Funding Xchange

Avengers and Guardians:

Protecting the Balance Sheet

March 2022

FXE Technologies

Following the launch of our PortfolioMonitoring solution in collaboration with Shawbrook Bank in December 2021, we have seen a strong response from the market, with several prominent lenders partnering with us and many more in discussions.

FXE Portfolio Monitoring provides actionable insights into risk and opportunity trends at a portfolio, segment and individual customer level.

The rapid adoption by the market is clearly a sign that the solution addresses an unmet need. It is a coincidence that the launch of the proposition happened at a time when fraud prevention in lending was intensely debated: news on fraud associated with government-backed lending schemes and an exceptional case in the Asset Finance market led to prominent coverage of FXE's PortfolioMonitoring solution by The Times as well as in the Trade Press.

Yet, most discussions with funders are not focused on fraud. Many funders are today in a strong position. They have rapidly expanded their balance sheets over the past few years – and are continuing to see a strong performance of their portfolios. Against this backdrop of strong balance sheets and appetite to deploy further funding, we are frequently hearing that funders are looking to understand how countervailing trends will play out over the coming years. Funders are seeking to understand how the paths ahead could rapidly shift economic fortunes for some businesses and the impact this could have on their portfolios:

- **Strong Recovery or Delayed Distress?**

  The strength of the recovery continues to surprise many and has clearly increased appetite to deploy funding. Announcements of successful funding rounds and capital to deploy shows that liquidity has returned to the market across more asset classes. Yet, there is a nervousness that the end of government hand-outs may still drive a wave of 'delayed' insolvencies - flushing out businesses that were never viable or that continue to be overly reliant on 'pre-pandemic' economic structures (commuters, bricks-n-mortar retail...) that are unlikely to return to their former shape. Much of this is still to come in 2021, company insolvency rates were still 21% below pre-pandemic levels. That's 10% higher than the historically low failure rates in 2020. That the adjustment is coming might be reflected in the 18% increase in insolvencies in Q4 vs. Q3 of 2021.

- **Agile or Caught-out?**

  Many companies have built leaner, more nimble organisations during the crisis. Yet, moving online and embracing virtual working may not protect them from the surge in energy prices, wages and inflated costs of raw materials. Even booming sectors, like construction, are facing a squeeze on margin that appears to be leading to a rise in insolvencies.

- **Cash Rich or Debt Strapped?**

  The large banks are reporting that many businesses have built up mountains of cash reserves as unspent government cash is creating a cushion. Yet, a vast section of micro-businesses are facing unprecedented debt levels. The £75B in government funding disbursed as loans to small businesses are contributing to weakening many small and micro-businesses' balance sheets.

- **Tiny Avengers**

  Businesses born during a crisis are often more resilient. Yet, the shift towards gig-entrepreneurs, while making it easier to become an entrepreneur also creates a large segment of marginal endeavours – often too small to be called businesses that exist to replace employment or fulfil a lifestyle. We are seeing this shift in the profile of funding requests coming through the marketplace with a 36% increase in the share of "gig-entrepreneurs" seeking finance (if we look at businesses operating for more than a year but with revenues of less than £5,000).

Balance Sheets: unspoken victims of the pandemic

Strong support leaving smallest businesses in a weak position

The response to the challenges of the last two years has dramatically altered fundamentals of our economy and businesses. Government assistance in the form of debt means that balance sheets of many businesses have been weakened – especially of micro businesses. These micro businesses account for 90% of UK businesses. They typically have £100k annual turnover and support the livelihood of millions of families across the UK. The government supported these businesses with access to BBLS loans that propped up businesses in the short-term.

While starving off the immediate crisis, the debt provided has weakened balance sheets where debt was used to replace revenues. We are tracking what this means for the top quartile of micro businesses that are using debt.

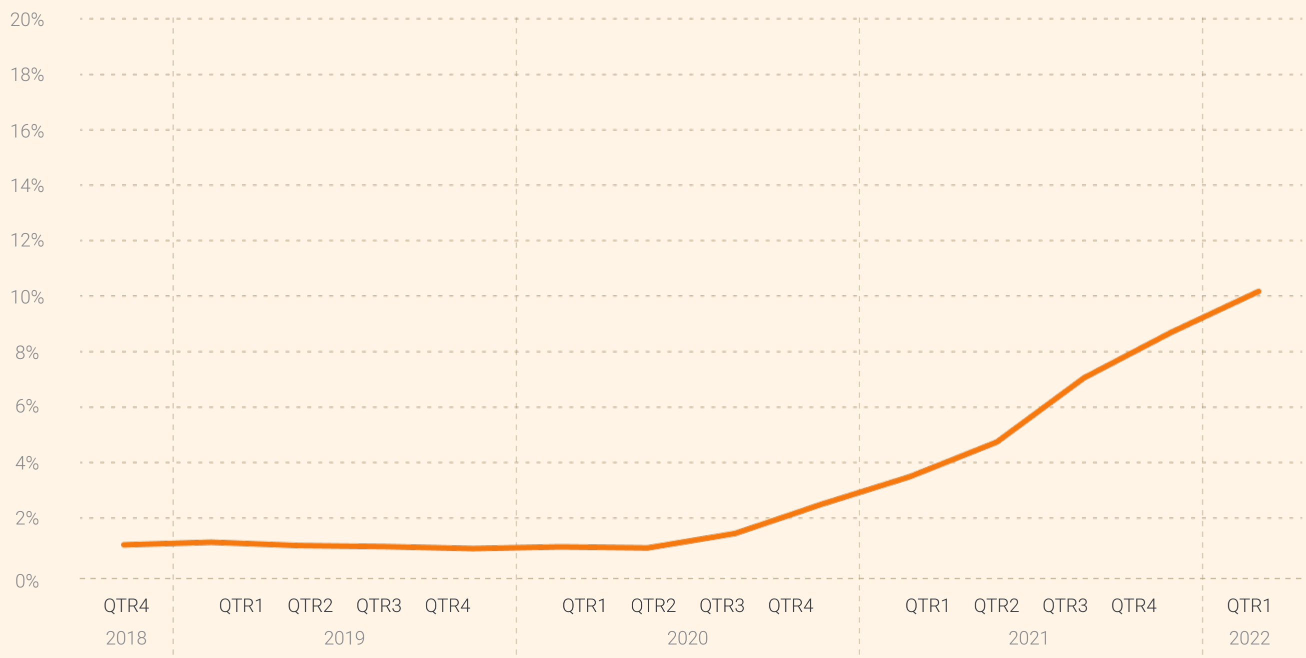
The median level of debt has increased 10-fold from pre-pandemic level relative to turnover.

This is an unprecedented increase in debt. While many other nations provided mainly grants to small businesses, the UK used banks as the main vehicle to distribute more than £75B in government aide that is to be repaid. This aide is now literally a liability and weakens balance sheets.

With repayments of government lending and unwinding of HMRC deferrals starting in late 2021, we are only now starting to see which businesses can shoulder the repayments. Given other macro challenges – Brexit, spikes in inflation, war in Europe – uncertainty for businesses and lenders will remain key concern in 2022.

Median indebtedness (debt-to-turnover ratio)

Moving average over 4 periods



Source:

Based on SMEs applying for funding through the FXE marketplace. Turnover is self-reported at the point of application. Debt balance as reported by Credit Reference Agency data at the point of application.

Avengers and Guardians:
Protecting the Balance Sheet

Funders are wary as tumultuous times tend to re-order winners and losers. In recessions, funders are used to sector-led downturn (e.g., property development) and see recovery spreading from one sector to another.

Unprecedented volatility in the performance of businesses will continue in 2022

Covid does not follow this pattern. We looked at 'Avengers' in FXE Lending Monitor (Q3 2021) and showed that individual businesses in specific sectors have widely different trajectories. Often the strength of the management team has been critical to the fate of the business – rather than sector dynamics.

It is clear that agile businesses that adjusted their business models fared better than those that mothballed their operations. This divergence of performance makes it harder for funders to assess credit risk – as picking a 'winning' sector is much less effective. More broadly, historic performance of a business has been much less effective at predicting outcomes. Possibly as the cost of energy, disruptions to international supply chains, or the impact of surging raw material costs on fixed-cost contracts are not factors in AI-models. At least not today. It is probably not surprising that AI-models are vastly under performing at this point – as underwriters' instincts and experience are more effectively navigating externalities that are not captured in historic data.

Strong growth in 2021 is creating need for portfolio monitoring in the Asset Finance sector

While Asset Finance providers might be less worried for the time being – secondary markets for recovered assets are booming and provide an effective hedge for bad underwriting – there is a general sense that understanding the trajectory of risk performance has become a lot more complicated – and a lot more important.

Here is where PortfolioMonitoring creates visibility of changes in risk profile and identifies what funders can do about these changes. PortfolioMonitoring helps funders understand how countervailing trends are playing out in real-time – for each company in their portfolio. By tracking performance of individual businesses, we can visualise trends by sector, geography, channel – what type of businesses are succeeding within sectors. For example, we can look at how different businesses in the construction sector are impacted by the rapid rise in the cost of raw materials – and what the impact is on cashflow across the sector and for individual businesses – as well as their capacity to repay debt. Powerful insights – but to put this picture together we start with the individual business, distinguishing between those businesses that are surviving and those that thriving.

Understanding clients' performance provides an opportunity to engage early

To deliver these insights, our access to rich, live, transactional data is critical. But rather than ask customers to provide access to data (Anne Boden is correct that businesses are largely not willing to connect Open Banking data), we focus on background data, that does not require customers to contribute data/connect accounts. This facilitates the ongoing monitoring of a business' trading position, debt repayment status across all lending contracts and cashflow position – without having to interact with the business.

We use rules that allow us to distinguish between businesses that are doing well and those that are struggling. These insights allow us to pinpoint the specific accounts where an intervention can make a difference – either by preventing a default or by winning greater share of wallet. Crucially, this reduces noise and allows funders' relationship management/collections/broker teams to focus on where their efforts create the biggest impact.

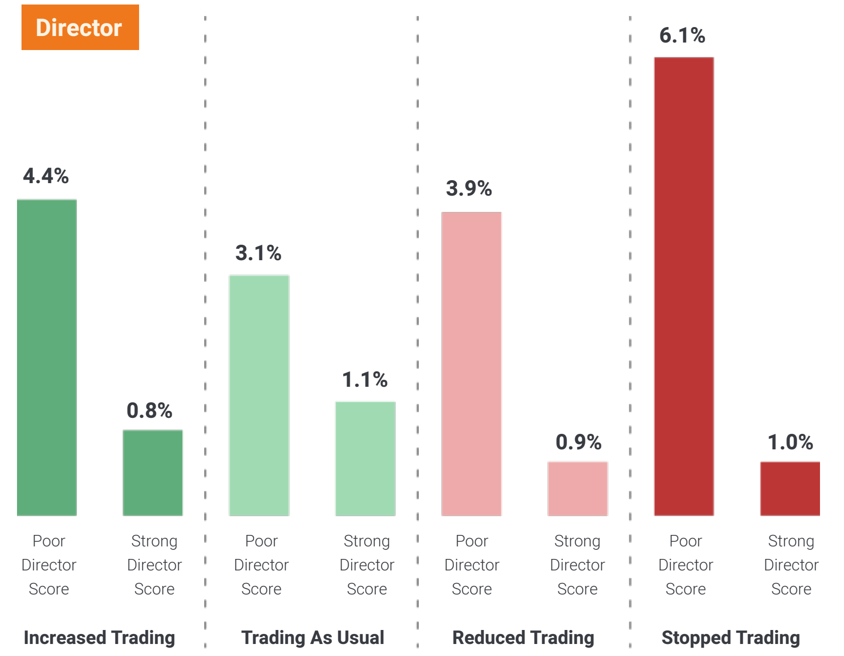
> *"Most lenders initiate account reviews once their exposure reaches £1M. This activates interactions with the customer on a quarterly basis to review MI, management forecasts, projections, cash flows, etc. In a perfect world, lenders would like this type of information on all their portfolio – but without investing the resources that the review process implies. Lenders have struggled to get the granular information to track accounts and where they have data, they typically are failing to use the data in a meaningful way to create insights and take actions."*

Stuart Doignie
Head of Fintech Strategy and Commercialisation
Shawbrook Bank

Not all data is equal

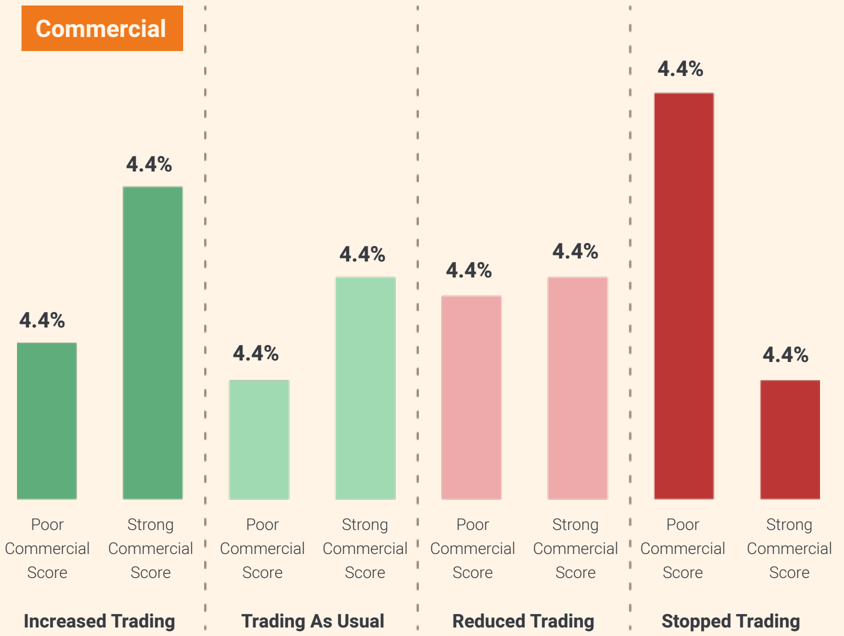
In uncertain times, people matter even more

% of businesses with any commercial default in the last 12 Months (by covid impact & personal score)



Can data replace Bank Managers' personal relationship with business owners?

While data cannot not replace personal relationships, it does help us understand which businesses are likely to be resilient. By looking at personal credit scores and trading performance during the crisis, a very clear picture is emerging of the importance of understanding directors' personal profile for small businesses: weak profiles show 3-6x higher default rates – irrespective of the trading performance during the crisis and the sector the business operates in. It is likely that with continued uncertainty and external shocks, the role of leaders in a business will be key to their resilience and success in 2022 and beyond.



Can a business be reduced to a single score?

Interestingly, aggregated commercial credit scores do not show the same meaningful insight for small businesses. In fact, a better profile seems to be associated with higher defaults in all case except where a business stopped trading entirely. Why is that? We believe this shows that summing up the resilience of a business in a single score does not capture the complex fabric of a business. We focus on disaggregated indicators of the underlying trading performance: repayment patterns, cashflow trajectory… and of course the business owner. Exactly as an underwriter would do.

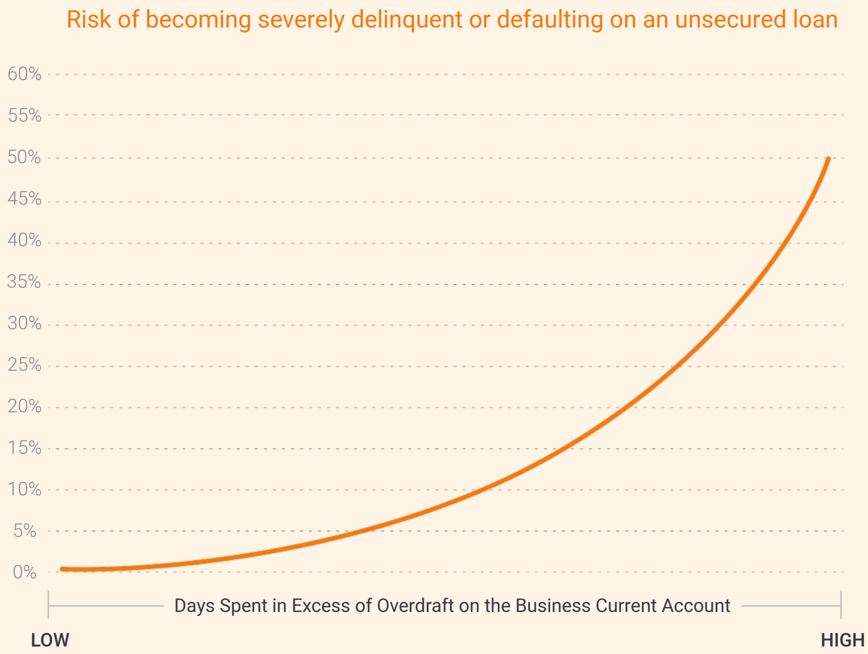
Source:

1. Funding Xchange. Personal credit scores for directors for businesses applying for funding between July 2021 and Feb 2022

2. Funding Xchange. Commercial credit scores for businesses applying for funding between July 2021 and Feb 2022

New background data sources enable this without impacting a business. A lender is not required to ask the business to connect accounts or send reports.

This enables lenders to identify which businesses to reach out to offer support during challenging times or put protections in place to detect credit fraud early. It also provides an opportunity to identify growing businesses where a lender wants to maintain their share of wallet.



Creating the opportunity to engage early

Today, background data tracks. Unlike Open Banking, background data tracking transactions, payments behaviour and cashflow can be accessed without the business having to do anything – enabling a lender to track performance across a portfolio without friction or chasing documents.

For example, the background data tracks rejected payments in business current accounts – i.e., where a business current account has insufficient funds to cover a payment – whether this is wages, suppliers or HMRC. The analysis for businesses with leasing contracts shows a strong correlation between rejected payments and a subsequent missed payment or default on the lease. By including rejected payments as an early warning indicator, a funder can be notified of a likely future delinquency. Giving the funder time to act.

Source:

Based on SMEs applying for funding through the FXE marketplace. Loan repayment status and days in excess data as reported by a Credit Reference Agency.

Portfolio Monitoring in practice

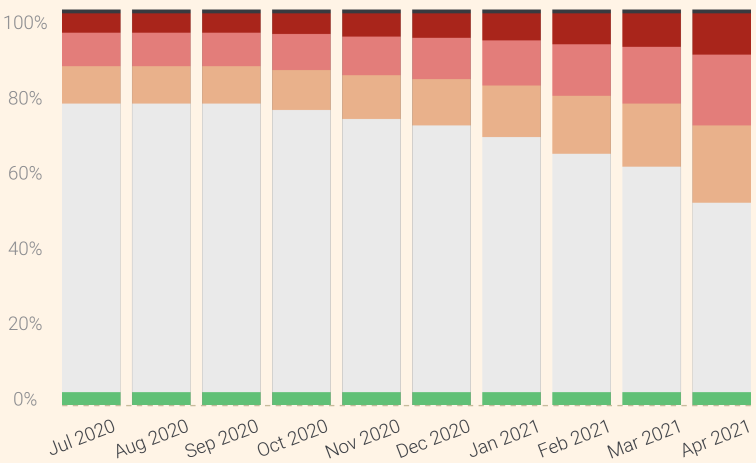
Insights driving meaningful interactions with businesses

Ask the right question: Where is risk emerging in my portfolio?

Credit risk may be worried about the impact of increased inflation on the cashflow of the construction sector after being alerted to the deterioration of contract performance in this sector. The PM tool identifies that construction makes up 15% of their overall portfolio and has seen an 7% increase in businesses that have seen an increase in risk profile in the last month an increase that is much higher than for the portfolio overall.

Businesses 7,195 -3.5% (199) since last month	**Portfolio value** £97.45m +12% (11.7m) since last month
Increased Risk 512	**Decreased Risk** 127

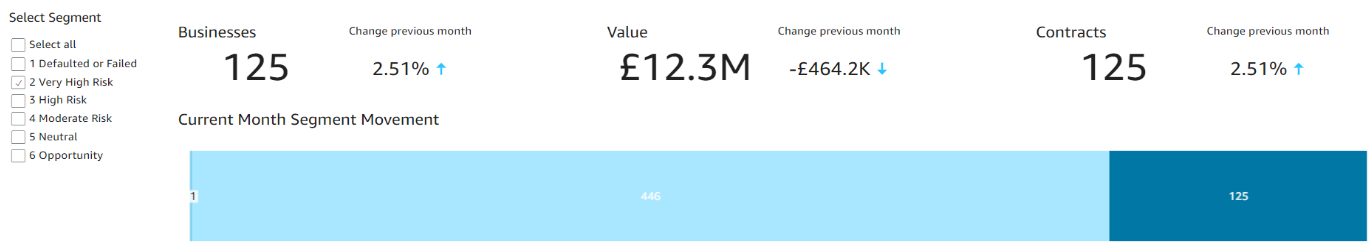
Contracts by Historical Segment Distribution



Understand the trends: Has risk increased over time?

The 12-month historical performance for this sector shows that this is a sudden shift in risk rating of businesses in the sector – giving an early warning about changing performance that has not yet translated into an increase in outright defaults.

Those 512 businesses that have seen an increase in the risk rating but have not yet missed any payments have already been flagged to pre-collections for follow up and the credit team is reviewing changes to risk appetite for new lending to the sector.



Narrow the focus: What is driving recent changes?

To drive focused action, we now flag a few dozen businesses with the highest risk rating and recent signs of stress for timely intervention. We can see the warning signs (credit rules) that these businesses triggered – See a range of indicators that suggest cashflow stresses.

Investigate and assign action: What needs to happen to mitigate risk?

We provide data on the trading performance, outstanding debt and repayments behaviour to determine the right action that should be taken next and with what level priority for each business.

In this example, the business has eight outstanding contracts with other providers and has recently defaulted on two of those - but not yet with the user of the PM tool.

Active Account Information (All Accounts)

Accounts
13

Outstanding Balance
£98,341

Worst Status
8

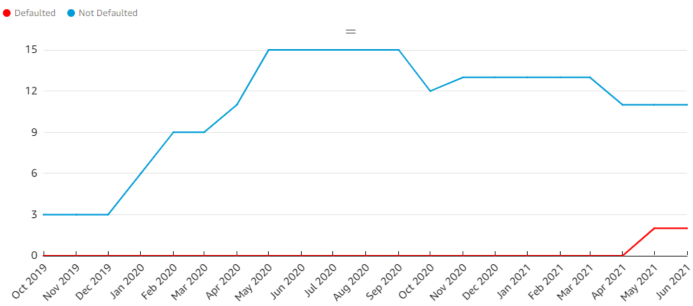
Defaulted Active Accounts

Accounts
2

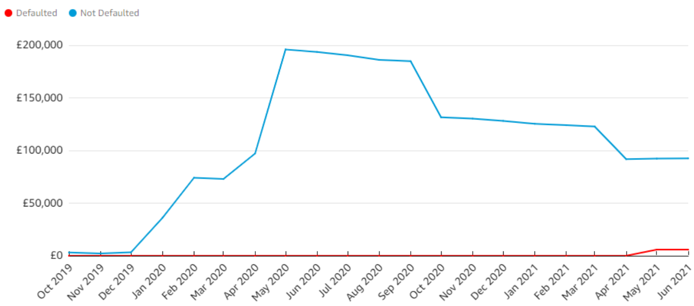
Outstanding Balance
£5,783

Monitored Risk Information

Active Accounts split by Default Status

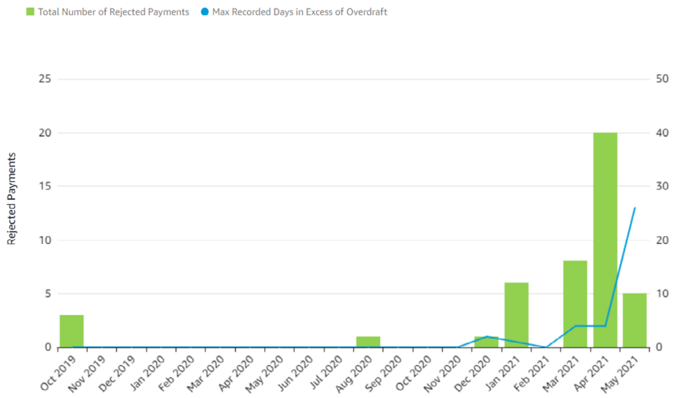


Outstanding Balance split by Default Status

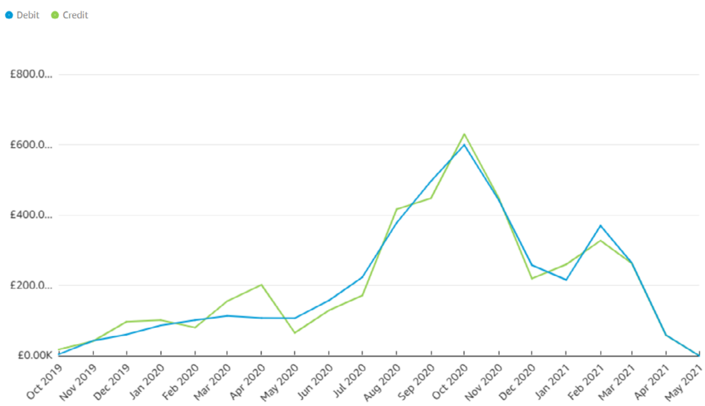


The trading performance shows the last two months saw an increase in the business outgoings and deterioration in current account balance along with several rejected payments hitting their business current account.

Current Account Flags



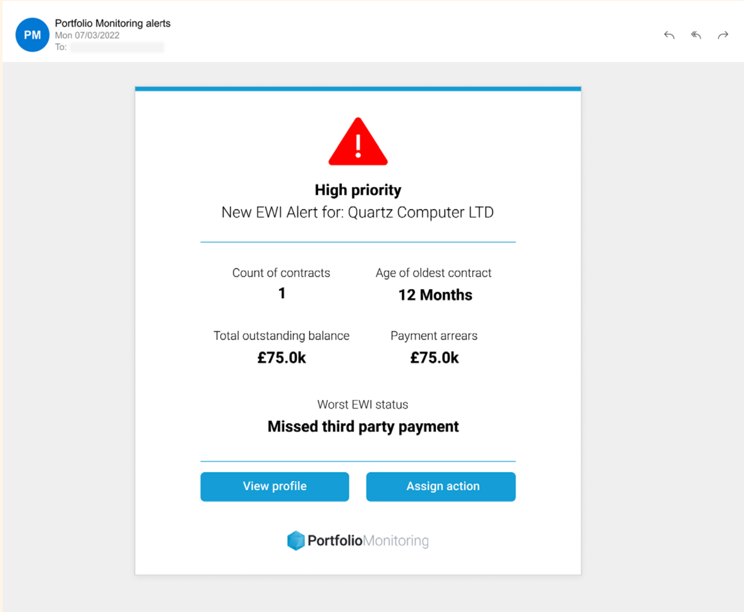
Current Account Turnover



Track impact: What has been the benefit of actions taken?

The lender is now referring the case to an RM to follow up with the client to understand exposure to fixed price contracts and suggest a concessions plan.

The RM and the business restructure the repayments on the loan over the short-term and the RM tracks the impact of this. A potential default is averted.



Alerts and intuitive workflow for better outcomes for businesses and lenders

- Understand portfolio through custom monitors for e.g., pre-collections, fraud, concession alerts for sectors, products, geographies and channels
- Interrogate the monitor to understand macro changes in risk performance before risk crystallises
- Focus attention on businesses where timely action will have the greatest impact
- Understand and investigate individual businesses without causing customer friction
- Drive and track outcome-based actions that are tailored to the situation

Funding Xchange

Funding Xchange has been a leading provider in the digital assessment of SME lending applications since 2014. The Funding Xchange MarketPlace puts businesses in control of their funding, providing access to 70+ lenders from one simple funding request, enabling them to easily compare terms and apply with confidence and not impact their credit score.

Funding Xchange SME Lending Monitor

We believe that collaboration between banks, alternative lenders, digital technology providers and policy makers is vital to ensure businesses have access to the critical lifeline that funding often represents. This collaboration brings together different capabilities, providing business owners with the ease of access to business finance that the consumer finance market has enjoyed for more than a decade.

Through our marketplace, which is used by over 30,000 businesses across the UK every quarter, we have a front row seat to observe any changes in funding needs – and the funding solutions available to them from more than 40 providers.

For further information on our capabilities and to learn how we help small businesses, please visit: **fundingxchange.co.uk**

FXE Technologies

FXE Technologies offers a suite of digital SME lending solutions that enable banks, brokers and lenders to instantly triage customers against underwriting models while transforming customer conversion and engagement. FXE Technologies' solutions are used by a range of customers including Tier 1 banks and boutique lenders.

View the FXE Technologies solution suite at **fundingxchange.co.uk/fxe-technologies** or email **ben.sher@fundingxchange.co.uk**

FUNDING XCHANGE Rise London | 41 Luke Street | London EC2A 4DP