developing your strategy to manage credit risk in revolving lines

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introduction

Nearly every community and regional financial institution in the U.S. offers some form of revolving credit to small businesses. The question for your credit management team is, how do you manage the credit risk inherent in this form of financing? Most financial institutions are not taking full advantage of the latest technology when managing emerging credit risk in this segment of lending. Instead, many are simply relying on personal guarantees and blanket asset filings to secure their positions, even as the lines grow well beyond the capacity for either to serve as an adequate repayment source.

Of the 32.5 million small businesses in the United States, roughly 6 million are employer firms. While non-employer firms also seek working capital finance, this paper focuses on those larger opportunities. The most recent Federal Reserve Credit Surveys show us that **while 74% of small businesses have debt outstanding, 6 in 10 maintain less than $100k in debt. This is where we tend to see non-monitored lines of credit, including lines secured only by business assets and personal guarantees.** As these lines grow, however, the reliance truly falls to the working capital assets, mainly accounts receivable and inventory.

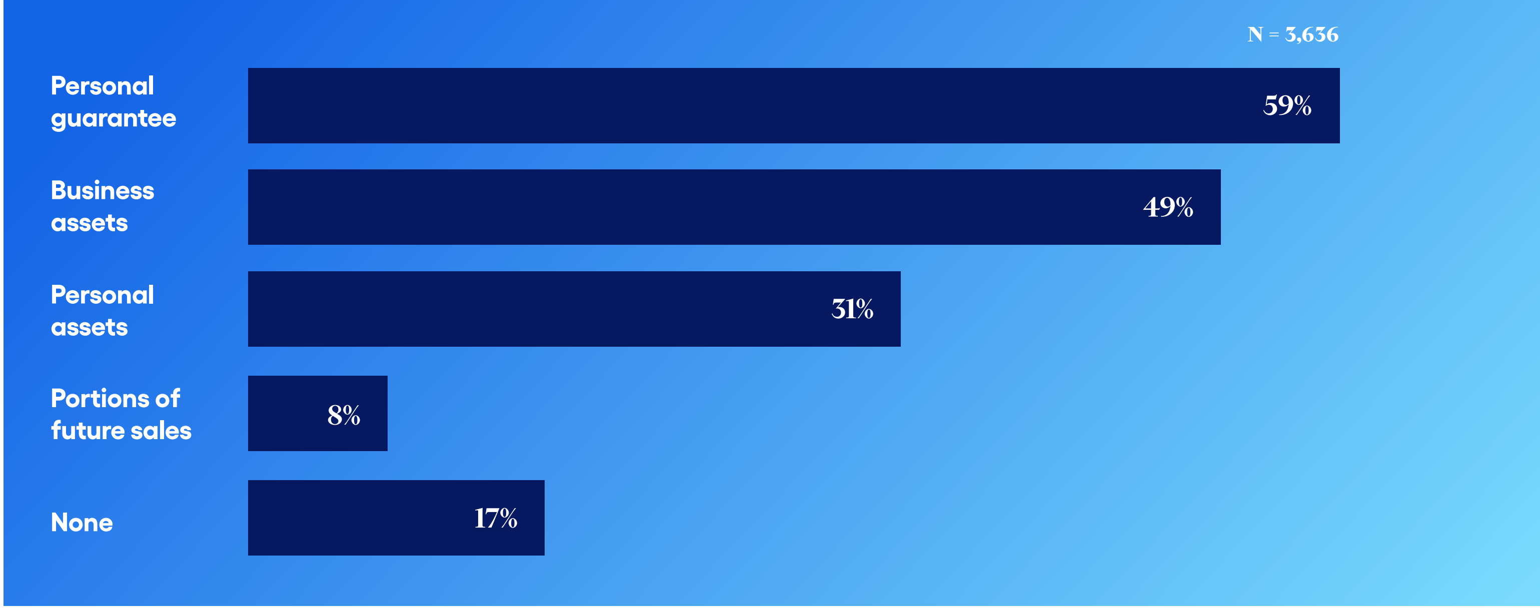
amount of debt[1]

Amount of Debt* at time of survey (% of employer firms with debt)

N = 10,679

*Categories have been simplified for readability. Actual categories are: ≤$25K, $25,001K-$100K, $100,001K-$250K, $250,001K-$1M, >$1M

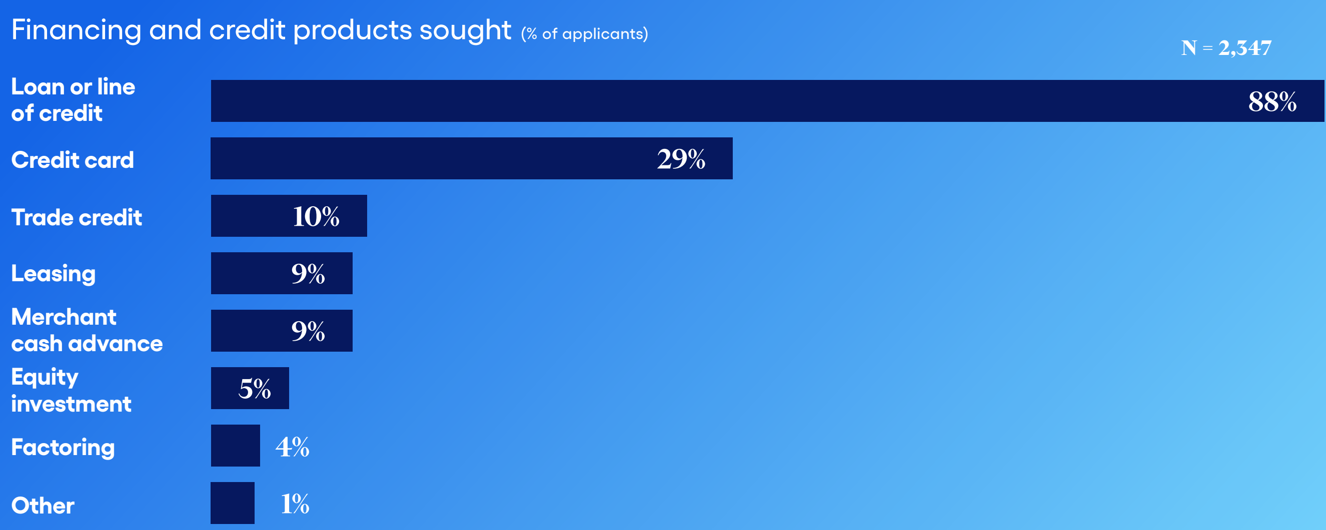
The next graph shows the reliance on personal guarantees and business assets. For smaller firms, the business owner may also be pledging personal assets such as home equity. As you can see, however, business assets serve as the primary collateral source for nearly 60% of revolving credit facilities. This strategy, when combined with an unsecured personal guarantee, seems to be the "go-to" structure for revolving lines with line commitments below $100k. As those lines grow, however, financial institutions must look to strengthen their collateral structure by tracking the value of business assets more closely. Technology now makes that relatively easy to do.



collateral used to secure outstanding debt[1] (% of employer firms with debt)

The line of credit is very often the first credit request made by a small business owner. In fact, 87% of employer firms that carry credit engage in some form of working capital finance. The question then becomes, how do you serve the market? How can your institution serve this need in such a way that it allows for expansion of the credit facility as the business grows? To answer that question, we need to consider the types of risk you are facing and the information you have at your disposal to help monitor that risk.

use of financing and credit[1]



The methodology used to monitor lines of credit can be compared to an iceberg. We are all familiar with the physical dynamics of icebergs. Roughly 10% of their mass is above the water line while 90% resides below the water line. A similar comparison can be made when reviewing the information you typically access when managing a line of credit. For standard borrowing base lines, chances are that you require lenders to review monthly aging reports and a quarterly or semi-annual P&L on the business. With this level of detail, however, you are missing some key credit risks that change quickly in every business. These are the risks that lie just below the water line and take more effort to manage like:

- Performance risk (and reputational risk)
- Lien issues (tax liens and levies, suppliers' liens, PACA liens)
- Invoice validity
- Industry-related risk
- Dilution rates (credit memos, returned goods, refunds)
- Collection rates (within your funding window)
- Terms of sale (consignment sales, progress billing)
- Account profitability

When structuring and managing revolving credit lines, it is important to monitor all business activity that could impact future cash flows. Other than cash, nothing moves on and off a balance sheet more quickly than accounts receivable and inventory, yet those are the very assets that serve as your primary repayment source for a revolving line of credit. It's possible to monitor all of the above credit risk in a very efficient and cost-effective manner. Below we'll review the five keys related to working capital finance.

the five keys

- Appropriate initial credit decision
  - » Dictated by credit policy
- Accurate and timely information
  - » Ideally information directly from the borrower's accounting system
- Control of cash (payment stream)
  - » Lock box controlled by the financial institution
- Effective and consistent monitoring practices
  - » Dictated by policy and enforced through lender training
- Protection against changing circumstances
  - » Adequate advance structured that can change over time
  - » Use of credit insurance on larger exposures

Many of the five keys can be managed using modern portfolio management systems. These systems not only track key business metrics, they automatically notify your credit team when business circumstances are moving beyond your acceptable range of credit risk. To state it within the context of our iceberg analogy, they allow you to see very effectively below the water line. As you evaluate your current approach, ask whether process is catching key business metrics.

do you use a system to monitor the following?

- Dilution rates
- A/R turn rates
- Concentration accounts
- Credit memo activity
- Payment compliance
- Account profitability for your financial institution

In addition to deploying technology to more effectively manage credit risk, consider using available data to actively survey the health of your business client, as well as their key customers, daily. Such services allow you to see same-day activity if a business or one of its clients has a suit, lien, or judgement filed against it. These tracking systems also prime your credit officers if the overall health of a business is deteriorating due to other circumstances. Such information is invaluable when managing a line of credit since your primary repayment source is the conversion of working capital assets into cash.

Consistency Across Lenders

The OCC has stressed the importance of developing tools that foster consistent management of credit facilities across lenders within the financial institution. Technology allows for this consistency.

consistency across lenders and lending units

In their most-recent guidance for monitoring asset-based lines, the OCC stressed the importance of developing tools that foster consistent management of credit facilities across lenders within the financial institution.

Technology allows for this consistency. Most of us realize that two or more credit officers, in the absence of a unified management system, tend to manage revolving credits differently. Consider the collection of periodic aging reports and profit statements. Some lenders study them carefully when received, while others simply stick them in the credit file – exception cleared. Once lenders are all held to the same standard, and that standard is reinforced by technology, exception notifications, and red flag updates, your institution has taken a giant leap forward in credit risk assessment.

the undesired results of unmonitored or loosely monitored lines

Most lenders have witnessed the pain of an unmonitored line firsthand. Without the five keys structure, you can easily find yourself in an overfunded situation, where the value of your collateral simply does not support your line balance. In worst-case scenarios, you end up with "evergreen" lines that become fully funded and do not revolve. With an unmonitored line, the financial institution has no control over the payment of invoices. It becomes the business owner's responsibility to revolve the line by using payments to pay down their principal balance. Evergreen lines result when this responsibility is overlooked. What is worse is that such scenarios end up strapping the business with more long-term debt, since the lines eventually must be termed out. Effectively using the Five Keys helps the business owner as much, if not more, than it aids the financial institution. It helps to set proper boundaries within the lending relationship.

Develop a strategy for managing revolving credit relationships through the ups and downs of every credit cycle and foster consistency among your entire staff.

the importance of considering economic cycles

There is no better time to consider ways to develop your strategy to manage credit risk and help businesses in their time of need. Many business owners are experiencing the toughest circumstances in their professorial careers. It is time to take stock of your processes. Develop a strategy for managing revolving credit relationships through the ups and downs of every credit cycle and foster consistency among your entire staff. By incorporating the latest technology into your strategy, you can break the iceberg into much more manageable pieces that can be effectively managed within your financial institution.

sources

1. 2021 Small Business Credit Survey, Federal Reserve Banks, accessed May 2022.

create limitless possibilities

Learn more about our technology to help you manage credit risk.

For more information about Jack Henry, visit jackhenry.com.