3.5.1 Making Yourself a Good Borrower

Unit: Unit 1 – Treasury strategy

Module: Module 3 – Financial strategy

Date: 1 September 2016

Summary: A look at the overall relationship between lender and borrower and how this can be improved for the benefit of the borrower. The perspective of the lender is studied, so that the borrower can answer questions. Banks are investigated as special cases. The bank pricing model is considered and rating agencies (as proxies for lender relationships) are investigated. A detailed study of bank relationships is briefly followed by a brief look at non-bank relationships.

Keywords: going concern, gone concern, guarantees, ring fencing, security, financial risk, business risk, measures, covenant, warranties, event of default, bank solvency, bank liquidity, bank regulation, ancillary business, liquidity, yield, ratio analysis, transaction banking, relationship banking, transparency

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Learning outcomes:

1. Borrowing is risky to the lender and also provides certain risks to managers and shareholders of the borrower. The main risk is default, or credit risk.
2. The approach of a CEO and CFO to credit risk can be different to that of a treasurer.
3. Lenders look at Going Concern and Gone Concern, and some businesses can be sold as a Going Concern in a Gone Concern scenario.
4. Corporate structure can lead to strange priorities in a Gone Concern scenario, leading to a requirement for guarantee structures.
5. Ring fencing is a common way to manage issues around corporate structures.
6. Security is common in many structures and needs careful management, arising from demanding lender requirements.
7. Measures of financial risk mirror those of leverage but lenders may have their own pet measures which differ from those of the borrower.
8. Credit protection follows a logical progression, leading into solutions in the terms and conditions of the loan. Major ones include:
   8.1 No lender to become more senior than them.
   8.2 Credit deterioration is to be avoided.
   8.3 Action must be possible if credit deterioration occurs.
9. Borrowers need
   9.1 Certainty of funding over a long period.
   9.2 Freedom to react to corporate situations.
10. This leads to covenants, warranties and events of default.
11. Qualitative analysis in credit is also important.
12. The treasurer can add value to the credit risk.
13. Banks are a special case of a lender because they offer other business apart from loans and need to make a return on their own equity.
14. Banks have major risks including solvency and liquidity.
15. Banks are heavily regulated.
16. Banks seek ancillary business to achieve a return on capital as most lending is actually unprofitable.
17. Non-bank lenders are motivated by Security, Liquidity and Yield
18. Rating agencies are effectively the conduit for credit relationships for many lenders.
19. Issues around rating agencies include confidentiality, possibility for conflict and timing of announcements.
20. Rating agencies analyse business risk and financial risk.
21. Ratio analysis is a crucial part of the credit risk assessment and borrowers model this extensively.
22. Transactional v Relationship banking has been a feature of the lending dynamic for many years.
23. Relationship banking is all about ensuring liquidity, by introducing a moral dimension into the equation, based on knowledge and partnership.
24. Banks have to decide how to allocate capital in banking relationships.
25. Transparency is a key message for any customer / supplier relationship.
26. Negotiations often start from a fixed point which can be difficult to change.
27. Borrowers like to know who their lender is, which becomes increasingly difficult in modern times.
28. Non-bank lenders in bank facilities create a dynamic around information and amendments.

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1 Introduction

The treasurer will always want to report that he has good relationships with lenders and particularly with banks. This will maximise the chances of being able to borrow when needed. The conversation that the treasurer most dreads is having to tell his Chief Executive that the funds the company seeks are unavailable.

We will approach this problem by looking at the principles of lending and considering the situation of the lender. This will be a generic approach for all types of lender. This is essentially a look at credit risk - the fundamental issue faced by lenders. This investigation into credit risk analysis allows the treasurer to understand the questions that are being asked and to be prepared with answers.

Banks can be considered to be a special case of a lender because they do much more than lend and because treasurers generally consider them always to be there for them, essentially a lender of last resort. Banks need to earn a return for their shareholders but non-bank lenders have a different view on life which we will also explore.

We then look at how rating agencies tackle the problem of credit risk assessment. This view will allow the treasurer to understand the approach of the agencies and therefore prepare the answers they need before they are even asked.

We conclude with a look at bank and non-bank relationship management.

We have seen some of the concepts discussed here in prior readings but they are important and give rise to different discussion threads.

2 The lender's perspective

Conventional corporate finance teaches that borrowing is the low risk / low return part of the capital structure. However, borrowing is actually risky and can be very risky. Borrowing is risky to shareholders, managers, employees and creditors of a firm. However, managers do not lose personally if their firm fails; they merely exit with a poor reputation. As an exception to this, however, managers in private equity schemes may well be shareholders and / or guarantors for debt in some cases, and such managers do have 'skin in the game'.

To the lender, however, borrowing, even investment grade borrowing, is certainly risky. High yield debt is particularly risky. It has almost the same volatility as equity and many investors in the high yield asset class treat it almost the same as equity.

The main risk to the lender is that of default by the borrower, i.e. the borrower's credit risk. Even if there is a full recovery of the debt, it is likely to take months if not years to realise. It is rare however for recovery to be anywhere near full. The other major risk faced by the lender is refinancing risk. This is the risk that at maturity of a loan, no other lender will be willing to lend to allow repayment of the first lender's loan. A further risk to the lender, especially those that are regulated, is of a reduction in credit quality of an existing borrower. In this case there

is no default, yet, but the increased risk requires more scarce capital to be put aside, thus likely making any loan unprofitable.

Usually borrowers believe they can repay a loan, although this may be in the long run after many refinancings. Management should believe that their business model will generate the cash to repay the loan eventually. However, lenders cannot take this for granted. A modern CEO may have a tenure of 2 to 3 years which compares to a loan life of perhaps 5 to 7. A CEO may well treat a loan as though it were equity. After the success of the financing a CEO's reaction could well be "We have the money, let's get on with it", whereas the treasurer's reaction is likely to be "How will I refinance that?"

Therefore, the dynamic between borrower and lender is that the borrower must persuade the lender that they can repay the loan, and must understand that the lender may not be so convinced. Consequently, the lender will investigate the ability of the firm to service and repay the debt using cash flow generated in the future from either:

- earnings or
- asset sales

In many cases a lender would like to ensure that repayment can be made from each of these, thus making the loan more secure. In any case a lender will want to ensure that the cash from earnings or asset sales accrues to him. The credit investigation by the lender will therefore cover two key aspects.

Credit risk increases with the size of debt, so one key aspect of credit analysis is to find a measure of the size of the debt. A useful concept to consider in credit analysis is that of debt capacity. We are aware of this personally when, for example, in a mortgage application debt capacity is described as:

A multiple of our earnings	Going concern analysis
A maximum percentage of house value	Gone concern analysis

When we have reached our debt capacity, we can borrow no more. Personally we may be able to take on credit card debt or a personal loan, but when a corporation reaches its credit capacity, the borrowing of another dollar or pound or Euro technically pushes the company into insolvency and the loss of shareholder value. Staying the right side of insolvency allows shareholders to make money. Evaluating debt capacity is a very useful way to analyse a borrower.

2.1 Going concern

The going concern analysis will cover the generation of cash from earnings and the quality of those earnings.

Of particular interest in a going concern analysis is the volatility of earnings and hence of cash flows. We've already seen this in our sectoral analysis and concluded that businesses with a high volatility of earnings make weaker borrowers. In credit analysis a lender must be persuaded of the quality of earnings.

Example 1: Advertising agency
Ads and Fads plc (AF) is an advertising agency and wishes to acquire Banners and Boards (B and B) which pastes adverts onto advertising billboard sites, which neither company owns. There are few assets in either company, the main asset of each company being its staff, which it clearly cannot control. The credit assessment of AF (together with its new subsidiary B and B) is based entirely around the cash flow metrics of the business as a going concern. Insolvency of AF is likely to lead to immediate loss of all the staff, thus valuing the business at effectively zero. The pricing of the lending risk and the credit assessment takes this into account.

2.2 Gone concern

The gone concern analysis will cover the generation of cash from a breakup of the assets of the borrower and hence look at the value and quality of those assets.

The lender would recover his money from selling the assets of the company:

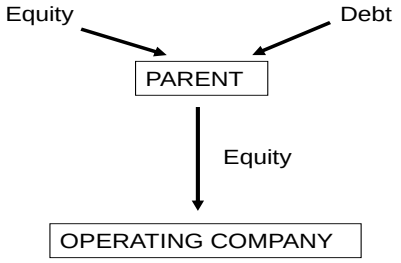
- Sale of the business as a going concern, but if this business has failed, who might buy?
- Sale of fixed assets
- Sale of inventory
- Sale of receivables
- Sale of Intellectual Property, patents, customer lists, know how

It is nevertheless, quite common for businesses to be sold as a going concern following a failure.

Example 2: Health clubs
Ivy Knockout plc (IK) owns two separate health clubs, operating in different sectors, Gungho Golf Ltd (GG) and Toppo Tennis Ltd (TT). It has financed them aggressively and despite relatively strong cash flows in each business, a rise in lending margins has caused IK to fail. However, the administrator has easily found buyers for each of GG and TT as going concerns and the lending banks recover all their money. Security was taken, thus advancing the banks ahead of other creditors. This ability to sell GG and TT was taken into account by the lending banks.

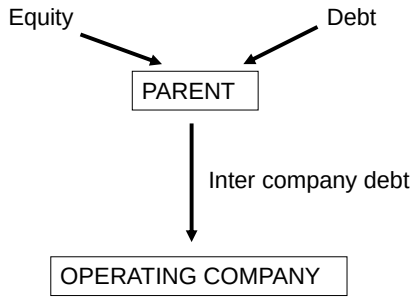
Considering the gone concern approach, it is useful to understand the lenders perspective in analysing how it might recover its money following a default. The following diagrams show how simple changes in corporate structure can radically alter a lender's position.

Exhibit 1: Debt lent to the parent, passed on as equity



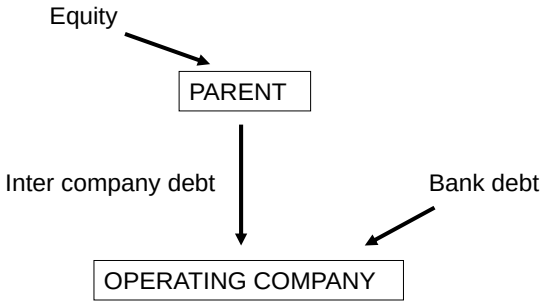
In Exhibit 1, a lender has advanced funds to the parent, which is made it available to its operating companies as an equity investment. Should the operating company fail, then all the creditors of the operating company will be paid before money can be paid up to the parent (the operating company's shareholder) to repay the debt. This rather weak structure (looking from the view of a lender) is actually very common among investment-grade corporations. The lender is said to be 'structurally subordinated' to the creditors of the operating company, because the structure of the group means that those creditors will be paid before the lender.

Exhibit 2: Debt lent to the parent, passed on as an intercompany loan



In Exhibit 2, the funds are made available to the operating company as intercompany debt. This simple change now puts the lender to the parent at the same level as other creditors to the operating company. Most corporations juggle the proportion of equity and intercompany debt to meet tax planning needs and the balance is rarely regulated in loan agreements, quite surprisingly.

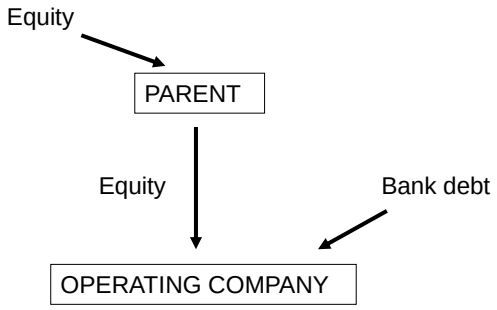
Exhibit 3: Debt lent to the operating company, also funded by inter-company debt



In Exhibit 3, funds are provided to the operating company by both the parent (as a loan) and a lender, mentioned here as a bank. On the failure of the operating company, the lender will be arguing with the parent for repayment of their loans. (The argument can be resolved up front if the bank loan agreement states that the intercompany loan can only be repaid after the

bank loan has been; i.e. the intercompany debt is subordinated to the bank debt.) In complex multinational groups this structure is very common although there is rarely any agreement that the intercompany debt is subordinated to bank debt.

Exhibit 4: Debt lent to the operating company, also funded by equity



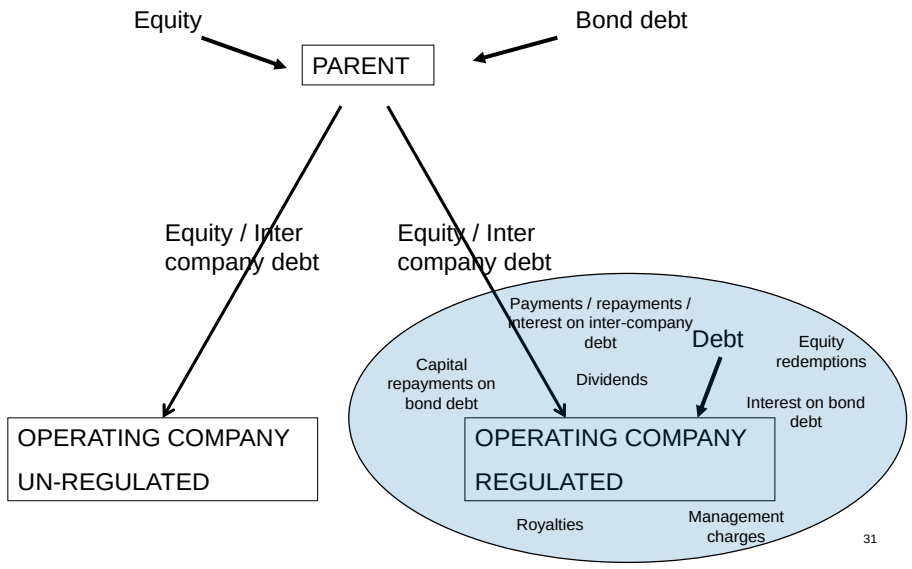
In Exhibit 4, funds are provided to the operating company as equity by the parent and as a loan from the bank. In this case, the bank ranks alongside other creditors but before the parent for repayment.

It is the complexities of multinational structures that cause lenders to ask questions, often leading to demands for guarantees by members of a group to the borrower and / or subordination of intercompany debt. In sub investment grade companies, guarantees and pledges over shares etc. are taken routinely to deal with this issue as well as controls over the funding of operating companies.

2.3 Ring fencing

Having established a principle of debt ranking, we can also apply the same concept to cash flows and earnings. A lender who is nearer to (has more senior rights to) the cash flows from earnings as well as to the assets is in a stronger position than a creditor who is further away. At its extreme this is the concept of ring fencing.

Exhibit 5: Ring fencing



In Exhibit 5 we have used the example of a regulated operating company, of which a classic example is a utility, but the principle can apply to any subsidiary or sets of subsidiaries. An operating company is "ring fenced" from the rest of the group. Its financing is heavily controlled, essentially so that no funds can escape from the ring fenced entity into the rest of the group without either first being applied to service debt in accordance with the terms of that debt, or permission being given by the lender. This entails controls on all payments flowing up or down from the parent or sister companies to the regulated company. Items such as interest, dividends, debt repayments etc. are all heavily controlled by the lender, or, in this case, the regulator, or both.

Example 3: Utility financing
National Water BV operates two separate businesses, a business exporting water treatment equipment to emerging markets and a water supply business to part of the European market. The water supply business is regulated and is accordingly ring fenced from the rest of the group. The treasurer operates two cash pools, two sets of borrowing and investments and is very careful about any payment between the regulated business and the rest of the group.

2.4 Security

Security, and its close relative subordination, is a very useful tool used by lenders, usually banks, to improve their position in a gone concern situation. In each of the examples above, a lender can avoid structural subordination to other creditors or to the parent of the borrower by taking security over assets. Security can be taken over assets in any group company if accompanied by a suitable guarantee. Indeed guarantees can also be included as a type of security.

Security can be taken over individual tangible assets, such as a mortgage of a property – this is a 'fixed charge' under the principles of English law. Or security may be taken over a class of similar assets such as inventory and receivables – a 'floating charge' under the principles of English law. In addition, charges (another word for security) can be taken over revenues, proceeds of sale contracts, insurance contracts, patents and other intangible assets, share certificates, cash / bank accounts (often leading to complications inside pooling arrangements) and deposits and money market fund investments.

Security on its own does not improve the lending decision but it can help. Its main purpose is to protect the position of the lender in relation to other creditors in the event of an insolvency.

In complex groups with many subsidiaries, it can be inefficient and costly to take security over all the assets of every company and all the share certificates of every company. As long as a percentage of either assets or earnings are secured, that is usually satisfactory.

Example 4: Security
Global Contracts SAS (GC) has subsidiaries in 20 countries around the world including 8 in its home country, Sweden. It has recently refinanced with security and has agreed to a covenant relating to security whereby it must provide security over 80% of its assets and 75% of its cash flow, measured by EBITDA. It therefore chooses 10 foreign subsidiaries and 4 of the domestic subsidiaries which meet this need. The remaining subsidiaries have to

remain ring fenced from the "secured" group. If the asset or EBITDA split changes to threaten the ratios, it must add further subsidiaries in to the secured group, despite the expense of this.

As its treasury becomes more sophisticated, it wishes to control more of its cash centrally and then chooses to voluntarily bring in more subsidiaries inside the ring fence, despite there being no real requirement to do so.

Subordination occurs when (as in Exhibit 3 above) the various lenders agree among themselves and with the borrower, as to the priority with which each will be repaid – whether or not the borrower is insolvent. Subordination can be used with security, or each can be used independently. The simplest case is that illustrated in Exhibit 3, where there is a single bank loan and a single intercompany loan. The bank loan agreement will state for instance that the intercompany loan cannot be repaid until a certain amount of the bank loan has been repaid.

The subordination concept can be extended to groups of lenders, and is a key concept used in constructing debt of varying seniorities in structured finance. When more than one external lender is involved, it is common to set out exactly who will be repaid what and when in an 'intercreditor agreement'. Although this is strictly between the lenders, the treasurer must be involved in its negotiation, as it sets out the terms under which lenders can act in an insolvency, and is a key influence on how much credit risk each lender has to the borrower.

2.5 Measures of financial risk

Exhibit 6: A basic picture of credit risk

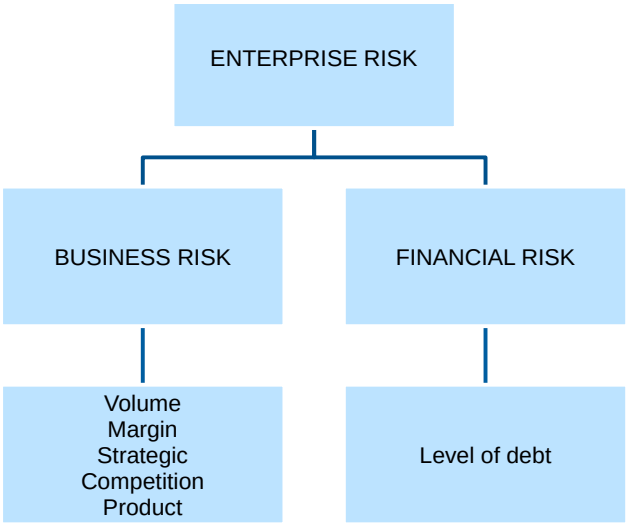


Exhibit 6 repeats a diagram we have already seen. Simplistically, the dimensions of credit risk are business risk and financial risk (operational risk is excluded for simplicity). Although business risk is seen in the volatility of earnings and is clearly a major element of analysis, we will not investigate it further here. The key influence on financial risk, of more interest to us, is around the level of debt. Clearly more debt means more risk and we need a measure of this. The following measures are most often used:

Exhibit 7: measures of financial risk

Interest cover	Profits / Interest charge
EBITDA cover	EBITDA / Interest charge
Income to debt	(Income + Depreciation) / Debt
Cash flow to debt	Cash flow / Debt
Debt / EBITDA	Debt / EBITDA
Debt / Equity	Debt / book or market capitalisation
Debt / (Debt + Equity)	Debt / (Debt + book or market cap)
Debt / Assets	Debt / Asset value (individual or portfolio)
Return on capital	Income / Total Assets

We have seen these measures before in terms of financial analysis and in choices around financial strategy, but they are seen in their most important context here. The company may have one view of targeting them, whereas lenders may have another. For example, in the US tangible assets are important to lenders and are used in one set of ratios for them. From these other ratios can be derived, such as repayment period.

Example 5: Four companies to analyse

The table below illustrates credit metrics of debt repayment ability (debt / profits) and asset cover (break-up asset value / debt) for four different companies, A, B, C and D. The three drivers for these metrics are profitability (profit as a % of assets), quality of assets (break-up value as a % of assets) and leverage (debt as a % of assets). Each company has 100 of assets at book (accounting) value.

	Drivers			**Credit metrics**	
Company	Net Return on Assets % (X)	Break-up Value % (Y)	Leverage % (Z)	**Repayment Period (yrs) Z/X**	**Break-up Asset Cover Y/Z**
A	8	44	11	**1.38**	**4.00**
B	2	47	25	**12.50**	**1.88**
C	10	15	25	**2.50**	**0.60**
D	4	20	60	**15.00**	**0.33**

Company A has medium profitability, good quality assets and very low leverage. As a result, the debt repayment period is very low (good) and asset cover very high (good); an excellent credit.

Company B has poor profitability, good quality assets and low leverage. As a result, the debt repayment period is high (bad) but asset cover high (good); the credit depends on the asset backing, not profits/cash flows.

Company C has good profitability, poor quality assets and low leverage. As a result, the debt repayment period is very low (good) but asset cover low (bad); the credit depends on profits/cash flows not the asset backing.

Company D has poor profitability, poor quality assets and high leverage. As a result, the debt repayment period is very high (bad) and asset cover low (bad); this company is not creditworthy – debt should be asset-financed (selecting the higher quality assets) or third-party guaranteed.

It is generally the experience of treasurers that lenders use rule of thumb ratios to assess credit and establish general lending norms. This will work for the going concern and the gone concern analysis.

For example, lenders might use 'loan to value' ratios against various types of assets e.g. LTV of 65% for real estate, 80% for good quality receivables. Interest cover above 3 is often taken as a benchmark for investment grade bank covenants. Another rule of thumb is to use multiples of EBITDA. Prior to the credit crunch it was quite common that in structured transactions, a senior lender could lend three times EBITDA and total leverage could reach six or seven times.

Particular industries may have particular measures of financial risk and particular rules of thumb, so the treasurer should keep up to date with the conventions for his sector.

2.6 Credit protection

Initial credit analysis, which drives the decision to lend, will be based on a combination of previous history and forecasts, where these are made available to lenders. It is perhaps a little unfair to deprive lenders of forecasts when the borrower has strong insight into its own industry. Many borrowers do just this however, and lenders will need to investigate from their own knowledge of the particular industry, derived from their experience with other borrowers.

The lender would expect (and will try to ensure) that the borrower will at least maintain the credit status that they had when they drew down the loan. Lenders are particularly susceptible to a fall in the credit status of a borrower. In such a case, bond markets will mark down the value of the affected bond. Banks are obliged to monitor continuously the status of their borrowers and they also will be required to mark down their assets if the borrower's credit deteriorates. In the case of banks, this causes particular problems, because scarce capital will have to be found to set aside against a riskier loan.

Therefore, while one aspect of credit analysis will be to consider the risks to the borrower, lenders will nevertheless take great efforts to avoid the deterioration of a borrower.

There are several basic principles involved:

- Lenders do not want someone else to get into a better position than them
- Lenders must protect against deterioration of the credit risk of the borrower
- Lenders need the ability to take action if the quality of the borrower does deteriorate
- Lenders are exposed over a long period, and a lot can happen
    - the economic background can change
    - competition can become stronger than anticipated
    - management can change

    - acquisitions and disposals may occur, or the borrower may be sold
- But - lenders have no fundamental control over the borrower

All of this leads to a set of responses set out in the loan documentation, the purpose of which is to give lenders a measure of control contractually.

Of course borrowers have their own issues:

- Borrowers want certainty of funding over a long period
- Borrowers want freedom to be able to react to changes in the business, or to take opportunities as they arise
- Borrowers want to be able to amend terms as necessary

Loan documentation accordingly has the following fundamental features:

- a defined credit quality for the borrower which the borrower must maintain
    - or indeed improve over time
    - defined by covenants, financial and non-financial
- sophisticated techniques to monitor credit quality over time
- warranties repeated by the borrower to prove that the credit quality is maintained at specified occasions, typically loan drawdowns
- Power given to lenders if the credit quality is not maintained
    - events of default defined
    - lenders may take specified actions if a default occurs (usually acceleration of the loan maturity)

Note that it is generally only short-term loan arrangements, such as those made with banks, which include financial covenants. Long-term debt such as that in bond markets does not generally include financial covenants because it is too restrictive to pin down financial ratios over a long period. High yield bonds do however include financial covenants, of an incurrence[1] design.

In addition, some other features of loan documents include:

- the possibility of amendment to the terms (e.g. on majority votes by value)
- the ability of the lender to trade the loan

These last two features are included as shown in the following table:

	Bank debt	**Bond debt**

[1] Incurrence covenants mean that certain activities are permitted only if the test is passed. They contrast with maintenance covenants which must be passed to avoid default.

Ability to trade	Increasingly for investment grade borrowers. Always for sub investment grade borrowers	Inherent in the securitised nature of the instrument
Amendments	Yes. Depending on the amendment, approval is usually from 2/3rds to 100% on amount of the facilities	Not usually anticipated

2.7 Other factors in credit analysis

Credit analysis looks beyond financial risk. Business risk is also assessed by lenders and the treasurer must be prepared to answer questions of the following nature, all of which are issues that need to be understood by lenders.

- Business strategy
- Management quality
- Attitude to risk
- Product / market life cycles
- Distribution channels
- Market and competition
- Economic backdrop
- Risk management policies and procedures
- Size of the firm
- Jurisdiction / law for the agreement
- Customer profile / key customers
- Supplier profile / key suppliers
- Geographic diversity
- Product mix
- Barriers to entry
- Employees – number, proportion per activity, skills, unions, relationships,
- Regulation & compliance record
- Government / political influences

2.8 Adding value

Can a treasurer really make a difference? Can a treasurer really persuade a lender of a lending case which would otherwise fail? How can the treasurer add value in communications with lenders?

No treasurer can make a hopeless case of credit risk into the safest investment in the world, either practically or ethically. There are limits to what any treasurer can do. However, they can maximise chances by:

- insisting that the firm has a financial strategy
- communicating the financial strategy to lenders
- making management available to explain business strategy to lenders
- where appropriate, acting on investor feedback on financial strategy
- understanding the financial dynamics of his firm

- understanding the situation of the lender
- understanding the corporate structure of the borrower
- understanding what is normal in the markets
- understanding that any borrowing is risky

Example 6: Adding value
As part of a refinancing, Top Tubes Inc (TT) had to put together an Information Memorandum for its prospective lenders, setting out in detail and confidentially, the going concern and gone concern analysis of the group, comprising forecast, commentary and group structure and valuation information. The treasurer has updated and reissued this annually for presentation to lenders, so that they are fully informed, and honestly, as to group progress.

This will help on any future additional financing or if the group has to prepare another Memorandum quickly.

3 The 18 credit principles

To give you a flavour of the lender's mind set we have included a summary of the '18 credit principles' taken from a book by Roger H. Hale entitled: Credit Analysis: A Complete Guide, unfortunately now out of print.

1. Quality of credit is more important than exploiting new opportunities.
2. Every loan should have two ways out that are not related and exist from the beginning.
3. The character of the borrower - or in the case of corporations, the principal management and shareholders - must be free of any doubt as to their integrity.
4. If you do not understand the business do not lend to it.
5. To lend is your decision and you must feel comfortable with it according to your own judgement.
6. The purpose of the loan should contain the basis of its repayment.
7. If you have all the facts you do not need to be a genius to make the right decision.
8. The business cycle is inevitable.
9. Although it is harder than evaluating financial statements, assessing a company's management is vital.
10. Collateral security is not a substitute for repayment.
11. When security is taken, a professional and impartial view of its value and marketability must be obtained.
12. Lending to smaller borrowers is riskier than lending to larger ones.
13. Do not let poor attention to detail and credit administration spoil an otherwise sound loan.
14. Local bankers should be participants in lending to local borrowers.
15. If a borrower wants a quick answer, it is "no".
16. If the loan is to be guaranteed, be sure that the guarantor's interest is served as well as the borrower's.
17. See where the bank's money is going to be spent.
18. Think first for the bank. Risk increases when credit principles are violated.

Any lender who strictly applied all of these eighteen points would probably not lend any money at all! Nevertheless, the list conveys the principles of what credit is all about.

4 The bank as a special case of a lender

A bank is not just a lender. This makes the borrowing relationship different to relationships with other lenders. A bank not only lends but also provides the following services to its customers:

- Bank accounts, cash management systems and payment & receipt mechanisms
- Access to SWIFT
- Credit products
- Direct funding
- Disintermediated funding
    - access to bonds, private placements, commercial paper, EMTNs, and non-bank lenders in bank transactions
- Guarantees, letters of credit, bid bonds, derivatives etc.
- Equity products such as underwriting, placings etc
- Mergers and Acquisitions
- Corporate Advisory
- Asset finance
- Trade finance
- Supply chain finance
- Information services
- Trading and confirmation systems
- Foreign exchange and interest rate derivatives and hedging advice
- Other derivatives (employee options, pensions, inflation, commodities, counterparty risk)
- Investment instruments, e.g. money market funds
- Asset management / custodian

4.1 Loss leaders and high margins

A bank is therefore very much like a supermarket, selling lots of different products, not all of which the customer needs (or at least not all at once), but which the supermarket would very much like to sell. Supermarkets also have ways to ensure that their overall return from a customer will meet their shareholders requirements for returns. Thus we are used to all sorts of deals at a supermarket, such as (probable) loss leaders like “Buy One Get One Free” but there are also the high margin products that we take because we are there.

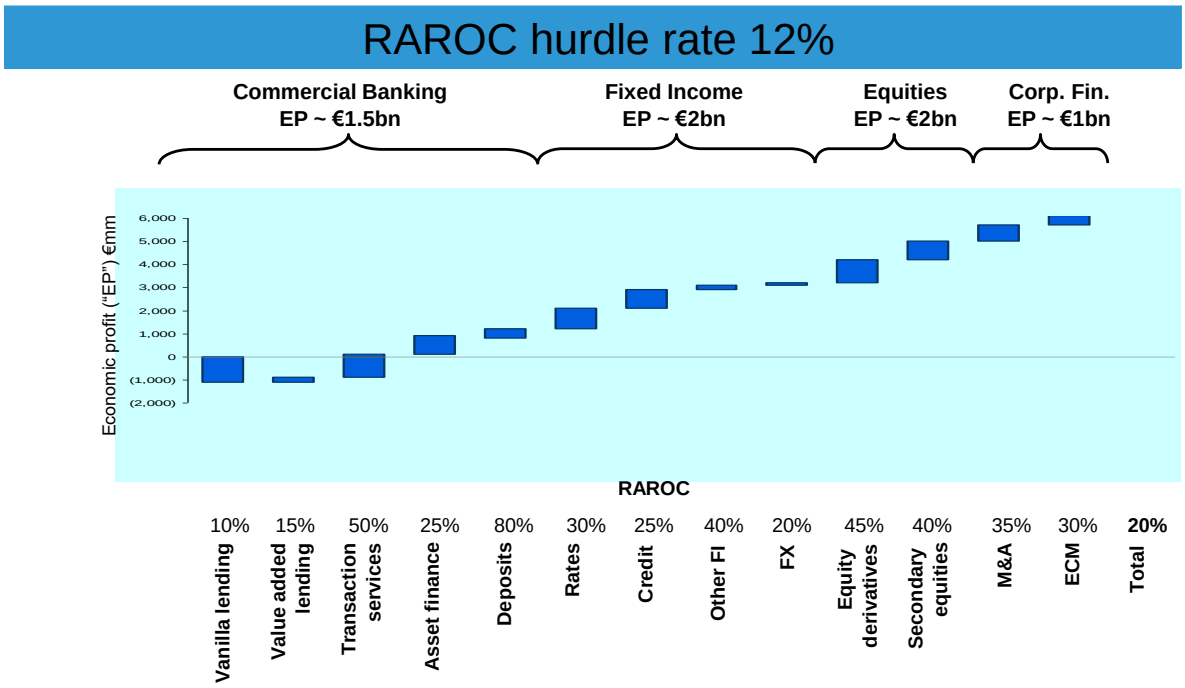
A bank seeks to make an overall adequate return from its customers to meet its RAROC. Leading UK banks have had and now have the following targets for return on equity.

Exhibit 8: Bank return on equity

Bank	Prior return on equity target	Return on equity target 2015 and later

Barclays	13%	12%
RBS	15%	12%
Lloyds	More than 15%	13.5%-15%
HSBC	12%-15%	More than 10%
Standard Chartered	Mid teen%	More than 10%

Exhibit 9: returns from different banking products



Source: Mercer Oliver Wyman, estimated recent annual average economic profit across European corporate and institutional banking products 14

We can see from Exhibit 9 the equivalent of loss leaders and high margin products provided by banks. Vanilla lending is traditionally the loss leader and profits are made from other products. Vanilla lending has to compete with other lenders such as bond finance, private placement providers and so on, so is rarely priced at an economic rate. An exception to this is that small and medium-sized enterprises and sub investment grade borrowers probably do pay an economic rate because in that sector of the market there is little competition to banks and possibly little ancillary business either.

4.2 Bank business models

The bank business model is relatively straightforward but, as we are all aware from the credit crunch, also very risky. Banks are highly leveraged and to stay in business must always stand ready to lend in that they must always have cash available, in the same way that a shop must have stock to sell to customers.

It is useful to understand the basics of a bank balance sheet.

Exhibit 10: example of a bank balance sheet

Liabilities		Assets	
Equity ('Capital')	10	Loans to borrowers	80
Deposits from investors	90	Cash	20
Total	**100**	**Total**	**100**

A bank takes deposits at a low interest rate and lends them out at a high interest rate as loans. To make a return on equity satisfactory to investors it needs sufficient leverage to earn a return after allowing for defaults on those loans. This is usually achieved with very high leverage. Deposits are traditionally taken for short periods as you and I as individuals and treasurers like to be able to spend the deposits on living or acquisitions and so on. This gives a bank several fundamental problems:

- liquidity is crucial because it must be able to survive withdrawal of deposits
- solvency is also crucial because it can only afford a certain drop in the value of its loans

Example 7: French banks suffering on credit risk
In August 2011 in the middle of the Eurozone crisis, it suddenly became apparent that French banks had an above average exposure to southern European government debt. Debt of Spain and Italy was sold because of concerns about them as borrowers. This reduced the price and therefore reduced the asset base of the holders of that debt, which included French banks. There was immediate concern as to the solvency of these banks.

Concerns over solvency can very quickly spill into concerns over liquidity as depositors withdraw their money.

While this sounds a very risky business model, it is nevertheless a necessary one for society. Banks carry out two fundamental roles. Firstly, they allow the maturity transformation described here, thus providing commerce with funds to trade. Secondly they carry out credit risk assessment as a basic check on commerce.

4.3 Regulation[2]

As we are all well aware now, banks are regulated. Until recently there were only two major concepts around regulation.

- Banks must be sufficiently capitalised to protect the depositor base
    - broadly a minimum 8% capital was required
- Assets were categorised according to credit risk
    - higher credit risk loans required more capital

Thus the capital required was not what was in the accounts but a regulatory capital separate from accounting capital. Banks also used economic capital on which they sought to make a return.

[2] We will be exploring the regulation of banks in more detail in Unit 2.

This regulation was called Basel II, which following heavy discreditation, is in the course of being replaced by Basel III together with a new act in the US, known as Dodd Frank.

Basel III introduces more stringent capital requirements such as a capital conservation buffer and a counter cyclical buffer. It also tries to tackle the liquidity issues and broadly requires 30 days of expected cash withdrawals to be covered by very liquid assets, typically government securities.

The implications of Basel III for corporations have yet to be fully worked through, as do their effect on the business model of banks. Products that corporations have come to expect as almost commoditised will become more difficult and more expensive to obtain. Derivatives, for example, will require higher capital allocation, thus driving up costs. Settlement facilities, such as daylight credit lines may also become more difficult to obtain, thus leading to increased cost or changed habits. Depending on their cash flow profile – particularly groups of customers likely to make substantial cash withdrawals, relationships will become more or less valuable to banks.

4.4 Implications for the business model

In the lending portfolio, banks need a wide diversification of borrowers, across industries and geographies and economic sectors to reduce their risk. Their assets are managed on a portfolio basis and this can lead certain banks to decline business from relationship customers and seek it from others at lower rates just to meet the requirements of the portfolio.

Lending to weaker borrowers is particularly difficult for banks as the regulatory model will always discriminate heavily against weaker credits as the most risky. This makes lending difficult, as we have seen in the mid 2010s, even at high margins, as banks seek an adequate return on capital.

Banks are also susceptible to any deterioration of the borrower over the term of the loan and this is why financial covenants are so important to bank lenders, to avoid more capital being set aside to cover that deterioration, causing them losses and possibly a need to shrink the balance sheet and stop lending to other customers as a consequence.

Banks will also seek the ability to trade loans over their life, not necessarily for credit purposes, but for the ability to manage their balance sheets. Treasurers like to know who their lenders are but this may be a luxury in the future.

Banks have sought to do business in areas which do not require capital. Thus banks are desperate to do transactions such as bond issues, cash management, and advisory work, all of which traditionally require less capital. This is the equivalent reaction that many multinationals have faced with a commoditisation of their own products. They have sought to add services to the mere provision of product.

4.5 Ancillary business

With banks lending at a loss, they need to find other sorts of business to do with their customers to ensure that they make an adequate return on capital over the whole business

portfolio. Therefore, banks need to do more than just lend money to customers. They need cash management, derivatives, bond issues, advisory work and so on. This can be very difficult for treasurers because there simply is not enough business to go around. Treasurers' most important demand from banks is lending and this often means that many banks are required to make up the amount, thus making the job of finding more business for the banks even more difficult. Treasurers have stories of promising the same business several times over.

Equally, tempers can often get frayed when lucrative transactions, such as bond issues or acquisitions become available, which can only be given to one or two banks out of a relationship group.

In the US, the linking of non lending transactions to lending is illegal but this has not stopped contracts being signed at the same time.

Example 8: Ancillary Business
Down in the Dumps plc (DD) had recently been downgraded and as part of a survival package, refinanced some debt while at the same time embarking on a strategy of downsizing to raise cash by selling some of the major businesses in its portfolio. DD agreed to offer the M & A aspects involved in this to the banks who participated in the refinancing. To the extent that there was not enough business to go round (more banks than businesses to sell) some business was given on joint advisory mandates and some other banks were appointed as managers in the loan transaction, attracting higher fees.

5 The motivation of non-bank lenders

We have seen that banks will act to try and achieve an adequate return on equity on its overall relationship with a customer. Non-bank lenders such as mutual funds and investment trusts are motivated simply by the three principles that treasurers understand for their own investments of cash:

- Security
- Liquidity
- Yield

They will seek security by both diversification and selection of counterparties by credit status, seeking an appropriate yield where the credit status indicates it. They will seek liquidity by investing in tradable bonds, i.e. quoted bonds for which there is a reasonable market, although many act as "buy and hold" investors leading to illiquidity in some bond issues. Bank facilities where loans are tradable are also attractive. Even then, however, the ability to trade is desirable. Finally, they seek yield over and above that available from bank and government bond investments. They will usually act on a portfolio basis, so that they have some room for riskier investments although many will be unable to go below investment grade status.

One main benefit of raising debt from non-bank lenders is that they do not seek ancillary business and so can be seen as "cheaper" to that extent. It is probably not reasonable to compare headline rates of lending (margins) when comparing banks and non-banks when the whole relationship is considered.

Many non-bank investors do not have a large credit research capability, relying instead on rating agencies. A relationship with these investors is therefore often held by proxy through rating agencies. One disadvantage of this is that non-bank investors do not cope easily with requests for amendments in terms and conditions of loans, through changes to documentation. Another disadvantage is that non-bank lenders prefer rated borrowers – so companies without a rating find it harder to access them. Non-bank lenders also find it difficult to handle confidential information.

6 The rating agency approach

Credit ratings have become more important in recent years, even though they have been part of the fabric of finance for decades. This is probably for several reasons:

Reason	Comment
The inclusion of a credit rating in Basel II / III for capital allocation	Regulatory capital is required to be allocated according to credit rating, *inter alia*. A bank can use internal ratings but the external model can also be adopted.
The increase in structured products	Starting with asset backed instruments, such as Asset Backed Commercial Paper, structured instruments (e.g. CDO[3]s) have become more prevalent, although declining since the credit crisis.
The increasing globalisation of finance	Investment is now very much cross border, with sovereign wealth funds and many institutions looking for yield and diversity, as well as with the introduction of the euro and the rise of the developing world, e.g. BRIC countries. Ratings give a common language for this world.
The trend for outsourcing	Outsourcing is very much a vogue for the 21st century. Replication of credit research departments across institutions is not efficient.

Credit ratings from the big three firms (Moody's, Standard & Poor's and Fitch) are typically for the larger firm and structured finance, and they are vitally important because they dictate the two key aspects of raising debt:

- access to finance — liquidity in debt markets is broadly correlated to rating
- cost of finance — margin (spread) is correlated to rating

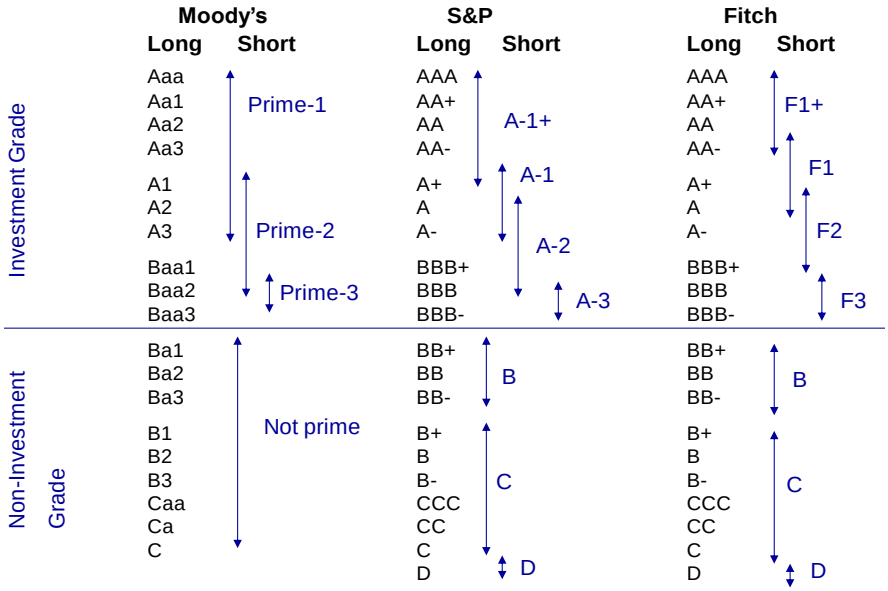
Note that developing market agencies are starting to gain a voice (e.g. Dagong in China).

6.1 Ratings gradings

Treasurers should understand the rating designations and their equivalence across the three main agencies, as shown in exhibit 11.

[3] CDO – Collateralised Debt Obligation

Exhibit 11: Long and short term rating levels and equivalence



As we have emphasised before, the boundary between investment grade bonds, between BBB and BB is a critical distinction in the world of lending, being the crossover between investment grade (High Grade) and speculative grade (High Yield, or Junk). Being either side of that line can make a huge difference in the approach of many different kinds of lender. High Yield status is often pariah status and restricts access not only to debt but also many other credit based products such as daylight exposure lines, FX lines, customer credit and so on.

Long term ratings are probably more significant than short term ratings, which are important really only in commercial paper markets.

6.2 Issues around rating agencies

Rating agencies have been under fire for several reasons for some time, but especially since the start of the credit crisis. They were thought to be too involved in structuring vehicles, particularly the CDOs and similar where AAA ratings were routinely assigned to investments which proved to be fundamentally flawed. This criticism is compounded by the potential conflict of interest in that they are paid by the issuer, or structure designer of the vehicles. Agencies were also accused of being too slow to spot adverse trends and to be followers of events, rather than leading thought. However, in the eurozone crisis of 2010/2011, where they could be thought to be leading the debate, they have been criticised by governments and accused of causing problems (by downgrades) where none really existed. Rating agencies are now regulated and increased regulation may well be extended further in future years, covering aspects such as access to confidential information.

Ratings are paid for by the issuer and the corporate must factor this into their planning. Conflict should be avoided by the separation of analysts and rating committees from the company's commercial aspects by Chinese walls. However, some ratings are unsolicited (and therefore free to the issuer) although in that case, the agencies normally rely only on public information and often do not seek to meet the management of the issuer.

Two issues affect most rated corporates:

Issue	Comment
Confidentiality	Agencies meet management and are designated insiders. However, these privileged analysts also meet with competitors and care must be taken that forecasts or plans are not generally made available. Discussions can reveal facts unwittingly. Care must also be taken that inside information is not somehow included in the press releases made by the agencies.
Timing of press releases	Agencies like to act very quickly following their decisions by making press releases. While they may confer with the issuer on the copy, very little time is often allowed for review by the issuer.

6.3 The credit assessment

The broad questions to be answered are:

- What is the future cash-generating ability, since operating cash flow is the primary source of repayment?
- What are future stocks of assets and other sources of liquidity, as the secondary source of repayment?
- What are future debt and all other liabilities, which are the competing claims on cash flow both on maturity and in liquidation?

Agencies will analyse issuers along classic lines as shown below.

Business risk	Financial risk
Country risk - where does the firm operate and what countries does it depend on?	Quality of accounting - “assessment of the aggressiveness of accounting policies”
Industry risk - is the industry mature, cyclical, consolidating etc.	Corporate governance / risk tolerance / financial policies
Special event risk – “predicting the unpredictable risk factors”. What could break the company?	
Basic operating and competitive position - “company’s standing and relative operating efficiency affect its ability to generate cash flow under different economic conditions, including stress”	Cash flow adequacy
Technology	Capital structure / Asset protection
Strategic / operational competence	Liquidity / Short term factors
Cost efficiency / profitability	Financing details
Management quality and attitude to risk taking - “ability to react appropriately to adverse conditions”	“understanding the legal claims on the cash flow of individual units within the group”

Peer group comparison

The relationship is marked by meetings between the issuer and agency, mostly requiring the CFO and treasurer but occasionally the CEO and operational management, thus very senior people in the borrower (issuer). Sometimes lenders (or bond arrangers) may be involved where structured financing is planned such as a large composite refinancing with a bond issue. Banks can also provide "ratings advisers" to help issuers plan meetings and financings as part of general financial strategy or as part of a structured financing.

Example 9: Meetings with Rating Agencies
Imagination Inc (II) is BBB rated and targets this rating over the long term as part of a financial strategy. II sets up regular meetings each year as follows:

Quarterly meetings with CFO and Treasurer participating.
Bi-annual meetings with CEO, CFO and Treasurer participating
Annual meetings with CEO, CFO, senior operating management and Treasurer participating.

A meeting agenda typically comprises:

- Industry environment and prospects
- Overview of major business segments
- Financial policies and performance goals
- Distinctive accounting practices
- Projections, including underlying market and operating assumptions
- Capital spending plans
- Financing alternatives and contingency plans
- Review of terms of financing

Financial ratio analysis inevitably forms a very large part of the credit assessment and agencies use industry-specific ratios and forecasting methodologies for different sectors, deriving a model for each issuer which can be stress tested as desired. Agencies usually share their models with issuers so that they can be replicated, thus almost encouraging the targeting of ratings (which of course can be a financial strategy) although this replication can be quite time consuming. Different agencies have different approaches to similar problems. For example, treatment of pensions or leasing (usually capitalised) can be different and so each agency (and a minimum of two are normally needed) requires a separate model.

The following exhibits include some example ratios and definitions from different agencies and indicate some of their approaches, notably the adoption of business risk categorisation by Standard & Poor's.

Exhibit 12: Ratio analysis – Industrials 2006-2008 (Standard & Poor's)[4]

	AAA	AA	A	BBB	BB	B	CCC

[4] Source: Applied Corporate Finance, 4th edition by Aswath Damodaran, from Standard and Poor's

EBIT interest coverage	17.5	10.8	6.8	3.9	2.3	1.0	0.2
EBITDA interest coverage	21.8	14.6	9.6	6.1	3.8	2.0	1.4
Funds flow / total debt	105.8	55.8	46.1	30.5	19.2	9.4	5.8
Free operating cash flow / total debt (%)	55.4	24.6	15.6	6.6	1.9	(4.5)	(14.0)
Return on capital (%)	28.2	22.9	19.9	14.0	11.7	7.2	0.5
Operating income / sales (%)	29.2	21.3	18.3	15.3	15.4	11.2	13.6
Long term debt / capital (%)	15.2	26.4	32.5	41.0	55.8	70.7	80.3
Total debt / capital (%)	26.9	35.6	40.1	47.4	61.3	74.6	89.4

Exhibit 13: Ratio analysis adopting business risk (Standard & Poor's)[5]

[5] Source (no longer available but equivalents elsewhere: Standard & Poor's website (registration required) http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245319314383

Business Risk/Financial Risk

	Financial risk profile				
Business risk profile	Minimal	Modest	Intermediate	Aggressive	Highly leveraged
Excellent	AAA	AA	A	BBB	BB
Strong	AA	A	A-	BBB-	BB-
Satisfactory	A	BBB+	BBB	BB+	B+
Weak	BBB	BBB-	BB+	BB-	B
Vulnerable	BB	B+	B+	B	B-
Financial risk indicative ratios*	Minimal	Modest	Intermediate	Aggressive	Highly leveraged
Cash flow (Funds from operations/Debt) (%)	Over 60	45 to 60	30 to 45	15 to 30	Below 15
Debt leverage (Total debt/Capital) (%)	Below 25	25 to 35	35 to 45	45 to 55	Over 55
Debt/EBITDA (x)	<1.4	1.4 to 2.0	2.0 to 3.0	3.0 to 4.5	>4.5

Exhibit 14: Definitions of the key ratios used by Moody's[6]

Moody's Industrial Company

Credit Research Guide

Ratings

Category	Moody's Rating

The major outstanding debt issues of each company are aggregated here.

Contacts

Analyst	Phone

Members of the research team at Moody's are available to respond to subscriber inquiries on each company.

Rating History Graph

We convert the rating of the individual company into numerical terms to generate this chart. The performance is then charted, using a solid black line.

Operating Statistics

Int. cover. (%): Interest Coverage = (Operating income + other income – other expense + foreign currency translation) ÷ interest expense.

RCF/TD (%): Retained Cash Flow/Total Debt = ((Gross cash flow – cash dividends) ÷ total debt) X 100.

Op. Margin (%): Operating Margin = (Operating income ÷ net sales) X 100.

ROS (%): Return on Sales = (Net Income ÷ net sales) X 100.

ROC (pretax) (%): EBIT to Average Capitalization = ((Pretax income + reported interest expense) ÷ Average capitalization) X 100.

Balance Sheet Statistics

TD (% cap.): Total Debt to Capitalization = (Total debt ÷ total capitalization) X 100.

DIT. &Min. Int. (%): Deferred taxes &Minority Interest to Capitalization = ((Deferred taxes + minority interest)÷ total capitalization) X 100.

Pfd. Stk. (%): Preferred Stock at Liquidation Value to Capitalization = (Preferred stock at liquidation value ÷ total capitalization) X 100.

Com. Equity (%): Common Equity to Capitalization = (Reported common & surplus – (preferred stock at liquidation value – reported value) ÷ total capitalization) X 100.

Total Cap. ($bil.): Total Capitalization = Total debt + minority interest + deferred taxes + investment tax credit + preferred stock at liquidation value + common and surplus - cumulative translation adjustment.

TD %Mkt. Cap.: Total Debt to Market Capitalization = Total debt ÷ (total capitalization – common & surplus + (common shares outstanding X year-end common stock price)) X 100.

Opinion

This summary gives the basis for current rating and highlights the key factors that Moody's believes will affect the credit quality of the company's debt—and Moody's ratings—in the future.

7 Bank relationship management

[6] Source: Moody's website

When treasurers talk about bank relationship management, the starting point is to understand the major dimension in this, which has been broadly on the treasurers' agenda for decades. This is transaction banking versus relationship banking.

7.1 Transaction v relationship banking from a treasurer's point of view

Transactional	Relationship
Banks are chosen as being the best for the transaction, based on a combination of price and service	Banks for any one transaction are chosen from a panel of banks, called 'relationship banks' who know the borrower well
There is no preference as to which banks are chosen to tender for each service	Business is given only to banks on panel unless no bank is actually competent in that offering
The technique is most popular with very high grade borrowers / service users	The broad principle is that borrowers are prepared to restrict their choice of bank, essentially risking a higher transaction cost in return for a greater certainty of execution
	Can be more expensive
	This model is often preferred by treasurers because there is a greater chance that banks feel morally obliged to support the borrower
	The principle extends to all bank products
	Generally adopted by most corporates, who like to have at least some banks they can easily call on
	The tie in between bank and corporate will usually adapt to work both ways. The corporate wants the bank to say yes and the bank wants a fair share of all the banking business. This leads to the concept of 'ancillary business' whereby banks under-price vanilla loan products so that they can gain access to higher margin products from the borrower

Example 10: Transactional banking and scorecards

TeeHee SA is a large global multinational and is highly rated. It is amongst the market leaders with regard to cash management and centralises cash wherever it can. It is therefore a regular participant in cash management selection and implementation projects. Whenever the requirement for a new tender arises, TeeHee approaches the banks it sees as the major participants in that market, regardless of their other relationships with TeeHee. The tenders are marked according to a pre-agreed scorecard and that alone dictates the winning bid.

Example 11: BBB borrower in relationship banking

Firstcall SAS is a provider of insurance based call out services to domestic customers in the Nordic region. It is BBB rated and has modest debt levels. It has a policy of managing all its banking business with just three banks, thus debt and letters of credit, cash management and

derivatives are all offered to just three banks, even if another bank may have a slightly better, or cheaper, product. This policy, where the banks know that a certain level of business is likely to be maintained, helps to ensure liquidity to Firstcall. The possible extra cost of services, caused by this restriction, is paid for in time saved going to other providers, and in any case, there is still some competition between the three main banks.

The essence of relationship banking, from the perspective of the treasurer, is to achieve an advantage in return for the privileged access to information given to the relationship bank. The bank has the opportunity to sell a cross section of products and services to the corporate; it believes that the access to information reduces the risk of bad debts, and enables it to offer margin-enhancing products to its clients on a targeted basis. Behind this is the real concern of treasurers around liquidity risk and the belief that having strong relationship banks means that liquidity is more likely to be assured. Thus they are less likely to have to have the dreaded conversation with the CEO where they have to say that a certain deal cannot be financed.

Relationship banking has drifted in and out of favour in recent years, generally in line with the economic cycle. During periods of growth there has been increased bank competition and a greater emphasis on a pure transactional approach by both banks and corporate clients – especially large corporates. The benefits of relationship banking became, if not totally ignored, at least reduced in perceived value.

In contrast once there was an economic downturn, the advantages of relationship banking were once again debated. This has been amply demonstrated in the credit crisis when those firms with strong relationships with their banks have been in a far stronger position than those firms relying on the transactional approach, where banks retrench towards their strong relationship or domestic customers.

Larger (and hence usually higher rated) corporates tend to be the ones who will more readily adopt the transactional approach, while more medium sized corporates, for whom the sourcing of debt is a perennial concern, tend towards the relationship model. Interestingly, as one moves further down the risk ladder, more weakly rated firms are more likely to take a transactional approach. For example, a structured transaction will be taken to those banks known to have capability in that area, whether or not the borrower knows the bank.

The cost of the more assured liquidity achieved by relationship banking has to be accepted by corporates as reflected in higher prices on banking products.

There is of course, no right answer as to which policy should be adopted and indeed for multinational corporations it may be a mixture. They may adopt a relationship approach at the parent level, where funding is mainly sourced, and adopt a transactional approach for foreign subsidiaries, especially if their relationship banks are unrepresented locally. Alternatively, they may adopt a relationship approach globally. Whatever the policy, however, the approach needs to be thought through and managed, and occasional checks should be carried out to ensure it is adopted.

7.2 Transaction v relationship from a banker's point of view

Banks make money from transactions, so whether a bank adopts a transactional or relationship approach to a corporate, it needs transactions to make money. It will therefore

seek transactions either from existing relationships or from customers it does not yet know and who it therefore has to poach from another relationship. Thus in good times a treasurer can expect cheap deals from non relationship banks.

We have seen that a bank does not usually make money on vanilla lending, so it has a natural tendency towards relationship banking with its borrowers; and will pick up what transactional business it can, particularly if such business requires little capital. Banks have choices as to where they invest resources and they also have retail and investor clients where capital may be better allocated.

Corporates can be capital hungry because they:

- Expect large amounts of capital to be deployed rapidly
- Often require integrated multi-product capabilities
- Have leverage with banks in general corporate purpose financing
- Increasingly demand global reach
- Expect value added insights and innovative solutions

So treasurers need to understand that relationship banking is not cheap to run.

What a bank expects from a relationship is:

- To be regarded as one of a limited number of lead banks
- Recognition that it cannot be best in class across all products and services
- For corporate not to expect exclusivity
- To have an active, open dialogue with the management of a firm
- To attain a trusted adviser status
- To share challenges as well as opportunities
- To work on problems and identify solutions rather than just pitch opportunities (also expected by the corporate)
- To expect to have to make the full resources of the bank available
- To be considered as an investor and not simply a supplier
- To be able to make an adequate return on capital

7.3 Customer / supplier relationships

There is much talk about the relationship between customer and supplier. In the United Kingdom, supermarket chains are under enormous scrutiny for the way that some of their food suppliers are treated, and where there seems little concern for the profitability, or survival, of their suppliers. By contrast, Rolls Royce, aware of the need for long term relationships because of the long term product life of its engines, has moved to sharing profitability with suppliers over the product life. Many highly rated manufacturers are using their credit strength to finance suppliers (and customers) through the modern techniques of supply chain finance.

Bank relationships are no different and work best when:

- The aims of each party are clear

- Pricing is transparent
- Each expects the other to profit, according to the risk
- Profits are not excessive
- Each is honest, maintains open communication, and recognises that surprises are not good for relationships
- Questions or requests are answered promptly
- Senior management meet on a regular basis (and not just during transactions)

Examples of transparency in bank relationships include:

Banks should explain their:

- Influences on pricing and capital rationing
    - RAROC calculation
    - Return targets
    - Departmental targets
    - Capital weighting
    - Market pricing
    - Where is pricing pitched pricing compared to the market,
- Limits
    - House limits
    - Rating limits
    - Sector limits
    - Name limits
- Approval procedure
- Progress in credit approvals
- Strengths and weaknesses
- Changes in relationship managers (and especially migration to “workout”)

Corporates should explain their:
- Business strategy
- Financial strategy
- Bank relationship policy
- How they assess bank performance
- Counterparty risk policy
- Cash investment policy
- RFP procedures and method of choosing providers

Individuals become the real crux of any relationship. Treasurers often follow individuals as they move from bank to bank and banks often follow treasurers as they move firms as well. Clearly, the better they know each other, the more they will trust each other and the more honest they will be, the quicker things will happen or be rejected as inappropriate.

Treasurers can be lonely, as often they will be the only treasurer in a firm and have no-one to turn to. A trusted adviser can be worth their weight in “gold”. However care must be taken that individual incentives, mostly operating in banks, do not upset the whole relationship. In

addition memories are long and whole bank relationships an be damaged by behaviour in one small area of a bank, which of course are usually very large organisations.

Changes in individuals need to be managed carefully by both bank and corporate. In 'normal' times individual succession can be planned and managed, however in conditions of stress, ie default or near default, the bank will transfer the relationship to its restructuring or workout team, and this will change the entire dynamic of the relationship. However fraught a workout may be, a bank which is still willing to act as 'trusted advisor' rather than simply focussing on being repaid, is in a better position to reap the long-term benefits from a successful turnaround.

7.4 Negotiations

It cannot be stated too often that a treasurer should not base financial decisions on cost alone. Service levels, flexibility, availability and the continued ability of the lender to provide value are important factors which effectively contribute to financial risk management.

Bearing this in mind the treasurer needs to know how to manage negotiations so that the aims set out so far are achieved. That is, for example:

- The bank achieves an adequate return on capital
- Pricing is broadly in line with market rates
- Excessive profits are not earned (nor that a product or service is too cheap)
- The bank will still stand as a relationship bank and continue to lend

In reality, for example in loan negotiations, there are not many chances for major negotiation. If the rates offered are close to market and are shown to offer an appropriate return on equity for the bank, then there is not much room to manoeuvre. The same applies to the terms of the loan and any control surrendered in the process. Market convention and credit strength leads to a certain price and to a base document, from which it will be difficult to change. So each of the base documents for a bond deal and for a high yield bank deal, a secured, highly covenanted loan agreement, will look remarkably similar when completed.

However, do pay particular attention to the initial term sheet as that might be the last chance to set out pricing and covenant levels. On the cusp of different credit levels there might be a chance to jump up to next standard. So a '5B' borrower (BBB (investment grade) from one agency, BB (junk) from another) might allow investment grade documentation and perhaps BB+ might allow investment grade documentation. Also in that case it is possible to have covenants that fall away as a goal is reached (e.g. investment grade) and which, if you are lucky, don't come back if you slip back.

Particular attention should be paid to baskets and carve outs so that the business can be run within the terms of the agreement, and with the minimum of expensive waivers or amendments. If the treasurer doesn't shout, no one else will.

Similar techniques apply to other banking products.

7.5 Know your lender

One issue that is important to discuss in terms of bank relationships is that of knowing who your lender is. If a borrower issues a publicly traded bond, it immediately loses any control

over who its lenders are, as the debt can be freely bought and sold. However, in terms of the bank relationships where we have seen that a mainstream approach to banks is to seek deep relationships with lenders, knowing who they are is, as with every key supplier, essential. When sitting across the table from his bankers, the treasurer needs to know how much they have lent, how much they might lend, how easily they will take news and whether they will agree to amendments. Although it is becoming harder to assess these factors, without the knowledge it is quite difficult to maintain a dialogue. In extremis the person across the table may no longer be a lender, or actually be 'short' credit (in that situation the banker profits on a default).

- For sub investment grade bank loans, lenders are usually free to trade their participation in loans, notifying the borrower afterwards
- For investment grade banking it is likely that borrower consent for trading is required but is not to be unreasonably withheld

There is a clear trend towards greater trading of corporate loans and the stress on bank balance sheets means that banks will need to be able to trade in and out of loans much more easily, for liquidity purposes as much as for portfolio or relationship reasons.

Another trend is also apparent. It is possible for a bank to remain a lender but then hedge its credit risk in the Credit Default Swap (CDS) market. In that case it would seem as though it were a relationship bank but it would have no credit exposure. In such a case, the bank relationship team might be wholly unaware of risk management (or indeed speculative) action that had been taken elsewhere in the bank, so the existence of CDSs opens up considerable uncertainty for borrowers. Cutting to the chase, a CDS can be viewed as a bet on a company going bust; and both parties to the CDS will want to win the bet. The buyer of protection (say the lending bank) may prefer to force a default and receive compensation up front via the CDS settlement, rather than (if the protection buyer were unhedged) supporting the business, "working out" the loan, but risking only receiving back part of its exposure. The seller of protection may wish to force insolvency in order to pick up shares in an otherwise attractive business at a knock-down price. This would either support a short-selling strategy (i.e. selling shares now for future settlement, which the seller plans to buy from the market in due course at a lower price), or because the protection seller wants to acquire the business at a knock-down price, or both. CDSs can make it quite difficult to conduct a relationship – particularly for the borrower but also in fairness, for the bank's relationship team.