M&A trend in banking poses big questions for treasurers

Pat Leavy of FTI in Dublin analyses banking consolidation and its implications for a company's relationship with its bank.

The recent acquisition of National Westminster Bank by Royal Bank of Scotland brings the question of banking consolidation sharply into focus. This should force corporate treasurers to consider how a global trend in banking consolidation impacts on their banking relationships.

Acquisitions and mergers of the largest financial institutions usually capture the headlines – BNP and Paribas, Union Bank of Switzerland and Swiss Bank Corporation, and Deutsche Bank and Bankers Trust.

Of course, not all planned alliances are successful, as evidenced by the recent failed merger proposals between Deutsche Bank and Dresdner Bank. More interestingly, however, are the examples of mergers of international banks since 1999 presented in this month's issue of *The Treasurer* (see page 56). It shows a sample of nearly 120 bank mergers and acquisitions recorded worldwide in 1999. This data substantiates the view of a global trend in banking consolidation and indicates a high level of activity in the area.

Banking consolidation is not a new phenomenon. The number of banks in the US in 1996 was approximately 9,500, which had fallen from a high of around 14,000 in 1985. The rationale for consolidation is not only expansion, but market position and global servicing. The planned alliance of Dai-Ichi Kangyo Bank, Fuji Bank and Industrial Bank of Japan is primarily motivated by preservation in the domestic Japanese market, rather than globalisation.

In considering the impact of this trend on banking relationships we must also recognise a number of other significant developments in banking and financial markets which influences the future relationship between banks and companies.

First, banks are now looking for a total target return on equity from their relationships. For example, a cheap loan (from a bank's perspective!) will have to be compensated from income from other products and services to ensure that a target return on equity is achieved from individual customers; banks are looking to make the provision of other services conditional to providing credit facilities, otherwise they may be unwilling to lend in the first place. As a result, banks are becoming increasingly selective towards who they service.

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Second, the advent of internet banking is changing the structure of the industry and the competitive environment within which it operates.

Third, the introduction of the euro provides a developed euro capital market offering greater liquidity and maturity and a further source of funding for companies. It also provides opportunities for new and advanced European foreign currency management and cash management structures.

Pat Leavy

This 'melting pot' of factors indicate less competition between a fewer number of bigger financial institutions, greater competition from new entrants and sources of capital, and a more aggressive approach from institutions to become total service providers to customers.

Current banking relationships

Before considering the impact of these factors on banking relationships it is worth reminding ourselves what the current position is generally. This position was well captured by Howard Burryin (*The Treasurer,* March 1998) who introduced the main findings of a Wilde Sapte survey which concluded that:

- 90% of treasurers had a relationship with five or more banks:
- a substantial number of the larger quoted companies continued to rely on bilateral facilities;
- 60% or more of treasurer's total debt requirement was financed through bank loans; and
- 81% of treasurers described relationship banking as very important.

Number of banks

Obviously, banking consolidation reduces the number of banks and correspondingly the (existing) number of banking relationships. As one wag put it recently, "This will reduce the number of golf outings!" But apart from the golf outings, what else will it reduce?

It cannot be assumed that, where a company has credit facilities from two merging banks, the new banking entity will automatically continue to provide the total amount of the original credit facility. The new entity will look at its credit exposure to a company and the total amount of the original credit facility may not fit into its new credit risk profile. It's the bank that is increasing in size, not the company.

The implication of this potential scenario for corporates is highly significant – the possible reduction of existing credit facilities. The question of committed and uncommitted facilities takes on a new dimension. Where this scenario arises, companies need to look to replace relationships.

However, because the trend for banks is for total service provision, the scope for extending relationships on a limited basis may diminish. All in all, this implies a possible reduction or limiting in overall credit or services available to some companies. Since it is generally acknowledged that the largest banks are not major lenders to small companies, this scenario is likely to hit small and medium-sized businesses most. Accordingly, alternative sources of financing will have to be considered as a result of bank mergers and acquisitions.

Banking culture

As we all know, different banks have different cultures – some are aggressive, some conservative, some are niche players and some are all-rounders.

A bank's culture influences the underlying nature of the banking relationship. The future culture of the new entity will probably be influenced by the acquiring or dominant bank. This might result in, for example, a different attitude to risk to the one which your company is used to, the consequence of which could be either positive or negative.

Funding

As funding is the most important service provided by a bank, it is worth separate consideration. Because of fewer banks due to mergers, and also because of pressure from banks to provide total services to their customers, it is likely that many companies may have to look to only one or two banks to obtain bank funding. As banks are likely to be reluctant to take on increased credit risk, it can be expected that some bilateral arrangements will become replaced with syndicated ones. Consequently, this will change the nature of bank funding transactions, bank relationships and commercial bank pricing.

The broader implication for companies is to look for alternative sources of funding other than bank lending. The development of the capital markets, particularly the euro capital market, are significant in this regard. It is estimated that euro issues in 1999 were three times the number of 1997. This expanding funding source contrasts with the potential for a shrinking bank debt funding source. Internet banking will also offer new funding opportunities in the future.

This scenario suggests that the balance between debt financing and capital market financing and the balance between bilateral and syndicated lending will both change.

The key impacts on banking relationships

Issue	Current position	Future position
Number of banking relationships	5 or more	Fewer
Loan structure	Bilateral favoured	More syndications
Percentage of debt financing	High dependency	Other sources
Importance of relationship	Important for corporates	Important for banks (as well)
Pricing		Increasing

Other banking services

There is limited availability of certain types of banking services. The most striking example is of pan-European cash and liquidity management structures, which provide a process of collecting and disbursing cash across European entities within the one group of companies.

Specific banking solutions for European cash and liquidity management are mainly focussed on the technology aspects involved. There are a limited number of good banking service providers in this area.

Furthermore, existing service providers tend to be quite selective towards who they do business with. A merging of entities who provide these services would negatively impact on the availability of these particular products. (Needless to say, this offers a market opportunity for a new service provider to develop and provide a good alternative.) Accordingly, choice of certain types of services may be reduced.

Banking relationship

The debate between transaction and relationship banking has been well documented and discussed at length over the years. The position at any point in time was often influenced by the global credit environment. The debate seemed to have been driven by corporates rather than banks, reflecting the greater need of the company rather than recognising the symbiotic nature of the relationship. Due to this greater emphasis by banks on targeted returns from the total relationship, they are now the new drivers in the discussion.

So, as banks come around to the banking relationship argument, it is not necessarily in the way corporates may have wanted it! In addition, the trend in banking consolidation will give the banks a stronger position in this discord.

Pricing

One of the basic tenets of the banking relationship debate has always been that it shouldn't always necessarily come down to price, that service and relationships are also key components in placing transactions and agreeing services.

Where price is the main driving factor, an element of choice is implied. If corporates are forced to transact substantial parts of their business with their relationship bank, through conditions attached to credit facilities, then the element of choice will be eroded.

Consequently, pricing will become less competitive. This factor, together with a move towards syndications and fewer banks, suggest that the impact of banking consolidation on pricing is likely to see bank prices rise.

Not all bad news

Clearly, banking consolidation is cause for concern for some corporates, most especially for small and medium-sized businesses. However, these concerns can be offset, to some extent, by developments in other financial areas, especially the euro capital market and internet banking. ■

Pat Leavy is an executive director of FTI, the Dublin based international treasury consultancy and out-sourcing firm, and is head of the company's corporate treasury business area.