Biz2X

The Modern CHIEF RISK OFFICER'S GUIDE to Digital Business Lending

EXECUTIVE SUMMARY

Business lending is one of the most significant growth areas for banks and other financial companies. With that growth comes an increase in potential risk. Financial technology (FinTech) has made it economically feasible (and more attractive in terms of risk management) to make more business loans than ever before while maintaining and even improving their risk-mitigation profiles.

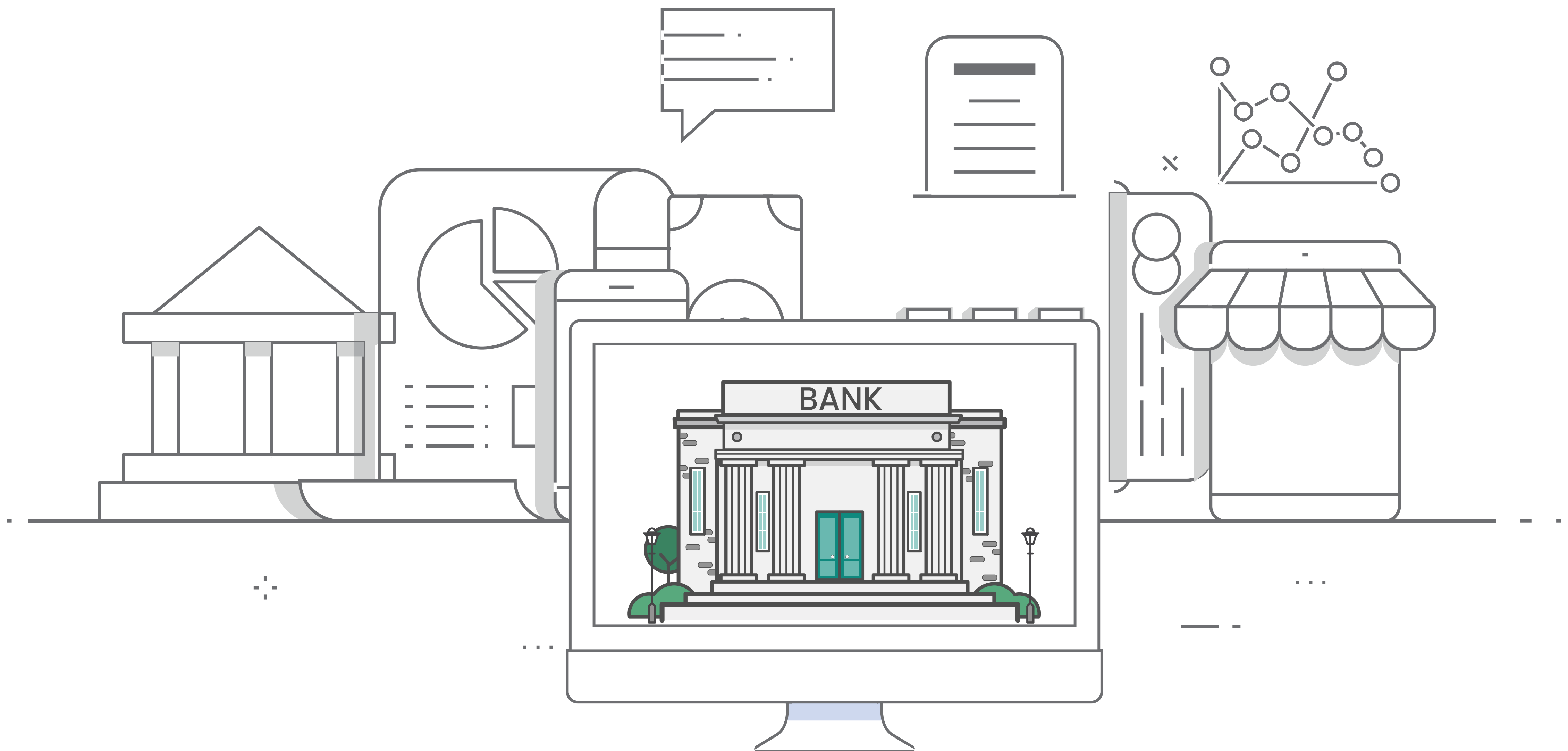
As risk management tools become increasingly sophisticated and efficient, banks can lend to businesses in greater numbers by relying on a more flexible risk profile than in the past. The net effect of FinTech has been the expansion of the potential customer base for business lending as many companies that were previously considered too risky to be offered loans, are now considered acceptable lending risks.

This ebook explores the evolutions and revolutions that are affecting risk management in business banking today and the trends that are emerging for the future. With insights from exclusive interviews with Chief Risk Officers, you will gain unique insights into the challenges that Risk Officers face in today's changing credit landscape.

Biz2X

Biz2X by Biz2Credit is an AI-powered digital banking platform that helps banks improve and automate core processes in risk management. Powered by data from hundreds of parameters and tested using millions of data points, the technology helps make more accurate underwriting decisions and provides ongoing monitoring for improved risk control.

TABLE OF CONTENTS



CHAPTER 1

UNDERSTANDING THE MARKETPLACE

For the Chief Risk Officer, driving the transformation of a bank from the old conservative mindset to a new technology-led approach is full of risks, but also represents a chance to grow their influence in the company and around the industry.

Topics covered under this chapter

Engineering Market Expansion Without All the Risk

The Legacy of Business Lending

How Banks Currently Service the Business Marketplace

BACK TO COVER

CONTENT

CHAPTERS

01 UNDERSTANDING THE MARKETPLACE

02 THE EVOLVING ROLE OF THE MODERN CRO

03 CHALLENGES FOR BANKS IN SMALL BUSINESS LENDING MARKETPLACE

04 TECHNOLOGY AND THE CHIEF RISK OFFICER`

Engineering Market Expansion Without All the Risk

The position that CROs face today is dictated by increasing competition in many segments, and an ever-precarious economic backdrop to contend with. Middle market banks are competing for market share when it comes to consumer deposits and wealth management. For the most part, the size of the marketplace for these services is fixed with the predictable ebb and flow of clients moving from one institution to another. On balance the migration of clients is stable over the long term. With few exceptions, the only meaningful way to increase market share of deposits or consumer lending has been through acquisition.

As a result, CROs are facing a market environment where they must support business objectives to increase transaction volumes without being able to rely solely on the traditional avenues of customer acquisition that were so common thirty years ago. This is where the new landscape of business lending comes into play.

The Legacy of Business Lending

Business lending is unique in a bank's portfolio. It involves the direct or indirect transfer of loan repayment responsibility to a business or corporate entity from that of the individual. However, for smaller businesses, it is common for lending institutions to require the personal guarantee (to repay a loan) of the business owner(s), effectively making it a blend of consumer and commercial finance.

Unlike venture capitalists or private investment groups, banks do not participate in the upside potential of a business. Banks engaging in business or commercial lending earn a fixed rate of interest and at the same time bear all the downside risk of credit default. In the past, this combination of factors has led CROs to mandate a strict set of credit criteria for business lending, to mitigate against these unwelcome factors.

Traditionally, bankers have relied on the “**Five C’s**” of credit to determine whether to write loans in a business lending context:

CHARACTER

Refers to the borrower’s credit profile, trustworthiness, repayment history and public standing. This is associated with “know your customer” (KYC) principles. Bankers should always know their borrower’s credit repayment history and a good deal about their personal background as well.

CAPACITY

Refers to a borrower’s means to repay a loan. Is there sufficient cash flow from the business to indicate the borrower’s ability to repay a loan?

CAPITAL

How much does the borrower have invested in the business? What is the borrower’s “skin in the game?” Someone who invests their own money is likely to take their business more seriously that those who don’t.

CONDITIONS

The current state of the business. A three-year assessment of the borrower’s business records is often the gold standard to establish a perspective of the current financial state of the business (growing, contracting, stagnant).

COLLATERAL

This refers to any backup source of assets (of high enough value) that can be used to repay the loan in case of default.

The traditional 5c’s of lending are still important when making business loan decisions. However, in today’s competitive lending environment, bankers are finding that they need to be better-armed with resources that go beyond traditional means to identify new lending opportunities while still maintaining an acceptable risk threshold.

How Banks Currently Service the Business Marketplace

It's important for CROs to consider how business lending is affected by the size of the business being evaluated. Segmentation enables more tailored decision-making. This is often the backbone of a solid risk management strategy.

One convenient approach is to break businesses up into three separate categories based on size and scale (measured in annual revenue dollars). Depending on the category, the risk and customer origination strategy can change considerably. These numbers are approximate and can vary depending on the bank:

MICRO ENTERPRISES	Annual revenue up to $1 million	Loan sizes up to $250,000
SMALL BUSINESSES	Annual revenue up to $20 million	Loan exposures up to $1 million
MIDDLE MARKET ORGANIZATIONS	Loan exposures between $1 million	an $20 million

Micro accounts are generally on-boarded and serviced by the branch network. These are local, single proprietor businesses such as landscapers, shop owners, mechanic shops, florists, etc. These businesses will likely have a personal checking account and conduct their banking with the branch that services their loan account.
Small Business Administration (SBA) loans are a critical part of lending to this segment because of the mitigation of default risk due to the government guarantee and higher credit standards. Banks can reduce their risk profile up to 50% on premium quality credit risk through SBA loan programs.
Micro enterprises and small business (explained below) account for the majority of business loan applications.

> Retail Business Banking can often cover both the micro and 'small' segments, and RBB is becoming a more common department label

Small Businesses may be handled by the retail banking group. However, it is becoming more common for these requests to be handled by specialists in a "Business Banking Group," sometimes labeled Retail Business Banking in larger companies. Business Banking Groups are usually part of the branch staff (although not present at all branches) now commonplace in banks of all sizes. They are charged with processing loan requests for amounts up to $1 million. It is also common for a Business Banking Group to cover several branches. They are also charged with consolidating the client's banking activities across loans, checking, credit cards and investment. However, these roles and department frameworks are evolving quickly.

Middle Market accounts are funneled into Commercial Banking or Enterprise Banking groups. Because of the loan amounts, this client segment is handled exclusively by a dedicated group of loan specialists. More complex transactions, heavier concentration on financial statements and occasional public market deals all entail a different, less-digital approach, at least in today's world

THE EVOLVING ROLE OF THE MODERN CRO

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BACK TO COVER

CONTENT

CHAPTERS

01 UNDERSTANDING THE MARKETPLACE

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03 CHALLENGES FOR BANKS IN SMALL BUSINESS LENDING MARKETPLACE

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The CRO's New Clothes: How CROs Are Shaping Customer Experience

Risk Officers are moving into unfamiliar territory. They are taking on wider initiatives and considerations than they have faced up to this point in their careers and often in their company's history.

Navigating this new role is an overarching concern for many in the risk management department. Ash Gupta, former CRO at American Express shares his advice for these new age CROs based on his 40+ year career in the industry:

CROs should not think they are just a control function in a company. they are a control and a growth function. The modern CRO must play active role in preventing catastrophe, but also has to accept that growth and excellence in customer experience are securely within their purview as leaders.

How can CROs play this new role?

→ Be clear about what is non-negotiable: compliance, fair lending – these cannot be sacrificed at the altar of originations, and every solution you implement must have these principles as the starting point.

→ Have a deep, innate understanding of products being sold and conversations that are being had with customers in the field today. think through your product design from beginning to end: from origination and KYC through collections. risk teams must take an active role when moving from one stage to another.

→ Don't become a yes/no person, be a solution (how) person. how will you cause solutions that promote growth and yet maintain strict controls? finding out the 'how' that makes sense for your organization can't be delegated and can't be ignored.

A CRO's Priority #1: Addressing the Inefficiencies of Business Lending at Banks

Credit Rating Agency Inconsistency -
Credit information vendor market is fragmented and not standardized. Credit-rating companies such as Dun & Bradstreet, Equifax and Experian each collect business credit information and issue a numerical "grade" for business creditworthiness. However, their methodologies and reporting are proprietary to the respective organizations and vary significantly from agency to agency.

Insufficient Technology -
Many banks rely upon manual, decentralized processes for collecting and assessing client credit profiles. Due to legacy data collection systems, many banks do not have the ability to access client data from a central database. Instead, decisioning relies upon the physical retrieval of client data. This may also mean requesting hard-copies of documents from remote locations. Underwriters bear the burden of manually reconciling and compiling borrower credit data.

Inability to Assess Business Creditworthiness Independently of Individual Credit –
Credit risk of the owner (FICO/personal global overview) still largely used as a proxy for the overall business risk due to inefficiencies and quality of existing scoring models from vendor agencies about true business risk

Did you know?

Are CROs and underwriting teams overly focused on underwriting at point of decision vs. ongoing risk monitoring?

Biz2X provides ongoing risk monitoring for existing loans and will automatically trigger alerts and escalation for cases that experience signals of worse performance - e.g. global NSF alerts compared to a master risk model)

many risk management teams are overly focused on a narrow scope of priorities. instead they should be looking for ways to understand the evolution of a deal from the time it is first looked at through to the final payment and close of account. this is not just because of risk considerations (which should always be top priority) but also to audit and ensure positive customer experiences.

How can CROs trust their analytics and systems are working properly and giving them the right signals and not false-flags?

Biz2X connects to core banking systems so that data flow is seamless and follows existing FI taxonomies

criticality of monitoring in the system. particularly in risk management, go through data at mean of portfolio and at edges. edge based MIS is critical. look at people with highest risk scores and the smallest lines and highest price. these are always the most likely to default, no matter how secure your standards have been. do individual case analysis (spot checking), same analysis at the other end. need to be able to see anomalies at an early stage. make sure models are transparent and explainable in English....tie to statistics and resonate with customers.

A CRO’s Priority #2: Post Decisioning Considerations and Risk Assessment Continuity

Monitoring Portfolio Performance

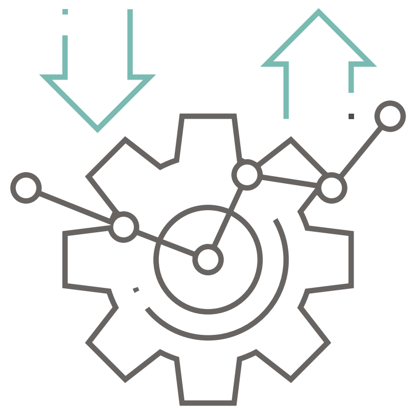
Once a loan has been approved and moved into the appropriate “silo” or portfolio categorization, is it actively monitored for its performance relative to its peers, on its own merits… or both? Post-decisioning has traditionally relied upon relative performance through passive monitoring. Modern risk management requires continuous (active) monitoring that uses sophisticated triggers and alerts that can conditionally forecast potential default scenarios.

On-going Risk Assessments

Chief Risk Officers need to build models that can reflect the ebb and flow of business conditions due to economic factors, business operations anomalies, regulatory changes and major trend shifts in the specific markets. But more than simply using a static point-in-time model, CROs should be applying models to each and every case at scale to detect when a change in the model may be warranted, or to identify when a stress-test is needed in close to real-time.

> An Early warning/Forecasting and Tracking system for probable covenant breaches and/or defaults is now a must-have, not a “nice-to-have” risk management feature.

What Good Risk Management Means to the Business Borrower



As the role of the Chief Risk Officer is evolving in the modern age, there are increasing demands on credit departments to consider the customer's experience. This requires CROs to seriously consider how good risk management helps not just the bank and investor base, but also the customer.

When speaking to former CROs, such as Ash Gupta, former CRO at American Express, it becomes clear that this needs to become a core value for leaders in risk management today:

Borrowers care about 3 things:

→ The process is quick, the decision is timely, and they can engage in the channel of their choice (if they fill out an application on mobile, they get a decision on mobile; if they fill it out online, it's online, etc.)

→ Price is reasonable: APR, size of loan, length of terms. loan fits the actual needs of business. all decisions should be framed in the context of the business's actual need, not merely in terms of creditworthiness. more empathetic to the customer.

→ Stay with them as they repay or their financial need changes. customers are willing to give you a lot of info about their business, their banking, their credit bureaus. all customers want their information to be secure and respected in terms of use of their data. show the customer that you are using the data for valuable purposes, and help them understand and improve their results.

CHAPTER 3

CHALLENGES FOR BANKS IN SMALL BUSINESS LENDING MARKETPLACE

TREND SPOTTER

Alternative Lenders are growing in number and influence. Already companies in the payments and digital lending spaces are capturing $3B in venture capital funding per year.

Topics covered under this chapter

TREND SPOTTER

THINKING CAP

TREND SPOTTER:

Alternative lenders are growing in number and influence. already companies in the payments and digital lending spaces are capturing $3b in venture capital funding per year.

Are younger (pure-digital) lending companies overtaking older, more established companies like banks?

Nimbler, more modular, more flexible companies have an advantage, advancing rapidly especially in China and India (where technology early-adoption rates tend to be highest) less so in traditional financial institutions in developed nations because credit systems have been working well, so change is slow. in the next decade, change will be big although it's initially slow now. Alternative Lenders are thinking about this. The shift to digital banking is cultural and generational. Tomorrow's entrepreneurs whose financial experience is purely digital will expect a seamless, end-to-end digital experience.

Reducing Transaction "Friction" in the borrowing process is becoming the number one demand of business borrowers, and younger lending companies are savvy to this trend. CROs should take notice of this now while there is still ample maneuvering room for their banks.

How can CROs deal with recessionsand other macro-economic trends?

CROs have the responsibility within the company of being the most responsive to the bigger economic picture. they have to think about all kinds of potentialities. how to think about a potential weakness in the economy. How to manage a company during a recession, how to prepare for recession. Not to predict a recession, but to be adaptable and have mechanisms to serve customers and work with partners properly. Learnings from a recession are forever. The goodwill you create with customers during a recession stays with you forever. Think of product design, stress test your portfolio, think through your partnerships, check your data and monitoring mechanisms. Recessions are a time to work on goodwill with customers and hunker down. Also, a good time to buy other businesses, and to collaborate with other companies as well. Don't plan for a recession DURING a recession – plan for a recession when the economy is still doing well.

What can CROs do to gain or solidify an advantage in the marketplace for their FI?

A Chief Risk Officer will be forced to re-evaluate financial institution enterprise risk as the universe of risk is redefined and expands. The advent of FinTech exposes the typical financial institution to completely new tranches of risk pools that were previously beyond the consideration of most lender's risk tolerance. The rules of the game have changed, but the basic notion of the expected outcome of risk management have remained constant. Specifically, how to mitigate risk when you, prima facia, are exposed to higher levels of potential default?

The challenge will likely be won by managing risk classes algorithmically This ultimately will require a reset of the notion of risk thresholds and enterprise risk tolerance. It could be argued that the short-term advantage will be with early adapters and first movers of the new technology.

THINKING CAP:

Some questions can only be answered by you for your business. Consider the trends that will affect your answers to these questions over the next 12-24 months, and in the long term.

→ What are the essential building blocks for creating a sustainable advantage that actually gets stronger through a downturn?

→ How do the most successful CROs think about creating/supporting their company's competitive advantage?

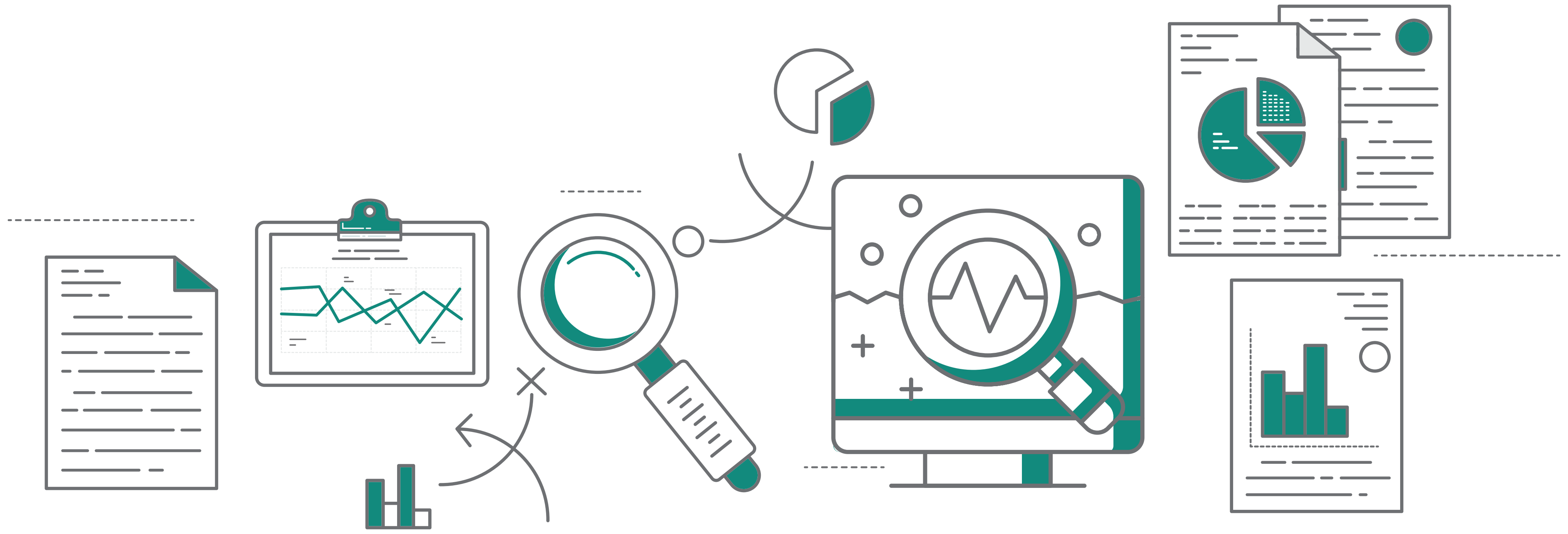
CHAPTER 4

TECHNOLOGY AND THE CHIEF RISK OFFICER

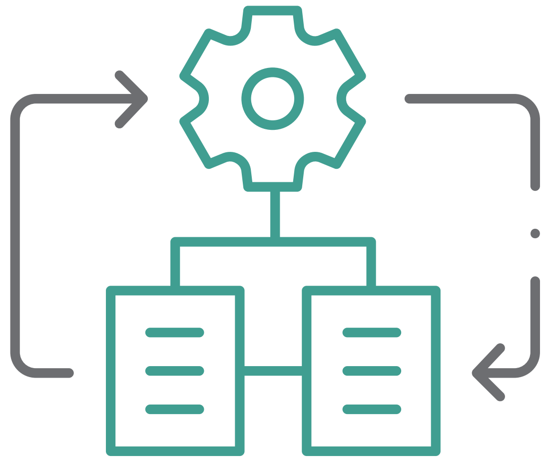
BUILD VERSUS BUY:

How Banks Meet the Future Demands Business Lending and Risk Assessment

One of the most challenging decisions facing any institution, and especially a CRO function, is the decision on what and when to outsource. Business lending is a fast-moving marketplace that is evolving at a faster pace than ever before. Time is of the essence and most institutions cannot afford to make costly mistakes or the luxury of a “do-over” in the event a strategy does not work-out as expected. Outsourcing is almost always the first (prerequisite) action before making an acquisition so it is important to get it right, the first time. FI’s face some of the biggest risk conditions in adapting and transitioning to new technologies from third parties.



Chief Risk Officers are being faced with the decision whether to automate business credit decisioning and servicing themselves; or, partner with leading FinTech Firms



Outsourcing risk assessment is difficult because it is the arguably the most sensitive point of vulnerability in any financial institution that could lead to a catastrophic failure. Not outsourcing risk when you cannot build internally runs the risk of eventually being overtaken by the competition. There are few times in the history of banking when risk managers have been forced into such binary decision-making as they are today. The choices are automate or don't automate. The stakes are very high.

Not only will banks need to adapt new technologies, but they also have business culture and new talent considerations

Building a major new technology as a traditional financial institution is almost always a no-starter. It's not because they cannot do it, it's about doing it efficiently and making it sustainable. Losing site of the core functions of your institution can result in catastrophe very quickly. There are a long list of reasons to make things in-house such as: security, confidentiality, morale-building and satisfaction. The smaller the business, the more compelling the intangible aspects of building become. But being able to build is not a good reason to do it. It comes down to focus, efficiency and sustainability.

On the other hand, it may be helpful to consider any technology partnership from the perspective of a potential acquisition. Are the staff at the company you are partnering with compatible with your business culture. It is likely that they may become employees some day.

ASH GUPTA

CHIEF RISK OFFICER

Most intelligent people want to just do it themselves. that's not practical. advice: know what you can do yourself and know what others can do. second, only collaborate with companies that share your values and processes, so you have a meeting of the minds both culturally and analytically. if you try to do everything yourself, your footprint will become very small and your ability to innovate will become very marginalized.

How do you complete a digital transformation of your lending without disrupting the well-oiled functions of the existing process?

Biz2x can be implemented in a test-and-learn manner with implementations as short as 6-8 weeks allowing for minimal disruption and faster transition - non-destructive to process

Your existing business is a well-oiled and profitable machine – you must preserve that as long as possible. the challenge is how to create second rail while the first train is still running well. someday the tracks will merge. consider:

1. Talent; want to mix new talent (who is familiar with new tech) with existing talent. 15% new, 85% existing; train and merge your teams.
2. Learn to collaborate well. test ideas, innovate quickly, learn without large upfront investments.
3. Change yourself as well. basic change in culture can lead to the most effective outcomes with digital transformations.

Gaining Transformational Consensus From Executive Management and Board members

keep board informed and spend/invest time in board themselves so board is part of the problem solving instead of just the recipient of the solution. they need to know underlying analytics, otherwise they are likely to not be totally pleased with the solution. not micromanaging! e.g., CEOs have good understanding of their customers even though other ppl are managing those customers. they have a good understanding of the products. so CEOs and boards need to have a good functioning understanding of new tech and become part of solutions.

promote more education across promote entire eco. new tech can look opaque to you – put data in machine, model comes out, nobody can follow the process. CROs need to promote transparency around decisioning logic, so it can be easily explained. decisioning logic should resonate with your own common sense and goodwill.

tech must meet regulatory requirements. not just law, but also what is good, moral, ethical in this society. new tech should not just meet but exceed these requirements.

For a detailed overview of how risk analytics and artificial intelligence tools can help you achieve higher origination volumes while improving your risk profile contact us to learn more about Biz2X and Biz2X AI add-ons from Biz2Credit

https://www.biz2x.com/

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