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Where Has All the Talent Gone?

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Exclusive RMA Study
By PayNet, Inc.

How to (Safely) Grow
Commercial and Industrial Loans

Credit risk from C&I lending remains moderate and opportunities can be found. But banks must remain vigilant as the effects of economic expansion and anticipated QE tapering take hold.

BY WILLIAM PHELAN

WAVEBREAK MEDIA/THINKSTOCK

ARNOLD PALMER, THE owner of probably the worst swing in professional golf but a holder of seven major titles, is known for saying, "It's a funny thing…the more I practice the luckier I get."

Luck can contribute to success, but most bankers know success favors those who are prepared. How else to deal with a still weak housing market, a sluggish economy, excess deposits, and increased regulations? Current banking challenges also include the following:

- Roughly $1.8 trillion in deposits, which present an untapped pool of capital and may tempt bankers to ease underwriting standards.
- Underperforming stock prices, which create enormous pressure to increase earnings at the expense of systems and processes.
- Peaking asset quality, which presents changing credit conditions that become difficult to judge, particularly when calculating the allowance for loan and lease losses (ALLL).
- The transition from low to higher interest rates, which may complicate the bank's business plans.

Regulators are concerned these conditions may force banks to take excessive risks in commercial and industrial (C&I) lending in an effort to improve profitability. And indeed, many banks are pursuing C&I as an alternative to their former focus on commercial real estate. But creating the new products needed for a C&I business model means acquiring the skills and expertise to compete in new markets.

This article presents a five-step road map to help bankers safely grow their C&I earning assets in 2014. It looks at the business cycle, market opportunities, asset quality, industry and regional trends, and interest rate impacts. Being able to assess the growth prospects and credit conditions in C&I lending—and to acquire and manage an influx of these assets—may help banks of all sizes transition to a C&I business model and prepare for a changing economy.

Looking Toward 2014

Operating challenges and new regulations are forcing banks to retool their business models. Nevertheless, as bankers grow their C&I lending, they must ensure they are paid for the risks they are taking. Credit risk from C&I lending remains moderate, but banks and regulators must remain vigilant.

For 2014, businesses are seeking clarity on the direction of the economy over the next year. Specifically, they are trying to 1) determine how much to invest in new property, plant, and equipment, including technology; 2) define hiring plans; and 3) decide whether to pursue acquisitions.

Meanwhile, financial institutions want to put capital to work. They are seeking to identify market opportunities and strengthen relationships among some of the millions of small and medium-sized businesses. But the economy remains uneven and growth is spotty. Credit risk has cycled from the highs of 2009 to the lows of 2012.

Small Business as a Leading Economic Indicator

The media, policy makers, and the business community all acknowledge the central role of small businesses in the U.S. economy. Publicly available information on small businesses, such as annual revenues or number of employees, relies on estimates rather than hard data. To gain market insight, PayNet collects and analyzes information on loans made by hundreds of lenders to small businesses.

As bankers grow their C&I lending, they must ensure they are paid for the risks they are taking.

The study described here relies on the largest database of C&I loans in the country and focuses on private companies with C&I loan exposures of less than $1 million. For the purposes of this study, PayNet defines a small business to be one with $1 million or less in total loans outstanding.

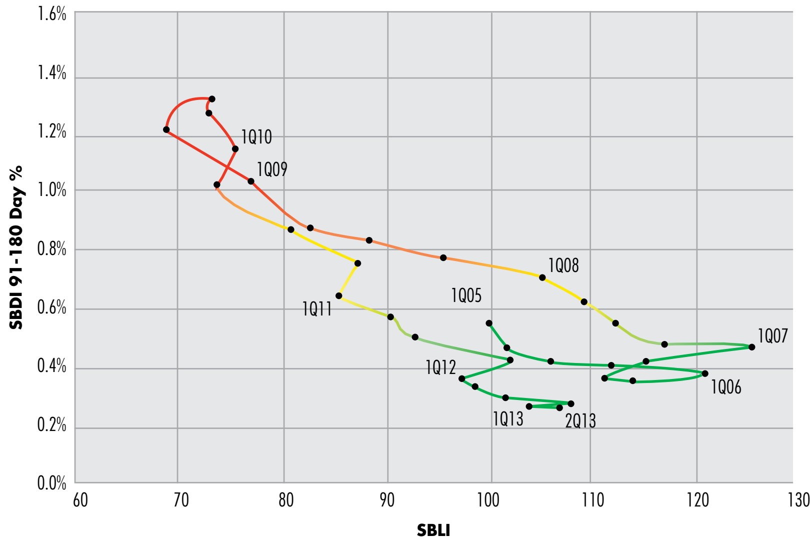
Outstanding loans reported by lenders represent one of the best measures of borrower business size, as they are objectively reported by a third party as opposed to being self-reported or estimated. Insights supported by such quantifiable data can help banks make smarter decisions about safe-growth sectors and prepare their portfolios for the ever-changing business cycle.

A cross-section of U.S. small businesses extracted from PayNet's proprietary database serves as the sample for this study. The database encompasses information on nearly $1 trillion in financial contracts involving millions of small businesses in the U.S. and is updated with real-time information each month. Through state-of-the-art analytics, this real-time data is converted into market intelligence and predictive tools that can be used to reduce the cost of credit granting and portfolio management.

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.

Research shows that small businesses act as a leading economic indicator because they generally respond to changes in economic conditions more rapidly than larger businesses. From its database, PayNet creates a time series of indicators that are representative of loan demand. Historical loan default rates are reported to put credit risk on small business loans into the context of a separate asset class. This study also provides a default forecast under various economic scenarios using PayNet AbsolutePD®, the only probability-of-default model available for small businesses to address the limitation of financial statements on private businesses.

Figure 1 The Business Cycle



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

Indicator 1: The Business Cycle

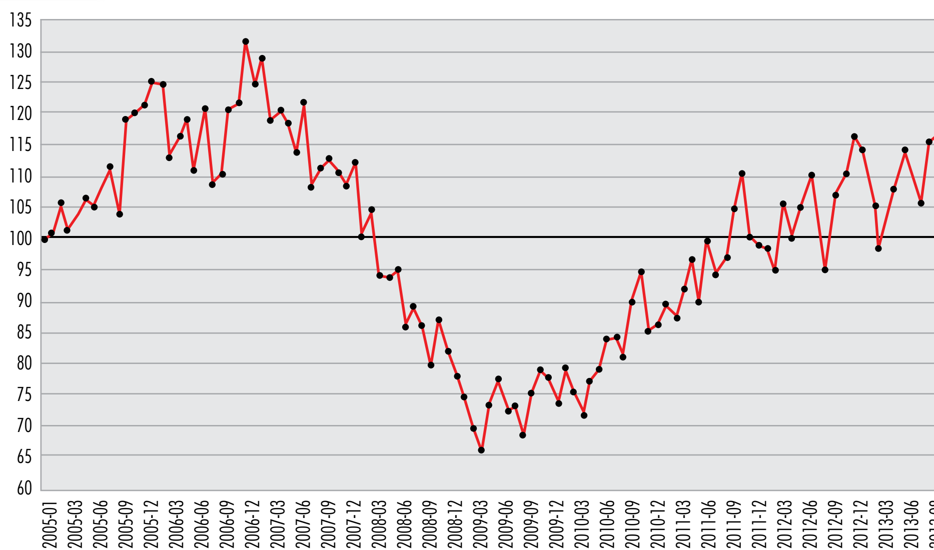
Figure 1 illustrates new investment by small businesses versus credit risk for each calendar quarter starting in 2005 up until the second quarter of 2013. As shown, the business cycle has been in a period of improving economic health for most of the past nine quarters. Small businesses were in a recovery phase from the fourth quarter of 2009 through the first quarter of 2011, as they borrowed more and their severe loan delinquencies fell.

A phase of expansion at low risk began in the second quarter of 2011 and has continued through the second quarter of 2013. During this period, small business investment in property, plant, equipment, tools, and services increased 9%. When businesses invest in more production capacity, they must be experiencing some degree of increased demand from consumers for goods and services.

Small businesses expanded investment in seven of nine quarters through mid-2013. Note the results for the first quarter of 2012 (1Q12) and the first quarter of 2013 (1Q13), during which small business investment contracted. Much uncertainty existed before these quarters because of elections, the sequestration, taxes, and major policy decisions. The good news is that small business is investing again, even if the pace is slower than the 21% increase in investment that occurred in the last low-risk expansion phase spanning the first quarter of 2005 (1Q05) through the first quarter of 2006 (1Q06).

Another big difference in the business cycle this time around is the sharply lower credit risk. In the previous cycle, severe loan delinquencies fell from 0.58% (1Q05 in Figure 1)

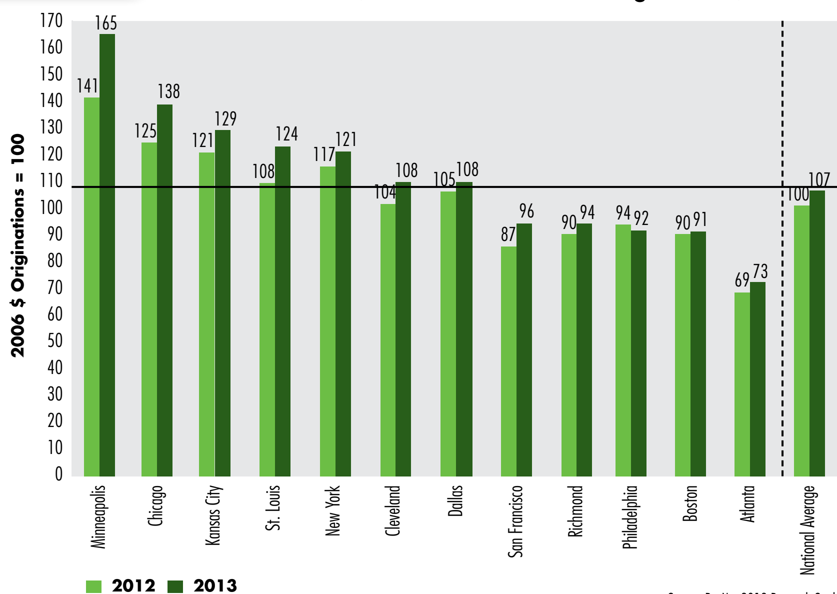
Figure 2 Thomson Reuters/PayNet Small Business Lending Index



Source: Thomson Reuters/PayNet SBLI

The latest SBLI showed an uptick following the slowing trend exhibited during the first six months of 2013.

Figure 3 **Small Business Originations by Federal Reserve District 2013 versus 2012 (12-Month Periods Ending in June)**



Source: PayNet 2013 Research Study

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

to 0.37%. In this cycle they have fallen from 0.57% to 0.29% (2Q13). The current phase has been marked by slower growth and lower risk than in 2005-06.

The big question 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 grow in the future. GDP has grown slowly during the same period. So how are banks able to grant so much credit and how are businesses able to expand faster than the rate of GDP?

Much of the growth by small businesses can be attributed to the recovery in 2011. However, the annual trend-line growth rate has slowed dramatically, moving from 16% in 2011 to 7% in 2013. Business cycles do not expire; rather, economic imbalances cause cycles to end. The potential for imbalance in this expansionary low-risk phase exists as the transition to normalized interest rates occurs.

No one knows for sure what the "market" interest rate would be without Federal Reserve intervention. One thing is certain: as the Fed tapers quantitative easing, interest rates will rise, causing the cost of money to increase and the value of assets to fall. An interest rate shock could create the basis for economic imbalances that would shorten this expansionary low-risk phase. However, it seems that businesses are in much better financial shape to deal with interest rate shocks than they were in 2005-06.

Indicator 2: Market Analysis

While small businesses seem to be starting to come alive, not all industry sectors and geographic regions are experiencing the same rate of growth. The Thomson Reuters/PayNet Small Business Lending Index (SBLI) is a quantified measure of the amount of new credit taken by U.S. small businesses. The SBLI uses a baseline of 100 beginning in January 2005. A current index value of 105 means small businesses borrowed 5% more in the current period than in January 2005.

As of this writing, the latest SBLI showed an uptick (2013-06 to 2013-08 in Figure 2) following the slowing trend exhibited during the first six months of 2013. This latest jump even surpassed 2005 levels, where the SBLI had stubbornly held for most of the last year.

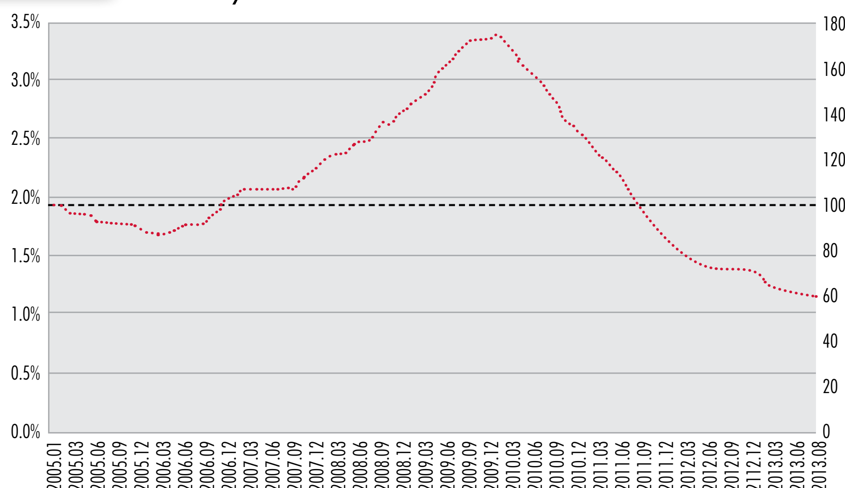
What's important about the latest report is its indication that small business is moving in the right direction. In August 2013, the index reached 116.6, the highest it had been since August 2007. That was a 6% increase over a year earlier and an 1% increase over July 2013. This result indicates that optimism is returning to small businesses, which are willing to invest in plant upgrades and to expand production of goods and services. The SBLI has been shown to lead GDP movement by two to five months, so this continued increase in investment bodes well for GDP in the short term.

Investment grew 16% in 2011 and slowed to 9% growth in 2012. As of this writing, small business investment in 2013 was up 7.4% over the prior year, but the recent months have shown a saw-tooth pattern of growth followed by contraction, an indication that small businesses lacked any conviction about a strong economy.

While small businesses are increasing their level of investment nationally, the rates of increase vary across Federal Reserve districts, as indicated in Figure 3. Last year's study showed consistent expansion among all Fed districts, but

Figure 4

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



Source: Thomson Reuters/PayNet Small Business Delinquency Index

The SBDI declined from peak delinquency rates in 2009 to 1.19% in August 2013.

that hasn't been the case this year. All regions have expanded their absolute level of investment over 2012 with the exception of Philadelphia, where small business investment was down 2%. But the pace of growth has varied. The Boston and Dallas regions are barely registering any expansion: 1.1% and 2.9%, respectively. In last year's study, Boston expanded 15% while Dallas expanded 26%.

Both the rate and the absolute levels of investment by small businesses are at their highest in the Midwest. Minneapolis, Chicago, and Kansas City stand out with investment levels at least 20% higher than the national average and nearly double the rate of investment levels in the Atlanta region. Small businesses in the St. Louis region roared back to life from the slowest growth last year to 15% growth this year.

Expansion is now most concentrated in the Minnesota, Chicago, St. Louis, and San Francisco regions. Rates have slowed dramatically in Kansas City, New York, Cleveland, Dallas, Richmond, and Atlanta. While these regions exhibit rates of investment in keeping with GDP growth, the concern is that growth is uneven across the country, which presents challenges for maintaining a sustainable national expansion.

Table 1

States with Highest and Lowest Loan Delinquencies

Legend: <1.00% | 1.00-1.49% | 1.50-1.99% | >=2.00%

Rank	State	2013:Q3
1	West Virginia SBDI	2.09%
2	District of Columbia SBDI	2.02%
3	Delaware SBDI	1.74%
4	Florida SBDI	1.68%
5	Georgia SBDI	1.60%
6	Alabama SBDI	1.57%
7	New Jersey SBDI	1.55%
		...
		...
		...
33	New Mexico SBDI	0.99%
34	Connecticut SBDI	0.98%
35	Utah SBDI	0.97%
36	Wyoming SBDI	0.96%
37	Wisconsin SBDI	0.91%
38	Washington SBDI	0.88%
39	Vermont SBDI	0.85%
40	Alaska SBDI	0.83%
41	Kansas SBDI	0.79%
42	Ohio SBDI	0.76%
43	Oregon SBDI	0.75%
44	Oklahoma SBDI	0.74%
45	Idaho SBDI	0.72%
46	Indiana SBDI	0.68%
47	Iowa SBDI	0.62%
48	Minnesota SBDI	0.56%
49	Montana SBDI	0.52%
50	Nebraska SBDI	0.48%
51	South Dakota SBDI	0.37%

Source: PayNet Small Business Delinquency Index

A look at loan delinquencies reveals that small businesses are well prepared financially for a slow-growth economy. The analysis uses the Thomson Reuters/PayNet Small Business Delinquency Index (SBDI), a measure of historical credit risk. The SBDI is the percentage of loans to small and medium-sized businesses that are greater than 30 days past due but less than 91 days past due (calculated on a monthly basis), and it reveals a high correlation with future nonaccrual loans.

The slowing rate of small business investment is not due to weak finances. As shown in Figure 4, the SBDI declined from peak delinquency rates in 2009 to 1.19% in August 2013. For more than 43 consecutive months, small businesses have paid their loans more promptly. Meanwhile, severe loan delinquencies, or those loans delinquent more than 90 days, recently declined to 0.29%, a historical low. This number is far less than in 2006, when delinquencies bottomed out at 0.36% toward the end of the last expansion phase. Regardless of the way you look at credit risk, it now stands at historical lows and provides a sense of security about the quality of credit portfolios.

Credit risk is not the same across all states, of course. PayNet data shows high-delinquency states are finally catching up with the lower-delinquency ones. The PayNet SBDI (Table 1) has fallen across almost all states and industries. Only seven states are in higher delinquency categories compared to last year's study. States with historically high delinquency rates, such as Florida, Nevada, and Arkansas, show big improvements since their recessionary spikes. Loan delinquencies in Florida fell 352 basis points, from 5.20% to 1.68%. Delinquencies dropped even in low-risk states such as Minnesota, where there wasn't as much room to fall. The rate there declined to 0.56%. The only states where loan delinquencies rose over the past year were West Virginia, Missouri, Iowa, Wisconsin, and Kansas. The industry sector showing increased loan delinquencies in many states is health care, with increases in 27 states.

Table 2

Actual Default Rates of 21 Major Industry Segments

Industry Segment	Historical Default Rates						
	2006	2007	2008	2009	2010	2011	2012
Printing & Publishing	4.1%	3.9%	7.2%	11.8%	8.3%	5.4%	3.8%
Trucking, Warehousing & Transportation Svcs.	4.3%	6.7%	11.0%	12.9%	7.2%	3.7%	2.2%
Furniture & Home Furnishing Stores	5.5%	4.9%	7.0%	8.9%	6.4%	2.9%	2.2%
Business & Personal Services	3.7%	4.0%	6.1%	8.5%	6.1%	2.8%	1.8%
Retail Food Stores	2.7%	3.4%	4.8%	7.4%	5.7%	2.7%	1.8%
Insurance Agents & Brokers	3.1%	2.6%	4.0%	4.0%	4.9%	2.7%	1.6%
Miscellaneous Retail	3.7%	3.5%	5.6%	5.9%	4.8%	2.6%	1.6%
Real Estate Services	3.4%	5.2%	8.4%	9.5%	4.7%	2.5%	1.6%
Health Services	2.5%	2.9%	3.6%	4.6%	4.1%	2.5%	1.5%
Building Contractors & Materials	2.5%	3.7%	6.7%	10.4%	4.0%	2.3%	1.5%
Membership/Legal/Social Services	2.1%	2.7%	3.6%	3.8%	3.8%	2.0%	1.5%
Wholesale Trade—Durable Goods	2.2%	2.6%	4.2%	5.4%	3.7%	1.9%	1.4%
Eating & Drinking Places	3.9%	4.3%	6.1%	6.5%	3.4%	1.8%	1.3%
Auto Repair, Services & Parking	3.7%	3.8%	4.9%	6.8%	3.2%	1.6%	1.2%
Amusement & Recreation Services	3.0%	3.6%	3.6%	4.5%	3.2%	1.6%	1.2%
Heavy Construction, Except Building	2.0%	2.9%	5.3%	9.3%	3.1%	1.5%	1.1%
Automotive Dealers & Service Stations	3.0%	2.8%	6.1%	8.3%	3.1%	1.5%	1.1%
Wholesale Trade—Nondurable Goods	2.0%	2.0%	2.6%	3.6%	2.8%	1.5%	1.0%
Agriculture Services	2.4%	3.0%	4.2%	5.8%	2.4%	1.4%	0.9%
Industrial & Materials Manufacturing	2.3%	2.0%	3.3%	6.3%	2.4%	1.1%	0.8%
Agricultural Production—Crops & Livestock	2.0%	1.3%	1.3%	2.4%	2.0%	0.8%	0.4%
All Industries	**2.9%**	**3.6%**	**5.5%**	**7.2%**	**4.2%**	**2.1%**	**1.4%**

Source: PayNet 2013 Research Study

Indicator 3: Asset Quality

Small business credit portfolios continue to improve, as 2012 exhibited the lowest default rates during the sample period. Table 2 shows that, at the peak of the recession, small business borrowers defaulted at a 7.2% rate. During 2005-06, which was the last expansion at the low-risk phase of the business cycle, the annual default rate averaged 2.9%, a more normal rate for this asset class. The higher default rates for 2008-10 illustrate the impact of a severe recession. The average annual default rate equaled 5.6%, as nearly 17% of all small businesses defaulted during this three-year period. From this data we can see the average during normal economic conditions and during severe economic stress. The 2012 actual default rate of 1.4% reflects the bias of companies with high-quality credit that survived the recession. The Fed's bond buying, which has artificially reduced interest rates and injected liquidity into the economy, probably also helped reduce the 2012 default rate.

Varying default rates by SIC code are no doubt due to the different business models, capital needs, and operating activities of these industry segments. The maximum default rate in 2009 ranged from 12.9% for trucking, warehousing, and transportation services to 2.4% for agricultural production – crops and livestock. The 2012 default rate for each of these industries contrasts with the much higher rates in 2009. Asset quality is very high now, so all industry categories look attractive.

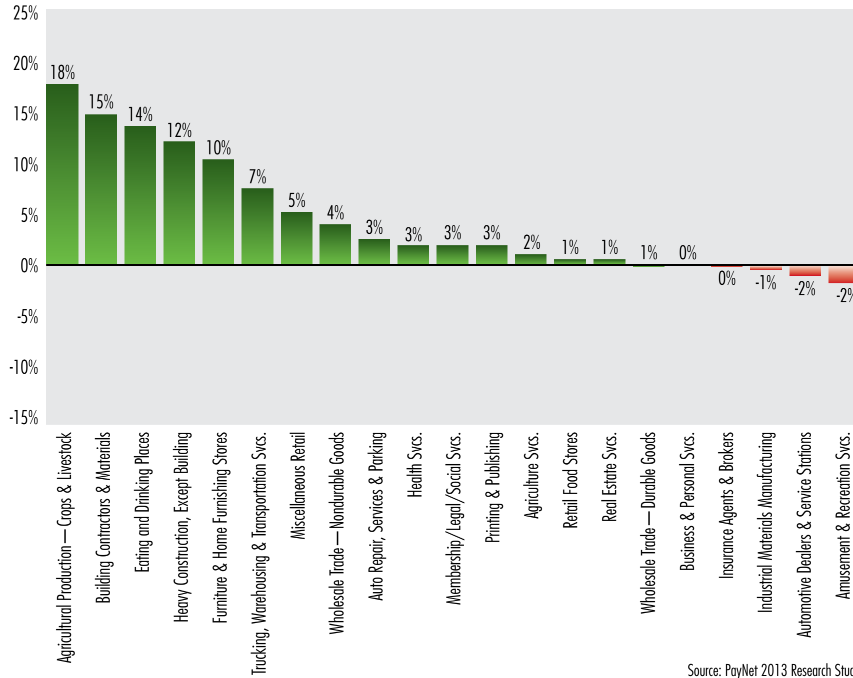
Indicator 4: Industry and Regional Trends

The economy is still healing, growth remains sluggish, and credit portfolios are now exhibiting unusually high quality. All that's needed is to set a strategy for 2014 and implement it.

Industry sectors that can impact growth strategies are shown in Figure 5, which presents the growth in new borrowings for 21 major industry sectors. The chart offers a

Figure 5

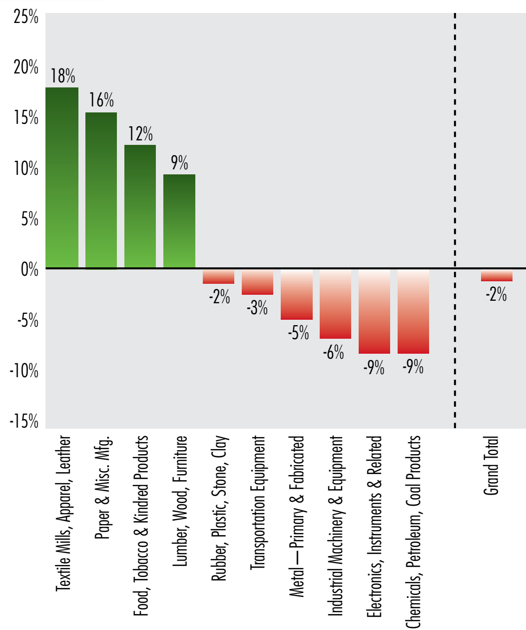
One-Year Change in New Originations for 21 Major Industry Segments, 2013 versus 2012 (12-Month Periods Ending in June)



For the 12-month period ending June 30, 2012, all 21 industry segments expanded their investment. In the more recent 12-month period, 16 of 21 segments expanded.

Figure 6

Manufacturing Industry: One-Year Change in Originations



look into which industry groups are borrowing and investing faster or slower than the national average increase of 7.4%. For the 12-month period ending June 30, 2012, all 21 industry segments expanded their investment. In the more recent 12-month period, 16 did so. The industries with the biggest expansions are agricultural production; building contractors and materials; eating and drinking places; heavy construction; and furniture and home furnishings.

Segments that are contracting include amusement and recreation services; automotive dealers and service stations; and industrial and materials manufacturing.

A deep dive into that last important segment—industrial and materials manufacturing—offers a glimpse into the slowdown. As shown in Figure 6, the segment reduced borrowings and investments by 2% in the 12 months ending June 30, 2013.

The slowdown in manufacturing investment shown in Figure 6 is striking. In the 12 months ending June 30, 2012, all sub-segments were borrowing and investing at higher growth rates. In the most recent 12-month period, only textile mills, apparel, and leather; paper and miscellaneous manufacturing; food products; and lumber, wood, and furniture invested more in property, plant, and equipment.

Credit ratings on small businesses reflect the probability that the borrower will default on a substantial portion of loans. Table 3 displays the forecast of borrower defaults by major industry sector for 2013 and 2014. One striking point

is that AbsolutePD forecasts a rise in borrower defaults this year and next. In each year since 2009, business defaults have been falling, which has enabled banks to capture earnings through release of loan loss reserves. Given the expected Fed tapering, a stronger economy, and the higher interest rates that will accompany those developments, a higher rate of default is likely.

Borrower defaults by region must also play a role in setting risk tolerances. What's interesting about this view is that credit risk is rising in all 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 forecast default rates reveals that credit risk is rising most in the regions of Boston (0.5%), Dallas (0.3%), Kansas City (0.4%), St. Louis (0.3%), and Chicago (0.3%), as shown in Table 4.

Indicator 5: Interest Rate Impact

One risk on everyone's mind is the impact of higher interest rates on private companies and bank C&I portfolios. The prospect of the Fed's tapering of QE bond purchases, which is expected to increase interest rates, has caused fear on Wall Street. (As of this writing, the big news was the Fed's announcement that it would delay the start of tapering indefinitely as it waits for the economy to show more improvement. Wall Street responded with big increases for the indexes.) Unfortunately, we have no public market to gauge tapering's possible effect on private businesses and the banks that lend to them. Therefore, PayNet conducted special studies to understand the impact of tapering and higher interest rates on banks and their clients.

While higher interest rates mean higher costs for business, the data indicates they also mean more investment by small business into capital-forming projects, which is counterintuitive. These capital-forming projects involve long-term investments of more than one year. Figure 7 shows the relationship between interest rates and small-business borrowing and investment.

As the SBLI grew 33% in 2006-07, the yield on five-year U.S. Treasury bonds rose 1.04 percentage points. Over the period 2005-09, the five-year rate fell 1.92 percentage points, or 53%, and the SBLI decreased 33%. U.S. Treasury yields and the SBLI show a clear positive correlation except for the last few years, when rates were essentially zero and unchanged due to the extraordinary efforts of the Fed. With tapering will come more risk taking. A strong economy with demand is better than a weak one with low interest rates. In this sense, tapering would provide a signal to businesses that now is a good time to invest.

Stress-test analysis is a useful planning tool offering a view into the impact of economic scenarios on bank C&I portfolios. Our study used PayNet AbsolutePD to project default rates under various economic scenarios based on the 14 macroeconomic variables prescribed by the Fed's Com-

Table 3

Forecast Default Rates by Industry Segments

Industry Segment	Forecast Default Rates 2013	Forecast Default Rates 2014
Printing & Publishing	3.1%	2.7%
Trucking, Warehousing & Transportation Svcs.	2.9%	2.6%
Furniture & Home Furnishing Stores	2.1%	2.5%
Business & Personal Services	2.0%	2.3%
Retail Food Stores	1.9%	2.4%
Insurance Agents & Brokers	1.1%	1.5%
Miscellaneous Retail	2.0%	2.3%
Real Estate Services	1.6%	2.0%
Health Services	1.6%	1.8%
Building Contractors & Materials	1.8%	2.2%
Membership/Legal/Social Services	1.6%	1.6%
Wholesale Trade—Durable Goods	1.8%	2.0%
Eating & Drinking Places	2.2%	2.7%
Auto Repair, Services & Parking	1.5%	2.0%
Amusement & Recreation Services	1.5%	2.3%
Heavy Construction, Except Building	1.3%	1.7%
Automotive Dealers & Service Stations	1.5%	2.0%
Wholesale Trade—Nondurable Goods	1.3%	1.9%
Agriculture Services	1.2%	1.6%
Industrial & Materials Manufacturing	1.2%	1.7%
Agricultural Production—Crops & Livestock	0.7%	1.0%
All Industries	**1.6%**	**1.8%**

Source: PayNet AbsolutePD

Table 4

Forecast Default Rates by Federal Reserve District

Federal Reserve District	Forecast Default Rates 2013	Forecast Default Rates 2014
Dallas	2.1%	2.4%
Atlanta	2.2%	2.2%
Boston	1.5%	2.0%
Richmond	1.8%	1.9%
Philadelphia	1.7%	1.9%
San Francisco	1.8%	1.9%
New York	1.7%	1.8%
St. Louis	1.4%	1.7%
Cleveland	1.4%	1.6%
Kansas City	1.2%	1.6%
Chicago	1.2%	1.5%
Minneapolis	0.9%	1.1%
All	**1.6%**	**1.8%**

Source: PayNet AbsolutePD

One striking point is that AbsolutePD forecasts a rise in borrower defaults this year and next.

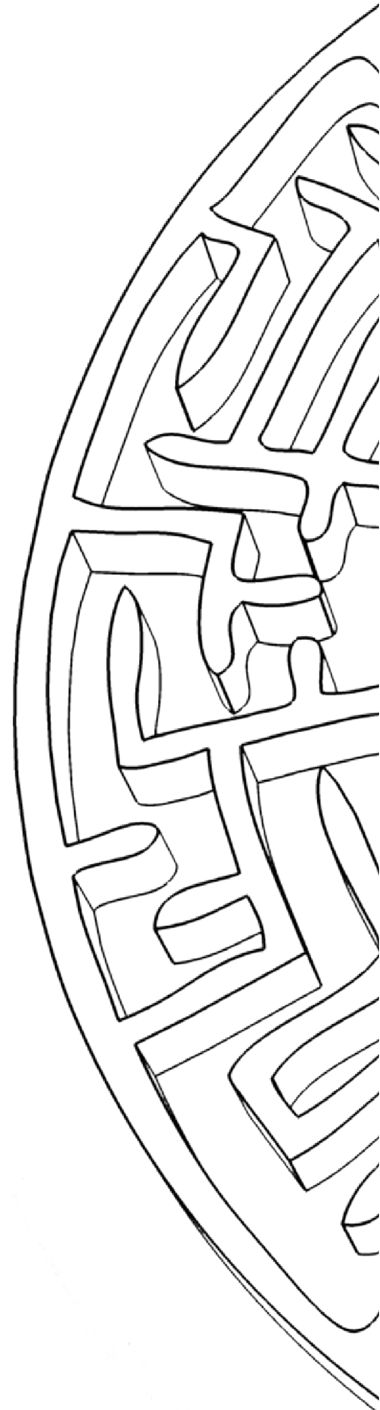
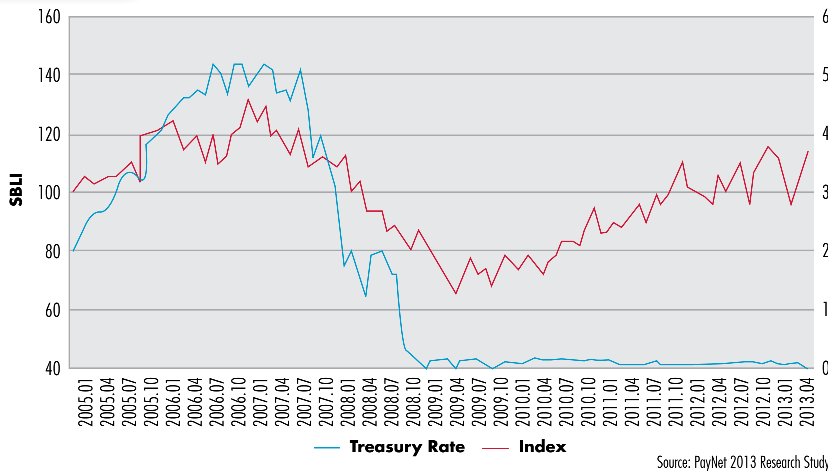


Figure 7 Five-Year U.S. Treasuries versus Thomson Reuters/PayNet SBLI



Source: PayNet 2013 Research Study

prehensive Capital Analysis and Review (CCAR) program. The severely adverse scenario shows GDP falling 6.1%, unemployment rising to 10%, the 10-year Treasury rate rising to 1.2%, and other adverse impacts. Table 5 reveals that the 1-percentage-point rise in default rates is far less severe in the adverse scenario than the rise shown in Table 2, when rates doubled from 3.6% in 2007 to 7.2% in 2009. Certain industries are hit harder than others, particularly cyclical ones like transportation and retail.

The good news is that credit portfolios are in much better shape to handle adverse economic scenarios than they were approaching the Great Recession. Defaults are projected to peak at 4.3% in the severely adverse scenario over the nine-quarter forecast period, versus 7.2% in 2009.

The Plan

More debt means higher risk. And certainly, more debt limits financial flexibility and too much debt can destroy companies. Having access to a substantial database of credit information gives us further insight into this precept.

Research tells us that as long as debt levels are moderate, companies that borrow more actually present a lower risk of default than those borrowing less. Figure 8 bears this out. Higher-growing companies find more attractive expansion opportunities, and their growth more than compensates for the added financial risk of increased debt levels.

Regions where businesses are increasing their borrowing and investing include Minneapolis, Chicago, St. Louis, Cleveland, and New York. Higher investment and borrowing go hand in hand with lower default risk (Figure 8), so tremendous opportunities exist for banks making C&I loans in these markets.

As mentioned earlier, growth is still occurring in all geographic markets except Philadelphia, but lenders need to be vigilant. For example, Atlanta presents growth opportunities in C&I lending, but this region is also experiencing higher default rates and slower growth. So banks should take these factors into account and price their loans accordingly for the added risk.

Credit risk versus growth by industry shows the general improvement in the economy. Five-year rates for growth and defaults have improved since the analysis conducted last year. Many of the same industries remain in the above-average-growth / below-average-defaults sector. Agriculture production, membership/legal/social, and insurance agents and brokers remain attractive investment sectors for C&I lending. In last year's study, wholesale trade and nondurable goods and manufacturing also offered attractive risk and growth opportunities. However, they have now moved into slower growth and higher risk sectors relative to other industry categories.

Health services is another sector that has shifted from last year's study. Health services companies have slowed their borrowings and investment in business expansion, while default rates have remained about the same.

Table 5

AbsolutePD Stress Scenarios

Scenario	Default Rates Forecast by AbsolutePD	
	FY 2014	3Q13-3Q15 (9 Quarters)
Baseline	1.4%	3.2%
Adverse	2.0%	4.2%
Severely Adverse	2.3%	4.3%

Projections as of 7/1/2013

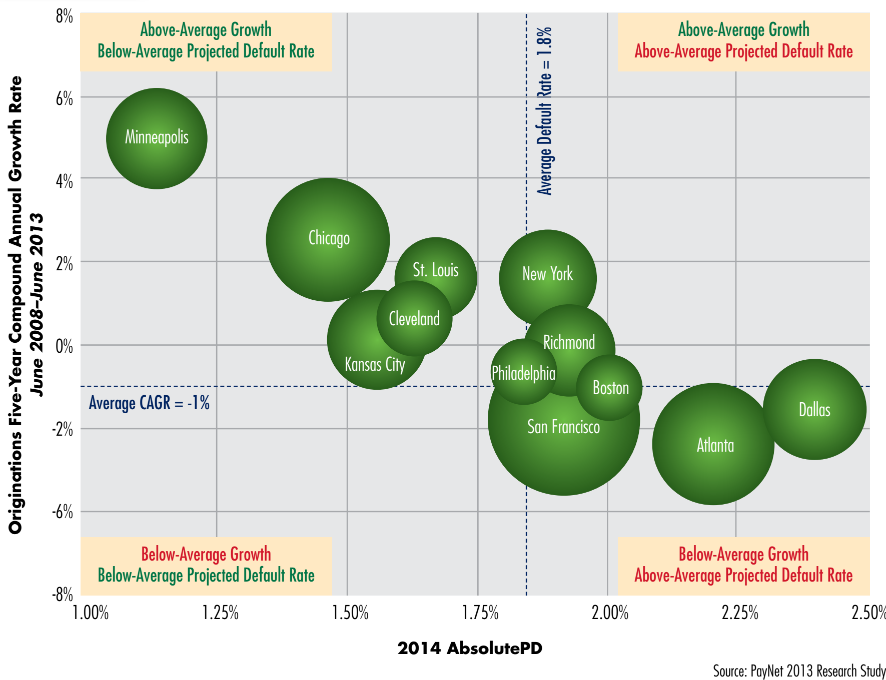
Source: PayNet AbsolutePD Stress Test Simulator

Conclusion

Bankers have recognized the highly competitive market for C&I lending as they compete for earning assets. Increasingly, less structure and easier underwriting terms are resulting as this competition intensifies.

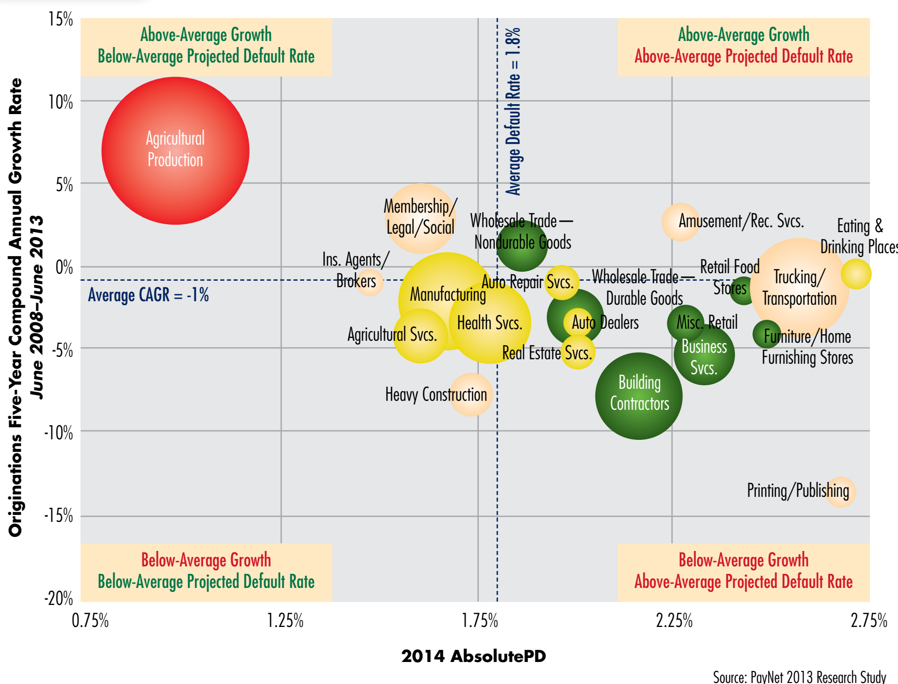
Our data reveals how the economy is changing. Borrowing remains moderate, which indicates judicious investment in expansion of production capacity by privately held businesses. Indeed, some industry sectors such as manufacturing are witnessing a contraction in borrowing and investment and some geographic regions are as well. This result is in stark contrast to last year's data, where all geographic regions and industry sectors showed expansion.

Figure 8 Investment Growth versus Default Risk by Geographic Region



Credit risk is changing, and the peak of the credit cycle has most likely been reached. These changing conditions mean bankers must adapt to the changing business cycle to prepare, as Arnold Palmer might say, for more luck. The trouble spots for banks lie in the potential for weaker underwriting standards and the question of whether they possess the skills to transition from commercial real estate to C&I lending.

Figure 9 Investment Growth versus Default Risk by Industry



The difficult part for banks is that they must continue to invest in their own internal risk systems while the sluggish economy offers only below-average growth. Cutting costs on systems and processes in order to increase stock price remains a danger. Many banks were unable to quickly and accurately aggregate risk exposures during the last recession, and they struggled to make informed business and strategic decisions. Investment in systems to understand exposure should remain a priority. The peak of the asset-quality cycle may go unnoticed, which means bankers may misjudge the ALLL provision. Adverse shocks, particularly those from higher interest rates, create further risk conditions, but the data indicates banks are far better prepared now than they were in 2005-06.

What's needed now is an understanding of the business and banking landscapes. The data show noticeable and subtle changes under way in the economy. Bank growth is not an accident; it depends on preparation and activity. Having knowledge about the current and future direction of market sectors can ease the workload and help bankers grow C&I safely. ❖

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