Level the paying field

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Illustration : Brian Cronin

Too many businesses don't manage their banking costs and don't take time to prepare their fee negotiation case. what they need is a strategy

Don Smith, the CFO of a mid-market Canadian company, returned from a meeting with the company's bankers with good news. He had negotiated a much-needed credit line and got the bank to ease the covenants. But this wasn't nearly enough for the new CEO, Lynn Jones, who was new to banking negotiations. To her, they started with credit lines and covenants, but didn't end there. Banking arrangements had cost consequences and Jones wanted them managed.

Jones' questions about bank pricing were pointed. "How do you know the fees we're being quoted are competitive?" she asked. "Our base pricing was set years ago when the company was smaller and not nearly as profitable. Given our current results and volumes, shouldn't we be looking at price rollbacks and reductions?" The questions tumbled out. "If we reset our base line pricing, we're looking at a multiyear return. Why don't we classify bank-cost savings as a shareholder value opportunity? Zero-basing bank pricing is worth at least 10 times as much as the one-year savings." The more she thought about bank pricing, the tougher the questions became. "Banks are suppliers," she continued, "why do we treat them differently? You insist that we tender most of our contracts. Most of those tenders include target pricing. What's so special about the bank? We're in good financial shape. Why aren't we tendering our banking arrangements?"

Smith sighed. It's not that he hadn't thought of these questions; what he needed were answers.

Smith and Jones may be pseudonyms, but their circumstance is commonplace: many businesses don't manage their banking costs and too few CFOs take the time to prepare their fee-negotiation case. When it comes to bank pricing, most companies reap what they sow. Banking costs should be managed because, in most cases, they are an untapped source of value. To unlock these savings, you need a strategy and a tool. The strategy is principled negotiating; the tool, benchmarking.

Banks' negotiating edge
Companies pay many bank fees. Typical banking renewal agreements cover credit facility pricing, operating line fees, current account service charges, cash management fees, interest compensation arrangements and credit/debit card discounts. When the time comes to negotiate banking costs, the sheer number of costs that need to be dealt with is daunting.

Banks bargain from strength. When they sit across from their corporate counterparts, they have been dealt face cards. They enjoy structural advantages that tilt the negotiating table in their favour.

For starters, banks are shielded from pricing pressures that are commonplace in other supplier relationships. Companies that tender their banking relationship are the exception, not the rule. When they do tender, they seldom include target pricing — an accepted practice in most other contract reviews. With little threat of nose-to-nose competition, bankers are insulated from price rivalry.

Also, banks are masters when it comes to bundling. They know fees are rarely a deal breaker in credit negotiations. Fees and service charges are marketed as part of the cost of obtaining credit, and financial executives and their advisers — be they chartered accountants or lawyers — seldom call the banks on this practice. Bundling establishes ground rules that give the banks another leg up at the negotiating table.

If structure and process advantages weren't enough, the banks have a third ace up their sleeve: they operate in an industry where switching costs are an issue. At best, banking arrangements are inconvenient to unravel. Few companies believe borrowing-cost and bank-fee-cost savings justify the aggravation of a banking change. This inertia favours the status quo, and tilts the negotiating table even further.

Another advantage is motivation and expertise. Borrowing costs and service fees are an important component in banks' profit models, therefore they take renewal negotiations seriously. They know a company's credit needs and limits. They know the competition — yours and theirs. They know the deals on the street and they are masters at balancing returns over a broad range of products and services. Many companies have the knowledge to negotiate favourable terms in one area, but few are savvy enough to avoid paying the piper in another. When it comes to negotiating their compensation package, bankers get it.

The final advantage comes from an unexpected source — the banks' customers. Simply put, managing banking costs is not a priority for most companies. Corporate banking concerns typically begin and end with credit availability. Banks benefit from this myopia. In many companies, banking fees are an unmanaged cost; in many negotiations, the banks prevail by default.

Managing banking costs

So, why don't financial executives pay more attention to banking costs? Part of the reason is training. Finance courses and accounting professional development programs don't address the topic. While there are numerous studies on retail bank pricing, little has been written on how banks price their commercial products and services. Managing bank pricing is learned at the negotiating table. Financial executives who consider themselves banking specialists are self taught. For the most part, they are graduates of the school of hard knocks, that is, they have learnt by doing — a painstaking and protracted process.

Quality negotiating experience is hard to come by. Many CFOs get initial banking experience in smaller companies. For them, bank pricing is neither an area of expertise nor a priority. They are hired to impose financial discipline on unruly operations. Moreover, the CFO often isn't the lead negotiator. Where banking is seen to have great strategic importance, the CEO or owner frequently handles this responsibility directly. In many cases this is a less than desirable learning opportunity. Too often the apprentice is better equipped to handle negotiations than the master.

Negotiating experiences in small and medium-sized companies often lack depth. Usually current account service fees are the only substantive pricing issue that gets tabled, which shouldn't come as a surprise. Current account pricing is an easily understood concept. It represents a service where internal bank costs are not increasing and is one section in the banking agreement where it's easy to draw a line in the sand.

Current account service fees are a visible bank pricing issue. However, contrary to popular belief, they aren't a bellwether cost. There's no evidence to suggest that service fee pricing sets a pattern for price increases in other areas. In most cases, they aren't even a major component in a bank's overall compensation package. For many small companies, haggling about current account service fees is a convenient and acceptable way to avoid substantive negotiations about real pricing issues. Fee negotiations that start and stop with current account service fees almost always benefit the bank.

The final reason that many CEOs lack expertise in managing bank pricing is organizational. Many CFOs cut their teeth in Canadian companies that are subsidiaries of US corporations, where treasury is a head-office function. In these companies, Canadian banking arrangements are a small part of a much larger financial picture. To US finance professionals, Canadian banking practices are unfamiliar. Typically these managers lack the time and expertise to give subsidiary banking arrangements their due. Managing Canadian bank pricing is not their priority and gets lost in the shuffle.

Expectations and yardsticks

In spite of these disadvantages, some companies routinely pay less than their competitors for bank services. What's their secret? For starters, their CFOs have made learning how to manage bank pricing part of their professional skill set. Second, CFOs who are adept at managing bank pricing have realistic expectations about their banking relationship. In their world, banks are businesses like any other and bankers are neither scoundrels nor villains. They understand that, when it comes to bank pricing, you get what you deserve and you deserve what you negotiate. They are proactive about representing their company's interests.

CFOs who successfully manage bank pricing have realistic expectations at the negotiating table. They know price is an important profit driver for banks. They understand that price leakage dampens bank earnings and that small price increases have a multiplier effect on bank returns. On the retail side, for example, they point to a recent Boston Consulting Group study that reports if banks increased prices by just 1%, with volume and costs remaining constant, return on equity would increase 6.8%. By contrast, a 1% increase in volume or a 1% decrease in costs would only raise return on equity by 1.8% and 2.3%, respectively. These CFOs recognize that price leverage in commercial banking is no less potent and, like retail pricing, potentially cuts both ways. They understand that for bankers, pricing is a key negotiating deliverable. They nod when McKinsey & Company calls pricing “the fastest and most effective way for companies to grow profits.” These CFOs expect bankers to push the price envelope in fee negotiations.

CFOs who actively manage bank pricing know bank pricing is as important for companies as it is for banks, though for a different reason. In most bank negotiations, the payback for managing bank pricing isn’t a one-time cost saving. Up-to-date bank pricing establishes a base line for future increases and sets up multiyear returns. The result may not quite be an annuity, but it is close.

Bank-cost savings are generally assumed to have a 10-times multiplier effect on shareholder value. A ,000 cost saving opportunity that yields a $500,000 shareholder value increase is an opportunity of substance. The shareholder value yardstick gives bank pricing much needed visibility and highlights the real cost of letting fee negotiations slide.

CFOs in the know understand the role information plays in banking negotiations. They recognize that in any negotiation it’s not unusual for one party to be better informed than another. Economists call this condition information asymmetry. They recognize that for banks the information gap is the ultimate source of competitive advantage. They understand that companies negotiating bank fees normally don’t have access to comparative pricing information. They know that relying on reasonableness tests and personal experience to validate bank pricing limits their options at the negotiating table.

“Banks charge fees for a broad range of products and services,” says one CFO. “Understanding which items have significant cost saving potential, which items need to be priced as a group and which items are negotiating giveaways is no simple task. Sometimes the savings that accrue in bank fee negotiations are small and accumulate across a range of bank services. Sometimes material cost savings are concentrated in specific areas. Saving money in bank fee negotiations can be a game of base hits or home runs.”

CFOs adept at capturing bank cost savings admit that when negotiating with banks, they need help. To level the playing field they search out comparative pricing information and look to negotiating strategies that neutralize the structural advantages that the banks enjoy in fee negotiations.

Levelling the playing field

CFOs in the know understand that the secret to unlocking borrowing cost and service fee cost savings is principled negotiating. And benchmarking is the tool that gives this strategy its resilience in bank negotiations.

Principled negotiating, as it applies to the negotiation of banking agreements, is a hybrid negotiating strategy. It doesn’t view negotiations as a collaborative process where interests meet; it doesn’t advocate soft bargaining or worry whether banking agreements enlarge the pie. Principled negotiating says bank negotiations are win-lose affairs. It recognizes that they are, at heart, exercises in claiming value.

When it comes to claiming value, banks have fared well. They have intelligent pricing strategies. When it comes to setting prices, banks have long held the upper hand. Size, limited price competition, structural advantages and information asymmetry have worked to their advantage. At worst, they’ve forced customers to be price takers. At best they have allowed compromise or splitting-the-difference strategies.

Principled negotiating recognizes that this is neither a desirable nor healthy state of affairs. As a strategy, principled negotiating steps outside the “win as much as you can” box. It introduces the notion of fairness into the equation. In principled negotiations, banks are still free to set prices to generate satisfactory returns; however, this doesn’t give them licence to put their customers at a disadvantage. Principled negotiating says banking pricing is only equitable if it meets an independent fairness standard. For the banks’ customers, this means pricing consistency. A company should expect the same pricing the bank offers its strategic peers.

Principled negotiating offers three important benefits to banks and their customers. First, it encourages both parties to set realistic expectations about what they’re entitled to. Principled negotiating is hard on merits and soft on posturing. Second, by insisting that negotiations reference an independent fairness standard, it protects both parties from being taken advantage of. Finally, it respects the banking relationship. Principled negotiating holds out the prospect of a tradition of fair dealing. If realized, this is an extraordinary asset. It’s one that creates ties that bind. It’s one that gives substance to banks’ claims that customers are their partners.

Benchmarking is the agent that makes principled negotiating work. It lets banks and their customers meet the fairness test. It decides pricing disagreements by referencing a standard that is independent of the negotiating strength of either party. Benchmarking also gives the strategy of principled negotiation its transparency. With benchmarking, both parties know when pricing is equitable and when it’s not; both parties know what each is due.

Borrowing cost and service fee cost savings
In Canada, principled negotiating is not the norm for banking negotiations. As a result, many firms have unrealized cost-saving opportunities locked in their banking arrangements. What savings can they expect to realize by using benchmarking in bank fee negotiations? Consider two examples.

Medium-sized companies and large corporations use bankers acceptances (BA) to fund a portion of their working capital financing. BAs have an absolute price advantage when compared with operating line pricing. Benchmarking is the best way to determine whether a proffered standard stamping fee is, in fact, standard. Benchmarking is also the best way to determine whether the relationship between operating line pricing and BA stamping fee is properly integrated. Stamping fees can be set so that the gap between BA pricing and operating line pricing is narrower than it should be. This is a form of premium pricing that give banks the advantage and customers the disadvantage.

Savings that accrue to companies that get pricing right on instruments like BAs add up. A 20-basis-point stamping fee difference translates into a $10,000 cost saving for a company that has a $10-million operating line and uses BAs to fund 50% of this requirement. Benchmarking is the best way to determine whether the relationship between operating line pricing and BA stamping fees tallies and whether a company's stamping fee is competitively priced.

The second example is foreign exchange (FX). Transparency in FX pricing is notable by its absence. Banks, as a rule, don't offer fixed markup FX pricing and they don't disclose margins. It's a business where information asymmetry reigns supreme. FX markups vary by institution, transaction size and volume. Many companies report that they trade at spot and assume this represents good pricing. It doesn't. Spot is a settlement convention that says nothing about the spread over the interbank rate that a company is charged.

FX pricing is difficult to manage. Most companies don't shop their FX business. Unless you have negotiated an FX line with a secondary bank, it's tough to get competitive quotes to validate lead bank pricing. Some companies use Internet currency converters to estimate bank wholesale prices and then manually compute markups hidden in settlement pricing and make FX purchase/buy decisions based on the reasonableness of margins being charged. The problem with this approach is it only tells you if your pricing is consistent, not if you're getting the right deal.

Companies that purchase or sell FX exclusively on lead bank Internet sites have the least flexibility. In the Internet world, FX is an anomaly. Conventional wisdom says the growth of the Internet should drive FX prices down. This hasn't happened. For the banks, Internet-based FX trading offers the best of all worlds — an efficient cost structure and better price management tools. Banks use algorithms in their trading programs that match markups to customer price sensitivity. The more your company acts as a price taker, the more you'll experience price creep. Because markups are hidden, a surprising number of companies unwittingly accept premium pricing in exchange for channel convenience. The cumulative effect of information asymmetry on FX price levels is substantial.

FX markups should begin at 25 basis points for $100,000 transactions and drop to 5 basis points on transactions of $1 million or more. Companies that don't buy and sell at these rates pay a premium every FX transaction. A 25-basis-point premium on a $10-million FX represents a $25,000 cost saving and a $250,000 shareholder value opportunity. For many companies, getting FX pricing right is easy money.

Benchmarking: creating winners and winners
Benchmarking presents new opportunities to stakeholders in bank fee negotiations.

The banks
At first glance, banks have much to lose. Where they have leveraged their advantaged position into premium pricing, savings that result from benchmarking will accrue to their customers. Given the multiplier effect that pricing has on bank returns, this is problematic. No bank wants to see profit erosion. At the same time, no bank wants to shore up results by disadvantaging its customers. Margin shortfalls may be a transition cost associated with the growth of benchmarking.

Problematic or not, pricing adjustments are a short-term issue. Long term, benchmarking will make the banks winners too. Benchmarking data will enable them to publicly justify their pricing policies — an important consideration in a regulated industry that's concentrated and reporting record profits. It will also remove much of the grumbling that's part of conventional fee negotiations. This can only strengthen the relationship between banks and their corporate customers.

Benchmarking has the potential to change how banks sell. When they are pitching to new customers, benchmarking data provides a more compelling rationale for switching. For years investment dealers have used the results of the Brendan Wood International, an investment industry consultant firm, or Euromoney magazine surveys to promote their organizations. Benchmarking data opens the same door for Canadian banks. Whether it is borrowing costs, FX, cash management fees, or overall client satisfaction, being able to say "we're No. 1" is a powerful marketing statement.

CA firms

Benchmarking has a similar yin and yang quality for CA firms. Credit negotiations are an important value added service for CA firms with mid-market clients. With benchmarking, they have the opportunity to add price to their service offering. CAs can help their clients secure that all-important line and negotiate more competitive rates. This is a potent combination.

For CAs charged with new business development, benchmarking is a powerful sales tool. Finding unrealized cost savings in a prospective client's banking arrangements is a door opener. Making sure these shortcomings trigger "make good" demands is a time-honoured sales tactic. Firms that ignore bank pricing will ultimately face an unpalatable situation — respond to client demands for compensation or risk losing them. Over time client expectations about bank pricing will come to mirror expectations about tax services.

What's the bottom line for CA firms? If your priority is client retention, benchmarking is a prudent defensive strategy. If you're working the business development beat, benchmarking will be a tool that differentiates you from less proactive peers. In public accounting, like any other business, either you're good or you're gone.

Companies

What about corporations and their CFOs? Benchmarking data will let corporations see the banking deal they are due. First-quartile companies that have size and attractive credit profiles will use benchmarking data to leverage the best pricing available. Firms on the cusp will use benchmarking to negotiate price concessions that are contingent on performance. As the banks' pricing hegemony starts to fray, more companies will look for better prices from their banks. Cost reduction consultants will force the issue in many firms. For them bank pricing anomalies are easy pickings.

For CFOs benchmarking is more than just a tool that delivers cost savings. It will establish expectations about the bank pricing they're expected to deliver. It will be proof that the negotiating team didn't leave money on the table. It will demonstrate that the banks are held to the same standard as other suppliers. Where necessary, it will justify change when change is needed.

The final word

Principled negotiating and benchmarking will deliver a better banking deal, more efficiently, than any other negotiating strategy. This much is clear today.

What's not so clear is how quickly this new approach will impact bank pricing practices. For most companies, sooner is better than later. If your company is paying a premium for its lending facility and banking services, the shareholder-value yardstick says benchmarking will deliver substantially more than one-time bank fee cost savings. When it comes to bank pricing, financial executives who can't deliver a properly priced banking deal will have some, as Desi Arnaz said, "splainin" to do.

For CA firms, sooner is also better than later. If benchmarking says bank pricing is right, there is one less loyalty issue to worry about. As for the banks, the last thing they want is the corporate equivalent of Ing Direct's Save Your Money campaign or Capital One's Hands in Your Pocket ads. Benchmarking will let them show that concentration in Canadian banking and competitive pricing are compatible, that profits don't come at the customers' expense.

Long-term principled negotiating and benchmarking will be a win-win for corporations, banks and advisers. If you're a financial executive who works the banking interface either as a banker, CA or CFO, your short-term choice is clear. Will you ride this new wave or swim with the fish?

Six simple steps to competitive banking arrangements

Negotiating competitive banking arrangements takes patience and preparation. Here are six steps to make your next renewal negotiation more productive:

1. Start with the big picture. Before you sit down at the negotiating table make the time to figure out what it takes to negotiate successfully. Understand why the negotiating table is tilted in the banks' favour. Understand why haggling over proposed price increases is neither an efficient nor effective bargaining strategy. Understand why principled negotiating and benchmarking is your best bet for delivering competitively priced banking arrangements.

2. Set the stage. Bank negotiations shouldn't start when the bank delivers a draft term sheet. Communicate pricing expectations and your rationale for these requirements well in advance. Once the term sheet is finalized, the die is cast. Term sheets should represent the outcome of ongoing negotiations, not the opening gambit.

3. Do your homework. Banks are not obligated to give your company best of class pricing. Your company is entitled to what you negotiate — nothing more and nothing less. To prepare your negotiating position, you need bench-marking information to validate pricing expectations. Do your homework. Support your negotiating demands with benchmarking data. Banks expect and will respect nothing less. Successful negotiations start with a prepared negotiating case. Benchmarking and competitive pricing are different ends of the same moustache.

4. Be prepared to negotiate. Bank negotiations are just that — negotiations. Know where you have leverage. Understand that posturing is part of the game. Expect and be prepared to respond to an initial no. Know what you're prepared to give up to get concessions that matter. Recognize that only exceptional results merit exceptional banking agreements. Banks rarely think a company's performance is as good or sustainable as its executives. Be reasonable.

5. Use common sense. Not all bank services contribute equally to overall bank costs. Not all services are equally important in the banking mix. Concentrate on pricing the big ticket items properly. Where there is a genuine dispute over the link between pricing and performance, invent solutions for mutual gain. Tiered pricing, for example, is an excellent way to address a price/performance impasse. Make sure the bank's proposal includes all instruments and services needed to minimize your banking costs. Errors of omission are a fact of life in banking agreements. Ask the right questions — all of them.

6. Know your bottom line. No negotiating method guaranteessuccess. Principled negotiating and benchmarking is not a silver bullet. Understand when you have negotiating leverage and when it's best to fly below the radar. Know when to zip it and make do, and when to quietly seek alternatives. Know your bottom line and plan accordingly.

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