Evaluation of Market Practices and Policies on SME Rating

Final report

Centre for Strategy & Evaluation Services

Panteia
Research to Progress

European Network for Social and Economic Research

Contents

Framework Service Contract for the Procurement of Studies and other Supporting Services on Commission Impact Assessments and Evaluations

Interim, final and ex-post evaluations of policies, programmes and other activities

Glossary

ABI	Associazione Bancaria Italiana (Italian Banking Association)
BBA	British Bankers Association
CeFiP/ KeFIK	Le Centre de Connaissances du Financement des PME (CeFiP)/ KenniscentrumvoorFinanciering van KMO
CRD	The Capital Requirements Directive which comprised of two directives: Directive 2006/48/EC and Directive 2006/49/EC of the European Parliament and the Council of 14 June 2006, relating to the taking up and pursuit of the business of credit institutions (recast), L 177/1, 30.6.2006.
CRR	The successor to the 2006 Directives is the CRD IV package, of which Regulation 575/2013 (CRR) entered into force on 28 June 2013 and the Directive 2013/36 (CRDIV) on 17 July. They will become applicable as of 1 January 2014.
CRD 145(4)	Directive 2006/48/EC Article 145(4), under disclosure rules by credit institutions, states: "Credit institutions should, if requested, explain their rating decisions to SMEs and other corporate applicants for loans, providing an explanation in writing when asked. Should a voluntary undertaking by the sector in this regard prove inadequate, national measures shall be adopted. The administrative costs of the explanation have to be at an appropriate rate to the size of the loan". See below CFRR 431(4).
CRA	Credit rating agency
CRR 431(4)	Under the CRR (see above) Article 431 (4), dealing with disclosure, credit "Institutions shall, if requested, explain their rating decisions to SMEs and other corporate applicants for loans, providing an explanation in writing when asked. The administrative costs of the explanation shall be proportionate to the size of the loan". As this is a Regulation, it does not need to be transposed.
CESR	Committee of European Securities Regulators
EAD	Exposure at default
ECAF	European credit assessment framework defines the procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards for all eligible assets is met.
ECAI	According to the Capital Requirements Regulation article 4:(98) 'external credit assessment institution' or 'ECAI' means a credit rating agency that is registered or certified in accordance with Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (1) or a central bank issuing credit ratings which are exempt from the application of Regulation (EC) No 1060/2009
ECB	European Central Bank
ESMA	European Securities and Markets Authority
Febelfin	The Belgian Financial Industry Association
FSAP	Financial Services Action Plan
IBF	Irish Banking Federation
ICAS	In-house credit assessment system source based on the standardised approach using externally provided ratings. Currently in use by: the Banco de España, the Banque de France, the Central Bank of Ireland, the Deutsche Bundesbank, the Oesterreichische Nationalbank, and the Banka Slovenije)
IFD	Initiativ Finanzstandort Deutschland
IRB	Internal ratings based approach to calculating regulatory capital for credit risk
KfW	A German government-owned development bank (its name originally comes from Kreditanstalt für Wiederaufbau, meaning Reconstruction Credit Institute).
LGD	Loss given default
M	Maturity of exposure
MSME	Micro, small and medium-sized enterprises (EU definitions)
NCB	National Central Banks
PD	Probability of default
RWA	Risk weighted assets

Glossary

SAFE	2013 SMEs' Access to Finance survey, Analytical Report, European Central Bank and DG Enterprise and Industry (European Commission)
SBRS	Statistically Based Rating Systems
SME	Small and medium-sized enterprises (EU definition)
UCM	Union des Classes Moyennes (Wallonia and Brussels region representation for SMEs)
UNIZO	Unie van Selfstandige Ondernemers (Union of self-employed entrepreneurs), Belgium.
VIES	VAT Information Exchange System

Executive summary

The objective of the study

The objective of this study is to evaluate the effectiveness of banks' practices in place at EU and Member State (MS) level as regards Small and Medium-sized Enterprise (SME) rating systems, with a particular attention to the use of qualitative ratings. It also evaluates the usefulness of the feedback provided by banks to SMEs. A secondary objective of the study is to highlight what policies public authorities in Member States and EU authorities have taken to promote the transparency of SME rating in the banking sector and the supply of such feedback to SMEs, and how effective they have been.

The study is based on desk research, over 200 interviews with stakeholders including banks, banking associations (EU and national), SMEs and SME associations (EU and national), academics, national authorities and regulators, and other firms. In addition a European survey was carried out through the Enterprise Europe Network, which had 466 responses, and a survey was carried out in Italy which elicited 70 responses.

For the purposes of this report, unless otherwise specified, the term "rating" refers to how it is used in the context of the Capital Requirements Regulation as in the Standard and the Internal Ratings Based (IRB) approaches, as set out in section 3 of the report.

SME success in application for bank finance

The research starts by considering the recent experience of European SMEs in obtaining bank finance based on the 2013 SMEs' "Access to Finance survey, Analytical Report" (European Central Bank- ECB). The ECB data suggest that the smaller a firm, the larger the likelihood that its funding application will be declined. Assuming that the need for feedback is greater when applications are declined, the smaller firms will also be the ones where feedback is most required. There is also a significant difference between Member States as regards declined funding applications from SMEs.

Commission policy initiatives

Commission's policy initiatives in this field have focused on increasing transparency, encouraging the use of qualitative factors in credit decisions, and providing legislation to require feedback to SMEs in respect of credit requests, and improving the supply of information through the agencies that provide banks with information about enterprises.

Bank practices as regards rating/ scoring, quantitative and qualitative data

The review of banks' practices finds that the largest share of credit provided to SMEs throughout the EU is from banks with Internal Rating Based (IRB) systems. The share of banks using the IRB system is set to increase, although an appreciable number use the Standardised Approach. The development of large and complex statistically based rating systems (SBRSs) that conform to the requirements of the Capital Requirements Directive (CRD) and now the Capital Requirements Regulation (CRR) has focused attention on the role of quantitative and qualitative ("soft") data inputs.

The relative importance of both these types of data varies between banks and types of banks. For most of the general banks it is usually within the range of 20-40% qualitative and the rest quantitative. In some public banks, or banks specialised in servicing SMEs, it may be the other way around – 60-80% qualitative and the rest quantitative.

Both data types have advantages and disadvantages. Quantitative data can be relatively robust and can be readily analysed, but it is usually backward-looking. Only a small number of SMEs have sufficient financial data to produce useful analyses. Qualitative data may be more forward-looking but is costly to collect and inherently more subjective. The interplay between these two types of data is of critical importance in banks' rating systems as regards client types.

Executive summary

In particular, there is a distinction between larger corporate and smaller retail clients. The retail segment (which includes the smaller SMEs) is scored rather than rated. Corporate clients – usually larger corporate clients – are more likely to be rated. The research suggests that it is in the area of scoring, or dealing with retail clients that most issues as regards transparency and feedback emerge, as the data used to inform the assessment is often generated by an automated process, or may have been obtained from external providers.

The role of qualitative factors in banks' credit assessments is multifaceted. On the one hand such factors can improve predictability of outcomes, but on the other hand research suggests that inclusion of qualitative factors does not necessarily improve SMEs chances of getting a loan or credit. At the same time, SMEs with negative soft factors seek out banks that take less soft factors into consideration in order to obtain finance. So there is no direct positive relationship between increased use of qualitative factors and SMEs success in obtaining finance, while the cost of gathering qualitative factors also goes against their increased use in the retail segment.

Feedback to SMEs

The feedback given to SMEs by banks is driven by the nature of the data used to assess them. In general, the larger the enterprise, the more data is available and the greater the chance that meaningful feedback and more of it will be provided. While there are some differences in this respect between Member States (for example, it is not an issue in Sweden, Finland and Germany), most SMEs are not particularly interested in knowing how their bank scores or rates them in terms of a number or letter, nor are they interested in the mathematics and statistics underlying the rating or scoring models. They are interested in whether they got the credit or not, and if yes, what the conditions are. If they did not get the funds, some are not interested in asking why that was, but rather more interested in trying to find an alternative supplier. Others find it useful to know why not and what could be done to get credit – and if that does not work they may seek other sources of funding. What is really useful to them is to know what the key criteria are that the banks consider important in assessing a credit application.

In the Enterprise Europe Network survey results, just over a half (52%) of respondents who had received feedback found it either useful or very useful. Almost two-fifths (38%) said it would help them to obtain funding in the future.

Feedback can be grouped into three categories: useful for accessing future loan applications; useful information for future loan applications but with enterprises not able to do anything about it (e.g. need for collateral, or a guarantee, that cannot be obtained); and, unable to use the feedback due to insufficient financial literacy. The research also found the implementation of CRD 145 (4) in support of transparency and feedback to be very patchy (although good in a few places, in particular Germany), and there were some divergences in perception on this score between members of the financial community and SMEs, with financial industry regulators or banking associations often unaware of the views of SMEs and SME associations.

Support initiatives

A wide range of initiatives in support of SMEs as regards rating and transparency has been undertaken. Those driven by collaboration between the financial industry and SMEs have addressed a wide range of issues such as self-assessment, training, developing platforms to exchange views, and even developing ratings that could be bought from the Chamber of Industry of the region. These can be very useful and often can be implemented at low cost but it is not sure if they will reach some of those "outside the networks" that may be most in need of the support. Industry Codes of Conduct may be useful but are easily forgotten or brushed aside when other pressing matters arise as they tend not to have "teeth". Some of the most interesting initiatives are around the development of credit registers (where they do not yet exist in the market), or independent mediators or credit reviewers, or similar institutions, and increasing of financial literacy that will improve the data and knowledge "backbone" of the industry in the longer term.

Standardisation

The study considered the standardisation of rating and scoring systems. The banking community is generally against standardisation as they consider their own in-house rating models as providing a competitive advantage. They are continually developing such models. Diversity is seen as leading to opportunities and innovation. Standardisation, it is argued, will raise costs and weaken competition. SMEs on the other hand say they would like standardisation but on being probed on the subject it becomes clear that they mean some form of standard data input for a credit application. National authorities tend to be of the view that it would be hard to design a standard system better than the ones already in use, and that may lead to increased systemic risk and stifle innovation. Many barriers are perceived to the development of such a system: time, cost, existence and accuracy and updating of data, to name a few.

One general finding is that the need for support is more of an issue for enterprises at the smaller end of the scale than the larger ones: the problems are more in the area of credit scoring than credit rating and providing feedback in that context. Policy should concentrate on this area.

Recommendations

The study makes recommendations in terms of who should be responsible for their implementation. These are listed in a summarised form below.

The Commission

Recommendation 1: To revive awareness of the issue of transparency and dialogue, it is recommended that that a Round Table event on the subject should be planned to take place which specifically focuses on feedback and the implementation of CRR 431(4).

Recommendation 2: The Commission should encourage European banking industry associations to get their members publicly committed to working with SME associations to develop an agreed standard of feedback to SMEs and to regularly report back on progress (see also Recommendation 13 below).

Recommendation 3: Given that so many applying for finance are small enterprises that might not be trading as enterprises but as private persons, and there are so many zero employee enterprises, and that these are invariably the entities about which least information is available, it is recommended that, as is the case in Germany, the provisions of CRR 431 (4) be extended to natural persons (who are usually credit scored) so that they can benefit from increased transparency as well, or alternatively that Member State governments enact such provisions themselves.

Recommendation 4: The research findings suggest that it will be neither practical nor particularly relevant to design a standardised rating system that will be accepted by banks and approved by the relevant regulators.

Member States

Recommendation 5: Member States need to find ways to raise awareness of enterprises as regards their rights to obtain feedback. The level of implementation of the new Regulation CRR 431 (4) should be regularly monitored at Member State level and the findings published.

Recommendation 6: Member States should consider the scope for a "feedback-friendly" certification of lending institutions by an independent third party organisation (public or private).

Recommendation 7: Some Member States have supported the development of institutions such as Central Credit Registers, Credit Mediators or independent Credit Review bodies. It is strongly recommended that

Executive summary

where such institutions do not exist serious consideration be given to their establishment and to ensure that they cover micro credit applications as well as larger sums.

Recommendation 8: Some Member States publicise how credit referencing data is used in lending decisions and encourage enterprises to learn what their scores are and improve them. Such an open approach can be very helpful and is recommended. Member State authorities should encourage commercial and public credit referencing agencies to help their customers check the accuracy of data held about them.

Recommendation 9: Member States should encourage SMEs to check the data held on them by credit rating agencies before making an application for credit facilities. In some cases, credit rating agencies make a material charge to SMEs if they want to get information to check. If a fee is charged by an agency to provide data to check it should be minimal.

Recommendation 10: Member States should renew their efforts at improving general levels of financial literacy. This could be done through financial industry associations, other financial training institutions and the secondary educational system so that even those with a minimal level of formal education have had some exposure to financial matters, and particularly debt – both borrowing and repayment.

Recommendation 11: One of the sources of data on many SMEs is their VAT payment record. Because the 4th Company Law Directive allows SMEs to file only minimal financial data, the VAT record is a useful credit indicator which might be accessed. As a first step, the Commission could consider whether the VIES system, which now allows anyone to check if a given VAT number is valid, could also provide the reverse data – that is, to indicate whether an enterprise has a valid VAT number.

The market

Recommendation 12: Industry and trade associations (other than banking associations) need to take on board the issue of raising awareness of the CRR 431 (4) provisions to their members to a greater extent than has been the case to the present.

Recommendation 13: Industry and financial industry associations should work with their members to develop a standard minimum content communication document for SMEs that have been declined finance (see recommendation 2 above for banks).

Recommendation 14: Where banks used external data to make a lending decision, it should be made clear in the feedback provided under CRR 431 (4). The name of the relevant agency, or agencies, should be provided together with contact details so that the enterprise in question can approach the agency to check the accuracy of data held. There should be standards for such agencies' responses to enquiries to ensure that they are comprehensible to those making enquiries. Fees, where in question, should be very modest. If it emerges that a bank declined credit based on inaccurate information held by the agency, the agency should compensate the party in question.

Recommendation 15: Where a number of credit referencing agencies operate in a Member State, they should agree a means of cross checking data that is held about a particular company. It would be inappropriate to ask a company to check data on multiple agencies and to pay for that. Such a system could be developed under the auspices of the relevant industry body.

Recommendation 16: Some approaches to transparency and comparability in ratings such as that of the nationally integrated Initiativ Finanzstandort Deutschland outlined in the report might work in other Member States. National industry associations should consider whether such an approach would be useful and could work in their countries.

Introduction 1

This introductory section sets out the objectives and scope of the project, the evaluation questions, and the approach adopted.

1.1 Assignment objectives and scope

The **overarching objective** of the study is to evaluate the effectiveness of market practices and policies in place at EU and MS level as regards SME rating systems and feedback provided by banks to SMEs, with a particular attention to the use of qualitative ratings.

The **main objective** of the evaluation is to have an overview of the bank practices in rating/scoring SMEs and of the feedback they provide to SMEs, on a voluntary base or upon request from SMEs. The evaluation will:

- Evaluate rating/scoring systems used by banks, with particular attention on the use of qualitative ratings;
- Assess whether and what type of feedback is provided to SMEs, e.g. just a code or also the underlying assessment, with a focus on the implementation of the CRD provision mentioned below;
- Investigate in depth the effectiveness and benefits provided by such feedback and how it is improving SMEs chances of getting better bank financing.

A **secondary objective** of the study is to highlight what kind of policies (both legislation and soft law, such as codes of good conduct, MoUs, etc.) public authorities in Member States (such as banking authorities) and EU authorities have taken to promote the transparency of SME rating in the banking sector and the supply of such feedback to SMEs. Industry initiatives also receive attention. The effectiveness of such actions will be evaluated. An assessment on locally based agreements (if any) will be made if circumstances allow it.

As a **third objective**, the study is to suggest the design of a practical, comparable and standardised rating system, with a set of indicators as a "minimum common denominator" which could potentially be used and accepted by different banks, and be of practical use for SMEs. CSES will recommend to the Commission whether and how such a system could be implemented. The evaluation will also suggest what could be the potential support by Member State authorities to promote such an approach.

The study will provide recommendations on:

- Which are the most effective bank practices
- Which are the most effective EU/MS policies
- The level of implementation of the CRD provision at MS level
- Ways to design a practical, comparable and standardised rating system and barriers to its implementation
- Which elements could also be used in other countries (depending less on the country specific environment)
- Possible policies/actions which could be implemented at EU level

1.2 Project methodology

The assignment has been designed and carried out in a three stage process:

Phase 1: Preparatory Tasks – these included a set up meeting, a review of material gathered and desk research, initial interviews, development of interview guides and methodologies and the stage 2 plan leading to an inception report. There was a meeting to discuss the inception report after which the report was finalised.

Phase 2: Fieldwork – this included the national studies: a desk review of national data and remaining EU level interviews, Member State level interviews, and the development, testing, launch and carrying out of a survey to run in collaborating Member States. There was also some follow-up interviews/research in selected countries. The first progress report was submitted and discussed.

Phase 3: Analysis and Final Report – During Phase 3 the research was finalised, we prepared a first findings and recommendations report, and after feedback from the Commission this draft final report was submitted.

1.3 The interview and survey programme

In order to obtain the views of the various stakeholders involved in this matter, we carried out a wide ranging interview and survey programme. A list of organisations interviewed is summarised in Table 1.1 below. At EU level, interviews were conducted with the major European banking and related associations, SME Associations and relevant European Commission officials, as well as the EIF/ EIB. At national level interviews were conducted with representatives of major national banking associations, individual banks, industry and SME associations, individual SMEs, relevant national authorities and Ministries, as well as academics specialised in the field. We have completed 207 interviews, and carried out an additional approximately two dozen follow-up interviews.

In addition, the Enterprise Europe Network[1] carried out a survey through the SME Test Panel. This produced some 466 responses of which 83 were rejections. Results of the survey have been analysed and are integrated into the report.[2] A separate smaller survey that obtained 70 responses was also carried out in Italy through Assolombarda and Confindustria[3].

[1] The Enterprise Europe Network brings together business support organisations from more than 50 countries. The Network operates the Small Business Test Panel which consists of individual companies from all over Europe, which are regularly consulted on policy initiatives of the European Commission. This is done through internet-based questionnaires that are easy to fill in. Any company can join the test panel, it is voluntary, and companies respond to surveys they consider relevant.
[2] 73 responses (15.6%) were from Italy, 173 (37.1%) from Poland.
[3] Assolombarda is the industry association of the region of Lombardy in Italy; Confindustria is the main organisation representing Italian manufacturing and services companies at national level.

Table 1.1 Interview and survey programme		
Type	**Category**	**Number**
Interviews (total: 201, plus 19 additional contacts)	Academics	18
	Banks	44
	Rating/ scoring/ referencing agencies	43
	EU Banking and Rating Associations	7
	EU Business Associations	2
	EU Commission	2
	EU Financial Institutions	3
	Member State Government/ Authorities	33
	National Banking Associations	23
	National Chambers of Commerce and Industry	35
	SMEs	33
	Others	3
Enterprise Europe Network Survey	SMEs	466
Assolombarda/ Confindustria Survey	SMEs	70

The economic and policy context 2

This section sets out the recent experience of European SMEs in obtaining bank finance and is based on the 2013 SAFE analytical report and data. It reviews the experience of micro, small and medium-sized enterprises. The key issues facing banks in providing finance for SMEs are then listed, and the main thrust of the Commission's intervention into the area of rating and scoring (including qualitative elements), transparency and feedback is outlined.

The section concludes that the smaller a firm, the larger the likelihood that its funding application will be declined, and assuming that the need for feedback is greater when applications are declined, the smaller firms will also be the ones where feedback is most required. There is also a significant difference between Member States as regards declined funding applications from SMEs. The Commission's policy initiatives have focused on increasing transparency, encouraging the use of qualitative factors in credit decisions, and providing legislation in support of feedback, SME finance through the rating and scoring system, and improving the supply of information through the CRAs.

2.1 SME financing–demand from banks

Small and Medium-sized Enterprises (SMEs) represent some 99 per cent of all European enterprises and play a key role in the economy in terms of employment, economic development and growth[4]. They account for 58.6% of the total gross value added (GVA) produced by private businesses and provide more than two-thirds of all employment opportunities in the private sector. More than 90% of enterprises in the EU-27 are micro enterprises employing less than 10 people[5]. The relative importance of SMEs is particularly high in the southern Member States: Italy, Spain and Portugal.

However, many SMEs face difficulties in accessing finance, particularly in the present economic environment. Although SMEs have a number of possible sources of financing, loan finance remains the most important source of external finance for SMEs in Europe. According to figures from the ECB, approximately 70-80% of the financing of SMEs is provided by banks[6].

According to the ECB (SAFE Survey)[7], in 2013 some 54% of EU SMEs indicated that they use only external financing. This was similar to the figure of 56% in 2011 but more than double the figure in 2009. SMEs were more likely than larger firms to have used only external financing (54% compared to 43%). The most widely used of such sources were bank overdrafts (39%), leasing/ hire purchase and factoring (35%), trade credit (32%) and bank loans (32%). 75% of EU SMEs used at least one source of debt financing in the last 6 months – the same as in 2011 but up from 61% in 2009.

The 2013 SAFE Report indicates that in 2013 21% of EU SMEs applied for a bank loan during the survey period of 6 months (compared to 19% in 2011 and 26% in 2009). SMEs most likely to apply were in Luxembourg (32%), France (30%) and Slovenia (30%), and those in Denmark (8%), Estonia (8%) and Latvia (5%) least likely to have done so.

21% applied for an overdraft during this period, especially in Italy (35%) and Slovenia (32%), but were least likely to do so in, Estonia (4%), Sweden (4%) and Greece (5%). 7% of EU SMEs did not apply for bank loans due to possible rejection, and reluctance to apply for loans or overdrafts because of that was

[4] Eurostat (2011); Key figures on European business, with a special feature on SMEs, p.11
[5] Eurostat (2011); Key figures on European business, with a special feature on SMEs, p.11
[6] Trichet, J-C (2009); "The ECB's Enhanced credit support", slide 5; and Draghi, M.; Press Briefing, 4 April 2013, Frankfurt.
[7] European Central Bank (2013); SMEs' Access to Finance Survey, (SAFE), Analytical Report, pp.6-8

particularly the case in Ireland, Greece and Cyprus. There are clearly significant differences between Member States that reflect those countries' underlying economic conditions and financing preferences.

Furthermore the SAFE Survey found that about two-thirds of those who applied for external finance were granted all they requested. Applications for bank loans or overdrafts were most likely to result in outright rejection (13% and 10% of cases respectively), but in general those who received all they requested when applying for external funds was similar to that in 2011.

The SAFE survey found that half of SMEs had taken out a loan in the preceding two years, the same as in 2011 but up from 46% in 2009. Micro enterprises were less likely to have done so (43% of those with 1-9 employees) compared to 59% of larger small enterprises (50 staff or more).

The most common (36%) amount borrowed was between €100,000 and €1,000,000, but 52% borrowed less than €100,000, with quite a large difference in average loan sizes between Member States. Banks were the main providers of loans (85%), and loans were mostly employed for funding working capital, land and buildings, and equipment or vehicles.

34% of SMEs applying for a loan thought that interest rates had increased in the last six months (compared to 52% in 2011). This was particularly the case among microenterprises (38%) compared to larger SMEs (29%) and large firms, Non-interest related costs are reported to have increased in 43% of instances over the past six months, and again, was more often the case with smallest SMEs (49%) as compared to larger SMEs (34%) and large enterprises (33%).

Requirements as regards collateral and other conditions attached to loans are also more likely to have increased than decreased, although for some 60% no changes are reported.

Bank loans remain the preferred source of external funding (57%) among SMEs expecting to grow in the next few years.

2.2 Key problem areas and rationale for intervention.

2.2.1 Key problem areas

A key assumption underlying this research is that the provision of feedback by a bank to an enterprise will be of more interest to an enterprise for which funding has been declined than for one for which it has been approved. While the successful firm may still want to hear what the bank has to say, and find it useful for the future, the firm for which funding has been denied would have a more immediate interest in understanding why that has been the case, either from the point of view of re-submitting an application, or to approach a different financial institution that may not, for example, require as much security, if that was the sticking point with the failed application. With this in mind, the results of the recent 2013 SAFE Survey are analysed below.

The tables from the 2013 SAFE analysis reflect the variety in SMEs' experience (between micro, small and medium-sized enterprises) and between Member States. Analysis of these tables suggests that some generalisations as to where the main challenges as regards SME applications to banks for finance lie are possible.

In the SAFE survey the following question is asked: "7B: If you applied and tried to negotiate for this type of financing over the past 6 months, did you: receive all the financing you requested, receive only part of the financing you requested, refuse to proceed because of unacceptable costs or terms and conditions, or have you not received anything at all?"

The response to question 7B by firm size makes it clear that **the smaller the firm, the larger the chance of the application being declined.** Thus, in the case of applications for bank loans, whereas the EU average for rejection was 12.6%, for micro enterprises it was 17.9%, small enterprises 13.5%, medium-sized enterprises 5.7% and large enterprises 3.4%. In the case of overdrafts, etc., the percentages were 10.4% for the EU average, whereas for micro-, small and medium enterprises it was 13.1%, 10.5% and 5.9% respectively. For large enterprises it was 4.9%.

The data suggest that **the problem of feedback would be more of an issue among micro-firms, or smaller firms, as they are more often declined funding**. This has important implications as regards the part of the banking system that deals with the firms in question as regards rating and scoring practices, and delivers services to them in terms of the nature of the staff and infrastructure put in place at that end of the market.

Additional data that point to where the feedback problem lies is from the UK Banking Taskforce's Appeals Process Independent External Reviewer[8], whose annual report notes that of the 827,000 applications for all credit products during the year in the UK, 114,000 (14%) were declined. Of these, 2,177 went to appeal and of them 39.5% were overturned (or less than 0.3% of the total). Importantly, 47% of appeals were for sums of less than £5,000 (of which 61% of the decisions were overturned); 14% were for sums between £5-10,000 (of which 45% were overturned); and 12% were for sums between £10-20,000 of which 33% were overturned).

Table 2.1 reflects the significant **diversity between Member States** in terms of maxima and minima for applications approved, partially approved and declined. The widely divergent situations as regards bank loans in Germany and the Netherlands, and as regards bank overdrafts, credit lines and credit card overdrafts in Germany and Greece illustrate this point. While this data does not indicate to what extent SMEs would have liked to apply for funding but have been put off on the basis of past experience[9], it does provide some indication as to in which Member States there might be challenges as regards feedback.

Table 2.1 Responses to applications for financing: average, maxima and minima in EU Member States.
Q7B Applied and tried to negotiate for this type of financing over the past 6 months

Bank loan (new or renewal excl. overdrafts and credit lines)	EU 28	Germany	Netherlands
Applied and got everything	64.5%	86.8%	32.0%
Applied and got most of it (between 75% and 99%)	9.0%	5.8%	7.5%
Applied but only got a limited part of it (between 1% and 74%)	7.3%	2.0%	8.7%
Applied but refused because cost too high	1.8%	-	7.3%
Applied but was rejected	12.6%	2.5%	31.3%
DK/NA	4.8%	2.8%	13.2%

8 Annual Report 2011/2012, p. 2
9 The report relating to financial conditions in Poland suggest this might be an issue of some significance there: PARP, (2012) Raport ko•cowy: Badanie rynku wybranych us•ug wspieraj•cych rozwój przedsi•biorczo•ci i innowacyjno•ci w Polsce „Finansowanie zwrotne."

Bank overdraft, credit line or credit cards overdraft	EU 28	Germany	Greece
Applied and got everything	62.1%	85.7%	3.3%
Applied and got most of it (between 75% and 99%)	9.5%	5.7%	14.0%
Applied but only got a limited part of it (between 1% and 74%)	12.5%	3.9%	10.3%
Applied but refused because cost too high	1.4%	0.2%	3.3%
Applied but was rejected	10.4%	1.6%	61.0%
DK/NA	4.1%	2.9%	8.1%

Source: SAFE (2013) Data, Q7B

From the supply side, banks are facing some barriers which limit their ability to provide funding to SMEs. These include[10]:

- Since the onset of the financial crisis in 2007-8, banks' return on equity has, overall, remained weak[11].
- Banks have had to adjust to regulatory requirements to rebuild and increase their capital base.
- Deleveraging has limited their ability to supply funds to the market, and banks have reduced their appetite for risk.
- Restructuring - banks have bought up competitors and their branch networks, often also closing those networks down and replacing them with lower cost alternatives such as regional and call centres – the total number of credit institutions in the EU-27 has been declining for more than a decade[12]. This has meant that SMEs have less contact with banks, and banks' shares in financing of individual SMEs has to be limited.
- Costs of assessing creditworthiness have risen, and attempts have been made to keep these under control through mechanisation. In the meantime, the time taken to process applications has, in some countries, increased.
- Timely and accurate information is difficult to obtain.

All these factors contribute to a more difficult environment for SME financing through the banking system.

2.2.2 The rationale for intervention

The preceding paragraphs suggest that there are some market failures present in the accessing of bank finance by SMEs: the higher rate of rejection for smaller firms, the high costs and low availability of timely information to assess creditworthiness of SMEs, and the reduced appetite of banks for risk.

The objective of this study is to examine these issues by looking at the way in which SMEs are rated or scored by banks, in particular as regards the extent to which qualitative factors are included in this process, and the way in which banks and SMEs communicate as regards feedback on credit applications.

[10]See for example - Bain & Co/ IIF (2013); Restoring Financing and Growth to Europe's SMEs, pp.3, and 11-16. This only deals with six Member States, of which Ireland, Portugal and Spain are in a very difficult situation, and Italy is also facing many challenges. The other two are the Netherlands and France. Although the sample countries are therefore somewhat atypical and do not reflect a rounded EU situation, the study does make useful points.
[11]European Banking Federation (2012); The European banking sector. Facts and Figures, p.21
[12]European Banking Federation (2012); The European banking sector. Facts and Figures, p.6

The view is that if the market failures identified are addressed by provision of increased transparency by banks on how they carry out rating and scoring, increased use of qualitative factors, and more and better feedback, this should result in increased awareness among SMEs about the general criteria applied in SME rating and scoring systems, how their creditworthiness is assessed and what factors determine loan application outcomes, which will be crucial in strengthening SME access to finance so that SMEs are better informed about how their creditworthiness is assessed. It should also help to highlight where issues as regards financial literacy remain as an impediment to accessing finance.

The provision of this type of information should also allow SMEs to learn lessons from rejected applications and to improve the quality of information supplied to banks in future requests. Depending on their creditworthiness, this should enable them to obtain better credit terms in future. Generally, improved dialogue and transparency should reduce information asymmetry, create stronger relationships and lead to reduced transaction costs which will have a positive effect on loan applications and further improve access to finance for SMEs in a beneficial feedback loop.

Based on this rationale the Commission has, as set out in summary form in 2.3 below, intervened by targeting key stakeholder groups in particular the banks, banking associations, SMEs and SME associations, to encourage them to work together towards developing solutions to these challenges. By enabling dialogue through, for example, the Round Tables and the SME Finance Forum where representatives of these groups can meet and exchange views, and presenting examples of good practice the aim has been to influence developments to move in the desired direction.

The Commission has also legislated in the area through the Capital Requirements Directive and the Regulation as mentioned below to drive openness in feedback and communication, and intervened in the area of CRAs to improve the quality and transparency of ratings provided externally.

2.3 Commission policy measures

The Commission has been active in the field of rating, feedback and qualitative factors to help remove obstacles to SME lending. It has put in place a wide range of initiatives related to rating and transparency and changing the legal framework[13].These measures include the various **Round Tables** that have been held since 1993. For example, the **Second Round Table (1995-7) Report** included a draft a Code of Conduct for the relationship between banks and SMEs and a Risk Assessment Form developed by the Forum of Private Business. The **Third Round Table** addressed the theme of risk assessment and ratings in detail, and the **Fifth Round Table** addressed, in particular, the question of transparency and dialogue between banks and SMEs subsequent to the introduction of the Capital Requirements Directive of 2006.

Transparency

Enhancing transparency in the lending process between banks and their counterparts (both businesses and individual consumers)[14] is viewed as a key factor to enable both SMEs and lenders to reduce their transaction costs and allow for the provision of more lending. The Commission's view is that better comparability and standardisation across the ratings used by different banks can have beneficial effects

[13]See DG Enterprise and Industry: "How to deal with the new rating culture", European Commission, 2005. http://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=2078&tpa_id=127&lang=

[14] The Directives on Credit Agreements for Consumers and on Mortgage Credit aim at allowing for more transparency in the bank-individual consumer relations.

on SMEs' access to finance, lead to less impartial and subjective evaluations, and help to foster the securitization and private placement of bonds.

Qualitative factors

Credit decisions taken by banks are not exclusively based on quantitative data. They can rely, at least in part, on qualitative criteria ("soft information") and banks have a right to refuse a loan based on such information. Soft information is also crucial for the assessment of entrepreneurial and management ability. The importance of qualitative ratings was highlighted in **the Commission 2011 Action Plan on Access to Finance**.[15] This took the view that qualitative performance indicators, such as the entrepreneur's track record, the competitive position of the company in the market or other intangibles, are essential to complement standard practices for evaluating SME loan applications because they take into consideration wider aspects of business performance which may add further information to a purely quantitative approach that may otherwise penalise SME loan applicants unnecessarily. Through the Action Plan, the Commission has undertaken to 'promote the exchange of good practice and to encourage the banking sector and SME federations to promote the use of qualitative rating as a tool to complement the standard quantitative assessment of SMEs' creditworthiness'[16].Many banks have adopted such systems and there are now a significant number of commercially available tools to help banks, as further described below. This study is a further element of this action plan.

However, while the Commission has promoted the use of qualitative alongside quantitative factors in SME credit ratings, it is recognised that the nature of such information is difficult to translate into credit rating and scoring models due to subjectivity in decision making processes and difficulties in modelling qualitative aspects of rating systems statistically. Decision-making in respect of qualitative criteria has elements of subjectivity, so it is not always conducive to strengthening transparency. It may be difficult for banks to provide qualitative feedback to SMEs about the reasons for their loan rejection, since banks may wish to keep their views on a decision confidential.

The evolving legal framework: the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR)

The evolving legal framework in respect of the Capital Requirements Directive implementing the Basel Accords in the EU deals with rating in general and feedback on credit decisions to applicants in particular. The key Directive with respect to SME rating and feedback was, until 2013, the CRD which comprised of two directives: Directive 2006/48/EC[17] and Directive 2006/49/EC[18]. In the Directive 2006/48/EC, Article 145(4)[19] states: "Credit institutions should, if requested, explain their rating decisions to SMEs and other corporate applicants for loans, providing an explanation in writing when asked. Should a voluntary undertaking by the sector in this regard prove inadequate, national measures shall be adopted. The administrative costs of the explanation have to be at an appropriate rate to the size of the loan". European SME Associations have previously stated that Article 145(4)[20] of the CRD has

[15] An Action Plan on Access to Finance for SMEs, COM (2011) 870 final.
[16] An Action Plan on Access to Finance for SMEs, COM (2011) 870 final, 5.1.3, p.32
[17] Of the European Parliament and the Council of 14 June 2006, relating to the taking up and pursuit of the business of credit institutions (recast), L 177/1, 30.6.2006.
[18] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) L 177/201, 30.6.2006, L177/ 52.
[19] Subsequently replaced by Article 431 (4) of the CRR.
[20] Subsequently replaced by Article 431 (4) of the CRR.

strong potential to contribute towards strengthening the transparency of credit decisions for SMEs so that they become more familiar with rating procedures and credit scoring systems.

In the context of provision of feedback, the successor to the 2006 Directives is the CRD IV package[21], of which Regulation 575/2013 (CRR) entered into force on 28 June 2013 and the Directive 2013/36 (CRDIV) on 17 July. They became applicable as of 1 January 2014[22]. Under the CRR regulation Article 431 (4), dealing with disclosure, credit "Institutions shall, if requested, explain their rating decisions to SMEs and other corporate applicants for loans, providing an explanation in writing when asked. The administrative costs of the explanation shall be proportionate to the size of the loan"[23]. As this is a Regulation, it does not need to be transposed.

SME assets

There are also special regulations for the assessment of credit risk in respect of that part of financial institutions assets which relate to loans to SMEs. Capital charges for exposures to SMEs are weighted at 75% and reduced through the application of a supporting factor equal to 0,7619 to allow credit institutions to increase lending to SMEs (CRR Article 501). This is designed to encourage lending to SMEs by reducing the capital requirements to make such lending. To achieve this objective, credit institutions should effectively use the capital relief produced through the application of the supporting factor for the exclusive purpose of providing an adequate flow of credit to SMEs established in the Union. Competent authorities should monitor periodically the total amount of exposures to SMEs of credit institutions and the total amount of capital deduction[24].

Legislation dealing with Credit Rating Agencies (CRAs)

The Commission also adopted a proposal to regulate CRAs in 2008, which was adopted in 2009: Regulation (EC) No 1060/ 2009 on Credit Rating Agencies (CRA Regulation).

Following the revision of the CRA Regulation in 2011, the European Securities and Markets Authority (ESMA) became the supervisor of CRAs in Europe. CRAs have to apply for registration to ESMA who supervises them. Credit ratings provided by EU registered or certified rating agencies can be used by a wide range of investors across different market segments and can be used for regulatory purposes. The aim of these changes is to ensure higher quality credit ratings and greater transparency in credit rating activities which should be of benefit to issuers and investors.

[21] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (1); and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (1).

[22] The Regulation amended the previous Regulation (EU) No 648/2012 and, as a Regulation, does not require transposition by Member States. Amongst other items, the revised Regulation deals with the assessment of credit risk. It makes special allowances for the risk of lending to SMEs. And it covers the role of External Credit Assessment Institutions (ECAIs).

[23] Regulation 575/2013 (CRR) of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (1 L176/ 254.

[24] CRR Recital 44.

The economic and policy context 2

The most recent changes in the CRA Regulation, the CRA Regulation III[25]entered into force in June 2013 and included provisions (inter alia) to ensure the independence and transparency of CRAs, increase competition on the CRA market and reduce over reliance on external credit ratings.

In parallel, in CRD IV the number of references to external ratings is reduced (if banks have a material number of exposures in a given portfolio they have to develop internal ratings for that portfolio) and financial institutions are required to do their own due diligence so that possible risk of over reliance on external ratings by the banking sector is reduced.

As will be made clear below, credit ratings by CRAs are not used a great deal for credit rating of SMEs, as most SMEs fall outside the scope of their activities. However, they may be relevant for the larger SMEs.

[25] Regulation (EC) No 1060/2009, as last amended by Regulation (EU) No 462/2013.

Definitions and components of systems 3

In this section explanation and definitions of some key terms as used in this report are provided (different approaches to rating by banks; the difference between rating and scoring; and the business information, rating and scoring firms, and credit reference agencies). The components of rating and scoring systems (quantitative and qualitative elements) are set out.

For the purposes of this report, unless otherwise specified, the term "rating" refers to how it is used in the context of the CRR as in the Standard and the Internal Ratings Based (IRB) approaches. The roles of the various business information providers and rating/ scoring organisations are described. The quantitative and qualitative data underlying rating systems both have advantages and disadvantages associated, but the key issues underlying both are those of costs and availability.

3.1 Rating, scoring and referencing

3.1.1 Rating in the Basel context

In this report rating refers to the development and use of systems intended to assess the expected likelihood of future borrower defaults[26]. Rating assesses credit risk, assigns internal risk ratings and quantifies default and loss estimates[27]. Rating systems tend to be highly complex and based on statistical analyses (statistical based rating systems – SBRSs) of past performance of client portfolios, although some do include greater reliance on judgemental factors. Internal ratings are those assessments developed by institutions for their own clients. External ratings (solicited and unsolicited) are provided by external suppliers (CRAs registered with ESMA).

Specifically, rating refers to how the term is used in the Basel Accords, as developed by the Committee on Banking Supervision of the Bank for International Settlements (BIS). The first Basel Accord (Basel I – established 1988, enforced in law 1992) was aimed at providing a uniform international regime for banks' minimum levels of capital to ensure their soundness, and to protect the international financial system and depositors. The level was determined in terms of the riskiness of assets held by banks. Lenders were required to keep an eight per cent equity position against their risky assets, in particular its corporate loans, but no consistent distinction was made between high risk and low risk assets.

By the late 1990's it became increasingly clear that the increased sophistication of banks meant that they could reduce risk weighted assets that did not reflect lower real risk and as a result a new regulatory approach was required. Basel II was developed to ensure better alignment of regulatory capital with risk, resulting in a more complex system than Basel I, and was implemented through the Capital Requirements Directive comprising Directives 2006/48/EC and 2006/49/EC, which came into full effect on 1 January 2008.

From the point of view of EU policy, developing a Single Market in financial services lies at the core of EU Member States' commitment to economic reform in Europe. The Financial Services Action Plan 2000-2005 (FSAP) had as one of its objectives the development of state-of-the-art prudential rules and supervision. The CRD is a key part of the FSAP and is intended to support the integration of financial markets across the EU.

Subsequent to the global financial crisis that was triggered by the sub-prime mortgage crisis, Basel III was developed in response to the deficiencies in financial regulation that became apparent. Basel III was

[26]Krahnen, J.P. and Weber, M. (2000); Generally Accepted Rating Principles: A Primer, p.2

[27]De Laurentis, G., Maino, R and L. Molteni (2010); Developing, Validating and Using Internal Ratings, Wiley, p.2. The authors refer to Basel Committee (2004), p.394

aimed at strengthening banks by increasing bank capital requirements, increasing bank liquidity and decreasing bank leverage. CRD IV is intended to implement the Basel III agreement in Europe.

The CRD IV package[28], of which Regulation 575/2013 (CRR) entered into force on 28 June 2013 and the Directive 2013/36 (CRDIV) on 17 July, became applicable as of 1 January 2014.[29]

3.1.2 Calculating minimum regulatory capital

Article 107 of the Regulation (CRR) requires institutions to apply either a Standardised Approach, or if permitted by the competent authorities, an Internal Ratings Based (IRB) Approach to calculate their risk-weighted exposure amounts. The most appropriate approach can be selected by the credit institution in question.

The standardised approach

The Standardised Approach (Chapter 2, art 111 onwards) requires institutions to allocate risks to one of sixteen categories, for example: (a) exposures to central governments or central banks; or (g) exposures to corporates. Risk weights are then applied to all exposures.

For corporate exposures (art 122), exposures for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to the credit assessment of the ECAI. ECAIs are Credit Rating Agencies (CRAs) that are registered or certified with ESMA in accordance with the CRA III Regulation.[30] These risk weights are in six bands giving a risk weight between 20% and 150%.

Exposures for which such a credit assessment is not available shall be assigned a 75 % risk weight or the risk weight of exposures to the central government of the jurisdiction in which the corporate is incorporated, whichever is the higher. As mentioned above, for SMEs this is then reduced by a factor of 0,7619.

While the recognition and validation of a particular ECAI’s assessments are the responsibility of national supervisors, the choice of the identity and number of ECAIs that banks work with is left to their discretion[31]. At the outset, it was estimated that this standardised approach would be adopted by about 30% of European banks, mainly smaller and medium-sized ones, mostly active in the retail, securities and cooperative sectors. However, while this may be in the region of 30% of the number of banks, in terms of the amounts of overall credit provided it is probably substantially less as the larger banks would use the approaches set out below.

Six European Central Banks have adopted the in-house credit assessment system source (ICASs) based on the standardised approach and use externally provided ratings: the Banco de España, the Banque de France, the Central Bank of Ireland, the Deutsche Bundesbank, the Oesterreichische Nationalbank, and

[28] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (1); and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (1).

[29] The Regulation amended the previous Regulation (EU) No 648/2012 and, as a Regulation, does not require transposition by Member States. Amongst other items, the revised Regulation deals with the assessment of credit risk. It makes special allowances for the risk of lending to SMEs. And it covers the role of External Credit Assessment Institutions (ECAIs).

[30] Article 3(98) CRR

[31] Van Roy, P. (2005); Credit ratings and the standardised approach to credit risk in Basel II, European Central Bank, Working Paper Series, 517, p.5

the Banka Slovenije. National Central Banks (NCBs) that develop their own ICAS are subject to a validation procedure and the Eurosystem performance monitoring process.

The internal ratings-based approach (IRB)

Subject to conditions, competent authorities can permit institutions to calculate their own risk-weighted exposure amounts using the Internal Ratings Based Approach (the 'IRB Approach'). There are two levels of IRB approach – "foundation" level institutions use their own models to determine the probability of default, whereas under the "advanced" IRB approach, an institution uses its models to calculate also all the other factors to arrive at risk weighted assets.

In each case the relevant models have to be agreed in advance by the competent authority. There is encouragement to move to this approach so as to reduce reliance on external credit ratings. In particular, as regards SMEs, the IRB approach allows other sources of information (e.g. CRAs, ECAIs and reference agencies) to be used in models provided this is agreed with the competent authorities.

The foundation internal ratings based (F-IRB) approach

In the foundation IRB approach, banks use their own empirical models to estimate Probability of Default (PD) for individual clients or groups of clients. These models need to be approved by the local regulator. Under F-IRB banks are required to use regulator's prescribed values for Loss Given Default(LGD) and other parameters such as Exposure at Default (EAD) and Maturity of Exposure (M) required for calculating the Risk Weighted Assets (RWA). The goal is to define risk weights by determining the cut-off points between and within areas of the Expected Loss (EL) and Unexpected Loss (UL), where the regulatory capital should be held, in the probability of default. Then, the risk weights for individual exposures are calculated based on the function provided by the regulator (total required capital is calculated as a fixed percentage of the estimated RWA).

The Advanced IRB (A-IRB) approach

The implementation of the A-IRB requires most advanced risk management and modelling skills. Lenders develop their own empirical model to quantify required capital for credit risk. They use their own quantitative models to estimate PD, EAD, LGD, and M for calculating the RWA. Total required capital is calculated as a fixed percentage of the estimated RWA.

In the case of retail portfolios only estimates of PD, LGD and EAD are required and the approach is known as Retail IRB. Banks can use this approach only subject to approval from their local regulators. Banks are generally encouraged to move towards A-IRB and Retail-IRB, and there is a modest release in regulatory capital required as banks move to A-IRB or retail-IRB.

Institutions are also encouraged not to rely to an undue extent on ECAIs. Risk assessment is to be based on external credit ratings only to the extent necessary. Where credit risk is material, institutions should therefore generally seek to implement internal ratings-based approaches or internal models. However, standardised approaches that rely on external credit ratings could be used where credit risk is less material, which is typically the case for less sophisticated institutions, for insignificant exposure classes, or in situations where using internal approaches would be overly burdensome.

3.1.3 Credit rating and scoring

The distinction between a credit rating and scoring is defined by the CRA III Regulation (Regulation (EC) No 1060/2009, as amended by Regulation (EU) No 462/2013) which defines credit rating as follows in Article 3(1[32]):

(a) 'credit rating' means an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories.

The CRA III Regulation also defines a credit score as follows in Article 3(1[33]):

(y) "credit score" means a measure of creditworthiness derived from summarising and expressing data based only on a pre-established statistical system or model, without any additional substantial rating-specific analytical input from a rating analyst;[34]

According to the CRA Regulation, the key difference between rating and scoring revolves around the notion of "additional substantial rating-specific analytical input from a rating analyst".

Furthermore, to issue external credit ratings within the EU it is necessary to be authorised and supervised by the European Securities and Markets Authority (ESMA) and comply with stringent rules in terms of transparency, methodologies and conflicts of interests.

Scoring refers to an assessment process whereby a score indicating a borrower's assessment is generated from key criteria excluding analyst input. It is not as complex as a credit rating, tends to take into account fewer variables, and may be a component of an IRB system. As in the case of internal credit ratings by financial institutions, there may be scope for overriding the credit score by the loan officer involved.

3.1.4 Business information, rating and scoring firms[35]

Banks may use business information and scoring firms to provide raw information as input to their internal credit risk models. In addition, they may use scores or ratings provided by external suppliers to back test the credit risk assessment resulting from their IRB Approach. The methodologies for developing such external scores or ratings used must be compatible with the methodologies developed in the banks' own IRB system and approved as such by the relevant regulator.

In some countries, banks use credit scores of a firm that has been recognised as an ECAI by the competent supervisory authority as input for the Standardised Approach as set out above.

3.1.5 Credit referencing

Credit referencing is a practice of the business information industry whereby a financial institution refers to credit referencing agencies to help them assess the risk of lending to particular people. The aim is to help reduce the risk of lending and fraud by looking at historical information held in individual credit files. This information can be of three types:

[32] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF
[33] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF
[34] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:146:0001:0033:EN:PDF
[35] EU Financial Stability Report, chapter 5, section 5.2

- Information on public records, such as electoral records to verify names and addresses, court judgements, bankruptcies, and various agreements with creditors.
- Credit account information – lenders share information about borrowers – to see if payments have been kept up to date, if they have loans outstanding with other institutions, and if those payments are up to date.
- Search information – the file carries records of credit checks by lenders and numbers of applications over short periods which could count against applicants.

Individuals or firms can apply to reference agencies to provide details of information held about them and if it is incorrect to have it changed. In some Member States applicants need to pay a fee to be able to check if the information held about them is correct. A credit reference output can be input into a scoring or rating system.

3.2 Components of rating and scoring systems

Rating and scoring systems have been developed to evaluate the credit worthiness of firms. Their aim is to look into the future of the enterprises in question, given current and historical information available, to determine whether they will be able to repay the funds they are hoping to borrow. Key components of rating and scoring systems are set out below. Following the definition the Basel Committee (2006), a rating system (which can subsume a scoring system) covers all methods, processes, controls, data and IT systems that are necessary to calibrate rating models and derive Probability of Default (PD) estimates.

There are two main types of factors that make up rating and scoring systems: quantitative and qualitative factors. Quantitative factors include economic and financial information on the enterprise from corporate accounts (balance sheets as well as profit and loss accounts) and a bank's proprietary information on the borrower – "behavioural data" (e.g. account history and behaviour)[36]. Qualitative factors include data about the enterprise such as entrepreneurial track record, management ability, internal processes and the human capital base.

Table 3.1 below summarises some of the elements present in a typical SBRS. A system would be constructed by such inputs, applying statistical and mathematical algorithms. There would usually be separate quantitative and qualitative modules and results, and these would be considered together to produce a score or rating (if there are further additional analyst inputs). There might be thresholds for certain elements that must be met for the application to be able to proceed.

Table3.1 Elements of a typical system
Quantitative ("hard") factors
Sources: annual accounts (ratio analysis, e.g.: - Liquidity - Capital structure - Turnover - Cash flow - Profitability
Qualitative ("soft") factors
Usually obtained from notes to balance sheet but also from personal relationship banking knowledge e.g.: - Management quality

[36] In some instances it is referred to as "qualitative", but because it is based on "hard" data, we categorise it as "quantitative".

- Management information systems - Strategy - Social skills - Leadership - Financial condition (if not audited) - Sector - Market position (competitive position, number of buyers, suppliers, etc) - Bank-customer relationship (proprietary information)
Behavioural data
Usually obtained from checking accounts e.g.: - Maximum/ minimum balances - Variances - Number and size of transactions - Violation of credit lines
Bought-in information
Acquired from credit bureaus, referencing agencies - Addresses - Court judgements - Payment histories, etc.
Based on: Lehmann, B. (2003); "Is it worthwhile? The Relevance of Qualitative Information in Credit Rating", Centre of Finance and Economics, University of Konstanz, SSRN 410186, pp.4-6.

Below we provide some more information about quantitative and qualitative data. Then some comments are made on the role of judgement in the credit assessment process.

3.2.1 Quantitative data

Rating and scoring systems can include a very wide range of quantitative data. For example, De Laurentis, Maino and Molteni list 30 ratios that could be included.[37] These include Return on Equity, EBITDA/ Sales, Return on Investment, Return on Assets, etc. all of which are familiar to a greater or lesser extent from the point of view of analysing accounts. The first challenge is to decide which are the most relevant and useful for the analysis being carried out.

The second challenge as regards quantitative data arises when the enterprises have very little in the line of formal financial accounting data. Febelfin (Belgian Financial Industries Association) and EACRA (European Association of Credit Rating Agencies) have mentioned that this problem has been exacerbated by the lower reporting requirements allowed for small firms under recent EU initiatives to reduce the burdens on business. In fact this is a major challenge for SME lending and several banks are of the opinion that the improvement of the timelines, accuracy and completeness of such data would probably be the most important driver for improvement in SME loan assessments. Text box 3.1 below summarises the situation as regards public financial statements.

Text box 3.1 The requirement to file financial statements
Most SMEs in the EU do not have to file financial statements and of those that do, many contain only abridged data. As explained below, over 90% of SMEs in the EU do not have to file detailed financial statements.

[37] De Laurentis, et. al,. op. cit., pp. 119-129.

Enterprises have to file public financial statements only if required to do so by law. The 4th Company Law Directive[38] defines the types of enterprises which need to file statements. These types of enterprise vary by Member State but are typically enterprises with limited liability. Normally, enterprises without limited liability (most micro enterprises) do not file financial statements.

Estimates by CSES[39] showed that only around a quarter of enterprises are of a legal form that is covered by the 4th Company Law Directive. The average across the Member States surveyed was 25.4%. There are significant differences between Member States in the proportion of enterprises that have 'company' status. Only 17% of enterprises in Italy (and 18% in Germany) have to file financial statements compared to 66% in Luxembourg.

Even if an enterprise is of a legal form covered by the 4th Company Law Directive ("a company"), it may be a small company which is required to file only an abridged balance sheet and not a detailed profit and loss account. Abridged statements do not provide sufficient data for financial analysis. This small company exemption covers most companies and the CSES report estimated that only about a quarter of companies exceeded the small companies' exemption limits. The report estimated that less than 10% of all enterprises have to file detailed financial statements.

In reality this means that banks often have to refer to credit referencing or business information providers for information when dealing with smaller enterprises. Such information could be considered as "qualitative", but the aim really is to fill the gap in quantitative data. Credit reference agencies run credit checks to look at payment histories or the presence of court judgements etc. against the loan applicants. Some countries such as Italy and Portugal have central databases (central credit registers) where loans of applicants are recorded and that can be consulted. In many instances granting of a loan may be driven by the credit history or reputation of the applicant as a person in terms their customer record at the bank, rather than as a firm, when there is little quantitative data available. In Germany, for example, Schufa[40] has data on personal credit records for individuals that can be consulted.

A further problem with quantitative data, where it exists, is that it is backward-looking. This creates two issues: in the first place this data is by definition old and out of date, so while it is useful from the point of view understanding how the enterprise has performed in the past, which is a guide to the future, it does not really allow for discontinuities that may result from, e.g. major expansions into foreign markets. If one asks for unaudited data (not yet filed) or forecasts these will be subjective and not "quantitative", which brings the question of subjectivity back in. As mentioned above, many small firms do not have complex accounting data available to make sophisticated calculations with, and some firms are new and do not yet have a track record.

Some banks increasingly make use of **behavioural data** – information on how the account behaves over time obtained by monitoring movements of funds in and out, maxima and minima on deposit, etc. – to arrive at credit decisions. One major UK bank advised that it makes extensive use of behavioural data for its SME accounts and has found this to be a very effective tool for credit assessment and prediction of default for SMEs, especially at the smaller end of the scale. The behavioural approach does however have the shortcoming that it only reflects the current situation and is influenced by the bank's credit

[38] Fourth Council Directive 78/660/EEC of 25 July 1978 as amended, accessed at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1978L0660:20070101:EN:PDF

[39] Evaluation of thresholds for micro enterprises, CSES, accessed at http://ec.europa.eu/internal_market/accounting/docs/studies/micro_entity_en.pdf

[40] http://www.schufa.de/de/

decisions (a self-fulfilling prophecy?). Behavioural predictors apparently work well for periods of about a year, whereas accounting data work better over longer periods. Software is available whereby it is possible to extract bank data from on-line bank accounts other than those the applicant is applying for the funds from, so if the applicant banks with two or three banks, it is possible for the lender to obtain behavioural data from those accounts as well.

3.2.2 Qualitative data

The aim of collecting qualitative data is to increase the predictive accuracy or the rating and scoring models by providing additional information about the firm in question. But dealing with qualitative data presents some major challenges for banks. Qualitative data is usually incorporated as nominal or ordinal data from questionnaires. These questionnaires are usually completed by relationship managers, so it can be a costly process and some issues remain due to the role of subjective factors (e.g. “capture of loan officers”) in completion of questionnaires and interpretation of responses and their relationship to sales incentives. In SBRSs qualitative data is either used as an explanatory variable with quantitative data to establish final algorithms (rarely), or, more usually, as a separate “qualitative” module which provides a qualitative rating. Usually this constitutes about 20-40% of the overall rating, depending on the kind of bank and kind of client in question. Critics suggest that low percentages do not always give enough weight to the strategic and competitive profiles that can be crucial in times of discontinuity[41]. In some public banks dealing with loans that could lead to step changes in young firms without a long trading history, the ratio can be the opposite: 60- 70% qualitative and 30-40% quantitative. A ratings expert also took care to point out that banks need to remain flexible about this as it depends very much on the company in question.

One of the problems related to qualitative data is that there is potentially so much that can be collected. A 2006 review of qualitative information collected by the San Paolo Group identified more than 250 questions around matters such as industrial and financial economy, theories of industrial competition and credit analysis practices. [42] The table below summarises these in various categories.

[41] De Laurentis, et. al,. op. cit., pp. 86-91

[42] Ibid., p.88

Table 3.2 Examples of qualitative items in credit analysis questionnaires
Corporate structure - Date of incorporation (or significant acquisition/ merger) - Type of firm - Group members, intensity of relationship with the parent/ subsidiary
Information on the company's business - Markets in which the company operates and their position in the business life-cycle - Positions vis a vis competitors and their competitive strength - Nature of the competitive advantages (cost, differentiation/ distinctiveness of products, quality/ innovation/technology, dominant/ defensible). - Years the company has operated in the actual core business - Growth forecast - Quality of perception in the market
Strategy - Strategic plans - Business plan - In case a business plan has been developed, the stage of strategy implementation - Proportion of assets/ investments not strategically linked to the company's business - Extraordinary transactions (revaluations, mergers, divisions, transfers of business divisions, demerger of business) and their objective
Quality of management - Degree of involvement in the ownership and management of the company - The overall assessment of management's knowledge, experience, qualifications and competence(in relation to competitors) - Is the company's future tied to key figures? - Presence of a dominant entrepreneur or investor (or a co-ordinated and cohesive group of investors) that influence strategies and the company's critical choices
Other risks - Risks related to commercial activity. - Geographical focus (local/ regional, domestic, within Europe, the OECD and non-OECD/ emerging markets). - Level of business diversification (a single product/ service, more products, services, markets) - Liquidity of inventories - Quality of the client base - Share of total; revenues generated by the three/ five main customers of the company - Exclusivity or prevalence with some company suppliers - Legal and/ or environmental risks - Reserves against professional risks, board members' responsibilities, auditors (or equivalent insurance)
Sustainability of financial position - Reimbursements in the next 12, 18 months, 3 years, concentration of significant debt maturities. - Off-balance sheet positions and motivations (coverage, management, speculation, other). - Sustainability of critical deadlines with internal/ external sources and contingency plans - Liquidity risk, potential loss in receivables, of one or more major customers, potential need to accelerate the payment of the most important suppliers).
Quality of information provided by the company to the bank, timing of documentation released and general

quality of relationship. - Availability of plausible financial projections - Information submitted on company's results and projections - Considerations released by auditors on the quality of budgetary information - Length of the relationship, past litigation, type of relationship (privileged/strategic/ tactical/opportunistic) - Managerial attention - Negative signals in the relationship history
Source: Based on De Laurentis, et. al.,p.88

Qualitative factors change weights and meaningfulness over time. For example, during the late 1980's one of the most discriminant variables was presence on international markets. Subsequent to globalisation, this is less important and factors such as technology, marketing skills, brands, quality, and management competences have become crucial. Other qualitative factors that have recently become more important are environmental compliance and conformity, social responsibility, corporate governance, internal checks and balances, protection of minorities, hidden liabilities like pension commitments and funds integration, and stock options.[43] Often there is also a shortage of historical data about qualitative factors.

3.2.3 The role of judgement

The automated processes and algorithms, using quantitative and qualitative inputs, and where appropriate further human inputs, result in a rating or score that assists in decision-making processes on SME loans. The question then is to what extent this drives the decision to provide credit and to what extent there can be judgemental input. Most banks interviewed indicated that the judgemental element was key to the decision. However, it is clear that there are also different levels of discretion depending on the size or type of loans and the firms in question which determine the role of judgemental factors.

Basel II did not specifically indicate that judgemental elements should be reduced in the rating process. In fact, as regards the use of models, it put the matter as follows[44]: "Credit scoring models and other mechanical rating procedures generally use only a subset of available information. Although mechanical rating procedures may sometimes avoid some of the idiosyncratic errors made by rating systems in which human judgement plays a large role, mechanical use of limited information also is a source of rating errors. Credit scoring models and other mechanical procedures are permissible as the primary or partial basis of rating assignments, and may play a role in the estimation of loss characteristics. Sufficient human judgement and human oversight is necessary to ensure that all relevant and material information, including that which is outside the scope of the model, is also taken into consideration, and that the model is used appropriately."

However, some evidence does suggest that there has been increasing mechanisation of decision making with the diffusion of internal rating and scoring systems. A survey by the Banca d'Italia (2007) of more than 300 banks found, among other things, that in credit underwriting for SMEs, about 50% of large and medium sized banks do not allow discretion to override the results of the SBRSs, while only 20% of the smaller banks take this position, and that greater underwriting powers have been given to branch

[43] Ibid., pp.90-1.
[44] Basel II, Use of models, art. 417

managers due to the robust rating processes that make decisions less prone to be manipulated.[45] In Italy the Banca d'Italia also uses the permissible degree of overriding as a tool to influence monetary policy, prescribing what is permissible at a given moment.

3.2.4 Rating and scoring systems

Scoring systems tend not to be as resource intensive as rating systems, and they are generally used for smaller loan values. There is not always a sharp dividing line between who gets rated and who gets scored, but in many instances corporate customers would get rated and retail customers – including most SMEs, get scored.

Major SBRSs are expensive to develop, so banks that have mainly small or micro-firm customers tend to develop scoring systems, some of which can be quite sophisticated. Scoring systems are not just quantitative – they are also subject to development and may include increased incorporation of qualitative data.

[45] Alberto, G., Benvenuti, M., Moretti, S. et.al. (2008); L'organizzazione dell'attivita creditizia e l'tulizzo di techniche di scoring nel sistema bancario italiano: risultati di un'indagine campionaria, Bamca d'Italia, Questione e Economia. e Finanza, 12, referred to in de Laurentis, et.al., p.291

Bank practices 4

This section provides an overview of bank practices in rating and scoring SMEs, especially from the point of view of qualitative factors, and the feedback they provide on a voluntary basis or upon request. First some distinctions are made between types of banks that are useful from the point of view of the analysis. Then market practices are set out: how systems have been developed, and what this means for rating and scoring practices; how categories of customers are rated or scored; how some banks further segment customers for scoring and rating; and individual rating or scoring of customers. Then qualitative factors are considered in more detail, as are implications for transaction costs. Then the way in which banks provide feedback is set out. Finally, comments as the evaluation of these systems are made.

The section concludes that while there are differences between types of bank and their customer orientations, the development and implementation of rating systems has required large inputs of data and resources by banks and informs a significant degree of banks' operations, in particular distinctions between corporate and retail clients, with the retail segment being scored rather than rated. The research suggests that this is the area where most issues as regards transparency and feedback emerge. The role of qualitative factors has been multifaceted. On the one hand they can improve predictability of outcomes, but on the other hand research suggests that inclusion of qualitative factors does not necessarily improve SMEs chances of getting a loan or credit. At the same time, SMEs with negative soft factors seek out banks that take less soft factors into consideration in order to obtain finance. So there is no direct positive relationship between increased use of qualitative factors and SMEs' success in obtaining finance, while the cost of gathering qualitative factors also goes against their increased use in the retail segment. The feedback given to SMEs by banks tends to be driven by the nature of the data used to assess them. Overall, it can be said that the rating systems perform as well as can be expected.

4.1 Types of banks

The European banking landscape contains different kinds of banks (e.g. private, savings, co-operative, and public) that are represented in different proportions in the EU Member States. For example co-operative banks have approximately 20% of the market share on average in countries where they are present[46]. Different bank types tend to have different customers. For example, in the main countries where they are present, co-operative banks tend to have on average some 20-50% of their client portfolios with SMEs[47], whereas in a global universal bank this percentage may be between 10-20%. Banks also have different approaches to customers, profit, risk and rating policies. In addition, the guarantee banks, working with the different kinds of banks, and present to a different extent in the different EU economies, also have approaches and rating or scoring systems of their own. All of this is reflected in lending behaviour towards SMEs and importantly, the feedback they provide to loan applicants.

The banks interviewed for this project are of a wide variety and include private banks, public banks, and savings and co-operative banks. Some of these are global banks, others are present primarily in a region such as the Baltic area, others are only national and others are local or provincial, or even focus on a specific industry sector in a region. Some banks focus on specific customer segments that may be related to firm size and industrial activity. The share of small to medium-sized firms (in terms of the

[46] http://www.eacb.coop/en/eacb.html, accessed 20/11/2013
[47] http://www.eacb.coop/en/cooperative_banks/characteristics.html, accessed 20/11/2013

number of accounts) in the portfolios of the banks spoken to varies from 10-15% to 80-90%. We have also spoken to banking associations that have been willing to collaborate with us.

One useful way to distinguish between banks from the point of view of this report is to group banks into two main categories: "**relationship"** banks and "**transaction**" banks (information-based).[48]In **relationship banking** banks assess the creditworthiness of their clients in the medium to long term and provide appropriate products, advice, services and assistance. Such banks "establish intense and long-term relations with their borrowers and thereby generate soft, and typically proprietary, information about the borrower that is hard to verify by other parties and subjective by nature"[49]. In **information/-based/ transaction banks**, banks can exploit information synergies from credit and risk assessments and commercial activities. Such banks "operate at arm's length, base their lending decisions on credit scoring models, and do not gather soft information. Their loan officers rely on information that is verifiable by third parties and is largely financial"[50]. While these two types may be considered as extreme types, it is a useful distinction to bear in mind.

Typical examples of relationship banks would be the co-operative banks in Germany or Italy, while transaction banks would be the large private banks such as Deutsche bank, or Intesa Sanpaolo. In Germany, the savings banks would fall between the two categories – as there is quite a good deal of diversity between them - with some of the larger ones tending to a transaction-based approach, and smaller ones to be more relational. The literature suggests that smaller banks tend to have stronger borrower relationships than larger ones, due to there being less managerial layers between loan officers and bank management than in larger banks, and that the greater the hierarchical distance, the less the importance of soft information in the credit approval process[51].

4.2 Rating and scoring systems in banks

The following are the characteristics of the rating and scoring systems of banks interviewed, with particular attention given to the role of qualitative factors.

4.2.1 Developing and implementing systems, nationally and internationally

In order to develop a methodologically sound rating or scoring system that will be approved by the relevant regulator, a sufficiently large data pool with a sufficient time series of data is required. This data base reflects the economic, fiscal, legal, debt recovery and other realities of the bank's customer base. In some cases, such data has not been available to banks who want to develop such systems, especially if they want to develop IRB systems. Such systems are also very expensive to develop and operate.

In order to develop a system, and to share the costs of development, individual banks of a certain type have in some instances pooled their data with other banks of the same type to develop SBRSs. This has happened for example in the case of the German private banks and public banks to develop an IRB system. In the case of the Italian co-operative banks they have done this to develop a scoring system (see text boxes 4.1 and 4.3).

[48] De Laurentis, G. et.al., p299; and Gropp, R., Gruendl, C. and A. Guettler. (2013); "Hidden Gems and Borrowers with Dirty Little Secrets: Investment in Soft Information, Borrower self-selection and Competition", European Banking Centre discussion paper, No. 2013-005.
[49]Gropp, R. et.al., p.1
[50]Gropp, R. et.al., p.1
[51] See Gropp, R., et.al.p.6 for references.

Text box 4.1: Creating national data pools for SBRSs

In Germany, different types of banks pooled their data in order to obtain a good population of data to use to develop a SBRS. The German public banks, under the umbrella of their association (Bundesverband Öffentlicher Banken Deutschlands) decided to pool their data to develop a system that they could share among themselves, as in most cases one bank on its own did not have sufficient data and it would prove too costly a process if each had to repeat the process on its own. So economies of scale were obtained from developing this system. For this they worked with the savings banks (Sparkassen) who had also developed internal rating systems. The German Savings Banks Association (Deutscher Sparkassen- und Giroverband) had established Die Sparkassen Rating und Risikosysteme GmbH (SR) to develop measuring and related instruments around the themes of credit risk and portfolio management in 2004 and was the specialised provider to the savings and giro banks group's approximately 100 members who provided data for the "pool".

The German private banks also pooled their data to develop a good basis for statistical computations in 2002, with initially some 35 banks participating and the main banks as shareholders for the development of the credit rating platform by Credarate Solutions GmbH. However, the larger banks have now developed their own systems. CredaRate covers all the main exposure classes: corporate, commercial real estate, banks and retail with IRB approved systems. Scope of application includes national and international companies covering all industry groups: SME´s and capital market oriented companies; rating for corporate groups and individual companies; segregation in different clusters; small business facilities (corporate sales of less than € 5 million and total credit line of less than € 1 million); corporates-standard (corporate sales of more than € 5 million or total credit line of more than € 1 million); start-ups (new businesses without balance sheet information). Quantitative data can work with both German (HGB) and international(IFRS) accounting regulations. For the qualitative factors ("soft facts")there are two identical scorecards, 32 questions (a scorecard for small business facilities and a scorecard for corporate groups / medium and large companies). Soft fact questions are weighted using empirical evidence and cover the following risk factors: data, management, market / industry, and finance. In addition, forward-looking macroeconomic assessments are required for development of sales, incoming orders, development of expenses and the competitive environment.

While a rating or scoring system of a bank that has been developed reflects the operating reality of its existing customer base, when it enters a new country, it will usually initially use a form of its existing system but modified to satisfy regulatory requirements in the new market. Such new market entrants can be a useful source of funds for SMEs that have not been able to obtain funds from established credit institutions as those new banks work hard to obtain market share (see also 4.3.1 below, as regards the role of qualitative factors). However, we were advised by one large bank operating in many countries that some international asset classes were becoming increasingly homogenous and might be rated in the same way.

4.2.2 SMEs in rating and scoring systems

Within the banks' loan portfolios, the definition of SMEs does not follow that of the European Commission, and in practice varies between banks[52]. The main division in terms of groups of accounts is between corporate and retail, with smaller SMEs sometimes falling in the retail category with personal borrowers and larger ones sometimes in corporate. Cut-offs in terms of turnover between retail and corporate vary in different banks in different countries from €500,000 to€1 million, €5 million, €10 million and €50 million; with the same bank sometimes applying different cut-offs in different EU Member States (and other third countries).

[52] However, one bank indicated that to obtain EIB support, they had to break down their customer list in terms of the EU SME definition.

Text box4.2: Corporate and retail

One private bank pointed out that for its rating models they use a different definition of SMEs than that in Basel where the distinction, in terms of turnover, is above and below €50 million turnover. They do not treat SMEs as one segment as € 50 million is far beyond their retail limit. The retail limit and what they consider as the SME-segment in their country is enterprises with up to €5 million turnover, in the CEE countries €1million. The self-employed are included in this segment, whereas in CEE countries they are not, as they have different systems for sole proprietors and micro enterprises. Companies above €5 million turnover are in the "corporate" category and are rated with different models. Rating models differ also according to the financing documents provided as a basis for the rating. For example if companies have a balance sheet a different system is applied than if a company has cash-based accounting. They differentiate between three types: cash-based, lump-sum and balance sheet accounting. They are legally obliged to use all relevant information for rating. Financial documents are important sources of information and as they look different in these three cases they apply different models.

Categorisation of enterprises between corporate or retail often drives whether customers are to be rated or scored. The difference between rating and scoring is based on the populations that are used and the information density and complexity that is available about them when constructing the models. Scoring tends to be applied for the Retail exposure class, while rating is applied for Corporates and Institutions. There is a difference in the criteria that the exposure classes are assessed against (due to different information availabilities). The exposure class Retail is assessed in a more automated way, comprising a large number of enterprises with similar exposure levels with a streamlined credit process; as opposed to Corporates and Institutions, where individual assessments are required. Scoring is applied on portfolios such as individuals and SMEs (Retail), and rating on larger SMEs and Corporates. For IRB, all exposures must be assigned a risk assessment (scoring or rating) with internal scoring and rating systems. (External ratings are used for benchmarking). Under IRB internal ratings are not, in principle, disclosed to the public, although banks may disclose them to the individual lenders if they wish to, or if client request such information. It is then up to the client whether they wish to reveal that information nor not.

Scoring tends to be used for small or very standardised (or homogenous) risk profiles where individual analyst input is not cost-efficient, which is typical of loans to private persons or small loans or loans to small corporates

Scoring thus tends to be used for small or very standardised (or homogenous) risk profiles where individual analyst input is not cost-efficient, which is typical of loans to private persons or small loans or loans to small corporates – this may be up to €500,000 or €1m (as approved by the specific regulator). Rating is used for other (higher) risk banking products that involve analyst input and quantitative and other qualitative factors.

However, importantly, scoring need not always be used in the same way by all banks. For example, while a global IRB bank may use scores in a relatively more mechanised way, a small local or regional bank, with predominantly micro, small and medium-sized enterprise (MSME) customers, that has not invested heavily in a rating system (due to cost factors, or insufficient data for example), may have a scoring system to which it applies a greater degree of expert judgement where it knows its client base very well. Two examples of such relationship-based scoring systems are set out in text box 4.3.

Text box 4.3: Scoring systems in two Italian institutions

In Italy the Cooperative Credit Banks tend to be small and local or regionally focused. They grouped together under Federcasse (Federazione Italiana delle Banche di Credito Cooperativo Casse Rurali ed Artigiane) to develop a scoring system, with separate models for micro/ small firms, medium-sized firms and co-operative firms and different sets of questions for manufacturing, agriculture, building, tourism and commerce. However, even though relatively simple compared to the SBRSs, it was found that the banks tended to revert back to their own in-house scoring systems.

The scoring system developed by an Italian financial institution tailored for small businesses in the handicraft sector has been in place for more than 12 years. The scoring model has been improved over the years, as follows:

- Initially, the scoring model was created by a group of experts which defined the scoring variables as well as the weights related to each variable, based on their experience and judgment.
- In 2003, they developed a statistical model based on a sample of previous observations. Data were collected from 1999 to 2003. The identification of default risk was assessed throughout a statistical behaviour model focused on payments history.
- In 2008, the statistical model was further developed introducing qualitative information (age and type of business, industrial sector, etc). The result is a mixed model based on both financial information and qualitative data with particular importance given to the latter. Qualitative information specific for SMEs led to significant improvement in the model's predictive accuracy.
- In 2011, the model was revised by back testing and fine tuning. As a result, the model incorporates specific characteristics that contribute to increased default prediction power.

One credit institution explained how they used different data for corporate and retail accounts. For a "corporate" account there is a mix of balance sheet and soft facts. Below the € 5 million turnover - in retail banking – they use information that is more current, data that can be analysed monthly – such as account activity. The main components of the system are: financing documents (balance sheet, statement of revenues and expenditures), account information (in retail banking), soft facts, and negative information (e.g. from a credit reference agency). Different soft facts are used for "retail" and "corporate". For "retail" they normally include less soft facts in the rating. Negative information is included for both. In general there is no difference between sectors. In corporate they differentiate capital intensive sectors such as production from others.

Research published in the European Financial Integration and Stability Report (2012)[53] makes it clear that **the majority of enterprises in a country fall in the retail rather than the corporate category and will be scored rather than rated**. As the data in section 2.2 made clear, it is also in the realm of small loans, where scoring is most prevalent, that there is most rejection of applications. So **it is to issues surrounding scoring and related feedback that most attention should be paid**.

4.2.3 Customer segmentation

In addition to the basic segmentation of customers into retail and corporate, which has a strong influence on whether the bank will use rating or scoring, a bank may further differentiate between several market segments for which different rating or scoring models can be applied. In the Final Report of the Second Round Table of Bankers and SMEs, one of the better practices recommended that could help improve access to finance was better segmentation practices[54]. In the course of the interview programme, one banker put it as follows: "customer segmentation is the key factor for successful implementation of the credit scoring model". This helps tailor loan applications to risk.

[53] See chart 5.3.1
[54] Final Report. Second Round Table of Bankers and SMEs, p.44

4.2.4 How banks rate and score individual customers

In view of the preceding comments it is not surprising that banks that have different rating and scoring systems, reflecting their differing market positions and risk appetites, may rate or score the same customer differently. Each system reflects the underlying individuality of the financial institution in question. Such differentiation is the basis of successful marketing of financial services and also reflect what the Basel rules prescribe – that rating and scoring should be based on the bank in question's customer data. This means that customers have more options for funding in case they are turned down.[55]

The sources of difference can be summarised as: different statistical models; different inputs in terms of quantitative and qualitative (and behavioural) data, especially when it comes to the treatment of existing as opposed to new customers; different business strategies in terms of target markets, customers, segments, risk profiles, etc.; different kinds of banks (e.g. global banks entering a new market, local banks in an established market, etc.); and different banking cultures (e.g. the Austrian or German SMEs' relationship with its hausbank, as opposed one among several banks of an Italian SME).

Having said that, not all firms are aware that they are being rated or scored, or interested in knowing what it is. For example, a Belgian organisation mentioned that over 65% of SMEs (and 70% of micro-enterprises) are either unaware of whether their bank rates them or do not know what a rating is. Of those who know they are scored or rated by their bank, 24% know what their SME's score / rating is.

4.2.5 Approving ratings or scores

When a rating or score is produced by the relevant unit of the financial institution, it does not always automatically lead to a credit decision. Practices differ among bank types. In the case of smaller, relationship banks, bankers interviewed as well as research[56] indicates that they tend to adjust ("override") the outputs of the systems, especially at the lower value end where there is scoring of smaller firms, on the basis of judgemental factors more readily than in the case of larger IRB ("transaction") – banks. In some countries such as Italy the central monetary authorities prescribe how much adjustment can be made.

In the case of one small financial institution, for example, when a loan application is processed, if the score is negative, the application is denied; if the rating is positive, the application is sent to a loan officer. The loan officer reviews applications and decides whether to approve them or deny the loan on the base of further documentation collected (post scoring assessment). The loan application may be processed at different levels in the organization, depending on the loan amount and rating.

In other instances, such as a public bank where qualitative factors can make up some 70% of the rating, there may not be a "loan officer" but a "consultant" (customer advisor) who assesses the companies and is also the one who knows the company the best. But in such instances at least one second person has to confirm the rating override – a classical four-eye-principle. Quite a lot of discretion is left to the consultants because they are the ones that are the closest to the company and that are the most experienced too. They also go through the loan application process with the client and have the relationship which makes them the direct contact for providing feedback. In the nature of things it is relatively unlikely that there will be a negative outcome (otherwise the client advisor would not have

[55] See for example below 5.1.4. In the Enterprise Europe Survey, of 46 of those that had said they had been declined credit, 33 went to other banks and of these 18 said they obtained credit from there.

[56] Gropp, R., et. al. p4

proposed the company) and if there is a negative outcome the advisor will be well-positioned to explain why that was.

In the case of a large private IRB bank, or a “transactional” – bank, what happens depends largely on whether it is a “retail” or a “corporate” client - the scope of action of the loan officer varies. He/ she does not have as much time for the retail segment where there may be very many accounts: the process is more automated and “overrides” may in fact not be allowed at all. In the corporate segment the process differs. There are larger sums at stake and a “4-eyes-principle” approach must be applied - someone has to confirm the decision. Every loan officer is able to authorise certain loans. There is a risk class for every customer and according to that risk class the loan officer is allowed to decide on his/her own or not. When the risk class worsens the loan officer has to decide together with another person and if it gets much worse the decision is centralised.

In sum, what happens to scores and ratings once they are produced in terms of actually providing loans varies in different types of banks, and also in terms of customer types.

4.3 The role of qualitative factors and transaction costs

4.3.1 The role of qualitative factors

As indicated in section 3.2.2 when credit institutions wish to consider qualitative factors, there is potentially a wide range of factors to choose from, and they can play a different role in the overall rating or scoring process, for example in terms of the weight assigned to qualitative factors (20-80%), and which qualitative factors are considered most important in a specific type of credit institution or customer type. Text box 4.4 below for example sets out the role that qualitative factors play in a public bank.

Text box 4.4: Qualitative factors in a public bank

Whereas normally banks weight hard facts at 60 – 70 % and soft facts for the rest, in this case it is the other way round. The consultants /customer advisors who complete the qualitative questionnaires provide a major input to the rating result. They do not rely on the balance sheet and backward oriented numbers that much, which is where they differ from traditional banks. When companies apply for support at this bank it is because of an investment project which would normally lead to a leap in terms of efficiency. That could be because, for example, if they want to explore new markets, or they want to produce a new product, etc. In these cases it is hard to evaluate the company only based on the balance sheet from the past so they try to look at how the company would be affected in case of a successful implementation of the project in the future, a future oriented approach for which soft facts are important. Sometimes the consultant/customer advisor has known the company for a long time – this is normally the case for older enterprises that come for repeat projects. In the case of younger companies the consultant/customer advisor does not know the company that well (when there is for example only a one time contact in the course of the application for the support). However they are in contact with the banks and the house banks of the client so they receive a lot of information. They have a questionnaire relating to different soft fact criteria to evaluate the companies and this questionnaire is also sent to the banks who then also have to evaluate the customer according to that questionnaire.

Some credit institutions that specialise in micro- and small-firm lending, such as co-operative and smaller savings banks have developed long term relationships with those firms over time and know them well, so that they are less reliant on quantitative data as regards decision making for loans.

Bank practices 4

Research suggests that smaller banks tend to lend more to smaller more opaque customers with little in the line of quantitative financial information than do the larger transaction-oriented banks.[57]

Generally speaking, as regards the private banks, for corporate clients a good deal of use is made of qualitative factors, and in the course of the interview programme with banks, the qualitative factors most often referred to were the following:

- The quality and financial competence of the management
- The quality of the project
- The quality of the financial data
- Cash flow and profit forecasts, and
- Market sector.

Table 3.2 above sets out in more detail what could be included under these headings.

However, risk managers emphasise that the factors should not be seen as separate but that the way they combine is really what is important, and that the critical factors vary by type of project and the firm in question.

As regards smaller firms, often treated as retail or personal clients, there is often very little information available, whether quantitative or qualitative, especially where there has not been a long-standing relationship with the bank in question. Firms may of course also have an interest in disclosing as little as possible for various reasons such as tax or other matters[58]. In such instances banks will tend to fall back on behavioural data (if a client, it is easy, if not, they can use software to obtain key details of account behaviour from the other account) and/ or use business information suppliers or national credit registers and such data as may be available. So while, in the absence of much in the line of quantitative data the use of qualitative data becomes more important, in many instances this may not be available either.

Qualitative factors appropriate in smaller firms, which might be used in scoring models, other than the usual of calibre of management or market) mentioned in the course of the interviews were:

- Intangibles (e.g. trademarks or patents)
- Relationships with other firms/ suppliers
- Linkages with industry and support organisations
- Type of firm (legal definition)
- Number of years in business
- Payment history

Banks tend to prefer not having to make things too complicated, so try not to use too many, too complex qualitative indicators.

The SMEs interviewed have a wide range of views when it comes to what they consider are the most important qualitative factors to take into account. Some are of the view that they do not know- it is a

[57] Gropp et. al. p. 6
[58] Gropp, et.al. p.5

question left for experts. Others mention "all" qualitative aspects, or financial stability, or financial capacity of the management, or the effect on the local business community. No clear view emerges from their comments.

There is generally a good deal of qualitative information available about larger clients from a wide range of sources, both obtained directly through interviews with those clients and other sources in the market, and the extent to which banks will invest in developing qualitative data about their smaller customers (current and new) depends on the market position the bank wants to adopt. This varies between banks, and while some may want to include smaller and medium-sized clients in their portfolios from the point of view of risk management, others may wish to have a specific presence in that market for purposes of their market positioning.

One of the key rationales for the Commission's intervention into this area is that increased use of qualitative data for assessing SMEs should increase the chances of such firms obtaining finance and also possibly result in better lending decisions by credit institutions.

The preceding paragraphs suggest that those banks that wish to have relationship-oriented customers tend to be the smaller ones and are already doing this as it is in their interest to do so, and will probably continue to do so. However, the larger transaction oriented banks' business models do not necessarily encourage increased qualitative information density and use of qualitative factors, and if required to do so the effect on SME lending would be uncertain as suggested below when discussing transaction costs.

Research by Bernet and Westerfeld in this area is of relevance. Their findings suggest that the idea that the use of more qualitative information will lead to a more ready supply of credit for SMEs may be an oversimplification of the real situation[59]. Their study compared the results of loan applications from a set of companies to banks that use qualitative factors in their ratings with the same set of firms applying to an institution that uses quantitative factors only and the outcomes were not significantly different. The real difference came from the ability within the qualitative models to override the rating based on the subjective experiences of the relationship manager. This suggests that the role of judgemental factors in the model is critical, rather than the extent of qualitative factors per se.

A study compared the results of loan applications from a set of companies to banks that use qualitative factors in their ratings with the same set of firms applying to an institution that uses quantitative factors only and the outcomes were not significantly different. The real difference came from the ability within the qualitative models to override the rating based on the subjective experiences of the relationship manager

Bearing in mind the distinction between relationship and transaction banking as set out above in 4.1, research by Gropp, R., Gruendl, C. and A. Guettler (2013) suggests that firms with positive soft (qualitative) information tend to self-select relationship banks as they know that such banks tend to take such data into account in lending decisions. This could help them get cheaper credit or even more than would have been available otherwise. Smaller banks tend to use more discretion in lending upgrades (override upwards). On the other hand applicants with more negative soft information tend to approach

[59]Bernet, B. & Westerfeld, S., (2008); ZeitschriftfürBetriebswirtschaft, 2008, Nr. 10, "KMU RatingmodelleundRatingqualität: Auswirkungen der Ratingarchitekturaufdie ex-ante Risikoklassifikation von KMU Kreditkontrakten".

transaction banks who may in turn apply a negative adjustment to the rating or score. But it means that those firms may actually be able to get a loan whereas a relationship bank looking at detailed qualitative factors might not have been willing to provide one. It also has implications for the nature of the portfolios of such banks as problems with the quality of the portfolio (adverse selection) and higher costs and possibly more requests of collateral could lead to reducing loans to SMEs in the longer term. As relationship banks increase investment in identifying soft factors, it may force more SMEs with blemished soft factors to deal with transaction banks. Their research also suggests that for firms where soft information was important in the lending decision there was no greater likelihood to default compared to firms where only financial information was used – so the adjustment of scores by loan officers' expert judgement did not lead to bad lending decisions.

Firms with positive soft (qualitative) information tend to self-select relationship banks as they know that such banks tend to take such data into account in lending decisions. … On the other hand applicants with more negative soft information tend to approach transaction banks who may in turn apply a negative adjustment to the rating or score

In sum, the preceding paragraphs suggest that **the relationship between qualitative factors and provision of SME credit is multifaceted.** Qualitative factors are important with large projects, where they provide a further dimension to quantitative factors; but they are also very important in the case of the banks that supply the smaller end of the market where there are no significant quantitative factors either. However, there is a different group of firms that specifically does not want to be looked at too closely in terms of soft data. For these firms "transparency" would not contribute to increased financing. In addition, research suggests that it is not always the fact that increased use of qualitative factors leads to increased credit for SMEs.

4.3.2 Transaction costs and soft facts

Transaction costs in provision of loans can arise in different ways, for example: "shoe leather costs" from shopping around for credit; actual cost of incurring the transaction; or costs of building a system and obtaining and updating data to input into the rating system.

One of the stated aims of increased transparency (e.g. as regards scores and ratings) and reliance on qualitative factors is to reduce transaction costs. The comments in the preceding paragraphs as regards smaller banks and those banks that focus on SME finance suggest that this is in fact what is happening in and driving the use of qualitative factors in those relationship oriented banks.

As regards the larger transaction oriented banks, there is some discussion about the impact on transaction costs of increased transparency and increased use of qualitative factors. From the point of view of the banks, they can invest in relationships and soft factors before the application is made by seeing enterprises more often, carrying out specific training workshops for groups of clients, or set up on-line systems to help enterprises prepare for credit applications. The costs of undertaking such activities of course need to be recovered through better approval rates and lowered transaction costs (for example, as one banker puts it, not having to make five telephone calls before the balance sheets are provided). The question is if such an approach would fit the business model of the bank. Also, not all clients would stand up to such higher levels of scrutiny, especially if they have self-selected a transaction bank because they have negative soft information and are willing to pay a premium to have it not discovered.

Such processes would also increase transaction costs for SMEs as they have to invest more time in preparing their applications, possibly improving their financial literacy, meeting with the bank loan officers, etc. Research in the UK suggests that often companies take very little time to prepare their applications, and often do not have appropriate financial skills, and are unwilling to invest in those skills, either in terms of internal training or from an external party.

The view of the transaction-oriented banks is that there are limits to the amount they can invest in gathering qualitative information about small enterprises as the costs involved in information gathering are not warranted by the size of the loan applications (e.g. site visits and meetings), even if the account is to be a loss leader for providing other financial services such as insurance, investment advice, etc..

Most of the SMEs spoken to were of the view that that there should be no increased costs for banks from increased transparency and more use of qualitative data, especially if banks implement this approach well. Another view was that costs will increase because of additional human resources employed, and this will be required for those additional applications that are approved, those that would have been approved anyway, and those that are still declined. Would this overall increase in costs be justified if it meant higher loan charges for all to recover the costs? Few SMEs reflected that they would also have to increase their information inputs, incurring costs, in order that banks could make use of such information.

On the other hand, some enterprises are of the view that they would be able to save money if rating and scoring issues were clearer due to being able to prepare and then present better documentation more quickly, which could make a finance director's life much easier and save a lot of time. Some think that increased investment by banks will lead to increased costs but will also benefit banks as they will have better performing loans as a result, while others are of the view that the increased costs will just be passed on to SMEs by increased charges. Others say they can't really say what the effects would be on costs. Nearly all the SMEs interviewed were not aware of how banks' rating or scoring systems work or what would constitute best practices.

4.4 Feedback provided by banks

In this sub-section we set out what type of feedback the banks provide. In the next section we discuss in more detail the effectiveness of the feedback provided from the SME point of view. It should be noted at this stage that in the course of the fieldwork for this project we have obtained different levels of response in terms of interviews from different Member States. In some, we have achieved high levels of interviews and there has been a good deal of support from those interviewed in terms of providing references to additional literature and reports. In others, the banks and associations have been less co-operative, so we have not obtained as full a picture of the situation. For this reason we cannot be completely categorical as regards the situation in every individual Member State, so in some instances we will generalise. However, for the five largest EU economies, we have obtained a good level of response.

Based on the fieldwork carried out, it can be said that the type of feedback that banks will provide is determined by the following factors:

- The type of customer (corporate/ retail/ special cases)
- The type and size of bank (transaction or relationship/ big or small)
- The banking/ business culture (degree of transparency or openness)

4.4.1 The type of customer

Generally speaking, the larger the enterprise, the more detailed and fuller the feedback provided. However, it is worth recalling, as pointed out above in 4.2.2, that size is not the key driver of the distinction between retail and corporate - the predictability/ homogeneity of the data pool in question that underlies the rating/ scoring process is the differentiator.

Corporate clients are treated differently to retail/ personal clients, and will generally have been rated rather than scored – there is a lot of hard and soft information that can be evaluated and talked about, the enterprise's representatives will have the financial literacy to understand what is being said and the enterprise may be able to respond to feedback from the bank. This is true as regards the transactions-oriented banks as well as the relationship oriented banks throughout the EU Member States. It makes business sense to invest in a business relationship that has the potential to provide a substantial reward. However, even here there may, in some Member States, given the nature of the business culture, be a reluctance to provide a highly detailed written response and a preference remain for verbal communication. On the other hand, in some Member States, such as Germany, under the Initiativ Finanstandort Deutschland (IFS), feedback could consist of a detailed presentation and reference to industry benchmarks to make enterprises understand fully the strengths and weaknesses of their application and what they can do to improve.[60]

One exception to this is in the case of what might be smaller businesses that have been targeted for special nurturing and support through public banks or funds for example to help them access and supply new markets or undertake investments in product development, or other innovations that will lead to step changes in their sales or efficiency.

For retail customers, including those who are scored and those without financial statements that might be assessed based on behavioural data, feedback is generally more restrained. There are also significant variations between types of banks and countries.

4.4.2 Type of bank

Corporate client feedback has been discussed above, so here we deal with retail and personal (business) client feedback, which would include most SMEs. The transactions oriented banks have more automated feedback systems. However there is some variation in feedback and how it is communicated between Member States.

Feedback, when the outcome to the application is negative, can vary from an email containing a few words, to a structured letter containing information on who to contact for further details or if there is a disagreement (both inside and outside the bank), to a short message on the phone, to no feedback at all, not even a yes/ no response resulting in enterprises going to credit unions, for example to get funds, even if at a higher cost, to get the business going (after which banks were prepared to provide funding).

The smaller relationship oriented banks are usually closer to their customers and more feedback is provided, both before and after application, usually face to face, although there is also a good deal of variation between individual banks and Member States. There is also often a reluctance to provide a written motivation for the refusal, as that may trigger a legalistic approach to responses, with the credit institution trying to say as little as possible so as to avoid any litigation, whereas in a more informal environment more contextual and more useful feedback can be provided freely.

[60] See below 6.2.6

4.4.3 The business culture

There are important differences between business cultures as regards openness and transparency in the EU and they are reflected in the relationships between banks and their customers, and in particular in the more opaque parts of the market – the smaller and very small enterprises where few data of any kind are available. In some Member States, for example, a house bank may have ready access to the various positive and negative soft factors in a business and act accordingly, whereas in others enterprises may have a more "political" approach to relationships with banks and manage the information provided to them. One bank expressed the view that in their market (Southern Europe) the culture of transparency was not as prevalent as it might be in other parts of Europe such as Scandinavia. A Scandinavian bank with operations in the Baltics suggested that their operations in the Baltic area, given the legacy of Communist rule in the area, had not yet developed such a high level of customer orientation and that feedback might still not be at levels expected in or comparable to some other Member States.

4.4.4 Providing the rate or score to the customer

No banks spoken to volunteer to provide a score or a rating, but in some cases if asked will provide this, although many are reluctant to do so. They certainly cannot make such a score or rate public without the permission of the client due to data protection issues. The banks are of the view that the provision of a number or letter is of little or no value to applicants, nor is it of much use to be able to understand how the score is calculated. Their view is that enterprises should be interested in presenting the business fundamentals that they use to assess applications, and usually this information is readily available from either the bank's website or banking or industry associations. The view is that if the business is sound and the application is sound and completed correctly with the correct supporting information it will be dealt with accordingly, and knowledge of a rate or score is rather immaterial. Also, it can lead to abuse if too much is known about how the underlying model works.

Even if a small business knew its score as provided by one bank, this would be of limited value as regards approaching another bank, as that bank would still want to recalculate the business's score in terms of its own practices.

Table 4.2 summarises some of the relationships between the variables discussed above.

Table 4.1 The relationship between enterprise size, assessment type, credit institution, data inputs and feedback

Size of enterprise	Assessment system used – can be Standard or IRB	Account type	Approach to score or rate - type of credit institution		Mix of data used	Type of feedback
			Larger transaction-type	Smaller relationship-type		
Medium-sized	Rate	Corporate/ retail	Flexible - override	Flexible – override	Qualitative very important (20-40%), plus a lot of quantitative	Detailed, extensive
Small	Score (probably)	Retail (probably)			Quantitative/ some qualitative (20%)	Less detail
Micro	Score/ account behaviour	Retail			Some quantitative/ qualitative/ referencing	In transaction banks can be very little, maybe with references to where more information or support is available. More feedback in relationship banks.
Zero-employees	Score/ account behaviour	Personal/ retail	Inflexible (low flexibility)/ more mechanical/ little or no override	Relatively flexible/ less mechanical, some override	Qualitative/ referencing/ little quantitative exists	In transaction banks can be very little, maybe with references to where more information or support is available. More feedback in relationship banks.

4.4.5 Good practices

When it comes to good practices among banks as regards rating/ scoring systems and provision of feedback, many of the practices have been developed in co-operation between banks, rather than by individual banks on their own, or in collaboration with relevant financial industry or SME/ industry associations. Good practices depart from the position that good inputs (complete, accurate and timely information) submitted by the applicant lead to good outputs for the applicant. The application is seen as a process, a journey, not just a series of discrete and unrelated events. This also links to the question of improving the financial literacy of applicants. From the point of view of identifying good practice, it is useful to look at the provision of feedback in four stages: pre-application; making the application; processing the application; post application feedback.

Banks generally do, continually, carry out initiatives to improve their customers' understanding of their systems by regular individual client contacts and workshops with groups of customers. A further critical factor of course is the training and the role of the loan officer or advisor giving the feedback and in charge of the relationship.

The key to provision of feedback in banks is the market segmentation strategy of the bank in question. Generally speaking, the larger the loan in question, the more the bank will be prepared to invest in the relationship, which includes pre-application advice, management of the process, and post-decision support and feedback. The findings of the interview programme carried out for this project suggest that transparency and feedback is, in general, not a major issue for larger loans and corporate clients who are rated and where there is discretion and discussion both before and after application.

Problems really start with smaller loan applications and it is here where good practices are more relevant, although at the smallest end there is some scepticism of the extent to which enterprises will be able to understand feedback and whether they will be able to do anything about it. Also, it is very hard for banks or industry associations to penetrate this part of the market. However, it is this difficult part of the market that should be targeted, rather than going for the "low hanging fruit" of corporate relationship banking.

4.5 Evaluating rating/ scoring systems, and the use of qualitative factors

The preceding paragraphs suggest that while the definition of rating and scoring, and the types of rating systems that exist, can be relatively clear-cut, in practice there is a good deal of variation about the matter. When it comes to evaluating rating and scoring systems, it can be done from different points of view: in terms of compliance with regulations; whether they do what they are supposed to do – provide credit better than if they were not in use; and what the role of qualitative data is. These will be discussed in turn.

4.5.1 Compliance with standards

To operate rating and scoring systems under Basel regulations they need to be very thoroughly tested and approved by the relevant financial organisations (e.g. the central bank or the relevant financial services authority or regulator) before they can be used. Banks continually review their rating/scoring systems to improve them (e.g. by back testing and looking at gini-coefficients). They do this both because of competitive reasons in order to improve their profitability and also because they are required to do so by regulators who come and do on-site checks and inspections. If they change their models, they need to advise the regulator and provide robust support for such changes. To improve effectiveness some will develop models specifically for particular sectors or segment (advanced IRB). There is continual change in the systems reflecting changes in economic circumstances or events in the enterprise life.

On the assumption that the criteria and standards that the systems were designed to meet were created by people who knew what they were doing, the systems that are operating are clearly performing as required. However, concern has been expressed by some commentators on the extent to which reliance is being placed on mechanical systems[61]. This creates some challenges for the ways in which banks carry out their business – the provision of credit - in the longer term. **What is the role to be of the use of expert judgements in making final credit decisions?** In **relationship banking** banks assess the creditworthiness of their clients in the medium to long term and provide appropriate products, advice,

[61] De Laurentis, G., et. al., p.299 ; see the comment above with reference to Basel II article 417.

services and assistance. A great deal of contextual interchange of information, learning, and ideas takes place which should lead to better decisions in the future. In **information-based transactions**, banks exist because they can exploit information synergies from credit and risk assessments and commercial activities. There are not information spill-overs that benefit customer activities. Such spill-overs are produced from judgemental approaches. To overcome the weaknesses of the SBRSs they need to be combined with human judgement and override capabilities that can account of all material factors and not just those in the calculations. But as seen above, it is often very difficult for banks to override a credit rating or credit score, especially when it is an upgrade.

So while the systems do have significant advantages in terms of operating costs, objectivity, integrity, being replicable, and compliance with rational rules, these can come at the cost of the role of judgement-based decision-making. In some banks this may mean that the role of the credit officer or consultant is diminished, who will not then develop the financial and business competence to analyse credit applications (this is especially relevant in the case of SMEs as those looking after the SME segment are usually young and at the beginning of their career), and can lead to the commoditisation of the process. This ultimately reduces the bank's ability to deal with non-standard events such as economic cycles.

Such developments may be accentuated by some of the trends in banking: the increasing size of banks (from mergers and acquisitions) that cut costs by taking expensive staff out of branches and replacing them with automatic tellers and cheaper transaction oriented staff with less local knowledge; benefiting from fewer knowledge spill-overs; reducing branches and therefore contact with customers; and the continued restructuring of the European banking sector, with the expected sale of many retail banking business divisions in the coming years.

4.5.2 Provision of credit

As to whether the rating and scoring systems provide the required levels of SME credit, that is a more complex question. Banks generally are of the view that their rating practices are up to standard as they are approved by external regulators, and the view is that if an enterprise has a good project in mind, has a good credit record, and has completed the application form correctly providing the required information, they will be funded, other things being equal. Banks are also continually improving their rating and scoring systems, driven by competitive factors which encourage them to increase credit and reduce defaults.

The data reviewed in section 2.1 and 2.2 also suggest that, on the whole, the majority of enterprises that apply for some form of loan finance or credit from a bank do get it, and where this is not the case in many instances it may be due to other macro-economic factors, rather than problems with the rating or scoring systems.

However, two important provisos to the abovementioned points need to be mentioned. The first is that the data in section 2.1 have suggested that **there may be an issue as regards provision of credit to micro-enterprises, and this is an area where there is often an absence of data and qualitative factors and judgement come into play. Here the question is much more about scoring than rating.**

The second is that we have not been able to identify data about performance of loan portfolios that refers specifically to SMEs as banks do not record their data in that way. However, even if such data were available a correlation with the role played by rating and scoring processes would not be enough and further detailed econometric or statistical analysis would be required before any conclusions might be arrived at.

The conclusion would therefore seem to be that rating and scoring systems on the whole perform as well as can be expected, but that there may be issues as regards scoring, as this deals with large numbers of enterprises on the basis of statistical behaviour which means individual circumstances may be overlooked or disregarded. At the same time, there are economic constraints on investment in research into so many enterprises by banks. While a retail portfolio may perform well as a whole, some enterprises in that portfolio might be overlooked.

The conclusion would therefore seem to be that rating and scoring systems on the whole perform as well as can be expected, but that there may be issues as regards scoring, as this deals with large numbers of enterprises on the basis of statistical behaviour which means individual circumstances may be overlooked or disregarded. At the same time, there are economic constraints on investment in research into so many enterprises by banks. While a retail portfolio may perform well as a whole, some enterprises in that portfolio might be overlooked.

4.5.3 Qualitative data

The role of qualitative data is to improve predictability of outcomes, but how it works in practice is multifaceted. Overall, it tends to be less important in the transaction-oriented banks than in relationship oriented banks. But even in such banks qualitative factors would play an important role in dealing with corporate clients that are being rated. However, these banks adopt a more mechanistic and quantitative approach to rating and scoring than the (generally) smaller relationship banks. They also tend to charge more as they would expect to pick up more customers that might have negative soft factors, although this is not necessarily a bad thing as those enterprises might not be able to get credit from banks that pay more attention to and gather more qualitative factors.

In the (smaller) relationship-oriented banks, qualitative factors play a more important role. They might have proportionately less large enterprises as customers (corporates) and for their target customers, especially at the lower end in terms of size, qualitative factors are all that they have available, complemented by judgement. However, while some financial institutions have found that adding qualitative factors to their scoring systems has improved predictability, research has suggested that there is not a necessary causal relationship between increased use of qualitative factors and increased success in SME loan applications.

A policy that generally supports the use of qualitative factors in SME rating and scoring would not necessarily lead to improved credit provision to the SME sector as a whole, although it could have a positive impact on some segments of the market – those where specific systems are developed for specific markets and prove to have a positive result

This suggests that a policy that generally supports the use of qualitative factors in SME rating and scoring would not necessarily lead to improved credit provision to the SME sector as a whole, although it could have a positive impact on some segments of the market – those where specific systems are developed for specific markets and prove to have a positive result (for example in the case of an institution that focuses on small and handicraft enterprises).

Feedback and its effectiveness 5

This section investigates the effectiveness and benefits of feedback provided by banks to SMEs and the extent to which that improves their chances of getting better bank financing. In a preceding sub-section (4.4) the feedback provided by banks is set out. The findings presented in this section are based on interviews with SMEs and SME associations, the Enterprise Europe Network Survey, a survey of Italian SMEs, and reports identified in the course of desk research and interviews. This section also deals with the implementation of the CRD article 145(4)[62] and what that has meant for SMEs as regards obtaining feedback.

In general, the larger the enterprise, the more the chance of feedback and the more will be provided. While again there are some significant differences between Member States, smaller firms interviewed were not always interested in feedback: they just wanted to know if they got the finds or not. Nor were they interested in, or in many cases even aware of, their rating/ score or that they were being rated or scored. They were interested in the criteria the banks use to assess them. In the survey results, some three quarters of those who had had a positive outcome to their loan application tended to find the feedback useful or very useful, whereas only about a fifth of those whose applications were declined found their feedback useful or very useful. Of this last group nearly two thirds found finance elsewhere subsequently. Feedback can be grouped into three categories: useful for accessing future loan applications; useful information for future loan applications but not able to do anything about it; and, unable to use the feedback due to insufficient financial literacy. The research also found the implementation of CRD 145 (4) in support of transparency and feedback to be very patchy (although good in some places), and there were some divergences in perception on this score between members of the financial community and SMEs.

5.1 Feedback provided by banks

5.1.1 The importance of feedback and understanding rating/ scoring systems used

Companies interviewed have different views about the importance of understanding the rating and scoring systems used by banks. Most say it is important to understand what it is that the banks are looking for in their credit applications. They do not want to understand the statistical relationships underlying the models used, rather what the criteria are that banks will judge them by in the course of their loan applications.

From the point of view of transparency, other SMEs interviewed were more interested in how the cost of borrowing was arrived than the rating or scoring so that they can compare offers from different banks (like consumers when they go shopping for a mortgage on a property). They are not interested in the letter or number – all they want to know is if they get the funding or not. And if not, they could possibly try to obtain funding elsewhere, unless as is the case in some countries, it is hard to obtain funding from outside the company's usual banker.

While none of the SMEs interviewed indicated that they were particularly interested in their rating or scoring as such, some, especially in Germany, were aware that they were rated or scored and knew what that was. The situation in Belgium, where over 65% of SMEs (and 70% of micro-enterprises) are either unaware of whether their bank rates them or do not know what a rating is, has been mentioned (4.2.4). And of those who know they are scored or rated by their bank, 24% know what their SME's score / rating is. In France some enterprises mentioned that they find their rating provided by the Banque de France useful in day–to-day credit transactions, such as for example obtaining supplier credit. However, this can also have unintended consequences.

[62] Subsequently replaced by Article 431 (4) of the CRR.

As regards telling clients exactly what their credit-rating or -score is and how that was arrived at there are significant differences between banks and practices in Member States both in respect of whether the figure is provided and how useful that actually is considered to be. In some Member States, and some types of banks, companies will, on request, be told their rating and some explanation given as to how the number is arrived at, if not down to the technical details. In others the provision of a number or scale is considered counter-productive as that detracts from the business drivers that underlie the rating, and might, as it is claimed happens in the USA, lead to fraudulent practices.

5.1.2 The role of the loan officer

The role of the bank's loan officer or credit advisor or consultant, depending on the specific description of the role in the bank, is crucial in the feedback process. This will differ depending on the type of client: retail or corporate, and also in terms of the type of bank: transactional or relationship (including public banks). Corporate bankers tend to be more senior and will provide more extensive feedback to customers who have probably been rated. They have less individual customers to deal with as well. With the retail sector, bank officers will have many more clients, and individual attention is less likely, particularly for the transaction oriented banks. In fact, in some banks this is considered a good thing as it reduces the probability of "capture" of the loan officer, especially as these officers may be the more junior and inexperienced staff. In fact, this is considered to be one of the advantages of a mechanical rating system: it can provide a consistent unbiased assessment. In smaller relationship oriented banks, where there is not such a large distance between the lender and the borrower, there is more scope for personal feedback based on knowledge of the entrepreneur's specific situation. Given the trends towards consolidation and mechanisation in the industry the question of relationship with loan officers is likely to be one that will not go away.

The location of feedback officers is also a factor. For large corporate clients the relationship may be managed from a corporate banking headquarters office in the financial centre of the country; an intermediate client – say a middle-sized enterprise – may be managed through a regional business banking headquarters, while small enterprises are managed from the local business centre. The smaller the bank, the less is the distance between the enterprise and the decision-makers.

Bank loan officers or advisors are trained to give bad news if needed, and should be able to provide that in a "customer-friendly" manner, a way that meets the client's expectations. However, this may be difficult, and this is where one hears stories about loans officers referring to rating or scoring as a "black box", or "acting crazy", etc. There are also cultural differences between different parts of Europe here: in some countries it is "permitted" for bankers to be transparent about some things whereas in others those are considered much more sensitive or even taboo.

Clearly, there is a good deal of scope for misinterpreting what people have said. For example, a loan officer may think he or she has provided a sufficient explanation but then in fact the company does not really understand it – either because it is not well explained or because of insufficient financial literacy; a loan officer, assuming again it is a case of face-to-face or telephone feedback, rather than email, an internet message or a phone call/ voice mail, may actually say that the person had a rating or score that was below what was required but then in fact cannot explain exactly how ratings are done (quite understandable) and then not be able to fully explain the reason for the rejection; or a bank may provide an adequate explanation in writing to an unsuccessful applicant that advises them to contact some credit reference agencies for further details – which the applicant thinks is unsatisfactory – or they might contact the reference agencies and find that their information is incorrect (it is understood that in the UK a good 10% of data used by reference agencies is incorrect – or that they then do not understand the communication of the reference agency – in which case, is the obligation of the bank as regards CRD 145(4)[63] discharged or not? Many scenarios are possible, and there is a lot of room for mutual misunderstanding and recrimination, particularly in the potentially highly emotionally charged situation of a micro enterprise seeking funds to keep it afloat.

5.1.3 The difficulty of obtaining feedback and reasons for refusal

While not all enterprises are interested in obtaining feedback on loan applications, whether successful or failed, there are instances when enterprises do want feedback. In the course of the research where we interviewed SMEs we have come across various responses to this matter. The Enterprise Europe Network Survey carried out for this project[64] found that some 57% of respondents (mostly micro- and small enterprises) found it difficult or very difficult to get some feedback from banks to whom they had applied to for credit.

On the other hand, in Germany, results of the bi-annual surveys of KfW are also relevant. The number of enterprises which have been declined credit and have not been given a sufficient explanation has declined to such an extent that in the most recent version of the publication this question has been dropped[65].

In Ireland the IBF advised that SMEs would be given reasons in all cases where such information was requested. The Irish Central Bank Survey of SMEs contains an analysis of the reasons given to SMEs for the rejection of an application. In the last four surveys the percentage of SMEs who said that they had been given no reason for rejection varied between 13% and 24%. Of those given reasons for rejection, 42% related to the applicant and 52% to bank policy (there may have been multiple reasons for rejection). The main applicant related reasons for rejection were “inadequate repayment capacity” (23%), “account performance/history” (18%) and “deterioration in business financial performance” (13%) – both are quantitative factors. The main bank related reasons were “change in bank lending policy” (33%), “inadequate/insufficient security” (14%) and “no longer a sector to which the bank is prepared to lend” (20%). The survey did not specifically ask about credit referencing but it will be appreciated that this will underpin the applicant related reasons for rejection. Over three quarters (77%) of those SMEs who have been declined bank finance disagree with the reasons given for the refusal. In this instance therefore there is some evidence of lack of feedback provided for refusals.

A survey in Poland carried out by PARP[66] indicated that the main reason for refusal of finance requests in 2011 was ‘denied credit without giving a reason’. This had increased from 15% in 2009 to 39% in 2011. While this may be a reflection of the true situation, it could also reflect forgetfulness, or unwillingness of the respondent to provide the real reason. It may also be the result of poor communication between the bank and the customer, as a result of which the client is not informed directly that the cause of refusal was its low debt capacity or lack of creditworthiness. The increase in "denial without cause" may also be a result of the 'credit scoring' methods that banks use for creditworthiness assessment. The customer might be given "zero-one" information, which either means: denial of credit or loan agreement, without further going into details of the decision and on scoring tools. This is interesting in view of the fact that

[63] Subsequently replaced by Article 431 (4) of the CRR.
[64] 466 respondents of which 181 did not have any experience of feedback, 202 got feedback after acceptance and 83 after a rejection.
[65] Unternehmersbefragung 2010 and 2013.
[66] PARP, (2012) Raport ko•cowy: Badanie rynku wybranych us•ug wspieraj•cych rozwój przedsi•biorczo•ci i innowacyjno•ci w Polsce „Finansowanie zwrotne”, p.48

the Polish Banking Act sets out in art.70.5 the legal obligation for the banks to provide, on the request of the company, the written justification concerning the SME rating. The survey suggests that low creditworthiness (communicated to the company or only implicated based in the response "denied without reason") is the most common cause of denials of financing by financial institutions in both 2009 and 2011.

In the United Kingdom the Business Finance Monitor asks companies if they had been informed of the reasons why a decision had been declined and the information given. 24% of those initially declined said that they had not been given a reason (excluding those who could not remember the reasons given). In the majority of cases (77%) the initial decision was communicated verbally, while 1 in 3 (29%) received a written response (a few had both).

Two important points emerge from these survey results for Germany, Ireland, Poland and the UK. In the **first place, they point to some important interpretative issues**, some of which will be apparent in the next paragraphs of this section. If a bank provides what it considers to be a sound reason for refusal of credit, such as, “unattractiveness of the market sector”, a SME might not consider that a “sufficient” reason and claim that it is a case of absence of feedback, or unclear or insufficient feedback. Or the SME might not agree with the reason given by the bank, such as, for example, “the firm has not been in business long enough” (insufficient track record), while the entrepreneur in question might have been in that “industry” all his life. From the bank’s point of view, this is a clear explanation, from the point of view of the SME completing a survey, it isn’t.

In the second place, it is clear that **there is a good deal of variation between Member States**, a point that will be picked up again below when dealing with feedback and the implementation of CRD article 145(4)[67].

5.1.4 Enterprises’ perceptions of feedback

- **Loan approvals**

Here we consider the Enterprise Europe Network survey responses as regards feedback provided with loan approvals. While not statistically robust or representative, it does provide some useful insights into the nature, value and use of feedback given to SMEs. Of the 466 responses, 202 of those whose loans had been approved indicated that they had received some feedback. By far the majority had applied to commercial banks for funds (mainly for overdrafts, followed by loans for less than three years, then loans for more than three years), with similar shares having applied to savings, public and co-operative banks. A third had applied for sums greater than €250, 000, with about a sixth each for sums of €100-249,999/ €50,000-99,999/ €25,000-49,999, and less than €25,000. Some 85% of respondents indicated that they had approached their “usual” bank in this instance.

A quarter said they found the feedback very useful. Examples of what they considered useful are: the rating was discussed, improvements that could be made highlighted, and ways ahead were discussed; the rating was discussed in terms of personal solvency, private savings, the equity ratio; the importance of having kept covenants was discussed.

Almost half said that they had found the feedback “useful”. Examples of what was considered useful feedback included: there was a positive assessment of the practice; there was a useful discussion of liquidity and finance; it was explained how the balance sheet parameters influenced the internal rating; there was an exchange of opinions on the analysis of the balance sheet; we appreciated the written

[67] Subsequently replaced by Article 431 (4) of the CRR.

positive decision; there was a risk analysis of the financial condition of the enterprise; the bank's appraisal of the business plan; the company's financial plan was reviewed by the bank, the financial indicators are defined (loan covenants) and discussions about the indicators took place; the feedback (formal) interview was done by the bank corporate manager that has known our company for several years and which knows the trends in our field of business; clarity was provided about the rates applied; and, a clear explanation was provided why they granted credit.

Just over a fifth of respondent found the feedback as of "neutral" value, and included in this type of feedback is basic information about the loan granted, how much and when it has to be repaid, the rate, etc. Five percent of respondents found feedback not useful, or not useful at all, which included the type of comments included in the "neutral" group.

About half of the respondents indicated that the feedback provided would be useful for future credit applications, and reasons for saying this included that they would in future undertake their business in a more planned (structured) way; being able to supply the project meant that their general creditworthiness would improve; they would undertake a cost reduction programme; and, they would work to reduce the guarantees.

30 respondents said they had subsequently approached another bank for credit, and of these 27 were successful.

The survey responses suggest that in the case of these positive responses, there was quite a mix of quantitative and qualitative factors.

- **Rejected applications**

Turning now to the case of the rejected applications in the Enterprise Europe Network survey, close to two thirds of the applications were with commercial banks, a fifth with public banks and the balance distributed relatively equally between savings banks, co-operative and other banks. About a quarter of the applications were for overdrafts; a quarter for loans of less than three years; a quarter for more than three years and balance spread over other types of loans. About a quarter of the loans applied for that were decline were for more than €250,000; and a similar percentage was for loans between €100,000 and €249,999. The balance was quite evenly distributed between loans for €50,000-99,999; €25,000-€49,999; and, loans of less than €25,000.

The reasons respondents gave for their applications being declined, in addition to those being offered but rejected due to unacceptable terms, included: the bank was of the view that there too many risks in the sector; the level of personal equity in the business was too low; the bank considered the existing credit sufficient; equity had been used up for product development, so the business no longer looked secure; the enterprise had faced insolvency proceedings; financial irregularities were identified; the business was too new, it had not been on the market long enough; the recession in the construction industry; industry recession; the project quality was not good enough; the firm position in the sector was not sufficiently strong; and, insufficient guarantees. In 6 instances the feedback consisted of nothing to very little other than a call or rejection email.

73 respondents provided information about the value of feedback they received. 4 enterprises said they found it "very useful". This feedback included: an explanation by the bank of why they made that decision and the proposal of alternative approaches; a more detailed explanation about the bank's rating criteria; and, confirmation of the bank's good will and a competitive analysis. Of these four, two tried for funds elsewhere and both obtained credit.

A seventh of the respondents found the feedback "useful". Examples of such feedback include: the bank explained that they would not be funded because they needed more personal guarantees and would not fund salaries and wages – only fixed assets (phone); the enterprise did not have a sufficient track record (verbal); sector risk (phone); the decision was made on the basis of screening the business plan, customers and contract; and, they identified irregularities in the accounts. Five of these firms applied to other banks and two were successful with the other banks.

The feedback was considered "neutral" by nearly a fifth of respondents, and included comments such as: the exposure was too high to this market; a personal guarantee was needed; and, insolvency proceedings were identified. Of these, 10 tried for credit at a different credit institution and 3 were successful.

Perhaps unsurprisingly, by far the majority (nearly two thirds) found the feedback to be "not useful" or "not useful at all". Examples of such feedback include: too much had been invested in that sector by the bank; no advice, no feedback; the need to provide the personal residence as a guarantee; political risk in a country the enterprise was active in; the credit analyst said "no"; there has been no clear response, neither yes nor no … the bank just said contact us when you need to discuss; personal security was required; the equity had been used up in product development; the decline in profits as compared to the two preceding years; just "no"; a phone call saying "no"; more security – real estate – was needed; the enterprise's turnover was too low; the rating was too low and to enable the loan to be made would require a charge that would make it unaffordable; the bank did not consider public sector as a viable debtor; the bank was short of funds; no real explanation – just a short email followed up by a phone call; the balance sheet was too weak, insufficient guarantees, enterprise too small; it would make exposure to that client too large; the company did not have a long enough track record; the project was not considered a viable investment by the bank; high risk of and lack of credibility in the sector (automotive); the effect of the loan on the capital structure and the effect on profitability and payback period; refusal; personal guarantees were needed; lack of bank funds; the last two years' accounts were not good enough. 33 of these enterprises tried other banks and of them 18 were successful.

Of the enterprises that were rejected, more than two thirds that applied to another bank were successful.

Overall, of those that received feedback, 52% found it either useful or very useful, and 36% said that it would help them to obtain credit in the future.

In a separate survey for Italian enterprises carried out by Assolombarda/ Confindustria, with 70 responses, in only one out of the 11 instances where credit had been refused was the feedback considered to have been useful. In 7 of the 11 rejections, the sums in question were of over €250,000 and success was achieved in only one of the 7 cases where there was a new application for credit having been refused earlier.

Some comments can be made about these responses. In the first place, **there are clearly some subjective elements in the evaluation of feedback by SMEs.** What might be a perfectly justifiable explanation in terms of a bank's credit policy (e.g. "the balance sheet results for the past two years were not good enough") might be considered quite useless to an enterprise whose funding application is being turned down. Secondly, the majority of these enterprises would have been scored rather than rated. Despite this, there is a wide range of both quantitative and qualitative factors present in the feedback provided, some of which is quite detailed, even though there is a sizable group who feel that communication has been inadequate. Finally, for a good many of the respondents, being declined funding in this instance was not the "end of the road" for them, as they did obtain funds elsewhere subsequently.

Responses to an open question in this survey suggest that in fact many who said they had not been given a reason had in fact been given a reason but they did not agree with it. In Poland a high proportion of those who provided comments following a rejection mentioned they obtained only verbal responses with little feedback. In Italy a high proportion also pointed to a lack of coherent explanations behind the reasons given for the refusal. In other countries that participated in the survey: Spain, Portugal, and the UK there was also evidence of a lack of reasons for refusals and dissatisfaction with the explanation for refusal, mainly among micro- and small enterprises.

5.2 The effectiveness of feedback

The effect of feedback after the decision whether to grant credit or not has been made, particularly in the case of declined applications can be of three types: it can be useful in the sense of preparing for the success of future applications; it can be useful knowledge for the applicants but not of practical use; or, it may not be of much use to the applicant as they do not have the necessary financial literacy to enable him or her to respond appropriately.

The effect of feedback after the decision whether to grant credit or not has been made,can be of three types: it can be useful in the sense of preparing for the success of future applications; it can be useful knowledge for the applicants but not of practical use; or, it may not be of much use to the applicant

5.2.1 Paving the way for future successful funding

Feedback may be useful so that **the enterprise can respond in such a way that it is successful (or more successful) in a subsequent application.** This could be due to understanding application criteria or procedures better, or better managing its working capital, or implementing a succession plan in the case of an ageing entrepreneur. Or, if it was the case of a business applying to a relationship bank that was informed there were issues as regards its soft factors, it might be able to go to another bank that is not so inquisitive as regards what might be negative soft information.

In the Enterprise Europe Network survey, about a sixth of respondents said they found the feedback of "very much" use as regards obtaining future credit. The reasons for this included: as a result they turned to foreign banks in their Member States; they decided to go for self-financing; they obtained information about project weaknesses; decided to change the financing applied for from commercial to asset financing; and, made an assessment that led to increasing the value of company stock.

About a quarter found the feedback useful "to a certain extent", and reasons for this included the decision to seek a private investor; changed banks – looked for a bank that had a positive approach to the publishing industry; and, it led to the enterprise reducing costs and increasing equity.

Overall, some two-fifths of respondents said that they thought that the feedback would help them obtain credit in the future. This is an area where further investment by banks could have valuable spin-offs.

Reasons given by the quarter who thought the feedback had a neutral effect on future funding applications included: went to a different bank where personal guarantees were not required; changes were made to business strategy unrelated to bank feedback; and, financing requested switched from loans to factoring. A seventh considered that it did "not really" improve their chances (for example, they just asked more credit institutions for funds); and a fifth said "not at all" for reasons such as: no – the rejection was not explained; they obtained funds from a different source; they have decided to try and get on without additional credit.

Clearly **the above examples of feedback demonstrate that enterprises do respond in different ways to bank feedback (or its absence).** However, an important approach is to try and switch funding sources, both within and without the banking system. Clearly some supplier diversity (e.g. transactional banks) is useful for the overall effectiveness of credit supply. Feedback does also encourage enterprises to undertake approaches to increase their efficiency and productivity, although many felt that the value of feedback in accessing future supplies of funds was either neutral or not of any use.

5.2.2 Useful knowledge but not of practical value

It may be useful knowledge for the enterprise in question to know why the application has failed, but **of little practical use as they are not in a position to change things** – for example provide additional security, or influence their historic current account behaviour, or change information provided through a reference agency, or they are in a sector of the market currently not favoured by the banks.

As the preceding paragraphs show, quite a good deal of the feedback provided, about a half, falls into this category: few firms can change their track record or the market they operate in, although some can go to banks that look more favourably on some sectors than others, or do not require personal guarantees.

5.2.3 Insufficient level of financial literacy

While the survey did not identify many **respondents that do not have a sufficient grasp of financial matters to enable them to respond to feedback, we have been advised in interviews with banks that this can be a problem**. It may be of no use to the enterprise if the owner/ manager of a small enterprise in question does not have sufficient level of financial literacy to grasp what the problem is and/ or what needs to be done (e.g. influence liquid asset ratios, or recapitalise). Also, often in such circumstances, those individuals rarely have the time to invest in obtaining such training.

In the case of enterprises with no employees, micro enterprises and some small enterprises, detailed, transparent feedback is not always of much value, as those enterprises are often not in a position to spend time listening to or considering feedback, or they are not sufficiently financially literate to take on board what is being said, or their chances of making required changes to capital structures (quantitative factors), or moving into another market (qualitative factors), etc. are non-existent. This is also probably the part of the market where most loans are in fact declined.

5.3 Getting feedback and the implementation of CRD 145(4)[68]

The CRD was a directive to be implemented by Member States (see 2.3 above), which has recently been superseded by the CRR which as a regulation does not need to be implemented.

It is worth noting that during the interview programme we did not find one SME that was aware of what it was entitled to in terms of CRD 145(4), namely that "Credit institutions should, if requested, explain their rating decisions to SMEs and other corporate applicants for loans, providing an explanation in writing when asked. Should a voluntary undertaking by the sector in this regard prove inadequate, national measures shall be adopted. The administrative costs of the explanation have to be at an

[68] Subsequently replaced by Article 431 (4) of the CRR.

appropriate rate to the size of the loan"; and for that matter, nearly all industry associations and most banking associations spoken to were (at least initially) unaware of its existence and role.

Among the bankers and banking associations spoken to, some banks have said that while they will provide feedback when asked but it is not their policy to provide written feedback. Others have made the point that although they have implemented CRD 145(4), there are hardly any cases where they have had to apply it, and usually an oral communication is good enough.

By way of contrast, the German Banking Industry Association has pointed out that it has been in compliance with Article 145(4)[69] of the Capital Requirements Directive since 2006 and made the following public commitment: "Every corporate client soliciting credit above a certain amount, the level of which varies by customer segment, can obtain information about its credit rating from its bank[70]." On the basis of two surveys carried out in 2008 and 2011, the member associations of the German Banking Industry Committee were able to demonstrate to the German Finance Ministry that German banks had translated this commitment into practice, a view supported by the German parliament. Bundestag printed paper (BT-Drucksache) no. 16/13741 states that the "commitment to inform corporate clients has largely been implemented. There is consequently no need for legislative action." In addition, in 2009, Articles 28b and 34 of the revised German Data Protection Act extended the transparency offered to corporate clients to natural persons, who normally undergo credit scoring. This means that small and very small businesses, which frequently have the same legal status as natural persons, can benefit from this improved transparency as well. From a German perspective, therefore, the requirement in Article 431(4) of the CRR is superfluous. We have not come across any evidence in the course of our research that obtaining feedback is a problem in Germany.

The implementation of this article has been successful in a very few instances, and it is being worked on others, but it has not really permeated throughout the EU to all who really need it. Implementation has generally not been monitored, and enterprises are not aware of it.

In 2009, Articles 28b and 34 of the revised German Data Protection Act extended the transparency offered to corporate clients to natural persons, who normally undergo credit scoring. This means that small and very small businesses, which frequently have the same legal status as natural persons, can benefit from this improved transparency as well.

As regards SME and industry or sector associations, in the course of our interviews we have found little awareness of this article, and no evidence that its use has been promoted or encouraged among the association's members.

The examples set out below have been selected on the basis that in these cases there are clear responses available from both the financial sector and the SME sector (associations, enterprises) as regards the implementation. They make clear the different approaches that have been adopted to implementing 145(4)[71] and the often different perspectives between the banking associations and authorities on the one hand, and the SMEs and SME associations on the other. Our view is that implementation of this article has been successful in a very few instances, and it is being worked on

[69] Subsequently replaced by Article 431 (4) of the CRR.
[70] It is understood this sum is €750,000.
[71] Subsequently replaced by Article 431 (4) of the CRR.

others, but it has not really permeated throughout the EU to all who really need it. Implementation has generally not been monitored, and enterprises are not aware of it.

Table 5.1Implementation of art. 145(4)[72] of the CRD			
Country	**Formal implementation**	**Comment/ response as regards actual implementation**	
		Financial sector	**SME sector**
Bulgaria	The provision of art.145(4)[73] of the CRD was fully transposed in the Art.337 of the adopted by the Bulgarian National Bank Ordinance N.8 on the capital adequacy of the credit institutions (14.12.2006).	The Bulgarian National Bank is not aware of complaints raised by the SME sector with regard to this issue, neither have banks discussed this as an essential topic during on-site inspections on rating systems. The prevailing opinion among the banks is that the feedback is a must because it keeps the clients. Interviewed banks confirm that they inform all their clients about rights under the art.145(4)[74]	According to the industry association, on the whole, SMEs are not aware of the art. 145(4)[75]
Germany	The German banking industry has been in compliance with Article 145(4)[76] of the CRD and made the following public commitment: “Every **corporate client** soliciting credit above a certain amount, the level of which varies by customer segment, can obtain information about its credit rating from its bank.”	Based on two surveys (2008 and 2011) the member associations of the German Banking Industry Committee demonstrated to the German Finance Ministry that German banks had translated this commitment into practice. This is also the view of the German parliament. Bundestag printed paper (BT-Drucksache) no. 16/13741 states that the “commitment to inform corporate clients has largely been implemented. There is consequently no need for legislative action.” In 2009, **Articles 28b and 34 of the revised German Data Protection Act extended the transparency offered to corporate clients to natural persons**, who normally undergo credit scoring. This means that small and very small businesses, which frequently have the same legal status as natural persons, can benefit from this improved transparency as	SME associations generally tend to agree that financing and feedback is not a significant issue in DE.

[72] Subsequently replaced by Article 431 (4) of the CRR.
[73] Subsequently replaced by Article 431 (4) of the CRR.
[74] Subsequently replaced by Article 431 (4) of the CRR.
[75] Subsequently replaced by Article 431 (4) of the CRR.
[76] Subsequently replaced by Article 431 (4) of the CRR.

		well.	
Hungary	The provisions contained in article 145(4)[77] of the CRD are regulated by the 137/A paragraph of the Hungarian financial act (Hpt.) thus, they are compulsory for the banks.	The provision is included in the corresponding Hungarian law, and in the Authority's work practice, this issue has very limited practical relevance in Hungary. In practice there are hardly any cases when it is actually applied.	SMEs associations are not very keen to know the details of the scoring system. Rather, they would like to know simply and precisely, what to do in order to meet the requirements they failed.
Ireland	The Central Bank of Ireland requires disclosure of rating decisions through a notice "Implementation of the CRD - 28 December 2006, as amended January 2011" whose legal basis is statutory instrument S.I. No. 660 of 2006 and S.I. No. 661 of 2006.	The Central Bank of Ireland publishes FAQs explaining the notice implementing the CRD. In respect of art 145(4), the FAQs clarify the level of detail required as follows "Institutions should take a pragmatic and common sense approach when dealing with these requests. The Financial Regulator does not seek to be prescriptive in this area and will keep the matter under review." The Irish Banking Federation published a leaflet explaining the credit rating process[78] and saying that "On request, the institution can also provide details of the reasons why it was unable to accept your application"	A Central Bank survey of SMEs contains an analysis of the reasons given to SMEs for the rejection of an application. In the last four surveys the percentage of SMEs who said that they had been given no reason for rejection varied between 13% and 24%. Of those given reasons for rejection, 42% related to the applicant and 52% to bank policy (there may have been multiple reasons for rejection). Over three quarters (77%) of those SMEs who have been declined bank finance disagree with the reasons given for the refusal.
Spain	The provisions contained in article 145(4)[79] of the CRD were transposed with Royal Decree 216 of 2008 of February 15 on the Equity Capital of Financial Institutions[80] into the Spanish law,	According to the regulator, this issue has been very peaceful in the Spanish system. They have no record any complaint or claim by SMEs regarding the rating/scoring made by banks or regarding the feedback provided by banks when applying for a credit. Therefore there has been no need to regulate bilateral decisions between banks and SMEs.	Depending on the type of entity and the location (regional division of a bank in one area and in another), the feedback provided varies. Some banks which are closer to SMEs provide more detailed and qualitative explanations about the reasons for not granting the credit or for the conditions offered. Other banks do not offer any explanation.

[77] Subsequently replaced by Article 431 (4) of the CRR. See footnote 1.
[78] http://www.ibf.ie/Libraries/Guides_Forms/Credit_Rating_Process_web.sflb.ashx
[79] Subsequently replaced by Article 431 (4) of the CRR. See footnote 1.
[80] http://www.boe.es/boe/dias/2008/02/16/pdfs/A08667-08706.pdf

United Kingdom	The Financial Services Authority publishes a Prudential sourcebook for Banks, Building Societies and Investment Enterprises(BIPRU). The work of the FSA has recently been passed to the Prudential rating Authority of the Bank of England. BIPRU 11.3.4[81], issued in 2007, which requires compliance with 145(4)[82] of the CRD "A firm must, if requested, explain its rating decisions to SMEs and other corporate applicants for loans, providing an explanation in writing when asked. The administrative costs of the explanation have to be at an appropriate rate to the size of the loan."	The Lending Standards Board publishes a Banking Code (voluntary), which applies to micro enterprises[83]. The Code includes the following: "If a micro-enterprise customer's loan application is declined, the subscriber should provide proactive and clear feedback to the customer on the main reason why the application was declined and inform the customer of their right to appeal that decision. The written explanation … could be given in the form of a leaflet if it is sufficiently focused. Subscribers should have regard to the potential for financial crime in the information they provide and will want to avoid compromising their security procedures." For other business customers, the British Bankers Association publishes a guide to credit scoring. This guide says that "If a bank does not wish to accept your application, they will tell you. They will also tell you on request the main reason why they were unable to agree your application. If you did not pass their credit score they will tell you."	The SME Finance Monitor provides survey data on the information given to SMEs on refusal of credit facilities 24% of those initially declined said that they had not been given a reason (excluding those who could not remember the reasons given). 36% said the decline related to their personal and/or business credit history (mentioned more by smaller SMEs)

[81] FSA BIPRU accessed at http://fshandbook.info/FS/html/handbook/BIPRU/11/3
[82] Subsequently replaced by Article 431 (4) of the CRR.
[83] http://www.lendingstandardsboard.org.uk/docs/lendingcode.pdf

Support programmes 6

In this section various approaches that have been developed in support of improved SME funding around the theme of improved understanding of ratings and increased transparency in feedback that we have identified in the course of this project are set out. The area is also close to, and overlaps with, other initiatives relating to improving financial communication and financial literacy where there is a wide range of initiatives in place[84]. We set out the types of initiatives, the agents who have been responsible for driving the initiative, the organisations implementing the initiatives and the main advantages and disadvantages of each approach. This is followed by an explanation and discussion of the individual approaches.

In terms of initiatives, those driven by collaboration between the financial industry and SMEs have addressed a wide range of issues such as self-assessment, training, developing platforms to exchange views, and even developing ratings that could be bought from the Chamber of Industry of the region. These can be very useful and often can be implemented at low cost but it is not sure if they will reach some of those "outside the networks" that may be most in need of the support. Industry Codes of Conduct may be useful but are easily forgotten or brushed aside when other pressing matters arise as they tend not to have "teeth". Some of the most interesting initiatives are around the development of credit registers (where they do not yet exist in the market), or mediators, or such institutions, and increasing of financial literacy that will improve the data and knowledge "backbone" of the industry in the longer term.

6.1 Types of support initiatives and programmes

Table 6.1 sets out the main types of initiatives identified. Few of the initiatives listed below are directly EU driven, and not many are directly driven by Member State governments (although they might be indirectly driven as in the case of setting up national credit registers, or the IFD). In addition, very few of these initiatives have been subject to thorough external evaluation, so it is not readily apparent what their successes and failures have been, other than at a rather anecdotal level.

Table 6.1 Policies to promote transparency of SME rating/ scoring and supply of feedback to SMEs.

Approach	Agent	Examples	Evaluation	
			Advantages	Disadvantages
Self-assessment, experience sharing via on-line tools	Banks, associations, public banks	ING, ICO, pymefinance,UNIZO/ UCM/ Febelfin, Assolombarda	Ready access, relatively low cost	Uncertainty as to whether it will reach those most in need.
Co-operation between SME and Banking Associations	Industry associations	ABI/ Confindustria; UNIZO/ UCM/ Febelfin, Netherlands	Very helpful way to share views, develop mutual understanding and share costs.	May not reach those outside the ambit of the associations involved (e.g. often micro-enterprises most in need of support).
Training and education in financial literacy	Industry associations, Public sector	UNIZO, CeFIC, ABI	Very useful way to develop an understanding of the issues	May not reach those outside the ambit of the associations involved (e.g. often micro-enterprises

[84] European Banking Federation (2010); Financial Dialogue: bank measures to foster SME financial knowledge.

				most in need of support).
Credit mediation	Public sector	France, Belgium, Ireland, UK	Provides an objective forum for resolution of conflicts and to capture knowledge about the issues from both sides of the table.	Often enterprises are not aware of the option, or it is seen as too time consuming or for only "larger" companies with the resources to deal with this.
Ratings provided by public sector organisations	Public sector (Central Banks)	6 ICAS central banks in the EU	Useful as an indicator of creditworthiness for general business purposes.	Can be incorrect/ out of date, and a lending bank will still do its own assessment
Integrated national rating system	Private (financial) sector	IFD (Germany)	Useful as an indicator of creditworthiness for general business purposes.	Can be incorrect/ out of date, and if appropriate a lending bank will still do its own assessment.
Buying a rating	Chamber of Commerce/ public sector	Austria, Czech Republic, Slovakia	Provides a signal to other enterprises in the market, helps enterprises to understand their own positions	Payment can discourage take-up and localised nature can reduce value
National credit registers	Public sector	Ireland, Italy, Spain, Portugal	Valuable external source of information	Cost of keeping them up-to date and accurate
Codes of conduct	Industry Associations	UK, Netherlands, Malta	Can state aims and intentions clearly and make commitments	Implementation can be vague and does not imply awareness among SMEs, needs to be monitored independently but could easily slip off the agenda and be ignored

6.2 Specific types of initiatives and programmes

In this sub-section, individual types of programme are discussed.

6.2.1 Self-assessment, experience sharing on-line tools

These tools generally involve an on-line application that SMEs complete to get an idea of how their application would be assessed either by the bank in question if it is on the bank's website (e.g. ING) or banks generally if it is on the web site of an industry association as in the case of for example http://www.pymefinance.es/. This type of pre-application support can be very helpful for SMEs to understand what the key drivers will be of how they are to be rated or scored. In some instances there is also the possibility of individualised personal support.

In Belgium, one outcome of the UNIZO, UCM and Febelfin platform has been the development of an online credit calculation tool. Difficult access by SMEs to bank rating / scoring models and discussions within the platform led to an understanding that SMEs want to understand what affected their scoring and rating rather than full disclosure of the models. This led to the development of an **online credit rating calculator** hosted by CeFiP-KeFiK, which allows SMEs to be given a score or rating (http://www.cefip.be/fr/simulateur-rating). While the credit calculator did not resolve all issues and complaints, one SME association linked it to a valuable pedagogical aspect that encourages entrepreneurs to strengthen their credit applications and the financial health of their company.

Another such an example, from Assolombarda (an association of some 5,000 enterprises in Lombardy, Italy, http://www.assolombarda.it/servizi/bancopass) is the **Bancopass** service. **Bancopass** consists of a set of software tools available for free from Assolombarda plus personalised support that helps companies to better manage their relationship with banks. The service is shared with and approved by the participating banks (Unicredit, BNL-BNP Paribas, Banca Popolare di Milano UBI Banca Popolare Commercio e Industria, UBI Banca Popolare di Bergamo, Banca Popolare di Sondrio, Banca Popolare di Vicenza, Monte dei Paschi di Siena, Cariparma - Crédit Agricole Group).

The software helps interpret business data and helps complete the template for business presentation. This helps reduce response times by the banks and increases the chances of a positive outcome. The software enables enterprises to analyse the financial condition of the company and assess its strengths and weaknesses. It also produces a Summary Report, helps define the guidelines for a balanced development policy, creates content to be included in or attached to the ' Model business presentation ', which can be sent to the banks in connection with requests for loans or financing. By exporting the data and sending them to the Association, enterprises can obtain a detailed financial analysis and get support in building a projection of the income statement for the business. There are three stages in the process: request the free customised software; complete the financial model; and make a visit (individual meeting) to Assolombarda for detailed support and guidance.

6.2.2 Co-operation between SME and Banking Associations

An instance of co-operation between Banking Industry Associations is that around the production of the publication "Conoscere il Rating. Come viene valutata l'affidibilità delle imprese con l'Accordo di Basilea" (Know your rating. How the creditworthiness of enterprises is assessed in the Basel Accord), led by the Italian Banking Association and Confindustria, and to which Confartigianato, Confapi, and several other associations contributed. This is a guide to help enterprises understand the criteria and processes involved. It deals, among other things, with external rating agencies, key risks, qualitative factors, and also, given the importance of guarantees n in Italy, how the providers of guarantees fit in the picture.

Another example is from Belgium, where UNIZO (the largest business organization in Flanders and Brussels representing entrepreneurs, sole traders and professionals), UCM (Union des Classes Moyennes, representing SMEs in Brussels and Wallonia) and Febelfin (the Belgian Financial Industry Association)set up a **platform** to allow stakeholders to share experiences and view of different aspects relating to SME finance and relationship between SMEs and banks more generally. This platform has helped different stakeholders understand each other's position and attempts to find solutions to the problems experienced. Arguably the most important outcome has been the development of an online credit calculation tool (see above). One important discussion in this platform was around the information that was given to companies when a credit application was refused. The discussions that took place in the platform has helped banks understand SMEs needs and SMEs understand that having access to banks' credit rating model was not possible for commercial reasons and that the information they sought could be available in different ways. This initiative has also led to increased communication between experts in charge of credit rating and companies to explain how the ratings are developed and help SMEs understand what they need to work on in order to ensure more success in future credit demands. However, the SME association does not believe that codes of conduct are binding enough to ensure transparency. In addition, the FEBELFIN academy, which provides training to bank employees, has a module explaining to relationship managers the basics of banks credit rating and scoring. This allows them to have a better understanding of the potential reasons why a credit demand has failed and explain it better to the their customers.

6.2.3 Training and education for financial literacy

A recent review of financial literacy initiatives in Europe by the European Banking Federation (Financial Dialogue. Bank measures to foster financial dialogue[85]) suggested that the within the field of SME lending the most important area of SME knowledge that needs improving is that surrounding preparation of sound and complete credit applications. Applicants tend to lack knowledge of the specificities of bank lending requirements which results in information asymmetries – banks are unable to evaluate fully the risk and creditworthiness of clients as enterprises cannot grasp the contract terms and implications of credit evaluation procedures. Lack of knowledge also means that some SMEs do not have the confidence to contact banks to discuss financing. One of the results is that enterprises do not always use the most appropriate bank products. Companies also do not always understand what can be done to improve the capital structure and financial position of the enterprise to obtain better access to finance. They also have difficulty understanding the feedback provided by banks on failed loan applications[86].

This problem tends to be most acute in the lower end of the market where the data suggest most of the problems around lack of access to finance lie. It is also often these enterprises that, given their operating circumstances, have least opportunity to participate in training courses. In addition, they are often out of reach of industry networks that provide training.

A wide range of initiatives to improve financial literacy is under way in the various EU Member States, many of which are listed in the EBF report. Examples of such programmes include: http://www.financieringvanondernemingen.be/ (through Febelfin); in Germany the Association of German Banks has produced a series of publications that provides smaller companies with essential knowledge of financial topics; the Irish Banking Federation produced a range of publications on topics such as “Credit Rating Process for Business Customers Explained”, and “How Basel II impacts on Banks and their Business Customers”; and the Italian Banking Association, through the PattiChiari Consortium, runs a financial education programme aimed at young adults, families and entrepreneurs. In addition, individual banks also undertake their own initiatives. For example Nordea has produced a publication “Kredithåndbogen” to help enterprises understand the credit processes, and the Bank of Cyprus carries out training and educational events, for example whenever changes in regulations come about.

Importantly, the level of financial literacy varies significantly in different Member States. These levels are driven both by industry and by national initiatives. The question of credit rating and scoring is considered as an integral part of improved financial literacy that enables better application for credit and implementing an improved financial structure.

[85] Financial Dialogue. Bank measures to foster financial dialogue (2010), p.7

[86] A recent pan-European survey of SMEs has shown that on average, 63% of SME feel confident to talk about financing with banks. Different factors can play a role in the responses, such as the confidence SMEs have in the bank’s capacity to lend money and that confidence the SME has in understanding its own needs and situation. While only 26% of respondents in Greece felt confident, only three Member States (Finland, Latvia and Malta) had a score above 80%. This can be explained by (i) the proximity of between banks and their customer and (ii) a relatively positive economic outlook.

6.2.4 Credit mediation "plus"

Credit mediation as a tool for improving financial dialogue has been developed many EU Member States in mainly two ways: internal to the bank where failed applicants can ask for a review of their application; and external to the lending institution through a specific case. By providing a forum where the applicant and the lender can, on a one-on-one basis, interact and exchange ideas, feedback can be increased beyond what might have been rather minimal feedback previously. The mediator is also in a position, through reviewing trends in appeals brought, to identify problem areas in application and feedback. For example, as UK Banking Taskforce's Appeals Process Independent External Reviewer, put it in the course of its Annual Report for 2012, of the applications brought, credit scoring was identified as the main reason for appeal (40%), specifically for start-ups and those switching banks. On the basis of this it was possible to recommend certain actions. This is what is meant by credit mediation "plus" – it is not just a case of credit mediation but also a proactive tool to identify and deal with wider ranging issues as regards transparency, information flow, etc.

In Belgium **CeFiP – KeFiK, the Knowledge Centre for SME finance**, is a good example of this "plus". It was set up in 2004 to pursue three main objectives: (i) become a national reference centre for SME finance, (ii) centralising and using knowledge linked to SME finance and (iii) act as a credit mediator. As such, the organisation is more than just a credit mediator, but a forum that provides an integrated service on key issues affecting SME finance, putting the question of rating and scoring in this wider context. As part of its activity, CeFiP - KeFiK publishes an annual survey of SME finance as well as a bi-annual barometer of SME finance (as mentioned earlier, CeFiP – KeFiK has also developed a tool for SMEs to be able to assess their credit rating). Over the past two years, the credit mediator has dealt with over 600 dossiers, two-third of which had a positive outcome and estimated to have saved 2,000 jobs. The main barrier to credit appears to be communication issue between the banking institution and the SME.

The Irish Government established a Credit Review Office (CRO), an independent reviewer for formal appeals on credit decisions made by banks (to refuse, reduce or withdraw credit facilities, including applications for restructured credit facilities). The CRO reviews decisions by the Pillar Banks, who were required to participate in the process as part of the bail-out process. The other large bank, Ulster Bank, which is a subsidiary of the Royal Bank of Scotland, is largely owned by the UK government and does not participate in the Credit Review Office. The review process reviews decisions from €1,000 up to €500,000. There is a charge to the borrower. The minimum fee for applications up to €100,000 is €100 and there is then a sliding scale up to a maximum fee of €250. For this, advice is provided in addition to the appeals process.

The credit reviewer issues quarterly reports which provide information on the cases reviewed and provide comments and views on SME financing in Ireland. The June 2013 quarterly report[87] contains data on the 367 cases reviewed since the commencement of the review system in 2010. 244 cases have been finalised and of those 135 cases have been decided in the borrower is favour and €16.8 million has been released to SMEs and farms, resulting in the saving of 1297 jobs.

The CRO also reports on the results of banks' internal review processes and it is understood that one effect of the credit review office is to strengthen the bank's internal review process. If necessary, the review office first puts an appeal through the banks internal process.

[87] Quarterly Report of the Credit Reviewer, June 2013, John Trethowan, accessed at http://www.creditreview.ie/docs/EleventhQuarterlyReportfromJohnTrethowanJune2013final.pdf

Originally, the CRO was seen as a shorter term solution. However, an independent evaluation of the credit review office was carried out and recommended its longer term continuation. The independent assessment of the CRO concludes (inter alia) that: the CRO, through its general activities and day to day operations since establishment, is contributing to ensuring that credit is not refused to viable businesses with valid credit propositions; through its focus on monitoring the banks progress on meeting lending targets, its operations, activities, observations and recommendations and its regular interaction with Government is assisting the Minister of Finance in facilitating the availability of credit; and, significant work has been completed by the CRO in examining the lending policies of the banks resulting in positive developments.

6.2.5 Ratings provided by public sector organisations

In this instance a public sector organisation assigns a rating to an enterprise which can then be published. For example, in terms of the **Banque de France (BdF) Scoring System,** any company with a turnover above €750,000 is given a credit score and a credit rating by the Banque de France for the company to use when negotiating credit. This is determined on an annual basis (or more often if important information is made available). It evaluates the viability of an enterprise for three years into the future. In addition to the quantitative information provided by company accounts, decisions from commercial tribunals and so on, a series of qualitative indicators are also used. Each year, around 50,000 interviews are held with company management which feeds into the credit rating. Sectoral variables are also taken into account to determine the rating. The rating system is constantly evaluated to ensure that ratings correspond to the reality (i.e. that defaults are more common as one goes down the rating system). After each default, the bank reviews the credit rating a company was given to provide an extra ad hoc check. The scoring system is based on the statistical analysis of a series of quantitative factors that are, ideally, not interlinked.

The BdF provides each of these individual enterprises with its credit-scoring and credit-rating information which includes a probability of default over the next three years, a positioning of the enterprise within companies of the same sector and size. Over 280,000 French companies are rated by the Banque de France; this number is increasing annually. Banks linked to the Banque de France's FIBEN (Fichier bancaire des entreprises) service are given access to anonymised data from the BdF's scoring system. This allows banks to fine-tune and further develop their internal scoring systems.

This provides a useful indicator to enterprises that are considering extending trade credit to their customers. However, it does not mean that companies will understand why they have been rated as they have, or that there are not problems related to the credit rating and it does not mean that banks will not undertake their own rating or scoring either. Another key issue is that, again, this initiative will not necessarily reach the enterprises at the lower end of the market where the data suggest the problem is concentrated.

In addition, under the CRA III Regulation, the European Securities and Markets Authority will publish on a European rating platform all credit ratings and rating outlooks of the rating instruments, information on the type of credit rating, the type of rating action and the date and hour of publication, except for those credit ratings or rating outlooks which are exclusively produced for and disclosed to investors for a fee. This measure aims to enhance comparability of credit ratings and improve the visibility of small and new credit rating agencies.

6.2.6 An integrated national rating system

In Germany, under the **Initiativ Finanzstandort Deutschland (IFD**), banks tell enterprises their rating. In the context of the implementation of the Basel II Accord and to improve financial dialogue between the financial community and the public, IFD, working with the German banking associations, developed a brochure that explains in layman's language the nature of internal and external ratings and the advantages of ratings for SMEs. Although the IFD has been superseded, this brochure is still often referred to as a standard of quality and has contributed to the development of a "rating culture" in Germany.

The document sets out clearly how internal rating systems are developed, using separate modules for quantitative (e.g. capital structure, liquidity, profitability, cash flow,) and qualitative factors (market and legal position, organisational structure, management quality, quality of information provided, and account history). In addition there are warning indicators built into the model so that it is possible to identify emergence of problems at an early stage and to take action. Analysis of liabilities is also carried out in terms of whether the enterprise is part of a group or not.

Importantly, the exposition of rating systems makes clear that there is scope for manual overriding of the rating if there is information available that has not been included in the data underlying the rating calculation. Different organisations have different procedures for doing this so as not to lead to abuse.

The basis for developing ratings is the historical data that the financial institutions have of client accounts. As a result there are differences between banks and savings institutions and even between client groups within banks and savings institutions. Different sizes of enterprises are also treated differently.

To deal with these differences a "Masterscale" has been created in Germany that allows the rating provided by one bank or savings institution to be compared with others. This means any enterprise is in a position to understand its credit situation vis à vis other enterprises and banks at a given moment. The brochure also explains the differing rating standards under the Basel Accords and emphasises how important it is for enterprises to provide the best possible information to banks to input into their systems.

The financial institution concerned issues a communication, related to the size of the client in question, about the rating provided to the enterprise. Larger enterprises will get a "Strengths and Weaknesses" profile, generated by the factors built into the rating system, that can be discussed and used as a tool for improving the creditworthiness of the enterprise. The actual factors and weightings input into the system are not disclosed as this may lead to abuse. The measures adopted are aimed at reducing dangers of automatisation and anonymisation of rating and scoring decisions for customers. The IFD approach is for larger loans, tending to be for "corporate" borrowers, rather than the smaller enterprises (where it has been found most problems occur).

6.2.7 Buying a rating

Another initiative to do with providing ratings has been where enterprises buy a rating or score. This has happened for example in Austria and the Czech Republic, through the Prague Chamber of Commerce (HKP). In Austria, a pilot project financed by the Federal Ministry of the Economy was launched to support the development of external ratings for SMEs. The total budget of the project amounted to € 250.000. Firms could buy a rating at a cost of some € 4.000. One of the project's objectives was to provide SMEs with external independent ratings identifying strengths, weaknesses and risks in order to enhance possibilities for access to financing. The project was discontinued due to the low demand from

SMEs who could have benefited from it. As no evaluation has been done, it is impossible to say whether this was due to low demand per se or the lack of publicity.

The Prague Chamber of Commerce (HKP) is the only non-banking institution in the Czech Republic that has provided a rating for SMEs. The project/product called SME Rating ("Rating MSP" in Czech) was launched in 2003. HKP came up with the idea to use its SME Rating as an economic evaluation tool of applicants for grants from the EU Structural Funds (implemented in the Ministry of Industry and Trade within the Operational Programme for Entrepreneurship and Innovations). HKP describes its rating as a certification tool highlighting the financial and non-financial solvency of the company. The view is that thanks to the rating, it is easier for SMEs to apply for loans. Its aim is to increase the credibility of SMEs that would allow them to make better business with their partners. The SME Rating is constantly evolving and improving on the basis of its past data. Currently it can be considered as a credit reliability rating system comparable with other ratings from large banks. The reason for its success is that it is based on quantitative (objective) indicators, as quantitative indicators also reduce possible corruption/ fraud, which can occur during qualitative assessment. The rating is available for around 5,000 CZK (i.e. 200 EUR).

The experience of these two different approaches possibly differs due to the differences in the business environment in which they are applied. Having said that, banks will still, particularly if they are IRB, carry out their own assessments.

6.2.8 National credit registers

Correct and up to date information is a key input into the credit assessment process. As the recent European Financial Stability and Integration Report 2012 points out (chapter 5) there are many rating, scoring and business information agencies in EU Member States. However, several countries have established centralised public credit registers, among other things, to help capture more and better credit information about enterprises to facilitate, streamline and improve the accuracy of data inputs into the credit assessment process, especially the quantitative elements.

There is a **Central Credit Register** in Portugal, a database managed by Banco de Portugal, using information reported by the participants (the institutions which extend credit) concerning credit granted to individuals and organisations and potential credit liabilities representing irrevocable commitments. The main purpose of the CCR is to provide information to back up the participants in their assessment of the risks attached to extending credit. To this end, the participants can access aggregate information on the credit liabilities of each client vis-à-vis the financial system.

Information on credit liabilities may be used for purposes such as the supervision of credit institutions and financial corporations, the analysis of financial system stability, the conduct of monetary policy and intraday credit operations and the compilation of statistics. In compliance with the constitutional and legal provisions governing the protection of citizens, any person has the right to be informed about any existing data in his/her name, in the Central Credit Register.

In Italy the **Central Credit Register (CentraleRischi)** is an information system on the debt of the customers of the banks and financial companies supervised by the Bank of Italy. The Bank of Italy collects information on customers' borrowings (over €30,000) from intermediaries and notifies them of the risk position of each customer vis-à-vis the banking system. In this way the Bank of Italy provides intermediaries with a service intended to improve the quality of the lending of the credit system and ultimately to enhance its stability. Persons interested in knowing their position at the Central Credit Register can apply free of charge.

These central credit registers can make valuable contributions to improving the data input into rating and scoring models.

6.2.9 Codes of conduct

Codes of conduct have been launched in several countries. For example, in Cyprus, there has been a voluntary **Code of Conduct for SMEs** since 1st September 2005[88], adopted by the Association of Cyprus Commercial Banks (ACCB). This resulted from inputs from the members of the ACCB and the organizations representing the Cypriot SMEs, under the guidance and cooperation of the ACCB. The Code is an example of a soft measure that aims to strengthen mutual trust and understanding between banks and SMEs. The code is not legally binding, but it is based on a common set of principles. It stresses the importance of a 'transparent credit application procedure", and states in particular that 'the Bank shall inform the SMEs of the approval procedure of their application. The SME will have the opportunity to provide additional information and explanations. The Bank will inform the SMEs of the scope of the relevant products or services offered and the relevant procedures involved. Prior to the approval procedure, the Bank will notify the SMEs of the required data and information considered necessary for examining their application. The approval or rejection of the application shall be notified in a comprehensive manner to the SMEs, and shall be reasoned'.

In the UK, the **Lending Code** is a voluntary code of practice which sets out standards for financial institutions to follow when they are dealing with small business customers in the UK, with a focus on micro enterprises[89]. Section 4 of the code addresses issues relating to credit assessment. Points 64-66 of the code are especially relevant:

The Lending Code

64. Subscribers should inform the customer of the time it will take for a lending decision to be made, starting from the point when a full suite of information is provided to complete an application.

65. Subscribers should ensure they have fair and effective processes in place to review decisions to decline a lending application.

66. If a lending application is declined, wherever practical the subscriber should provide proactive and clear feedback to the customer on the main reason why the application was declined and have fair and effective processes in place to review decisions to decline a lending application. Each bank should have their individual solution to handle a request to review an application that was turned down. Examples for this include: a second bank manager reviewing the decision on request or a central telephone hotline to make the application again.

It is worth pointing out that some SMEs have successfully appealed and overturned initial refusals of SME loans by banks. It is the role of the Lending Standards Board to monitor and enforce the Lending Code.

In Denmark, the National Danish Financial Supervisory Authority suggested that the Danish Bankers' Association develop a code of conduct making it the banks' duty to disclose all material facts. According to this, banks agreed to inform the company which information is necessary when a loan-application is being processed, and to ensure that obtaining the information should not be unduly burdensome or costly to obtain for the company. When a company has applied for a loan, the bank would explain which

[88] http://www.emporikicyprus.com/codes-legal-issues/21-codes-legal-issues/61-cyprus-banking-code-sme.html

[89] Micro-enterprises are those that employ fewer than 10 persons and have a turnover or annual balance sheet that does not exceed €2 million.

parameters have been important for the assessment. The assessment/explanation should be in written form if the company wishes. Also, before the bank and the company make an agreement the bank should inform on which terms the loan is being given. An annex describes which parameters/factors are relevant when a bank is processing a loan application from a company. The recommendation applies to all companies but especially the SMEs. One of the larger Danish banks has implemented the recommendation into their "credit-handbook".

Codes of conduct can be very helpful but it is very easy for them to degenerate into pious statements of belief unsupported by action. Often their noble aims will slip by the wayside, especially when other more urgent matters may be pressing. Only in the UK (above) have we found an instance of the code being monitored. Without such independent objective monitoring, codes may be of little value.

A standardised system 7

In this section the views of the different stakeholders are presented: the banking community, SMEs and the national authorities and regulators. Then the barriers to standardisation are mentioned.

The banking community is generally strongly against standardisation as they consider their own in-house rating models as underlying their competitive advantage. They are continually improving them, to the benefit of their customers also. Diversity leads to opportunities and innovation. Standardisation it is argued will raise costs and weaken completion. SMEs say they would like standardisation but on being probed on the subject they tend to understand thereby some form of standard data input into a credit application. National authorities tend to be of the view that in reality it would be hard to design a system better than the ones already in use, and that may lead to increased systemic risk. Many barriers are perceived to the development of such a system: these include time, cost, existence and accuracy and updating of data.

7.1 A standardised system

The question of standardisation of rating and scoring systems as a driver for increased provision of credit for SMEs in the long term (and possibly other forms of non-bank finance)[90] is a complex and sensitive issue for the banking community and there are varying responses from the different banks and different types of banks in the EU Member States with their different banking systems, cultures and traditions. IRB banks are also being encouraged to make less use of externally supplied information to develop their systems.

Turning to the views of different stakeholders, first those of the banking community are presented. These are followed by those from SMEs and industry associations, and the national authorities and regulators.

7.2 Views on standardisation

7.2.1 Feedback from the banks and banking associations

The question as to whether standardisation or better comparability of credit rating/ scoring systems and feedback will improve chances of financing for SMEs produces several responses from banks. In the first place it is pointed out that banks actually want to give credit – it is in their interest to do so, in as much as the transactions will not lead to losses or a weakened competitive position. So banks already do as much as they feel they can to increase financing. In some instances standardisation or comparability of rating may improve chances of financing, such as where banks compete on price for business and they can see a certain client has a specific rating, and they know what the rating of the client is in terms of a master scale as in the case of Germany. However, if the company does not have a fundable proposition, or its basics are bad, no amount of standardisation will affect that. Nor will standardisation solve the credit crisis. There are also less positive spill-over effects from price-based transactional approaches.

Overall the banks spoken to feel that their systems work well and they are continually working to improve them. Banks' rating and scoring models reflect their business model, experience of divergent customer groups, different economies, tax and accounting systems, bankruptcy legislation, and use of financial instruments. These models are validated and approved. If they are standardised, there would be no impetus to improve their predictive powers and compete to develop better systems and reap the associated rewards.

[90] See for example: Finance Trainer (2013); Creating a European SME Capital Market Exploring the Potential, EIB/ EIF Workshop #2,Luxembourg.

Some banks also suggested that it is probable that the actual scores and ratings of SMEs will probably not differ greatly between them. However, there is a different appetite for risk in different market segments for different banks, and this could have a greater impact on whether credit is granted to a particular enterprise at a given moment than the score itself. So standardisation will not really make a difference in such instances.

It has also been pointed out that if ratings or scores are standardised and a SME can't get finance from one bank, it is unlikely that it will get it from others. The findings of the Enterprise Europe Network survey discussed above made it clear that it was quite often the case in practice that when an enterprise is turned down by one credit institution it can obtain funding from a different one – this is because they all have different rating/ scoring systems. Added to this, in some countries at least, if a legal person applies for funding it has to indicate whether it has done so in the past and been refused. If the entity has been refused in the past it may count against it from a scoring point of view. So the harder it is to get funding, the harder it becomes if systems are standardised. In some highly concentrated banking markets such as the UK and Sweden it is understood that it might, to an extent, in fact already be the de facto case that if one bank won't provide funding it is unlikely that others will. In such markets increasing the heterogeneity of banking types might do more than further standardisation as regards providing credit for SMEs, if that is considered a problem that requires some intervention to solve.

The score or rating itself is an element in the decision, and while, especially at the lower end of the market scores tend to be quite inflexible and important in the decision as to whether to grant credit or not, for larger sums, where ratings become important, human intervention through relationship managers and credit committees is increasingly important, and standardisation will not affect that.

Even if there is a standardised system, banks will still use their own system to assess credit risk. The concurrent running of two (or more) systems will make credit assessment more complex and costly, which will have a negative effect on provision of credit. If banks are required by law to conform to a standard system, where the standard system does not reflect credit risk accurately, it could lead to systemic faults with wide-ranging impacts.

So the overall the view from the banking industry is that a standardised system will weaken competition to improve systems, weaken risk assessment of SMEs, and probably raise costs of financing SMEs.

As regards standardised (prescribed) feedback, this may help, but whether and to what extent it will actually improve funding, as discussed in section 5.2 above, depends on whether the enterprise can and actually does do something about the feedback. Some micro-enterprises are not in a position to change their capital structures or provide increased security – or change the industry sector they are operating in – even if they know those are the reasons its funding was not approved. Another concern that was raised is that if standardised formats become mandatory it could lead to an impoverishment in feedback as written feedback becomes more minimal for reasons such as concern about legal action and a lot of contextual information that can be provided verbally is lost. This may end up leading to a worsened customer-bank relationship.

7.2.2 SME and SME associations' feedback

As far as the notion of a practical, comparable and standardised rating system is concerned, most enterprises interviewed were positive about the idea, with some three quarters of the respondents to the Enterprise Europe Network survey supporting the idea, although some respondents did add the proviso that it should be informed by banking and financial considerations. Again, as mentioned above, according to UNIZO, in Belgium, 65% enterprises do not know that they are being rated or scored by banks, and of those that do know, only 25% know what it is. Enterprises often think that having a (public) rating or score may help them in terms of how they are perceived in the market, and help them access finance (e.g. through trade credit), although this can also have unintended negative consequences and incur significant additional transaction costs for SMEs.

Discussions with SMEs indicate that they tend to be not so much interested in the actual number or score, or the workings of the models that calculate ratings or scores, as what drives the assessment and what they need to do to improve their credit risks. Most SMEs are family businesses and may have relatively low financial literacy, so knowing what a score is or trying to interpreting it may not be of much use.

They also think the emphasis in credit assessment should be more on future orientation (more qualitative factors), rather than historical records, and that one should not be excluded if one does not pay a mobile phone bill for example (a clear reference to credit reference agencies used for scoring).

However, some SMEs made the point that they thought such as system is unrealistic, or that it will not lead to more bank credit but just an increased workload for all concerned. The view was also expressed that governments are not better at risk assessment than enterprises and should stay out of the banks, and asked if it goes wrong who will end up paying?

The Enterprise Europe Network survey responses to question as to whether there would be benefits for SMEs in the introduction of a system of standardisation or better comparability of the rating/scoring systems provided a mixed response. About half that replied said it would be useful as it will help companies understand how they were perceived by other enterprises, or because it would make future applications easier if all used the same documentation, but generally they did not provide a great deal of detail.

Those who were against the idea thought that all business entities had their own specific risk; or that the government should stay out of the market and not standardise bank ratings, but that they could give companies a rating as long as it was done by the public service and is freely available to all. Another view was that reliable feedback and clarification of what was required to obtain credit was more important than knowledge or standardisation of ratings; or that ratings were a competitive tool of the banks, and that banks who screen better would perform better, so it was not in the interest of banks to share their know-how with competitors.

So overall while most SMEs liked the idea, not all had the same understanding of what was meant by it and there was a mixed view among SMEs about the value of a standardised system, with some seeing it as an unrealistic ideal, others seeing its use in terms of market positioning, and others seeing bank ratings and scoring as critical to the competitive position of banks, and not something that the public sector should get involved in. However, it seems that the main thing SMEs actually want is to understand what drives their assessment, and what they can do about that if anything.

7.2.3 National Authorities and Regulators

In several countries the view was expressed that certainly some comparability between systems would be helpful for companies, but in general the view was that **it would be very difficult to implement and other issues may outweigh such advantages**. For example it was considered unlikely that a public body would be able to establish a better system than the private bank whose business it is to do so, particularly in relation to its specific client portfolio; it may not be adapted to local banking conditions and markets; the fact that all rating systems are in fact imperfect could lead to wide ranging systemic error; and, there would be a reduction in the flexibility of management in banks. IRB banks in ICAS countries still do their own assessments.

Points were also raised about how long it would take to do something like that and to get it approved, by which time conditions will have changed and all will need to be changed again – an endless stream of bureaucracy, lobbying, meetings and reports was envisaged, none of which would do a great deal to solving the core problem of finance for the micro and small enterprises in the countries where they were declined funding.

7.3 Barriers to standardisation

A wide range of barriers to the development and implementing of a standardised system was foreseen by interview respondents. One of the key perceived barriers to implementing standardised rating and feedback systems is the effect on the competitive advantage or individuality of banks. Banks have different aims, targets and assets that require specific treatment. Banks would be unwilling to part with their intellectual capital if they have a good system. It would take years of negotiation and large costs and there would be the possibility that it would continuously be out of date. Who would develop it? How would the data pool be created? Who would carry out the modelling? How and who would keep it updated? This would require a substantial bureaucracy, who was going to have to pay for that? And then, when it is implemented, who would trust it sufficiently to put their bank's future, and the shareholders' funds involved, in its hands? In Switzerland a standard system was implemented but banks did not trust it enough and still kept their own systems alongside it. This is also the case in other ICAS countries. Having to use standards developed for other banks as their own would limit competiveness.

Other barriers identified for such rating systems were: absence of historical data, accuracy of data, bureaucracy, bank policies, state money funding banks so they are not sufficiently business-like, and one respondent was of the view that the differences between projects, businesses, countries and currencies was such that the barriers are insurmountable. Another view was that in fact banks are already competing to develop better systems as it is in their interest to develop better systems – they do not need public intervention to do this. Finally, one respondent suggested that it might be more practical to focus on realisable improvements such as not having branch managers change so often, and better trained branch managers and loan officers, so that they can get to know their territories (businesses, etc.) better, and that they could be provided with more discretionary powers when evaluating loans.

The co-existence of many types of institutions with different rating and scoring systems providing finance to a range of different market segments with different needs helps to ensure that there is competition, innovation and choice in the market.

Conclusions 8

This section presents the conclusions of this research under the headings of bank practices, SME feedback and policies promoting transparency in SME rating/ scoring.

8.1 Bank practices

Systems and data used

The majority of credit provided to SMEs throughout the EU is from banks, and of those by far the majority have IRB systems, and this majority is set to increase, although an appreciable number does use the Standardised Approach. The development of large and complex SBRSs that conform to the requirements of the CRD and now the CRR has focused the attention on the contribution of quantitative and qualitative inputs into the systems.

The relative importance of both these types of data varies between banks and types of banks. For most of the general banks it is usually within the range of 20-40% qualitative and the rest quantitative. In some public banks, or banks specialised in servicing SMEs, it may be the other way around – 60-80% qualitative and the rest quantitative.

Both data types have advantages and disadvantages. Quantitative data can be relatively robust and can be readily manipulated, but it is backward-looking, only a minority of firms in the EU has sufficient financial data to produce valid analyses with and such data may be hard to collect.[91] Qualitative data on the other hand may be more forward-looking but is costly to collect and inherently more subjective. The interplay between these two types of data is of critical importance in banks' rating systems as regards client types.

Corporate and retail

In practice banks have two major ways of grouping client enterprises: either as "corporates" or as "retail". The largest majority of SMEs would be grouped in the "retail" category. While size is a factor, the distinction between the two groups is based on the different data pools and types of data underlying the systems used to assess them: in the larger general ("transaction") banks with IRB systems, for "retail" there is a large relatively homogenous group of firms on the basis of which predictions are made using a relatively limited number of variables that might be supplemented by data from CRAs or reference agencies. These tend to be predominantly quantitative.

For "corporate" clients more qualitative information is collected, as it is considered that this improves the predictive power of the models. But there is also much more quantitative information available about these larger SMEs and larger enterprises.

In the smaller, more "relationship" oriented banks dealing more with SMEs, in order to meet the lack of information about them there is more emphasis on behavioural and qualitative factors and judgement, rather than using large standardised data pools.

This means that in reality, due to the nature of the data available and the cost of collecting information, the larger firms ("corporate") tend to be rated and the rest ("retail") are scored.

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91 See also: Institute of International Finance and Bain & Co (2013); Restoring Financing and Growth to Europe's SMEs, pp. 11-16

Conclusions 8

The role of qualitative data

The qualitative factors most often mentioned as being relevant are: the quality and financial competence of the management; the quality of the project; the quality of the financial data; cash flow and profit forecasts; and, market sector.

There are some issues about the general value of investment in qualitative factors for the purposes of developing rating or scoring systems. In the first place there is the issue of cost. Costs can be of several kinds and related to the very large number of SMEs in existence. The question is if the incremental number of approved applications that might occur if more qualitative data is collected will justify such a wide ranging increase in costs. Secondly, there is the question as to whether increased use for qualitative factors does improve the approval ratio of SME loan applications. Recent research comparing outcomes of the same basic data input and run through a systems using only quantitative information and one using qualitative information as well suggest that there is not a great deal of difference. However, some institutions do report that the predictability of their scoring system has improved since including more qualitative data. In addition, research has found that some firms with negative soft information can still get funding from transactional banks that do not pay a great deal of attention to soft information. These findings suggest that the relationship between qualitative information and increased credit for SMEs is more complex than appears at first hand.

The problem area

Being provided with a credit rating or a credit score does not automatically transfer into a credit decision as there might be scope for an “override” by the loan officer, risk team or credit committee involved. Such overrides are harder to do “upwards” than “downwards” and in some of the larger banks virtually impossible – there is more scope among the smaller relationship banks, although there the central banks may also have an input to control what happens with systems that they have approved.

The research suggests that in the part of the market that is “rated” – corporate clients where most information is available, both of a quantitative and a qualitative nature, there is more scope for meaningful dialogue, interaction and feedback between the banks and enterprises. The SAFE data also makes clear that it is at this end of the market that there are fewer refusals of loans.

It is at the smaller end of the market where there may be issues, where enterprises are scored by the banks using large data pools and the economics of the situation does not support detailed and intense discussions and negotiations. While statistically a bank’s retail portfolio might perform well, an individual enterprise may feel it has been unjustly or incorrectly assessed. What this means is that the type of feedback provided by the banks is driven by the data they have used to consider the credit application.

In such circumstances it is important that other banks, with a different strategy or risk appetite exist that such a firm can turn to, and from whom finance might be available; or that appropriate feedback mechanisms are in place so that the enterprise understands why it has not been provided with funding.

How well do the banks’ rating and scoring systems work?

From a compliance point of view they do work, as they are reviewed and monitored. From the perspective of the banks, they are continually reviewed to see if they are working well and can be improved. Based on discussions with the banks, they appear generally satisfied. Do they lead to the optimal provision of credit to SMEs? This question is hard to answer as there is no data to evaluate SME loan performance. However, the role of judgemental factors or relative lack thereof in SBRSs is a concern to some leading observers.

The massive and large scale implementation of such SBRS' throughout the EU in recent years may have long term implications in some Member States as regards the part of the SME market that has been identified as most at risk of not being able to access credit from banks above: the zero-employee and micro-enterprises without financial statements subject to credit-scoring and business referencing that constitutes the largest share of SMEs.

8.2 Feedback to SMEs

Based on ECB data as regards the recent experience of European SMEs in obtaining bank finance, it can be said that the smaller a firm, the larger the likelihood that its funding application will be declined, and assuming that the need for feedback is greater when applications are declined, the smaller firms will also be the ones where feedback is most required.

SME interest in ratings or scores

The chances are also that the larger the SME, the more likely it will get feedback on its loan application. This is due to the larger SMEs being grouped in the "corporate" segment in bank portfolios, whereas the smaller ones tend to be grouped as "retail". The former group tends to be rated, while the latter is scored.

While there are some differences in this respect between Member States, most of the smaller SMEs interviewed and reported in surveys are not particularly interested in knowing how their bank scores (or if appropriate) rates them in terms of a number or letter, nor are they interested in the mathematics and statistics underlying the rating or scoring models. They are interested in whether they got the credit or not, and if yes, what the conditions are. If they did not get the funds, some are not interested in asking why that was, but rather more interested in trying to find an alternative supplier. Others find it useful to know why not and what could be done to get credit – and if that does not work they may seek other sources of funding. What is really useful to them is to know what the key criteria are that the banks consider important in assessing a credit application.

What does feedback consist of?

Analysis of the examples of feedback provided by banks in the Enterprise Europe Network survey to both those who were successful and those who failed indicated that while in some cases there was no response at all, and in others only very little communication by email or a phone call, in a good deal of instances there was an exchange that involved both quantitative and qualitative factors.

However, at the smallest end of the market, there is very little data to base a decision on it is often not possible to give a great deal of feedback, and as mentioned previously, transaction sizes do not warrant investment of much time by staff in obtaining further information. In such a context it is not surprising that enterprises do not always find the feedback they get useful.

In addition, where information on which the decision was based is obtained from a third party supplier, the bank may not itself know what that information is (just a number or a code might be provided) or be at liberty to disclose it if the data is owned by another firm or there are data protection issues. This is the area of the market that requires most attention.

There are also differences in business culture between Member States that affect feedback in terms of what it is and how it is delivered to SMEs.

How useful is feedback?

Among the survey respondents whose applications were approved, about a quarter found the feedback provided very useful, a half useful, and a quarter neutral or not useful. About half of those who responded to the question indicated that they found the feedback useful as regards obtaining future funding.

Among those whose applications were rejected, 5% found the feedback very useful, 15% useful, and the rest neutral or not useful. However, a good number of those who were unsuccessful actually found funding from other banks subsequently.

Overall, of the 282 respondents that had received feedback, 52% found it either useful or very useful, and 38% indicated that it would be useful for them specifically as regards obtaining credit in the future.

The effectiveness of feedback can be grouped into three categories of response: those for whom feedback is useful and who can do something about it (the survey findings suggest that at least some 38% of those that had received feedback fall into this category); those for whom feedback is useful but they can't do anything about it (20% found feedback of little or no use); and those for whom feedback is not really useful as they do not really understand what it means for them. The survey responses were not sufficiently detailed to provide more precise estimates of the first two categories. Nor was it possible, based on responses, to clearly separate out respondents from the third category. Some financial institutions who work with small handicraft enterprises, have said that they do, in the process of providing feedback, make a point of transferring some financial culture and understanding to the entities involved. So, on the whole, while it is difficult to quantify them based on the survey findings, there are clearly benefits obtained from provision of feedback. The provision of feedback is more of an issue in the case of smaller firms than larger ones, one of scoring rather than rating.

8.3 Policy implications

CRD 145 (4)

One of the important findings of the research has been that while article 145(4)[92] of the CRD has been transposed into the legislation of most Member States, apart from in the case of a handful of such states, very little has been done to actually implement it at enterprise level. None of the SMEs we interviewed were aware of it, few of the SME Associations were aware of it, and even several Banking Associations had trouble remembering what it was.

There was also a significant mismatch between what authorities seemed to understand was the state of play and what we heard on the ground from SMEs. Some banking associations suggested that the reason for this might lie in the fact that enterprises and associations were preoccupied with the fall-out of the credit crunch, and that this had slipped off the radar-screen; or that the focus of policy was now seen to be innovation or non-bank finance and the emphasis was on that. However, there is certainly scope for close monitoring of the on-the-ground implementation of CRR article 431 (4).

Support programmes

There have been many projects and initiatives aimed at supporting enterprises in dealing with matters related to how their banks rate and score them, and the feedback that is provided, both directly and indirectly. However, few of these have been systematically evaluated. They can be grouped in different categories: those dealing with preparation for applications; those that provide support in the actual

[92] Subsequently replaced by Article 431 (4) of the CRR.

application process; those dealing with applications; and, once the application has been dealt with, the existence of an ombudsman that can deal with complaints and highlight issues. Support provided through Chambers of Commerce or similar business associations is certainly useful, but tends to reach the only part of the population that participates in such activities.

Codes of conduct can also be useful, but experience of recent years in the EU has shown that they can easily become just pious expressions of good intentions and can be easily discarded or relegated to the bottom of the list when other crises appear.

The use of company ratings provided by a public sector organisation, or buying a company credit rating tends to affect, it seems, mainly larger SMEs, and while it may help with credit provided through the non-financial community, banks do like to make their own credit assessments. Enterprises also have a wide range of business information providers available if they want to do credit checks.

There are various interpretations of what a standardised rating system could involve, but those involving standard methodologies for all banks and reference to a standard data pool do not meet with a good deal of favour from banks and regulators.

One general finding is that the need for support is more of an issue for enterprises at the smaller end of the scale than the larger ones: the problems of feedback are more in the area of credit scoring than credit rating and providing feedback in that context. Policy should concentrate on this area. Also, the relative importance of SMEs is particularly high in the Southern Member States, Italy, Spain, Greece and Portugal.

This section sets out our recommendations under three headings: those for the Commission; those for Member States; and those for the market. While these are separate, they will require close collaboration among the parties involved to ensure effective implementation.

9.1 The Commission

Recommendation 1: There is a continuing need for banks and representatives of SMEs to maintain a dialogue on transparency and communication. To revive awareness of the issue it is recommended that a **Round Table event** on the subject should be planned that specifically focuses on feedback and the implementation of CRR 431(4). This should be followed by high-level contact with the Banking and SME associations to discuss ways in which they could collaborate and get their members to support and implement the recommendations set out below.

Recommendation 2:The Commission should encourage European banking industry associations to get their members publicly committed to working with SME associations to develop an agreed **standard of feedback** to SMEs and to regularly report back on progress (see Recommendation 13 below).

Recommendation 3: In view of the fact that so many applying for finance are small enterprises that might not be trading as enterprises but as private persons, and there are so many zero employee enterprises, and that these are invariably the entities about which least information is available, it is recommended that, as is the case in Germany, **the provisions of CRR 431 (4) be extended to natural persons (**who are usually credit scored) so that they can benefit from increased transparency as well, or alternatively that Member State governments enact such provisions themselves..

Recommendation 4: The research findings suggest that it will be neither practical nor particularly relevant to design a standardised rating system covering all companies and banks in all countries that will be accepted by banks and approved by the relevant regulators.

.2.1 Member States

Recommendation 5: Member States (with few exceptions) need to find **ways to raise awareness of enterprises as regards their rights to obtain feedback**. In view of the patchy level of implementation of the CRD 145(4)[93]throughout the EU, the level of implementation of the new Regulation CRR 431 (4) should be regularly monitored by third party research at Member State level and the findings published.

Recommendation 6: Member States should consider if there is scope for a **"feedback-friendly" certification of lending institutions** by an independent third party organisation (public or private). Such a "label" or "brand" might improve the competitive position of the banks that have it, and could eventually lead to a ranking of banks in terms of their feedback-friendliness. It could also be considered if there is scope for an EU league table of "feedback-friendly" countries.

Recommendation 7: Some Member States have supported the **development of institutions such as Central Credit Registers, Credit Mediators or independent Credit Review bodies**. These capture and make information available that increases transparency and provide a means of review of situations that are considered unfair. They also sometimes are involved in training and research. They help reduce credit risk in the system, build transparency and facilitate feedback. It is strongly recommended that where such institutions do not exist serious consideration be given to their establishment and to ensure that they cover micro credit applications as well as larger sums.

[93] Subsequently replaced by Article 431 (4) of the CRR.

Recommendation 8: Some Member States publicise **how credit referencing data is used in lending decisions and encourage enterprises to learn what their scores are and improve them**. Such an open approach can be very helpful and is recommended. Member State authorities should encourage commercial and public credit referencing agencies to help their customers check the accuracy of data held about them.

Recommendation 9: Member States should encourage SMEs **to check the data held on them by referencing agencies before making an application for credit facilities**. In some cases, such agencies make a material charge to SMEs if they want to get information to check. If a fee is charged by an agency to provide data to check it should be minimal.

Recommendation 10: Member States should renew their efforts at **improving general levels of financial literacy.** This could be done through financial industry associations, other financial training institutions and the secondary educational system so that even those with a minimal level of formal education have had some exposure to financial matters, and particularly debt – both borrowing and repayment.

Recommendation 11: One of the sources of data on many SMEs is their VAT payment record. Because the 4th Company Law Directive allows SMEs to file only minimal financial data, the VAT record is a useful credit indicator which might be accessed. As a first step, the Commission could consider whether the VIES system, which now allows anyone to check if a given VAT number is valid, could also provide the reverse data – that is, **to indicate whether an enterprise has a valid VAT number**.

9.3 The market

Recommendation 12: **Industry and trade associations (other than banking associations) need to take on board the issue of raising awareness of the CRR 431 (4) provisions to their members** to a greater extent than has been the case to the present.

Recommendation 13: Industry and financial industry associations should work with their members to develop **a standard minimum content communication document for SMEs that have been declined finance** (see recommendation 2 above for banks). This should include the reason for which finance was declined, details of any external information sources used (including their contact details), where in the bank itself the applicant can refer to for a review of the decision, and an external organisation that can be referred to for an external independent review if considered necessary. Finally the contact details of an organisation that could be consulted to provide advice on funding applications should be provided.

Recommendation 14: Where banks used external data to make a lending decision, **it should be made clear in the feedback provided under CRR 431 (4).** The name of the relevant agency, or agencies, should be provided together with contact details so that the enterprise in question can approach the agency to check the accuracy of data held. There should be standards for such agencies' responses to enquiries to ensure that they are comprehensible to those making enquiries. Fees, where in question, should be very modest. If it emerges that a bank declined credit based on inaccurate information held by the agency, the agency should compensate the party in question.

Recommendation 15: Where a number of credit referencing agencies operate in a Member State, they should **agree a means of cross checking data that is held about a particular company**. It would be inappropriate to ask a company to check data on multiple agencies and to pay for that. Such a system could be developed under the auspices of the relevant industry body.

Recommendation 16: Some approaches on **transparency and comparability in bank ratings of enterprises such as that of the nationally integrated Initiativ Finanzstandort Deutschland**, whereby (among other things) a national master scale is created to make company ratings by different banks comparable, as outlined in the report, might work in other Member States, and national industry associations should consider whether such an approach would be useful and could work in their countries.