Check Bank on Risk Profile *Management of Bank Relationships*

Hugo van Wijk

In April 2008, before the US subprime crisis turned into a true global credit crisis – Lehman´s failure was still 5 months forward, I wrote in Het Financieele Dagblad an essay about a banking sector with less risk. Key point in that article was the trade-off between the quest for maximum return for the bank´s shareholders and the gaming of solvency rules through financial innovation by bankers with all its occasional disastrous consequences as a result. I also pointed out that regulatory authorities of course can tighten the rules once more, but that without the additional pressure of market discipline exercised by clients on their banks another crisis will be inevitable.

Two years have passed. The financial crisis was followed by a deep economic recession. Some bankers have apologized, banks generically have been saved and the profession of banker is now a job like any other – no star status anymore. Many (good) reports have been produced and the Basel Committee has delivered on its promise to propose better rules. Also regulation of financial innovation is now on the radar screen in Basel and Paul Volcker – chairman of President Obama´s council of economic advisors, has stated that as far as he is concerned the most useful financial innovation has been the ATM. Banks widely have promised to behave better on key points and also have formulated more modest return on equity objectives than pre-crisis.

But we have seen negative excesses as well, like the statement of one person who still believes bankers are doing God´s job. And we have more reason to be realistic.

Andrew Hilton of the Centre of the Study of Financial Innovation noted in the British monthly The Banker that "we´re wasting a good crisis" and that in the end nothing has really changed. One of the explanations he provides is "sheer, brute cash": the money spent by Wall Street on lobbying in Washington doubled in 2009. Another reason he gives is that the critics and regulators themselves are divided, which in turn is being exploited by bankers. On the one hand the case is made for more and better rules within the existing architecture of the financial sector. On the other hand the solution is being sought in change of the architecture itself. Hilton identifies a sore spot when he says that the definition of a good banker still is "someone who frequently outsmarts the regulators with the predictable consequence that the financial sector from time to time explodes."

The worry that the momentum for change is fading away was already expressed last year in May by the then Dutch Finance Minister Wouter Bos. Recently, Nout Wellink, Chairman of the Basel Committee noted in a speech in London that the urge to change is felt less and less by politicians and bankers now that the first green shoots of economic recovery have emerged. Wellink also observed that the resistance against proposals for different rules is increasing as a result of, indeed, lobbying by the financial sector. At the same time, however, another momentum is gaining weight: the client nowadays views its bankers very differently. Professional and solid bank relationship management (BRM) has moved up the priority ladder within a lot of companies already: it has become Chefsache. In conjunction with another key priority at this moment – maximization of internal funding (cash is king), CFO´s take a critical look as to which banks are the really right partner. Just like this happened in the selection processes of vendors of payroll processing software or the suppliers of core raw material and key components, companies who are really on top of it, are now reviewing their banks in this same framework of business critical suppliers. Of course, companies want to reduce dependency on banks through working capital optimization, but in tandem with this the question then immediately arises: which bank? In these companies, BRM has become a key compliance-question. The CFO will want to be (and has to be) accountable towards the firm on his banking policy, just like the firm will want to accountable towards its stakeholders on its BRM as well. Who are the banks, and why? How have these banks been selected, has business been awarded, and how is this assessed and adjusted every year?

Illustration: Max Kisman

Risk management bi-lateral

Risk management in the relationship between company and bank has become as a result of the financial crisis absolutely bi-lateral. This goes well beyond the traditional question which bank is best for placing a deposit. Also, from the other angle, whether a bank is willing yes or no to provide a credit facility is not at all the only key question anymore.

As a result of the crisis, and rightly so, these firm take a fundamentally very different view on their banks, and are including a lot of additional elements into their considerations today. A first relevant question, for example, is identifying the right number of the right banks, so as to ensure sufficient mutually strategic depth in the relationship. This requires a much more subtle answer than "many, so as to ensure alternatives". When one has too many banks, domino-risk is prominent. That is the risk that a bank with a small share of wallet decides on pro-active exit, with the other banks then following suit because they fear an information gap.

Another element concerns taking into account the return on equity target the bank has set. In the annual 2009 FD-Vallstein Banking survey in The Netherlands, over 50% of the firms indicated doing this now. A major European airline has indicated it does not accept relationships with banks that have a set a return requirement that is higher than its own: 12%. In this survey it became also clear that compensation policies is a factor being considered for over 40% and that risk management policy of the bank plays a role in 70% of the bank selection criteria.

The question therefore is no longer just whether the bank is willing to deal with the company but also vice versa: does the company have appetite for the bank?

Compliance Theme

Nowadays the CFO needs to spend more time on BRM

Limitations on bank supervision increase relevance of solid BRM

Companies need to select their banks carefully

Just like in the medical sector the respect from someone in a white coat at some point in time got reduced to healthy proportions, the relationship between client and bank slowly but surely becomes more balanced. Increasingly companies take the view that having a solid BRM-policy is mandatory, because one cannot just assume the regulator always will ensure banks are ready to provide financial services. Also, such a BRM-policy is viewed as a constructive way to convert discontent into a more solid bargaining position towards the bank. This does not mean that a revolution is going on right now. There is also no need for that: a well-thought BRM policy requires more than a one-day workshop.

The response to such a challenge also requires a deep understanding about own banking requirements and associated risk profile. Based on this and in tandem with generic risk acceptance principles a clear formulation of realistic demands towards banks can be achieved. In this respect, having the necessary basic knowledge is essential. Jargon and information provided by the bankers cannot just be taken at face value. The Basel II solvency rules have become much more complex on the one hand, but much more relevant for the individual company on the other hand. Banks do not hesitate to point towards "new rules and increased solvency requirement". The Dutch Association of Banks was quick to note in Het Financieele Dagblad that the newly proposed Basel rules could very well make credit more expensive. In depth knowledge of the rules and a good understanding of the firm´s position is however absolutely necessary to assess the true and relevant impact, if indeed any, on its position towards its bank.

Because not everything a banker claims is always objective. In many cases it is in reality just one opinion among potentially many others. One could equally say that the new proposed Basel rules provide a good incentive to banks to stop with socially useless activities, in the words of FSA Chairman Lord Turner, as a result of which solvency in fact would be freed. This in turn would also facilitate reducing the financial sector to a more healthy size compared to the real economy, in recognition of the fact that the sector became "swollen beyond the optimal size", again in the words of Turner. After all, it is not just how much solvency that matters, but above all what you actually use it for.

In that perspective it is worthwhile paying some consideration to the disintermediation that has taken place in financial services between origination, risk acceptance and financing. Traditionally, these three were managed by the bank itself. With the introduction of new instruments like securitization and credit default swaps this was split, the transaction still being originated by the bank but the credit risk being sold on or the financing being off-loaded from the balance sheet through securitization.

Moral Hazard Too Big

However, this also makes it more complex to understand what credit risk ultimately resides with the bank (which requires solvency). The new products obviously implied new solvency rules. In line with this more specialization within the banks developed, between origination (relationship management), risk acceptance (risk management) and balance sheet management (financial control, ALCO, trading). As a result, the relationship manager sitting in front of the client is unlikely to know all relevant Basel rules by heart. But based on this incomplete knowledge he then comes up with a commercial proposition for the client. Being the client, getting a second opinion in that case does not really sound like bad advice.

With the promotion of strategic BRM to the level of compliance-item, the CFO has gained an additional responsibility. This is surely not just in the interest of the firm itself. This is also important for the society at large. Because better BRM precisely provides the necessary beef to Pillar 3 in the Basel Accord: market discipline. Socially and economically sustainable banking thus becomes an intrinsic part of doing socially sustainable business.

Solid BRM is highly relevant. In the words of Nout Wellink: "there are limits to what supervision can do. We cannot supervise everything even if we wanted to." Moreover, he is right in adding that more supervision and more rules also bring more moral hazard, which reduces the incentive for banks and clients to exercise sufficient prudent and socially responsible behavior. That the theme of market discipline is also embraced in the USA does not surprise. As Kevin Warsh, of the Federal Reserve Board says: "moral hazard in the financial system is higher than any of us should want to. We need a new financial system, where better rules and better supervision play important roles together with more market discipline".

A solid BRM policy will help catching two birds with one stone: first it will ensure companies have done the maximum to secure themselves in a sustainable way of good banking services at attractive terms and conditions and second, it will contribute to a healthier financial system at large.

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