DCU BULLETIN

Division of Credit Unions
Washington State Department of Financial Institutions
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NEW Rulemaking and Recommended Approach to OREO Management for Credit Unions

The Real Estate Foreclosure Problem in Context

By the end of 2008, more than 870,000 homes were lost to foreclosure in the U.S., doubling from 2007. In Washington State, foreclosures were up 43% compared to one year earlier. With unemployment and delinquencies continuing to increase, and a significant volume of nontraditional mortgages due to reset within the next few years, the rising number of foreclosures will present challenges for families, the economy, and financial institutions, including credit unions.

When credit unions repossess property, by foreclosure or default on a loan collateralized by real property, they find themselves the legal owners of real property, termed “other real estate owned” (OREO). This problem, once rare for credit unions, is widespread enough to require rulemaking and a policy to guide state-chartered credit unions in how to handle OREO.

Rulemaking Begins

As foreclosures and defaults continue to increase, it is essential that credit unions manage their risk carefully. In order to enhance the safe and sound operation of state-chartered credit unions that handle OREO as the result of foreclosure, the Division of Credit Unions has started the rulemaking process by filing the CR-101 WSR 09-09-076 on April 14, 2009.

The rulemaking will cover requirements and standards for the following subjects:

- mitigation of loss to the credit union from foreclosures and defaults on loans collateralized by real property;
- analysis and management of the extensive costs of real property ownership to the credit union;
- the imperative need for board oversight of OREO;
- appropriate accounting for and documentation of OREO.

During DCU rulemaking, stakeholders and interested persons are invited to attend and participate in the meetings by teleconference or in person. We will also be using the expertise of a Task Force of credit union representatives with various levels of OREO experience. They will provide technical input on establishing "best practices" for handling OREO.

Invitation to Serve on Task Force

If you are interested in serving on the Task Force, please contact Rhonda Mires at 360-902-8718 or rmires@dfi.wa.gov. The following credit unions and stakeholders are currently represented:

Washington Credit Union League
OBee CU
Sound CU
Columbia Community CU
BECU
Spokane Teachers CU
WSECU
Harborstone CU
Lacamas Community CU
Verity CU
Qualstar CU
WECU

The first meeting is **April 29, from 2-4p.m.** at DFI headquarters. To join the teleconference, dial 1-877-298-8255 and use conference ID # 7009517. You are also welcome to attend in person at DFI headquarters, 150 Israel Rd SW, Tumwater, Washington, 98501. Please allow time to check in with reception.

After extensive stakeholder and public discussion, we will propose a draft of the new rule. The draft will be available for public comment for a reasonable time period prior to the official public hearing and final adoption of the rule.

As always, all of the information on the rulemaking (including document drafts, meeting notices, summaries of meetings, and audio of official hearings) will be constantly updated and available on the DCU website: www.dfi.wa.gov/cu/rulemaking.htm

An Overview of Important Elements of OREO Management

A credit union that finds itself on the verge of foreclosing on property must focus on managing risks to the credit union. The Division of Credit Unions (DCU) generally agrees with the National Credit Union Administration (NCUA) that it may, in some circumstances, be beneficial to "encourage credit unions to consider reasonable workout arrangements, whenever sound, that allow members to keep their homes." NCUA letter 07-CU-06 at: http://www.ncua.gov/letters/2007/CU/07-CU-06.pdf

However, the primary consideration must be the safe and sound operation of the credit union. Each preforeclosure situation should be carefully analyzed, and each borrower reassessed in accordance with prudent lending standards. Some studies indicate a greater than 50% rate of redefault on loans, so merely contracting for new terms may not solve the problem for the borrower or the lender.

Public Policy Unsettled

In addition to the variables involved in evaluating appropriate mitigation of foreclosure problems, the legal and regulatory environment itself is changing. Current state and federal legislative efforts may quickly affect the manner in which lenders can or should handle the treatment of borrowers prior to foreclosure, as well as the handling and reporting requirements for OREO.

General Recommendations and Considerations

1. Evaluate each residential mortgage delinquency or default on loan collateralized by real property, and assess risks to the credit union on a case-by-case basis. Each piece of real estate is legally unique. When reasonable, work with qualified borrowers to see if refinancing into fixed rate, or other preforeclosure solution, is likely to prevent foreclosure. If appropriate risk management and good underwriting practices ("loan modification protocols") can prevent foreclosure that is the optimal solution for borrower and lender. Realize, however, that this will not always be possible or appropriate.

2. A credit union should take the loss ASAP if the credit union's analysis indicates that it is likely to lose money by owning a foreclosure, and/or it has no real organizational capacity to deal with foreclosures. If analysis of the OREO indicates that holding it may eventually offset the loss, DCU's recommendation is still to promptly market and sell the property, preferably within one year of foreclosure if possible.

3. Document the management and marketing of OREO including the credit union's efforts to work with borrowers. Be prepared to show examiners the basis for your actions regarding foreclosure prevention, refinancing, and post-foreclosure handling of OREO. Have a written policy on how OREO is handled at the credit union. Have a method of identifying borrowers in need of preforeclosure intervention, and an analytical, not anecdotal, basis for making lending decisions based upon the facts in each situation. Loan decisions will be evaluated by DCU based upon safety and soundness standards.

Rationale for DCU recommendations

1. The speculative nature of "holding" real estate long-term is not contemplated by the Washington Credit Union Act (WCUA, RCW 31.12). Owning and managing a portfolio of real property as an investment is not generally within the scope of credit union business. It involves risks, and affects liquidity and profitability. The making of loans that end up as OREO is incidental to the normal course of financial institutions business operations. Carrying the OREO long-term, as an investment, is not.

2. OREO that is foreclosed residential real property is outside the scope of RCW 31.12.438. That provision of the WCUA contemplates the ownership of property for credit union operation and expansion, not speculative investment.

3. Lack of professional real estate management staff & expertise, including legal expertise, makes ongoing management of foreclosed properties highly problematic for most credit unions. The legal work required in complex foreclosure transactions is a specialty. Professional outside property management is costly.

4. Costs of ownership ("holding costs")
    a. Legal costs – as indicated above, legal costs require specialization and experience, and can be significant, depending upon the encumbrances and other conditions of the property in question
    b. Insurance – as the owner of the foreclosed property, the credit union must continue to maintain property insurance. Some insurers will no longer cover unoccupied property after a certain period (e.g., 1 year), or will only do so at specially-placed high cost premium rates.
    c. Taxes – property taxes continue to be due on foreclosures, and property tax assessments, even in current economic conditions, continue to increase. The credit union will have to pay the property taxes during the period of ownership.
    d. Tenant screening, rent collection & problems – if the credit union believes it can mitigate costs by leasing out the foreclosed property, it will have to perform legally-appropriate tenant screening, collect rent payments, and deal with the full range of tenant problems, including maintenance, property damage, complaints, and crime. This may require the expense of hiring a professional property manager, and possibly an attorney. If the credit union attempts to manage the property itself as a rental, it will be subject to all the potential legal liability for compliance with applicable state and federal landlord-tenant fair housing laws, as well as for premises liability.
    e. Repairs and maintenance – ownership of foreclosures will involve maintaining the property to preserve its sales value. Here, as with the costs of holding and renting, the credit union will probably need to hire the work done, and oversee its completion, or hire a management firm to do so. Deterioration of foreclosed property affects the whole neighborhood, so failure to adequately protect and maintain OREO can have a negative reputational and public relations impact on the credit union.

f. Costs of sales and marketing – credit unions must promptly market and sell foreclosed properties. Depending upon the location, it may be difficult to find a qualified realtor who can handle these transactions. Commissions, appraisals and marketing costs and programs need to be understood, analyzed and negotiated.
g. Liability exposure - real property ownership exposes the owner to several types of potential liability:
    i. property damage/waste
    ii. vandalism of unoccupied property
    iii. environmental hazard mitigation
    iv. premises liability, including liability to trespassers
    v. criminal use of vacant property

5. Market risk – there is currently an unusually high level of market risk in real estate, especially residential real estate. If and when the market will recover is unpredictable. A lender cannot predict that holding a foreclosed property for any time period will result in a sale that covers the costs of doing so.

6. "Opportunity cost" and loss of profitable alternatives – perhaps one of the best reasons to limit the holding of OREO is that the cost of holding includes "opportunity cost." (Opportunity cost is the rate of return that the best alternative investment or course of action would have provided). Credit unions benefit their members by making prudent loans and investments, not by real estate speculation.

Additional analysis of the multitude of issues involved in OREO is available in an NCUA letter: http://www.ncua.gov/letters/2008/CU/08-CU-25.pdf

As the Division of Credit Unions moves forward with rulemaking for the safe and sound management of OREO, you are encouraged to keep informed and participate in the DCU's rulemaking discussion.

Please note that the DCU does not provide legal advice. If you have questions regarding the DCU's recommendations on the handling of OREO, or on the OREO rulemaking process, please contact Linda Jekel, Director, Division of Credit Unions, 360-902-8778, ljekel@dfi.wa.gov