

WHITEPAPER

Author

Helene Page
Banking Engagement Advisor,
Moody's Analytics

Contact Us

Americas	+1.212.553.1653
Europe	+44.20.7772.5454
Asia-Pacific	+852.3551.3077
Japan	+81.3.5408.4100

Seven key challenges in assessing SME credit risk

Assessing the credit risk of small and medium size enterprises (SMEs) is one of the most challenging tasks in banking. The difficulties stem from fragmented financial data, the strength of risk models, length of the process, and broader issues such as the tension between sales and credit. The competitive lending environment, regulatory requirements, different geographies, and positions in the economic and credit cycles also have an impact. This paper discusses how these challenges might be addressed from a Moody's Analytics perspective, which has been developed over time with our extensive experience in assessing credit risk.

What's in a Name?

What do we mean by an SME? The definition varies depending on the market and who is making the definition. SMEs encompass a broad range of company shapes and sizes, and other variants such as the industry within which the company operates. Nevertheless, there are some common factors, such as:

- » Private ownership
- » Less than \$50 million in revenue and fewer than 250 employees
- » Higher default rates than larger enterprises, although medium size enterprises have been cited as an exception, having lower default rates compared with both small and large enterprises.

These three factors drive a host of other shared characteristics, including the ability to take a longer term view on business and investment plans, inconsistency in the quality of financial information, and reliance on key individuals who are also likely to be owners.

SMEs play an important role as the backbone of economies in most regions of the world. This role is by virtue of employing large numbers of people and their significant contributions to gross domestic product. However, many lenders still struggle to come up with an efficient model to assess the creditworthiness of SMEs. This is an issue because the success of these small but vital enterprises depends on them being adequately funded. Fortunately, modern technology offers an effective solution to these underwriting challenges.

Seven Key Challenges

There are seven key challenges related to assessing credit risk, including challenges stemming from the wider business infrastructure. While alternative lenders seek to differentiate themselves from traditional lenders through business models which have a strong technology focus, both sets of lenders share some basic challenges when it comes to credit risk assessment:

1. Financial information – level of detail, reliability, timeliness
2. Difficulty predicting future cash flow
3. Accuracy or relevancy of rating models
4. Process efficiency and system infrastructure
5. Data, reporting, and audit requirements
6. Problem loan management
7. Business model sustainability

Meeting the Challenges

1. **Financial information.** A common complaint, especially of credit executives, is that SME financial information does not provide sufficient detail to understand the drivers of the business. Examples include:
 - » How sales break down by product, geography, or line of business
 - » Performance compared with budget
 - » The absence of any cash flow statement.

Borrowers often argue that the information they produce is sufficient for them to run their business successfully, and that they do not have sufficient resources to produce bespoke financial information. However, the banks providing funding are not versed in the business and need more explicit information.

If a good relationship exists and the request is reasonable, borrowers are usually open to amending the information they provide. Moreover, technological advances can address some of these challenges, as many providers offer the ability to link a borrower's financial accounting software directly with the bank's records. This automated delivery of financial data from borrower to lender can help resolve the resource, detail, and timeliness issues.

2. **Predicting cash flow.** Before cash flow can be predicted, it must be derived from either historical or forecast income and balance sheet statements. After data has been extracted, it is not an unduly difficult task using a financial analysis package. However, understanding the expected trend of the borrower's business, and ensuring that the characteristics of any new capital structure are included in forecast cash flow modeling, can only be undertaken with appropriate information from the borrower.
3. **Rating models.** Models are only as good as the quality and richness of the data that drives them. It is therefore important to have a proven and valid benchmark – reliable market information from historical SME company default data. Thus, a database of historical financial statements and default rates on a global scale and of substantial size is required. For example, Moody's Analytics RiskCalc is the largest database of private company financial information and default rates in the world. It feeds into models based on ratios which have been proven to be highly predictive of default, and which therefore provide an effective early warning against credit deterioration.

4. Process efficiency and infrastructure. The key issue here is the time it takes for a lender to process a loan application and disburse funds, commonly known as “time to cash.” Many factors can impede the time to cash:

- » Market environment (after the global financial crisis banks' approval processes slowed markedly)
- » Quality of decision makers
- » System infrastructure

Where the process is too manual and there are too many systems and where data is duplicated, this inefficiency can cause slower response times. While installed systems and hardened data siloes can make streamlining lending processes challenging, new outsourced or cloud platforms offer an attractive alternative since they require no new hardware, no additional IT staff, and are automatically updated and backed up. These advanced SaaS systems, such as Moody's Analytics Lending Cloud, provide a single, integrated solution for managing the entire credit lifecycle.

5. Data, reporting, and audit. The ability to extract meaningful data to understand key performance indicators and for audit requirements depends on several things. First, a focus on exactly what data is the most meaningful is required. Next, a data structure or system that captures the right data in a user-friendly way is essential. And finally, strict discipline and well-defined processes are necessary to ensure that the data is accurately captured and maintained.

6. Problem loan management. Lenders who have effective processes for the early detection of distressed loans are most likely to minimize losses. Bankers should:

- » Build good relationships with borrowers
- » Have early warning triggers such as covenants in place
- » Have a specialist team – initially on a monitoring basis, but if necessary scaling up to partial or full management of distressed credits.

7. Business model sustainability. Alignment between the market strategy of the business and sectors that have sufficiently strong creditworthiness is important to mitigate against losses when a particular sector starts to underperform. In addition to alignment with strong sectors, fundamentals such as making sure that the overall business strategy is viable in an increasingly competitive marketplace go without saying. But there are two more factors that come into play:

- » Weak financial performance can lead to pressure to take greater risks and go beyond established risk parameters
- » Many lenders do not fully understand the profitability of the deals they are underwriting

A strong risk culture, with low tolerance for behavior outside acceptable risk parameters, is essential to address the first point. To address the second point, robust models that feed into appropriate deal-pricing tools are necessary.

Keys to Success

SME risk assessment is a multi-faceted process with many challenges. Key to success in addressing these challenges are processes that enhance the analysis of quantitative and qualitative data, the quality of decision making, and the relationships between borrowers and lenders. To learn more about our perspectives in this area, feel free to contact us.

© 2016 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody's.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."