Scoring at both ends...

Straw poll **this month asks the question – can trade creditors score customers in the same way that consumer credit grantors do?**

In theory anyone can score

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In theory, provided there is enough data available from which to construct a scorecard, it is possible to predict all manner of outcomes.

For instance if estate agents collected enough information on all the prospective purchasers who walked through their doors, it would be possible to assess the likelihood of any individual being a serious purchaser rather than a window-shopper. Likewise for trade creditors – and related activities like credit insurance and bank financing for businesses.

Indeed the idea is not new. In the early 1980s a technique known as Z-scoring received much publicity. This was a generic score that measured company solvency and was based on financial ratios.

Like credit scoring (in which separate scorecards often exist for different customer groups who behave differently from each other) separate models were developed for different industries.

The UK has since become enmeshed in Europe with its attendant regulations (in this context, to do with filing company data) and commercial opportunities (making the use of this data all the more critical).

Most trade creditors will not have sufficient data to commission customised models – nor would it be cost-effective.

Thus the logical place for these scores to be constructed and generally made available is the commercial credit bureaux.

In terms of data, the bureaux are able to collect a far wider range of information than just accounts-based data, and this can be sourced from most industry sectors.

Given that many of the bureaux also operate throughout Europe, cross-border trading data can also be added to the scorecard-development pot. The end result is a suite of scorecards (or ratings) that are differentiated not only by sector but also by country.

Traders, bankers and insurance companies can all avail themselves of these strong indicators of future corporate behaviour in much the same way as consumer credit grantors do.

The major difference however is in the use of these scores. With consumer lending, decisions are frequently made on the basis of score alone.

But with commercial lending, it is more prudent to use the score as an aid to decision-making, ie it is an additional piece of quantifiable information that enhances the decision-making process.

Trade scoring is possible

Mark Stirling is a director of Paragon Business Solutions, the specialist risk assessment software company

First we should consider why the consumer industry decided to move to automated credit scoring in the first place. The obvious answer is to enable the industry to process volume lending and offer a consistent, robust and reliable lending decision.

Trade lending by and large does not have the volume-processing problem of consumer lending, unless it is lending in a quasi-retail fashion to small businesses, and it is in this area that the largest gains can be made.

The accepted approach with small and medium sized companies is to risk-assess the business proprietor. However, this leaves us some way short of our objectives as we have simply performed a different variety of consumer scoring.

The reason for this classic approach and the problems we have to answer are twofold. Firstly, reliability of commercial information (from company accounts) which is a challenge being met by modern credit bureaux. Secondly, paucity of informative scoring characteristics.

We can answer this by adopting another approach current in the consumer industry, that of customer relationship management.

The idea of CRM in the risk department is to gather together all known facts concerning your customer so that we can make a consistent decision based on all his dealings with our organisation.

In the same way, the most advanced companies are treating their business customers as a combination of risk rankings, predictions and current information from a variety of sources.

What this means in practice is that we state the fundamental question "Will the customer repay us?", and then break it down into the component parts which will enable us to predict the outcome. These component parts might be: "What will be the company's turnover within the next five years?", "What is the performance of all existing accounts?", "How much (revolving) income will the account generate?".

Note that we are not simply saying, for example, look at the company turnover, but explicitly calculating a predicted value for the future.

Each of these sub-problems can then be modelled in the manner of a classic scorecard and the results combined to give an overall view of the potential customer.

So the answer is "yes", we can score trade customers and we can do considerably better than simply scoring the obvious characteristics.

next month

Next month's straw poll question touches on one of the most crucial aspects of trade credit management – how easy is it for small businesses to cook the books and hoodwink creditors seeking an accurate picture of the true financial position of the buyer?

If you would like to contribute to the straw poll, or pose a potential question for a future issue, please send your submissions (with a picture, if available) to: *Credit Today*, Straw Poll, 84 Tooley Street, London SE1 2TF. Fax to: 0207 407 4704. E-mail: office@credittoday.co.uk.

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