Speakers in session discussing business cycles and considerations for the next recession. From left to right: Ken Katz, Wells Fargo; Ben Carlile, Small Business Lending Expertise; Michael Mount, US Bank Equipment Finance; Dennis Mullin, Wells Fargo and Steve Hanneman, US Bank Equipment Finance.

Ready for the Next Downturn …

Diligent Credit and Risk Managers Worry

BY SUSAN CAROL

***Monitor* contributor, Susan Carol,** reports on the ELFA's Credit and Collection Conference where credit and risk managers remain confident when it comes to compliance and fundamental practices as they prepare for the next inevitable downturn.

Credit and risk managers of bank-owned equipment finance firms seem to agree that their companies have grown more efficient while striving during the past few years to meet stringent regulatory compliance requirements. They have worked hard since 2008 to establish, maintain and formalize standards, policies and procedures.

With the industry at a peak in the continuum of cyclical ups and downs, these executives who are more likely than others to be looking at the glass half empty worry about when to expect the next downturn. They are focused on how to structure transactions that won't be problematic later, while seeking to help their companies grow competitively.

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>
> — Eric McGriff, *EverBank Commercial Finance*

"The last downturn forced us to really establish who we are and to clearly define where we play," said Eric McGriff, chief credit officer at EverBank Commercial Finance, in a recent *Monitor* interview following the Equipment Leasing and Finance Association's (ELFA) annual Credit and Collections Conference in June. Now, with market competition fierce, he and other credit professionals are feeling pressure to expand the credit box." McGriff noted that credit managers are particularly feeling pressure to increase "application-only" limits — the amount that a lender will lend without the benefit of full financial disclosure.

"What we learned from the downturn is that no matter what business area or segment we enter, and no matter the current level of credit performance, we must ask ourselves, how will the segment perform through an entire economic cycle? We are getting considerable data on past performance routinely and this is critically important to us," said McGriff.

He cites the positive impacts that the regulatory oversight has had on the business. His company

The interactive panel included speakers Frank Peretore, Esq., of Peretore & Peretore (pictured), along with Eric McGriff (EverBank Commercial Finance) and Dana Pace (PNC Equipment Finance).

There is no expectation that the next recession will be like the last one, but the industry is talking about extending credit on longer lease terms which can create a problem. While a solid A- rating may not cause stress, a marginal B rating could sap more resources and have an impact on a company's portfolio within the next five years when another downturn is likely.

became part of a bank in 2010 and the additional refinement of their policies, procedures and risk management framework has made them stronger, McGriff said.

Andy Mesches, a consultant with The Alta Group, said many companies have created formal Risk Appetite Statements to document the aggregate level and types of risk a firm is willing to assume within its risk tolerance guidelines and related to business plans. The risks included in these statements encompass credit, interest rate, liquidity, price, operational, compliance, strategic and reputation.

The executives interviewed said the risks are not new; it's the level of scrutiny that is new. For example, reputation has always been an important risk factor, said Ken Katz, senior vice president, deputy chief credit officer of Wells Fargo Equipment Finance, "Our biggest concern now is not only the increased level of regulation, but the fact that it keeps getting ratcheted up. "Everybody has been wrestling with the regulatory issues and how they have changed the landscape. It can slow the credit process down quite a bit," Katz said, also noting that regulations are not being implemented uniformly because bank size determines the timing and level of compliance.

"We're working hard to remain competitive and use technology to see how far that can take us," he added. "As in all stages of business cycles, when you are at the peak, there is a tendency to stretch on pricing, credit and structure; we're in the midst of that environment as an industry," he said. "It is very competitive and people — in some cases — are forgetting the lessons of the past. We must be vigilant," he continued.

The credit executives say their perspective is broad-based. The pressure they feel is occurring across all industry segments, with one in particular getting their attention this year — energy. According to an annual credit manager survey conducted through the ELFA, 71% of respondents said they will decrease exposure in energy. Just last year 86% were reporting plans to increase their exposure in oil and gas. While the lower gas prices may be good for consumers and manufacturing, it's not rosy for energy producers. Other areas under scrutiny are healthcare with the national shift from Medicare to private insurance reimbursements, as well as the cyclical nature of transportation.

Nevertheless, Katz, who chairs the ELFA Credit and Collections Committee, said there seems to be consensus that everyone's portfolio is performing well. People who left came back into the business and even though banks are somewhat disadvantaged due to the compliance burdens, they do have liquidity. Also, while some banks were in better condition immediately following the crisis, some independents had trouble raising money for capital during that time. However, now everyone appears to be in good shape.

What Has Changed

Katz said the most significant change in the credit process since 2008 has been the level of documentation needed for compliance purposes. "We've been going through the various steps we take to ensure that in an audit one could precisely follow the exact process we do."

He explained that the biggest lesson learned during the last downturn was how credit standards during one period of time can quickly change over an ensuing time frame depending on where you are in a particular cycle. "Whatever we do today may work for a while," he said. "But as the economy changes there will be some impact, and that can be good or bad."

James Jankowski, risk manager for UniFi Equipment Finance, agreed that there are no new risks and the fundamentals are the same. However, he said there is one new element — the establishment of more efficient processes to meet both compliance and marketing mandates to speed processing to remain competitive.

Data supports current concerns about competition and the need to speed processing. The ELFA Credit Managers Conference Survey summarized at this year's conference indicated that 24-hour turnaround timing on credit is possible for 53% of captives, 41% of independents, but only 24% of bank lessors.

McGriff said one thing has changed the most over the course of his close to 30-year career in vendor finance: In the past a manufacturer would sign an exclusive arrangement with one vendor finance company; today, manufacturers tend to create in-house captives to control the sale while selling off accumulated portfolios to multiple funding sources. The economic downturn highlighted the risk of having all of your eggs in the basket of one finance company. In such a world, differentiating your company from the competition it is often difficult, he added.

"The banks are strong in the lower yield, higher credit quality arena and non-banks in the higher yield, lower credit quality space," McGriff said. "All in all, it results in a hyper competitive market where each competitor strives to clearly define its value proposition. Service quality and responsiveness, the two key elements of our value proposition when the business was started 11 years ago, are still the basis on which we compete today."

Jankowski said things have normalized at the company he has served for 21 years, and he is not expecting another downturn for a least a year, maybe two, barring any unforeseen or global events.

ALTERNATIVE FINANCE COMPANIES: DISRUPTION OR OPPORTUNITY?

Credit and Collections Conference attendees became aware of just how much disruption and opportunity the growing number of alternative financing companies (AFCs) are creating during a panel discussion at this **ELFA** event in Washington, D.C. in June. The speakers suggested it is time to pay attention to this growing market sector and consider finding an alliance.

Charles Wendel, principal of **FIC Advisors**, said the AFC executives may be wearing hoodies, but they are astute. He reported the AFCs are forming alliances with traditional lenders and moving toward full integration whereby they will assume responsibility for the bank's low-dollar transactions. Wendel will be contributing an article on the AFC space in the next issue of *Monitor*.

"A lot of bank customers are not getting served," said **Sandip Nayak**, chief risk officer for the **Fundation**. He said the Fundation platform can create simple interest loans for working capital up to half a million dollars. "The automation does the heavy lifting, but there is manual oversight as well."

Angela Ceresnie, co-founder of the **Orchard Platform**, displayed an interesting "lendscape" *(see Ceresnie's article on page 36)* that illustrates the various platforms. Among them are **Funding Circle**, **OnDeck** and **Lending Club**, but there are a variety of lesser known AFCs that are marketplaces, aggregators or forms of lending clubs.

The panelists said institutional investors are buying in to this business category that is now estimated at $5 billion in the U.S.

"We have our eye on it," said **Eric McGriff**, chief risk officer of **EverBank Commercial Finance**. "We're curious about how they will perform in an economic downturn," he said, adding that there are some merits to the approaches.

Concerned with compliance and under federal regulatory scrutiny, traditional lenders are not able to make it easy for small companies to get lending or financing that leaves the door wide open to alternative financing companies.

James Jankowski, risk manager for **UniFi Equipment Finance**, who has 21 years of experience in the industry — all with the same company — said this was his first time at this conference and that it affirmed his thinking about the current business landscape and cycle.

He said his company's parent, **Bank of Ann Arbor**, is scrutinized to the level of a trillion dollar institution and that this scrutiny will eventually seep into the non-bank environment. He is looking to the coming national election for the impact it may have on confidence.

Regarding the AFCs, Jankowski said there will be a lot of sorting out and it will happen very quickly because so many people are rushing in. "Those that prove out will be acquired by banks and then they will have the platform and be able to manage the risks beneath it." ■

Ken Katz (left) confers with Dennis Mullin, both of Wells Fargo Equipment Finance.

He expressed a hope that the next federal election will lead to more business confidence. UniFi was acquired by Bank of Ann Arbor in 2013 and went through an extensive rebranding and review of operations for the regulatory requirements of a bank lessor.

"We recently looked at our industry concentration report to assess business by industry, credit, region and asset quality," Jankowski noted, explaining that the big challenge right now is to identify balanced risk/reward opportunities to expand market share, knowing that we are in a longer-than-normal economic recovery period. He said there is no expectation that the next recession will be like the last one, but the industry is talking about extending credit on longer lease terms which can create a problem. While a solid A- rating may not cause stress, a marginal B rating could sap more resources and have an impact on a company's portfolio within the next five years when another downturn is likely.

"From conversations with peers," he continued. "I think we'll need to consider shorter finance terms as the best way to mitigate risk, since a five-year deal today puts us mid-way into the next downturn."

During the ELFA conference, the shape of collections departments today was noted as less than robust, and readiness for the next downturn remained in question.

Brett Boehm, a principal of TBF Financial and an active member of the ELFA Credit and Collections Committee, said that while companies today are not focused on collections, they may be scrambling during the next uptick in delinquencies. Already the 30- to 60-day default rates are rising, but most companies believe they can still collect with late fees in this category.

Overall, the credit and risk managers are confident they are meeting their compliance requirements and maintaining fundamental practices, and what is most likely to be keeping them up at night are concerns about the business cycle because they report it is not at a sustainable level. There is going to be a downturn, and it's just a matter of when, said Mesches and his words were echoed by the executives and speakers at this year's conference. m

SUSAN CAROL has been a contributing reporter for the *Monitor*, specializing in writing about the equipment leasing and finance industry since 1989.

Eric McGriff (above), of EverBank Commercial Finance in session.

It was hard to find a seat in the popular "Consequences of the Cycle" session (below).

Photos by Susan Carol