# SUCCESS TO COME IN C&I LENDING IN 2015

In his annual outlook article for *The RMA Journal,* PayNet's founder says the economy is slowly but surely returning to equilibrium between risk and reward.

BY WILLIAM PHELAN

ON FEBRUARY 18, 1964, the Fab Four met The Greatest in Miami Beach, Florida. It was a meeting of the artistic and sports icons of that era. At the time, the Beatles were on their first visit to America and Cassius Clay had not yet

SHUTTERSTOCK, INC.

won the heavyweight crown. Just as this meeting foreshadowed fame for the Beatles and the man who would become Muhammad Ali, the current conditions for commercial and industrial lending signal a sign of success to come for bankers.

Although the economy has remained sluggish, it is clearly gaining momentum. The data presented in this article indicates that economic expansion is becoming broad-based geographically, and new industry segments are leading the way. These improved economic conditions can help bankers overcome the challenges of the past four years as more of the excess deposits sitting on bank balance sheets will be put to work earning a return. The costs from more regulations will be partly offset by higher profits as banks improve operational efficiency.

Certainly regulators are not sitting still. They report growing credit risk after a period of improved credit quality and disposal of problem loans. Erosion in underwriting standards is the main area of concern, arising from underwriting exceptions, higher collateral-advance rates, modified guarantees, and more liberal payment terms. A gradual loosening of terms is being driven by increased competitive pressures among banks to grow earning assets.

In this report, the business cycle, markets, asset quality, industry and regional trends, and specialized markets are analyzed in depth to assess the growth prospects and credit conditions in small business C&I lending to help banks realize safe growth. The information provided here may help banks, which have been unable to achieve the same level of return as before the recession, retain their role as the primary capital source to small and medium-sized private U.S. companies.

An *RMA Journal* article in the December 2013 – January 2014 issue ("How to Safely Grow Commercial and Industrial Loans") focused on the sectors of the economy that were venturing forth from the uncertainty of 2013. Tapping PayNet data, we identified the industry groups that were investing in new property, plant, equipment, tools, and services. More recent PayNet data cited in this article indicates growing confidence on the part of small business owners, and that will lead to greater opportunities for bankers to serve their growing needs with credit.

In terms of its life cycle, banking today is in an adaptive phase. Credit-driven earnings are essentially over for banks. Returns from smaller banks are lagging the returns earned by the bigger banks. Regulatory pressures are forcing some banks to become niche players with specialized business models. Online and mobile banking activity now makes up about 50% of bank customer interactions.

The media, policy makers, and the business community all acknowledge the central role of small businesses in the U.S. economy. Indeed, small business financing activity acts as a leading economic indicator. Research shows small business lending is a measure of investment that leads the direction of GDP by two to five months, and small business loan delinquency leads the performance of nonaccrual loans, which are important measures of bank safety and soundness.

This article presents a road map to help bankers grow and reshape their loan portfolio into commercial and industrial assets, as well as expand net interest margins in 2015 to offset persistently lower yields.

Research shows that small businesses act as a leading economic indicator because they respond to changes in economic conditions more rapidly than larger businesses.

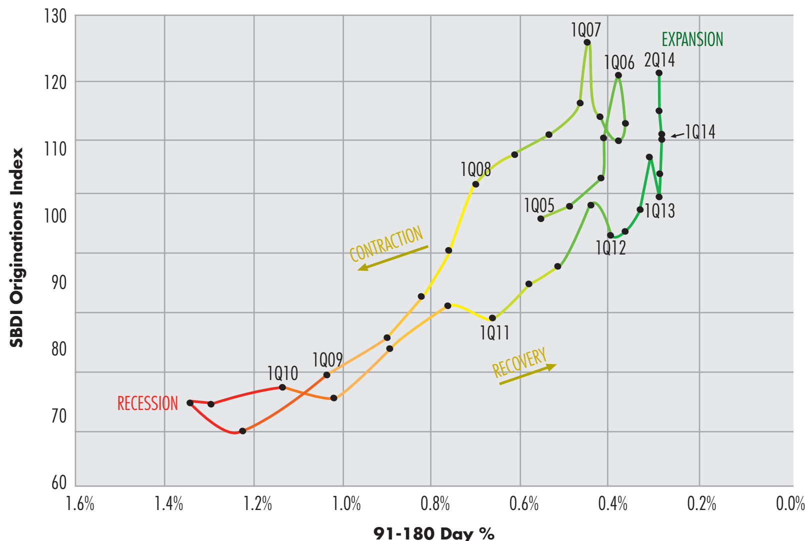
### Small-Business Defaults Are an Economic Indicator

For the purposes of this study, PayNet defines a small business as one with $1 million or less in total loans outstanding. Outstanding loans reported by lenders represent one of the best measures of borrower business size, as they are objectively reported by a third party as opposed to being self-reported or estimated.

A cross section of U.S. small businesses serves as the sample for this study. Summary statistics from this sample show the average loan amount to be just under $60,000. The average high credit per business is roughly $350,000, and the average term of all financial obligations is 55 months. Loan types encompass long-term obligations such as term loans, commercial leases, and credit lines used for capital investment in property, plants, or equipment.

Research shows that small businesses act as a leading economic indicator because they respond to changes in economic conditions more rapidly than larger businesses. In this study, historical default rates are reported in order to put credit risk on small business loans into a separate asset class. This study also provides a default forecast under various economic scenarios using PayNet's AbsolutePD® model, which assesses small businesses' probability of default and addresses the limitation of private businesses' financial statements.

Figure 1 **The Business Cycle**




Source: Thomson Reuters/PayNet Small Business Lending Index (SBLI); Thomson Reuters/PayNet Small Business Delinquency Index (SBDI)

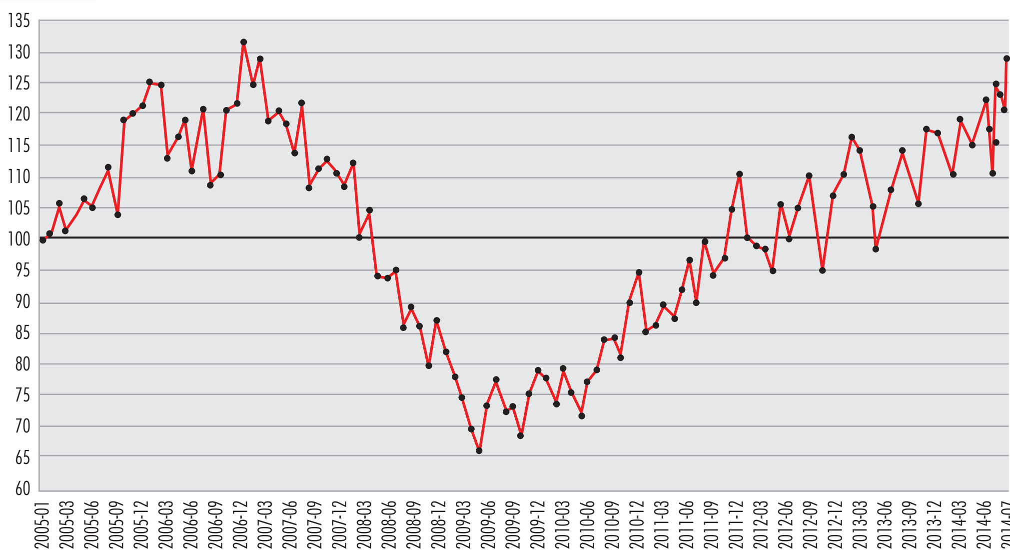
## The Business Cycle

Figure 1 illustrates the business cycle of the economy by comparing investment and credit risk for each calendar quarter starting in 2005 and ending in the second quarter of 2014. This analysis shows that the business cycle is now consistently in low-risk expansion. This recovery cycle differs from past cycles in longevity and rate of growth. In 2005, low-risk expansion ran four quarters and grew a total of 20%. In contrast, low-risk expansion has run for five uninterrupted quarters beginning in the first quarter of 2013, but expansion has totaled 13% during this recent phase.

Credit risk improved during the expansion phase in 2005, whereas it has remained at a constant level during the 2013-14 time frame. This is indicative of today's very low credit risk among business borrowers, which has little room to improve. Severe loan delinquencies for small private companies stood at just 0.30% as of this article's writing, compared to 0.37% at the quality peak of the 2005-06 expansion. The survivors of the Great Recession are seasoned business operators who have de-levered balance sheets and learned from the economic crisis.

This expansion phase of the business cycle will not go down in history as the fastest of all time but rather longer. The dampening effect of policies meant to reduce the chance of bubbles has created a sluggish economy—with the result being slower growth of C&I borrowing.

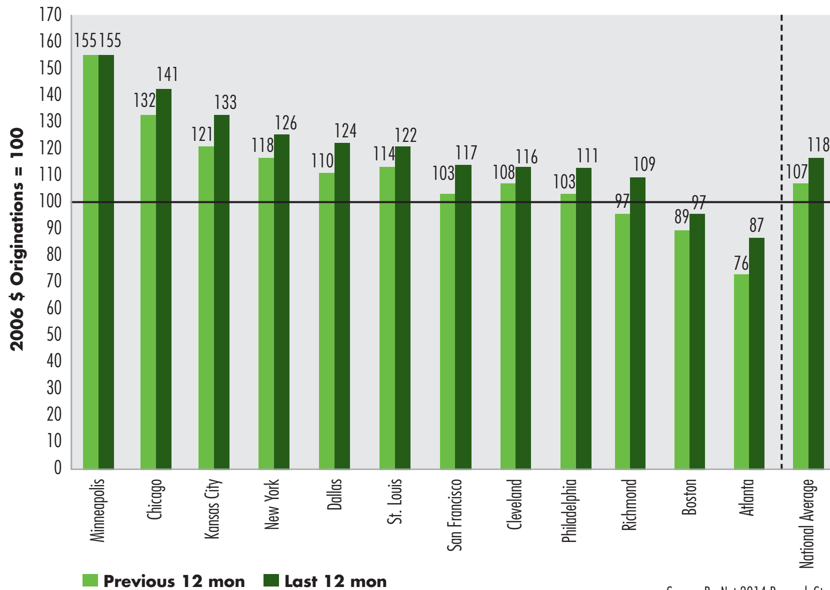
Figure 2 **Thomson Reuters/PayNet Small Business Lending Index**




Source: Thomson Reuters/PayNet SBLI

Figure 3 **Small Business Originations by Federal Reserve District**

**2014 versus 2013 (12-Month Periods Ending in June)**




While small businesses are increasing their level of investment nationally, the rates of increase vary across Federal Reserve districts.

Likewise, various policies have been introduced to de-risk financial markets. The net effect of these forces is lower growth and credit risk, which fosters conditions for future expansion.

The big question mark is how long this low-risk expansion phase will continue. The longer it is sustained, the more capital formation will increase and the larger the base of production capacity on which to provide future growth. To put this growth into context, much of the growth by small businesses can be attributed to the recovery in 2011; however, the annual trend-line growth rate, which slowed dramatically to 7% in 2013, has picked up in 2014 to a healthy 14%. Business cycles do not expire from old age but rather from economic imbalances. The stagflation of the 1970s and the recessions in 1991, 2000, and 2009 all have one common theme. Small business credit has been more a victim of bubbles, not a cause of them.

## Market Analysis

The transition from recovery to solid expansion seems to be under way, as indicated by faster and more consistent growth. The Thomson Reuters/PayNet Small Business Lending Index (SBLI) measures the amount of new credit taken by U.S. small businesses for investment in durable goods such as property expansion, equipment purchases, plant building, new tools and services, working capital supplies, or expansion of business units (Figure 2). When the SBLI increases, the resultant impact on GDP is positive—with more hours worked, more durable goods purchased, and more spending on business supplies. The index baseline of 100 is set at January 2005, so the recent value of 128.5 means small businesses borrowed 28.5% more in the current period than in January 2005.

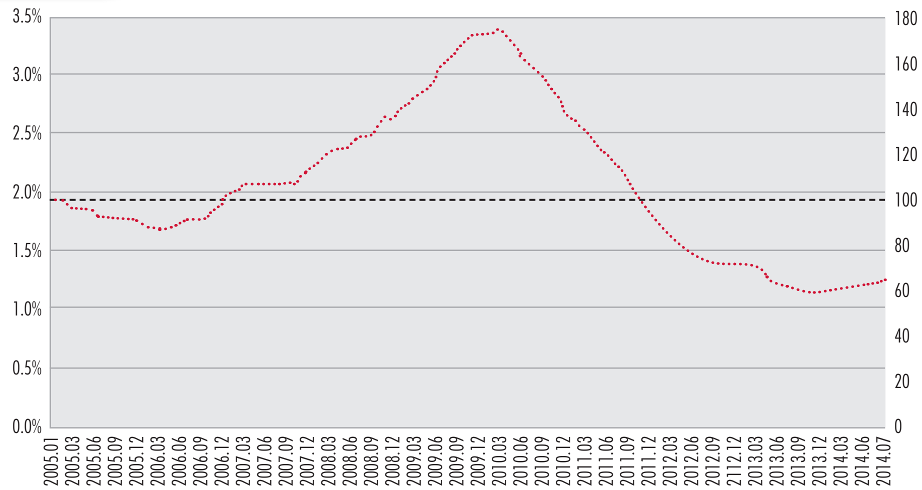
Recently, the SBLI signals growing confidence and investment activity by small businesses. The latest index values indicate an acceleration of growth from the slowing trend in the first quarter of 2014. As of July 2014, the index stood at 128.5, just slightly below the all-time high in January 2007 and a 10% increase over the same period last year. The July index grew 7% over June, the fifth consecutive month to exhibit a double-digit increase (year over year). This represents organic growth and a rebound from the year's slow start, during which GDP shrank in the first quarter.

In another encouraging sign, small business investment momentum continued at a healthy 11% growth trend rate, which bodes well for future expansion. Investment grew 16% in 2011 and slowed to a 9% pace in 2012. Investment slowed further in 2013 to 7% annual growth, which is why the faster trend-line growth of 14% and the annual increase of 10% are positive developments.

While small businesses are increasing their level of investment nationally, the rates of increase vary across Federal Reserve districts, as indicated in Figure 3. This year's data shows a positive development—last year's lagging regions are getting into the game in a big way while previous leaders are showing steady growth.

Last year's study had noted inconsistent expansion. The Philadelphia region had contracted 2.1%, while Boston and Dallas barely registered any expansion, 1.1% and 2.9%, respectively, for the 12-month period ending in June

Figure 4 **Thomson Reuters/PayNet Small Business Delinquency Index 31-90 Days**




Source: Thomson Reuters/PayNet Small Business Delinquency Index

2013. Last year the Midwest clearly showed the highest rates of expansion by small businesses, recording double-digit increases in Minneapolis, Chicago, and St. Louis.

This year, small business expansion is taking hold in parts of the country that had previously lagged. The Northeast and Southeast districts are expanding the fastest. Companies based in Richmond, Boston, and Atlanta invested 12.4%, 9.0%, and 14.5% more than in the prior year, respectively. The Dallas region is up 12.7% and San Francisco is higher by 13.6%. Meanwhile, small business investment in the Midwest is investing less rapidly: The rates are 0% for Minneapolis, 6.8% for Chicago, and 7.0% for St. Louis.

Investment into more regions of the country indicates a broader expansion phase. Combining double-digit investment in the previously lagging regions with solid single-digit increases in the leading regions from last year yields a stronger economy.

Last year the expansion was spotty and regionalized. This year it is moderate in the Midwest and strong in the Northeast and Southeast. Had growth not caught on with the Northeast and Southeast businesses, we would likely see a much different economy today and in the future: one built on a lack of diversity, concentrated in a few regions, exhibiting even more tepid growth, and perhaps moving toward contraction—a result of reliance on a few regions

Table 1
**States with Highest and Lowest Loan Delinquencies**

| <0.50% | 0.50-0.99% | 1.00-1.50% | >=1.50% |
|---|---|---|---|
| | State | 2014.06 | |
| | Mississippi SBDI | 2.05% | |
| | Delaware SBDI | 1.88% | |
| | District of Columbia SBDI | 1.88% | |
| | New Jersey SBDI | 1.65% | |
| | Florida SBDI | 1.61% | |
| | Connecticut SBDI | 1.56% | |
| | Alabama SBDI | 1.51% | |
| | | .... | |
| | | .... | |
| | Colorado SBDI | 0.99% | |
| | Tennessee SBDI | 0.97% | |
| | Michigan SBDI | 0.97% | |
| | North Dakota SBDI | 0.94% | |
| | Rhode Island SBDI | 0.93% | |

Table 1 (continued)

| <0.50% | 0.50-0.99% | 1.00-1.50% | >=1.50% |
|---|---|---|---|
| | State | 2014.06 | |
| | Missouri SBDI | 0.90% | |
| | Arkansas SBDI | 0.89% | |
| | Hawaii SBDI | 0.85% | |
| | Montana SBDI | 0.82% | |
| | Ohio SBDI | 0.82% | |
| | Oregon SBDI | 0.81% | |
| | Oklahoma SBDI | 0.78% | |
| | Wisconsin SBDI | 0.77% | |
| | Iowa SBDI | 0.71% | |
| | Vermont SBDI | 0.71% | |
| | Indiana SBDI | 0.68% | |
| | Minnesota SBDI | 0.67% | |
| | South Dakota SBDI | 0.55% | |
| | Idaho SBDI | 0.43% | |

Source: PayNet Small Business Delinquency Index

Table 2
**State Industry Sectors with Highest and Lowest Loan Delinquencies**

| 31-90 Days | 2013.06 | 2014.06 | YOY Change |
|---|---|---|---|
| Georgia Agriculture | 0.45% | 0.73% | 62.2% |
| Michigan Construction | 0.73% | 1.02% | 39.7% |
| New York General | 1.11% | 1.44% | 29.7% |
| New York Health Care | 0.98% | 1.17% | 19.4% |
| Ohio General | 0.67% | 0.79% | 17.9% |
| Wisconsin Retail | 0.83% | 0.96% | 15.7% |
| Texas Construction | 1.59% | 1.79% | 12.6% |
| New York Retail | 1.27% | 1.38% | 8.7% |
| Florida Retail | 1.60% | 1.07% | -33.1% |
| Illinois Agriculture | 0.13% | 0.09% | -30.8% |

Table 2 (continued)

| 31-90 Days | 2013.06 | 2014.06 | YOY Change |
|---|---|---|---|
| New York Transportation | 1.08% | 0.72% | -33.3% |
| Michigan Agriculture | 0.29% | 0.19% | -34.5% |
| Illinois Transportation | 1.13% | 0.74% | -34.5% |
| Pennsylvania Agriculture | 0.55% | 0.36% | -34.5% |
| Florida Transportation | 1.53% | 0.98% | -35.9% |
| Ohio Transportation | 0.87% | 0.55% | -36.8% |
| Michigan Transportation | 1.02% | 0.55% | -46.1% |
| Pennsylvania Transportation | 1.52% | 0.79% | -48.0% |
| Wisconsin Health Care | 0.76% | 0.39% | -48.7% |
| Wisconsin Transportation | 0.99% | 0.49% | -50.5% |

Source: PayNet Small Business Delinquency Index

to carry the load. When the economy has a broader base of expansion derived from varying sources, the expansion has more depth and presents less risk.

Credit risk stands at all-time lows, owing in part to exceedingly low loan delinquencies. The Thomson Reuters/PayNet Small Business Delinquency Index (SBDI), the percentage of small business loans greater than 30 but less than 91 days past due, calculated on a monthly basis, reveals a high correlation with future nonaccrual loans.

The rising rate of investment by small businesses is due partly to strong finances. As shown in Figure 4, the SBDI declined from peak delinquency rates of 3.39% in August 2009 to 1.25% in July 2014. This represents a 63% improvement in moderate loan delinquencies and a slight rise from the all-time low delinquency rate of 1.15% reached in October 2013.

In similar fashion, severe loan delinquencies have improved to all-time lows. Loans 91 to 180 days past due remained at 0.29% for much of 2013 and have held at that level in 2014. This is almost an 80% improvement from the high level of severe loan delinquencies of 1.36% reached in September 2009. Regardless of the way you measure credit risk, it now stands at historical lows and provides the conditions for continued investment, which will lead to further economic growth.

Credit risk differs regionally, of course, as shown in Table 1. PayNet data shows the broad shift toward moderate loan delinquencies across a larger number of states. States with historically high delinquency rates, such as Florida, Georgia, Michigan, and California, showed 68% or greater improvements in loan delinquencies, which peaked in mid-2009. For example, loan delinquencies in Florida fell 347 basis points, from 5.08% to 1.61%. On a year-over-year basis, loan delinquencies rose in Wisconsin, Pennsylvania, and Georgia, but they fell in Michigan, Ohio, Illinois, and New York.

As seen in Table 2, the largest 10 states by population illustrate the general broad-based improvement in credit quality across the U.S. and most industries. Loan delinquency has improved among 63% of the industry groups in the largest states. Delinquencies have improved the most in the transportation industry, which includes seven of the top 10 most improved sectors. During the same period,

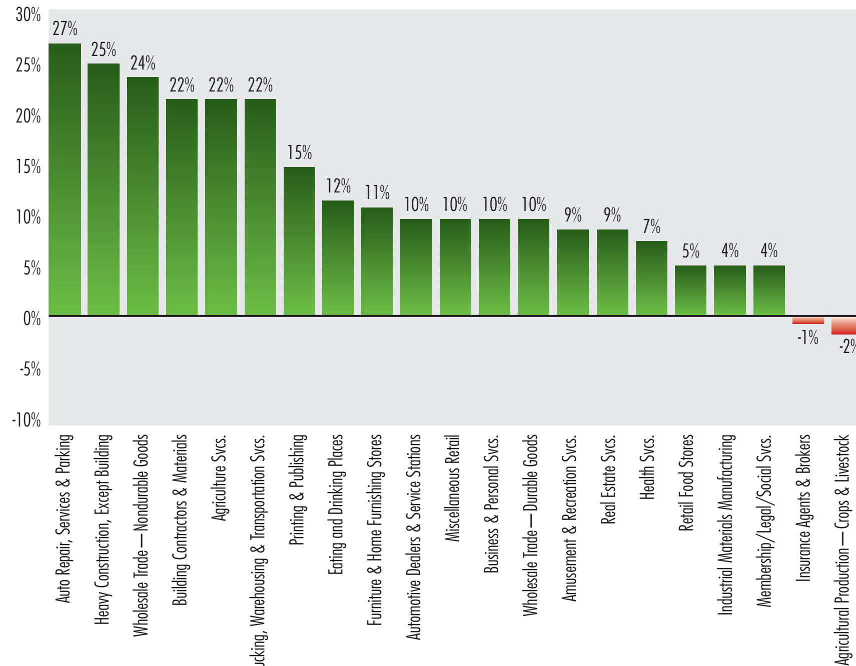
Table 3
**Actual Default Rates of 21 Major Industry Segments**

| Industry Segment | Historical Default Rates | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
| Printing & Publishing | 4.1% | 3.9% | 7.3% | 11.9% | 8.3% | 5.1% | 3.4% | 3.6% |
| Trucking, Warehousing & Transportation Svcs. | 4.3% | 6.7% | 11.1% | 12.9% | 7.2% | 3.7% | 2.2% | 2.1% |
| Eating & Drinking Places | 3.9% | 4.5% | 6.1% | 6.7% | 4.7% | 2.4% | 1.3% | 1.5% |
| Business & Personal Services | 3.7% | 3.9% | 6.1% | 8.4% | 4.7% | 2.6% | 1.7% | 1.4% |
| Wholesale Trade—Durable Goods | 2.2% | 2.6% | 4.2% | 5.4% | 3.6% | 1.7% | 1.2% | 1.2% |
| Furniture & Home Furnishing Stores | 5.4% | 4.9% | 7.0% | 8.9% | 6.1% | 2.5% | 1.9% | 1.2% |
| Retail Food Stores | 2.7% | 3.5% | 4.8% | 7.3% | 4.1% | 2.2% | 1.7% | 1.2% |
| Membership/Legal/Social Services | 2.1% | 2.7% | 3.6% | 3.9% | 2.2% | 1.4% | 1.2% | 1.2% |
| Real Estate Services | 3.4% | 5.3% | 8.4% | 9.6% | 4.7% | 2.6% | 1.4% | 1.2% |
| Automotive Dealers & Service Stations | 3.0% | 2.8% | 6.1% | 8.4% | 3.4% | 1.4% | 1.0% | 1.1% |
| Building Contractors & Materials | 2.5% | 3.7% | 6.7% | 10.5% | 6.1% | 2.8% | 1.5% | 1.1% |
| Health Services | 2.5% | 2.9% | 3.7% | 4.6% | 2.9% | 1.3% | 1.2% | 1.1% |
| Amusement & Recreation Services | 3.0% | 3.6% | 3.6% | 4.5% | 2.9% | 1.9% | 1.1% | 1.0% |
| Miscellaneous Retail | 3.7% | 3.7% | 5.6% | 5.9% | 3.9% | 2.4% | 1.4% | 1.0% |
| Wholesale Trade—Nondurable Goods | 2.1% | 2.0% | 2.6% | 3.7% | 2.3% | 1.4% | 0.9% | 0.8% |
| Auto Repair, Services & Parking | 3.7% | 3.8% | 5.0% | 6.8% | 3.2% | 2.0% | 1.3% | 0.8% |
| Agriculture Services | 2.6% | 3.0% | 4.2% | 5.8% | 3.7% | 1.6% | 08% | 0.7% |
| Industrial & Materials Manufacturing | 2.3% | 2.0% | 3.3% | 6.3% | 3.1% | 1.4% | 0.7% | 0.6% |
| Heavy Construction, Except Building | 2.0% | 2.9% | 5.4% | 9.3% | 5.7% | 2.5% | 1.1% | 0.6% |
| Insurance Agents & Brokers | 3.0% | 2.7% | 4.1% | 4.0% | 2.9% | 0.9% | 1.4% | 0.6% |
| Agricultural Production—Crops & Livestock | 2.0% | 1.3% | 1.3% | 2.4% | 1.9% | 0.8% | 0.4% | 0.4% |
| **All Industries** | **2.9%** | **3.6%** | **5.5%** | **7.2%** | **4.2%** | **2.1%** | **1.4%** | **1.1%** |

Source: PayNet 2014 Research Study

Figure 5

**One-Year Change in New Originations for 21 Major Industry Segments, 2014 versus 2013 (12-Month Periods Ending in June)**




Source: PayNet 2014 Research Study

loan delinquencies have risen in Georgia agriculture and Michigan construction. New York accounts for three of the largest increasingly delinquent industry sectors.

## Asset Quality

Just when you thought credit quality could not improve further, business defaults reached a new all-time low at year-end 2013. As shown in Table 3, only 1.1% of small businesses defaulted during 2013, which represents an improvement over the already low default rate of 1.4% during 2012.

Only about one out of every 100 small businesses went out of business at some point in 2013, and these defaults compare very favorably to the 7.2% default rate in 2009, reflecting the financial stress brought on by the recession.

During 2005-06, the average annual default rate was 2.9%, which represents a normalized level for this asset class. During 2008-10, the average rate equaled 5.6%, with nearly 17% of all small businesses defaulting during this three-year period. In contrast, the average default rate over the 2011-13 period stands at only 1.5%, while the eight-year average default rate for the period ending 2013 stands at 3.5%. These current default rates are abnormally low now, creating the potential for a false sense of security.

Varying default rates and changes in defaults by industry segment remain a function of business models combined with rising and falling economic prospects. Some industries consistently exhibit higher default rates through good times and bad. Businesses in printing and publishing, transportation, and warehousing register consistently higher-than-average default rates, in part owing to low barriers to entry. Building contractor and heavy construction businesses felt the sting of the recession with 10.4% and 9.3% default rates, respectively, in 2009, as the housing market collapsed. Contractors and construction businesses that survived the Great Recession look attractive now because their default rates remain low at 1.1% and 0.6%, respectively.

What's changed is that stronger businesses survived and the housing market has improved. Business models for contractors and construction companies have probably become more complex with more licensing requirements, policy issues, and mortgage application scrutiny. The very low default rates for businesses in nondurable goods, auto repair, agriculture services, industrial machinery, and agricultural production are due more to the scar tissue remaining from the recession than a business model change. The Great Recession left a deep impression on small business owners, making them averse to incurring debt and taking risks.

Meanwhile, the brakes imposed on the economy by regulations and policies to avert bubbles have dampened economic growth for an extended period. Default rates

> Businesses in the manufacturing industry group invested 4% more in property, plant, equipment, tools, and services over the past 12 months.

may be considered abnormally low today compared to earlier in the decade, and they will likely stay lower than the long-term average.

## Industry and Regional Trends

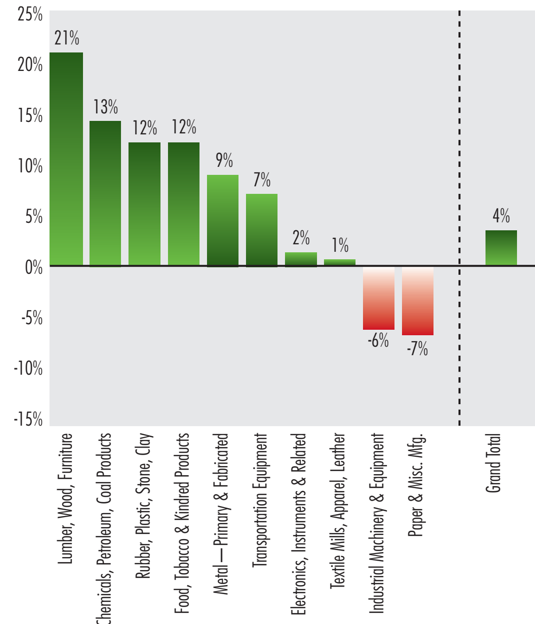
Lending activity is gathering strength, growing 15% over the prior year. Figure 5 shows that 19 of 21 major industry groups are borrowing more money to make more long-term investments. A majority of the industry groups are increasing investment at a rate of 10% or greater, and six of the groups show rates of 22% or better over the prior year.

Industries investing more heavily include auto repair (up 27%), heavy construction (up 25%), wholesale non-durables (up 24%), and building contractors, agriculture services, and trucking warehousing (all up 22%). What's going on? The average age of a car on the road today remains at an all-time high. Home remodeling is in high demand. Farmers are buying production inputs to obtain more crop yield. More goods are being transported, particularly in and out of the new energy-producing centers in North Dakota, North Texas, and Pennsylvania.

Industries with declining investment are in the minority. Insurance agencies are in the midst of a cyclical consolidation as larger agencies, which are considered large businesses, buy up smaller independents. Agricultural producers are feeling the pressure from lower prices for cash grains as the price of corn fell from $7 per bushel in mid-2013 to $4 in mid-2014.

With 19 of 21 major industry groups registering more investment, this economic expansion is gathering momentum because of the broad base of participation by so many industry groups. Bankers may believe the party is over because all of this investment has already occurred. Businesses investing now are building more capacity to produce more goods. The pace of investment will likely slow as businesses digest their new capital, but will likely create add-on investments in 2015. Studies show that every

Figure 6 **Manufacturing Industry: One-Year Change in Originations,** 2014 versus 2013 (12-Month Periods Ending in June)




Source: PayNet 2014 Research Study

dollar of capital investment produces added spending for supplies, which means more working capital lines of credit granted to buy the needed supplies.

A PayNet study has also shown that every one-point increase in the SBLI leads to 50,000 jobs, most of which will require checking accounts and other bank services. Payments services will increase as well, as more money flows through the financial system. Generating investment means stronger economic expansion over the next few quarters and a larger productive asset base on which to grow in 2015.

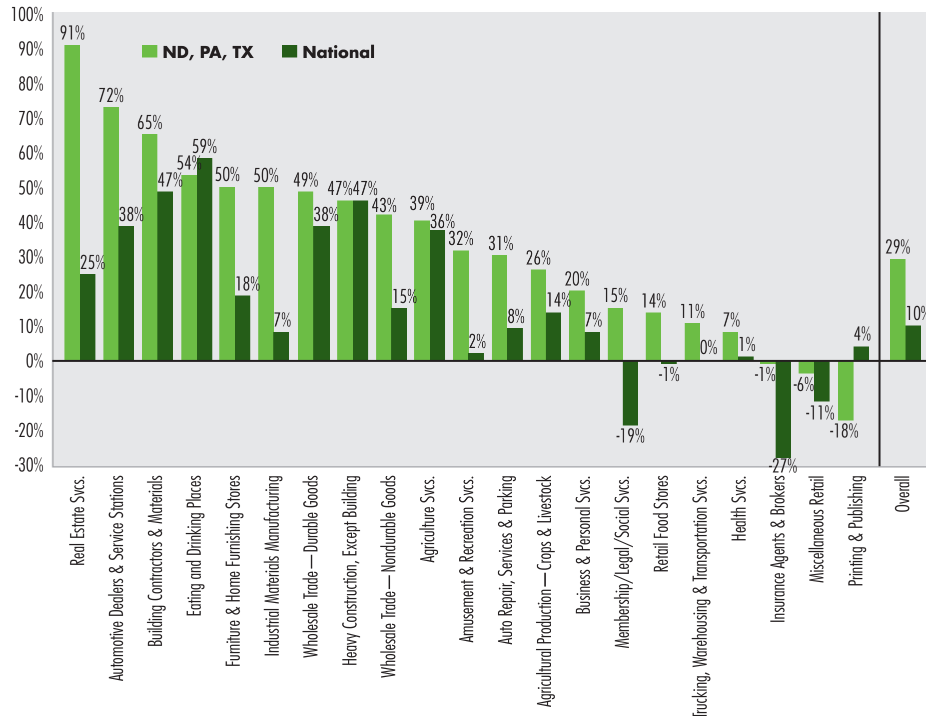
A deep dive into the industrial and materials manufacturing segment also reveals increased investment. As shown in Figure 6, businesses in the manufacturing industry group invested 4% more in property, plant, equipment, tools, and services over the past 12 months. Again, a broad-based expansion is under way as eight of the 10 sub-sectors of manufacturing expanded. Lumber, wood, and furniture led the way, up 21%, while energy-related products, synthetics, and food showed healthy increases of 13%, 12%, and 12%, respectively.

Industrial machinery and equipment has remained sluggish, however, with investment contracting 6%—the second straight year of shrinkage in this significant group. It is likely that the industrial machinery businesses invested heavily to take advantage of accelerated depreciation of capital purchases for tax purposes,

Figure 7

**Rate of Start-up Businesses: Oil Patches versus National Average**

Change in New Borrowers in North Dakota, Pennsylvania, and Texas vs. Nationally, 2009 vs. 2013




Source: PayNet 2014 Research Study

reflected in investment increases of 23% in 2011 and 19% in 2012. Given the lack of investment over the past several years, some increases in 2015 can be expected to replace worn-out assets. Meanwhile, paper manufacturing remains under pressure, in part from the U.S. Postal Service's three-cent increase in consumer postage prices. The largest postage increase in more than a decade is causing businesses to reduce their paper-based marketing efforts.

## Energy

Many stories have been written about the local economic stimulus created by the oil booms in North Texas, North Dakota, and Pennsylvania. Schools in the oil patch are looking for more teachers to educate the influx of new students. Oil producers are increasing production as fast as labor, housing, materials, transportation, and local permitting will allow. As shown in Figure 7, the oil boom is not only generating more energy, it is also driving more start-ups of small businesses to support this growth. Start-up businesses in real estate services, automotive dealerships, building contractors, and furniture stores have increased 91%, 72%, 65%, and 50%, respectively, over the 2009-13 period.

Overall, start-ups in the oil boom regions are up 29% versus the national average start-up rate of 10% over the same period. In every major industry category except printing and eating places, start-ups in the oil patch are ahead of the national average for their respective industry group. On a national basis, eating places, building contractors, and heavy construction businesses show the most start-up activity, owing in part to an improving economy, a better housing market, and the oil boom.

## Strategy

Low-risk expansion, along with broadening low delinquencies and abnormally low default rates, presents favorable conditions for bank lending. The economy has healed further, sluggish growth has been picking up, and credit portfolios are of unusually high quality. All that's needed now is to set up a strategy for 2015 and implement it.

Credit ratings reflect the numeric probability that borrowers will default on a substantial portion of loans. Table 4 displays the forecast for small-business-borrower defaults by major industry sector for 2014 and 2015. Business defaults have been falling since 2009, which has enabled banks to capture earnings through release of loan loss reserves. Regulators are voicing concern over the continued release of reserves while auditors are wary of FASB's looming new accounting standard, Financial Instruments Sub-topic 825-15 for Current and Expected

Table 4

**Forecast Default Rates by Industry Segments**

| Industry Segment | Forecast Default Rates | |
|---|---|---|
| | 2014 | 2015 |
| Printing & Publishing | 2.9% | 2.8% |
| Trucking, Warehousing & Transportation Svcs. | 2.6% | 2.4% |
| Eating & Drinking Places | 2.2% | 2.8% |
| Business & Personal Services | 2.2% | 2.4% |
| Wholesale Trade—Durable Goods | 1.7% | 2.0% |
| Furniture & Home Furnishing Stores | 2.1% | 2.5% |
| Retail Food Stores | 1.6% | 2.3% |
| Membership/Legal/Social Services | 1.9% | 1.7% |
| Real Estate Services | 2.3% | 2.1% |
| Automotive Dealers & Service Stations | 1.7% | 1.9% |
| Building Contractors & Materials | 1.9% | 2.1% |
| Health Services | 1.7% | 1.8% |
| Amusement & Recreation Services | 1.8% | 2.3% |
| Miscellaneous Retail | 1.9% | 2.3% |
| Wholesale Trade—Nondurable Goods | 1.4% | 1.8% |
| Auto Repair, Services & Parking | 2.0% | 2.1% |
| Agriculture Services | 1.5% | 1.5% |
| Industrial & Materials Manufacturing | 1.5% | 1.7% |
| Heavy Construction, Except Building | 1.5% | 1.7% |
| Insurance Agents & Brokers | 1.5% | 1.5% |
| Agricultural Production—Crops & Livestock | 0.9% | 1.0% |
| **All Industries** | **1.8%** | **1.9%** |

*Forecast defaults based on existing portfolio*

Source: PayNet AbsolutePD

Table 5

**Forecast Default Rates by Federal Reserve District**

| Federal Reserve District | Forecast Default Rates | |
|---|---|---|
| | 2014 | 2015 |
| Dallas | 2.4% | 2.5% |
| Atlanta | 2.3% | 2.3% |
| Boston | 1.9% | 2.0% |
| Richmond | 1.9% | 2.0% |
| San Francisco | 1.8% | 2.0% |
| New York | 2.0% | 2.0% |
| Philadelphia | 1.8% | 1.9% |
| St. Louis | 1.7% | 1.7% |
| Cleveland | 1.6% | 1.7% |
| Kansas City | 1.5% | 1.6% |
| Chicago | 1.4% | 1.5% |
| Minneapolis | 1.0% | 1.2% |
| **All** | **1.8%** | **1.9%** |

Source: PayNet AbsolutePD

Credit Losses, to account not only for incurred losses but also expected losses on loans.

Obtaining the proper ALLL will be a big challenge for banks. For 2014 and 2015, PayNet's AbsolutePD model forecasts increases in business default rates of 1.8% and 1.9% annualized, respectively. It also forecasts lower default rates in printing (down 0.7%) and higher defaults in business services (up 0.8%), furniture stores (0.9%), real estate services (1.1%), miscellaneous retailers (0.9%), auto repair shops (1.2%), and industrial machinery, heavy construction, and insurance agencies (0.9%). These default rates fall well below the long-term average of 3.5% and the normalized rate of 2.9% cited previously, but they also reflect underlying dynamics.

More investing and more start-ups mean more economic winners and losers, which will result in more business defaults. The other side of the coin is caution. Business owners and managers who experienced the Great Recession won't forget looking into the economic abyss. Business defaults lower than the long-term average will continue to be the norm for the next several years.

Borrower defaults by geographic region must also play a role in setting risk tolerances. What's interesting about this view is that credit risk is rising in all geographic regions, but more so in some versus others. Small businesses depend on the local economies in which they operate. Factoring the local economy into the forecasted default rates and comparing those to 2013 actual default rates reveals that credit risk is rising the most in Atlanta (0.8%), Dallas (1.1%), Richmond (0.8%), and Boston (0.9%) as shown in Table 5.

## Interest Rate Impact

Stress-test analysis is a valuable planning tool that looks at the impact of various economic scenarios on bank C&I portfolios. PayNet projected default rates under different scenarios based on the 16 macroeconomic variables prescribed by the Federal Reserve in its Comprehensive Capital Analysis and Review (CCAR).

The severely adverse scenario factors in GDP falling 6.1%, unemployment rising to 11.3%, the BBB corporate spread rising to 5.1%, and other unfavorable changes. The results presented below in Table 6 reveal that the 1.4-percentage-point difference between the historical default rate in 2013 and the projected default rate of the severely adverse scenario is far less than the rise shown in Table 3, when rates doubled from 3.6% in 2007 to 7.2% in 2009.

The good news is that credit portfolios are in much better shape to handle adverse economic scenarios than they were approaching the Great Recession.

## The Plan

A major principle taught in business school is "no risk, no reward." Last year's study noted greater risk and less investment in Dallas, Atlanta, and Boston and lower risk and greater investment in Minneapolis, Chicago, and Kansas City. I thought about asking my business school for a partial refund: The real world was reflecting higher risk and lower reward last year.

In this year's study, we find that business school was right. Companies in the Federal Reserve districts of Atlanta, Dallas, Richmond, Boston,

Table 6

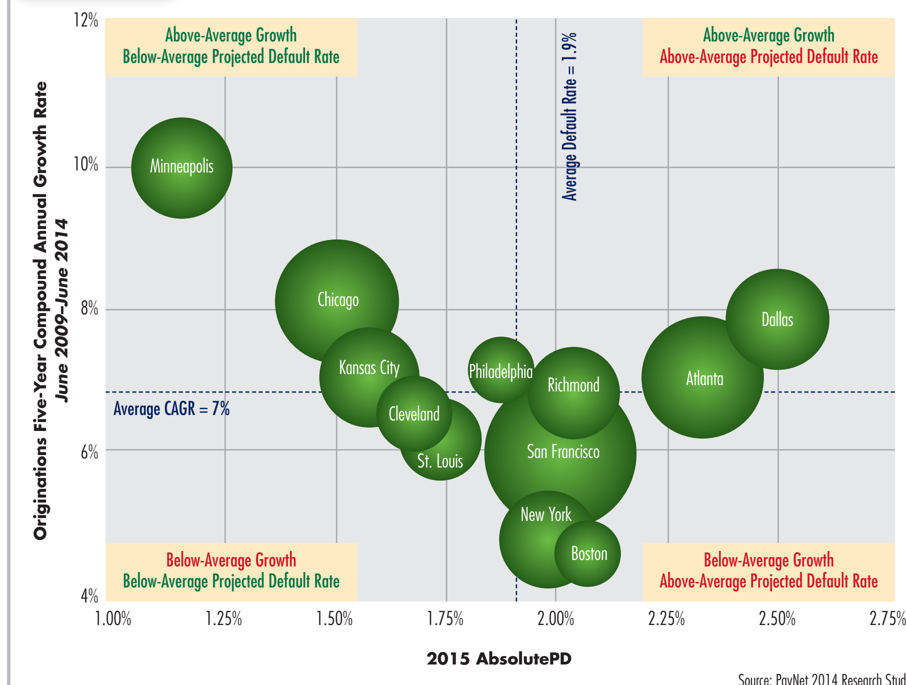
**Stress Scenarios**

| Scenario | AbsolutePD Stress Test Simulator: Forecasted Default Rates |
|---|---|
| | 7/1/2014 to 6/30/2015 |
| Baseline | 1.6% |
| Adverse | 1.9% |
| Severely Adverse | 2.5% |

*For borrowers with an exposure less than $2.5mm; projections as of 10/1/2013*

Source: PayNet AbsolutePD Stress Test Simulator

Figure 8 **Investment Growth versus Default Risk by Geographic Region**




Source: PayNet 2014 Research Study

and San Francisco exhibit higher investment and higher default rates. Meanwhile, businesses in the Minneapolis and Chicago districts display lower investment and lower default rates. We are witnessing a shift back to normal business conditions.

Immediately after the Great Recession, a flight to quality prevailed that rewarded the higher-quality companies with more confidence to invest. In 2014, this "great normalization" is in play—a subtle but definite shift back to more risk taking with commensurate expectations for higher returns. This transition may take another year or two to play out, but comparisons of risk-and-reward relationships over the past several years validate this change in risk tolerance.

As Figure 8 illustrates, geographic regions where businesses are increasing their borrowing and investing include Atlanta, Dallas, San Francisco, Richmond, Boston, and New York. Higher investment and borrowing go hand-in-hand with default risk above the 2015 average of 1.9%.

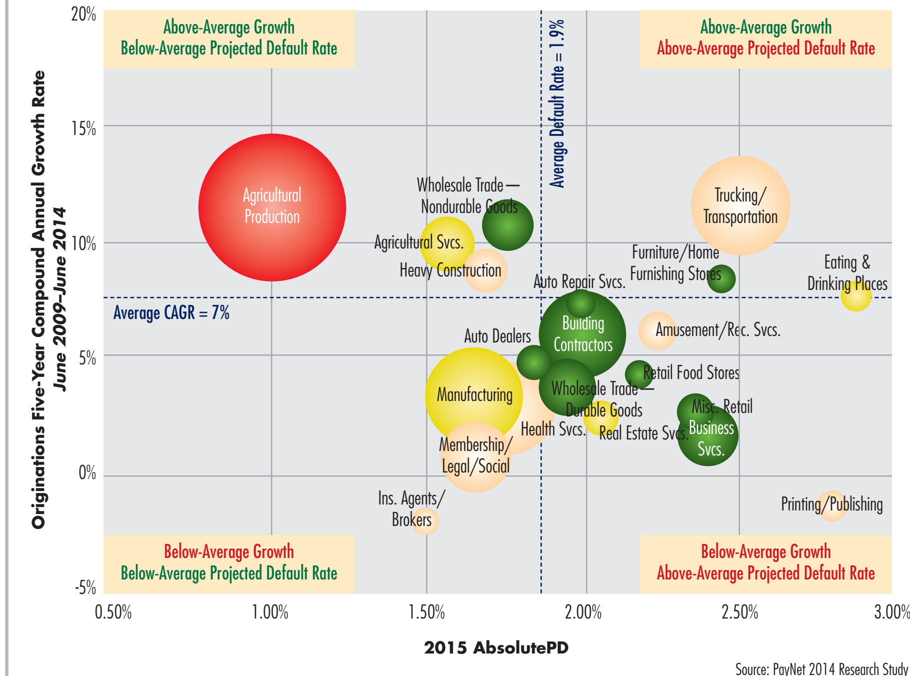
Credit risk versus growth by industry shows the general improvement in the economy, as the five-year annual growth rate has increased from -1% in 2013 to 7% in 2014 (see Figure 9). Meanwhile, credit risk has barely budged, which means more earning assets at about the same risk level for banks.

Many of the same industries remain attractive: agricultural production, wholesale nondurables, heavy construction, and agriculture services. Businesses in the low-growth/higher-risk category include printing and publishing, business services, and wholesale trade durables. Energy is manifested in manufacturing, where growth increased this year. Wholesale trade nondurables and heavy construction also are in the higher-growth quadrant this year.

## Conclusion

The last several years have been like a hard day's night for banks. Fortunately, they have adjusted to the helter-skelter caused by the recession and re-regulation of financial services. Scar tissue from the Great Recession remains, however. We see in this data that small businesses are reluctant to borrow excessively, and they are taking a highly conservative approach to investing in expansion. Slower growth is the side effect, but greater longevity of this expansion is a

Figure 9 **Investment Growth versus Default Risk by Industry**



Source: PayNet 2014 Research Study

reasonably good trade-off and most likely viewed as more favorable by regulators and policy makers.

Today's default rates present potential peril for bankers because these abnormal lows provide an unrealistic expectation for future credit losses. Default rates are expected to be lower than the average currently in this decade but higher than the low point reached in 2013. The result is that credit losses will likely rise over the next few years.

Broader geographic participation in this expansion is a very positive development for this business cycle. With broader participation comes a more diverse and resilient economy and a signal that this expansion is for real. Rotation into new industries is also a healthy sign. How long could any expansion realistically ride on the shoulders of one or two industry groups? This study shows that the great normalization is under way. The economy is slowly but surely returning to equilibrium between risk and reward.

Tomorrow's bank will not look like the one from yesterday. As Tom Brown of SecondCurve Capital noted at PayNet's Executive Banking Forum in May 2014, successful banks will develop a focused strategy with superior execution while disinvesting in physical delivery and investing in mobile applications.

As one of the Beatles' more memorable songs goes, "The sun is up, the sky is blue, it's beautiful, and so are you." Bankers will always face challenges, and tomorrow never knows which will be foremost. With sunny economic conditions amid blue skies, bankers will see favorable conditions during this low-risk expansion phase of the business cycle. ❖

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