



# New Banks' Business – Rating Competence for the Real Sector

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## Abstract

**Background:** The global financial crisis has revealed the urgency of changes in the business models of banks around the world. Due to rising regulatory costs and the effects of the low-interest rate phase, the revenue of banking sector is under pressure. Banks have to generate new sources of revenue. A conceivable externalization of bank internal rating data is appropriate. This available knowledge has a potential to generate new business potentials. **Objectives:** The goal of this paper is to compare the procurement of internal ratings by credit institutions and the supplier evaluation, particularly regarding the assessment of their financial capacity, as well as the identification of potential interfaces. **Methods/Approach:** The methods used in the research included an example-oriented presentation and an analysis of indicator systems aimed at assessing the financial soundness within the internal rating by credit institutions and the supplier evaluation. **Results:** Results show the intersections between the two evaluation systems. **Conclusions:** Despite the determination of evaluation results by their objective function, apparently significant trends of financial (dis)soundness can be recognized as a part of the two evaluating systems. This result provides starting points to initiate the discussion about a possible (partial) externalisation of internal ratings by credit institutions to be used for the supplier evaluation.

**Keywords:** business models, revenue, internal rating by banks, supplier evaluation

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## Introduction

The financial crisis starting in 2007/2008 rapidly spread around the world. The US government was urged to bail out several large financial institutions. Following suit, a number of European banks also failed and stock markets declined across the board (Kudrna, 2012). Thus, the financial crisis resulted in a global banking crisis that culminated in the European debt crisis. Therefore, the global banking sector was

affected in various ways. The regulating authorities put several new measures, provisions and rules. As a lesson learned, one central task should be strengthening the resilience of the financial system to future crises. In this context, a new global regulatory framework for more resilient banks and banking systems (Basel III) was implemented by legislators. The implementation at European level will be carried out through two legal acts, together called the CRD IV package. Basel III concerning higher capital requirements for banks. In addition to the quantity and quality improvement of own funds, banks must introduce a supplementary non-risk based capital ratio to restrict leverage in the banking system, higher risk weights for certain risk positions and harmonized liquidity requirements (Hartmann-Wendels, 2013). The regulatory offensive of supervisors and legislators will continue to push the regulatory costs high for a long time (Wöhler, 2015). Thus, entire banking business sectors are losing their appeal, especially in investment banking (Maisch, 2014).

In the aftermath of the financial crisis, the economy experienced historically low levels of interest rates because of monetary policy. This is based on extremely central bank intervention, with which they are trying to boost economic growth worldwide. Relating to this case, there is no end in sight: the ongoing low-interest phase will obviously continue to provide customers, banks and governments with major challenges.

The global banking sector has made various progress over the past years towards stabilizing after the financial crisis. Banks have launched numerous initiatives to improve capital efficiency, revenues, and costs (McKinsey & Company, 2016). However, also furthermore banks will face major challenges during these times. Particularly, the challenges for a sound earning situation may continue to increase. Hence, the business model of many banks will change presumptively. In addition to the fundamental demand for banking services, new alternative sources of revenue will have to be taken (The Economist, 2015).

Starting from these considerations, it seems to be beneficial for banks to detect the existing potential in their business activity to gain new revenues. Banks are typically assigned the economic task of transforming terms and credit risks. This task has made internal ratings in the credit business a core function of banks (Bieg et al., 2011). It seems conceivable, under certain conditions, that this knowledge could be used to take new alternative sources of revenue. Therefore, in a fundamental approach this paper discusses the question whether internal ratings by credit institutions can add value to real sector companies' evaluating their suppliers. Emphasis is put on the assessment of financial capacity also by identification of potential interfaces.

## Literature review

### *Internal Ratings by Banks*

With the introduction of the Basel framework regarding equity recommendations for banks (Basel II; now replaced by Basel III), they were required to systematically assess their credit risks for the first time. According to the rules of the CRD IV package, the systematic evaluation of credit risks can be based on two different approaches: a credit risk standardised approach (SA) based on external ratings or an internal-ratings-based approach (IRBA). Banks that use the IRB approach determine the default risk at the level of individual credit and borrowers, and make their lending decisions based on this (Meeh-Bunse et al., 2012). Thus, rating systems are mandatory by using the IRB-approach. The regulatory minimum requirements require i.a. an annual actualization of the rating. If new material information is available

concerning the borrower, the rating is to be updated ad-hoc (Meeh-Bunse et al., 2012). The basis of each credit rating is a reliable database. This is fed essentially by the annual financial data of the borrowers. Borrowers have to provide this data annually (respectively during the period) to the banks. So it is for banks possible to gain a comprehensive overview of the financial strength of their borrowers by internal rating.

### *Supplier Evaluation*

Due to the increasingly close integration of suppliers in the companies' production processes (Kraljic, 1983; Ellram, 1990; Ellram et al., 2014), it is natural to assign a central role to the identification, evaluation and selection of the "right" potential or already established suppliers (De Boer et al., 2001). Various scientific publications have reported that there are benefits to a systematic approach to supplier selection (such as Weber et al., 1991; Vonderembse et al., 1999). Suppliers are thus increasingly subject to a review of their holistic performance as suppliers (Hirakubo et al., 1998). The relevance of evaluating financial performance is more and more emphasised in this context (Min, 1994; Simpson et al., 2002). Arnolds et al. (2012) state that solvent companies are better able to guarantee a timely and continuous supply of products of an assured quality, contingent on the necessary investments, product improvements and developments. In addition, financially sound suppliers with high profits are more likely to reduce their price than marginal sellers. Using the automotive supply companies "Peguform" and "Delphi" as examples, Schneck (2006) describes the potential danger of financially weak suppliers filing for bankruptcy. This would also threaten internal fulfilment of demand.

These findings have led to situations in which (potential) suppliers are increasingly being required to prove to the assessing company that they are financially sound. Traditionally, this has only been done in the context of internal ratings by banks or rating agencies.

### *Intersections between Supplier Evaluations and Internal Ratings by Banks*

The assessment of financial soundness as a feature of the internal ratings by banks and the supplier performance are, among other things, generated on the basis of annual financial data. This qualitative analysis should make it possible to develop, based on previous business performance, forecasts or trend predictions for the future, or uncover relevant opportunities and potential risks. This quantitative information is complemented by qualitative criteria. The analysis of the qualitative evaluation criteria involves, among others things, assessing management quality, evaluating competitiveness, succession planning, etc. It seems almost impossible to objectively compare qualitative data. Therefore, in the authors' view, the focus of the evaluations is on the analysis of qualitative criteria. Depending on the direction of the evaluations, the financial statements are viewed from different perspectives in order to gain an impression of the liquidity, market success, cost structure and other factors. The resulting reporting makes use of company performance indicators.

The authors begin from the fact that despite the determination of the evaluation results by their target function, it is possible to detect significant trends of financial (un)soundness, both in the context of supplier evaluations and the context of internal ratings of credit institutes. From this, the authors develop the hypothesis that the internal ratings by banks can make statements that are relevant for supplier

evaluation. The evaluating systems for the internal ratings systems by banks and the supplier evaluation of financial soundness should therefore be compared.

## Methodology

To verify the hypothesis presented, the authors draw on example-oriented descriptions and the analysis of selected indicator systems to evaluate financial performance in the context of the internal ratings by banks and the supplier evaluation. This formally descriptive and comparative perspective takes to a profound insight into the complexity of the object of investigation. It allows recognizing the individuality of each example sharply. With this approach, i.a. the profiled illustrate situations and problems as well as detecting patterns are brought into interrelated

For this purpose, the authors renounced a comprehensive quantitative evaluation. However, we make use of two representative examples for both evaluation systems. The underlying examples of this paper were selected on the basis of an appropriate literature review. It became clear that comprehensive supplier evaluation systems operational in companies are hardly published. In this context, we default to a sound example on the basis of our literature review. For the purpose of comparison with an internal rating system applied by banks, we refer to the internal rating system of the German Association of Savings Banks (Sparkassen Verband), as one of the market leaders in Germany. Both presented rating systems concern a compilation of established covenants. These covenants can be largely derived from the company's annual financial data. For reasons of clarity and comprehensibility we make use of four main comparison groups in order to assign the covenants.

## Results

A comparison of the criteria and performance indicator systems for assessing the financial performance of a company between the internal rating systems by banks and the supplier evaluation hints at three issues in particular (Table 1).

First, it can be stated that analysing annual financial statements, notwithstanding the criticism of their ex-post analysis, plays an important role for both methods. The annual financial statement analysis allows an objective assessment of a company's finances on a regular basis, since the information used mainly originates from the company's (audited) financial statements. Evaluation is usually automated. Thus, it should ordinarily be possible to reconstruct the results at any time. So the data from the annual financial statements seems to be appropriate to compare the procurement of internal ratings by credit institutions and the procurement of the supplier evaluation. This rational is in particular regarding the assessment of the suppliers' financial capacity, and, as well as the identification of potential interfaces.

Second, it can be shown that both methods of financial statement analysis depicted have a basic congruence. Both methods make use of tried and tested indicator systems that involve an analysis of the income, financing, liquidity, and statement of financial position ratios. The calculation of the respective ratios apparently largely occurs in an overlapping manner. Their results are evidently correlated.

Third, when comparing the evaluation procedures, it is important to always bear in mind that they are determined by their respective target functions. Banks' internal rating procedures serve to systematically evaluate default risks to determine

regulatory capital requirements and calculate internal risk costs. The determination of financial performance as a touchstone for evaluating supplier performance should provide information on the (potential) benefits and risks of a long-term customer-supplier relationship. The available knowledge could on the benefit side help to generate new business potentials. The diverging target functions of the evaluation process are likely reflected in the actual selection, weighting and scope of the indicators used. To make more specific statements in this regard, there is a need for further empirical research. These results confirm the initially formulated hypothesis.

Table 1

Comparison of the key indicator systems in the context of the internal ratings using the example of the German Association of Savings Banks (Sparkassen Verband) and a supplier evaluation

	Internal Ratings by Banks	Supplier Evaluation
<b>Key performance indicators</b>	Return on capital Return on sales Operating profitability Cash flow rate Gross profit rate Personnel expense ratio Depreciation rate Rental expense ratio Interest expense ratio Turnover per employee Per-capita income	Net income Return on sales Return on equity Return on assets Operating profit (EBIT)  Rental expense ratio Interest expense ratio
<b>Financing and liquidity ratios</b>	Asset coverage Short-term liquidity Dyn. debt ratio Days sales outstanding Days payable outstanding in days Storage time in days	Cash flow Days payable outstanding Dyn. operating profit 3rd degree liquidity Capital commitment
<b>Balance sheet key figures</b>	Equity ratio Short term debt Capitalisation ratio	Equity ratio Equity to fixed assets ratio Stock index number Storage time
<b>Other key figures</b>	Total capital turnover Investment rate Depreciation on fixed assets Self-financing ratio	

Source: based on Disselkamp et. al. (2004), Gleißner et al. (2014)

## Discussion

The deduced existence of intersections between the described methods for evaluating companies' financial performance prompts the question of whether a (partial) externalisation of the information on internal ratings developed by banks could be valuable for evaluating companies when rating suppliers. As outlined above, comprehensive supplier evaluation systems operational in companies are little revealed. This aspect limits the study. Future empirical research is deemed necessary on application of comprehensive supplier evaluation system. Following this, another alignment should ensue to test our hypothesis. Furthermore, the study is



limited by the tested key indicator systems. Thus, the underlying tested indicator systems should be subject of further empirical research. It should be analysed whether the tested indicator systems should be modified, expanded or concentrated. Some sources even take into question sensibility of financial reporting data at all under a digitalized environment (Deloitte, 2014).

Moreover, it is open to discussion whether a (partial) externalisation could provide added value for the companies being assessed, the suppliers. First, it is important to consider that the relevance and fundamental congruence of the evaluation processes presented here were merely based on the analysis of the financial statements. Qualitative criteria may have to be left out of consideration, because of the absence of established guidelines that make them measurable. A discussion of a possible externalisation of internal ratings by banks can therefore only be suggested for the sub-area of quantitative criteria. In consequence, additional questions are ignored in the context of this article.

However, it is not just the company's point of view that the advantage of the externalization of bank-internal rating data is appropriate. The credit institutions themselves can also benefit. With bank-internal ratings, a corresponding knowledge is available, which can be used to generate new business and hence profit potentials. Differing to rating agencies, banks have to make credit ratings as part of the credit allocation process (risk measurement using the IRB-approach). The idea of externalising these bank-internal rating data needs to be analysed and discussed politically. This would require a rating network in which the necessary data is bundled and reprocessed. For this purpose, the credit institutions could pass on their internal rating data to an association entrusted with such task. If a corporate customer now needs the necessary credit information on a supplier, he pays a fee to the credit rating association or the corresponding credit institution that provided the information. It is important in this context that the rating data of different banks are to be standardized in the rating association. A uniform database and the resulting credit rating are necessary. With this idea, credit institutions could generate new business segments and a common data pool of the bank-internal ratings would reduce the dependency of the oligopolistic structured rating market (Meeh-Bunse et al., 2014).

Via a possible externalisation of processed and condensed information from the analysis of financial statements by banks, one could, in the view of the authors, undoubtedly make statements about the basic financial soundness of the rated companies. With respect to the evaluating company, this would mean that it would not need to have a corresponding capacity to evaluate a supplier's financial performance within the company. This would particularly benefit SMEs, since they can hardly have adequate capacity available on a regular basis and are hardly in a position to create it. This resource-saving effect is likely to be directly measurable in monetary terms. At the same time, it is important to consider that the suppliers could also benefit from an externalisation. One supposable form of shaping could be a certification function that makes transparent previously proven solidity and allows for more advanced forecasting on this basis. In the context of the supplier-customer relationship, this "certified" credit rating could also, for example, strengthen the negotiating position with suppliers and corporate customers. A diversification of credit ratings into demand-oriented ratings on basis of individual corporate customers demands is also conceivable. In contrast to established service providers offering information about the financial health of companies (suppliers), the decisive

difference is the reliability of this information as they are less supported by industry regulation.

## Conclusion

This paper identified the intersections between the analysed evaluating systems by showing the two indicator-based systems for evaluating financial performance in the context of supplier evaluation and bank ratings. Despite the determination of the results by their target function, significant trends of financial (un)soundness can seemingly be identified. The results found here support the hypothesis that the internal ratings by banks can make statements relevant for supplier evaluation.

Previous research treated the evaluation systems independently. Here, the attempt was made to relate both systems to one another and to generate practical benefit. Considering the importance of information on the (potential) benefits and risks of a long-term customer-supplier relationship, the determination of financial performance for evaluating supplier performance increases. The existing knowledge relating to their customers financial performance available within banks may be a sustainable new alternative sources of revenue for them. By using the banks' so far internal knowhow about financial performance, the assessing companies could reduce costs in their own evaluation while the same time increasing quality and applicability. The profit situation of both banks and assessing companies could be affected positive.

A possible (partial) outsourcing of internal ratings by banks in the authors' view create create benefit for the evaluating and the evaluated companies as well as for the banks. Hence, the economic system would experience a stabilizing impact taking a holistically effect.

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