations) are necessary to successfully market the property; and

8) Determine that OREO acquired for investment purposes is in compliance with federal regulations restricting activities and investments of state banks.

ADDITIONAL INVESTMENTS, ADVANCES AND EXPENSES FOR OTHER REAL ESTATE OWNED

For legal OREO (the bank has acquired title to the property), additional investments and/or expenses are permitted to complete unfinished projects and to make necessary improvements to enable the bank to recover its total investment or dispose of the property. Such expenses may be capitalized (added to the book value of OREO) if the bank maintains documentation that the expenses result in a more salable property AND are recoverable. Expenses for general maintenance repairs may not be capitalized. A bank may also expend additional funds on acquired property to operate an establishment whose value depends substantially on uninterrupted operation.

For accounting OREO (property in which the bank has received physical possession of the property, regardless of whether formal foreclosure proceedings have taken place) additional advances and/or expenses (including the purchase of prior liens) are considered disbursements of loan proceeds to the borrower and are subject to the legal lending limit. Although the accounting treatment reflects foreclosure, the bank still has a secured loan to its borrower for legal purposes.

GUIDELINES FOR CLASSIFYING OTHER REAL ESTATE OWNED AND REAL ESTATE SALES CONTRACTS

OREO is frequently a nonearning bank asset. Each parcel of OREO, whether held by the bank or a real estate subsidiary, is to be reviewed and classified on its own merits. Pursuant to a thorough review of documentation previously discussed (refer to the heading, "Information Required to Evaluate Status and Prospects"), examiners should consider the following:

1) Present and future income, less appropriate expenses, generated by the property (a yield comparable to loans for similar investment purposes is considered a reasonable rate of return);

2) The source and quality of the appraisal/valuation;

3) Local economic conditions;

4) The manner in which the bank intends to dispose of the property;

5) Compliance with applicable laws and regulations; and

6) An offer and acceptance must be written and include earnest money to not be considered for adverse classification.

OREO not subject to adverse classification must generate a reasonable rate of return after expenses, have a book value not greater than the current fair market value, and contain no evidence of additional losses. Substandard classifications are indicative of OREO that generates little or no return, and no additional losses are anticipated. OREO classified Doubtful and/or Loss have book values that exceed current fair market value and/or contain additional losses that are identifiable.

Real estate sales contracts generally result when the purchaser's down payment is inadequate and title to the property remains vested in the name of the bank. Sales contracts may allow banks to dispose of nonearning assets, to the extent that interest is received, and be relieved of expenses for taxes, insurance, repairs and similar charges. Sales contracts may prove to be unfavorable if payments are no greater than potential rental income and the contract provides for extended terms.

Information to consider when determining classification of sales contracts includes:

1) Does the contract represent a bona fide sale;

2) The rate of return (yields should be comparable to loans for similar investment purposes);

3) The present equity of the purchaser;

4) The financial capacity of the purchaser;

5) Compliance with applicable accounting requirements regarding recognition of gains on the sale of OREO and discounting for financing at interest rates below current market rates;

6) The payment history of the purchaser pursuant to the terms of the contract; and

7) The bank's track record in utilizing sales contracts to dispose of OREO.