SURVIVAL IN A COLD CLIMATE

FACING MOUNTING PRESSURE FROM ALL SIDES, COMPANIES ARE INCREASINGLY TURNING TO SERVICE PROVIDERS TO EASE THE PAIN. **JOHN NICHOLAS** OF HSBC BANK PLC DISCOVERS MORE.

Before addressing how service providers are responding to the cash management needs of companies, it is worth spending a few minutes summarising some of the key environmental factors.

THE ECONOMIC CLIMATE. Clearly, certain industries are still suffering from the dreadful events of September 11 and with the present political and economic climate creating future uncertainty and falling stock markets, the future certainly looks bleak. As I write this article, the UK base rate has just fallen to its lowest level for several decades and US rates are also at a 40-year low. With company ratings under increasing scrutiny from the rating agencies, M&A activity yet to really stabilise, as acquisitive CEOs see attractive targets in the current environment, and the EU set to expand as additional accession countries sign up, change on all fronts is inevitable.

Regulatory pressures:

- EU Directives on cross-border payments
- Basel II
- Financial Action Task Force (FATF) on money laundering
- IAS 39 and FAS 133
- Corporate governance
- Sarbanes-Oxley Act

TOUCHING ON TECHNOLOGY. The advances in internet technology continue to open up all kinds of opportunities to realise efficiencies and to change the way we do things. Supply chain management and integration are currently generating a great deal of interest. Enterprise resource planning (ERP) and treasury management systems (TMS) frequently attract much attention, as companies continue to embark upon major IT change management programmes to achieve the perceived benefits of such initiatives. On the supplier side, there is much consolidation as the key players jostle for a place at the table. And linked to technology come standards to ensure maximum benefit can be derived from such technology.

One such initiative in this space is the Treasury Workstation Integration Standards Team (TWIST), a not-for-profit industry-wide group delivering non-proprietary integration standards to facilitate an efficient, controlled and open dealing market for financial instruments. On the corporate side, names including Shell, GSK, BAT, Nokia and Tesco, and banks, including HSBC, are supporting the initiative.

CAPITAL MEASURES. So, against this backdrop, what is happening in the cash management market specifically? What are companies doing, what do they need, and how is the supply side satisfying their requirements? To answer these questions, it is first useful to examine how the banks segment their customers and how such segmentation influences the way banks target these segments and with which services.

In today's climate, banks need to be even more diligent in their customer selection process. Robust analysis of risk adjusted return on capital (RAROC) is essential. This is having the effect of a shrinking customer base. Banks, more than ever before, need to make a profit and, as other traditionally lucrative business lines contract, so transactional banking, such as the core payments and cash management business, comes to the fore.

With any form of return on capital measure, the amount of capital deployed is critical. Transaction activity attracts relatively little capital versus lending products, and the fees earned are disproportionate to the level of capital deployed. Such ancillary services tend to follow the provision of credit, but in the current environment, banks have capped credit in some of the underperforming/more risky industry sectors. While this may release balance sheet capacity to deploy in other more attractive sectors, it removes the cash management lever in another.

Banks targeting the cash management market in Europe fall into six broad categories, as follows:

- domestic;
- regional;
- pan-European;
- niche;
- banking 'clubs'; and
- global.

'COMPANIES ARE NOW TAKING A CLOSER LOOK AT THEIR IT SPEND, PARTICULARLY THOSE PLANNING TO INSTALL OR REPLACE EXISTING ERP OR TMS INFRASTRUCTURES'

Some banks fall into more than one of the above categories. For example, HSBC falls into four: domestic (as it is a major local bank in several countries in Europe); pan-European (linking domestic and 'overlay' services); banking club participation through its membership of IBOS (see article on page 44); and global (as it is represented in no less than 81 countries and territories).

If I consider the big four UK domestic players, they satisfy a broad range of clients, ranging from small and medium enterprises (SME) through large corporate to UK headquartered multinationals (MNCs). The way the customer base is segmented will vary from bank to bank but can be driven by customer turnover, bank revenue, customer 'needs sets'/industry sector, or credit-driven, or a combination of these. The services developed are primarily domestic in nature. However, those banks that have developed international cash management propositions are well positioned to leverage their respective client franchises in their home markets.

Regional banks, such as Nordea or RZB, have become extremely good at assembling competent in-country propositions spanning all the countries in Scandinavia and Central/Eastern Europe respectively. Their focus will be on those clients with purely regional requirements and will very often complement the service propositions of some of the other cash management providers with no/minimal offerings in these regions.

The pan-European players have developed strong regional networks, and where they are the core domestic bank too, target such clients to award the local as well as the cross-border cash management mandate.

The banking clubs have harnessed the inherent domestic strengths of each member and created a network through which a comprehensive service portfolio is delivered. Stringent service agreements have been developed between participants in an attempt to match the service propositions offered by a sole provider.

Niche players have developed expertise in certain products, such as cross-currency pooling and netting, and have created bespoke client solutions around this expertise.

Finally, the global players, of whom there are probably no more than a handful, can leverage their global coverage to maximise penetration with a particular client.

ON THE HOME FRONT. Any bank which has a large client franchise in its home market and operates on a sub-regional/pan-regional and global basis is extremely well-positioned to transfer its service propositions from segment to segment and to leverage its customer base internationally.

However, against this background, it is important to recognise that the service providers are working hard to differentiate themselves. Within what are arguably rapidly commoditising product sets, this is difficult to achieve and it is not merely about price. As one climbs the corporate ladder, from SME to MNC, the level of sophistication/requirement changes. Banks have responded with packaged propositions at the mass market SME end, moving to more bespoke solutions at the upper MNC end. However, this is a sweeping statement and there are clearly thousands of companies that fit somewhere in-between. But these clients' needs are not overlooked and, again, banks have positioned themselves to respond with service propositions that target certain client groups with similar needs or structures or specific business groups (for example, solicitors) or around specific products.

PROVIDING A FEW ANSWERS. So let me try to answer the questions I posed earlier. First, there is a definite trend across all sectors to focus on economic profit (EP) and working capital management, as it is the 'lifeblood' of most companies. Having the right amount of cash, in the right currency, in the right place, at the appropriate time is key. This sounds a simple objective. But in reality, it often proves extremely difficult, particularly for those companies operating across geographies and timezones. The introduction of the euro has made life easier in Europe, but there is still room for improvement. The receivables management market is also an area of focus, as companies strive to improve trade terms and reduce days sales outstanding (DSO).

Second, companies of all sizes are, not surprisingly, taking a closer look at their cost bases, as they strive to improve EP. Much has been done on the cost side, but complacency is not an option. The outsourcing trend, which usually starts with catering, cleaning, management of the company car fleet and the like, is now entering the corporate treasury department and alarm bells are starting to ring.

Third, companies see a multitude of bank relationships as potentially unmanageable and costly and are taking steps to rationalise on a pan-regional basis wherever they can. Clearly, some companies need a multi-bank approach for a variety of reasons – not least of which, the provision of credit. These bank relationship rationalisation programmes raise some difficult issues as companies, particularly those that obtain credit from a panel of banks, struggle to allocate a fair share of the ancillary services cake, such as cash management, to their credit providers. This really is becoming a major issue, as banks are not slow at coming forward when asking clients for their cash management mandate when they have committed the bank's balance sheet for that client.

Companies are now taking a closer look at the IT spend, particularly those planning to install or replace large ERP or TMS infrastructures. These projects can be very expensive and are often too big. They also rarely deliver all the benefits envisaged and implementation is very often neither completed on time or within budget. This situation is giving further weight to the outsourcing debate and the application service provider (ASP) population is watching with interest.

Regulation, particularly within the UK banking environment, is causing a very focused review among the major clearing banks. The EU Directive, effective from July 2003, will reduce bank revenues as the price of a cross-border payment within the EU harmonises to that of a domestic transfer. The directive initially covers payments up to €12,500, increasing to €50,000, provided the payment satisfies certain straight-through processing (STP) criteria.

SO, AGAINST ALL OF THIS, HOW IS THE BANKING COMMUNITY RESPONDING? Clearly, relationships remain absolutely key, with all the major players taking a very close look at their client bases. The core transactional piece, payments and collections is rapidly commoditising and banks realise they need to do much more to bring value to their clients to derive additional revenue streams and sustain the relationship.

The major international banks, HSBC included, have positioned themselves to leverage their global strengths, scale, strong balance sheets, depth of service and global reach. Furthermore, they have invested huge sums in their IT infrastructures to provide solutions, including internet access, mainframe to mainframe connectivity, cash pooling structures, payment 'factory' propositions and ERP/TMS integration solutions. Perhaps it is worth elaborating on these points.

'THE EU DIRECTIVE, EFFECTIVE FROM JULY 2003, WILL REDUCE BANK REVENUES AS THE PRICE OF A CROSS-BORDER PAYMENT WITHIN THE EU HARMONISES TO THAT OF A DOMESTIC TRANSFER'

IT INFRASTRUCTURES. The major cash management players have spent large sums of money on their own systems to improve STP rates and lower unit costs and clients have benefited from such investments. Processing and operational centres have been located in low-cost environments, with service quality being maintained and, in many cases, improved. Banks are keen to provide choice to their clients and customers have benefited in higher automation and choice of communication channel from 'thick' client to 'thin' client[1] applications, while host-to-host connections have eliminated the need to re-key data, minimised error rates and improved efficiencies.

CASH POOLING STRUCTURES. The introduction of the euro has provided an opportunity for many companies to review their cash management processes across the region. At the same time, banks capitalised on the euro to develop innovative cross-border cash pooling solutions, providing interest savings on a pan-regional basis. At the same time, triple-AAA rated money market funds were taking off and customers benefited by being able to sweep their consolidated euro positions into these higher yielding vehicles.

PAYMENT FACTORIES. As companies strive for further efficiencies through the establishment of shared service centres and/or payment 'factories', banks have responded with technological solutions that provide a 'one-to-many' payment pipe. This enables a company to exchange a single payments file with its bank, encompassing any number and type of instruments, in any currency and to any country. The instructions arrive at the bank in standard message format(s) out of the company's ERP and mapping tools then convert each into the appropriate format of the local clearing systems. This technology has brought a whole new complexion to the world of the accounts payable process.

ERP INTEGRATION. Following on from the above paragraph, banks have focused a great deal of effort on integrating their technology with that of their clients. Particular emphasis has been placed on integration with the major ERP systems such as SAP, JD Edwards, PeopleSoft and Oracle, and their inherent file formats and protocols. These interfaces enable standard file formats to be exchangeable between the client and the bank, delivering cost saving and efficiency benefits.

Local banks have adopted strategies that capitalise on their local expertise, knowledge of the local markets and proximity to their clients. However, no single bank, even with the geographic reach of HSBC or Citigroup, can satisfy every client need, in every country. For this reason, we have witnessed an increase in banking partnerships and alliances that use stringent service charters and technology to 'gap-fill'.

In summary, banks are on the receiving end of a number of regulatory pressures, most of which result in reduced revenues. Businesses are looking at new ways of managing their cash/treasury activities and are seeking innovation from their service providers. Several factors remain unclear, but one thing is certain: change is inevitable in the areas of regulation, technology, systems, customer service and the implementation cycle. The winners will be those that can harness real value in these areas.

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Notes

[1] 'Thick' client applications allow remote workstations to perform processing where 'thin' applications look to a central server for all processing operators.