

FASB Emerging Issues Task Force

Issue No. 13-E

Title: Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure

Document: Issue Summary No. 1, Supplement No. 1*

Date prepared: October 31, 2013

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Date previously discussed: June 11, 2013

Previously distributed EITF materials: Issue Summary No. 1, dated May 31, 2013

Background

1. At the June 11, 2013 EITF meeting, the Task Force reached a consensus-for-exposure to clarify that an in substance repossession or foreclosure occurs, and a creditor (reporting entity) is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (a) the creditor obtaining legal title to the residential real estate property or (b) 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. The Task Force also reached a consensus-for-exposure that would require a reporting entity to disclose a roll-forward reconciling the change in the amount of foreclosed residential real estate held by the reporting entity. In addition, a reporting entity would be required to disclose the recorded investment in consumer mortgage loans secured by residential real estate properties that are in the process of foreclosure. A proposed Update was issued on July 19, 2013, with a September 17, 2013 comment letter deadline.

*** The alternative views presented in this Issue Summary Supplement 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 amendments in the proposed Update would be applied on a modified retrospective basis to collateralized residential consumer mortgage loans and foreclosed residential real estate properties held by the creditor at the date of adoption through a cumulative-effect adjustment as of the beginning of the annual reporting period in which the proposed amendments are effective. The cumulative-effect adjustment would be recorded as of the date of adoption by reflecting any reclassification between residential consumer mortgage loans and foreclosed residential real estate properties in the carrying amounts of those assets as of the beginning of the period that the amendments are effective. A corresponding adjustment, if any, would be made to the opening balance of retained earnings for the current year. Prior periods would not be adjusted. Early adoption would be permitted.

3. At the November 14, 2013 EITF meeting, the Task Force will have the opportunity to consider the feedback received through comment letters and the FASB staff's outreach as it redeliberates the consensus-for-exposure. The Task Force will then be asked whether it wishes to affirm its consensus-for-exposure on this Issue as a final consensus.

Summary of Comment Letters, Outreach, and FASB Staff Analysis and Recommendations

4. The Task Force received 18 comment letters on this proposed Update. After reviewing the comment letters, the staff performed outreach with the respondents and others, including preparers, professional associations, accounting firms, and regulators. Comment letter respondents included the following:

Constituency Group	Number of Comment Letters
Accounting Firms	2
Government Sponsored Entity	1
Regulators	1
Preparers	11
Professional Associations	3
Total	18

5. Constituents were asked to comment on the following questions in the proposed Update:

Question 1: Should the scope of the proposed amendments about the timing of reclassification of receivables to foreclosed residential real estate properties be

extended to commercial real estate mortgage loans? If yes, please explain why, including a discussion on any special considerations related to reclassifying commercial real estate mortgage loans.

Question 2: Should the scope of the proposed amendments about of reclassification of receivables to foreclosed assets also be extended to loans collateralized by nonfinancial assets other than real estate (for example, auto loans)? If yes, please explain why, including a discussion on any special considerations related to reclassifying loans that are collateralized by nonfinancial assets other than real estate.

Question 3: Do you agree that a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan upon (a) the creditor obtaining legal title to the residential real estate property or (b) 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? If not, please explain why.

Question 4: Do you agree that the recurring disclosures of (a) the recorded investment in consumer mortgage loans secured by residential real estate properties that are in the process of foreclosure according to local requirements of the applicable jurisdiction and (b) a roll-forward schedule reconciling the change from the beginning to the ending balance of foreclosed residential real estate properties provide decision-useful information and should be required to be provided in interim and annual financial statements? If not, please explain why and what disclosures, if any, you would propose.

Question 5: If the scope of the proposed amendments is extended to commercial real estate mortgage loans and/or loans collateralized by nonfinancial assets other than real estate (for example, auto loans), should different disclosures be required for these loans? Please describe how and why you think the disclosures should be different.

Question 6: Do you agree that the proposed amendments should be applied to both collateralized residential mortgage loans and foreclosed residential real estate properties existing at the date of adoption by means of a cumulative-effect adjustment as of the beginning of the annual reporting period for which the guidance is effective? If not, please explain why.

Question 7: If an entity is required to reclassify foreclosed residential real estate property to consumer mortgage loans upon transitioning to the proposed guidance, at what amount should those loans be recorded at the date of adoption? For example, (a) should the recorded investment in such consumer mortgage loans at the date of adoption be the initial recognition basis of the foreclosed residential real estate property and (b) should any difference between the carrying

amount of the foreclosed residential real estate property at the date of adoption and its initial recognition basis be recorded as an allowance for loan losses for such consumer mortgage loans? Please explain the reasons for your view.

Question 8: Do you agree that the proposed amendments should apply to both public entities and nonpublic entities? If not, please describe how and why you think they should be different.

Question 9: Do you agree that an entity should be permitted to early adopt the proposed amendments? If not, please explain why.

Question 10: How much time would be needed to implement the proposed amendments, and should the effective date differ for nonpublic entities versus public entities? Please explain why.

6. The FASB staff has summarized the comment letters received and has provided the staff's analysis and recommendations in the following sections:

- Scope (Questions 1 and 2)
- Reclassification from Loans to Real Estate (Question 3)
- Disclosure (Questions 4 and 5)
- Transition and Early Adoption (Questions 6 - 9)
- Effective Date (Question 10)

Scope

7. In Question 1, respondents were asked whether they believe that the scope of the proposed amendments should be extended to commercial real estate mortgage loans. Ten of the 14 respondents who answered Question 1 said the scope should not be extended. Those 10 all pointed out that the foreclosure process and applicable laws were significantly different for commercial real estate. For example, one respondent (CL#5) highlighted that a commercial lender may enter into a deed in lieu of foreclosure¹ with the borrower that is placed in escrow and only recorded if the borrower defaults. Furthermore, respondents (CLs #5 and #8) mentioned that there is no diversity in financial reporting of foreclosed commercial real estate loans, and regulatory guidance is more established regarding loans collateralized by commercial real estate properties. One respondent (CL#14), who disagreed with extending the scope, noted:

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.

Foreclosure procedures for residential mortgage loans are distinct from other types of secured loans, predominantly due to the legal protections provided to residential mortgage loan borrowers. It is these legal protections that create uncertainty about when the creditor has obtained physical possession especially in scenarios where the creditor is taking steps to preserve the collateral but does not have access to it because the borrower may occupy the home. These scenarios generally do not exist for other types of secured loans and we are not aware of any concerns regarding the timing of [O]REO classification for these other secured loans.

8. Three respondents (CLs #6, #15, and #10) recommended that if the Task Force decides to extend the scope, additional outreach should be performed before concluding that the proposed guidance could be applied beyond residential mortgage loans.

9. In Question 2, respondents were asked whether they believe that the scope of the proposed amendments should be extended to loans collateralized by nonfinancial assets other than real estate (for example, auto loans). Similar to the Question 1 responses, 11 of 13 respondents disagreed with extending the scope of the proposed amendments to loans collateralized by nonfinancial assets. Five of those respondents (CLs #2, #3, #5, #14, and #15) recommended not extending the scope because of differences in either the foreclosure process or the legal environment between such loans and real estate loans. Furthermore, one respondent (CL#17) noted that there is no diversity in practice regarding the loans collateralized by nonfinancial assets other than real estate.

10. Two respondents (CLs #7 and #13) agreed with extending the scope of the proposed amendments to all collateralized mortgage loans in order to promote comparability. One of those respondents (CL#7) also supported extending the scope to loans collateralizing nonfinancial assets other than real estate.

11. The basis for conclusions in the proposed Update noted that commercial real estate loans may involve structured financing arrangements that are beyond the scope of this Issue, such as use of special purpose entities. One respondent (CL#12) recommended adding in the basis for conclusions that interests in a legal entity would initially need to be evaluated under the VIE

consolidation guidance. That concern was also raised by a professional organization during the staff's outreach efforts. The staff understands that real estate in a commercial lending agreement is often held in an entity and the collateral may be designated as the equity interest in that entity instead of the real estate. For residential loans, such structures are uncommon and the collateral is the real estate. Therefore, assuming the scope remains limited to residential real estate loans, the staff does not believe that this clarification is necessary.

Staff Analysis and Recommendation

12. This Issue was raised to deal with diversity in practice on foreclosed loans collateralized by residential real estate. The diversity in practice was made apparent with the increase in foreclosures of residential real estate coming out of the recent global financial crisis. The comment letters and other input from the staff's outreach indicate that there is no diversity in practice associated with commercial real estate. Therefore the staff recommends that the Task Force affirm its consensus-for-exposure and limit the scope to residential real estate loans.

Question 1 for the Task Force: Does the Task Force agree with the staff recommendation to keep the scope of the proposed amendments to residential real estate property collateralizing a consumer mortgage loan?

Reclassification from Loans to Real Estate

13. In Question 3 of the proposed Update, respondents were asked whether a creditor should be considered to have received physical possession of residential real estate upon (a) the creditor obtaining legal title to the residential real estate property or (b) 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. Sixteen of the 18 respondents agreed that a creditor should be considered to have received physical possession of residential real estate property based on legal criteria. Two respondents (CLs #7 and #18) disagreed with the proposed Update. The Office of the Comptroller of the Currency and the National Credit Union Administrators (OCC and NCUA), two regulators of financial institutions, noted in a joint response (CL#18) that in their view a creditor should be considered to have physical possession

before obtaining legal title if the creditor has physical access to abandoned real estate and is maintaining the property.

14. Those who agreed with the principal of legal title transfer in the proposed Update raised two issues with respect to the interpretation of the legal title transfer principle: (a) whether to consider post-foreclosure redemption rights held by the borrower, and (b) whether the distinction between deed in lieu of foreclosure and legal title is necessary.

15. This Issue Summary Supplement will first analyze the issues brought up by the respondents with respect to the legal title transfer principle, and then the staff will provide additional analysis of View B outlined in the original Issue Summary. View B would require reclassification of loans to real estate upon the earlier of a legal title transfer (as applied based on the Task Force's decision) or physical possession before legal title (to be defined later in the Supplement). View B was discussed at the June EITF meeting, but the staff decided to reintroduce it because the staff has obtained additional information about how that view could operate in practice.

Post-Foreclosure Redemption Rights

16. Six of the respondents (CLs #3, #4, #6, #12, #14, and #15) requested clarification about determining when a creditor should reclassify a loan to real estate under the proposed Update when the borrower has redemption rights after the foreclosure sale and therefore the creditor does not have clear and unencumbered title. One of those respondents (CL#14) noted the following:

In many states, the deed acquired at foreclosure vests ownership interest in the property however, clear title may be impacted by the borrower's redemption right. We understand that differences in accounting practices exist due to redemptions rights; some institutions delay recognition of [O]REO until after expiration of the redemption period while others record the [O]REO at the time of acquiring ownership at foreclosure sale, irrespective of redemption periods.

17. The staff performed outreach with preparers and regulators to better understand the effect of redemption rights on foreclosures. Many jurisdictions have mandatory redemption periods that can range from 15 days to more than a year after foreclosure. The staff obtained a summary of

post foreclosure redemption rights by state and noted that approximately half of the states have redemption rights and the redemption periods are on average about 7 months long. (The term "after foreclosure" is the period after the foreclosure sale, which is also called a "sheriff's sale" in many jurisdictions.) The rights that a borrower and a creditor have on the property during the redemption period vary by jurisdiction. During that period, the borrower can typically continue to live in the property and has the right to redeem the property by paying the outstanding amount of the loan (principal and interest), foreclosure costs, and other expenses. In some jurisdictions, the borrower may be able to redeem the property for the amount of the winning bid at the foreclosure sale if the amount is lower than the outstanding loan amount. With some exceptions, the creditor can market the property for sale during the redemption period. However, since the property may still be occupied during the redemption period and the redemption period stays intact upon sale, the creditor may not be able to practically sell the encumbered property. The staff has heard that redemption rights are rarely exercised because a borrower who fails to make monthly payments is typically unable to pay the entire loan balance before the redemption period expires.

Staff Analysis and Recommendation

18. During the post-foreclosure redemption period the creditor has legal ownership subject to the borrower's right of redemption. The staff understands from comment letter responses and outreach that most creditors and regulators interpret the transfer of ownership to be at the time of foreclosure sale and not the end of the redemption period.

19. The staff believes that the loan should be reclassified at the time ownership transfers to the creditor regardless of redemption rights. After the foreclosure sale, the creditor has received an asset in full satisfaction of a receivable as outlined in paragraph 310-40-40-3. While the creditor may not have unencumbered legal title until the redemption period expires, it generally has the right to sell the property subject to the redemption period restriction. From the creditor's perspective, the only mechanism to recover the asset is now through sale of the property as the chance that a borrower will pay the entire loan balance before the redemption period expires is remote. In the rare event that the borrower exercises the redemption right after transfer of legal

title to the creditor, the transaction should be treated by the creditor as a sale of that property back to the borrower.

20. The staff believes that this treatment is consistent with the principle that physical possession occurs when the creditor obtains legal ownership of the property. To avoid potential diversity in practice over the interpretation of whether a creditor has legal title when the borrower has redemption rights, the staff recommends clarifying the use of the term *legal title* in proposed new paragraph 310-40-55-10A(a) of the proposed Update as follows (additions are underscored):

- a. The creditor obtaining legal title to the residential real estate property. A creditor may obtain legal title to the residential real estate property through foreclosure even if the borrower has redemption rights whereby it can legally reclaim the real estate property for a period of time.

Question 2 for the Task Force: Does the Task Force agree with the staff's recommended clarification of the timing of the creditor obtaining *legal title* in the proposed new paragraph 310-40-55-10A(a)?

Deed in lieu of foreclosure and legal title

21. In the proposed Update, paragraph 310-40-55-10A(b) states:

- b. 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 OCC and NCAU pointed out that "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 is 'to transfer; pass the title to.'" The joint respondents emphasized that recording of the deed is a process to protect the owner's interest in the property after legal title has already passed. Another respondent (CL#17) said that determining what constitutes completion of a deed in lieu of foreclosure is open to interpretation. That respondent recommended removing reference to deed in lieu of foreclosure because they believe that the

time period between when a deed in lieu is completed and legal title is recorded is not significant.

Staff Analysis and Recommendation

22. The basis for conclusions of the proposed Update, describes "completion of a deed in lieu of foreclosure or similar legal agreement" in contemplation of a situation in which the creditor receives "physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place." The staff does not believe that the Task Force intended for the proposed Update to make a distinction between obtaining legal title and recording the title. To avoid any misinterpretation, the staff recommends the following modification to proposed new paragraph 310-40-55-10A(b) of the proposed Update as follows (deletions are ~~struck through~~):

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 deed in lieu of foreclosure or similar legal agreement is completed when agreed terms and conditions have been satisfied by both the borrower and the creditor.

Question 3 for the Task Force: Does the Task Force agree with the staff's recommended modification to proposed new paragraph 310-40-55-10A(b) of the proposed Update?

23. If the Task Force agrees with the staff recommendation, the consensus view in the proposed Update would be revised as follows (additions are underscored and deletions are ~~struck through~~):

A creditor shall be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan only upon either of the following occurring:

- a. The creditor obtaining legal title to the residential real estate property. A creditor may obtain legal title to the residential real estate property through foreclosure even if the borrower has redemption rights whereby it can legally reclaim the real estate property for a period of time.
- b. 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 deed in lieu of foreclosure or similar legal agreement is completed when agreed terms and conditions have been satisfied by both the borrower and the creditor.

The following section presents a discussion of View B presented in the original Issue Summary. As noted in paragraph 15, the staff has obtained additional information about how this view could operate in practice.

View B: Physical Possession before Legal Title

24. The OCC and NCAU's joint comment letter noted "defining in-substance foreclosure in the manner proposed in the ED follows legal form and not the economic substance," and "effectively eliminates the concept of in substance foreclosure," which has been in existence since FASB Statement No 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

25. In the original Issue Summary, View B provided indicators for the creditor to assess whether it has significant involvement with 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. The following is an abbreviated (and clarified) version of the indicators for in substance foreclosure of that approach (See Exhibit 13-EA for the more detailed version, which has been carried forward from the original Issue Summary):

- a. The creditor has initiated foreclosure proceedings
- b. The borrower has little or no equity in the property, and the borrower is in default
- c. The creditor has access to the property
- d. The creditor is maintaining the property.

26. One of the concerns raised by Task Force members about View B was the subjectivity and lack of consistency that could result as entities make facts-and-circumstances-based judgments. The staff further analyzed the indicators to assess whether they could be assessed objectively. Banks are currently required to disclose in regulatory filings the amount of loans in process of foreclosure. Since the creditor is able to determine which loans to include in this disclosure they should be able to objectively determine whether foreclosure proceedings have begun. Most

reporting entities also have processes to assess the value of properties in relation to the loan so the borrower can objectively determine the borrower's equity position regarding the property. In regards to indicators (c) and (d), as the OCC and NCAU observed in their joint comment letter, whether a creditor has physical access to the property and is paying to maintain the property are not subjective determinations.

27. The OCC and NCAU indicated that the indicators of physical possession actually come down to these two criteria (and that the additional criteria as proposed under the staff's View B may not be necessary):

- a. Physical access to abandoned real estate collateral
- b. Physical maintenance of the property.

28. Proponents of this two-criteria view cite paragraph 70 of the basis for conclusions in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, which states that in substance foreclosure was intended to apply when the "creditor was in possession of an asset with or without having to go through formal foreclosure proceedings." Therefore, proponents of this view believe that if the creditor has access to the property, and is maintaining the property, it has physical possession. Proponents further highlight the history of the various indicators-based interpretations of the in substance foreclosure concept under U.S. GAAP before "physical possession" was added in Statement 114 with the intent to simplify the interpretation of in substance foreclosure; the intent was not to change to a legal-title transfer principle.

29. The opponents of the alternative view of "access before legal-title transfer" cite paragraph 71 of the basis for conclusions in Statement 114, which notes that "the Board recognized 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." Opponents also note that the creditor does not control the asset until it holds legal title, and without control, one of the three essential characteristics of an asset is missing. They further note that until the creditor controls the property, it only has protective rights and not ownership rights. Some respondents (CLs #2 and #14) also pointed out that if a

loan starts to re-perform after it has been transferred to real estate, there is no mechanism in U.S. GAAP to subsequently account for it as a loan. A principle based on legal title transfer would likely see that situation more rarely than a principle based on earlier creditor access.

Staff Analysis and Recommendation

30. The staff believes that View B (whether it has four criteria or two criteria) is more operational than the staff's previous understanding of that view. However, the staff supports the view that a loan should not be reclassified to foreclosed residential real estate owned until the creditor obtains legal title since prior to obtaining title the creditor only has protective rights associated with the property and cannot legally or practically market or rent the property. Accordingly, the staff recommends that the Task Force reaffirm its consensus for exposure that physical possession occurs when the creditor obtains legal title at foreclosure or through a deed in lieu of foreclosure or similar legal agreement.

Question 4 for the Task Force: Does the Task Force wish to reaffirm its consensus-for-exposure that physical possession occurs when the creditor obtains legal title at foreclosure or through a deed in lieu of foreclosure or similar legal agreement, subject to the modifications outlined in Questions 2 and 3?

Disclosure

31. In Question 4 of the proposed Update, respondents were asked whether they agreed with the proposed disclosures of (a) the recorded investment in consumer mortgage loans that are in the process of foreclosure and (b) a roll-forward schedule. Nine of the 15 respondents who answered this question stated that neither of the proposed recurring disclosures should be required. Twelve of the 15 respondents did not agree with providing the recurring roll-forward disclosure. Three respondents (CLs #12, #13, and #17) agreed that the proposed disclosure for loans in the process of foreclosure would provide decision-useful information, and two of those respondents (CLs #12 and #17) also supported disclosure of the roll-forward.

32. Respondents questioned whether the value of the incremental disclosures outweighed the costs of providing similar information in two public documents. A number of respondents (CLs

#3, #5, #8, #9, #11, #14, and #15) noted that depository institutions provide the outstanding principal amount for loans collateralized by residential real estate that are in the process of foreclosure as part of the Consolidated Report of Condition and Income (Call Report). A number of those respondents pointed out that those reports are generally filed and available within 30 days of the end of the quarter. One respondent (CL#3) noted that a disclosure of OREO assets is also provided in the Call Report, and when that information is combined with the loans in the process of foreclosure, it provides a fairly comprehensive view of a bank's foreclosed properties.

33. Two respondents (CLs #12 and #10) expressed concern about the scope of the roll-forward. They questioned whether the information was decision useful because a creditor can have other types of foreclosed real estate properties but the disclosure is specific to only residential. Other respondents (CLs #5 and #9) noted that foreclosed residential real estate is not typically a material asset and questioned the value of the roll-forward and the prescriptive format in the proposed Update. Other respondents (CLs #9, #10, and #11) pointed out that depending on materiality, cash flows related to sale of foreclosed residential real estate may also be captured in the creditor's cash flow statement.

34. When those disclosures were discussed by the Task Force, the ability for a user to see the progression of loans in the process of foreclosure into the roll-forward of foreclosed property was important in concluding that the disclosures were decision useful. Based on the feedback received and the importance of the connection between the two disclosures, the staff considered whether the scope for both disclosures should be expanded to all foreclosed real estate properties. The staff noted that the Call Report currently does not require disclosure of commercial real estate loans in the process of foreclosure. Also, one respondent commented (CL#17) that it is "very common for such foreclosures to be deferred or reversed if, for example, a loan is modified or refinanced. Therefore such a disclosure would not provide helpful information to users about the volume of commercial loans secured by commercial properties that are expected to be transferred to OREO."

35. In Question 5, respondents were asked whether they agreed that different disclosures should be required if the scope of the proposed amendments is extended to commercial real estate

mortgage loans and/or loans collateralized by nonfinancial assets other than real estate (for example, auto loans). All 11 respondents who answered the question thought a change in scope should not result in different disclosure requirements.

Staff Analysis and Recommendation

36. The staff notes that U.S. GAAP currently requires disclosure of foreclosed assets (paragraph 310-10-45-3). To the extent that the roll-forward would reveal a known trend, a public company would be required to disclose that fact in the MD&A portion of its periodic filings. Moreover, for nonpublic companies, the proposed Private Company Decision Making Framework (PCDMF) notes that the Board and Private Company Council should generally not consider requiring a detailed reconciliation of beginning and ending balances when considering disclosures. In part, the basis for this conclusion in the PCDMF is because "many users of private company financial statements do not seek the same level of detailed information as do users of public company financial statements and because of cost consideration." Therefore, the staff recommends eliminating the proposed roll-forward and retaining the requirement in the proposed Update to disclose the amount of foreclosed residential real estate held along with the amount of residential real estate mortgages in the process of foreclosure. That disclosure would also provide more transparent information about loans for which foreclosure proceedings have begun but the loan has not been reclassified to real estate. The staff believes that by comparing the trend of these disclosures over time, users should be able to assess whether the change in the amount of residential real estate held is due to an increase in the rate of foreclosures.

Question 5 for the Task Force: Does the Task Force agree with the staff recommendation to eliminate the roll-forward requirement in the proposed Update and require disclosure of the amount of outstanding foreclosed residential real estate at each balance sheet date, along with the amount of the recorded investment in residential real estate mortgage loans in the process of foreclosure?

Transition and Early Adoption

37. In Question 6, respondents were asked whether they agreed that the proposed amendments should be applied to both collateralized residential mortgage loans and foreclosed residential real

estate properties existing at the date of adoption by means of a cumulative-effect adjustment as of the beginning of the annual reporting period for which the guidance is effective. Nine of the 13 respondents agreed with applying a modified retrospective approach with a cumulative effect adjustment.

38. Three respondents (CLs #7, #10, and OCC & NCAU) disagreed with the application of the proposed amendment and requested that the Task Force consider a prospective approach due to the costs related to applying a modified retrospective approach with a cumulative effect adjustment. Under a prospective approach, an entity would apply the guidance to new foreclosures on or after the effective date. The OCC and NCAU noted that, "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."

39. In Question 7, respondents were asked to determine at what amount loans should be recorded at the date of adoption if an entity is required to reclassify foreclosed residential real estate property to loans upon transitioning to the proposed guidance. In the example provided with Question 7, the amount of the recorded investment was the amount that was originally reclassified to foreclosed residential real estate with any subsequent reductions through the date of adoption presented as an allowance for loan loss. Eight of the 10 respondents to this question suggested reclassifying either the fair value of the foreclosed residential real estate property less cost to sell or the current book value of the foreclosed residential real estate. One of the respondents (CL#10) who supported a prospective transition approach noted that it "would alleviate the need to recast the carrying amounts at the adoption date attributable to the recorded investment in the loans and the allowance for loan losses."

40. Three respondents (CLs #3, #14, and #16) noted that if the property was reclassified back to loans as if the loan had never been transferred, then the carrying amount for certain loans would exceed the current carrying amount of the foreclosed residential real estate. Under that approach a loan that was charged-off to the fair value of the collateral less cost to sell prior to adoption

could be written up at adoption and subsequently incur a duplicate charge-off when foreclosure occurs.

41. In Question 8, respondents were asked whether they agreed that the proposed amendments should apply to both public entities and nonpublic entities. All nine respondents answering the question agreed that the proposed amendments should apply to both public and nonpublic entities. One respondent (CL#12) noted that if the disclosure in paragraph 310-10-50-11 relating to the roll-forward of foreclosed real estate properties is retained, they do not believe it should be applicable to nonpublic entities.

42. In Question 9, respondents were asked whether they agreed that an entity should be permitted to early adopt the proposed amendments. All nine respondents who answered this question agreed that an entity should be permitted to early adopt the proposed amendments.

Staff Analysis and Recommendation

43. The staff has considered the feedback provided and recommends that the Task Force allow an entity to adopt the guidance on either a prospective basis or a modified retrospective basis with a cumulative effect adjustment. Under the prospective approach, entities that transfer property to real estate prior to obtaining legal title will have a period of time with inconsistent treatment of some loans because they will have real estate on their balance sheets for which they have no legal title, or loans on their balance sheets for which legal title has transferred. However, as soon as the foreclosure sales occur on all (or most) such real estate, the inconsistency will be alleviated—in most cases within one year. The staff believes that for smaller banks that may have applied the earlier reclassification threshold, the lack of balance sheet comparability for one year that would arise from prospective application is not problematic, and the costs of adopting on a modified retrospective basis with a cumulative effect adjustment may outweigh the benefits. The staff believes that entities should also have an option to adopt on a modified retrospective basis with a cumulative effective adjustment. However, even under that approach an entity would have at least one year of incomparable presentation because the prior year balance sheet would not be adjusted. If an entity elects to adopt the guidance on a modified retrospective basis

with a cumulative effective adjustment, the staff recommends that the reclassification to loans should be based on the carrying value of the foreclosed property at the date of adoption.

Question 6 for the Task Force: Does the Task Force agree with the staff recommendation that the proposed guidance can be adopted on either a prospective or a modified retrospective basis as follows:

- a. For prospective transition, a reporting entity would apply the proposed reclassification guidance to all existing residential loans and to any new residential loans after the date of adoption.**
- b. For modified retrospective transition, the reporting entity would adopt by means of a cumulative-effect adjustment as of the beginning of the reporting period that the guidance is effective to all residential loans and foreclosed residential real estate properties existing as of the date of adoption. Any necessary reclassification from real estate to loans would be based on the carrying value of the real estate at the date of adoption.**

Effective Date

44. In Question 10, respondents were asked how much time would be needed to implement the proposed amendments and whether the effective date should differ for nonpublic entities versus public entities. Seven of the eight respondents who answered this question stated that the implementation should not take longer than one year. One of the seven respondents (CL#7) noted that implementation could be effective within two months of issuance but requested an additional year for non-public companies to "develop procedures to capture the information needed for the new disclosures." The other respondent (CL #5) indicated that if the proposed disclosure of the roll-forward were required, the implementation could take longer than a year.

45. The FASB staff has considered the feedback provided and recommends that the amendments in the proposed Update be effective for fiscal years beginning after December 15, 2014, and interim periods within those fiscal years for both public and nonpublic entities. The staff believes that even if the Task Force allows a prospective approach for transition, certain entities will need time to establish new processes for reclassifying properties based on the

consensus view to Question 5, and certain entities will need to design processes to capture the new disclosures. Early adoption should be permitted.

Question 7 for the Task Force: Does the Task Force agree with the staff recommendation on the effective date for the proposed Update and on permitting early adoption?

Exhibit 13-EA

Alternative View—Indicators of Physical Possession Before Legal Title (As presented under View B at the September 13, 2013 EITF meeting)

- 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.