A GOOD WAY TO DO BUSINESS

AT THE ACT'S AUTUMN PAPER, **JOHNNY CAMERON** OF THE ROYAL BANK OF SCOTLAND SHARED HIS THOUGHTS ON WHY HE BELIEVES THERE IS A GREAT FUTURE FOR RELATIONSHIP BANKING.

Relationship banking has been with us for years, even centuries. In spring 1728, with The Royal Bank of Scotland (RBS) less than a year old, a customer came to us with a problem. William Hogg, a merchant in the High Street of Edinburgh, was not unique. He bought and he sold – and that meant there were times when he had enough money and times when he did not. He did not want to borrow a fixed sum for a fixed period – the existing form of borrowing – he wanted something more flexible, borrowing only what he needed, when he needed it, and moreover paying for it on that basis.

The Board of RBS deliberated. They knew the man, they knew his business, they understood his needs. On 31 May 1728, by happy coincidence the bank's first birthday, the Board minutes record a special 'cash credit' arrangement, allowing Hogg to withdraw as much as £1,000 more than he had in the bank. There in the handsome script of Georgian Britain you can still see the new word: the 'overdraft'. The bank had invented one of the most flexible instruments ever in business lending, and all because it knew its customer and his business.

THE BASIS OF GOOD BANKING. I am not going to pretend that banking today is that simple. I simply want to show that good banking has always depended on relationships and interaction with customers.

I made my first speech on the subject of relationship banking in the1980s. You might think that there is nothing new to say. But I am still very enthusiastic about the topic, because while the basic concept is permanent, its application must change with the times and much has happened in the past 10 years or so.

The introduction of the euro has influenced the market massively. It has enabled the financing of some very significant transactions that simply could not have been funded before. Liquidity has increased substantially in the European market. Access to international funds and markets has never been easier. The classic example of this would be Olivetti's successful €60bn bid for Telecom Italia in 1999, which could not have been funded in the domestic Italian Lira market.

We have also seen large-scale consolidation in the financial institution sector. Many banks have given up their aspirations to be players in the international scene. There are now far fewer international corporate banks, leading to a significant reduction in the number of players in the corporate loan market. There are far fewer 'stuffees'. On the other hand, the capital markets continue to grow at an astonishing rate. Since 1990, the global loan market has grown more than 200%, whereas the global bond market has grown over 1,000%.

This has meant there has been growth in disintermediation. The range of products available for investors has never been greater. To list a few: high yield bonds, whole business securitisations, monoline-wrapped bonds, collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs) – there are now even synthetic CDOs – credit derivatives and so on. We have also seen a huge increase in private placements, in particular into the US, as companies increasingly diversify their sources of funding.

CHANGES IN APPROACH

These changes have been accompanied by changes in the approach of banks to relationships and to customers.

You will all remember Aesop's fable of the tortoise and the hare. Well, you may not know that there was another runner in the race: there was a tortoise, a hare and an elephant. The other thing that you may not have known is that the tortoise, hare and elephant were all bankers.

THE ELEPHANT. The elephant is clearly the universal bank. The universal bank has one obvious virtue: it is big. It is able to offer its customer the full range of banking products from cash management and clearing to mergers and acquisitions (M&A) and equities. It is the ultimate one-stop shop and this may be perceived to be attractive. However, this approach implies a very complex relationship between the bank and the customer. It is not easy to understand, define and manage the relationship between the universal bank and its customer. For example, I believe it is impossible to find a relationship manager whose knowledge spans cash and payments through to M&A and equity products. In addition, the returns to the bank will be marked by the occasional 'home run' fee, eg for advice on an acquisition which is hard to

value in discussions between the bank and the customer on what is expected from the relationship.

In universal banks, there is also a particular problem of culture – do the corporate bankers run the investment bank or vice versa? This internal battle can drain the energy from an organisation and confuse the message to the customer. Indeed, banks can end up switching between these two alternatives.

THE HARE. Now the hare, on the other hand, is the investment bank which, determined to win the race, will do everything it can to get there. What it wants to win is the big deal. But we are seeing increasingly in the market that investment banks are being forced by their customers to lend as a prerequisite to winning the big deals. Investment banks, by their very nature, do not want to do this type of business. This leads to a mismatch of expectations between the customers and the investment banks.

On one hand, investment banks are being forced by the competition to lend; on the other, they still do not want to do it. So when they do lend they often sell down very aggressively at almost any price, subsidised by M&A fees. This is not in the borrowers' interests, and I do not think that this is sustainable.

Currently, there is an increasingly fierce debate in the US on 'tying' – that is, tying the provision of credit to other, more lucrative, services. Tying is illegal in the US, and the authorities have no proof that it takes place, but the belief in some quarters in the US is that US companies are under pressure to hand over investment bank business in return for cheap bank lines. Not only would this be illegal, but, again, would be unsustainable.

My solution – and I would say this, wouldn't I? – is for all the products to be priced fairly. Lending margins should go up and investment banking fees down.

THE TORTOISE. Finally, there is the tortoise. Now he may appear a little less glamorous than the hare, or even the elephant, but he is consistent and reliable – and that is what relationship banking is all about. We are proud to be a tortoise! The tortoise is an old-fashioned relationship bank. It has a range of products organised for its customers by a relationship manager. It looks for a long-term relationship that will almost certainly include lending. It will offer a range of products that adds value to the customer and generates a fair return on capital for the bank. It will expect to make a fairly consistent return – that is, few 'home runs'.

I am happy that with our product range we can generate our target return on equity (ROE), and that our range of products is more than sufficient to allow our customers to build a relationship that works for them. Banks and customers have to share a view of what the bank hopes for and share a view that it is achievable in a mutually satisfactory way. This, to me, is the key insight into what makes a relationship work. The bank has to offer a range of products that makes sense to the customer and adds enough value to generate a fair return on capital for the bank.

The other critical component for us is that we operate corporate banking and financial markets as *one business*. Our sense of the interdependencies between our customer bases and the product sets including, for example, financing, liability management, treasury and payments is such that any formal business split fractures those links. The evidence is pretty compelling – for example, the success in the way our financial markets risk management solutions have been taken up by our mid-corporate and larger commercial customer base. Whereas, if you split the business, or let one dominate the other, it is harder for customers to choose the combination of products that suits the relationship they are seeking, and/or you generate significant cultural tension.

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DIFFERENTIATION

So if the tortoise has got it right, how many tortoises are there, and how do you know which one to back? Do all the tortoises look and act the same?

I am sure that every bank you see claims to be a relationship bank. I am equally sure that on the surface most banks look the same, in terms of the service they provide – if not the products. So what is the difference? I can only tell you what differentiates RBS. It is for you to say what others do.

MAKING IT HAPPEN. Like most banks, we start with the vision for the organisation – to put the customer first. But you need the internal culture and systems to make sure this vision is fulfilled. Most of all you need to be totally rigorous in applying the relationship model consistently and vigorously. We say "make it happen".

Nowhere is this more obvious than in our credit committee process. We give each transaction, and each relationship manager, a tough time in the committee. And that is the way it should be. We focus not just on the credit risk, but also on the customer relationship and our return on the capital invested in the relationship.

We are prepared to lend. But before we lend, we ask ourselves two simple questions. Is the risk acceptable? Is the return acceptable?

The assessment of the risk starts with our relationship managers, and the key to getting the assessment right is to provide a consistent approach in considering risk. We are proud that we have a very low turnover of relationship bankers. This promotes a consistency of approach to credit risk, and provides a consistent point of contact for the customer.

The credit committee makes the final decision on risk. It consists of credit professionals and key business executives. We believe that executives, chosen and promoted for their business acumen and experience, add invaluable expertise to the committee process. In particular, in the assessment of the risk versus the return.

In order to decide if the return is acceptable, we measure the risk-adjusted return on equity (RAROE). We expect a minimum return on equity. We use a pretty simple model that we have had in place since the mid-1990s. It is a straightforward calculation of the risk-adjusted return divided by the equity allocated to a deal. I do not think we are going to win any Nobel prizes for the formula. But what it gives you is consistency of results and a stable pricing tool that is understood by all relationship managers and members of the credit committee. Applying the model every time is more important

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than getting the percentage return right to the nearest two decimal places.

This is key to ensuring our systems are working for the bank and the customer. Others in banking, and some regulators, seem to think it can all be done by numbers, by statistical analysis, leading to incredibly sophisticated but opaque theories on credit risk management. Analysts would love to believe that there is 'one best way', preferably an entirely quantitative science involving expected loss.

TAKING A VIEW. We still believe it is our job to take a view. Sometimes you will welcome this, other times you may disagree with us, but think how difficult it would be for you if all banks used a 'black box' that produced the same outcome.

We also spend a long time in credit committee trying to understand our customers' business. We ensure that annual reviews of customers must go through the committee process at a minimum every two years, usually every year. The strength of relationship and the return on it are the main conversation points during these reviews. We take the relationship as seriously as the return.

During these sessions, we like to seriously test our relationship managers. We want to know that the relationship is working for the bank and the customer. Is the customer RAROE okay? Will it be okay in the future? Has the relationship delivered as promised by the relationship manager?

RELATIONSHIP BANKING IN EUROPE

So I have talked first about what I think a bank and customer should expect from a relationship, and then about how we try to ensure we achieve the desired result. But a key question remains: does the model work outside of one's home market?

It is relatively straightforward to have a strong clearing bank relationship with key customers. If you are a clearing bank, it puts the relationship on a different footing. You have daily contact with your customer and can truly know them. Clearing by itself brings a number of important specific revenue opportunities.

The challenge in Europe is, can one be a relationship bank without being a clearing bank?

It is worth emphasising that, while banking has, for many years, been an international business, it has, at the same time, been among the most nationalistic of activities, with domestic banking confined and protected within national boundaries. But, as I have mentioned, the euro has helped change a lot of that. The radical changes within Europe have opened the door to countries where there is a lack of domestic banks with international experience and capabilities.

It is worth considering individually the largest economies. In countries such as Italy and Spain, companies are seeing the need to add banks with international and sophisticated capital market capabilities to their core banking group. Many of the domestic banks simply do not have these capabilities. This offers obvious opportunities to truly international banks.

In Germany, on the other hand, although some domestic banks are large and have international strength, many are struggling. The smaller domestic banks are coming under increasing pressure from international competition, not just from international banks, but from international markets, as alternate sources of financing become available to their customers. They are under pressure to sort out their balance sheets prior to state guarantees falling away. Compared with their heyday in the 1980s, when the German financial system was bank-dominated, and the financial markets under-developed, the traditional universal banks are suffering. Even the bigger banks have struggled with their ambitions to achieve both global and investment banking success. This has led them to neglect their core domestic customer base and many of those customers are reacting strongly to this perceived neglect. This provides opportunities for a relationship-building bank with a clear and consistent strategy.

In France, the banks have a history of uneconomic lending. In the 1980s, the French economic system was strongly influenced by the state and banks were dominant, much like in Germany. The international financial markets were all but closed to French corporates. Since the banks have lost their traditional privileges, some have struggled to find their place in the modern environment. The traditional universal banking model in France is being reassessed and the banks are searching for a clear and profitable strategy. There is a shortage of competent banks with an international capability. This state of flux has opened the market up for international banks with the right products and the right customer focus.

So, in the majority of countries, we see companies reassessing their banking relationships and realising that they need several international banks in their core banking group. To join this group, the international bank must have, *inter alia*, the ability to access the capital markets, with skills in areas such as securitisation or private placements.

In some ways, it reminds me of how RBS built itself up in England prior to the takeover of NatWest. We were in a position to be very selective in matching our skills, and products, to the right customers. Perhaps equally important, especially in Europe, is to manage costs at a level appropriate for the potential income.

There is no doubt that European companies are delighted to have the opportunity to work with a true relationship bank. They and we believe we can build a relationship that is, crucially, mutually profitable.

To sum up then. Successful relationship banking depends on consistent application of a rigorous discipline that is well-understood by customers and bank alike. There is no magic bullet to ensure success, but success is certainly possible.

I think there is a future for relationship banking in the UK and in Europe. Are we the only bank that that does? I certainly hope so.

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