

Predicting risk: the relationship between business and consumer scores

A study by Experian's Business Information Solutions

An in-depth examination of whether personal or business credit information is most effective in detecting credit problems among small businesses



About this study

First come, first served often applies for creditors. Those creditors that act quickly when small businesses encounter payment problems are most likely to be paid. Latecomers may be left holding the bag.

But when it comes to tools for monitoring small businesses' credit, a debate exists. Some in the credit and collections industry insist that personal credit reports are a fine indicator of the health of that owner's underlying small business. The thought is that small-business owners' personal financial well-being is so closely tied to the health of their business that problems with the business will soon show signs on the home front as well.

For other small-business lenders, a report on the business itself is what they want to make the most accurate assessment possible. If you want to be first in line and have an edge on other creditors, a report on the actual business will show the first signs of trouble, they think.

It's true that many small-business owners fail to separate their business expenses from personal expenses. The credit card they use to take the family out to dinner also gets used to gas up a company vehicle or to pay for supplies used by the business. Half of all small businesses use some form of personal credit to finance their businesses.¹

With those kinds of numbers, one would expect a high degree of correlation between business and personal credit reports. But what really happens? Does a small-business owner allow his or her personal credit to suffer first in an attempt to protect the business? Or does the owner let the business credit accounts go delinquent before letting it affect his or her personal credit? Individual situations will vary, but what do the statistics support as the most common scenario?

By studying both personal and business credit data, this report will answer these questions, showing that business credit indicators are best at picking up the early signs of small-business failure and that credit scores that blend business and consumer information are the best overall at providing the earliest indication of trouble.

Methodology

To complete this study, Experian® analyzed proprietary data from its Business Owner Link database, which makes the connection between small-business owners and their home addresses. Business Owner Link thus makes it possible to examine both the business credit as well as the personal credit histories for a business owner.

Experian examined the credit report information for a random sample of about 50,000 small businesses and their owners, both of which showed no major past delinquencies. In each quarter over the course of four years, the study then examined the credit of both the business and the business owner to determine which went "bad" by going 90 days or more past due on any form of reported credit or by having a derogatory public record like a bankruptcy or tax lien recorded against them. The period of 16 quarters examined ran from August 2001 to August 2005.

¹ Research conducted by MasterCard, 2004

The big picture

For just more than 82 percent of those small-business owners studied, their life without negative credit marks continued over the four-year study period. Neither their business nor their personal credit suffered any notable blemishes.

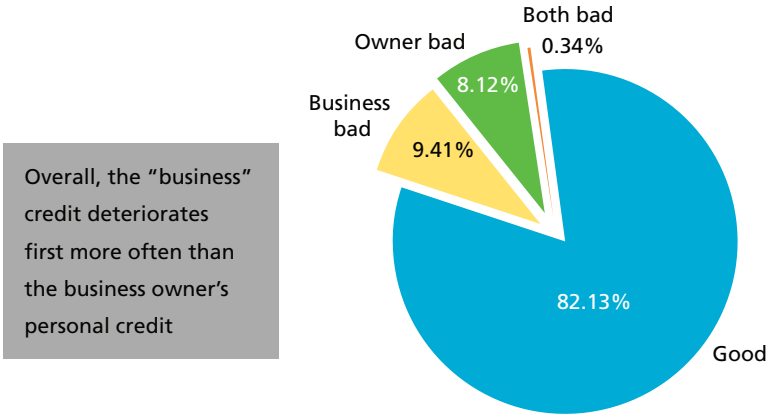


Figure 1: Which goes "bad" first? In 9.41 percent of all small businesses studied, signs of financial trouble were revealed on their business credit report at least one quarter before any negative marks appeared on their consumer credit report.

Looking at those small businesses that did become seriously delinquent in paying their credit obligations, 9.4 percent of all small businesses studied revealed the first clues of payment trouble through a mark against their business credit report. Meanwhile, in that same quarter when the business credit issue arose, their personal credit report remained clean.

Conversely, the first signs of trouble appeared on personal credit reports for 8.1 percent of those small businesses studied. In that same quarter when that first derogatory report surfaced on their personal credit history, no problems were reflected on their business credit report.

For just .34 percent of the overall group, problems initially surfaced on both commercial and personal credit fronts in the same quarter.

Of those who experienced significant credit problems, 53.5 percent revealed their first signs of credit problems through their business credit report. Problems were first present on the owner's personal credit reports for 46.5 percent of the businesses.

This 7 percent gap represents a significant advantage for creditors using business credit reports, which have a time advantage in collections over those companies that rely on personal credit for warning signs of problems on the horizon in their credit portfolio.

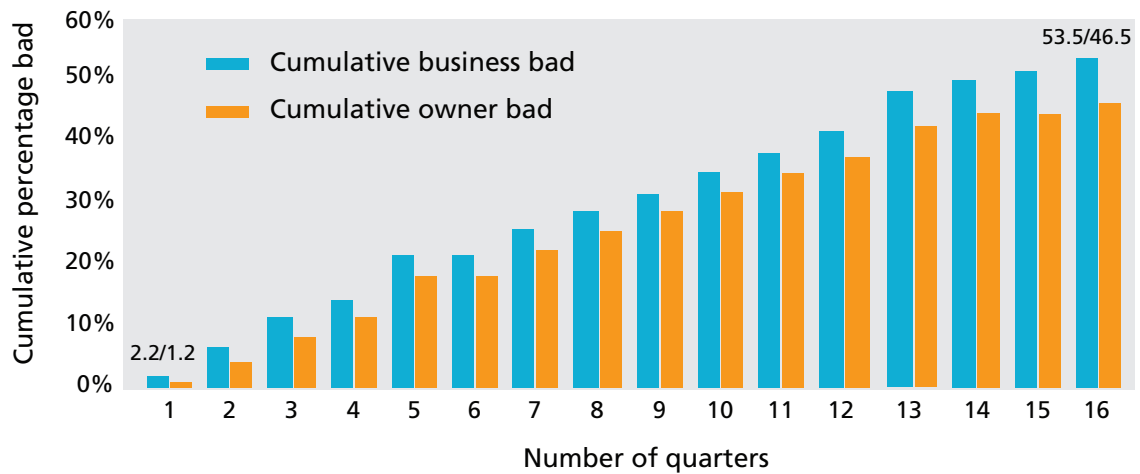


Figure 2: Over time, business credit reports are leading indicators when compared with consumer credit reports when judging a business’s financial health.

The size effect

For owners with four or fewer employees, it appears personal and business credit activities are far more intertwined than for small businesses with five or more employees. Whether it is because these “microbusiness” owners have not separated their business and personal finances enough or whether they try to save their microbusiness through their personal credit resources, the result is that personal credit issues arise first more often among the owners of these smallest businesses.

Of all the small companies that showed the first signs of credit issues through consumer credit report blemishes, nearly 70 percent were microbusinesses of four or fewer employees. Of all businesses where first indication of payment problems was through a business credit report, just 52.5 percent had four or fewer employees.

So for these smallest of small businesses, a personal credit report actually proved to be an earlier indicator of problems with the owner’s business. Even though consumer credit goes bad first more often in this segment, we aren’t saying that the consumer credit is proven to be a better predictor; instead, we can say that most often, the consumer credit of the business owner is first affected — possibly showing that these owners sacrifice their own personal credit in an attempt to save their struggling business or that business credit is so intertwined with personal credit that the two are not easily separated.

However, when looking at larger small businesses — those with five or more employees — the first signs of trouble consistently are shown first through their business credit.

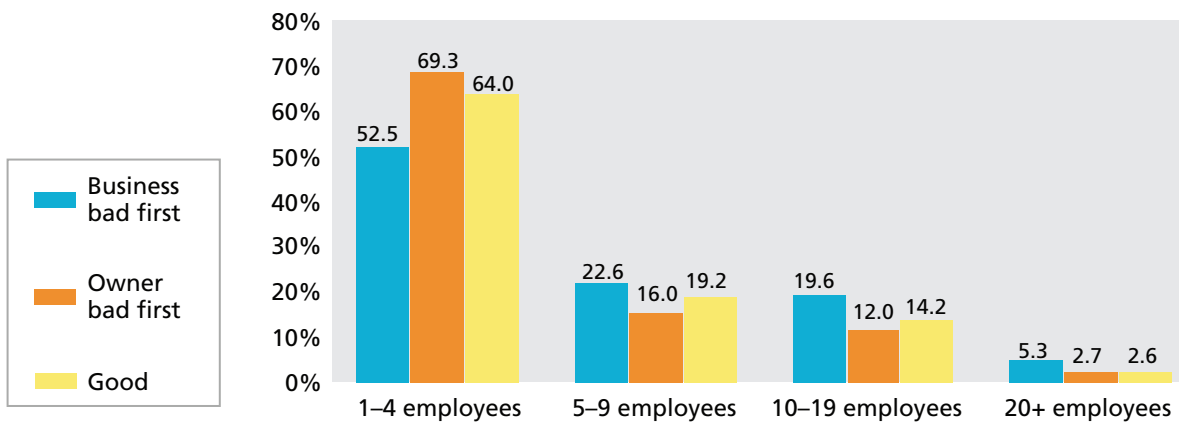


Figure 3: Business distribution by employee size

The age effect

Similar to smaller businesses, younger businesses tend to show the first signs of trouble through the owners' consumer credit problems. Again, it appears the separation between personal and business credit simply is not as well defined.

Small businesses in operation for up to two years accounted for 30 percent of all cases where the owners' personal credit showed the first signs of trouble. At three to five years, the personal and business credit indicators were almost equal in which showed the first blemish. At greater than five years, the business credit report was where credit problems surfaced first.

Small businesses that were at least 10 years old accounted for 37 percent of the cases where the business credit report was the leading indicator. Those companies in business at least a decade accounted for just 19 percent of the cases in which a personal credit report was the leading indicator.

For companies that have made it beyond their fifth anniversary, as well as for companies with more than four employees, a business credit report is, on average, clearly the leading indicator of issues, showing problem signs at least one quarter earlier than the owner's personal credit report.

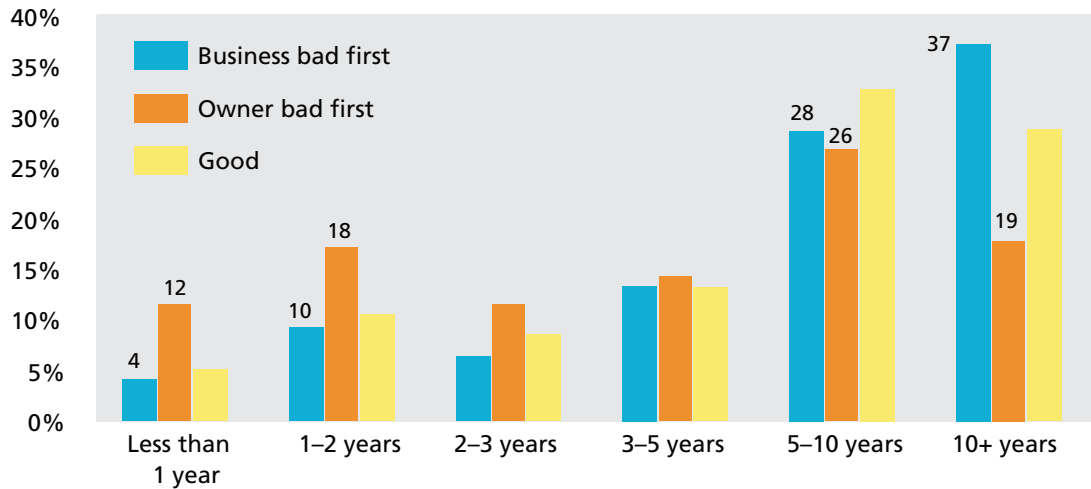


Figure 4: Distribution of businesses by years in business

Following the leader

Questions also arise about the lag time between personal and small-business credit report deterioration. If one credit report is the leading indicator in a certain instance, how far behind is the other likely to be?

The study found that when the personal credit of the business owner goes bad, business credit issues tend to occur in the quarter immediately following. In 28.5 percent of the cases where the personal credit report was the leading indicator with a negative mark, the business credit report showed red flags in the very next quarter.

However, when the business report led the way with the first report of a credit issue, the consumer credit report was more likely to lag behind significantly. In just 9 percent of cases where the business report was the leading indicator, the consumer credit report showed problems in the next quarter. Consumer credit reports started catching up in the second and third quarters after the business report showed its first negative mark.

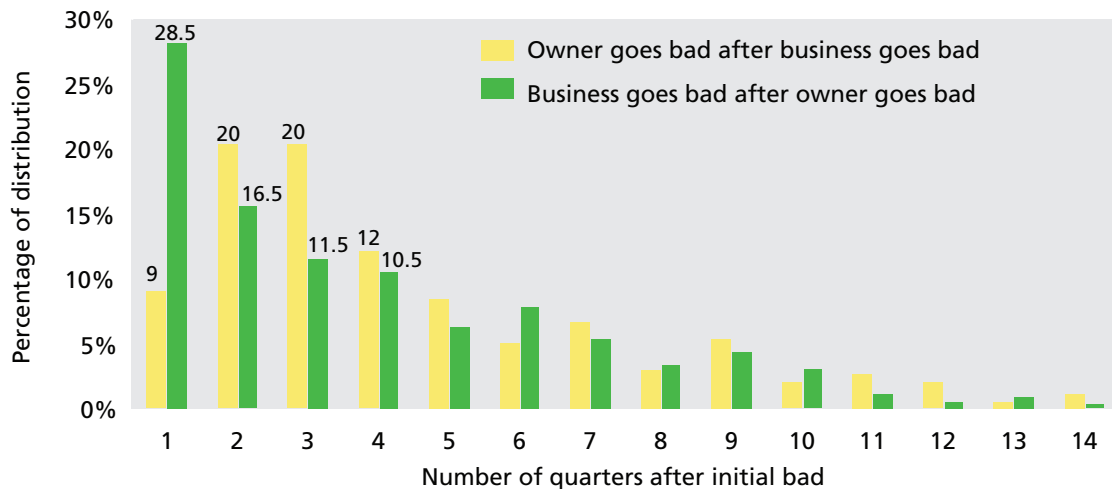


Figure 5: When business credit reports lag behind consumer credit reports, they are most likely to catch up in the very next quarter.

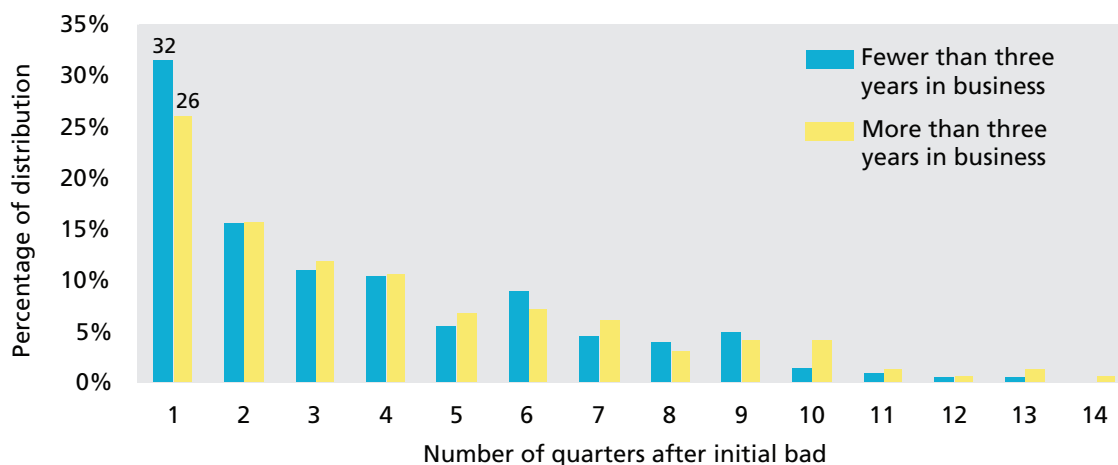


Figure 6: When a small business's credit shows the first indication of problems, the small-business owner's consumer credit is more likely to follow quickly in young businesses, while owners' consumer credit reports remain problem-free longer for businesses at least three years old.

This lag is more significant when dealing with established companies. Small businesses that are at least three years old distance their personal finances from the business failure for a longer time.

Among businesses less than three years old that showed the first signs of issues on their business credit report, one-third had problems with the owners' personal credit the very next quarter. But for businesses at least three years old, only one-fourth of their owners showed signs of personal credit trouble in the next quarter.

The advantage of blending

The study found that the best tool for predicting small-business failure — no matter the age or size of the business — is blended information. Blended scores combine the owner's personal information with that of the business into a single assessment.

The weakness of relying on a consumer score alone is clear in the data. This study revealed that when the business went bad first — as they most often do — commercial and blended scores each dropped an average of 25 percent over four quarters, while the consumer score showed no statistically significant decline over the same period. So those creditors relying on a consumer score alone would remain unaware that anything was amiss with that small business in their portfolio. Meanwhile, those using blended information would have early warning signs from business credit problems.

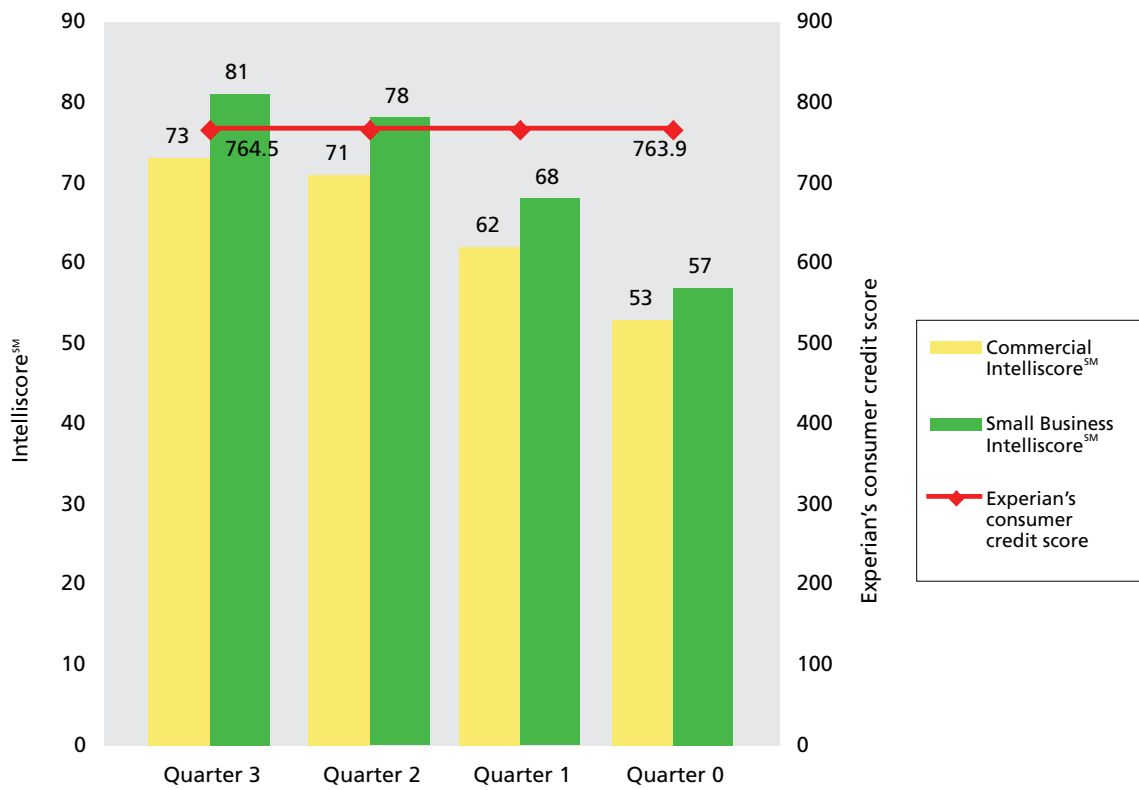


Figure 7: When the businesses go bad first, the owner's consumer scores show very slight deterioration.

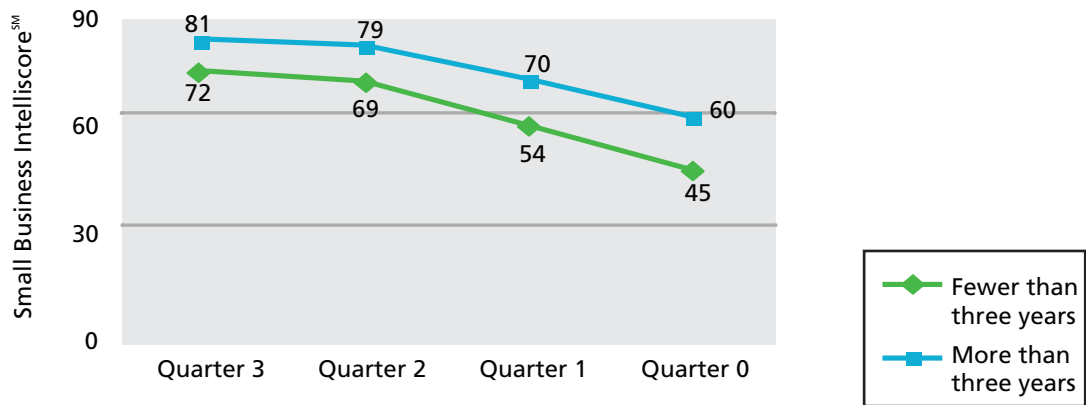


Figure 8: Blended scores lead the wave of business credit deterioration for both the newer and the older businesses.

The predictive nature of the blended approach also showed how it can cut across issues with the age of businesses, where consumer scores are not strong predictors of business risk, even among newer, smaller businesses. The blended score declined on a similar trajectory for businesses both older than three years and younger. So the user of blended information is able to capitalize on having the best small-business credit information, whether that small-business owner is just starting out or has been in business for many years.

Conclusion

While business credit scores are a leading indicator of emerging credit problems, the most predictive method for determining small-business risk is a blended commercial and consumer credit score.

Blended scores, like Experian's Small Business Intelliscore,SM give creditors the best of both worlds. Blended data combines the advantages of business credit scores, which are a leading indicator of credit payment issues for larger and older companies, with the advantages of consumer scores, which have a slight edge in predicting issues with the smallest and newest businesses, where the owners have not fully separated personal and business expenses.

Blended credit scores perform best regardless of the size or age of the company. They take into account that business scores generally are leading indicators for business scoring while also factoring in consumer credit information on the owner in cases where consumer credit marks show up first.

Relying solely on personal credit scores to judge the financial health of the owner's small business is clearly not ideal in predicting business behavior, although many creditors unwisely choose this approach. With many business credit card executives having migrated from consumer credit card businesses, it's understandable that they would use the tools they know.

However, as the facts show, those that continue to apply consumer credit principles to small-business accounts are leaving their portfolios open to added risk. Creditors that use blended credit scoring tools have a collections edge over those creditors that continue to rely on business owners' personal credit scores.

Smart creditors are taking advantage of these new blended commercial scoring tools to continually assess the health of small businesses in their portfolio, giving them an advantage in managing their portfolios. Those that continue in their old ways risk encountering problems later than others and ending up at the back of the line for collections.

About Small Business IntelliscoreSM

A risk model developed especially for small businesses, Small Business IntelliscoreSM uses both commercial and consumer credit data to generate a risk score with greater accuracy. The integration of both data sources may significantly increase the predictability of small-business risk over a standard business-only model.

About Commercial IntelliscoreSM

Leveraging Experian's commercial credit database of more than 18 million U.S. businesses, Commercial IntelliscoreSM is a highly predictive risk score that is designed to simplify business-to-business credit decisioning. The score was developed using enhanced technology and advanced algorithms to accurately predict payment delinquency in the commercial marketplace.

About Business Owner Link

Business Owner Link provides information on approximately 4 million small-business owners of nonincorporated small businesses, enabling marketers to make reliable marketing decisions. Business Owner Link intelligence includes the business owner's name and personal address as well as the demographic profile of the business and the owner.

About Experian

Experian is a global leader in providing value-added information solutions to organizations and consumers. Experian provides information, analytics, decision-making solutions and processing services. Using its comprehensive understanding of individuals, markets and economies, it helps organizations to find, develop and manage customer relationships to make their businesses more profitable. Experian promotes greater financial health and opportunity among consumers by enabling them to understand, manage and protect their personal information, helping them control financial aspects of key life events and make the most advantageous financial decisions. Experian works with clients across diverse industries, including financial services, telecommunications, health care, insurance, retail and catalog, automotive, manufacturing, leisure, utilities, e-commerce, property and government. A subsidiary of GUS plc with headquarters in Nottingham, UK, and Costa Mesa, Calif., Experian employs more than 12,500 people in 28 countries worldwide who support clients in more than 60 countries. Annual sales are in excess of \$3.0 billion.

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