
**Office of the Comptroller of the Currency
National Credit Union Administration**

October 4, 2013

Ms. Susan Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. EITF-13E: Proposed Accounting Standards Update: Receivables—
Troubled Debt Restructurings by Creditors (Subtopic 310-40), *Reclassification of Collateralized
Mortgage Loans upon a Troubled Debt Restructuring*

Dear Ms. Cospers:

The staffs of the Office of the Comptroller of the Currency (OCC) and National Credit Union Administration (NCUA) – (together, Agencies) appreciate the opportunity to comment on the Financial Accounting Standards Board’s (FASB or the Board) proposed Accounting Standards Update (ASU) to Subtopic 310-40, Receivables: *Troubled Debt Restructurings by Creditors: Reclassification of Collateralized Mortgage Loans upon a Troubled Debt Restructuring* (the Exposure Draft or ED).

The OCC charters and supervises national banks and federal savings associations (together, banks). OCC-regulated banks hold a significant majority of residential mortgage loan related assets in the banking industry including: 74% of residential mortgage loans; 91% of residential mortgage loans in process of foreclosure; and 73% of foreclosed residential properties, known as other real estate owned (OREO).¹

The NCUA is the independent federal agency that regulates, charters, and supervises federal credit unions. With the backing of the full faith and credit of the U.S. Government, NCUA operates and manages the National Credit Union Share Insurance Fund (NCUSIF), insuring the deposits of more than 95 million account holders in all federal credit unions and the

¹ Represents the percentage of total banking assets reported in the Consolidated Reports of Condition and Income (i.e., the Call Report) held by OCC-supervised institutions, based on Call Report data as of June 30, 2013. Residential real estate loans include first mortgage loans and junior liens, including home equity lines of credit (HELOCs). OREO includes foreclosed properties from loans included in GNMA mortgage backed securities.

overwhelming majority of state-chartered credit unions, in total including approximately 6,700 credit unions in the United States. Of the \$613 billion aggregate loan assets held by federally-insured credit unions, 41% are first mortgage real estate loans. Foreclosed and repossessed real estate comprise 87% of the aggregate \$1.3 billion foreclosed or repossessed assets.²

While we appreciate the Board's consideration of this issue and agree it would be helpful to have one physical possession concept apply to all loan types, the Agencies do not support the proposed ED because it removes, rather than defines, the concept of physical possession, which we do not view as an improvement to financial reporting. We have observed that the proposed ED would require a majority of financial institutions supervised by the Agencies to change accounting practices for residential real estate properties abandoned by borrowers for which they obtain physical possession prior to obtaining title. For residential real estate, we believe a financial institution has obtained physical possession upon meeting both of the following criteria:

- Physical access to abandoned real estate collateral, and
- Physical maintenance of the property.

Background

A brief outline of the history of the issue is useful as it helps frame our position. The concept of in-substance foreclosure has been around for more than 35 years. As originally issued in 1977, Statement of Financial Accounting Standard (SFAS) 15, paragraph 34, required a creditor to account for a troubled debt restructuring that is in-substance a repossession or foreclosure by recognizing the fair value of the collateral as an asset, even if the creditor does not formally repossess the collateral. However, SFAS 15 did not identify any criteria to determine when a creditor was considered to have substantively repossessed collateral.

After finding inconsistency in accounting practice, the Securities and Exchange Commission (SEC) in 1986 issued Financial Reporting Release 28 (FRR 28) prescribing criteria for when a loan should be accounted for as an in-substance repossession of collateral. Those criteria focused on whether the primary risks and rewards of collateral ownership had passed from the debtor to the creditor. The criteria included (among others):

1. "The debtor had little or no equity in the collateral, considering the current fair value of the collateral; ..." and,
3. "The debtor has: ..."

² Based on data collected in the Call Report (5300) as of the quarter ending June 30, 2013 displayed in the publicly available aggregate financial performance report. First mortgage real estate loans include first mortgage loans along with home equity lines of credit.

- b. “retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor and/or the collateral in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.”

In April 1990, the Accounting Standards Executive Committee of American Institute of Certified Public Accountants issued Practice Bulletin 7 (PB 7), *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*, to apply the criteria of FRR 28 to companies not required to register with the SEC.

Under the criteria of FRR 28 and PB 7, a loan was required to be reclassified to OREO even in situations where the debtor retained both title and physical possession of the collateral. This could occur when the debtor had little or no equity in the collateral and it was doubtful the debtor could rebuild equity in the foreseeable future.

Upon adoption of SFAS 114 in May 1993 (through an amendment to SFAS 15, paragraph 34), a creditor is required to recognize in-substance foreclosure only when the creditor receives physical possession of the collateral, regardless of whether formal foreclosure proceedings take place. The Board explained the reason for this change in paragraphs 70 and 71 of the basis for conclusions in SFAS 114. Paragraph 70 indicates: “This Statement amends paragraph 34 of Statement 15 to clarify the applicability 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.**” Paragraph 71 states: “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.] We have long interpreted this language to mean that in situations where the debtor retains possession of collateral, the loan should not be reclassified to OREO before title passes even if the debtor has little or no equity and foreclosure is likely. However, when the creditor obtains physical possession of real estate collateral, the asset should be reclassified as OREO even though legal title has not yet passed to the creditor.

To summarize, the concept of in-substance foreclosure was initially introduced in SFAS 15 without defining criteria. The SEC and AICPA then defined in-substance foreclosure very broadly, but that proved not to be operational. In response, the FASB narrowed the scope of in-substance foreclosure in SFAS 114 to include only physical possession. In our view, the current principle of considering collateral to be in-substance foreclosed when the creditor obtains physical possession is appropriate and operational. Providing additional guidance on determining how a creditor should evaluate whether it has obtained physical possession is

worthwhile. We do not support the ED because, as explained in the following paragraphs, it effectively eliminates the concept of in-substance foreclosure.

Proposed Accounting Standards Update

The ED would clarify an in-substance repossession or foreclosure occurs, and the creditor is considered to have received physical possession of residential real property collateralizing a consumer mortgage loan, upon (1) the creditor obtaining legal title to the residential real estate property, or (2) completion of a deed in lieu of foreclosure or similar legal agreement under which the borrower conveys all interests in the property to the creditor to satisfy the loan. While we agree that OREO should be recognized under those conditions, it is because they represent legal title, not because those conditions represents in-substance foreclosure. In our opinion, collateral should be recognized as OREO earlier than those conditions in the limited circumstance where the financial institution obtains physical possession (in-substance foreclosure).

The Agencies do **not** agree the proposed Accounting Standards Update would be an improvement to U.S. generally accepted accounting principles (GAAP) because the ED:

- Provides less transparent reporting to users of the financial statements;
- Improperly emphasizes legal form over economic substance, thereby changing rather than interpreting GAAP; and
- Requires reclassification of existing in-substance foreclosed OREO back to loans for a period prior to obtaining legal title, after which the collateral would return to OREO.

Less Transparent Reporting

Physical access to and physical maintenance of residential real estate collateral property constitute physical possession of the collateral, and continuing to portray the asset as a loan is less transparent to users of financial statements.

The Agencies believe that when a borrower surrenders physical possession or control of a non-financial collateral asset to a financial institution, the collateral asset should be reflected on the financial institution's balance sheet as a repossessed asset rather than a loan. With regard to residential mortgage loans, physical access to abandoned real estate collateral and physical maintenance of the collateral property by the financial institution constitute physical possession of the collateral. Such physical possession represents an in-substance foreclosure and is appropriately reported as OREO rather than as a loan. At the point that it takes physical possession, the financial institution: (1) is exposed to the risk of real estate ownership, (2) manages the asset as real estate, (3) is highly likely to eventually obtain legal title to the real estate, and (4) will primarily realize the benefits of the asset from its sale of real estate.

Continuing to portray the asset as a loan is less transparent for users of financial statements and does not represent an improvement in financial reporting.

For example, most would agree that when an automobile securing an automobile loan is repossessed the asset should be reclassified to repossessed assets from loans upon physical possession, even though legal title has not yet been acquired. While the time period from repossession of an automobile to obtaining legal title is generally significantly shorter than for real estate collateral securing a mortgage loan, the principle should be the same. Although real estate cannot be towed to a lot secured by the financial institution, we are of the opinion obtaining physical access and physically maintaining real estate is the functional equivalent of repossession in the case of an automobile.

The general principle of physical possession should apply regardless of the collateral's nature, including residential mortgage loans, consumer auto loans, commercial mortgage loans, or other commercial loans, even though the evidence of physical possession may vary by collateral type. For example, while a loan secured by farmland would not be subject to access by means of a key and commercial property may not be abandoned, if the borrower surrenders control / possession of the collateral to the financial institution, it should nevertheless be reclassified to OREO even though legal title has not yet been obtained.

Those advocating for the proposed view assert the criteria proposed in the ED is more objective and auditable. We observe that whether a financial institution has physical access to the property and is paying to maintain the property are not subjective determinations.

Legal Form over Economic Substance

By clarifying that an in-substance foreclosure occurs only when the creditor obtains legal title (by foreclosure or deed in lieu of foreclosure) to the collateral property, the ED elevates legal form over economic substance.

The ED states “an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon (1) the creditor obtaining legal title to the residential real estate property or (2) completion of a deed in lieu of foreclosure or similar legal agreement under which the borrower conveys all interest in the residential real estate property to the creditor to satisfy that loan, even though legal title may not yet have passed.” The result of both of these proposed conditions is legal title has *already* passed to the financial institution. The ED appears to equate the recording of a deed with conveyance of legal title. Paragraph BC7 states: “The Task Force considered transfer of legal title and a completed deed in lieu of foreclosure to be similar because legal title typically can be obtained within a few months of a completed deed in lieu of foreclosure.” This is incorrect as completion of a deed in lieu of foreclosure or similar legal agreement to convey all interest represents the granting of the legal title to the

financial institution. The legal definition of convey means “to transfer; pass the title to.” Recording of the deed is a process to protect the owner’s interest in the property after legal title has already passed.

Thus, both conditions in the ED regarding in-substance foreclosure in fact represent a situation in which legal title to the real estate property has already been obtained. The term *in-substance* in accounting literature has always been used to mean that the accounting follows the economic substance rather than the legal form. Defining *in-substance foreclosure* in the manner proposed in the ED follows legal form and not the economic substance.

Current Practice

The ED would require a majority of the more than 8,300 community financial institutions regulated by the Agencies to “reclassify” in-substance foreclosed OREO back to loans, and then return the loans to OREO once legal title is obtained.

The ED indicates there is diversity in practice because the terms *in-substance repossession or foreclosure* and *physical possession* are not defined in the accounting literature. While we agree those terms are not explicitly defined in the literature, we do not find they represent difficult concepts to understand. As noted in the EITF 13-E Issue Summary, proponents of the view proposed in the ED “do not consider there to be significant diversity in practice among the larger creditors” as they typically currently follow the proposed criteria. We observe a majority of financial institutions regulated by the Agencies report as OREO abandoned collateral properties for which they have physical access to and physically maintain. The expense, burden, and time commitment to implement the ED by those institutions is not trivial.

In our view, to the extent there is diversity in practice, it has resulted more from a lack of focus on a physical possession concept rather than a lack of definitions of physical possession and in-substance foreclosure. This was likely a result of the issue being immaterial leading up to the financial crisis and as it became more material, practice not keeping up with the increases in OREO activity.

Alternative Recommendation

We recommend the Board do two things if it decides to move forward with the proposal. First, rather than redefine *in-substance* to equate to legal form, we recommend the Board simply scope out residential mortgages from having to apply the concept of in-substance foreclosure and physical possession found in ASC 310-40-40-6 (formerly SFAS 15, paragraph 34). Thereby, residential mortgage loans would be moved to OREO only upon transfer of legal title, whether through foreclosure or deed in lieu of foreclosure. In our view, it would be better to be transparent in that the concept of in-substance foreclosure and physical possession do not apply to residential mortgages rather than redefine it as legal title.

Second, we urge the Board to consider having the standard applied prospectively, rather than the modified retrospective treatment proposed. We see little to be gained by requiring community financial institutions to transfer abandoned real estate they have physical control over back to loans, only to move those loans back to OREO in the future when legal title of the collateral is obtained. The compliance burden would be more than trivial with little or no benefit to financial statement users.

Concluding Comments

We hope the Board finds our comments informative. We are happy to discuss our views in detail or further clarify the Agencies' existing supervisory guidance and practices relating to physical possession and in-substance foreclosure.

Sincerely,

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Office of the Comptroller of the Currency

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