Contents

Introduction 1
Overview 1
Advantages 2
Disadvantages 2
ABL Structures 3
Risks Associated With ABL 4
Credit Risk 4
Operational Risk 5
Compliance Risk 5
Strategic Risk 6
Reputation Risk 6
Risk Management 6
Loan Policy 7
Borrower Analysis 7
Establishing the Borrowing Base 15
Term Loans 21
Controls 21
Third-Party Guarantees or Insurance 25
ABL Administration 26
Purchasing Participations in ABL Transactions 30
Debtor-in-Possession Financing 30
Credit Risk Rating Considerations 32
Nonaccrual Status 35
Problem Loan Management 36
Allowance for Loan and Lease Losses 37

Examination Procedures 38
Scope 38
Quantity of Risk 41
Quality of Risk Management 47
Conclusions 53
Internal Control Questionnaire 55
Verification Procedures 58

Appendixes 60

Appendix A: Trade Cycle Analysis Worksheet 60
Appendix B: Risk-Rating Examples 61
Appendix C: Quantity of Credit Risk Indicators 67
Appendix D: Quality of Credit Risk Management Indicators 69
Appendix E: Glossary 71

References 77

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Ideally, one bank is the exclusive lender against the receivables and inventory. Sometimes, however, a bank makes a loan against a portion of a borrower's receivables or inventory, and another lender advances funds on the balance of those assets. This type of arrangement significantly increases risk because ownership and control of the collateral among the lenders can be uncertain. It is often impossible to clearly identify the secured interest in receivables among lenders when those obligations are due from common customers. Likewise, it is difficult to separate inventory among lienholders. A bank that accepts this additional risk should take precautions to make commingling of collateral difficult or impossible. At times, a supplier may file a purchase money security interest in raw materials or component parts. This too can compromise the bank's collateral position.

Frequent field audits and detailed collateral descriptions can help reduce the risks, but the best solution is for a lender to ensure that it is the only lender to hold a lien against a firm's accounts receivable or inventory. When there are multiple lenders, the lenders are often forced to resolve ownership issues through litigation. Not only must each lender absorb the expense of litigation, but each lender may also be forced to compromise with the other lenders in a manner that is not totally satisfactory to anyone.

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Collateral Appraisals

Collateral appraisals are important aspects of ABL underwriting, administration, and problem loan management. A bank should obtain an appraisal during the underwriting process to determine the value of the underlying collateral and help establish the borrowing base and advance rates. Updated appraisals should be obtained throughout the life of the loan to monitor the collateral value, collateral trends, and adequacy of the borrowing base. Reappraisal should be permitted by the loan agreement and occur on a regular basis consistent with the risk inherent in the lending relationship. In particular, the frequency of reappraisal should increase as issues arise.

An ABL lender typically relies on expert appraisals or valuations performed by companies experienced in inventory and other asset liquidation. The appraisal should provide a NOLV as the standard for collateral valuation, not cost or retail value. The bank's experience in liquidating similar types of collateral should also be considered.

Field Audits

Field audits are integral to monitoring and controlling ABL. A field audit helps detect fraud and financial weakness and is a customary way to confirm the quality of the borrower's financial data, receivables, inventory, and internal controls.

The field auditor should obtain written account verifications and perform sufficient reconciliations and testing to ensure that the borrower's financial records are accurate. Testing financial records involves reviewing borrowing base collateral—physically inspecting the collateral, testing its validity and value as reported on financial statements and borrowing base certificates, and examining original invoices and other supporting documentation. During the field audit, the auditor should carefully review credit memo

documentation, testing for both reasonableness and accuracy. A field audit is usually the best means of evaluating internal controls, information systems, and operating systems. The audit should confirm that the borrower's accounting systems are adequate. Some banks require independent audited opinions of the borrower's operating and internal control systems.

A field audit should be conducted before a new account is booked and regularly thereafter—often quarterly but more frequently if risk dictates. In a high-risk relationship or workout situation, weekly or daily audits may be appropriate. The examiner should review how the bank determines the frequency and scope of field audits, paying special attention to an ABL unit that delays audits or extends audit cycles because of staffing shortages. An ABL unit should have dedicated field audit staff that includes skilled accountants.

A bank that does not have dedicated field audit staff should still inspect collateral and review supporting documentation periodically. Smaller banks may have staff lenders that are independent of the transaction perform the audit; others outsource. Regardless, the cost is generally passed on to the borrower.

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Financial Reporting Requirements

The type and frequency of financial reporting should depend on how much credit risk the borrower poses. An ABL lender often requires borrowing base certificates and supporting documentation on a weekly or monthly basis. Interim financial statements may also be required; these can help the bank determine whether uncollected receivables and obsolete inventory have been identified and appropriately reported on the balance sheet. In some cases, the bank may waive requirements for interim statements if collateral reporting (borrowing base certificates, receivable agings, etc.) is reliable and field audits are completed on a regular basis without significant findings. The bank's policies and procedures should address reporting requirements and permissible exceptions.

The frequency of reports on inventory depends on the bank's assessment of the borrower's operations, the nature of the inventory, and the reliance on inventory in the borrowing base. Normally, the borrower should be required to periodically certify the amount, type, and condition of inventory; provide inventory valuations; and permit the lender or an independent firm to audit the inventory.

Covenants

Loan agreements typically include multiple financial covenants that require the borrower to maintain or achieve certain financial ratios or other financial performance metrics as an ongoing condition of credit. The covenants not only establish standards for financial performance, they also serve as early indicators of potential problems and provide the bank with default triggers that force restructuring or other remedial actions that can moderate the risk of loss. Covenants can also be used as tools to limit a borrower's capacity to take unwarranted risks.

The use of covenants in ABL differs from traditional commercial lending. An ABL lender places less reliance on financial covenants and more reliance on collateral controls and monitoring. This is a significant benefit to an ABL borrower that may be experiencing rapid growth or financial challenges. Covenants commonly focus on excess availability and may take the form of a reserve against the borrowing base and cash controls, such as cash dominion using a lockbox arrangement. Financial covenants, when present, typically take the form of a minimum fixed charge coverage ratio, the definition of which can vary by borrower. Limits on capital expenditures are also common in ABL. Covenants should be consistent with the borrower's projected performance.

Some lenders originate ABL facilities with springing covenants, meaning the covenants are operable only when certain conditions defined in the loan agreements are not met. For example, cash dominion may not be required unless excess availability falls below an established threshold. A springing covenant arrangement is advantageous to the borrower as fewer restrictions provide more freedom to operate. Such arrangements can, however, adversely affect the controls that are the strength of an ABL credit. A bank that offers springing covenants should develop policies that establish clear guidelines outlining the appropriate use of such arrangements and effective risk mitigating requirements, which may include standards for the adequacy, stability, and preservation of liquidity.

The bank's loan policy should clearly establish financial covenant standards for ABL transactions. The lender should carefully review the borrower's information to determine the borrower's compliance. The bank should carefully analyze any violation to determine the root cause and appropriate corrective action. The decision to waive covenant requirements, at underwriting or subsequently during the life of the loan, should be documented and well supported. Failure to identify covenant violations or regularly waiving them may impair the lender's ability to enforce the covenants in the future.

Pricing

ABL facilities are often priced based on a complex structure of fees and loan spreads that change based on performance. For example, the base for variable pricing may be the London InterBank Offered Rate (Libor), with the spread varying according to the availability and the borrower's financial leverage. Other pricing triggers may include delinquency, excess dilution rates, covenant violations, and over-advances. A loan agreement should clearly establish conditions that trigger interest rate changes, as well as fee-based servicing requirements. The fee structure typically includes customer charges for administrative costs, including field audits, lockbox arrangements, and appraisals.

Some banks may capitalize interest and fees by charging those costs to the ABL revolver instead of collecting payments in cash. The advantage to the bank is the ability to collect additional interest on those balances. While this practice is considered a sign of a borrower's financial weakness in most forms of commercial lending, it is a long-standing and normal practice in ABL and is not, by itself, cause for an adverse risk rating.

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Over-Advances

An over-advance can dilute the collateral coverage and may cause the lender to be under-collateralized, creating what is commonly referred to as a "stretch piece" or "airball."

Over-advances should be approved in accordance with the bank's loan policies and be supported by an assessment of the adequacy of the company's cash flow to repay the over-advance. Credit approval and loan documents should explicitly state when and under what conditions the lender permits an over-advance. The documents should stipulate the amount, frequency, duration, and period of the year when an over-advance is permitted. Over-advances in excess of prudent advance rates or that rely on cash flow for repayment weaken the ABL loan structure and should have a defined repayment plan with repayment over a short term. Most banks do not allow an over-advance in excess of 10 to 15 percent of the borrowing base. The bank should also make every effort to verify that the borrower is using the proceeds as designated rather than masking obsolete inventory or slow sales.

An unapproved over-advance in ABL may indicate a serious deficiency in the administration of the loan or inaccurate reporting by the borrower. The bank should immediately develop a strategic response that could include demanding repayment, renegotiating the terms of the loan, or even liquidation of collateral. Renegotiation affords the bank the opportunity to add collateral, guarantor support, or collateral controls.

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Third-Party Guarantees or Insurance

Third-party guarantees or insurance are common features associated with ABL facilities. Credit insurance, in particular, can be tailored to provide funds beyond the loan amount to cover items, such as accounts payable, that could affect the bank's lien status and ability to liquidate inventory. This can assure the bank's security interest in the collateral and protection as loss payee. Such a bank may also be able to justify increased advance rates and credit availability based on the reduced level of risk. The increased availability benefits the borrower and, in some cases, may offset the borrower's cost of obtaining the insurance. In general, a healthy borrower is less likely to agree to the added cost of credit insurance if it has the ability to secure financing elsewhere without it.

Credit insurance underwriting requires participation by the bank and the borrower. Most insurers review the borrower's financials, assess the management team, evaluate the borrower's customer base and relationships with suppliers, and review the draft loan agreement between the borrower and the bank. This process is central to determining insurance premium costs and can serve as a risk management check for the bank.

There are also government-sponsored programs that support foreign trade, such as the Export-Import Bank of the United States and the Foreign Credit Insurance Association.

ABL Administration

The complexity of administering ABL loans results in higher transaction risk than for most other types of commercial loans. ABL departments should be structured with a distinct separation of administrative duties between employees responsible for credit approval, collateral/cash proceeds control, field audits, and portfolio management. Lending units that allow employees to perform conflicting roles can increase the bank's operational risk.

Prudent administration of an ABL loan is integral to controlling credit and operational risk. Loan agreements are typically complex, particularly with regard to collateral requirements, and ensuring compliance with administrative requirements is labor-intensive. To be successful, an ABL program must have an experienced and adequately staffed back-office operation. The examiner should evaluate whether employees are sufficiently trained and experienced to perform their responsibilities and should assess the quality of internal controls and audit systems. Because the overhead costs of properly administering ABL can be high, some banks may be tempted to cut costs in this area. An examiner reviewing a bank with smaller volumes of ABL loans should pay particular attention to the adequacy of staffing, controls, and monitoring systems.

ABL activities should be supported by strong management information systems (MIS) that can accurately compile and track information. Reports should be timely and accurate. Good MIS enables an ABL lender to identify overadvances and changes in borrowing patterns or collateral quality. Timely identification allows the bank to take swift action to control risks. The examiner should evaluate the bank's systems against the range of risks assumed.

When a borrower has loans with more than one unit of a bank, one of the units should be assigned primary responsibility for the entire relationship. This can make the relationship easier to monitor, help ensure that the borrower is treated consistently, and maximize the bank's recovery in the event of a troubled credit. Most often, because of the special requirements associated with ABL, the ABL unit is best suited to be the responsible unit.

An ABL borrower's financial condition may become more difficult to monitor when the borrower has credit relationships with other financial institutions. ABL facilities often include a covenant in the loan agreement that prevents borrowing at another institution without the original banks' knowledge and consent. Prudent banks specifically prohibit ABL facilities at other institutions because of the control issues associated with shared collateral. An ABL lender may not object to other types of borrowing, however, and may be comfortable with another lender providing specialized financing, equipment leasing, or a mortgage.

Disbursing Revolving Loan Advances

An ABL lender can choose from many systems for controlling the disbursement of loan proceeds and monitoring collateral. The goal is to safeguard the bank if the borrower defaults; which process is best depends on the size of the bank's portfolio and the risk profile of the individual customer.

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ABL units commonly exert strict control over the disbursement of loan proceeds. The most tightly controlled are fully followed lines, for which funds are advanced against specific supporting collateral documents (e.g., invoices, shipping documents, or receipts) that are verified and reconciled during field audits.

Some borrowers draw against the available borrowing base rather than against specific supporting collateral documentation. Because this type of revolving arrangement gives the bank less control over the loan proceeds, the bank should keep track of borrowing activity so that it can investigate any unusual activity. Borrowing patterns should conform closely to the buildup of inventory and collection of receipts as reported on the borrowing base certificates. Borrower-prepared cash flow projections should detail expected borrowing needs and repayment activity. An examiner should ascertain whether the bank exerts appropriate control over loan disbursements.

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Monitoring Systems

Effective monitoring and reporting systems are the foundation of prudent ABL risk management and should be achieved jointly between the borrower and the lender. The bank should investigate and develop a comprehensive understanding of the borrower's business, accounting practices, and reporting capabilities as part of the credit decision process. From there, the bank can determine the controls necessary to effectively monitor fluctuating collateral bases and the company's borrowing needs, as well as ensure that cash collateral proceeds are collected and appropriately applied to the loan balance.

Monitoring the Borrowing Base

The most common collateral control in an ABL transaction is provided by a borrowing base arrangement. The borrowing base is the collateral base, agreed to by the borrower and lender, that limits the amount of funds the lender will advance to the borrower. The borrowing base specifies the maximum amount that can be borrowed in terms of collateral type, eligibility, and advance rates. The loan agreement establishes how the borrowing base is determined and how frequently it is recalculated.

The bank's biggest challenge when lending against a borrowing base is maintaining current and accurate information. An ABL borrower may be required to submit borrowing base certificates and supporting information (receivable agings, inventory reports, etc.) as frequently as daily, depending on the borrower's risk profile and the nature of the collateral. The certificates and supporting reports often serve as the bank's primary sources of information regarding changes in the borrower's financing needs, cash conversion cycle, and collateral condition. It is important, therefore, that the lender develops a sound understanding of the borrower's business and reporting systems and verifies the integrity of the borrower's reporting systems through regular field audits.