

September 4, 2013

Russell G. Golden  
Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Via email: [director@fasb.org](mailto:director@fasb.org)

RE: File Reference No. EITF-13E: *Reclassification of Collateralized Mortgage Loans upon a Troubled Debt Restructuring*

Dear Chairman Golden:

The American Bankers Association (ABA)<sup>1</sup> appreciates the opportunity to comment on the Exposure Draft, *Reclassification of Collateralized Mortgage Loans upon a Troubled Debt Restructuring (ED)*. The main objective of the ED is to clarify when an in substance foreclosure occurs for a residential real estate property, thus marking the time when the related mortgage loan is derecognized and the property is recorded as other real estate owned (OREO). The in substance foreclosure occurs when a creditor is considered to have taken physical possession of the property collateralizing the mortgage loan, which is (1) when the creditor obtains legal title to the residential real estate property, or (2) upon 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.

### **Clarification and Scope**

The ED will have a significant impact on bankers, consolidating practice and clarifying the interpretations of physical possession between bankers and banking regulators. Basically, the ED defines when a residential home mortgage should be reclassified as OREO. With this in mind, we support the clarification, as we believe it recognizes the practical limitations inherent in a creditor's involvement with residential real estate property transfers – namely, that until legal title is transferred, state and local laws and regulations often limit a creditor's ability to exercise dominion over the property without fear of adverse legal consequences.

In situations when legal title is obtained at the time of the foreclosure sale (also often referred to as the sheriff's sale), some question whether title is actually legally transferred (and, therefore,

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<sup>1</sup> ABA represents banks of all sizes and charters and is the voice for our nation's \$14 trillion banking industry and its two million employees.

question the legitimacy of creditor rights) because of redemption periods in many states. However, we believe that title is indeed transferred, though subject to the contingency related to the applicable redemption period statute. Such periods also do not legally preclude the new owner from marketing the property for sale. Prior to this sale, although the creditor may have been given the keys to the property, the creditor's rights (and, thus, abilities) are normally limited to those to protect the property.

Since the legal environment in the U.S. related to residential mortgages is unique, we believe that the scope of the ED should be limited to residential mortgages, as opposed to including loans collateralized by other property, such as commercial real estate or automobiles. We are not aware of any significant issues related to in substance foreclosure for other types of collateral.

### **Additional Disclosures are Not Necessary**

The ED proposes requiring disclosures of (a) the recorded investment in consumer mortgage loans secured by residential real estate properties that are in the process of foreclosure and (b) a roll-forward schedule reconciling the applicable beginning and ending balances. These requirements are proposed to be included in both annual and interim financial statements.

We acknowledge that such information can, in certain circumstances, be helpful in an analysis of asset quality. We also believe that gathering such information is not overly burdensome. However, we question whether there is sufficient incremental value added by requiring these quarterly disclosures and whether they will justify the additional costs of internal controls and audit. We say this for the following reasons:

1. Loans in the process of foreclosure and OREO are already included in a bank's disclosures of non-performing assets, which is a widely-used and well-established credit quality indicator for the banking industry. Since the scope of the ED is limited to residential home mortgages, and the residential home mortgage market is concentrated in a relatively low number of institutions, the relevance of such information is likely to be low for the vast majority of banks. Requiring disaggregation when such amounts are not be material is counterproductive to the goal of providing decision-useful information to financial statement users.
2. Banks already report much of this information in quarterly Call Reports, including:
  - a. The balance of residential mortgage loans in process of foreclosure
  - b. The balance of all foreclosed properties (OREO), broken out by the following collateral:
    - i. Construction, land development, and land
    - ii. Farmland
    - iii. Multi-family residential housing
    - iv. Non-farm, non-residential
    - v. "GNMA loans"
  - c. The balance of OREO covered under FDIC loss-sharing agreements

- d. The balance of OREO recoverable under guarantees, such as FDIC loss-sharing agreements
- e. Rent and other income from OREO properties
- f. Gains and losses on the sale of OREO properties

Call Reports are filed within 30 days after quarter-end – prior to most 10-Q filings. We believe that the information already provided within Call Reports is sufficient to obtain a relatively comprehensive view of a bank’s foreclosed properties. When those amounts are material or significant to a bank’s portfolio of loans, more detailed information is likely provided in a bank’s Management’s Discussion and Analysis within its filing with the Securities and Exchange Commission.

### **Various Important Factors Must be Considered Regarding Transition**

Broadly speaking, most banks’ accounting processes align (or can quickly be adjusted to align) to the proposed guidance in the ED. However, as described below, the ED will may provide significant challenges.

The ED proposes adoption on a modified retrospective basis. The proposed guidance would be applied to the residential mortgage loans and foreclosed real estate properties held by the creditor at the date of adoption, with a cumulative-effect adjustment recorded to the beginning of the annual reporting period. This differs from full retrospective adoption, as the modified retrospective basis does not require application to prior periods.

While not advocating for a prospective treatment at transition or the modified retrospective method, ABA supports the decision to not require a full retrospective adoption, as doing so would require banks to obtain historical data that may not currently exist within their systems/records, such as the fair value of collateral at various points in time. Obtaining this data would be overly burdensome (and in some cases, not possible) and we do not believe full retrospective adoption would provide incrementally more decision-useful information to financial statement users, considering the nature of the residential foreclosure process. With this in mind, the following factors should be considered by the Board in determining the final transition method.

Banks with smaller in substance foreclosure portfolios may prefer prospective adoption to avoid the complexities of the modified retrospective basis (which includes identifying the accounts needing reclassification, determining and recording transition impact, etc.). Conversely, banks with larger portfolios may prefer the modified retrospective basis, as this would eliminate the need to continue tracking and accounting for the existing portfolios, thus ensuring better consistency, control, and comparability.

If a modified retrospective adoption methodology will be required, banks that currently have in substance OREO under interpretation of existing rules will need to reclassify certain amounts back to loans. Consideration should be given to allowing banks to reclassify the current book value of the OREO – not the beginning-of-the-year amount -- back to loans, thus eliminating a

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need for a cumulative-effect adjustment. This will ease the challenges of transition and, more important, prevent certain counter-intuitive results, such as the possibility of double-recognition of charge-offs on loans.<sup>2</sup> As a large portion of the assets that will be reclassified back from OREO to loans will ultimately complete foreclosure and end up being classified as OREO again, establishing the loan book value based on the OREO book value would best align the accounting measurement to the ultimate realizability of the asset.

Thank you for your attention to these matters. Please feel free to contact me ([mgullette@aba.com](mailto:mgullette@aba.com); 202-663-4986) if you would like to discuss our views.

Sincerely,



Michael L. Gullette

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<sup>2</sup> A loan charge-off would have already been recorded in prior periods for the in substance foreclosure property at the time it was reclassified into OREO (and written-down to collateral value, less costs to sell). If, at the time of adoption, the borrower is less than 180 days past due and the ISF asset is reclassified as a loan, the loan's original basis would be reinstated (with cumulative effect through retained earnings). If the loan subsequently proceeds through foreclosure and the bank obtains title to the property, a charge-off will again be recorded for the asset.