PAST DUE

# Getting Started with Commercial Credit and Collections Scoring

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## Why Commercial Credit Scoring Has Been Slow to Take off

When one looks at credit and collections scoring and its adoption rates thus far by trade credit professionals, a number of questions arise. Why have other forms of lending moved ahead so quickly with credit scoring, while trade credit has moved much more conservatively? Given the pressure that trade credit professionals feel to "do more with less," why have they been relatively slow to integrate credit and collections scoring into their daily lives?

For decades, the consumer finance and banking industries have used scoring to improve efficiencies, drive sales and minimize bad debt. For evaluating the risk of a consumer, rather than business, Fair Isaac's FICO score has become the de facto standard. In our daily lives, consumer credit is abundant and fast – effectively eliminating any barrier to a sale. Whether you are buying a car or spreading payments out at zero percent interest for the first six months on your new refrigerator, the application, approval and credit line granted is all completed in a few minutes while the consumer is waiting.

Likewise, the insurance industry has also used scoring and actuarial models to accurately predict default and expected net income. In today's environment, it is extremely rare to find a credit professional in these industries who does not use scoring.

Scoring is not a new topic in the trade credit world. The pages of Business Credit and CRF's Credit and Financial Management Review have documented the numerous benefits of commercial credit scoring for many years. However, adoption rates remain relatively low.

Discussions with trade credit professionals have revealed that the resistance to scoring has always boiled down to these main misperceptions:

- Lack of trust in the accuracy of scoring models
- Cost of scoring models
- Lack of IT Support

However, whether you are using a homegrown spreadsheet, a score from a leading data provider or a dedicated scoring software system, the good news is that today most of the barriers that prevented industry-wide acceptance of commercial scoring have been eliminated.

# Common Misperceptions About Credit Scoring

### Common Misperception:
"Scoring models cannot be trusted to evaluate my accounts accurately."
### Fact:
Scoring models have been developed to accurately assess risk on all types of companies from the small mom and pop shops to large public companies. Scoring providers include the traditional data bureaus (e.g., Cortera, Experian, and Equifax) as well as scoring specialists (e.g., Moody's K•M•V and PredictiveMetrics). All of these organizations have thoroughly documented and statistically validated the fact that their scoring models consistently predict risk more accurately than the subjective credit analysis of a given commercial concern.

### Common Misperception:
"Scoring sounds great, but it is just too expensive for more me to implement."
### Fact:
Today, statistically valid and proven scoring elements are available on most of the data bureau reports currently being pulled by your credit analysts. For example, data elements such as Cortera Score, Experian Commercial Intelliscore, and Equifax SBE Score are part of most data reports and are statistically valid models that predict the likelihood of a company becoming severely delinquent in their payments in the future. Even beyond these more recognized scores, the heightened awareness of scoring over the last several years has created many specialized scoring consulting agencies which in turn has driven down the cost of developing custom statistical models.

### Common Misperception:
"I have multiple bureau needs both domestically and internationally which would be too difficult and expensive to integrate at our company."
### Fact:
Software technology is available today that allows seamless access to domestic (e.g., Cortera, Experian, CreditExchange) and international bureaus (e.g., Graydon, Coface, CreditSafe), industry-specific information (e.g., NACM Tampa, Cortera Industry Monitors) and public financials (e.g., S&P, Bureau Van Dijk, Reuters) for scoring on diverse accounts. The costs of these technology solutions have also come down considerably and they no longer imply lengthy, custom projects. Many of the technology solutions today easily interface with existing ERP or A/R systems. Direct customer engagement such as manual phone calls have been based on strategies that include company type (e.g., size, industry, etc.), past due balance (e.g., higher balance = higher priority) and days past due (e.g., 60 day bucket, 90 day bucket). Factoring account risk in the collection strategies will allow your collectors to spend their most productive time (direct customer engagement) on those accounts that are the highest risk of default.

### Common Misperception:
"My scoring models and approval process are too complex. It would cost a fortune to integrate with a technology provider."
### Fact:
Commercial scoring technology has advanced to the point where providers today can process a diverse array of scoring models that use data from multiple sources all in a single, flexible system. Regardless of the complexity of the model, a number of technology trends have contributed to put scoring within the financial reach of any organization. For example, some technology providers, including Cortera, offer "software-as-a-service" solutions which enable companies to get started almost immediately with little or no IT involvement required.

### Common Misperception:
"I have wanted to implement scoring into my credit and collection process for years, but never can get budget or IT resources."
### Fact:
With the Sarbanes-Oxley Act and the increasingly common desire for corporate transparency, documentation of internal processes is often very high on the CFO's priority list whether you are a private or public company—and scoring fits neatly into this category. The ROI for scoring a portfolio and eliminating bad debt often quickly justify the initial expense of adding scoring to a company's process.

## Barriers to acceptance

The need and desire for credit scoring for commercial companies has been prevalent for years. The problem has typically boiled down to 3 main barriers:

- Accuracy
- Cost
- Technology

Today those barriers have been overcome, which has allowed companies of all sizes to enjoy the benefits of scoring that today's larger commercial companies and consumer/financial/insurance industries have enjoyed for decades.

Regardless of the type of scoring employed (judgmental/rules-based, behavior/statistical-based, neural network or genetic algorithm-based), this is the best time to begin the use of scoring at your organization.

## The Benefits of Commercial Credit & Collections Scoring

Detailed below are six major benefits of scoring. Most companies use scoring to gain one or several of these advantages, with substantive results. While one of the biggest barriers for many companies is still budget constraints, the following benefits should provide you with enough scenarios to begin building a value case/ROI for scoring in your organization.

### Improve Efficiencies

One of the key advantages of credit scoring is the ability to automate many low value-added tasks for a high percentage of accounts., In order to estimate the benefit of improving efficiencies for your company, ask how much time your credit analysts spend on the following activities:

- New account processing
- Financial spreading and analysis
- Credit reviews
- Workflow communication
- Credit hold reviews

Today's technology can manage all of the activities listed above, and can trigger the credit analyst on those accounts that failed automated review. Even in the case of a manual review, the scoring process has already gathered much of the data required to make an accurate decision, allowing the analyst to focus on the credit decision rather than on the data collection. In both cases, the automated scoring process is able to quickly gather the necessary information, evaluate the account, determine the proper workflow, and ultimately communicate the result of the decision back to the requestor.

For example, traditionally a credit application is faxed or e-mailed into the credit department by sales, customer service, a branch location, or the customer. The credit analyst will then pull bureau information and/or call trade and bank references, make a decision on approval and credit limit, and then communicate the results back to the originator. This process can take anywhere from one to several hours to complete. With an automated scoring solution, only those accounts that fail the automated approval process are routed to the appropriate credit analyst, which typically saves 50-80% of the credit analyst's time for new account processing and other value-added tasks.

## Increase Sales and Improve Customer Service

With growing frequency CFOs these days are challenging their credit department to contribute at even greater levels as an integral asset in protecting and growing revenue. Partnering with their sales counterparts when credit limits can be raised (increasing the size of the relationship), being timely in response to credit requests (keeping competitors at bay) and providing alerts when revenue is at risk due to worsening customer payment performance or other signs of deterioration are just some examples of the important role the credit department plays in driving revenue.

How would you feel if, after test driving and negotiating the purchase of a new car, you were told it would be at least a day or two before the credit approval decision came back? This does not happen today with car sales because dealers use real-time credit scoring to ensure that your application is processed in seconds while you wait.

However, in the commercial world this "wait for approval" scenario happens all the time. To overcome this issue, many companies will either ship the first order and try to chase it on the backend, or risk losing the business by taking the time to make sure the potential customer is creditworthy.

The second scenario puts sales at risk and leaves an unfavorable first impression with the prospective customer. Today, technology has enabled the integration of a variety of scoring models to allow for real-time credit analysis, which can:

- Lower walk-away business sales "abandonment"
- Improve customer service through:
    - Real-time credit approval
    - Reduced surprise credit holds on existing accounts

Another sales tool used by all finance companies is risk-based pricing. The credit card offers you receive in the mail have all been processed using your credit FICO score to determine your interest rate (higher risk = higher APR). Today, more and more commercial businesses are using risk-based pricing to help them approve more high-risk accounts and offer more competitive pricing to lower risk accounts. The result of both initiatives is higher sales.

## Accurately Predict Bad Debt Exposure

Predicting bad debt exposure is usually a process that involves looking at last year's number, historical numbers and making a best guess on future bad debt reserves. Today, predictive scoring models can accurately predict bad debt exposure by assessing how risk classes of customers historically go bad (this same process is used when bundling mortgages for sale on the open market, for example). A simplistic example is in the table below:

| Risk Class | Number of Accounts | Total AR | Historic Bad % | Bad Debt Per Risk Class |
|---|---|---|---|---|
| 1-Low Risk Class | 1000 | $5,234,555 | 1.2% | $62,814 |
| 2 | 2500 | $14,234,900 | 1.7% | $241,993 |
| 3 | 4200 | $31,903,976 | 2.2% | $701,887 |
| 4 | 3000 | $18,984,983 | 2.7% | $512,594 |
| 5-High Risk Class | 1200 | $7,293,410 | 8.5% | $619,939 |
| Totals | 11,900 | $77,651,824 | 2.8% | $2,139,227 |

In this example, there is a very clear understanding of the risk in my customer portfolio as well as the historic bad/write-off rate for each risk class. From there I can easily calculate my expected write-off rate based on the overall risk of my portfolio.

This will allow for proper debt reserve allocation. Having a debt reserve that is too high ties up cash for revenue producing activities, while having a debt reserve that is too low puts pressure on net income and interest expense to pay for the additional write-offs.

## Proactive Risk Analysis

Most credit departments have a review policy to proactively assess risk on a portfolio of accounts, however, many of these departments are stretched too thin to proactively perform the proper reviews on all accounts.

Automating the monthly, quarterly, or annual scoring of your account base will allow your credit analysts to spend their time on exception handling and free them from reviewing the "no brainer" accounts.

Proactive risk analysis will save credit analysts' time, which they can then devote to more value-added exception accounts. It will also identify potential bad debt accounts earlier in the deterioration process. For example, if you are a primary vendor, you will likely be the last to know that a customer has slowed their payment habits with the majority of their suppliers. Proactive risk scoring and analysis will identify those accounts on a more immediate basis.

Today's best practices include incorporating your credit risk score into collection strategies for more appropriate treatment of your accounts.

## Collections

Most collections departments use aged trial balances to collect on past-due customers, working from right to left on the aging report. Some collections departments have software that will electronically route work to collector work queues every night, based on the company's collection policies and strategies. Today's best practices include incorporating your credit risk score (collection recovery score) into collection strategies for more appropriate treatment of your accounts.

For example, the credit approval process may identify an account as high risk. The ability to then adopt a more aggressive collection policy and strategy on that account will improve the collector's ability to collect and lower DSO. Study after study has shown that the more an invoice ages, the less likely it will be to collect on that past-due balance. Being more proactive and aggressive on your high-risk customers will improve overall collector performance and company DSO.

## Compliance

If your organization is a public company, you have been affected by Sarbanes-Oxley. If your organization is a private company, you may have been involved in an internal audit which documents and follows many of the same principles of SOX compliance. Automating the credit analysis process with objective and consistent scoring can help in SOX and internal audit compliance in the following ways:

- Producing quantifiable results with documented audit trail
- Instituting consistent risk metrics across the customer base
- Capturing exception case override details
- Preventing intentional and accidental misappropriation of credit lines
- Delivering accurate bad debt forecasts to avoid re-statement of earnings

Never has there been a better time to evaluate and implement credit and collections scoring for your company. Yesterday's barriers to commercial scoring are gone, which will allow everyone from the Fortune 500 company to the small business, the opportunity to enjoy the benefits of an automated scoring solution.

Regardless of your order volume and order size, all companies can benefit from credit and collections scoring. Depending on your business, two groupings of benefits emerge:

| Industry/Type | Distributors, Wholesalers, Various Forms of Leasing, Business Retail And Services | Manufacturers |
|---|---|---|
| Typical Characteristics | • Receive hundreds of new applications per month<br>• Sell in a competitive industry with an average new order size of less than $10,000<br>• Decentralized credit origination (e.g. field sales, branch locations) while credit approval process is done centrally | • Low order volume or size of customer base<br>• Manage multi-million dollar credit lines<br>• In-depth reviews of existing customers<br>• Complex (often global) business hierarchy and linkages |
| Example Benefits | • Auto-approvals of up to 95%<br>• Application processing turnaround time is often reduced by up to 90%<br>• Reduce the risk of a customer going to a competitor due to slow credit turnaround | • Credit analysts spend less time gathering data and more time talking with customers, conducting analysis, assessing corporate risk exposure<br>• Reduced time of entering and analyzing financials by up to 67%<br>• Automatic portfolio and monitoring provides thorough insight |

## About Cortera

Cortera provides analytical and cloud-based workflow solutions that enable companies of all sizes to better understand their customers, suppliers and business partners. Our comprehensive solutions increase visibility into the financial health of your B2B customers while keeping you informed of important changes that traditional credit reporting tools miss. Thousands of companies across diverse industries use Cortera's solutions to increase revenue, improve sales effectiveness, and reduce risk.

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