

*The Surprising Use of Credit Scoring in
Small Business Lending by 'Community
Banks' and the Attendant Effects on
Credit Availability and Risk
by Allen Berger, Adrian Cowan and Scott Frame*

*Discussant remarks by Margaret Miller
Presented at the Conference:
Small Business Finance – What Works, What Doesn't
May 6, 2008
Washington, D.C.*

Literature on SBCS

- Literature
- Introducing SBCS as issue:
 - Petersen & Rajan (2002) SBCS reducing importance of distance
 - Others looking at segmentation in small business credit reporting where large institutions use SBCS – including Dell’Ariccia and Marquez (2002), Hauswald and Marquez (2002) and Brevoort and Hannan (2004)
 - Akhavein, Frame & White (2005) – early SBCS adopters in NY Fed district, more centralized organizational structure (larger in size)
- What is impact of SBCS:
 - Berger, Frame & Miller (2005) (expanded credit, higher prices, greater risk, learning curve, and importance of rules v. discretion)

This paper's contribution

- This paper –
 - Looks specifically at small community banks in US
 - Includes both CCS and SBCS
 - Panel data (follow behavior before / after adoption)

Valuable insights for an institution like the World Bank because these institutions more similar in size, resources, sophistication to locally owned banks in developing countries, and even to more advanced microfinance institutions serving microenterprises

Surprising insights use of CCS

- Reliance on Consumer Credit Scoring (CCS), almost no adoption of Small Business Credit Scoring (SBCS)
 - potentially surprising given availability of generic SBCS tools in US market
 - SBCS adoption only slightly increasing over time (2003-2005) where 8 banks started using both CCS and SBCS

Really surprising findings on use of credit scoring

- Limited use of any credit scoring (47%) – amazing finding –
 - Is it believable?
 - Are they using FICO or other scores as input to decision or embedding such number in some other technology?
 - If not using it, why not –
 - Don't want to have to show poor quality
 - Are lending to some type of captive base (ie. WB credit union) where borrowers have auto-deposit of paychecks, etc.
 - Lending to people not in credit system - undocumented workers
 - Other?
 - Does the inclusion of the CCS really constitute a change in the lending technology? Does including a CCS in the lending technology for a small business loan constitute the use of scoring? How is it being used – in a discretionary manner? As a minimum standard? In an algorithm?

Empirical results

- Empirical results provide limited insights
 - Increase in loans only about \$500,000
 - Since we're talking about loans in size up to \$100,000 this could mean adding only a handful of loans to portfolio
 - With such a meager increase, why should credit quality decline at all with credit reporting, as shown in Table 6?
 - Quality improvements from adopting SBCS may represent more accurate picture of what happens when lending technology changes with scoring

Extensions to the paper

- Why aren't a majority of these institutions using any scoring tools?
- More detail needed on what it means to adopt credit scoring by these institutions.
- Would be nice to know more about the institutions in the sample (both total sample and those with credit reporting)
 - Where are they located?
 - Who is the customer base?
 - Do they share any unique characteristics?
 - Are they profitable? Are they growing?