



TAKING THE RISK OUT OF
SMALL BUSINESS LENDING

Achieving Accurate Small Business Credit Ratings

Behavioral vs. Financial Statements

In the Federal Reserve Banks' *2015 Small Business Credit Survey*, 43% of small businesses cited the long wait for credit decision and 52% the difficult application process as top reasons for dissatisfaction seeking credit from small banks. Twenty-one separate requirements are needed for underwriting and loan review:

Business and Personal	Industry and Collateral
Loan Purpose	Industry Analysis
Structure	Competitors
Borrower Financials/Tax Returns/Projections	Major Customers/Suppliers
Guarantor Financials	Industry Outlook
Personal Credit Reports	Borrower Capability
Historic & Projected Operating Performance	Management Experience
Cash Flow	Valuation & Liquidity of Collateral
Interest Coverage	Accounts Receivable
Borrowing Base Coverage	Inventory
Ability to Repay	Manufacturing/Office/Warehouse
	Real Estate/Vehicles

Risk is ultimately a matter of judgment which is informed by tools for measuring and pricing for risk. Credit decisions on small businesses using behavioral based credit models utilize loan payment analysis to more accurately predict borrower performance. Behavioral based credit models consistently outperform financial statement based models lacking proper small business data and are not statistically fitted to predict default (ROC = 0.829 for loan payment, 0.820 for financial statements).

PREDICTION MADE BY	ON POPULATION	ROC STATISTIC 1 YEAR	
RiskCalc® EDF Credit Measure	US Non-Fin'l Public Cos w/ Sales \$30-\$300 Million	1996- 2006	0.820
PayNet AbsolutePD®	PayNet lenders overall portfolio	2012- 2014	0.829

Source: Korablev, Irina & Douglas Dwyer. *Power and Level Validation of Moody's KMV EDF™ Credit Measures in North America, Europe, and Asia*. Moody's KMV Company, 2007.

Banks often don't receive quality financial reports on their customers, so they don't fully know the business risk. Financial statements are compiled at best. Tax returns don't provide an

economic view of small businesses. Available software and database platforms lack relevant small business industry information required to make proper credit decisions. Credit quality of small businesses can change rapidly and portfolio managers must check frequently for changes in risk. Behavioral models meet the needs of the small business credit markets. They are more predictive than financial statement based systems providing the red flags to identify changes in borrower risk. In addition, they compensate for the lack of financial statements and tax returns and can lower some costs of granting and managing credit by up to 50%.

Your company can choose to spend over \$4,000 to underwrite a loan applicant or over \$1,000 to conduct loan review. Another route is to use technology to lower the cost of delivering financial services to small businesses and in doing so, improve the efficiency of your company. PayNet has created AbsolutePD (APD), a behavioral based credit risk model that provides probability of default in the absence of accurate or timely financial statements

This increased transparency helps financial institutions to better identify and capitalize on the growth and profit opportunities in their portfolios when applied in the following areas:

Risk Rating Process

- Credit rates millions of private companies when current or reliable financial statements are not available
- Enables consistent risk evaluation throughout the loan lifecycle
- Provides ratings transparency and constancy across the institution

ALLL Allocation

- Provides future-looking defaults at the account, regional, industry and business segment level
- Enables more precise ALLL estimates and efficient internal allocation of economic capital

Portfolio & Account Monitoring

- Provides account, regional, industry, and business segment forward-looking risk trend analysis
- Enables strategic portfolio and account management
- Features preemptive risk and growth detection

Regulatory Compliance

- Provides quantitatively-driven, granular risk ratings to meet regulator demands
- Adopts best practice credit risk management practices through a dual risk rating approach
- Enables decision support and dynamic risk assessment

Contact PayNet at info@paynetonline.com or (866) 825-3400 to learn ways technology can help your company lower the cost of safely delivering financial products to your customers.