

# A new dawn beckons the bold

CONTROLLING CASH AND OPTIMISING ITS VALUE ARE CRITICAL FOR CORPORATIONS TO MAKE THE MOST OF THEIR MONEY OPERATIONS. NEW TECHNOLOGY AND METHODS OFFER SWEEPING CHANGES IN LIQUIDITY MANAGEMENT FOR THOSE BANKS BOLD ENOUGH TO GRASP THE NETTLE, SAYS **MARIO TOMBAZZI** OF HSBC.



## Executive summary

The obstacles which an efficient liquidity management programme must vault include the restrictions imposed by market regulation, multiple banking solutions, and the volatility of cash positions. Banks need to offer a truly integrated, international liquidity proposition, which in turn is built on an exacting set of criteria. A new generation of technology and systems promises to enable this improvement, and secure a dramatic leap in the quality of liquidity management.

Liquidity management is vital to the financial well being of an organisation. It is also one of the most demanding disciplines, not just in terms of managing and optimising cash pools in multiple currencies and locations, but also predicting available liquidity accurately and matching those predictions against possible contingencies over multiple timeframes.

Advances in the techniques used for liquidity management in recent years have been relatively gradual. Now we appear to be on the brink of something on an altogether larger scale; liquidity management is on the cusp of a completely new generation of technology, methods and – ultimately – performance.

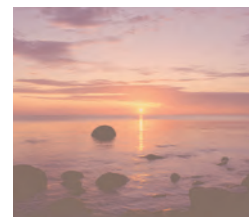
**STATUS QUO OBJECTIVES** While the feasibility and effectiveness of liquidity management have significantly improved over time, its general objectives have remained broadly unchanged. The primary objective for many

corporations is to maximise the use of internal sources of funds, irrespective (where possible) of geography or business structure. This objective takes two forms. First, the need to avoid the cost of cash shortfalls that could be covered instead by surplus funds at other group companies. Second, the opportunity cost of idle balances that deliver sub-optimal returns.

An associated objective is the desire to reduce the “access risk” of relying on markets or third parties for liquidity; events since the third quarter of 2007 have been a fairly obvious example of the importance of market/counterparty liquidity risk in its purest form, both from a sourcing (financing) and deployment (investment) standpoint. A further risk to be eradicated relates to the visibility and safekeeping of assets. In an increasingly regulated world the costs and penalties associated with compliance failure are far too severe to be neglected.

Finally, there is the desire to reduce the management overhead relating to the underlying end-to-end process. In an entity as leanly staffed as the modern corporate treasury, manual tasks are clearly undesirable, as is the need to be continually (re)evaluating the same execution options and their pricing. In an ideal world, the degree of human intervention required for cash pool administration should be minimal, with parameterised system logic and resilient automated processes taking the strain instead.

**SERIES OF OBSTACLES** Unfortunately, the treasury professional attempting to achieve these objectives is



confronted by a series of obstacles of ascending complexity. One of the first is the intricacy of the legal ownership structures involved in the liquidity management solution configuration. Another is the unpredictability and volatility of cash positions. Business seasonality, geographic distribution, industry type, disbursement and collection practices all influence the accuracy of cashflow forecasting. Liquidity structures serve as a safety net for such uncertainty. The organisation's management model – for example centralised or decentralised – combined with the degree of autonomy of local business units can also prove a substantial hurdle. In the Middle East, organisations tend towards centralised models, however, the full value of their individual business units' working capital positions is not maximised at all times. Also, where decentralised models exist, overcoming these hurdles might require considerable management effort.

Sooner or later, any discussion of liquidity management turns to the core issue of market regulation, which comes in the form of various restrictions on capital movements and currency conversion.

These apply across both developing and emerging markets and reduce the efficacy of liquidity management structures. They include specific conditions applied to interest compensation available on local and/or foreign currency holdings, prohibitions or clearance requirements on the conversion of holdings between these currencies and limitations on the activities permissible by non-resident entities or on inter-company lending. A further burden comes in the form of administrative and reporting requirements relating to these restrictions.

The Middle East is no exception to this, although many markets have simplified tax systems to a degree, corporations recognise that regulations and tax are dynamic factors that any liquidity management strategy must adapt to accommodate. Compared to other obstacles, regulation and taxation are particularly problematic: while careful planning can overcome problems relating to organisational structure and volatility of flows, regulation and tax obviously cannot be directly determined by corporations. In most cases, tax planning and business transformation considerations – such as in the adoption of a re-invoicing centre or a commissionaire model – are a key influence (if not a determinant) on the design of the liquidity solution. This incurs a substantial initial investment in the analysis, due diligence and project/change management required, as well as a periodic maintenance cost necessary to keep abreast of regulatory, fiscal or corporate organisational changes.

**CONTINUOUS PROCESS CHAIN** These various obstacles have meant that many corporations find themselves operating with suboptimal liquidity management practices and structures. One further and highly critical factor in the success (or otherwise) of the results achieved has been the inability of many cash management providers to offer a fully integrated, pan-regional cash and liquidity management service.

Traditionally, very few top tier international cash management institutions have been able to support the full

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spectrum of payment and collection instruments (from paper to electronic, from notes and coins to cards) across any region, including the Middle East. Furthermore, even fewer have been able to complement this with the comprehensive portfolio of liquidity management tools required to structure the optimal solution.

The need for corporates to have a cash management provider capable of covering all these bases cannot be overemphasised. The maintenance of a continuous “clearing to concentration” process chain is essential to the success of a liquidity management structure. Once this process chain is fragmented by the participation of independent third-party providers or out-of-network intermediaries, inefficiencies creep in and value is lost. Different file formats, early cut off times, inconsistent processing platforms and non-standard working practices are just a few of the elements that can quickly cause this deterioration. To overcome the obstacles outlined above, a best-in-class liquidity management structure has to be a sophisticated but operationally simple piece of engineering. The addition of an external component or agent may not break it entirely, but will undoubtedly reduce its effectiveness.

**JOINING THE DOTS** Deregulation can only happen at a pace that is synchronised with the financial and economic development of the country concerned; essentially an outcome with a long and uncertain timeline. More immediately relevant is the paucity of international cash-management banks that have the reach and depth of services to offer a truly integrated cash and liquidity management proposition on a regional, if not global, basis.

Any bank aspiring to claim such end-to-end facility has to be able to meet a formidable list of criteria.

One of the most fundamental of these is direct clearing membership across all countries, clearing channels/zones and instruments involved. As soon as any critical element of the clearing process has to be outsourced, the risk of errors and/or frictional inefficiencies arises, unless the agent can deliver additional value over and above the direct process ownership.

The corollary to this is the need for an extensive regional network capable of catering for full local banking services, with the consistency and quality of delivery that is expected from an international institution. Apart from the efficiencies



this offers in terms of transaction processing control through direct clearing participation, it goes very much hand in hand with the development of local expertise. This is critical to the process as a whole in various ways; in addition to delivering a deep understanding of local business practice and clearing mechanisms, it also improves the quality of regulatory intelligence. This can prove invaluable in terms of providing early notice of any possible changes (and perhaps even influencing those changes) that could affect the liquidity structure, allowing any adjustments to be made in a timely manner.

However, such local capability is easily dissipated if it is not supported by a robust regional and global liquidity management platform and infrastructure. These are essential if local capabilities are to be leveraged to the maximum macro advantage for the client. Put simply, efficient consolidation of cash at a local level is quickly devalued if upstream systems introduce inefficiencies and delays in mobilising the liquidity across entities and locations. This has obvious implications for information management too; a bank may offer the most sophisticated reporting tools with a superlative graphical interface, but if platforms are incapable of extracting the value trapped in slow moving or suboptimally employed pools of liquidity, these tools are powerless.

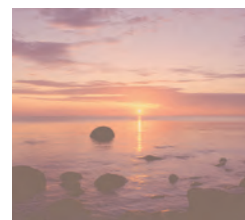
To the treasury manager trying to forecast and plan in multiple timeframes, it is not just the existence of cash that is important; it is also the certain knowledge of available cash and of how it will flow through a liquidity structure. What is obviously critical to the overall efficiency of the structure is the consistent quality of delivery, but also of methodology: simply put, this translates to process standardisation and automation. Corporations are increasingly mindful of their own direct costs when assessing liquidity solutions, particularly in relation to the cost of managing exceptions and errors, and more generally in relation to inconsistent methods and procedures. At the very top of a liquidity chain lie management tools and investment and funding instruments.

Historically, some banks have regarded these as almost an afterthought, or something to be dealt with by the client; an

attitude very much at odds with client objectives. As treasury departments have evolved into more business-focused and cost-conscious organisations, their desire to minimise manual intervention has increased. Management tools that deliver maximum information plus the integrated facility to act on that information are now a common requirement. At the same time, treasurers want their staff to undertake more value-added tasks, rather than administering working capital funding or investment policy. Once they have established the policy guidelines and the acceptable instruments and key performance indicators, they would ideally like parameterised business logic to take care of the policy execution and enforcement.

**NEW APPROACH NEEDED** Needless to say, delivering all of the above requires a substantial investment in both product functionality and application integration. The number of banks prepared or with the capacity to make such an investment is limited. Nevertheless, only those banks that do so will be able to lay the essential foundations for transforming their liquidity service offerings and taking them to the next level.

However, corporations wishing to benefit from this transformation will require a different approach to the bank selection process. In the past, liquidity and transaction banks were typically chosen on an entirely discrete basis. This was understandable, as there was typically minimal overlap in many regions between banks that could offer the best regional liquidity management and those that could offer the best domestic transactional banking. A fairly common outcome was that local banks were selected for transactional banking because of their stronger on-the-ground capabilities, with an overlay regional bank responsible for the liquidity consolidation. The result was a fragmented banking relationship and a sub-optimal liquidity management process. This is a long way from best practice, given the substantial investment made by some banks in implementing a more holistic transaction/liquidity approach. Such an approach deserves a similarly holistic decision-making process on the part of buyers.



**NEW POSSIBILITIES** The primary focus of liquidity management to date has been on process automation within the concentration structures typical to the particular region and country where they are located (eg physical/notional, single/multi-entity, domestic/cross-border). This is now progressing to the next level with market leaders in international cash management services investing in dedicated global liquidity management platforms to enhance their service. Such platforms will offer expanded product functionality and new service features that will revolutionise the way clients manage their portfolio of working capital balances and access integrated funding and investment options.

In a perfect world, this functionality should be available in any market falling within the provider's footprint, and such a footprint should be as extensive as possible. Not all functionality may be immediately applicable due to local regulation, but regulation is not static and tends to evolve in parallel with a country's economy. Having the technical infrastructure already in place offers immediate service consistency across all markets, while allowing for rapid future deployment when regulatory conditions permit.

The investment by leading banks in new liquidity-related functionality also has the potential to break down barriers between perception and reality. A case in point is multi-currency pooling, which has traditionally been regarded as too complex for clients to understand and too unwieldy for providers to implement and administer. In a brave new world, where both liquidity and transactional banking can be closely integrated in one provider, this is no longer true; multi-currency pooling becomes immediately accessible to a far broader range of potential users.

Another benefit of bank investment in liquidity management functionality is configurability; liquidity structures will no longer be constrained by their providers' domestic limitations. Instead, clients will have access to optimal multi-regional liquidity structures and cashflow management tools that fit their specific business model and requirements. From a client perspective, this consistency and flexibility of configuration has a tangible effect on the bottom line. Their liquidity positions in any market (subject to regulatory constraints) can for the first time make a positive contribution to their overall regional or global position.

**CONCLUSION** At the core of these changes to the world of liquidity management lie two things – the control of cash and its optimised value. Maximising the potential of both is the crucial foundation that a select few providers are striving to achieve. Once that is in place, new management tools and extensive integrated workflows will be limited only by imagination. Eventually, end-to-end automation and standardisation become a given, with enhanced analytics simplifying decision-making and business-rule driven processes extracting the full value from working capital on a real time basis. Welcome to the new liquidity horizon.

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