Decide with Confidence

D&B White Paper

Bankruptcy: Why the Surprise?

Avoid the **Cloaking Effect** *of Timely Payments*

Decide with Confidence

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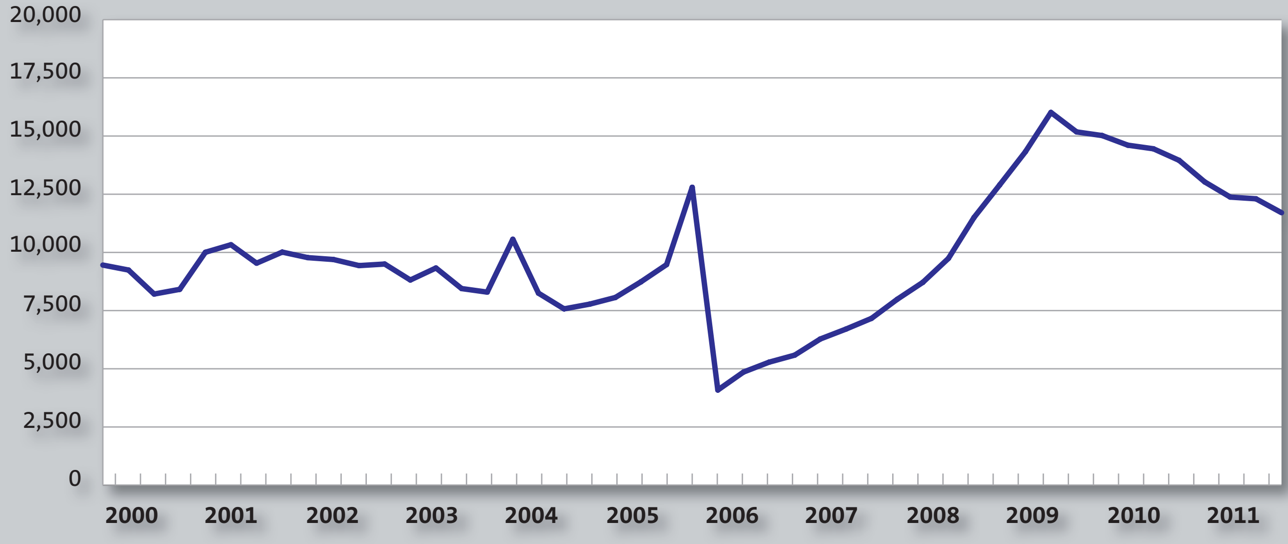
In the past few years, the level of bankruptcy filings and business failures has been unprecedented. Have you been caught unaware by a customer closing their doors or filing bankruptcy? Have you wondered why you didn't see it coming? If so, you are not alone. Even with sophisticated tools at their disposal, our customers want to know why they are being blindsided. We decided to investigate for ourselves. After analyzing our data and studying a variety of scenarios the reason, in many cases, has become clear, it is: The **Cloaking Effect** of Timely Payments

Exhibit 1: Business Bankruptcy Filings 2000 to 2011

Even with recent decline in bankruptcy filings, the average since mid-2008 is at an all-time high.



Source: D&B

Section 1 **Why the Surprise?**

We will define and describe the *Cloaking Effect* and places in the credit process where the *Cloaking Effect* may occur.

Section 2 **How to Avoid Cloaking**

We will provide you with real strategies to prevent being Cloaked again.

Why the Surprise?

There are numerous scenarios that might be labeled as precursors to potential bankruptcy filings, with some being more overt than others. However, there is one circumstance that appears to go against logic:

What's the Cloaking Effect?

Some companies pay their trade credit obligations in a discount or prompt manner right up to the actual filing/closing date

This may happen because the company has established automated payment methodologies, makes timely payments to received highly valued discounts or continues to purposely pay on time to avoid setting off red flags. Whatever the reason, when this happens, the payment patterns or performance of the troubled company mask their true financial condition, creating the *Cloaking Effect*. At most corporations, these instances do not typically represent the bulk of bad debt losses but are the examples that attract the most attention because of the surprise and lack of opportunity for early intervention.

We have received many inquiries from the credit community asking why we had not predicted a filing or closing. In many of these cases, the inquiries include an accompanying comment from the credit executive confirming that they had been paid on time right up to the bankruptcy filing date—thus creating a confusing scenario, leaving the credit executive searching to understand why their debtor had not appeared on their radar as a possible high-risk customer. The investigations typically show that the customer had satisfied the majority of their obligations in a prompt or discount manner. In fact, to complicate things further, any scores heavily weighted by historical payment data would have reflected the timeliness of those payments—and here is where we will begin our discussions.

Let's look at NewPage Corporation, a recent bankruptcy filing that we have received many inquiries about and one where the debtor paid most obligations relatively promptly, right up to the bankruptcy filing date.

Exhibit 2:
Case Study—NewPage Corporation

NewPage Corporation, Miamisburg, OH
Case # 11-12808 Wilmington, Delaware
Filing date: September 7, 2011

Duns Number: 19-753-3446
Source: D&B

NewPage Corporation filed for protection under Chapter 11 of the Bankruptcy Code on September 7th, 2011. They are a coated paper(s) manufacturer and at the time was 2011's largest business filing, representing $3.5 billion in assets.

Archived D&B Data

PERIOD	CCS CLASS	CCS PCTILE	CCS POINTS	PAYDEX	FSS CLASS	FSS PCTILE	FSS POINTS	SER
CURR	1	100	551	072	5	1	1328	9
11Q2	1	100	536	071	5	1	1328	9
11Q1	1	100	536	071	5	1	1328	9
10Q4	1	100	536	071	4	3	1361	9
10Q3	1	99	586	070	4	5	1370	8
10Q2	1	99	518	070	4	5	1383	8
10Q1	1	96	500	068	5	1	1319	9
09Q4	1	100	546	068	5	1	1320	9
09Q3	1	95	496	070	4	2	1347	9

It is understood that this specific bankruptcy and others like it, will not catch everyone off guard. However, given the number of inquiries received against this bankruptcy filing, an examination of what may have allowed this company to escape additional scrutiny as a high-risk company from many in the credit community is worth a closer look. When researching these inquiries, we uncovered a few process areas where the *Cloaking Effect* appears to mask the inherent risk. The *Cloaking Effect* actually covers three of the more traditional approaches related to risk assessment:

1. Do I Review?
2. What Do I Review?
3. How Do I Review?

All are process related. All are payment based. All have anchors in an over-reliance on payment performance. The nuance between the three is a question of where the *Cloaking Effect* can occur. Let's take a closer look at the impact each of these scenarios can have on the accuracy of the identification of risk.

Question One: Do I Review?

Based on our observations, the countless operational reviews conducted, learning's from User Groups, surveys and external research, what we found is that **many credit departments are primarily reviewing only those existing customers that have past due balances or have exceeded their credit limits.**

The driving force causing this process reality could be any of a number of reasons. It may be due to the impact of downsizing resources within the credit function. The loss of resources forces the credit professional to alter internal processes and the way they undertake their responsibilities regarding risk assessment, including taking an exception only approach to account reviews. Whatever the reason, the effect of these operational process modifications is contributing to the surprises that our customers are experiencing.

This theory is reflected and confirmed in the outputs of the Credit Research Foundation (CRF) study entitled: *Credit Decisioning* (see extract in Exhibit 3). The CRF study citing "what circumstances trigger a review of an existing account" clearly indicates that accounts receivable past due status and/or an account having exceeded an existing credit limit is what determines the point of the review. This approach results in the situation where a potentially high-risk customer that continues to retire their obligations in a discount or prompt manner and remains under their credit limit will be never be identified. Therefore, the question of whether to review or not to review the account is never entertained.

Exhibit 3:
Credit Decisioning by Credit Research Foundation

Detail the circumstances that would trigger a review of an existing account. (Check all that apply)	
Customer payments have fallen past due.	95%
Customer orders exceed credit limit.	86%
Special Event (such as Change in Ownership, Fire, Flood, Theft, etc.)	72%
Received industry trade credit interchange report indicating slowing payment to trade creditors.	68%
Received report from subscription service notifying of a change in the customers credit or financial situation.	57%
Customer has released updated financial information.	56%
Received information indicating a change in the customers parent company credit or financial situation.	56%
Legal Filings (Suits, Liens & Judgements)	52%
All accounts are reviewed on a specific schedule.	40%
Received alert from subscription service notifying of a change in the credit limit recommendation.	37%
Rating Agency Change (Moody's, S&P or Fitch)	30%
Other	9%

Returning to our case study, NewPage Corporation, this would have been the case. According to D&B data, of the 616 trade lines 94% of their obligations were being retired in less than 30-days past due resulting in a Paydex of 72. This equates to 12 days beyond terms—generally deemed "acceptable" by most credit departments. Looking at the previous eight quarters of performance, the PAYDEX has remained fairly consistent (see Exhibit 2)—with not enough of a continued monthly variance to trigger or highlight a concern. Given this, NewPage Corporation would **not** have come up for an account review because the customers' internal processes didn't call for it.

In order to avoid being hit by the *Cloaking Effect*, more than internal payment history must trigger a review.

Question Two: What Do I Review?

What Do I Review to assess the credit worthiness? Our research shows that regardless of the number or combination of elements used, credit professionals are applying too much emphasis on payment related data. Some of the most frequently used inputs in a manual credit review are:

- Internal payment history
- Payment based scores
- Payment history from a vertical trade credit group
- Trade experiences shown in the D&B report
- Calls to trade references

Exhibit 4:
Credit Decisioning by Credit Research Foundation

Identify the information sources that you use to make an existing account decision. (Check all that apply)	
Customer History with your organization (A/R, payment history, etc.)	73%
Credit Trade Group Interchange Report	54%
Trade Reference	54%
Bank Reference	53%
DNBi	49%
D&B Business Information Report	36%

In reality, **none of the above payment data sources is either singularly or collectively sufficient to perform the credit analysis needed.** Let's go back to NewPage Corporation. All of the aforementioned would have been perceived as positive or resulted in positive comments/points/scores; yet none would have revealed the underlying financial stress the company was experiencing. The bottom line is that almost everyone would have stated they were being paid according to terms with only slight variances. This historical view and over emphasis on payments would lead to the same conclusion articulated above—with payments being properly handled, the line of credit would be extended and the risk of failure would be missed.

Question Three: How Do I Review?

There have been numerous articles written about automated decisioning or credit scoring. These articles typically espouse the benefits and advantages, from both an operational and strategic perspective, of automating all or some aspects of the credit decisioning process. The articles help the reader, define and structure cost benefit analysis and related ROI type scenarios for implementing such programs. They often detail everything from throughput efficiencies to Sarbanes Oxley compliance. The only misgiving from all of these benefit-related approaches is that the articles generally fail to highlight or emphasize the elements driving the decisioning process. What they fail to highlight is the tendency for credit practitioners to place too much weight on historical payment performance when utilizing automation.

To illustrate this critical point, we researched and gathered approximately one hundred active scorecards from credit organizations where the trade credit manager used their own weightings and elements to drive the decisioning outcomes. The distilled compilation of these results is depicted in Exhibit 5 below.

Exhibit 5:
Aggregated Scorecard from Use Case Samples

Element	Weight
Payment Based Scores (CCS & Paydex)	44%
Internal Company Payment Data (% Past Due, % > 90, Total Past Due, etc.)	25%
Financial Based Scores and Elements (FSS, Rating, Financial Statement Data)	23%
All other Elements (Years in Business, Employees, Public Filings, etc.)	8%

As you can see in this example, nearly 70% of the sample set scorecards are heavily founded on payment performance, leaving their companies vulnerable to *automated cloaking*. Confirming that a company paying well, even if other elements may signify high risk, will not accumulate enough negative points to offset those points received from the positive payment performance. The result is no red flag for the Customer Credit analyst.

Taking this concept one step further, let's review how our case study account, NewPage Corporation, would have fared using data sets from six months prior to the their bankruptcy filing date.

Exhibit 6 empirically shows that if the framed scorecard and related data from six months prior to the bankruptcy filing had been used, the final score would have been 6.7 for NewPage Corporation. This value would have been sufficient for NewPage Corporation to pass a typical automated credit review. Therefore, without the benefit of additional information NewPage Corporation would have continued to pass monthly credit reviews and the credit executive would not have anticipated the bankruptcy filing.

Exhibit 6:
Case Study—NewPage Corporation

Element	Weight	Data Set March 2011	Points Achieved
Payment Based Scores			
Commercial Credit Score	24	100	2.4
PAYDEX	20	72	1.8
Internal Company Payment Data			
Average Days to Pay	15	36	1.3
Percentage 90+ Past Due	10	0%	1.0
Financial Bases Scores and Elements			
Financial Stress Score	18	1	0.0
D&B Rating	5	-	0.0
All Other Elements			
Years in Business	8	6	0.2
Total			**6.7**

To calculate the score, the original sample aggregated scorecard in Exhibit 4 was expanded into a typical configuration but retaining the consolidated weights.

Note: *This is not a recommended score card but rather an example of typical elements used in many scorecards.*

How to Avoid Cloaking

There is significant value in a customer payment patterns. Slow payments or increasingly slower payments remain a good leading indicator of concern, but it is not enough to just look at payment history. As we saw in our analysis of NewPage Corporation, customers often retire their obligations in a timely manner regardless of their overall financial health. To avoid being surprised, consideration regarding the cloaking effect of prompt payment patterns must become part of the overall equation when analyzing or assessing risk and also when developing the weighted elements of an automated decisioning system.

NewPage Corporation is not an isolated case or example of these concepts—even since their September 2011 filing there are additional examples of other notable bankruptcies such as American Airlines, Dynegy Holdings and even the more current filing by Hostess, which give evidence to this theory. **Given the fact that these potential surprise bankruptcies continue to occur, so will the *Cloaking Effect* unless credit professionals examine the three process questions for potential gaps in the outcomes. This is the only way to avoid becoming a victim of the *Cloaking Effect*.**

Action Items for Avoiding the Cloaking Effect

1. **Don't Overreact.** Judiciously review your internal operating practices to make sure you don't fall into the pitfalls highlighted above. More often than not—a simple tweak to policy or process will produce the desired solution.

2. **Use the archived pre-bankruptcy data elements** for NewPage Corporation in Exhibit 2; verify that your credit process would have captured the risk. If it wouldn't have, revise your policy to receive a warning for this type of credit risk.

3. **Reexamine your scorecards and weights.** Many times using a negative attribute for lower Financial Stress Scores (i.e. 32 or lower) may provide the desired outcome.
   - If you don't want to change your scorecard, you can create an exception rule to capture these high risk accounts.

4. **Identify customers** within your current portfolio who might fall into these scenarios by creating a filter that segments good paying customers that have other signs of high risk—Commercial Credit Score >90 and a Paydex score > 70 with a Financial Stress Score < to 35.
   - Continuously review the situation and all available resources that augment your decisioning process as the reviewed account could be captured within this filter for a period of time before ultimately failing.

5. **Do not reallocate weights** for missing elements in scorecards. In situations where data elements are not present, allow the scorecard to remain true and only represent what points it is awarding for elements that are present.

6. **Never hesitate to request support** or assistance in reference to any of the above.

***We want to reinforce that accounts falling into the categories defined are not to automatically be deemed high risk—in fact, there may be no risk at all, but if you have been the victim of a surprise bankruptcy, there is a high likelihood that you were* cloaked.**

About the Authors

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AVP—Risk Management Applications

David Earickson is AVP of Risk Management Applications at D&B. David has extensive experience in helping D&B's customers map their operational practices to the latest technology solutions. Based on his solid understanding of the specific business needs and objectives of the risk management professional, David has been recognized by both his colleagues and customers for his expertise in enabling the use of D&B's solutions and capabilities to create significant business process improvements and a "best practice approach" for customers. David has developed numerous training programs designed to educate credit professionals on the techniques that can be used to embed scoring and portfolio management methodology into everyday risk management processes.

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Bill Balduino is VP Risk Management Practices for D&B. A former credit management practitioner, Bill brings a wealth of experience and knowledge that is based on more than 25 years experience in the profession. Prior to joining D&B, Bill held senior credit and financial management positions at Fortune 500 companies in multiple industries. Among these positions, he served as Director of Credit for Engelhard Corporation and Director of Credit for Union Camp Corporation. Bill is widely recognized as an accomplished speaker on the subject of risk management best practices. He has been featured in numerous credit forums and periodicals discussing the intrinsic value and evolution of the credit discipline.

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