Five Ways the Pandemic Will Change the Trajectory of Lending Through the 2020s
Contents

Current Economic Conditions in America ................................................................. 3
Digital Lending Trajectory ......................................................................................... 5
A Shift in Consumer Loan Demand ........................................................................... 6
Emerging Trends in Business Loan Demand ............................................................ 9
The Evolution of Underwriting ................................................................................... 10
Going All-In on Experience ...................................................................................... 13
The COVID-19 pandemic is unprecedented in modern times and will change the way that we function for years, if not decades, into the future. Those of us living through the event will likely reflect on our lives in pre-pandemic and post-pandemic terms going forward. The changes caused by the events of 2020 will offer both challenges and opportunities to lenders across the country and will influence the preferences of the consumers and business owners they serve. The following pages will address five transformative ways the pandemic is likely to shape the path forward for all categories of lending. The process of lending, having already changed so much since the great recession, will now enter a new phase of evolution that could redefine borrower relationships as we have known them.

Current Economic Conditions in America

The United States entered the recession in February, ending the longest economic expansion in our history at 127 months. When studying likely impacts, it is critical to understand the nature of this economic event. This is the first recession in our history to be led by the service sector. It is also the first to be initiated by government action – the shuttering of businesses to help curve the spread of COVID-19. In many ways, this is an ongoing experiment. No one knows what happens when you shut down roughly 30% of a $20 trillion economy for eight weeks and try to restart it. That has never been done before. Today we face significant uncertainty regarding the future spread of the virus and its direct impacts on our society. While appearing to bend the initial wave of the spread, the summer months brought a reemergence of new infections as key states began to reopen. The story of COVID-19 to date can be told in three pictures fromtracktherecovery.org, a joint venture between Harvard and Brown Universities and the Bill and Melinda Gates Foundation. In this first graphic, you can see the initial wave followed by its reemergence as southern states began reopening in late May and early June.
The second graphic shows the changes in consumer spending throughout the year, using January as a baseline. When reviewing this graphic, remember that consumer spending represents more than 67% of gross domestic product (GDP) in the U.S. (At the site itself, you can also look at data for your state as well as key counties.)

This final graphic shows the changes in small business revenue over time. Notice the second drop in July, when states that had reopened began to introduce new measures to reduce the spread.

While they may just be graphs, they represent the movement of trillions of dollars in the U.S. economy, further impacting countries around the world. They also reveal an uncomfortable truth. Our economic fate is directly related to the spread (or control) of the virus, its impact on our healthcare system, and on consumer and business confidence. The graphs also point us to an eventual recovery that will be shaped by our collective response to the pandemic over the next six to 12 months, how well therapeutics can successfully resolve active cases, and if a vaccine can be introduced to prevent new ones.

Our economic fate is directly related to the spread (or control) of the virus, its impact on our healthcare system, and on consumer and business confidence.
Trends of this magnitude have long-lasting impacts on societies, and that leads us to our next discussion. While virtually all areas of life have changed throughout the world, we are focused on the field of consumer and commercial lending. How is the pandemic changing the way these financial services are delivered? How are financial institutions across the country responding to the needs of their clients? What industries and consumers are most impacted by the events to date?

**Digital Lending Trajectory**

The widespread closure of branch offices led to an immediate acceleration of digital financial service delivery. This jump was caused by the necessity to continue delivering financial services through the shutdown. While this impacted all financial services, it likely accelerated digital lending by at least five years from the trajectory it was on prior to March. That step-jump acceleration was due in part by the need for financial institutions to support CARES Act initiatives such as the Paycheck Protection Program (PPP).

During the month of April, while bank branches were closed, digital banking app installs in the U.S. increased by 60%, according to data from AppsFlyer. It is also interesting to note that 56% of respondents reported at least a 20% increase in the use of remote deposit services in March, in a survey conducted by remotedepositcapture.com. We have all heard personal stories about grandparents taking a picture of a check to make their first deposit on a mobile app, but during the shutdown, it was a reality. The real question is, will these become long-term consumer behaviors? Will consumers and business owners continue to utilize mobile banking at the same levels as branches reopen? In other words, is this a sea change moment or just a momentary shift?

![Mobile Deposit Growth during COVID Crisis](chart)

While adoption of digital lending strategies had not been as robust as other financial services during the past 10 years, it was picking up steam as we entered 2020. As of 2019, the market for digital lending platform technology...
was forecasted to reach more than $11 billion worldwide by 2025, a CAGR of more than 20%. The step-jump experienced as a result of branch shutdowns and PPP has likely accelerated the trajectory for lending. A global tech adoption study commissioned by Ernst & Young shows us how borrowing compared to other financial services at the beginning of 2020. Digital borrowing habits were rising, but still lagging other financial services.

### Comparison of FinTech categories ranked by adoption rate from 2015 to 2019

<table>
<thead>
<tr>
<th>Category</th>
<th>2015</th>
<th>2017</th>
<th>2019</th>
<th>RANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money transfer and payments</td>
<td>18%</td>
<td>50%</td>
<td>75%</td>
<td>1</td>
</tr>
<tr>
<td>Savings and investments</td>
<td>17%</td>
<td>24%</td>
<td>48%</td>
<td>2</td>
</tr>
<tr>
<td>Budgeting and financial planning</td>
<td>8%</td>
<td>20%</td>
<td>34%</td>
<td>3</td>
</tr>
<tr>
<td>Insurance</td>
<td>8%</td>
<td>10%</td>
<td>29%</td>
<td>4</td>
</tr>
<tr>
<td>Borrowing</td>
<td>6%</td>
<td>10%</td>
<td>27%</td>
<td>5</td>
</tr>
</tbody>
</table>

Notes: The figures show the average percentage of respondents who reported using one or more FinTech services in that category. Data for 2015 differs from that originally published in order to align to the 2017 categorization and averaging methodology.

We know that the path toward digital lending will continue as it did from 2010 though 2020. Whether this will be a significant and permanent step-change moment for digital lending platforms has yet to be determined. Early signs point to a significant shift in the move toward digital lending experiences for both consumers and businesses.

### A Shift in Consumer Loan Demand

Consumer loan demand was strong and growing as the economy began to shut down in mid-March. Second quarter reports are now indicating that non-mortgage loan demand has subsided while mortgage related debt has increased. Low interest rates are, as you would expect, driving mortgage loan and refinance activity upward. The same may be true for home equity lines of credit, given that people are spending significantly more time at home. A trip to your nearest Home Depot or Lowe’s will tell you all you need to know about the state of home improvement projects in America as consumers reimagine home offices, create study spaces for their kids, and more. While housing and home improvement flourish, the lending market for new autos and student loans is expected to move lower. People are just not driving as much, as evidenced by the auto insurance refunds we have seen this year. We may see a similar trend with university enrollments and student loans. While new data should be available on this soon, a recent study by Niche indicates that 20% of students may hold off on enrolling in the fall semester.
The chart below shows where consumer lending trends across loan types were headed as we entered the second quarter of this year.

### Total Debt Balance and its Composition

The bigger question for consumer lenders may be how delinquencies will evolve into the fall and winter months. From late March to early July, more than 50 million (from a total workforce of 165 million) Americans filed claims for unemployment. Currently, there are just over 17 million estimated as still unemployed. The unemployment rate itself is expected to hover around 10% through the year, as we see local economies work to get back to normal business activity. The direct economic and personal impact of the layoffs was, to a great extent, cushioned by federal stimulus via the CARES Act and the extra $600 per week in unemployment benefits. Further federal action now pending to extend a portion of those extra benefits could further strengthen the position of lower-income consumers. This event will no doubt be studied by economists and students for years to come. One thing we know for certain is that the lowest income workers in the U.S. bore the brunt of the initial shock. This is evidenced by how quickly consumer spending returned for these individuals when the stimulus checks arrived.
The two graphs below the separate spending recoveries among low- and high-income individuals. Notice that spending by low income consumers has nearly recovered to January levels.

The next graphic shows that consumer delinquencies had, for the most part, maintained level performance in recent years after reaching a peak during the 2008-2009 recession. We are expecting to see a rise in new delinquencies during the second and third quarters of this year based on the shear numbers of employees impacted by the shutdown.

Source: tracktherecovery.org

Source: New York Fed Consumer Credit Panel/Equifax
The next few months will be very revealing in terms of the trajectory of consumer spending and consumer lending within the U.S. economy. The success we have in developing vaccines and in controlling the spread of the virus in the fall and winter are also likely to influence consumer confidence moving forward.

**Emerging Trends in Business Loan Demand**

When considering business loan demand for the remainder of 2020 and 2021, it is important to remember that, of the 30 million small businesses in the U.S., 24 million are non-employer firms. The other six million range in size from one employee to 500. The graphic below shows a spike in commercial and industrial loan activity starting in March. This initial increase reflects large corporations drawing up on their existing lines just prior to the shutdown. The huge spike in April and May reflect loans funded through PPP. But what will loan demand look like after PPP and other programs have run their course?

It is very likely that the dominant loan request during the next 12 months will be either Small Business Administration (SBA) financing through the 7(a) and 504 programs or revolving lines of credit, in various forms and sizes. The initial wave of shutdowns hit the service sector harder that any other. Restaurants, hospitality, travel, personal services, and entertainment took the brunt of the initial drop in business revenues. These are all industries that lend themselves to SBA financing. At the same time, all industry sectors are dealing with the sporadic nature of business re-openings and, in many cases, re-closings when the virus increases in communities. All businesses are dealing with, to varying degrees, the fluctuation in consumer demand.
At the height of the initial wave approaching mid-April, approximately 34% of American businesses had closed their doors. Then after coming back, many had to shut down again in July, mainly in states such as Florida, Texas, Arizona, and California as the virus reemerged. That activity placed tremendous stress on small businesses, especially when PPP was only designed to cover a gap of about eight weeks. In order to reopen and stay open, businesses will need access to short-term working capital – thus the forecast of increased usage of working capital lines of credit.

The Evolution of Underwriting

Perhaps the most overlooked of the Five C’s of Credit through the years has been “conditions.” Lenders carefully evaluate collateral. Capacity and capital certainly carry top billing within the financial spreads. Character usually results in lively discussions during credit committee meetings. But “conditions” often seems to be the last consideration – until now. Now is when conditions really matter, perhaps more than any time since the great recession. From the moment that the “Ides of March” were upon us, macro-economic conditions had an immediate impact. Just consider whether you or your lending peers can ever remember a time in your career when you drafted more forbearance agreements than you did in March of 2020. Up until that time, few underwriters would have ever imagined a scenario where 34% of U.S. businesses shut their doors for more than eight weeks, and 50 million employees were furloughed or laid off.

Underwriting for both consumer and commercial loans has changed dramatically, at least for the remainder of this year. Personal and business credit scores took a back seat to more immediate measures of financial health. Historical financials may tell you something about where a small business was heading into the pandemic, but they do little to tell you how that business is weathering the storm. That takes active and constant communication. In today’s world of credit risk management, we use words like “triage” to describe portfolio management. We
actively monitor business vital signs in the form of weekly cash flow projections. The chart below from a McKinsey study attempts to show the impact of the pandemic across sectors based on the degree to which they are directly impacted by the shutdown and the financial risk they must manage in the process.

**Vulnerability of Small Businesses**

*By Sector, to Financial Risk and to the Effect of COVID-19*

Some of the primary industry sectors to watch in the months ahead include:

- Energy and supporting businesses (historically weak U.S. oil demand)
- Luxury goods and services (new auto, new technology, etc.)
- Accommodations and food service (reopening at limited capacity due to local area impacts)
- Business and consumer air travel (coming back online, demand will vary based on impacts)
- Large events (concerts, sports, trade shows, conferences, etc.)
- Personal services (coming back online at reduced capacity, subject to continued interruptions)
- Commercial real estate (stressed)
- In-store retail (stressed)
- Dental services and elective medical procedures (resuming with special measures in place)
- General tourism (subject to local area surges for the remainder of 2020)
Another method of evaluating the pandemic’s direct impacts is to review which industries received the most in PPP funding, as shown in the table below from the SBA.

### Industry by NAICS Sector

<table>
<thead>
<tr>
<th>NAICS Sector Description</th>
<th>Loan Count</th>
<th>Net Dollars</th>
<th>% of Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health Care and Social Assistance</td>
<td>508,145</td>
<td>$66,781,156,115</td>
<td>12.91%</td>
</tr>
<tr>
<td>Professional, Scientific, and Technical Services</td>
<td>641,118</td>
<td>$65,943,363,570</td>
<td>12.74%</td>
</tr>
<tr>
<td>Construction</td>
<td>468,156</td>
<td>$64,113,731,038</td>
<td>12.39%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>230,003</td>
<td>$53,696,102,072</td>
<td>10.38%</td>
</tr>
<tr>
<td>Accommodation and Food Services</td>
<td>368,311</td>
<td>$41,874,859,061</td>
<td>8.09%</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>451,441</td>
<td>$40,080,460,085</td>
<td>7.75%</td>
</tr>
<tr>
<td>Other Services (except Public Administration)</td>
<td>535,476</td>
<td>$30,876,639,581</td>
<td>5.97%</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>167,698</td>
<td>$27,506,682,339</td>
<td>5.32%</td>
</tr>
<tr>
<td>Administrative and Support and Waste Management and Remediation Services</td>
<td>241,866</td>
<td>$26,205,302,079</td>
<td>5.06%</td>
</tr>
<tr>
<td>Transportation and Warehousing</td>
<td>194,794</td>
<td>$16,913,955,937</td>
<td>3.27%</td>
</tr>
<tr>
<td>Real Estate and Rental and Leasing</td>
<td>247,091</td>
<td>$15,420,146,121</td>
<td>2.98%</td>
</tr>
<tr>
<td>Finance and Insurance</td>
<td>169,475</td>
<td>$12,000,306,409</td>
<td>2.32%</td>
</tr>
<tr>
<td>Educational Services</td>
<td>81,800</td>
<td>$11,894,209,521</td>
<td>2.30%</td>
</tr>
<tr>
<td>Unclassified Establishments</td>
<td>221,914</td>
<td>$9,833,348,981</td>
<td>1.90%</td>
</tr>
<tr>
<td>Information</td>
<td>69,358</td>
<td>$9,205,660,921</td>
<td>1.78%</td>
</tr>
<tr>
<td>Arts, Entertainment, and Recreation</td>
<td>119,310</td>
<td>$7,971,161,316</td>
<td>1.54%</td>
</tr>
<tr>
<td>Agriculture, Forestry, Fishing and Hunting</td>
<td>139,729</td>
<td>$7,876,179,303</td>
<td>1.52%</td>
</tr>
<tr>
<td>Mining</td>
<td>21,616</td>
<td>$4,469,100,815</td>
<td>0.86%</td>
</tr>
<tr>
<td>Public Administration</td>
<td>13,459</td>
<td>$1,728,736,616</td>
<td>0.33%</td>
</tr>
<tr>
<td>Management of Companies and Enterprises</td>
<td>8,937</td>
<td>$1,551,745,946</td>
<td>0.30%</td>
</tr>
<tr>
<td>Utilities</td>
<td>7,958</td>
<td>$1,474,438,348</td>
<td>0.28%</td>
</tr>
</tbody>
</table>

Approvals through 07/10/2020

Source: SBA

At least for the short term, the practice of underwriting based on historical financial performance will take a back seat to more forward-looking techniques. This will cause lenders to communicate more closely with potential borrowers as well as existing clients. The process will look more like the underwriting of a new business, similar to analysis performed for a 7(a) SBA loan when evaluating a start-up operation. In the years ahead, businesses will be evaluated based on how they performed during the pandemic. In many ways, it will be considered the ultimate stress test for the portfolio. Whether this will result in permanent changes is unknown. Perhaps this event will cause businesses and consumers to be more conservative about carrying debt and more motivated to build up emergency savings. Only time will tell, but the relationship between debtors and creditors is likely to change as a result of the events of the past several months.
Going All-In on Experience

In a recent article, *The Four Laws of Digital Design in Financial Technology*, we discussed the importance of human interactions within digital workflows. These included the experiences of both your employees and your customers as they interacted with the technology. The pandemic of 2020 has forced us into a position where, for a time, the digital path was the only path. This forced us to look at how we all consume technology. Of course, the best financial technology strengthens human interaction during the process of fulfilling transactions. It automates redundant tasks and streamlines workflows. When done right, this practice creates happier employees and satisfied customers.

The past several months have been a crisis-induced stress test for how we use technology, and more importantly, how we can improve that technology in the months and years ahead. Whether we are talking about more consumers engaging digitally with our institutions, or more employees working remotely, the bar has been raised on creating meaningful experiences.

In April of 1959, John F. Kennedy reminded us all that, “The Chinese use two brush strokes to write the word ‘crisis’. One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger – but recognize the opportunity.” The pandemic of 2020, as challenging and destructive at it has been, also presents us with a significant opportunity to reimagine our future, including the ways we interact with each other as lenders and borrowers. We now have a chance to take what we have learned and apply it to the new technologies we build and the way we communicate with our customers. In the end, our response to this crisis will be our legacy.

To learn more about Jack Henry Lending, visit [jackhenry.com/lending](http://jackhenry.com/lending) or contact us.

SOURCES:

https://covid-tracker.mckinsey.com/small-business-vulnerability