

Competitors and clients: The paradox of inter-bank relationships

By Jonathan Shih, UBS AG

When banks interact, they do so often as competitors but also often as clients of one another. Prima facie this is a paradox that has become ever more marked in recent years, driven by economies of scale and scope¹, both of which are exacerbated by a global dimension that is difficult for banks to avoid. With competition as a given, these economic drivers are helping to dispel the paradox, as banks respond by extending the scale and the scope of relationships that they have with each other. The implications are profound.

THE EVOLUTION IN INTER-BANK RELATIONSHIPS

For many years, banks have worked together to address banking industry challenges. The creation of SWIFT over 30 years ago provides a good example of how banks co-operated to create a secure messaging system, which effectively allowed the industry as a whole to take advantage of network effects. Positive network effects occur when more users join a network because as they do so, mutual access to fellow users normally increases.

If a bank is considered to be a financial intermediary, a client's ability to access a number of banks via one bank, in order to spread risk through syndicated transactions, is also helpful and a long-standing practice in finance. Furthermore, if a bank transacts many payments overseas, it normally requires an account to be opened with another bank in the recipient country, which effectively ensures that the payment reaches its destination. Historically, trade finance was an important reason for maintaining such clearing accounts in various countries, and so-called "correspondent banking" relationships were the result.

These are just a few examples of traditional areas where banks work together to benefit their clients. However, in today's banking arena, inter-bank relationships have evolved to include many more products and services. There is both a demand-side and supply-side explanation for this.

MARKET DEMAND AND SUPPLY

In markets which exhibit "commoditisation" of some products on the one hand and exotically specialised products on the other, banks are

faced with the challenge of remaining responsive to clients' demands. They assess which products and services they need to supply to their clients and those that, as a consequence, they may need to demand from other providers, if they lack the capability to supply these on their own at competitive prices and quality. Effectively, banks are deciding whether or not to outsource or conversely "insource" certain activities, and increasingly seeking to establish a healthy balance between the two.

On the supply-side, some banks are seeking to leverage trading infrastructure and dilute substantial fixed costs by offering access to their trading platforms and products. On the demand-side, other banks may not have the appetite to invest in the independent infrastructure that is required to access all necessary global markets, or to acquire the knowledge necessary for providing exotic products. They may also prefer to adopt cost structures that are more variable than fixed in nature and look to outsourcing as a solution.

The impetus for demand to meet supply is clear, and this conjunction can be both "passive" and "active": passive when banks decide, as a coincidence of products and services which they already produce for clients, to offer them to other banks; active when banks consider what banks as a specific client segment are demanding, and effectively respond by creating supply to fulfil this demand. Certain banks may even attempt to become banks that serve other banks as an integral part of their daily business.

THE INTERSECTION OF DEMAND AND SUPPLY – RELATIONSHIP IS CRITICAL

As a result, banking relationships are arguably becoming ever more critical. Indeed, one way to look at relationship is as a means of ensuring that demand and supply are satisfied in the market.

It could be said that the relationship between two banks exists irrespective of individuals. However, people are undeniably important and, as bank relationships evolve, more people in more banks will be talking to each other as product specialists. This requires facilitation to ensure that the right people are talking both intra and inter-bank; rarely can products operate in isolation in a bank and rarely do banks

mirror each other in organisational structure. Furthermore, in order to ensure that problems, which could potentially sour the entire relationship, are dealt with quickly and to the mutual satisfaction of both banks concerned, a "troubleshooting" competence is important.

To this end, most banks maintain a strong relationship function that has been in place for many years, often stemming from traditional correspondent banking relationships. One of the function's roles is to thoroughly understand client banks, identify business opportunities and access gatekeepers and decision-makers with the ultimate aim being to sell. Of course, a single sale is not the aim of a relationship which should transcend each individual client interaction. That is a sell-side perspective but there is also a buy-side role for the relationship function when it is approached by another bank. Even more significant, a relationship that has been built over many years enjoys a high level of understanding and trust, and the relationship function is intended to encapsulate these qualities. As banking relationships become more complex, a high quality relationship function will increasingly become a necessity that can provide banks with a competitive advantage, as they try to occupy the ground that lies at the intersection between supply and demand.

Ideally, a relationship is holistic such that when a bank makes a promise to a client, it must be understood to be speaking with one voice. Accordingly, the more senior the voice, often the more appreciated and respected it is. Hence, periodic board member to board member dialogue can be very helpful in supporting the "operational" day to day relationship.

SHAPING RELATIONSHIPS

It is natural that banks will seek out partners that fit well with their own competencies and thereby offer symbiotic relationships. It is also conceivable that almost by chance, patterns could emerge when banks use each other's services. However, haphazardly formed relationships are not optimal and it is therefore incumbent upon banks to shape individual relationships. A number of factors play a role in the evolution of inter-bank relationships.

A fundamental factor is the experience of the relationship between given banks. Good experience encourages a high quality development in the relationship; bad experience begets a strained or, at worst, a failed relationship. Another factor is the sell-side perspective, since there is also clearly a tendency to prioritise the focus on those banks with the most potential. The determinants of potential might include such things as the volume and type of business that the

bank in question currently generates or is expected to generate through successful implementation of strategy or by virtue of its geographical focus. On the buy-side, the importance of a close relationship to monitor the quality of products and services being provided by a bank and in the market in general, ought not to be understated. There might even be a perception amongst some banks that the sell-side is dependent on the buy-side and vice-versa, such that a bank may tend towards purchasing products and services from a bank if it is successful in selling its own products and services to that same bank. This can be a misguided strategy, especially if a bank is seeking out "best in class" products and services, where it is natural for relationships to be formed with the best providers, and also providers who show commitment to the market in which they offer their product or service. This is particularly important in cases where products are "white-labelled" (when a bank offers another bank's products under its own brand). An increasingly significant factor is the expense of maintaining or establishing relationships; knowing your customer, for example, takes up considerable resources.

These are just some of the factors that banks may consider, and the relatively complex interaction thereof invokes banks to devise appropriate strategies, in order to maximise the value derived from their inter-bank relationships. Indeed, banks are increasingly rationalising their relationships, or at least considering carefully the costs and benefits associated with entering into new ones.

A DISAPPEARING PARADOX

It might be implied that as the banking industry evolves, smaller banks will be the outsourcers and bigger banks the insourcers, but this is by no means the case. The industry dynamics apply almost equally to both small and large banks, such that both can potentially benefit from indirect access to many of the economies of scale and scope available in the market.

It could also be argued that economies of scale and of scope are not unrelated, such that either type of economy can encourage the other. This yields many opportunities for all banks, irrespective of their size because in determining strategic direction, banks do not need to think primarily in terms of scale and scope but instead need to focus on where their competitive advantage lies. They can then decide whether to pursue certain economies of scale and/or scope internally or to purchase them externally from other banks who may already enjoy them. At the same time they can consider whether or not the products and services that they produce, which may be the result of internal economies of scale and scope, can be marketed to

other banks.

This growing inter-bank trade in a competitive market, whereby all banks can potentially access the best products and services available in the market and thereby benefit from the success and specialisation of other banks, appears to exaggerate the paradox cited in the introduction. Ultimately, when apparently conflicting facts are comprehended, a paradox disappears. Banks must, of course, always strive to consider the facts that surround them and react appropriately. Cultivating inter-bank client relationships is an important consideration and also an appropriate reaction; one which is much less paradoxical than, at first glance, it might appear.

Note:

- ¹ Economies of scale can be regarded in simple terms as a decline in cost as output increases. Economies of scope can be regarded as the reduction in cost by producing two or more products or services together rather than separately.

**This article was written by Jonathan Shih, Director, Global Relationship Financial Institutions at UBS AG, P.O. Box, 8098, Zurich Switzerland.
jonathan.shih@ubs.com**

**Web: www.ubs.com/b4b
Tel: +41-44-239 80 08
Email: b4b@ubs.com**