

The Business Credit Journal

A monthly newsletter published by NACM Oregon

November 2005

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Solving The Mystery of Credit Scoring Models



White paper

As the speed of business continues to accelerate, more and more companies are challenged to keep pace with the demands of their markets, their customers and competitors. The marketplace is shrinking, with distinctions among global, national and regional marketplaces blurring. To increase the efficiency of processing and to meet the demands of time-sensitive customers, businesses must make decisions in real time or near-real time. Larger organizations have been utilizing credit scoring to quickly and accurately assess the risk level of their prospects, applicants and existing customers. Increasingly, midsize and smaller organizations are appreciating the benefits of credit scoring as well.

The credit score is reflected in a number or letter(s) that summarizes the overall risk utilizing available information on the customer. The credit score empowers users to make quick decisions or even to automate decisions. Whereas a decision based on manual review may take hours, a decision based on a credit score will take seconds. However, not all credit score models are created equally. That's why organizations must understand and match their needs to an appropriate credit score model. To select the appropriate model, one must understand not only the similarities and differences of the credit score models available, but also understand and be comfortable with using credit scoring.

To feel confident about using risk scoring in your environment, you need to have a good conceptual and practical understanding of what a risk score is and how it is developed. A risk score is generated when information related to an entity (a business or a consumer) is fed into a risk model. The risk model examines the information and assigns the relative importance of each piece of information, aggregating the individual contributions of each piece of information into one risk score that summarizes the entity's risk level. That's it in a nutshell. Now let's explore in detail each step in the process of generating a risk score.

The risk model

You undoubtedly have heard the word "model" used many different ways. We have forecasting models, revenue models, analytical models, physics models and models of trains, planes and automobiles to name a few. Like a model plane, train or automobile, all models can be thought of as simplistic representations of the real world. As such, models are imperfect facsimiles, never 100 percent accurate. No one expects a model car to replicate the intricacies of its real-life counterpart, and no one should expect other models to be completely accurate either. Besides physical models, there are predictive models, which predict an event based on empirical data — information observable in the real world.

A weather forecast is actually a prediction made by a system that takes empirical data, such as current temperature, humidity, wind conditions and other factors, to determine what the most likely weather conditions will be for the next several days. Weather forecast systems have certainly become more sophisticated over the years with advancements in technology. Whereas earlier weather forecast systems used a few observable factors to make predictions, current systems use hundreds of factors to make weather predictions almost an exact science. As a general rule, the more information that is available, the better the model will perform and the more accurate the prediction will be. However, no one should expect predictive models to be crystal balls. A weather forecast model would be 100 percent accurate only if it were to have perfect information of everything that affects the weather, which is impossible. How often have you dressed for a sunny day, as predicted, only to have it rain or vice versa? Certainly, there have been plenty of times when the forecast was inaccurate. Yet, we still trust in the weather forecast. Why? Well, for the most part, the weather forecast is accurate. It is valid in its prediction and has been consistently reliable over the years.

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Chairman's Message

Have You Been On a Web Crawl Recently?

Dave Erickson, CCE, Chair 2005-2006

This is not a toddler activity on the office floor—it is championed by many credit professionals and office co-workers to get answers quickly from the screen and the keyboard.

At two credit conferences, one in Portland in 2004, I was in the audience of Dennis Gallin—a true master of web crawling. It is time for each of us to work proactively. Dennis stated that there were 4 P's to the Internet:

Produce It;
Publish It;
Profit From It;
Protect It.

A trade group recently was hosted to a web crawl in-mass at a lunch meeting—it took place in the NACM Classroom. I'm still referring clients to websites I learned about in that session. In the group, the interaction was great fun. Some tips to repeat successes:

1. Use your book marks on the internet program from your desktop, they save time.
2. When someone provides you with a good link, visit that space, and if useful go back again on another topic and book mark it!
3. Here are some sites to look into to ease your search for information of clients that want to do business with you:

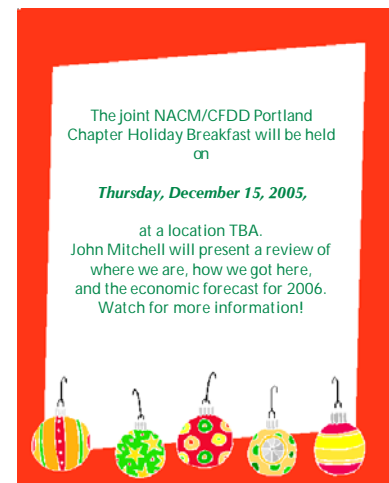
PRNEWswire.com (Press releases on publicly traded companies.)
BUSINESSWIRE.com
ALLTHEWEB.com

Credit Reports on-line?

For most of the "users" and NACM member firms, the access for credit reports is through the internet. The advancements made in information available on credit are soon to be available on one NACM Oregon internet web portal. You probably already have www.nacmoregon.org as a "favorite" bookmark. I understand from the NACM staff that changes (soon coming) will enable you to have one-stop ordering for credit reports at this site. I for one, will be glad to have one spot to be bookmarked for credit reports and not three different ones!

So next time a question arises from within of your company or at home, try some of the new web points for quick information. You just might capture someone's attention with a quick and correct [credit approval] answer!

NACM/CFDD Portland Chapter Holiday Breakfast



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NACM Credit Manager's Index

The Credit Manager's Index (CMI) is created from a monthly survey of credit and collection professionals. The CMI survey asks NACM members to rate favorable and unfavorable factors in their monthly business cycle. Favorable factors include sales, new credit applications, dollar collections, and amount of credit extended. Unfavorable factors include rejections of credit applications, accounts placed for collections, dollar amounts of receivables beyond terms, and filings for bankruptcies. The results provide a benchmarking and forecasting tool that looks at the entire cycle of commercial business transactions. The CMI has gained rapid acceptance among the business and financial community as an economic indicator to both watch and report on.

Member participation in this survey is both welcome and encouraged, and takes less than five minutes each month! However, it is an ongoing monthly commitment.

Visit www.nacm.org for a complete listing and explanation of results.

Combined Manufacturing & Service Sectors

	Oct '04	Nov	Dec	Jan '05	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Sales	63.3	62.5	58.3	51.6	60.6	70.6	71.6	66.7	68.5	64.3	61.4	71.7
New credit applications	57.3	57.0	51.5	50.5	60.5	65.7	64.5	60.8	62.4	60.3	61.1	63.0
Dollar collections	64.7	60.1	61.1	54.2	56.5	63.6	70.2	64.8	63.9	62.2	58.5	61.1
Amount of credit extended	63.7	64.4	61.3	57.2	63.4	71.4	71.3	69.7	68.3	64.6	65.6	68.7
Index of favorable factors	62.3	61.0	58.1	53.4	60.2	67.8	69.4	65.5	65.8	62.8	61.6	66.4
Rejection of credit applications	50.7	54.7	55.0	54.3	50.4	439.	50.0	51.7	50.8	52.3	50.7	52.2
Accounts placed for collections	54.1	53.6	52.8	51.4	54.3	50.9	50.5	53.2	52.5	51.8	49.7	51.5
Disputes	51.0	50.7	52.3	48.7	49.1	48.8	50.5	49.2	49.9	47.8	48.6	48.7
Dollar amount beyond terms	50.2	50.7	49.9	51.0	52.6	55.1	59.0	55.8	53.7	53.7	48.7	51.0
Dollar amount of customer deductions	48.7	47.9	49.0	47.7	51.1	50.0	49.9	49.3	51.5	51.7	48.7	48.0
Filings for bankruptcies	58.6	60.4	58.5	60.0	58.0	58.5	56.0	52.2	57.1	58.9	54.2	50.5
Index of unfavorable factors	52.2	53.0	52.9	52.2	52.6	52.1	52.6	51.9	52.6	52.7	50.1	50.3
NACM Combined CMI	56.2	56.2	55.0	52.7	55.6	58.4	59.3	57.3	57.8	56.7	54.7	56.6

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The Legal Corner

By William G. Fig, Attorney

Last month, we discussed the importance of having a written agreement signed by the customer that sets forth the terms and conditions governing your relationship. Part in parcel with such an agreement is the personal guaranty. This should also be obtained at the inception of your relationship with the customer.

A personal guaranty is a contract that obligates a third party for the debt of the customer. This usually takes one of two forms: (1) a principal of a corporation/limited liability company ("LLC") guarantying the obligations of the entity; or (2) an unrelated third party guarantying the obligations of an individual or entity. In either instance, a personal guaranty can provide you with significant leverage when dealing with a delinquent customer.

In the case of a corporation or a LLC, a written agreement with the entity is only enforceable against the entity. In other words, absent extraordinary circumstances (or a person guaranty), the individual officers, shareholders, or members of an entity are not personally liable for the debts of the entity. A judgment obtained against a corporation/LLC is *only* enforceable against the assets of the entity. This can present a real problem in the case of a distressed entity with no, or heavily encumbered, assets.

The liquid assets of an entity (*i.e.* cash) are typically distributed

to its principals/members on an on-going basis thereby making the entity "cash poor." In the context of a closely held entity, a personal guaranty allows you to "pierce the corporate veil" and reach the assets that were distributed to the principal/member who guaranteed the entity's obligations. However, you are not limited to pursuing the entity's former assets. A personal guaranty allows you to obtain a judgment against the guarantor and satisfy the debt owed to you from the personal property and assets of the guarantor. Among other things, a judgment against the guarantor becomes a lien against any real property owned by the guarantor, including their home.

Having their (or a third party's) personal assets at risk makes it much more difficult for a customer to dissolve their entity and "walk away" from its debts. Most guarantors will have at least some equity in real property they own that will be put at risk. Therefore, guarantors are typically willing to satisfy at least part of the debt to obtain a release of the guaranty.

As you might expect, because it is a contract, the language contained in the guaranty is important. Among other things, the guaranty must state the consideration given in exchange for the guaranty. The guaranty should state that it is a continuing guaranty, covers all existing and future obligations, and that it may only be terminated in writing. It should also contain venue and attorney fee provisions.

Being able to look beyond the customer for payment is a powerful collection tool. In order to minimize their personal exposure or the exposure of the guarantor, to the greatest extent possible, a debtor will usually put the creditor with a personal guaranty first in line to get paid. The guarantor will typically pressure the debtor to see that this happens. Thus, a well-written personal guaranty significantly increases the chances that you will be paid for the debt owed by the customer even if that customer is going out of business.

William F. Fig is an attorney with Sussman Shank, LLP. His practice focuses on business litigation, construction law, environmental litigation, and consumer debtor/creditor matters. Bill represents creditors, general contractors, subcontractors, and small to mid-sized businesses. He holds a specialty certificate in environmental law with a focus on hazardous wastes. Mr. Fig has been active as a speaker and presenter at various NACM Oregon seminars. His email is billf@sussmanshank.com.

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Internal Job Openings

Human Resources/Staffing



Customer Relationship Rep

Specialty niche firm is seeking an enthusiastic, energetic self-starter to join our team. Sell our services to prospective customers; establish & maintain existing client relationships; assist with recruiting and placement of qualified professionals. Minimum requirements: 2-yr degree, business school training, or comparable experience; exceptional communication skills; minimum 2 yrs experience and demonstrated success in outside sales. Previous experience in credit or finance industry preferred. Team player attitude is a must! Competitive base salary, incentive opportunities, and excellent benefit package.

If you meet minimum requirements, to apply, submit your resume and cover letter by fax to 503.245.6055, or email to staff@credentiastaffing.com. Credentia Staffing Resources, (FKA CrediTemps Staffing) specializes in credit, collections, banking/lending, accounting, and administrative services.

Temporary, Temp-to-Hire, and Direct Hire placements!

An Equal Opportunity Employer

reveal that no one particular group of employees is more likely to steal than another.

In a hurry to find workers, some employers will just go on a "gut" reaction or assume that because someone is a friend or relative of a current trusted employee, the same must be true of the new prospect. Sometimes that theory works; sometimes it doesn't. Did you know that 27% of job applicants have lied about their education? A lack of job knowledge accounted for 25% of performance issues; 19% of applicants had been fired or were deemed ineligible for rehire by a previous employer; and 10-14% have criminal conviction records relevant to the hiring process. Hiring the wrong person can be devastating to your company—an astonishing 33% of all business bankruptcies are the result of employee theft.

Taking people at face value is no longer a safe practice when recruiting and hiring. The more you know about your candidates before you hire them, the more certain you can be that you are hiring the right people for your company. So what can you do to ensure you are not putting your company at risk by hiring someone who has omitted relevant facts or even misrepresented themselves or their qualifications?

Following are several steps your company can take to minimize your risk.

I. Training Policy and Procedures

The biggest challenge for an organization can be to promote safe hiring and due diligence across the organization. The goal is to ensure that managers across different divisions and locations follow procedures and pay attention to safe hiring.

Establishing a training policy and procedures for safe hiring is the first step in ensuring the security of your company's assets. Some important considerations when establishing a program for your company are:

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Human Resources Tips

Does Your Company Have a Safe Hiring Policy?

By Valerie Maier, PHR

Each year employee theft costs U.S. companies \$40 - \$50 billion (United States Dept. of Commerce). Theft occurs in a variety of forms, from fictitious billings with outside vendors, to over billing expenses, to stealing merchandise, to Internet exposures. As hard as it is to believe that someone you hire to fill a trusted

position in your company would actually take from you, it happens every day in all kinds of businesses. It is estimated that up to 75% of all employee theft goes unnoticed.

Experts say that the reasons for economic crime in the workplace are numerous, but at the heart of the problem, of course, is human greed. The old formula of mixing one part temptation with one part opportunity can equal significant losses to a company. Don't assume that well-paid employees will resist the temptation to steal, or that trusted employees will report others who steal, or that new employees are more likely to steal than those with the most seniority. Studies

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Does Your Company Have a Safe Hiring Policy?

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Training

- Establish thorough training for managers informing them of the hiring process
- Develop a process for measuring and monitoring the success of your training program
- Develop a fraud policy to provide guidance to employees in the area of fraud detection and reporting
- Educate employees through periodic fraud awareness training

Auditing of safe-hiring practices

- Identify the person(s) responsible for conducting the audits
- Establish a process to ensure hiring managers follow set procedures for each hire
- Establish frequency of audit process

Communication of policies and procedures

- Identify how the company's policy will be communicated to the workforce and managers
- Establish frequent communication of policies and procedures

II. Placing Applicants on Notice Before Hiring Process Starts

Include in your job posting information regarding safe hiring practices and discourage applicants with something to hide from applying in the first place. This will save you the time of reviewing the application, and possibly interviewing, only to find from a background check that the applicant has a criminal history or serious credit issues, etc.

It would also be wise to include the notice on the application form that a prospective candidate receives, as a reminder that your hiring process includes a thorough pre-screening stage.

III. Application Review

In reviewing the application, look for the following critical factors:

- Verify that the applicant signed the application
- That s/he signed the consent for background screening
- That criminal questions are not left blank
- That s/he has not failed to provide reasons for leaving past jobs
- Also, that s/he has not failed to explain gaps in employment history
- Verify that any explanation for gaps in employment or reasons for leaving previous jobs makes sense
- Look for excessive cross-outs and changes
- Look for instances of incomplete information (i.e. insufficient information to identify a past employer, leaves out salary, etc)
- Verify that applicant did not fail to indicate or indicate s/he cannot recall the name of a former supervisor

IV. Interviewing

One of the best indicators of future performance is past performance. Most hiring managers have conducted job interviews in which they felt that a job applicant was prepared for the interview questions to the point where their answers seemed almost scripted. It's true, most candidates are prepared for standard questions like, "Where do you want to be 5 years from now?" or "What are your greatest strengths/weaknesses?"

Using behavioral interview questions to prompt the applicants to provide examples of their work can be a more accurate reflection of their true knowledge and skills. Questions that begin with "Describe a situation in which . . .," "Give me a specific example of a time when . . .," or "Tell me about a time when you . . ." are questions that are designed to prompt the applicant to provide specific examples that support what they've reflected in their resume and/or job applications.

V. Resume Verification

Verifying a candidate's identity, employment history, education, licenses, credentials and certifications are essential steps in the hiring process.

Case Studies:

- One survey reported a candidate who quoted her salary as being \$43,000; when asked to confirm this, her previous employers stated that the salary was actually \$30,500
- One applicant gave her reason for leaving a company as reaching the end of a fixed term contract. However, the candidate's manager stated that she was dismissed.
- Another candidate who stated that he had never had civil proceedings brought against him by creditors was found to have five County Court Judgments in his name totaling \$2,250.

A reasonably written resume provides the person's previous employers in descending order starting with their present (or most recent) employer. Someone who left a job on bad terms may omit that employer from his or her job history, leaving a gap in the record. Even less satisfactory, there may be no dates of employment given or dates so vague that it's not possible to determine someone's tenure. Also, unexplained periods of self-employment should be questioned.

VI. Reference Checking

First and foremost when it comes to references, remember that the applicant chose them for the positive impression he or she thought they would give. However, references still sometimes reveal critical information about applicants.

You should verify the nature of the relationship between the applicant and personal reference and the length of time they have known each other. You may be able to increase the objectivity

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Does Your Company Have a Safe Hiring Policy?

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of the information you receive from the reference if you stress the kinds of responsibilities that the applicant will have if selected for the position.

When checking references, ask leading questions to let the reference provide the information. Instead of saying "John Smith told us that you and he have known each other for 10 years. Is that right?" you might want to ask, "How long have you and John Smith known each other?" Avoid asking questions that can be answered by a simple yes or no. Instead, phrase the questions so that references are required to think about their responses and to answer in their own words.

Even if a past employer won't give details about job performance, just verifying the job dates and job title is crucially important, as this in itself may reflect a misrepresentation by the candidate, such as indicating they've worked for an employer from 2000-2001, which implies up to 2 years of employment, when the actual dates may have been December 2000 through February 2001; or stating their position as being Credit Manager, when actually their title was Credit Administrator.

VII. Background Checking

The financial cost to businesses from theft, violence and false credentials can be enormous. There are additional costs that are hard to measure, such as the harm to employee morale or the firm's reputation. Industry statistics suggest the cost of even one bad hiring decision can exceed \$100,000, taking into account the time spent recruiting, hiring, training, and the amount of time the job is left undone or done badly by an unqualified applicant.

There are a number of background checks available today and companies would be wise to implement a customized pre-screening program that includes background checking.

It's important to note, too, that it's perfectly acceptable to have different levels of screening for different positions as long as everyone is treated fairly. Someone on an assembly line, for example, would not necessarily receive the same level of scrutiny as a potential executive. But all assembly-line workers should be treated the same way and all executives should be treated the same way.

The most common background reports include:

- County criminal (felony only, felony and misdemeanor, misdemeanor only)
- Prior employment verification
- Education and/or professional licensure verification
- Motor vehicle record
- Credit review
- Social Security number verification
- Reference checks

Out-Sourcing Your Recruiting & Pre-Screening Needs

For many managers doing the screenings themselves, the decision to do a background check on a new hire usually boils down to whether they have time to make the calls. Even when hiring managers take the time to check past employers, very seldom do they verify college degrees or professional licensures.

There are a growing number of pre-screening firms available that more and more employers are taking advantage of, mainly due to the time involved in performing the checks, but also because accessing the information can be complicated. For example, although much of the criminal history information is public record, accessing it is not simple. An essential first step in running a thorough criminal check is a Social Security number trace, which will provide a list of an individual's previous addresses. Screeners tend to do criminal background searches by county, but criminals don't usually provide addresses in counties where they have committed crimes.

If your company chooses to outsource its pre-screening process, it's

important to determine what criteria you feel is most important to consider and then look for a vendor that can provide those elements. Several key components might be:

- **Compliance:** Does the firm provide information to you and the subjects in compliance with the Fair Credit Reporting Act and other applicable federal and state laws?
- **Accuracy:** Firms that utilize multiple information sources will be able to provide the most accurate, up-to-date information regarding candidates.
- **Comprehensive coverage:** Does the firm provide all the screening services needed by your organization or will it be necessary to use more than one vendor?
- **Customization:** While the cost of most reports is minimal, it's important to pay for only what you need. Look for a company that can customize their reports to your specific needs.
- **Client Satisfaction:** What client satisfaction guarantees does the firm provide? Is the firm willing to provide customer references for you to contact?

Whether you choose to handle your recruiting and pre-screening process internally, or outsource the process, pre-employment screening is an essential tool in determining, and validating, the qualifications of today's job applicants. More and more job applicants are misrepresenting themselves and withholding important information about past job performance or even criminal activity in order to gain employment. Establishing a consistent safe-hiring practice can considerably minimize your company's risk of hiring someone with a criminal history, who may be likely to become a repeat offender, or even someone who has simply misrepresented their qualifications for the position they have applied for.

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Education

Good Morning Credit!

The Good Morning Credit classes is an excellent way to learn fundamental credit and collection management techniques or to train new staff. The program starts at 7:30 a.m., so you or your staff can head back to the office by 9:30. Join us for these informative sessions packed with practical tools for immediate use.

7:30 - 9 a.m.

NACM Oregon
7931 NE Halsey, Portland,
Suite 201

.15 CEU per class

November —

8 – International Credit Methods

Learn special methods of extending credit to international businesses.

December —

13 – Bankruptcy Basics

What should you do when a customer files for bankruptcy? Find out how to best protect your interests while working with your customer and the courts.

Seminars & Events

November —

8 — Financial Statement Analysis (FKA Financial Statement Analysis I) Fall 2005

This five-day class meets one of the requirements for the CBA certification. The objective is to provide the student with a comprehensive introduction to financial analysis as a method used in credit evaluation.

Seminars & Events, continued

8 — Risk Management Seminar

1:30 - 4:30 p.m. (Dinner + bonus class

5:30 - 8:30 p.m.)

Red Lion Inn on Market St., Salem

A comprehensive and practical course in credit analysis/risk assessment. This seminar is designed to provide up-to-date techniques, management, and professional requirements for individuals involved in commercial credit management. Sponsored by CFDD Salem-Albany Chapter.

Bankruptcy Abuse Prevention & Consumer Protection Act of 2005

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was passed by the United States

Congress and signed into law by President

Bush on April 20, 2005. The legislation contains the most

significant changes to federal bankruptcy law since the enactment of the Bankruptcy Code in 1978. This timely book breaks down the act and explains its relevance to credit professionals. \$19.95 to all NACM members. Regular shipping rates apply.

Contact Barbara Salazar at 971.230.1182 or email to bsalazar@nacmoregon.org to order your copy today.



For more information or to register for a class, please contact Claudia Sarinana at 971.230.1184 or go to www.register@nacmoregon.org

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Scholarships

NACM-Oregon Foundation

- NACM Seminars
Total: \$1,000
- Certification Fees—to establish files for exams and for continuing certifications and re-certifications.
Total: \$1,500
- College courses approved and required for accreditation and certification. Includes online courses through NACM National Education Department.
Total: \$1,000
- Certified International Credit Professional Fee—FCIB online course.
Total: \$350

Contact Lou Rice for an application or more information at 503.454.1051 or email to lrice@pacificmetal.com.

NACM Oregon

- Three (3) scholarships for each seminar available (does not apply to National seminars and Good Morning Credit! classes/series).

CFDD Portland Chapter

- Georgia Noble (Basic Credit—one (1), \$100 scholarship.
Total: \$100
- Phylliss Clark (Basic Credit)—one (1), \$100 scholarship.
Total: \$100
- NACM Oregon seminars—one (1), \$100 scholarship.
Total: \$100
- CFDD Seminars—four (4), \$100 scholarships.
Total: \$400

Contact Charlene Gothard, Land O'Lakes Farmland Feed at 503.286.7188 for more information.

CFDD Eugene/Springfield Chapter

- Please contact Tony Ceniga, Industrial Finishes & Systems at 541.284.2225.

CICP Recipients

Congratulations to the following individuals that were awarded the CICP certificate.

Philip Angelechio, CCE, CICP, Oregon Steel Mills
Alice Campbell, CBF, CICP, Oregon Steel Mills
Deborah Davis, CCE, CICP, Schnitzer Steel
Diane Sanders, CCE, CICP, Oregon Steel Mills

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Welcome New Members

Caffall Bros. Forest Products, Inc., a manufacturer of forest products.
Kurt W. Ostermiller
503.682.1910
155575 SW Sequoia Pkwy. #150
Portland OR 97224

Campbell Crane & Rigging, a crane rental company.
Tracy Murphy
503.283.3111
PO Box 11347
Portland OR 97211

Jet Heating, Inc., a heating and air-conditioning firm.
Deborah Strauss
503.363.2334
PO Box 7362
Salem OR 97303

Leupold & Stevens, Inc., a manufacturer of sports optics.
Ken Hiron
503.646.9171
PO Box 688
Beaverton OR 97006

Monaco Coach Corp., a manufacturer of motor homes.
Wayne Searle
541.686.8011
91320 Coburg Industrial Way
Coburg OR 97408

Packaging Specialties, a distributor of packaging material.
Teri Stroud
503.620.3711
PO Box 1649
Lake Oswego OR 97034

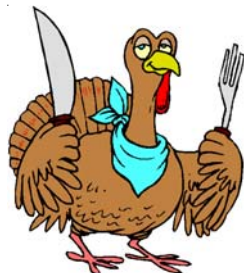
Oregon Bolt, Inc., a distributor of industrial fasteners.
Beverly Tiedemann
971.244.0800
14965 SW 72nd Ave.
Tigard OR 97224

Premium Denim, LLC, a manufacturer of women and men's denim.
Larry Schiern
310.733.2100
10119 Jefferson Blvd.
Culver City CA 90232



Mardi Gras
April 1, 2006
Watch for more information about this fun-filled event.

Happy Thanksgiving!

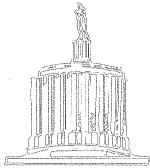


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CFDD Chapters



Salem/Albany Chapter

Meeting Date: Tuesday,
November 8, 2005

Location: Red Lion Inn
3301 Market St.

Networking Time: 5:30 p.m.
Dinner: 6 p.m.

Program: "Financial Analysis—
How to Get The Most Out of
Your Risk Analysis of a
Company's Financial Reports"

Presenter: Hal Wineland, CCE,
Credit Manager, Pendleton
Woolen Mills

Coordinator
Theresa Quillard
503.362.3633 x539
tquillard@airbpaviation.com



Eugene/Springfield Chapter

Meeting Date: Wednesday,
November 9, 2005

Location: Downtown Athletic
Club Conference Ctr.
999 Willamette St.

Networking Time: 5:30 p.m.
Dinner: 6 p.m.

Topic: "Bankruptcy Law Re-
forms"

Presenters: Gabriela (Gabi)
Sanchez-Amparan, Attorney and
Patrick Wade, Attorney,
Hershner, Hunter, Andrews, Neill
& Smith, LLP

Coordinator
Rebecca Jarrett
541.242.7121
rjarrett@levi.com



Portland Chapter

Meeting Date: Thursday,
November 10, 2005

Location: Days Inn City Center
1414 SW 6th Ave.

Networking Time: 5:30 p.m.
Dinner: 6 p.m.

Topic: "Credit Management in
the Legal Arena"

Presenter: Mark Wada, Harrang,
Long, Gary & Rudnick PC

Coordinator
Charlene Gothard
503.286.7188
cgoth@landolakes.com

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Credit Scoring Models

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Credit bureaus offer models that predict credit risk. Similar to the weather forecast system, credit models generate a credit risk prediction based on readily available information. Credit risk models follow the general rule that more information leads to a better prediction. However, they also exhibit the weakness of all models: a small margin of error. Despite this limitation, credit risk models have been used for nearly two decades and repeatedly have proved to be both valid and reliable. Validity and reliability are two key measures that determine a predictive model's usefulness. Validity refers to whether a model does what it is made to do, and reliability refers to a model's validity over time.

Now that we understand what models are, their strengths and limitations, and how their usefulness is measured, let's explore how a model is actually developed.

Model development

To facilitate understanding, we will provide a conceptual explanation of the process of model development, followed by a "real-life" example of each model building step.

1. **Model development is driven by an objective**, which answers the question, "What is the model supposed to predict?"

Let's say Martians do exist and they are of the scientific sort. One Martian scientist is interested in human beings — specifically, this Martian scientist has a burning desire to predict a human's weight!

2. Once the objective has been defined, the next step is to **gather as much data as possible related to the objective**. A common rule of thumb in model development is "The more data gathered, the better."

Since the Martian doesn't know much about humans and only wants to predict weight from afar (Mars), he will need to collect all the data he can observe from a distance, including hair color, eye color, skin color, height, waist size, shoe size and so forth.

3. Next, the **data is analyzed** through a

statistical process, usually call **regression**, to create a model. Common statistical packages used for regression include SAS, SPSS and even Microsoft® Excel! The statistical process looks for any significant relationships between what the model wants to predict — called the **dependent**, or **predicted variable** — and all the possible variables that can influence the predicted variable. The variables that have a relationship with the predicted variable are called **independent**, or **predictor variables**. Once the regression process identifies all significant relationships between the predicted variable and the predictor variables, then a regression equation is generated that can be used to calculate the predicted variable when the predictor variable values are known. The model can be fine-tuned at this point to be more predictive by segmenting the population used to create the model into more homogeneous, or similar groups. Conceptually, this step is the most difficult to understand, so let's continue with the example, which will clarify this part of modeling.

*The Martian now needs to look for relationships between the predicted variable, weight, and the predictor variables. Because the Martian is unable to observe the weight of people from afar, he actually will need to abduct a large number of people from Earth! This group of people who have been abducted is called a **sample population**. The size of the sample population has to be large enough to be representative of the entire population of people on Earth. Now the Martian can weigh all the people to capture the predicted variable values, capture other human features to get potential predictor variable values and then dump all the data into the regression process. At this point, the regression process will look for any significant relationships between weight and all the other potential predictor variables, such as hair color, eye color, skin color, height, waist size, shoe size and so on. For simplicity, let's say that there are only significant relationships between weight and waist size and between weight and height. Then the regression process will generate an **equation** that best estimates a person's weight based on waist size and height. Let's say the equation is as follows: Weight (in Earth pounds) = **1.4 x waist size (in inches) + 1.7 x height (in inches)**.*

*If the Martian then observes someone on Earth to have a waist size of 30 inches and a height of 70 inches, the person's predicted weight will equal $1.4 \times 30 + 1.7 \times 70$, or 161 pounds. Based on the sample population, 161 pounds can be considered the likely weight of a person with that waist size and height. Now, is there any way to make weight prediction more accurate? Looking at the sample population, is there a dimension by which the Martian can **break up the population into smaller, more homogenous groups**? Yes, there is, and that dimension is gender. That makes sense. The average man with the same waist size and height as a woman will typically weigh more because men have a higher percentage of muscle mass than women and muscle mass weighs more than fat. So, the sample population is grouped by gender and run through the regression process again. Now there are two regression equations to predict weight, one for males and one for females. The male weight equation is $\text{weight} = 1.5 \times \text{waist size} + 1.8 \times \text{height}$, and the female weight equation is $\text{weight} = 1.3 \times \text{waist size} + 1.6 \times \text{height}$.*

*Given the waist size of 30 inches and a height of 70 inches again, the predicted weight of a man is 171 pounds and the predicted weight of a woman is 151 pounds. The Martian has a more accurate weight prediction model! The process of dividing the sample population into more homogeneous groups is called **segmentation**. This weight model now has two segments.*

4. Now that a **model** is created, it **needs to be validated**. When a model is being developed, a small number of subjects from the sample population is randomly selected to validate the model after it is created. This excluded group is called the **holdout sample**. Once the model is developed, the predicted variable value for the holdout sample is compared with the actual value being predicted. The closer the predicted variable is to the actual value, the better the model is performing.

The Martian would hold out a group of people to be excluded from those used for model development. Once the model is developed, the predicted weight of the holdout group is compared with their actual weight.

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The closer the predicted weight is to the actual weight, the better the model is performing.

Those are the basics of model development. **If you understand this, you understand how all predictive models are developed.** For example, let's consider **Experian's Commercial IntelliscoreSM model** and how it was developed.

The development of Commercial Intelliscore followed the exact same steps described above.

1. Define the objective—The objective of Commercial Intelliscore is to predict the likelihood of a business becoming greater than 90 days delinquent within a 6-month window.

2. Collect data—Experian[®] analyzed data on 3.4 million businesses in its database, including commercial credit information, business demographic information and public record information.

3. Analyze data—The Commercial Intelliscore model was developed through regression. However, unlike in the simplistic Martian example, where there were two segments and two predictor variables, Commercial Intelliscore has six segments (also known as scorecards) and more than 50 predictor variables. The six segments are based on prior trade experience, amount of trade activity, presence of public record information and business size.

4. Validate the model—The Commercial Intelliscore model was validated when it was created and continues to be validated regularly by Experian and its clients that use the model to score their portfolio of accounts.

If you understood the above conceptual, "real-life" and Commercial Intelliscore examples of how a model is developed, then you will understand all the other predictive models out there. This fundamental understanding will help you assess which predictive model is best for

your business needs.

Credit risk model selection

As we have said, not all credit risk models are created equally. So, how do you choose the right model for you? Besides understanding how a model is developed and what it predicts, knowing how well it predicts is essential. A risk table, or performance chart, is created for each model and is used to gauge a model's performance. The risk table displays basic score distribution information. Along with the table, the Kolmogorov-Smirnov (KS) statistic may be provided as well. The KS statistic, which is named after its two creators, is a widely accepted measure of model performance. Let's go over the risk table below to understand the information provided.

	A	B	C	D	E	F	G	H	I	J
	Score interval	% bads in interval	# of Goods	# of Bads	Cum. Goods	Cum. Bads	Cum. Goods %	Cum. Bad %	% Cum. Diff.	Odds of goods to one bad
	82.93–100.00	0.92%	991	9	991	9	5.27%	0.75%	4.52%	107.7
	79.67–82.92	1.29%	987	13	1,978	22	10.52%	1.83%	8.69%	76.5
	77.17–79.66	1.51%	985	15	2,963	37	15.76%	3.08%	12.68%	65.2
	74.99–77.16	1.66%	983	17	3,946	54	20.99%	4.50%	16.49%	59.2
	72.89–74.98	1.79%	982	18	4,928	72	26.21%	6.00%	20.21%	54.9
	70.82–72.88	2.11%	979	21	5,907	93	31.42%	7.75%	23.67%	46.4
	68.76–70.81	2.30%	977	23	6,884	116	36.62%	9.67%	26.95%	42.5
	66.74–68.75	2.47%	975	25	7,859	141	41.80%	11.75%	30.05%	39.5
	64.71–66.73	2.67%	973	27	8,832	168	46.98%	14.00%	32.98%	36.5
10	62.67–64.70	2.96%	970	30	9,802	198	52.14%	16.50%	35.64%	32.8
11	60.49–62.66	3.46%	965	35	10,767	233	57.27%	19.42%	37.85%	27.9
12	58.05–60.48	3.82%	962	38	11,729	271	62.39%	22.58%	39.80%	25.2
13	55.03–58.04	4.32%	957	43	12,686	314	67.48%	26.17%	41.31%	22.1
14	51.42–55.02	4.64%	954	46	13,640	360	72.55%	30.00%	42.55%	20.6
15	46.70–51.41	5.65%	943	57	14,583	417	77.57%	34.75%	42.82%	16.5
16	40.41–46.69	6.53%	935	65	15,518	482	82.54%	40.17%	42.38%	14.3
17	31.67–40.40	8.14%	919	81	16,437	563	87.43%	46.92%	40.51%	11.3
18	19.10–31.66	10.85%	892	108	17,329	671	92.18%	55.92%	36.26%	8.3
19	5.31–19.09	15.98%	840	160	18,169	831	96.64%	69.25%	27.39%	5.3
20	0.00–5.30	36.91%	631	369	18,800	1,200	100.00%	100.00%	0.00%	1.7

First, all the businesses used to develop the model are scored, then rank ordered from lowest risk to highest risk. Then, the businesses are divided into twentieths — equal 5 percent segments. Column A shows the **score interval** for each of the 20 rows. The score range is 0 to 100, with 0 indicating highest risk and 100 indicating lowest risk.

So, the lowest-risk 5 percent of the businesses scored between 82.93 and 100 (cell A1). The second-lowest-risk 5 percent scored between 79.67 and 82.92 (A2), and so on. The worst-scoring 5 percent scored between 0.00 and 5.30 (A20).

Column B shows the **percentage of bad businesses** within each score interval. A bad account for this model is defined as a business that becomes more than 90 days delinquent within one year. The percentage of bads increases as we move down the column, which is

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to be expected since moving down the column means we are looking at higher-risk businesses. If we did not see this pattern of increasing percentages of bads, then the model would not be valid.

In the first row, the lowest-risk 5 percent of businesses, the percentage of bad businesses that fall into this row is 0.92 percent (B1). In row 20, the worst-scoring 5 percent of businesses, the percentage of bad businesses is 36.91 percent (B20). Column C displays the **number of good accounts** for each row, and column D displays the number of bads in each row. Again, one can see that the **number of bads** dramatically increases as we move down the column, from low risk to high risk.

Column E displays the **cumulative number of goods**, which is summing the total number of goods at and above a given row. For example, the cumulative goods for row 2, 1,978 (E2), is calculated by adding the number of goods for row 2, 987 (C2), and the number of goods for row 1, 991 (C1). This means that there are 1,978 businesses that scored at or above 79.67.


Column F, cumulative bads, is calculated the same way using the number of bads. Column G is the **cumulative good percentage**, which is the percentage of all the good businesses at and above a given row. The total number of good businesses is 18,800 (E20). Therefore, to calculate the cumulative good percentage for row 5, 26.21 percent (G5), the cumulative goods for row 5, 4,928 (E5), is divided by the total number of goods, 18,800 (E20).

Column H, the **cumulative bad percentage**, is calculated the same way using bads. Column I is the **cumulative percentage difference** between the cumulative percentage good (G) and cumulative percentage bad (H). For example, for row 10, the cumulative percentage difference, 35.64 percent (I10), is calculated by subtracting 16.50 percent (H10) from 52.14 percent (G10). If there is no difference between the cumulative good percentage and cumulative bad percentage, then we can conclude that the model cannot differentiate between good

and bad businesses. Conversely, we can conclude that the greater the cumulative percentage difference, the better the model is at accurately assessing risk. **The greatest cumulative percentage difference value is the model's KS statistic.** Column J displays the **odds of goods to one bad**. For Row 1, the value is 107.7, which means there are 107.7 good businesses in this row for every one bad business.

Credit risk model score application

Using the credit risk model score enables quick, accurate and consistent decisions. The score is unbiased and objective over time and across reviewers. The examples below show how the score can be applied for enhanced decisioning.

Risk level	Risk averse goal: reduce risk	Standard	Aggressive goal: increase sales	
<div style="text-align: center;">  <p>100 low risk</p> <p>0 High risk</p> </div>	Automatically accept	Automatically accept	Automatically accept	
	Review			
	Automatically reject	Review		Review
	Automatically reject	Automatically reject		Automatically reject

Automated decisioning is applicable for large-volume, low-dollar transactions. This chart shows the flexibility of scores based on automated decisioning. A risk-averse business can use the score to automatically accept applicants that scored very low risk, manually review those that scored in the low-risk range and automatically reject those that scored mid to high risk. A business with standard risk tolerance would raise the level of risk tolerance, and the level would be raised even more for aggressive businesses.

Current review	Low risk score (poor risk)	Medium risk score (marginal risk)	High risk score (good risk)
Poor risk	Reject automatically	Reject automatically	Marginally approve
Marginal risk	Reject automatically	Marginally approve	Approve with favorable terms
Good risk	Marginally approve	Approve with favorable terms	Approve with best terms

For those businesses that review all transactions, the risk score can be integrated with the current review process to enhance accurate risk assessment and decisioning. This chart is an example of integrating the risk score with the existing review method to decision applications.

The risk score has diverse utility. As described above, it can be used for application processing in determining approval or decline as well as setting prices, premiums, down payments, credit limits, terms and conditions. The score also can be used for effective portfolio management. Scoring the portfolio enables portfolio risk evaluation and risk distribution assessment. Low-risk accounts can be identified for cross-sell and up-sell campaigns. Collections efforts can be prioritized based on risk score. Renewals can be automated for low-risk accounts, and high-risk accounts can be terminated. The risk score also can be used for effective marketing by targeting low-risk prospects instead of mass-marketing. Targeting low-risk prospects will result in lower-risk applicants, which ultimately will lead to a healthier portfolio.

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Allports Forwarding, Inc.
david@allports.com

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cheryl_wahlberg@fsafood.com

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jonpat@consolidatedsupply.com

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glenn.brooks@pacificcorp.com

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Rick Weisman, CCE
Graybar Electric Co.
rick.weisman@gbe.com

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Barbara Davis, CBF
Liberty Northwest Insurance Co., Inc.
barbara.davis@libertynorthwest.com

Steven Fancy, CCE/CICP
Pope & Talbot, Inc.
steven_fancy@poptal.com

Doug Jacobson
XPEDX
douglas.jacobson@ipaper.com

Lori Kimball, CBA
Norpac Foods, Inc.
kimball@norpac.com

Darrell L. Robinson
E C Company
darrellr@e-c-co.com

Yvonne Prinslow, CCE
Pope & Talbot, Inc.
yvonne_prinslow@poptal.com

Ann Wineland
awineland@comcast.net

Rod Wheeland, CCE
President
NACM Oregon
rwheeland@nacmoregon.org

Contacts

Customer Service/Credit Reporting

971.230.1220

services@nacmoregon.org

Education

Claudia Sarinana

971.230.1184

csarinana@nacmoregon.org

Industry Groups

Kathy Gibson

971.230.1176

kgibson@nacmoregon.org

Claudia Sarinana

971.230.1184

csarinana@nacmoregon.org

Collection Services

Denise Redding

971.230.1178

dredding@nacmoregon.org

Credentia Staffing Resources

Karen Mowrey

971.230.1118

kmowrey@credentiastaffing.com

Billing

Barb Smidt

971.230.1146

bsmidt@nacmoregon.org