

Rules Based Credit Scoring: Make the Right Decisions Fast

By Joe Granda

In today's challenging economic environment, credit professionals are expected to know much more about the credit risk of customers. Not surprisingly, you also must be aware of credit risk issues early to proactively manage risk. Departments are consolidating and slimming down, as well as under more scrutiny from auditors. Under these conditions, how do you perform the detailed and consistent analysis needed to avoid unnecessary credit risk? Problem solved, with rules based credit scoring.

Rules based credit scoring can quickly transform your raw credit data into intelligent, consistent, support for your day-to-day decisions. Rules based scoring methodology is based on your existing formal or informal decision-making process. This methodology enables you to build a structured decision process, whereby best practices and your experience can be consistently leveraged. In other words, your business policies and procedures will be translated into a logical set of business rules. For this reason, rules based scoring is easy to implement and it reflects your business policies. It is a major improvement over a generic report not designed around your business. The rules can easily adjust as economic and business conditions change.

Moreover, this approach will try to replicate your decisions based on all information you desire reviewing. Therefore, it incorporates multiple sources of credit information from both internal and external sources. In this way, evaluations are made holistically for a complete picture—rather than piece-meal, hoping disparate sets of information are connected.

Background

According to a recent Credit Research Foundation study, "credit scoring is set to become the cornerstone of the receivable management process for the future." The study revealed one in three respondents currently utilize credit scoring, while 30 percent of those not using credit scoring plan to use it in the next two years. In fact, over two-thirds of the user respondents utilize rules based credit scoring.

The factors discovered driving credit scoring were that technology changed what—and how—the credit function performed. In addition, margin and economic pressure requires fewer people doing the same job while having more emphasis on the revenue chain. Finally, compliance issues to state the true value of the portfolio are a concern. Rules based credit scoring will address all the driving factors by structuring and automating the credit decision process.

Why Rules Based Credit Scoring?

Rules based credit scoring can have a positive impact on the quality of your receivables and business processes. Benefits of credit scoring can vary depending on size, company and industry. The beauty of rules based credit scoring systems is that they generally take less time to set-up. Hence, your payback period is almost immediate. Here are the main benefits that are seen by most.

- Customers can be scored and approved in seconds with automated software. Also, automated data feeds can speed up data entry of financials, ratings, account status and exposure, and other key data points. In fact, all decision factors are consistently evaluated by the entire staff at

all locations, while human error is eliminated.

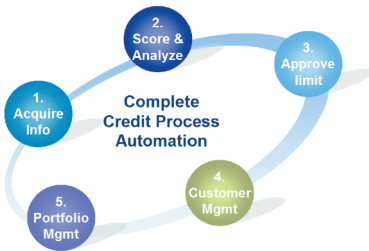
- Bad debt can be reduced since high-risk customers are identified as exceptions and reviewed by a credit analyst. By quickly identifying existing customers that require immediate attention, you can hold orders that otherwise may have been shipped.
- Particularly with firms having many thousands of customers, the impact of credit scoring, combined with the use of an automated software system, can significantly reduce personnel costs. With automated credit scoring, fewer people are needed to research customers, check references and make decisions. Furthermore, collection activities can be prioritized based on risk and the amount owed.
- Credit scoring also enables the credit executive to prepare reports that accurately reflect the quality of the total accounts receivable portfolio, and other reports that will reveal if certain groups of customers carry more risk. Additional reports will focus attention on the amount of bad debts for each risk category, pricing strategies, overly rigid or liberal applications of credit policy, credit department staffing and expenses, and other issues vital to a firm's future.
- Lastly, due to the Sarbanes-Oxley Act, auditors are more likely to require supporting materials on the collectability of receivables and class of receivable. Expert reviews can reveal inadequate bad debt

reserve and overlook significant write-offs from prior periods. This failure could result in material errors in past and current financial statements. Credit scoring enables you to support decisions by tracking data evaluated and how decisions were made. Additionally, you can score to regularly re-evaluate your portfolio in a timely manner. In this way, your decisions will be more reliable and supportable for financial reporting.

A Good Credit Management Process Is Good Management

Who wants to worry about whether policies are being followed and undue risk is being taken? Rules based credit scoring provides a framework for the decision-making process in order to be consistent and objective. Flexibility and configurability are essential for fitting your unique policies, procedures, and circumstances. To reiterate: generic reports from credit agencies are not built specifically for you, but a scoring system can be tailored to your business needs. Below is a sample process flow for managing credit risk of your accounts and portfolio. The first two steps will be discussed in this article.

Figure 1: Credit management is a continuous process



1. Acquire information for the complete picture

Decisions are only as good as the information they are based on. Therefore, you will want to use all the different sources of information you use today, at a minimum. In many cases, automated techniques enable you to collect more information at 50-75 percent less cost.

It thereby enables you to get more information on a more timely basis.

The first place you can start is with AR. You can score pay history tracked in your AR system for existing accounts, since it is highly predictive of future payment history. This is information we all look at, but generally is manually reviewed and inconsistently interpreted. Hence, importing key AR data into your scoring system is beneficial for consistency and ensuring this crucial element is always used.

Reviewing financials when available is also valuable. Bringing in detailed financials from the SEC can provide greater insight than summary financials commonly found. You will also want to look at financials for private firms, especially for larger or riskier credit lines. In addition, you may want to look at financials of non-U.S. firms if you

have global sales. Bureau van Dijk is an excellent source of financials for European (public and private), as well as rest-of-world public financials that might not be found with other U.S.-centric sources.

You will also want to incorporate information from multiple credit agency sources for better coverage or confidence. Some credit agencies are good for mid to larger firms, while other agencies have better coverage of small businesses. In fact, there are some agencies that can leverage their consumer database for owner profiles of small businesses. Also, many agencies that work well in the states may be less reliable in other parts of the world. Sources are available to help you with customers in Europe, Latin America, Asia, and the rest of the world. Moreover, industry-specific agencies or

Table 1: Criteria Examples

Criteria Category	Criteria Examples
Traditional / Non-financial	Pay history, references, years in business, bankruptcy, liens, collection claims, suits, etc.
Financial	Key financial ratios compared to peers
Credit Agency	D&B, Experian, S&P, Moody's, etc.

Table 2: Decision criteria scoring examples

<p>Pay History to Your Firm</p> <ol style="list-style-type: none"> Discounts Pay Promptly Slow 1 to 15 Days Slow 16 to 30 Days Slow 31 to 60 Days Slow over 60 Days 	<p>Control Years</p> <ol style="list-style-type: none"> Over 15 Years Over 10 Years Over 5 Years Less Than 5 Years Less Than 3 Years Less Than 1 Year
<p>D&B Rating</p> <p>4A1 = 1 4A2 = 2 4A3 = 4 4A4 = 6 3A1 = 1 3A2 = 2</p>	<p>Experian Days Beyond Terms</p> <p>Zero to 10 Days Late = 1 11 to 15 Days Late = 2 16 to 20 Days Late = 3 21 to 30 Days Late = 4 31 to 40 Days Late = 5 Over 41 Days Late = 6</p>

Note: you should have total flexibility in designing the scoring criteria and the list of criteria for each scoring model.

industry trade groups can provide more targeted insight—and could be cheaper.

By having the flexibility to use multiple sources in your scoring system, you are not dependent on one source that may not completely cover your entire customer base or may not provide you with current or sufficient information. In addition, you may want to automate data access of SEC financial filings and credit agencies such as D&B, Experian, S&P, Moody's, Coface, and Equifax in order to eliminate human error and time wasted.

2. Rules based credit scoring applies best practices

The next step in the process is to evaluate the accounts using the information retrieved. As mentioned earlier, you can set rules based on your experience and policies. Essentially you build a checklist of all the decision criteria you feel are important in evaluating a firm's creditworthiness. Each decision criteria is graded as you normally would do in your head. For example, you may consider the age of a firm important, where a young firm carries higher risk. You do this for each item on your list of criteria.

Of course, some criteria items you consider are more important than others. Therefore, you set the weighting based on importance. Generally, payment history and financials are better indicators of risk than references provided by your customer. Have you heard of many trade references being terrible? Therefore, you may only place a small weighting on references. The scoring system will then calculate a weighted score for an overall score to assess risk. It's simple and easy to understand. You can see which elements are of concern or positive reflections of the firm.

Again, you can see the customers are consistently analyzed and assessed. All the information you consider important is pulled together for a complete picture of overall risk. You should also look at

having different scoring models based on the circumstances. You may want to use different models based on channels, regions, business unit, etc. For instance, you may have scoring models designed for each channel—contractor, distributors, or retailers. Or your business decisions may be evaluated differently in each region of the world. In this way, you are not trying to fit a square peg to every round hole. Scoring systems should allow you to adapt to the business issues at hand. You end up getting local decision-making flexibility, while having total tracking and control.

Summary

The resulting rules based credit scores are a barometer or early warning system of your customer's risk. The score is not an absolute—but it does give you a relative risk. You can quickly diagnose areas of interest, and take appropriate action based on the score. The credit professional becomes more proactive with this information in hand. Now you can:

- make credit line recommendations with consistency and justification,
- set terms based on risk,
- identify risk in your portfolio and focus on exceptions,
- prioritize collections,
- manage portfolio risk and create information based reports,
- plus much more.

You get the picture. Rules based credit scoring provides you with the tools to consistently and objectively review new and existing accounts.

Furthermore, the steps described above can be done manually and used immediately to help you deploy a systematic and consistent approach to credit decisions. However, manual scoring will have limited benefits. You can take full advantage of the benefits by using computers to automate the process. Not only will you be able to take advantage of the

speed, accuracy, audit tracking, and reduced personnel costs; you may be able to implement enterprise wide for your entire department—centrally located or decentralized around the world. Are you ready to join the majority of credit scoring users that employ rules based credit scoring?

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