Merton models or credit scoring: modelling default of a small business

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Abstract

Risk associated with lending to small businesses, which forms the subject of this presentation, shares the features of both retail and corporate sectors, and this has been recognised by Basel II provisions. The dual nature of small business lending makes it possible to assess the credit risk using the approaches from both corporate and retail lending sectors. The corporate world relies mainly on structural market-based models for credit risk measurement, whilst retail lenders use empirical predictive models (credit scoring).

Driven by Basel II, the presentation compares two approaches by applying Merton-type and credit scoring models to predict financial health of the U.K. small businesses. The comparison is extended to cover several cut-off points, corresponding to different acceptance policies and risk appetites.