

It's a New Ball Game

For many years, organizations and their banks looked at their relationship as a long-term commitment of mutual loyalty. However, this view of things no longer holds, due to a number of developments that I shall discuss in this book.

If you think the old rules still apply, you're sadly mistaken. Managing bank relations—the establishment, maintenance, and elimination of credit and non-credit services—is viewed differently today. This change applies across the board from small companies to large multinational corporations to not-for-profit organizations to governmental entities.

The influence of credit needs

In the past, it was convenient to think of the relationship as a partnership, although I never fully subscribed to this point of view. Many organizations found themselves with dozens of bank relationships or even more, if they had retail locations. It was natural for one or two banks to become the “leaders of the pack,” while the others played subordinate roles.

Customers frequently showed loyalty to the bank or banks that fulfilled their credit needs, and the credit relationship heavily

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influenced the choice of banks. Banks were focused on the revenue generated by credit activity, and this focus often dominated the bank's point of view.

Years ago, a strong credit need often dictated how a company looked at its banks. For instance, a company with sizable credit needs might spread the business among several banks to obtain the amount of credit it required. On the other hand, if one bank could fill that credit need, it could expect additional non-credit services as added business because credit needs were so valuable and non-credit needs were not considered separately.

Changes in bank use

As treasury managers began to recognize that their cash management needs were growing and that they could tap the commercial paper market for short-term credit needs, they started handling credit and non-credit services separately. They began to select the bank or banks that could provide the best non-credit services, independent of credit needs.

At the start of the 21st century, interest rates were at historically low levels, and this encouraged banks to focus on their profitable lines of business. This meant non-credit services, where the banks themselves could set and reset the prices. The thin spreads on credit services were not likely to provide revenues the way cash management (non-credit) services could.

In my original book on this subject, *Managing Bank Relations*, I talked a lot about lead banks and why banks coveted that spot. Being the lead bank usually translated into a substantial amount of business for the bank in terms of credit and non-credit services. The lead bank did whatever it took to keep its lead customers happy, matching other services as needed or solving a customer's special problems, such as moving funds to a difficult foreign site or arranging for emergency funding quickly. Although this arrangement created strong loyalties, it was also subject to market pressures.

As companies and the banking world underwent consolidation, both customers and banks began to reassess how bank services should be viewed. Banking was changing. With the growth of a handful of major banks through merger and new legislative

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freedom, the close relationship between customer and bank was being replaced by a more impersonal one.

From partner to service provider

Customers had long shed excessive compensating bank balances to fees for service charges, just as banks had shifted their focus from garnering balances to generating desirable fee-based income. As banks and companies focused on fees, they changed from partners to service providers and users. Banking service charges have risen sharply over the past decade, and the change-over to a service provider environment seems virtually complete.

As a result of changes in bank and customer attitudes toward banking services, bank relationship management has changed. It seems more appropriate for you to consider your bank as a critical service provider with whom you need to maintain a healthy buyer-seller relationship, similar to what develops between an organization and its other long-time suppliers.

You need to function in this regard as a purchasing manager because that is what you are—a purchasing manager for bank-provided services. Familiarity and closeness are still related to the provision of services, but they are not the common goal of two linked parties (as is the case in a partnership).

Overview

Managing bank relations is one of your most important responsibilities as a treasury manager. It is one of the most common responsibilities of all treasury managers, no matter what their title or executive level. It is often misunderstood or taken for granted. Nevertheless, if conducted properly and effectively, maintaining effective bank relations pays dividends for your company.

You may believe that strong bank relations are only important if your organization is a borrower. The last few years have shown that this is not the case.

While treasury managers have experienced a strong push from their bankers for non-credit services if credit services are needed, organizations that are primarily investors have felt similar pressure from their banks for more non-credit services. These companies have seen more attractive investment rates and

Compensation—Get It Right!

The least understood and most neglected aspect of managing bank relations is compensation. Yet bank compensation clearly is one of the most important considerations in your relationship with your bank.

In this chapter I discuss the forms of bank compensation and which approach is more feasible. I will review the primary form of compensation documentation—the bank account analysis statement. I also discuss the process of bank selection and why corporations make changes to their group of banks.

Underlying assumptions

Historically, banks have been flexible about compensation levels, but not about methods; compensating balances were the main method. In recent years, this has changed substantially. Today, customers are more likely to compensate their banks with fees than with collected balances. In fact, most customers actually use a combination of the two.

I will assume that you look like the typical organization and compensate your bank(s) monthly by a combination method—receiving an offset for the value of your balances against the total

bank charges and paying the remainder by fee. In the rare instances that your balances translate into a value that is higher than your total service charges, you should negotiate with your banks to carry over excess balance values for the next month or two. This carry-over should be negotiated before-hand, however. It is unrealistic to expect the bank to agree to such an arrangement on the spot.

Choosing the Best Compensation Method

In the past, when interest rates were low and did not change much from year to year, senior executives and industry analysts regarded cash in the organization's bank accounts as a good sign of liquidity and a convenient means of bank compensation. However, as interest rates became more volatile and increased substantially, this view changed. Cash could be put to work to become an earning asset, and it was not good to have it sit idly in the bank.

As a result, organizations have switched from using compensating balances exclusively. At first, treasury managers attempted to make a complete switch from balances to fees, but they soon recognized that this was often impossible to manage.

Fee compensation

Compensation by fee is usually less expensive because of two main factors:

- Banks assign value to average compensating balances through an earnings credit that is typically less than a comparable short-term corporate rate. This is because the general credit rate is based on a short-term money market rate, usually the 90-day U.S. Treasury bill rate. Most investors can beat this rate.
- The earnings credit rate is reduced by the reserve requirement banks are assessed by the Federal Reserve, currently 10% on demand deposits. Thus, even if the earnings credit rate were the same as the organization's short-term investment rate (e.g., assuming that the organization were investing in 90-day t-bills), compensation with balances would be less efficient. For example, an earnings credit rate of 6%, which is

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approximately .005 on a monthly basis, would only be worth 5.40% (6% times 90%; 100% minus the 10% reserve requirement), or .0045 on a monthly basis.

In the past, some banks have tried to charge a surcharge to companies that choose fee compensation (or a fee-balance combination). This was done to equate the two methods of compensation. However, in recent years, banks, especially the largest ones, are doing this less frequently. They have substituted “tiered” earnings credits to reflect average balances. For instance, a bank may use \$250,000 as a cut-off, so any business customer that maintains a balance below this threshold would receive a substantially lower rate than those whose balances were higher.

You may find such charges from banks for parts of your business when banks have different charges based on geographic location. You should try to negotiate standard rates and earnings credit rates with your banks to avoid these charges or lower rates.

Some organizations prefer to compensate with fees because they are explicit and offer tighter cost control. Others prefer balances because they are more flexible. In the past, such balances were sometimes referred to as the treasury manager’s shadow budget. This was because many treasury managers were able to purchase services and other bank products without showing them as regular corporate budget items. With fees, of course, this is usually not possible. Some organizations still maintain a portion of their compensation on a balance basis to have this budgetary flexibility.

Fee-balance combination

In reality, most organizations cannot eliminate all their balances and compensate their banks fully on a fee basis. Many banking transactions, especially deposits, generate balances. In addition, corporate disbursements cannot be so finely tuned as to eliminate some balance build-up in the bank. Consequently, organizations seek a compromise with their banks—a fee-balance combination.

Both sides agree that any collected balances generated in the company’s bank accounts will first be used to offset bank service charges. The shortfall (assuming that the balances were insufficient) is then made up by paying a fee.

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The major drawback to this system is that the balances offset fees at the bank's earnings credit rate (see discussion above), rather than at the customer's short-term investment or borrowing rate. The primary advantage, however, is that the treasury manager does not have to worry about small or accidental balance increases; these are put to use.

It would appear that both sides win with this approach. The organization can titrate its compensation, and, to the extent that it can reduce its balances, it realizes more of the benefits of fee compensation. From the bank's point of view, it receives full compensation regularly, usually monthly. For banks, this may be very attractive as it reduces the need to monitor balance level constantly.

Switch your mind set

Since you will most likely be paying for your service charges by the fee-balance combination discussed above, it is appropriate and advisable for you to focus on fees as much as possible. Of course, you should not ignore balances, but your goal should be to keep them to a minimum. You can do this by dealing with what I call "fee equivalents." By focusing on earnings allowances and fees paid, I think you get a better picture of your compensation. It is not too difficult to do this, but it may mean changing old habits.

Years ago, banks encouraged compensating balances and looked warily at fee payers. This attitude changed as both treasury managers and bankers came to understand the clarity and efficiency of fees. For treasury managers, bank costs are straightforward; for banks, the revenue flow from a customer is easy to measure.

However, if you look at most account analysis statements, you may be surprised to still see a reference to "required" compensating balances. In a section below I will deal with the numbers.

Navigating Your Account Analyses

The document that shows bank balance activity and itemizes monthly bank service charges is the bank account analysis statement. Treasury managers should receive an account analysis (in

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Thinking Like a Banker

In considering how to manage your bank relationships, it is important to understand how banks look at relationships. Banks are profit-making (or profit-seeking) institutions; they are not in business to lose money. Bank profits come from the loans they make, from returns on other investments, from spreads on financial transactions (e.g., foreign exchange) and from fees (or the equivalent in balances) from non-credit services, such as cash management. More progressive banks look at the total relationship with their customers, and that means that you should be aware of everything your organization does with your bank (or banks, if there is more than one).

I do not mean to imply that all bankers see their relationships this way, but the good ones do. In the past, banks could count on steady income from spreads on loans and other financial products. However, in times of low interest rates, they found these products were no longer providing adequate returns. As a result, banks placed more emphasis on fee-based income, which meant that cash management and other similar services were counted on to pick up the revenue slack. Banks also found that fee-based services, which include cash management services,

offer a far greater return to the bank than loans or other transactions.

As a result, bankers have changed their approach in many cases, now requiring some level of fee-based services for providing short-term credit facilities (e.g., a line of credit). This switch can create problems for you if you want to keep your cash management business concentrated in one bank but need more than one bank for your credit needs. In such cases, you may have to split up your business to get what you want. You may be able to split up your business so that one bank still remains your main bank, while the other bank (or banks) receives a narrow group of services, such as local or lockbox deposit services.

Profitability Items

As we might expect, typical returns for different types of bank services vary widely. These differences have become evident to banks as they evaluate individual product lines and attempt to tap into those services that have higher revenue and profitability potential. While the returns may be higher for many fee-based types of services, it is important to keep in mind the scale of the returns. By far the largest amount of revenue should come from loans, while the returns from the other types are higher relatively but smaller in absolute terms.

Fee-based services, such as cash management services, foreign exchange, and swaps transactions can provide the greatest rate of return. The return on loans depends on the type of borrower. For example, banks can obtain a higher rate of return from smaller companies (i.e., middle market) than from large company borrowings. This is due to the competitive nature of these loans—large companies have other competitive alternatives like commercial paper, while smaller companies have far less choice. Competitive shopping by larger borrowers may reduce the customer loyalty banks show to them compared to how they treat smaller borrowers. This is shown in the Phoenix-Hecht Blue Book of Bank Prices for 2002-2003 report, which found that almost 40% of large corporations reported that they had credit commitments reduced by their banks, while only 15% of smaller companies did.

This helps explain why so many banks have been concentrating their calling efforts on the middle market segment. Banks

Measuring Performance

In any working relationship, it is appropriate to agree on some level of performance measurement. This is especially true in corporate-bank relationships because the relationship is founded on service. Measuring the quality of bank services can be too subjective if the proper framework for performance is not established. Furthermore, evaluating the bank's financial stability is another part of a treasury manager's responsibilities. In this chapter, I discuss approaches to performance measurement and present some alternatives.

Operating performance

In a very basic sense, you could use the satisfaction levels of company personnel who deal with the bank to measure the quality of the bank's performance. This does not help you, however, in managing bank relations because it is not sufficiently objective or quantitative.

Using bank measures

One way to establish appropriate benchmarks is to use what the service providers—the banks—use internally. With some ad-

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aptations, bank measures may be a tool you can use. However, this may not work effectively because the bank's standards are not customer-oriented; they are oriented toward measuring bank employee performance.

In the past, many banks held customer "round tables" to review how well the bank was performing and to inform the bank's customers on bank quality improvements. Many of these programs seem to have been put on the shelf, so obtaining service quality information may be difficult.

Developing measures

Performance measurement is becoming more commonplace in treasury. Measures can be quantitative and/or qualitative, and the data to develop the measure have to be readily available. Also, the frequency of measurement—ongoing vs. one-time—must be agreed upon.

To establish a proper framework, you, your staff, and your bankers should work out appropriate performance measures and how they will be applied. This usually entails developing operating benchmarks derived from some unit of activity, such as an item (check, wire transfer) processed or deposited, or an action, such as notification of controlled disbursement clearings, lockbox concentration call, or a bank information report.

Figure 6-1 shows some typical performance measures for treasury management activities. These are examples of standards that can be used internally or externally (i.e., with your banks) as benchmarks for measuring each of the activities shown. Of course, you should use this as a starting point and customize the standards to your need.

In applying standards to measure performance, you should be sure to maintain an objective perspective and to measure activities in the long term, not in the short term. Also, it may not be realistic to beat the benchmark; maintaining performance within tolerances, such as $\pm 5\%$ may be perfectly acceptable. The keys to making an operating performance measurement system work are the acceptance of the benchmarks by both sides, objective collection of the data and periodic review of the performance results.

Measuring Performance

Figure 6-1: Performance measurement standards

<u>Activity</u>	<u>Standard</u>
Short-term investing	Short-term money market rate, such as 90-day US Treasury bill or comparable instrument for each overseas market, obtained from standard source routinely
Short-term borrowing	Short-term bank rate (matched by maturity), Federal Reserve composite rate available from NY Fed, or standard rates (from banks) for overseas locations
FX trades	Use standard daily rates from independent source, such as Reuters, major trading bank, interbank rate, Wall Street Journal, et al.
FX exposure management	Gain or loss vs. plan, or create hypothetical result from 100% unhedged position
Cash management studies	Improvement in bank balances freed up, valued at company's cost of capital on annual basis, fees reduced by implementing study, overseas: reduced bank credit line usage, etc. (Might depend on consultant's estimate)
Bank compensation	Excess balances not utilized, or average fees vs. plan or vs. historical average
Risk management	Gain or loss vs. plan, or create hypothetical result from 100% unhedged position