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MEASURING AND MITIGATING CONDUCT RISK

A clear regulatory imperative obliges banks to be 100% vigilant in policing conduct p. 52

THE IMPORTANCE OF VENDOR DUE DILIGENCE

Ways to protect your clients and your institution p. 48

It's Gonna Take Time

Despite the surge in stocks, small business borrowers are taking a patient approach to growth

BY WILLIAM PHELAN

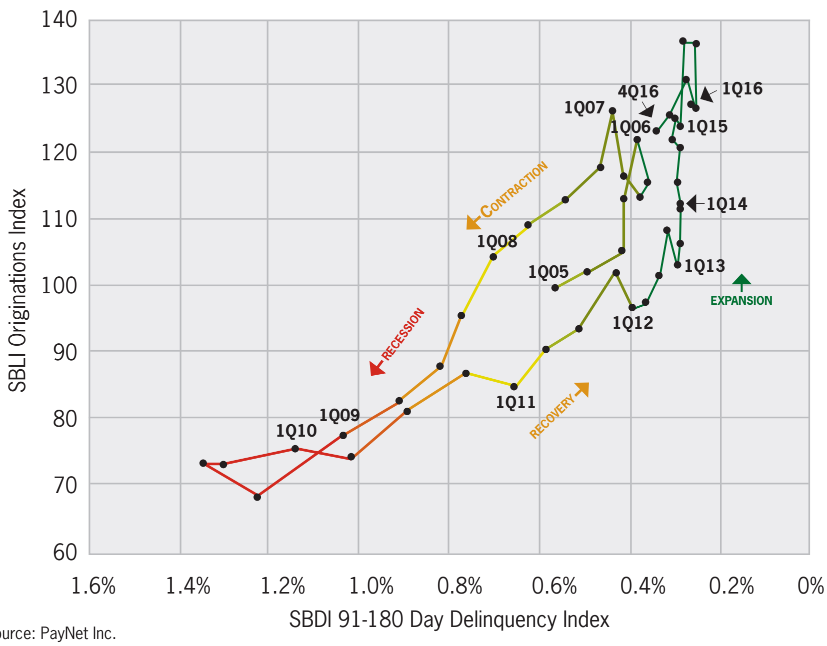
WE'VE ALL HEARD the advice to be patient—that good things take time. The Chicago Cubs had to lose over 100 games a few years ago, the thinking goes, to build the team that notched its historic World Series victory last year. Likewise, any athlete who has suffered an injury knows that getting better is a matter of time.

Much of the same philosophy applies now to business conditions across a wide swath of the economy.

The jump in stocks since last November's election—10% as of mid-March—reflects optimism about reduced regulations, new government spending (think infrastructure and defense), and lower corporate tax rates. Some take the view that the surge in share prices has gotten a little ahead of itself. Even so, the rally amounts to a clear vote of confidence by investors that these policies will propel the roughly 3,700 publicly listed companies to more profitable days ahead.

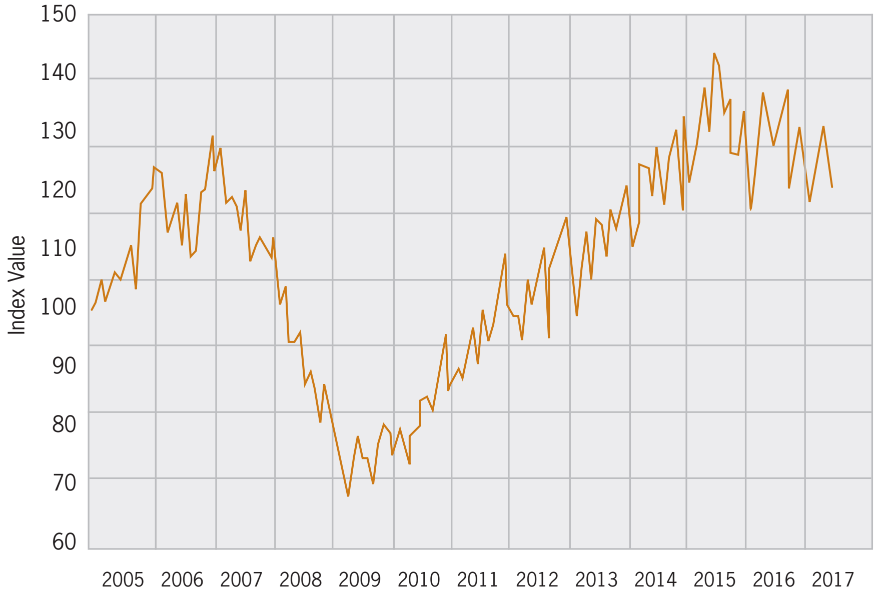
PayNet's research shows that this optimism is shared by the country's significantly larger number of private businesses (6 million) and micro-businesses (22 million). However, unlike the public businesses, these companies remain cautious and are holding back on new investment in plant

FIGURE 1: PAYNET SMALL BUSINESS CYCLE



Source: PayNet Inc.

FIGURE 2: THOMSON REUTERS/PAYNET SMALL BUSINESS LENDING INDEX (JANUARY 2005 - JANUARY 2017)



Source: PayNet Inc.

and machinery. When we talk to private business owners, their initial reaction to the current environment is positive. But many quickly add a caveat: "It's just too soon to hire because my employees are like family and I don't want to have to lay them off if business goes south again."

In other words, patience has become the watchword among owners of small and mid-sized businesses.

Upbeat as they may be about the potential for better business conditions, they are waiting to see whether and when the building blocks for those conditions will be put in place. We call these businesses positive doubters, or "posi-doubters." If solid measures can be enacted to lower taxes, cut red tape, and build infrastructure, these posi-doubters could quickly put their money to work to meet the inevitable jump in demand for their products and services.

Like the Cubs and the injured athlete, they are confident that their patience will be rewarded—when the new administration's policies become clear.

The Business Cycle

Early signs point to 2017 being a more prosperous year than 2016 for small and mid-sized businesses. During three of last year's four quarters, we saw a downward shift in the business cycle. Severe loan delinquencies rose and investment fell. But investment rebounded in January, and 2017 appears to offer continued expansion at low risk. However, we do not expect the business cycle to rocket ahead at anywhere near the same pace as the stock market.

Recent Investment Activity

The Thomson Reuters/PayNet Small Business Lending Index (SBLI) turned positive in January, showing borrowing and investment up 4% from a year earlier.

This means that 2017 has started on an optimistic note, in stark contrast to the hunkering down that marked most of 2016. Borrowing and investment are again growing compared to the same time last year. The index stood at 123.3 in January, up from 118.1 in January 2016.

Credit Risk

The Thomson Reuters/PayNet Small Business Delinquency Index (SBDI) rose slightly in 2016, continuing to move off all-time lows in 2013 that marked a flight to quality and the cleanup of loan books in the wake of the Great Recession. The 31-to-90-days-past-due rate stood at 1.32% in January, up 11 basis points from January 2016.

Despite the rise in loans past due, the overall credit risk for small businesses remains quite low. Even though rising delinquency rates point to an uptick in credit risk in 2017, the numbers still indicate generally strong credit quality among commercial and industrial borrowers.

Industry Analysis

The sectors currently driving commercial and industrial loan expansion are not the usual ones. The arts, entertainment, and recreation sector jumped 14.3% from January 2016 to January 2017, and public administration rose 9.8%. The other two sectors driving growth are administrative and support and waste management and remediation services (up 8.1%) and construction (6.6%). These sectors remain in expansion mode and show the most momentum of all industry sectors on a national basis.

The overall rate of commercial and industrial borrowing is curtailed by contraction in some key sectors. Loans for mining, quarrying, and oil and gas extraction were down 11.6% in January 2017 compared to the prior year. Agriculture fell 9.5%, and health care and social assistance declined 8.2% on a national basis. A 6.9% drop in accommodation and food services reflects weak consumer spending.

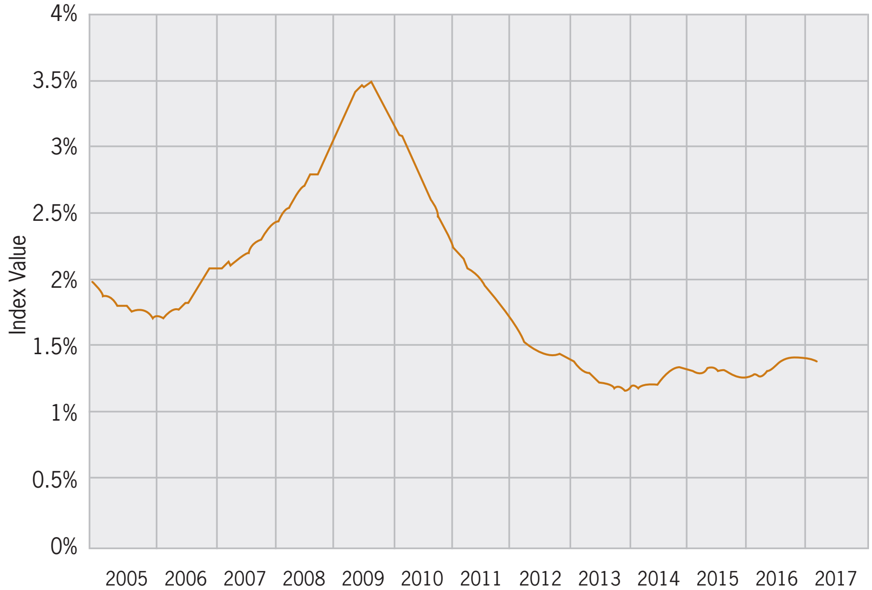
Transportation and warehousing remains the most worrisome sector. Loans were down 14%, a sharp reversal from two years ago when this sector led commercial and industrial loan growth.

A rise in a sector's loan delinquencies signals higher overall credit risk for that sector. The good news is that some of the most volatile sectors have recently reported improvements. The transportation delinquency rate fell 4 basis points to 1.72% in January, its second straight monthly decline—although it remained 52 basis points higher than a year earlier. Prior to November 2016, the delinquency rate for this sector had not fallen for 21 months. Among retailers, the delinquency rate climbed 3 basis points in January to its highest level since March 2013.

Regional Analysis

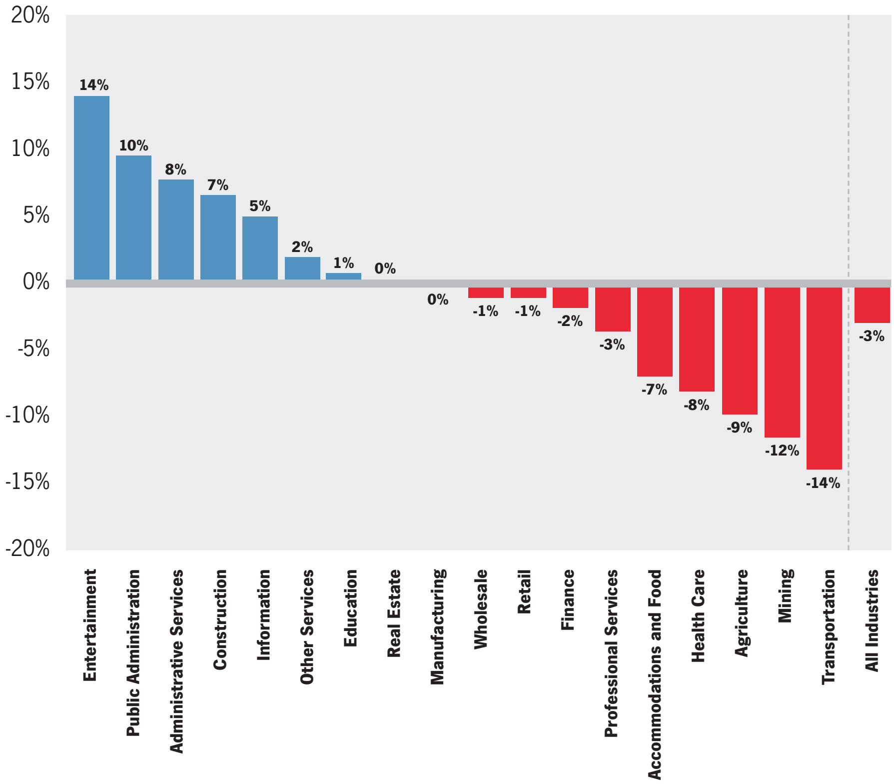
Private-company borrowing and investment advanced in only four of the 10

FIGURE 3: THOMSON REUTERS/PAYNET SMALL BUSINESS DELINQUENCY INDEX (JANUARY 2005 - JANUARY 2017)



Source: PayNet Inc.

FIGURE 4: ONE-YEAR CHANGE IN NEW ORIGINATIONS BY MAJORITY INDUSTRY, 2017 versus 2016 (12-Month Period Ending in January)



Source: PayNet Inc.

TABLE 1: PAYNET SMALL BUSINESS LENDING INDEX, VARIOUS STATES

	YoY % Change	Rolling 3-month YoY % Change
North Carolina	4.0%	3.8%
Florida	2.3%	3.8%
New York	1.5%	1.8%
Georgia	0.3%	0.6%
Michigan	-1.7%	-1.9%
Pennsylvania	-2.4%	-2.6%
United States	-3.0%	-3.3%
Ohio	-3.8%	-5.8%
Illinois	-5.3%	-7.3%
California	-7.3%	-7.2%
Texas	-7.6%	-8.0%

Source: PayNet Inc.

TABLE 2: HISTORICAL AND ABSOLUTE PD® FORECAST DEFAULT RATES, BY INDUSTRY

Industry Segment	Actual Historical Default Rates											Forecast Default Rates	
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Mining	1.3%	2.8%	3.6%	7.5%	5.1%	2.0%	2.1%	1.1%	1.3%	2.3%	4.6%	2.1%	1.9%
Transportation	4.3%	6.5%	10.3%	12.8%	7.8%	4.2%	2.7%	2.7%	2.4%	2.6%	4.1%	4.5%	3.7%
Information	3.9%	4.8%	5.4%	7.7%	3.9%	3.5%	3.0%	2.9%	2.6%	2.5%	2.1%	3.1%	2.8%
Construction	3.0%	4.4%	7.0%	10.4%	7.5%	3.8%	2.2%	1.6%	1.7%	1.8%	2.1%	2.4%	2.1%
Agriculture	2.1%	1.9%	1.9%	2.8%	2.3%	1.4%	0.9%	0.8%	0.9%	1.4%	2.1%	1.7%	1.6%
Professional Services	2.7%	3.6%	4.3%	5.3%	3.5%	2.4%	2.0%	1.7%	1.6%	1.7%	2.0%	1.9%	1.8%
Accommodation & Food	4.0%	5.2%	6.7%	7.4%	5.4%	3.1%	1.7%	2.1%	1.6%	1.6%	1.9%	2.7%	2.9%
Administrative Services	2.7%	3.3%	4.6%	6.5%	4.6%	2.8%	2.2%	1.8%	1.9%	1.6%	1.8%	2.4%	2.1%
Health Care	2.8%	3.2%	3.8%	4.3%	3.5%	2.2%	2.1%	1.9%	1.8%	1.7%	1.8%	2.3%	2.2%
Manufacturing	2.2%	2.5%	3.5%	6.0%	4.1%	2.3%	1.7%	1.3%	1.5%	1.5%	1.8%	2.0%	1.9%
Retail	2.6%	3.3%	4.6%	6.4%	4.4%	2.5%	2.0%	1.7%	1.7%	1.8%	1.8%	2.1%	2.2%
Other Services	2.5%	2.9%	3.9%	4.7%	3.0%	2.1%	1.6%	1.3%	1.2%	1.2%	1.5%	1.9%	1.8%
Real Estate	2.3%	3.6%	5.2%	6.9%	4.3%	2.3%	1.5%	1.4%	1.4%	1.0%	1.4%	1.9%	1.8%
Finance	3.4%	6.9%	6.8%	5.7%	3.4%	1.9%	2.0%	1.3%	1.2%	1.2%	1.4%	1.8%	1.6%
Wholesale	2.1%	2.1%	3.1%	4.2%	3.0%	1.8%	1.2%	1.1%	1.3%	1.3%	1.3%	1.7%	1.7%
Entertainment	3.2%	3.9%	4.4%	4.3%	2.6%	2.3%	1.6%	1.2%	1.0%	0.9%	1.1%	1.5%	1.6%
Public Administration	2.3%	2.9%	2.4%	2.7%	1.4%	1.6%	2.2%	1.0%	0.5%	0.6%	0.9%	1.9%	2.0%
Education	2.6%	2.7%	2.9%	3.1%	2.1%	1.5%	1.4%	0.9%	1.1%	0.8%	0.9%	1.8%	1.7%
ALL INDUSTRIES	**2.7%**	**3.7%**	**4.9%**	**6.3%**	**4.3%**	**2.5%**	**1.9%**	**1.6%**	**1.5%**	**1.5%**	**1.8%**	**2.1%**	**2.0%**

Sources: PayNet Small Business Default Index; PayNet Absolute PD® — $1.0mm or Less in Total Lease/Loan Exposure

largest states in January 2017 compared to a year earlier—and then only by single digits. The four were North Carolina (up 4%), Florida (2.3%), New York (1.5%), and Georgia (0.3%). The advance in North Carolina has been driven by big jumps in mining and quarrying and by real estate services. In Florida, arts, entertainment, and recreation is on a big growth spurt.

The chief laggards in January were Texas (down 7.6%), California (7.3%), and Illinois (5.3%). Even among states where borrowing and investment are up, the momentum appears tepid. Florida was the only state exhibiting material trend-line growth. Borrowing and investment in some states, like Ohio and Illinois, show decelerating rates of growth. Despite a 3.3% decrease year-over-year, the trendline has improved on a quarter-over-quarter basis (-0.8%) and month-over-month (-0.1%) basis.

Credit Risk Forecast

The economy is on a growth trajectory based on the recent strong advance in the stock market, which is usually a reliable leading indicator. The Federal Reserve now seems firmly committed to a path of raising interest rates, having done so most recently in March. Even so, taxes, regulations, trade policy, health care, and government spending—among other issues—remain big question marks for small and mid-sized businesses. This lack of certainty, despite optimism that forthcoming changes will be positive, continues to hold back private borrowing and investment.

It's becoming clear that we will need to wait until later this year, and perhaps well into 2018, for details of these policies to unfold before we can assess their full impact on private companies. We do know that current conditions point to rising defaults during 2017 because of the following:

- An acceleration in loan delinquencies.
- Rising credit risk in several key industry sectors.
- An accelerating economy and rising interest rates, which tend to result in businesses taking more risks.

We expect the default rate for private companies to climb to 2.1% in 2017 from 1.8% last year. While this is not the direction we would prefer to see, the uptick will likely be moderate, marking a return to traditional metrics for commercial and industrial loans after the all-time lows of recent years. Even the expected 2.1% default rate at the end of 2017 remains well below the 2.5% typically considered normal for commercial and industrial loans to small and mid-sized businesses. R

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