Consumer versus commercial scores
A blend of both is best for small business

Deciding whether to extend credit to a small business has long been more art than science. Small-business lending historically has been a process built on relationships, judgment calls — and luck.

Today days, evaluating a small business's creditworthiness is becoming less of a guessing game with credit scores.

"Small business information is generally quite opaque and often difficult to assess," a recent Small Business Administration (SBA) study noted. However, the study indicated, "small business lending is in a state of transition in which credit scoring plays a part. Credit scoring is one of several … innovations changing the lending landscape for small business loans."

As the credit landscape changes, determining which data should drive credit decisions is a matter of considerable disagreement. After further analysis, however, the only surprise is that there's any debate at all.

To some the key factor is to look at the owner or owners of a small business. If the owner's personal credit is strong, the logic goes, then the small business is likely strong as well.

Others disagree, believing that if you are evaluating the creditworthiness of a business, you need to check the data — however scant — on that business.

A third position — and I would argue the right position, as supported by data — is that the best view of a small business can be achieved by a sophisticated blending of both consumer and commercial data.

Before looking at the power of blended data, let's examine the arguments for exclusively using consumer data on owners and exclusively using commercial data to assess a small business.

Advocates of relying solely on consumer data might point out that small-business owners often look and act like consumers. Nearly half — 46 percent — of small businesses use personal payment cards. Many small businesses fail

to separate business and personal expenses, according to research conducted by MasterCard.™

Indeed, an analysis of Experian's internal databases shows that there is a positive correlation between the creditworthiness of the business and the business owner.

Many banks currently use consumer data exclusively when evaluating the creditworthiness of small businesses, according to the SBA study published in November. (The study, "A Survey Based Assessment of Financial Institution Use of Credit Scoring for Small Business Lending," may be found at www.sba.gov/advo/research/rs283tot.pdf.)

The SBA found that larger, more urban banks with greater technological sophistication were more likely to use credit scores. Among banks that use credit scores to help evaluate small-business loans, by more than a 4-1 ratio they use the credit score of the owner as the key credit metric — not business credit scores.

On the other side, there's a common view — driven possibly by mere force of habit — that only information on the business is needed to make a commercial credit decision.

But risk managers who choose one option or the other rather than blending business and business owner information may be left with a blind spot. They may wonder:

• Are the small-business owners I am dealing with relying solely on their personal credit to finance their business or are they also using business credit?

• Will business owners allow their personal credit to suffer before letting the business go under?

• How do you assess risk on a relatively new business with limited commercial credit information?

The weakness of relying on consumer data alone was shown in a recent Experian study. Experian® analyzed payment history and other credit-related information on roughly 50,000

small businesses and, using its proprietary Business Owner Link, analyzed personal credit information on the owners of those same businesses. The goal was to determine which credit information provides the best indicator in determining the creditworthiness of a small business.

The study revealed that when trouble hit the business, blended scores each dropped an average of 30 percent over the four quarters leading up to the "bad" event. Meanwhile, business owner consumer scores showed no statistically significant decline over the same period. Those creditors relying on a consumer score alone would remain unaware that anything was amiss with that small business in their portfolio.

The key reason is that, unlike consumer scores, blended scores are designed to predict business performance. The consumer score utilizes personal information to predict consumer performance. On the other hand, the blended score evaluates the personal information on the owner as it relates to business performance.

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 — did problems surface 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.

Reasons vary for why trouble sometimes shows itself first with the owner's personal credit profile and other times on the company's credit.

For owners with four or fewer employees, personal and business credit activities are far more intertwined than for small businesses with five or more employees. Microbusiness owners often have not separated their business and personal finances. They may be willing to try saving their business with personal credit resources. Whatever the case, the data shows that personal credit issues surface among microbusiness owners first.

Of the small companies that showed the first signs of credit issues through consumer credit report blemishes, nearly 70 percent were microbusinesses with four or fewer employees.

In slightly larger small businesses — those with five or more employees — the first signs of trouble consistently show up first through business credit.

Much the same as with 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 is not as well-defined. Also, at this stage owners pour money into their business, so the strain on personal assets is high.

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.

Using a blend of consumer and commercial information smoothes out such differences and offers increased predictive power whether a business is small or large, new or old.

When blended scores are validated by looking at the scores of a portfolio of businesses 12 months ago and checking to see how they actually performed, the benefits are clear. Across portfolios, blended scores typically outperform commercial-only and consumer-only scores by 10 percent to 20 percent.

That allows a risk manager to do one of two good things: increase approvals without increasing losses or keep approval rates the same and reduce losses.

Blended scores produce better results because more goes into them. On the business side, they should take into account derogatory legal activity, payment history, commercial credit history and days beyond terms. They 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, blended scores should be tied to the business owner's bank accounts, revolving accounts, credit history, real-estate account balances and demographic information.

A key consideration to a risk manager considering the use of both commercial and consumer data is whether the data truly is blended. It's better to pull data from a single source rather than simply looking at two databases side by side.

Syncing specific owners with specific businesses on a large scale can be a formidable IT challenge. It is a job best done with sophisticated search tools to accurately knit together disparate sources of information.

Leading-edge information providers are investing heavily in technology to expand their ability to deliver the right results. For example, top-drawer systems continuously "learn" variations of business identities to deliver accurate matches. The more data a system receives, the more the system learns about a record. By constantly triangulating data, the system can discard typos or other bad information and zero in on the best view.

It is critical that information providers deliver a persistent identifier to track a business over time. By assigning a number to each operating location of a business that will never be expire or that never will be reassigned to another business, records may be accurately matched and tracked over time.

Depth of coverage is another important consideration. The more robust the business and consumer data, the higher the hit rate and the more accurate the score. This is especially true for new small businesses where the commercial file is likely to be very thin.

Credit providers can expect to see a higher "hit" rate because in those instances where commercial credit is not available, the business owner data may still be scored. Why is this better than a consumer score? Because the owner's information is evaluated as it relates to business performance. Therefore, you receive a score more targeted to your needs.

The idea behind blended data is simple. The more information you feed into a model, the more predictive it will be. Blended data gives creditors the best of both "consumer and business information" information worlds.

For risk managers, a blended score means more "good" approval rates, fewer "bad" accounts and the confidence to increase the size of credit lines and loans.

For small businesses, there's a benefit to smart credit decision making as well. By helping eliminate "subjective, and sometimes prejudicial, aspects of lending," credit scores may actually increase the availability of credit, according to the SBA's study on small-business credit scoring. "Rather than limiting the availability of credit, credit scoring appears to encourage lending to small businesses by providing banks with a quantifiable measure of risk."

In other words, high-quality scores allow small-business creditors to do their job: lend goods or money to qualified, value-generating businesses.