Example 2
Measuring Impairment: Fair Value Method (Operation of Collateral)

A $4,200,000 loan is collateralized by an apartment building. At origination, an appraisal supported a $6,700,000 "as stabilized" MV for the building. However, the current appraisal notes an "as stabilized" MV of only $4,000,000 and an "as is" MV of approximately $2,400,000 due to a significantly increased vacancy rate and a decline in rental rates. A review of the appraisal found all assumptions and conclusions to be reasonable. Management concluded that, due to the recent date of the current appraisal and the absence of changes in market conditions and property use since the appraisal date, the "as is" MV conclusion is considered an appropriate estimate of the fair value of the collateral for financial reporting purposes.

Management determines a loan workout would be in the best interests of the bank and the borrower. However, the terms of the modification do not provide reasonable assurance of repayment of principal and interest due to an extended interest-only payment period at a reduced interest rate. The resulting payment during the interest-only period is the amount the borrower's cash flow currently supports. The economy is beginning to improve, and management reasonably believes that the property will reach the "as stabilized" MV within the next 2 years.

The borrower has no other assets and no ability to service the debt from other sources; therefore, the loan is collateral dependent. After a thorough analysis of the borrower's financial condition, management concludes the best way to mitigate credit loss is through the borrower continuing the operation of the collateral, rather than foreclosure or the borrower selling the collateral to repay the debt.

How should this loan be accounted for in the ALLL?

A.	Loan balance	$4,200,000
	Less: Fair value of collateral ("As Is" MV)	$2,400,000
	Initial valuation allowance for impairment	$1,800,000
	Loan balance	$4,200,000
	Less: "As Stabilized" MV	$4,000,000
	Amount classified Loss and charged to ALLL	$ 200,000
	Valuation allowance for impairment after charge-off	$1,600,000
B.	Loan balance	$4,200,000
	Less: Fair value of collateral ("As Is" MV)	$2,400,000
	Valuation allowance for impairment	$1,800,000
C.	Loan balance	$4,200,000
	Less: "As Stabilized" MV	$4,000,000
	Valuation allowance for impairment	$ 200,000

The best answer is A.

Answer A is the best answer. The difference between the loan balance and the "as is" MV, which is most reflective of fair value, should be established as the impairment amount within the ALLL. This results in management allocating $1,800,000 to the ALLL before considering the need for any charge-off. In this case, because the modified terms do not provide reasonable assurance of collection of all principal, the shortfall between the loan balance and the prospective "as stabilized" MV does not appear collectible, resulting in management charging off the $200,000 shortfall against the ALLL. The $1,600,000 impairment amount after the charge-off remains in the ALLL and should be reevaluated for appropriateness each quarter.

The fair value of the collateral will need to be periodically re-estimated to ensure the impairment amount is properly stated in regulatory reports. If property occupancy improves as expected and the "as stabilized" MV is achieved, no additional charge-offs would be necessary. If occupancy does not improve or worsens, it may be necessary to re-estimate the "as stabilized" MV of the collateral to determine whether additional charge-offs are required.

Answer B fails to reflect a charge-off of the shortfall between the loan balance and the prospective "as stabilized" MV.

Answer C incorrectly uses the "as stabilized" MV rather than the "as is" MV to measure the impairment on the loan.