Converting information to intelligence
Current trends in mitigating small-business risk through analytics
Executive summary
Although general economic conditions appear to be improving, small businesses that have survived the Great Recession have been hesitant to borrow as they are still riding out the residual effects of the economic downturn. Regulatory concerns, high unemployment and the volatility of current economic conditions have made it challenging for risk managers to acquire well qualified small business accounts. At the same time, risk managers face growing pressure to bolster profits while dealing with leaner budgets and staff. Fortunately, today, small-business portfolio managers can cost-effectively tap new data sources and more sophisticated analytic techniques to effectively identify risks and opportunities within their portfolios, while satisfying skeptical regulators. This white paper presents some of the trends affecting the small-business lending landscape. Specifically, it illuminates how companies are using more granular data sources and analytics — from consortium data to rapid model customization — to maximize their interactions with small-business customers and drive improved profitability.

While not out of the woods yet, portfolio managers who oversee small-business loan portfolios are seeing signs that the economic picture is improving. However, they still confront major challenges that may inhibit a full return to the better days enjoyed in the middle of the past decade. Risk managers of small business portfolios are facing increasing regulatory pressures and limited opportunities for growth in the lower risk segments of their portfolios as many small business owners are hesitant to borrow in the face of their own lingering economic and regulatory uncertainties.

This has triggered a very competitive environment as portfolio managers find that they must work harder to generate more borrowing and new-account activations from the best qualified small-business prospects. In addition, a segment of small businesses have emerged with longer-term, structural issues with their balance sheets. These businesses made it through the past few years by tapping into revolving lines without repaying principal over that time period, so debt-restructuring needs are increasing. This puts greater pressure on portfolio managers to identify and act on any emerging risks associated with these restructurings.

Portfolio managers also don’t want to repeat old mistakes. Previously, when times were good, they merely followed their traditional lending model. However, the risks that portfolio managers now face require a new way of looking at risk management, as traditional methods may no longer provide the insight that they need.

Portfolio managers must strike a balance between lessons learned from the unprecedented number of bad loans they saw during the Great Recession and the natural tendency to become gun-shy because of those negative experiences. The bad experiences resulting from the recent economic downturn can keep them from making new loans or can cause them to overestimate their future losses. This highlights the need for ongoing stress testing of their assumptions and expectations.
A growing number of small-business risk managers are taking a fresh look at their portfolios. New nontraditional data sources and advanced analytic techniques are helping them do just that. These tools couldn’t have emerged at a better time for portfolio managers who confront growing pressures to improve profits with limited budget and staff resources.

**Enter new data and analytic tools**

New tools and techniques are evolving that allow small-business portfolio managers to employ several fresh approaches. For instance, risk managers are increasingly using blended models that combine commercial and consumer credit data to better judge a small business’s financial strength. Further, they can employ nontraditional data sources — in concert with more granular views of traditional commercial and consumer information — to increase their ability to more accurately assess a small business’s creditworthiness. They don’t want someone, particularly a regulator, asking, “Why did you approve this customer who only had stated income of $25,000?” They need to be able to demonstrate consistently applied methodologies that confirm thoroughness in their decision making.

Small-business lenders also are leveraging their own customer data, enabling them to generate a full relationship picture providing a broader, timelier view of assets and liabilities across multiple products. When used by an internal analytic team to develop more robust custom scores, the combination of internally generated data with third-party-verified credit reporting agency data can yield strong results. However, cost considerations and lack of internal analytic resources may prevent some organizations from implementing this type of customization. Fortunately, technologies are evolving to meet the challenges of the new economy, including analytic platforms that enable rapid score optimization for a specific portfolio more quickly and cost-effectively. Experian® professionals say that within the past year, unlike any other period within the past five years, small-business portfolio managers are more interested in building customized models optimized for their specific portfolios. This enables credit risk managers to more effectively identify risk when acquiring new accounts and to more proactively manage their existing account base at a fraction of the cost of a full custom model build.

These optimized scores can also be incorporated into portfolio benchmarking reports to enhance credit strategies and reserve calculations. Risk managers are counting on the new tools to help them find the balance between increased approval rates and bottom-line portfolio performance, especially as federal regulators are taking a tougher stance with regard to the credit industry.

The challenge of better managing and growing their existing accounts while identifying ways to profitably woo new customers can be daunting. Advanced analytic techniques can improve performance in mining the existing small-business portfolio for opportunities to up-sell or cross-sell new products. For instance, a lender may want to cross-sell an existing demand deposit customer into a more profitable alternative, such as a small-business credit card. Applying the appropriate analytics can identify customers in the portfolio that are best suited, from a risk and utilization perspective, as targets for up-sell/cross-sell.
Discarding the old model, building the new
Building new, more predictive models has become a necessity in the post recession economy. Analytics serve as the catalyst for small-business lenders to compete more effectively. And it’s not just financial institutions that are employing the latest advanced analytics:

- Web-based book and media sites use sophisticated analytics to better understand each of their customers through their site-related searches and purchases
- Casinos employ predictive modeling techniques to mine for associations and classifications among their guests
- Hospitals use analytics to identify characteristics of the patients who will drive the majority of future claims

Accessing new, nontraditional data and analytic tools will require some initial investment but can deliver a significant return in predicting outcomes. Indeed, the use of analytics to discover hidden risks, identify market opportunities and prove a portfolio’s health for regulatory audits has become a required element of risk management programs. By leveraging these new data sets and tools, tech-savvy managers can harness the power of analytics, enabling them to improve their interactions with individual customers. They will also strengthen their chances of winning competitively.

Data consortia are making a difference
Experian plays a part in many data consortia, membership-driven confederations of companies that share their data with one another to gain greater insights into fraud and credit risks associated with their customers. Members may share, for example, expanded payment-performance data on lines of credit, credit cards, loans and leases. Consortium data sources give additional insights that a customer’s data alone may not provide.

These data sources give portfolio managers many attributes to consider when analyzing a loan applicant or an existing portfolio including hundreds of commercial credit reporting agency and consortium attributes, as well as hundreds of consumer attributes. These granular attributes provide highly predictive scores that identify riskier prospects and accounts enabling portfolio managers to more effectively match customers with more profitable terms.
Experian’s technology takes off
Building a new model is only half the battle. You still need to deliver the results in real time. As a way to quickly and efficiently deliver a highly predictive loan decision, Experian has developed a Web-based online service that provides optimized scores. Organizations derive great value from this service, as portfolio managers often operate with very lean teams that must leverage new tools to get their job done.

Experian launched optimized risk scores during the recession and market acceptance is now accelerating as portfolio managers turn their attention from bad debt and reserve planning to organic portfolio growth and new customers. By employing these new tools, portfolio managers can realize a predictive lift over traditional commercial credit risk scores.

Optimized risk scores deliver highly predictive results for nonfinancial portfolios as well. For example, Experian recently worked on a project to optimize score usage for a major utility company. In regulated markets, utility companies are interested in optimizing their deposit policy, so understanding the risk associated with a small business is critical in capturing adequate deposit reserves for high-risk accounts while ensuring that good accounts are not overly burdened. In unregulated markets, utility companies are interested in evaluating the risk associated with prospects and customers to fine-tune pricing policies to stay competitive.

For this utility company, validation results proved very strong, with exceptional hit rates. The models did well in rank ordering the dollar value of bad debt. The optimized scores performed the best during the customer’s tests. Two optimized utility models were tested, and each showed a lift over a generic score. One resulted in a 69 percent lift over the best generic model, while the other model showed a 19 percent lift over the best generic. Armed with the additional insights provided by the optimized scores, this utility is in a much better position to modify its credit policies and provide a better customer experience while mitigating risk.

Conclusion
With the economy improving and better times emerging for small-business risk managers, it is essential to incorporate better ways to assess risk. After a recession, especially one as deep as the most recent downturn, a fresh appraisal of a small-business loan portfolio can help a lender identify promising new business from its existing portfolio and develop new models for assessing prospects. The most successful risk managers recognize the competitive necessity of incorporating nontraditional data and advanced analytic techniques to help deliver their desired business results.