Cash management in the euro-zone

Tony de Caux of The Bank Relationship Consultancy looks at the ways in which the euro is likely to impact on cash management in Europe.

It is difficult to overestimate the impact of the single currency on European cash management. The ability to make cross-border euro payments for same-day value has the potential to revolutionise treasury structures and operations inside and outside the euro-zone.

One of the main areas in which the euro is making its presence felt is in treasurers' changing demands on bank services. Many corporates want new services that will enable them to treat the euro-zone as a single 'domestic' market, while discarding other products made obsolete by the single currency and the changes in banking technology. Indeed, developing trends in the delivery of bank services may, in the long run, prove even more significant than the euro.

Pricing is still an issue

Even as new practices and services replace old, pricing will continue to be an issue. Banks have towed the official Brussels line by selling the euro to corporates on its ability to cut costs in treasury and finance departments. However, banks are also aware of the need to boost income streams where they can in order to compensate for diminished business in other areas as well as to recoup substantial conversion costs. The elimination of float (following the advent of euro-denominated cross-border payments for same-day value) is one of the issues presented by some banks as a major advantage of switching to the euro; others mourn the loss of their principal method of compensation.

The new payment mechanisms

A look at the arrangements behind the new euro Electronic Funds Transfer (EFT) services demonstrates that cost-effective use of the new payment mechanisms is not a straightforward task for banks or their clients. Complicating factors, explored in more detail in the paragraphs that follow, include:

- the existence of 15 national clearing systems;
- methods developed to cover daylight exposures;
- differing capabilities of banks when interfacing with each national clearing system (*see Example 1 on page 58*);
- differing abilities of banks to provide intra-day balance reporting services to customers;
- differing rules on pooling between states; and
- internet delivery.

Clearing systems

The principle of remote access to the EU's 15 national clearing systems predates the single currency, but the efforts of some banks to establish remote links to effect cross-border euro payments across their own network, have often proved frustrating.

The decision to sign up for membership to TARGET, EBA, an RTGS national clearing, a pan-European payments alliance and/or to invest in one's own branch network, depends largely on a bank's existing capability and structure. But since some of these methods of effecting cross-border funds transfers are unproven, a large number of banks are hedging their bets by covering some, if not all, of these channels. The costs incurred by banks in establishing and using these links will be passed on to corporates, which would do well to consider the cost to banks of providing a pan-European payments service.

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The cost of collateral

Membership fees and the cost of setting up links to clearings are only part of the costs incurred by banks: more significant is the collateral required by clearing systems. Collateral, usually in the form of repurchase agreements or equivalents, is required by the clearing systems to cover daylight overdrafts on commercial banks' settlement accounts at national central banks. Net settlement systems pose the additional problem of daylight exposures between commercial banks, which rely on the credit standing of the sending bank until settlement occurs at the end of that day.

Collateral costs vary according to the structure of the system. A net settlement system, such as EBA, requires less collateral than an RTGS system, but cannot guarantee immediate finality of payment, potentially leading to inter-day risk between participating banks. Only the volume of collateral that individual banks can provide limits liquidity in the RTGSs in TARGET. This favours larger banks, which might be more able to soak up collateral costs, but it is also likely that some of the cost to banks will be passed to corporate customers. Hybrid systems, such as Germany's EAF2, allow banks to fund settlement accounts from their ELZ (Germany's RTGS system) settlement account, thus reducing risk and collateral costs.

Staying in the black

With banks now connecting to several payment infrastructures, there is a potential need to switch collateral from

EXAMPLE 1

Euro-pooling

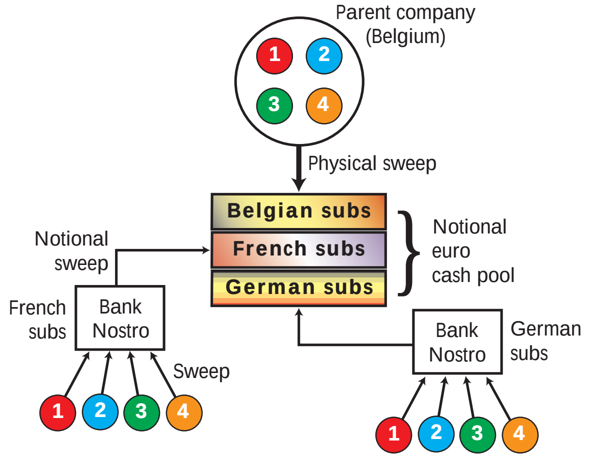
The issue that is occupying most minds in treasury and cash management at present is euro-pooling. Despite the introduction of a single currency in 11 EU member states, different rules in these countries prevent notional pooling of euro balances for the majority of corporates; most firms must resort to a physical concentration of euro balances, or a hybrid structure. Nevertheless, use of the existing electronic banking capabilities and cash management banking arrangements may facilitate euro-pooling in certain circumstances.

This flow chart gives an example of how this might occur. Of course, no such specific example can be transposed on to all other corporates, but it does suggest that innovative solutions are available from a number of European cash management banks.

The benefits of notional pooling

- no cross-border transfers;
- no lifting fees;
- central bank reporting;
- best location for notional pool is in the UK or the Netherlands;
- concentration account is the bank nostro account; and
- no withholding tax is deducted at source from interest payments.

Cross-border – notional pooling



one system to another in order to maintain liquidity – and avoid overdrawing settlement accounts. Whereas the correspondent central bank model permits movement of collateral between different RTGS systems, there are no established intra-day liquidity 'bridges' between the different systems. A bank that is instructed to make an urgent ?50m payment when it has a zero balance and only ?40m collateral available with a given payment system may face some difficult choices. Despite this, liquidity management, based on close monitoring of settlement accounts, can be conducted via swaps, which enable a bank, for example, to switch a 'long' balance at the Bank of England to the Bank of France.

Moreover, far from suffering from the restrictions imposed by the ECB on intra-day liquidity to non-euro zone RTGS systems, UK banks have found that their expertise in managing payment flows in the CHAPS sterling system has been of use in recycling liquidity across Europe and in avoiding blockages or liquidity ceilings. Banks that are unable to manage liquidity effectively by these means may need to separate standard same-day transfers from 'urgent' transfers, in order to prioritise payment flows through their books and the clearing systems, with obvious implications for pricing structures.

So far, banks have made arrangements according to their existing capabilities. For example, Chase and Bank One have chosen the German clearings as their main entry point (ELS for RTGS payments and EAF2 for less urgent business). This centralises liquidity in one hub, but also suits the fact that neither bank is a direct member of enough national RTGS systems. Multi-centre clearing banks, such as Citibank (access to TARGET via 10 RTGS systems, plus three net settlement systems) and ABN AMRO, are using multiple entry points inside and outside the euro-zone. All of this suggests that the real savings on offer to the corporate from same-day value transfer of euro payments will be less than might have been expected for the foreseeable future.

If we can't expect the euro to reduce payment costs as much as banks might have us believe, can we at least look forward to the tools to manage cash more efficiently across the euro-zone?

The impact of TARGET

High-value euro payments that are sent via TARGET, either directly or via a national RTGS system such as CHAPS euro, are settled up to a maximum of 30 minutes after initial execution. Pan-European network banks can effect cross-border euro payments across their own books, often in a cheaper and quicker way than TARGET, while still guaranteeing immediate finality of payment. But any corporate will struggle to maximise benefits of prompt delivery of funds if its bank is unable to provide intra-day – if not real-time – balance reporting. Less than half of large European corporates are provided with regular electronic updates of current-day transactions (*Global Cash – Europe '98: The Bank Relationship Consultancy*) and virtually none are receiving account details from other banks on a same-day or intra-day basis. The use of such delayed and incomplete transaction data deteriorates further with the advent of near real-time funds transfer across the euro-zone.

A secondary impact of TARGET is the standardisation of clearing practices across Europe. The 15 RTGS payment systems linked to TARGET are open 07:00–17:00 CET every weekday apart from Christmas Day and New Year's Day, thus lending a novel pan-European uniformity to the cut-off times before which corporates must instruct their banks to effect transactions for same-day value. A German corporate with a cut-off time of 12:00 CET for Deutschmark payment instructions may previously have been content with balance reporting up to the close of business previous day, as the information provided can only be a maximum of four hours old. But the new larger window for same-day value euro payments requires the bank to supply intra-day updates just to maintain pre-euro service levels.

The ability of electronic banking systems to provide consolidated balance reporting of accounts held throughout the euro-zone (on an intra-day basis for accounts held at its own branches, and once a day for other banks reporting in) should be the very least that the European-based corporate should expect from its lead cash management bank in the short- to medium-term. It is only a matter of time before multinationals will push their banks' EB capabilities further and demand a global same-day information platform for their cash management strategy.

Internet delivery

Any article concerning the future of cash management in Europe would be incomplete if it failed to address the question of internet delivery. Bank offerings are remarkably erratic; some of yesterday's pioneers are already looking dated, while later arrivals are moving on to the internet in a piecemeal fashion. For example, while most leading European cash management banks can provide balance and transaction reporting over the internet, relatively few provide access to their own mass payment systems.

Nevertheless, improved security features (or the increased acceptance of possible security levels) together with an enhanced ability to report and process payments, are beginning to turn heads in what is traditionally a sceptical market. Treasurers regularly call on banks to provide a single module for all their electronic payments; the ability to access internet banking services from the desktop, with no extra hardware, will surely be accepted as a significant step forward in the long term. The fact that some of the more sophisticated treasuries are increasingly linking to other departments, as well as to suppliers and customers, via internet-enabled ERP systems, may prove an added incentive.

Conclusion

This article began by suggesting that the introduction of the single currency was an all-pervading influence on European cash management. Indeed, it is hard to escape the shadow that has been cast by the euro. However, it is only by astute and innovative use of advances in technology that the treasurer can hope to realise the full potential of the benefits of the euro. Banks would be very ill-advised to relax their development efforts just yet. ■

Glossary of terms:

CHAPS	Clearing House Automated Payment System
EAF2	Euro-Access Frankfurt
EBA	Euro Bankers Association
ELZ	*Eiliger Zahlungsverkehr*
ERP	Enterprise Resource Planning
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer
RTGS	Real-Time Gross Settlement

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