

COLLATERAL VALUATION AND DOCUMENTATION

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INTRODUCTION

Identifying FAS 114 (ASC 310-10-35) loans for impairment analysis and calculating the [appropriate reserve amount](#) is a vital part in an institution's [allowance calculation](#). An important part of this procedure is using the appropriate valuation method to calculate the given reserve for each impaired loan. There are three valuation methods for FAS 114 impairments:

- **Fair Market Value of Collateral**
- **Present Value of Future Cash Flows**
- **Loan Pricing**

As many institutions must accommodate collateral-dependent loans that have not been restructured or loans for which the borrower cannot make future cash payments, the fair market value of collateral is widely used in reserve calculations. This paper discusses when a bank or credit union should use collateral for their FAS 114 analysis and how to gather the necessary collateral data to document their allowance findings.

WHEN TO USE COLLATERAL

NOTE:

An **impaired loan** is collateral dependent if “repayment is expected to be provided solely by the underlying collateral,” which includes repayment from the proceeds from the sale of the collateral, cash flow from the continued operation of the collateral, or both.

[Learn more](#)

Determining [when to use collateral valuation](#) instead of cash flows can actually be one of the most difficult steps in the impairment. But it’s also a critical decision that examiners will question because the three acceptable methods for evaluating a FAS 114 impaired loan could each require a different level of reserve, impacting the bank’s earnings and loss provisions.

For the two most used methods (Fair Market Value of Collateral and Present Value of Future Cash Flows), the appropriate impairment method is dictated by the answer to one question:

- **Is the loan collateral dependent? IF YES, use Fair Market Value of Collateral.**
- **Is the loan collateral dependent? IF NO, use Present Value of Future Cash Flows.**




The Fair Market Value of Collateral should be utilized when repayment is entirely based on the sale or operation of the collateral, assuming all other cash flow sources are expected to be “no more than nominal.”¹ And this often requires judgment on the part of the analyst, concerning the availability or dependability of other repayment sources.

For this impairment, the expected revenue from the sale or operation of collateral, less selling costs, yields the value to hold against the total recorded investment of the subject loan. Normally this occurs because the borrower does not have the ability to make sufficient cash flow payments.²

WHEN TO USE COLLATERAL (CONT.)

In other scenarios where the loan is not collateral dependent, the [Present Value of Future Cash Flows](#) should be utilized.

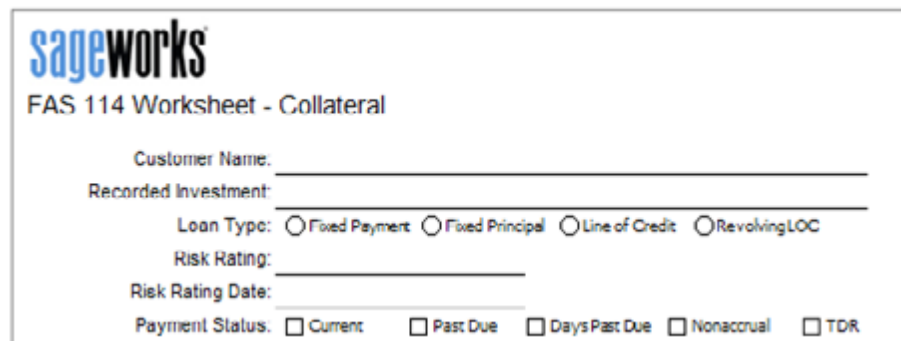
Shared Collateral

Attached Documents	Collateral	Appraisal Value	Appraisal Adjustment	Current Value	Prior Liens	Equity	Selling Costs	Fair Value	Appraisal Date	Expand All
 1	245 Elm St	\$ 800,000.00	5.00%	\$ 760,000.00	\$50,000.00	\$710,000.00	\$60,000.00	\$ 650,000.00	09/01/2011 	Expand 
Total:		\$ 800,000.00		\$ 760,000.00				\$ 650,000.00		

Example of collateral data necessary for documented FAS 114 analysis on a collateral-dependent loan.

Recommended Resource:

Download a complimentary FAS 114 loan impairment worksheet that can be used for a simplified, collateral-based analysis. This worksheet is formatted to analyze one loan at a time with one piece of collateral. [Access the worksheet.](#)



The screenshot shows a form titled "sageworks FAS 114 Worksheet - Collateral". The form includes the following fields and options:

- Customer Name: _____
- Recorded Investment: _____
- Loan Type: Fixed Payment Fixed Principal Line of Credit RevolvingLOC
- Risk Rating: _____
- Risk Rating Date: _____
- Payment Status: Current Past Due Days Past Due Nonaccrual TDR

WHEN TO USE **COLLATERAL** (CONT.)

DID YOU KNOW?

[Sageworks ALLL](#)

provides 3 valuation methods to evaluate FAS 114 loans:

1. Fair Market Value of Collateral
2. Present Value of Future Cash Flows
3. Loan Pricing

There are also other specific items to consider when identifying if a loan is collateral dependent:

1. Would cash flow payments be no more than nominal amounts? If so, Fair Market Value of Collateral should be used.
2. Will additional guarantors tied to the loan relationship and loan agreement provide cash flow support? If so, Present Value of Future Cash Flows should be used.
3. If cash flow is generated by business operations or outside of the collateral securing the subject loan, the loan should not be considered collateral dependent, and Present Value of Future Cash Flows should be used if those amounts are more than nominal payments. For example, if an impaired loan is collateralized by a hotel, then cash flow would be expected from rental income generated by the operation of the hotel, rendering it collateral dependent. If the loan is collateralized by an owner-occupied building for a retail store, then cash flow would be generated by the business's operations rather than the collateral's operations.
4. If only a portion of the cash flow is generated by the sale or business operation of the collateral, the loan would not be collateral dependent, and Present Value of Future Cash Flows should be used.

DATA COLLECTION

Appraisal values should be updated as frequently as possible since they drive the Fair Market Value of Collateral. Guidance states that collateral should be updated at least on a yearly basis to account for the most current appraisal information within the FAS 114 assessment.³

Appraisal source, appraisal date, original value, appraisal value, appraisal discount rates and any selling costs associated with the collateral for the FAS 114 impairment analysis should be included in the institution's allowance calculation. This vital information should be securely stored yet easily accessed by the appropriate party to utilize or document a specific reserve.

Common data elements to obtain and store:

Collateral

Basic Information		Valuation		Appraisal/Comments	
Existing Property:	<input type="text"/>	Original Value:	\$ 800,000	Appraisal Date:	09/01/2011
Collateral Code:	010	Appraisal Value:	\$ 800,000	Source:	Appraiser
Collateral Type:	Real Estate	Appraisal Adjustment:	5.00%	Location of Document:	<input type="text"/>
Description:	245 Elm St	Current Value:	\$ 760,000	Comments:	<input type="text"/>
Pledged By:	6th Street Corp.				

Liens Against the Selected Collateral

Loan Number	Lien Holder	Lien Position	Applicable Collateral Value	Prior Liens	Loan Balance/Lien Amount	Comments
⊗ Loan with another institution	Bank of America	1	\$ 760,000	\$ 0	\$ 50,000	
⊗ 470058540-50	Bank of Sageworks	2	\$ 710,000	\$ 50,000	\$ 499,811	
⊗ 275148003-10	Bank of Sageworks	3	\$ 210,189	\$ 549,811	\$ 1,400,000	

DATA COLLECTION (CONT.)

Making the initial lending decisions based on accurate collateral data and having processes in place to capture updated data allow an institution to manage risk and capital positions before a loan is even on the books. This process can be shored up by:

- **Presenting collateral when doing loan analysis.** Loan to Value percentages should be documented and presented specific to each loan and globally.
- **Matching loan to value percentages and values with the given documentation on the collateral.** Appraisals and descriptions should directly impact loan information as it relates to the LTV calculation.
- **Knowing your collateral!** Go out and collect the most current information you can, and tighten processes to ensure appraisal collection is part of a robust [loan administration system](#).
- **Documenting LTV requirements in the loan analysis.** This could vary based on collateral types – accounts receivable, inventory, equipment, etc. – but a bank or credit union should not lend when the LTV percentage requirements fall below underwriting guidelines.

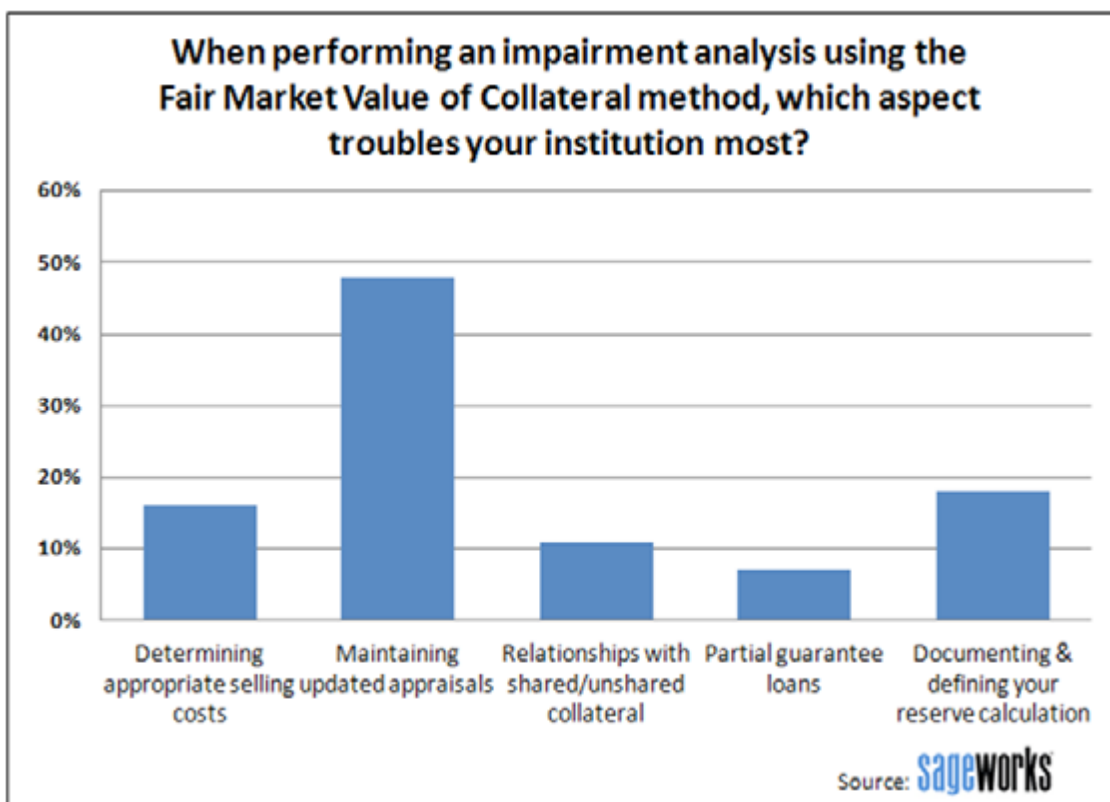
ADDITIONAL RESOURCE:

Whitepaper: Compiling the Best Data for the Reserve Calculation

[Access the whitepaper](#)

DATA COLLECTION (CONT.)

Remarkably, even though this information is so important to the impairment analysis most institutions admit that maintaining updated appraisal information continues to be one of the most difficult items to manage at their institution.⁴



Poll conducted during Sageworks' webinar, [How to Calculate Your FAS 114 Reserves](#). Over 160 bankers responded to the poll question. [View the webinar recording](#).

WHY IT'S IMPORTANT

Leslie Schlanger, assistant vice president of [Community Bank of Bergen County](#) who specializes in the bank's ALLL calculation, commented, "An institution should always consider this information to be as updated as possible when applying the collateral to the total recorded investment for the reserve calculation. Not having the most updated collateral valuation would be detrimental to the institution's accuracy of the reserve and would certainly raise red flags with examiners."

Managing your collateral at the beginning and through the end of a loan cycle allows an institution to manage risk and provide [more accurate calculations](#) that drive an institution's bottom line. Having an updated appraisal on collateral will lead to a more accurate and defensible reserve calculation every time.

Recommended Resource:

For more information on the three valuation methods for FAS 114 loans, download the whitepaper titled: [How to Calculate Your FAS 114 Loans](#).

ABOUT SAGEWORKS & THE AUTHOR

Sageworks (www.sageworks.com) is a financial information company working with financial institutions, accountants and private-company executives across North America to collect and interpret financial information. Thousands of bankers rely on Sageworks' credit risk management solutions to streamline credit analysis, risk rating, [portfolio stress testing](#), loan administration and [ALLL calculation](#). Sageworks is also an industry thought leader, regularly publishing [whitepapers](#) and hosting webinars on topics important to bankers.

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ALLL

[Sageworks ALLL](#) is the premiere automated solution for estimating a financial institution's reserve. It helps bankers automate their ALLL

process and increase consistency in their methodology, making it defensible to auditors and examiners. Sageworks' risk management consultants also assist clients with the implementation of their ALLL models and guidance interpretation. To find out more, visit www.sageworksanalyst.com.

Garrett Morris is a senior risk management consultant at Sageworks, where he serves as an expert helping financial institutions manage their loan portfolio. His primary focuses are helping financial institutions understand and comply with federal accounting guidance when focusing on their allowance for loan and lease losses reserve and portfolio stress testing.

He also specializes in credit analysis, loan review, calculating and assessing risk, and loan administration management. Joining Sageworks in 2006, Garrett has been instrumental in the development and growth of the Credit Risk Management Solutions offered through the Sageworks Suite of products and has helped over 800 financial institutions in his term. He is a graduate of North Carolina State University's College of Management where he studied business management, marketing and finance.

ADDITIONAL RESOURCES

“The Complete Guide to the ALLL,” *Sageworks*.

<http://web.sageworks.com/complete-guide-ALLL-reserves/>

“ALLL Glossary,” *Sageworks*.

<http://web.sageworks.com/alll-glossary/>

Lubansky, Michael. “Challenges in the Estimation of the ALLL,” *Sageworks*.

<http://web.sageworks.com/alll-challenges-whitepaper/>

Morris, Garrett and Chuck Nwokocha. “How to Calculate Your FAS 114 Reserves,” *Sageworks*.

<http://web.sageworks.com/fas-114-reserves/>

“FAS 114 Impairment Analysis Worksheet,” *Sageworks*.

<http://web.sageworks.com/federal-fas-114-reserve-alll-policy-impairment-analysis/>

ENDNOTES

¹ “Troubled Debt Restructurings.” *FDIC – Financial Institution Letter*. October 24, 2013. <http://www.fdic.gov/news/news/financial/2013/fil13050.html>

² Morris, Garrett and Chuck Nwokocha. “How to Calculate Your FAS 114 Reserves”. *Sageworks*. <http://web.sageworks.com/fas-114-reserves/>

³ Lubansky, Mike. “Challenges in the Estimation of the ALLL.” *Sageworks*. <http://web.sageworks.com/alll-challenges-whitepaper/>

⁴ “Challenges with Fair Market Value of Collateral”. *Sageworks*. <http://sageworks.com/blog/post/2013/07/02/challenges-with-collateral-method-poll.aspx>