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Not Getting Lost in the Flood

Learning the Complete Profile of Your Customers

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The United States is facing a long road to recovery. Businesses are mired in an epidemic of souring consumer confidence that has swept through and ravaged sectors from construction, to retail, to big ticket items and beyond. Optimism from small business owners and credit managers also continues to plunge as the economy struggles to regain footing on solid ground.

As the economic situation becomes more desperate, there is a greater onus placed on credit managers to ensure the financial health of their existing and potential customers, and to increase their ability to collect on accounts. Tossed on top of the heap is the overhead squeeze that is forcing credit and collection departments to reduce headcounts and take on more responsibilities. The need for more secure capital means greater pressure is also being placed on professionals to bring in more cash in shorter periods of time. All of these forces are driving an evolution in a variety of risk management and collection strategies.

In the United States, over 94% of the more than 26 million businesses are considered small businesses. Of that percentage, 67% are categorized as micro-businesses (one to four employees). It's an important distinction for credit managers because micro-businesses act more like consumers in their spending and financing habits.

"The business landscape in the U.S. is dominated by these micro-businesses, these less than five employee businesses," said Dan Meder, vice president, Marketing and Product Management, Experian Business Information Solutions during a presentation at NACM's 112th Credit Congress. "A key thing to keep in mind is that these are very informal business structures. This could be the person who mows your lawn. This could be the plumber who came by and fixed your pipes. This could be your accountant. These are people who have very, very small businesses and don't operate like a true business. In fact, many of them don't have any commercial footprint at all. So, in many cases if you tried to pull a business report, you might not find it and maybe the only credit they are using is their consumer credit."

Another key figure in the nation's business snapshot is that sole proprietorships make up 77% of American businesses, which often means the business' health has a direct tie to the financial well-being of its owner. Partnerships make up another 15% of the small business landscape.

"Why is that a significant number? Because, according to the Fair Credit Reporting Act (FRCA), if you have a partnership or a proprietorship, and you have an arm's-length credit transaction, or you have a current business in your portfolio that you are reviewing for credit limit purposes or collection purposes, you are allowed to check their consumer credit," explained Meder. "And it makes sense, because in these cases, as we all know, there is a liability the individual has for the obligations of the business."

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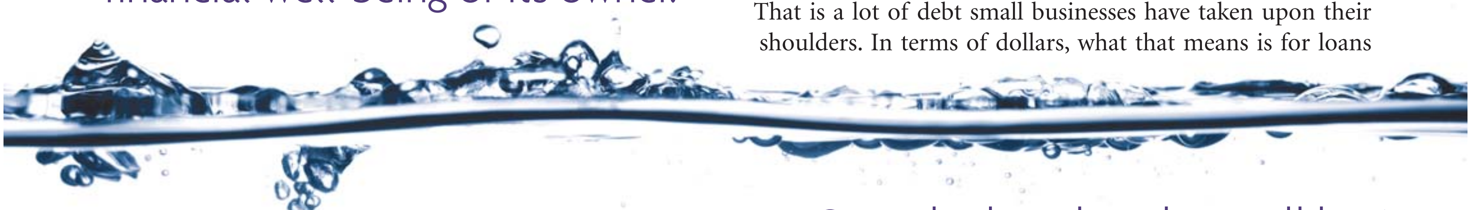

Roll of the Dice

The services and retail sectors are the two largest segments of businesses in the United States. More noteworthy is that in the service sector, 4.9 million businesses have less than five employees, while 2.2 million micro-businesses make up the retail sector. The construction and financial sectors, rounding out the four largest sectors of the U.S. economy, each has more than one million businesses that are equally small.

"If you add up the micro-businesses, you've got roughly 9 million of the 26 million small businesses that are micro-businesses in just those four segments," said Meder. "And they are highly, highly vulnerable to the condition of the economy right now."

Admittedly, overextension is the reason markets around the world are knee deep in the current quagmire. With consumer confidence tanking, consumer spending continues to dwindle to the point that the United States and Europe are facing the unwanted prospect of deflation. It's estimated that 70% of the U.S. economy is fueled by the consumer. If the consumer doesn't have money to spend or isn't willing to spend, small businesses are on the frontline of those who suffer most. Credit managers are likely already seeing the rollover effect of this trend among their customers.

"We're hearing all the time about the big names suffering," said Meder. "Imagine how the little guys are suffering as well. It's a scary time for them."

Primarily, small businesses are financed by the owner's savings. Oftentimes, when the owner runs out of money, they turn to their neighbor, siblings or parents, or they'll go to another business associate to secure funds. But, over the last decade, small business financing has become a booming industry of its own, with government entities like the Small Business Administration (SBA) approving loans at record volumes for five years straight. Between 2001 and 2007, small business loan volume grew at an annual rate of approximately 14.5%.

"Small business has become very big business for banks and financial services companies and that's something to keep an eye on, because that is potentially a big issue as well," said Meder. "We talked about how many there are. We talked about how vulnerable they are. Then you look at how much debt is out there now. There are 26 million loans outstanding that are $100,000 or less. There are two million loans outstanding of $100,000 to $1 million. Those are a lot of loans. That is a lot of debt sitting out there."

That is a lot of debt small businesses have taken upon their shoulders. In terms of dollars, what that means is for loans

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under $100,000—which tend to be for those very small businesses—that equals $165 billion outstanding. For loans between $100,000 and $1 million, it's a staggering $622 billion outstanding. Since the start of the new millennium, loans to small businesses have ramped up from a total of $460.4 billion to $788.5 billion in 2007. With the country facing uncertainty over how lengthy and severe the current recession will be, that's plenty reason to feel uncomfortable.

"That's kind of a scary number," admitted Meder. "We talked about a mortgage bubble and when you start to look at some of those numbers you start to feel that there may be a similar thing going on in the small business area. There's reason to believe that there's a small business bubble forming as well, again in a highly vulnerable market."

In 2008, small business loans guaranteed by the agency declined 30% from the high-water mark set in 2007, while the total dollar amount for loans granted fell 13%.

On the trend side, seven years ago, small business credit cards were not a considerable factor in terms of contribution to the total spending of small businesses, hovering around 45%. Tower Group did a report for Experian that forecasts that through 2009, small business credit cards are going to represent up to 71% of a small business' spending, approaching nearly $400 billion.

For those businesses that have sales of less than $1 million, they often rely on owner financing. Only 32% of those businesses use a credit line. On the other side, 56% are using a credit card, and that doesn't necessarily mean a small business credit card; it can be a personal credit card as well. Credit managers have probably noticed a desire among their customers to pay with a credit card over the last year, even from their larger accounts.

Waiting on a Sunny Day

The evidence from the banking industry over the last several quarters shows unadulterated growing unease. Lending standards have continued to get tighter and tighter, despite the government's infusions of cash. As the economy struggles and job losses mount, banks and financial institutions continue to post eye-popping quarterly losses and consumer spending dries up, businesses are forced to tackle the issues of cash flow and securing funding, or go belly up. Unfortunately, business bankruptcy filings increased 49% between 2007 and 2008, further souring any appetite for lending.

Small businesses are perfectly aware that banks are putting a stranglehold on their lending standards. The United States has entered an era where cash is king, and banks are sitting on as much of theirs as they can. Demand for new loans has dropped 18.3% and many credit professionals have witnessed new applications decline as well. Even the SBA's loan program was hit hard by tighter credit standards and growing uncertainty about the future of the economy. In 2008, small business loans guaranteed by the agency declined 30% from the high-water mark set in 2007, while the total dollar amount for loans granted fell 13%.

"With that much pessimism, with that inability to get additional funding, there's also small businesses not wanting to go after additional funding because they're not sure they can repay it," said Meder. "As small businesses suffer and the banks pull back, you're often being asked to perform a lot of the functions of the bank. A lot of your clients are relying on you."

For many credit departments, the tables have turned. A few years ago, credit managers had to approach banks for loan information on potential customers. Now, the opposite is taking place as banks are turning to trade creditors and trying to extract information on loans that borrowers have outstanding, trying to cull information on payment history, possible new contracts and any other business information that might be useful.

"They're using you as their bank because they can't get credit; they can't get any more money and they have to get funding from somewhere. If their cash flow dries up, they're out of business," said Meder. "It's giving you an opportunity to form a stronger bond with those clients that you want to form that bond with. We are going to get out of this someday, and maybe you're going to be better for it if you pick your spots the right way."

There's a lot of due diligence placed on the shoulders of creditors, and they in turn are hit with the unsavory truth that customers are looking for ways to slow payments or to extend terms, which only adds headaches to collection efforts later. The daunting reality of micro-businesses is that the majority fail within two years and nearly three-quarters have been in business less than five years. With 92% having revenues less than $1 million per year and a little more than half being home-based, these businesses, as stated earlier, practically have no commercial footprint. Any information that exists on them is often only going to be found on the owner's consumer credit report.

Added to the likelihood of consumer credit card use is the variety of incentives credit card companies give on purchases. The reality could be that smaller business owners are going to use these consumer cards to get rewards which could ultimately be paying for their vacation. For information on business credit cards, there are bureaus to which credit managers can turn.

Your Own Worst Enemy

As mentioned earlier, the fact that more than three-quarters of the small businesses in the United States are sole proprietorships is of importance to credit grantors. Personal liability doesn't exist in a corporation, but it does exist in a proprietorship and the partnership world, meaning it is acceptable to check the business owner's consumer credit. Whenever possible, Meder recommends that credit managers get a signature that authorizes them to pull a consumer credit report. As always, since these are personal and legal issues, professionals want to address them in detail with their legal department to make sure they have permissible purpose to check the owner's credit.

"There is never a problem, and no one will question it if you've got the written authorization from the individual," said Clarke Brinckerhoff with the Federal Trade Commission. "That's what any lawyer should recommend to their clients to be certain that there is no FCRA problem in any situation. Get the consumer—the individual—to consent, and you've got it made." He added, "That's the safest thing to do. That's what I would do."

During the uncertainty and rising bankruptcy rates expected over the next several quarters, companies will continue to need to scrutinize their customers and prospects carefully.

Under the FCRA, it is acceptable to use consumer credit data in a commercial transaction only when the individual involved is the sole proprietor, general partner in a partnership that is the account debtor, the individual who signed a personal guaranty on the subject debt, or the individual who provided a written authorization specifically approving the review of his or her personal credit history. Using these guidelines, managers can freely use a consumer credit report to base decisions on:

- Extending a commercial line of credit
- Reviewing an existing commercial account
- Collecting on an existing commercial account

"Federal regulators view it as permissible purpose when the individual is on the hook, has guaranteed or signed individually for the loan," explained Brinckerhoff. "The theory is that it amounts to the extension of individual credit—which is consumer credit—which gives you permissible purpose, but, to my knowledge, no court has ruled one way or the other on that view."

Meder stressed, "If they don't want to personally guarantee the loan, then you have no recourse to look at the owner's personal information."

Violations of the FCRA come with considerable fines. Under sections 616 and 617 of the FCRA, any actual damages sustained by the consumer as a result of noncompliance, either willfully or through negligence, will not be less than $100 or more than $1,000. Violators also have to pay any punitive damages that the court allows, as well as reasonable attorney's fees.

"That statute has a private right of action for both negligent and willful noncompliance with substantial penalties," said Brinckerhoff. "The basic point is that people can be sued for damages if you violate the statute. If you get somebody's credit report without a permissible purpose, and the court says you are guilty, you're going to have to pay the plaintiff damages."

During the uncertainty and rising bankruptcy rates expected over the next several quarters, companies will continue to need to scrutinize their customers and prospects carefully. Credit managers will also need to be aware of their credit concentration, and where the majority of their risk lies. Consumer credit reports can provide powerful insight about a business owner and can assist greatly in a credit decision, particularly if the individual owns multiple businesses.

"It gives you a holistic picture and not just what you get on a credit application," said Meder. "You can see the whole big picture of who this owner is. You can not only see how he is as an individual, or how he is with just that one business, you can also take a look at how he is with other businesses as well. It just makes for a better credit decision overall."

He added, "The best way to do it is to look at the two side by side and see if there is an overall shift in the debt or if there is an actual reduction in the debt and try to pull from both sources."

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