FASB Emerging Issues Task Force

Issue No. 13-E

Title: Reclassification of Collateralized Mortgage Loans upon a Troubled Debt Restructuring

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FASB Staff: Goswami (ext. 358) / Sangiuolo (ext. 426)

EITF Liaison: John Althoff

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Background

1. The number of vacant or abandoned residential properties resulting from the weakness in the housing market has increased the potential for higher levels of other real estate owned (OREO) by banks or similar lenders (creditors). Because of the extended foreclosure processes, creditors are reviewing and updating their policies on when to reclassify a collateralized mortgage loan to OREO. OREO consists of real property held by a creditor for reasons other than to conduct its business. As such, holding OREO is not part of the creditor's normal operations and there is different operational risk to managing real estate versus an impaired loan. A growth in OREO also could be indicative of deteriorating credit for the bank with non-earning assets that are growing. Therefore, loan reclassifications and presentation as OREO may be of qualitative significance to users of the creditor's financial statements. As such, the timing of loan reclassification to OREO is of interest to regulators and other users of financial statements in terms of uniformity in interpreting and applying U.S. GAAP guidance.

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* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

2. The U.S. GAAP guidance for recognition of foreclosed real estate is set forth in Subtopic 310-40, Receivables—Troubled Debt Restructurings by Creditors (formerly FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*); Subtopic 310-10, Receivables—Overall (formerly FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*); and Subtopic 360-10, Property, Plant, and Equipment—Overall (formerly FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*).

3. Paragraph 310-40-40-6 addresses the accounting for a troubled debt restructuring

> … that is *in substance a repossession or foreclosure* by the creditor, that is, the creditor receives *physical possession* of the debtor's assets *regardless of whether formal foreclosure proceedings take place*, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable…. (Emphasis added.)

However, the terms *in substance a repossession or foreclosure* and *physical possession* are not defined in the accounting literature and, also, there is diversity in the timing of their application for purposes of reclassifying the loan receivable.

4. Paragraphs 310-10-35-7 and 310-40-40-3 require that in a troubled debt restructuring described in paragraph 310-40-40-6 (excerpted above), the creditor should initially record the assets received (and held for sale) at their fair value less cost to sell. The amount at which the foreclosed real estate is initially recorded becomes the initial carrying amount of that foreclosed real estate.

5. Paragraph 360-10-35-43 requires that a long-lived asset classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell. The guidance also provides that a loss should be recognized for any subsequent decrease in fair value less cost to sell, and a gain should be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized. That is, the recorded value can never exceed the initial cost basis.

Scope

6. This Issue affects consumer loans issued by banks or other lenders that are collateralized by the real estate property for which the loan was obtained.

Accounting Issue and Alternatives

When a creditor should be considered to have taken physical possession of a real estate property collateralizing a loan, such that the loan should be reclassified (for example, to OREO).

View A: A creditor should be considered to have taken physical possession of real estate property collateralizing a loan, such that the loan should be reclassified, upon (a) the creditor obtaining legal title to the real estate collateral or (b) the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy that loan even though legal title may not have passed.

7. Proponents of View A believe that reclassifying the loan before transfer of legal title or the conveyance of all interest in the residential property by the borrower, such as by way of a completed (all terms and conditions have been satisfied by both parties) deed in lieu of foreclosure,[1] may potentially create greater complexity and diversity in practice because in that case significant judgment may be required in determining whether an *in substance repossession or foreclosure* has occurred. Proponents of View A also do not consider there to be significant diversity in practice among the larger creditors in that typically View A is followed for loan reclassifications. However, they acknowledge that clarifying this Issue would address concerns of regulators and users that the guidance has been appropriately interpreted.

8. Proponents of View A note that under regulatory guidance, the recorded investment in a collateral-dependent delinquent loan that is significantly past due (as would be typical for a loan

[1] A deed in lieu of foreclosure agreement is an agreement by which the borrower conveys all interest in residential property to the lender to satisfy a loan that is in default by agreeing to vacate (surrender) the property. Once the agreement is signed by the borrower, generally the bank and the borrower have shared access to the property. The agreement is completed when all terms and conditions have been satisfied by both parties. At that time, the bank can deny the borrower access to the property and the documentation is sent to the municipality/authority to record title.

within the scope of this Issue) generally would be written down to the fair value of the collateral less cost to sell. Therefore, in terms of the effect on reported financial results of reclassifying a loan to OREO, they believe that in most cases, both foreclosed real estate and a collateral-dependent delinquent loan that is significantly past due will be measured the same way; that is, based on the fair value of the collateral less cost to sell. Considering that the accounting would be similar, some proponents of View A question the relevance and necessity of reclassifying a loan prior to a transfer of title or the conveyance of a completed deed in lieu of foreclosure.

9. For purposes of this Issue, proponents of View A consider transfer of legal title and a completed deed in lieu of foreclosure to be similar because legal title can typically be obtained within a few months of a completed deed in lieu of foreclosure. Further, proponents of View A believe that the reference in the accounting guidance to the creditor receiving *physical possession* of the debtor's assets *regardless of whether formal foreclosure proceedings take place* could be construed to be referring to situations in which a deed in lieu of foreclosure is completed, ultimately leading to title being received by the creditor without formal foreclosure proceedings taking place. In support of that view, proponents of View A refer to paragraph 70 of the basis for conclusions in Statement 114, which states that

> This Statement amends paragraph 34 of Statement 15 [codified in paragraph 310-40-40-6] to clarify the applicability of that paragraph. Paragraph 34 was intended to apply to *a narrow set of circumstances*; that is, a troubled debt restructuring or other circumstance in which a debtor surrendered property to the creditor and the creditor was in possession of the asset with or without having to go through formal foreclosure procedures. [Emphasis added.]

10. Proponents of View A observe that unless contractually specified otherwise, the creditor generally only has protective rights associated with OREO for which it is not legally the owner. In such circumstances, the actions taken by a creditor with regard to the property, including maintaining the physical property, paying taxes to avoid a tax lien being placed on the property, and reviewing insurance policies and potentially obtaining insurance coverage, are to protect the creditor's interest in the property and prevent deterioration in the property so as to maximize the recovery value. However, the creditor lacks the most important rights associated with ownership in that it cannot receive rent income or sell or otherwise transfer the real estate property before

title is obtained (or all interests are conveyed), and, therefore, many of the benefits of ownership are dependent on possessing title or upon the borrower conveying all the interests in the property, such as evidenced by a completed deed in lieu of foreclosure. Proponents of View A believe that when legal title is received or a deed in lieu of foreclosure is completed, there has been an exchange transaction between the creditor and debtor. They believe that only such an exchange should give rise to a reclassification of the receivable to OREO. They also believe that this would result in more objective and auditable accounting in that application of judgment would be limited.

11. Proponents of View A believe that earlier reclassification of the loan to OREO also may result in other practice issues in accounting for an asset for which the creditor is not legally the owner. For example, they note that sales of past due (nonperforming) loans is not uncommon and observe that in case reclassified loans are sold to a third party before the creditor owns the collateral, questions may arise as to whether the guidance for real estate sales in Subtopic 360-20, Property, Plant and Equipment—Real Estate Sales, or the guidance for sales of financial assets in Topic 860, Transfers and Servicing, should apply.

12. Proponents of View A also note that a creditor's obligations with respect to real estate property as a lien holder are different from its obligations as an owner. In their view, accounting recognition of a real estate property for which the creditor does not yet hold title (or for which the borrower has not conveyed all interest) may impede the creditor's ability to limit its obligations to those of a lien holder and force it to assume the broader obligations of an owner. For example, the creditor may be treated as owner and may get demands from local governments to clean up or remediate dangerous conditions or zoning violations concerning abandoned real estate properties for which they are merely the lien holder and for which they may change their previous decision to foreclose on the property and instead walk away from the property.

13. Opponents of View A state that the creditor's legal liability would be unaffected by an internal reclassification for accounting purposes because they believe that statutory requirements are not dependent on internal classifications. They observe that regulations that limit the holding period of OREO (for example, some jurisdictions limit it to five years) by certain creditors is not

necessarily dependent on internal reclassification of the loan for accounting purposes, but is more of a legal determination. Opponents of View A do not consider transfer of title or a completed deed in lieu of foreclosure to be necessary in determining whether there has been in substance a repossession or foreclosure, that is, the creditor receives physical possession as provided by paragraph 310-40-40-6 for purposes of reclassifying the loan. They believe that a creditor can, in substance, have physical possession prior to the legal formalities being completed.

14. Opponents of View A also note that in some cases, even a transfer of title may not equate to physical possession, and, therefore, they believe that reclassification of the loan should not necessarily be dependent upon the transfer of title or completion of a deed in lieu of foreclosure. For example, as part of the foreclosure process, certain jurisdictions have mandatory redemption periods after a title passes to the creditor whereby the borrower can reclaim title by fully satisfying the debt. During the redemption period, the borrower may occupy the property, thus maintaining physical possession of the collateral. Additionally, the borrower may secure other financing to pay off the debt. In such circumstances, generally a creditor does not have the ability to enter the residential property until the redemption period has expired.

View B: A creditor's assessment of whether it should be considered to have taken physical possession of property collateralizing a loan prior to obtaining title (or conveyance of all interests) is dependent upon facts and circumstances. If such facts and circumstances reflect that the creditor has significant involvement in the collateral such that its primary risk is real estate risk, that would be considered to be in substance a repossession or foreclosure and the loan should be reclassified to reflect that fact.

15. Proponents of View B believe that whether an in substance repossession or foreclosure should be considered to result in the creditor taking physical possession of property collateralizing a loan prior to obtaining legal title to the property (or all interests being conveyed, such as by way of a completed deed in lieu of foreclosure), is dependent upon the facts and circumstances about whether the creditor's primary risk is real estate risk. Proponents of View B believe that a loan should be reclassified (for example, to OREO) when a creditor determines

that it has significant involvement in the collateral such that its primary risk is real estate risk related to the value of the property, due to its intent to recover on the loan through the sale of that property, as opposed to its primary risk being the credit risk of the borrower. Under such circumstances, proponents of View B believe that financial statement users are best served by reclassifying that loan (for example, to OREO).

16. Under View B, the creditor would be required to consider various factors in determining whether the loan should be reclassified. The following are some indicators that could be considered under this approach:

a. Whether the creditor has initiated foreclosure proceedings. If the creditor has decided to foreclose and is in foreclosure proceedings, that is an indication that the creditor’s primary risk is real estate risk related to the value of the property, due to its intent to recover on the loan through the sale of the property, as opposed to its primary risk being the credit risk of the borrower.

b. The borrower's equity position regarding the property. If the borrower has little or no equity in the property and the borrower is severely delinquent (for example, over 180 days) and is not expected to be able to make payments on its loan or maintain the property (for example, borrower is not paying escrow, utilities, lawn maintenance, and so forth), that may indicate that the creditor’s primary risk is real estate risk due to repayment or satisfaction of the loan likely being dependent on the sale of the collateral.

c. The nature of the creditor's access to the property. A creditor may have physical possession of the real estate through "shared access," as described below, long before it obtains legal title or a completed deed in lieu of foreclosure. In some circumstances, obtaining "shared access" may indicate that the creditor's primary exposure has shifted to real estate risk because recovery of the loan would likely arise from foreclosure proceedings and eventual disposition of the real estate collateral. In a shared access situation, typically,

1. The creditor determines the property to be vacant or abandoned based on available evidence and inspections (for example, borrower moved-out, no utilities connected, no visible signs of occupancy, limited or no personal possessions being present on the property, no response to any notices, and so forth).
2. Once the property is determined to be vacant or abandoned, the bank secures access to the property by changing or re-keying locks to obtain access and maintain the property and protect its investment. The borrower may have access to one of the locks to return to the property. Although the borrower has a legal right to reenter the property even though they may have already abandoned or vacated it, it is typically not common for the borrower to exercise that right. Therefore, shared access may not be substantively different from the sole access that is obtained by the creditor through transfer of title or a completed deed in lieu of foreclosure.
3. The bank posts a notice indicating that it is maintaining the property; the notice provides a toll-free number that the homeowner, and others, can use to contact the bank. Many jurisdictions require the bank as lien holder to maintain the property.

d. The creditor's involvement in maintaining the property. The creditor may be paying property costs and securing the property to protect its investment and fulfilling its requirements to maintain the property. Property costs include insurance, taxes, and maintenance. Examples of maintenance costs include: winterization, debris removal, clean outs, board ups, general repair, lawn care, and inspections. In addition, the creditor may be adhering to local government requirements and vacant property registration ordinances that identify the creditor as the primary contact regarding property complaints and maintenance needs. Actions taken by the creditor to protect its investment (which may be legally required) may indicate that the creditor's primary risk is real estate risk, because repayment or satisfaction of a loan will likely be dependent on the sale of the collateral.

17. Proponents of View B also refer to paragraph 70 of the basis for conclusions in Statement 114, but unlike proponents of View A, they emphasize the guidance about the creditor being "in

possession of the asset *with or without having to go through formal foreclosure procedures*" (emphasis added). Proponents of View B state that consideration of the nature of the creditor's access to the property, the creditor's role in maintaining the property, and the borrower's equity position regarding the property is consistent with the guidance about not necessarily having to go through formal foreclosure proceedings for in substance a repossession or foreclosure, that is, physical possession to occur as provided by paragraph 310-40-40-6. However, they agree that initiation of foreclosure proceedings would be an important factor to consider in making that determination.

18. Opponents of View B observe that reclassifiying the loan before transfer of legal title (or the conveyance of all interest in the property) may result in practical problems in accounting for an asset for which the creditor is not legally the owner and should not lead to reclassification of the loan. In support of their view, opponents of View B refer to paragraph 71 of the basis for conclusions in Statement 114, which states that

> The Board recognizes that in practice paragraph 34 [codified in paragraph 310-40-40-6] of Statement 15 and the term in-substance foreclosure are applied in situations other than troubled debt restructurings *or situations in which a debtor surrenders property to the creditor*…. The Board recognizes the *practical problems* of accounting for the operations of an asset the creditor *does not possess* and concluded, therefore, *that a loan for which foreclosure is probable should continue to be accounted for as a loan*. [Emphasis added.]

19. Opponents of View B interpret "possess" to mean that the creditor legally possesses that asset and/or enjoys the full benefits of ownership, which they do not believe to be possible prior to obtaining legal title (or the conveyance of all interest in the property). Further, opponents of View B assert that foreclosure only is *probable* and not a certainty until legal title is obtained (or all interests in the property are conveyed) and note that paragraph 71 in the basis for conclusion of Statement 114 (excerpted above) concluded that a loan for which foreclosure is probable should continue to be accounted for as a loan.

20. As such, opponents of View B do not believe that the factors listed in paragraph 16 provide the sufficiently *narrow set of circumstances* discussed in paragraph 70 of the basis for

conclusions in Statement 114 for applying the "in substance" guidance provided by paragraph 310-40-40-6 nor do they believe that those factors are indicative of the debtor *surrendering* property to the creditor (as discussed in paragraph 71 of that Statement). Opponents of View B interpret surrendering property to mean that the borrower has *voluntarily* conveyed all interest in the residential property to the creditor such as by way of a completed deed in lieu of foreclosure. They do not believe that the factors listed in paragraph 16, such as the borrower abandoning the property, which is typical in a shared access situation, is the same as surrendering that property.

21. In addition, opponents of View B believe that because significant judgment may be required on the part of the creditor to determine whether it has significant involvement in the collateral such that its risk is primarily real estate risk, it does not resolve the existing diversity in practice and, in fact, may potentially create greater complexity and diversity in practice. Further, they observe that a loan becoming collateral-dependent as provided in paragraph 310-10-35-22 is not specified to be a trigger for physical possession under Subtopic 310-40 even though some may argue that in a collateral-dependent loan, the creditor's primary risk is real estate risk. Proponents of View B argue that the factors in paragraph 16 extend beyond a loan only becoming collateral-dependent and also consider whether the creditor has initiated foreclosure proceedings, the nature of the creditor's access to the property, and other indicators of an in substance possession or foreclosure.

Recurring Disclosures

22. The FASB staff notes that Sections 310-40-50 and 310-10-50 require certain disclosures to be made by creditors about troubled debt restructurings and modifications of financing receivables.[2] Those include disclosures about the recorded investment in an impaired loan and the nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses. Additionally, Section 205-20-50 requires certain disclosures about assets held for sale. However, disclosure about when a loan is reclassified (for example, to OREO) is not required even though judgment may be

[2] A financing receivable is defined in the Master Glossary of the Codification as a financing arrangement that both (a) represents a contractual right to receive money either on demand or on fixed or determinable dates, and (b) is recognized as an asset in the entity's statement of financial position. Paragraphs 310-10-55-13 through 55-15 provide more information on the definition of a financing receivable, including a list of items that are excluded from the definition (for example, debt securities).

applied in making that determination. The staff does not believe that this Issue should lead to incremental disclosures and, therefore, does not believe that additional recurring disclosures are necessary.

Transition

23. Presented below are two transition alternatives for Task Force consideration:

View A: Entities should apply this Issue on a modified retrospective basis from the beginning of the first period presented. Early adoption would be permitted.

24. Under the modified retrospective application, any reclassifications upon the date of adoption between loans and OREO existing at the beginning of the earliest period presented would be reflected in the carrying amounts of those assets as of the beginning of the earliest year presented. An offsetting adjustment, if any, would be made to the opening balance of retained earnings (or other appropriate components of equity) for that period. Financial statements for each individual prior period presented would be adjusted to reflect the period-specific effects of subsequent reclassifications.

25. Proponents of transition View A believe that applying any amendments using a modified retrospective approach would result in consistency and comparability. Proponents of transition View A observe that the FASB's conceptual framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. Those proponents refer to paragraph B7 of the basis for conclusions in FASB Statement No. 154, *Accounting Changes and Error Corrections*, which states that:

> The Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data.

26. Opponents of transition View A note that reliable records necessary for the modified retrospective application may not be available for periods prior to the date of adoption especially

if a consensus is reached on View B of the Accounting Issue and Alternatives section of this Issue Summary. Further, they argue that a modified retrospective application under View B of the Accounting Issue and Alternatives section would not be operational or objective in that hindsight necessarily would need to be applied in making a determination as to whether in substance a possession or foreclosure existed in the period prior to the amendments being effective.

27. Opponents of transition View A note that even if a consensus is reached on View A of the Accounting Issue and Alternatives section of this Issue Summary, creditors who are currently reclassifying the loan before transfer of legal title (or conveyance of all rights) would be required to review their "archived" legal and other foreclosure documents, which may not always be readily available, and adjust prior periods as necessary. They believe that this retrospective exercise would be burdensome, not only for the larger creditors that may have numerous such loans but also for smaller entities that may have limited staff and expertise. Opponents of transition View A also believe that if a consensus is reached on View A of the Accounting Issue and Alternatives section, requiring creditors who were reclassifying their loans prior to obtaining legal title to adjust prior periods unduly "penalizes" those creditors and unnecessarily increases transition costs. As such, opponents of transition View A believe that retrospective application would be too onerous and costly and would outweigh the benefits of providing that information.

28. Opponents of transition View A also refer to paragraph 8 and note that in terms of the effect on reported financial results of reclassifying a loan to OREO or vice versa, both foreclosed real estate and a collateral-dependant delinquent loan that is significantly past due generally will be measured the same way; that is, based on the fair value of the collateral less costs to sell. As such, opponents of transition View A do not believe that the income statement (or retained earnings) would significantly be affected by this Issue. Therefore, they question the relevance of a modified retrospective application when the accounting effect of that application essentially would only be a balance sheet reclassification.

View B: Entities should apply any amendments on a prospective basis from the date of adoption. Early adoption would be permitted.

29. Proponents of transition View B agree with the opponents of modified retrospective application and believe that only a prospective application is justified from a cost-benefit and relevance perspective. Under the prospective application, any reclassification upon date of adoption between loans and OREO would be reflected in the carrying amounts of those assets as of the beginning of the current year presented. An offsetting adjustment, if any, would be made to the opening balance of retained earnings (or other appropriate components of equity) for the current year. Financial statements for the current and subsequent years would be adjusted to reflect the period-specific effects of subsequent reclassifications.

30. Proponents of View B support applying any amendments arising from this Issue to loans and OREO *existing* at the date of adoption and loans that are issued on or after that date. They note that if the amendments were only to be applied to new loans that are issued after the date of adoption or loans modified after that date, it would result in current practice continuing to be followed for existing loans. If that current practice differs from the conclusion (if any) reached on this Issue, it would result in a "two-model approach" being followed for loan reclassifications, affecting comparability and user understanding and also increasing the burden on the preparer.

Transition Disclosures

31. The guidance on other presentation matters in Subtopic 250-10, Accounting Changes and Error Corrections—Overall, is applicable for any voluntary change in accounting principle, including a change in the method of applying an accounting principle. The staff recommends that the Task Force require companies to apply the disclosure requirements in Section 250-10-50 for an accounting change required by this Issue. Additionally, the staff recommends that the Task Force not require any additional disclosures other than the requirements in paragraphs 250-10-50-1 through 50-3.