Banks, Law Firm Profitability and Management Information

Law firms have traditionally held a quite uniquely privileged position in their relationships with bankers. Lawyers have been low-risk, profitable customers for the banks for a number of reasons, and this law firm profitability has allowed firms access to funding on extremely favourable terms, often with a minimum of security.

Law Firm Profitability: A New World

The world, however, has changed almost beyond recognition in the past two years. Law firms do not constitute the inherently highly profitable sector they once did and the risk of lending to them has been increased by the move from Joint and Several Liability to Limited Liability Partnerships. Whilst the introductions they provide to other potential customers have lost some of their value as banks' lending appetite has been limited by the 'credit crunch', the Client account balances which make law firms account most attractive to the bankers have shrunk in line with the volume of property transactions.

This all means that the balance of the relationship between solicitors and their banks has changed, and attitudes must respond. Bankers' concerns must be acknowledged, and considerable effort made to allay their fears. Specifically, bankers feel that they have been viewed by solicitors as sources of "permanent" capital, rather than overdrafts being in place to deal with fluctuations in the business cycle. They also suggest that access to extra capital has been sought as a way of avoiding difficult conversations with partners or clients.

What the Banks Want

In the first place, bankers want solicitors to recognise that they are involved in a relationship, and that the bank is a 'partner' – not a mere 'supplier'.

This means that the most important element of the banking relationship has to be communication. Bankers want to work with united, coherent and committed partnerships and this will now need to be demonstrated by more than words. More extensive probing about the personal financial affairs of the partners has (or will soon) become a fact of life, and this means that full Assets and Liabilities or Income and Expenditure statements for all partners will be required at the renewal of facilities. This will require someone to collate the information and give it to the bank.

The bank also needs to know that it is supporting a well-managed firm with good prospects of future success. Times might be tough, but this only underlines the importance of financial management. Communication is also important here, as firms must be able to show their bank that they are financially sound and in a position to honour their commitments. Having a Finance Director, or financially literate partner, with good communication skills handle the relationship is crucial.

The bank will now require regular copies of the firm's management information, and after partners' meetings a copy will need to be sent to the bank. The annual review of facilities should be booked well in advance, and all relevant information prepared so the firm is in a position to get the most favourable renewal terms it can. In all dealings with the bank, preparation is key.

What the Banks Don't Want

Clearly, bankers do not want to feel that they are being taken for granted (as many have in the past). What's more, they certainly do not want any surprises. Keeping the bank in the loop, even if things do not go to plan, will pay great dividends and will certainly elicit a much more positive response if facilities do need to be extended. This highlights again the vital role that communication has to play in the relationship. Bankers also do not want to be regarded as providers of 'quasi-equity' – permanent capital in the form of overdraft.

Management Information and a Healthy Relationship

The basis of a sound relationship with the bank is to have a plan and to communicate it clearly to the bank, in their language. This means detailed cash flow forecasts, based on explicit realistic assumptions, as well as the Profit and Loss accounts plus balance sheet. It also means committing to meeting the projections, and being proactive within the firm. The bank can no longer be relied on as a 'soft option' in place of taking tough management decisions – the firm may need to be recapitalised at least partly by the partners themselves, jobs may need to be cut in unprofitable areas, and the firm's business model may need to be fundamentally altered. This would all be painful, but in the absence of an alternative it may also be necessary.

If the above all fails, then it may be time to look elsewhere – but expect an 'intrusive process' and do not assume you will get more favourable terms. In many cases, the inconvenient truth will be that the bank has a point – and working closely with them will be vital for the firm's future prosperity.

Please feel free to contact me for further advice.

Barry Wilkinson