Character Can’t Tell the Story: Mitigating Risk in a Changed Lending Environment

Michael Stefanick, SVP Commercial Analytical Services, Equifax
Bonnie Bowling, Chief Operating Officer, Access to Capital for Entrepreneurs
Moderated by Terry Burks, Commercial Product Specialist, Equifax

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Agenda

The changing small business landscape
• Key market trends
• Small business growth and contraction
• Small business loan demand and lending
• Health of small firms

Critical factors for identifying and mitigating risk
• Common goals and key components of underwriting
• The ACE approach to underwriting — and results
• The ACE approach to portfolio management
• Tools you can use
The changing small business landscape and important trends

Small Business Landscape

Aging/boomer demographics will play a positive influence on small business formation levels due to both financial and cultural drivers.

Small business formation lags in the recovery, while heightened small business shuttering has subsided.

Self employment as a percentage of total employment, BLS

Small business networks and alternative loan providers are becoming more important for decision making and will become more accessible.

C&I loans under $1 million, balances year over year (FDIC)

Small business credit growth lags in the recovery but the trend is slowing.

Small business networks and alternative loan providers are becoming more important for decision making and will become more accessible.
Number of Small Businesses

Sole proprietorship share increased from 76.9% (2004) to 79.5% (2010).

- Jobless recoveries
- Cloud services and other technology enabling small business
- Employer shifts to sole proprietorships versus organic growth

Employer firms declined 314,000 or 5.3 percent from 2008 to 2010 vs. 2007.
Sole proprietorships declined 357,000 or 1.6% from 2007 to 2008. Post-recession increases are half pre-recession levels (~ 380,000/year).
The decline in small businesses has been from both SMB shuttering, lower formation rates.

Small business formation lags.
Small business shuttering normalizes.

<table>
<thead>
<tr>
<th>Qtrly Averages (1000's)</th>
<th>Births</th>
<th>Deaths</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-Recession, 2006</td>
<td>216.0</td>
<td>164.3</td>
</tr>
<tr>
<td>Pre-Recession, 2007</td>
<td>211.0</td>
<td>201.0</td>
</tr>
<tr>
<td>Post-Recession, 2011</td>
<td>185.25</td>
<td>188.0</td>
</tr>
<tr>
<td>Post-Recession, 2012</td>
<td>182.5</td>
<td>185.0</td>
</tr>
</tbody>
</table>

% Difference

Source: US Census Bureau (numbers in millions)
Source: US Bureau of Labor Statistics (numbers in thousands)
Household Wealth

Wealth composition trends

The make-up of household net worth has changed significantly since 2007:

- Business equity was 14.1% of net worth in 2007 and home equity was 15.0%.
- In 2012 they made up 12.2% and 12.4% respectively.
- Holdings of equities and mutual funds and pensions* now dominate net worth.

Other wealth
- Business equity
- Pensions*
- Home equity

Holdings of equities and mutual funds and pensions* now dominate net worth.

Source: Federal Reserve Board of Governors, Equifax
*Pensions include 401Ks, IRAs

Small Business Loan Demand

Loan demand (inquiries) by geography: 9 census divisions.

- Loan demand highlights product repositioning to term loans from card.
- Card demand continues to decline but at a decelerating rate across the U.S.
- LOC / loan demand highlights varying rates of geographic growth.

Equifax inquiries through March 2013, indexed January 2008 = 100. 3-month average. Vertical axes not aligned.
Small Business Loan Demand

Top 3 industries comprise 54% of Q1 2013 loan demand:
- Services
- Retail
- Construction

Loan demand remains below Q1 2008:
- Card demand driver
- LOC/loan demand higher c/e Q1 2008
c/e YOY since 2010

Excludes B2B trade/service credit

Small Businesses Lending

Small business lending lags real estate (RE) and C&I balances.

- Small business lending (origination loan amounts less than $1 million) is lagging contrary to other credit sectors, 4 years into the U.S. recovery.
- Recent trends highlight that small business loan contraction is slowing and may be moving to an inflection point.

<table>
<thead>
<tr>
<th>Sectors</th>
<th>6/2008</th>
<th>3/2013</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Business RE</td>
<td>375.0</td>
<td>298.9</td>
<td>23.3%</td>
</tr>
<tr>
<td>Small Business C&amp;I</td>
<td>136.4</td>
<td>285.4</td>
<td>15.2%</td>
</tr>
<tr>
<td>Small Business</td>
<td>711.4</td>
<td>584.3</td>
<td>17.9%</td>
</tr>
<tr>
<td>Large Business</td>
<td>1,797.8</td>
<td>2,012.3</td>
<td>11.4%</td>
</tr>
<tr>
<td>Total Business</td>
<td>2,509.2</td>
<td>2,665.4</td>
<td>6.8%</td>
</tr>
</tbody>
</table>
Small Businesses Lending

Small business lending pivots C&I balances.

- Excluding commercial real estate, recent trends highlight that balance contraction reversed in 2012 for loan amounts greater than $100,000 and 2013 for microloans or loan amounts less than $100,000.
- The recent trends are a pivot point for small business loans three-years plus into the recovery.

<table>
<thead>
<tr>
<th>$ billions</th>
<th>6/2008</th>
<th>3/2013</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $100K</td>
<td>141.7</td>
<td>122.9</td>
<td>(13.3%)</td>
</tr>
<tr>
<td>$100K–$250K</td>
<td>57.3</td>
<td>46.8</td>
<td>(18.3%)</td>
</tr>
<tr>
<td>$250K–$1M</td>
<td>137.4</td>
<td>115.7</td>
<td>(15.8%)</td>
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Small Business Health

- Industry risk scores off lows.
- Industry lower risk today than 2007 with caveats:
  - Manufacturing
  - Mining
- Portfolio quality improves.
- De-leveraging ending:
  - Improved financial health
  - Credit capacity
Critical factors for identifying and mitigating risk

Common Goals for Underwriting

goal (göl) n.
Recognition of acceptable risk versus undue risk as well as mitigating factors to compensate for the risk.

- Effective underwriting is a key predecessor to favorable portfolio quality.
- Proper underwriting allows for growth at a pace to meet demand.
- Subtle and/or gradual modifications to underwriting policies will reflect in the CDFI’s risk profile:
  - Document changes.
  - Consider the necessity to increase pricing in order to sufficiently compensate for the increased risk in easing credit standards.
Essential Components of Underwriting

- Efficiency
- Consistency
- Fact-based decisions
- Well-defined credit principles
- Minimum requirements
- Controls over judgmental underwriting practices

The ACE Approach for Underwriting

- Small business loans $50,000 and below.
- Commercial loans above $50,000.
- Loan products.
- Technical assistance program:
  - Provides ongoing counseling and assistance to clients as needs arise such as I.T. support, marketing, general accounting, etc. to clients through outside resources and internal personnel.
  - Assists with obtaining documentation required on annual basis.
  - Conducts site visits to verify that business is still operating.
  - Validates condition of collateral.
- YOY loan growth more than doubled.
The ACE Approach – Underwriting Process

- **“First pass” analysis:**
  - Based on application submitted online.

- Credit scoring automation via Equifax QTC Advantage:
  - Verification and credit review (business and consumer/guarantor).
  - Decision framework.
  - Credit report statistics.

- Spreadsheet analysis:
  - Personal financial statement analysis, cash flow analysis, business financial analysis.

- Judgmental analysis:
  - Bank statements, business plan evaluation, collateral review.

- Business Advisory Committee / Board Loan Committee.

The ACE Approach – Credit Scoring Automation

- Verification and credit review:
  - Business and guarantor.

- Decision framework:
  - BEACON score.
  - Credit quality rating (tier 1–7).
  - Underwriting grid (based on credit score, initial loan amount and term recommendations).
  - Credit limit approval.
  - Loan duration / terms.
  - Decision reasons.

- Credit report statistics:
  - Counts (i.e. number of collections in past 6 months).
  - Summaries (i.e. total high credit of all trades).
  - Calculations (years of credit).
  - Application fraud prevention procedures.
The ACE Approach – Spreadsheet Analysis

- Personal financial statement analysis:
  - A comparison of the current year to prior year of assets, liabilities, and net worth.
  - Current credit report summary and debt burden in relation to liquidity and personal income.
  - YOY analysis of assets, liabilities, net worth.
  - Calculation of adjusted net worth.

- Cash flow analysis:
  - Sufficient global cash flow to meet business obligations.
  - Minimum 1.25/1 debt service coverage.

- Business financial statement analysis:
  - Review current year plus previous 2 years.
  - Ratio analysis.
  - Discuss trends and changes in balance sheet and income statement.

The ACE Approach – Judgmental Analysis

- Bank statement review:
  - Trends for deposits vs. withdrawals, overdraft issues.

- Business plan evaluation:
  - Borrow request.
  - Management skills / experience.
  - Succession planning.
  - Nature of business.
  - Quality of projections.

- Collateral review:
  - Method valuation.
  - Monitoring methods.
  - Margin LTV.
  - Liquidity LTV
The ACE Approach for Portfolio Management

- 100% portfolio review annually.
- Individual loan review for relationships $50,000+ within six months of origination and then annually.
- Segmented loan review for relationships less than $50,000:
  - Industry type: retail versus service.
  - Loan officer.
  - Start-up business versus existing business.
  - Other criteria such as comparison of YOY loan-to-values (LTV), current versus original credit score, etc.

The ACE Approach - Loan Review Process
The ACE Approach - Tools You Can Use

Loan policy and procedures  Underwriting grid  Required document list

Commercial loan application checklist  Risk rating grid  Equifax QTC Advantage™ platform

We're happy to share our tools and provide you with more detail on our process.

Questions?

We're happy to provide you with more information and answer any questions you might have.