Christopher Charles Meadowcroft

The Role of Lending in Corporate Banking

Empirical Evidence and Implications for value-based Loan Pricing and Bank Management

Schriftenreihe für Bankmanagement und Controlling
Band 7 herausgegeben von Michael Lister

Christopher Charles Meadowcroft

The Role of Lending in Corporate Banking

Steinbeis-Edition

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Imprint

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Christopher Charles Meadowcroft: The Role of Lending in Corporate Banking
Empirical Evidence and Implications for value-based Loan Pricing and Bank Management

Likewise Steinbeis University, dissertation 2018
Series of Publications for Bank Management and Controlling Volume 7 published by Michael Lister

1st edition, 2021 | Steinbeis-Edition, Stuttgart
ISBN 978-3-95663-262-4

Layout: Christopher Charles Meadowcroft | Technical Editing: Steinbeis-Edition
Production: e.kurz+co druck und medientechnik gmbh, Stuttgart

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Acknowledgements

Since the beginning of my career in the financial services industry I have had a keen interest in corporate banking and I consider it a great privilege to have had the opportunity to perform a research project in this field. There is a number of people whose support has been instrumental in allowing me to write this thesis and whom I would like to sincerely thank.

First I would like to thank my doctoral supervisor Prof. Dr. habil. Michael Lister for taking on this project and for supporting me all along the way. I have thoroughly enjoyed all the interactions we have had and your sense of humour is uniquely refreshing. I truly hope we stay in touch and one day have the chance to watch a Manchester City vs. Schalke match together. I would also like to thank Prof. Dr. Bernd Rolfes for his review of the thesis. Further I would like to thank Prof. Dr. Dr. h.c. mult. Johann Löhn, Prof. Dr. Marco Wölfle, Prof. Dr. Thorn Kring, Prof. Dr. Dr. Helmut Schneider and Prof. Dr. Bernd Hofmann for their valuable contributions and inputs along the way.

I would like to express a special thank you to Dr. Daniel Muff who took me under his wing during the early days of my career and who sparked an interest in applied academic research in me. Memories of our numerous meetings philosophising about bank management (and other less sophisticated topics) always bring a smile to my face. I am further extremely grateful to Daniel Schweizer for his great support.

I owe a debt of gratitude to my parents Barbara and Charles for all the love and help they've always given me. Words can not do justice to describe how incredible you are.

Finally the biggest "thank you" of all goes out to my dear wife Melanie for her continuous support, encouragement and patience throughout this project, but most importantly for being the wonderful person she is.

Christopher Charles Meadowcroft

Editor's preface

In times of increasing costs of regulatory rules, decreasing interest margins and disruption caused by digitalization banks get more and more problems to make profits. Most experts say it could be useful to take more risk in treasury management, to lower the running costs as much as possible and, last but not least, to lend more corporate loans. But in times of uncertain markets it only seems to make sense lending more loans if you can fix the right price.

The corporate loan market is very competitive. If you invest there and try to let your volumes grow you will soon understand that there is no easy way to acquire new corporate clients. To do so often needs to give in lower interest rates and better conditions to your clients.

But there is a thesis that gets around since many years. It says that if you start a new relation to a new client with a corporate loan the client will be tied up to your bank. The reason for that is that it seems to be difficult for the corporate client to change the bank if the client once has taken loans. And if a bank can reach a higher level of customer loyalty the bank will be able to make more profits from that relationship in later years. This special idea of cross selling based on lending a corporate loan in the beginning is called "the anchor product hypothesis".

Until now the hypothesis has never been confirmed. Christopher Meadowcroft made use of a comprehensive data-set which gave him the chance to make a special research in kind of profound empirical analysis that has never been done before

Mr. Meadowcroft overall succeeded in a very good work on scientific content. He succeeded to analyze his exceptional sample with statistical accuracy, using the right methods and instruments. The found results are very useful for practical approaches. It is no new knowledge that banks should reduce prices today to reach higher contribution margins in the future. But using Mr. Meadowcrofts findings banks are first time able to calculate those lifetime contribution margins. The level of innovation is high with focus

on methodology and very high with focus on the confirmation of the anchor product hypothesis.

As the editor I am very proud that this dissertation of exceptional quality is published in Steinbeis edition. I hope this book will reach a high level of attention in the world of science as much as in financial institutes.

Prof. Dr. Michael Lister

Berlin / Münster, 2021

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Abbreviations

AC	Ancillary Costs
AIC	Akaike Information Criterion
AIRB	Advanced Internal Ratings Based
AP	Ancillary Profit
APT	Arbitrage Pricing Theory
AR	Ancillary Revenues
AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BIC	Bayesian Information Criterion
CAPM	Capital Asset Pricing Model
CCF	Credit Conversion Factor
CCP	Central Counterparty
CCR	Counterparty Credit Risk
CE	Certainty Equivalent
CET1	Common Equity Tier 1
CFROI	Cash Flow Return On Investment
CLV	Customer Lifetime Value
COC	Cost Of Capital

CV	Continuation Value
CVA	Cash Value Added
DCE	Dynamic Customer Equity
DCF	Discounted Cash Flow
DCM	Debt Capital Markets
DDM	Dividend Discount Model
DTA	Deferred Tax Asset
EAD	Exposure At Default
EBITDA	Earnings Before Interest Taxes Depreciations and Amortisations
EBV	Economic Book Value
ECA	Export Credit Agency
ECM	Equity Capital Markets
eFCF	Eternal Free Cash Flow
EL	Expected Loss
EP	Economic Profit
EV	Enterprise Value
EVA	Economic Value Added
FCF	Free Cash Flow
FE	Fixed Effects
FX	Foreign Currency

GCF	Gross Cash Flow
GDP	Gross Domestic Product
GI	Gross Investment
GLM	Generalized Linear Model
HQLA	High Quality Liquid Assets
IC	Invested Capital
ICM	Income Capitalisation Model
IPO	Initial Public Offering
IPRE	Income Producing Real Estate
IRB	Internal Ratings Based
IRR	Internal Rate Of Return
KPI	Key Performance Indicator
L/C	Letter of Credit
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LR	Leverage Ratio
LRE	Leverage Ratio Exposure
LTV	Loan To Value
M&A	Mergers & Acquisitions
MFTP	Matched Funds Transfer Pricing

MIS	Management Information System
MU	Monetary Unit
MV	Market Value
MVA	Market Value Added
NOPAT	Net Operating Profit After Taxes
NOPLAT	Net Operating Profit Less Adjusted Taxes
NPV	Net Present Value
NSFR	Net Stable Funding Ratio
OPEX	Operating Expenses
OPM	Option Pricing Model
P&L	Profit & Loss
PD	Probability Of Default
PFE	Potential Future Exposure
PTI	Pre Tax Income
RAC	Risk Aversion Coefficient
RAPM	Risk Adjusted Performance Measure
RAROC	Risk-Adjusted Return on Capital
RCF	Revolving Credit Facility
RE	Random Effects
RIO	Return On Investment

ROA	Return On Assets
ROE	Return On Equity
ROIC	Return On Invested Capital
RORAC	Return on Risk Adjusted Capital
RV	Residual Value
RWA	Risk Weighted Assets
SA	Standard Approach
SCE	Static Customer Equity
SFT	Securities Financing Transaction
SIFI	Systemically Important Financial Institution
SME	Small and Medium Sized Enterprise
SSE	Explained Sum of Squares
SSR	Residual Sum of Squares
SST	Total Sum of Squares
SV	Shareholder Value
SV	Salvage Value
SVA	Shareholder Value Added
T2	Tier 2
TIP	Total Investor Performance
UL	Unexpected Loss

VaR	Value at Risk
WACC	Weighted Average Cost of Capital

Abstract

Corporate banking is often associated with lending. While the lending business does constitute a major part of the revenues of corporate banks, increased capital requirements as part of recent regulation combined with often saturated markets and associated pressure on margins continue to challenge the profitability of corporate lending for banks. Under the paradigm of value-based management, firms should price products such that they increase or at least conserve the value of the firm (which includes covering the cost of capital). From a bank's perspective this is especially vital for capital intensive lines of business such as corporate lending. From a stand-alone perspective, loans should only be granted if they can be priced to meet all associated direct costs (including the cost of capital). However, it can occasionally be observed that banks offer loans at rates which do not cover all costs. A reason for this is the fact that the loan is commonly construed to be an anchor product in corporate banking which enables the realisation of cross-selling. So far, neither the often stipulated positive effect of lending on cross-selling (the positive anchor product hypothesis of lending in corporate banking) has been empirically examined, nor has a framework for establishing minimum loan prices considering cross-selling been developed in academic literature. This dissertation aims to fill this gap by addressing the following two research objectives:

1. Testing the positive anchor product hypothesis of lending in corporate banking
2. Developing a framework for establishing minimum loan prices in consideration of implied cross-selling

The dissertation is structured in three main parts. The first part outlines the fundamentals of value-based management with a special emphasis on its applications in bank management and customer relationship evaluation. Further, the theories underlining the existence of corporate banking relationships are discussed and recent empirical studies are presented. In addition, different forms of corporate lending, as well as the cost-based approach to loan pricing are introduced. A formulation of the central hypothesis concludes the first part.

The second part is dedicated to the empirical examination of the positive anchor product hypothesis of lending in corporate banking. The hypothesis is tested using a total of 16 different econometric procedures (linear regression, logit regression, cross-sectional as well as cross-sectional-time-series regression). The results largelly support the hypothesis.

The third part aims at developing a framework for establishing minimum loan prices considering the effects of implied cross-selling. The framework is illustrated with two practical examples where implied cross-selling is derived with a scenario-based approach, as well as with a regression-based approach. A discussion of the implications and limitations of the results of this work as well as an outlook and proposals for future research conclude this dissertation.

Introduction

A) Corporate banking as a relevant research field

Corporate banking is a discipline that dates back to the very origins of banking itself. Records from around 1800 B.C. provide evidence of basic lending activities taking place and being officially governed in Babylonia, where merchants would grant grain loans to farmers and traders who would redeem the loans through the proceeds of their business activities.[1] As economic systems, trade flows and technology evolved over time, so did the practice of banking. But to this day, corporate banking remains an integral part of the economic and financial system.

From an academic standpoint, research in the field of corporate banking has focused on a broad spectrum of specific questions in recent decades. While theoretical economic research has largely focused on explaining the preconditions for the existence of corporate banking relationships,[2] empirical research has attempted to understand the duration of corporate banking relationships[3] as well as the evolution of such relationships over time[4]. Within the research field of bank management, recent literature has touched on topics such as identifying value-drivers within corporate banking,[5] optimizing business processes and steering principles,[6] understanding corporate client behaviour with respect to their interaction with banks[7] or the quantification of up-selling potential in corporate banking.[8]

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Corporate banking is often associated with lending. While the lending business does generally constitute a major part of the revenues of corporate banks, increased capital requirements combined with often saturated markets continue to challenge the profitability of corporate lending for banks. Under the paradigm of value-based management, firms should price products such that they increase or at least conserve the value of the firm (which includes covering the cost of capital). From a bank's perspective this is especially vital for capital intensive lines of business such as corporate lending. At the same time, the impact which lending has on the overall possibility to generate value in corporate banking should be understood. In this work, the hypothesis that lending serves as an anchor product which facilitates cross-selling is empirically examined. In addition, possible implications for value-based loan pricing are discussed.

Christopher Charles Meadowcroft studied Management & Economics at the University of Zurich. He earned his doctoral degree at the Steinbeis University in 2018. He has more than 15 years of experience in the banking industry.

ISBN 978-3-95663-262-4

9 783956 632624

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