Generally, commercial loans comprise the largest asset concentration of a branch, offer the most complexity, and require the greatest commitment from branch management to monitor and control risks. Proper management of these assets requires a clearly articulated credit policy that imposes discipline and sound loan administration. Since lenders are subject to pressures related to productivity and competition, they may be tempted to relax prudent credit underwriting standards to remain competitive in the marketplace, thus increasing the potential for risk. Examiners need to understand the unique characteristics of the varying types of commercial and industrial loans, as well as how to properly analyze their quality.

Commercial loans are extended on a secured or unsecured basis with a wide range of purposes, terms, and maturities. While the types of commercial and industrial loans can vary widely depending on the purpose of loans made and market characteristics where the branch operates, most commercial and industrial loans will primarily be made in the form of a working-capital loan, term loan, or loan to an individual for a business purpose. This section will provide examiners with a fundamental understanding of secured and unsecured transactions, the key principles for assessing credit quality, and basic bankruptcy law. Other sections of this manual discuss more specific types of lending.

TYPES OF COMMERCIAL LOANS

Working Capital or Seasonal Loans

Working capital or seasonal loans provide a business with short-term financing for inventory, receivables, the purchase of supplies, or other operating needs during the business cycle. These types of loans are often appropriate for businesses that experience seasonal or short-term peaks in current assets and current liabilities, such as a retailer who relies heavily on a holiday season for sales or a manufacturing company that specializes in summer clothing. These types of loans are often structured in the form of an advised line of credit or a revolving credit. An advised line of credit is a revocable commitment by the branch to lend funds up to a specified period of time, usually one year. Lines of credit are generally reviewed annually by the branch, do not have a fixed repayment schedule, and may not require fees or compensating balances. In the case of unadvised lines of credit, the branch has more control over advances and may terminate the facility at any time, depending on state law or legal precedents. A revolving line of credit is valid for a stated period of time and does not have a fixed repayment schedule, but usually has a required fee. The lender has less control over a revolving credit since there is an embedded guarantee (i.e. firm commitment) to make advances within the prescribed limits of the loan agreement. The borrower may receive periodic advances under the line of credit or the revolving credit up to the agreed limit. Repayment is generally accomplished through the conversion or turnover of short-term assets, such as inventory or accounts receivable. Interest payments on working capital loans are usually paid throughout the term of the loan, such as monthly or quarterly.

Working-capital loans are intended to be repaid through the cash flow derived from converting the financed assets to cash. The structure of the loans can vary, but they should be closely tied to the timing of the conversion of the financed assets. In most cases, working-capital facilities are renewable at maturity, are for a one-year term, and include a clean-up requirement for a period sometime during the low point or contraction phase of the business cycle. The clean-up period is a specified period (usually 30 days) during the term of the loan in which the borrower is required to pay off the loan. While this requirement is becoming less common, it provides the branch with proof that the borrower is not dependent on the lender for permanent financing. It is important to note, however, that an expanding business may not be able to clean up its facility since it may be increasing its current assets.

Analysis of Working-Capital Loans

The analysis of a working-capital loan is best accomplished by a monthly or quarterly review of a company's balance sheet and income statements to identify the peak and contraction phases of the business cycle. The lender should know when the peak and contraction phases are, and the loan should be structured accordingly. The lender's primary objective is to determine whether the advances are being used for the intended purposes (inventories or payables) and not for the acquisition of fixed assets or payments on other debts. Repayments on the facility should also be consistent with the conversion of assets. If the borrower has other loan facilities at the branch, all credit facilities should be reviewed at the same time to ensure that the activity with the working-capital facility is not used to pay interest on other loans in the branch. Projections of sources and uses of funds are also a valuable tool for reviewing a working-capital line of credit and determining the sales cycle.

Quarterly balance-sheet and income statements are very helpful when a comparison is made with the original projections. Other helpful information can be obtained from a review of an aging of accounts receivable for delinquencies and concentrations, a current list of inventory, an accounts-payable aging, and accruals made during the quarter. This information can be compared with the outstanding balance of the facility to ensure that the loan is not overextended and that the collateral margins are consistent with borrowing-base parameters.

A borrowing base is the amount the lender is willing to advance against a dollar value of pledged collateral; for example, a branch will only lend up to a predetermined specified percentage of total outstanding receivables less all accounts more than a certain number of days delinquent. A borrowing-base certificate should be compiled at least monthly or more often during peak activity in the facility. When reviewing working-capital loans, examiners should remember that a branch relies heavily on inventory as collateral in the beginning of a company's business cycle and on receivables toward the end of the business cycle. However, in traditional working-capital loans, greater emphasis is usually placed on accounts receivable as collateral throughout the loan's tenure.

Normally, a branch is secured by a perfected blanket security interest on accounts receivable, inventory, and equipment, and on the proceeds from the turnover of these assets. Well-capitalized companies with a good history of payout or cleanup may be exceptions and qualify for unsecured lending. An annual lien search, however, would be prudent under this type of lending relationship to detect any purchase money security interest that may have occurred during the business cycle.

The following are potential problems associated with working-capital loans:

- *Working-capital advances used for funding losses.* A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility.
- *Working-capital advances funding long-term assets.* A business will use working-capital funds to purchase capital assets that are normally acquired with term business loans.
- Trade creditors not paid out at end of business cycle. While the branch may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the branch to support funding needs that were previously financed by trade creditors.
- *Overextension of collateral.* The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Examiners should review borrowing-base certificates to verify that coverage meets the prescribed limitations established by the branch's credit policy for the specific assets being financed.
- *Value of inventory declines.* When a business does not pay back the branch after inventory is converted to cash or accounts receivable, the value of the inventory declines. Other causes of inventory devaluation include obsolescence, a general economic downturn, or in the case of a commodity, market volatility. Declines in inventory value will commonly put a working-capital facility in an out-of-borrowing-base situation and require the excess debt to be amortized and repaid through future profits of the business.
- *Collectibility of accounts receivable declines.* The increasingly past-due status of accounts receivable or deteriorating credit quality of account customers both result in the noncollection of receivables. This can also cause an out-of-borrowing-base situation for the lending institution.
- *Working-capital advances used to fund long-term capital.* Funds may be inappropriately used to repurchase company stock, pay off

subordinated debt holders, or even pay dividends on capital stock.

These situations may cause a loan balance to be remaining at the end of the business cycle. If this should occur, the branch generally has one of three options: (1) Require the unpaid balance to be amortized; This option is, however, dependent on the ability of the business to repay the debt through future profits; (2) Request the borrower to find another lender or require an infusion of capital by the borrower. This is not always a feasible option because of the probable weakened financial condition of the business and ownership under these circumstances; or (3) Liquidate the collateral. Foreclosing on the collateral should only be executed when it becomes obvious that the business can no longer function as a going concern. The problem with this option is that once the branch discovers that the business is no longer a viable concern, realizing the full value of the collateral is in jeopardy. The need to resort to any of these options will usually prompt criticism of the credit.

Term Loans

Term loans are generally granted at a fixed or variable rate of interest, have a maturity in excess of one year, and are intended to provide an organization with the funds needed to acquire long-term assets, such as physical plants and equipment, or finance the residual balance on lines of credit or long-term working capital. Term loans are repaid through the business's cash flow, according to a fixed-amortization schedule, which can vary based on the cash-flow expectations of the underlying asset financed or the anticipated profitability or cash flow of the business. Term loans involve greater risk than short-term advances because of the length of time the credit is extended. As a result of this greater risk, term loans are usually secured. Loan interest may be payable monthly, quarterly, semiannually, or annually. Loan principal should amortize with the same frequency in order to fully pay off the loan at maturity.

In most cases, the terms of these loans are detailed in formal loan agreements with affirmative and negative covenants that place certain conditions on the borrower throughout the term of the loan. In affirmative covenants, the borrower pledges to fulfill certain requirements, such as maintain adequate insurance coverage, make timely loan repayments, or ensure the financial stability of the business. Negative or restrictive covenants prohibit or require the borrower to refrain from certain practices, such as selling or transferring assets, defaulting, falling below a minimum debt coverage ratio, exceeding a maximum debt-to-equity ratio, or taking any action that may diminish the value of collateral or impair the collectibility of the loan. Covenants should not be written so restrictively that the borrower is constantly in default over trivial issues; however, violations should be dealt with immediately to give credibility to the agreement. Violations of these covenants can often result in acceleration of the debt maturity and payments. A formal loan agreement is most often associated with longer-term loans. If a formal agreement does not exist, the term loans should be written with shorter maturities and balloon payments to allow more frequent review by branch management.

Analysis of Term Loans

While a working-capital loan analysis emphasizes the balance sheet, the analysis of term loans will focus on both the balance sheet and the income statement. Because a term loan is repaid from excess cash flow, the long-term viability of the business is critical in determining the overall quality of the credit. In evaluating long-term earnings, the examiner must develop a fundamental understanding of the company's industry and competitive position in the marketplace. Most of the analysis will be conducted based on the historical performance of the business and its history of making payments on its debt. Any historical record of inconsistencies or inability to perform on existing debt should prompt an in-depth review to determine the ability of the borrower to meet the loan's contractual agreements. One of the most critical determinations that should be made when evaluating term debt is whether the term of the debt exceeds the useful life of the underlying asset being financed.

While cash flow of the business is the primary source of repayment for a term loan, a secondary source would be the sale of the underlying collateral. Often, if circumstances warrant a collateral sale, the branch may face steep discounts and significant expenses related to the sale. Examiners should carefully consider these issues when evaluating the underlying value of collateral under a liquidation scenario.

The following are potential problems associated with term loans:

- The term of the loan is not consistent with the useful life of collateral.
- Cash flow from operations does not allow for adequate debt amortization, a fundamental problem that can be solved only by improved performance.
- The gross margin of the business is narrowing, which requires the business to sell more product to produce the same gross profit. Higher sales volume could require more cash for expansion of current assets, leaving less cash for debt amortization. This situation is a common by-product of increased competition.
- Sales are lower than expected. In the face of lower sales, management is unable or unwilling to cut overhead expenses, straining cash flow and resulting in diminished debt servicing ability.
- Fixed assets that are financed by term loans become obsolete before the loans are retired, likely causing the value of underlying collateral to deteriorate.
- The business's excess cash is spent on higher salaries or other unnecessary expenses.
- The payments on term debt have put a strain on cash flow, and the business is unable to adequately operate or allow natural expansion.
- The balance sheet of the business is weakening. The overall financial condition of the business is deteriorating because of poor performance or unforeseen occurrences in the industry.

Shared National Credits

Regulatory agencies participate in a program for the uniform review of shared national credits (SNC). A SNC is defined as any loan, commitment, or group of loans or commitments aggregating $20 million or more at origination that is:

- Committed under a formal lending arrangement.
- Shared at its inception by two or more supervised institutions or sold to one or more institutions with the purchasing entity assuming its pro rata share of the credit risk.

A single facility with different terms and/or participants for tranches should be reported as separate credits. Loans sold to affiliate banks of the same holding company are not part of the SNC program.

If the outstanding balance or commitment of a SNC falls below $20 million after its inception, and it is not criticized, the credit will not be reviewed at the next review date. Therefore, the examiner should conduct an individual review of the credit at the branch under examination. However, if the former SNC facility fell below the threshold through a charge-off, and was classified or specially mentioned at the most recent SNC review, the credit relationship would continue to be reviewed under the SNC program until such time that the balance falls below $10 million. The Federal Deposit Insurance Corporation (FDIC), the state agencies, and the Office of the Comptroller of the Currency (OCC) also participate in this program. The Federal Reserve carries out the examination of SNCs at the lead or agent banks that are state-member banks, state-chartered foreign branches, and credit-extending nonbank subsidiaries of domestic and foreign organizations. The FDIC is primarily responsible for any SNC credits at state non-member banks, and the OCC supervises the review of those SNCs in which the lead bank is a national bank or an OCC-chartered foreign branch.

SNCs should not be analyzed or reviewed during the examination of the individual participating branch. If the examiner is uncertain whether the credit was reviewed under the SNC program, the respective Reserve Bank coordinator should be contacted. If credits eligible for the program are found but have not been reviewed (other than new SNCs since the time of the last SNC program review), the examiner should submit a memorandum detailing those credits to the respective Reserve Bank coordinator to be forwarded to the SNC coordinator at the Federal Reserve Bank of New York.

The SNC program does not track subparticipations. A subparticipant is a banking organization that has purchased a share from either a bank in the original syndicate or from a bank considered a first-tier participant. Therefore, if the bank is a subparticipant in a credit, it will not appear in the "Report of Lenders and their Borrowers". However, the credit may have been reviewed by the SNC Program and examiners can obtain the results of such a review by calling the SNC coordinator for their agency.

SECURED AND UNSECURED TRANSACTIONS

This subsection is intended to be a general reference for an examiner's review of a credit file to determine whether the branch's collateral position is properly documented. Examiners should be aware that secured transactions encompass an extensive body of law that is rather technical in nature. The following discussion contains general information for examiners on the basic laws that govern a branch's security interest in property and on the documentation that needs to be in a loan file to properly document a perfected security interest in a borrower's assets.

Secured Transactions

Most secured transactions in personal property and fixtures are governed by article 9 of the Uniform Commercial Code (UCC). The UCC has been adopted by all 50 states, the District of Columbia, and the Virgin Islands. Timing differences as well as filing locations differ from state to state. Failure to file a financing statement in a timely manner or in the proper location will compromise a lender's security interest in the collateral.

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. Mortgage transactions are not covered, marine mortgages are filed with the Coast Guard, and aircraft liens are filed with the Federal Aviation Administration. A *security interest* is defined in the UCC as ''an interest in personal property or fixtures which secures payment or performance of an obligation.'' A secured transaction requires that there be an agreement between the parties indicating the parties' intention to create a security interest for the benefit of the creditor or secured party. This agreement is commonly referred to as a security agreement.

Article 9 of the UCC refers to two different concepts related to security interests: attachment and perfection. *Attachment* is the point in time at which the security interest is created and becomes enforceable against the debtor. Perfection refers to the steps that must be taken in order for the security interest to be enforceable against third parties who have claims against collateral.

Attachment of Security Interest

The three requirements for the creation of a security interest are stated in UCC section 9-203(1). Once the following requirements are met, the security interest is attached.

- The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement that contains a description of the collateral and, when the security interest covers crops now growing or to be grown or timber to be cut, a description of the land concerned.
- Value has been given to the debtor.
- The debtor has rights in the collateral.

Thus, unless the collateral is in the possession of the secured party, there must be a written security agreement that describes the collateral. The description does not have to be very specific or detailed— ''any description of personal property... is sufficient whether or not it is specific if it reasonably identifies what is described'' (see UCC section 9-110). The agreement must also be signed by the debtor. The creditor may sign it, but its failure to do so does not affect the agreement's enforceability against the debtor.

Giving value is any consideration that supports a contract. Value can be given by a direct loan, a commitment to grant a loan in the future, the release of an existing security interest, or the sale of goods on contract.

While the debtor must have *rights* in the collateral, he or she does not necessarily have to have title to the property. For example, the debtor may be the beneficiary of a trust (the trustee has title of trust assets) or may lease the collateral. The debtor, in such cases, has rights in the collateral, but does not hold the title to the collateral. The secured party, however, only obtains the debtor's limited interest in the collateral on default if the debtor does not have full title to the collateral.

Perfection of Security Interest in Property

Perfection represents the legal process by which a creditor secures an interest in property. Perfection provides the branch assurance that it has a legal interest in the collateral. The category of collateral will dictate the method of perfection to be used. The most common methods of perfection are: (1) automatic perfection when the security interest is attached (such as in the case of purchase-money security interests applicable to consumer goods other than vehicles); (2) perfection by possession; (3) the filing of a financing statement in one or more public filing offices,[1] and (4) compliance with a state certificate of title law or central filing under a state statute other than the UCC, such as registration of vehicles.

The most common method of perfecting a security interest is public filing. Public filing serves as a constructive notice to the rest of the world that the branch claims a security interest in certain property of the debtor described in both the security agreement and the financing statement. Public filing is accomplished by filing a financing statement (UCC-1) in a public office, usually the county recorder or secretary of state. The system of filing required by the UCC provides for a notice filing whereby potential creditors can determine the existence of any outstanding liens against the debtor's property.

The form of the financing statement and where to file it varies from state to state. While the filing of a nonstandard form will generally be accepted, the failure to file in the proper public office can jeopardize the priority of the lender's security interest. The UCC provides three alternative filing systems:

- *Alternative System One.* Liens on minerals, timber to be cut, and fixtures are filed in the county land records. All other liens are filed in the office of the secretary of state.
- *Alternative System Two.* The majority of states have adopted this version. It is the same as system one, except liens on consumer goods, farm equipment, and farm products are filed in the county where the debtor resides, or in the county where the collateral is located if it is owned by a nonresident.
- *Alternative System Three.* In a few states, filings made with the secretary of state must also be filed in the county of the borrower's business (or residence if there is no place of business in that state). Otherwise, the requirement in these states is the same as system two.

As each state may select any of the above three alternatives or a modified version of them, it is important that the examiner ascertain the filing requirements of the state(s) where the branch's customer operates. Most importantly, it is the location of the borrower, not the branch, that determines where the financing statement must be filed.

Evaluation of Security Interest in Property

Key items to look for in evaluating a security interest in property include the following:

- *Security agreement.* There should be a proper security agreement, signed and dated by the borrower, that identifies the appropriate collateral to be secured. It should include a description of the collateral and its location in sufficient detail so the lender can identify it, and should assign to the lender the right to sell or dispose of the collateral if the borrower is unable to pay the obligation.
- *Collateral possession.* If the institution has taken possession of the collateral to perfect its security interest, management of the institution should have an adequate record-keeping system and proper dual control over the property.
- *Financing statement.* If the institution has filed a financing statement with the state or local authority to perfect its security interest in the collateral, in general, it should contain the following information:
  - — names of the secured party and debtor
  - — the debtor's signature
  - — the debtor's mailing address
  - — the address of the secured party from which information about the security interest may be obtained
  - — the types of the collateral and description of the collateral[2]

1. The financing statement is good for five years, and the lender must file for a continuation within the six-month period before expiration of the original statement.

2. Substantial compliance with the requirements of UCC

- *Amendments*. Not all amendments require the borrower's signature, and branches may file an amendment for the following reasons:
  - — borrower's change of address
  - — creditor's change of address
  - — borrower's name change
  - — creditor's name change
  - — correction of an inaccurate collateral description
  - — addition of a trade name for the borrower that was subsequently adopted
- *Where to file a financing statement.* In general, financing statements filed in good faith or financing statements not filed in all of the required places are still effective. If a local filing is required, the office of the recorder in the county of the debtor's residence is the place to file. If state filing is required, the office of the secretary of state is the place to file.
- *Duration of effectiveness of a financing statement.* Generally, effectiveness lapses five years after filing date. If a continuation statement is filed within six months before the lapse, effectiveness is extended five years after the last date on which the filing was effective. Succeeding continuation statements may be filed to further extend the period of effectiveness.

Perfection of Security Interest in Real Estate

As previously mentioned, real estate is expressly excluded from coverage under the UCC. A separate body of state law covers such interests. However, for a real estate mortgage to be enforceable, the mortgage must be recorded in the county where the real estate covered by the mortgage is located.

Real estate mortgage/deed of trust. When obtaining a valid lien on real estate, only one document is used, the mortgage or deed of trust. The difference between a mortgage and a deed of trust varies from state to state; however, the primary difference relates to the process of foreclosure. A mortgage generally requires a judicial foreclosure, whereas, in some states, a foreclosure on a deed of trust may not. Nearly all matters affecting the title to the real estate, including the ownership thereof, are recorded in the recorder's office.

When determining the enforceability of a real estate mortgage or deed of trust, the examiner should be aware of the following requirements:

- The mortgage must be in writing.
- To be recordable, the mortgage must be acknowledged. There are different forms of acknowledgments for various situations depending on whether individuals, corporations, partnerships, or other entities are executing the mortgage. Make sure that the form of the acknowledgment used is in accordance with the type of individual or entity executing the mortgage.
- If a corporation is the mortgagor, its articles of incorporation or bylaws often will specifically state which officers have authority to sign an instrument affecting real estate. In these instances, the designated officer should be required to sign. If the corporation has a seal, that also must be affixed. If the corporation does not have a seal, this fact must be shown in the acknowledgment.
- As soon as possible after the mortgage is executed, it should be recorded in the office of the recorder for each county in which the property described in the mortgage is located. In most cases, the borrower signs an affidavit that indicates, in part, that he or she will not attempt to encumber the property while the lender is waiting for the mortgage to be recorded. In any event, the lender should conduct a title search after the mortgage is recorded to ensure that his position has not been compromised.
- If the mortgagor is married, the spouse must join in the execution of the mortgage to subject his or her interest to the lien of the mortgage. If the mortgagor is single, the mortgage should indicate that no spouse exists who might have a dower interest or homestead interest in the property.
- If the mortgagor is a partnership, it must be determined whether the title is in the name of the partnership or in the names of the individual partners. If the title is in the names of the individual partners, their spouses should join in executing the mortgage. If the title is in the name of the partnership, those partners

section 9-402 is sufficient if errors are only minor and not seriously misleading. Some states require the debtor's tax ID number on the financing statement.

who are required to sign under the partnership agreement should sign.

Unsecured Transactions

Unsecured transactions are granted based on the borrower's financial capacity, credit history, earnings potential, and/or liquidity. Assignment of the borrower's collateral is not required, and repayment is based on the terms and conditions of the loan agreement. While unsecured loans often represent the branch's strongest borrowers, the unsecured loan portfolio can represent its most significant risk. One of the primary concerns related to unsecured credit is that if the borrower's financial condition deteriorates, the lender's options to work out of the lending relationship deteriorate as well. In general, if a credit is unsecured, the file should contain reliable and current financial information that is sufficient to indicate that the borrower has the capacity and can be reasonably expected to repay the debt.

Emerging Problem Loans

The following are key signals of an emerging problem loan:

- *Outdated or inaccurate financial information.* The borrower is unwilling to provide the financial institution with a current, complete, and accurate financial statement at least annually. Management also should request a personal tax return (and all related schedules) on the borrower. While borrowers will usually present their personal financial statements in the most favorable light, their income tax return provides a more conservative picture.
- *The crisis borrower.* The borrower needed the money yesterday, so the branch advanced unsecured credit.
- *No specific terms for repayment.* The unsecured loan has no structure for repayment, and it is commonly renewed or extended at maturity.
- *Undefined source of repayment.* Repayment sources are often not identified and are unpredictable. These types of loans are often repaid through excess cash flow of the borrower, sale of an asset(s), or loan proceeds from another financial institution.

REVIEWING CREDIT QUALITY

Importance of Cash Flow

Evaluating cash flow is the single most important element in determining whether a business has the ability to repay debt. Two principal methods of calculating the cash flow available in a business to service debt are presented in this subsection. The results of these methods should be used to determine the adequacy of cash flow in each credit evaluated at an institution. The accrual conversion method is the preferred method because it is the most reliable. The second and less reliable method is the supplemental or traditional cash-flow analysis; however, the information needed for this analysis is usually more obtainable and easier to calculate. The traditional method can be used when circumstances warrant, for example, when the borrower's financial statements are not sufficiently detailed for the information requested in the accrual conversion analysis or when historical information is inadequate.

Analysis and Limitations of Cash Flow

Cash-flow analysis uses the income statement and balance sheet to determine a borrower's operational cash flow. Careful analysis of all investment and financing (borrowing) activities must be made for an accurate assessment of cash flow. In reality, examiners face time constraints that often prevent them from performing the complex mathematical calculations involved in sophisticated cash-flow analysis. Therefore, the cash-flow methods presented below were designed to be reasonable and practical for examiner use. However, examiners should be careful of conclusions reached using the traditional cash-flow analysis, without consideration of balance-sheet changes or other activities that affect cash flow. The traditional cash-flow analysis does not recognize growth in accounts receivable or inventory, a slow-down in accounts payable, capital expenditures, or additional borrowings. If the credit file contains a CPA-prepared statement of cash flow or a statement prepared using the accrual conversion method, the examiner should concentrate efforts on reviewing and analyzing these statements rather than on preparing a traditional cash-flow statement.

One critical issue to remember is that deficit cash flow does not always mean that the borrower is encountering serious financial difficulties. In some cases, deficit cash flow is caused by a business's experiencing significant growth, and there is a pronounced need for external financing to accommodate this growth and eliminate the deficit cash-flow position. In this case, an adequate working-capital facility may not be in place to accommodate the need for additional inventory. A comprehensive analysis of changes in the balance sheet from period to period should be made before the loan is criticized.

Components of the Accrual Conversion Method of Cash Flow

Category	*Basis for Amount*
Sales:	Dollar amount of sales in period
+/–change in A/R, INV., A/P:	Represents the absolute difference of the current period from the corresponding period of the previous year in accounts receivable, inventory, and accounts payable.
Formula:	a) An increase in any current asset is a use of cash and is subtracted from the calculation. Conversely, a decrease in any current asset is a source of cash and is added to the calculation. b) An increase in any current liability is a source of cash and is added to the calculation. Conversely, a decrease in any current liability is a use of cash and is subtracted from the calculation.
SGA:	Subtract selling, general, and administrative expenses.
Interest Expense:	Add interest expense to the calculation if SGA ''expense'' includes interest expense.
Excess (Deficit) Cash Flow:	Represents cash available before debt service.

Calculation of Supplemental/Traditional Cash Flow

Net Income:	Amount of net income reported on most recent annual income statement before taxes.
Interest Expense:	Add the total amount of interest expense for the period.
Depreciation/ Amortization:	Add all noncash depreciation and principal amortization on outstanding debt.
Cash Flow before Debt Service:	Indicates net Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). Amortization should include both principal and interest payments required on debt.
Debt Service:	Subtract scheduled principal and interest payments.
Capital Expenditures:	Subtract all capital expenditures for the period.
EQUALS— Excess (Deficit) Cash Flow:	Total amount of excess or deficit cash flow for the period after debt service.
Coverage Ratio:	Cash flow before debt service divided by debt service (principal and interest).

Importance of Financial Analysis

While cash-flow analysis is critical in reviewing whether a borrower has the ability to repay individual debt, a review of the borrower's other financial statements can offer information about other sources of repayment, as well as the borrower's overall financial condition and future prospects. The availability of historical balance-sheet and income information, which allow declining trends to be identified, is critical. Also, it may be appropriate to compare the borrower's financial ratios with the average for the industry overall. Much of the financial information that examiners will review will not be audited; therefore, considerable understanding of general accounting principals is necessary to competently review an unaudited financial statement. At a minimum, financial statements should be obtained annually; where appropriate, the branch also should obtain monthly or quarterly statements.

When reviewing a credit file of a borrowing customer of a branch, the following financial information should be available for review: income statement, balance sheet, reconciliation of equity, cash-flow statements, and applicable notes to financial statements. The components for a financial review can be segregated into three areas: operations management, asset management, and liability management. Operations management is derived from the income statement and can be used to assess company sales, cost control, and profitability. Asset management involves the analysis of the quality and liquidity of assets, as well as the asset mix. Liability management covers the analysis of the company's record of matching liabilities to the asset conversion cycle, such as long-term assets being funded by long-term liabilities.

In studying these forms of management, various ratios will help the examiner form an informed and educated conclusion about the quality of the credit being reviewed. The ratios can be divided into four main categories:

- *Profitability ratios.* These ratios measure management's efficiency in achieving a given level of sales revenue and profits, as well as management's ability to control expenses and generate return on investment. Examples of these ratios include gross margin, operating profit margin, net profit margin, profit-to-sales ratio, profit-to-total assets ratio, and direct cost and expense ratios.
- *Efficiency ratios.* These ratios, which measure management's ability to manage and control assets, include sales to assets, inventory days on hand, accounts receivable days on hand, accounts payable days on hand, sales to net fixed assets, return on assets, and return on equity.
- *Leverage ratios.* These ratios compare the funds supplied by business owners with the financing supplied by creditors, and measure debt capacity and ability to meet obligations. These ratios may include debt-to-assets, debt-to-net-worth, debt-to-tangible-net-worth, and interest coverage.
- *Liquidity ratios.* Include ratios such as the current ratio and quick ratio, which measure the borrower's ability to meet current obligations.

Common "Red Flags"

The symptoms listed below are included to provide an understanding of the common problems or weaknesses examiners encounter in their review of financial information. While one symptom may not justify criticizing a loan, when symptoms are considered in the aggregate, they may help the examiner detect near-term trouble. This list is only a sampling of "red flags" that should prompt further review; examiners should also be able to identify issues that may require further investigation from their cursory review of a borrower's financial statement.

- *A slowdown in the receivables collection period.* This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts.
- *Noticeably rising inventory levels in both dollar amount and percentage of total assets.* Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins.
- *Slowdown in inventory turnover.* This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results.

- *Existence of heavy liens on assets.* Evidence of second and third mortgage holders is a sign of greater-than-average risk. The cost of junior money is high. Most borrowers are reluctant to use this source of funds unless conventional sources are unavailable.
- *Concentrations of noncurrent assets other than fixed assets.* A company may put funds into affiliates or subsidiaries for which the branch may not have a ready source of information on operations.
- *High levels of intangible assets.* Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit.
- *Substantial increases in long-term debt.* This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment.
- *A major gap between gross and net sales.* This gap represents a rising level of returns and allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability.
- *Rising cost percentages.* These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses.
- *A rising level of total assets in relation to sales.* If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Examiners should be concerned when assets are increasing faster than sales growth.
- *Significant changes in the balance-sheet structure.* These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business.

BANKRUPTCY LAW AND COMMERCIAL LOANS

This section provides examiners with an overview of the United States Bankruptcy Code (code) chapters that affect commercial and industrial loans. Bankruptcy law is a significant body of law; it would be difficult in this manual to discuss all the issues necessary for comprehensive understanding of the code. This subsection will focus on basic issues that an examiner needs to be familiar with relative to three principal sections of the code, chapters 7, 11, and 13.

Creditors of a Bankrupt Business

A creditor in bankruptcy is anyone with a claim against a bankrupt business, even if a formal claim is not filed in the bankruptcy case. In bankruptcy court, a claim is defined very broadly. A claim may include a right to payment from a bankrupt business, a promise to perform work, or a right to a disputed payment from the debtor that is contingent on some other event. The two basic types of creditors are secured and unsecured. Secured creditors are those with perfected security interest in specific property, such as equipment, accounts receivable, or any other asset pledged as collateral on a loan. Unsecured creditors are generally trade creditors and others who have not taken a specific interest in property supplied to the bankrupt debtor.

Voluntary Versus Involuntary Bankruptcy

When a debtor files a bankruptcy petition, it is described as a voluntary bankruptcy filing. The individual or organization does not have to be insolvent to file a voluntary case. Creditors may also file a bankruptcy petition, in which case the proceeding is known as an involuntary bankruptcy. This form of petition can occur in chapters 7 and 11 bankruptcy cases, and the debtor generally must be insolvent. To be deemed insolvent, the debtor must be unable to pay debts as they mature. However, the code does limit who an involuntary action can be sought against.

Chapter 7—Liquidation Bankruptcy

A chapter 7 action may be filed by virtually any person or business organization that is eligible to file bankruptcy. Chapter 7 bankruptcy can be filed by a sole proprietorship, partnership, corporation, joint stock company, or any other business organization. Restrictions apply to only a few highly regulated businesses, such as railroads, insurance companies, banks, municipalities, and other financial institutions. This chapter is often referred to as ''straight liquidation'' or the orderly liquidation of all assets of the entity. Generally, a debtor in a chapter 7 bankruptcy case is released from obligations to pay all dischargeable pre-bankruptcy debts in exchange for surrendering all nonexempt assets to a bankruptcy trustee. The trustee liquidates all assets and distributes the net proceeds on a pro rata basis against the allowed claims of unsecured creditors. Secured creditor claims are generally satisfied by possession or sale of the debtor's assets. Depending on the circumstances, a secured creditor may receive the collateral, the proceeds from the sale of the collateral, or a reaffirmation of the debt from the debtor. The reaffirmed debts are generally secured by property that the debtor can exempt from the bankruptcy estate, such as a home or vehicle. The amount of the reaffirmation is limited to the value of the asset at the time of the bankruptcy filing.

Some characteristics of a chapter 7 bankruptcy are described below:

- A trustee is appointed in all chapter 7 bankruptcies and acts as an administrator of the bankruptcy estate. The bankruptcy estate that is established when the petition is filed becomes the legal owner of the property. The trustee acts to protect the interest of all parties affected by the bankruptcy.
- The trustee has control of all nonexempt assets of the bankrupt debtor.
- The trustee is required to liquidate the estate quickly without jeopardizing the interests of the affected parties.
- The proceeds from the sale pay trustee's fees and other creditors. Trustee fees are determined according to the amount disbursed to the creditors and are a priority claim.
- A chapter 7 bankruptcy is typically completed in 90 days, depending on the time needed to liquidate collateral. In rare situations, other chapter 7 bankruptcies may take years to complete.
- The court may allow the trustee to continue to operate a business, if this is consistent with the orderly liquidation of the estate.

Chapter 11—Reorganization

Most major or large businesses filing bankruptcy file a chapter 11 reorganization. As in chapter 7, virtually any business can file bankruptcy under chapter 11. There are specialized chapter 11 reorganization procedures for certain businesses such as railroads, and chapter 11 is not available to stockbrokers, commodity brokers, or a municipality. The basic concept behind chapter 11 is that a business gets temporary relief or a reprieve from paying all debts owed to creditors. This temporary relief gives the business time to reorganize, reschedule its debts (at least partially), and successfully emerge from bankruptcy as a viable business. The basic assumption underlying a chapter 11 bankruptcy is that the value of the enterprise as a going concern will usually exceed the liquidation value of its assets.

Reorganization Plan

Generally, the debtor has an exclusive 120-day period to prepare and file a reorganization plan. If the debtor's plan has not been confirmed within 180 days of the bankruptcy filing, a creditor may file a plan. A plan can provide for any treatment of creditor claims and equity interest, as long as it meets the requirements set out in the code. For example, a plan must designate substantially similar creditor claims and equity interest into classes and provide for equal treatment of such class members. A plan must also identify those classes with impaired claims and their proposed treatment. Finally, a method of implementation must be provided. Although plans do not have to be filed by a deadline, the bankruptcy judge will generally place a deadline on the debtor or creditor authorized to prepare the plan.

Some characteristics of a chapter 11 bankruptcy are described below.

- The bankrupt debtor usually controls the business during the bankruptcy proceedings. This arrangement is referred to as ''debtor in possession.''
- The business continues to operate while in bankruptcy.
- The debtor is charged with the duty of developing a reorganization plan within the first 120 days of the filing. After this period

expires, the court may grant this authority to a creditors' committee.

- Once the plan is approved by the bankruptcy court, the debtor's payment of debts is generally limited to the schedule and amounts that are detailed in the reorganization plan.
- A chapter 11 proceeding can be complex and lengthy, depending on the number of creditors, amount of the debts, amount of the assets, and other factors that complicate the proceedings.

Chapter 13—Wage-Earner Bankruptcy

A chapter 13 bankruptcy is available to any individual whose income is sufficiently stable and regular to enable him or her to make payments under the plan. As long as the individual has regular wages or takes a regular draw from his or her business, the individual may qualify under chapter 13 of the code. Under chapter 13, an individual or married couple can pay their debts over time without selling their property. As a protection to creditors, the money paid to a creditor must equal or exceed the amount that the creditor would get in a liquidation or chapter 7 bankruptcy. Chapter 13 may be used for a business bankruptcy, but only if the business is a proprietorship. In most cases, the business needs to be fairly small to qualify.

Some characteristics of a chapter 13 bankruptcy are described below:

- In most cases, only an individual can file a chapter 13 bankruptcy.
- Secured debt may not exceed $350,000.
- Unsecured debt may not exceed $100,000.
- The debtor must propose a good-faith plan to repay as many debts as possible from available income.
- A debtor makes regular payments to a trustee, who disburses the funds to creditors under the terms of the plan.
- The trustee does not control the debtor's assets.
- A chapter 13 bankruptcy may include the debts of a sole proprietorship. The business may continue to operate during the bankruptcy.
- After all payments are made under the plan, general discharge is granted.

1. To determine if lending policies, practices, procedures, and internal controls regarding commercial loans are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of commercial lending activities. However, if the branch conducts significant commercial lending activities, and additional information is needed, the examiner should perform the following procedures.

1. If selected for implementation, complete or update the Internal Control Questionnaire for this area.
2. Determine if deficiencies noted at previous examinations and internal/external audits have been addressed by management.
3. If the branch has any credits that should be reviewed under the Shared National Credit program but were omitted (other than new credits that originated since the previous review) submit a memorandum to the SNC coordinator detailing those credits to the respective Federal Reserve District. Do not include subparticipations, where the branch purchased its share from either a bank in the original syndicate, or from a bank considered a first-tier participant. Subparticipations should only be tracked internally by the branch.

Refer to the Credit Risk Management internal control questionnaire for a general review of the branch's internal controls, policies, practices, and procedures. If additional information is needed, complete the following internal control questionnaire. For audit procedures, refer to the Credit Risk Management section 3010.5.

POLICIES

1. Has the head office adopted written commercial loan policies for the branch that:
   a. Establish procedures for reviewing commercial loan applications?
   b. Define qualified borrowers?
   c. Establish minimum standards for documentation?
2. Are policies reviewed, at least annually, to determine if they are compatible with changing market conditions?
3. Do loan records provide satisfactory audit trails that permit the tracing of transactions from initiation to final disposition?
4. Has the branch instituted a system that ensures:
   a. Security agreements are filed?
   b. Collateral mortgages are properly recorded?
   c. Title searches and property appraisals are performed in connection with collateral mortgages?
   d. Insurance coverage, including loss payee clause, is in effect on property covered by collateral mortgages?
   e. The borrower is in compliance with all the covenants of the loan agreement?
5. Does the branch have an internal review system that:
   a. Ensures liens are perfected?
   b. Checks collateral values when the loan is made and at reasonable intervals thereafter?
   c. Ensures that cash flow analyses are performed on appropriate borrowers in a timely manner?
   d. Determines that loan payments are promptly posted?
6. Do working capital loans require clean-up periods?
7. Who is responsible for monitoring the clean-up period, the account officer or an independent source?
8. What are the consequences if the borrower cannot clean-up the line?
9. Are different criteria used for loans to borrowers on an unsecured basis versus a secured basis (e.g. more stringent documentation requirements, more frequent credit reviews, or cashflow analyses)?
10. Is there any evidence that the branch is extending working capital loans to finance the acquisition of long-term assets or capital?
11. Do all term loans require meaningful principal amortization (at least quarterly)?
12. Does the term of the loan correspond to the useful life of the underlying asset being financed?

CONCLUSION

13. Is the information covered by this internal control questionnaire adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
14. Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

Corporate restructurings have become a technique for financing acquisitions through leveraged buyouts, resisting takeovers, and restructuring corporate balance sheets. They encompass traditional leveraged buyouts, management buyouts, corporate mergers and acquisitions, and significant stock buybacks. Leveraged Employee Stock Option Plans (ESOPs) may also be considered as corporate restructurings if they are used to acquire or recapitalize an existing business.

It is not considered inappropriate for branches to lead and/or participate in loans to finance corporate restructurings so long as they are conducted in a sound and prudent manner. However, booking of such credits could affect asset quality and increase overall levels of risk exposure.

Corporate restructurings involve many of the same characteristics and risks that have traditionally been evaluated during on-site examinations. These relate to the borrower's income, cash flow, and general ability to pay interest and principal on outstanding debt; economic conditions and trends; the borrower's management; and the borrower's ability to realize value through the sale or liquidation of assets. What usually distinguishes corporate restructurings from typical bank loans is the level of debt the borrower assumes in relation to standard measures of financial capacity or ability to repay. Clearly, a high level of debt in relation to net worth or total assets can place heavy demands on a borrower's cash flow and reduce the borrower's ability to absorb the effects of unanticipated financial shocks or economic adversity.

Branches may be involved in corporate restructurings at a number of levels. First, they, together with other institutional lenders, may provide senior secured financing that typically represents the largest portion of a corporate restructuring. In addition, branches may extend credit on a subordinated basis. Bridge loans also represent another type of financing, which may be considered as senior debt or mezzanine financing, depending on its characteristics.

Because corporate restructurings traditionally entail high leverage, they often increase the vulnerability of borrowers to adverse market and financial developments and have the potential to raise the level of risk in bank loan portfolios. For these reasons, bank supervisors have actively urged bank management to exercise caution and apply especially rigorous lending and investing standards in participating in these transactions.

WAYS TO FINANCE CORPORATE RESTRUCTURINGS

Corporate restructurings are typically financed through a complex combination of debt and equity instruments. A general overview of the types of financings is provided as follows:

Senior Debt

This term refers to all loans and debt securities secured by first liens on assets or the stock of the borrower's operating entities; and, any unsecured loans and debt securities, which have priority in repayment over all other creditors and equity investors in the event of liquidation. The majority of senior debt generally consists of secured term loans; however, other types of debt, including revolving working capital loans, bridge loans, and debt securities may be considered senior debt. To be considered as senior debt, the loans must not be subordinated to any other obligations in the event of liquidation.

Mezzanine Financing

Mezzanine financing consists of all layers of financing between senior debt and equity investments. These include all unsecured loans and debt securities where payment is subordinated, loans or debt securities secured by liens inferior to those of senior debt, fully subordinated debt, and any limited-life preferred stock with significant debt characteristics.

Bridge Loans

Bridge loans have varying characteristics and are considered as either senior debt or mezzanine financing based upon the definitions above. Repayment of bridge loans is dependent on the successful marketing of longer term securities or the sale of assets for repayment. Bridge loans that would be subordinated to other obligations in the event of liquidation are considered mezzanine financing.

Noninvestment Grade Bonds

These bonds consist of all noninvestment-grade, high-yield debt securities involved in corporate restructurings (commonly referred to as junk bonds). This includes various types of high yield issues, which have attributes of debt, such as zero-coupon or zero-slash bonds and pay-in-kind (PIK) bonds. Pay-in-kind preferred stock and other issues with significant equity attributes are considered equity investments.

Financing Corporate Restructurings
Examination Objectives
Effective date July 1997

Section 3060.2

1. To determine if policies, practices, procedures, and internal controls regarding corporate restructurings are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To determine compliance with applicable laws and regulations.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Determine if management performs the following:

1. Evaluates the adequacy and stability of the borrower's current and prospective cash flow under varying economic scenarios, including the possibility of an economic decline.
2. Sets reasonable in-house limits regarding exposure to individual borrowers, total exposure to all corporate restructured borrowers, and industry concentrations resulting from corporate restructurings.
3. Establishes credit analysis, approval, and review procedures that take account of the high levels of debt involved in these transactions.
4. Maintains internal systems, controls, and reporting procedures that track the performance and condition of individual exposures, monitor the organization's compliance with internal procedures and limits and keep head office management adequately informed on a timely basis of the organization's involvement in corporate restructurings.
5. Establishes pricing policies and practices that take into account a prudent manner of the trade-off between risk and return.
6. Avoids compromising sound banking practices in an effort to broaden market share or realize substantial fees.

This section refers to deposit accounts with nonrelated banking organizations. These deposit accounts can be either noninterest-bearing settlement accounts (demand) or interest-bearing deposits and placements (time). For information on accounts with *related* banking offices and affiliates see the Due From/Due To Related Offices section of this manual. In addition, the instructions for the FFIEC 002, Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, are an important source of information on accounts with nonrelated and related offices and institutions.

DEMAND DEPOSITS

Banks maintain deposits in other banks to facilitate the transfer of funds. Those assets, known as due from banks-demand, correspondent bank balances, or settlement accounts, are a part of the primary, uninvested funds of every bank. A transfer of funds between banks may result, in part, from the collection of cash items, the transfer and settlement of securities transactions, the transfer of participating loan funds, and the purchase or sale of Federal funds.

Banks also utilize other banks to provide certain services that can be performed more economically or efficiently by the other banks because of their size or geographic location. Such services include processing of cash letters, packaging loan agreements, funding overline loan requests of customers, performing EDP services, collecting out-of-area items, exchanging foreign currency, and providing financial advice in specialized loan areas. When the service is one-way, the bank receiving that service usually maintains a minimum balance that acts as a compensating balance in full or partial payment for the services received.

Some banks, particularly branches, must be prepared to make and receive payments in foreign currencies to meet the needs of their international customers. This can be accomplished by maintaining foreign currency due from banks-demand accounts with affiliates (nostro balances) or with other banks in foreign countries.

TIME DEPOSITS

Branches also maintain interest-bearing time deposits, known as due from banks-time, with other banks. Those assets may also be referred to as placements, placings, interbank placements (deposits), redeposits or even Federal funds, in instances where their maturities are similar to Federal funds. These placements represent a source of primary liquidity to many branches.

All banks with which the branch has demand and time accounts shown on its books should be subject to an appropriate level of scrutiny for creditworthiness, which should be documented in the branch's on-site credit files. In cases, where these credit evaluations are conducted by the head office or another related office, branch management should obtain copies of these evaluations for its files.

Due from banks-time deposit activities became important with the growth of the Eurodollar market. The bulk of due from banks-time deposits now consist of Eurodollars, with smaller amounts in other Eurocurrencies. Other foreign currency time deposits are placed in substantially the same manner as Eurodollar deposits, subject to differing exchange control regulations or local customs.

Eurodollar (interbank) deposits are sometimes linked with foreign exchange transactions. As a result, the branch's foreign exchange or Eurocurrency deposit traders frequently work closely with the trader responsible for placing due from banks-time deposits. Foreign exchange brokers also may act as intermediaries if warranted by market conditions, local customers, the size of the branch, or other factors.

The practice of placing interbank deposits (and takings on the liability side) originated in London because, under U.K. regulations, banks were entitled to "accept" interbank deposits whereas interbank borrowings (i.e. loans) required authorization by the Bank of England. Therefore, due from banks-time deposits are "accepted" even though the receiving bank may have instructed its foreign exchange trader, directly or through brokers, to find a bank willing to offer it such deposits.

Due from banks-time deposits contain the same credit and country risks as any extension of credit to a bank. Consequently, a prudently managed bank should place deposits with (i.e. lend to) only well-managed banks. The traders should be provided with a list of approved banks with which funds can be deposited up to prescribed limits for each bank. Due from bank-time deposits differ from other types of credit extensions because they often represent deposits of relatively short maturity which normally receive first priority in case of insolvency. Nevertheless, the credit and country exposure exists, and customer limits must be established by credit officers and not by foreign exchange traders. Such limits must be reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions.

The examiner also must recognize that credit risks intensify when due from bank-time deposits are placed for longer periods. Furthermore, the credit risks for specialized or smaller banks that have recently entered the interbank deposit market can be far greater than that for larger, long-established banks. Banks which traditionally utilized only regular lines of credit or special facilities also have entered the due from banks-time deposit market to meet their external needs. Those banks could be the first to be caught in a market crunch.

Incoming confirmations from banks must be meticulously checked by the bank to record copies in each instances to protect against fraud and errors. Similarly, a systematic follow-up on non-receipt of incoming confirmations should be carefully monitored by the bank.

Due From Nonrelated Banks
Examination Objectives
Effective date July 1997

Section 3070.2

1. To determine if the policies, practices, procedures, and internal controls regarding balances due from banks, both demand and time, are adequate.
2. To determine if branch officers and employees are operating in conformance with established guidelines.
3. To determine that all due from accounts are reasonably stated and represent funds on deposit with other banks.
4. To determine whether the branch evaluates the credit quality of banks with which demand and time accounts are maintained.
5. To determine the scope and adequacy of the internal and external audit coverage as it applies to this area.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

1. If included in the scope of the examination, complete or update the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls within the parameters of the established scope.
3. Scan the most recent bank-prepared reconcilements for any unusual items and determine that closing balances listed on reconcilements agree with the general ledger and with the balance shown on the cut-off statement if one has been obtained.
4. If the bank's policy for charge-off of old open items provides for exceptions in extenuating circumstances, review excepted items and determine if charge-off is appropriate.
5. If the bank has no policy for charge-off of old open items, review any items which are large or unusual or which have been outstanding for over two months, along with related correspondence, and determine if charge-off is appropriate.
6. Obtain a trial balance of the due from banks —time balances. Reconcile balances to department controls and general ledger.
7. Check a sample of confirmations. This will ensure that the balances are indeed due from bank balances and not loans to banks (for Call Report purposes). If any transactions are not confirmed as of the date of examination, determine why incoming confirmation is missing.
8. The credit quality of placements is included in the scope of the asset quality review. Using appropriate sampling techniques, select deposit customers for examination and review the credit file maintained on each bank. Ensure the bank has performed a credit analysis on all approved due from bank counterparties. If the credit analysis has been prepared by the head office, shadow files need to be maintained at the institution.
9. Check back office procedures, adequacy of separation of duties, and who monitors limits.
10. If problems are detected concerning the institution's policies or lack thereof, the deficiencies should be discussed under Risk Management. If the institution is deficient in its operations and is not following its policies, the exception should be discussed under Operational Controls.
11. Prepare comments on deficiencies or violations of law noted above for inclusion in the examination report.
12. Assemble workpapers to support conclusions reached. Include any information that will facilitate future examinations.

AUDIT COVERAGE

1. Does the scope of the branch's internal audit program include procedures covering:
   a. Due from banks-demand accounts?
   b. Due from banks-time accounts?
2. Do audit procedures include all of the following to ascertain the effectiveness of internal controls:
   a. Ensure that procedural manuals or instructions covering the reconcilement function exist?
   b. Ascertain if statements are not reconciled by an individual, who also:
      - Has signing authority on the account?
      - Approves entries?
      - Posts the general ledger?
      - Effects money transfers?
   c. Ensure that statements are reconciled promptly when received?
   d. Check to see that reconcilements are prepared on preprinted forms?
   e. Ensure that completed reconcilements are properly stored to satisfy record-retention requirements?
   f. Ensure that open items are promptly referred to and followed up by the appropriate operating department or responsible officer?
   g. Test that open entries outstanding beyond a reasonable length of time are:
      - Referred to appropriate senior branch management in writing?
      - Charged off to profit/loss accounts?
      - Transferred to special suspense accounts, pending additional follow-up action?
   h. Ensure that reconciliation personnel are prohibited from preparing adjusting entries?
   i. Spot check selected general ledger tickets and supporting documentation for:
      - Adequate details of the transaction?
      - Proper officer approvals?
   j. Test check on selected transactions that include open, reconciled, adjusted, and charged-off items to ascertain propriety of disposition?

POLICIES FOR DUE FROM BANKS

3. Do current written policies and procedures exist for due from banks-demand accounts that:
   a. Provide for periodic review and approval of balances maintained in each such account?
   b. Indicate person(s) responsible for monitoring balances and the application of approved procedures?
   c. Establish levels of check-signing authority?
   d. Indicate officers responsible for approval of transfers between correspondent banks and procedures for documenting such approval?
   e. Indicate the supervisor responsible for regular review of reconciliations and reconciling items?
   f. Indicate that all entries to the accounts are to be approved by an officer or appropriate supervisor and that such approval will be documented?
   g. Establish time guidelines for charge off of old open items?
4. Do current written policies and procedures exist for due from banks-time account that:
   a. Establish maximum limits of the aggregate amount of due from banks-time deposits for each:
      - Bank?
      - Currency of deposit?
      - Country of deposit?
   b. Restrict due from banks-time deposits to only those customers for whom lines have been established?
   c. Establish definite procedures for:
      - Balancing of accounts?
      - Holdover deals?
      - Rendering of reports to management, external auditors, and regulating agencies?
      - Accounting cut-off deadlines?
      - Handling of interest?
5. Are the policies and procedures for due from bank accounts reviewed at least annually to determine their adequacy in light of changing conditions?

BANK RECONCILEMENTS

6. Are branch reconcilements prepared promptly upon receipt of the statements?
7. Are statements examined for any sign of alteration and are payments or paid drafts compared with such statements by the persons who prepare branch reconcilements? If yes, skip question 8.
8. If the answer to question 7 is no, are statements and paid drafts or payments handled before reconcilement only by persons who do not also:
   a. Issue drafts or official checks and prepare, add, or post the general or subsidiary ledgers?
   b. Handle cash and prepare, add, or post the general ledger or subsidiary ledgers?
9. Are branch reconcilements prepared by persons who do not also:
   a. Issue drafts or official checks?
   b. Handle cash?
   c. Prepare general ledger entries?

OTHER

10. Is a separate general ledger account or individual subsidiary account maintained for each due from bank account?
11. Are overdrafts in due from bank accounts properly recorded on the branch's records and promptly reported to the responsible officer?
12. Are individual interest computations checked or adequately tested by persons independent of those functions?
13. Are accrual balances for due from banks-time verified periodically by an authorized official? If so, indicate frequency.
14. Do all internal entries require the approval of appropriate officials?

CONCLUSION

15. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
16. Based on the information gathered, evaluate the internal controls in this area (i.e., strong, satisfactory, fair, marginal, unsatisfactory).

1. Determine the number of the last unissued draft of each due from bank account and record for comparison when performing reconcilements.
2. Prepare a listing of all due from bank accounts, together with their balances from the branch's daily statement as of the examination date. Compare each balance or total balances to the appropriate subtotal in the general ledger as of the examination date.
3. Request a cut-off statement as of the examination date and for a subsequent date, not less than five days later for each due from account. Include instructions that the statements be addressed to the examiner-in-charge and be delivered unopened.
4. In preparing or reviewing reconcilements:
   a. Review reconciling items carefully to determine that the time period between debit or credit entries and the offsetting credit or debit by the correspondent bank is comparable for similar types of items. If any differences in timing occur, ascertain the reason.
   b. Determine that wire transfers appear on the correspondent statement the same day as entered on the branch's books. Determine the reason for any exception.
   c. Test all drafts included in the cut-off statement for authorized signature, proper endorsement, dates of drafts, payee, and amounts and determine that:
      - Dates drawn are not subsequent to dates paid by the correspondent bank.
      - Drafts issued to transfer funds from the branch's account to the correspondent's account are not outstanding more than the normal transit time.
      - Drafts are numbered.
      - Drafts are issued sequentially.
5. Reconcile due from bank accounts on a reconcilement form using the following steps:
   a. Prove the mathematical accuracy of the prior reconcilement by a machine run of the figures.
   b. Determine that *our balance to their debit* agrees to general ledger as of their prior reconcilement date.
   c. Determine that *their balance to our credit* agrees to each correspondent bank statement as of the prior reconcilement date.
   d. Determine that the closing balance and date listed on the statement used in the branch's last reconcilement agrees to the opening balance and date listed on the cut-off statement as of the examination date.
   e. Determine that any open items from previous reconcilements have cleared.
   f. If any items on a previous reconcilement do not clear, list on the reconcilement form being prepared.
   g. Determine that each debit and credit entry shown on the general ledger since the date of the last reconcilement is offset by a corresponding credit or debit on the correspondent bank's cut-off statement.
   h. Any items on the general ledger, except outstanding drafts, that are not offset by an appropriate debit or credit on the correspondent bank's cut-off statement are considered open and should be transferred to the reconcilement form under the appropriate we debit or we credit caption along with the date and a brief description.
   i. Any items on the correspondent bank's cut-off statement that are not offset by an appropriate debit or credit on the branch general ledger are considered open and should be transferred to the reconcilement form under the appropriate they debit or they credit caption along with the date and a brief description.
   j. ‘‘We credit’’ items that represent drafts outstanding should not be listed on the ‘‘we credit’’ section of the reconcilement form. Each outstanding draft should be listed by number on the reverse side of the reconcilement form and the total should be carried forward opposite the caption drafts outstanding. The listing should include any drafts still outstanding from the previous reconcilement.
   k. Prove the reconcilement.
6. Determine clearance of ‘‘we debit’’ and ‘‘we credit’’ items using later cut-off statements, when available, and:
   a. If an item is cleared by reversing the entry, that is, by a subsequent offsetting debit or credit entry on the ledger of the branch under examination, check the entry through to its source.

b. All material ‘‘we debit’’ and ‘‘we credit’’ items that do not clear on the later cut-off statements received should be confirmed, with a copy of the confirmation tracer retained for comparison to the original after it is returned.
7. Utilizing the general ledger or appropriate subsidiary ledger, determine clearance of ‘‘they debit’’ and ‘‘they credit’’ items. The reason for nonclearance should be determined for all ‘‘they debit’’ and ‘‘they credit’’ items that do not clear in a reasonable amount of time.
8. Review the accrued interest accounts by:
   a. Reviewing and testing procedures for accounting for accrued interest and for handling adjustments.
   b. Scanning accrued interest for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.
9. Obtain or prepare a schedule showing the accrued interest balances and the deposit balances for selected time periods since the previous examination.
   a. Calculate ratios.
   b. Investigate significant fluctuations and/or trends.

Financing foreign receivables includes open account financing, sales on consignment, advances against collections, banker's acceptances, factoring, and forfaiting. Certain foreign receivables are guaranteed or insured for credit and political risk by the Export-Import Bank of the United States, the Foreign Credit Insurance Association, or other American and foreign organizations.

OPEN ACCOUNT FINANCING

The simplest method of financing foreign receivables is on open account. In such a sale, the buyer and seller agree on payment at a specified date without any negotiable instruments, such as a draft or acceptance, evidencing the obligation. In most instances, the shipping documents are sent directly to the buyer rather than through a bank. The exporter may request the buyer to make payment to the bank in which the exporter maintains an account. The advantages of an open account sale are its simplicity and the lack of bank charges and stamp duties applied to drafts by certain countries.

The financing of open account sales contains certain risks. The lending bank and exporter have no control over the documents and the buyer (importer) may take possession of the goods without the bank's or the exporter's consent. In addition, if the importer does not register the goods with the proper authorities, the dollar or other exchange may not be available at the time of payment. Probably the greatest risk in open account financing is the lack of standard trade financing documentation on which to base legal action against the importer in the event of default. Therefore, open account sales are most appropriate when the buyer (importer) is a subsidiary of a related company or is well-known to the seller.

SALES ON CONSIGNMENT

Under a consignment arrangement, goods are consigned to the importer (consignee) abroad and the exporter (consignor) retains title to them until they are sold to a third party. However, unless the shipment is made to an exporter's overseas branch or subsidiary, the credit risk is considerable. As with open account sales, there is a lack of standard trade financing documentation on which to base legal action if the consignee defaults. The exporter should thoroughly understand the inherent credit risks, especially when goods are consigned to an agent, representative, or import house abroad.

In countries with free ports or free trade zones, consigned goods may be placed in a bonded warehouse in the name of a foreign bank or branch of the bank. Arrangements may then be made to release the consigned merchandise at the time it is sold. Merchandise is cleared through customs after the sale has been completed. However, that type of consignment should not be made and will not usually be accepted by many foreign banks until all pertinent conditions, regulations, and storage facilities are verified. The exporter's bank also should verify that goods not sold may be returned to the country of origin. Bank financed consignment shipments should be limited to those countries that do not have burdensome foreign exchange restrictions and have sufficient foreign exchange available to pay for imports.

To overcome the disadvantages of financing shipments on an open account or consignment basis, exporters frequently ship goods against documentary collections. That practice means that the exporter, in the case of a time or arrival draft, and the exporter and the importer, jointly, in the case of a sight draft, finance(s) the shipment. The exporter and the importer may have unused credit lines with their banks and be able to borrow the needed money without tying the financing to the trade transaction. Often, however, the exporter's or the importer's regular bank lines are used up for other transactions. Consequently, they may ask their bankers to provide financing through advances against outward collections, discounting trade acceptances, bankers' acceptances, factoring, or forfaiting.

ADVANCES AGAINST FOREIGN COLLECTIONS

A manufacturer or merchant conducting a strictly domestic business often gets a loan from a bank, finance company, factor, or forfaiter by using accounts receivable as security. Because outward collections are the same as foreign receivables, the same general type of financing vehicle is available to exporters.

A common method of financing foreign receivables is for the exporter to pledge all outward collections to its bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables pledged at any one time. When notes, rather than drafts, are used to finance foreign collections, they are usually paid on demand enabling the exporter to increase or decrease the loan depending on need and the current amount of collections outstanding. Preferably, all of the collections lodged with the exporter's bank should be pledged to the bank. When a particular collection is paid, it is remitted by the foreign collecting bank to the domestic bank that has advanced the funds. The latter uses the proceeds of the collection to reduce the exporter's loan. Some exporters have no need for a continuous financing arrangement but occasionally may wish to obtain financing on only one large foreign collection. In such instances, the branch may be willing to advance money with only that one receivable as security. Again, the branch establishes a maximum percentage of the amount of the draft that it is willing to advance. When payment for the receivable is obtained, the branch uses the proceeds to liquidate the loan, crediting any excess to the exporter. Bank financing in the form of advances against export collections is an accepted practice in international trade and is not considered factoring.

Besides having a pledge on the exporter's outward collections, the branch usually retains recourse to the exporter whose financial condition and reputation are of prime importance. Other factors, however, are also significant. If the foreign importers are prime companies with undoubted reputation and financial strength, the branch will probably advance a larger percentage on collections directed to them. The branch will also advance a larger percentage of funds to importers in those countries that promptly pay drafts drawn on them. In other countries, where payment is generally slow, perhaps because importers are financially weak or because U.S. dollar or other foreign currency exchange is hard to obtain, the branch will advance a lower percentage on collections. Certain collections to habitually slow paying importers or countries may be entirely ineligible for financing.

When a branch advances against foreign collections, it must carefully scrutinize the shipping documents. Because the branch wishes to maintain control of the merchandise, the bill of lading should be either to the order of the shipper and blank endorsed or to the order of the branch. The bill of lading must not be consigned to the buyer (importer); otherwise, the buyer has control over the goods. In addition, shipments financed should be covered by adequate insurance.

DISCOUNTING TRADE ACCEPTANCES

A draft accepted by the foreign buyer becomes a trade acceptance, carrying the full credit obligation of the importer. Such trade acceptances are also frequently called trade bills or trade paper. The acceptance is returned to, and becomes the property of, the exporter, who will ask the collecting bank to present it to the acceptor for payment at maturity. The exporter is, therefore, providing the financing or carrying its own foreign receivables. However, if the exporter needs the funds before maturity of the trade acceptance, the exporter may ask the branch to discount the draft with or without recourse. If the primary obligor (acceptor) is a well-known company of good credit standing, the branch may be willing to discount the draft without recourse to the exporter. More commonly, however, the lending bank looks to the exporter for recourse, should the primary obligor fail to pay the amount when due.

When discounting a trade acceptance, the branch advances the face amount of the draft to the exporter, minus discount charges, until the maturity date. In that case, the branch is buying the trade acceptance for value and is entitled to any benefits due it from the primary obligor as a holder in due course of a negotiable instrument. That is also the case whenever the branch makes advances against a single collection or a pool of collections. Any intermediary collecting bank also has a financial interest in the collection and has all the rights of a holder in due course under the Uniform Commercial Code.

BANKER'S ACCEPTANCES CREATED AGAINST FOREIGN COLLECTIONS

During periods of tight money, branches may choose to finance foreign collections by using banker's acceptances. Banker's acceptances are discussed separately in this manual, so the following comments relate only to the financing of foreign collections.

As with all acceptance financing, the exporter first submits a signed acceptance agreement to its bank. To obtain acceptance financing for foreign receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (importer) that, along with the necessary documents, is sent for collection in the usual manner. The other draft, for the same or smaller amount as agreed on by the branch and exporter, is drawn by the latter on the branch and has the same tenor as the draft drawn on the importer. The branch accepts the latter draft and discounts it, crediting the net amount to the exporter's account. The branch has now created a banker's acceptance that can be sold in the highly liquid acceptance market, provided the branch's reputation is fully established. When payment is received from the importer, the branch applies the proceeds to pay its own acceptance, which will be presented for payment if sold in the market. Should the importer default, the branch has recourse on the drawer and can demand payment from that source.

FACTORING

A factor buys accounts receivable with or without recourse. In the past, factoring was used primarily in domestic trade in certain industries, such as textiles. In recent years, however, several domestic factors have established foreign affiliates or invested in foreign finance companies and several banks have purchased or established factoring firms to finance foreign trade. Branches are also financing foreign trade by factoring.

Factoring is the purchase, on a without recourse basis, of the accounts receivable of a client. Factoring differs from asset-based lending financing, in that the factor assumes the credit and collection risk associated with the receivables. In asset-based lending these risks remain with the client. Among the principal advantages of factoring to the client, is that the client is certain of the collection of the proceeds of its sales, regardless of whether or not the factor is paid. Other advantages of factoring are that the client does not have to maintain a credit department to evaluate the creditworthiness of customers and collect past due accounts or maintain bookkeeping or accounting records pertaining to the status of receivables. These responsibilities have been assumed by the factor. In addition, under the terms of an advance factoring arrangement, the client receives payment for its receivables before the time agreed upon under the normal terms of the invoice.

Maturity factoring and advance factoring are two basic types of service offered by the industry. In maturity factoring, an average maturity due date is computed for the receivables purchased during a period and the client receives payment on that date. Advance factoring uses the same computations; however, the client has the option of taking advance payments equal to a percentage of the balance due at any time prior to the computed average maturity due date. The unadvanced balance, sometimes called the client's equity, is payable on demand at the due date.

The typical factoring agreement stipulates that all accounts receivable of a client are assigned to the factor but not all are purchased without recourse. The agreement between the factor and the client will usually state that receivables subject to shipping disputes, errors, returns, and adjustments are chargeable back to the client because they do not represent bona fide sales. In addition, sales made by the client without the factor's approval are considered client risk receivables, with full recourse to the client if the customer fails to pay. The usual approval process requires the client to contact the factor's credit department before filling a sales order on credit terms. The credit department will conduct a credit review, determine the creditworthiness of the customer and approve or reject the sale. If the credit department rejects the sale, the client may complete the sale but at the client's own risk. The most commonly rejected sales are those to affiliates, to known bad risks, to customers whose credit cannot be verified, and to those customers whose outstanding payables exceed the factor's credit line to those customers.

Once a sale has been made and the receivable, whether or not approved, is assigned to the factor, the client's account will be credited for the net invoice amount of the sale. Trade or volume discounts, early payment terms, and other adjustments are deducted from the invoice amount. The receivable then becomes part of the client's availability to be paid in advance or at the computed date, depending upon the basis of the factoring arrangement.

Factoring Foreign Receivables

A factor who purchases a foreign receivable must approve the credit standing of a specified foreign obligor before the sales contract is concluded. If the foreign buyer's credit is not approved, the exporter may still make the shipment but at its own risk. If shipments to approved importers are made on a documentary collection basis, the drafts and documents are submitted to the factor who purchases them without recourse. The factor pays the money to the exporter either at the average maturity date, when actually received or, if financing is also required, immediately. Thereafter, the drafts and documents are routed through commercial banks for collection. Because the factor owns the drafts and documents, the collection process is undertaken for its account. Occasionally, a factor will make use of its own credit line with a commercial bank to carry receivables purchased from the exporter until payment is received from the ultimate buyer.

When financing imports, the factor may arrange for the opening of a letter of credit through its bank in favor of an overseas supplier. The factor becomes an intermediary between its customer and the bank, substituting its own credit for that of the client. Because the factor is guaranteeing the letter of credit, the bank is willing to open the credit, which it might not have done for the importer directly.

When the goods are shipped, the title documents are either consigned or endorsed over to the factor. The factor, in turn, releases the documents to the importer against either a trust receipt or warehouse receipt. All proceeds from subsequent sales are turned over to the factor. Once the final sale has been made to a customer approved by the factor, an account receivable is created. The factor, according to its agreement with the customer, buys that receivable without recourse.

When the bank turns over the shipping documents to the factor, arrangements must be made to pay under the sight letter of credit. The factor may pay the bank from its own funds. The goods are cleared through customs and the factor is paid on the average or final maturity date of the accounts receivable, which the factor has bought from its customer without recourse.

Time letters of credit are paid to the bank by the factor at maturity and the resulting acceptances are charged to the customer's account for payment to the factor when due.

Frequently, instead of making immediate payment under a sight letter of credit, the factor will utilize its credit line with the bank. This option may be taken by either asking the bank to create a banker's acceptance or by charging the factor's loan account. In both instances, the factor must pay the bank at maturity of the acceptance or loan. Such maturities should coincide as closely as possible with the expected payment of the accounts receivable by the ultimate customer.

A factor buying foreign accounts receivables created through open account shipments follows the same basic procedures as in purchasing domestic receivables. As discussed heretofore, the exporter and financing institution could lose control over the goods because the shipping documents are consigned directly to the importer. Consequently, open account shipments should be conducted only with prime foreign buyers.

Client Records

A client's balance sheet will have a due from factor account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, thus affecting turnover ratios and other short-term ratios. The difference relates to the client's ability to convert sales to cash faster with a factor than if the receivables were to be collected by the client.

Each month, the client receives an accounts current statement from the factor, detailing transactions on a daily basis. This statement reflects the daily assignments of receivables, remittances made (including overadvances and amounts advanced at the client's risk), deductions for term loans, interest charges, and factoring commissions. Credit memos, client risk charge-backs, and other adjustments also will be shown. Client risk charge-backs are the amounts deducted from the balance due to the client upon the failure of customers to pay receivables factored at client risk. The accounts current statement and the availability sheets are necessary for asset analysis. The accounting system that develops this data probably will be automated, allowing the factor to compare and monitor data on the client. Examiners should use the data provided, within client records, toenhance the asset analysis process for these types of credits.

Factor Records

The factor's balance sheet reflects the purchased accounts receivable as factored receivables on the asset side and due to clients as the corresponding liability. Usually, the due to clients balance will be less than the factored receivables balance because of payments and advances to the clients. If, however, the factor makes advances to the client for greater amounts than are due to the client, these amounts will be reflected on the asset side of the balance sheet as overadvances. Overadvances are tantamount to unsecured loans. A limit on the amount of overadvances available at any one time to the client should be included in the factoring agreement. Such limitation is generally based upon, but not necessarily secured by, the amount of the client's inventory. This relationship is used because, theoretically, the inventory will be sold to generate receivables that the factor has contracted to purchase. The proceeds from the factored receivables will then be used to repay the overadvance. The factor's income statement will show factoring commissions that represent the discount on the receivables purchased as income. Interest income for advances on the due to client balances may or may not be a separate line item.

An analysis of the changes in the relative proportions of the due to clients account should provide valuable input into the analysis of the earnings of a branch's factoring operation. Because factoring is a highly competitive industry, price cutting has reduced factoring commissions to a point where they provide minimal support to earnings; therefore, the interest margins on factoring advances have a significant impact on net income. The implication of the analysis of proportional changes is that as more clients take advances (reducing due to clients), profit margins should widen. Conversely, as the due to clients proportion of total liabilities rises, profit margins may be expected to narrow.

Evaluating the Factoring Operation

The evaluation of a branch's factoring operation includes: (a) a review of its systems and controls, and (b) an analysis of the quality of its assets. A major portion of a factor's assets will be factored receivables, for which the credit department has the responsibility for credit quality and collection. The other major portion of the assets will be the client loans and credit accommodations, such as overadvances and amounts advanced at the client's risk, for which the account officers are responsible.

Any factor's ability to buy receivables without recourse is predicated on its ability to make sound credit judgments regarding buyers. The factor, therefore, replaces the credit and, in part, the receivables bookkeeping departments of sellers. The credit department maintains a credit file for each of its client's customers, which are continually updated as purchases are made and paid for by the customers. These files include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Credit information on domestic buyers is easier to obtain than on buyers located overseas. However, by establishing foreign affiliates, factors have improved their ability to determine the credit standing of foreign importers.

Systems and Controls

Considering the large volume of daily transactions that flows through a factor, any internal control that can be easily negated represents a potential problem. The review of the factoring department's internal systems and controls should be continuous during the examination. This review should include the credit controls for both clients and customers. Credit controls and systems must be responsive to the identification of these problems because problems can develop rapidly in factoring. Earnings are evaluated in terms of the department's own performance. The factoring department's earnings trends may be evaluated by using a comparative yield on assets approach. By analyzing yields on asset categories from period to period, the examiner will be able to make a judgment as to the efficiency of the systems. Factors are subject to the same price competition in the commercial finance market as accounts receivable financiers. Declining portfolio yields may reflect the inroads made by competition and may indicate a decline in future profitability.

Asset Evaluation

The asset evaluation involves an evaluation of (1) credit accommodations to each client and

(2) customer receivables purchased by the factor at its own risk. For the first part of the evaluation, generate a list of each client's aggregate credit exposure to the factor, both direct and indirect, including overadvances and receivables purchased at the client's risk. For the second part of the evaluation, use the aging schedule of factored receivables aggregated by customer but net of client risk receivables. Select clients and customers for review based upon the same selection methods used for the commercial loan review. Clients with high dilution of receivables (i.e., customer nonpayment due to returns, shipping disputes, and errors and the like) and those with client risk receivables equal to 20 percent or more of factored volume may also be included.

Credit Accommodations to Each Client

In order to evaluate credit accommodations to each client, generate a list of each client's aggregate credit exposure to the factor, both direct and indirect, including overadvances and receivables purchased at the client's risk. Although past due status is an essential element in evaluating customer accounts, it should be noted that for its clients, a factor usually collects principal and interest payments directly from the client's availability. This practice means that the expected delinquency rate is minimal. Past due volume is not an effective measure of client quality.

A client's availability is the sum of all factored receivables, less trade and other discounts, factoring commissions, client risk charge-backs, and other miscellaneous charges to the client's account. There may also be other deductions for letters of credit and other credit accommodations. An advance client's availability would be further reduced by advances on the factored receivables, interest charges, and the reciprocal of the contractually agreed upon advance percentage. This reciprocal, 20 percent in the case of an 80 percent advance client, is sometimes referred to as the client's equity in the factored receivables. Availability may be increased by liens on additional collateral, such as inventory, machinery and equipment, real estate, and other marketable assets. Loans against this type of collateral may be handled in the commercial finance section of a factoring department.

An analysis of the client's balance sheet should incorporate an assessment of the client's ability to absorb normal dilution and the potential losses associated with client risk receivables, particularly when these elements are higher than usual for the portfolio. The analysis also should consider the client's ability to repay any advances received from the factor in the form of overadvances, term loans, or other credit accommodations.

When classifying the credit exposure to a client, the client risk receivables portion of factored volume is the only amount appropriate for use in the classification. Because of the recourse aspect, the balance is considered as an indirect obligation rather than a direct obligation. Any other credit accommodations to a client that are not reflected in factored receivables, such as overadvances, term loans, etc., are also appropriate for classification. Asset quality, as measured by classifications, may be influenced by seasonal aspects of clients' businesses and should be carefully analyzed allowing for such influences.

Customer Receivables Purchased by the Factor at its Own Risk

To evaluate receivables purchased by the factor at its own risk, use the aging schedule of factored receivables aggregated by customer but net of client risk receivables. Select customers for review based upon the same selections methods used for the commercial loan review. Past due volume is an essential element in evaluating customer accounts. In addition, customer files maintained by the factor should include financial statements and an analysis of the customers' financial condition.

When classifying credit exposure to a customer, factored receivables are appropriate for classification. Care should be taken not to classify any receivables that have already been classified under client risk exposure.

FORFAITING

A number of financial institutions are financing receivables from Eastern European and developing countries by a method called forfaiting.

Forfaiting is nonrecourse financing of receivables similar to factoring. However, while a factor normally purchases a company's short-term receivables, a forfait bank purchases notes that are long-term receivables with maximum maturities of eight years. The forfaiting bank has no recourse to the seller of the goods but gets the notes at a substantial discount for cash.

The centers of forfaiting are Zurich and Vienna, where many large banks, including American institutions, provide forfaiting through either their branches or specialized subsidiaries.

Forfaiting is used when government export credits or credit guarantees are not available or when a seller does not extend long-term credits to areas, such as Eastern Europe. Forfaiting is also an important method of financing for small and medium-sized companies because it enables them to negotiate transactions that would normally exceed their financial capabilities. By using forfaiting, small and medium-sized concerns can immediately sell their long-term receivables without recourse.

The examiner should review the branch's forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to frequent political changes and fluctuations in exchange rates. In addition, the other risks peculiar to factoring are present in forfaiting, along with the risks associated with the long-term nature of receivables purchased.

U.S. AND FOREIGN RECEIVABLES GUARANTEE AND INSURANCE PLANS

To reduce credit, political, and other risks associated with foreign receivables financing, branches may avail themselves of a variety of guarantee and insurance plans, both public and private, that are available in many countries.

Because of the complexity of the numerous plans available, an examiner must frequently rely on the technical knowledge of the staff of the branch. Nevertheless, the examiner should know the risk coverage and claim adjustment provisions of the major plans. Often a branch's experience with its receivables insurance and guarantee plans indicates its effectiveness and whether the branch has properly met its responsibilities under the programs.

THE EXPORT-IMPORT BANK OF THE UNITED STATES

The Export-Import Bank of the United States (Eximbank) issues to commercial banks, for a fee, guarantees of payment for foreign receivables that the branch purchases from exporters, generally without recourse to the latter. The maturities of the receivables range from 181 days to over five years. Generally, the foreign buyer must make a cash payment, either before or upon delivery, of at least 10 percent of the invoice value and the amount of receivables purchased by the branch without recourse to the exporter normally cannot exceed 90 percent of the financed portion of the sale (invoice amount less cash payment). That guarantee covers political risks, such as inconvertibility of foreign currencies into U.S. dollars, governmental actions preventing importation of goods, war, civil strife, expropriation, and confiscation by government action. Commercial risks, basically the credit risk of the foreign purchaser, usually are covered from six months to five years.

THE FOREIGN CREDIT INSURANCE ASSOCIATION

The Foreign Credit Insurance Association (FCIA) is an association of leading marine, property, and casualty insurance companies. In cooperation with Eximbank, FCIA offers a comprehensive selection of credit insurance policies, which protect policyholders against loss from failure to receive payment from foreign buyers.

FCIA coverage protects the exporter against the failure of the buyer to pay dollar obligations for commercial or political reasons; enables the exporter to offer foreign buyers competitive terms of payment; supports the exporter's prudent penetration of higher risk foreign markets; and, gives the exporter greater financial liquidity and flexibility in administering a foreign receivables portfolio.

The FCIA does not itself finance export sales; however, the exporter who insures account receivables against commercial and political risks is usually able to obtain financing from commercial banks and other lending institutions at lower rates and on more liberal terms than would otherwise be possible by assigning the proceeds of the FCIA insurance to the lenders.

Comprehensive FCIA policies protect insurers against nonpayment of receivables due to unforeseeable commercial and political occurrences. Commercial risks that are covered include insolvency or protracted default, which may be caused by economic deterioration in the buyer's market area, shifts in demand, unanticipated competition, tariffs, or technical changes. Political risk coverage applies to defaults due to government action, such as currency inconvertibility, expropriation, and cancellation of import license and to political disturbances such as war, revolution, and insurrection.

FCIA generally offers four basic types of insurance policies covering political and commercial risks (Source: Washington Agencies that Help to Finance Foreign Trade, Seventh Edition, Bankers Trust Company, N.Y.C.):

1. Short-term policies covering shipments normally sold on terms up to 180 days. The usual policy covers 100 percent of political risk and 90 percent of any losses from commercial risk.
2. Minimum-term policies insuring transactions from six months to five years. FCIA covers up to 90 percent of commercial risks and up to 100 percent of political risks, with the remainder retained by the exporter.
3. Combined short-term/medium-term policies for sales that pass through distributors before reaching final buyers.
4. Master policies that include the basic insurance features of the previous policies, plus discretionary and deductible provisions. Under a master policy, usually only for short-term and seldom for medium-term transactions, exporters may obtain FCIA authority to grant insured credit up to a certain amount without seeking prior approval. The deductible provision, used only for commercial risks and not political risks, requires the exporter to assume a fixed amount of the first loss on total debts.

OTHER INSURERS

There are numerous other private and governmental institutions, both in the U.S. and overseas, that guarantee or insure risks assumed by banks financing foreign receivables. Some foreign examples are the Export Credits Guarantee Department (ECGD) in the United Kingdom, COFACE in France, and HERMES in West Germany.

Financing Foreign Receivables
Examination Objectives
Effective date July 1997

Section 3080.2

1. To determine if the policies, practices, procedures, and internal controls regarding the financing of foreign receivables are adequate.
2. To determine if branch officers are operating in conformance with established branch guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to the financing of foreign receivables.
5. To recommend corrective action when policies, practices, procedures, or internal controls are deficient.

1. If selected for implementation, complete or update the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest reviews by internal and external auditors from the examiner performing the audit assignment, and determine if appropriate corrections have been made.
4. Obtain the following information for:
   a. Open Account Financing:
      - Whether the shipment is directed to third parties or branches and subsidiaries of the borrower.
      - The financial strength and trustworthiness of the overseas buyer.
      - The extent of foreign exchange control and the availability of exchange for the importer to effect payment.
      - The branch's past experience in dealing with the borrower who sells on open account.

   b. Sales on Consignment:
      - Whether the shipment is directed to third parties or branches and subsidiaries of the obligor.
      - The financial strength and trustworthiness of the foreign consignee.
      - The responsibilities of the foreign sales agent, overseas representative, or import house under contract.
      - The extent of foreign exchange control and the availability of exchange for that type of transaction in the country of destination.
      - Whether the borrower's goods without a definite buyer are consigned abroad in the name of the borrower's bank or a foreign bank.
      - Whether the goods being shipped are assigned to a responsible warehouse.
      - Any arrangements that have been made whereby the selling agent negotiates for the sale of the goods.
      - The regulations in the country of destination regarding the return of unsold consigned goods to the country of origin.
      - The branch's past experience in dealing with the borrower who sells on consignment.

   c. Advances Against Collections:
      - The relationship between the amount collected in a month on the collections pledged as collateral and the borrower's credit limit.
      - The tenor of sight drafts stated number of days after sight or a stated number of days after the date of the draft.
      - Instructions regarding delivery of documents against payment (D/P) or documents against acceptance (D/A).
      - Whether amounts advanced against collections are within the percentage of advance limitation established.
      - Aging of drafts (collections).
      - Ineligible drawees, including house bills.
      - Concentrations of drawees.
      - Financial strength of drawees.
      - Unusual situations such as disputes, nonacceptance of goods, and possession of goods without payment.
      - Dishonor and protest instructions.
      - Any special instructions.
      - The extent of foreign exchange controls and the availability of exchange for that type of transaction in the country of destination.
      - The branch's experience in dealing with the borrower who receives advances against collections.

   d. Discounted Trade Acceptances:
      - The relationship between the amount collected in a month on the trade acceptances discounted and the borrower's credit limit.
      - Whether the branch discounted the trade acceptance with or without recourse.
      - Whether the borrower retains a percentage of the trade acceptance endorsed to the branch.
      - Aging of trade acceptances.
      - Ineligible drawees, including house bills.

- Concentrations of drawees.
- Financial strength of the drawees.
- Unusual situations, such as disputes, nonacceptance of goods, and possession of goods without payment.
- Dishonor and protest instructions.
- Any special instructions.
- The extent of foreign exchange controls and the availability of exchange for that type of transaction in the country of destination.
- The branch's experience in dealing with the borrower for whom its trade acceptances are discounted by the branch.

e. Banker's Acceptance Financing:
- The relationship between the amount collected from the foreign buyer in a month and the borrower's credit limit.
- Whether the discounted draft drawn by the exporter (customer) on the exporter's bank has the same tenor as the draft addressed to the foreign buyer.
- The procedures for applying payment received from the foreign buyer to pay the branch's own acceptance.
- Aging of time drafts drawn on the importer (drawee).
- Ineligible foreign buyers (drawees), including house bills.
- Concentrations of foreign buyers (drawees).
- Financial strength of the foreign buyers (drawees).
- Disputes, nonacceptance of goods, and possession of goods without payment.
- Dishonor and protest instructions.
- Any special instructions.
- The extent of foreign exchange control and the availability of exchange for that type of transaction in the country of destination.
- The branch's experience in dealing with the borrower.

f. Factoring:
- The extent of factor guarantees (letters of credit opened by the branch in favor of overseas suppliers).
- Whether the title documents on import transactions are consigned to or endorsed over to the factor.
- Whether the importer who receives goods under trust receipt agrees to hold them in trust for the factor.
- Whether the imported goods held under warehouse receipt are stored in an independent warehouse for the account of the factor.
- Whether banker's acceptances are charged to the branch customer's account for payment to the factor when due.
- Whether the factor creates a banker's acceptance pending payment of accounts receivable resulting from the sale of goods imported under letters of credit.
- The financial strength of the importer for whom the branch opened the letter of credit.
- Any disputes, nonacceptance of goods, and possession of goods without payment.
- The branch's experience in dealing with the factor.

g. Forfaiting:
- Agings of debtor accounts purchased.
- Ineligible debtor accounts purchased, including affiliate receivables, if any.
- Concentration of debtor accounts purchased.
- The adequacy of the branch's credit investigation before approving the sale (or signing of a sales contract) creating a receivable.
- The financial strength of the debtor accounts purchased.
- The capability of the exporter from whom receivables were purchased to provide any required after-sales service and to honor warranties.
- Disputes and returns.
- The extent of foreign exchange restrictions, availability of exchange, and country risk involved that could jeopardize collection of receivables purchased.
- The branch's experience in dealing with both the debtors and the exporter.

h. U.S. and foreign receivables guarantee and insurance plans:
- Whether foreign receivables coverage by FCIA, Eximbank, or other insurance or guarantee programs is sufficient, adequately identifies risks, and is consistent with established limits.

5. Analyze secondary support offered by guarantors and endorsers.

6. Determine compliance with the branch's established loan policy.
7. At this point, the examiner needs to decide whether further examination and testing is needed. If further work is warranted, refer to the audit guidelines. After reviewing the audit guidelines, proceed to step 8.
8. Discuss with appropriate officers and prepare summaries in appropriate report form of:
   a. Delinquent loans.
   b. Loans not supported by current and complete financial information.
   c. Loans on which documentation is deficient.
   d. Loans with credit weaknesses.
   e. Inadequately collateralized loans.
   f. Criticized loans, including supporting commentaries.
   g. Concentrations of credit.
   h. Other matters regarding the condition of the department.
9. Evaluate the branch with respect to:
   a. The adequacy of written policies relating to financing foreign receivables.
   b. The manner in which branch officers are operating in conformance with established policy.
   c. Adverse trends in those sections concerned with financing foreign receivables.
   d. Recommended corrective action when policies, practices, or procedures are deficient.
   e. The competency of departmental management,
   f. Other matters of significance.
10. Update the workpapers with any information that will facilitate future examinations.

POLICIES

1. Has the head office adopted policies that:
   a. Establish procedures for reviewing financing applications?
   b. Establish standards for determining credit lines?
   c. Establish standards for determining the percentage of advances made against acceptable collections (receivables)?
   d. Define acceptable receivables (collections)?
   e. Establish minimum requirements for verification of borrower's receivables (collections)?
   f. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

ACCOUNTING RECORDS

If the following questions have been answered in the Credit Risk section (3010), skip to question 9.

3. Is the preparation and posting of subsidiary records performed or adequately reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?
4. Are subsidiary records reconciled, at least monthly, with the appropriate general ledger accounts, and are reconciling items adequately investigated by persons who do not normally handle foreign receivables financing?
5. Are inquiries regarding loan balances for foreign receivables financing received and investigated by persons who do not normally process documents, handle settlements, or post records?
6. Are bookkeeping adjustments checked and approved by an appropriate officer?
7. Is a daily record maintained summarizing transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger entries?
8. Are frequent debt instrument and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

DOCUMENTATION

9. Are terms, dates, weights, description of the merchandise, etc., shown on invoices, shipping documents, trust receipts, and bills of lading scrutinized for differences?
10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
11. Are payments received from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

LOAN INTEREST

If the following questions have been answered in the Credit Risk section (3010), skip to question 14.

12. Is the preparation and posting of loan interest records performed or adequately reviewed by persons who do not also:
    a. Issue official checks or drafts?
    b. Handle cash?
13. Are independent interest computations made and compared or adequately tested to initial loan interest records by persons who do not also:
    a. Issue official checks or drafts?
    b. Handle cash?

COLLATERAL

14. Does the branch record a first lien on assigned foreign receivables for each borrower on a timely basis?
15. Do loans granted on the security of the foreign receivables also have an assignment of the inventory?
16. Does the branch verify the borrower's receivables or require independent verification on a periodic basis?

17. Does the branch require the borrower to provide aged receivables schedules on a periodic basis?
18. Are underlying bills of lading covering shipments either to the order of the shipper or blank endorsed to the order of the branch rather than the foreign buyer?
19. Are the shipments being financed covered by adequate insurance?

ADVANCES AGAINST COLLECTIONS AND DISCOUNTED TRADE ACCEPTANCES

20. Are permanent registers kept for foreign collections against which advances were made or trade acceptances were discounted?
21. Are all collections indexed in a collection register?
22. Do these registers furnish a complete history of the origin and final disposition of each collection against which advances were made or trade acceptances were discounted?
23. Are receipts issued to loan customers for all collections received from them?
24. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
25. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collections?
26. Is a daily record maintained showing the various collections that have been paid and credited to the borrower's advance?
27. Are proceeds of paid collections credited to the correct customer's advance?
28. Is an itemized daily summary made of all interest charged and received from the exporter or importer (drawee) indicating underlying collection numbers and amounts?
29. Are payments collected from importers (drawees) by foreign banks or branches of U.S. banks forwarded directly to the branch and not through the exporter?
30. If the exporter accepts importer (drawee) payments directly, are controls established or audits of exporter's books conducted? If so, explain briefly.
31. Are employees handling collections periodically rotated, without advance notification, to other banking duties?
32. Is the employee handling collection proceeds required to apply them to the borrower's advance on the same business day that payment is received?
33. Is the disposition of each collection noted on the register so that verification of disposition can be made?
34. Has a regular policy of follow-up procedures been established for sending tracers and inquiries on unpaid collections in the hands of correspondents?
35. Should the foreign drawee refuse to honor the draft, are instructions clear as to what actions should be taken by the collecting bank?
36. In the event of nonpayment of the collection, is the borrower promptly notified by the branch?
37. Are collections against which advances have been made or trade acceptances discounted distinctly segregated from ordinary collection items?
38. Are financed collections maintained under memorandum control and is the control balanced regularly?
39. Are collections against which advances have been made or trade acceptances discounted booked by persons other than employees handling those items?
40. Are collections carried over to the next business day adequately secured?
41. Does the customer for whom trade acceptances were discounted know whether they were purchased with or without recourse to that customer?
42. Do all parties, i.e., the seller (exporter), importer (buyer), and banks, clearly understand whether interest, discount, and collection charges are to be absorbed by the seller or paid by the importer?

FACTORING

43. Has the branch properly surrendered the shipping documents to the factor either through endorsement or consignment?
44. Do advances or banker's acceptances coincide with the expected payment of the accounts receivable by the ultimate customer?

FOREIGN CREDIT INSURANCE ASSOCIATION INSURANCE

45. Is the branch aware of risks not covered under its assigned FCIA insurance?
46. Does the branch monitor whether the borrower exceeded its FCIA established credit limits?
47. Does the branch monitor whether the borrower properly assigned the proceeds of its FCIA insurance to the branch?
48. Is the branch aware of whether the FCIA insurance is on either simple notice or a special assignment basis?
49. Does the branch retain recourse to the exporter under its FCIA arrangement?
50. Has the branch reported delinquencies to FCIA in accordance with its agreement with the Association?
51. If default occurs, does the branch file a proper claim with FCIA?

EXPORT-IMPORT BANK OF THE UNITED STATES

52. Does the branch, financing under Eximbank arrangements, have properly executed Eximbank guarantees or commitments covering transactions?
53. If the branch has discretionary authority from Eximbank, does it nevertheless inform Eximbank of each transaction thereunder?
54. If the branch has been issued an equipment political risk guarantee by Eximbank, does it have a written statement from the government of the country in which the equipment will be used indicating that it will permit the importation, use, and any subsequent exportation of the equipment?
55. Does the branch monitor whether loan agreements between applicable borrowers and the branch are acceptable to Eximbank?
56. Does the branch report delinquencies to Eximbank in a timely manner, as specified in its agreement with that agency?
57. If default occurs, does the branch file a proper claim with Eximbank?

CONCLUSION

58. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
59. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

1. Test the addition of trial balances and their reconciliation to the general ledger. Include loan commitments and other contingent liabilities.
2. If memoranda controls are maintained, prepare a trial balance of each account so controlled. Using an appropriate sampling technique, select representative items and:
   a. Review all supporting documents.
   b. Verify the authenticity of each item selected and trace and clear each item through final payment, including appropriate credit to the customer's account.
   c. In the case of unusual, altered, or long-standing items, prepare and mail confirmation requests to customers.
   d. Examine financing instruments for completeness and verify dates, amounts, and items to the trial balance.
   e. Check to see that financing instruments are signed, appear to be genuine, and are negotiable.
   f. Check to see that required initials of an approved lending officer are on the financing instrument.
   g. Determine that the amount is within the officer's lending limit.
   h. Determine that any necessary insurance coverage is adequate and that the branch is named as loss payee.
   i. Review disbursement ledgers and authorizations to determine if:
      - Authorizations are signed in accordance with the terms of the loan agreement.
      - Collection funds received are credits in accordance with provisions of the borrower's loan agreement.
   j. Determine that records are posted promptly on collections settled, preferably on the same day they are received.
3. Review the applicable accrued interest accounts by:
   a. Reviewing and testing procedures of accounting for accrued interest and for handling adjustments.
   b. Scanning accrued interest for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.
   c. Independently calculating for those credit extensions selected in step 2, the amount of accrued interest and confirming the amount to the detail of accrued interest receivable for that loan.
4. Using a list of nonaccruing loans, check accrual records to determine that interest income is not being recorded.
5. Test appropriate records to determine that discount, commissions, fees, and collection charges are in accordance with established amounts and that the income accounts are properly credited.
6. Obtain or prepare a schedule showing the monthly interest income amounts and applicable loan balances at each month-end since the last audit and:
   a. Calculate yield.
   b. Investigate significant fluctuations and trends.

A branch's authority to hold real estate rests with the laws of its respective state (if state licensed) or the National Banking Act (if federally licensed). State and federal laws and regulations may dictate accounting procedures, maximum holding periods, and other details relating to other real estate owned. Examiners should follow the most recent interagency guidelines when verifying the proper identification, reporting, valuation, and accounting for disposal of other real estate owned (OREO).

Relevant interagency joint statements include ''Interagency Guidance on Accounting for Dispositions of Other Real Estate Owned,'' dated July 16, 1993, and ''Interagency Guidance on Reporting of In-Substance Foreclosures,'' dated June 10, 1993. In addition, refer to the final rule entitled ''Real Estate Lending Standards,'' promulgated by the Federal Reserve Board, FDIC, OTS, and OCC in December 1992. See Final Rule, 57 Fed. Reg. 62890 (December 31, 1992). The various state and federal agencies may differ in terms of specific practices and methodologies used to implement the above guidelines. For further guidance in this area, examiners should consult with their respective agencies.

Real property becomes other real estate owned through:

- Conveyance in satisfaction of debts previously contracted;
- Exchange for future advances to an existing borrower to fully or partially satisfy debts previously contracted;
- Purchase to secure debts previously contracted;
- Relocation of branch premises; or
- Abandonment of plans to use real estate acquired for future expansion for banking premises.

Although the borrower may still retain possession and legal title to the property, certain troubled loans secured by real estate are considered to be ''insubstance foreclosures'' and are also treated as other real estate owned. An insubstance foreclosure situation is generally characterized by a borrower with little or no equity and the sale of the property is the only source of repayment.

ENVIRONMENTAL LIABILITY

Under federal and state environmental liability statutes, a branch may be liable for cleaning up hazardous substance contamination of other real estate owned. In some cases, the liability may arise before the branch takes title to a borrower's collateral real estate. A property's transition from collateral to branch ownership may take an extended period of time. As the financial problems facing a borrower worsen, a branch may become more involved in managing a company or property. Such involvement may become extensive enough that the branch is deemed to have met substantially all ownership criteria, the absence of a clear title in the branch's name notwithstanding. Generally, the more involved branch management is in such activity, the greater the branch's exposure to any future clean-up costs assessed in connection with the property. A more thorough discussion of environmental liability can be found in the Real Estate Loans section of this manual.

TRANSFER OF ASSETS TO OTHER REAL ESTATE OWNED

Real estate assets transferred to OREO should be accounted for individually on the date of transfer, at the lower of the recorded investment in the loan or fair value. The recorded investment in a loan is the unpaid balance, increased by accrued and uncollected interest, unamortized premium, finance charges, and loan-acquisition costs, if any, and decreased by previous write-downs and unamortized discount, if any. Any excess of the recorded investment in the loan over the property's fair value must be charged against the allowance for loan and lease losses immediately upon the property's transfer to OREO. Legal fees should generally be charged to expenses unless payment of the fees is for the purpose of enhancing the property's value (for example, obtaining a zoning variance).

Establishing a valuation allowance for estimated selling expenses may also be necessary upon transferring each property to OREO to comply with AICPA Statement of Position 92-3, Accounting for Foreclosed Assets. According to this pronouncement, the value of OREO properties must be reported at the lesser of the fair value minus estimated selling expenses or the recorded investment in the loan. For example, if the recorded investment of the property is $125, the fair value is $100, and the estimated selling expenses are $6, the carrying value for this property would be $94. The difference between the recorded investment and the fair value ($25) would be charged to the allowance for loan and lease losses at the time the property was transferred to OREO. In addition, since the branch estimated it would incur selling expenses of $6, a valuation reserve for this amount must be established. The net of the fair value and this valuation reserve for selling expenses is called the ‘‘net realizable value,’’ and in this example would be $94. Changes to this valuation reserve should be handled as outlined in the subsection ‘‘Accounting for Subsequent Changes in Market Value.’’

On the other hand, if the recorded investment in the property is $250, the fair value is $300, and the estimated selling expenses are $18, the carrying value of this property would be $250 (the lesser of the recorded investment or the fair value). In this example, a valuation reserve for estimated selling expenses is unnecessary, as netting the estimated selling expenses ($18) from the fair value ($300) would yield a net realizable value of $282.

The transfer of a loan to OREO is considered to be a ‘‘transaction involving an existing extension of credit’’ under 12 CFR 225.63(a)(7) and is exempt from Regulation Y’s appraisal requirement. However, under 12 CFR 225.63(b), the branch must obtain an ‘‘appropriate evaluation’’ of the real estate that is ‘‘consistent with safe and sound banking practices’’ to establish the carrying value of the OREO. A branch may elect, but is not required, to obtain an appraisal to serve as the ‘‘appropriate evaluation.’’ Until the evaluation is available, a branch should rely on its best estimate of the property’s value to establish the carrying value. The federal banking agencies have issued appraisal and evaluation guidelines to provide guidance to examining personnel and federally regulated institutions regarding prudent appraisal and evaluation policies, procedures, practices, and standards.

The appraisal or evaluation should provide an estimate of the parcel’s market value. Refer to Real Estate Loans section of this manual for a definition of market value. Generally, market value and fair value are equivalent when an active market exists for a property. In discussing OREO, it is common practice to use the terms ‘‘fair value’’ and ‘‘market value’’ interchangeably. When no active market exists for a property, the accounting industry’s definition of fair value applies because the appraiser cannot determine a market value. The accounting industry definition requires the appraisal or evaluation to contain an estimate of the property’s fair value based on a forecast of expected cash flows, discounted at a rate commensurate with the risks involved. The cash flow estimate should include projected revenues and the costs of ownership, development, operation, marketing, and sale. In such situations, the appraiser or evaluator should fully describe the definition of value and the market conditions that have been considered in estimating the property’s value.

When a branch acquires a property through foreclosure as a junior lienholder, whether or not the first lien has been assumed, the fair value of the property should be recorded as an asset and the senior debt as a liability. The senior debt should not be netted against the assets. Any excess of the recorded investment of the property over the fair value should be charged off, as the recorded investment may not exceed the sum of the junior and senior debt. Payments made on senior debt should be accounted for by reducing both the asset and the liability, and interest that accrues on the senior debt after foreclosure should be recognized as interest expense.

For regulatory reporting purposes, a collateral-dependent real estate loan should be transferred to OREO only when the lender has taken possession (title) of the collateral. Nevertheless, to facilitate administration and tracking, branches may choose to include a collateral-dependent real estate loan in the OREO portfolio as potential or probable OREO. Examiners should review these loans using the same criteria applied to OREO.

CARRYING VALUE OF OTHER REAL ESTATE OWNED

A branch should have a policy for periodically determining the fair value of its OREO property by obtaining an appraisal or an evaluation, as appropriate. While the Federal Reserve has no prescribed time frame for when a branch should reappraise or reevaluate its OREO property, the branch’s policy should conform to state or federal law, if applicable, and address the volatility of the local real estate market. Specifically, a branch should determine if there have been material changes to the underlying assumptions in the appraisal or valuation that have affected the original estimate of value. If material changes have occurred, the branch should obtain a new appraisal or evaluation based on assumptions that reflect the changed conditions.

ACCOUNTING FOR SUBSEQUENT CHANGES IN MARKET VALUE

Charges for subsequent declines in the fair value of OREO property should never be posted to the allowance for loan and lease losses. If an appraisal or evaluation indicates a subsequent decline in the fair value of an OREO property, the loss in value should be recognized by a charge to earnings. Branches should attempt to determine whether a property's decline in value is temporary or permanent, taking into consideration each property's characteristics and existing market dynamics. The preferred treatment for permanent losses in value is the direct write-down method, in which the charge to expenses is offset by a reduction in the OREO property's carrying value. If the reduction in value is deemed temporary, the charge to earnings may be offset by establishing a valuation allowance specifically for that property. In the event of subsequent appreciation in the value of an OREO property, the increase can only be reflected by reducing this valuation allowance or recognizing a gain upon disposition, but never by a direct write-up of the property's value. A change to the valuation allowance should be offset with a debit or credit to expense in the period in which it occurs.

In addition to the preceding treatment of the write-down in the OREO value, the previous subsection "Transfer of Assets to Other Real Estate Owned" discusses setting up a valuation allowance for estimated selling expenses associated with the sale of the other real estate. The balance of this valuation reserve can fluctuate based on changes in the fair value of the property held, but it can never be less than zero. The following examples are presented to illustrate the treatment that subsequent depreciation and appreciation would have on OREO properties.

Depreciation in OREO Property Value

Assume a branch has written down its initial recorded investment in an OREO property from $125 to its fair value of $100. Since the fair value of the property was less than the initial recorded investment, a valuation reserve for estimated selling expenses was established. In this example, assume these to be $6. Accordingly, the net realizable value was $94 ($100 minus $6). Next, assume a new appraisal indicates a fair value of $90, reducing the estimated selling expenses to $5. Although the branch must expense the depreciation in the fair value ($10), the valuation reserve for selling expenses would be reduced by the difference in the estimate of the selling expenses ($1). Given this scenario, the "adjusted" net realizable value would be $85 ($90 minus $5).

Appreciation in OREO Property Value

Assume a branch has written down its recorded investment in an OREO property to its fair value of $100. Since the fair value of the property was less than the original recorded investment, an estimated valuation reserve for selling expenses of $6 was established. Accordingly, the net realizable value was $94. A new appraisal indicates an increase in the fair value of the property to $110, with selling expenses now estimated at $7. As a result, the net realizable value is now $103. Given that the new net realizable value is greater than the recorded investment of $100, the selling expense valuation reserve is no longer necessary and the $6 can be reversed to income. Notwithstanding the property's increased fair value, the recorded investment value cannot be increased above $100. The valuation reserve for selling expenses can never be less than zero, thus prohibiting an increase in the value of the property above the recorded investment.

ACCOUNTING FOR INCOME AND EXPENSE

Gross revenue from other real estate owned should be recognized in the period in which it is earned. Direct costs incurred in connection with holding an OREO property, including legal fees, real estate taxes, depreciation, and direct write-downs, should be charged to expense when incurred.

A branch can expend funds to develop and improve OREO when it appears reasonable to expect that any shortfall between the property's fair value and the branch's recorded book value will be reduced by an amount equal to or greater than the expenditure. Such expenditures should not be used for speculation in real estate. The economic assumptions relating to the branch's decision to improve a particular OREO property should be well documented. Any payments for developing or improving OREO property are treated as capital expenditures and should be reflected by increasing the property's carrying value.

DISPOSITION OF OTHER REAL ESTATE OWNED

OREO property must be disposed of within any holding period established by state law and, in any case, as soon as it is prudent and reasonable. Branches should maintain documentation reflecting their efforts to dispose of OREO property, which should include a record of inquiries and offers made by potential buyers, methods used in advertising the property for sale whether by the branch or its agent, and other information reflecting sales efforts.

The sale or disposition of OREO property is considered a real estate-related financial transaction under the Board's appraisal regulation. A sale or disposition of an OREO property that qualifies as a federally related transaction under the regulation requires an appraisal conforming to the regulation. A sale or disposition that does not qualify as a federally-related transaction nonetheless must comply with the regulation by having an appropriate evaluation of the real estate, that is consistent with safe and sound banking practices.

The branch should promptly dispose of OREO if it can recover the amount of its original loan plus additional advances and other costs related to the loan or the OREO property before the end of the legal holding period. The holding period generally begins on the date that legal title to the property is transferred to the branch, except for real estate that has become OREO because the branch no longer contemplates using it as its premises. The holding period for this type of OREO property begins on the day that plans for future use are formally terminated. Some states require OREO property to be written off or depreciated on a scheduled basis, or to be written off at the end of a specified time period. The branch should determine whether such requirements exist and comply with them.

ACCOUNTING FOR THE SALE OF OTHER REAL ESTATE OWNED

Gains and losses resulting from a sale of OREO properties for cash must be recognized immediately. A gain resulting from a sale in which the branch provides financing should be accounted for under the standards described in Statement of Financial Accounting Standards 66 (SFAS 66).

SFAS 66 recognizes that differences in terms of the sale and in selling procedures lead to different profit recognition criteria and methods. Branches may facilitate the sale of foreclosed real estate by requiring little or no down payment, or by offering loans with favorable terms. Profit shall only be recognized in full when the collectibility of the sales price is reasonably ensured and when the seller is not obligated to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be deferred. Collectibility of the sale price of OREO property is demonstrated when the buyer's investment is sufficient to assure that the buyer will be motivated to honor his or her obligation to the seller rather than lose the investment. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

The practice of recognizing all profit from the sale of branch-financed OREO at the time of the sale is referred to as the full-accrual method. A branch shall not recognize profit using this method until all of the following general criteria are met:

- A sale is consummated.
- The buyer's initial and continuing investments adequately demonstrate a commitment to pay for the property.
- The branch's loan is not subject to future subordination.

- The branch has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale, and it has no substantial continuing involvement in the property.

A sale will not be considered consummated until the parties are bound by the terms of the contract, all consideration has been exchanged, and all conditions precedent to closing have been performed.

Initial investment, as defined by SFAS 66, includes only cash down payments, notes supported by irrevocable letters of credit from an independent lending institution, payments by the buyer to third parties to reduce existing debt on the property, and other amounts paid by the buyer that are part of the sale price. In these situations, SFAS 66 requires that profit on the sale be deferred until a minimum down payment has been received and annual payments equal those for a loan for a similar type of property with a customary amortization period. The amount of down payment required varies by category of property: land, 20–25 percent; commercial and industrial, 10–25 percent; multifamily residential, 10–25 percent; and single-family residential, 5–10 percent. Ranges within these categories are defined further in the statement.

Continuing investment requires the buyer to be contractually obligated to make level annual payments on his or her total debt for the purchase price of the property. This level annual payment must be able to service principal and interest payments amortized for no more than 20 years for raw land, and for no more than the customary amortization term for a first-mortgage loan by an independent lending institution for other types of real estate.

If a branch finances the sale of foreclosed property it owns with a loan at less than current market interest rates or noncustomary amortization terms, generally accepted accounting principles require that the loan be discounted to bring its yield to a market rate, using a customary amortization schedule. This discount will either increase the loss or reduce the gain resulting from the transaction. Interest income is then generally recognized at a constant yield over the life of the loan.

If a transaction does not qualify for the full-accrual accounting method, SFAS 66 identifies alternative methods of accounting for sales of OREO property as described below.

The Installment Method

This method is used when the buyer's down payment is insufficient to allow the full-accrual method, but when recovery of the cost of the property is reasonably assured if the buyer defaults. The installment method recognizes the sale of the property and the booking of the corresponding loan, although profits from the sale are recognized only as the branch receives payments from the buyer. Under this method, interest income is recognized on an accrual basis, when appropriate.

Since default on the loan usually results in the seller (the branch) reacquiring the real estate, the branch is reasonably assured that it will be able to recover its costs with a relatively small down payment. Cost recovery is especially likely when loans are made to buyers who have verifiable net worth, liquid assets, and income levels adequate to service the loan. Reasonable assurance of cost recovery also may be achieved when the buyer pledges adequate additional collateral.

The Cost-Recovery Method

Dispositions of OREO that do not qualify for either the full-accrual or installment methods are sometimes accounted for using the cost-recovery method. This method recognizes the sale of the property and the booking of the corresponding loan, but all income recognition is deferred. Principal payments are applied by reducing the loan balance, and interest payments are accounted for by increasing the unrecognized gross profit. No profit or interest income is recognized until either the buyer's aggregate payments exceed the recorded amount of the loan or a change to another accounting method (for example, the installment method) is appropriate. Consequently, the loan is maintained on nonaccrual status while this method is being used.

The Reduced Profit Method

This method is used in certain situations when the branch receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full-accrual method. The branch again recognizes the sale of the property and the booking of the corresponding loan but, as under the installment method, profits from the sale are recognized only as the branch receives payments from the buyer. Since sales with adequate down payments generally are not structured with inadequate loan-amortization schedules, this method is seldom used.

The Deposit Method

This method is used when a sale of OREO has not been consummated. It also may be used for dispositions that could be accounted for under the cost-recovery method. Under this method, a sale is not recorded, so the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the buyer are reported as a liability until the use of one of the other methods is appropriate.

Branches may promote the sale of foreclosed real estate by offering nonrecourse financing to buyers. These loans should be made under the same credit terms and underwriting standards the branch employs for its regular lending activity. Financing arrangements associated with this type of transaction are subject to the accounting treatment discussed above.

Branch records should (1) indicate the accounting method used for each sale of OREO, (2) support the choice of the method selected, and (3) sufficiently document that the institution is correctly reporting associated notes receivable, as either loans or OREO property, with valuation allowances as appropriate.

CLASSIFICATION OF OTHER REAL ESTATE OWNED

The examiner should generally evaluate the quality of each OREO property to determine if classification is appropriate. OREO usually should be considered a problem asset, even when it is carried at or below its appraised value. Despite the apparent adequacy of the fair or market value, the branch's acquisition of OREO through foreclosure usually indicates a lack of demand. As time passes, the lack of demand can become more apparent, and the value of the real estate can become increasingly questionable.

When evaluating the OREO property for classification purposes, the examiner must consider the property's market value, whether it is being held in conformance with state law, and whether it is being disposed of according to the branch's plan. The amount of an OREO property subject to classification is the carrying value of the property, net of any specific valuation allowance. The existence of a specific valuation allowance does not preclude adverse classification of OREO. The examiner should review all types of OREO for classification purposes, including sales that fail to meet the standards required for the full-accrual method of accounting. When the branch provides financing, the examiner should determine whether it is prudently underwritten.

The examiner should review all relevant factors to determine the quality and risk of the OREO property and the degree of probability that its carrying value will be realized. Some factors the examiner should consider include :

- The property's carrying value relative to its market value (including the date of any appraisal or evaluation relative to changes in market conditions), the branch's asking price, and offers received;
- The source and quality of the appraisal or evaluation, including the reasonableness of assumptions, such as projected cash flow for commercial properties;
- The length of time a property has been on the market and local market conditions for the type of property involved, such as history and trend of recent sales for comparable properties;
- Branch management's ability and track record in liquidating other real estate and assets acquired in satisfaction of debts previously contracted;
- Income and expenses generated by the property and other economic factors affecting the probability of loss exposure;
- The manner in which the branch intends to dispose of the property; and
- Other pertinent factors, including property-title problems, statutory redemption privileges, pending changes in the property's zoning, environmental hazards, other liens, tax status, and insurance.

Other Real Estate Owned
Examination Objectives
Effective date July 1997

Section 3090.2

1. To determine if the policies, practices, procedures, and internal controls regarding other real estate owned are adequate.
2. To determine that branch officers and employees are operating in conformance with the established guidelines.
3. To verify the carrying value of all other real estate owned.
4. To determine the scope and adequacy of the internal/external audit function.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Other Real Estate Owned
Examination Procedures
Effective date July 1997

Section 3090.3

1. If included in the scope of the examination, complete or update the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any audit deficiencies noted in the latest review by internal/external auditors, and determine if appropriate corrections have been made.
3. Obtain a list of other real estate owned and reconcile the total to the general ledger.
4. Review the other real estate owned account to determine if any property has been disposed of since the prior examination and:
   a. If so, determine that:
      - The branch accepted written bids for the property.
      - The bids are maintained on file.
      - There is justification for accepting a lower bid if the branch did not accept the highest one.

   b. Investigate any insider transactions.
5. Test compliance with applicable laws and regulations:
   a. Determine that other real estate owned is held in accordance with the provisions of applicable state or federal laws and regulations.

   b. Determine if other real estate is being amortized or written off in compliance with applicable state or federal laws and regulations.

   c. Consult with the examiners assigned to ''Loan Portfolio Management,'' ''Other Assets (and Other Liabilities),'' and ''Bank Premises and Equipment'' to determine:
      - If the branch holds real estate acquired as salvage on uncollectible loans, abandoned bank premises, or property originally purchased for future expansion but which is no longer intended for such usage.
      - If troubled real estate loans meeting the criteria for in-substance foreclosures and covered transactions are identified.
      - If covered transactions and in-substance foreclosures are being properly accounted for and reported as other real estate owned.

   d. Review the details of all other real estate owned transactions to determine that:
      - The property has been booked at its fair value.
      - The documentation reflects the branch's persistent and diligent effort to dispose of the property.
      - If the branch has made expenditures to improve and develop other real estate owned, proper documentation is in the file.
      - Real estate that is former banking premises has been accounted for as other real estate owned since the date of its abandonment.
      - Such property is disposed of in accordance with state or federal laws and regulations, including Regulation Y.
      - The valuation is not affected by an Environmental Protection Agency issue.
6. Review parcels of other real estate owned with appropriate management personnel and, if justified, assign appropriate classification. Classification comments should include:
   a. Description of property.
   b. How and when real estate was acquired.
   c. Amount and date of appraisal.
   d. Amount of any offers and branch's asking price.
   e. Other circumstances pertinent to the classification.
7. Review the following with appropriate management personnel or prepare a memo to other examiners for their use in reviewing with management:
   a. Internal control exceptions and deficiencies in, or noncompliance with, written policies, practices, and procedures.
   b. Uncorrected audit deficiencies.
   c. Violations of law.
8. Prepare comments in appropriate report form for all:
   a. Criticized other real estate owned.
   b. Deficiencies noted.
   c. Violations of law.
9. Update the workpapers with any information that will facilitate future examinations.

Other Real Estate Owned
Internal Control Questionnaire
Effective date July 1997

Section 3090.4

OTHER REAL ESTATE OWNED RECORDS

1. Are postings to the general ledger account for other real estate owned approved and/or tested, prior to posting, by persons who do not have direct, physical, or accounting, control of those assets?
2. Are the subsidiary records for other real estate owned balanced at least quarterly to the appropriate general ledger accounts by persons who do not have direct, physical, or accounting control of those assets?
3. Are supporting documents maintained for all entries to other real estate owned accounts?
4. Are acquisitions and disposals of other real estate owned reported to senior management at the head office?
5. Does the branch maintain insurance coverage on other real estate owned, including liability coverage where necessary?
6. Are all parcels of other real estate owned reviewed at least annually for:
   a. Current appraisal or certification?
   b. Documentation inquiries and offers?
   c. Documented sales efforts?
   d. Evidence of the prudence of additional advances?
   e. Anticipated methods for disposal of property?
   f. Changes in tax status, zoning restrictions, other liens, etc.?

OTHER PROCEDURES

7. Does the branch have written policies and procedures relating to other real estate owned?
8. Does the branch factor in Environmental Protection Agency issues and their impact on valuation into its policies?

CONCLUSION

9. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
10. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

1. Test the additions of the subsidiary ledgers and reconcile the total to the general ledger. Include insubstance foreclosures and property sold in ''covered transactions.''
2. Using appropriate sampling techniques, select specific properties and determine that:
   a. Legal title to the property is obtained when the asset is recorded as other real estate owned.
   b. Legal fees and direct costs of acquiring title, including payment of existing liens, taxes, and recording fees are expensed when incurred and are not capitalized.
   c. Insurance, including liability coverage, is adequate and the branch is named as loss payee.
3. Using appropriate sampling techniques, select specific properties, and for expenses incurred in maintaining the properties or capitalized costs of improvement and development:
   a. Trace the transaction to any previous records and to postings in the general ledger.
   b. Examine documentation supporting the transaction and prove any computations reflected on the supporting document.