ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

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SUBJECT: Other Real Estate Owned (OREO) Defined

I. 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. This fair value less cost to sell becomes the “cost” of the real estate. Any write-down required at the time of foreclosure should be recorded as a charge to the bank's Allowance for Credit Losses (ACL). After foreclosure, each parcel must be carried at the lower of (1) the fair value minus the costs to sell or (2) the “cost” of the real estate. If the property’s fair value minus costs to sell is less than the cost, the deficiency must be recognized as a valuation allowance against the real estate which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) for changes in the real estate’s fair value or estimated selling costs.

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 the acquisition date will be considered OREO if a written plan has not been submitted to the Bank Commissioner.

3) ASC Subtopic 610-20 requires the application of specified portions of ASC Topic 606, to an institution’s sale of ORE. In determining the appropriate accounting for a transfer of ORE under ASC Topic 606, the institution assesses whether the buyer is a legal entity and if so, whether the selling institution has a controlling financial interest in the legal entity. If an institution determines that it has a controlling financial interest in the buying legal entity, it should not derecognize the ORE and should apply the guidance in ASC Topic 810 - Consolidation. If a controlling financial interest in the buyer does not exist or the buyer is not a legal entity, which is typically the case for most sales of ORE, the entire gain or loss, if any, along with the derecognition of the ORE are recorded if certain requirements in ASC Topic 606 and ASC Subtopic 610-20 are met.

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.

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

Arkansas Code Annotated (A.C.A.) §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.

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.

Arkansas state-chartered 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 the fair value less cost to sell. The fair value of the property must be substantiated by an appropriate evaluation or qualifying appraisal. A current appraisal prepared by an independent, qualified appraiser must be obtained when the amortized cost of the loan or recorded value of the asset exceeds $500,000. An appropriate evaluation must be performed when the amortized cost of the loan or recorded value of the asset is at or below $500,000. If a valid appraisal or evaluation has been performed within the last twelve months, no new appraisal or evaluation will be required when a property is transferred to OREO, unless there has been an obvious and material change in market conditions or physical aspects of the property.

Management should ensure that any material changes in market conditions or physical aspects of the property are periodically recognized. Subsequent deficiencies to the cost of the property (whether from changes in the assets fair value or estimated selling costs) must be recognized as a valuation allowance against the real estate which is created through a charge to expense.

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.

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. To request permission for this extension, the bank must submit, along with the Board Resolution, a plan for utilizing the property and and an explanation of why the property has not been used as intended. The request must also address the following factors which the Bank Commissioner will evaluate **on a case-by-case basis**:

(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.

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.

III. 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/evaluation 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.

IV. GUIDELINES FOR CLASSIFYING OTHER REAL ESTATE OWNED

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 Section III above), 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 fair value less cost to sell and/or contain additional losses that are identifiable. However, any amount classified Loss in the Report of Examination should not be charged-off by the institution. The loss should be recognized as a valuation allowance or an increase in an existing valuation allowance.