

Loan Fraud Affecting Community Banks

H. G. Busby & Associates, LLC
555 Sun Valley Drive, Suite M2
Roswell, GA 30076
770-552-7220 800-686-0636

Course Objectives

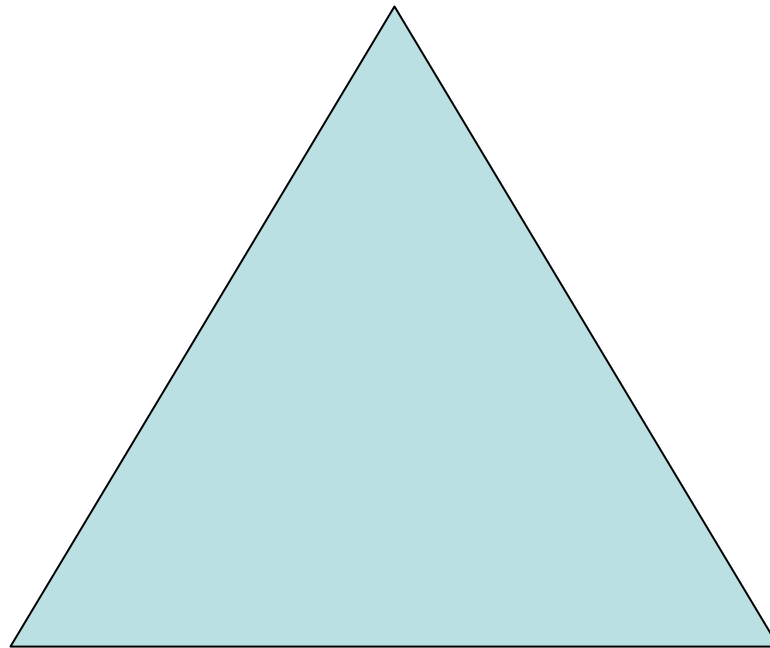
- Knowledge of what constitutes loan fraud
- Federal law pertaining to loan fraud
- Fast Track reporting
- Internal and external loan fraud schemes
- Due diligence prevention
- Internal controls prevention
- Indicators of loan fraud
- Types of financial statement misbehavior
- Detection - horizontal and vertical analysis

Topics to Be Covered

- Federal statutes
- Civil versus criminal investigation - Fast Track referrals
- External loan fraud
- Internal loan fraud
- Common types of loan fraud
- Due diligence – do you really know your client?
- Internal controls
- Control environment assessments
- Financial statement misbehavior
 - Revenue recognition (SAS No. 99) - shifting revenue and phony revenue
 - Failing to record or underreporting debts
 - Increasing inventory and net profit
 - Shifting expenses to other periods
- Hands on case study (passed out in class)

Fraud Triangle

Opportunity



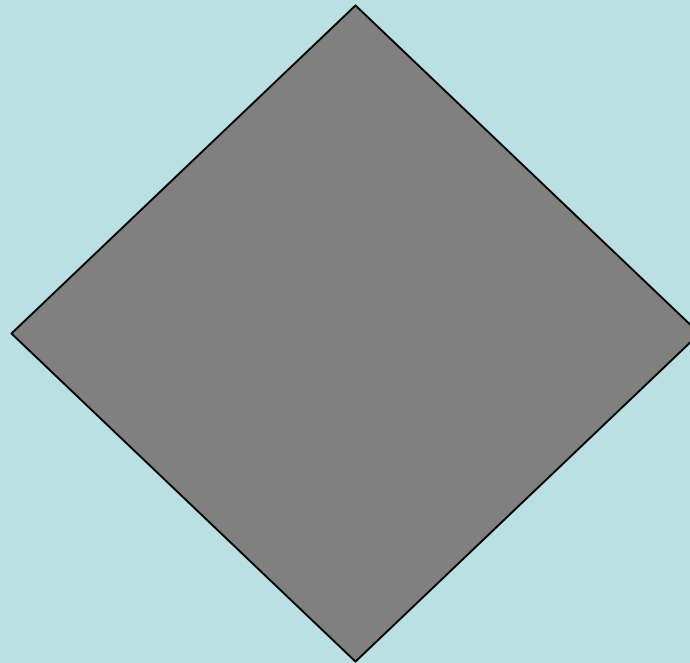
Incentives/Pressures

Rationalization/Attitude

Elements of Fraud

False statement, representation, or document

Made intentionally
or recklessly



About a material
detail

Upon which a victim relies

Criminal Referrals – Suspicious Activity Reports (SARs)

- Federal Reserve, FDIC, OCC, OTS, and NCUA
- Any violation involving an **insider** (director, officer, principal shareholder, employees or agent), regardless of amount
- **Any violation** involving or aggregating more than **\$25,000** in the event that no suspect can be identified—the threshold drops to \$5,000 if a potential suspect can be identified
- Categories include **check, credit, and wire transfer fraud; defalcation/embezzlement and mysterious disappearances**; unauthorized access to a protected **computer**; and a general category under “**other.**”

Do Not Defraud a Financial Institution -- Numerous Federal Criminal Statutes

- 18 U.S.C. 1001, 1005, 1006, 1007 (false statements)
- 18 U.S.C. 1014 (false statement to financial institution)
- 18 U.S.C. 1344 (scheme to defraud)
- 18 U.S.C. 1030 (computer fraud)
- 18 U.S.C. 212 (offer made to bank examiner)
- 18 U.S.C. 213 (offer accepted by bank examiner)
- 18 U.S.C. 215 (gift to bank examiner)
- 18 U.S.C. 225 (King Pin)
- 18 U.S.C. 656 & 657 (embezzlement falsification by bank officer)
- 18 U.S.C. 1341/1343 (mail/wire fraud)
- 18 U.S.C. 1961 (racketeering)
- 26 U.S.C. 7201/7206 (tax evasion/filing false statements)

18 U.S.C. 1001, 1005, 1006, 1007, False Statements

- False or fraudulent statements orally or in writing to various federal agencies and federally insured financial institutions.
- 1001 (statements, entries generally),
- 1005 (bank entries, reports, transactions),
- 1006 (federal credit entries, reports, transactions),
- 1007 (FDIC)
- Fined up to \$1,000,000 and imprisoned up to 30 years.

18 U.S.C. 1014, Bank Fraud (Applications, Loans, Etc.)

- False or fraudulent statements orally or in writing to various federal and state credit agencies and insured financial institutions of all types.
- Fined up to \$1,000,000 and imprisoned up to 30 years.

18 U.S.C. 1344, Scheme or Artifice to Defraud a Financial Institution

- Punishes scheme or artifice to defraud a financial institution or to obtain monies, assets, etc. owned or controlled by a financial institution.
- Covers both insiders and all other persons, even those not affiliated with the financial institution
- Applies to check kiting (courts excluded check kiting from 18 U.S.C. 1014).
- Also applies to offshore frauds.
- A predicate offense under Racketeer Influenced Corrupt Organization (RICO) statute.
- Fined up to \$1,000,000 and imprisoned up to 30 years.

18 U.S.C. 1030 (a) (4), Computer Fraud

- This prohibits the unauthorized access of a computer to obtain financial records of a federally insured or federally chartered financial institution
- Section 1030 (a) (4) specifically criminalizes the knowing use of a protected computer without authorization or in excess of authorization to commit fraud.

18 U.S.C. 656 and 657

- **Embezzlement,**
- **Misapplication, and**
- **False Entries**
- **by a Financial Institution Officer or Employee**

18 U.S.C. 212, Offer of Loan or Gratuity to a Bank Examiner

- Prohibits financial institution officers, directors, and employees from giving a loan or a gratuity to a bank examiner.

18 U.S.C. 213, Acceptance of an Offer of Loan or Gratuity by a Bank Examiner

- Prohibits a bank examiner from accepting a loan or a gratuity from financial institution officers, directors, and employees.

18 U.S.C. 215, Receipt of Commissions or Gifts for Procuring Loans

- Prohibits giving or receiving any thing of value to influence a financial institution director, officer, employee, agent, or attorney.
- Fines up to \$1,000,000 and imprisonment of up to 20 years.

18 U.S.C. 225, Continuing Financial Crime Enterprise Statute

- Prohibits criminal enterprises that commit a series of specified crimes against financial institutions (most of the above statutes).
- Better known as the “S&L Kingpin” statute, this law provides fines of up to \$20,000,000 for organizational defendants and up to \$10,000,000 and up to life imprisonment for individuals who receive \$5,000,000 or more during a 24-month period of the criminal enterprise.

18 U.S.C. 1341, Mail Fraud

18 U.S.C. 1343, Wire Fraud

- Use of the mails (USPS, UPS, FedEx, etc.), wire (telephones, facsimile machines, interstate wire services), or television to carry on a scheme or artifice to defraud.
- Any time the mails or wires/televisions are touched can be a separate count. Fines of up to \$1,000,000 and imprisonment of up to 20 years.

18 U.S.C. 1961, Racketeer Influenced Corrupt Organizations (RICO)

- RICO prohibits an offense by a person associated with an “enterprise” involved in interstate commerce to conduct the affairs of the enterprise through a “pattern of racketeering activity.”
- A “pattern of racketeering activity” includes two or more specified criminal violations, including bribery, extortion, mail fraud, wire fraud, and financial institution fraud.
- Penalties include forfeiture of all ill-gotten gains and up to 20 years in prison.

26 U.S.C. 7201, Tax Evasion

26 U.S.C. 7206, Filing False Tax Return

- Failure to report income from “whatever sources derived” (e.g., bribes and extortion) on income tax returns may be prosecuted as tax evasion or filing a false return.
- Filing a false return is easier to prosecute.

Criminal Investigation

- **The Black Hole** – information goes into but does not come out of the Feds (one way)
- **Has to be done** – Suspicious Activity Reports (below)
- Often time consuming - because of the FBI/SS's (FDIC/HUD/SBA) workload and DOJ investigation/prosecution thresholds, **the criminal investigation can take a year or more**, particularly if your alleged loan fraud is part of a series of specified crimes against financial institutions
- **Restitution often ordered too late** – if plea bargained or court ordered, the restitution order often transpires way after the money and/or assets disappear

Civil Investigation

- Operates **parallel** to the criminal investigation
- Your **legal counsel is privy** to the results of the fraud investigation
- More timely to
 - seek federal, state, or local prosecution;
 - deal with insiders; and,
 - obtain more timely restitution

Note: **OCC has its own Fast Track program.**

Fast Track Referrals Directly to Prosecutors

- On smaller external loan frauds (e.g., under the \$100,000 threshold), submit the results of the civil investigation through your legal counsel directly to the federal, state, or local prosecutor.
- Expedite prosecution and restitution.
- Time can be of the essence, particularly with restitution.

Sarbanes-Oxley and Auditor Independence

The act promotes auditor independence by prohibiting an auditor from providing a number of non-audit services when performing an audit for a public company audit client including:

- bookkeeping and other services related to client accounting records or financial statements;
- internal audit outsourcing services; and,
- legal services and expert services unrelated to the audit.

External and Internal Loan Fraud

- Can be multi-faceted and simultaneously include several types of criminal activities
- Large loan frauds may have several schemes working at the same time
- Many loan frauds involve real estate

Example: Gilbert Funeral Home

Common Types of External Loan Fraud

Loans to Non-existent Borrowers

- This usually involves **an external party** submitting an application with false information (e.g., name, address, social security number, and net worth) and/or false documents (false IRS Forms W-2).

EXAMPLE: Carpet tufter's failed to disclose \$500,000 wrongful death judgement.

Common Types of External Loan Fraud

False Applications with False Credit Information

- Loan applicants provide
- false information about persons, understated or missing debts, and/or overstated asset valuations and/or
- false documents (e.g., false IRS Forms W-2, false income tax returns, or false financial statements).

EXAMPLE: Unknown to bankers, CPA provided income tax returns with inflated receipts

Common Types of External Loan Fraud

Loans to Non-existent Borrowers

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Common Types of External Loan Fraud

Single Family Housing

- Unqualified borrowers misrepresent personal credit worthiness and overstate ability to pay or real estate developers misrepresent characteristics of the housing unit.

Common Types of External Loan Fraud

False Appraisals

- Appraisers (conspirators to the loan fraud) inflate appraisals that support loans, which exceed the loan value of the property. Loan applicants and appraisers are subject to a concurrent aiding and abetting or conspiracy charge.

Common Types of External Loan Fraud

Land Flips

- In a land flip, perpetrators buy and sell a parcel of land very quickly. They often buy and sell the same parcel several times between themselves to increase the prices and then take out an artificially high loan.

EXAMPLE: Current schemes in Georgia

Common Types of External Loan Fraud

Nominee Loans

- Loans made to a straw borrower or agent without disclosing the identity of the real borrower.
- **EXAMPLE:** Thomas Waldron (Sunshine S&L and 13 other thrifts)

Common Types of External Loan Fraud

Double Pledging of Collateral

- Borrowers pledge the same collateral with different lenders before liens are recorded and without telling the lenders.

EXAMPLE: Thomas Waldron (legal description attached to debt in lieu of foreclosure excluded property)

Common Types of External Loan Fraud

Borrower Misapplication of Funds

- This involves a borrower obtaining proceeds (or collateral) for one purpose and then using it for another purpose. The misapplication may transpire simultaneous with the loan or at a later date (e.g., bust out scheme). Misapplications cover everything imaginable, including the payment of kickbacks; personal expenditures; real estate, management, and/or legal fees; escrowed funds; unrelated loans; and reimbursement of the principal behind the land flips. It may also subsequently involve such misapplications as the sale of tangible assets not attached to real estate or theft of operating proceeds.

EXAMPLE: Gilberts used loan to complete mausoleum to pay personal expenses on defaulted personal loans.

Due Diligence of External Loan Fraud

Review support.

- When reviewing loan/mortgage applications, financial statements, and supporting documents, know that some clients will materially understate the amounts of debts, fail to list who has a claim against their assets, and/or provide misleading copies of income tax returns, financial statements, and IRS Forms W-2. **Apply additional examination steps like horizontal and vertical analysis of financial statements or comparisons with other (e.g., ad valorem or sales) tax returns.**
- For example, when evaluating sales on sales ledgers, income tax returns, or statements of profit/loss, make sure to request and add up the corresponding 12 monthly sales tax returns and reconcile that total other sales totals. You would be surprised how many sales tax returns are materially underreported.

EXAMPLE: Piggly Wiggly of Tabor City. Owner excluded \$50,000/year in state sales tax. Found by totaling state tax returns and comparing results to total receipts on financial statements.

Common Types of Internal Loan Fraud

Bribery (Before) or Illegal Gratuity (After)

- The **offering/soliciting, giving, or receiving of anything of value to influence an official act** (bribery) or **because of an official act** (illegal gratuity).
- A **demand by a lender** for a bribe or kickback may constitute **extortion** (i.e., obtaining property through actual or threatened force or fear of economic loss) and be prosecuted as extortion instead of bribery or kickback.

Common Types of Internal Loan Fraud

Conflicts of Interest

- A director, officer, employee, or agent's taking an interest in a transaction that may have an adverse interest to the person taking the action, **without disclosure** to the principal.
- **RECUSE YOURSELF!**

Common Types of Internal Loan Fraud

Breach of Fiduciary Duty

- An agent (i.e., **director, officer, or employee**) owes a fiduciary duty to his/her principal and must act in the best interest thereof.
- Breach is where an agent seeks his/her personal interest to the detriment of his/her principal.
- The elements of Breach of Fiduciary Duty are **simpler than fraud and do not require proof of wrongful intent.**

Common Types of Internal Loan Fraud

Loans to Non-existent Borrowers

- This type of loan fraud usually involves a **director, officer, or employee of the financial institution submitting false information** (e.g., name, address, social security number, and net worth) and/or false documents (false IRS Forms W-2).

Common Types of Internal Loan Fraud

Sham Loans with Kickbacks and Diversions

- Here a director, officer, or employee of the financial institution makes a loan to an accomplice. The accomplice then gives part or all of the proceeds to the perpetrator.
- This type of fraud opens the insider to an additional charge of conspiracy or aiding and abetting.

Common Types of Internal Loan Fraud

Reciprocal Loan Arrangements

- Directors or officers in different financial institutions buy and/or sell loans to other financial institutions with unrecorded agreements to sell back and buy back their loans.
- The purpose is to conceal loans from bank examiners to enhance the financial institutions' asset and/or liquidity.

Common Types of Internal Loan Fraud

Mortgage Pulling

- Loans are made to several members of a partnership or joint venture to disguise loans exceeding a financial institution's legal loan limit to a single borrower (e.g., a partnership or joint venture).
- Under an arrangement between the members, they invest in the partnership or joint venture, which holds the collateral.

Common Types of Internal Loan Fraud

Swapping Bad Loans—Daisy Chain

- Similar to reciprocal loan arrangements
- Directors or officers in different financial institutions buy, sell, and or swap nonperforming loans to cover up those loans with new documentation and make them look more recent (i.e., performing).

Common Types of Internal Loan Fraud

Linked Financing

- Borrowers offer large deposits on the condition of making certain loans to affiliated parties.
- This entices bankers with high returns on the longer-termed loans.
- Such loans may involve kickbacks to the banker.

ETHICAL CULTURE

- **Sets Tone**: Corporate culture from the top down sets the organization's ethical tone (e.g., Keystone & Best Bank).
- **Published Code of Ethics**: The community bank's code of ethics should annually be distributed to and signed by each director, officer, and employee.
- **Enforcement of the Code of Ethics**: Where a director, officer, or employee breaches the code of ethics, it should be dealt with quickly and fairly based on the severity of the breach.
 - It establishes the perception that insider fraud will be detected.
 - If severe, you may want to seek the advice of legal counsel and may have to file a SAR with the regulators.
 - File written copies of the outcome and the SAR for subsequent review by the financial institution regulators.

Internal Controls – Segregation of Duties

Loan Approvals, Disbursements, Record Keeping, and Safekeeping of the Collateral

- Segregation of these four functions keeps a single individual from having control over the entire loan transaction.
- Involvement by two or more additional individuals reduces the risk of internal loan fraud.

Internal Controls – Segregation of Duties

Loan Origination, Underwriting, Closing, Disbursement, and Servicing

- Segregation of these four functions keeps an insider from committing internal loan fraud.
- Segregation also provides one or more levels of independent review (extra eyes), which reduces the risk from external loan fraud.

Internal Controls – Segregation of Duties

Approval of All Large or Atypical Loans by Committee

- When a committee is involved, insiders (whether intentionally or under pressure) should have a more difficult time perpetrating external loan.
- **IN COMMUNITY BANKS, BEWARE OF STRONG INSIDERS! DO NOT RUBBER STAMP!**
This was a major cause of community bank failures during the late 1980s and early 1990s.

Internal Controls – Independent Reviews

- Independent review of loans provides an impartial second opinion for all loan transactions.
- Independent review can be performed on a regular or periodic basis by independent reviewers, the internal auditors, or Sarbanes-Oxley specialists.
- It can also be done at yearend by the external auditors.
- The results can be used to establish loan loss reserves.

Management or Audit/Loan Committee Review of Loan Write-offs

- Write-offs can conceal insider fraud and conflicts of interest.
- Write-offs of officer loans should be reviewed by senior management.
- Write-offs of senior management loans should be reviewed by at least the next level of supervision (i.e., outside members of the audit and/or loan committee).
- **AGAIN, BEWARE OF STRONG INSIDERS AND DO NOT RUBBER STAMP!**

Lending Policies and Procedures

- Loan policies and procedures covering:
 - Committee and officer lending limits,
 - Disbursements/closings,
 - Independent reviews,
 - Safeguarding of collateral,
 - Originations,
 - Underwriting, and
 - Servicing needs to be in writing.

Lending Policies and Procedures

- Reasons for deviations from policies and procedures need to be documented and/or “red flagged” and followed up by internal audit or Sarbanes-Oxley specialists.
- Follow standardized procedures (processing of applications, documents needed, credit/D&B reports, appraisals, physical inspection of collateral, confirmations, etc.).
- Standardized procedures save time and reduce the risk from fraudulent loans.

Know Your Customer

- **FINANCES CHANGE!**
- “Red flag” and follow up on any deviations from the norm, particularly deteriorations or financial distresses in their finances (i.e., incentives/pressures from the Fraud Triangle).
- Resist throwing money at a problem (e.g., overdrafts).

Verify Information and the Identity of the Applicant

- Sufficient verification can prevent external loan fraud from happening.
- Despite the balance act (losing a customer to another institution), the larger the loan the greater the verification effort should be (i.e., do not rely on past knowledge of your customer).
- Do not hesitate to tell your customer that the information will be verified. If he/she balks, find out the reason why.
- Follow up on “red flags.” See horizontal/vertical analysis below.

Financial Statement Misbehavior - COSO

COSO (Treadway) Study

- A study released in March 1999 by the Committee of Sponsoring Organizations (COSO) analyzed approximately 200 SEC financial statement fraud actions brought against public companies from 1987 to 1997 to better understand the nature of fraud on financial statements.

Financial Statement Misbehavior - COSO

As to who commits fraud, the COSO study concluded:

- Among SEC registrants, most companies committing financial statement fraud were relatively small in size (less than \$75 million in assets and revenues).
- In 83% of the cases, the CEO, CFO, or both were involved in financial statement fraud.

Does the same apply to small, closely-held businesses?

Financial Statement Misbehavior - COSO

As to the nature of fraud, the COSO study concluded:

- Many of the frauds were:
 - committed at the end of a period (both quarterly and annually),
 - often by recording end-of-period adjustments or other entries outside the normal accounting cycle processing.
- About 50% of the fraud instances involved the improper recording of revenues (fictitious or premature)
- About 50% of the fraud instances involved the improper recording of assets (fictitious or overstated).
- Expense and liability understatements were less frequent.

Does the same apply to small, closely-held businesses?

Financial Statement Misbehavior

- Materially misstating financial statements (i.e., statement of financial condition, statement of profit or loss, and statement of cash flows and the notes thereto) usually involves
 - Overstating assets, revenues, and profits and/or
 - Understating liabilities, expenses, and losses.
- Financial statement fraud is intentionally or recklessly falsifying, misrepresenting, or omitting information from the financial condition, profit or loss, or cash flow of a business, trust, or individual omission to deceive users of that information.

Financial Statement Misbehavior

- **Categories Most Often Involved:**
 - Overstated assets or revenue;
 - Understated liabilities and expenses; or
 - A combination of both.
- Overstating assets and revenues misrepresents a financially stronger company by inclusion of fictitious asset costs (e.g., additional inventory) or artificial revenues.
- According to Statement of Auditing Standard No. 99 (Consideration of Fraud in a Financial Statement Audit), improper revenue recognition is the number one false statement.

Financial Statement Misbehavior

- Understated liabilities and expenses are often caused by the exclusion of selected costs or financial obligations (e.g., off-balance sheet transactions/vehicles to hide debts).
- **EXAMPLE: Capital One and ENRON**
- Both methods (overstating assets and revenues or understating liabilities and expenses) result in increased equity and net worth for the company. This overstatement and/or understatement results in **increased earnings and a better picture of financial health.**
- **EXAMPLE: Managing Partner, CPA Firm**

Financial Statement Misbehavior

- Because financial records revolve around **double-entry transactions**, fraudulent accounting entries:
 - affect two or more accounts and
 - often can be detected by vertical and horizontal analysis of financial statements taken from several accounting periods (i.e., annually, quarterly, or monthly).
- The five most prevalent financial statement misbehaviors are:
 - fabricated or inflated revenues;
 - timing differences (e.g., early or late recognition of revenue or debts);
 - improper asset valuations (e.g., fictitious or overvalued inventory);
 - concealed liabilities and expenses (e.g., to avoid loan covenant violation); and
 - irregular expenses.

Fictitious or Inflated Revenues

- There are four criteria for revenue recognition:
 - Definition
 - Measurability
 - Relevance
 - Reliability
- Revenue is defined by:
 - Actual or expected cash inflows
 - Which have occurred or will occur
 - As a result of the business's ongoing
 - Major or central operations
 - During the accounting period

Fictitious or Inflated Revenues

Timing (when revenue is recognized):

- Revenue should be recognized in the accounting period in which the goods are sold or services are rendered
- Fraudsters recognize revenues early or late (e.g., revenues recognized when inventor is:
 - pulled but not shipped
 - shipped with a right of return)
- Fraudsters also recognize revenue for fake customers or from off-balance sheet entities

Improper Asset Valuation

- Assets should be recorded at historical cost
- Some assets are recorded at the lower of cost or market value (e.g., written down if the market value has decreased)
- However, assets are not increased to record current value
- Inventory (for example) is valued:
 - At the lower of cost or market value
 - Zero if it no longer has a market value
 - Note: inventory is subject to manipulation by count or valuation (e.g., excess or obsolete inventory)

Improper Asset Valuation

- Accounts receivable (for example) is subject to manipulation for:
 - Fictitious receivables
 - Overestimation of the amount of bad debts
 - Underestimation of the amount (or failure to write off) bad debts
- Fixed assets (for example) are overvalued by:
 - Fictitious assets
 - Misstated values
 - Capitalization instead of expensing
 - Misstated depreciation

Concealed Liabilities and Expenses

- Understated debts and expenses cause net income and net worth to increase
- Conversely, overstated assets (e.g., inventory) cause net worth to increase
- Liabilities and expenses are concealed by:
 - Omission of liabilities and expenses
 - Improper capitalizing and expensing
 - Misstated returns, allowances, and warranties

Horizontal and Vertical Analyses

- When dealing with businesses, **calculate** horizontal and vertical (ratio) analyses for three or more accounting periods and **compare** the ratios between periods and in comparison to total assets or total sales and to benchmark ratios for similar companies.
- **Horizontal** = between periods
- **Vertical** = in comparison to total assets (balance sheet) or total sales (income statement) and to benchmark ratios for similar companies
- For example, compare the cost of goods sold to sales ratio gross profit percentage, or net profit percentage for several periods.
- Also, compare those ratios to benchmarks as published in the Recovery Management Associates (previously known as Robert Morris Associates) Annual Statement Studies.

Financial Statement Fraud Example

- **EXAMPLE:** Building contractor's tax returns
- A vertical and horizontal comparison of a local builder's IRS Schedules C to ratios contained in RMA Annual Statement Studies showed that the builder's gross profit and net profit percentages were less than one-third of those in the lowest quartile (i.e., builders with the lowest profitability).
- Division of the net profit by 1,800 hours a year also showed that the builder made less than minimum wage and could not afford to purchase an expensive truck, a boat, and upscale housing.

Financial Statement Fraud Example

- Closer examination of cost of goods sold (COGS) showed that he valued COGS as checks for purchases and checks made payable to “Me.”
- The calculation should have been beginning inventory, plus purchases, minus ending inventory, equals COGS.
- Result: Comparing the net profit percentage from RMA and follow-up procedures “red flagged” that builder and then found that he/she allegedly overstated COGS and understated net profit and income taxes due.
- In the above scenario, the community bankers, who had a longstanding banking relationship with the builder, never bothered to ask for his IRS Schedule C. Had they done so, they might have seen a builder who either made less per hour than minimum wage and/or was potentially lying to the IRS.

Ratio Analysis

Ratio analysis analyzes relationships between the various interrelated components of financial statements

- **Current or cash/almost cash assets**
 - Current ratio
 - Quick ratio
- **Receivables/inventory**
 - Turnover ratios
- **Financial Statements**
 - Debt-to-equity
 - Asset turnover
 - Profit margin

Compare the ratios to similar ratios as published in the RMA Annual Statement Studies.

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