SIR ISAAC NEWTON ON RELATIONSHIP LENDING

by Steve Brown

Sir Isaac Newton's law of reciprocal actions is commonly paraphrased as, "For every action there is an equal, but opposite reaction." In banking we often see this played out in commercial lending.

Some lenders will persistently react to borrowers while others make their borrowers react to them. Truly exceptional lenders preempt the borrower's decision-making process. For, example, the last place a lender wants to be is in a competitive bidding situation. In that case, the borrower is forcing multiple banks to react to a request for a financing proposal. In that situation, no bank, including the winning bank, achieves above industry returns. By the time the borrower has decided that they need financing; the structure of the financing and which banks to approach for a proposal; there is little room left for negotiation or additional profit.

Take another example of a borrower approaching a banker for a loan. In this example, the banker may have avoided a competing bid, but the banker has still lost much of their negotiating power. That is because the banker has not created full value for the borrower. Instead, the borrower has already decided that a financing situation exists and that bank debt makes the most sense, so alternatives are not as welcome.

A relationship banker is one that approaches a borrower before they are aware that a potential financing situation exists. These bankers propose a solution for the borrower. The problem with relationship banking is that it also requires more work, since solutions can only be found if the banker understands the customer's business, liquidity situation, expansion opportunities, or acquisition prospects. In this case, the banker earns a premium for services rendered, because the banker acts as a consultant (solving problems, identifying opportunities or adding resources to the borrower's business). In short, the banker is part of the borrower's business. The most common trap many bankers fall into is when they make the mistake of assuming relationship banking means a legacy of business between borrower and lender.

It is true that every borrower can distinguish a 7.00% fixed rate from an 8.00% fixed rate and will be motivated to choose the former. However, rate becomes less important when the loan comes with ancillary services in the form of an insightful consulting banker that is helpful to the customer's business.

Newton must have been on to something, because his 3rd law is applicable to existing loans. Community banks with term loans that do not include prepayment protection are acting as a force to put unforeseen things into motion. There are countless situations where borrowers paying higher floating rate pricing (i.e. Prime+) are approached with term sheets from competing banks offering 10Y, 7.00% fixed rate loans. By the point the current bank becomes aware of the issue it is left with only two choices: match the terms and pricing or lose the customer for 10Ys. However, if that bank preempts the borrower and exercises force first (by approaching the client before the competition does); they may be able to lock in a new loan at a 7.75% fixed rate (and retain the customer for the next 10Ys). Sure, the bank is giving up current net interest margin, but retaining a high credit quality customer for 10Ys (think of the cross-sell opportunities) can generate much more profit than losing that customer entirely.

The best lenders are those that generate the highest risk-adjusted returns for the bank. They have a profound understanding of the borrower's business, the local economy and industry trends. These lenders continually present financing opportunities to customers before clients have the time to create an RFP. Best lenders also sell their services as part of a loan package. The capital required to make a loan is a commodity, but the lending expertise tied to that loan is unique and when used properly, should command above-market returns.

BANK NEWS

Flu Pandemic

The new Homeland Security study finds that productivity dramatically decreases in the workplace once more than 40% of a company starts to telecommute. Banks should consider the risk that some core functions could not be achieved if high

Remote Deposit Capture

Studies find banks need only have 10% of their commercial clients adopt RDC for it to achieve an acceptable ROI. Client adoption is also running very high, with commercial customers saying they particularly like the increased convenience, earlier funds availability, efficiency and productivity improvements it provides.

New ATM

Select-a-Branch has come out with an ATM set up that allows for the branding from multiple banks. The ATMs do not carry any logos on the exterior, but when customers put their cards into the machines; their bank's logo and brand appear. Banks pay a $2 per transaction fee for usage.