Funding Xchange | Simply—

Acrobatics without a safety net

Lending Monitor Q3 2022

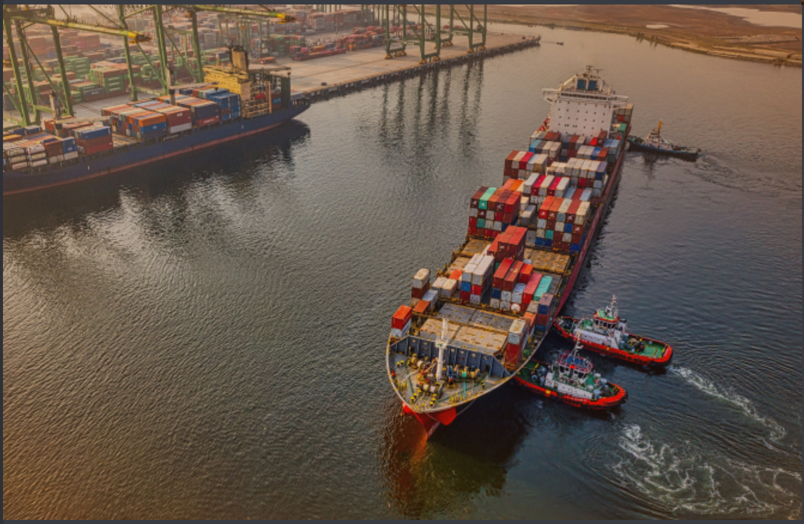
August 2022

Funding Xchange

Our most recent Lending Monitor, written just as the war in Ukraine was unfolding, asked whether to expect a strong recovery or delayed distress to crystallise in 2022. We are picking up on these themes and examine development in the last six months to understand where the next year might take us. As we reflect on the road ahead, we welcome in this edition observations from Ylva Oertengren, Simply Asset Finance's Chief Operating Officer, on what this outlook means for funders and their support to businesses.

We are now at the point where the extended protection of government schemes to UK businesses has largely ended: the vast amounts of cash disbursed during 2020/21 created a 'safety net' that meant that balances held by businesses doubled almost overnight and stopped most business failures and masked other signs of distress. Yet, this protective cash cushion has been spent - with cash balances back at pre-pandemic levels.

At the same time, 2022 has brought new challenges as the war in Ukraine and spiralling inflation are impacting businesses weakened by Covid and new trade barriers with Europe. As businesses are facing into these new challenges, they have less cash at hand while also facing weak balance sheets that reflect the government-backed debt businesses took on.



While economic dislocation in the more recent past primarily affected specific industry sectors (e.g., property-related sectors in the fall-out from the 2008/9 financial crisis), the current challenges appear to play out for individual businesses rather than sectors. Exposure of supply chains to international disruptions, energy consumption, commercial arrangements with customers (like fixed price contracts) are different for each business.

The dynamic nature of our current economic environment means that looking at the rear-view mirror to define risk appetite and mitigate risk building up in the portfolio will be insufficient. This Lending Monitor uses macro-data from FXE's marketplace to understand how trends in risk analytics are playing out and the implications for banks and lenders.

Summary:

Return to 'pre-crisis' risk analytics is likely to miss key challenges

While we are entering a period where 'normal' risk rules should apply, we are finding that the world has changed quite dramatically. Going back to 'pre-crisis' risk analytics appears insufficient.

Traditional data used to assess credit risk continues to be affected by the crisis response that very effectively masked risk. The government's crisis response has kept businesses funded that would have otherwise struggled. As this report shows, cash balances held by businesses rose dramatically as the result of interventions and are only now returning to pre-crisis levels. Businesses that would have struggled, ended up surviving – swelling for example the ranks of businesses that are now turning three years old. These businesses did not face the typical start-up challenges as they qualified for government support but are now encountering a much harsher world. This could potentially mean that failure rates of these businesses will get closer to those expected from start-ups.

- **Given the success of the interventions, the data from the last two years is 'sanitised' of arrears and defaults as well as business failures that under normal circumstances would have occurred.** Building risk assumptions around this data set is misleading if we accept that some of the distortions will wash out and more normal risk patterns return as the effects of the interventions wane. Banks and lenders need to bridge this gap between observed events and actual risk as they calibrate their risk appetite. This requires an understanding of actual trading performance and available cashflow – rather than review of events like arrears. Sectors, like construction, are facing a squeeze on margin that appears to be leading to a rise in insolvencies.

- **Cash balances are only now returning to pre-crisis levels – in concert with early warning indicators ticking up:** 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.

- **People and prudent management matter when navigating rapidly evolving challenges.** While trading performance and cash balances are important, the last two years have also clearly shown that Directors with a strong financial profile have been able to steer smaller businesses more successfully through the challenges. Combining insights from personal profiles of Directors and trading performance offering much greater correlation to credit risk for a small business than a commercial score for this business.

- **Waiting for a rise in arrears and defaults before acting removes the opportunity to affect outcomes.** Early indicators are critical to understand the trajectory of a lender's portfolio and creating the window to pro-actively engage with customers before arrears and defaults occur. Demonstrating how the lender is 'avoiding harm' is an obligation under incoming Consumer Duty rules and also set the tone for the FCA's recent 'Dear CEO' letter on collections… it is also in the interest of lenders seeking to protect their balance sheet.

- **Understanding the trajectory of businesses' performance provides the opportunity to adjust credit appetite and integrate a broader set of performance data in credit decisions to originate new credit with greater confidence.** Periods of upheaval create challenges for any credit models that are trained on historic data. With arrears and defaults masked by covid-interventions, data that provides confidence in the performance of business and business owners becomes more critical. Seizing opportunities in uncertain times is a winning strategy but requires strong credit insights.

The Playbook:

Preparing for uncertain times

The impact of the challenges ahead requires a strong playbook to navigate risk and seize opportunities. FXE Technologies support the development of a playbook with our tools that provide insights into portfolios and support underwriters with credit assessment based on 'live' performance of each business, unlocking the power of background data that provides signals four months before traditional EWIs. Our tools enable lenders to engage customers early to deliver better outcomes for clients and reducing risk exposure:

- **Real-time understanding of evolving portfolio risk** using consistent assessment of each contract/business/group based on comprehensive view of trading performance, payments behaviour, market's debt exposure, directors' profile to assess for fraud/credit risk.

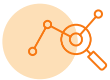
- **Proactive and early engagement of internal and external stakeholders** on changes in overall risk profile and implications for client engagement / collections / guarantees.

- **Demonstrably fair and consistent application of engagement strategies** that are informed by data-led/unbiased assessment of businesses to demonstrate adherence to policies. Data-led strategies are reducing operating costs and protecting banks' reputation.

- **Identify opportunities to build valuable client relationships** – at individual and segment level. Through differentiated engagement strategies.

What our data says:

Treasury's safety net suspended the laws of gravity

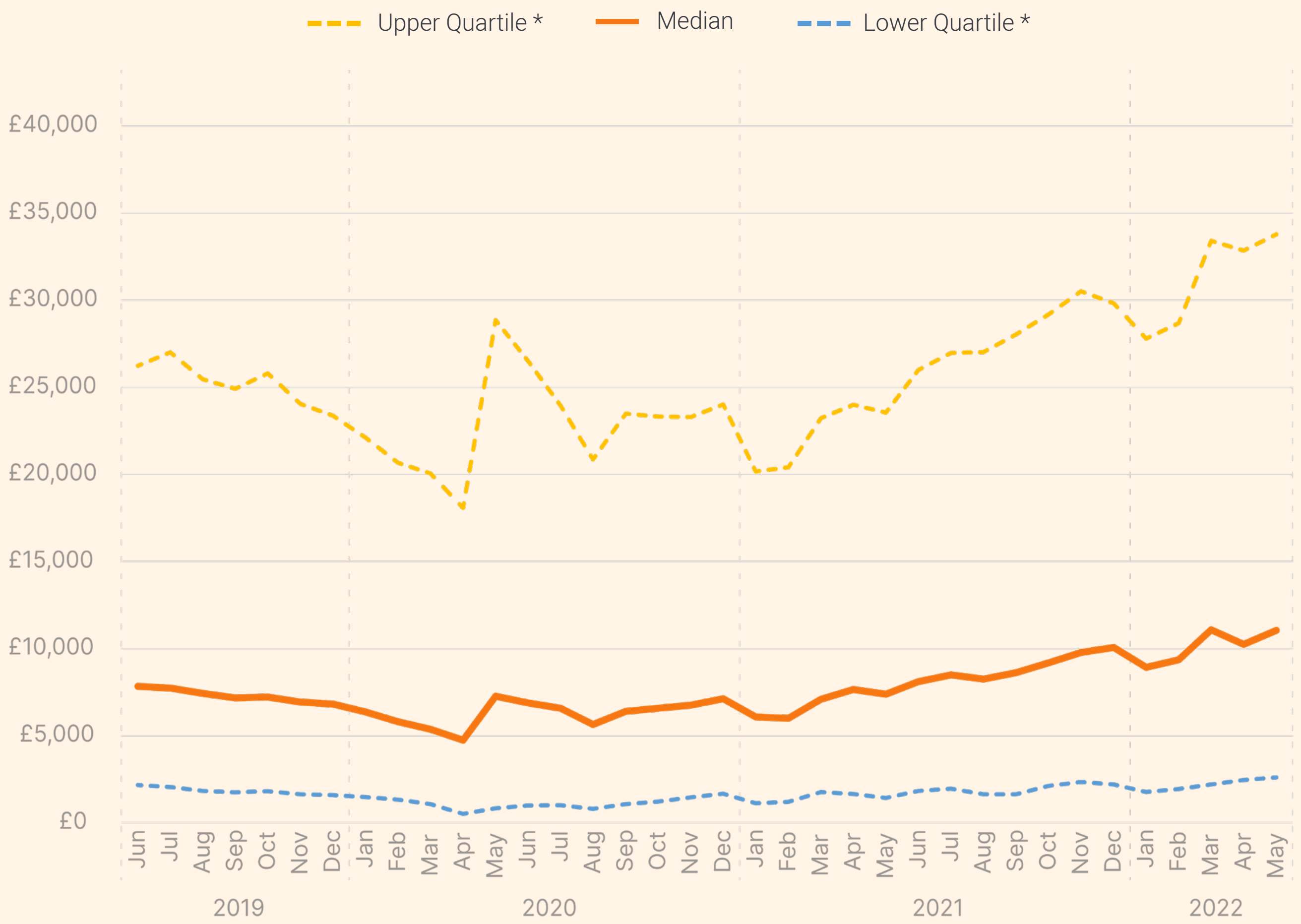


Strong recovery of trading activities in 2021 sets positive tone – but challenges in 2022 appear to be taking a toll

Recovery in trading activity and related growth in revenues is clearly visible across all businesses - with the strongest quartile seeing more than 50% growth in revenues in 2021. That trajectory has not continued in 2022 as the war in Ukraine and high inflation have created real challenges for businesses – leaving the outlook for the coming year much more uncertain.

Money In

Deposits received per month based on businesses applying for funding through FXE Marketplace



Source:
Funding Xchange, business current account trends (as reported through the Commercial Credit Data Sharing scheme) for businesses applying for funding

* A quartile represents the median of the lower or upper half of the distribution. I.e. if the upper quartile in May 2022 is £35,000 , it means that 25% of the reported population in that month had received £35,000 or more in deposits into their business current account.

Cash cushion provided by the Treasury offered protection for the past two years but now appears to have been spent

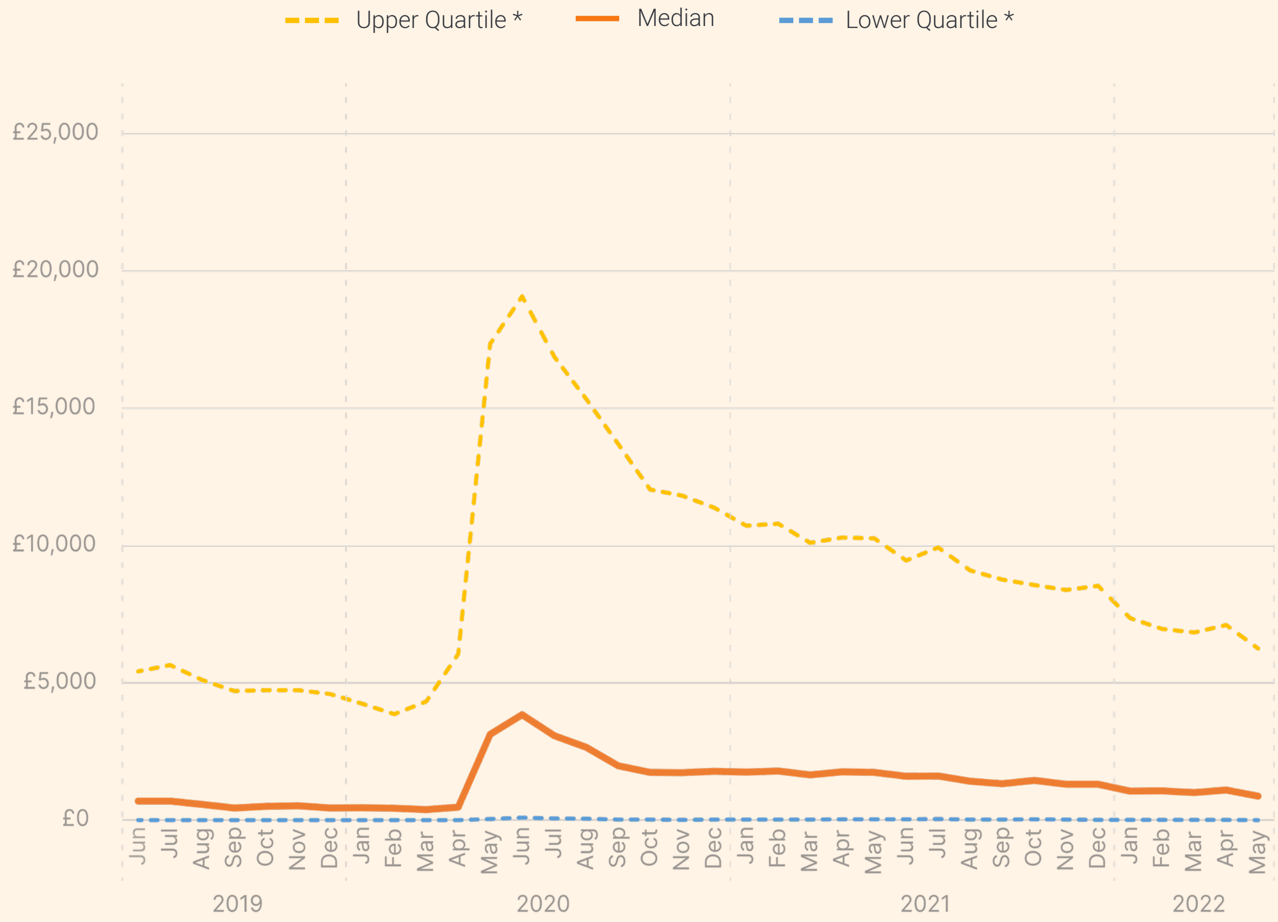
The grants and government-backed debt – including the £47B in BBLS loans - are clearly visible in the cash balance surge in April and May 2020. The resulting cash cushion was partially used during the 2020 lock-downs and has since September 2020 been 'drawn-down' at a slower rate as the economy re-opened and restructuring of costs stemmed the draining of cash.

This shows that the government interventions in early 2020 have had a longer-term protective effect that has provided relief for businesses as they faced external challenges even in the earlier parts of 2022.

It is only now that these cash balances are starting to approach pre-pandemic levels. With the safety net no longer available, banks and lenders need to consider how risk is going to crystallise after two years of artificially low arrears, defaults and business failures.

Cash Balance

Cash balances held by businesses applying for funding through FXE Marketplace



Source:
Funding Xchange, business current account trends (as reported through the Commercial Credit Data Sharing scheme) for businesses applying for funding

* A quartile represents the median of the lower or upper half of the distribution.

Unexpected economic headwinds are stressing portfolios further

Economic uncertainty has been increasing even as the cash cushion is dwindling. Q2 is driving strong and unexpected economic headwinds for the UK economy, with spiralling inflation, wage cost pressures and disrupted supply chains pointing at a looming recession just as other Western and Eastern economies are also moving into reverse.

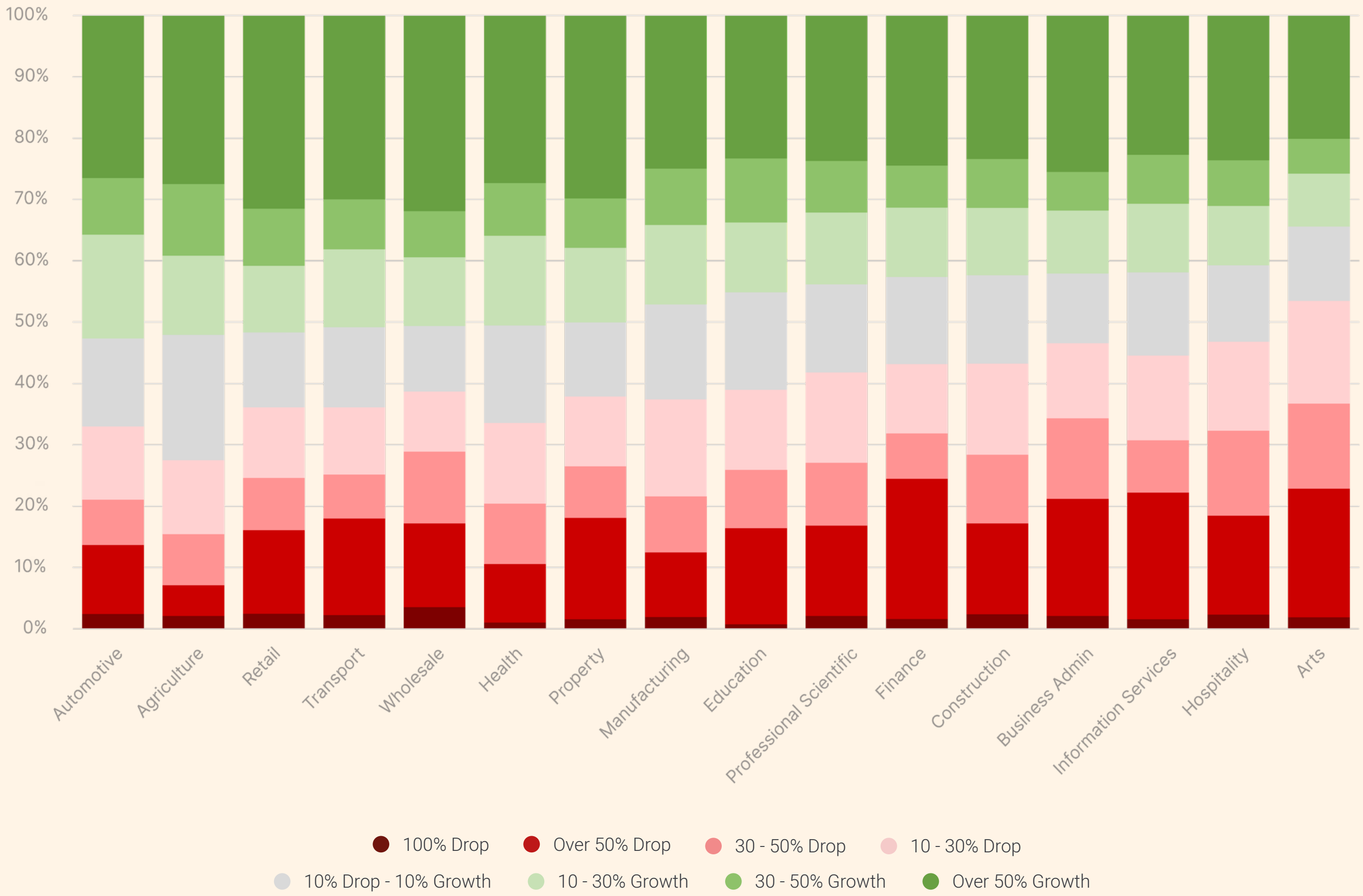
Today, most lenders are attuned to sector-led downturns (e.g., property-led recession following the financial crisis in 2008/9) that see contagion spreading from one sector to another related sector. Yet, the last two years show that individual businesses in specific sectors have widely different trajectories.

Often the strength of the management team and the specific business model has been critical to the fate of the business – rather than sector dynamics. Our last Lending Monitor showed the influence that Directors' credit profiles have on defaults – insights that commercial credit scores have not delivered in the last two years. While commercial scores are inconclusive, strength of management, business models and trading trajectory are not: businesses with fixed-pricing are caught out by rising input prices and international supply chain disruptions are leading to higher costs and lower revenues.

In the current environment an understanding of individual businesses' performance is critical to identify opportunities and risk: trading metrics, payments behaviour, the profile of Directors, and outstanding debt are painting a clear picture and help pinpoint where risk is changing and lenders can pro-actively take actions to mitigate risk.

Avengers: even sectors most impacted by the crisis have strong performers

Revenue Trends by Sector (Mar 19 - Oct 19 vs Mar 20 - Oct 20)



Source:
Funding Xchange, business current account trends (as reported through the Commercial Credit Data Sharing scheme) for businesses applying for funding

The protective effect of the Treasury's cash cushion appears to be wearing off with early warning indicators trending back up to pre-crisis levels

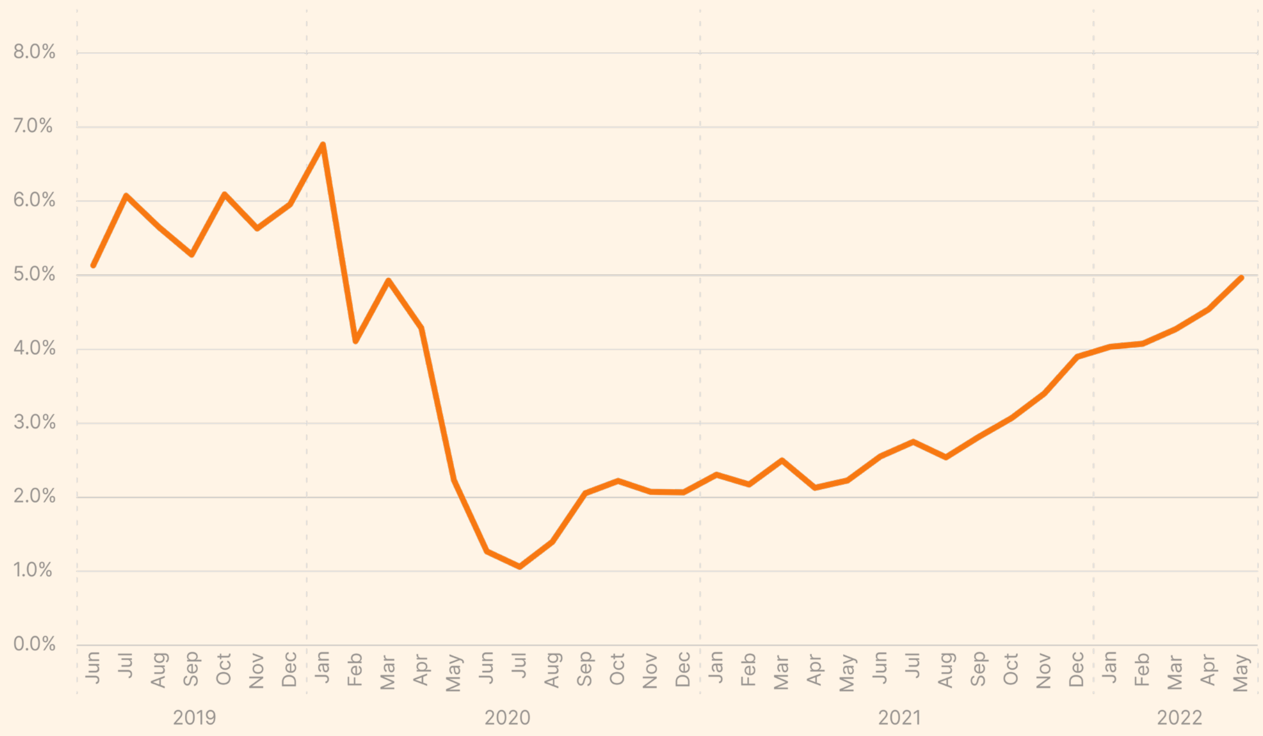
These new headwinds for UK businesses are putting business models under increasing stress. The cash transfer to businesses did stem the approaching tidal wave of arrears and defaults so effectively that the UK saw a 38% decline in insolvencies during the pandemic (Q1 2021 vs Q1 2020). This intervention also meant that many businesses that would have 'naturally' failed were saved through Covid-support measures.

As the impact of the Treasury measures is wearing off, the number of company insolvencies in England and Wales has risen by 40% year-on-year to June 2022. While new headwinds are likely to play a role, the restarting of a natural cleansing process that was suspended by the support measures is also starting to show through. We observe that cohorts of businesses that were started before the crisis, that avoided high failure rates usually associated with start-ups due to government money, are now showing early signs of vulnerabilities.

One of the earliest indicators to understand changes in risk profile of a portfolio is a lender's exposure to clients with 3+ rejected payments in a given month. Lack of cash in a bank account causing multiple rejected payments is a leading indicator for future arrears that eight months later can turn into defaults.

Cash injections by Treasury almost eliminated rejected payments in the mid-2020. Yet, as cash balances are moving back to a pre-crisis level, this early indicator of distress is also ticking up and starting to reach pre-crisis benchmarks.

Share of Businesses with 3+ Rejected Payments



Source:
Funding Xchange, business current account trends (as reported through the Commercial Credit Data Sharing scheme) for businesses applying for funding

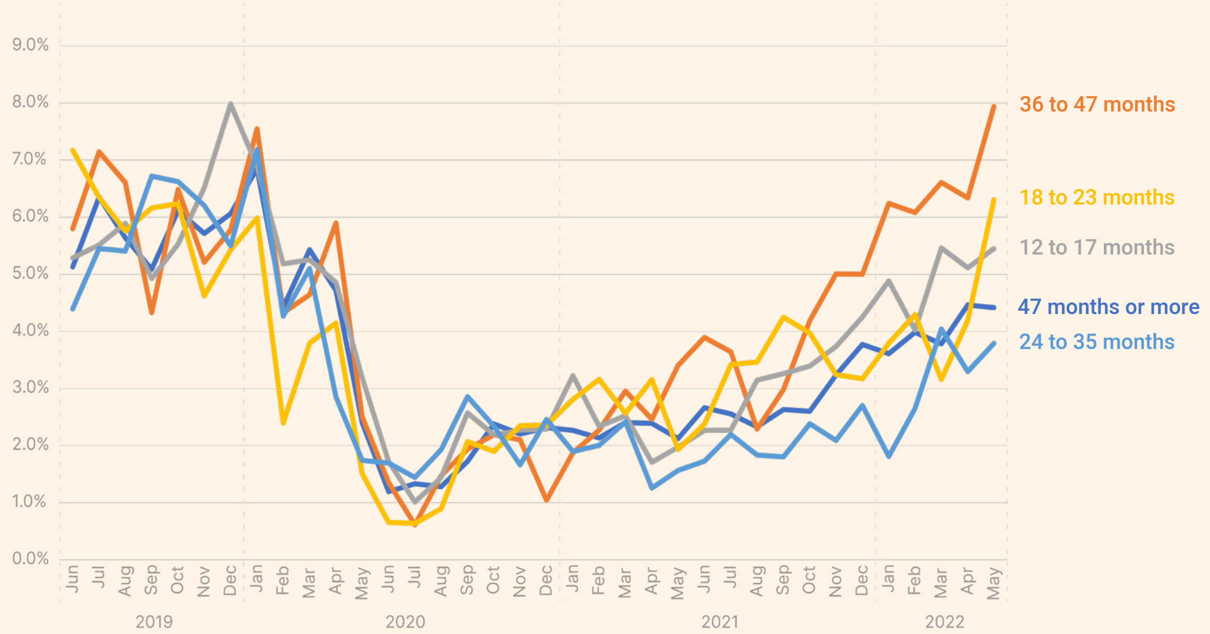
Trading history of the business is in normal times used as a basic but effective indicator of risk

Yet, our data shows that businesses with three years trading history – often seen as 'safer bets' – are showing a worrying trend in their ability to meet payment obligations.

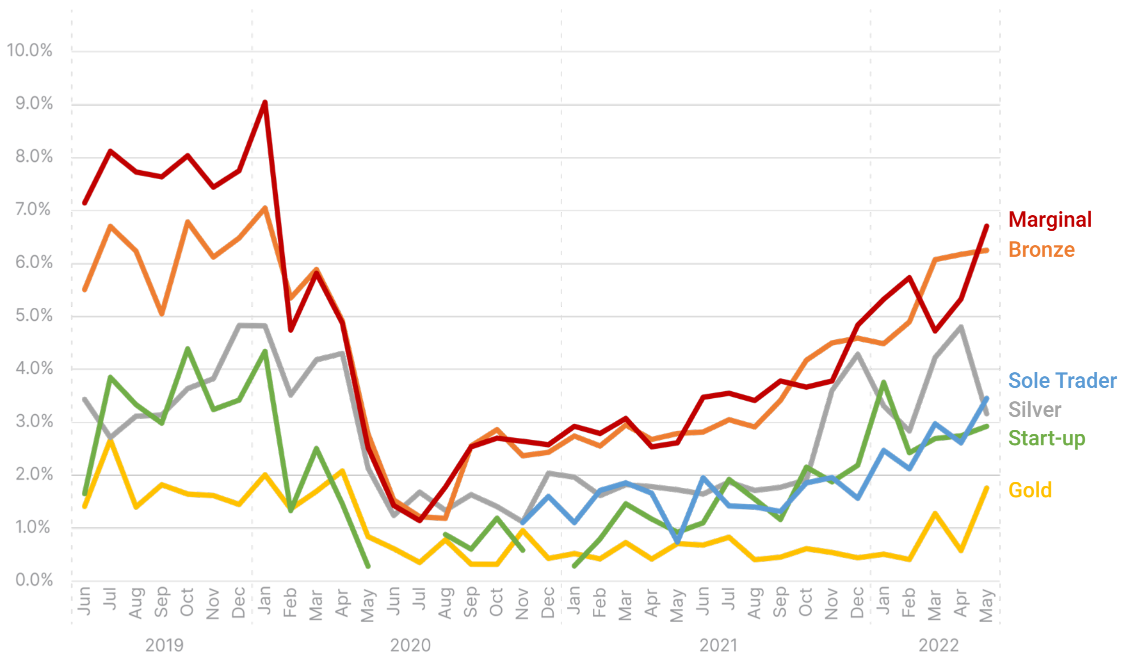
These businesses were established shortly before the pandemic, and would in normal times have had high failure rates during their first year. It is likely that some of these businesses have been saved by pandemic cash – and are now heading towards much higher failure rates than would normally be expected from this cohort – indicating a delayed 'natural failure' rate. The government payments and shifting of riskier loans into government-backed schemes also suspended for a period expected behavioural profile of different risk bands in mid-2020.

The diminishing cash cushion is driving a return to more expected outcomes based on risk bands: trajectories of different segments are diverging - with the spread between profiles accelerating in 2022.

Share of Businesses with 3+ Rejected Payments by Trading History



Share of Businesses with 3+ Rejected Payments by FXE Segment



Source:
Funding Xchange, business current account trends (as reported through the Commercial Credit Data Sharing scheme) for businesses applying for funding

Funder's perspective:

Supporting businesses in good and challenging times

Maintaining lending to creditworthy businesses will be critical for the small business sector

The rate of arrears and defaults has remained substantially below pre-crisis levels throughout the crisis. Given the cash disbursed and the ability to delay repayment of government-backed loans, this is not surprising – for now.

Even with some expected deterioration in risk performance, banks and lenders will look for opportunities to support new lending. This is critical for the UK small business sector. In the past we have seen, that challenging environments afford opportunities for funders.

We have asked Ylva Oertengren, Chief Operating Officer of Simply Asset Finance, to share her thoughts on how Simply is looking to support businesses even in uncertain times.

"As a lender in the SME space, Simply was built on the belief that SMEs deserve better. We listen to our customers, we understand their business issues and our goal is simple - to help them. With the current economic and political turmoil our customers and SMEs in general need help, they need finance, refinance and equity to grow and prosper.

But, SME lending isn't easy and right now, it is probably more difficult than ever.

Lending to SMEs requires two things: an open mind and time – these are two things that are not normally abundant in credit institutions who are looking to cut costs and standardise processes.

The problem for most lenders is that SMEs don't tend to fit a score card, they aren't cookie cutter businesses. There are too many variables associated with each business and each is unique and it is difficult to find patterns that enable short cuts in credit assessments. But that is what also makes these business so interesting and valuable.

This is where the an open mind is required. When you are looking to lend to SMEs it is important not to get distracted by the high-level indicators. Underneath the headline data is a real business, with dedicated staff and a clear business plan. It is more likely than not a viable business and deserves investment and support. As a lender, you need to see through the credit score and assess the business' real potential.

There is plenty of data out there, new sources of indicators and information about sectors, assets, cash flow, fraud, early warning indicators. You can assess spending trends on a week-by-week basis. You can see if a customer is seeking debt or repaying it. You can estimate the true value of potential security at a low-level detail to forecast equity vs residual values at any given moment in time.

But to digest all of this takes time. Unless you have the tech that can absorb and display the data in a way that works for you.

Ylva Oertengren
Chief Operating Officer
Simply Asset Finance

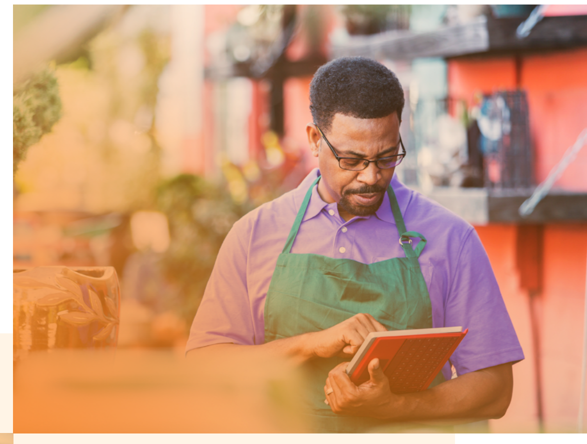
Of course, you can't ignore the data, but you have to drill down and not just look at the surface data. The good news for us is that there is plenty of data out there, new sources of indicators and information about sectors, assets, cash flow, fraud, early warning indicators. You can assess spending trends on a week-by-week basis. You can see if a customer is seeking debt or repaying it. You can estimate the true value of potential security at a low-level detail to forecast equity vs residual values at any given moment in time.

But to digest all of this takes time. Unless you have the tech that can absorb and display the data in a way that works for you. If built correctly, it is possible to do the deeper level of review without either eroding time taken to make a decision or adding operational costs.

Market uncertainty has become the norm. But SMEs are resilient, what they need is support, lenders that understand their business, what they are trying to achieve and ultimately enable their success. They don't want to wait months for a decision that ultimately might be negative, they want quick decisions so that they can continue to run their business.

At the height of the pandemic, we were approached by a family business with trading history over four generations. With 200 employees, they were struggling to overcome a standstill in their marketplace and faced existing funding lines being withdrawn because the high-level performance indicators showed a failing business. By utilising a comprehensive analysis of all relevant data points, we were able to establish the business case and replaced their previous credit lines with new funding. They are now back in a profitable growth mode.

What we are hearing from our customers is that it is time to get on with things. Yes, there are many challenges ahead. But as long as lenders can afford to look properly at the data and beyond, then there are many good businesses out there who need and deserve funding. It is up to us lenders to step up and help them."



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.

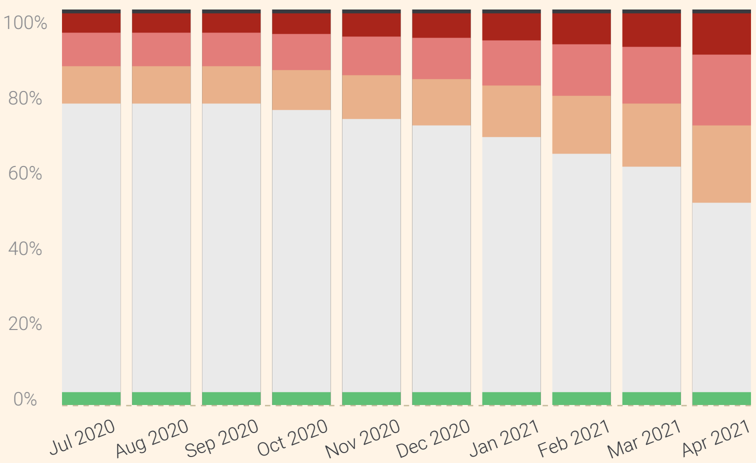
Businesses
7,195
-3.5% (199) since last month

Portfolio value
£97.45m
+12% (11.7m) since last month

Increased Risk
512

Decreased Risk
127

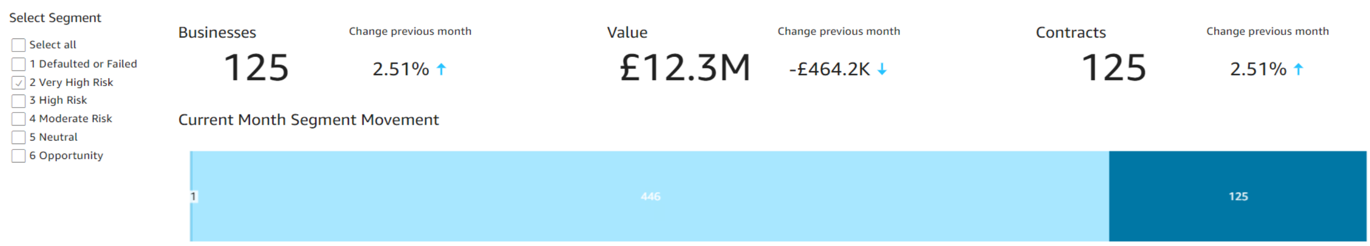
Contracts by Historical Segment Distribution



Understand the trends: Has risk increased over time?

The 12-month historical performance for this sector shows that this is 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)

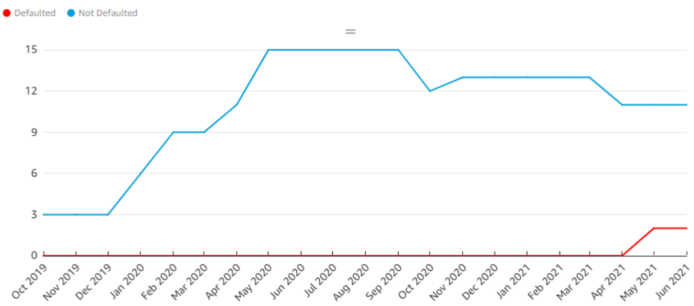
Accounts	Outstanding Balance	Worst Status
13	£98,341	8

Defaulted Active Accounts

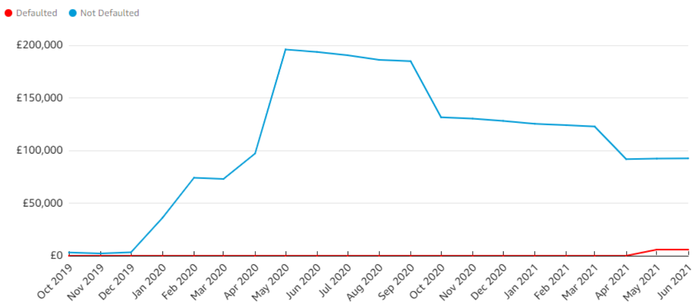
Accounts	Outstanding Balance
2	£5,783

Monitored Risk Information

Active Accounts split by Default Status

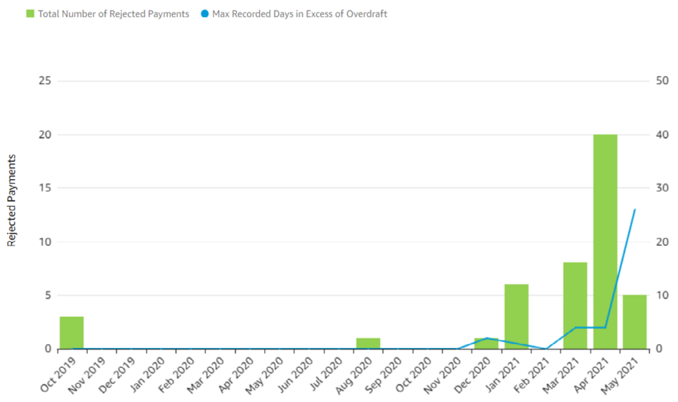


Outstanding Balance split by Default Status

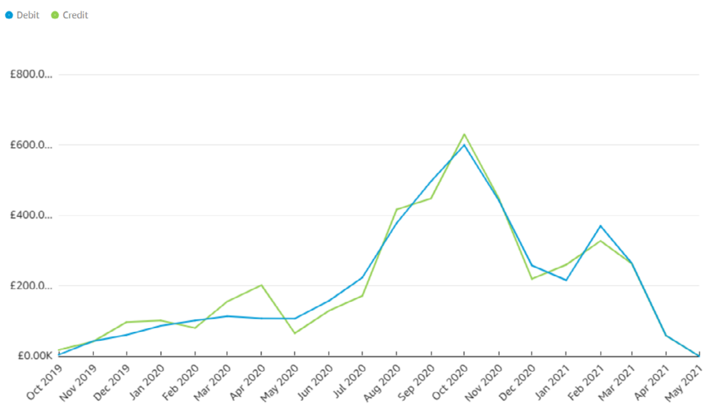


The trading performance shows the last two months saw an increase in the business outgoings and deterioration in current account balance along with several rejected payments hitting their business current account.

Current Account Flags



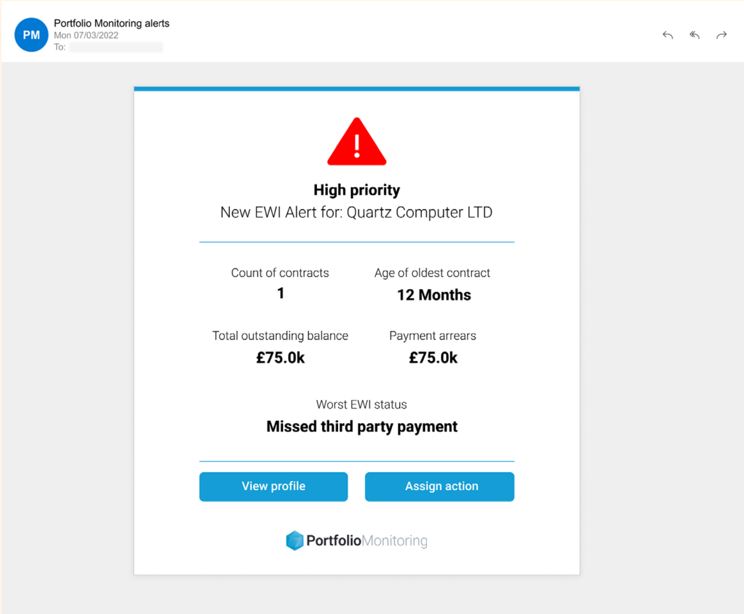
Current Account Turnover



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 **katrin.herrling@fundingxchange.co.uk**

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