NEW ERA OF RELATIONSHIP BANKING (PART I)

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NEW ERA OF RELATIONSHIP BANKING

Part I: How relationship banking has shifted in recent times and created imbalances in corporate Australia.

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2012 has been frequently touted as a challenging year for businesses and corporates seeking finances. The easy and cheap credit of yesteryear has been replaced with much tougher credit conditions. Debt finance is no longer an easily available commodity and even highly-rated businesses now have to compete for the right debt package.

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Fingers are all pointing to the other side of the table, at banks, which unfortunately are also grappling with their own neoteric era of challenges such as the Eurozone crisis, Basel III, the US's slow recovery, benign local credit growth. Banks around the world are shoring up capital to safeguard balance sheets whilst aggressively cutting their workforces to maintain or increase productivity and profitability. All these components are driving new behaviour from banks in dealing with their customers, existing and new. Against this backdrop, businesses and corporates must modify their traditional ways of working with banks. This three-part series of *New Era of Relationship Banking* will elaborate on:

- the "ins and outs" of banking
- the challenges banks are facing
- how we can leverage the new knowledge to achieve better results from our chosen value-aligned relationship banks.

Thomson Reuters stated that A$54.5bn worth of corporate loans matures in 2012, with a further A$47bn in 2013 and A$45bn in 2014. Meanwhile, many foreign banks, which funded around 45 % of our corporate loan markets, have left our shores. In Q411, European banks supplied only 12% of total commitments. This has put undue pressure on the Australian banks to meet the refinancing demand and has driven an array of new behaviour from our banks. Whilst the large and highly rated companies will have high bargaining power against banks, others will need to modify their traditional ways of dealing with banks. *New Era of Relationship Banking*, a three-part series, will demystify the art and science of working with banks and help devise new strategies.

In Part 1 we will first focus on understanding the role of banking in the economy and how relationship banking has changed in recent years.

Banks purpose in a nutshell

Banks, nowadays, claim to be a one-stop shop for all our financial needs. They provide a vast array of products and services from the simplest (bank accounts) to the more complex (structured lending, project finance, securitisations). Armed with these products, they cater for individuals (moms and pops, you and me), SME (small-to-medium enterprises with revenue of $1m to $75m), corporate and institutional clients (top ASX companies such as Harvey Norman, Westfields, Telstra, etc). Despite all this client segmentation and fancy product names, the role of banks and the sole purpose for their existence is, in a nutshell, to aggregate savings and wealth from the public and to efficiently and appropriately channel the capital into productive activities such as infrastructure and business expansion. Banks "*manage and absorb risks"* on behalf of the wider public by writing various types of loans with different credit risks and terms. This process effectively places banks as agents to fuel our economic growth.

However, events in recent years have shown that banks do not perform true to their core duties. Pre-GFC, capital was thoughtlessly channeled to unproductive areas such as, sub-prime securities and over-leveraged countries. Then, during and post-GFC, the capital pendulum swung too far to not allocating enough capital to quality businesses. Because of their capital mismanagement, banks have effectively caused their own liquidity crisis and perpetuated the after-effects of the crisis to the public, our overall financial system and the global economy.

How did banks get it so wrong?

For centuries, banks commendably employed the "relationship banking" model to assist with the process of "managing and absorbing risks", whilst deriving an income for themselves. Contrary to transaction-oriented banks which focused on individual / one-off transactions, relationship banks relied heavily on the understanding and knowledge they developed of their customers/borrowers to inform the provision of financial products and services to them. The understanding of customers' businesses helped mitigate risks to banks as well as provide a strong linkage between customers and banks. Both sides were reminded of their mutual trust, commitment, and loyalty. Once established, these relationships were rarely terminated and were passed onto multiple generations. This *was* the traditional principle and foundation of "relationship banking". However, over the last quarter of the century, the authenticity of relationship banking became almost a relic of the past.

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Nowadays, neither customers nor banks are putting much trust and commitment into their banking relationships.

Cross-sells to customers

The depth of relationships, unfortunately, is now measured by the number of cross-sells to the customers and the total income generated to the banks. Traditional principles of relationship banking expected banks to partner customers for growth and to accommodate customers during difficult times. However, recent anecdotal evidence argued differently. In dealing with distressed assets, it is true that relationship banks would always assess the comparative value of exercising demand repayment of already loaned money against further extending the credit in the hope of recovering it in the not too distant future. The latter usually prevails under normal circumstances. However, it has been at a significant cost to borrowers. During the GFC and even now, banks, contrary to the very principle of relationship banking, have shown limited patience and sympathy in their attempts to understand their customers' issues. Perhaps banks were inundated with too many problem assets within a short period of time. Many unfortunate companies were simply served with demands to repay as banks prioritised their own economic viability ahead of their customers' survivability. Those luckily to escape the demand repayment had to endure increased pricing and added quarterly/monthly monitoring with new stringent covenants. On the lower end of the business segment, penalty fees were enforced so that any present and future breaches would automatically entitle banks with increased margins. This inadvertently added undue stress to already financially distressed companies. Even the better rated corporates had to tolerate over a 100 percent increase in margins on their multi-billion facilities. Despite full sympathy and appreciation of banks' capital and liquidity issues, none of us can dismiss the banks' blatant opportunistic behavior in growing their income at the expense of their struggling customers. This violated the very traditional principle of relationship banking – "accommodate customers during difficult times".

The most frequently voiced problem with longstanding relationship banks is "complacency" and "memory Lapse".

Complacency and memory lapse new banking trend

The fundamentals of relationship banking have shifted. From the customers' point of view, other than the unsympathetic approach by banks, the most frequently voiced concern or problem with their longstanding relationship bank is that the institutions suffer from "complacency" and "memory lapse". These two problems are as much a consequence from the recent evolution of banks as the companies' negligence in managing their banking relationships. Banks are very clear on the importance of their role in the financial stability of the economy and your businesses and the value they bring to the borrowers' present and future. As a result, borrowers can easily fall at the mercy of banks if they unknowingly or unreservedly commit to the relationships whilst not keeping fully abreast of the banking markets.

To test complacency, I recently advised a client to spot check the 10 year old relationship with their bank. My client put in a request to the incumbent relationship bank and a competing bank simultaneously for a historic table of daily BBSW for the past 24 months. Being publicly available, the BBSW's historic figures are a matter of a push of a button by a financial market colleague. The goal was to check the responsiveness of the incumbent relationship bank to their client, who had been a loyal client for 10 years. Unfortunately, the result was appalling. Whilst the competing bank, eager to gain new business, responded within a business day, the incumbent's relationship bank disappointingly responded back two weeks later, after being reminded by my client. In this example, complacency was clearly demonstrated by the incumbent relationship bank.

I further uncovered that my client's account was downgraded multiple times over the last 10 years from "platinum" status to its then current status where it had been sidelined to a relationship team which managed the "lower value" customers. The reason was because my client was a single product user and was generating less than $200k of annual banking wallet to the bank.

By the way, with an annual review of $300 million and 200+ staff, my client was hardly an unimportant business in anyone's eyes. It was because my client did not proactively manage his banking relationship that it was unfairly swayed towards the bank.

Memory lapse makes re-educating banks almost an annual exercise.

Memory lapse, unfortunately, is another inevitable evil that erodes banking relationships nowadays. Whilst the traditional value proposition offered by relationship banking is "long-standing, trust, familiarity, and consistency", I would be pleasantly surprised to find any business that had the same relationship manager or team for longer than 24 months in the past five years. Consider it a blessing if you have the same relationship team for more than three years – it is a rare find. This constant staff turnover in relationship banks is epidemic and is driven by a combination of the banks' anti-fraud compliance system, aimed at preventing staff from becoming overly attached to any clients; the banks' constant attempts to restructure for the lowest cost-to-income ratio and profitability; plus the change in demographic and values of our workforce, which is now constantly seeking better roles with better pay. No matter how sophisticated the "client relationship management" system and the new social media are, the sentiment and integrity of relationship history is seldom recorded and passed on to the next wave of succeeding relationship bankers. Both good and bad memories are erased every 2-3 years which makes re-educating banks about specific relationships almost an annual exercise. This is an unfortunate reality and a counter-intuitive phenomenon of relationship banking that we all have to learn to work with!

Benefits still yielded by relationship banks

On the origination front, relationship banking, so long as it is strategically managed at the start, can yield benefits to businesses.

During a recent transaction, one banker, who was shown our client's presentation, drew me apart and said: "*Just tell me what you need. I will find ways to accommodate and get the deal done.*" Our presentation was sharp on our client's strengths and the challenges facing the business. It also tactically intimated to the banker the potential cross-sells and networks this new relationship could bring to the table. It wasn't a simple transaction. Nevertheless, the banker, with my coaching and the appropriate motivation, persevered over 10 months and we now have a happy customer. Under apt competitive tension, relationship banks could also provide funding facilities at competitive pricing, even if it means short term losses on the facilities, so long as they can expect present or future cross-sells or additional businesses to help offset the losses on the transaction at hand. These cross-sells can be as simple as your daily transaction banking mandates or can be more complex mandates such as, capital market issuances.

In some cases, relationship banks would even deploy predatory pricing tactic on client's existing facilities if they sense potential threat of losing valuable customers. Last year, I witnessed a relationship bank offer an extremely competitive package, practically unsustainable on a stand-alone transaction basis in both terms and pricings, to an existing client with 10 years of relationship history in order to fend off competing banks. Pricing is often a function of the relationship. The longer, healthier and more valuable the relationship is to the banks, the higher the potential of competitive pricing may be. This is an important aspect to remember in positioning the story to banks.

Having long-standing relationships can also help pave future access to the larger bank syndicates and capital markets as borrowers' funding requirements expand. All banks have prudential limits set for any specific company and industry. By developing long-standing banking relationships, borrowers effectively establish credibility. All the ongoing information sharing and covenant monitoring will later serve as a means of certification into the larger banking and capital markets.

Mid-tiered companies will have tough negotiations with their banks and may need to rely on equity.

In most cases of capital market issuance, relationship banks would be asked to provide commentary on the relationship history, the facilities and even credit standing of borrowers to be included in the information memorandum.

A long-standing and healthy relationship with your relationship bank can enhance your credentials to alternative funding sources.

Accept the reality of the new era of relationship banking

Rather than dwelling on the "should-be" of relationship banking and not getting preferred results from banks, we should be focusing on reversing the current imbalance of relationship banking. By knowing that relationship banks have strong preference for cross-sells and reliance on company insights to originate and price loans, we, at inception, ought to focus on a skilled presentation highlighting key selling points on the borrowers' credit story and their respective industries to prospective relationship banks. Once the relationship is established, we need to persistently work on this borrower/lender relationship. We cannot dismiss the importance of proactively managing our relationship with banks which involves timely quality compliance reporting and professional presentation of company insights at every periodic review. The longer the relationship continues and the more that this exclusive knowledge of the borrower is developed, the more entrenched the relationship becomes, and the more the bank is willing to continue investing in the relationship; that is extend or renew the loans at favourable terms. After all, the original mandate and principle of relationship banking, despite being financially based, is about mutual understanding.

Conclusion

Banks are undoubtedly important to our economy and crucial to the growth of businesses. Relationship banks, even more so, provide many benefits to businesses. However, the evolution of banks which will be further elaborated in Part II, has changed the fundamentals of "relationship banking" and is putting many borrowers at the mercy of banks. Especially in 2012 whilst the cost of wholesale funding, impacted by Eurozone crisis, continues to rise, compounded by the mounting refinancing wall in the near horizon as a result of foreign banks having left our shores, Australian banks are in an ever stronger position to cherry pick their assets.

This year, the large and highly-rated companies with limited debt-funding requirements and diverse funding pool are well-positioned to negotiate against their banks. However, the vast majority of mid-tiered to smaller Australian companies, with limited knowledge of navigating the banking maze, will face tough negotiations with their banks. With limited access to alternative funding sources, these companies may need to resort to equity to sustain or to grow.

There is now, more than ever, a strong need for an intermediary, who retains your "corporate memory" and has the ability to present your company in "banking" language so that the gap caused by the fundamental shift in our banking market can be effectively bridged.

NEW ERA OF RELATIONSHIP BANKING (to be continued)

Part II: New challenges the banks are facing and hence our new strategies

In the second part of *New Era of Relationship Banking*, I will explore the new and mounting challenges facing our relationship banks and how these challenges impact on the banks' client-relationship model, which directly drives their behavior in financing new transactions and refinancing existing loans on their balance sheets. The paper will explain how borrowers can use this understanding to modify their financing and banking strategy to achieve financing success.

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