PART I

HOW CREDIT WORKS

Chapter 1: Credit in the Business World
Chapter 2: Credit in the Company
Chapter 3: Organizing the Credit Department
Chapter 4: The Credit and Sales Partnership
Credit in the Business World

Overview

Credit is a privilege granted by a creditor to a customer to defer the payment of a debt, to incur debt and defer
its payment, or to purchase goods or services and defer payment. This chapter provides an introduction to the topic
of credit. It explores the history of credit, the primary reasons credit is offered and presents an overview of the
credit process.

Additionally, the types of credit are defined and discussed. Lastly, the chapter provides an overview of the
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Think About This

Q. How would business be conducted in a world without credit?
Q. A new tech startup and a company that is speculated to have poor financial management both place an order with your company, what factors would you take into account when extending credit?
Q. How does credit change based on the industry or the economic and business conditions?

Disciplinary Core Ideas

After reading this chapter, the reader should understand:

- The historical development of credit.
- The primary reasons credit is offered.
- The important elements of credit.
- The credit process and where credit fits into a business cycle.
- The different types of credit.
- The Federal Reserve System and its impact on the economy.

Chapter Outline

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A Brief History of Credit

The idea of exchanging goods or services in return for a promise of future payment developed only after centuries of trade; money and credit were unknown in the earliest stages of human history. Nevertheless, as early as 1300 B.C., loans were made among the Babylonians and Assyrians on the security of mortgages and advance deposits. By 1000 B.C., the Babylonians had already devised a crude form of the bill of exchange so a creditor merchant could direct the debtor merchant in a distant place to pay a third party to whom the first merchant was indebted. Installment sales of real estate were being made by the Egyptians in the time of the Pharaohs.

Traders in the Mediterranean area, including Phoenicia, Greece, Rome and Carthage, also used credit. The vast boundaries of the Roman Empire encouraged widespread trading and a broader use of credit. In the disorganized period that marked the decline and fall of the Roman Empire, credit bills of exchange and promissory notes were widely used to reduce the dangers and difficulties of transferring money through unorganized trading areas.

During the Middle Ages, a period which spanned 1,000 years from about 500 to 1500 A.D., credit bills were essential to the trading activities of the prosperous Italian city-states. Lending and borrowing, as well as buying and selling on credit, became widespread practices; the debtor-creditor relationship was found in all classes of society from peasants to nobles. A common form of investment and credit, especially in Italy, was the “sea loan” whereby the capitalist advanced money to the merchant and thus shared the risk. If the voyage was a success, the creditor got the investment back plus a substantial bonus of 20 to 30 percent; if the ship was lost, the creditor stood to lose the entire sum.

Another form of credit was the “fair letter,” which was developed at fairs held regularly in the centers of trading areas during the Middle Ages. The fair letter amounted to a promissory note to be paid before the end of the fair or at the time of the next fair. It enabled a merchant, who was short of cash, to secure goods on credit. This gave the merchant time either to sell the goods brought to the fair or to take home and sell the goods that had been purchased on credit.

Credit in Early America

The discovery of the New World provided new opportunities for the growth of capitalism and the expansion of credit. The first recorded use of open credit in early America took place with the establishment of the first permanent colony in New England. In September 1620, the Mayflower set sail from England for Virginia. Because of bad weather and navigational errors, the Pilgrims ended up off the coast of Cape Cod and eventually established the village of Plymouth in Massachusetts. Not only was the journey itself was a tremendous achievement, its financing was as well.

The Pilgrims had spent three years of arduous negotiations in England attempting to raise the funds necessary for the trip. A wealthy London merchant financed the trip and provided for “all credit advanced and to be advanced.” In return, the Pilgrims contracted to work for seven years. At the end of that period, payment would be made to the creditors based on the size of the individual investment.

The original credit of £1800 could not be paid at the end of seven years, so an alternative arrangement was agreed upon: £200 to be paid annually for a term of nine years. This arrangement had to be renegotiated and finally, after 25 years, the last payment was made. This was the first example of credit in early America.

To finance the American Revolution, the Second Continental Congress made efforts to finance the Army of the United Colonies. The Congress had only three alternatives: borrow the money from sympathetic countries abroad, which was an impossible task since the Colonists’ credit in the world stood at zero; impose taxes, which was unpopular and the very cause that had brought about the American Revolution; or issue bills of credit.

In June 1775, the Continental Congress authorized the printing of $2 million in various denominations ranging from one dollar to eight dollars. Trouble for the Continental currency began almost at once; each note had to be hand signed, which was not a simple task considering there were 49,000 of them. Counterfeiting of the currency was rampant. The principle behind the Continental currency was, in essence, a promise to pay the final bearer, at some point in the future, the face value in Spanish coins, the coins in widest circulation at that time.
In 1783, the Treaty of Paris was signed bringing an official end to the war and official recognition of the United States by England. Trading resumed and American importers and wholesalors extended generous terms to their customers. Generally, sales were made on terms of 12 months, but even where six- or nine-month terms were offered, it was not uncommon for an account to remain unpaid for a much longer period, sometimes up to 24 months or more.

With the restoration of pre-Revolutionary trade customs and habits, credit references assumed importance, although in most instances, proper information was still lacking. Some prospective purchasers took the precaution of using the names of prominent people they knew when placing orders on credit. While credit references sometimes accompanied orders, in most cases merchants took their chances. Terms of sale, as they developed during the 1800s, reflected the changes in the rapidly expanding economy. The 12-month period, which had prevailed, gradually became shorter. By the 1830s, the average term of sale was about six months.

Hard financial times hit the country in the mid-1830s. The population was rapidly growing and business was expanding. The sale of land on credit went virtually unchecked and the banking system was not centralized. By the summer of 1837, bank after bank closed its doors and thousands of businesses went into bankruptcy. The financial panic of 1837 saw the beginnings of the Mercantile Agency, established in 1841 by Lewis Tappan. It was this credit information agency that eventually became Dun & Bradstreet and helped transform credit and, with it, the course of American commerce.

Transition from Barter

It has been said that the growth of specialization is one of the distinguishing features of modern society. That may be so, but specialization surely began far back in the midst of time when one of our ancestors decided that he had just had too much! He couldn’t do everything himself—hunt, fish, shape axe heads, fashion spears, and gather wood, salt and berries. Perhaps it was at that time that the revelation occurred. He was a good fisherman; his neighbor was not.

But that neighbor certainly knew how to turn out axe heads! He could give some of the surplus of fish to the neighbor in exchange for an axe head or two. Thus, the birth of barter.

A particularly fascinating type of barter, and one that implicitly established one as a creditor, was practiced by Native Americans: a form of exchange called potlatch. The social status of the giver rose in proportion to the magnificence of the gifts offered—and the accompanying influence that was gained by having others in your debt.

Simple barter, useful as it was, had some limitations: If your neighbor didn’t want any of your fish, you had to find someone who did—and fast. Commodity money, which developed out of simple barter, overcame this difficulty. Commodity money was something that had assumed some accepted value. As a portable store of value, it could be exchanged for a wide variety of items. Cowrie shells, for example, were used in China 3,500 years ago and more recently in New Guinea, Africa, many Pacific Islands and in various parts of the Middle East. Cattle were, and still are, used as money in parts of the world. Salt was also a common medium of exchange (salt bars were still being used as money as recently as the 1920s). Early American colonists borrowed an idea from Native Americans—wampum (elaborate and beautiful strings of beads)—and declared it legal tender in Massachusetts in 1637. Other examples abound: fish hooks, feathers, amber, rice, human skulls, ivory, drums, nails, hoes and furs, to name but a few.

Comprehension Check

Explain the reasons credit has evolved.

The story of American credit was not solely influenced by Dun & Bradstreet. Another organization important for credit professionals worldwide was formed in 1896 in Toledo, Ohio. A group of credit executives, representing a hundred or so of their colleagues, organized a national association for credit professionals, the National Association of Credit Men. Their exchange of credit information was initially conducted on local and regional levels. The association expanded into the National Association of Credit Management (NACM), which today with its network of Affiliated Associations, represents more than 14,000 credit professionals worldwide. NACM’s purposes and objectives are:
• To promote honest and fair dealings in credit transactions.
• To ensure good laws for sound credit.
• To foster and facilitate the exchange of credit information.
• To encourage efficient service in the collection of accounts.
• To promote and expedite sound credit administration in international trade.
• To encourage training for credit work through colleges, universities, self-study courses and other means.
• To foster and encourage research in the field of credit.
• To disseminate useful and instructive articles and ideas with respect to credit management techniques.
• To promote economy and efficiency in the handling of estates of insolvent, embarrassed or bankrupt debtors.
• To provide facilities for investigation and prevention of fraud.
• To perform other such functions as the advancement and protection of business credit may require.

Primary Reasons to Offer Credit

Business or trade credit has been part of the U.S. business scene for hundreds of years—and the use of credit in the purchase of goods or services is so common that it is taken for granted. Trade credit is, and continues to be, a very important source of funds for firms. It provides more financing to businesses than does commercial borrowing or corporate bond financing. Without business credit, the economic system would not exist.

The primary reason for a company to offer credit terms to customers is to accommodate the sale of goods and services in order to create revenue. The principal reasons companies offer credit are:

• Increase Sales. Extending credit to buyers often involves a trade-off between holding inventory or holding accounts receivable.
• Competition. Matching a competitor’s credit terms may be a sales necessity.
• Promotion. A business may offer special credit terms as part of a promotional program for a product.
• Credit Availability. Some buyers may not have access to any other forms of credit. In tight credit times, seller trade terms or financing may be necessary.
• Convenience. Trade credit provides benefits not easily obtained from other payment arrangements. One of the biggest benefits is the simple convenience of paying for hundreds of purchases in a single transaction.
• Demand. Credit is extended in response to customer demand for a company’s products or services. This implies that the sale may or may not take place without the extension of credit.
• Price. The granting of trade credit is an aspect of price. The time that the buyer gets before payment is due is one of the dimensions of the product, such as quality and service, which determines the attractiveness of the product. Like other aspects of price, the firm’s terms of sale and credit-granting decisions affect its sales volume.

Comprehension Check

Explain why organizations like NACM evolved.

Comprehension Check

List and explain the reasons credit is offered.

Explain why a sale may not occur without credit.
Elements of Credit

Several essential points are always included in any definition of credit. First, there must be an exchange of values which sets up the transaction. Goods or services are obtained for a promise to pay, and payment is made when it comes due. This introduces the second factor: futurity and its companion, trust. The credit sale relationship between customer and supplier is based on trust and mutual need. The very derivation of the word “credit” from the original Latin credere, to believe or trust, graphically describes the entire process of credit as a matter of mutual trust and confidence. The buyer selects the supplier on the basis of its reputation as a source of a quality good at an acceptable price. The supplier accepts the order and extends the credit necessary to facilitate the sale if it believes the customer will honor the contract by paying the invoice according to the terms agreed. Thus, credit can be appropriately described as the transfer of economic value now, on faith, in return for an expected economic value in the future.

Where goods or services are exchanged immediately for cash, there is no futurity, no trust and no need for the seller to have confidence in the buyer. None of these is needed since economic payment is made at the time of purchase.

Credit sales represent an extension of the cash inflow timeline. When credit is granted, the seller does not require cash at the time of the sale, but rather permits payment to be made at a specific date in the future. When a payment is offered, the seller must decide whether or not to accept it. Many times company policy will guide the seller’s action, while at other times a snap judgment may be necessary. Since the transaction involves futurity, trust and confidence, the credit concept is involved. The futurity of non-cash payments is short—just long enough for the payment to clear. Trust and confidence, however, are just as significant in this example as they are with longer terms. Once the seller has transferred goods to a buyer, legal steps are necessary to repossess these goods.

When unsecured credit terms are offered, the seller gives up goods or provides services in exchange for the promise of the buyer to pay at a specific future date. The seller is convinced that payment will be received when it is due—and that the buyer can be trusted. In a sale made on 30 or 60 day terms, for instance, the futurity aspect of credit is important; and as selling terms lengthen, the seller’s analysis of the buyer’s ability to pay on or by the due date becomes increasingly important.

There is no doubt that selling on credit is more costly than selling for cash. Those costs include the cost of the credit department, the investment of company funds in receivables, discounts for early payments, and the cost of converting receivables to cash and collecting bad debts. All of these factors comprise the cost of credit. No matter how great these costs, however, they are more than offset by distinct sales advantages. By offering credit terms, the seller can build a greater customer base, make more efficient use of production facilities, create greater goodwill, expand geographical markets, accept marginal risks, earn incremental profits and ultimately realize a greater return on investment.

There are several important elements of credit:

- **Risk of Nonpayment.** The purchaser may default in making any or all of the payments due to the seller.
- **Timing.** When credit is offered, the seller must wait for payment, even if that payment is received on time. This increases the risk of losing the use of funds that are tied up in financing the credit transaction or, if a payment is late, in carrying or financing the past-due customer.
- **Security.** As a means of gaining partial or full protection for the credit transaction, a seller may require the purchaser to pledge a form of collateral or provide a financial guarantee. This can be accomplished by pledging an asset, providing a personal, corporate or bank guarantee or entering into a security agreement.

Comprehension Check

What does the Latin term *credere* mean?

Explain why selling on credit is more expensive than cash, but ultimately beneficial.
• **Extra Costs.** The seller incurs expenses with granting credit, such as carrying receivables and the costs associated with the collection process.

• **Legal Aspects.** Federal and state laws have been enacted that affect both the credit grantor and debtor. Both businesses and consumers must be aware of applicable state and federal laws.

• **Economic Influences.** Changes in economic conditions, such as the rate of inflation and currency value fluctuations, can have strong effects on credit sales. For example, in inflationary times, a seller will not want to wait too long before getting paid and will likely impose stricter credit policies.

Companies are exposed to many changes: political and demographic changes, recessions, inflation and interest rate fluctuations. Companies within a particular industry confront additional risks relating to technological changes, shifting competition, rapid growth, regulation and the availability of raw materials and labor. Management competency, litigation and the company’s strategic direction are additional sources of risk. All of these factors affect a company’s operating performance, net income and cash flows, which affect the buyer’s ability to pay. Credit in its broadest sense is based on the components of trust, risk, economic exchange and futurity.

### The Five Cs of Credit

Credit analysis is traditionally based on what is known as the **Five Cs of Credit:** (1) **Character,** (2) **Capacity,** (3) **Capital,** (4) **Collateral** and (5) **Conditions.** The Five Cs of Credit provide the credit manager or analyst with a framework for conducting a controlled investigation process and, therefore, deliver a credit evaluation that considers each component of credit risk associated with credit approval.

But are we limited to only the Five Cs listed? Consider the changes over the years in various industries not to mention the economy at large. **Competition** is also important since the credit analysis process can be influenced by terms or conditions the competition is offering in the marketplace. In addition, the credit professional must exercise **Common Sense;** if, on the surface, something doesn’t seem right, then more questions should be asked, more information gathered and a harder look taken.

In each case the credit professional must measure the business credit account against every one of the Cs before issuing credit approval or a final recommendation. Sometimes the degree of credit investigation can depend on the customer’s or potential customer’s size or importance to the credit grantor and to the credit grantor company’s established policy and procedures; thus, credit policy can require certain levels of credit investigation for different sizes or types of accounts. Therefore, it is possible for one C component to outweigh other C components.

### Character

**Character** refers to the *willingness* of a debtor to pay its obligations and imputes a level of ethics, integrity, trustworthiness and quality of management that is provided or available to the business customer (proprietorship, corporation, etc.). Examining the business character of a customer requires that the credit professional learn about the previous business background of the people who own, manage or preside over that entity. Management that have been, or are currently in business on their own, or who have been officers of corporations, can be evaluated on the success or failure of the business in which they have been or are currently involved. A company with a long-standing record of operation without litigation or financial difficulty indicates a favorable business record. On the other hand, a company with a record of litigation or bankruptcy could suggest a possible risk. In both cases, a company reflects upon the people who managed it during times of success, setback or even failure. If a business applying for business credit involves ownership by a principal who has been involved in a business failure, the credit professional should determine the cause and then consider the reason in any subsequent credit decision. A previous business holding
that was destroyed as a result of a force of nature could have a bearing on a decision to grant credit that is far different from a previous business holding that failed because of mismanagement or negligence.

When questions linger about a principal (or personal guarantor), it is reasonable to obtain a personal (consumer) credit report on the principal of the business that is applying for business credit. A “permissible purpose” and the written consent of the subject of the inquiry are required to obtain a consumer credit report.

Other Character considerations:

- Is this business able to redefine itself in a changing market?
- What is the impact of technological evolution on this business?
- How willing is the customer to share information?
- How diligently does the customer complete the credit application?

Capacity

Capacity deals with the inclination or propensity of a business to operate profitably and its ability to pay trade creditors, banks, employees and others as those debts become due. Capacity can be substantiated by a customer’s ability to generate positive cash flow and by current and previous acts and deeds. The credit professional needs to know how the company handles large volume orders, exacting specifications or tight delivery schedules. Can the company grow and is it able to provide or obtain the needed capital and the necessary financing?

Capital

The value of a customer’s business in excess of all liabilities and claims is referred to as its equity or net worth, and represents its financial strength in terms of Capital. Capital does not equate to cash; it is the amount of wealth available, in several forms, to be employed by a business in the production of more wealth—in the form of products/inventory purchased for resale, manufactured goods, or the purchase of permanent and fixed assets such as machinery or buildings. In evaluating Capital, the credit professional seeks to determine whether the customer possesses the ability to satisfy its obligations and lessen credit risk. This approach is different from the first “C,” Character, which seeks to judge if the account is willing to pay. This factor highlights a company’s financial condition and trend of operations. Each case is judged on its own merit, since many factors affect financial condition. Some industries need a large investment in fixed assets; others require only a minimum investment in machinery and fixtures. Similarly, some lines of business must have large amounts of ready cash and liquid assets to meet seasonal operating expenses, while others may rely on regular cash inflows to meet maturing debts.

Collateral

If the cash flow of a business customer is not adequate, the credit manager can request a second source of repayment called Collateral: property that may be pledged as security for the satisfaction of a debt. The type of property that can be pledged includes equipment, buildings, accounts receivable, stocks and bonds, inventory and other tangible assets that, once pledged, can be seized and sold by the creditor if the company defaults on the debt.

The credit manager must determine whether the business has additional resources in the form of equity in the assets pledged that can be liquidated for payment. Additionally, the credit professional must discover if the potential collateral is unencumbered or if it has been pledged to, and secured by, other creditors. If the asset pledged is not free and clear, then the creditor taking the security interest may be at the mercy of other creditors who took the same asset as security ahead of later entries. The position of the secured party is based on the legal principle of “first in time, first in right,” which means that liquidation of security interests is based on what priority the security instruments were taken and filed.

Assets can be pledged voluntarily with the use of security agreements and filings. This type of pledge is best administered in advance of a credit sale. The security agreement should carefully identify items pledged as collateral.

Assets can also be obtained involuntarily using such legal instruments as liens or judgments then executed to liquidate property taken and used for repayment. Encumbering assets in this manner is usually after the fact of the
credit sale, is not by agreement but rather by a function of state law, is not friendly and often involves additional time and expense.

**Conditions**

External events, occurrences, phenomena and factors that may interrupt or otherwise disturb the normal flow of business are *Conditions* the credit professional considers when examining a new or existing customer’s credit. Some examples of *Conditions* are:

- National, regional or local economic environment.
- State and federal government regulations.
- Weather phenomena (hurricane, ice storm, drought, flood, etc.).
- Catastrophic events (fire, explosion, terrorist attack, etc.).

If providing credit to a customer who sells internationally, then other *Conditions* must be considered such as the stability of a foreign country’s government and/or currency exchange rates.

The credit professional considers how sensitive the company’s sales are to these *Conditions*. Will the company’s sales fall dramatically or will they be relatively unaffected if faced with situations as described above? Companies with stable sales that are not tied closely to the overall economy (e.g., food and essential life products) are generally looked upon more favorably by creditor grantors. Similarly, the likelihood of a satisfactory credit experience is greater when the subject is in an industry that is in a period of growth.

It is important for the credit professional to know industry cycles and if a customer’s industry is subject to periods of highs and lows. The credit professional will look more favorably on a business that demonstrates increasing sales, profits and net worth. Essentially, two words may summarize *Conditions*: demand for the product or service the customer offers, and circumstances that affect the business that are beyond management’s control.

### Comprehension Check

**Why might one C be considered more important?**

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**Canons of Business Credit Ethics**

The cornerstone of the global business economy is the extension of commercial credit. As such, business credit executives, as the guardians of commercial receivables, play the vital and critical role of ensuring the flow of commercial goods and services that support world commerce.

In fulfilling their professional duties, business credit professionals pledge to conduct their duties within the constraints of law and to not maliciously injure the reputation of others. Further, business credit professionals pledge themselves to the highest professional standards and principles and to guarding and securing, in confidence, information obtained for the sole purpose of analyzing and extending commercial credit.

Credit professionals pledge to:

- Adhere to the highest standards of integrity, trust, fairness, personal and professional behavior in all business dealings.
- Negotiate verbal or written credit agreements, contracts, assignments, and/or transfers with honesty, fairness, and due diligence to and for the benefit of all parties.
- Render reasonable assistance, cooperating with impartiality and without bias or prejudice, to debtors, third parties, and other credit professionals.
- Exchange appropriate, historical and current factual information to support the process of independent credit decisioning.
FIVE Cs OF CREDIT

When investigating a new customer or performing a review on a current customer who does not have financials to investigate, turn to a process that was employed nearly a half-century ago. The process is known as the 5 Cs of Credit: Character, Capital, Capacity, Conditions and Collateral.

A customer’s character will define their willingness to pay for the product or service being provided. To develop an opinion on a customer’s character, it is advantageous to review their management staff and see if they have been in the same form of business for a long period of time, or if this is their first time in the industry. If the business history is short, it is advisable to move with caution. Some of the steps a credit professional could take in this situation are to visit the customer, see how the business is set up and talk with the management to see what their growth plan or business plan is. Ask them if you can review their financials while you are there and discuss any flags that you may find. If the credit professional is unable to visit, a credit report could be pulled along with the references they provide to see what the payment history of the company is. Also check if the company has any judgments against them, if any of their accounts have been placed for collections, or if any liens have been established. When the credit professional performs the bank reference check, a review of the NSF checks that are reported and how long the bank account has been opened can also assist in defining character.

Unlike character, capital determines if the customer is able to pay their debts in a timely manner. Ideally, it is beneficial to have financial statements available for review. However, a credit professional is able to look at other factors if they are not available. A review of the customer’s life cycle can define when the cash flow is at a high for the company and their expenses are at a high (i.e., a seasonal operation or companies that do not make payments at quarter end). A credit professional could use the third-party credit data that was pulled to see if there are any judgments or liens that might become due during the time frame when a payment would be expected. If the credit professional’s industry has an Industry Trade Group, it would be beneficial to see how the company being reviewed is defined in the trade group ranking and see how they compare with companies that others in the industry sell to. If it is an existing customer and a review is being done, what the credit analyst has experienced with the customer could be taken into consideration when reviewing capital. If the credit analyst has developed a rapport with the accounts payable analyst, they may have additional insights as to how the company is performing based on previous conversations.

The capacity of a company shows the credit professional whether the customer has the proper legal structure to allow the corporation to continue making payments to the debtor. This can relate to the review of management that was performed in the character section by looking at the managers in charge of the three key business operations: marketing, financial and production. From the marketing standpoint, the credit professional could review the different business segments that the company is involved in as well as the company’s marketing priority. From the financial standpoint, the manager that is in place can be researched to see what other companies they have been tied to. Look at the history of those companies and understand their general overall strategy. From the production standpoint, the credit professional could review the level of automation the company has to see if the it can keep up with changing demands of production. If the information on the managers is not available on the company’s website, perhaps an Industry Trade Group would be able to provide the information, or use third-party credit ratings or certain websites such as Manta.com. Once the information about the managers is found, a great way to see their professional history and review the companies they worked for is to look on their LinkedIn profile.

When considering conditions, the general economic conditions that currently exist in the country where the company would be doing business are important. The credit professional would review the overall performance of the industry that they are operating in to help determine the amount of risk that is acceptable. A review of what the selling margin would be could possibly allow certain levels of risk to be overlooked, or if the customer also sells product to your company, a review of the payables due to them could help mitigate risk of open receivables.

Lastly, employing collateral would allow the credit professional to obtain a letter of credit as a payment option, a personal or a corporate guarantee from the company, any liens on equipment that might be able to be placed, and again, as in conditions, any payable that your company may owe them to offset any debtor obligation. If the credit professional is able to offset any liability with these options, the review of the customer could become easier.

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Graduate School of Credit and Financial Management class of 2016
• Exercise due diligence as required to prevent unlawful or improper disclosure to third parties.
• Disclose any potential conflict in all business dealings.

Further, credit professionals acknowledge the importance of, and shall promote the benefits of, continued improvement of their knowledge, skills, and expertise in business credit. The pursuit of knowledge will support the strategic advancement of the commercial credit function as it leads businesses to profitability and growth.

The Credit Process

In simple terms, the credit process begins with a buyer (a company or individual consumer) deciding to purchase a product or service from a seller that either makes or provides a product or service. The buyer offers a means of trading value, or a medium of exchange, for the goods or service. Cash is most readily accepted by the seller, but the seller may also offer a form of deferred payment or credit.

The Credit Process
- Sales makes contact and order is taken.
- Credit department reviews customer for creditworthiness.
- Goods or service delivered on credit.
- Payment is made on time/within terms.

Credit is part of a company’s operating cycle. An operating cycle can be defined as the period of time between the acquisition of material, labor and overhead inputs for production and the collection of sales receipts. During the operating cycle, a manufacturer is both a debtor and a creditor. Consider a typical operating cycle for a manufacturer: the operating cycle begins when the manufacturer purchases raw material from a supplier. The purchase of raw material is usually a business credit transaction. The material is converted into goods during the production stage, and the manufacturer must pay its supplier for the material. The manufacturer then sells the finished goods to a customer, who ultimately pays for the goods that were purchased on credit during the collection stage.

The purchaser becomes the debtor or user of credit, while the seller becomes the creditor or grantor of credit. The purchaser’s ability to obtain a product or service based on its promise to pay at a later date is called creditworthiness.

Figure 1-1 Operating Cycle

Comprehension Check
Define operating cycle.

Why will a manufacturer be both debtor and creditor at any given time?
Types of Credit

Because of its different uses, credit can be broadly classified as either public credit or private credit. **Public credit**, also known as government credit, is credit extended to or used by governments or governmental divisions, agencies or instrumentalities. **Private credit** is extended to or used by individuals or businesses to carry on the exchange of goods and services in the private sector.

**Public Credit**

Public credit includes the extension of, or borrowing by, any governmental unit. All levels of government—federal, state and local—borrow money to meet public needs, including financing the cost of schools, highways, health and social welfare and military preparedness. Governments buy a wealth of products and services such as tanks, planes, food, office supplies, books, computer equipment, labor, electricity and so forth. Private sector businesses provide nearly all of these products and services. In all cases where financing needs exceed revenue, governments must draw upon their borrowing capacity. This is usually done by the issuance of state, municipal or federal bonds, or in the case of the federal government, through the issuance of shorter-term Treasury bills and notes. Currency itself can be regarded in a sense as a credit obligation of the federal government, though it is usually not classified as such. Analysis of public debt is usually made on the basis of a government’s powers of future taxation.

On the other side of the equation is federal and state lending, which often has public policy objectives. Some of these loans include disaster loans, loans by the U.S. Small Business Administration, USDA business and industry loan programs and many others.
Private Credit

**Private credit** is extended to or used by individuals or businesses to carry on the exchange of goods and services in the private sector. Private credit can be divided into five broad categories:

1. Investment credit.
2. Consumer credit.
3. Agricultural credit.
4. Business credit.
5. Bank credit.

**Investment Credit**

This refers to the placement of funds in productive assets to earn a profit. **Investment credit can be defined as the long-term borrowing of large amounts of money to finance productive assets.** It consists primarily of loans made to governments or businesses to raise capital to pay for expansion, modernization or public projects such as highways or schools. A borrower may be an institution, a corporation, the U.S. Treasury or a state, city, town or county; an investor is a lender who can buy bonds issued by U.S. companies, the U.S. Treasury or states, counties and cities. **Bonds are loans that investors make to corporations and governments through which borrowers obtain the cash they need while lenders earn interest.** **Corporate bonds, usually applied to longer-term debt instruments, with maturity of at least one year, are higher risk than government bonds and thus higher yielding.**

Companies often prefer to offer a bond rather than to issue stock to raise money because issuing additional stock may lessen the value of shares already owned by investors. Unlike stockholders who have equity in a company, bond holders are creditors. Corporate bonds are listed on the New York Stock Exchange. Since governments are not profit-making entities and cannot issue stock to raise money, bonds are the primary way for governments to raise money to fund capital improvements.

**Bonds, or fixed-income securities, are generally long-term (more than 10 years) securities that pay a specified sum (called the principal) either at a future date or periodically over the length of a loan, during which a fixed rate of interest may be paid on a regular basis.** Every bond has a fixed maturity date when the bond expires and the loan must be paid back in full. The interest a bond pays is also set when the bond is issued. The rate is competitive, which means the bond pays interest comparable to what investors can earn elsewhere. As a result, the rate on a new bond is usually similar to other current interest rates, including mortgage rates.

The word “bond” once referred to the piece of paper, which described the details of a loan transaction; the term is used more generally to describe a vast and varied market in debt securities.

**Asset-backed bonds, created in the mid-1980s, are secured or backed up by specific holdings of the issuing corporation such as equipment or real estate.**

**Debentures are the most common corporate bonds.** They are backed only by the financial strength or standing of the organization issuing it, rather than by any specific assets. A debenture buyer relies on the issuer’s faith and credit as the only assurance of being paid the interest and principal.

**Secured bonds** have specific titles attached to them, such as mortgage bonds, equipment and trust certificates and collateral trust bonds. **Mortgage bonds are secured or collateralized with specific corporate assets such as real estate (land and buildings).** Mortgage bonds are backed by a pool of mortgage loans. **Equipment trust certificates (ETC) are bonds issued to pay for new equipment, secured by a lien on the purchased equipment.** ETCs are frequently issued by airlines, railroads and shipping companies to finance the purchase of railroad freight cars, airplanes and oil tankers. **Collateral trust bonds are similar to mortgage bonds except they are backed by securities of any company through the pledge of stocks and bonds.**
Consumer Credit

Consumer credit is defined as credit extended to a natural person primarily for personal, family or household purposes. It excludes business and agricultural credit and loans exceeding $54,600 (subject to increase for inflation) that are not secured by real property or a dwelling. It must also be extended by a creditor. Common forms of consumer credit include credit cards, store cards, auto finance, personal loans (installment loans), consumer lines of credit, retail loans (retail installment loans) and mortgages.

Consumer credit can be classified as open-end, closed-end or incidental.

Open-end credit is an agreement by a bank to lend a specific amount to a borrower and to allow that amount to be borrowed again once it has been repaid. Also called revolving credit or revolving line of credit. In open-end credit, the creditor:

- Reasonably expects the customer to make repeated transactions.
- May impose a finance charge from time to time on the unpaid balance.
- Generally makes the amount of credit available again to the consumer as the outstanding balance is paid.

Closed-end credit means credit which is to be repaid in full (along with any interest and finance charges) by a specified future date. Most real estate and auto loans are closed-end.

Incidental credit is extended by service providers, such as a hospital, doctor, lawyer or retailer and allows the client or customer to defer the payment of a bill. There is no credit card involved. There is no finance charge and no agreement for payment in installments.

Agricultural Credit

Agricultural credit encompasses any of several credit vehicles used to finance agricultural transactions, including loans, notes, bills of exchange and banker’s acceptances. These types of financing are adapted to the specific financial needs of agricultural operations, which are determined by planting, harvesting and marketing cycles. Short-term credit finances operating expenses,
intermediate-term credit is used for farm machinery and long-term credit is used for real-estate financing. Agricultural credit often presents more risk to the creditor and is sometimes placed into its own unique category.

**Business Credit**

Business credit refers to extensions of credit primarily for business or commercial purposes. It is often referred to as business-to-business (B2B) credit. Outstanding trade credit represents nearly 20% of the annual U.S. GDP. Without business credit, the majority of companies would have a serious liquidity issue.

The important characteristics of business credit are:

- Selling terms are relatively short.
- Transactions are usually on open account or unsecured, but may be partially secured or secured in full.
- Cash discounts may be offered for payment before the net due date.
- The terms include transactions to manufacturers, wholesalers and retailers, but specifically exclude the consumer.
- The timeliness in reaching a decision whether or not to extend credit is often much more critical in the business setting. Delays in the manufacturing process can increase costs and reduce the quality of perishable goods.

The fact that business credit finances the intermediate and final stages of production and distribution distinguishes it from consumer credit. Business credit sales also yield a profit on goods sold rather than interest or investment income, which distinguishes it from bank and investment credit.

Unsecured, open account credit is the most widely used form of domestic business credit. In open account credit, the creditor reasonably expects the customer to make repeated transactions and generally makes more credit available to the buyer as the outstanding balance is paid. A typical business creditor who sells on open account terms is relying specifically on the full faith and credit of a purchaser. The seller establishes the terms of sale. Open account terms are also called ordinary terms or standard terms.

A secured credit arrangement is one in which collateral is provided to the creditor. By obtaining some form of security, the creditor can reduce repayment risk. Examples where secured credit may be useful are a start-up business or an undercapitalized business or an opportunity to sell an account that cannot justify a high credit exposure. Security is obtained not only when the buyer’s financial condition is weak, but in order to guarantee payment if the buyer’s financial condition changes. While it cannot strengthen a buyer’s financial weakness, a secured credit arrangement does reduce the likelihood of loss. Secured credit is defined in Article 9 of the Uniform Commercial Code. It is important to note that drafts, trade acceptances and promissory notes are not forms of security. Each of these instruments is written evidence of debt. However, no security attaches to the instrument.

The ability to compete in the global marketplace is a necessity resulting in the globalization of credit. The procedure for an export credit decision includes more elements than for a domestic decision. In addition to the traditional Five Cs of Credit, other elements such as the risks associated with the economic stability of a country (country risk) must be evaluated. The strength and stability of foreign currency versus the exporter’s currency play a major role in the success of an international credit transaction. Also, the buyer’s culture and customs may influence the credit transaction. These factors—country risk, currency issues and culture—add three more dimensions to the Five Cs of Credit.

**Comprehension Check**

Explain what open account credit is.

What is the difference between unsecured and secured credit?

**Bank Credit**

Bank credit differs from business credit in a number of ways, but primarily in terms of the type of resource which changes hands in a transaction. A bank furnishes money, while a business (supplier, wholesaler, manufacturer or
other service provider) furnishes goods or services. After the transaction is completed, both the banker and the business supplier are creditors: the customer owes money to each entity.

The Federal Reserve and the U.S. Payment System

The Federal Reserve Bank, more commonly known as the Federal Reserve or simply the Fed, is the United States’ central bank, charged with ensuring the stability and flexibility of the nation’s monetary and financial systems.

The Federal Reserve is structured to be independent within the federal government. The Federal Reserve System is made up of the Board of Governors, the Federal Open Market Committee and 12 regional banks.

Structure

The Board of Governors

The Board of Governors, located in Washington, DC, is the “government agency” part of the Federal Reserve System; it is the Chairman of the Board of Governors who reports to Congress, and the Board of Governors that sets the regulations for the entire Federal Reserve System per its Congressional mandate.

There are seven members of the Board—themselves called governors—who are all appointed by the president of the United States and confirmed by the U.S. Senate. Each governor’s term is limited to 14 years, and the terms of each governor are staggered so that one governor’s term expires every other year. The Chairman and Vice Chairman of the Board—required to have been Board members themselves—each serve four-year terms.

Of the four monetary policy tools at the Fed’s disposal (open market operations, the discount rate, reserve requirements and contractual clearing balances), the Board of Governors has sole control over reserve requirements and joint control over the discount rate (with the regional banks), but it does not control open market operations.

The Regional Banks

There are 12 regional banks within the Federal Reserve System. Each bank is run by a bank president and nine directors, chosen from outside the bank. Three of those directors represent member banks and the rest are from the public, designed to represent a diverse selection of the region’s population.

The functions of the 12 regional banks include:
• Operating their portion of the nationwide payment system.
• Distributing currency throughout the region.
• Supervising regional member banks and bank holding companies.
• Serving as bankers for the U.S. treasury.
• Acting as a banker’s bank—a depository institution for the regional banks (responsibilities include lending money to depository institutions through the discount window).

Each bank is assigned a number and a letter: look on any U.S. currency to see a number and a letter corresponding to the Federal Reserve Bank that distributed that piece of currency. To aid the regional banks in their supervisory and financial service responsibilities, many banks have branches throughout their districts. The following table lists the 12 regional Federal Reserve Banks and their branches.

**Figure 1-5 Federal Reserve Banks**

<table>
<thead>
<tr>
<th>Number</th>
<th>Letter</th>
<th>Bank</th>
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<td>1</td>
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<td>Boston</td>
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The Federal Open Market Committee

The third part of the Federal Reserve System is the Open Market Committee, which is charged with buying and selling securities on the open market in order to change the supply of money held in deposit at the Federal Reserve Banks.

The FOMC is made up of all seven governors from the Board of Governors, the president of the Federal Reserve Bank of New York and four presidents of other regional banks. The four positions for regional Bank presidents rotate each year.

The FOMC meets eight times a year to discuss current economic conditions in the United States. At that meeting, the FOMC sets a target federal funds rate which is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight, on an uncollateralized basis. It is a rate it perceives will affect the supply of and demand for money so as to stimulate the economy in the desired direction. After the federal funds target rate is set, securities are accordingly bought and sold on the open market by the Federal Reserve Bank of New York.

Federal Reserve Areas of Responsibility

Since the Fed was established by the Federal Reserve Act in 1913, its roles and responsibilities have evolved. The Fed has three primary areas of responsibility:

1. To guide monetary policy for economic stability.
2. To regulate and supervise banking institutions in the U.S.
3. To provide financial services to banking institutions, the U.S. government and foreign official institutions; as well as to play a major role in operating the nation’s payment system.

Monetary Policy

The overall economic goals of the Federal Reserve are maximum employment, stable prices and moderate long-term interest rates. When reached, those goals indicate that the U.S. economy is strong and stable. The Federal Reserve uses four possible tools to control, to a certain extent, the amount of money in the economy.

The Discount Rate

The discount rate is the interest rate Federal Reserve Banks charge their member banks for short-term loans. These loans are conducted through the discount window at each of the regional Federal Reserve Banks. The discount window is often used by banks to satisfy not only their short-term funds needs, but also to fund longer-term loans (e.g., those needed to cover seasonal fluctuations in customer deposits and withdrawals).

Loans made through the discount window are transacted at the prevailing discount rate. If the Fed lowers the discount rate, for example, it becomes more lucrative than before for banks to borrow money from the Fed, so they do borrow, putting money into circulation in the economy. If, on the other hand, the Fed wants to decrease the amount of money in the economy, it can raise the discount rate, making it less lucrative for banks to borrow money from the Fed, so they borrow less, leaving more cash on deposit at the Fed and less in circulation in the economy.
**Open Market Operations**

Open market operations is the purchase or sale of securities, primarily U.S. Treasury securities, in the open market to influence the level of balances that depository institutions hold at the Federal Reserve Banks and the rate at which banks lend each other money from their Federal Reserve Bank balances (the federal funds rate). Open market operations are conducted at the Federal Reserve Bank of New York.

Even though banks are lending money from their Federal Reserve deposit accounts, the Fed cannot actually change the federal funds rate. Instead, the Federal Open Market Committee targets a federal funds rate that it believes would mean stability and strength for the economy on the whole. Then it engages in open market operations to try and get the actual federal funds rate close to the target rate.

Open market operations are based on the same principle as the discount rate: changing the supply of money. By selling government securities, for example, the Federal Reserve decreases the supply of money available to depository institutions (because it’s effectively giving security notes in exchange for cash)—and that, in turn, increases the price of that money—the federal funds rate. Buying government securities, on the other hand, increases the supply of money available to depository institutions (it’s effectively taking security notes in exchange for cash), which, in turn, decreases the price of that money—the federal funds rate.

**The Reserve Requirement**

The reserve requirement is the portion of a member bank’s deposits that it must hold in reserve in its own vaults or on deposit at its regional Reserve bank.

By increasing the reserve requirement, it takes money out of the economy. By decreasing the requirement, it increases the money supply. In practice, the Fed rarely changes the reserve requirement more than once every few years.

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**Comprehension Check**

Briefly explain the concept of reserve requirement.

What would the effect be if the Fed raised the reserve requirement? What if the requirement was lowered?
Contractual Clearing Balances

Contractual clearing balances is an amount that a depository institution agrees to hold at its Federal Reserve Bank in addition to any required reserve balance.

Banking Supervision

One of the primary reasons that Congress created the Federal Reserve System in 1913 was to avoid banking crises like the one in 1907. One way the Fed does that is by backing up banks’ deposits, if need be, through discount window loans. Another way the Fed works to ensure a stable banking system is through regulation and supervision.

The Board of Governors is responsible for the regulation part, writing the rules that will keep the banking system stable and competitive. The 12 regional banks, along with the Board, are responsible for supervision, enforcing those rules.

Safe, Sound and Competitive Banking Practices

Together, the regional Federal Reserve Banks supervise approximately 900 state member banks and 5,000 bank holding companies. Banks that are not supervised by the Federal Reserve, such as national banks and state banks that are not members of the Federal Reserve System, are supervised by the Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation, respectively.

The supervisory role of the Federal Reserve banks involves annual examinations of each bank’s risk management and other performance measures. At each examination, the bank is given a performance rating from the Federal Reserve, which amounts to either a mark of approval or a warning to do better. Banks that do not get the mark of approval are monitored more closely throughout the year and can be mandated to make certain changes to come back within the bounds of the regulations.

Protection of Consumers in Financial Transactions

Congress has charged the Federal Reserve with making, interpreting, and enforcing laws that protect the rights of consumers, such as discrimination in lending and inaccurate disclosure of credit costs or interest rates.

Comprehension Check

List the four major tools used by the Fed to expand or contract the money supply and to control interest rates.
The Federal Reserve Banks also take a large educational role in helping consumers understand the rights they have in financial transactions, and helping consumers spot signs that those rights are being violated.

**Stable financial markets**
One of the roles of the Federal Reserve Banks is to provide stability to the financial system and contain systemic risk that may arise in financial markets.

**Financial Services**
In addition to guiding monetary policy and supervising and regulating member banks, the Federal Reserve also provides a number of **financial services** to member banks and to the federal government. These services include payment systems policies and solutions as well as currency distribution operations.

**The Banker’s Bank**
The financial services that the Federal Reserve Banks provide their member banks include:

- Maintaining the banks’ deposit accounts with the Federal Reserve.
- Providing payment services, including collecting and processing checks as well as bank-to-bank electronic fund transfers (EFTs) and automated clearing house (ACH) services.
- Distributing and receiving U.S. currency into and out of the banks’ deposit accounts.

**The Government’s Bank**
The financial services that the Federal Reserve Banks provide the federal government include:

- Acting as fiscal agents.
- Paying treasury checks.
- Processing electronic payments.
- Issuing, transferring and redeeming U.S. government securities.

**Research and Information**
The Federal Reserve System also conducts research on the U.S. and regional economies and distributes information about the economy to the public through published articles, speeches by board members, seminars and websites. This information is released to the public as part of the Fed’s mandate to study the economy.

Two important outlets for this information are:

- **Summary of Commentary on Current Economic Conditions** by Federal Reserve District commonly known as the **Beige Book**. This report is published eight times per year. Each Federal Reserve Bank gathers **anecdotal information on current economic conditions in its District** through reports from Bank and Branch directors and interviews with key business contacts, economists, market experts and other sources. The Beige Book summarizes this information by District and sector. An overall summary of the twelve district reports is prepared by a designated Federal Reserve Bank on a rotating basis.
- **Fed Minutes** are notes from discussions the Federal Open Market Committee has over economic policy. They are released eight times a year, after each meeting. They often detail discussions between members over what policy to follow.

**Comprehension Check**
What two publications does the Fed release to the public as part of their mandate to study the economy?
Check Processing

The Federal Reserve Banks provide check collection services to depository institutions. When a depository institution receives deposits of checks drawn on other institutions, it may send the checks for collection to those institutions directly, deliver them to the institutions through a local clearinghouse exchange, or use the check-collection services of a correspondent institution or a Federal Reserve Bank. For checks collected through the Federal Reserve Banks, the accounts of the collecting institutions are credited for the value of the checks deposited for collection and the accounts of the paying banks are debited for the value of checks presented for payment. Most checks are collected and settled within one business day.

In the 1950s, the Federal Reserve developed and implemented the magnetic ink character recognition (MICR) system for encoding pertinent data on checks so that the data could be read electronically. The characters are printed at the bottom of a check in what is called the MICR line.

The first section, or the first nine digits, of the MICR line is called the transit routing number, which provides information about the financial institution on which the check is drawn. Additional sections of the MICR line identify the: payor’s account number, sequence number and encoded amount. (See Figure 1-8)

Comprehension Check
What is the MICR system?
What information does the MICR line contain?

In 1987, Congress enacted the Expedited Funds Availability Act (EFAA), which limits the time that banks can hold funds from checks deposited into customer accounts before the funds are made available for withdrawal. The law, implemented in September 1988 through the Board of Governors’ Regulation CC, Availability of Funds and Collection of Checks, also establishes rules designed to speed the return of unpaid checks.

The Federal Reserve has an availability schedule that details the time it takes to make funds available. The delay between the time a check is deposited at the bank and the time the depositor’s account is credited with collected funds by the bank is called availability float.
Availability float was affected by the Check Clearing for the 21st Century Act (Check 21), which became effective October 28, 2004. The purpose of Check 21 is to remove barriers to the electronic collection of checks allowing banks to “truncate checks.” Check truncation is the process of taking the physical paper check out of circulation, capturing the check information electronically, and moving the electronic copy through the clearing system. The paper check is destroyed or put into secured storage.

There are some practical effects of Check 21 that credit managers must take into account. When a customer claims payment was made, the credit manager must accept the substitute check as proper evidence of payment. According to the Act, courts, retailers and services providers are all required to accept the substitute check as proof of payment in the same manner as they would accept the original. From a credit manager’s standpoint, the faster clearing process has two significant benefits:

1. Funds will end up in the creditor’s accounts faster thus increasing their cash balances.
2. Checks drawn on an account with insufficient funds will be known sooner.

Electronic Funds Transfer

Electronic funds transfer (EFT) is the electronic transfer of money from one bank account to another, either within a single financial institution or across multiple institutions, through computer-based systems and without the direct intervention of bank staff. There are several types of services for electronically transferring payments.

Automated Clearing House (ACH) is an electronic network for financial transactions in the United States. ACH processes large volumes of credit and debit transactions in batches. The Federal Reserve Banks (FedACH) and Electronic Payments Network (EPN) are the two national ACH operators.

Fedwire is a real-time method of transferring cash value from one bank to another, using Federal Reserve account balances.

SWIFT (Society for Worldwide Interbank Financial Telecommunication) is a dedicated computer network to support funds transfer messages internationally between member banks worldwide.

CHIPS (Clearing House Interbank Payments System) is a worldwide bank-owned, private-sector U.S.-dollar funds-transfer system for cross-border and domestic payments.

TARGET2 is the real-time gross settlement (RTGS) system owned and operated by the Eurosystem. TARGET stands for Trans-European Automated Real-time Gross settlement Express Transfer system. TARGET2 is the second generation of TARGET.

TIPANET (Transferts Interbancaires de Paiement Automatisés) is an international payment system set up by the European cooperative banks.
Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) was created in 1913 as an independent agency to preserve and promote public confidence in the U.S. financial system by insuring deposits in banks and thrift institutions for at least $250,000; by identifying, monitoring and addressing risks to the deposit insurance funds; and by limiting the effect on the economy and the financial system when a bank or thrift institution fails. The FDIC insures approximately $9 trillion (as of 2016) of deposits in U.S. banks and thrifts—deposits in virtually every bank and thrift in the country.

The standard insurance amount is $250,000 per depositor, per insured bank, for each account ownership category. The FDIC insures deposits only. It does not insure securities, mutual funds or similar types of investments that banks and thrift institutions may offer.

The FDIC directly examines and supervises more than 4,500 banks and savings banks for operational safety and soundness, more than half of the institutions in the banking system. Banks can be chartered by the states or by the federal government. Banks chartered by states also have the choice of whether to join the Federal Reserve System. The FDIC is the primary federal regulator of banks that are chartered by the states that do not join the Federal Reserve System. In addition, the FDIC is the back-up supervisor for the remaining insured banks and thrift institutions.

The FDIC also examines banks for compliance with consumer protection laws, including the Fair Credit Billing Act, the Fair Credit Reporting Act, the Truth-In-Lending Act, and the Fair Debt Collection Practices Act, to name a few. Finally, the FDIC examines banks for compliance with the Community Reinvestment Act (CRA) which requires banks to help meet the credit needs of the communities they were chartered to serve.

The FDIC is managed by a five-person Board of Directors, all of whom are appointed by the president and confirmed by the Senate, with no more than three being from the same political party. It is headquartered in Washington, DC, but conducts much of its business in six regional offices, and in field offices around the country.

Online Business Banking

For credit professionals, the advent of online business banking has simplified money management. Enrolling in online business banking makes it easier to monitor accounts, financials, account history and statements; transfer funds between accounts and banks; pay bills and more.

With online business banking and remote deposit capture, it is not necessary to carry checks to the bank. They can be scanned in the office and deposited via a secure internet connection. Images of posted checks are available when necessary.

Online banking also allows for the assignment of different security levels for multiple users. In addition to secure deposits, all other transactions online are usually protected by a firewall and encryption technology to ensure the security of business information and financial data.

Other advantages include: automatic payments and debits, transaction alerts, cost savings and direct deposit, among others.

For businesses trading worldwide, there are international banks which provide access to bankers working in other countries. They can provide currency risk management and also help with foreign exchange, importing and exporting, wire transfers and inter-country payments.

Comprehension Check

What does the FDIC not insure?

What are some of the advantages of online business banking?
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Comprehension Check

1. The idea of exchanging goods or services on credit developed after centuries of trade. Explain some of the reasons why credit evolved.
2. Explain why organizations like NACM evolved.
3. List and explain the reasons credit terms are offered.
4. Explain why a sale may not occur, in the business setting, if credit is not offered.
5. What does the Latin term credere mean? How does it describe the credit process?
6. Explain why selling on credit is more costly than selling for cash, but ultimately beneficial. Give three reasons.
7. List and explain the important elements of credit.
8. List and explain the Five Cs of Credit. What are some additional Cs of Credit? Describe why one is considered more important than the others.
9. Define the term operating cycle.
10. Why will a manufacturer be both a debtor and a creditor at any given time?
11. Define and give an example of public credit.
12. Define and list the major types of private credit.
13. What is the most common type of corporate bond? List the characteristics of this type of bond.
14. What is the difference between a secured bond and a debenture?
15. How do mortgage and collateral bonds compare?
16. Define the term consumer credit.
17. List and explain three ways consumer credit can be classified.
18. Define and explain the important characteristics of business credit.
19. Explain what open account credit is.
20. What is the difference between unsecured and secured credit?
22. Define the term discount rate.
23. Briefly explain the concept of reserve requirement.
24. What would the effect be if the Fed raised the reserve requirement? What if the requirement was lowered?
25. List the four major tools used by the Fed to expand or contract the money supply and to control interest rates. Explain the relationship between the tools and their influence on the money supply.
26. Must all banks belong to the Federal Reserve System?
27. What two publications does the Fed release to the public as part of their mandate to study the economy?
28. What is the MICR system?
29. What information does the MICR line contain?
30. Define the term availability float.
31. Define check truncation.
32. Define the term electronic funds transfer.
33. List the types of services for electronically transferring funds.
34. What does the FDIC not insure?
35. What are some of the advantages of online business banking?
Summary

• Credit has been documented to have been used as early as 1300 B.C. by the Babylonians and Assyrians. Credit also played a fundamental role in financing the United States during the American Revolution.

• Institutions like Dun & Bradstreet and NACM arose because of a clear need for information and resources, which include, but are not limited to the following:
  – Honest and fair dealings in credit transactions
  – Ensuring good laws for sound credit
  – Fostering and facilitating the exchange of information
  – Promoting and expediting information for international trade
  – Training credit professionals

• The seven reasons to offer credit are:
  – To increases sales
  – Competition
  – Promotion
  – Credit availability
  – Convenience
  – Demand
  – Price

• Credit involves trust and is ultimately more costly than dealing in cash, although the benefits can outweigh the costs.

• The six elements of credit are:
  – Risk of nonpayment
  – Timing
  – Security
  – Extra costs
  – Legal aspects
  – Economic influences

• The Five Cs of Credit are character, capacity, capital, collateral and conditions, but one might want to also consider competition and common sense as additional Cs.

• The two types of credit are public and private. Public involves the government, while private extends to businesses and individuals.

• The five types of private credit are:
  – Investment credit
  – Consumer credit
  – Agricultural credit
  – Business credit
  – Bank credit

• The Federal Reserve is composed of the Board of Governors, the Federal Open Market Committee and the 12 regional banks.

• The Federal Reserve has four main tools that control the money supply and the monetary policy of the U.S., which ultimately controls and manipulates various interest rates. They include: open market operations, the discount rate, reserve requirements and contractual clearing balances.
• Besides controlling monetary policy and interest rates, the Federal Reserve also ensures safe, sound and competitive banking practices, consumer protection, stable financial markets, financial services and published economic research.

• The **FDIC** insures approximately $9 trillion (as of 2016), which correlates to $250,000 per depositor, per insured bank.

• **Online business** banking has simplified money management making it easier to monitor accounts, financials, account history and statements, as well as facilitating the transfer of funds between accounts and bank assisting domestic and international business.

References and Resources .................................................................


"Credit Risk Review." NACM Graduate School of Credit and Financial Management project, 2016. Kathie Knudson, CCE; Lisa Ball, CCE; Stacy Parker, CCE; and Dawn Dickert, CCE.


