Comptroller's Handbook A-FPL

Safety and Soundness

Capital Adequacy (C) | Asset Quality (A) | Management (M) | Earnings (E) | Liquidity (L) | Sensitivity to Market Risk (S) | Other Activities (O)

Floor Plan Lending

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Introduction

The Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook* booklet, "Floor Plan Lending," is prepared for use by OCC examiners in connection with their examination and supervision of national banks and federal savings associations (collectively, banks). Each bank is different and may present specific issues. Accordingly, examiners should apply the information in this booklet consistent with each bank's individual circumstances. When it is necessary to distinguish between them, national banks and federal savings associations (FSA) are referred to separately.

The booklet is one of several specialized lending booklets that complement and augment information contained in the "Loan Portfolio Management," "Large Bank Supervision," "Community Bank Supervision," and "Federal Branches and Agencies Supervision" booklets of the *Comptroller's Handbook*. The booklet addresses the risks inherent in floor plan lending and discusses prudent risk management guidelines and supervisory expectations. The booklet includes expanded examination procedures to guide examiners in evaluating the impact of floor plan lending activities on a bank's risk profile and financial condition.

Overview

Floor plan lending is a form of inventory financing for a dealer of consumer or commercial goods, in which each loan advance is made against a specific piece of collateral. Items commonly financed through a floor plan facility are automobiles, trucks, recreational vehicles, boats, construction equipment, agricultural equipment, manufactured homes, snowmobiles, large home appliances, furniture, television and audio equipment, or other types of merchandise sold under a sales finance contract. As the dealer sells each piece of collateral, the loan advance against that piece of collateral is repaid. When inventory does not sell as expected, the dealer may be required by the loan agreement to repay the debt with other cash sources.

Dealers are usually highly leveraged because of the need to maintain large amounts of inventory. As the cost of the inventory rises, the dealer's floor plan requirements also rise, increasing the amount of capital needed to operate. This type of inventory financing becomes an important source of capital that a bank can provide to the dealer.

A floor plan borrower typically has stronger asset liquidity than other commercial borrowers due to a tangible collateral base. A dealership operates much like a cash-based business, and the essence of the dealership business model is to turn over inventory for cash proceeds in a relatively short time. A dealer could also try to rapidly sell its installment sales finance contracts, if it has any, for cash in the loan markets. In a normal market, a successful dealer can liquidate its financed inventory relatively quickly, before the inventory loses a significant amount of its original value.

The primary source of repayment for a floor plan loan is the proceeds from the sale of the inventory. Goods are sometimes sold under a finance contract instead of for cash, and the

consumer may or may not be working with other lenders to finance the purchase. The bank may expand its borrower base by also providing financing to the consumer who purchases an inventory item. The dealer sells the goods under a finance contract and the bank provides the financing, resulting in the bank financing both sides of the transaction: the dealer floor plan and the consumer purchase.

Lending Authority and Limits

A national bank may make floor plan loans under 12 USC 24(Seventh) as being incidental to the business of banking. There is no regulatory limit on the aggregate amount of such loans the national bank can make and carry on its book, so long as these loans do not pose unwarranted risk to the bank's financial condition, exceed limits on loans to one borrower, or violate restrictions on transactions with affiliates or insider lending.[1]

An FSA is authorized to make floor plan loans pursuant to either 12 USC 1464(c)(2)(A) or 12 USC 1464(c)(2)(D) and 12 CFR 160.30. Under 12 USC 1464(c)(2)(A), an FSA may make commercial loans, in aggregate, up to 20 percent of its total assets, provided that any loans in excess of 10 percent are small business loans. Under 12 USC 1464(c)(2)(D), an FSA may make an aggregate of up to 35 percent of assets in consumer loans, commercial paper, and corporate debt securities, provided that amounts in excess of 30 percent are direct lending by the FSA and that the FSA does not pay any finder, referral, or other fee to any third party.

Neither national banks nor FSAs are subject to a minimum regulatory requirement on the floor plan collateral or values with respect to the sizes of the loans. Similar to other loans and investments, however, floor plan loans entered into by national banks and FSAs need to comply with legal lending limits and restrictions as follows:

- Limits to one borrower: 12 USC 84 and 12 CFR 32.
- Restrictions on transactions with affiliates: 12 USC 371c, 12 USC 371c-1, and 12 CFR 223 (Regulation W).
- Restrictions on insider lending: 12 USC 375a, 12 USC 375b, and 12 CFR 215 (Regulation O).

In addition, the following laws apply to FSAs only:

- Limits to one borrower: section 5(u) of the Home Owners' Loan Act (HOLA) (12 USC 1464(u)).
- Restrictions on transactions with affiliates: 12 USC 1468(a).
- Restrictions on insider lending: 12 USC 1468(b).

[1] Banks are subject to various banking laws and regulations, including standards for safety and soundness and minimum capital requirements. Banks should have a robust risk management framework, such as appropriate internal policy limits, concentration and portfolio management, effective board oversight and management controls, and other prudent risk management practices. Refer to the "Concentrations of Credit" booklet of the *Comptroller's Handbook* for more information on concentration risk management.

- Documentation and record-keeping requirements: 12 CFR 163.170(c), 12 CFR 163.170(d), and 12 CFR 163.170(e).

Master Agreements

A floor plan loan agreement for new inventory usually involves three parties: the supplier of goods, the dealer, and the bank. The dealer purchases inventory from the supplier through the bank's guarantee of payments to the supplier. This arrangement is facilitated and governed by a complex set of legal documents, such as the bank-dealer master loan agreement, the manufacturer-dealer agreement, and the bank-manufacturer agreement. For pre-owned inventory, manufacturers may be absent from the floor plan lending arrangements.

When a dealer first enters into a financing arrangement with a bank, the dealer executes a master loan agreement, which sets forth the basic conditions of the relationship between the dealer and the bank. This agreement normally grants the bank a continuing security interest in the dealer's inventory, receipts, and accounts receivable. Generally, article 9 of the Uniform Commercial Code (UCC) requires a bank to enter into a security agreement with the dealer and provide public notice of this security interest. Because states must individually adopt the UCC and may choose to vary from it, however, the method of perfecting a security interest may differ from state to state.

A floor plan facility often includes an agreement from the supplier/manufacturer to repurchase unsold inventory within specified time limits. The bank and the manufacturer could execute other agreements on matters such as loss sharing and recourse.

The loan documents often contain provisions for insurance, dealer reserves, and curtailments,[2] among others. As previously mentioned, floor plan advances are typically repaid as the inventory is sold, but a curtailment provision that requires periodic principal reductions by the dealer for stale inventory is normally included in the agreement. Curtailments are usually set forth in the bank-dealer loan agreement or the manufacturer-dealer agreement. The provision establishes the required timing and percentage reduction in principal for each loan when the financed inventory does not sell within a specified period of time.

Traditionally, the evidence of debt for a floor plan lender is the trust receipt.[3] There are generally two methods by which trust receipts are created. One method is for a bank to enter a drafting agreement with a manufacturer similar to a letter of credit. In this situation, the

[2] Refer to appendix D of this booklet for a definition of curtailment.

[3] A trust receipt is a form of security interest used in asset-based lending and trade financing. In inventory financing involving a trust receipt, the bank is the owner of the merchandise and holds the title, while the dealer holds and sells the merchandise in trust for the bank to repay the loan but is obligated to keep the merchandise separate from the other inventory. The bank releases the title to the dealer when the inventory is sold and the loan repaid.

bank agrees to pay documentary sight drafts[4] covering shipments of merchandise to the dealer. The sight drafts often require the manufacturer to provide evidence of the dealer's receipt of the merchandise and the manufacturer's statement of origin (MSO).[5] The drafts are payable when the inventory is received or, if the manufacturer permits, after a grace period that allows the dealer to prepare the inventory for sale. The inventory remains with the dealer until the dealer sells the inventory. Title documents, such as MSOs, are held by the bank. The trust receipts created through sight drafts provide the legal documentation for the inventory held by the dealer and the dealer's indebtedness to the bank.

The drafting agreement usually limits the number of units, the per-unit cost, and the aggregate cost that can be shipped at one time, and includes a cancellation clause or a buy-back agreement. These restrictions help prevent a manufacturer from forcing excessive inventory on a dealer and allow the bank to cancel or suspend shipments of unwanted merchandise. In addition, the drafting agreement frequently is made in conjunction with a manufacturer recourse or repurchase agreement. A manufacturer recourse agreement allows the bank or the dealer the right and option to ship any unsold or unwanted inventory back to the manufacturer to reduce the associated floor plan debt or avoid having to pay the manufacturer. While under a manufacturer repurchase agreement, the manufacturer agrees to take back its merchandise under certain circumstances, such as for inventory remaining unsold after a specified period of time.

The second method of creating a trust receipt is for a dealer to execute trust receipts and present them to a bank for loan advances when merchandise is shipped under an invoice system. The dealer receives the merchandise, accompanied by invoices and titles (or MSOs) where appropriate. The dealer presents the original documents to the bank. The bank then pays the invoice and attaches duplicates of the documents to the trust receipt, which is signed by the borrower. Depending on the type of inventory and dealer, the title may remain with the bank or be released to the borrower.

Not all floor plan lenders use trust receipts, and in recent years some banks have not held the original titles or the MSOs of the inventory and have not been the owners of the inventory under floor plan financing. Instead of relying on trust receipts and titles for security protection, these banks place a blanket UCC priority lien on the dealer's total business assets or a lien on the specific inventory backing the floor plan loan. Depending on each state's security perfection requirements, floor plan lenders may need to send notices to other creditors or establish inter-creditor agreements to perfect their priority interest on the floor plan collateral.

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[4] Sight drafts are used in trade financing and for shipments of inventory to a dealer under floor plan financing. Unlike a time draft, which allows for a short-term delay in payment after the dealer receives the goods, a sight draft is payable immediately when presented to the financing bank for payment.

[5] A manufacturer's statement of origin, also known as the manufacturer's certificate of origin, is a certification of a brand-new vehicle by the manufacturer. The MSO may be required in some states to register or title a new vehicle.

Loan Structure

Terms

Generally, a floor plan facility is structured as a revolving line of credit with a term of one to five years, which can be renewed through an annual review process. The maturity or tenor of a floor plan facility and the individual loan advances can vary depending on the nature of the inventory, the typical inventory level required, historical average turnover rate, and speed of depreciation of the inventory. Some specialized floor plan facilities for high-value products that normally take a longer time to market or have a seasonal selling window could have a longer tenor that may be tied to the terms of the bank-manufacturer and dealer-manufacturer agreements.

Individual advances under a floor plan facility can have fixed terms as well, in conjunction with a curtailment requirement. The terms for such loans are shorter than the facility's maturity and specifically tied to the type of inventory financed. For example, it is common to set a term of 90 days for each manufactured home shipped under a floor plan agreement. The bank can renew the initial term, in conjunction with a curtailment requirement, for successive 90-day periods if the dealer is unable to sell the merchandise within the original term.

Some floor plan lenders do not establish maturity dates on loans but require the dealer to pay progressively higher interest rates if the dealer cannot sell the inventory within certain periods of time. This requirement is established in the loan agreement and has an effect similar to a maturity term. Other floor plan lenders use a discretionary demand line of credit that does not have a specific maturity term but can be terminated by the bank at any time. Depending on the specific clauses and conditions, the bank could demand a full repayment of principal and interest of a demand line of credit at any time from the dealer with or without prior notice.

Not all floor plan loans have a specific maturity date, and some are repaid on a "pay as sold" basis—that is, the loans are due when the dealer has sold the inventory backing the loans. So long as the curtailment structure is in place, the loan advance on the inventory is not without a maturity. For example, a new car floor plan loan that is subject to a monthly curtailment of 10 percent of the original loan balance starting with the 10th month has a maximum maturity of 19 months. Similarly, a used-car floor plan loan with a 10 percent monthly curtailment starting in the fourth month has a maximum maturity of 13 months.

A floor plan facility may also require that all collateral be sold and the floor plan loans be paid off at the end of the maturity term. This requirement is consistent with the common banking principle that asset-based revolving credit lines should be cleared periodically. It is common, however, for a floor plan lender to carry forward existing collateral to serve as collateral for the renewed floor plan facility.

Advance Rates

A floor plan's advance rate can be defined in two ways: according to the size of the line and according to the loan-to-value or loan-to-price ratio.

The total size of a floor plan facility is primarily driven by the dealer's needs, which are a function of the dealer's "rate of travel" and the amount of credit necessary to support a normal inventory requirement for a particular type of inventory. "Rate of travel" measures the dealer's average monthly sales performance in units and is typically set as the sales goal for the dealer under the dealer-manufacturer agreement. The rate of travel combined with the typical number of days' supply needed for the wholesale operation establishes the size of the floor plan. For example, if the typical inventory supply for an auto dealership is 60 days, the dealer's rate of travel is 100 units per month, and the average invoice cost of each unit sold is $20,000, the appropriate size of the floor plan line is $4 million (the result of multiplying two months by 100 units and the average unit cost of $20,000).

There is no legal or regulatory maximum limit on the amount a bank can lend with respect to floor plan collateral value alone. A floor plan lender typically finances 100 percent of the dealer's invoice cost for new merchandise. For used or old merchandise, the lines are usually extended with lower advance rates. For example, the typical advance rate for used cars is 90 percent to 100 percent of the actual cost or the wholesale values suggested by *Kelley Blue Book*, *National Automobile Dealers Association (NADA) Guide*, and *Black Book*, whichever is lower or more appropriate. The industry standard is for the bank to define specific advance rates and the required principal curtailments based on the specific inventory shipped by the manufacturers or otherwise acquired by the dealer so that reasonable loan-to-value ratios are maintained.

Sublimits

A floor plan facility sometimes contains a sublimit to restrict certain product lines, models, years, and used inventory. A sublimit can also be established for letters of credit, through which a manufacturer may draw payments directly from the bank for merchandise shipped to the dealer. The letters of credit have a maturity that is shorter than the bank-dealer and bank-manufacturer agreements and are revocable by the bank without cause under certain conditions, such as a default by the dealer.

Pricing

Floor plan loans usually are priced at a specific margin above a specified index rate. Manufacturers may provide incentives to dealers, such as offering to pay the dealers' interest costs during certain inventory marketing or promotional periods. Interest expense usually is lower during the period under manufacturer support. Pricing also is dependent on the type of collateral financed. Pricing for used inventory normally is higher to compensate for the increased risk.

Floor plan interest usually is payable monthly and is based on the average daily balance of the amount outstanding under the floor plan line. The floor plan liability is shown on the dealer's balance sheet as notes payable, which can be further divided into detailed categories, such as new or used.

Indirect Dealer Loans

Indirect dealer loans are loans dealers extend to consumers or commercial end users to finance their purchases of products. These loans are referred to as "dealer paper," "indirect paper," or "loan paper."

The bank may provide both the floor plan financing and financing to the consumer for the purchase of inventory under a sales finance contract. The consumer may also work with other creditors to finance the purchase. Upon sale of the inventory, the bank either requires cash from the dealer or receives proceeds from the indirect financing to retire the floor plan debt proportionally. In addition, a bank's installment lending or investment department may purchase indirect loans from dealers outside of any floor plan lending agreement.[6]

Dealer Recourse

There are two basic arrangements for receiving indirect loans or sales contracts from dealers: recourse and nonrecourse. With recourse agreements, the bank purchases the contract from the dealer and may exercise recourse by requiring the dealer to repurchase the contract or pay any deficiencies in the event of nonperformance by the consumer. In exercising this provision, the bank passes all of its title rights to the dealer who acquires title to the property. Enforcing this provision protects the bank against all loss if it is applied to every defaulted contract, provided the dealer remains capable of buying back the contracts. On the other hand, with nonrecourse purchases, the bank assumes full responsibility for underwriting the loan and carries all of the risk, even though the dealer handles the loan application, initial contact, and interview.

Recourse arrangements with the dealer vary depending on the loan agreement terms, and often include time limits. Typically, at some point in the delinquency, the bank should notify the dealer and charge back the contract. If the bank does not do so, as stipulated in a recourse agreement, the bank may forfeit its option to require repurchase by the dealer. Dealer paper with recourse may be subject to the special lending limit treatment under 12 CFR 32.3(b)(2) for loans and extensions of credit to one borrower.

Dealer Repurchase

In addition to the recourse agreement, a bank can also use a dealer buy-back or repurchase agreement to protect against undesirable indirect dealer loans. A dealer buy-back or

[6] Refer to the "Installment Lending" booklet of the *Comptroller's Handbook* for more information on purchasing indirect dealer loans by a bank's installment lending department and risk management measures associated with this retail lending product.

repurchase agreement is somewhat less demanding on the dealer compared with a recourse agreement. This agreement typically states that the dealer will actually repossess the defaulted unit for the bank. The dealer then has the option of buying or reselling the unit at a price based on the dealer's market and the condition of the unit. If the price is less than the bank's carrying value of the unit, the deficit is absorbed as a loss by the bank.

Risks Associated With Floor Plan Lending

From a supervisory perspective, risk is the potential that events will have an adverse effect on a bank's current or projected financial condition[7] and resilience.[8] The OCC has defined eight categories of risk for bank supervision purposes: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation. These categories are not mutually exclusive. Any product or service may expose a bank to multiple risks. Risks also may be interdependent and may be positively or negatively correlated. Examiners should be aware of this interdependence and assess the effect in a consistent and inclusive manner. Examiners also should be alert to concentrations that can significantly elevate risk. Concentrations can accumulate within and across products, business lines, geographic areas, countries, and legal entities. Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for an expanded discussion of banking risks and their definitions.

The primary risks associated with floor plan lending are credit, operational, compliance, strategic, and reputation. Price and liquidity risks may also be applicable to the extent the bank syndicates or sells floor plan loans. Refer to the "Loan Portfolio Management" booklet of the *Comptroller's Handbook* for detailed discussions regarding the role of price and liquidity risk in commercial lending.

Credit Risk

The primary risk created by floor plan lending is credit risk. Dealers generally operate with minimal equity capital and narrow operating margins, and in a volatile or seasonal business environment. Collateral margins, if they exist, are usually low, and the collateral depreciates more rapidly the longer it is held for sale. Loans to dealers, therefore, may result in higher default risk and significant credit losses if not properly managed. Floor plan lending can be a profitable and low-risk lending activity if properly monitored and controlled; excessive credit risk arises from poor borrower credit analysis and risk selection, weak underwriting, and poor collateral controls and monitoring.

[7] Financial condition includes impacts from diminished capital and liquidity. Capital in this context includes potential impacts from losses, reduced earnings, and market value of equity.

[8] Resilience recognizes the bank's ability to withstand periods of stress.

Operational Risk

Operational risk is inherent in the internal processes, systems, human resources, management oversight, documentation requirements, legal structure, relationship management, and collateral controls related to floor plan lending. Risk of loss due to operational failure is elevated by the complex legal structure involving multiple parties, the potential failure of a major dealer-customer, inadequate controls for collateral and customer payments, and ineffective monitoring of the dealer's financial condition. If a floor plan lender fails to perfect its security interest or has poor documentation, its ability to act—including collecting the debt, repossessing the collateral, and selling the collateral—could be limited.

A floor plan lender typically is unable to exercise full control over the inventory a dealer has for sale and may find itself in a sold-out-of-trust position. A dealer sells out of trust when the inventory is sold and the funds are not immediately remitted to the bank to retire the corresponding debt. This situation usually occurs when the dealer is experiencing cash flow shortages or critical financial problems. In addition, if the dealer has inadequate accounting and inventory control systems it can expose the bank to heightened risk of fraud.

Compliance Risk

Floor plan lending is subject to the same regulatory and compliance issues as other types of commercial lending. As in all commercial lending activities, bank management and applicable lending staff should be aware of safety, health, and labor laws and regulations applicable to the dealer and the products that could lead to an indirect risk to the bank. The costs associated with noncompliance with laws and regulations could compromise the borrower's financial capabilities and ultimate ability to repay the bank.

If a floor plan lender structures a loan in violation of statutory and regulatory requirements, it may face a greater difficulty in defending its contractual rights during debt collection, repossession, and sale of the collateral. It could also face consequences for noncompliance, such as a civil money penalty and lender liability lawsuits. Because floor plan goods are usually consumer-related and dealers often produce indirect loans, floor plan lenders are also subject to the various consumer protection laws and regulations.[9]

Strategic Risk

A bank should fully integrate any specialized loan product offering with the bank's strategic goals and direction and assess whether such product offering provides an adequate return on investment on a risk-adjusted basis. For any specialized loan product, including floor plan lending, bank management should perform adequate due diligence reviews before engagement and ensure that the bank has a strong risk management system and a highly specialized and knowledgeable staff to recognize, assess, mitigate, and monitor the risks

[9] To obtain guidance on consumer protection laws and regulations, refer to the "Other Consumer Protection Laws and Regulations" booklet of the *Comptroller's Handbook*.

unique to the specialized product. Any floor plan lending transactions conducted without thorough preparations and a continuing investment in the personnel and infrastructure necessary to maintain a sound and profitable operation could run counter to the bank's strategic goals and pose significant strategic risk to the bank. In addition, failure to provide effective oversight of floor plan lending activities by bank management and the board of directors can increase the bank's strategic risk in addition to other correlated risks, such as credit, operational, and reputation.

Reputation Risk

A bank's failure to adhere to its policies and standards, such as failure to advance, fund, or pay a legitimate invoice on a timely basis, as well as actions taken by a bank to protect its interests, such as the termination or modification of a floor plan agreement or repossession and liquidation of the collateral, may tarnish the bank's reputation. Material credit losses or a soured relationship with a major dealer-customer in a particular industry also may have a negative effect on the bank's reputation. Failure to meet the needs of the community, inefficient operational systems, lender liability lawsuits, and consumer-related litigation all may diminish the bank's reputation. The other risks the bank faces could also lead to reputation damage.

Risk Management

Each bank should identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for the size and complexity of its operations. When examiners assess the effectiveness of a bank's risk management system, they consider the bank's policies, processes, personnel, and control systems. Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for an expanded discussion of risk management.

A bank's board of directors should periodically review and approve floor plan lending policies and procedures as appropriate for the bank's floor plan lending activities. The board should assess whether the internal audit and loan review functions perform timely reviews of this area and are independent of floor plan lending approval and credit administration functions. The board should also periodically review appropriate management information system (MIS) reports regarding the institution's floor plan lending activities to better fulfill its oversight role.

Policies

Loan Policy

The core of effective risk management is the establishment of prudent policies and procedures for this type of lending, in accordance with the board of directors and senior

management's risk appetite, strategic goals, business plan objectives, and capital. Such policies should include

- descriptions of the type and qualifications of dealers and products the bank will lend to and lend for.
- limits on the size of the floor plan lending portfolio relative to total assets and capital.
- lending limits for each dealer and each type of product being financed.
- advance rate and loan-to-value limits.
- over lines and guidance line limits, if applicable.
- underwriting requirements, such as borrower and product manufacturer analysis and due diligence, loan structure, pricing, collateral standards and controls, relevant financial metrics to be used, loan covenants standards, and loan approval processes.
- curtailment programs and implementation requirements.
- verification that collateral controls, such as floor plan inspections, exist and operate in a timely fashion.
- collateral inspection scope and frequency, and management's oversight of inspections.
- stress testing and financial projections requirements.
- standards for guarantor or other third-party support.
- dealer and collateral insurance requirements.
- requirements for competent staff, sufficient staffing level, and adequate resources.
- standards for comprehensive and timely MIS reports relating to floor plan lending.

Curtailment Policy

Each floor plan loan agreement should effectively address a bank's curtailment policy standards so that debt reductions match or exceed the market depreciation of the collateral. This is necessary because stale inventory may depreciate precipitously. For example, the collateral may depreciate rapidly if it is used by the dealer as a demonstrator, is no longer a current-year model, or was previously owned or used when included in a dealer's floor plan. Because loan advances are made to 100 percent of the collateral value, as the collateral begins to depreciate, the individual loan amounts should be curtailed. The curtailment structure should be adequate and should consider the demand, quality, and overall market condition of the collateral so that the bank's credit exposure is adequately protected by the underlying collateral.

Banks should also include curtailments at renewals of any floor plan facility, as mandated by the bank's floor plan policies or procedures, in addition to a standard age-driven curtailment schedule. At the first renewal, the dealer should pay all interest to date and a percentage of the principal as curtailment. At subsequent renewals, constant or increasing curtailments and interest should be due. The curtailments at renewals should be programmatic and fully documented in the loan agreement. The purpose of automatic curtailments at renewal is to both limit risk of loss to the bank and to push the dealer into moving slow inventory, by wholesale if necessary, to minimize bank losses.

Lender Protection Policy

Manufacturer and dealer repurchase and recourse provisions are customary in floor plan lending. Such provisions are intended to provide the bank with an additional margin of safety and to ensure the performance of the floor plan loan and the quality of indirect loans made by the dealer. Therefore, floor plan loan policy and procedures should incorporate all these considerations, if applicable.

Indirect Lending Policy

The bank's policy for indirect lending should fully conform to the bank's underwriting requirements, regardless of whether the bank or the dealer underwrites the loans. The bank should implement controls to verify that the dealer is complying with relevant laws and consumer regulations. The bank's approval of a dealer for indirect lending is an expression of willingness to accept those loans that meet the bank's standards, and no obligation to buy the loans should be made or implied. This is particularly important for nonrecourse indirect dealer loans because the bank assumes all of the risk.

Indirect dealer lending policy should also include the provisions for dealer recourse or repurchase to ensure that the dealer bears the consequence for its own poor credit decisions. All past-due loans with recourse should be considered direct debt of the dealer if the dealer is liable for the debt under the recourse agreement. The bank should also investigate any material losses that the bank sustains under a recourse or repurchase agreement and determine whether the bank's interests were protected to the fullest practical extent.

Although recourse agreements and, to a lesser extent, repurchase agreements provide additional protection for the bank buying the dealer paper, it is important to consider that the indiscriminate enforcement of the recourse provision could quickly exhaust a dealer's resources and is, therefore, no substitute for prudent loan underwriting. Unless the dealer performs the underwriting in the same manner as with nonrecourse loans, the bank should consider recourse loans as both loans to the dealer and to the borrower. If too many of the dealer's indirect loans default, the dealer will also go into default. Therefore, the bank should establish a master loan agreement with the dealer. Both the bank and the dealer should adhere to the same underwriting policy and standards and closely monitor policy adherence and performance. Because recourse agreements provide little credit protection for the bank, recourse agreements can be considered primarily as a repossession and sales benefit for the indirect lender.

Processes

Underwriting Standards and Practices

Dealer Background and Analysis

Underwriting standards should establish criteria for the credit history, collateral values, loan terms, and financial condition of the dealer and indirect borrowers, if any. The bank should

perform appropriate due diligence on dealers and obtain credit approval through the bank's loan approval process. The loan approval process should include a thorough analysis of the dealership and its credit application. Review of the application should include

- the dealer's primary business address.
- the locations of all of the sales and storage lots the dealer operates.
- the names of all persons having a proprietary interest in the dealership, with the ownership expressed in terms of percentage of the whole.
- a general description of the types and price ranges of units the dealer sells.
- any advertising literature.
- a list of all manufacturers supplying the dealer.
- the terms of a manufacturer or supplier's buy-back or repurchase agreement and program.
- any other manufacturer-specific conditions or requirements.
- whether or not the dealer is willing to sign recourse or repurchase agreements in favor of the bank.

The background review and analysis of a dealer should include fiscal year-end financial statements for at least the previous two years and interim financial statements, if available. Generally, audited financial statements, including balance sheet and income and cash flow statements, are best practice, but smaller dealerships may only have unaudited statements. If the loan is supported by guarantees, appropriate financial statements should be obtained and analyzed on each guarantor.

Understanding the inventory valuation method is important in balance sheet analysis, as most dealerships use the last in, first out (LIFO) accounting method for valuing inventory in order to minimize taxable income. It is also important to understand that dealership balance sheets may reflect substantial intangible assets that generally represent franchise rights.

Lending officers should also review any written audit or inspection reports of a borrower to assess the adequacy of sales, inventory, and the accounting system, and evaluate the severity of historical out-of-trust incidents, if any. In addition, written credit reports on the dealer and the principals from recognized credit reporting and business rating agencies should be reviewed if they are available. The purpose of reviewing these items is to ensure that a bank limits its relationships to dealers who show sufficient financial strength to maintain a viable dealer operation, as well as sound business ethics and integrity.

Manufacturer Due Diligence

To the extent that manufacturer repurchase or recourse agreements exist, and particularly if the manufacturer pays the floor plan interest for the dealer during a manufacturer support period, repayment capacity analysis of the borrower should include a review of the manufacturer's financials. The manufacturer's agreement, complete financial analysis, and subsequent reviews should be part of the documentation requirement and be included in the bank's individual loan files. This is particularly important because some manufacturers may be no more creditworthy than individual dealers.

Term Setting

The terms for the floor plan facility and for each loan advance under the facility should not be excessive, and maturities should be based on the type of inventory financed. The condition of the inventory and the speed with which it depreciates should be given the utmost consideration. A thorough on-site inspection by qualified individuals is the best way to determine the condition of the collateral. Well-prepared inspection reports are excellent aids to the bank in determining appropriate loan terms.

Understanding the historical sales, inventory days outstanding, and ordinary industry inventory levels can help determine whether the loan term and the curtailment structure are appropriate. For example, if a dealer has an average inventory turnover rate of four times per year in a normal operating environment, a 90-day loan advance term might be appropriate. In the event a dealer is unable to sell the merchandise within the original term, the loan could be renewed for a successive 90-day period, up to a maximum of two renewals.

Inventory refinancing should be limited, because a dealer's inability to reduce inventory indicates a marketing problem that could lead to stale, unsalable inventory. Setting a stringent limit on the term is particularly important when the loan agreement does not contain a curtailment requirement or when there is doubt that the dealer can perform the curtailment requirement.

Advance Rate and Loan-to-Value Ratio

Banks should refrain from over-advances that result in oversupply of dealer inventory. Dealers generally try to maintain an inventory figure based on their historical sales, average inventory days outstanding, and consistency with the normal industry inventory supply. Banks should also refrain from extending credit in excess of the wholesale value of the inventory. As a general rule, the loan-to-value ratio for new merchandise shipped by a manufacturer should be capped at 100 percent. For used or old merchandise, there should be a conservative estimate of the value, and sometimes a discount or haircut on the value is appropriate. Lower advance rates are usually appropriate for used merchandise. For example, although a typical used-car floor plan facility may advance 90 to 100 percent of the lower of the auction price or the wholesale values provided by the *Kelley Blue Book*, *NADA Guide*, or *Black Book*, it may be more prudent to limit the advance rate to 80 percent or lower under certain circumstances, such as for slow-selling models, during an offseason, or under other poor market conditions.

Covenants

Affirmative and negative covenants, such as those relating to timely financial reporting and collateral protection, should generally be included in the dealer agreement. Depending on the size of the dealership, the nature of the inventory, the existence of other working capital or term credit facilities, and the manufacturer's agreement, it may be prudent to include appropriate financial covenants in the loan agreement, such as a minimum debt service ratio,

minimum cash burn days,[10] and a minimum tangible net worth. Dealers, however, tend to have low book equity and their cash flow tends to be volatile due to seasonality of sales.

Security Perfection

A bank should perfect its security interest in the collateral, or hold clear titles to the collateral, to secure repayment for the amounts advanced from floor plan lending. Security perfection is important because it enables the bank to repossess and liquidate the collateral to satisfy the loan obligation if the dealer defaults.

Credit Administration

Disbursement

Loan disbursements should be supported by the original copy of the manufacturer's invoice retained in the bank's file. To ensure that the manufacturer is paid for the merchandise, loan proceeds should always be made payable—either directly to the manufacturer or to the manufacturer and the dealer jointly—by draft payable on sight of the MSO, if possible. In the case of used inventory, loan proceeds should be made payable to the sources, such as the auction houses or the selling dealers, or to the sources and the dealer jointly.

Documentation

Floor plan lending documentation is similar to the documentation for any secured financing. The bank should retain in-house or outside legal counsel familiar with floor plan lending and the laws of secured transactions to review floor plan facility documentation. For every floor plan loan the bank makes, the bank should retain the following documents in the bank's loan file:

- Floor plan master loan agreement that details the loan structure, such as the obligation, payment amounts, and term.
- Security agreement enforceable in the jurisdiction where the collateral is located, whereby the bank can acquire title and repossess the collateral property in the event of default.
- Evidence that security interest has been perfected under applicable law.
- Original credit application.
- Credit report submitted by a credit reporting or business rating agency, if applicable.
- Original copy of the manufacturer's invoice.
- For indirect dealer loans, an assignment from the dealer, passing rights under the financing arrangement to the bank.
- Copy of the sales contract.

[10] Refer to appendix D of this booklet for a description of a typical cash burn measure used in dealership business.

In addition, the bank should maintain a continuous register of loans originated through the dealer in order to have readily available knowledge of its status with that dealer. The register should contain the following information:

- Loan number.
- Amount of loan.
- Date of loan, or date of purchase.
- Borrower's name.
- Dealer's name.
- Recourse provision included in assignment.
- Repurchase provision included in assignment.
- Interest rate.
- Term of loan.
- Date loan is repaid.

Regardless of whether the information pertains to a loan to the dealer or an indirect loan made by the dealer, the bank should have control of and possess the entire documentation in the bank's files. Not only can the bank readily monitor the documents, but, in certain situations, possessing the actual loan paper and supporting documents can provide a distinct advantage when the bank tries to perfect or repossess collateral or take control of cash flow from the underlying borrowers. In addition, all the legal and transactional documents related to the floor plan activities should be inspected physically during the floor plan inspection to prevent inadvertent or fraudulent dual financing on the same collateral.

Ongoing Financial Analysis and Monitoring

Dealers typically have low equity capital, so the bank should review the dealer's financial statements frequently and thoroughly. The borrower should provide quarterly balance sheets and profit and loss statements and, in some cases, monthly statements, depending on the quality of the borrower and the exposure size. These statements should be promptly reviewed as part of ongoing credit monitoring and analysis and can be useful in providing early warning signals should a dealer encounter financial difficulty.

Dealers have financial reporting responsibilities to both the manufacturers granting the franchise and the bank providing the floor plan financing. Manufacturers typically require highly detailed monthly financial statements from the dealers, such as balance sheets and profit and loss statements, as well as interim and year-to-date statements. Financial information may be further broken down by product lines or other characteristics of the dealer. Annual financial statements in various degrees of detail and coverage may also be required, depending on the size and complexity of the dealership and the nature of the floor plan arrangement. Therefore, the bank could leverage the manufacturer reporting requirement and make use of the detailed financial reports in its analysis. The bank should, however, validate the financial information and analysis and exercise its own judgment.

The most important source of information about the dealer's financial condition is the final year-end audited financial statements. These statements generally contain a set of

adjustments, such as write-downs on stale inventory, changes to depreciation expenses, and accounting basis adjustments. Because these adjustments could affect profitability and capital adequacy, banks should focus on these annual statements when evaluating the dealer's financial condition.

Other considerations in the ongoing financial analysis of the borrower include the following:

- Review of the dealer's financial condition should be based on the financial data for each individual borrower, as well as the consolidated corporate family when there are multiple, related legal entities or ownership interests, or if there is a parent-subsidiary relationship.
- Analysis of the additional sources of repayment should include the financial statements or tax returns on each principal of the dealership and its guarantors, if any, and a review of their tax situations. This information helps the bank determine additional sources of repayment besides business cash flow and assets, the value of personal guarantees, and the ability and willingness of the owners and guarantors to make up for any shortfalls in the dealer's debt repayments.
- Analysis of the dealer's profitability should include its sales, cost of goods sold, the number of units sold, and the specific units sold. Dealers usually use the LIFO method for inventory valuation to achieve a lower taxable income, so banks should first identify the inventory valuation method to better understand a dealer's inventory level and profitability. If the dealer values inventory using LIFO, the amount of the LIFO reserve should be added to the inventory level.
- Review of a dealer's profitability should also account for factory receivables. Dealer profitability is in part reflected in factory receivables in the form of holdbacks and warranty claims. Holdbacks are the amounts due from the manufacturers. For an automobile manufacturer, a holdback is added to the invoice price of the unit and is usually 2 percent to 3 percent of the new vehicle cost. Holdbacks are usually paid to the dealer quarterly. Warranty claims for covered parts and services need to be processed and submitted by the dealer in a timely fashion. Such claims are paid on a cycle determined by the manufacturer.
- A comparison should be made between the number of units sold and the number financed to assess whether inventory levels are excessive. A typical dealer of any product must maintain a reasonable inventory. The inventory is generally the dealer's principal asset, and its acquisition normally creates the dealer's major liability. The dealer's financial statement should show an inventory figure at least equal to the related floor plan liability as of the date of the financial statement. Unless the difference is represented by sales, factory receivables, or contracts-in-transit, a floor plan outstanding liability that is greater than the amount of inventory is an indication that the dealer may have sold out of trust. A dealer that has sold portions of its merchandise out of trust by diverting the funds received leaves the bank with a partially unsecured floor plan line.
- Monitoring of customer activity, which is consistent with a well-managed and well-controlled floor plan arrangement, may include the dealer's deposit account. A review of the flow of funds into and out of the account may reveal that inventory has been sold without debt reduction, that the dealer is incurring abnormal expenses, or that unreported diversification, expansion, or other financial activity has occurred that might warrant a

reconsideration of the credit arrangement. Token or overdrawn balances should trigger increased collateral inspections.

Banks should regularly monitor the dealer's financial performance and liquidity condition. Delinquent notes (either unpaid interest or unpaid curtailments), out-of-trust sales, maturities extended beyond reasonable expectation, and low cash coverage of future cash expenditures relative to the industry norm are warning signs. These signs indicate that the dealer is having cash-flow difficulties and should alert the bank to conduct collateral verifications and inspections more frequently. Slow-moving inventory, other than farm equipment or other seasonal merchandise, could be a sign of fraud or poor management on the dealer's part. Monitoring for most dealers should occur monthly, normally using financials the dealers prepared for the manufacturers.

Banks should also monitor floor plan balances for any over-advances and take quick action to resolve the situation. Any portion of the loan balance (principal and earned interest) that exceeds the wholesale value of the collateral is reliant entirely on the dealer's ability to repay and is unsecured on the part of the bank.

Inventory Inspection

As with all inventory financing, collateral value and collateral controls are of prime importance. Floor plan lending is ideally structured so that the debt is repaid from the sale of the collateral before the collateral depreciates to a liquidation value that is below the loan amount. This requires the bank to determine the collateral value at the time the loan is placed on the books, continuously inspect the collateral to determine its condition and value, and schedule curtailments that are sufficient to keep collateral values in line with loan balances. Therefore, floor plan lenders should regularly inspect and verify the inventory, take control of title documents, and, if necessary, take physical control of the inventory or use bonded warehouses to control the collateral.

The scope of inspections should be broad enough to detect irregular activities. The bank should ensure that the frequency and scope of collateral verifications are adequate and comprehensive. Floor plan checks should be completed by bank staff or an approved external vendor at least quarterly, but more frequently depending on the repayment terms as well as the dealer's reputation and financial condition. For example, floor plan loans on a "pay as sold" basis should generally be inspected more frequently, such as on a monthly schedule, while floor plan loans on a "scheduled pay" repayment term, especially those that are fully amortizing, may require only a quarterly inspection schedule. For purpose of quality assurance, it may be necessary to rotate the bank inspectors and inspection duties regularly among the department's staff or outside servicers.

As necessary and appropriate, floor plan inspections should include both pre-announced and unannounced visits. Because dealers may send inventory off the lot or out of the warehouse for demonstration purposes or possibly for minor maintenance issues, inspection checks made on a pre-announced basis allow the dealer to prepare the inventory so that the bank can verify all the collateral under the floor plan facility and compare the stock against records

obtained from unannounced inspections. For inventory that is out on a test drive or demonstration, at a body or detail shop for repair or maintenance, or not at the dealer's lot or warehouse for any other reason, the bank may request that the dealer produce the goods within a reasonable time, e.g., two days. The bank's floor plan inspector may also visit the body or detail shop or any other locations where the inventory is located to verify the existence of the goods.

Checks should include the inspection of identifying documents, verification of serial numbers, and comparison with any inventory lists to determine the inventory's existence and condition and to confirm that the inventory is available for sale. For used automobile inventory and demonstrators/loaners, vehicle mileage should be checked to confirm that depreciation is not occurring at a rate faster than expected. Any missing articles or other exceptions revealed by the floor plan check, as well as the dealer's explanation thereof, should be verified as proper and be followed up at subsequent floor plan checks. Banks should also verify that missing inventory reportedly sold and unpaid is related to contracts in process, and such contract-processing time should be reasonable. Inventory covered by the floor plan that is sold but not in process of payment represents a breach of trust by the dealer, and the amounts owed represent a portion of unsecured credit.

The bank should confirm that the inventory financed is not sold out of trust, i.e., sold without repaying the bank's wholesale loan. If any inventory has been sold out of trust, the bank should take steps to ensure that the loan associated with that inventory is repaid immediately and should investigate whether fraud was potentially involved. If fraud is detected, the bank should undertake effective measures to prevent or limit loss and inform the appropriate authorities.

Sometimes banks permit dealers to delay repayment of floor plan loans for a few days after sales. For example, dealers selling in large volume are usually granted a three-day leeway before proceeds from inventory sold must be received by the bank. This permissible time lag allows the dealer to conduct the amount of necessary bookkeeping at the dealer's place of business. If, however, inventory is missing at the time of floor plan inspection and the dealer then remits, it is a sign that the dealer may be taking advantage of a float, i.e., using proceeds of inventory possibly sold weeks before the inspection rather than remitting promptly as required.

Dealer inventory records should be retained in the dealer file along with the application for approval and the dealer's financial statements. Floor plan check sheets should also be on file in the bank, indicating that a bank representative has personally verified every piece of inventory, by serial number and description, shown by bank records as unsold and in the dealer's possession.

If inventory inspection reveals that a dealer is deliberately withholding funds received from the sale of pledged inventory collateral beyond the normal allowable period, the bank should immediately discuss the situation with the dealer management and determine the appropriate legal course of action to prevent or minimize loss exposure.

Relationship Management

Dealer lending relationships require analysis similar to that for any other commercial loan, but the legal agreements and controls required for floor plan lending are particularly complex. Bank lending staff should be aware that some dealers finance inventory with two or more lenders simultaneously, even though the ideal arrangement for a bank is to have an exclusive floor plan lending agreement with a dealer. Even when inventory financing is limited to one lender, the bank should not expect to receive all cash proceeds or all indirect consumer installment loans on every unit the dealer sells, because some inventory might be unfinanced or financed with other types of loans from other creditors. Sometimes the dealer can quickly sell inventory for cash without relying on floor plan financing, and sometimes consumers arrange their own financing. Other times consumers do not meet the bank's underwriting standards for indirect dealer financing.

Banks should segregate accounting and reporting for indirect loan accounts by dealer. Such segregation allows a bank to determine each dealer's reliability from the quality of loan paper the bank receives and to determine the profitability of the dealer's indirect account. If the bank does not receive an adequate portion of loans the dealer generates, or if the loans are of inferior quality, the relationship is likely of questionable value to the bank. Small indirect dealer loans related to consumer products should be treated like other consumer loans for underwriting, monitoring, collection, and control practices, and for ascertaining whether the dealer complies with consumer laws and regulations.

Dealer Reserve for Indirect Lending

One common practice that has caused earnings volatility and even lower profitability for banks is to pay the dealer fees or provide the dealer with discounts without setting up a dealer reserve. The practice has caused banks to miscalculate their yields on the dealer paper, which could end up lower than anticipated. A dealer reserve account can mitigate these problems. A dealer reserve account is a deposit account credited with discounts the dealer earns on the sale of indirect loans to the bank. The account is used to charge back nonperforming loans to the dealer and is controlled by the bank.

For example, it is a common practice in manufactured-home lending for the dealer to participate in a dealer reserve arrangement with the bank. Both dealers and banks consider this as a legitimate source of income to the dealer. In such an arrangement, the dealer writes a loan to yield, e.g., 8 percent, then discounts the loan to the bank to yield, e.g., 4 percent, with the discount credited to the dealer reserve account. Normally, the discount is set aside in this reserve at the time a loan is made or purchased. The typical reserve agreement states that the purpose of the reserve is to absorb credit losses and unearned interest income due to prepayment from the individual borrowers, and the amounts not used in this manner are to be paid to the dealer periodically on a percentage basis.

Dealer reserves should be rigidly controlled for contract compliance. They generally should not be used to bring past-due accounts current, but should be used to pay off past-due accounts in full.

Personnel

Capable management and appropriate staffing are essential to effective risk management. Recruiting and retaining competent floor plan lending executives, line managers, risk management personnel, and back-office staff is crucial. The skills and expertise of floor plan management and staff should be commensurate with the complexity of the bank's floor plan products and services. The skills and compensation required for larger banks are generally greater and more varied than those required in less complex banks. Mergers and consolidations may also present complicated personnel challenges. Merger plans should set forth strategies for retaining the staff members critical for effective risk management.

Floor plan lending personnel should be thoroughly familiar with the documentation for floor plan financing and its operations regardless of how a transaction is structured. The bank should retain in-house or outside legal counsel that is familiar with floor plan lending and laws governing secured transactions. The bank's counsel should thoroughly review the documentation for all of the bank's floor plan facilities. Floor plan lending staff should also understand all of the statutory and regulatory requirements for floor plan activities, consumer protection issues, the bank's risk appetite, and the risks associated with floor plan lending.

Control Systems

Internal Loan Review

Similar to any lending products, floor plan loans should be subject to credit reviews and other control processes. A bank's independent loan review and compliance functions should include regular reviews of floor plan lending. The credit review staff performing the review of floor plan loans should make sure that the floor plan lending personnel have performed all procedures concerning the existence and value of the related collateral. The bank's policies and procedures should be clearly defined, with compliance noted. Effective controls over the borrower should be verified. Collateral values should be supported by source documents or bank appraisals. Internal loan review personnel should discuss any deficiencies within the floor plan lending department with management and the board of directors.

Periodic independent reviews should also verify the accuracy of ratings and the operational effectiveness of the bank's risk-rating processes. Objective reviews of credit risk levels and risk-management processes are essential to effective portfolio management.

Loan review is a key internal control and an element of the safety and soundness standards described in the "Interagency Guidelines Establishing Standards for Safety and Soundness" found in appendix A of 12 CFR 30. The "Loan Portfolio Management" booklet of the *Comptroller's Handbook* and attachment 1 of the "Interagency Policy Statement on the Allowance for Loan and Lease Losses," conveyed in OCC Bulletin 2006-47, "Allowance for Loan and Lease Losses (ALLL): Guidance and Frequently Asked Questions (FAQs) on the ALLL," provide more information for evaluating a bank's loan review function.

Audit Functions

Floor plan lending activities should be included in a bank's audit program as part of the bank's internal control and risk management system. For example, a bank's auditor may accompany the bank's floor plan inspector during inspection as an additional quality control measure and to deter bank staff collusion with the dealer. Inventory subject to each floor plan loan should be verified by the audit department during the regularly conducted audits.

External audit services may be contracted by the dealer or the bank to provide independent assessments of the dealer's business processes and controls. Inventory audit servicers can be used to assist inspections, but these third-party services should not be relied on without proper oversight by bank management.

Management Information Systems

Floor plan lending activities should have accurate and complete MIS and reporting frameworks to help identify, measure, monitor, and control risk. MIS should enable management to monitor inventory shipments, drafting, payment status, inventory levels, inventory conditions, turnover rates, collections, manufacturer and dealer repurchases or recourse, loan curtailments, and concentrations of credit within the floor plan lending portfolio. Other periodic portfolio management reports would typically include, but not be limited to, a summary risk rating profile of the dealers financed, composition of new versus used inventory, over-line accounts, past-due floor plan inspections, and the level of exceptions to policy or underwriting guidelines.

Risk Rating Floor Plan Loans

Rating Factors

Risk rating considerations should focus on the strength of the primary and secondary sources of repayment. A floor plan loan's primary source of repayment is cash received from the sale of the assigned collateral, with the secondary source of repayment being cash flow from operations of the dealership. The following factors are important to consider when assessing the internal risk rating and the appropriate regulatory risk rating of a floor plan loan:

- Quality and liquidity of inventory as demonstrated through the dealer's sales, inventory turnover, and payment history.
- Strength of the credit's structure and controls.
- Borrower's financial condition and performance, including liquidity, capital, and operating trends.
- Strength and reliability of the company's cash flow from operations.
- Actual operating performance versus planned operating performance.
- Quality and performance of the indirect loans generated by the dealer under the floor plan facility, if applicable.

A dealership's operating cash flow should be sufficient to service the interest on the floor plan facility, consistent with the expectation for a short-term working capital line of credit. It should also be able to meet the principal curtailment requirements and pay any residual amounts under the floor plan facility, in case the dealer liquidates the inventory below the original loan amount.

A dealership's operating cash flow becomes more important when the floor plan lender does not exclusively finance the dealer's inventory or when the dealer has a broad range of income sources not directly related to the inventory under the floor plan facility. Operating cash flow is also important because a floor plan facility typically finances up to 100 percent of the cost of collateral and does not have the excess collateral protection typically seen with an asset-based loan (ABL) with a strong borrowing base limit.

A dealership's other liquidity sources, guarantors, and manufacturer support programs, if any, could be a tertiary source of repayment or a mitigating factor in assessing the credit rating of a less-than-ideally structured floor plan facility. A bank that relies on sponsor or manufacturer supports as a tertiary source of repayment should establish guidelines for evaluating the qualifications of the sponsor and the manufacturer and should implement a process to monitor their financial conditions regularly. A bank may consider sponsor and manufacturer supports in assigning a risk rating when the bank can document the history of demonstrated supports and their economic incentives, capacities, and stated intent to continue to support the transaction.

Regulatory Risk Ratings

Examiners should apply the uniform classification definitions found in the "Rating Credit Risk" booklet of the *Comptroller's Handbook* when assessing and rating floor plan loans. To determine the appropriate risk rating, examiners should consider all available information relevant to the borrower's ability to repay the loan in full.

Pass

A credit is considered pass if it does not fall under the special mention, substandard, doubtful, or loss categories as defined in the "Rating Credit Risk" booklet. The following floor plan loan characteristics generally indicate a pass rating:

- Credit is self-liquidating through timely cash sales of the inventory, without relying on the bank's purchase of dealer paper to reduce the floor plan liability.
- Liquidity is adequate, well managed, and not expected to be adversely affected by extraordinary capital needs.
- Controls around the credit facility are satisfactory and the dealer has no significant out-of-trust sales.
- Dealership is adequately capitalized and historically profitable.
- Operating performance is sound and consistent with financial projections.
- Credit is stand-alone, with a perfected first priority claim on the collateral not subordinated to other credit facilities.

- Credit contains a manufacturer recourse or repurchase agreement, and the manufacturer has consistently performed on its obligation.
- There is a loss-sharing agreement from the manufacturer, and there is no history of the manufacturer breaching the agreement.

Special Mention

A floor plan credit rated "special mention" is one that has potential credit weaknesses, such as a loan with weak controls or structure, that may, if not checked or corrected, weaken the asset or inadequately protect the bank's position at some future date. Such loans pose elevated risk, but their weakness does not yet justify a substandard classification. For example, a floor plan credit that has liberal terms can be rated special mention because the deficiencies in the structure could potentially lead to nonpayment by the borrower and inadequate protection for the bank. Similarly, a floor plan credit that does not have a curtailment requirement or is missing key support mechanisms or other important risk mitigation features may be rated special mention if the weaknesses are not adequately mitigated. Other potential weaknesses include deficient supervision of the facility by the loan officer, lack of appropriate collateral inspections, stale or missing financial statements, and inadequate file documentation, among others. Deteriorating trends in revenue, profit margins, and operating cash flow are also relevant factors to consider for a special mention rating.

Classified

Floor plan loans with well-defined credit weaknesses should be classified substandard, doubtful, or loss. A substandard floor plan loan is one that is inadequately protected by the current sound worth and paying capacity of the dealer or the inventory pledged. There is a distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. A doubtful credit has all the weaknesses associated with a substandard credit, with the added characteristic that the collection of the principal and interest in full is highly questionable and improbable. A loan is classified loss if it is considered uncollectible and of insignificant value to warrant its continuance as a bankable asset. The underlying dealership so classified is often in bankruptcy or in default for a sustained period.

A credit can be classified if it has well-defined weaknesses, such as an unsatisfactory cash flow profile, inadequate debt service capacity, and a worsening trend that is not mitigated. In addition, a floor plan loan with multiple structural deficiencies or serious control issues can be classified. For example, a classified rating is appropriate if the loan has not been fully repaid while the associated inventory is missing or if the dealer frequently and persistently sells inventory out of trust. Further, if liquidation of collateral (e.g., a forced sale by the bank or the dealership) is a floor plan loan's most likely source of repayment, the loan would likely be classified.

A credit may be classified if it is experiencing faster-than-expected depreciation of the pledged collateral, resulting in collateral shortfalls that are not adequately and timely remedied. Other collateral quality issues, such as stale inventory and inventory concentrations (particularly when not properly analyzed by the bank), lengthening of the

operating cycle and seasonality, recurring and unexpected inventory write-downs, and unaddressed adverse field examination results can also be indications for an adverse risk rating. Trends in the dealership's operating cycle and overall financial performance can signify credit or collateral quality deterioration that could also lead to an adverse risk rating.

For more information, refer to appendix A, which provides case studies of pass, special mention, and classified ratings and the typical rating considerations for each rating decision.

Examination Procedures

This booklet contains expanded procedures for examining specialized activities or specific products or services that warrant extra attention beyond the core assessment contained in the "Community Bank Supervision," "Large Bank Supervision," and "Federal Branches and Agencies Supervision" booklets of the *Comptroller's Handbook*. Examiners determine which expanded procedures to use, if any, during examination planning or after drawing preliminary conclusions during the core assessment.

Scope

These procedures are designed to help examiners tailor the examination to each bank and determine the scope of the floor plan lending examination. Examiners making this determination should consider work performed by internal and external auditors and other independent risk control functions and by other examiners on related areas. Examiners need to perform only those objectives and steps that are relevant to the scope of the examination as determined by the following objective. Seldom will every objective or step of the expanded procedures be necessary.

Objective: To determine the scope of the examination of floor plan lending and identify examination objectives and activities necessary to meet the needs of the supervisory strategy for the bank.

1. Review the following sources of information, and note any previously identified problems related to floor plan lending that require follow-up:

    - Supervisory strategy
    - Examiner-in-Charge's (EIC) scope memorandum
    - OCC's information system
    - Previous reports of examination (ROE) and work papers
    - Internal loan review reports
    - Internal and external audit reports[11] and previous audit work papers
    - Bank management's responses to previous ROEs and audit reports
    - Floor plan inspection reports and the responses from borrowers and the bank
    - Customer complaints and litigation

[11] If an examiner was assigned to review internal and external audits, a copy of any significant deficiencies for this area should be obtained from that examiner. If the internal and external audit was not part of the overall scope of examination, review the work performed by the internal and external auditors in this area and obtain a list of any deficiencies noted in their most recent review.

2. Obtain from the examiner assigned to loan portfolio management (LPM) the following schedules, if applicable to this area:

    - Past-due loans.
    - Exception reports.
    - Loans purchased since the preceding examination.
    - Loans sold in full since the preceding examination.
    - Loan commitments and other contingent liabilities.
    - Extensions of credit to major shareholders, officers, directors, or their related interests.
    - Extensions of credit to officers and directors of other banks.
    - Miscellaneous loan debit and credit suspense accounts.
    - Loans considered "problem loans" by management, including those identified and added by management since the last examination.
    - Loans classified during the preceding examination.
    - Information on directors, executive officers, principal shareholders, and their related interests.
    - Current interest rate structure and pricing.
    - Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee.
    - Reports furnished to the loan and discount committee or any similar committee.
    - Reports furnished to the board of directors.
    - Listing of rebooked charged-off loans, if any.

3. During early discussions with management, determine

    - how management supervises floor plan lending.
    - any significant changes in policies, practices, personnel, and control systems.
    - any internal or external factors that could affect floor plan lending.
    - management's perception of the credit culture for floor plan lending.

4. Analyze the risk and reward of the bank's floor plan lending business and its direction, considering

    - portfolio growth and acquisitions.
    - new products and services for floor plan lending.
    - management changes.
    - policy and underwriting changes.
    - changes in risk limits.
    - significant changes from the last examination in third-party relationships, products, services, delivery channels, volumes, markets, and geographies.
    - changes in external factors, such as
        - national, regional, and local economy.
        - competition.

5. Determine whether the bank's policies and procedures are adequate and consistently followed by interviewing management and reviewing

    - internal and external audit reports and management letters regarding dealer-related credits.
    - minutes (or a recap provided by the examiner reviewing the minutes) applicable to this area.
    - policy statements, underwriting guidelines, and manuals.
    - policy and underwriting exception reports.
    - any prior examination findings regarding the bank's policies and procedures and policy adherence.

6. Review the qualifications, capabilities, and expertise of loan officers in relation to their responsibilities.

7. Based on an analysis of information obtained in the previous steps, as well as input from the EIC, determine the scope and objectives of the floor plan lending examination.

Quantity of Risk

Conclusion: The quantity of each associated risk is (low, moderate, or high).

Credit Risk

Objective: To determine the quantity of credit risk associated with floor plan lending.[12]

1. Analyze the quantity of credit risk. Consider factors such as the products, markets, geographies, technologies, volumes, exposures, quality metrics, concentrations, and third-party relationships.

2. Assess the effect of external factors, including economic, industry, competitive, and market conditions, on floor plan lending's quantity of credit risk.

3. Assess the effect of potential legislative, regulatory, accounting, and technological changes on floor plan lending's quantity of credit risk.

4. Review the information received from management and the LPM examiner and evaluate the adequacy of the collateral, credit quality, and collectability of the floor plan portfolio to assess its quantity of credit risk.

5. Using an appropriate sampling technique, select loans that require in-depth review based on information derived from the review above. Include participations purchased or sold, loans recently classified, commitments and other contingent liabilities, and rebooked loans, if pertinent. If not already prepopulated in the credit line sheets, record on the line sheets the following information for each borrower selected:[13]

   - Total outstanding loan balance.
   - Total floor plan commitment.
   - List of inventory subject to the floor plan loan, including date, description of property, amount advanced, and curtailment, if any.[14]
   - Status of any outstanding interest or curtailment billings.

[12] Appendix B provides a detailed matrix for assessing the quantity of credit risk.

[13] The OCC's National Credit Tool can be used for this purpose.

[14] Similar items and model year should be shown in aggregate and entry dates shown as a range, except on stale or not properly curtailed items.

6. Obtain the following information from the bank's loan files, and summarize on the line sheets:

    - Agreements between the bank and the dealer, e.g., master loan, repurchase, and recourse agreements.
    - Agreements between the manufacturer and the bank, e.g., drafting and buy-back agreements.
    - Evidence that the security interest has been perfected.
    - Details of any guarantees that may be held.
    - Details of any other collateral.

7. Determine whether loan documentation is adequate, considering whether each loan has

    - a credit memorandum setting forth required documentation for original loan approval.
    - documents that are correctly executed.
    - liens filed in the appropriate jurisdiction.
    - title documents that match trust receipts.
    - supplier/manufacturer buy-back agreements.
    - curtailment agreements in compliance with the loan policy.

8. Document the following loan underwriting information on the line sheets:

    - Current and reliable financial data, financial analysis metrics, and credit history.
    - Current dealer business reports and industry outlook from external sources.
    - Current memoranda detailing visits to dealership and trends in dealer's operations.
    - Loan structure, such as term, advance rate, sublimit, pricing, curtailment, inspection, and dealer supports.
    - Underwriting and loan performance assessments of the dealer's indirect loans, if applicable.

9. Analyze the credit information for each borrower in the sample, including credit quality, adequacy of loan and collateral documentation, collateral value, and borrower financial condition.

10. Review compliance with the terms of the loan agreement and with the floor plan lending policy. Note exceptions on the line sheet and list the date of the loan, name of the credit, and the dollar amount outstanding.

11. Determine whether each loan has

    - any violations of the curtailment agreements.
    - verification of collateral values.

12. Analyze the borrower's current financial performance by evaluating the following factors from the borrower's most recent income statements:

    - Level and trend of earnings, with appropriate consideration for any seasonality.
    - Quality and volatility of earnings.
    - Revenue trends, with prior year same period comparison.
    - Gross profit margin, net profitability, operating expense, and operating margin.
    - Service absorption[15] and interest expense support from the manufacturer, if applicable.
    - Finance and insurance income, service income, and impact of any unusual or extraordinary items.

13. Analyze the borrower's current financial condition by evaluating the following considerations from the borrower's most recent balance sheets:

    - Liquidity of the balance sheet, including the level of working capital, current ratio, and cash burn.
    - Trend in the level and composition of assets, including period over period and prior year same period comparisons.
    - Trend in the level and nature of liabilities, structures, and the maturity and repayment requirements of liabilities other than the floor plan note.
    - Inventory turnover and comparison with the industry norms.
    - Adequacy of and trend in total net worth, the level of capital fund ratio,[16] and the potential for external support.
    - Reconciliation of net worth and tangible net worth, including detail for any significant unreconciled differences.

14. Analyze the borrower's current liquidity condition by evaluating the following considerations from the borrower's most current cash flow statements:

    - Adequacy of cash sources to meet cash needs in the near and intermediate term.
    - Trends or significant changes in cash flow, incorporating any seasonality factors.
    - Amount of cash used or generated by discretionary or nonrecurring capital expenditure.
    - Cash available from sources outside the borrowing entity.
    - Debt service coverage ratio, including coverage for any curtailment requirements.
    - Effects of a stressed interest rate scenario to determine the borrower's ability to meet debt service requirements in a higher interest rate environment.

[15] Refer to appendix D for a definition of service absorption.

[16] Refer to appendix D for a definition of capital fund ratio.

15. For each loan, review the two most recent floor plan inspection reports and determine whether

    - any items were sold out of trust and the resolution timelines.
    - where trust receipts are used, all title documents were physically inspected during floor plan inspection.
    - appropriate follow-up was made on all missing items.
    - reports are sufficiently current and whether their scope is adequate and consistent with bank policy.

16. Review floor plan loan participations purchased and sold since the last examination, if there are any in the sample. Determine whether

    - parties share in the risks and contractual payments on a pro rata basis, by examining the participation certificates and records.
    - books and records properly reflect the bank's liability.
    - any participations were sold immediately before the examination to avoid possible criticism during this examination.

17. Review loans in the sample that were classified by previous examiners or by bank management, if any. Determine disposition of loans so classified by recording on the line sheets

    - key rating factors, financial and liquidity measures, and collateral value.
    - current loan balances and payment status.
    - any charged-off amounts or concessions.
    - date loan was repaid and sources of payment, if applicable.
    - any changes to the loan classification or the borrower and collateral conditions.

18. For loan commitments and other contingent liabilities in the sample, if any, determine whether

    - borrower has been advised of the contingent liability.
    - combined amounts of the current loan balance and the commitment or contingent liability exceed any applicable limit.

19. Review rebooked charged-off loans in the sample, if any, and determine whether the rebooked loans

    - meet the criteria and terms of the bank's lending policy for granting new loans.
    - conform to generally accepted accounting principles and regulatory guidelines.
    - are subject to classification.

20. For indirect lending, review the volume and performance history of indirect dealer paper. Determine whether the dealer is overly dependent on the bank's purchases of its dealer paper in order to service its floor plan debt.

21. For indirect lending, review the adequacy of recourse and repurchase provisions, if applicable, and the dealer's performance history in this area. Determine whether dealer guarantees provide the bank with adequate protection if the borrower defaults.

22. Review adequacy of dealer reserve agreements, if applicable.

23. Consider rejection rates of loans referred by dealers to determine the independence and adequacy of dealers' loan underwriting.

Operational Risk

Objective: To determine the quantity of operational risk associated with floor plan lending.

1. Assess the effect of floor plan lending on the quantity of operational risk. Consider

   - any operational losses resulting from floor plan lending activities.
   - control weaknesses identified by audit, loan review, or any other control group.
   - quality of board oversight.
   - quality of credit administration, e.g., segregation of duties, financial analysis, collateral controls, and documentation standards.
   - quality and independence of the audit and loan review functions.
   - staffing turnover affecting the floor plan lending.
   - responses to this booklet's internal control questionnaire (ICQ).

2. Obtain a trial balance of all floor plan accounts and

   - verify that balances agree to department controls and general ledger.
   - review reconciling items for reasonableness.

3. Review miscellaneous loan debit and credit suspense accounts and

   - discuss with management any large or old items.
   - perform additional procedures as deemed appropriate.

4. Review recent floor plan checks and determine the following:

   - Are inventory checks performed regularly and frequently?
   - Are there any units not seen since the previous inspection for which evidence of loan repayments is lacking?
   - Are floor plan checks periodically rotated among the bank's personnel or audit services?

- Are floor checks performed on both unannounced and preannounced bases?
- Are discrepancies reconciled and explained?

5. Determine whether the bank corrected any deficiencies mentioned in the prior examination, loan review, and audit reports.

6. If third-party servicers are used in servicing dealer loans and performing inventory floor checks, determine the following from discussions with management:

   - Was a formal contract executed and approved by the proper level of management?
   - Were financial statements and references checked?
   - Are performance objectives established and monitored?
   - Does the local jurisdiction require service company licensing, and, if so, is the required license on file with the bank?

7. Discuss findings with the EIC and provide conclusions regarding the effect of floor plan lending on the bank's operational risk profile.

Compliance Risk

Objective: To determine the quantity of compliance risk in accordance with applicable laws and regulations arising from floor plan lending activities.

1. Review the bank's history of compliance with laws and regulations applicable to floor plan lending. Determine

   - for all banks, whether financing arrangements meet the limits on loans or extensions of credit to one borrower under 12 USC 84 and 12 CFR 32.[17]
   - for all banks, whether financing arrangements involving transactions with affiliates meet the restrictions on transactions with affiliates under 12 USC 371c, 12 USC 371c-1, and 12 CFR 223 (Regulation W).
   - for all banks, whether financing arrangements involving insider lending meet the restrictions on insider lending under 12 USC 375a, 12 USC 375b, and 12 CFR 215 (Regulation O).
   - for FSAs, whether floor plan financing arrangements meet the limits on loans or extensions of credit under 12 USC 1464(c) and 12 CFR 160.30, the special limits on loans to one borrower under 12 USC 1464(u)(2), and restrictions on transactions with affiliates and insider lending under 12 USC 1468.
   - for FSAs, whether floor plan financing arrangements meet the documentation and record-keeping requirements under 12 CFR 163.170(c), 12 CFR 163.170(d), and 12 CFR 163.170(e).

[17] To determine the bank's compliance with the legal lending limit, combine total outstanding floor plan indebtedness with all other indebtedness, including the dealer installment paper, with recourse, that the borrower has sold to the bank.

2. Review extensions of credit to officers and directors of other banks. Investigate any circumstances that indicate preferential treatment.

3. Determine whether the bank's floor plan lending activities are in compliance with consumer protection laws and regulations.

4. Discuss findings with the EIC and provide conclusions regarding the effect of floor plan loans on the bank's compliance risk profile.

Strategic Risk

Objective: To determine the quantity of strategic risk associated with floor plan lending.

1. Evaluate strategic risk within the bank's floor plan lending portfolio. Consider the following factors:

   - Bank's floor plan lending strategy, business plan, any planned changes, and supporting capital.
   - Management's record of decision making.
   - Board oversight of strategic initiatives.
   - Quality of the bank's floor plan lending policies, underwriting standards, risk management systems, and consistency with the bank's business strategy and the board's risk appetite.
   - Staff's ability to implement floor plan lending strategies without exposing the bank to unwarranted risk.
   - Due diligence process for new products and services.

2. Discuss findings with the EIC and provide conclusions regarding the effect of floor plan lending on the bank's strategic risk profile.

Reputation Risk

Objective: To determine the quantity of reputation risk associated with floor plan lending.

1. Evaluate reputation risk within the bank's floor plan lending portfolio. Consider the following:

   - Management's ability to anticipate and respond to legal, regulatory, or market forces that could affect reputation risk.
   - Quality of the bank's floor plan lending policies, credit administration, and problem loan workout function.
   - Adequacy of floor plan lending controls and the independent review function.
   - Volume of floor plan lending-related litigation.

2. Determine the level of the bank's floor plan loan participation, syndication, and selling activities, if applicable. Review related policies and procedures for appropriateness and assess management's ability to meet legal and fiduciary responsibilities without incurring unwarranted reputation risk.

3. If the bank produces a significant amount of unconventional or inappropriately structured floor plan loans, review and assess the bank's due diligence procedures, oversight, and internal controls. Also consider the results of loan reviews by the OCC and any independent third parties.

4. Discuss the findings with the EIC and provide conclusions regarding the effect of floor plan lending on the bank's reputation risk profile.

Quality of Risk Management

Conclusion: The quality of risk management is (strong, satisfactory, insufficient, or weak).

The conclusion on the quality of risk management considers all risks associated with floor plan lending.[18]

Policies

Policies are statements of actions adopted by a bank to pursue certain objectives. Policies guide decisions and often set standards (on risk limits, for example) and should be consistent with the bank's underlying mission, risk appetite, and core values. Policies should be reviewed periodically for effectiveness and approved by the board of directors or designated board committee.

Objective: To determine whether the board has adopted adequate and effective policies that are consistent with safe and sound banking practices and appropriate to the size, nature, and scope of the bank's floor plan lending activities.

1. Evaluate relevant policies to determine whether they provide appropriate guidance for managing the bank's floor plan lending activities and are consistent with the bank's mission, values, and culture. Verify that the policies

   - establish procedures for reviewing floor plan applications.
   - define qualified borrowers and due diligence requirements.
   - establish minimum underwriting and loan approval standards.
   - establish curtailment guidelines, including providing proper incentives to the dealer to turn over inventory on a timely basis.
   - provide sound practices for approving, monitoring, and controlling the collateral.

2. Determine whether the board of directors, consistent with its duties and responsibilities, periodically reviews and approves the bank's floor plan lending policies as appropriate. Determine if the review and approval process adequately considered changing market conditions, regulatory changes, and the bank's risk appetite and loan strategies.

3. Determine whether policies establish risk-based limits, expressed as a percentage of total capital, and describe appropriate actions if the limits are exceeded.

4. Review policy exception reports and determine whether management is taking appropriate steps to achieve compliance with established policies or practices. Identify

[18] Appendix C provides a detailed matrix for assessing the quality of credit risk management.

any area with inadequate supervision or undue risk and discuss with the EIC the need to perform additional procedures.

Processes

Processes are the procedures, programs, and practices that impose order on a bank's pursuit of its objectives. Processes define how activities are carried out and help manage risk. Effective processes are consistent with the underlying policies and are governed by appropriate checks and balances (such as internal controls).

Objective: To determine whether the bank has processes in place to define how floor plan lending is carried out and whether the loan administration processes are adequate.

1. Evaluate whether operating procedures are effective, consistent with underlying policies, and effectively communicated to appropriate staff.

2. Determine the adequacy of floor plan underwriting procedures, including loan application, credit history and financial condition criteria, loan term and limit, covenant requirements, manufacturer due diligence, manufacturer supports, and security perfection.

3. Determine the adequacy of floor plan loan administration practices, including fund disbursements, loan documentation, ongoing financial analysis and monitoring of the borrower, collateral inspection and controls, and borrower relationship considerations.

4. Determine whether appropriate internal controls are in place and functioning as designed. Complete the ICQ section of this booklet, if necessary, to make this determination.

5. Determine whether the board or senior management has established adequate procedures for ensuring compliance with applicable laws and regulations.

6. Determine whether the bank has established standards and procedures for the use of independent inventory inspectors, collateral value appraisers, or any other third-party service providers in accordance with OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance."

Personnel

Personnel are the bank staff and managers who execute or oversee processes. Personnel should be qualified and competent, have clearly defined responsibilities, and be held accountable for their actions. They should understand the bank's mission, risk appetite, core values, policies, and processes. Banks should design compensation programs to attract and retain personnel, align with strategy, and appropriately balance risk-taking and reward.

Objective: To determine management's ability to supervise floor plan lending in a safe and sound manner, and whether bank personnel possess and display acceptable knowledge and technical skills in managing and performing duties related to floor plan lending.

1. Given the scope and complexity of the bank's floor plan lending, assess the management structure and staffing. Consider the following:

   - Whether reporting lines encourage open communication and limit the chances of conflicts of interest.
   - Level of staff turnover.
   - Use of outsourcing arrangements.
   - Capability of management and staff to address identified deficiencies.
   - Management and staff's responsiveness to regulatory, accounting, industry, and technological changes.

2. Determine whether the staffing level is appropriate given the size, complexity, and level of risk in the floor plan lending portfolio.

3. Assess bank managers' and personnel's knowledge, expertise, and technical skills related to floor plan lending, and determine whether training is needed to address any knowledge gaps.

4. Assess performance management and compensation programs. Consider whether these programs measure and reward performance that aligns with the bank's strategic objectives and risk appetite.

   If the bank offers incentive compensation programs, determine whether they are consistent with OCC Bulletin 2010-24, "Interagency Guidance on Sound Incentive Compensation Policies." The programs should be consistent with the bulletin's three key principles: (1) Provide employees with incentives that appropriately balance risk and reward; (2) Be compatible with effective controls and risk management; and (3) Be supported by strong corporate governance, including active and effective oversight by the bank's board of directors.

Control Systems

Control systems are the functions (such as internal and external audits and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes and personnel. Control functions should have clear reporting lines, sufficient resources, and appropriate access and authority. MIS should provide timely, accurate, and relevant feedback.

Objective: To determine whether the bank has systems in place to provide accurate and timely assessments of the risks associated with its floor plan lending and determine the effectiveness of control systems employed to manage floor plan lending.

1. Obtain and review internal and external audit reports related to floor plan lending. Assess the scope, frequency, independence, and findings of these audits. Also consider accessibility to necessary information and board and management's responses to audit findings.
2. Obtain the most recent loan review report on floor plan lending (or report that encompasses floor plan lending). Assess the effectiveness of independent risk control functions in floor plan lending, such as the effectiveness of the loan review function in identifying risk in floor plan lending. Determine whether management has appropriately addressed noted concerns. Consider the following:

    - Scope of reviews.
    - Frequency of reviews.
    - Qualifications of loan review personnel.
    - Independence of loan review function.
    - Identification and reporting of emerging risks in loan review reports.
    - Results of activities in the "Quantity of Risk" section of these examination procedures.

3. Obtain and analyze the following reports management uses to supervise floor plan lending:

    - Schedule of curtailment requirements for each dealer.
    - Schedule of approved floor plan lines for each dealer, including outstanding balances.
    - Delinquent curtailment billing report.
    - Amount of outstanding drafts and drafting reports.
    - Loan payoff reports.
    - Collateral documentation and inspection reports.
    - Delinquent interest billings, date billed, and amount of past-due interest reports.
    - Volume and performance history of indirect dealer loans related to the inventory under floor plan financing.
    - Listing of inadequate dealer reserve accounts from indirect dealer loans under floor plan financing.
    - Risk rating reports.

4. Determine whether MIS provides timely, accurate, and useful information to evaluate risk levels and trends in the bank's floor plan lending. Consider the following:

    - Past-due and nonaccrual status.
    - Risk ratings.
    - Loan yield and profitability data.
    - Trend analysis.
    - Commitments, industry type, amount and level of expected use, and highest use on record.
    - Maturity categories.
    - Concentration analysis.

- Exceptions to policy, underwriting, and documentation standards.

5. Evaluate the effectiveness of the monitoring systems to identify, measure, and track exceptions to policies and established limits.
6. Assess the effectiveness of the compliance review function. Evaluate the scope, timing, and frequency of the reviews, the qualifications of the party performing the reviews, and the reviewers' ability to identify potential compliance issues and assess the risk.

7. Determine the adequacy of any other control systems management uses to supervise floor plan lending activities.

Conclusions

Conclusion: The aggregate level of each associated risk is (low, moderate, or high). The direction of each associated risk is (increasing, stable, or decreasing).

Objective: To determine, document, and communicate overall findings and conclusions regarding the examination of floor plan lending activities.

1. Consolidate examination findings and prepare preliminary conclusions and supporting documentation for the appropriate section of the risk assessment as depicted in the following chart:

Summary of Risks Associated With Floor Plan Lending				
Risk category	**Quantity of risk**	**Quality of risk management**	**Aggregate level of risk**	**Direction of risk**
	(Low, moderate, high)	(Weak, insufficient, satisfactory, strong)	(Low, moderate, high)	(Increasing, stable, decreasing)
Credit				
Operational				
Compliance				
Strategic				
Reputation				

2. Prepare a summary memorandum that includes overall conclusions from the floor plan lending examination activity and provide the conclusion memo to the EIC or LPM examiner. The memo should address, at the minimum, the following items:

- Review of applicable CAMELS ratings.
- Adequacy of floor plan lending policies and processes.
- Degree of compliance with floor plan lending policies and procedures, including underwriting standards.
- Identified weaknesses in risk management processes, including
  - management and support staff.
  - credit administration processes.
  - control functions, such as audit and loan review.
  - internal control deficiencies or exceptions.
  - MIS.
- Quality and effectiveness of strategic and capital planning related to floor plan lending.

- Violations of laws or regulations.
- Descriptions of recommended matters requiring attention (MRA) for the ROE.
- Any other matters of significance.

3. If substantive safety and soundness concerns that may have a material adverse effect on the bank remain unresolved, further expand the scope of the examination by completing the verification procedures.

4. Highlight any issues in the conclusion memorandum that should be included in the ROE. As appropriate, prepare a brief floor plan lending comment on the quantity of risk and quality of risk management.

5. Determine, in consultation with the EIC, whether concerns identified are significant enough to merit bringing them to the attention of management and the board in the ROE. If so, compose an MRA comment.[19]

6. Determine the time frame for timely resolution of the matters, identify the person(s) responsible, and obtain commitments for the corrective action.

7. Discuss the examination findings included in the summary memorandum with bank management, and document management responses and proposals for corrective actions, as appropriate.

8. Specifically lay out in the conclusion memorandum what the OCC should do in the future to effectively supervise floor plan lending in the bank, including time periods, staffing, and workdays required. Provide the memorandum to the EIC for consideration of future supervisory strategies.

9. Update, organize, and reference work papers in accordance with OCC policy.

10. Update the OCC's information system and any applicable ROE schedules or tables.

11. Ensure that any paper or electronic media that contain sensitive bank or customer information are appropriately disposed of or secured.

[19] Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for more information on MRAs.

Internal Control Questionnaire

An ICQ helps an examiner assess a bank's internal controls for an area. ICQs typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update ICQs during examination planning or after reviewing the findings and conclusions of the core assessment.

Floor Plan Agreement

1. Are floor plan agreements required for all dealers?

2. Are agreements accompanied by borrowing resolutions when necessary?

3. Is a written agreement between the manufacturer and the bank required on any floor plan lending line that includes drafting arrangements with the manufacturer?

4. Do such agreements with the manufacturer stipulate under what conditions the bank will accept merchandise to be included in the floor plan arrangement?

Line Limits

5. Are all floor plan loans granted under an established floor plan line?

6. Are floor plan line approvals structured to permit the bank to cancel or suspend shipments of unwanted merchandise?

7. Are dealer floor plan line limits strictly adhered to?

Trust Receipts

8. Are all trust receipts required to be supported by invoices or other evidence that title to the security is vested in the bank?

9. Are trust receipts required to include

   - description of each item?
   - serial number of each item?
   - loan amount for each item?
   - interest rate?
   - date?
   - authorized signature of dealer or person holding power of attorney to execute the trust receipt?

10. If the bank and dealer permit a bank employee to execute trust receipts under a power of attorney granted by the dealer,

    - are proper documents on file granting the power of attorney?
    - does the bank maintain a numbered register for trust receipt notes?
    - are trust receipt notes under dual control?
    - are checks made periodically to confirm that only those individuals granted power of attorney are signing the trust receipts?

11. When a dealer trade or inventory swap occurs, does the bank

    - obtain the manufacturer's invoice from the selling dealer on the new unit acquired?
    - obtain the invoice from the borrowing dealer for the new unit?
    - have a trust receipt executed on the new unit?

12. Does the bank have a procedure to check all indirect paper received from a dealer against the trust receipts of inventory included in the floor plan for that dealer to ensure that there is no duplication of loans against the same security?

Curtailment

13. Has a curtailment policy been established?

14. Does the policy provide proper incentives to the dealer to turn over inventory on a timely basis?

15. Is the loan written so that the inventory under the floor plan loan never depreciates faster than the speed of loan repayment?

16. If the manufacturer of the merchandise covered by a floor plan loan has entered into a repurchase agreement, are curtailments structured to keep the loan balance in line with any declining repurchase amount?

17. If demonstrator units of merchandise are included in the floor plan, are such units subject to separate curtailment requirements, which keep the loan balances in line with their liquidation value?

18. Are records maintained on curtailment billings so that delinquency is easily determinable?

19. Are notices of past-due curtailment payments sent promptly?

Financial Information

20. Are dealers required to submit financial and operating statements on a continuing basis?

21. Are dealers required to submit copies of internal financial and operating statements to the bank if they prepare those statements more frequently than annually?

22. Are all financial statements received from dealers reviewed promptly?

23. Do financial statement reviews include a determination that floor plan loans, deposit accounts, and other information match the bank's records?

24. Are periodic reviews made of deposit accounts to detect any possible out-of-trust sales?

25. Are periodic reviews made of the indirect paper being generated to determine whether the bank is receiving an adequate share of the total volume?

26. Are financial statements and credit rating reports pertaining to the manufacturer obtained and reviewed at the inception of the loan and throughout the life of the loan, especially when the manufacturer plays a role in the loan performance?

Collateral

27. Are floor plan checks or physical inventories conducted at least quarterly and on both preannounced and unannounced bases?

28. Are more frequent floor plan checks required if the dealer is experiencing financial difficulties?

29. Are individuals performing floor plan checks rotated?

30. Are floor plan inspectors required to determine or verify the following and indicate their findings on the floor plan check sheet?

    - Make, model, year, and serial number of item.
    - Odometer reading, if applicable.
    - Condition of item.
    - Location of item, if other than normal place of business.
    - Existence of any fire or theft hazards.

31. Does the floor plan inspector include the following information on the check sheet?

    - Date when inspection was performed?
    - Date when any item located elsewhere was checked?
    - Comments and logs for any missing items?
    - His or her signature?
    - Summary of his or her report, if appropriate?

32. Are all demonstrator units under the floor plan loan checked?

33. Does an officer review floor plan reports?

34. Are follow-up inspections made of items not seen during the regular inspection?

35. Does the bank require that items the dealer reports as sold are paid off within the allowed time frame?

36. Does the floor plan inspector determine the date the dealer sold the item(s)?

37. Does the bank review the dealer's sales patterns to confirm that the number of units reported sold at the time of floor plan inspection is not excessive and does not indicate a float?

38. Do bank personnel verify payments in process that the dealer reports during floor plan inspection?

39. Are wholesale values determined independently of dealer appraisals?

40. Does someone independent of the floor plan lending area periodically review the wholesale values that floor plan personnel assign?

Floor Plan Loan Records

41. Is the preparation and posting of subsidiary floor plan loan records performed or reviewed by persons who do not also

    - issue official checks or drafts singly?
    - handle cash?

42. Are the subsidiary floor plan loan records reconciled daily with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?

43. Are delinquent account collection requests and past-due notices checked to the trial balances used in reconciling floor plan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?

44. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

45. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash? (If so, explain briefly.)

46. Is a daily record maintained summarizing note transaction details, e.g., loans made, payments received, and interest collected, to support applicable general ledger account entries?

47. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?

48. Is an overdue account report generated frequently? (If so, record the frequency.)

Accounting Controls

49. Is a trial balance of each dealer's trust receipts/security agreements prepared at least monthly?

50. Are dealer trial balances reconciled to department and general ledger controls?

51. Are disbursements for floor plan loans on new units made only against the original copy of the manufacturer's invoices?

52. Are the original invoices retained in the bank's files?

53. Are loan proceeds on new units paid directly to the manufacturer or to both the manufacturer and the dealer together, rather than to the dealer alone?

54. Are accounting records established so that the bank has records of all inventory included in the floor plan with adequate individual identification?

55. Are limits on loan advance versus invoice price and current wholesale value of used inventory clearly established in the lending procedures?

56. Is the amount of loan advance prohibited from exceeding 100 percent of the invoice price of a new item or the wholesale value of a used item?

57. If assignment of rebates has been made, have procedures been established to ensure that factory rebate checks are promptly forwarded to the bank?

Loan Interest

58. Are floor plan interest charges systematically computed and regularly billed?

59. Are notices of past-due interest payments sent promptly?

60. Are all interest, curtailment, and unit payoff payments from dealers posted promptly?

61. Is the preparation and posting of interest records performed or reviewed by persons who do not also

    - issue official checks or drafts singly?
    - handle cash?

62. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also

    - issue official checks or drafts singly?
    - handle cash?

Insurance

63. Does the bank have floor plan property damage insurance or require that the dealer maintain such coverage, with the bank named as loss payee?

64. Is the insurance coverage periodically reviewed for adequacy?

65. Is the insurance provider's financial condition evaluated and determined to be adequate?

Conclusion

66. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above? (Explain negative answers briefly and indicate conclusions as to their effect on specific examination or verification procedures.)

67. Based on the answers to the foregoing questions, internal control for floor plan lending is considered (strong, satisfactory, insufficient, or weak).

Verification Procedures

Verification procedures are used to verify the existence of assets and liabilities or test the reliability of financial records. Examiners generally do not perform verification procedures as part of a typical examination. Rather, verification procedures are performed when substantive safety and soundness concerns are identified that are not mitigated by the bank's risk management systems and internal controls.

1. Test the addition of the trial balance.

2. Test reconciling items to the extent considered necessary.

3. For past-due loans, compare the following and determine any material inconsistencies:

    - Past-due loans provided to the examiners.
    - Delinquency reports submitted to the board.
    - List of loans considered problem loans by management.
    - Delinquency levels provided on reports to regulators.

4. Using an appropriate sampling technique, select floor plan loans and

    - prepare and mail confirmation forms to dealers to confirm loan balances, schedules, and dates of items floored, among other pertinent information.
    - after a reasonable period, mail second requests.
    - follow up on any no-replies or exceptions and resolve differences.
    - compare title documents or invoices to trust receipts.
    - obtain a list of the most recent floor plan interest billings, and check calculation of interest report.
    - determine whether interest payments are delinquent, and trace to inclusion in delinquency report.
    - determine whether appropriate action has been taken to bring delinquent accounts to a current status.

5. Review physical inspections of collateral, and

    - determine the reason for differences between the bank's collateral records and the actual items held by the dealer.
    - trace those items represented as sold or in process at time of inspection to the items' subsequent removal from the bank's liability ledger.
    - determine the number of days between the sale date and removal from liability ledger.
    - using the above information, review the dealer's deposit account(s) and determine whether the dealer may be withholding funds received from the sale of the pledged collateral.
    - investigate other differences to the extent considered necessary.

6. If floor plan inspection procedures are considered deficient or if they are not performed on a timely basis, contract with a competent professional inspector independent from both the bank and the borrower to perform physical verification of collateral on a sample basis.

Appendixes

Appendix A: Risk Rating Examples

Example A: A Car Dealership

Borrower	A Car Dealership, LLC
Business	Dealer of new and used cars from a major manufacturer.
Credit facility	A 5-year floor plan revolver facility with a $3.5 million total commitment for new cars and a $500,000 total commitment for used cars. The facility is subject to annual reviews. Current outstanding balances are $3.1 million for the new floor plan line and $500,000 for the used floor plan line.
Pricing	Libor + 200 basis points (bps) (during manufacturer support) and Libor + 250 bps (after manufacturer support) due monthly.
Repayment sources	• Primary: Conversion of floor plan inventory to cash • Secondary: Operating cash flow and guarantor support • Tertiary: Collateral liquidation, sale of business, and manufacturer support
Structure and controls	• Independent floor plan inspectors perform monthly floor checks. • Curtailments are required for all loans per the loan agreement, and the level and timing of curtailments depend on the type of inventory financed. • Both personal and corporate guarantees are required per loan policy. • Loan advances are not to exceed 180 days of inventory supply for new cars and 90 days of inventory supply for used cars at any time. • Financial covenants include a minimum debt service coverage ratio of 1.0x, minimum cash-burn coverage of 60 days, and a minimum floor plan coverage ratio of 1.0x. • The manufacturer provides inventory repurchase and loss rebate programs and a marketing incentive under which the manufacturer will pay the dealer's floor plan interest expenses for the initial six months after the products have been shipped to the dealer.
Collateral	The new car revolver is secured by new cars shipped to the dealer by the manufacturer. The used car revolver is secured by used inventory sourced from customer trade-ins and other dealers nationwide. Loans for new cars are advanced at 100 percent of the invoice prices, while loans advanced for used cars are limited to 90 percent of the wholesale values per industry valuation guidance. Overall, the entire floor plan collateral value, as appraised by a third-party valuation consultant, provides over 100 percent coverage of the floor plan debt outstanding.

Borrower financial characteristics	• Over the past three years, the borrower's balance sheet leverage levels moved from 6.7x to 7.2x and then to 7.1x, while its debt-to-earnings before interest, taxes, depreciation, and amortization (EBITDA) leverage levels changed from 6.5x to 7.3x and then to 6.9x. • The current availability under the new car floor plan line is $400,000, or 12 percent of the total commitment. The borrower does not have other creditors. • Operating cash flow was generally positive and fluctuated from quarter to quarter due to seasonality of sales and occasional delays in the collection of manufacturer receivables. Debt service coverage ratios (DSCR) for the last three years changed from 1.4x to 1.1x and then to 1.2x. • Net income was slightly negative for each of the last two years due to year-end distributions to preferred shareholders. • Performance on the current floor plan lines and prior floor plan obligations were satisfactory, with no history of out-of-trust sales or loan charge-offs. • Cash burn rate that measures the number of days that the dealer can fund its business operations with its liquid assets without any new sales is currently 65 days, and is expected to improve as the dealer enters a busy selling season.
Risk-rating decision	Pass
Rating rationale	Key factors: • Satisfactory floor plan structure. • Satisfactory floor plan controls and performance. • Reasonable liquidity position and cash flow generation. • Adequate collateral support. Despite high leverage and cash flow volatility, this credit is rated pass due to satisfactory loan structure and controls, satisfactory performance on floor plan credits historically, a reasonable liquidity and cash flow profile, and an adequate collateral coverage.
Alternate Scenario A	
New information	• Over the past year, the dealership's gross profit margins declined 20 percent from the prior year, resulting in reduced net operating margins and free cash flow. Cash balance and tangible equity decreased 10 percent and 15 percent, respectively, from the previous year. • Most recent year-end DSCR was 1.1x, and the appraised collateral coverage could still cover slightly over 100 percent of the outstanding floor plan debt. • Inventory turnover is getting slower than usual. To increase sales, the dealer recently increased the volume of financing contracts to subprime consumers and sold all the dealer paper to the bank under the master loan agreement. • The manufacturer was facing financial difficulty and was recently downgraded to a non-investment-grade rating by a major rating agency. Repurchase requests are increasingly difficult and warranty claims and factory receivables are not received timely. • Economy is drifting into recession, as recent economic news on gross domestic product, employment rate, and consumer confidence were all disappointing.
Updated risk-rating decision	Special mention

Updated rating rationale	Key factors: • Decline in operating performance and liquidity. • Increase in subprime dealer paper. • Weakening of manufacturer support. • Marginal collateral coverage. • Worsening economic conditions. This credit is rated special mention due to potential weaknesses that include the recent decline in operating performance and liquidity, the negative impact from a weakening manufacturer, the increase in financed sales to subprime consumers through indirect dealer paper, marginal collateral coverage, and the declining economic conditions that could hamper the dealer's business and debt repayment prospects.
Alternate Scenario B	
New information	• Company sales and operating income have declined for two years, and net profit was negative from the most recent year-end result. Operating cash flow was insufficient to service its floor plan debt, with a DSCR of 0.9x at year-end. • Company entered into a new borrowing relationship with another creditor for a $250,000 line of credit secured by the company's real estate and other business assets to meet its working capital needs. • Both book and cash flow leverage levels increased to 9x and 11x, respectively. • Most recent floor check revealed four instances of out-of-trust sales, and it took one month on average to resolve each of the four issues. The floor check also discovered modest deterioration in the company's collateral value under the floor plan debt. Conservative estimate indicates that the current collateral value could still cover 100 percent of the total floor plan liability. • Neither the bank nor the dealer has ordered an independent professional appraisal of the collateral in the last three years. • Current cash burn metric shows 30 days. • Manufacturer is now bankrupt and is not honoring some of its repurchase and loss rebate obligations. • Economy is now in recession. • Floor plan interest has been paid as agreed, but the borrower was granted a waiver of curtailment for three months.
Updated risk-rating decision	Substandard/nonaccrual/cash basis.

Updated rating rationale	Key factors: • Inadequate primary source of repayment. • Weak economic conditions and manufacturer bankruptcy and default. • High leverage. • Marginal collateral coverage. • Out-of-trust sales. This credit should be downgraded to substandard due to well-defined weakness in the primary source of repayment, poor debt service capacity and liquidity, extremely high leverage, marginal collateral coverage, increasingly frequent and prolonged out-of-trust incidents, manufacturer bankruptcy and default, and poor economic conditions that have hampered the dealer's business and debt repayment prospects. It is likely that the floor plan lender will sustain some loss and the borrower's paying capacity is questionable. The loan should be placed on nonaccrual status because collateral coverage is marginal and collection of principal and interest in full is in doubt. Future interest received can be recognized on a cash basis as long as collateral values protect principal.

Example B: A Marine Dealership

Borrower	A Marine Dealer Inc.
Business	An independent marine dealership of new and used powerboats and yachts.
Credit facilities	A five-year floor plan due on demand revolver facility with a $4 million original commitment, which was later amended to $4.4 million, and a current outstanding balance of $4.4 million. The $4.4 million total commitment contains a $1 million sublimit for used boats and yachts.
Pricing	Libor + 350 basis points due monthly
Repayment sources	Primary: Conversion of floor plan inventory to cash Secondary: Operating cash flow Tertiary: Collateral liquidation, sale of business, and refinancing
Structure and controls	• This is a five-year floor plan revolving line of credit facility originated two years ago, with an original commitment amount of $4 million and a 10 percent overline limit. • The facility is a discretionary demand revolving line of credit, which allows the bank to legally freeze the line and demand an immediate repayment at any time under certain conditions. • Loans are repaid on a “pay as sold” basis and there is no specific maturity term for each loan. • Floor checks are done annually. • Curtailments are not required for new inventory. A 10 percent monthly curtailment is required for used boats and yachts after six months. • Only corporate guarantee is required per loan policy. • No financial covenants.
Collateral	The revolver is secured by new and used powerboats and yachts that are financed under this floor plan facility. Loans are advanced at 100 percent of the invoice price for new inventory and 95 percent of the wholesale value for used inventory. A floor check conducted early in the year found some stale inventory, but estimated that the collateral could provide over 100 percent coverage of the floor plan debt outstanding.
Financial synopsis	• The borrower is a family-run business and has been in the marine dealership business for the last two years. The owner is a retired former executive from a large shipbuilding and marine equipment manufacturer with whom the dealer does business. • The last two years’ financials indicate that the borrower maintained a decent profit margin, but there was no growth in sales last year. Operating cash flows were positive, but have declined slightly due to higher operating expenses. The most recent DSCR was 1.4x, and the fixed charge coverage ratio was 1.2x. • Both balance sheet and cash flow leverage levels remained high for the last two years, with the most recent levels at 6.5x and 7.1x, respectively. • So far, two floor checks have been conducted. The most recent floor check conducted in the first quarter of this year discovered two instances of out-of-trust sales, but they were immediately resolved during the examination. The floor check also identified stale inventory with faster-than-expected deterioration in collateral value, resulting in 110 percent collateral coverage of the outstanding floor plan debt compared with 120 percent a year ago. • Interest payments on the current floor plan line have been satisfactory.
Risk-rating decision	Special mention

Rating rationale	Key factors: • Weak floor plan structure. • Inadequate floor plan controls and monitoring. • Faster-than-expected inventory depreciation. This credit is rated special mention due to weak loan structural support and controls and faster-than-expected collateral depreciation, which, if not corrected or mitigated in a timely manner, could significantly impact the borrower's capacity to repay the debt.
Alternate Scenario A	
New information	• Financial crisis hit in Year 3, and the economy is in deep recession. Sales of powerboats, yachts, and other luxury consumer goods have declined significantly over the past year. The borrower ran into financial difficulties three years after it entered into this floor plan relationship. • The borrower's profit margin declined significantly last year, and both net income and free cash flow have turned negative. Adjusted EBITDA was still positive but was only marginal to service the floor plan debt. The most recent DSCR was 1.05x, and the fixed charge coverage ratio was 0.98x. • Since its start-up three years ago, the company has been burning cash at a rate higher than expected. Currently, the borrower is funding its cash burn mainly through its startup capital, cash reserves, and additional borrowings. Current liquidity can fund the business for the next 55 days, assuming no additional new sales are made. • Both book and cash flow leverage levels went up last year, with the most recent levels at 8.8x and 9.2x, respectively. • Floor check conducted last year unveiled three instances of out-of-trust sales, with an average resolution time frame of 14 days. • The most recent floor check also identified stale inventory with deterioration in value, but a conservative estimate indicates sufficient collateral value to cover 100 percent of the total floor plan debt outstanding. • Interest payments on the current floor plan line have been kept current in part through an unsecured working capital line funded by a third-party lender.
Updated risk-rating decision	Substandard/accrual
Updated rating rationale	Key factors: • Weak primary source of repayment and marginal debt service capacity. • Inadequate capital and excessively high leverage. • Weak structural protection and controls. • Increasingly frequent and prolonged out-of-trust incidents. This credit should be downgraded to substandard due to well-defined weakness in the primary source of repayment, slow inventory sales and turnovers, marginal debt service capacity overall, inadequate capital with high leverage, weak structural protection and controls, and the unsatisfactory dealer behavior with respect to the out-of-trust sales. Accrual treatment of the credit is supported by adequate collateral coverage and a marginally adequate debt service capacity.

Alternate Scenario B	
New information	• Economy continued to worsen in Year 4, and the company's sales and operating income declined further at year-end, resulting in a negative net profit, negative operating cash flow, and a negative DSCR. • The company filed for Chapter 11 bankruptcy protection in the fourth quarter of Year 4, and the borrower has not paid any interest for more than three months. • The Chapter 11 petition was dismissed and converted to Chapter 7 because the court determined the business has little or no chance of becoming profitable. • The bankruptcy court ordered an independent appraisal of the company's entire assets including the floor plan collateral. The appraisal indicated that the floor plan collateral can be liquidated at 30 cents on the dollar. • Two buyers showed a genuine interest in buying the company and both submitted bids to pay 30 cents on the dollar to settle the floor plan lender's claim. • The bank believed it could achieve a higher liquidation value for the collateral and ordered its own appraisal from a nonaffiliated valuation consultant, which determined the liquidation value of the collateral to be 50 cents on the dollar. • The bank petitioned the court to reject the buyers' bids, and the court approved the bank's request and ordered the dealership assets be sold within the next three months.
Updated risk-rating decision	30 percent substandard / 20 percent doubtful / 50 percent loss. Nonaccrual with future cash receipts applied to principal reduction.
Updated rating rationale	Key factors: • Collateral dependent/impaired loan. • Default/bankruptcy. • Insufficient collateral coverage. • Unsatisfactory operating results and insufficient debt service capability. • Unsatisfactory dealer behavior on the floor plan debt. This credit should be rated 30 percent substandard based on the independent valuation of the collateral obtained by the bankruptcy court, 20 percent doubtful based on the higher valuation in the bank-ordered collateral appraisal, with the remaining 50 percent classified loss. The loan should be placed on nonaccrual status as collection of principal and interest in full is in doubt. All future payments received from the borrower or the bankruptcy court should be applied to reduce the remaining book balance of the loan.

Appendix B: Quantity of Credit Risk Indicators

Examiners should consider the following indicators when assessing the quantity of credit risk associated with floor plan lending activities.

Low	Moderate	High
The level of floor plan exposures is low relative to capital.	The level of floor plan exposures is moderate relative to capital.	The level of floor plan exposures is high relative to capital.
Floor plan loan portfolio growth rates are supported by local, regional, or national economic trends. Growth has been planned for and is commensurate with management and staff expertise and operational capabilities.	Floor plan loan portfolio growth rates exceed local, regional, or national economic trends. Growth has not been planned for or exceeds planned levels and may test the capabilities of management, floor plan lending staff, and MIS.	Floor plan loan portfolio growth rates significantly exceed local, regional, or national economic trends. Growth has not been planned for or exceeds planned levels, and stretches the experience and capability of management, floor plan lending staff, and MIS. Growth may also be in new products or outside the bank's traditional floor plan lending area.
Interest and fee income from floor plan lending activities is not a significant portion of loan income.	Interest and fee income from floor plan lending activities is an important component of loan income, but the bank's floor plan lending activities remain diversified.	The bank is highly dependent on interest and fees from floor plan lending activities. Management may seek higher returns through higher-risk product or customer types. Floor plan loan yields may be disproportionate relative to risk.
The bank's floor plan lending portfolio is well diversified, with no single large concentration or a few moderate concentrations. Concentrations are well within reasonable risk limits. The floor plan lending portfolio mix does not materially affect the risk profile.	The bank has a few material floor plan lending concentrations that may approach internal limits. The floor plan loan portfolio mix may increase the bank's credit risk profile.	The bank has large floor plan loan concentrations that may exceed internal limits. The floor plan loan portfolio mix increases the bank's credit risk profile.
Floor plan loan underwriting is conservative. Floor plan facilities with structural weaknesses or underwriting exceptions are occasionally originated, but the weaknesses are effectively mitigated.	Floor plan loan underwriting is satisfactory. The bank has an average level of floor plan facilities with structural weaknesses or exceptions to underwriting standards. Exceptions are reasonably mitigated and consistent with competitive pressures and reasonable growth objectives.	Floor plan loan underwriting is liberal and policies are inadequate. The bank has a high level of floor plan facilities with structural weaknesses or material underwriting exceptions. The volume of exceptions exposes the bank to increased loss in the event of default.

Low	Moderate	High
Advance rates are conservative. Collateral controls and monitoring are effective. Valuations are reasonable, timely, and well supported. Field audits are timely and appropriate. Curtailment requirement is in place and fully supported by the dealer's strong financial condition.	Advance rates are less conservative, but risks are mitigated by satisfactory collateral controls and monitoring systems. Some valuations may not be well supported or timely. Field audits are generally appropriate. Curtailment may be in place, but enforcement of the requirement may not be effective.	Advance rates may be aggressive. Collateral controls and monitoring systems may not effectively mitigate risk. Valuations are not regularly obtained, frequently unsupported, or reflect inadequate protection. Field audits are inadequate or not performed in a timely manner. Curtailment is not in place, or enforcement of such a requirement is deemed unrealistic given the dealer's poor financial condition.
Floor plan loan documentation exceptions and other underwriting variances are low and have minimal impact on the bank's risk profile.	Floor plan documentation exceptions and other underwriting variances are moderate, and exceptions are reasonably mitigated and corrected in a timely manner. The risk of loss from these exceptions is not material.	Floor plan documentation exceptions and other underwriting variances are high. Exceptions are not mitigated or not corrected in a timely manner. The risk of loss from the exceptions is heightened.
Distribution of floor plan loans across the pass category is consistent with a conservative risk appetite. Migration trends within the pass category favor the less-risky ratings. Lagging indicators, including past-dues and nonaccruals, are low and stable.	Distribution of floor plan loans across the pass category is consistent with a moderate risk appetite. Migration trends within the pass category may favor riskier ratings. Lagging indicators, including past-dues and nonaccruals, are moderate and may be slightly increasing.	Distribution of floor plan loans across the pass category is heavily skewed toward riskier pass ratings. Lagging indicators, including past-dues and nonaccruals, are moderate or high, and the trend is increasing.
The volume of adversely rated floor plan loans is low and is not skewed toward more severe risk ratings.	The volume of adversely rated floor plan loans is moderate, but is not skewed toward more severe ratings.	The volume of adversely rated floor plan loans is moderate or high, skewed to the more severe ratings, and increasing.
Floor plan loan refinancing and renewal practices raise little or no concern regarding the quality of floor plan loans and the accuracy of problem floor plan loan data.	Floor plan loan refinancing and renewal practices pose some concern regarding the quality of floor plan loans and the accuracy of problem floor plan loan data.	Floor plan loan refinancing and renewal practices raise substantial concerns regarding the quality of floor plan loans and the accuracy of problem floor plan loan data.
The volume of adversely rated floor plan indirect paper is low and is not skewed toward more severe risk ratings.	The volume of adversely rated floor plan indirect paper is moderate, but is not skewed toward more severe ratings.	The volume of adversely rated floor plan indirect paper is moderate or high, skewed to the more severe ratings, and increasing.
Indirect dealer paper underwriting standards are conservative and comparable to the floor plan loan. Performance is excellent.	Indirect dealer paper underwriting standards are weaker than the floor plan loan, but risk is mitigated by recourse or repurchase requirements. Performance history is generally satisfactory.	Indirect dealer paper underwriting standards are significantly looser than the floor plan loan, or the purchases are nonrecourse and without the repurchase requirement. Performance history is poor.

Appendix C: Quality of Credit Risk Management Indicators

Examiners should consider the following indicators when assessing the quality of credit risk management of floor plan lending activities.

Strong	Satisfactory	Insufficient	Weak
The floor plan lending credit culture is strong. Board and management's appetite for risk is well communicated and fully understood.	The floor plan lending credit culture is generally sound, with only minor and insignificant issues that pose minimal regulatory concern.	The floor plan lending credit culture may not be uniform, and risk appetite may not be communicated clearly throughout the bank.	The floor plan lending credit culture is absent or materially flawed. Risk appetite may not be well understood.
Floor plan lending initiatives are consistent with a conservative risk appetite and promote an appropriate balance between risk-taking and strategic objectives. New floor plan lending products and industries are well researched, tested, and approved before implementation.	Floor plan lending initiatives are consistent with a moderate risk appetite. Generally, there is an appropriate balance between risk-taking and strategic objectives. Anxiety for income may lead to higher-risk transactions, and new products may be launched without sufficient testing, but risks are generally understood.	Floor plan lending initiatives may not be consistent with a moderate risk appetite. Anxiety for income is resulting in higher-risk transactions, and new products are being launched without sufficient testing. Risk-taking is evident and severe enough to warrant supervisory concerns.	Floor plan lending initiatives are liberal and encourage risk-taking. Anxiety for income dominates planning activities. The bank engages in new products without conducting sufficient due diligence or implementing the appropriate controls.
Floor plan lending policies effectively establish and communicate portfolio objectives, risk limits, loan underwriting standards, and risk selection standards.	Floor plan lending policies are fundamentally adequate. Enhancement, while generally not critical, can be achieved in one or more areas. Specificity of risk limits or underwriting standards may need improvement to fully communicate policy requirements.	Floor plan lending policies do not provide clear portfolio objectives, appropriate risk limits, loan underwriting standards, and risk selection standards. In some instances, the policies may be adequate but are not enforced or followed.	Floor plan lending policies are largely deficient and require significant improvement. Policies may be unclear or too general to adequately communicate portfolio objectives, risk limits, and underwriting and risk selection standards.

Strong	Satisfactory	Insufficient	Weak
Floor plan lending is effectively managed. Floor plan lending staff possesses sufficient expertise to effectively administer the risk assumed. Responsibilities and accountability are clear. Appropriate remedial or corrective actions are taken when necessary.	Floor plan lending is satisfactorily managed, but improvement may be needed in one or more areas. Floor plan lending staff generally possesses the expertise to administer the assumed risks, but additional expertise may be required in one or more areas. Responsibilities and accountability may require some clarification. In general, appropriate remedial or corrective actions are taken when necessary.	Floor plan lending is insufficiently managed, and improvement in risk management is needed in several areas. Floor plan lending staff may not possess the expertise needed to administer the assumed risk effectively, and additional expertise is required in a few areas. Responsibilities and accountability require clarification or correction. Appropriate remedial or corrective actions are not always taken, and a more proactive stance is needed.	Floor plan lending risk management is deficient. The floor plan lending unit may not possess sufficient expertise or may demonstrate an indifference or unwillingness to effectively administer the risk assumed. Responsibilities and accountability may not be clear. Corrective actions are deficient to address root causes of problems.
Diversification management is effective. Floor plan loan concentration limits are set at reasonable levels and risk management practices are sound, including management's efforts to reduce or mitigate exposures. Management effectively identifies and understands correlated risk exposures and their potential impact.	Diversification management is adequate, but certain aspects may need improvement. Floor plan loan concentrations are identified and reported, but limits and other action triggers may be absent or moderately high. Concentration management efforts may be focused at the individual loan level, while portfolio-level efforts may be inadequate. Correlated exposures may be identified, and their risks are generally understood.	Diversification management is insufficient to manage concentrations adequately. Concentrations may be identified but not completely or with strategic plans in mind. Limits or triggers may be absent, high, or not understood. Portfolio-level concentration management efforts are inadequate. Correlated exposures are not adequately identified, and their risks are not fully understood.	Diversification management is passive or deficient. Management does not identify concentrations, or takes little or no action to reduce, limit, or mitigate the associated risk. Limits may be present but represent a significant portion of capital. Management does not identify and understand exposure correlations and their potential impact. Concentration limits may be excessively raised or frequently exceeded.
Floor plan management and personnel compensation structures provide an appropriate balance among floor plan loan/revenue production, floor plan loan quality, and portfolio administration, including risk identification.	Floor plan management and personnel compensation structures provide a reasonable balance among floor plan loan/revenue production, floor plan loan quality, and portfolio administration.	Floor plan management and personnel compensation structures provide an insufficient balance among production, loan quality, and portfolio administration.	Floor plan management and personnel compensation structures are skewed to floor plan loan/revenue production. There is little evidence of substantive incentives or accountability for floor plan loan quality and portfolio administration.

Strong	Satisfactory	Insufficient	Weak
Floor plan staffing levels and expertise are appropriate for the size and complexity of the unit. Staff turnover is low, and the transfer of responsibilities is orderly. Training programs facilitate ongoing staff development.	Floor plan staffing levels and expertise are generally adequate for the size and complexity of the unit. Staff turnover is moderate and may result in some temporary gaps in portfolio management. Training initiatives are adequate.	Floor plan staffing levels and expertise may not be adequate to support the size and complexity of the unit. Recent turnover and experience levels are affecting portfolio management. Additional staff training may be needed.	Floor plan staffing levels and expertise are deficient. Turnover is high. Management does not provide sufficient resources for staff training.
Staff effectively identifies, approves, tracks, and reports significant policy, underwriting, and risk selection exceptions individually and in aggregate, including risk exposures associated with off-balance-sheet activities.	Staff identifies, approves, and reports significant policy, underwriting, and risk selection exceptions on a loan-by-loan basis, including risk exposures associated with off-balance-sheet activities, but little aggregation or trend analysis is conducted to determine the effect on portfolio quality.	Staff insufficiently identifies, reports, and monitors exceptions to policies, underwriting, and risk selection on a loan-by-loan basis, including risk exposures associated with off-balance-sheet activities. Aggregation and trend analysis is lacking, which could result in flawed reporting of the portfolio quality and uninformed decision making regarding risk selection.	Staff does not identify, approve, or report policy, underwriting, or risk selection exceptions; does not report them individually or in aggregate; or does not analyze the exceptions' effect on portfolio quality. Risk exposures associated with off-balance-sheet activities are not considered.
Credit analysis is thorough and timely both at underwriting and periodically thereafter.	Credit analysis appropriately identifies key risks and is conducted within reasonable time frames. Post-underwriting analysis may need improvement.	Credit analysis is insufficient to identify key risks in a timely manner. Periodic analysis is inadequate or not always timely. Additional training may be needed.	Credit analysis is deficient. Analysis is superficial and key risks are overlooked. Credit data are not reviewed in a timely manner.
Risk rating and problem floor plan loan review and identification systems are accurate and timely. Credit risk is effectively stratified for both problem and pass-rated credits. Systems serve as effective early warning tools and support risk-based pricing, ALLL, and capital allocations.	Risk rating and problem floor plan loan review and identification systems are adequate. Problem and emerging problem credits are adequately identified, although room for improvement exists. The gradation of pass ratings is generally adequate but may need to be expanded to facilitate early warning, risk-based pricing, or capital allocations.	Risk rating and problem floor plan loan review and identification systems are insufficient to provide accurate and timely information. The gradation of pass ratings is insufficient and should be expanded to facilitate early warning, risk-based pricing, or capital allocations.	Risk rating and problem floor plan loan review and identification systems are deficient. Problem credits may not be identified accurately or in a timely manner, resulting in misstated levels of portfolio risk. The gradation of pass ratings is deficient to stratify risk for early warning or other purposes.

Strong	Satisfactory	Insufficient	Weak
The accuracy, timeliness, and scope of MIS are satisfactory. Management and the board receive appropriate reports to analyze and understand the impact of floor plan lending activities on the bank's credit risk profile, including off-balance-sheet activities. MIS facilitates timely exception reporting.	The accuracy, timeliness, and scope of MIS are generally satisfactory. Management and the board generally receive appropriate reports to analyze and understand the impact of floor plan lending activities on the bank's credit risk profile, but modest improvement may be needed in one or more areas. Generally, MIS facilitates timely exception reporting.	The accuracy, timeliness, and scope of MIS may not be acceptable. Management and the board do not consistently receive appropriate reports to analyze and understand the impact of floor plan lending activities on the bank's credit risk profile, and improvement is needed in several areas. MIS may not facilitate timely exception reporting.	The accuracy or timeliness of MIS is materially deficient. Management and the board are not receiving sufficient information to analyze and understand the impact of floor plan lending activities on the bank's credit risk profile. Exception reporting is deficient and requires a major overhaul.

Appendix D: Glossary

Asset-based lending (ABL): A specialized loan product based on assets pledged as collateral and structured to provide a flexible source of working capital for the borrower by monetizing the borrower's assets on the balance sheet. Advance on ABL is limited by a percentage of the collateral value known as the borrowing base, and the bank is required to have extensive monitoring and reporting of the borrower and strong controls of the underlying collateral and cash flows through mechanisms such as field audits, cash dominion, and lockboxes.

Capital fund ratio: A solvency measure reflecting the balance sheet leverage of a dealership, taking into consideration the tax effect of LIFO reserve. The ratio can be expressed as: (total liabilities – subordinated debt) ÷ (tangible net worth + a percentage of LIFO reserve + subordinated debt).

Cash burn: An asset liquidity measure also known as working capital burn rate that indicates how long a dealership could sustain its current operations without any new sales. For a dealership, the ratio can be expressed in number of days as: (unrestricted cash + contracts in transit + holdback + factory accounts receivable + inventory accounts receivable + new inventory – reserve for doubtful accounts – new floor plan debt outstanding) ÷ [(operating expenses – depreciation + cash interest paid + cash tax paid + current portion of long-term debt + curtailment paid) ÷ days in the statement period].

Curtailment: Additional principal reduction beyond what is required under a typical loan amortization scheme. The extra principal reduction can be predetermined or prompted by the occurrence of adverse credit conditions, such as faster-than-expected depreciation of the collateral.

Dealer endorsed: An installment sales contract guaranteed in full or in part by the dealer.

Dealer paper: Retail sales contracts underwritten and sold by a dealer to a financing source, such as a bank or credit union.

Dealer recourse: An agreement between the bank and the dealer that provides the bank the right and the option of requiring the dealer to buy back indirect dealer paper it has sold to the bank or pay any deficiencies in the event of nonperformance by the consumer.

Dealer repurchase: An agreement between the bank and the dealer that under certain circumstances a dealer may, at its discretion, buy back indirect dealer paper it has sold to the bank or pay any deficiencies in the event of nonperformance by the consumer.

Dealer reserve: A deposit account credited with discounts the dealer earned on the sale of indirect loans to the bank. The account is controlled by the bank and is used to charge back nonperforming loans to the dealer.

Factory/manufacturer receivables: A dealer's accounts receivable from the manufacturers. It is usually in the forms of factory holdbacks and warranty claims.

Floor plan coverage ratio: A measurement of inventory coverage of the floor plan liability. The ratio can be calculated as: (inventory (including LIFO reserve) + factory holdbacks) ÷ floor plan debt outstanding. The ratio can be customized for new or used inventory.

Holdback: A form of factory receivables, i.e., the amounts due from manufacturers. For an automobile manufacturer, a holdback is added to the invoice price of the unit and is usually 2 percent to 3 percent of the new vehicle cost. Holdbacks are usually paid to the dealer quarterly.

Inventory days: The average number of days it takes to turn over new and used inventory. It is calculated as: 365 x (average inventory ÷ the cost of sales).

Inventory turnover: The number of times inventory turns over in a year, calculated as cost of goods sold divided by average inventory in a year.

Last in, first out (LIFO): A method of valuing inventory and cost of goods sold that provides for costing in the income and expense statement on the basis of the cost of the latest dated items taken into inventory. The major objective of the LIFO method is to use the most recent costs to account for goods sold. The LIFO inventory method understates inventory value when prices are rising, thus understating a company's earnings, its tax liability, and its ability to repay debts.

Manufacturer recourse: An agreement between the bank and the manufacturer or between the dealer and the manufacturer that allows the bank or the dealer the right and option to send any unwanted or unsold inventory back to the manufacturer to repay the associated floor plan obligation or to avoid having to pay the manufacturer.

Manufacturer repurchase: An agreement between the bank and the manufacturer or between the dealer and the manufacturer that, under certain circumstances, the manufacturer may at its discretion take back any unwanted and unsold inventory to reduce the associated floor plan debt.

Manufacturer's statement of origin (MSO): Also known as the manufacturer's certificate of origin, an MSO is a certification of a brand-new vehicle by the manufacturer. The MSO is required in some states to register or title a new vehicle.

Out of trust: A dealer is considered to have sold out of trust if a floor plan check determines that the dealer failed to pay the bank for sold inventory within the required time frame and that the amount owed is in excess of the dealer's available cash balances, or if the bank cannot verify any links between contracts in transit and the sold inventory.

Rate of travel: A measure of the dealer's average monthly sales performance in units. It is typically set as the sales goal for the dealer under the dealer-manufacturer agreement.

Service absorption: The level of fixed overhead covered by the gross profit from the parts, service, and body shop departments of a dealer. The measure can be calculated as: gross profit from the parts, service, and body shop ÷ (total expenses – variable sales expense).

Sight draft: A type of draft used with shipments of inventory to a dealer under floor plan financing. Unlike a time draft, which allows for a short-term delay in payment after the dealer receives the goods, a sight draft is payable immediately when presented to the financing bank for payment.

Trust receipt: A form of security interest used in ABL and trade financing. In inventory financing involving a trust receipt, the bank is the owner of the merchandise and holds the title, while the dealer holds and sells the merchandise in trust for the bank to repay the loan.

References

Laws

12 USC 24(Seventh), “Corporate Powers of Associations”
12 USC 84, “Lending Limits”
12 USC 371c, “Banking Affiliates”
12 USC 371c-1, “Restrictions on Transactions With Affiliates”
12 USC 375a, “Loans to Executive Officers of Banks”
12 USC 375b, “Extension of Credit to Executive Officers, Directors, and Principal Shareholders of Member Banks”
12 USC 1464, “Federal Savings Associations”
12 USC 1468, “Transactions With Affiliates; Extensions of Credit to Executive Officers, Directors, and Principal Shareholders”

Regulations

12 CFR 30, “Interagency Guidelines for Establishing Standards for Safety and Soundness”
12 CFR 32, “Lending Limits”
12 CFR 160.30, “General Lending and Investing Powers of Federal Savings Associations”
12 CFR 163.170(c), 12 CFR 163.170(d), and 12 CFR 163.170(e), “Establishment and Maintenance of Records”
12 CFR 215, “Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks” (Regulation O)
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