

OCC 2011-10

Subject: Other Real Estate Owned
Date: March 24, 2011

**To: Chief Executive Officers of All National
Banks, Department and Division Heads, and All
Examining Personnel**

OCC 2011-10 was replaced by OCC 2013-20

Description: Exchanging Other Real Estate Owned for Other Assets

Background

The deterioration in asset quality due to the weak economic environment has led to an increase in nonperforming assets, including other real estate owned (OREO), on bank balance sheets. Several companies have started marketing OREO exchange programs to national banks as a means to reduce problem assets. These programs purport to reduce nonperforming assets by exchanging OREO for an interest in another asset, which is represented to be performing. This “performing asset” is often an equity interest in the entity acquiring the OREO or a trade for a large volume of loans such as home equity lines of credit. These programs can raise significant safety and soundness, legal, and accounting concerns and the Office of the Comptroller of the Currency (OCC) strongly encourages national banks to consult with their supervisory offices before entering into any such agreements.

Common issues associated with the exchange of OREO assets for an equity interest (generally in a limited liability company (LLC)) include

- The bank’s loss of control over its OREO assets,
- The exchange of OREO for an asset of questionable liquidity and value,
- The commingling of the bank’s OREO with other real estate that may be of poorer quality,
- Significant up-front fees and recurring management fees paid to the organizing company, and
- Unfavorable priority of payments between the banks and equity investors.

In addition, the entity acquiring the OREO is often involved in activities that are not permissible for national banks, making the exchanged asset acquired by the bank an impermissible asset. Moreover, the structure of the exchange transaction typically does not meet the accounting definition of a true sale. Thus, rather than improving its position, the bank ends up in an economically inferior situation, with additional legal and accounting issues.

Another example of transactions offered to national banks to reduce their nonperforming asset balances is an “adjusted price trade.” This type of transaction involves an offer to purchase the bank’s nonperforming real estate loans or OREO at book value, with the stipulation that the bank purchase other assets, at inflated values, from the same party. The “adjusted price trade” is not only unsafe and unsound but may constitute fraud if it results in the misrepresentation of the bank’s financial statements.

In a limited number of circumstances, a national bank may acquire a noncontrolling equity interest in an LLC in exchange for its interest in OREO. The OCC has approved only one type of exchange, in which an LLC was established as a means *for the participants in the original loan* to hold the real estate collateral acquired through or in lieu of foreclosure. In this case, the participants in the original loan were the members of the LLC, and each participant held an interest in the LLC equivalent to its participation interest in the loan and OREO. The LLC was established specifically to manage and dispose of the OREO. The member banks retained control over the OREO asset and maintained the same level of risk as before the exchange. The exchange, however, enabled the participants to manage and dispose of the OREO more efficiently than if each bank had to manage its own partial interest in the property.

A national bank wishing to complete such an exchange of its loan interest for an equivalent LLC interest has two alternatives. The bank may follow the well-established licensing procedures in 12 CFR 5.36 for making a noncontrolling investment by submitting a notice (limited to well-capitalized, well-managed banks) or application, as appropriate.¹ Alternatively, the bank may seek approval from its supervisory office under the standards established in OCC Interpretive Letter No. 1123 (September 18, 2009).² The

supervisory office approval under the standards established in Interpretive Letter No. 1123 is available only for those instances, as described previously, in which the participants in a loan form an entity to hold, manage, and dispose of the OREO collateral acquired for debts previously contracted. Interpretive Letter No. 1123 does not provide legal support for national banks to exchange OREO for equity interest in an entity aggregating various unrelated OREO parcels from multiple banks.

Considerations

Banks need to use caution when looking at novel methods of trading nonperforming OREO balances for other assets. Before entering into any type of OREO exchange, the bank should have a detailed, documented plan. Bank management and the board of directors, at a minimum, should

- Document how the exchange is permissible and in the best interest of the bank and how it would improve the ability of the bank to recover or otherwise limit, its loan loss. This determination should address how the transaction is in line with board-established strategies to reduce nonperforming assets. The board of directors should review the determination before approving the transaction.
- Make a determination as to whether the exchange qualifies as a sale under Accounting Standards Codification Topic 860, *Transfers and Servicing*. Policies and procedures should be in place to ensure that the bank is following generally accepted accounting principles. The accounting policies and procedures should also address how to value any account or expenses related to the OREO and/or the exchanged asset at consummation of the transaction and on an ongoing basis.
- Identify the reasons that are preventing the bank from selling the OREO and provide documentation supporting why the exchange will make the real estate more marketable.
- Ensure that an accurate value of the exchanged asset is established and determine a schedule or trigger points for when to update the value.
- Ensure that adequate risk management, measurement systems, and controls are in place to enable the bank to exchange for, hold, and dispose of the acquired interest in a safe and sound manner.
- Set parameters and methods for tracking assets received in the OREO exchange to avoid multiple exchanges for interests in any other real or personal property.
- Ensure that any entity in which the bank acquires an interest complies with the provisions of the OCC's OREO regulation, 12 CFR 34, subpart E, including requirements for additional expenditures, and appraisals or evaluations.
- Conduct adequate due diligence to determine and document that all activities are permissible banking activities. The activities to be performed by any entity in which the bank acquires an interest in exchange for the OREO should be clearly documented and the bank should obtain a commitment from the third party with regard to activities performed.
- Have processes in place to dispose of its interest in any such entity no later than five years from the date the bank initially acquired title to the OREO (unless granted an extension by the OCC as allowed by 12 USC 29).

Although the transaction may be marketed as a simple way to reduce nonperforming assets, these transactions can be very complicated and must be reviewed thoroughly before entering into them.

Further Information

Please contact your supervisory office with questions on specific exchange programs or processes. You may also direct questions or comments to Darrin Benhart, Director of Commercial Credit Risk, at 202-874-4564; or Steven Key, Special Counsel, Bank Activities and Structure, at 202-874-5300.

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¹ <http://www.gpo.gov/fdsys/pkg/CFR-2010-title12-vol1/pdf/CFR-2010-title12-vol1-sec5-36.pdf>

² <http://www.occ.gov/static/interpretations-and-precedents/oct09/int1123.pdf>