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Small Business Corner

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Blended Scores Are Better Scores

Small-Business Study Finds Role For Both Personal, Business Information

Obtaining timely, accurate information on the credit risk profile of any small business can be elusive. In the past, risk models suffered from a dearth of historical data and rules that were based more on best guesses than statistical analysis. And information that is outdated, wrong or simply not there can leave a creditor holding the bag should a small business fail.

In a recent study, Experian® analyzed credit report and other information on roughly 50,000 small businesses and, using its proprietary Business Owner Link, the owners of those same businesses. The goal was to find the best tool for predicting small-business failure. Many credit issuers still size up the potential performance and risk of small businesses with one limited measure: the owners' consumer credit information. Other small-business creditors track credit reports on the actual business to watch for signs of trouble. The study found that neither approach is optimal. The best view on judging the creditworthiness of a small business comes from a sophisticated melding of personal credit information of business owners along with credit information on the business itself.

The weakness of relying on a consumer score alone is clear in the data. The study revealed that when trouble hit the business, commercial and blended scores each dropped an average of 25 percent over four quarters. Meanwhile, business owner consumer scores showed no statistically significant decline over the same period. Those creditors relying on a consumer score alone would remain blissfully unaware that anything was amiss with that small business in their portfolio.

But solely tracking business credit is no panacea. The study found that of businesses that experienced significant credit problems, about 53 percent, revealed their first signs of credit problems through their business credit report. However, nearly half the time, 46 percent, problems showed up first on an owner's personal credit report. Moreover, very rarely, in only a fraction of 1 percent of the studied cases, problems surfaced on both commercial and personal credit fronts in the same quarter. Hence, creditors using blended information have the best early warning system for business credit problems.

BLENDED SCORES GIVE CREDITORS THE BEST OF BOTH CONSUMER AND BUSINESS INFORMATION WORLDS.

One might ask why trouble sometimes shows itself first with the owner's personal credit profile and other times on the business's credit. For owners with four or fewer employees, it appears personal and business credit activities are far more intertwined than for small businesses with five or more employees. Whether it is because these "micro-business" owners have not separated their business and personal finances enough or whether they try to save their micro-business through their personal credit resources, the result is that personal credit issues arise first more often among the owners of these smallest businesses.

Of all the small companies that showed the first signs of credit issues through consumer credit report blemishes, nearly 70 percent were micro-businesses of four or fewer employees. However, when looking at larger small businesses, those with five or more employees, the first signs of trouble consistently are shown through their business credit.

Similar to smaller businesses, younger businesses tend to show the first signs of trouble through the owners' consumer credit problems. Again, it appears the separation between personal and business credit simply is not as well defined. Plus, it is in this stage that the owners are pouring money into the business, so the strain on their personal assets is greatest.

Small businesses in operation for up to two years accounted for 30 percent of all cases where the owners' personal credit showed the first signs of trouble. Conversely, small businesses that were at least 10 years old accounted for 37 percent of the cases where the business credit report was the leading indicator. Those companies in business at least a decade accounted for just 19 percent of the cases when a personal credit report was the leading indicator. It appears that at this point the business owners are more likely to insulate their personal finances from the business.

A blended score smooths out such differences and offers a strong predictive capability whether a business is small or relatively large, new or old. The blended score produces better results because more goes into it. On the business side, it should take into account derogatory legal activity, payment history, commercial credit history and days beyond terms. It also should judge the inherent risk associated with any given business sector, how long a company has been in business, trends in business performance and the overall economy. On the consumer side, it should look at the business owner's bank accounts, revolving accounts, credit history, real-estate account balances and demographic information.

Along with robust sets of business and consumer data, it's often important to proactively link business and consumer databases. While business ownership information would be provided in the course of applying for a loan, the link between the two provides a crucial deeper look useful for targeting businesses with preapproved credit offers or other opportunities. Blended consumer and commercial information adds value throughout the credit product management cycle: targeting and building a portfolio; underwriting, setting limits and otherwise managing accounts; and

optimizing relationships with cross-selling opportunities.

The blended score helps credit managers maximize the bad accounts that are rejected while not increasing the rejection rate of accounts that actually would be good. And it can help manage riskier accounts by appropriately adjusting credit limits or repricing credit to reflect risk. Blended scores can give greater confidence in issuing lines of credit, loans or installment loans. Sometimes when a customer requests a loan, the proper response is not only an approval, but also to offer the customer a larger sum. This ability to up-sell known good credit risks can safely and inexpensively add to top-line revenue. The scores can be used for direct-mail prescreens, preselections or preapprovals. They can be refreshed regularly to stay current or according to triggers such as recorded judgments or collection threats.

In sum, blended scores give creditors the best of both consumer and business information worlds. Blended data combines the advantages of business credit scores, which are a leading indicator of credit payment issues for larger and older companies, with the advantages of consumer scores, which have a slight edge in predicting issues with the smallest and newest businesses, where the owners have not fully separated personal and business expenses. Smart creditors are taking advantage of these new blended commercial scoring tools to continually assess the health of small businesses in their portfolio, giving them an advantage in managing their portfolios. They know what a blended score means: more "good" approval rates, fewer "bad" accounts and the confidence to increase the size of credit lines and loans. It's all good. ■

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