

Discussion of:

Modeling Credit Risk for SME's: Evidence from the US Market

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Main objective of the paper

- * Develop a model to predict business default among SME's
- * Analyze its effectiveness compared to a general (i.e. corporate) model

Method:

- * Logit model
- * Horizon = 1 year
- * New angle: other transform of variables

Data:

- * 2k US firms, TS < \$65mn, 1994-2002

Findings

* EBITDA/TA, STD/E, Ret.Earnings/TA, Cash/TA, EBITDA/Interest, Logged variables perform best

* Out of sample predictive power: 30% up.

Type I error rate down 14%

Type II error rate unchanged

* What's the issue?

Basel II mechanically assumes lower correlation for SME loan portfolios

* Supposed justification:

Correlation between SME's is small, so at a portfolio level, loans to SME's should be less risky in terms of unexpected credit risk (compared to corporates)

Therefore, capital requirements for SME's should be lower

Questions and suggestions 1/2

* Use same model for all purposes?

=> is a good default prediction model also a good model to determine portfolio risk and capital requirements?

=> crucial element: modeling of correlation

* What determines the absolute and relative level of risk among firms?

=> relative risk: financial ratios

=> absolute level of risk: macro shocks

Questions and suggestions 2/2

* What does out of sample pred. power 30% up mean?

=> Large firms: mostly exposed to "aggregate" risk (macro)

=> SME's mostly idiosyncratic risk \Leftrightarrow firm specific variables explain more

* If macro is excluded, then only gain from estimating SME specific model

* Why only Type I errors down? Explanation?

Minor issues

=> "Qualitative" vs "quantitative" variables?