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Five Steps for Business Loan Planning in 2013

Quantifiable data and analysis provide insight into lending trends, the financial health of small businesses, future projections of risk, and the current stage of the business cycle. This data may surprise you.

BY WILLIAM PHELAN

BUSINESS PLANNING FOR 2013, one of the most difficult jobs in corporate America this year, is now under way in board rooms, conference rooms, and executive offices across the country. The uncertainties facing business managers remain well defined: the fiscal cliff, health care implementation, tax policy, the federal deficit, and elections, to name only some.

As they shape their plans for 2013, businesses are seeking insights into how the economy may play out over the next year. Specifically, they are trying to 1) determine how much to invest in new property, plants, and equipment, including technology; 2) define hiring plans; and 3) decide whether to pursue acquisitions.

Meanwhile, financial institutions will be asked to respond to the loan requests those decisions will generate. But will bankers put their foot on the accelerator and grant more credit, or will they jam on the brakes? The answer will contribute to each bank's performance and ultimately shape the U.S. economy.

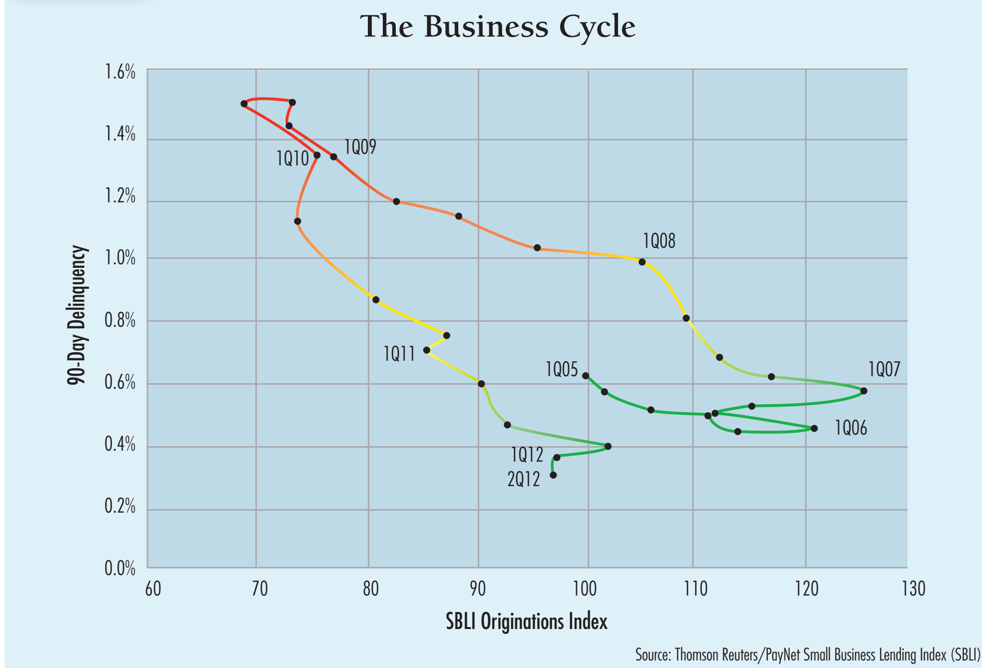
A major decision facing banking executives centers on capital planning. Is now a good time for banks to accumulate more capital, or should they put more capital to work? If bankers decide to keep their foot on the gas, what can they expect the return on capital to be?

The changing composition of the U.S. small-business economy also presents different rewards for lenders. This article presents a five-step road map to help bankers develop business plans for 2013, based on a study of private companies with C&I loan exposures of less than $1 million—the category of small-business borrower. Insights supported by quantifiable data are meant to help banks make smarter decisions about safe growth sectors and prepare their portfolios for the ever-changing business cycle.

A Study of Small Businesses

The media, policy makers, and business community all acknowledge the central role of small businesses in the

Figure 1



U.S. economy. Publicly available information on small businesses, such as annual revenues or number of employees, relies on estimates rather than hard data. In an ideal world, the financial statements of small businesses would be as readily available as those of public corporations. However, in the absence of financial statements, and for the purposes of this study, PayNet defines a small business to be one with $1 million or less in total loans outstanding. Loans outstanding represent one of the best measures of business size, as they are objectively reported by a third party, the lender, as opposed to being self-reported or estimated.

Through state-of-the-art analytics, this real-time data is converted into market intelligence and predictive tools that can be used to lower the cost of credit granting and portfolio management.

A cross section of U.S. small businesses serves as the sample for this study. This sample, extracted from PayNet's proprietary database, reflects the geographic and industry makeup of the small-business economy in the United States. PayNet's database encompasses information on nearly $1 trillion in financial contracts by 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 lower the cost of credit granting and portfolio management.

Summary statistics on 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 long-term investment in expansion of property, plants, or equipment.

Because small businesses react so quickly to economic inflection points, their borrowing and payment behavior is a very good source for leading economic indicators. From this data, PayNet creates a series of analytics and indices that are representative of U.S. small businesses. Historical loan default rates will be reported to put credit risk on small business loans into context as a separate asset class. This data also will provide a risk forecast under various economic scenarios using the innovative PayNet AbsolutePD®, the only probability-of-default model available for small businesses where financial statements are not available. This model now incorporates stress-test capabilities for small business loans at the borrower and portfolio level.

Step 1: The Economy

PayNet is not in the business of making economic forecasts, so we will not attempt to publish one for 2013. However, we can provide insights into where we are in the economic cycle by using a slice of the PayNet database focused exclusively on small businesses.

Many sources exist for creating economic forecasts that can help in planning for 2013. One approach for putting the economic cycle into perspective is to map risk and reward, relying on small businesses as a leading economic indicator.

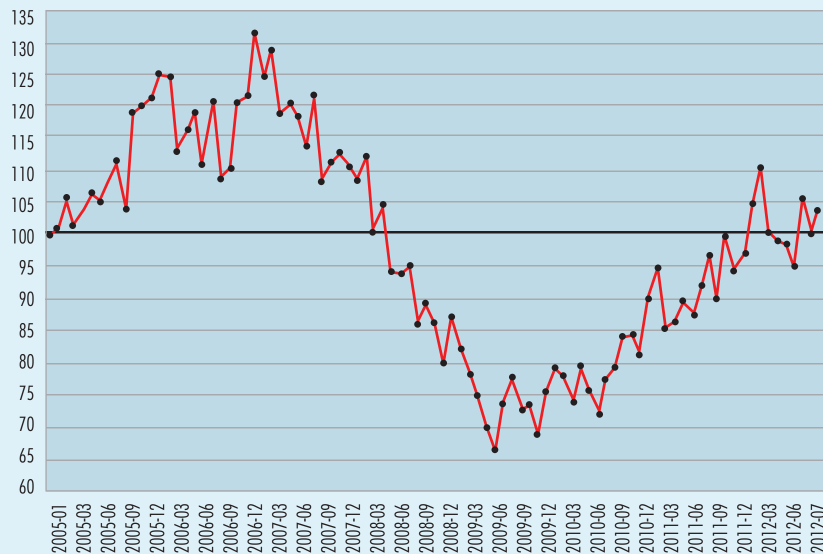
Figure 1 shows new business credit against severe credit risk and presents a perspective on the stage of the business cycle. It highlights that the business cycle has been in a period of improving economic health for most of the past nine quarters. Small businesses were in a recovery phase from the fourth quarter of 2009 through the first quarter of 2011, when borrowings increased and loan delinquencies fell. We define the expansion phase to be the five quarters from the second quarter of 2011 to the second quarter of 2012. During that period, risk fell to historical lows,

as evidenced by severe loan delinquencies of less than 0.40%, and originations increased by an average of 17%.

The chart shows that businesses pulled back from expansion in the first quarter of 2012. This pullback is curiously similar to a period in 2006, when businesses shrank investment even while the overall economy was humming along. In late 2006, however, businesses then took on capital at a rapid clip right before the economy started to retreat in the first quarter of 2007. Given the current low interest rates, now appears to be a good time for businesses to take on capital, just as they did in 2006 right before the inflection point into recession.

Figure 2

Thomson Reuters/PayNet Small Business Lending Index



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

Step 2: Market Analysis

While small businesses as a group seem to be pulling back, pockets of growth can be found in certain industry sectors and geographic regions. The Thomson Reuters/PayNet Small Business Lending Index (SBLI) is a quantified index measuring the amount of new credit taken by U.S. small businesses. The index is represented against baseline activity beginning in January 2005, such that a current index value of 104 means small businesses borrowed 4% more in the current period than in January 2005.

Compared to July 2011, the index is up 15% in July 2012, which is a year-over-year growth rate equal to or higher than in the past five months. As shown in Figure 2, the small business lending index increased 3% in July to 103.8, from 100.5 in June. With this level higher than in five of the past six months, the index is exhibiting a slow but steady growth trend. The pace of increase is slowing, however. In 2011, annual growth was up 17% from 2010, but thus far in 2012 yearly growth has fallen off.

While small businesses are increasing their level of investment, the rates of increase vary across Federal Reserve districts, as indicated in Figure 3. Dallas expanded at the

Figure 3

Small Business Originations by Federal Reserve District 2012 vs. 2011

12-Month Periods ending in April

Source: PayNet 2012 Research Study

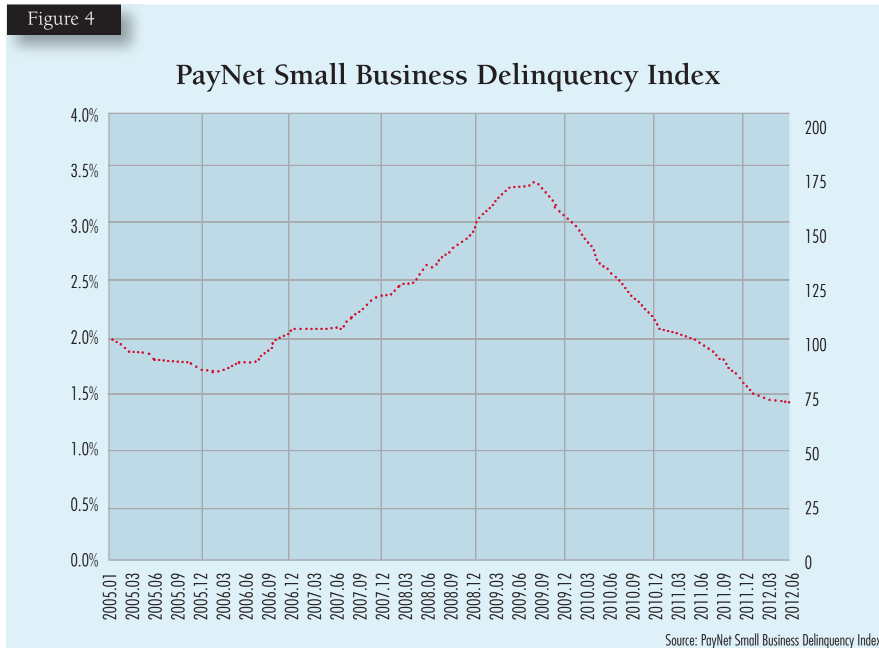


Figure 4

PayNet Small Business Delinquency Index

Source: PayNet Small Business Delinquency Index

fastest rate (26%), while St. Louis registered the slowest (9%). Two of the regions that previously lagged the national average, Richmond and San Francisco, are now approaching that threshold.

A look at loan delinquencies reveals that small businesses are preparing financially for a slow-growth economy. This analysis uses PayNet's Small Business Delinquency Index (SBDI), a new measure of 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.

As shown in Figure 4, the SBDI declined from peak delinquency rates in 2009 to 1.42% in June 2012, which means $1.42 out of every $100 of loans was late. For over 30 consecutive months, small businesses have become more prompt at paying their loans. Meanwhile, severe loan delinquencies are falling too. Loans delinquent more than 90 days declined to 0.28%, a historical low. This number is far less than in 2005, when delinquencies bottomed out at 0.44% in the last part of the expansion cycle. 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.

States with historically high delinquency rates, such as Florida, Nevada, and Arkansas, showed big improvements from their recessionary peaks.

Credit risk is not the same by state, of course, and the data shows that the high-delinquency states are finally catching up with the lower-rated ones. The SBDI fell across almost all states and industries. States with historically high delinquency rates, such as Florida, Nevada, and Arkansas, showed big improvements from their recessionary peaks. Loan delinquencies in Florida fell 330 basis points, from 5.2% to 1.9%, which is a 63% improvement. Even in low-risk states like Minnesota, loan delinquencies fell further to 0.8%. The states with steadily falling loan delinquencies (down 11 of the past 12 months) were New York, Colorado, and Arizona, decreasing an average of 33%. The only states where loan delinquencies rose over the past year were Hawaii, Mississippi, Delaware, and New Hampshire.

Step 3: Credit Portfolio Analysis

Small business credit portfolios remain in great shape, exhibiting the best risk profile since 2005. PayNet's database of loans worth $1 trillion, collected monthly, can be used to create benchmarks by portfolio default rates, industry default rates, geographic defaults, and borrower size. Current default rates at business-cycle lows show that credit losses are manageable, and interest margins should remain healthy for loans on the books now. The data also shows that small business lenders are focused on the safer sectors of the economy, probably because they were burned so badly in the last recession.

Historical default rates reflect the improvement in borrower credit quality. Table 1 shows that, at the peak of the recession, small business borrowers defaulted at a 7.2% rate. This was an increase from 2006, when the default rate stood at only 2.9%. In 2011, business failures fell to cycle lows of 2.0%, and they are projected to remain a low 2.0% through year-end 2012.

Credit portfolios are lengthening in maturity as lenders become more comfortable with credit quality and extend

Table 1

Actual Default Rates of 21 Major Industry Segments

Industry Segment	Historical Default Rates					
	2006	2007	2008	2009	2010	2011
Printing & Publishing	4.1%	3.8%	7.0%	11.5%	8.1%	5.2%
Trucking, Warehousing & Transportation Svcs.	4.3%	6.7%	10.9%	12.7%	7.1%	3.5%
Building Contractors & Materials	2.5%	3.7%	6.6%	10.2%	6.3%	2.8%
Business & Personal Services	3.7%	3.9%	6.1%	8.3%	6.0%	2.7%
Real Estate Services	3.5%	5.2%	8.3%	9.1%	5.6%	2.6%
Miscellaneous Retail	3.6%	3.4%	5.5%	5.7%	4.8%	2.4%
Eating & Drinking Places	3.9%	4.2%	6.1%	6.3%	4.7%	2.4%
Furniture & Home Furnishing Stores	5.2%	4.8%	6.7%	8.5%	4.6%	2.3%
Heavy Construction, Except Building	2.0%	2.9%	5.3%	9.1%	3.9%	2.3%
Retail Food Stores	2.7%	3.3%	4.4%	7.3%	3.8%	2.2%
Auto Repair, Services & Parking	3.7%	3.7%	4.7%	6.6%	3.7%	2.0%
Amusement & Recreation Services	3.0%	3.5%	3.5%	4.4%	3.4%	1.9%
Wholesale Trade - Durable Goods	2.2%	2.6%	4.0%	5.3%	3.3%	1.7%
Agriculture Services	2.4%	2.8%	4.0%	5.4%	3.2%	1.5%
Membership/Legal/Social Services	2.1%	2.6%	3.5%	3.7%	3.1%	1.5%
Health Services	2.5%	2.9%	3.6%	4.5%	3.1%	1.5%
Automotive Dealers & Service Stations	3.0%	2.7%	6.0%	8.0%	2.8%	1.5%
Industrial & Materials Manufacturing	2.3%	1.9%	3.1%	6.1%	2.5%	1.4%
Wholesale Trade - Nondurable Goods	2.0%	1.9%	2.5%	3.5%	2.3%	1.4%
Insurance Agents & Brokers	3.1%	2.6%	3.6%	4.0%	2.1%	1.1%
Agricultural Production - Crops & Livestock	1.9%	1.2%	1.2%	2.3%	2.0%	0.8%
All Industries	**2.9%**	**3.6%**	**5.5%**	**7.2%**	**4.1%**	**2.0%**

Source: PayNet 2012 Research Study

easier terms to borrowers. The average maturity of a small business term loan stands at 55 months, about equal to the average term in 2008 before maturities were shortened and lending standards tightened.

Credit portfolios are comprised of industries reflecting the broader small-business economy. What's interesting about the composition is its changing makeup. In 2000, the distribution of companies by industry group was more heavily weighted to the big three: construction, transportation, and manufacturing. Now, however, the composition is made up more of service-based companies in sectors like health services and membership organizations. A churning dynamic is constantly at work as entrepreneurs and business owners adapt by exiting businesses and by opening new ones that meet the changing demands of U.S. and international consumers.

Another fascinating perspective regarding credit portfolios is the upgrade in risk ratings. A look at a typical bank portfolio reveals the trend toward higher quality in credit portfolios. Risk ratings are improving as upgrades have dominated the downgrades by roughly two to one over the past year.

Step 4: Strategy and Implementation

The economy remains uncertain, growth markets are spotty, and credit portfolios are of high quality. So all that's needed is to set a strategy for 2013 and implement it. Clearly, a 25% growth goal for 2013 is unrealistic for an institution that expects growth to arise solely from organic activity. However, competing banks may be looking for opportunities to sell, so acquisition-based growth is a real possibility.

Industry sectors that impact a growth strategy are shown in Figure 5, which presents the growth in new borrowings for 21 major industry sectors. The chart offers a detailed look into industry groups that are borrowing and investing faster than the national average of 8%. Eating and drinking establishments are expanding at a healthy rate and taking on more credit to fund that expansion. Additionally, we are all hearing about "onshoring," the return to U.S. soil of manufacturing operations that had been sent overseas.

Subsectors within each of the 21 major industry groups can provide a source of asset growth for banks as well. As shown in Figure 5, industrial and materials manufacturing, as a major group, borrowed 24% more in the recent 12 months. However, subsectors such as electronics instruments and petroleum products, shown in Figure 6, offer attractive targets for steady expansion and a chance to build new customer relationships. These sectors also seem to fit well with the macroeconomic trends of high tech and energy production.

A look at a typical bank portfolio reveals the trend toward higher quality in credit portfolios.

Figure 5

One-Year Change in New Originations for 21 Major Industry Segments 2012 vs. 2011

12-Month Periods ending in April

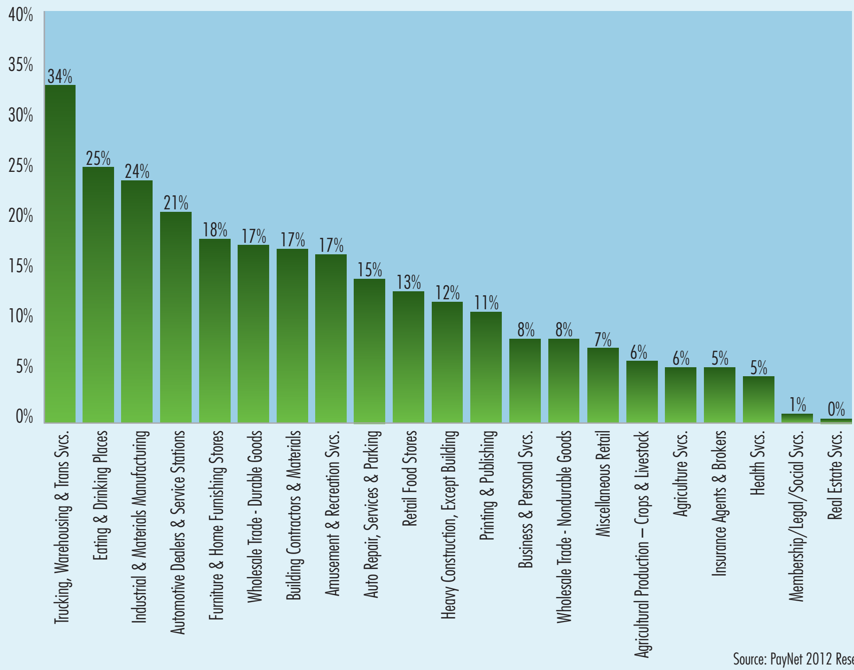


Table 2 looks at borrower defaults by major industry sector. One striking point is that PayNet AbsolutePD forecasts a rise in borrower defaults for the first time since 2009, when business defaults peaked at over 7%. Slowing GDP is having an effect as reduced sales activity will make it more difficult for some small businesses to make ends meet. The projected 10% rise in business defaults is significant and sends a warning signal that the probability of more business defaults is increasing at a time when banks are easing credit terms and lowering pricing to win more business.

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 most geographic regions, but not all. 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 moderating in the Atlanta region and inching upward in Richmond, New York, and St. Louis, as shown in Table 3.

Larger increases in business defaults are forecast for Dallas and San Francisco, where rates are projected to increase 8% and 10%, respectively. What's so surprising is that the largest rises are forecast in the regions that displayed the lowest credit risk through the last cycle: Minneapolis, Chicago, and Kansas City. These low-risk regions have been buoyed through the last cycle by oil and gas exploration, cash grains producers, and diverse local economies.

A slowing economy means less GDP to go around, which will make it more difficult for some small businesses to survive. The challenge is to find the low point in this slowdown in order to prepare for it. PayNet has run a fiscal cliff scenario ("stressed" in Table 4) using the PayNet AbsolutePD® Stress Test Simulator, which shows

Figure 6

Manufacturing Industry: One-Year Change in New Originations 2012 vs. 2011

12-Month Periods ending in April

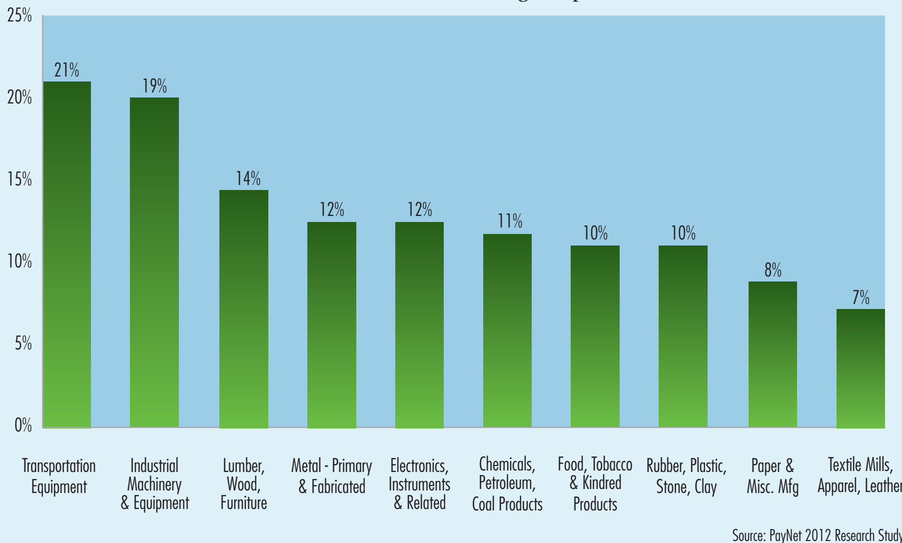


Table 2

Forecast Default Rates by Industry Segments

Industry Segment	Forecast Default Rates	
	2012	2013
Printing & Publishing	3.2%	3.3%
Trucking, Warehousing & Transportation Svcs.	3.0%	3.0%
Building Contractors & Materials	2.5%	2.5%
Business & Personal Services	2.4%	2.7%
Real Estate Services	2.5%	2.3%
Miscellaneous Retail	2.3%	2.6%
Eating & Drinking Places	2.3%	3.2%
Furniture & Home Furnishing Stores	2.4%	2.8%
Heavy Construction, Except Building	1.9%	2.0%
Retail Food Stores	2.1%	2.9%
Auto Repair, Services & Parking	2.0%	2.2%
Amusement & Recreation Services	2.4%	2.9%
Wholesale Trade - Durable Goods	1.9%	2.3%
Agriculture Services	1.7%	1.8%
Membership/Legal/Social Services	1.8%	1.8%
Health Services	1.7%	2.0%
Automotive Dealers & Service Stations	1.8%	2.2%
Industrial & Materials Manufacturing	1.7%	2.0%
Wholesale Trade - Nondurable Goods	1.6%	2.2%
Insurance Agents & Brokers	1.6%	1.7%
Agricultural Production - Crops & Livestock	1.0%	1.2%
All Industries	**2.0%**	**2.2%**

Source: PayNet 2012 Research Study

Table 3

Forecast Default Rates by Federal Reserve District

Federal Reserve District	Forecast Default Rates	
	2012	2013
Dallas	2.6%	2.8%
Atlanta	2.9%	2.7%
Boston	2.1%	2.4%
Richmond	2.3%	2.4%
Philadelphia	2.0%	2.3%
San Francisco	2.1%	2.3%
New York	2.1%	2.2%
St. Louis	2.0%	2.1%
Cleveland	1.7%	2.0%
Kansas City	1.6%	1.9%
Chicago	1.4%	1.7%
Minneapolis	1.1%	1.4%
All	**2.0%**	**2.2%**

Source: PayNet 2012 Research Study

Table 4

AbsolutePD Stress Scenarios

Industry	9 Quarters		
	Stressed	Baseline	Favorable
Agriculture	3.8%	3.1%	2.6%
Construction	5.7%	5.0%	4.4%
General	5.5%	4.7%	4.0%
Health Care	6.0%	5.3%	4.8%
Retail	7.4%	6.6%	5.9%
Transportation	8.1%	6.8%	5.7%
All Industries	5.9%	5.1%	4.4%

Source: PayNet AbsolutePD Stress Test Simulator

business defaults (failures) nearly tripling from where they are now or rising to roughly 6% in the next business cycle. Certain industries are hit harder than others, particularly cyclical ones like transportation and retail.

Banks need to make certain they are ready for a slowdown by using risk ratings that project probabilities of default over the next several years. Typical bank risk ratings are backward-looking, which accentuates the boom-bust U.S. business cycle.

Backward-looking risk ratings typically result from pool-based analyses that require at least 18 months of seasoning before providing conclusive direction on defaults. Risk ratings based on credit scores suffer from the same backward-looking problem. Historical default rates from the credit score development sample are typically years old, and they miss the current macroeconomic conditions, thus compounding the backward-looking problem.

Historical defaults from credit scoring models are commonly mistaken for "probabilities of default" when in fact they are actually the default rates that existed at the time the model development sample was created. This backward-looking problem with risk ratings means banks over-lend in the recession and under-lend during recoveries because risk ratings lag the current economy by at least 18 months.

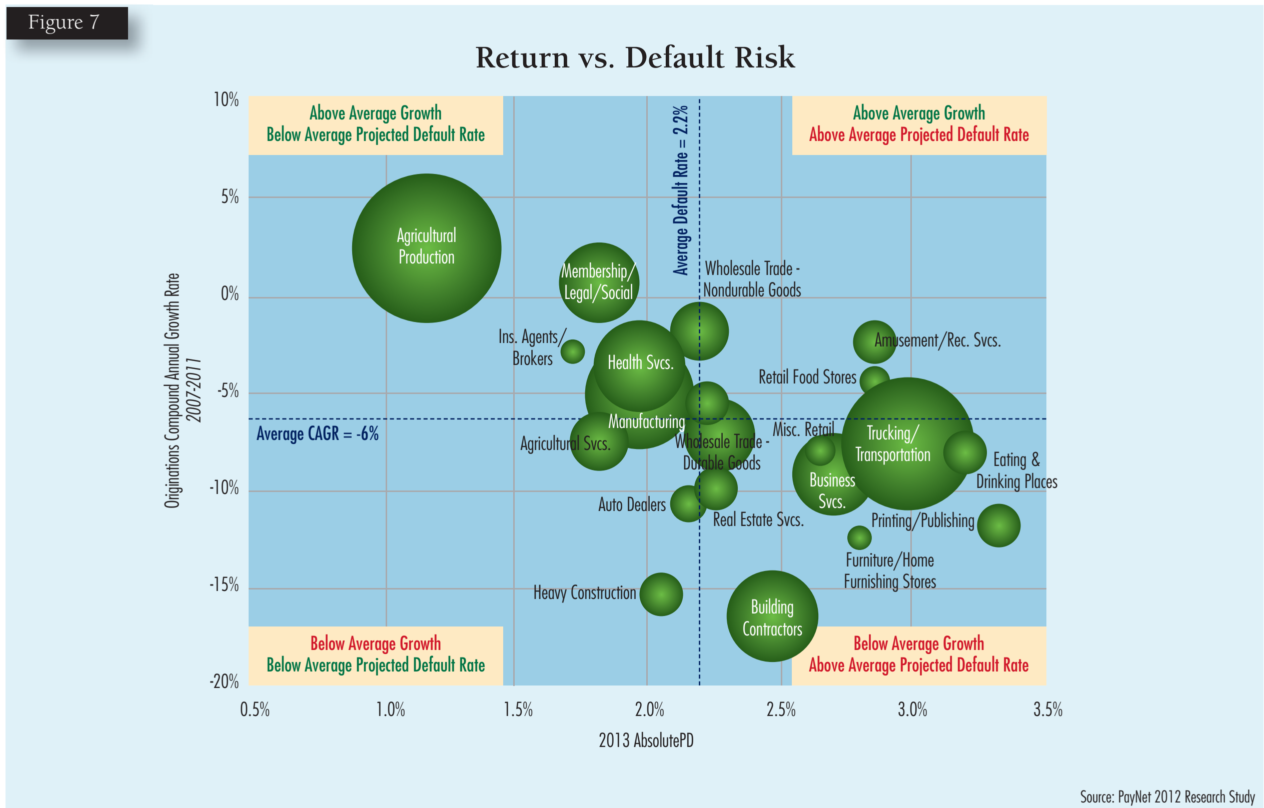
This current cycle is no different as banks may put questionable loans on the books in the hopes of growing, just when defaults are forecast to rise. Given banks' desire to lend and the slowing economy, we see the potential for a classic credit bubble that puts bank capital in jeopardy at a time when more capital must be built through earning assets.

Banks need to make certain they are ready for a slowdown by using risk ratings that project probabilities of default over the next several years.

Step 5: The Plan

A former money manager who met regularly with Wall Street brokers trying to sell him new institutional investments once said, "Having seen a few fads, I had acquired skepticism about new investments. Every time I heard the words 'This time is different' it usually meant it was not.'"

Similarly, this business cycle is not different because, at some point, it will come to an end. The only question is when. Clearly, all the indicators are pointing to a



continued slowdown for the next few quarters, so banks should seek defensive credits, perhaps shorter maturities and safe growth sectors.

Combining safe growth sectors with low volatility credit sectors, based on the data, is best represented by Figure 7. Comparing 21 major industry groups—by five-year growth rates to represent return versus a four-quarter probability of default—provides a basis for identifying safer and higher growth sectors. The size of the bubble is important. It represents the size of credit demand in any particular industry sector relative to the others.

To create a plan for 2013, start with the growth number. To grow a portfolio just 5%, you need to add about 15% of new assets to offset attrition and amortization. Selecting your risk plan requires decisions about industry sectors and geographic regions that can provide growth at credit losses within your bank's tolerance.

The simple template in Table 5 presents an overview of industry sector selection based on risk tolerance. If your risk tolerance on average is less than a 0.7% expected loss on assets, then you need to target a probability of default of less than 2%, assuming your loss in the event of default is 35%. This method enables you to select industries within your footprint that will deliver expected loss based on future probabilities of default, rather than historical defaults.

RMA's Risk Appetite Workbooks are an excellent tool to assist in establishing a business strategy. Setting operational limits based on your company's stated risk appetite helps in formulating the annual plan and budget. Having this level of data helps you define risk tolerances by industry, geographic region, and business demographics.

Conclusion

Annual planning is always full of uncertainties because planners need to make a call on growth, costs, and investments. Planning for 2013 will be particularly tough. The data tells us that small businesses are slowing their borrowing activity, most likely because they are uncertain about next year. Credit risk has run its natural course through this last business cycle and probably cannot improve much further.

With a slowing economy, it appears that downside risk is greater than upside risk for bank credit portfolios. Growth may be spotty, but a slow economy does not mean a recession. Growth sectors can still be found if you know where to find them. Information and analytics have developed to the point where they can be used for making more-informed decisions, including the annual plan for 2013 small business credit. ❖

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RMA University is offering a new online course, "Ethics in Commercial Lending." More information is available on www.rmahq.org.

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Annual planning is always full of uncertainties because planners need to make a call on growth, costs, and investments.

Table 5

Target Growth Industries

Industry	Target Average Balance New Loans	Average Net Interest Margin Spread	Probability of Default as of 12/31/2013	Loss Given Default	Expected Loss	Contribution Profit
Printing & Publishing	$0	$0	3.3%	35%	$0	$0
Trucking, Warehousing & Transportation Svcs.	$0	$0	3.0%	35%	$0	$0
Building Contractors & Materials	$0	$0	2.5%	35%	$0	$0
Business & Personal Services	$0	$0	2.7%	35%	$0	$0
Real Estate Services	$2,150	$75	2.3%	35%	$17	$58
Miscellaneous Retail	$0	$0	2.6%	35%	$0	$0
Eating & Drinking Places	$0	$0	3.2%	35%	$0	$0
Furniture & Home Furnishing Stores	$0	$0	2.8%	35%	$0	$0
Heavy Construction, Except Building	$522	$18	2.0%	35%	$4	$15
Retail Food Stores	$0	$0	2.9%	35%	$0	$0
Auto Repair, Services & Parking	$1,628	$57	2.2%	35%	$13	$44
Amusement & Recreation Services	$0	$0	2.9%	35%	$0	$0
Wholesale Trade - Durable Goods	$2,347	$82	2.3%	35%	$19	$64
Agriculture Services	$2,011	$70	1.8%	35%	$13	$57
Membership/Legal/Social Services	$6,241	$218	1.8%	35%	$40	$179
Health Services	$7,599	$266	2.0%	35%	$52	$214
Automotive Dealers & Service Stations	$0	$0	2.2%	35%	$0	$0
Industrial & Materials Manufacturing	$1,627	$57	2.0%	35%	$11	$46
Wholesale Trade - Nondurable Goods	$1,370	$48	2.2%	35%	$11	$37
Insurance Agents & Brokers	$830	$29	1.7%	35%	$5	$24
Agricultural Production - Crops & Livestock	$2,293	$80	1.2%	35%	$9	$71
Total	**$28,618**	**$1,002**	**1.9%**		**$193**	**$809**

Source: PayNet 2012 Research Study