HOW CAN COMPANIES ACTIVELY REDOUND TO IMPROVE THEIR RATINGS? A CURRENT BANK SURVEY

Heribert Speth, Juraj Šebo, Jozef Kováč

Introduction

Competitive advantages can be realized by an aware, controlled risk management, because risks are to be seen within the scope of enterprise activities not only as a source of danger, but above all as a necessary condition for enterprise success.[2] The general business risk is therefore viewed as another control quantity, which becomes operationalized and configured within the scope of risk management. The objective is to recognize and disclose risks as soon as possible in order to create „scopes of action allowing a long-term protection of the existing as well as construction of new successful potentials and thus protect the continuity of the company."[4] This approach corresponds to the idea of value-based management. Risk management does not pursue the intention to remove all business risks completely, because this condition would offer no chances and would lead to stagnancy of the enterprise. A proactive and consequent risk management serves, above all, the protection of the company's existence, the protection of the future success and the increase of the fair market value of the company.[14]

1. Basel II, Rating and Risk Management

The minimum capital requirements under Basel II are more risk-sensitive and more comprehensive than they were before. This statement emanates from the fact that this leads, amongst others, to a more efficient risk accomplishing – with equal regulatory capital in the whole bank system as before. Market risks, credit risks and operational risks under Basel II must be determined in detail, valued and - if possible - reduced.

In the case of financial crises, it is often disputable whether their escalation (domino effect) could have been dammed or even avoided with more regulation. Basel II relies on the examination procedures of the national supervisory authorities as well as on the adjusting role of the market discipline. The new formulation of the equity agreement tries to meet the more complicated banking business and the developments in risk management and to organize the capital requirements for banks in a more risk-sensitive way. The required statutory capital should be made more dependent on the economic risk and be aligned with the economic risk by banks upon their own discretion and on the basis of their business management calculus in relation to equity capital. A set of options permitting the calculation of the absorption of losses from the least necessary equity capital is available to banks for this purpose.

Nevertheless, Basel II not only has consequences on the risk management of banks. Also the companies which depend, within the scope of their procurement of capital, on credit capital must implement - besides other conditions – a working risk management if they want to receive such capital at low interest or at least generally. A well-oiled risk management system is often an important component of the assessment by banks (ratings).

The term rating describes in general an assessment procedure whose target consists of the identification of a value adjudgement in the form of a linear ordinal scale.[1] Moreover, the rating does not limit itself to a certain object, and is therefore used in different areas. Thus, in the beginning, ratings were used in the German-speaking world probably in psychology and sociology, whereas in the Anglo-Saxon regions the field of application is substantially more diverse.[6] Besides, different meanings can be inherent to the term "rating". On the one hand, value adjustment can be identified as rating, on the other hand, rating can also mean the assessment procedure.

[5] From the other view, rating is a mechanism for trust building into the institution.[3] It could be also understood as a communication instrument with investors or creditors.[12]

The target of the rating procedure is the release of a clear and accurate credit standing evaluation in consideration of the actual influencing factors.[1] While the clarity and the accuracy of the rating are accepted in general, criticism is practiced, especially, in the actuality of the rating.[6] The changes or adjustments of the rating by the rating agencies do not often affect the market values - an indication of the fact that the market has already anticipated the up- or downgrading and the reaction of the rating agencies has followed consequently too late.[7,13] Despite of this fact, many empirical studies proved that especially the downgrade of rating results in a substantial value drop of given companies at the time of announcement but also in the following days.[12]

Hence, ratings do not really describe a new instrument. Credit decisions have taken into consideration the solvency evaluation of a company for many years already. However, the fundamental meaning of the rating for banks and companies is new. Basel II requires that historical data for the approximation of the probability of insolvency is available since 2002, even though the regulations came into force at a later date. Therefore, banks have already improved and developed their credit assessments of the customers (bank-internal ratings) since some years. Optimized ratings and their stringent application have the advantage for the banks that these, as part of their risk management, deliver a more precise evaluation of the probability of default of the credits granted by them. The banks can thereby refine their conditions and, above all, make them more appropriate for risk, which leads again to an improvement of their own risk management and their refinancing conditions.

Good ratings, no matter whether arranged from banks or from external rating agencies, imply appropriate interest terms for companies. The authors of the article advance the hypothesis that the meaning of ratings at the granting of credits to companies has not increased much because of the current financial crisis. However companies can actively contribute to improving their rating and thus reach better conditions in the procurement of credit capital.

The factors influencing the rating are well-known to many companies. Hence, in practice it is often a target to influence these factors and the key figures positively.

The following chapter describes the results extracted for this purpose from a survey which was carried out between 28 November 2008 and 28 February 2009.

2. Results of the Bank Survey

The questionnaire was distributed to 200 banks. 39 banks sent back the questionnaires filled out. As a result, 39 questionnaires are analyzed overall. This corresponds to a rate of return of 15.6 %. The questionnaire consists of four sections (section 3 of this article deal with):

Section 1: Information about company
Section 2: External rating
Section 3: Improvement – Company
Section 4: Up-to-date situation

For the analysis of the questionnaires, mainly descriptive statistics was used, i. e. frequency tables and histograms were generated, and characteristics were computed with certain numerical variables, such as mean and median value, standard deviation, or minimum and maximum value. The statistical analyses were carried out with SPSS15, German version. Primarily, the FREQUENCIES procedures were applied to the analysis of frequencies, and the EXPLORE procedures for the production of explorative data analyses. The application of SPSS15 is directed to Janssen and Laatz [8] and Norusis [9]. The underlying statistical methods are attributed to Sachs [11]. Statistical abbreviations are likewise attributed to Sachs, whereas "n" was used above all for the number of data sets.

The analysis of the third section of the survey constitutes the core part of this article. Within this chapter the ranges of measurements are divided into the following subsections:

- documentation / accounting policy / balance relations
- finance / liquidity
- strategy other

An evaluation of the results of the survey (part 3) is presented at the end of the chapter. The results of all measurements in all subsections are illustrated in the tables and figures.

2.1. Measures Concerning Documentation / Accounting Policy/ Balance Relations

In this chapter, the obtained answers concerning the topics documentation, accounting policy and balance relations are analyzed.

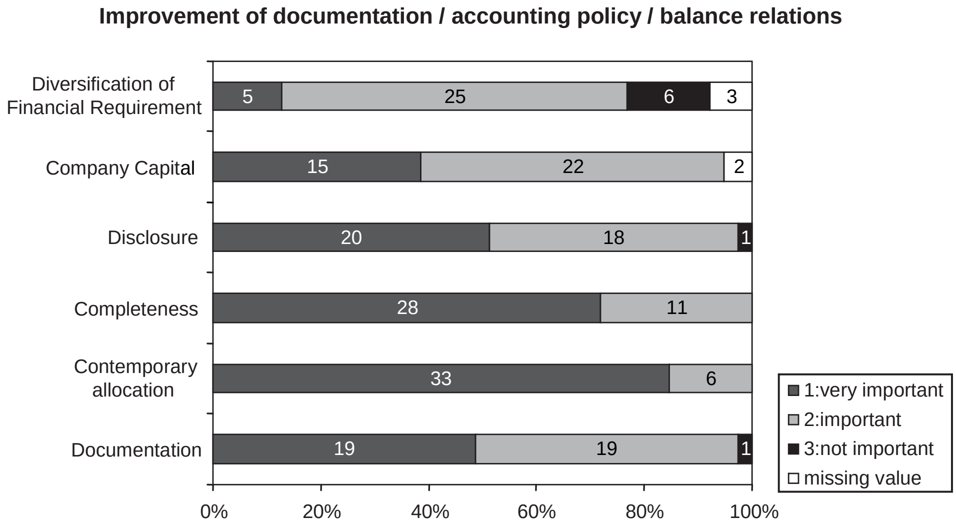
A clear majority (n = 33) of the interviewees regarded the contemporary allocation of the documents as a very important measure to improve the rating, followed by the completeness of the documents (n = 28). Also the disclosure of the financial policy is regarded by a narrow majority (n = 20) as very important (Table 1, Figure 1).

Tab. 1: Evaluation of Measures: Documentation / Accounting Policy / Balance Relations

Measures		Documentation	Current allocation	Completeness	Disclosure	Company capital	Diversification of financial requirement
n	Valid	39	39	39	39	37	36
	Missing	0	0	0	0	2	3
Mean		1.54	1.15	1.28	1.51	1.59	2.03
Median		2.00	1.00	1.00	1.00	2.00	2.00
Standard deviation		,555	.366	.456	.556	.498	.560
1: Very important		19	33	28	20	15	5
2: Important		19	6	11	18	22	25
3: Unimportant		1	0	0	1		6
Missing						2	3

Source: own.

Fig. 1: Improvement of Documentation / Accounting Policy / Balance Relations



Source: own.

Tab. 2: Alternative Financing Instruments

Alternative financing instruments	Frequency	Per cent
No statements	13	33.3
1	4	10.3
1,2	7	17.9
1,2,3	5	12.8
1,2,3,4	2	5.1
1,2,4	1	2.6
1,3	1	2.6
1,3,4	1	2.6
3	2	5.1
3,4	1	2.6
3,5	2	5.1
Overall	39	100 %

Note: 1=Leasing, 2=Factoring, 3=Mezzanine, 4=Asset-Backed-Securities, 5=Others

Source: own.

Only five persons stated the improvement of the balance relations is "very important", and 25 as "important". The weighting of the five instruments (leasing to others) is shown in the following table 2. 13 interviewees gave no answer. Multiple answers were allowed.

As the following table 2 points out, leasing measures (code = 1) are alone or in connection with other measures (code = from 2 to 4) the most often mentioned alternative financing instrument. Leasing is called alone or in connection with other alternative financing instruments in 53.8 % of the cases.

Five proposals were made as further financing instruments (one answer in each case):

- Capital market / bonds
- Consolidation of the equity capital basis by acceptance of further investors (financial investors/going public)
- Everything is possible and depends on the case.
- Others subordinated loans (certificate of debt or similar)
- Shareholder's loan

2.2 Measures Concerning Finance / Liquidity

In this chapter, the obtained answers concerning the topics finance and liquidity are analyzed.

Within the scope of finances and liquidity, the actual financial planning and profit planning are considered by the majority of the interviewees (n = = 24) as very important. The variance analysis is regarded as very important by only 11 interviewees, the reduction of the receivables and their duration by even less interviewees (Table 3, Figure 2).

2.3 Measures Concerning Strategy / Others

In this chapter, the obtained answers concerning the topics strategy and other issues are analyzed.

As for the category "strategy and other", the mentioned of the most important products is considered as very important by nearly 38 % of the interviewees (n = 14), 12 interviewees stated the usage of a modern IT-system is very important.

Staff-relevant key figures are mostly regarded as important, however, 17 interviewees, which is

Tab. 3: Evaluation of Measures: Finance / Liquidity

Measures		Actual financial planning	Variance analysis	Reduction of receivables	Reduction of duration of receivables
n	Valid	38	36	38	38
	Missing	1	3	1	1
Mean		1,37	1.86	1.92	1.87
Median		1,00	2.00	2.00	2.00
Standard Deviation		,489	.683	.587	.578
1: Very important		24	11	8	9
2: Important		14	19	25	24
3: Unimportant			6	5	4
Missing		1	3	1	2

Source: own.

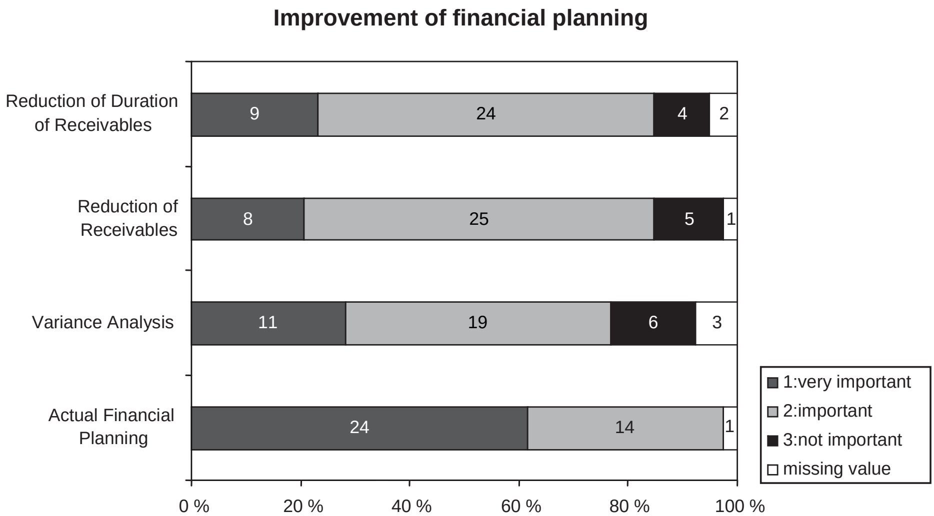
nearly 45 %, have also classified these figures as insignificant (as high as with no other parameter).

2.4 Continuative Evaluation of the Survey Results

But what possibility is the best for a company to improve its rating? Provided that one values the response "very important" with two points, the response "important" with one point, and the response "unimportant" and missing responses are valued with zero points, one receives the following result.

Beside the pure consideration of this ranking one can also read a strong weighting of the banks on measures in the ranges of documenta-

Fig. 2: Improvement of Financial Planning



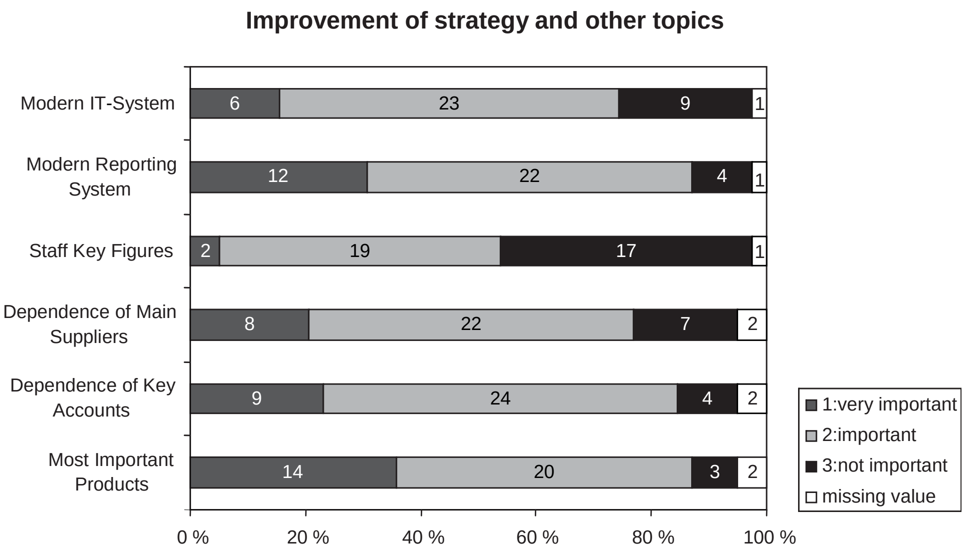
Source: own.

Tab. 4: Evaluation of Measures: Strategy and Other

Measures		Most important products	Dependence of key accounts	Dependence of main suppliers	Staff key figures	Modern reporting system	Modern IT-system
n	Valid	37	37	37	38	38	38
	Missing	2	2	2	1	1	1
Mean		1,70	1,86	1,97	2,39	1,79	2,08
Median		2,00	2,00	2,00	2,00	2,00	2,00
Standard Deviation		,618	,585	,645	,595	,622	,632
1: Very important		14	9	8	2	12	6
2: Important		20	24	22	19	22	23
3: Unimportant		3	4	7	17	4	9
Missing		2	2	2	1	1	1

Source: own.

Fig. 3: Improvement of Strategy and Other Topics



Source: own.

Tab. 5: Weighting of measures overall

	Very important = 2	Important = 1	Unimportant = 0		
Measure	**Number of mentions**	**Number of mentions**	**Number of mentions**	**Missing**	**Summary**
Contemporary allocation of documents	33	6	0	0	72
Completeness of documents	28	11	0	0	67
Actual financial + profit planning	24	14	0	1	62
Disclosure of accounting policy	20	18	1	0	58
Extensive company documentation	19	19	1	0	57
Increase of company capital	15	22	0	2	52
Most important products	14	20	3	2	48
Modern reporting system	12	22	4	1	46
Reduction of duration of receivables	9	24	4	2	42
Reduction of dependence of key accounts	9	24	4	2	42
Variance analysis	11	19	6	3	41
Reduction of receivables	8	25	5	1	41
Reduction of dependence of main suppliers	8	22	7	2	38
Alternative financing instruments	5	25	6	3	35
Modern IT-system	6	23	9	1	35
Staff-relevant key figures	2	19	17	1	23

Source: own.

tion and balance relations. In these areas, five of six measures result with the highest scores.

Conclusion

A successful implementation of the cognitions of the survey would help companies to improve their rating. The importance of this aspect is also shown in a current representative study of the market research and polling institute FORSA, ordered by the auditing company KPMG, which imply, among others, that especially small- and medium-sized companies wish that the bankers use their tools (the rating systems were mentioned here in particular) and their knowledge more in favor of the customer.[10]

Banks are absolutely interested in the fact that companies achieve good ratings. This means, as a rule, that these companies receive good interest rates for their credits, which implies lower income for the banks. At the same time, however, better ratings also mean that companies are better organized and structured, and are sustainable in the market. Such companies usually dispose of working risk management. And all these issues support the fact that such companies are more able to pay back their credits again. And defaulted credits mean, in sum, a higher debit for the banks than lower interest income on account of good ratings of their customers.

But how can companies actively contribute to improving their rating and thus reaching better conditions in obtaining of credit capital? The analysis of the question under block 3 of the survey mentioned above clearly indicates the preferences of the banks. It is evident, for example, that the contemporary allocation of the essential documents is classified as very important by many banks. Also, the disclosure of the accounting policy and the improvement of the balance relations, either by increasing the percentage of company capital or by using alternative financing instruments respectively through the diversification of financial requirements, are valued by the banks as important measures. With alternative financing instruments "leasing" receives an especially frequent mentioning.

With regard to finances and liquidity, banks give a special consideration to the actual financial planning and profit planning. The overall reduction of receivables and the reduction of the average duration of receivables receive a similar important valuation. Both lead to an improved liquidity situation thanks to which the company is more able to serve its liabilities in time and in full circumference.

From the point of view of the banks, in the range of strategy/other companies have, above all, a good possibility to optimize their ratings by mentioning their most important products/mainstay of sales. Further in the classification, measures such as reduction of the dependence on key accounts and main suppliers are mentioned. A modern reporting system is another often mentioned bank measure, valued as important. In this part of the survey, it appears to be especially interesting that the range of the staff-relevant key figures is valued as insignificant with regard to the improvement of the rating by many comparable banks (44.7 %).

However, it should be noted that, from the point of view of banks, have an absolutely large number of possibilities to improve their rating. The precise analysis of the survey in chapter 10 shows the precise graduation concerning this matter. Therefore, the hypothesis of the authors can be evaluated as correct.

The analysis of the survey identified contemporary allocation of documents, completeness of documents, actual financial + profit planning, disclosure of accounting policy and extensive company documentation as the best five possibilities for companies to improve their ratings. Also, we can note a strong weighting of the banks in relation to measures within the ranges of documentation and balance relations.

Of course, the conclusion concerning the best possibility for the rating improvement cannot be seen as unambiguous, as it depends on too many variables. With what bank does the company co-operate? In what areas is the company strong and in what areas it must still improve? But, nevertheless, the results of the survey imply a trend which can help companies, in the consideration of their specific circumstances, to influence their rating and thus their position at their bank positively.

Furthermore, it is to be considered that the rating that reflects the credit standing and financial reliability of the company is money equivalent and, hence, a reference not only for the capital market.

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ABSTRACT

HOW CAN COMPANIES ACTIVELY REDOUND TO IMPROVE THEIR RATINGS? A CURRENT BANK SURVEY

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The article deals with the possibilities of improving companies´ ratings used for the evaluation of the probability of default of the credits granted by banks. There are two general views mentioned in the article. The view of banks, which can refine their conditions, and, above all, adapt themselves to potential risks, which leads to an improvement of their own risk management and their refinancing conditions. The view of companies, whose good ratings, no matter whether arranged by banks or by external rating agencies, imply appropriate interest terms. The influencing factors for the rating are known by many companies. Hence, in practice it is often a target to influence these factors and key figures positively. A successful implementation of the findings of the conducted survey would help companies to improve their rating. The main part of the article describes the results extracted for this purpose from the survey which was carried out between 28 November .2008 and 28 February 2009. The analysis of the survey identified contemporary allocation of documents, completeness of documents, actual financial + profit planning, disclosure of accounting policy and extensive company documentation as the five best possibilities for companies to improve their ratings. Also we can see a strong weighting of the banks on measures within the ranges of documentation and balance relations. Of course, the conclusion concerning the best possibility for the rating improvement cannot be seen as unambiguous, since it depends on too many variables.

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