risk management
CASH POOLING

Break the bank link

JAN VERMEER EXPLAINS HOW TREASURY SOFTWARE CAN REPLACE BANKING SERVICES, FREEING CORPORATES FROM BANKING DEPENDENCE AND UNFAIR COVENANTS.

The financial crisis hasn't been all bad. It has, for instance, taught us a few things. One of the most important is that the banking landscape has changed significantly. Services that were traditionally offered by banks can now be obtained in alternative ways because the crisis has enforced developments in technology. As a result, the role that banks have been playing for corporations may change in the near future. This article focuses on one aspect of this change: in-house banking.

Before the financial crisis, few corporations actively measured and managed their risks on financial counterparts, and equally few organisations actively managed their own credit rating. Managing the balance sheet was often considered less important than managing the profit and loss account. Now we have all learned that banks, no matter how big, can go bankrupt. For many organisations it is not that easy any more to obtain funding, and their own credit rating has become an even more important element in creating alternative funding resources. Bid-offer spreads on risk management transactions have also increased significantly, and the names of banks that act as market maker in transactional banking have changed. As a result treasurers may want to reconsider their key treasury policies. As an example, let's look at transactional banking.

Suppose your organisation consists of two legal entities, and both have one bank account with the same bank. One entity has a credit balance of 100 and the other has a debit balance of 80.

For your organisation, this implies you are supplying net liquidity (20) to the bank. But because you have to pay a higher interest percentage on the debit balance than you are receiving on the credit balance, you may be paying net interest to the bank. Moreover, you will end up in a discussion with the bank about covenants you have to sign, simply because the bank sees the debit balance as finance, although the reality for you as an organisation is that you are a net liquidity supplier to the bank. As most organisations find this unacceptable, they ask the bank to set up a cash pool on the accounts[1].

A simple solution in this case is to set up a notional cash pool[2] with the bank involved. However, notional pooling is not possible in all countries. Also, notional pooling draws a distinction between interest compensation and balance compensation[3]. In most countries where it can be offered, the pooling is often limited to interest compensation[4]. As a result, banks will charge for solvency costs to the organisation.

After you have asked the bank whether you can set up a cash pool, it will get back to you with a set of documents to sign. Careful study

of these documents will reveal that the bank has turned things around. The legal wording will show that the bank is requesting a right of offset between the credit and debit balances despite your wish to receive this offset[5]. The documents are worded so that you take on the bank's risk of losses in case (part of) your organisation goes into default. Your organisation assumes this very risk on the bank, but this is not addressed in the bank's documentation. Before the financial crisis this was not a point of much interest for many corporations, but this may no longer be the case.

At first, the bank will ask for a pledge of all assets of the entities taking part in the pooling, although technically it only needs a right of offset on the current bank account balances, and not on future cashflows on the bank accounts[6]. The basic mindset is still that the bank considers the debit balances on the accounts as finance, however big the credit balances on the other accounts are. In the event of the bank defaulting, you will loose the credit balances, and through the pledge of the assets, lawyers will also recuperate the debit balances. Besides that, the bank will charge different costs for missed income because you have requested to set up the cash pool.

During the financial crisis we have all gained new perspectives on this landscape. A bank with a solvency ratio of 8% is still regarded as a strong bank. But that means that about 92% of the assets consists of capital that is not owned by the bank – assets like the credit balance of your subsidiary. How banks are managing and investing this capital has become clear during the financial crisis.

So on top of being a net supplier of liquidity to the bank, you have to pay interest and sign for covenants (virtually giving the ownership of your organisation to the bank). Why should you put up with this way of working? It is not so easy any more to obtain funding, and eliminating trapped cash on bank accounts has become a quick way in which you can, if nothing else, decrease your external funding needs. Besides, banks can go bankrupt, and their traditional way of working transfers most risks to your organisation. However, as the crisis has proved, the internal (investment) risk processes within banks seem questionable. In short, your cash is at risk, which is another reason for eliminating trapped cash.

Technological developments have made it possible to replace banking services with software solutions. They also offer significant cost savings and synergy, and will decrease your risk on financial counterparts. Their use could let you:

■ minimise the need for external bank accounts;

- eliminate the need for services in the area of transactional banking;
- eliminate trapped cash[7] so you can minimise external debt needs, optimise the financing of working capital, and reduce the risk you have on financial counterparts;
- set up a pooling completely independent of the banks, so you don't have to pay pooling charges; and
- minimise organisation costs.

Offering a detailed software solution, combined with redefinitions on policy, organisation and processes in treasury organisation, is beyond the scope of this article, but I would like to sketch out the idea of such a solution and its impact.

Important characteristics of the software solution would be:

- **Intelligence, stemming from**:
  □ Import: maximum format flexibility. For instance the :86 field of an MT-940[8] has a lot of different dialects[9].
  □ Reconciliation capabilities: once the software can post the different fields in the :86 tag of the MT-940 correctly, the reconciliation hit rate will consistently improve, allowing multiple entities use the same bank account[10].
  □ Export: results/reports of the software should be presented to existing systems within the organisation via straight-through processing (STP) or a generic format interface so any required export format can be produced.
- **Full integration with existing systems**: software suppliers will be forced to make a choice of technology and others will have an IT legacy[11].
- **Bank account relationships**: in case you want to organise and manage cash pools through your software, the software should support defining relationships between accounts and relationship rules, so that, for instance, zero/target balance sweeps can be recognised easily and booked automatically in the internal current accounts, but also the software can steer the accounts automatically (such as zero-balance transfers), replacing the banking services.
- **In-house banking capabilities**: automatic booking in the internal current accounts of zero/target balance sweeps, settlement of intercompany hedges, intercompany funding, shareholder advances and intercompany netting. If you have multiple entities using the same bank account, this will imply that the operating companies will book realised cashflows from invoices on an internal current account instead of an external bank account.

With the capabilities described above you have different possibilities to organise pooling. For instance, an objective could be to have one bank account per currency, and have multiple entities make use of these bank accounts, or your software could steer a zero-balance pool by generating MT-101 payments for the zero-balance transfers

calculated within the software. The automated generation of the sweeps, and the automated booking of the sweeps in the related internal current accounts, is a relatively easy solution.

An important impact on policy would be that the documentation of agreements with banks, such as in the pooling case above, should come from the corporate organisation instead of the bank, simply because the legal wording needs to be revised. The issues raised in the example given has significant risk aspects for corporations. The documentation currently used will clearly not solve these issues. And maybe, after having read this article, you will redefine your request to the bank for a pooling solution. The concept of the house bank, and "different banks for different purposes", also needs to be reconsidered.

Once you have decided that your treasury software should not only support the treasury organisation, but (partly) also the operating companies, you will find that it can become an important add-on for operating companies and a corporate solution rather than only a treasury solution. The potential savings are significant, but above all, it offers corporates a completely bank-independent alternative without the need to sign unfair covenants or run the risk of your bank redefining "core business". And, if tomorrow your bank should go bankrupt, your infrastructure will simply stay in place and you will not lose your money. You will have also minimised your external funding needs.

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1 Practically, you are asking the bank to calculate the interest settlement based on the sum of the balances of the two accounts, eliminating the debit/credit interest spread.
2 I am specifically mentioning a notional cash pool here as this is the pooling solution that precisely answers the question of the example. A zero-balance cash pool, for instance, involves a change from bank costs as it involves intercompany current account booking resulting from the zero-balance sweeps.
3 The most favourable country for notional pooling is the Netherlands, as both interest and balance compensation can be offered in the Netherlands because of favourable regulations.
4 A notional cash pool with interest compensation only in practice means that the bank will effectively calculate the net interest settlement based on the sum of all account balances. But as there is no balance compensation, no debit balances may exist on the accounts in the pool unless the organisation has received credit lines from the bank. If no debit balances exist in the cash pool, the organisation has "trapped cash" (and is forced to supply liquidity to the bank).
5 The IFRS perspective offers you another reason to receive this offset, so that you can report the net liquidity with the bank instead of having to split the debit and credit balances.
6 If you agree to such a pledge, you will implicitly eliminate alternative funding sources, such as the possibility of securitising your customer invoices.
7 Trapped cash is defined as existing liquidity positions on bank accounts that are not directly available for the organisation to repay debt or to finance the organisation.
8 The SWIFT MT-940 format is commonly used for the electronic daily statements supplied by banks. Detailed fields within this format can differ per bank, so hundreds of dialects of this format exist.
9 Intelligent software could support a matrix where different fields in the :86 tag can be defined. The result would be that the software would learn to better recognise fields such as counterpart, remarks field, bank account counterpart, etc, whenever electronic daily statements were imported.
10 Again, a reconciliation matrix can enable the software to learn from past reconciliations, consistently improving the reconciliation hit rate.
11 For organisations working with MS Dynamics, Microsoft.Net will offer significant advantages. This technology currently has clear advantages for future functionality that needs to be developed and it is database-independent.