

B&B REVIEW

Financial Services and Transactions Creditors Rights and Bankruptcy

WHAT TO EXPECT IF YOUR “OTHER REAL ESTATE” IS THE SUBJECT OF A REGULATOR’S EXAMINATION

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INTRODUCTION

It is an unfortunate sign of the times that banks increasingly find themselves owning real estate acquired from foreclosures (usually called “other real estate” or “ORE”). Sometimes, a bank can even find itself being considered the owner of ORE by a bank examiner in the absence of formal foreclosure, such as when a borrower retains possession and title to real property securing a loan but has little or no equity.

Last year, the Federal Deposit Insurance Corporation provided ORE guidance to state-chartered banks it supervises. In our **B&B Review**, “Community Banks Offered a Refresher on How to Hold ‘Other Real Estate’”, August 2008, we summarized the operational issues facing a bank holding ORE, as set forth in the FDIC’s guidance. For example, banks are required to have procedures in place for properly valuing ORE, for maintaining ORE (including by maintaining the properties and paying taxes and insurance premiums), and for accounting for ORE in accordance with accounting rules.

This B&B Review will summarize the actual examination process likely to be followed by a banking supervisor, federal or state, which would include examination of a bank’s adherence to last year’s FDIC operational guidance.

PRIOR PROBLEMS WITH ORE

As with any other area of a bank examination, the first focus of an examination of ORE is likely to be problems that were identified in a previous examination. If your bank had an ORE-related finding in a previous examination then the first order of business should be to ensure that the remedial action that was taken a

no new findings result from a subsequent examination, a failure to effect corrective action from a prior finding can jeopardize the success of the subsequent examination.

ORE POLICIES AND PROCEDURES

In their “first day letters”, examiners are likely to request copies of the bank’s ORE policies and procedures. They will expect that the ORE policies have been approved by the board or a designated committee and have been reviewed and updated at least annually by the board.

Within the policies, examiners will expect that they establish responsibilities and accountability, and that they require that risk management processes be set forth (including for the operational issues of the type described in the FDIC’s 2008 guidance). Examiners will also look for some proof (ideally a policy) that management addresses environmental risks. (See **B&B Review**, “Banks Must Manage the Environmental Risks in ORE”, December 2008.)

MANAGEMENT PERSONNEL

Examiners will be assessing whether your bank’s management has and displays knowledge and technical skills to manage ORE. Banks should summarize for examiners the following for their employees managing ORE:

- Previous real estate management experience;
- Previous problem loan workout experience;
- Previous ORE administration experience; and
- Any formal education or planned continuing education.

Examiners might also scrutinize transactions involving bankrupt borrowers. For example,

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banks have been criticized for releasing a bankrupt borrower from liability while at the same time agreeing to split the profits on the sale of ORE transferred from the borrower. Some examiners might view this as improper real estate development rather than prudent avoidance of losses on ORE. It should also be noted that ORE obtained as a result of foreclosure would be subject to the relevant statutory right of redemption in favor of the borrower (one year in Alabama). Under Alabama law, If such ORE is sold within such period, then the bank must pay any profit realized from the sale to any junior lienholders, or the borrower if there are no junior lienholders.

CONTROLS

One of the required findings in an ORE examination is likely to be whether your bank has effective control systems in place to monitor compliance with established policies and procedures. The "first day" letter is likely to contain a request for reports used by management to supervise ORE. Examples of "reports" would include:

- Reports reconciling ORE since the last exam (See "Prior Problems with ORE" above);
- Reports on the condition of local real estate markets;
- Reports on concentrations (this would be particularly expected for banks that are considered to have a commercial real estate concentration under the guidance provided in early 2007 by the federal banking supervisors);
- Reports on ORE losses;
- Reports on nonperforming real estate loans considered potential ORE;
- Recent internal audit, regulatory compliance and loan review reports (see below); and
- General ledger.

Loan Review Function. Examiners will look carefully at a bank's loan review function to determine its effectiveness in identifying risk in ORE. Among the specific areas that will be examined are:

- the scope and coverage of ORE reviews;
- the frequency of reviews;
- the qualifications of loan review employees;
- the comprehensiveness and accuracy of findings and recommendations by the loan review function; and
- the adequacy and timeliness of follow-up.

Regulatory Compliance Review Function. Examiners will also consider the scope and adequacy of the audit/regulatory compliance review function, including all of the above

elements for the loan review function. They will also look for evidence that your bank has identified and worked to manage compliance with specific laws and regulations, particularly federal and state environmental laws and regulations.

REAL ESTATE ACQUIRED FOR FUTURE EXPANSION

If your bank has acquired real estate for future expansion, you can expect that your ORE examination will include this property. Most banking examiners will expect that within a year or so of acquiring real estate for future expansion, the board of directors will have adopted a resolution indicating definitive plans for its use. If there is no such resolution, then examiners might require that such property be transferred to ORE. (It should also be noted that some banking supervisors require advance approval for the acquisition of real estate for future expansion, and all require such approval for the establishment of a new branch.)

If plans are abandoned to use property that had been acquired for future expansion, then banking examiners will expect that it be accounted for at the lower of its net book value or its "fair value" at the date of transfer to ORE. "Fair value" means the cash price that would reasonably be anticipated to occur within the next twelve months if a buyer and a seller in a sale transaction were each acting prudently, knowledgeably and under no necessity to buy or sell. If there is an excess of net book value over fair value then that excess will likely have to be expensed during the current accounting period.

CONCLUSION

ORE examinations would not have been an emphasis in bank supervision even as recently as a year ago. However, the current problems in our economy and in bank loan portfolios have thrust this part of bank asset management to center stage. Careful advance preparation for an ORE examination can make the difference between a successful examination and a problem examination.