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To: Clients and Friends

From: David F. Dulock

Subject: Federal Reserve Board Policy Statement on Rental of Residential Other Real Estate Owned Properties

On April 5, 2012, the Federal Reserve Board (“FRB”) released a policy statement regarding the rental of residential other real estate owned (“OREO”) properties by financial entities for which the FRB is the primary federal supervisor, including state member banks, bank holding companies, non-bank subsidiaries of bank holding companies, savings and loan holding companies, non-thrift subsidiaries of savings and loan holding companies, and U.S. branches and agencies of foreign banking organizations, (collectively “banking organizations”).

Although this memorandum attempts to summarize the major provisions of the policy statement, you are advised to read the policy statement, which may be found at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120405a1.pdf>.

Introductory Statements

- The policy statement reminds banking organizations and examiners that the FRB’s regulations and policies permit the rental of residential OREO properties to third party tenants as part of an orderly disposition strategy within statutory and regulatory limits and outlines supervisory expectations for these rental activities.
- The policy statement includes all one-to-four family properties and does not include multi-family residential or commercial properties.
- The policy statement supplements other relevant FRB guidance, including the policy statement on disposition of property acquired in satisfaction of debts previously contracted (*see* 12 CFR 225.140).
- The FRB’s general policy is that banking organizations should make good faith efforts to dispose of OREO properties at the earliest practicable date. The policy statement explains that banking organizations may rent residential OREO properties within legal holding-period limits without having to demonstrate continuous active marketing of the property for sale, provided that suitable policies and procedures are followed.
- The policy statement further provides that, to the extent that OREO rental properties meet the definition of community development under the Community Reinvestment Act (“CRA”) regulations, the banking organizations would receive favorable CRA consideration. (*CRA regulations define community development to include activities that provide affordable housing to low- and moderate-income individuals as well as those activities that revitalize or stabilize low- and moderate-income areas.*)

Risk Management Considerations for Residential OREO Property Rentals

Banking organizations with relatively small holdings of residential OREO properties - fewer than 50 individual properties rented or available for rent - should use a operational framework that appropriately records the banking organizations' rental decisions and transactions as they take place, preserves key documents, and is otherwise sufficient to safeguard and manage the individual OREO assets.

- Banking organizations with large inventories of residential OREO properties - 50 or more individual properties available for rent or rented - should utilize a framework that systematically documents how they meet the supervisory expectations described in the next section: "Specific Expectations for Large-Scale Residential OREO Rentals."
- Banking organizations should pursue a clear and credible approach for ultimate sale of the rental residential OREO properties within the applicable holding-period limits. Exit strategies in some cases may include special transaction features to facilitate the sale of residential OREO properties, potentially including prudent use of seller-assisted financing or rent-to-own arrangements with tenants.
- Banking organizations' residential property rental activities are expected to comply with all applicable federal, state, and local laws and regulations.
- Banking organizations may use third-party vendors to manage properties but should provide necessary oversight to ensure that property managers fully understand and comply with these federal, state, and local requirements.
- Banking organizations should account for OREO assets in accordance with generally accepted accounting principles and applicable regulatory reporting instructions. Banking organizations should also provide the appropriate classification treatment for their residential OREO properties. Residential OREO is typically treated as a substandard asset, as defined by the interagency classification guidelines (*i.e.*, Commercial Bank Examination Manual section 2060.1 "*Classification of Credits*"). However, residential properties with leases in place and demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return should generally not be classified (*see* footnote 12 of the policy statement for explanation of "reasonable rate of return").

Specific Expectations for Large-Scale Residential OREO Rentals

- Banking organizations with large inventories of residential OREO properties (50 or more available for rent or rented) that decide to engage in rental activities should have in place a documented rental strategy, including formal policies and procedures for OREO rental activities, and a documented operational framework.
- These formal policies and procedures should:
 1. clearly describe how the banking organization will comply with all applicable

- laws and regulations;
2. include processes for determining whether the properties meet local building code requirements and are otherwise habitable, and whether improvements to the properties are needed in order to market them for rent;
 3. establish operational standards for the banking organization's rental activities, including that (i) adequate insurance policies are in place, (ii) property and other tax obligations are met on a timely basis, and (iii) expenditures on improvements are appropriate to the value of the property and to the local market;
 4. require plans for rental of residential OREO properties, down to the individual property level, that cover the full holding period from the time the banking organization received title to ultimate sale by the banking organization;
 5. identify which properties would be eligible for rental;
 6. establish criteria by which properties are chosen for marketing as rental properties, and the process by which rental decisions should be made and implemented;
 7. describe the general conditions under which the banking organization believes a rental approach is likely to be successful, including appropriate consideration of rental market and economic conditions in respective local markets;
 8. address all risk management issues that arise in renting residential OREO properties - for example, (i) the credit risk associated with tenants' potential failure to make timely rent payments, (ii) potential conflict of interest issues such as the use of a firm by a banking organization to both provide information on a property's value and list that property for sale on behalf of the banking organization, (iii) dealing with vacancy, marketing, and re-rental of previously occupied properties, (iv) liability risk arising from rental activities, along with the use and management of liability insurance or other approaches to mitigate that liability and risk, and (v) legal requirements arising from the potential need to take action against tenants for rent delinquency, potentially including eviction.
 9. provide that third-party vendor individuals or organizations that manage the banking organization's OREO properties have appropriate expertise in property management, be in sound financial condition, and have a good track record in managing similar properties;
 10. call for contracts with such vendors to carry appropriate terms and provide, among other key elements, for adequate management information systems and reporting to the banking organization, including rent rolls (along with actual lease agreements), maintenance logs, and security deposits and charges to these deposits; and
 11. provide for adequate oversight of vendors.

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