CASH POOLING MAY BRING SIGNIFICANT BENEFITS TO CORPORATE TREASURERS, BUT REGULATORY CHANGES SUCH AS BASEL II ARE NOT NECESSARILY MAKING IT ANY EASIER. WHAT IS THE BEST ROUTE TO CASH CONSOLIDATION? **PETER HAZOU** REPORTS.

Is pooling just a notion?

For corporates, cash pooling and internally-generated funding are very attractive options because both the banker's spread and the risk of interest-rate fluctuations are eliminated. The gain for corporate treasurers is consistency of service and commonality of interface – in essence, one bank provides a single service pipe to the corporate. And once an organisation implements the structures and services required to support this type of arrangement, the cash pooling machine will go on generating benefits.

However, the regulatory environment can have a very important impact on cash management practices. In an ideal world, new tax regulations, the adoption of International Accounting Standards and Basel II (see *Capitalising on Basel II*, page 47, *The Treasurer*, June) would create a level playing field, thus removing regulation as an issue. But although, this may have been the general intention, in reality it is still a long way away from being achieved. This is in spite of the fact that measures to harmonise taxes are clearly underway, at least in the European context, with the adoption of Directive 2003/49/EC.

The regulatory environment will continue to have a major impact on corporates' cash management practices for three main reasons.

Firstly, regulations are subject to interpretation. Various regional and country-specific regulators are interpreting the tenets of Basel II and the final outcome, and implications for cash management will depend on these individual interpretations.

Secondly, the debate surrounding notional pooling versus physical concentration of funds is influenced by a number of other factors. These include the ability to apply credit interest to companies' accounts, local regulations regarding resident and non-resident accounts and, in some jurisdictions, regulations governing inter-company transactions. No matter how Basel II is interpreted, these considerations will still apply.

Executive summary

- Cash pooling and internally-generated funding are attractive because they eliminate the banker's spread and the risk of interest rate fluctuations.
- The regulatory environment has a major impact on corporates' cash management practices. The latter will be impacted, for example, by the various regional and country-specific interpretations of Basel II.
- If externally-generated liquidity is required at some points in the working capital cycle, it is better to rely on a range of providers.
- Corporates should always retain responsibility for their 'risk appetite' and not let their service providers decide on suitable investments.

Finally, the provision of notional set-off depends upon banks' ability to handle the consolidated position from a credit perspective. Cross guarantees and set-off clauses are only as good as their enforceability – and this depends on the strength of the legal opinions behind them. In this respect Basel II, with its introduction of operational risk as a consideration, will force banks to be even more rigorous in their due diligence.

Basel II does, however, introduce greater transparency. This is the case with the treatment of cross-currency pooling, where a risk weighting must now be attached to the foreign exchange risk implicit in the service.

BENEFITS OF CASH CONSOLIDATION. With so many wide-ranging benefits, it is interesting to question why many companies have not yet consolidated their cash management under one roof. While a global bank cannot provide all the services that a local bank can in every country, consolidation offers the opportunity to optimise use of internally-generated funds. But if externally-generated liquidity is required at some point in the working capital cycle, then it is better to have a wide range of potential providers from whom this can be sourced.

In a world where banking margins are being squeezed on all sides, very few banks are prepared to lend without ancillary revenues – and the ancillary revenues that banks like best come from transaction banking. This often explains why centralised cash management structures are often not quite as centralised as initially thought. In other words, rather than relying on one bank, having two, three or more banks managing your corporate liquidity is more likely to be the scenario.

In such relationships, treasurers should expect the main bank they use to be flexible and wise and assist in cost benefit analysis. In many cases, the main bank must be prepared to work closely with other banks to provide one liquidity solution despite the multi-faceted underlying structure.

For the main bank, getting to this stage demands extensive preparatory work to, for example, ensure that the other banks involved can process transactions to defund local accounts and obtain agreements to achieve good value on funding transactions. In this instance, the local banks used must appreciate that co-operation is the price to pay for retaining an organisation's local transaction banking business and this may mean suspending certain local practices, such as value-dating.

OUTSOURCING ALL BUT RISK. While execution can always be outsourced, this is not the case with risk management.

However, risk parameters can be established so that every decision does not have to be referred back to a corporate – for example, excess short-term liquidity can be swept automatically into a money market fund. However, the service provider should not decree what types of investment are suitable, with the corporate remaining fully responsible for assessing and establishing its own risk appetite.

Also, although they themselves may not realise it, many corporates do already benefit from cash outsourcing. Quite basic liquidity services, such as interest re-allocation with pooling, are in fact a form of outsourced service.

Cash concentration, meanwhile, is a function that requires little analysis, and can be performed by companies themselves. The place where analysis is required is, firstly, in reviewing the results, and secondly, in comparing them to the forecast cashflows with a view to understanding the reasons for variances, and then working with group companies to improve performance.

Ultimately, there is one arguable truth – surplus funds left in a bank account overnight will not earn as good a return as known balances actively invested.

Managing your liquidity

Cash pooling involves the physical or notional concentration of liquidity into a single position – typically for a group of inter-related companies, resident in a variety of different jurisdictions.

Where the co-mingling of funds held in different legal entities' names is not an issue, then physical concentration of cash is the simplest and best approach. But if such co-mingling is undesirable because it creates accounting and tax complications, notional pooling must be the preferred approach.

The specific cash pooling services made available to corporates depend upon several factors – the seasonality of an organisation's internally generated cashflows, global reach, corporate strategy and, in particular, the regulatory and tax environment.

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