

# THE CREDIT RATING PROCESS FOR BUSINESS CUSTOMERS EXPLAINED



IRISH  
BANKING  
FEDERATION

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The European Capital Requirements Directive (Directive 2006/48/EC - Article 145(4)) requires institutions, if requested to do so, to explain their credit rating process to SMEs and other corporate applicants for loans. The information below is intended to provide an overview of the credit rating process used by credit institutions when assessing applications for loans.

## The Credit Rating Process

A credit rating is a formal evaluation of an individual's or a company's credit history and ability to repay obligations. A credit rating therefore assesses the credit worthiness of an applicant. The term 'credit rating process' is used to describe the methodologies used by banks to determine the credit rating of a loan applicant.

Credit ratings are assessed in a number of ways. For **larger corporates**, the rating is more likely to be based on an assessment of financial accounts, the operation of customer accounts and non-financial factors such as the experience and track record of management. Transactional factors such as the length of loan requested and the amount of security available may also be taken into account. For **smaller businesses**, credit scoring will frequently be used.

There are essentially two different credit scoring techniques used by banks: i) application scoring and ii) behavioural scoring.

### i) Application scoring

Application scoring is often used to help inform decisions about lending to small businesses and the opening of new small business accounts. Application scoring takes into account information banks may hold about you or your business, and any information that you supply or that they may obtain from other organisations such as credit reference agencies or fraud prevention agencies.

### ii) Behavioural scoring

Behavioural scoring, also known as customer or predictive scoring, rates customers on the way they operate their financial affairs, based on the pattern of activity observed by banks on existing customer accounts.

Behavioural scoring is typically used where customers have been with a bank for a period of time. This information is used to consider credit applications, and for the ongoing management of account facilities, as it builds up a picture of how a customer manages their money, with the underlying principle that previous performance trends can be used to reflect future patterns particularly with smaller business loans. An example of a negative indicator might be where cheques or other items have been

returned unpaid. Statistically, this approach has been shown to be more consistent in identifying acceptable credit risks to banks than manual assessments of borrowing requests. Behavioural scoring may be used in conjunction with application scoring to enable a lender to consider whether they should lend money or not.

It is important to note that lenders have different lending policies and scoring systems. As a result, applications may be assessed differently by banks. This means that one lender may accept an application which another may not. Credit ratings are internal measures used by banks and as such are not comparable between lenders.

## What happens if your application is declined?

If your application is not accepted by an institution, you are entitled to discuss it with them. On request, the institution can also provide details of the reasons why it was unable to accept your application. Examples of why an application may be declined could include:

- The applicant's ability to repay the loan does not meet the institution's criteria,
- The risk profile of the loan is outside the risk tolerance level of the institution,
- Risk factors have come to light as part of the bank's assessment of the application.
- Further information is required from the applicant to help the bank's complete assessment of the application.

The precise reasons why an application is declined may differ from institution to institution. As part of their ongoing commitment to responsible lending, banks want to ensure that they make financial decisions that best suit the circumstances of your business. Responsible lending is essential for both you and your bank.

## **Is credit rating fair?**

We believe that credit rating is fair and impartial. It does not single out a specific piece of information as the reason for declining an application and is based on the use of objective criteria to make a decision. Credit rating methods are tested regularly to make sure they continue to be fair and unbiased.

It is important to stress that although credit rating has an important part to play in determining the price at which a bank will offer to lend money; it is just one of several factors which are taken into account.

# The European Capital Requirements

## Directive

All EU credit institutions are required to comply with the European Capital Requirements Directive (CRD). The CRD determines the minimum amount of capital that a bank must set aside for each lending transaction. This capital protects the bank against the risk or threat of the counterparty failing to repay the bank. The risk that a counterparty may fail to repay the money lent is known as credit risk. There are 3 alternative ways that can be used by banks to determine the amount of capital they should hold to protect against credit risk;

- Standardised Approach to Credit Risk: Institutions calculating the required capital under the Standardised Approach use methods wholly prescribed by the CRD. The majority of these methods determine the applicable risk charge based on the external credit ratings attached to the borrower. Where there is no external credit rating available, a pre-determined risk charge will be applied.
- Foundation- Internal Ratings Based (IRB): Institutions calculating the required capital under the Foundation IRB Approach are

permitted to use their own models to estimate the risk of customer default (Probability of Default). The additional factors used to calculate required capital are prescribed by the CRD. These factors include the amount likely to be drawn if a customer defaults (Exposure at Default) and the amount of loss likely to be incurred (Loss Given Default).

- Advanced - Internal Ratings Based (IRB): Institutions calculating the required capital under the Advanced IRB Approach are permitted to use their internal models to estimate both customer and transactional risks.

In Ireland, banks using either the Foundation IRB or Advanced IRB Approach require the specific prior approval of the Irish Financial Regulator. More details on the Capital Requirements Directive and Basel II may be found on the Financial Regulator's website, using the following link:

<http://www.financialregulator.ie/index.asp>



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