Traditional boundaries blur

WHERE IS THE CASH MANAGEMENT INDUSTRY HEADED IN 2005? ASK **HUGH DAVIES, AMOL GUPTE** AND **ERIC SEPKES**

Several factors – prime among them the changing role of the corporate treasurer – will combine to shape the international cash management business in the coming year. Together with the continuation of established trends, such as the shift towards centralisation and the expanding role of primary bank/overlay relationships, these factors are likely to see treasurers demanding more from their banks in a way that defies some of the traditional boundaries between cash, trade and advisory services.

This year may also be a defining one for the Single European Payments Area (SEPA) project to create a domestic payments zone across Europe by 2010. This was driven by the European Parliament's adoption in 2001 of Regulation 2560 for transactions of up to €12,500.

Executive summary

- SEPA commits banks to pan-European payments infrastructures.
- Threshold for low value payments covered by Regulation 2560 lifts from €12,500 to €50,000.
- Dialogue between treasurers and cash management banks wider than ever before.
- The Transaction Workflow Innovation Standards Team (TWIST) moves off the drawing board and into the pilot stage.

SEPA commits the banking industry to migrate to pan-European, rather than national, payments infrastructures and to a single set of payment and collection products (excluding cheques) by 2010. While 2005 is devoid of any big target dates by which banks must implement change, the industry now has less than six months in which to produce country-by-country plans for making the migration a reality.

One action date does loom. With the lifting of the threshold for low value payments covered by the Regulation from €12,500 to €50,000 due to take place on January 1, 2006, corporate treasurers need to put some thought into the way the operations are structured to ensure they derive maximum advantage from the new regime.

THE CHANGING ROLE OF THE TREASURER
The corporate treasury function is changing and the cash management industry is having to change with it. Historically, treasurers have focused on corporate finance, the management of exposures, the concentration of liquidity and payments and collections. Their role has been that of an aggregator – pulling together data (and liquidity) from the commercial operations but not shaping or driving them. Increasingly, they have a much wider role in the creation of corporate efficiencies.

Now, in many of the bigger corporates, the treasury function has an operational reach to it. The treasurer is involved in the procurement process, in optimising cash within the supply chain, in change management throughout the organisation. Increasingly, treasury is as much about maximising operating efficiencies and improving key ratios as it is about obtaining the best overnight rate on cash.

The treasurer is expected to contribute to the big strategic decisions, too. If a corporate is considering moving manufacturing to China, or opening up in a new jurisdiction, the treasurer will be expected to have an understanding of the tax, regulatory, funding and liquidity issues that presents – and play a part in optimising the proposed new corporate structure.

As a consequence, the conversations that take place between treasurers and their cash management banks are also likely to be broader in scope than before – and to touch on business issues every bit as much as on the nitty-gritty of payments and collections processes. Banks are being called upon to play more of a support and advisory role. On one level, that may mean assisting the treasurer with input on decisions over where operations may be sited – providing all the data on tax rates, wage rates, regulatory issues and so on. On another, it may mean arming the group treasurer with the detailed information needed to fend off unwelcome propositions from local management or local banks involving manufacturing, supply or distribution issues.

Increasingly, the line between cash management services on the one hand and trade finance services on the other is becoming blurred. Banks are moving away from selling products to a partnering approach that is more closely integrated with the customer's business.

THE SHIFT TO CENTRALISATION Is the trend towards centralisation – most apparent in the proliferation of shared service centres (SSCs) and payments factories – set to continue? The only possible answer is 'yes'. For many large corporates, the establishment of regional SSCs is early payback for implementing a unified, corporate-wide Enterprise Resource Planning (ERP) system. The two increasingly go hand-in-hand. While the number of SSCs established has mushroomed in the last three years, there are still many territories where treasurers have been slow to make the move.

However, complete centralisation may not make sense. Some corporates need to be close to their customers. Banks have to be flexible enough to support structures in which some functions are centralised while others are not. Other variations on the centralisation theme are emerging. One is the 'virtual' SSC. An existing corporate location becomes the centre at which all payment files are consolidated before being sent on for processing to the cash management bank. The virtual SSC captures many of the synergies of centralisation without the costs of a new site, new processes or staff transfers. But without a single ERP system, treasurers must deal with different interfaces and the security issues that implies.

For many corporates, centralisation occurs by degree – first cash, then payments, then receivables (a perverse set of priorities, it might be argued). Those going the whole hog end up moving human resources, legal and logistics into their SSC. For corporates having to bow the knee to the requirements of Sarbanes-Oxley, centralisation makes reporting easier and more transparent.

Given the increasing complexity of the treasurer's function, the next logical step for some of these corporates is to consider outsourcing the management of their SSCs. At present, virtually all are managed in-house (though many corporates have separately outsourced treasury functions). Banks and business process outsourcing specialists are all busy tailoring outsourcing solutions in which all the rules-based activities can be shifted into processing hubs in low-cost areas while the risks are actively managed elsewhere. However, there is more talk than action on SSC outsourcing, and that is unlikely to change in a hurry.

The other big question is whether 2005 will see the emergence of global SSCs to replace regional ones. Here the jury is out. Big corporates need a multiplicity of banking relationships, something that militates against the establishment of a global SSC. While, in theory, there is no reason why a well run SSC should not be able to manage multiple bank partners efficiently, there are risk issues in putting all the corporate eggs in one basket.

However, the move towards standardisation of messaging formats and away from proprietary systems reduces the cost to a corporate of switching banks, making the appointment of a single cash management bank a more viable proposition. And that process is due to take a major step forward in 2005 as a new standard from the Transaction Workflow Innovation Standards Team (TWIST) moves off the drawing board and into the pilot stage.

TWIST is a corporate-led group which includes bankers and technology providers. The new standard now has what amounts to

official status. It involves a core payments 'kernel' designed to deliver a single file format for mass payments globally. Banks will start to offer it to clients this year as a standard payments mechanism in HTML that can be plugged into any other standard – including those applying in the logistics and supply chain areas, for instance. The TWIST standard offers a huge advance in bank connectivity, as the adoption of a single standard should cut implementation costs for all involved.

GEARING UP FOR STEP II The vision of a single payments system across Europe is one where there is no distinction in terms of cost or efficiency between domestic and cross-border credits or debits; and where there is no need to maintain more than one bank account in each country or currency. Nonetheless, it remains elusive. In 2001, banks were given the incentive to get cracking on building the infrastructure for SEPA when the EU adopted the Regulation.

The first pan-European automated clearing house (PE-ACH) was set up last year by the Euro Banking Association for low-value transactions across the eurozone. Over time, each national grouping of banks is expected either to migrate its domestic (and not just cross-border) payments traffic onto an existing PE-ACH or convert its existing domestic ACH into a PE-ACH.

With the advent of the first PE-ACH, it is now possible to make so-called 'Step II' payments – those made through a pan-European clearing mechanism. However, at the present time cross-border payments in excess of €12,500 still have to be processed either through the Euro Banking Association's Euro1 payments system or through TARGET, which is operated by the European Central Bank (ECB). Both are designed for high-value, same-day payments and are relatively expensive to use. With the limit for regulated payments due to be lifted from the start of next year to €50,000, that changes.

The exemption threshold for central bank reporting of non-residents' transfers will also be raised to €50,000, thereby eliminating one of the cost factors involved in cross-border payments. There is some carrot, and there is some stick to encourage banks to use the new system, not just for their cross-border payments but for domestic, too.

Many banks already have the capability to make and receive Step II payments but have been reluctant to do so on cost grounds. To take advantage of the low-cost payments covered by the Regulation, all transactions in PE-ACH must indicate the customer's International Bank Account Number (IBAN) and the bank's Bank Identifier Code (BIC). That is already necessary for cross-border transactions but it will be expensive migrating domestic payments (which do not require IBANs or BICs today) onto a PE-ACH. There is therefore in-built inertia that is slowing the migration process.

However, the ECB intervened last autumn to set a mid-2005 deadline by which firm plans for this migration (or conversion of existing ACHs to PE-ACHs) must be in place in each country. That has removed many of the question-marks over the SEPA project. However, its realisation is not only in the hands of the banks. A prerequisite for success is the acceptability of pan-European direct debits (PEDDs). A PEDD project initiated by the European Payments Council has been defined but not yet agreed. But various forms of legislative change will be required before the project can be implemented. In most European countries, the payee must by law have an in-country account. Banks are unlikely to decommission their existing links to domestic ACHs until all the issues surrounding both sides of the payments process have been ironed out.

From the treasurer's point of view, however, January 1 2006 does represent something of a watershed. It will certainly be possible for banks to offer some of the benefits of Step II in 2006, making it possible for corporates to conduct a lot of their cross-border and domestic business through a single account. And that means treasurers need to give consideration now to the optimal structure they should adopt for their European operations. Is it time, for instance, to start thinking again about an in-house bank structure for a 'payments on behalf of' model?

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Eventually, Step II promises to change the payments landscape. Today, a corporate with operations across Europe may well have to maintain 40 or 50 different accounts across 15 countries and engage in netting and pooling strategies to gain the advantages of cash concentration. Step II has the potential to make much of this redundant (but not all – not until the eurozone stretches from Dublin to the Urals), cutting costs and the changing approach treasurers take to managing their payment flows and liquidity solutions. All of that may be another three or four years away. But it is not too soon for treasurers to start laying their plans.

What does that involve? On one level, treasurers need to start collecting customers' and suppliers' IBANs and BICs and entering them in their ERP systems – even though they might not need them until a particular country migrates to a PE-ACH. On the other, they need to review the tax and legal implications of a pan-European account structure to make sure they are organisationally structured in a way that permits them to take full advantage of the changes in store.

The key point to note is that SEPA will not be implemented by way of a 'Big Bang'. Banks and corporates alike need to think in terms of a five-year strategy. But those corporates that have positioned themselves to become early adopters of the new payments regime will also be the first to benefit from new efficiencies and reduced operating costs.

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