CRANKING DOWN ON OTHER REAL ESTATE

by Steve Brown

Headlines everywhere blast the news that people are up to their eyeballs in debt. The average household now carries $8,565 in credit card debt. The thing to remember about this headline statement, however, is that it refers to an average. We'll look closer at that later, but first we muddle through Other Real Estate (ORE).

Economic weakness and extremely difficult lending conditions have resulted in rising levels of ORE at banks. In addition, for many banks, it has been quite a few years since the last time they had to deal with ORE. That is why we provide this morning's refresher, just in case you find yourself with any ORE in the coming months.

Obviously, the first step for banks is to try and avoid a foreclosure altogether that leads to the ORE. However, if that fails, banks can be better prepared.

To start, regulations require all banks to have policies and procedures in place for acquiring, holding and disposing of ORE. For most banks, existing policies are probably not adequate, so perusing them now and making any changes is important. Policies and procedures should be designed to ensure the bank's interests in the ORE are protected, while also mitigating the impact on the value of any surrounding properties.

Next, truly understanding what is ORE and what is not, is important. For most community banks, ORE is real estate owned or controlled by the bank (or a subsidiary) that has been acquired through foreclosure (regulations say banks should account for ORE, even if they have not yet received title to the property). That said, it is also important to recognize that ORE can include tax credit fund investments, other direct/indirect investments in real estate ventures or property the bank originally acquired for future expansion (but no longer intends to use for that purpose). ORE for discussion purposes here will ignore those nuances and focus on repossessed property.

Foreclosed real estate basically consists of three primary phases that include acquisition, holding period and disposition. During the acquisition phase, a borrower has defaulted on a loan and the bank is just beginning to deal with the problem. Here, accounting rules assume these assets will be held for sale (since the bank obviously didn't want to own the property and their primary goal is to sell it off). That makes sense in general, which is why rules also require banks to record ORE at fair value less any incremental direct costs to transact a sale. These costs usually include broker commissions, legal fees, title transfer fees, closing costs and others. During the acquisition phase, banks need to obtain a valuation/appraisal to ensure material changes to the property/market conditions have both been recognized.

During the next phase, the holding period, ORE is specifically handled to minimize liability, maximize the bank's ability to get the best price for the property and focused on reducing reputation risk. The overriding goal during this phase is to prevent ongoing deterioration in the property/maximize recovery value. In this phase, expenses such as maintenance, homeowner dues, real estate taxes, insurance, utilities and others should be paid and charged against the ORE property until it is sold.

In the final phase, disposition, the bank is required to recognize any loss immediately. In general, if the property has only been held a short period of time, adjustments to losses originally recognized at the time of foreclosure would be charged against or credited back to the ALLL. Meanwhile, adjustments to losses on properties that have been held for longer periods of time should be booked into gains/losses on sale of ORE owned.

ORE by definition is a problem asset, so expect close scrutiny by regulators and auditors alike. As such, any payments, changes to the property, adjustments, etc. should be well documented in the loan files. In addition, getting on problems early, not waiting to hire an attorney to help and working through the issues as they arise in a realistic fashion is critical.

As we return to our opening discussion on credit card debt, we are sure many already picked up on the fact that the headline was about averages. As such, it missed the fact that 24% of households have no credit cards and 31% pay off their credit card bills in full each month. Our point - while bank ORE is likely to increase in coming months, not all of it is the same. No matter how flashy the headline, banks would be well served to educate stakeholders of the nuances of ORE in order to keep from getting swept up by the average.

BANK NEWS

Mutual Fund Problem

Reserve Primary Fund became the first mutual fund in 14Ys to expose investors to losses, after "breaking the buck" on its money market mutual fund. The fund wrote off $785mm of debt issued by Lehman that it owned, which in turn led investors to dump more than 60% of fund assets through redemptions. The fear at this point is that if this problem spreads through the mutual fund sector, it could lead to withdrawals from other funds. While good for banks (since the money would likely flow back into the safety of bank deposits), it would further exacerbate the crisis.

ID Theft

A new study finds 57% of small businesses don't think they need a formal plan to secure their data. The FCC reports the average cost to replace a stolen identity is $8k.