Article

Author

Ed Oetinger
Director of Product Management

Contact Us

Americas
+1.212.553.1653

Europe
+44.20.7772.5454

Asia-Pacific
+852.3551.3077

Japan
+81.3.5408.4100

Making Smarter Small Business Lending Decisions

Introduction

There are over 28 million small businesses in the United States. The need to fund these businesses has grown measurably in the last decade. According to the Federal Deposit Insurance Corporation and the National Credit Union Administration, approximately $750 billion in loans are extended to small and medium-sized firms (SMEs) each year. One of the fastest-growing loan segments is between $250,000 and $1 million, for businesses seeking to secure facilities (for example, lines of credit or term loans).

Given that small businesses are a critical driver of the overall economy, it is no wonder that lenders and underwriters strive to make each credit decision correctly. At Moody's Analytics, we are using our credit analytics expertise to set the standard for risk assessment of small businesses by lenders, underwriters, and credit analysts.

The history of small business lending

When we reflect on lending to a small business, we think of a decision-making continuum – from relationship-based lending on one end to quantitative or financial model-driven lending on the other. How lenders assess a small business' ability to service a loan has evolved over time and will continue to evolve as credit cycles impact the lending environment.

In the past, when lending to a small business owner, the lender often used qualitative, relationship-based components such as personal knowledge of the owner and their reputation in the local community, or length of management experience in a particular industry. Community banks and credit unions were, and sometimes still are, comfortable making lending decisions based on the business owner's personal credit score. For years, this was one of the few sources of reliable and quantifiable data, and it continues to be used for business loans up to a modest size. While there could be a high correlation between the owner's personal credit score and the financial strength and payment reliability of their business, that is not a universal assumption.

Using the financials of a business is now a best practice. Historically, doing so was not always feasible because small business owners did not always have updated and reliable financial statements. There was a persistent question about the reliability of personally supplied, unaudited financial statements of the business. A business tax return was used as proxy, but information could vary depending on the business entity. Also, the timeliness of a tax return and the reported financial position was not always useful to lenders.

Using personal credit as a primary decision criteria should not be best practice for any commercial lender in today's market. Evaluating the financial strength of a business entity, based on numerous other data points and sources, is the best way to make strong credit decisions.

The evolution of small business lending

Today, with more available data, software automation, and new credit analytics, the credit decisioning process can be more targeted, in turn supporting the overall profitability of small business loans. Modern accounting systems such as QuickBooks and Xero can produce daily financial positions and cash flows which can be readily accessed via modern application programming interfaces. Regularly updated financial statement data gives underwriters a source to assess the risk and ability of a business to make loan payments through ratio analysis, and with less friction around receiving the data.

Lenders can now use a combination of data sources available on a smaller borrower quickly and efficiently. Examining firmographic information, such as a business' geographic location and the sector in which it operates, allows us to determine and apply average loan defaults for a given business. Other useful sources of information on credit worthiness include tradeline data – how a small business addresses their trade account payables, or if they have any loans or debt – and the behavioral data of how they have paid against those debts over time. For a small business with total revenue of less than $10 million, we have validated that merging these data components enables the lender to be highly predictive in making a credit decision.

Today, detailed and high-quality business financial data can be readily obtained. In the past, if a business owner came to a lender seeking a loan, the process of collecting all the required information was cumbersome and time consuming. If a piece was missing, there was a lag in processing the loan, often resulting in significant wasted time and impacting the overall customer relationship. Unfortunately, many institutions are still using this cumbersome process. However, the technology exists for the modern loan origination system itself to collect the data directly from the tools the business owner already uses, yielding more efficiency and less wasted time. Lenders can also source data from other banks and credit bureaus.

Through different research studies, Moody's Analytics has come to understand the power of combining data and analytics to make more predictive small business lending decisions. Working with our research and product teams and our external data partners, we have studied different data attributes of small businesses and determined which are the most powerful, and ultimately most predictive of future credit success.

We are mindful that lenders do not always get all the information they would like from a business. Therefore, many of our investigations are centered on how to make strong decisions with limited information. Even with incomplete information, lenders can still determine a meaningful business credit risk score using Probability of Default (PD) modeling on a small business. For instance, you can score a business with only financial statements or business tax returns. However, that score becomes more accurate when more information is used, as depicted in the accompanying graphic.

Small Business Credit Decision – Predictive Power

GOOD SCORE	BETTER SCORE	BEST SCORE
Firmographic* + Tradeline Information	Firmographic + Tradeline Information + Financial Statement Information	Firmographic + Tradeline Information + Financial Statement Information + Loan Behavioral Data
Firmographic is the financial size, industry, and geographic characteristics of the small business.	Tradeline information is the accounts payable of a small business, such as supplier or utility bill. This data is typically obtained from a bureau or data provider.	Loan Behavior Information is the history of loan payments. In the case of a credit line, it also includes things like how much of the line was used.

The next frontier in credit data

There is another emerging source of data that we have been exploring for use in credit decisioning: “alternative” or social data. Social media platforms contain an immense amount of data on businesses, such as what locations or businesses have been visited, where and when those visits occurred, and personal reviews. Examining alternative data on an aggregate basis can offer another meaningful source to help lenders assess or determine a company’s ability to succeed and to pay back their loan.

We are currently evaluating the predictive outcome of these alternative datasets as they are applied to various stages of the credit process. While the results are preliminary, it is our view that as alternative data matures, it will be yet another source of data which lenders or underwriters should include, when available, to increase their predictive ability to score a small business.

Conclusion

Lenders and credit analysts have been challenged in recent years to make credit decisions quicker and more cost-effective. This pressure has increased given recent competition from growing and maturing fintech lending platforms. While it can be difficult to obtain data on a small business, we believe that our findings demonstrate a scoring approach that supports small business lenders and the efficient use of data sources that are readily available. Even with limited information, lenders can still determine a meaningful business credit risk score using flexible framework for a small business. Through the combination of financial statements with firmographic, tradeline and loan behavioral data, predicting a business’ ability to pay becomes highly accurate. This methodology allows small business lending portfolios to be well-balanced and profitable for their institutions. Ultimately, we view this scoring framework as a key part of streamlining small business lending overall addressing data collection, risk assessment, origination, and monitoring.

CONTACT DETAILS

Visit us at **moodysanalytics.com** or contact us at a location below.

AMERICAS
+1.212.553.1653
clientservices@moodys.com

EMEA
+44.20.7772.5454
clientservices.emea@moodys.com

ASIA (EXCLUDING JAPAN)
+852.3551.3077
clientservices.asia@moodys.com

JAPAN
+81.3.5408.4100
clientservices.japan@moodys.com

SP52620