Basel III and Bank Relationship Management

Basel III imposes major new requirements for bank balance sheets that will have a significant effect on the cost and availability of credit and treasury services. This has been discussed in general in our first article on the subject[1] and in relationship to notional pooling in our second[2]. Banks are changing their business plans, marketing strategies and pricing as they work through the impact of Basel III. Corporates that plan to stay in charge of their banking relationships will also need to take action. The question addressed by this article is: What is a good way of doing so?

Two complementary approaches may offer the best answer to this question. The first is to maintain good two-way communications. Earlier articles have suggested a number of questions that corporates should be asking members of their banking groups. The communication should not end there. Do banks understand your general treasury management strategy and where they fit into the overall scheme? Are you planning any tactical changes in cash concentration or liquidity management as a result of Basel III? Tell them, it may save you some money or generate a few suggestions on how to do so.

The second is data driven and objective and it is to know the value of your relationship to the bank. RAROC—Risk Adjusted Return on Capital—is a tool that banks and regulators have been using for many years in evaluating a given bank's book of business. This is convenient because as banks reallocate or change capital structures in response to Basel III they have a rational basis for their decisions. We believe that RAROC can also be a valuable tool for corporates—for the same reasons.

RAROC got its start in the 1970's when a major US bank used it as a tool to measure the risk in its business portfolio. While the initial focus was on lending relationships, RAROC quickly became a tool used to value operating service business and eventually became the metric that

1 See Basel III at **http://www.treasuryalliance.com/assets/publications/cash/Basel_III.pdf**

2 See Basel III—Pooling at **http://www.treasuryalliance.com/assets/publications/cash/Basel_III_Pooling.pdf**

many banks used to measure relationship profitability across all lines of business. As banks continue to work on maximizing the value of increasingly limited capital resources RAROC remains a key tool of choice.

Since banks are probably using some form of RAROC to assess the value of corporate relationships, it would seem logical that their corporate clients should use the same metric. This is a good idea in concept that becomes more difficult to apply in practice. While the basic formula for RAROC is simple (risk-adjusted return divided by the risk-adjusted capital needed to generate that return), the various elements that make up the calculation are subject to some interpretation and will probably vary from bank to bank. So the challenge for corporates trying to replicate the analysis is to make reasonable estimates that will most closely approximate those used by their various banks.

An example of the challenge is the credit rating of the client company. Each bank uses a mix of custom tools, bond ratings and other credit ratings in its underwriting decisions. Corporates do not have access to the specifics but can make reasonable estimates. Another example is that default and loss ratios are specific to each bank. But once again there are national averages that can be used as reasonable proxies. Assumptions will have to be made for other factors such as spread on investments, spread on FX and ratio requirements for credit. To complete the analysis add or delete the appropriate assumptions for the factors that comprise the relationship with each bank. These estimates may contain flaws but will be consistent across the model and can be validated and changed as necessary. A good RAROC model will actually allow you to do sensitivity analysis on each variable. An external advisor may be helpful in the process having gone through the exercise a number of times already.

It is fair and important to ask if a company can effectively reverse engineer the process and create a RAROC calculation that is anywhere near any given bank's actual calculation. The answers are yes, no and close enough. While a corporate version of RAROC will not be identical to a bank's specific calculations, it will be directionally correct. In other words it can effectively be used to help analyze the relative value the company is providing to each of its banks. If Bank A has a RAROC that is 500 basis points higher than Bank B with a similar absolute level of spending there is an imbalance that both banks are likely going to be able to identify. And Bank B is not going to be happy.

But go back to the other key element of good relationship management, communication. Even a less than perfect RAROC analysis becomes an excellent communication tool in discussions with the banks. When Bank C complains that it is not getting enough return from the relationship, a well-prepared treasurer can respond by sharing the results of the RAROC calculations to refute this complaint and ask the bank to explain where and how they are incorrect. In some cases, the bank may not have factored in all elements of the relationship such as M&A, trade finance, or card services. In others, the company may not have been fair in allocating business which is never a good idea over the long term. In our work we have seen both types of errors and in one case the bank had made a basic underwriting mistake. Had the company not asked the questions, the bank might have walked away from a profitable relationship under the impression that it was not in fact a valuable one.

RAROC by itself is not the complete solution to managing banking relationships. Other measures such as share of wallet or the percentage of available business that a company provides to any given bank are also important. Bank D may have a very high RAROC, but a very small piece of the available business. While the business is profitable, it may not be enough to maintain a long-term relationship as Basel III tends to incent banks to focus on larger relationships. Calculating the RAROC and share of wallet and adding them to a more traditional bank report card creates a powerful tool that can be used in managing bank relationships.

Bank relationship management has been around a long time. Basel III will force treasury professionals to up their game and two-way communications in concert with RAROC are excellent tools in this arsenal.

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