Transparency the top priority

THE RELATIONSHIP BETWEEN BANKS AND THEIR CLIENTS HAS CHANGED IN THE POST-CRISIS PERIOD, WITH COUNTERPARTY RISK NOW A CORE CONCERN FOR TREASURERS. A COMMITMENT TO TRANSPARENCY BY BOTH PARTIES – COUPLED WITH A RIGOROUS METHODOLOGY FOR ASSESSING COUNTERPARTY RISK – IS A SOUND BASIS FOR A MUTUALLY BENEFICIAL RELATIONSHIP, SAY **RICHARD KING** AND **MATTHEW DAVIES**.

The principal concerns of treasury departments remain broadly the same, regardless of the macro-economic environment, massive regulatory reform or any of the other dramatic changes that have been thrust on the world's corporations in recent years. That is what European, US and Asian treasurers told Bank of America Merrill Lynch's annual survey, conducted throughout March.

Cash management and forecasting and operational risk management remain the main focuses for treasurers, while managing counterparty risk has also assumed importance. More surprising is that, despite the turmoil of the past year and the work done by banks and companies to develop contingency plans for a departure from the euro zone or a collapse of the euro, so few respondents consider euro contingency planning to be very important. More predictably, the Single Euro Payments Area (SEPA) continues to underwhelm respondents.

The survey also charted how treasurers' views of what is important to them have changed over the past 12 months. Again, perennially important topics such as cash management and forecasting and working capital management have become more essential than ever. But there was a significant gain in importance for two other areas: banking relationships and the closely linked area of counterparty risk.

Having the right mix of banks in a group of providers is now essential for corporates. Whereas many companies' bank groups used to resemble a who's who of the banking world, now they are based far more on the geographical and capability needs of the company. What is important is to ensure that the company's needs are met and that there is sufficient wallet available to make it worthwhile for a bank to maintain the relationship. After all, the new regulatory environment means that banks' capital commitments must now deliver returns on that valuable investment.

Anecdotal evidence from Bank of America Merrill Lynch's global multinational customers confirms many of the findings of the survey. For example, ensuring access to liquidity is important and many companies have been prefunding themselves during recent strong market conditions in the expectation of renewed volatility. More generally, in Europe there is a continuing move away from bank debt finance towards a US-style capital markets model.

Equally, risk management – of foreign exchange (FX), working capital, interest rates, commodities and pensions funds – is a top priority. However, counterparty risk – just as in the survey – has grown in importance. Among the global multinationals canvassed informally by Bank of America Merrill Lynch, it now ranks third in the list of topics treasurers consider most important to the wellbeing of their companies.

THE POST-CRISIS WORLD HAS INCREASED COUNTERPARTY RISK FOR CLIENTS AND MADE THE CHOICE OF BANK PROVIDER MUCH MORE IMPORTANT.

UNDERSTANDING COUNTERPARTY RISK
Counterparty risk has always been a consideration for treasurers. In the pre-crisis era – when many banks were triple-A rated – the choice of bank to work with depended on the capabilities and attributes of banks rather than their financial viability: risk assessment was based on ratings. Now, with many banks downgraded to a single-A rating and the entire US and European banking system on review for a future downgrade by ratings agency Moody's, the security of the sector is somewhat different.

Moreover, the credibility of ratings agencies has come under fire in the intervening years while the pace of change in the banking sector makes it impossible to rely solely on credit ratings as an indication of financial stability. As a result, in the last few years many companies have endeavoured to find new ways to understand the types of risk they are taking on when working with banks. Corporations have also been trying to find ways to track and manage that risk across the many areas where they interact with banks, such as deposits, loans, derivatives, FX and trade finance.

The challenge is a large one: even small multinationals work with multiple banks, and the largest global companies may have more than 100 bank relationships, despite the bank relationship rationalisation that has gathered momentum in recent years. Scrutinising such a large number of financial institutions is necessarily time-consuming and difficult.

Any analysis of banks must use a number of parameters in addition to credit ratings, including share price, changes in share price over a set period, market capitalisation, size of net assets compared to risk-weighted assets (indicating the level of gearing), credit default swap (CDS) spreads (to give an indication of market perception of credit risk), tier one common equity ratio, and (less tangibly) an assessment of how systemically important an institution is to the markets it serves (and therefore the likelihood of it being supported by the government in the event of a calamity).

THE CHALLENGES OF ASSESSING COUNTERPARTY RISK The disparity between banks' ratings can be hard to understand – some European banks have experienced difficulty gaining access to US dollar liquidity but are rated more highly than US banks that do not have similar problems. However, the CDS market can tell a more detailed story: spreads on those European banks may be double that of some US banks, indicating the market's perception of greater risk.

Interpreting CDS spreads can be complex, as the market is often distorted by technical factors or trading volumes. More generally, the level of scrutiny of banks now required can be difficult for smaller companies with fewer resources. However, many companies do not continually assess banks' share prices, gearing or CDS spreads. Instead, they simply analyse their bank group once a month or even once a quarter. In addition, they may set trigger points (perhaps based on CDS spreads, although given volatility these must be treated with caution) at which a more rapid reassessment of bank relationships would occur.

What is essential in assessing the strength of banks is to view no single factor in isolation. Banks should be willing to help their clients better understand their financial position by ensuring that they have timely access to information, not only about rating changes, but also about capital ratios and how they will change under new regulatory requirements such as Basel III.

The scale of the change in some clients' thinking on the issue of bank financial stability is demonstrated by a recent request for information (RFI) from a global company in preparation for a request for proposal (RFP) to provide cash management services in Europe. In the past, an RFI might have focused on the product, service, technical and geographical capabilities of the invited banks so that a shortlist could be invited to submit an RFP. But this recent request focused solely on factors that would let the company assess the banks' counterparty quality. Only once the strongest banks had been shortlisted were their cash management capabilities taken into consideration.

The importance of correctly assessing bank risk is reinforced by corporations' concerns about money market funds (MMFs). Earlier this year, during one of the euro zone's frequent crises, some investors were worried to learn that their triple-A rated MMFs held European bank debt. With preservation of capital paramount for companies, some clients took funds out of MMFs and deposited them with their banks, knowing that they could at least assess the risk of their banks more accurately than the risk in an MMF.

RELATIONSHIPS CENTRAL TO DECISION-MAKING Ultimately, any decision about the level of exposure a company is willing to take on for a given bank must be subjective. Factors such as the potential damage to the company were a bank to cease operating and the breadth and depth of the services it provided can aid that decision.

However, inevitably limits are also set based on other, less tangible, factors – most notably the bank/client relationship. The post-crisis world has increased counterparty risk for clients and made the choice of bank provider much more important. However, the new regulatory regime has made it essential for banks to choose to work only with clients that reward them appropriately for their commitment. The key to both requirements is transparency and honesty so that both corporations and banks understand fully the risks they are taking on and the strategy of the other party.

For more on counterparty relationship management, download the Measure to Manage article in the February 2012 issue of Middle East Treasurer at tinyurl.com/d6eeplp

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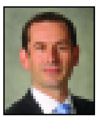

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