REASONS TO CASH POOL

OPTIMISING LIQUIDITY AND MINIMISING INTEREST COSTS ARE KEY OBJECTIVES FOR THE CORPORATE TREASURER. **CHRIS CORNER** LOOKS AT THE POTENTIAL BENEFITS OF CASH POOLING.

The ACT's Euro Cash Pooling Working Group (ECPWG) has been charged with providing practical guidance for the treasury profession on the latest developments in euro cash pooling. It will address the current lack of detailed information on the technical and implementation aspects of euro cash pooling and provide guidance on the potential for improving cash management procedures. But why should a treasurer be interested in cash pooling in the first place?

The principal approaches to cash pooling are defined in *Figure 1*, and form the basis of the many cash pooling models available. Details of each of these models are beyond the scope of this article but will form a key part of the ECPWG's output over the coming months. Here, we focus on the variety of benefits available from cash pooling. These can be categorised under the following headings:

- improving the interest charge;
- simplifying cash management procedures; and
- increasing liquidity.

It is important to note that the principles of cash pooling can be applied to multiple currencies, in a variety of geographical locations. The ECPWG's focus on euro cash pooling derives from the opportunities for pooling benefits to be realised from the scale of euro-denominated cashflows and the existence of euro accounts in a number of locations. That is not to say, however, that treasurers should disregard the potential cash pooling opportunities in respect of other currencies.

FIGURE 1
APPROACHES TO CASH POOLING.

☐ **Notional pooling.** The notional offsetting of multiple balances for the purpose of calculating interest on the net balance. There is no actual movement of funds between participating accounts.

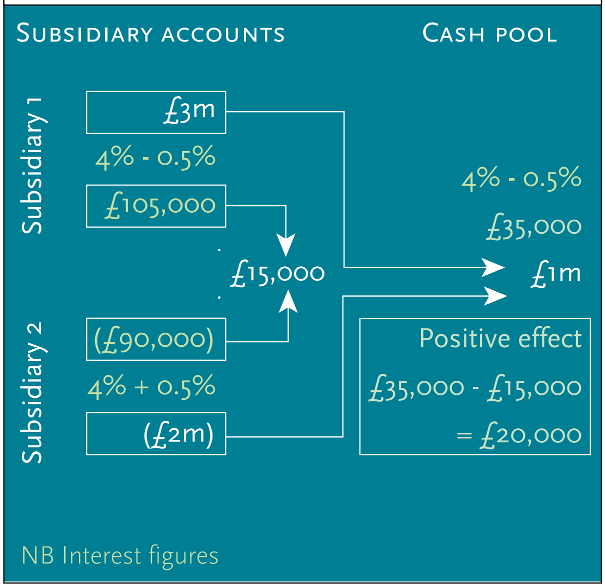
☐ **Zero balancing.** The physical offsetting of multiple balances to a concentration account for the purpose of calculating interest on the net balance. There is a physical transfer of funds leaving a zero balance on all accounts, except for the concentration account.

IMPROVING THE INTEREST CHARGE. The main attraction of cash pooling is the reduction in interest paid, or the increase in interest received, which results from netting credit and debit balances. Rather than receiving interest on credit balances and paying (invariably higher) interest on debit balances, the pooling of all accounts and subsequent single interest calculation results in a better interest charge.

Figure 2 illustrates the basic mechanics of cash pooling, and gives a worked example of the interest benefits. The example assumes a simple group structure of two subsidiaries – one with a credit balance of £3m and the other with a debit balance of £2m. Assuming credit balances earn interest at 0.5% below base rate and debit balances pay interest at 0.5% above base rate, Subsidiary 1 will earn annual interest of £105,000, while Subsidiary 2 will pay annual interest of £90,000, giving net interest received of £15,000. By pooling the subsidiaries' accounts, the group's net (cash pool) balance is £1m, on which credit interest of £35,000 would be received. This is an increase of £20,000 over the net interest received at the subsidiary level, representing the positive effect of cash pooling.

In addition to the group's positive effect – effectively cancelling the interest spread charged by banks – subsidiaries may also benefit from more competitive rates of interest provided by the pooling bank. It is often the case that subsidiaries offer local banks insufficient business to warrant competitive rates of interest, and it is not unheard of for subsidiaries' credit balances to earn zero interest. Similarly, subsidiary credit risk may result in loan facilities being provided at much higher rates of interest than would be available to the group. In both instances, the inclusion of such subsidiaries in a cash pool will enable access to more competitive rates of interest than the subsidiary could command independently.

FIGURE 2
CASH POOLING IN PRACTICE



Following the same logic, even if all pooled accounts are credit balances – and there is therefore no positive effect to be earned from pooling – there is still the opportunity to increase the interest received, as the pooled balance would command a higher rate of interest than would be applied to the individual accounts.

The ability to quantify the interest benefit of pooling is an advantage that should be utilised, not just to demonstrate the potential to improve the interest charge (often used as the justification for establishing a cash pool) but also to evaluate the actual benefit of the cash pool once established. This analysis is a vital part of monitoring the effectiveness of the structure and should be performed regularly to ensure the existing pooling arrangements are maximising the interest benefit for the group. However, it is important not to lose sight of the less tangible advantages of pooling, over and above the interest benefits.

SIMPLIFYING CASH MANAGEMENT. The consolidation of bank account activity resulting from pooling offers a number of opportunities to simplify existing cash management procedures. If the cash pool involves concentration of all accounts with a single bank, the standardisation of cash management procedures will reduce the resources required to manage those accounts.

Consolidation of accounts also provides the opportunity to standardise bank charges, along with reducing those charges, given the economies available from larger account volumes.

Pooling also offers the significant benefit of only requiring a single funding (or depositing) decision. All unpooled accounts must be managed individually to ensure that overdraft limits are not exceeded, or that surplus funds are repatriated to the group when pre-determined thresholds have been breached. Pooling negates the need for such account management because only the group's pooled balance must be managed. This represents a significant saving in terms of treasury and back-office resources.

Further efficiencies can be achieved by executing intercompany payments within the cash pool. This benefit is maximised where the pooling bank is able to execute book transfers between two pooled accounts – the associated costs are minimal and the avoidance of any physical transfer ensures no missing funds or lost value days. This benefit is particularly valuable where cross-border payments involving some of the less developed clearing systems would otherwise be required.

Further benefits can come from automating regular transfers within the cash pool. Such transfers could be in respect of repatriation of funds between subsidiaries and the parent, or payments between two subsidiaries. The subsequent elimination of manual transfer instructions will allow treasury and back office personnel to focus on more productive functions. These opportunities to automate previously manually-intensive processes should not be overlooked. While their value is difficult to quantify, significant resource savings can be achieved.

INCREASING LIQUIDITY. Away from cost savings and process improvements, pooling offers increased liquidity for the cash pool participants. It is usually easier for subsidiaries to access funds from the cash pool than from their local banks – funds can be available on the same day, without the need for reference to the bank's credit committee. If payments within the cash pool are automated, this benefit is increased, as funds can be transferred to and from the subsidiary without any manual involvement. As a result of subsidiaries accessing pooled funds to cover debit positions, local overdraft facilities can be cancelled. This frees up the banks' credit lines previously used to support the overdrafts, allowing the banks to increase credit facilities for the group elsewhere. This increases the capital available to the group, without impacting upon subsidiary-level financing.

The parent company (or finance subsidiary) can also benefit from the liquidity provided by the cash pool, by withdrawing surplus funds to pay down group borrowings. In this way, the parent company is using the liquidity provided by its subsidiaries' surplus cash to reduce the group's debt – without a cash pool, this process requires significantly more treasury and back-office resources to repatriate funds to the parent prior to repaying outstanding loans.

POOLING POINTS. Cash pooling offers treasurers the opportunity to add considerable value in improving the group's interest charge, and increasing liquidity among all cash pool participants. The extent of the process enhancements that may also be realised will depend upon the level of automation of the cash pool structure. Treasurers should give careful consideration to the various forms of cash pooling available, to ensure that the model chosen is appropriate given the cashflow profile and geographical scope of the firm. Future output from the ECPWG will be designed to assist in this, both in terms of detailing the services offered by the leading banks and implementation case studies from firms with existing cash pools.

Treasurers should be aware of the potential obstacles when setting up a cash pool, particularly if international in scope. However, the one-off costs of establishing a cash pool can be minimal when evaluated in the context of the continuing financial, process and liquidity benefits – food for thought if you're not already pooling.

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