

Financial institutions: converting commercial mortgages to REO — valuation and accounting considerations

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Overview

The commercial real estate markets are currently experiencing unprecedented declines resulting in escalating mortgage defaults and a sharp spike in Real Estate Owned (REO) assets held by lenders. An REO asset is a property that is in the possession of a lender as a result of foreclosure or forfeiture by a borrower. Taking over the ownership of an asset is just one of several options that a financial institution has in managing non-performing loans on commercial real estate. In fact, REO is often considered a last resort by lenders after other options such as loan workouts and sales of the loans are considered; this is because many lenders do not have the resources and/or experience to manage and operate the real estate to maximize its value. Nonetheless, the number of REO assets has increased dramatically from April 2009 thru December 2009; a trend which may continue in the foreseeable future.

There are many valuation and accounting considerations that factor into the decisions that executives at financial and lending institutions make when converting commercial mortgages to REO assets. This topic is particularly relevant in the current challenging economic times as financial institutions are faced with very difficult decisions related to their troubled loan portfolios.

Current commercial real estate market and debt conditions

Commercial real estate market

Over the twelve months from 4Q 2008 to 4Q 2009, the commercial real estate market has experienced a significant downturn. As illustrated in the table below, transaction volume for the five primary property types has decreased by approximately 22% for retail properties to 76% for office properties from 4Q 2008 to 4Q 2009.

U.S. transaction volume (\$mil)			
Property type	4Q 2008	4Q 2009	Percent change
Office	7,640	1,834	-76.0%
Industrial	3,100	1,120	-63.9%
Retail	3,141	2,445	-22.2%
Hotel	1,005	296	-70.5%
Apartment	4,922	2,901	-41.1%

Source: Real Capital analysis

These figures demonstrate the drastic reduction in sales activity within the market across these primary property types. Similarly, property returns have been severely impacted.

As presented in the following table, annualized long-term historical returns for commercial real estate fall within the range of 8% to 10%, whereas returns from 3Q 2008 to 3Q 2009 across these primary property types were approximately -22%.

U.S. transaction volume (\$mil)					
Property type	3Q 2008 to 3Q 2009	2Q 2009	3Q 2009	Annual since inception	Inception date
Office	-24.50%	-6.52%	-3.30%	8.20%	4Q 1977
Industrial	-22.38%	-5.09%	-3.94%	9.24%	4Q 1977
Retail	-15.78%	-3.03%	-3.14%	9.35%	4Q 1977
Hotel	-26.45%	-5.46%	-4.47%	8.36%	1Q 1997
Apartment	-23.03%	-5.13%	-3.00%	8.26%	3Q 1984
National	-22.09%	-5.20%	-3.32%	8.91%	4Q 1977

Source: Real Capital analysis

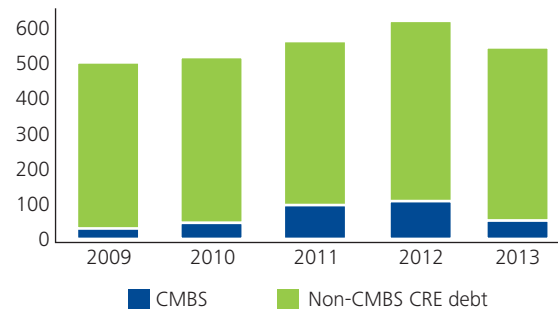
Commercial real estate debt

It is estimated that approximately \$2.5 trillion in commercial mortgage backed securities (CMBS) and non-CMBS debt on commercial real estate will come due between 2009



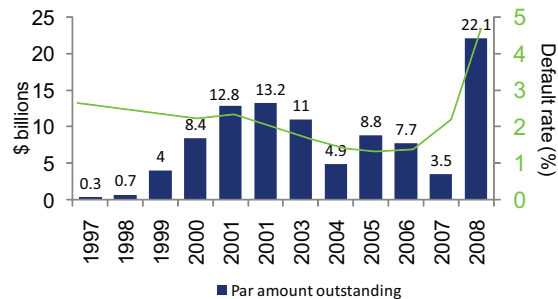
and 2013. A Real Estate Roundtable report projects that upcoming debt maturities will exceed \$500 billion in 2010 and peak at nearly \$600 billion in 2012. These upcoming debt maturities, combined with the downturn in commercial real estate values/returns and much tighter underwriting standards, point to the potential for significant distressed debt in the near term for financial institutions and possible further deterioration in the commercial real estate market.

Annual CMBS and Non-CMBS debt maturities



Source: Real Estate Roundtable, Green Street Advisors, Mortgage Bankers Association, Wells Fargo, Trepp, Bank of America

As to be expected, default rates have increased dramatically and continue to do so. As of December 2008, the level of leveraged loan debt in default was over \$22 billion, which is an increase of over 500% from the levels experienced in December 2007 at \$3.5 billion.



Source: North American Distressed Debt Market Outlook 2009, Debtwire North America (January 2009), Federal Reserve website

Although there is distressed debt in the market related to almost every property type, multi-family and retail loans have experienced the highest level of delinquencies. Retail delinquencies may continue to increase substantially as consumer spending continues to suffer and store closings and retailer bankruptcies occur. Delinquencies on hospitality assets may also rise as both business and leisure travel are projected by several data sources to remain slow in the foreseeable future. Across property types, development assets currently have an extremely high level of delinquency, because the fair value of the underlying collateral may have declined, there is no current income and in many cases, there is no projected income for five to seven years.

According to Realpoint Research, delinquencies in Florida, Texas, and California account for approximately 30% of CMBS delinquency. Further, the 10 largest states by delinquent unpaid balance comprise 56% of CMBS delinquency.

As previously noted, REO is often a last resort for financial institutions holding non-performing loans on commercial real estate. As of December 29, 2009, the total dollar amount of distressed assets for which the mortgage is in default, the owner is bankrupt, or the property has already been foreclosed upon in the U.S. was approximately \$170.74 billion. Of this amount, nearly 12%, or \$20.65 billion, pertained to REO assets. Many of the \$170.74 billion in assets classified as "troubled" may eventually become REO assets.

The following is a comparison of the information presented in the above chart over the eight months from the end of April through the end of December 2009. This illustrates that the number of distressed assets is increasing substantially and an increasing number of the assets are being taken into REO by the lenders. In fact, the carrying value of distressed REO properties has increased by approximately 125% over this eight month period.

A geographic breakdown of the distressed and potentially troubled assets is presented by region below. While the Southeast region of the United States has the highest amount of distressed properties including the largest proportion of properties in lender REO, the Northeast region has the highest amount of troubled properties. The Southeast and West regions have the highest amount of lender REO properties.

Pre-REO planning

Taking a property into REO is often a time-consuming and complicated process for a financial or lending institution. The lender should consider many factors, including:

- Is the property distressed or is the borrower distressed (i.e., is it a bad asset and a good borrower or a good asset and a bad borrower)?
- What are the potential risks of owning the property and how can they be mitigated?
- Is construction on the property completed or is it considered a development asset?
- What are the management requirements of the property?
- Does the lender have the resources and experience to manage the property in a way that maximizes the asset's value?
- What are the benefits and costs of outsourcing certain aspects of the asset/property management?
- What are the short-term capital requirements (including dealing with any deferred capital or maintenance expenditures) to maintain the property and keep it competitive in the market?
- What are the normal operating expenses (e.g., real estate taxes, insurance, etc.) to be incurred during the holding period?
- What is the expected timeframe until a sale (holding period) to a third-party once the property becomes REO?
- Can the anticipated appreciation or depreciation during the holding period be projected?

- What are the costs to take the property into REO and what are the projected costs to sell the property (e.g., advertising, broker's commission)?
- What type of internal controls should be implemented to manage risks?
- How should the property be accounted for under U.S. GAAP?
- What type of valuation policy should be implemented?
- What are the tax implications?

Although all of the items above are important considerations for a lender considering taking a property into REO, the accounting and valuation considerations are highly important to the REO strategy and can have immediate accounting and reporting implications to the financial statements of the lender.

Once a lender takes back a REO asset, one of the first decisions that should be considered is regarding the asset's disposition strategy, which determines the classification of the asset, and in turn, the initial accounting treatment of the REO. Under an immediate sales strategy, assuming certain criteria¹ are achieved under accounting principles generally accepted in the United States (GAAP), the REO would be classified as a "Held for Sale" asset. If the asset doesn't qualify for the "Held for Sale" criteria, the asset is classified as "Held and Used".

Once this determination of the classification of the REO is made, the lender would adhere to troubled debt restructuring rules² under GAAP and record the REO asset and remove the related loan from its books. After the troubled debt restructuring, the lender accounts for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.

REO asset classified as "Held for Sale"

The REO would initially be recorded at fair value less cost to sell. The lender would record a loss on the cancellation of the loan asset for any excess of the recorded net investment in the receivable satisfied over the fair value of assets received less estimated cost to sell.

The "Held for Sale" classification requires the lender to report the REO using single financial statement line item presentation, rather than a traditional operating model (gross presentation) used by an owner of real estate. Under the "Held for Sale" reporting presentation, all the related assets of the REO are grouped into a single asset caption ("Assets Held for Sale") and all the related liabilities of the REO are grouped into a single liability caption ("Liabilities Related to Assets Held for Sale") on the lender's balance sheet. In addition, if material and meets the definition of a component under GAAP, the related operations of the REO would be collapsed and reported as discontinued operations in the lender's income statement.

¹ASC 360-10-45-9 through 45-11 *Property, Plant, and Equipment* (formerly known as FAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*)

²ASC 310-40 *Receivables - Troubled Debt Restructurings by Creditors* (formerly known as FAS 15 *Accounting by Debtors and Creditors for Troubled Debt Restructurings*)

While the REO is classified as "Held for Sale", depreciation of the REO asset is suspended, while interest and other expenses attributable to the liabilities continue to be accrued. Legal fees and other direct costs incurred by a creditor to effect a troubled debt restructuring are included in expense when incurred.

Once the REO is sold, a true-up of the estimated selling costs is made in the final determination of the recognized gain or loss on the sale of the REO asset. Typically, the related gain/loss on the disposition of the REO would be reported within the discontinued operations section of the lender's income statement.

What happens if the lender decides not to sell the REO in the near term?

If circumstances arise that previously were considered unlikely and, as a result, the lender decides not to sell the REO asset, the asset shall be reclassified as "Held and Used". Under GAAP, the reclassified asset is measured at the lower of its (a) carrying amount before the asset was classified as "Held for Sale" adjusted for any depreciation expense that would have been recognized had the asset been continuously classified as "Held and Used" or (b) the fair value at the date of the subsequent decision not to sell.

REO asset classified as "Held and Used"

The REO asset would initially be recorded by the lender at the fair value of the real estate. The lender would record a loss on the cancellation of the loan asset for any excess of the recorded net investment in the receivable satisfied over the fair value of assets received.

Unlike "Held for Sale" treatment, a "Held and Used" REO asset is accounted for as if the lender purchased the asset to operate for a period of time. The lender would generally be required to account for the acquired asset under the acquisition method of accounting for business combinations.³ As a result, the lender must recognize and measure in its financial statements the identifiable assets acquired and the liabilities assumed related to the REO asset based on fair value. After the allocation of purchase price is determined, the REO asset (including its separate identifiable tangible and intangible assets and liabilities) is depreciated and amortized. Many accounting estimates are required to be made by the lender in order to properly account for the "Held and Used" REO asset. The lender must first allocate the purchase price to the various identifiable tangible and intangible assets and liabilities based on their fair values. In addition, the lender must establish the useful lives of each of the REO assets in order to properly determine the related depreciation or amortization charge that would be recognized in the lender's financial statements. Similar to the "Held for Sale" accounting treatment discussed above, legal fees and other direct costs incurred by a creditor to effect a troubled debt restructuring shall be included in expense when incurred.

Besides the initial and ongoing accounting for operating real estate, the lender should establish internal accounting and reporting processes, modify or implement a financial system to record and process real estate related transactions, as

³ASC 805 *Business Combinations*

well as establish a comprehensive system of internal control over maintaining REO assets.

Besides the asset management considerations of REO, financial institutions should consider the financial reporting implications of managing REO. Several reporting implications will likely change the lender's financial statements. First, the lender will be required to consolidate the real estate investment on its books and perform the accounting, as if it had originally acquired real estate, rather than merely providing a loan to a borrower. As a result, additional real estate investment disclosures could be required under GAAP, thereby expanding the complexity of the lender's financial statements. As a result of owning and operating REO assets, a lender may experience cash flow and earnings volatility. Such volatility may result from changes in occupancy, rental rates, incentives provided to tenants, planned or unexpected capital expenditures, unreimbursed operating expenses and property impairments.

REO valuation issues

There are a number of valuation issues that financial institutions should consider when bringing assets into REO.

Institutions typically acquire REO through foreclosure or deed in lieu of foreclosure after a borrower defaults on a loan. To adhere with guidance published by the FDIC, financial institutions should obtain a new or updated valuation that complies with state law at the time of acquisition of REO, as well as, the *Appraisal Regulation (12CFR Part 323)*, *Interagency Appraisal and Evaluation Guidelines*. Additionally, many state laws may require institutions to obtain annual or periodic valuations for each parcel of REO to determine that any material change in market conditions or the physical aspects of the property are recognized. Lastly, upon the disposition of REO, certain state laws may require appraisals if an institution is selling an asset or financing the transaction.

Fair value for financial reporting

There are three phases in the life cycle of foreclosed real estate: acquisition, holding period, and disposition. For purposes of financial reporting for the REO at both acquisition and during the holding period, an estimate of fair value is required.

At acquisition, and if the asset is classified as "Held for Sale", the foreclosed real estate should be recorded at the fair value less estimated costs to sell the property at the time of foreclosure. This amount then becomes the "cost" or carrying value of the foreclosed real estate. GAAP defines costs to sell as "the incremental direct costs to transact a sale," which include "broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred.

During the holding period, each foreclosed real estate asset must be carried as outlined above. At the time of disposition, typically no fair value estimate is required.

Fair value defined

A determination of fair value is necessary to properly account for REO assets under GAAP. As such, it is important to understand the definition of fair value and its implications

for financial reporting.

Fair value is defined under GAAP as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."⁴

GAAP also states that an orderly transaction "is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)."⁵ Based on this definition, a valuation specialist should state and justify the estimated exposure time.

Another provision included in the definition of fair value is the concept of an exit price. Under GAAP, "the transaction to sell the asset or liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price)."⁶ It is important to note that fair value does not incorporate transaction costs. As such, for purposes of establishing the carrying value of a foreclosed property for financial reporting purposes, the costs to sell should be estimated by a valuation specialist or other qualified professional and deducted from the concluded fair value estimate.

Other important considerations in the definition of fair value are (1) a fair value measurement assumes that the transaction to sell the asset occurs in the principal or most advantageous market for the asset; (2) the fair value should be based on the assumptions of market participants defined as "buyers and sellers in the principal (or most advantageous) market for the asset...";⁷ and (3) a fair value measurement assumes the highest and best use (the use of an asset that maximizes its value) of the asset by market participants.

Valuation techniques

There are three generally accepted valuation techniques for estimating the fair value of real estate: the market approach, income approach, and cost approach. Fair value accounting guidance states that "valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value."⁸ This guidance indicates that in some cases a single valuation technique will be appropriate and in other cases multiple valuation techniques will be appropriate. If multiple valuation techniques are applied, the indications of value derived from each technique should be weighted and reconciled appropriately.

⁴ASC 820 *Fair Value Measurements* (formerly known as FAS 157 *Fair Value Measurements*)

⁵ASC 820 *Fair Value Measurements*

⁶ASC 820 *Fair Value Measurements*

⁷ASC 820 *Fair Value Measurements*

⁸ASC 820 *Fair Value Measurements*

Financial accounting

In some cases, a financial institution acquiring an REO asset may be required to account for the tangible and intangible components of the asset in accordance with accounting for business combinations.⁹

Tangible components of commercial real estate typically include:

- Land;
- Building;
- Site Improvements; and
- Tenant Improvements.

Intangible components of commercial real estate may include:

- Foregone Rent and Expenses;
- Unamortized Leasing Commissions;
- Unamortized Legal Expenses;
- Above Market Leases;
- Below Market Leases;
- Customer or Tenant Relationships;
- Management Contracts; and
- Other.

Regulatory considerations

Based on information provided in the Comptroller's Handbook (Section 219) published by the Comptroller of the Currency; Administrator of National Banks as well as information provided by the Office of Thrift Supervision ("OTS"), there are several regulatory issues to consider with REO properties. The following are some of the more relevant considerations.

In accordance with 12 CFR 560.172, a savings association must appraise each parcel of REO at acquisition. As such, upon transfer to REO, fair value must be substantiated by a current appraisal prepared by an independent, qualified appraiser. This requirement is waived when the entire property is recorded at or below the lower of 5% of the bank's equity capital or \$25,000. Additionally, the requirement can be deferred three months after the bank takes title when the bank can document reasonable expectation of a sale other than in a covered transaction. Throughout the holding period, prudent management policy dictates the timing and frequency of appraisals.

An REO property can generally not be held by a financial institution for longer than a period of five years. In certain instances a bank may be permitted to hold the REO up to an additional five-year period beyond the original one if approved by the OTS.

An appraisal for an REO property should estimate the cash price that might be received upon exposure to the open market for a reasonable time, considering the property type and local market conditions. When a sale within 12 months is unlikely, the appraiser must discount all cash flows generated by the property to obtain the estimate of fair value.

⁹ASC 805 *Business Combinations* (formerly known as FAS 141R (revised 2007), *Business Combinations*)

Conclusion

The decision by lenders to take back real estate is not as simple as one might expect when a borrower is in default on their mortgage note. Often times, those decisions become difficult and complex given that many financial institutions have not recently been active in owning and operating real estate. If the lender decides to hold and operate REO assets, it should consider carefully developing a comprehensive strategy for acquisition, operation, and disposition of its REO inventory.

Prior to taking back a REO asset, financial institutions should consider fully evaluating the risks and rewards of owning real estate. When a lender takes possession of the loan collateral, the lender typically intends to maximize the value of the REO asset through efficient operations to reposition the asset, and/or realize additional incremental value through longer term appreciation. In these volatile market conditions, the decision to hold and operate an asset could be a winning strategy for the lender if future disposition of the property results in recovery of previously recognized losses on the loan or generates a gain greater than if it had held the original mortgage note. In other cases, the lender may decide that an immediate disposition strategy is best to extract immediate cash proceeds from the REO asset, rather than taking on additional risks as an owner of real estate. These critical decisions multiply when financial institutions take back portfolios of REO assets. Either strategy will likely result in significant accounting, valuation and financial reporting impacts on the financial statements of the lender.

As the U.S. economy climbs out of the global recession, a growing number of investors will likely take advantage of new investment opportunities in areas that serve as a bridge or substitution to the existing capital markets. A number of sources indicate that investors have seen a rise of new commercial real estate investment funds, initial public offerings, nonlisted blind pool registrations, asset recovery funds, and mortgage REITs, which could serve to augment the existing CMBS market and create an additional source of purchasers of mortgage-backed investments. These funds could also serve as the eventual buyers of REO assets from financial institutions when these lenders execute their REO disposition strategy.

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