STATE OF ALABAMA
STATE BANKING DEPARTMENT

Robert Bentley
Governor

John D. Harrison
Superintendent of Banks

TO: CHIEF EXECUTIVE OFFICERS OF ALABAMA STATE-CHARTERED BANKS

FROM: JOHN D. HARRISON, SUPERINTENDENT OF BANKS

SUBJECT: SBD OPINION 2015-01 – POLICY ON BOOKING AND HOLDING REAL PROPERTY INTERESTS

DATE: JANUARY 11, 2016

Attached is a copy of the Alabama State Banking Department revised Policy on Booking and Holding Real Property Interests ("Policy"), which is effective as of December 31, 2015. For purposes of this revised Policy, the term "real property interests" includes other real estate ("ORE").

In recent years, we have dealt with a number of issues regarding real property interests that have been acquired by banks for debts previously contracted. Consequently, we are including these real property interests, such as leasehold interests, mineral rights, etc., within the revised Policy to treat them in a manner similar to our existing policy on ORE. The revised Policy also clarifies that certain information may be required to establish appropriate carrying values for real property interests, and that the holding of such interests for extended periods should be evaluated by taking into account the property's carrying costs, earning or nonearning status, and potential to expose the bank to liability. This revised Policy, which is effective as of December 31, 2015, supersedes the previous Policy on Booking and Holding of Other Real Estate dated March 22, 1985. Banks may use this revised Policy, including its provisions allowing increases in values, for reporting as of December 31, 2015.

If you have questions, please feel free to contact: Deputy Superintendent Trabo Reed at (334) 242-3507, trabo.reed@banking.alabama.gov; Banking Division Manager Nelson Cook at (334) 242-3547, nelson.cook@banking.alabama.gov; Northern District Supervisor Jeff Ellis at (334) 328-9815, jeff.ellis@banking.alabama.gov; or Southern District Supervisor Eric Wilson at (334) 328-9814, eric.wilson@banking.alabama.gov.

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SBD Opinion 2015–01 – POLICY ON BOOKING AND HOLDING REAL PROPERTY INTERESTS[1]

December 31, 2015

In recent years, many Alabama, State-chartered banks have taken possession of real property interests as a result of default on debts previously contracted ("DPC") to which the real property interests were pledged as security. With the real estate markets having recently been in a prolonged slow-down period, banks have had difficulty disposing of these assets. As a result, banks have increasingly sought the approval of the Superintendent of Banks ("the Superintendent") for permission to hold real property interests for extended periods of time. Because of this, the Alabama State Banking Department ("the Department") is updating and amending the previous policy, dated March 22, 1985, which this Opinion supersedes. This revised Policy is effective as of December 31, 2015.

Acquisition and Booking of Real Property Interests

This Policy applies to real property interests acquired for DPC. It addresses the safety and soundness aspects, such as valuation and costs, of the acquisition and holding of such real property interests.

Real property interests should generally be accounted for in accordance with the Instructions for the Preparation of Reports of Condition and Income ("Call Report Instructions"). However, there are differences between the requirements of this Policy and the Call Report Instructions. Where such differences exist, the requirements of this Policy should be followed. The primary differences between this Policy and Call Report Instructions are:

a) Upon acquisition of a real property interest, this Policy does not allow the real property interest to be written up above the recorded amount of the loan with a gain recognized.

b) This Policy requires real property interests that are held for five years to be written down to $1 if the bank has not received written approval of the Superintendent for an extended holding period.

At the time of acquisition, the real property interest must be appraised, following the standards of federal appraisal regulations,[2] by a competent, qualified appraiser.[3] Banks should exercise particular care in selecting the appraiser as well as the basis of valuation for specialized property types. The Department reserves the right to require an additional appraisal if the appraised value is viewed as outdated or unreasonable.

The real property interest may not be entered on a bank's books in an amount exceeding the lesser of the then appraised, as-is value less costs to sell the property, or the recorded amount of the loan.[4] Any excess of the recorded amount of the loan exceeding the as-is, appraised value less costs to sell the property, not including foreclosure/acquisition expense, should be charged to the Allowance for Loan and Lease Losses ("ALLL") at the time of acquisition. Direct costs incurred by a bank in a foreclosure/acquisition should be expensed as incurred.

Acquisition by Special Purpose Entities

In some instances, banks choose to allow possession of real property interests to be acquired and held by a special purpose entity ("SPE") in which the bank has an equity ownership interest or a loan receivable therefrom. This may occur in SPEs which are wholly owned by individual banks[5] and which may hold individual or multiple properties of the bank owning the SPE. SPEs may also be owned by multiple banks that participated in the original loan collateralized by the property which is held by the SPE. At all times, for such real property interests held by SPEs, including those that are not wholly owned, the SPE is subject to all documentation requirements of this Policy, and its books and records must be made available for inspection by examiners to the same extent as records of the bank. In such cases, the value of the ownership interest or collectability of the receivable is dependent upon the value of the underlying real property held by the SPE, and, in general, the repayment of the receivable or equity interest depends upon the proceeds received by the SPE from selling the underlying real property. Consequently, examiners will look to the underlying parcels of real estate held by the SPE as ORE which is subject to all of the requirements of this Policy and which will normally result in adverse classification at examinations.

Valuation of Real Property Interests after Acquisition

New appraisals may be required by the Department whenever it appears that there may have been a material decline in the condition or market value of a specific property or when there has been a general decline in real estate values. Banks should annually review their real property interests to determine whether updated appraisals may be needed. The book value of a real property interest cannot exceed the lesser of the then appraised, as-is value less costs to sell the property, or the original recorded amount of the real property interest on the acquisition date. As noted above, the original recorded amount of the real property interest on the acquisition date would be the lesser of the then appraised, as-is value less costs to sell the property, or the recorded amount of the loan on the acquisition date. Such excess will be classified Loss by examiners.

All expenses necessary to maintain the real property interest, all income therefrom, and all subsequent write-downs thereon, should be handled in accordance with the Call Report Instructions and the requirements of this Policy. No expenses incurred to maintain the real property interest may be capitalized.

According to generally accepted accounting principles and Call Report Instructions, banks may establish a valuation allowance for an acquired real property interest to reflect changes in the fair value or estimated selling costs subsequent to the acquisition date. Banks wishing to establish valuation allowances for real property interests should consult with their accountants/auditors regarding the proper accounting treatment for establishment and use of valuation reserves. According to the Call Report Instructions, once established, the valuation allowance should be increased or decreased (but not below zero) for changes in the fair value of the real property less estimated selling costs. Under this Policy, no real property interest may be written up to an amount greater than the amount of its original book value on the date of acquisition.

The previous Policy on Booking and Holding Other Real Estate dated March 22, 1985 did not permit any write-ups in the value of other real estate parcels after initial acquisition and booking. Under this revised Policy, the values of real property interests may be written up subject to conditions as detailed in the following paragraphs.

Valuation Changes – Appraised Value Changes

The values of real property interests that have been written down after their initial acquisition and booking may be written up due to subsequent increases in appraised value. Banks making such write-ups must

(1) obtain a current, outside appraisal (meeting the standards of federal appraisal regulations for outside appraisals) of the real property interest; and
(2) write up the value to an amount not exceeding the lesser of (a) the then appraised, as-is value less costs to sell the property, or (b) the original recorded book value of the real property interest on the date it was acquired through foreclosure or otherwise.

A bank which has written up a real property interest due to an increase in appraised value, must, for each real property interest that has been written up, maintain in its files the following information:

a. an outside appraisal[6] (meeting the standards of federal appraisal regulations for outside appraisals) of the real property interest;
b. documentation of full information on the current and past listing prices and length of listings for the real property interest;
c. information on offers received from potential purchasers of the real property interest and the dates of those offers;
d. memoranda or notations on bank management's expectations regarding the length of the holding period before the real property interest can be sold; and
e. documentation of changes to the book value which shows the original recorded amount of the loan at the time of acquisition of the real property interest, the original amount booked at acquisition of the real property interest, and the amounts of and supporting documentation for all subsequent changes to the book value.

In all cases where a real property interest has been written up, adverse classification may include Loss classification if the increase in book value is not supported by reasonable, updated appraisals.

In other limited circumstances, the book value of a real property interest may be written up (1) to include the amount of a senior lien on the property, or (2) to complete the property in order to get it to a saleable condition. These circumstances are discussed below. In either of the following situations, increases in book value may require the bank to obtain a new appraisal after the increase in book value, and the increase in book value will be subject to adverse classification at examinations.

Valuation Changes - Real Property Interests Subject to Senior Liens

Call Report Instructions allow banks that foreclose on a junior lien position to report the amount of any senior debt (principal and accrued interest - even when the bank has not purchased in the senior debt) to which the acquired real estate is subject at the time of foreclosure as a liability in Schedule RC, item 16, "Other borrowed money." For banks reporting outstanding senior liens in this manner, the book value of the real property interest would be increased by a corresponding amount provided that the book value cannot exceed the as-is, appraised value less costs to sell at any time. In all circumstances, a bank must maintain current documentation of the amounts owed on any senior liens to support amounts reported.

A bank deciding whether to purchase the interest of a senior lienholder should carefully consider the ultimate increase in the value of its position as well as the carrying costs of expending funds to increase a position in a nonearning asset for an indeterminate amount of time. When making decisions regarding senior liens, banks should recognize that the additional expenditure by a bank for buying in or paying off a senior lien position, when combined with any uncollected portion of the original amount loaned by the bank on the real property interest (including the book value of ORE), will be viewed by the Department as an additional extension of credit which would be limited by the lending limit statute, Alabama Banking Code Section 5-5A-22, and State Banking Board Regulation No. 14.

Valuation Changes - Completion of Property

An increase in the book value of a real property interest may occur when a bank makes expenditures after acquisition of ORE to complete the property in order to bring it to a saleable condition. In deciding whether to complete a property, banks should carefully consider the potential liability arising from engaging in construction activities. Prior to doing so, banks should evaluate their liability insurance coverages and whether the construction activity should be done through a SPE or another entity separate from the bank.

Banks should seek the guidance of the Department when considering such material expenditures. In general, the Department would view expenditures as reasonable only when made to bring the property to a saleable condition in its current state. For example, if a bank originally made a loan to develop a subdivision and then forecloses on the land on which no significant work had been done, the bank should generally value and attempt to sell the land in its current state as raw land and not attempt to put in streets, utilities, etc., in order to sell the property as developed lots. Similarly, it may be reasonable to complete partially finished houses, but it would generally be unreasonable for a bank to expend the funds to construct houses on vacant, developed lots and, in doing so, write up the book value of the parcel of ORE. Generally, expenditures to complete a property should not exceed the expected increase in the when-completed appraised value.

Holding Period for Real Property Interests

This Policy does not require banks to divest all real property interests after a specified period of time, but does require that write-downs of the book value be made based on changes in appraised value or expiration of the allowable, holding period as described below. In general, there are adverse consequences from holding nonearning, real-estate related assets with significant expenses necessary to carry and protect the assets and which can, in some cases, expose a bank to liability. Consequently, banks should make every reasonable effort to sell these nonearning assets as soon as possible.

If a bank has held a real property interest for a period of five years[7] from the date of its acquisition (including any statutory redemption period), the bank should charge the book value down to one dollar. The nominal, one-dollar value should be retained on the bank's books as a record of the bank's ownership. No extension of time beyond five years will be granted for holding a real property interest at a book value above one dollar unless a written request is made to the Superintendent accompanied by:

a. the current book value of the real property interest;
b. a current appraisal (meeting the standards of federal appraisal regulations) of the real property interest;
c. documentation of full information on the current and past listing prices and length of listings for the real property interest;
d. information on offers received from potential purchasers of the real property interest and the dates of those offers;
e. bank management's expectations regarding the length of the holding period before the real property interest can be sold; and
f. documentation of changes to the book value which shows the original recorded amount of the loan at the time of acquisition of the real property interest, the original amount booked at acquisition of the real property interest, and the amounts of and supporting documentation for all subsequent changes to the book value.

While real property interests that are held at a book value of one dollar or, with approval of the Superintendent, at a higher book value, are not required by this Policy to be disposed of; banks should recognize that the Superintendent may require divestiture if the nonearning status, carrying costs and potential liability present a significant negative impact on the bank.

Property Acquired for Future Expansion

For property intended for future expansion of bank operations, a bank may hold such property on its books as property held for future expansion[8] for a period of up to five years from the property's acquisition date. However, a bank which still intends to use a property for future expansion may request in writing an extension from the Superintendent on the period in which the bank may continue to hold the property on its books as property for future expansion. A bank making such a request should provide the Superintendent with the current book value of the property, the acquisition date of the property, the reasons for not having started construction of bank premises on the property, and its expectations for using the property for future expansion. If the bank abandons its plans to use the property for bank premises or if the bank has not begun construction of bank premises on the property after five years and has not received an extension from the Superintendent, the book value of the property should be moved to other real estate on the bank's books. It will then be subject to this Policy and treated as ORE according to this Policy for examination purposes.[9]

Endnotes

[1] For purposes of this Policy, the term "real property interests" refers to all property interests related to real estate including surface rights, mineral and other subsurface rights, leasehold interests, etc. The term includes other real estate ("ORE") acquired for DPC including foreclosed property and property acquired by deeds in-lieu-of foreclosure.

2 The term "federal appraisal regulations" as used in this Policy refers to the applicable appraisal standards contained in Part 323 of the FDIC Rules and Regulations for State, nonmember banks and Federal Reserve Board Regulation Y, Subpart G for State, member banks.

3 The terms "appraised," "appraisal," "appraiser" and "appraised value" are used in this Policy; however, it is recognized that federal appraisal regulations do not require outside appraisals for certain transactions, including those which are $250,000 or less. In cases where federal appraisal regulations do not require an outside appraisal, appropriate internal evaluations, signed by two knowledgeable bank officers or directors, that are consistent with safe and sound banking practices and sufficiently detailed to comply with federal appraisal regulations will be accepted. However, the Department reserves the right to require an outside appraisal under this Policy whenever the Department believes it is necessary to address safety and soundness concerns, and the Superintendent may require an outside appraisal when a bank seeks to write up the carrying value of a real property interest. Also, federal appraisal regulations may not apply to certain real property interests such as mineral rights, leasehold interests, etc., that are severable from the land when the DPC transaction did not involve the associated parcel of land. This Policy requires an outside appraisal performed by an appraiser competent to determine a market value for these specialized types of real property interests.

[4] The recorded amount of the loan is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest. Any adjustments to the recorded amount of the loan, increases or charge-offs, which are made due to changes in the fair value of the real estate collateral that are determined at the time of foreclosure or repossession, should be made through entries to the ALLL at the time the asset is transferred to ORE. Call Report Instructions, in an instance where an appraised value is greater than the recorded amount of the loan, allow real property interests to be booked at an amount greater than the recorded amount of the loan. However, this Policy does not allow booking of a real property interest at an amount greater than the recorded amount of the loan.

[5] SPEs in which multiple banks pool interests to hold real property interests acquired for DPC from one borrower (such as those that may result from participation loans purchased) are permissible under this Policy. However, any bank wishing to acquire, after the effective date of this Policy, an equity ownership interest in or receivable from a SPE owned by multiple banks and holding multiple properties acquired from multiple borrowers must seek the prior approval of the Department. The Department will generally not approve participation in such multiple-bank SPEs where such SPEs hold properties of other banks arising from DPC transactions in which the bank seeking approval had no interest in the original DPC transactions. Participation interests in such multiple-bank SPEs held prior to the date of this Policy are grandfathered from this approval requirement.

[6] While federal appraisal regulations may allow internal evaluations in certain circumstances, for purposes of writing up book values under this Policy, an outside appraisal meeting the federal appraisal regulation standards for outside appraisals is required.

[7] The five-year holding period begins on the date when, according to the Call Report Instructions, the real property interest should be recorded. Call Report Instructions state that this date is (1) when the real property interest is acquired in any manner for debts previously contracted (including, but not limited to, real estate acquired through foreclosure and real estate acquired by deed in lieu of foreclosure), even if the bank has not yet received title to the property, or (2) when a bank has obtained physical possession of the collateral, regardless of whether formal foreclosure proceedings have been instituted against the borrower. For real property interests held by a SPE, the holding period begins with the earlier date on which either the bank or the SPE acquired the real property interest.

[8] Refer to Memorandum to Chief Executive Officers of All Alabama, State-chartered Banks dated January 1, 2016 regarding Property Acquired for Future Expansion and Branch Applications for additional guidance regarding property acquired for future expansion.

[9] A bank transferring property from property for future expansion to ORE would have an additional five-year holding period under this Policy, even if the parcel had already been held as property for future expansion for five years.