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Chapter III

Credit Scoring and Risk Management for Small Business Lending

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Introduction to the Financial Services Industry

"The house always wins" is a common reprise for the empty pocket tourist leaving the gambling tables at Vegas. You do not need to be a professional gambler to understand that the house always wins because the odds are stacked in their favor. Unfortunately, the recent conditions in the financial services industry have been tighter than the quarter slot machines in the Vegas airport.

The financial services industry has been initiated with a never-ending ebb and flow between deregulation and "re-regulation". In general, the reaction to changing regulations has been an industry consolidation and the creation of global, national and super regional lending markets, replacing the traditional "brick and mortar" structure.[1] The restructuring of the financial markets has virtually eliminated the relevance of a "banking footprint", in which knowl-

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edge of the local economy and personal relationships was a key factor in managing risk. In today's environment, the lending officer's local market knowledge has dissipated and the relationship with the end user is more informal and often impersonal.

The inevitable intensifying competition has increased the cost of funds to the lender and lowered the interest rate paid by the borrower. The resulting lower margins have required that financial institutions lower costs by increasing efficiency and improving processes for customer acquisition and service. This transformation requires a change in both strategy and tactics, making the financial risk manager's job even more challenging.

Risk Management: The Art of Control

For the financial services industry, the balance between growth and profitability ultimately rests with an institution's risk management strategy. At the end of the day, losses make or break a lending institution's income statement. To better deal with this environment, the successful financial service companies are adopting advanced risk management strategies to manage and profitably grow their customer base.

A successful risk management strategy requires putting in place the necessary credit controls to maintain the portfolio's quality without stifling growth. The leading financial services companies have adapted knowledge-based decision systems as the foundation of their risk management strategy, in which these decision tools are used not only to make credit decisions faster, but over time the risk management profession has begun to appreciate that these advanced systems make better decisions.

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