2.4 MANAGING BANK RELATIONSHIPS

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Summary: An introduction to the establishment and management of bank relationships including criteria for selecting a relationship bank and the ongoing management.

Key Words: Relationship, transactional, bank, ancillary business, selection, management.

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1 Introduction

Banking relationships are important. Banks not only provide liquidity for a business, they also provide products and services which make the job of managing liquidity possible on a global scale, for example by buying and selling currencies. They also provide ideas, (eg for raising funds or for making international payments), and provide market intelligence (eg on banks aiming to increase/reduce their lending).

The first thing a treasurer will do in a new job is probably work out the banking relationship situation in their business. Relationships will change with different treasurers but some will continue. Companies cannot manage without banks, for lending, cash management, market intelligence, trends and new ideas. Very often, a bank is the first place to turn when a treasurer has a new challenge.

2 Relationship and Transactional Banking

Bank jargon for a company is a *corporate*, derived from the concept of incorporation of a company. When banks talk of corporates, they mean trading companies. This distinguishes them from other broad types of companies such as investment companies, other banks or hedge funds. Trading companies have adopted this jargon and refer to themselves in the same way. Corporate and company are thus almost interchangeable.

In the past, there were two distinct approaches to establishing a relationship between a corporate customer and a bank:

Relationship approach: A corporate used a small number of banks for all its banking business and the corporate and bank developed a close and mutually beneficial relationship.

Transactional approach: A corporate selected banks for individual transactions, each time using the bank that offered the best deal (often a bank specialising in that type of transaction). The corporate therefore did business with a large number of different banks, but did not develop a particularly close relationship with any particular one or group of them.

For example, if a corporate needed to borrow, a transactional approach would be to negotiate with several banks and select the bank offering the best credit terms. In contrast, with the relationship approach, a small number of banks would be asked to provide funding and the corporate would expect the credit terms offered to be reasonable and acceptable.

The key differences between relationship banking and transactional banking can be summarised as follows:

	Relationship banking	**Transactional banking**
Corporate view	Deal only with one or a small number of banks for all or most banking services.	Expect to deal with many different banks for different transactions.
	Assume the bank will provide all the banking support needed. Open and full communication of the corporate's intentions, financial position and banking requirements.	The selection of a bank for a transaction is price-driven. Likely to look at banks specialising in the particular type of transaction. Communication limited to the requirements of the transaction.
	Only one or just a small number of relationships with just a small number of banks.	Deals with many banks in many countries.
	Gives the bank enough business so that the bank is able to make an adequate financial return.	
Bank view	The overall relationship with the corporate should be profitable, even if some individual transactions are not.	Each individual deal has to make a profit.
	Tries to cross-sell its other services to the corporate client.	The bank is continually looking for new clients with whom to arrange new business.

The distinction between relationship banking and transactional banking has now become less clear cut because:

- Consolidation in the banking industry has reduced the number of specialist banks in the market which are purely transactional in their outlook and capability. At the same time, there has been a growing acceptance by corporates of the idea of a total service provider bank.
- Banks have recognised that developing long term relationships is in their commercial interests. Both corporates and banks have accepted the idea of transactional performance measurement, but within the context of a long term strategic relationship. Banking relationships are now increasingly dependent on transactional efficiency by the banks.

The quality of banking relationships is particularly important for multinational companies. Historically they have had to deal with many relationship banks and hundreds of bank accounts. Developments in electronic banking systems have enabled multinational companies to operate with fewer bank accounts and consequently to reduce the number of relationship banks they deal with on a regular basis.

3 Choosing a Relationship Bank

Treasurers want to develop good relationships with the firm's banks. This usually means trying to restrict the number of banks it talks to on a regular basis, since maintaining a meaningful relationship with a large number of banks is very difficult and time consuming. Treasurers usually have a panel of a few banks in their home country which they will use for major lending and other services used centrally, such as foreign exchange.

In addition to this, however, the treasurers of multinational companies need banks in every country of their operation and are usually faced with the following choice to achieve the services they need:

- Global banks providing comprehensive services, such as cash management and foreign exchange, with relatively few branches in other countries but with an extensive operation in the multinational's home country; or
- Local banks offering very good local coverage in each of the countries in which the multinational operates. Local banks will have ready access to their

local clearing systems, whereas global banks probably have to rely on their main foreign branches for access to local clearing systems.

Multinationals often adopt a combination of these approaches, selecting the more appropriate approach depending on services required in each region.

Medium sized corporates will usually develop a close relationship with probably no more than three banks. As a general rule, they rely on bank funding more than larger corporates, therefore their choice of bank will be largely motivated by the funding proposals that banks are prepared to offer. In return, the corporate must be able to demonstrate to the bank that it is reliable and honours its agreements and undertakings.

Treasurers should have a clear view of the services they will require from a bank and it is worth meeting with banks to ensure that this is always clear. Services include not only lending, cash management and treasury products, but also corporate advice. Does the treasurer expect the bank to comment on certain aspects of the company's strategy, or assist in answering corporate finance questions that the Board may ask from time to time? Some banks have the expertise to answer questions on strategy or corporate finance, but they will not provide such services free of charge. They will either expect to be paid a retainer fee (an annual fee for corporate advice), or expect their advisory services to result in additional business for the bank if a decision is taken by the Board to action certain financial proposals.

3.1 Understanding the Banker's Perspective

To make the relationship with its bank work well, a corporate must be aware of the bank's motivation in the relationship. Given their high cost base, banks are under huge pressure to make their corporate banking services as profitable as possible within credit constraints.

Banks expect to earn a satisfactory return on their capital like any other business. However the concept of capital is very explicit in the banking industry because banks need to be managed so that depositors' funds are secure. The minimum amount of capital that banks must keep invested is governed by the Basel II Accord which is an agreement between bank regulators in various jurisdictions covering the capital adequacy ratios of banks (this is the ratio of a bank's capital to its total assets).

Banks are required to keep a minimum amount of capital as protection against:

- Credit risk (the risk of bad debts amongst their borrowers).
- Market risk (the risk of trading losses and losses due to a fall in the market value of their financial assets).
- Operational risk (the risk of losses arising from inadequate or failed internal processes or people and systems).

This whole risk management process is controlled very precisely and the capital of the bank is typically allocated in different proportions to the bank's products and services depending on the degree of risk attached to them. Products with a risk of loss of capital (eg lending) require more capital to be allocated, and therefore a higher margin to produce the required return on capital. The amount of capital required varies according to the credit rating of the corporate customer and rises steeply for sub investment grade companies. This use of capital feeds directly into margins and puts huge pressure on banks to achieve the maximum return from funds lent to corporates.

Banks commonly find it difficult to create a business case from lending alone and so they will seek further business from the corporate to justify the investment of the bank's capital. This further business is called ancillary business and the mutual management of each party's expectations of what ancillary business is available, and how much can be taken up, is extremely important. Ancillary business is really the root of modern relationship banking, and the trust between the bank and corporate (that the bank will be considered for ancillary business, and if successful will provide effective services at a reasonably cost) makes business possible.

Like any customer/vendor relationship, both parties must profit from the relationship or else it will not last. Treasurers must accept that although it is in the company's interests to negotiate the best possible terms with its bank, the bank must have a reasonable earnings stream from the relationship, or at least the prospect of reasonable earnings in the future.

3.2 Criteria for Selecting a Bank

The criteria a corporate uses for selecting a bank, and for developing a long-term working relationship, should including the following:

- The amount of financial support (balance sheet support) the bank is prepared to give. Financial support means not only the level of committed borrowing facilities from the bank but also the willingness of the bank to support any possible acquisitions which may demand substantial but possibly short term funding.

- The capital adequacy and credit rating of the bank. This is particularly important whenever the general level of credit quality for banks is relatively low, such as in a period of recession or slow economic growth. If a bank is financially stretched, it might be unable to extend sufficient credit lines to its corporate customers.
- The bank's ability to deliver good quality customer service and operate efficiently. Operating efficiency is particularly important; mistakes at the processing level need to be kept at a minimum to avoid management time being taken up with mundane matters such as the incorrect processing of cheques or the incorrect transfer of monies between bank accounts.
- The bank's reputation and management quality. There is now a much greater awareness of corporate governance and the way that organisations are managed. Just as banks will be aware of the corporate governance practices of their large corporate customers, so too should corporates monitor the corporate governance of banks, and select their bank (or banks) accordingly.
- The bank's size. Banks should be sufficiently large to match the key requirements of the corporate customer.
- The bank's global spread. The bank should have sufficient global spread in its operations to match the geographical diversity of the corporate's business.
- The bank's product portfolio. Is it able to offer a proven portfolio of products and services to meet the requirements of the corporate customer?
- The bank's ability to understand the business. For a good relationship to develop, the bank must be able to understand the business of its corporate customer.
- The bank's ability to innovate. The corporate might want to select a bank able to offer its customers new products or services.
- The bank's price-competitiveness. The treasurer should be aware of the prices charged for products and services in the market place and ensure that the chosen banks remain competitive.
- The bank's willingness to maintain (where possible) the same relationship manager for several years. It is frustrating when the relationship manager changes on a regular basis since on every occasion the treasurer will have to invest time developing a good rapport with a new relationship manager.

4 Ongoing Management of Banking Relationships

Once a relationship bank has been selected, the ongoing relationship must be proactively managed. Both the corporate's and the bank's circumstances will change over time and their business strategies will evolve. Consequently, it is important that company and bank maintain a regular dialogue to ensure their relationship continues to work well as changes occur.

Treasurers should monitor banks by:

- Keeping abreast of news on the banking sector.
- Reviewing each bank's strategy with a senior manager.
- Ensuring that the ratings of the relationship banks are monitored on a regular basis.
- Checking whether the bank's personnel changes on a regular basis.
- Ensuring that each is clear about the exact relationship and expectations under different circumstances.

Treasury management systems should be able to provide reports summarising the level of business undertaken on a bank by bank basis, and if a disproportionate portion of business is undertaken with one bank, the reasons for this should be documented and understood. This is done to avoid favouring one bank over others unless there is a very good reason, such as one bank offering consistently more competitive prices that cannot be matched by other banks. It is also worth keeping a record of all communications of a relationship nature with each bank, so that evolution of the relationship can be monitored and controlled.

In the cash management arena, monitoring bank charges and tariffs is an important aspect of managing a banking relationship. The treasurer should periodically check that a bank's charges and tariffs remain reasonable and renegotiate terms with the bank as necessary, or be prepared to re-tender the business. Key points to consider here are:

Comparisons with other banks: Benchmarking should be used, and the bank's charges compared with those of other banks.

Hidden costs: A corporate should be on the look-out for hidden costs such as:

- Float: how long does it take to obtain value for cheques and other credit items banked?
- Ad valorem fees[1] on remittances (mainly on international transactions) as these are often taken by deduction from the transfer itself.
- Credit interest rates. Many banks offer relatively poor interest rates (if any) on credit balances.

The treasurer should always be asking questions about his banking relationships.

Flexibility: Does the bank meet the longer-term requirements of the business? If necessary, how might the service be altered to meet the changing requirements of the corporate, and how much will it cost? Conversely, is the corporate making the best use possible of what the bank can offer? For example a good relationship bank will always update its products (such as electronic banking systems) to remain competitive with other products that are available in the market, and will work with its customers to maximise their utilisation.

Synergies: A corporate should seek benefits that arise because the bank in question provides additional services. For instance, many banks are more willing to provide borrowing facilities to customers who also take fee-based services such as custody or cash management. This is the point about ancillary business seen in section 3.1 above.

Controls over service quality: A corporate should monitor the quality of the services its bank provides. If the relationship bank fails to deliver, the corporate should consider ways of recovering some of the costs it has incurred.

[1] Ad valorem fees are made by reference to the payment amount, not on a per transaction basis.

